# Policy briefing

August 2014

# Insurance Contract Law reform: Business insurance disclosure, warranties, and insurer remedies

As part of their on-going review of Insurance Contract Law, the Law Commissions have made recommendations on business customers' duty to provide pre-contract information to their insurer and the actions insurers can take if the policyholder breeches the warranty. Most of these recommendations have been included in the *Insurance Bill* which was laid before Parliament on 17 July.

This Bill would almost complete the range of reforms to insurance contract law to make it consistent with current regulatory and legal practice. It covers:

- Duty of disclosure by customer: requires a fair presentation of risk based on what the customer knows or ought to know, and gives the insurer information that would put them on notice to make further inquiries on material circumstances;
- Breach of warranty: introduces suspensive conditions in warranties, whereby the insurer's liability is only suspended rather than completely discharged. If the breach has remedied before the loss occurred, the risk is reinstated;
- Basis of contract clauses: bans clauses using the "basis of the contract" principle, a statement that effectively turns everything on that form into a warranty; and
- Remedies for fraudulent claims: of remedies for fraudulent claims that are meant to be both proportionate and appropriate to deter fraudulent behaviour while minimising the risk of undue punishment.

**Next Steps:**

- While Law Commission bills tend to be uncontroversial, debate over the more controversial provisions is expected. The Bill must pass before Parliament dissolves in March 2015 ahead of the General Election.

## Background

The Law Commission of England and Wales and the Scottish Law Commission (the Law Commissions) have been undertaking a root and branch review of the underpinning law of insurance contracts since 2006. It has involved nine issue papers discussing the various areas of reform, three consultation papers, and two major final reports.[1] This work has culminated in the current Bill before Parliament as well as two previous Law Commission pieces of legislation:

- the Third Parties (Rights against Insurers) Act 2010: makes it easier for a third party to pursue a claim directly against liability insurers if the insured is or becomes insolvent; and more notably

[1] The Chartered Insurance Institute had submitted responses to separate consultations on the consumer insurance and business insurance proposals, and have published several briefings and articles on the subject. See the list of CII publications in the Appendix of this briefing.

- the Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA): this focuses on misrepresentation, disclosure and breach of warranty in consumer general insurance contracts.

### The case for reforming non-consumer insurance

Following the CIDRA, the Law Commissions focused on the various aspects of non-consumer insurance, which evidence suggested was as problematic as the well publicised retail general insurance issues. Part of the problem is that current UK law is based on principles such as "utmost good faith" which were developed in the eighteenth and nineteenth centuries and codified in the Marine Insurance Act 1906.

The 1906 Act was arguably designed to protect a then-fledgling insurance market from exploitation by long-established client firms: at a time when customers knew their business while the insurers did not. It gave insurers wide-ranging opportunities to avoid insurance policies at any sign of wrong-doing by the customer. Although it may be rare for an insurer to deliberately exploit these defects, it results in two key problems identified here:

***Why reforming the law is so important:***

- **The law undermines market trust and confidence:** the unbalanced nature of the law exacerbates disputes between insurers and business, reducing trust and confidence in insurance by UK economy; and
- **The law threatens the credibility of UK business law:** very fact that the law is so antiquated and inconsistent with current practice threatens the long established credibility of UK business law itself. Whereas insurance law in many other key jurisdictions such as in North America and Asia has been modernised, UK law is now out of line with the international marketplace.

The Law Commissions received evidence from the full range of industry and customer sources, and it was clear that these two issues were affecting business insurance practices. Surveys of UK businesses by various bodies found that:

- 40% had made a made a significant insurance claim within the last four years;
- only 25% of these claims were said to have been (or were about to be) resolved to the customer's satisfaction;
- over 45% of claims had given rise to major disputes, which were taking on average three years to resolve;
- the top four grounds for dispute were: policy coverage, quantification of loss, breach of warranty or condition and non-disclosure; and
- 53% of AIRMIC members described "innocent non-disclosure of material information" as one of the five aspects of insurance that most concerns them.

A more disturbing finding is that the insurer-customer information asymmetry is distorting the market. As buyers are aware of some poor quality products on the market, but are unable to distinguish them from good quality ones, they settle for a lower overall price. This disadvantages sellers of good quality products, and creates a "market for lemons": an overall reduction of market quality as well as price.

The Law Commissions published its final report on 17 July making recommendations for reform in three key areas: duty of disclosure, breach of warranty, and "basis of contract" clauses. The Insurance Bill which began its passage through Parliament in the House of Lords on the same day.

## Key features of the Bill

### Duty of disclosure

**Problem:** currently non-consumer insurance is based on the principle of "utmost good faith" whereby the insurer replies on the customer disclosing every material circumstance. However, most people who buy insurance (including business customers) are unaware of what is materially important. Once a claim is made, an insurer may find

circumstances which were not mentioned, and then proceed with a single draconian remedy of outright avoidance of the contract.

**Solution:** the Bill takes several steps to address this problem, and the solution is derived (albeit appropriately tailored) from the approach taken in the CIDRA:

- **Fair presentations of risk:** requiring the disclosure of "every material circumstance that the customer knows or ought to know", failing that "disclosure which gives the insurer sufficient information to put a prudent insurer on notice that it needs to make further inquires". This places in statute a practice that is becoming common in much case law, and has the effect of eliminating disputes.
- **Prompting the insurer to ask questions:** in an attempt to prevent the insurer from acting passively through poor presentations and then waiting until the claims stage before asking questions, this new approach requires an adequate assessment of risk at the pre-contractual stage.
- **Review remedies available:** expanding the list of remedies available to the insurer beyond simply avoiding the contract. Options would range from recovering the appropriate amount in the event of omission of information to outright claim refusal and possibly event recovery in situations where deliberate or reckless misrepresentation was made.

## Breach of warranty

**Problem:** warranties are supposed to be risk-mitigating promises that the policyholder must undertake. However the law allows insurers to discharge their overall contractual obligation or liability even if a breach of warranty is remedied, and even if that warranty is unrelated. It takes this further and allows total avoidance of a policy in a range of circumstances, such as denying a flood claim because a burglar alarm had failed and was repaired years earlier. While claims are rarely refused on this ground, it unbalances the negotiating position with customers, adding cost, complexity and delay in claims settlement.

**Solution:** Clause 10 of the Bill makes all warranties suspensive conditions, whereby the insurer's liability is only suspended rather than completely discharged. If the breach has remedied before the loss occurred, the risk is reinstated. A proposal to limit warranties to particular risks in terms of risk, time and place was rejected by the Treasury – see *Outstanding Issues* below.

## "Basis of contract" clauses

**Problem:** some insurance proposal forms contain clauses using the "basis of the contract" principle, a statement that effectively turns everything on that form into a warranty, licensing the insurer to void the claim if any information on the form, however immaterial, is inaccurate. This simple but obscure feature of insurance law has been a thorny issue since 1908, and costly and expensive actions have been pursued over issues as trivial as a mis-spelt address line.

**Solution:** Clause 9 of the Bill abolishes "Basis of contract" clauses from business insurance contracts, reflecting the approach already taken in CIDRA.

## Remedies for fraudulent claims

**Problem:** some of these harsh rules in insurance law are sometimes deployed when the insurer suspects but cannot prove fraud. The result is that customers are liable to be wrongly suspected of committing fraud, resulting in a whole insurance policy being voided after years of paying premiums.

**Solution:** Clauses 12 and 13 provide a set of remedies for fraudulent claims that are meant to be both proportionate and appropriate in detering fraudulent behaviour while minimising the risk of undue punishment:

- **No liability to pay a fraudulent claim:** if the insurer finds that a claim is fraudulent, the Bill confirms what already takes place in case law that they can forfeit the claim, and retain any premiums which have already been paid.
- **An option to terminate the contract at the time of the fraudulent act:** the insurer may treat the contract as terminated at the point of the fraudulent act, and "it need not return any premiums which have been paid prior to this right being exercised". This addresses uncertainty in current case law.
- **Protected legitimate losses prior to the fraudulent act:** if a policyholder makes a fraudulent claim, the insurer would not be allowed to withhold any payouts from prior legitimate claims that may be outstanding. This is the case even if the contract has been treated as terminated at the time of the fraudulent claim.

## Outstanding issues

The Law Commissions' recommendations were, in the main, adopted and the Insurance Bill put before Parliament largely reflected the draft bill proposed. However, two clauses were omitted (see below) and the Treasury issued a short-notice consultation ahead of the publication of the Insurance Bill.

- **Damages for late payment of claims:** insurance customers in England and Wales are uniquely not entitled to damages in relation to unreasonable claim payout delay or non-payment. The paper controversially proposed to introduce an implied term in all insurance contracts (consumer and non-consumer) to address this.
- **Limiting warranties by type, risk, time and place:** where a warrantee term related to a particular type of loss—or loss at a particular time or location—is breached, the insurer's liability should only be suspended in relation to that particular loss. The Law Commissions use the example of an insurer not paying out on a flood claim because a burglar alarm warrantee was not honoured.

## Appendix: CII publications related to insurance contract law reform

**Reforming the law on consumer insurance: creating a strong foundation for professionalism**, by Laurence Baxter, in Peter Tyldesley, ed., *Consumer Insurance Law: Disclosure, Representations and Basis of Contract Clauses* (London: Bloomsbury, 2013), pp.221-225.

**Insurance contract law: the business insured's duty of disclosure and law of warranties**, *CII consultation response*, September 2012.

**The ABC of... insurance contract law**, by Daniel Crockford, *The Journal*, February/March 2012.

**Insurance contract law reform: consultation on post-contract duties and other issues**, *CII Policy Briefing*, February 2012.

**Insurance contract law reform: the Consumer Insurance (Disclosure & Representations) Bill**, *CII Policy Briefing*, May 2011.

**What happens when the ink is dry? Claims and parties' post-contract duties**, by David Hertzell, *CII Thinkpiece* 46 (November 2010).

**Insurance contract law reform: bringing the underpinning law into the twenty-first century**, by Peter Tyldesley, *CII Thinkpiece* 47 (November 2010).

**Business insurance law reform: summary of responses to the Law Commissions' proposals**, by David Arnold Cooper, CII Knowledge Services article, November 2008.

**The reform of insurance contract law: why have consumers waited so long?**, by Peter Tyldesley, CII Knowledge Services article, January 2008.

**Insurance contract law: misrepresentation, non-disclosure and breach of warranty in consumer insurance contract law**, *CII Consultation Response*, December 2007.

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