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Scottish Law Commission
promoting law reform

INSURANCE CONTRACT LAW REFORM

June 2012

Consultation Paper 3

- S 17 Marine Insurance Act 1906 – utmost good faith.
- S 18 MIA– duty of disclosure.
- S 19 MIA – Brokers' duty of disclosure.
- S 20 MIA – Representations.
- Ss 33 – 49 MIA – Warranties and Voyage Conditions.
- Inducement post *Pan Atlantic.*
- Associated case law.

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Current Law - MIA 1906

- Contracts of utmost good faith.
- Proposer must disclose every “material circumstance” a prudent underwriter wants to know.
- If questions - “material representations” must be true.
- Failure to disclose or a misrepresentation – insurer can avoid policy. Only statutory remedy.
- Warranties – must be strictly complied with whether material to the risk or not. Breach cannot be remedied.
- Breach of warranty - insurer is “discharged from liability” from date breach.

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Disclosure - What happens elsewhere?

- Australia – retains duty disclosure but “materiality” as considered by “reasonable insured” + proportionate remedies.
- New York – duty of disclosure only for marine and reinsurance - remedy for “wilful concealment”.
- Eire – retains duty but balanced by a duty on insurers to carry out reasonable investigations.
- France, Germany, PEICL – insurer must ask questions.

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Consultation Proposals- Business

- Two policy areas to consider

1) pre-contract. What is relevant? Who should know what? How (or who) decide(s) materiality? Who does what? (R.I. vs P.U.)

2) "remedies" or post contract – what happens if…?

- 2007 Consultation :-
  - 50:50 for changes to materiality tests and even split insurers and insureds.
  - 60:40 for remedies but mixed views.
  - The 40% concerned about remedies often proposed alternatives i.e. "no but…."

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Disclosure and materiality

- Inclined to follow thrust of consultation response. Insufficient support for pre contract change + difference reasonable insured advised by reasonably competent broker vs prudent underwriter likely to be minimal. Therefore evolutionary approach:-
- Retain duty of disclosure. Familiar, may reduce cost.
- Retain current law on materiality (prudent underwriter survives). Reasonable insured uncertain test.
- Codify inducement (as per consumer bill). Insurer must show information relevant to **its** decision.
- Update S 18 to clarify responsibilities.

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Update s18 MIA?

S 18 (1) ….the assured must disclose to the insurer,….every material circumstance which is known to the assured and the assured is deemed to know every circumstance which, in the ordinary course of business, ought to be known by him.

S 18(2) Material circumstance = something *which would influence judgment of prudent insurer in fixing premium, or determining whether he will take the risk.*

S18 (3) In the absence of enquiry the following circumstances need not be disclosed, namely:-

(a) Any circumstance which diminishes the risk;

(b) Any circumstance which is known or presumed to be known to the insurer. The insurer is presumed to know matters of common notoriety or knowledge, and matters which an insurer in the ordinary course of his business, as such, ought to know;

(c) Any circumstance as to which information is waived by the insurer;

(d) Any circumstance which it is superfluous to disclose by reason of any express or implied warranty.

Update to cover recent case law and phrase in C21st language? In particular s18 (1) and (3) (b) and (c).

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Policyholder's obligations

- Policyholder must disclose all information needed to give fair presentation of risk – query who and what?
- Who? - "Knowledge" for company = known to Board and insurance purchasers – e.g. risk manager.
- Policyholder also has duty to disclose information that would have been discovered by reasonable proportionate enquiries (i.e. need good system).
- What? - Actual knowledge + "blind eye knowledge".
- Broker should disclose information obtained as agent for insured (s19 MIA 1906).
- Align representations (s 20 MIA 1906) – facts "ought to know" – must be true. Otherwise statement must be made "in good faith".

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Insurer's Obligations

- *"….the proper line that an underwriter should take ….is absolutely to abstain from asking any questions and leave the assured……….to make full disclosure of all material facts without being asked.* Per LJ Scrutton 1926

- Appropriate C21st?
- Professional competence?
- Why employ underwriters at all?
- Insurer should expect fair presentation but proposer can expect competent and knowledgeable underwriter.

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Insurer's Obligations

- When insurer receives information which would prompt reasonable underwriter to make further enquiries cannot rely on failure to disclose what those enquires would have revealed – (waiver). Professional competence.
- Policyholder need not disclose matters of

1) common knowledge,
2) matters which insurer writing relevant class should know,
3) information already known to insurer (Board or underwriters or agent). IT systems?

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Nothing New?

- *Insurance is a contract upon speculation. …….the underwriter trusts to his* (the proposer's) *reputation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge, to mislead the underwriter into a belief that the circumstance does not exist, and to induce him to estimate the risque, as if it did not exist.*

- *If he* (the underwriter) *thought that omission was an objection at the time, he ought not to have signed the policy with a secret reserve in his own mind to make it void; if he dispensed with the information, and did not think this silence an objection then he cannot make it up now after the event.*

  Lord Mansfield 1766 (Carter v Boehm)

- Fair presentation on the one hand and no "claims underwriting" on the other.

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Remedies

- *S17 MIA "…………..if the utmost good faith be not observed by either party, the contract may be avoided by the other party"*
- Brutal but simple.
- Arguably imposes disclosure discipline but…
- Must over or under compensate insurer.
- Much criticised by judges and commentators.
- Quite limited support in 2007 consultation.
- Often not followed.
- Not very mutual in practice.

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“Proportional” Solution?

- Follows inducement – “OK. What would you have done?”
- Seek to restore parties to position should have been in e.g. -
- Claim will not be paid if insurer would not have accepted risk or imposed exclusion.
- Claim may be paid in part if insurer would have imposed different limits or charged higher premium.
- Claim paid if insurer would have accepted on same terms (less likely given P.U. and inducement).

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Fault/Issues

- If non-disclosure or misrepresentation is deliberate or reckless – avoid.
- Otherwise apply proportional remedy – reason for error not relevant. Different to consumer bill.
- Default regime as now. Freedom of contract applies.
- Good faith continues as interpretative principle.
- Uncertainty? Yes – more apparent than real. Courts very familiar with "what if?" elsewhere.
- Subscription market. Will require guidance – follows inducement.

Warranties: Current law

- What is a warranty?
  LJ Rix *"It is a question of construction,…."*

- Can be express or implied. May or may not use word "warranty".

- Is not the same as normal contract warranty and is not a consumer guarantee.

- Section 33 MIA 1906 – partial definition which includes:-
  a statement about past or present facts
  a promise to do or not do something
  a statement that some condition will be fulfilled.

- "Basis of contract clauses" – convert statements into warranties.

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Warranties: Current law

- Section 33(3) MIA 1906 – exact compliance (i.e. no link breach and loss) or…
- Insurer automatically discharged from liability from date of breach.
- Breach cannot be remedied.
- Section 34 (1) MIA 1906 - Breach may be excused if warranty “ceases to be applicable” or when compliance becomes unlawful.
- Section 34(3) MIA 1906 – breach can be waived.

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What does this mean?

- Warranties that:-

  -Ship has at least 50 hands on departure. Had 46 but picked up 6 more shortly afterwards. Claim not paid.

  -Lorry parked at address. Parked in safer location. Claim not paid

  -Item value £285. Actual price £271. Claim not paid

  -Vessel “fully crewed at all times”. Not crewed when berthed – claim not paid.

- In practice rare for insurers to rely on strict rights. FOS do not permit in consumer insurance.

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What happens elsewhere?

- New Zealand. Must be causal connection between loss and warranty. Extends to terms other than "warranties". Under review.
- Australia. Complex provision. Also wider than "warranties". Insurer can refuse to pay claim unless insured can show absence of causal connection. However insurer can reduce liability to extent "interests were prejudiced". Plenty of litigation.
- Canada. Similar to UK but courts developing concept of "absolute" and "suspensive" warranties.
- New York. Warranty is term which acts as condition precedent and where subject matter "tends to increase" risk of loss.
- Civil Law countries/PEICL – no direct equivalent.

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Main defects in the current law

- “Basis of the contract” clauses – avoids S 20 MIA 1906. Catch policyholders out (although some protection for consumers now).
- Increasingly indiscriminate use of warranties – applied to terms dealing with minor matters.
- Effect of breach automatic, complete (all risks discharged) and severe. Policyholder may be without cover and not realise it.
- Later remedy irrelevant – even for most minor of breaches.
- Waiver – on what basis? “The contract is dead but the insurer can still waive it back to life”.
- The court’s use of construction to moderate harshness of the law – increased uncertainty. *(Kler Knitwear)*

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Consultee opinion

- 2007 Consultation – consultees strongly supported principle of reform. “Best Practice” not to rely on strict legal rights.
- Very strong support to abolish basis of contract clauses.
- Consultees had concerns about detail of other proposals.
- Consultees preferred simple scheme addressing main practical problems.
- Consultees wary of causal link between warranty and actual loss.

Proposals for reform

- 1) Abolish “basis of the contract” clauses.

- 2) All warranties – breach suspends insurer’s liability for duration of breach. Breaches can be remedied and cover restored.

- 3) Terms designed to reduce the risk of a particular type of loss – breach suspends insurer’s liability for that type of loss for duration of breach. Insurer remains liable for other types. Avoid causal connection test (underwriting perspective – not claims).
  - See *Vesta v Butcher, Bamcell II, Printpak v AGF*

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How will it work?

- Yacht policy has 3 warranties:-

1. Premium payment warranty. Premium due on 1 June but not paid until 15 June.
2. Lock warranty on hatch. Specific lock required.
3. Pleasure use only warranty.

- Owners breach all three. On 1 July yacht is total loss as a result of storm damage whilst on paid for whale watching trip.

- What is the effect of these warranties?

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Specific Points

- Consumer insurance - new regime is mandatory.
- Business insurance - can contract out but only effective if in clear, unambiguous writing and if brought to attention of policyholder.
- MAT – regime applies to express and MIA 1906 implied warranties but can contract out.
- Implied voyage conditions retained and not brought within the regime.
- Reinsurance – regime applies but can contract out.

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