Law Commission
Reforming the law

Scottish Law Commission
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Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured

A Summary

17 July 2007

Law Commission and Scottish Law Commission
Joint Consultation Paper

Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured

SUMMARY

1. In our joint consultation paper, we set out provisional proposals for the reform of insurance contract law and seek responses by **16 November 2007**. We concentrate on three areas:

   (1) misrepresentation and non-disclosure by the insured before the contract is made;

   (2) warranties and similar terms; and

   (3) cases where an intermediary was wholly or partly responsible for pre-contract misrepresentations or non-disclosures.

2. We have already published Issues Papers on these subjects,[1] and have received very helpful responses.[2] These have led us to modify several proposals.

3. Here we summarise our main proposals and outline the reasons for them. For those who wish to read more, we refer to the relevant sections of the Consultation Paper: the part and paragraph references are set out in brackets below.

4. Copies of the Consultation Paper are available on our websites at http://www.lawcom. gov.uk and http://www.scotlawcom. gov.uk.

5. Please send responses either:

   (1) by **email** to

   commercialandcommon@lawcommission.gsi.gov.uk;

   (2) or by **post** to

   Elizabeth Waller, Law Commission, Conquest House, 37-38 John Street, Theobalds Road, London WC1N 2BQ.

[1] Paper 1 on Misrepresentation and Non-Disclosure in September 2006; Paper 2 on Warranties in November 2006 and Paper 3 on Intermediaries and Pre-Contract Information in March 2007. Copies are available on our website.

[2] These are listed in Appendix D of the Consultation Paper.

THE CURRENT LAW (Parts 1 & 2)

The law of non-disclosure and misrepresentation

6. The law imposes heavy duties on those applying for insurance. Potential policyholders are required to volunteer information to the insurer about anything that would influence a prudent underwriter's assessment of the risk.[3] If the policyholder fails in this duty, and the insurer can show that, if it had been given the information it would not have agreed to the policy on the same terms (or at all), the insurer may "avoid the policy". This means that the insurer can treat the policy as if it never existed. Similarly, the insurer may avoid the policy if the policyholder makes an incorrect statement of fact that is material.[4] It does not matter that the policyholder had no reason to know that the statement was untrue, or that it was material to the insurer.

The law of warranties

7. The law also takes a strong approach to enforcing terms of an insurance contract known as "warranties". A warranty may refer to the future – that is, a promise that "a particular thing shall be done or shall not be done, or that some condition shall be fulfilled". Alternatively, it may apply to the past or present – where the policyholder "affirms or negatives the existence of a particular state of facts".[5] Warranties "must be exactly complied with, whether material to the risk or not".[6] The insurer is not required to pay any claims that arise after the date of the breach, even if the breach is later remedied or had nothing to do with the loss in question.

CRITICISMS OF THE LAW (Parts 1 & 2)

8. These principles of law were developed by the courts over time and were codified in the Marine Insurance Act 1906. The 1906 Act has been treated as codifying the law applicable to all insurance contracts (not just marine). It is written in clear, forthright terms, and the courts have found it difficult to adapt its principles to changing social and economic circumstances.

9. We have concluded that some principles embodied in the 1906 Act are no longer appropriate to a modern insurance market, and do not meet policyholders' reasonable expectations. The main problems are:

    (1) *The duty of disclosure may operate as a trap*. Many policyholders, both consumers and businesses, do not realise that they have a duty to disclose information that they have never been asked for but which would influence the judgement of a prudent insurer. Even if they are aware they have such a duty, they may not know what would influence a prudent insurer. For example, a consumer taking out household contents insurance may not realise that the insurer wants to know about outstanding county court judgments.

[3] Marine Insurance Act 1906, s 18.

[4] Marine Insurance Act 1906, s 20.

[5] Marine Insurance Act 1906, s 33(1).

[6] Marine Insurance Act 1906, s 33(3).

(2) *Policyholders may be denied claims even when they have acted honestly and reasonably*. A policyholder may have given inaccurate or incomplete factual information because a question was unclear, or outside their area of knowledge. The law will nevertheless allow the insurer to avoid the policy. For example, where a question asks about "conditions affecting the nervous system", a consumer may not realise that this includes numbness in her leg.

(3) *The remedy for misrepresentation and non-disclosure may be overly harsh*. Where a policy is "avoided", the insurer can refuse all claims, even claims which the insurer would have paid had it been given full information. We give an example where a consumer taking out critical illness insurance failed to mention a hearing loss and later developed unrelated leukaemia. The law permits the insurer to refuse the leukaemia claim, even if, had it been aware of the hearing loss, it would merely have excluded hearing claims from the policy. This goes beyond what is necessary to compensate the insurer for the loss it has suffered. It is appropriate where policyholders act dishonestly. It is less appropriate if they were merely negligent, and it is inappropriate if they behaved honestly and reasonably.

(4) *Insurers may use warranties of past or present fact to add to the remedies the law already provides for misrepresentation*. If the statement which is "warranted" is incorrect, the insurer may refuse all claims under the policy, even if it made no difference to the risk, and did not induce the insurer to enter the contract.

(5) *A statement on a proposal form can be converted into a warranty using obscure words that most policyholders will not understand*. If a prospective policyholder signs a statement on the proposal form stating that the answers form "the basis of the contract", this converts all their answers into warranties.

(6) *Where a policyholder gives a warranty about future actions, any breach will discharge the insurer from further liability, even for claims that have no connection with the breach*. For example, where a policyholder warrants to maintain a burglar alarm, under strict law any failure will discharge the insurer from liability, not only for burglary (which might be expected), but also for flood or any other kind of damage. This continues to be the case even after the alarm has been mended.

(7) *The policyholder often bears the consequences of mistakes or wrongdoing by intermediaries*. Consumers and businesses often arrange their insurance through intermediaries. Intermediaries are usually considered to be the insured's agent rather than the insurer's agent - even if they are members of the insurer's panel and sell only a limited range of products. This means that any misrepresentation or failure to disclose by the intermediary entitles the insurer to avoid the policy. It is often difficult for the consumer or the business to know whether the intermediary is acting for them or for the insurance company. Furthermore, the insurer is often in a much better position to ensure that the intermediary does not make mistakes.

10. The law in these areas has long been criticised, most notably by the Law Reform Committee in 1957,[7] by the Law Commission in 1980,[8] and by the British Insurance Law Association in 2002.[9]

11. Despite many calls for change, the law remains much as it was a hundred years ago. This is not because the insurance industry has sought to justify the principles in the 1906 Act: it is accepted that they are inappropriate to a modern consumer market. Instead, industry representatives argued that consumers were best protected by Statements of Practice, conduct of business rules or ombudsman discretion, rather than by changes in the law.

12. The strict law is now overlain by accretions of self-regulation, regulation and ombudsman practice.

    (1) The first *Statements of Practice* were issued in 1977 and were strengthened in 1986. Insurers agreed not to rely on their strict legal rights in some circumstances. In 1980, the Law Commission criticised this approach: the Statements were not legally binding; they left insurers as the sole judge of whether rejection of a claim was reasonable; and they did not protect businesses. (paras 3.5 to 3.10)

    (2) The *Financial Services Authority* (FSA) took over responsibility for investment insurance in 2001 and for general insurance in 2005. It has incorporated some principles in the Statements of Practice into FSA Rules. For example, the Rules state that an insurer must not refuse to meet a claim on the grounds of misrepresentation unless it was fraudulent or negligent.[10] Unlike the Statements of Practice, the FSA rules are binding on insurers. However, they are of limited use to individual policyholders. In a court action, the insurer would have a legal right to avoid the policy, and the consumer would have to bring an action against an insurer for breach of statutory duty. This would be a difficult and unusual course of action. Furthermore, like the Statements, the detailed FSA Rules only protect consumers, not businesses. (paras 3.11 to 3.21)

[7] Fifth Report of the Law Reform Committee (1957) Cmnd 62.

[8] Insurance Law: Non-Disclosure and Breach of Warranty (1980) Law Com No 104.

[9] BILA, *Insurance Contract Law Reform – Recommendations to the Law Commission* (2002).

[10] Investment Conduct of Business, Rule 7.3.6(2)(b).

(3) The *Financial Ombudsman Service* (FOS) is a dispute resolution service that receives complaints from consumers and from small businesses with a turnover of less than £1 million.[11] An ombudsman has the power to make an award against an insurer of up to £100,000, which becomes binding on the insurer if accepted by the complainant. The FOS determines complaints by what is "fair and reasonable in all the circumstances of the case".[12] This means that it is not bound by the law. Instead it is developing its own approach which demands much more of insurers than the strict law, and often goes further than the FSA rules. However, its decisions are not public. Although information about the FOS approach is available in its internal publications, this is far from comprehensive. (paras 3.22 to 3.72)

13. In many ways the FOS offers an accessible and fair method of consumer redress. The consultation paper identifies ten advantages the FOS has over court action.[13] However, we do not think that it is a substitute for law reform. This is because:

(1) The FOS cannot protect everyone. In particular it does not hear disputed claims that require witnesses to be cross-examined, and it cannot make binding awards of over £100,000.

(2) The fact that FOS decisions are private and discretionary does little to encourage insurers to make the right initial decisions. Insurers may not understand or follow the FOS approach.

(3) Consumers who have had a claim rejected may not realise that the FOS can help them. Even consumers who successfully pursue a complaint to the FOS find the process stressful. Our survey found that many complainants were suffering from serious illnesses.[14] Worry over their insurance claims can only have added to the stress.

(4) The FOS can deal with complaints from small businesses, but not from any business with a turnover of more than £1m.

14. Thus for consumers, the overall position is incoherent, unclear and inaccessible. The law says one thing, the FSA Rules require another and the FOS reaches decisions based on a third. There are serious gaps in coverage. For most businesses, the strict law applies with all its defects.

[11] It was set up under the Financial Services and Markets Act 2000 and replaces the previous voluntary schemes, including the Insurance Ombudman Bureau.

[12] Financial Services and Markets Act 2000, s 228(2).

[13] Consultation Paper, para 3.56.

[14] See Consultation Paper, Appendix C. A quarter of complainants in the survey were suffering from cancer, and two thirds had some form of physical or mental disability (para C11 and Table 3).

THE CASE FOR REFORM

15. Our starting point is that the law should strike a fair balance between the interests of insurers and policyholders. It should give potential policyholders confidence in insurance by ensuring that it meets their reasonable expectations while protecting the legitimate interests of insurers and not imposing undue costs or unnecessary restrictions. It should also be coherent, clear and readily understandable. (paras 1.38 to 1.73)

16. We do not believe that FSA Rules or FOS practice are adequate substitutes for law reform. The current position is needlessly complex, confusing and inaccessible, with the potential for cases of real injustice falling into the cracks in the system. The law should be brought into line with accepted good practice, and set out in a clear statutory statement of the obligations on both insureds and insurers. (paras 3.18 to 3.21 & 3.56 to 3.74)

17. Our proposed reforms deal separately with consumers and businesses.

    (1) For *consumer insurance,* we provisionally propose a mandatory regime, based largely on existing FOS guidelines. This would apply to individuals who take out insurance for purposes wholly or mainly unrelated to their businesses.[15]

    (2) For *business insurance*, we provisionally propose a new default regime, based on accepted good practice. It would apply in the absence of an agreement to the contrary.

18. We also propose measures to protect businesses that deal on the insurer's standard terms. Such terms should not undermine the business's reasonable expectations of cover.

PRE-CONTRACT INFORMATION IN CONSUMER INSURANCE (Part 4)

Abolishing consumers' duty to volunteer information (paras 4.13 to 4.32)

19. It is now accepted practice that insurers should ask questions about what they want to know. The FOS refuses to allow insurers to avoid a consumer policy for non-disclosure where no question has been asked. We provisionally propose that this should become the law.

20. Our proposals would permit insurers to ask general questions. However, insurers would not have a remedy unless a reasonable consumer would realise they should give the information the insurer complains was not provided in response to that question.

A duty to answer questions honestly and reasonably (paras 4.33 to 4.49)

21. The consumer's duty would be to act honestly, and to take all reasonable care to answer questions accurately and completely. An insurer would have a remedy where it can show that

[15] Our definition mirrors the Financial Services Authority's definition of a 'retail customer': see paras 4.5 to 4.12.

(1) the consumer made a *misrepresentation* (ie a statement that is inaccurate or misleading);

(2) which *induced* the insurer to enter the contract (ie if the insurer has been aware of the full facts, it would not have entered into the contract on the same terms or at all); and

(3) a *reasonable person* in the circumstances would not have made the misrepresentation.

22. The remedy the insurer receives would depend on the consumer's degree of fault.

(1) Where the consumer had made a "*deliberate or reckless*" misrepresentation, the insurer would be entitled to avoid the policy.

(2) If the consumer has behaved *negligently*, the remedy would aim to put the insurer into the position it would have been in had it known the true facts.

Three categories

23. In effect, the proposals distinguish between three types of misrepresentations:

(1) "*deliberate or reckless*" misrepresentations, where the policy is avoided;

(2) *reasonable* misrepresentations (which the FOS terms "innocent"), where the policyholder is protected; and

(3) *negligent* misrepresentations (which the FOS terms "inadvertent"), where the insurer is granted a compensatory remedy.

Acting "deliberately or recklessly": the policy is avoided (paras 4.50 to 4.99)

24. Where the consumer has effectively acted dishonestly – by making a "*deliberate or reckless*" misrepresentation – the insurer would be entitled to treat the policy as if it did not exist, and refuse all claims under it. This goes further than is necessary to compensate the insurer for the loss it has suffered. It has a penal element to show society's disapproval of the behaviour and to deter wrongdoing. We ask whether, on the same principle, the insurer should have the right to retain any premiums paid.

25. In our first Issues Paper we described "deliberate or reckless" misrepresentations as "fraudulent". This drew concern. Many insurers associated the term fraud with criminal standards of proof, and thought they would not be able to prove fraud. They asked how our definition differed from that used by the FOS.

26. We provisionally propose that the insurer would have a right to avoid the policy if it can show that, on the balance of probabilities, the consumer made the representation:

(1) knowing it to be untrue, or being reckless as to whether or not it was true; and

(2) knowing it to be relevant to the insurer, or being reckless as to whether or not it was relevant.

27. In practical terms, the category would apply when the consumer *must have known* that what they said was inaccurate and that the inaccuracy mattered. It would not apply simply because they *should have known* it was inaccurate and relevant: that would be negligent. If the insurer had asked a clear question, the consumer would be taken to know that the issue was relevant to the insurer. The second limb would apply mainly where the question is general or ambiguous.

28. Our survey of ombudsman decisions initially suggested that our approach to recklessness might be narrower than that currently used by the FOS. However, the sample was dated: it covered cases from 2003 to 2005. The FOS has recently told us that its view of recklessness is similar to our own.

Acting honestly and reasonably: the policyholder is protected (paras 4.100 to 4.129)

29. Under the FSA Rules, insurers are not permitted to refuse claims for a misrepresentation that was neither fraudulent nor negligent. Our proposals intend to set this out in statutory form. Where a consumer acted honestly and reasonably, the insurer would be required to pay claims under the policy.

30. The test of reasonableness would take into account the type of policy, the way the policy was advertised and sold and the normal characteristics of consumers in the market.

31. The test would not take into account consumers' individual circumstances, unless the insurer knew about them. For example, the court would not make allowances for the fact that the consumer did not speak English or was illiterate, unless the insurer was aware of the issue.

Acting negligently: a compensatory remedy (paras 4.153 to 4.189)

32. A consumer who acted honestly, but nevertheless failed to match up to the standards of a reasonable consumer, would be considered negligent. The insurer would be entitled to a remedy that aims to put the insurer in the position it would have been in had it known the true facts. This involves asking what the insurer would have done had it been told the truth.

(1) If the insurer would have charged more, the claim should be reduced proportionately to the under-payment of premium.

(2) If it would have excluded a particular type of claim, it should not be obliged to pay claims that would fall within the exclusion.

(3) If it would have imposed a warranty or excess, the claim would be treated in the same way as if the policy included that warranty or excess.

(4) If it would have declined the risk altogether, the policy may be avoided, the premiums returned and the claim refused.

33. We think there may be cases of possible injustice where the policy is avoided because the insurer would have declined the policy. Take the following example: a widow applies for building insurance by stating that the house has no signs of subsidence. A reasonable person would realise that the lengthening crack over the front door was a sign of subsidence. However, this particular consumer did not realise it because she left house maintenance to her husband. She acted negligently: she was not dishonest, but did not match the objective standard of a reasonable person. It would be fair to refuse her claim for subsidence. However, if the insurer argues that had it known it would not have insured her at all, our proposals would entitle the insurer also to refuse a claim for flood damage.

34. We therefore ask whether there should be a discretion to prevent avoidance where the insurer would have declined the risk but the policyholder's fault is minor and any prejudice the insurer has suffered could be compensated adequately by a reduction in the claim.

Negligent misrepresentations in life insurance: should there be a cut-off period? (paras 4.190 to 4.204)

35. In life insurance, many years may elapse between the proposal and the claim. It may be extremely difficult to assess the reasonableness of a statement made long ago by a person who has now died. Other jurisdictions deal with this problem by imposing a "cut-off" period for defences other than fraud. Insurers may not refuse claims on the basis of negligent statements after a set period (which is two years in many US states and three years in New Zealand and Australia).

36. In Issues Paper 1, we asked if a similar provision should apply in the UK, and tentatively suggested a period of three years. This drew considerable comment, both for and against. Several life insurers told us that the cost of introducing a cut-off period after three years would be excessive, but a five-year period might embed good practice and increase confidence in the market.

37. We think serious thought should be given to imposing a *five-year cut-off period* in respect of life insurance. Insurers would still be able to avoid for deliberate or reckless mistakes, but not for purely negligent ones. The costs would need to be considered carefully, but we have been told that they are unlikely to be excessive.

Where the consumer thinks the insurer will obtain the information (paras 4.130 to 4.152)

38. A common reason why consumers do not fill in forms completely is because they think the insurer has access to the information and will check for itself. There have been many complaints about the confusions that arise where insurers ask for authority to obtain medical reports and then do not obtain them; or where insurers fail to check their own files; or where they do not consult available databases about flood risks or claim histories.

39. In Issues Paper 1 we considered whether special rules were needed to deal with these problems. We received many representations on this issue, as insurers highlighted the difficulties of checking incompatible record systems, and the expense of unnecessary medical reports.

40. On balance, we do not think that special rules are needed. This problem can be dealt with under the general principles we have outlined. In considering whether a consumer has acted reasonably, a court or ombudsman may take into account whether it was reasonable for the consumer to assume that the insurer would obtain that information for itself.

Renewals (paras 4.205 to 4.213)

41. In law, renewals are treated in exactly the same way as new applications. Under our proposals, consumers would not be required to volunteer information, but would be required to answer questions honestly and carefully.

42. On renewal, it is common for consumers to be asked very general questions, along the lines of "has anything changed?". FOS guidelines suggest that an insurer should only ask this type of question if it provides a copy of the information it already holds in relation to the policy. Otherwise, it should ask more detailed questions. In Issues Paper 1 we suggested building this practice into law.

43. On further reflection, we do not think that special rules are needed. The issue would be dealt with by our proposal on general questions. An insurer who asks a general question would only have a remedy if a reasonable consumer would understand that the question was asking about that information.

Abolishing "fact warranties" and "basis of the contract" clauses (paras 4.219 to 4.229)

44. "Basis of the contract" clauses have been criticised for many years. Few policyholders understand their effect. They would not expect an insurer to be discharged from liability for a mis-statement that was immaterial, did not induce the contract, and might have been made entirely innocently. In 1986, the Statement of General Insurance Practice barred their use; they are not thought to treat customers fairly; and the FOS would almost certainly reject an attempt by an insurer to rely on them.

45. We propose to abolish basis of the contract clauses. Where a consumer makes a statement of past or current fact before entering an insurance contract, it should be treated as a representation rather than a warranty. This would bring the law into line with recognised good practice.

46. It would mean that if a policyholder signed an incorrect statement on an application form, the insurer would not have an automatic right to avoid the policy. Instead, the insurer's remedy would depend on whether the incorrect statement was made recklessly, negligently or innocently.

PRE-CONTRACT INFORMATION IN BUSINESS INSURANCE (Part 5)

47. We are consulting on a default regime, which would apply to all business insurance. Unlike the Law Commission's report in 1980, we do not suggest separate rules for marine, aviation or transport insurance, or for reinsurance. (paras 5.148 to 5.156)

48. This is for three reasons:

(1) It would be unduly complex to have one law for major construction projects (for example) and another law for ships.

(2) We wish to avoid arbitrary distinctions where possible.

(3) Our scheme permits the parties to contract out of the default regime. If sophisticated businesses wish to come to other arrangements to suit their needs, they will be free to do so.

Modifying businesses' duty to disclose: a new default rule

49. For business insurance, we propose that the duty to disclose should be retained. It is part of the way the UK market works; it may be needed for unusual risks; and where the insured is represented by an experienced broker the system generally works well. (paras 5.24 to 5.30)

50. However, the duty is currently too wide. At present, the insured is required to disclose anything that it knows, or should know in the ordinary course of business, if it "would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk".[16] We do not think that the law should penalise those who act honestly and reasonably, simply because they do not understand what would influence a prudent underwriter. Under our proposals, in order to found a claim for non-disclosure, the insurer would have to show either:

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

(2) that the proposer actually knew the fact was one that the insurer would want to know about.

51. We see this as a flexible test, which would adapt to the many different circumstances in which insurance is bought. In a sophisticated market, where both the insurer and insured are experts or professionally represented, we would expect almost no difference between the existing and the proposed law. However, a small, unsophisticated business buying off-the-shelf products without professional help may have little idea of what influences insurers. Here the onus will be on the insurer to ask appropriate questions. (paras 5.61 to 5.84)

Misrepresentation: new default rules

52. For misrepresentations, we propose new default rules similar to the scheme we have outlined for consumers. The insurer would need to show that:

(1) the business made a *misrepresentation,*

(2) which *induced* the insurer to enter the contract, and

(3) which a *reasonable person* in the circumstances would not have made.

[16] Marine Insurance Act 1906, s 18(2).

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

53. The structure of the reasonableness test would be similar to the one proposed for consumers. An insured may act reasonably if they believed what they said was true, or if they answered a general question ("Is there anything else we should know?") and reasonably did not appreciate what information was required. However, the content may be very different. Again, it should be a flexible test: reasonableness will depend on the type of market, whether the business received professional advice, and the clarity of the questions asked. (paras 5.31 to 5.60)

Remedies: should the law distinguish between dishonesty and negligence? (paras 5.85 to 5.108)

54. We ask whether the remedy of avoidance should be reserved for dishonest conduct. Where the misrepresentation or non-disclosure was merely negligent, should the insurer be given a compensatory remedy? This would involve asking what the insurer would have done had it been told the truth, as set out in paragraph 1.32 above.

55. Avoidance involves over-compensating insurers for the loss suffered. The insurer not only avoids the added risks arising from the misrepresentation, but also avoids the risks that it knew about (and which were effectively paid for). As a matter of principle, it might be argued that this has a penal element, which is only appropriate where the insured is morally culpable.

56. However, it has been argued that avoidance should be retained as the default remedy for negligent misrepresentations and non-disclosures because:

    (1) it is difficult to prove that a corporate organisation acted dishonestly;

    (2) for non-standard risks, it is difficult to show what an insurer would have done had they known the true facts;

    (3) there should be strong incentives to encourage businesses to act carefully.

We welcome views on this issue.

Contracting out of the default regime (paras 5.109 to 5.132)

57. Under our proposals, the parties would be free to agree different rules. For example, if the parties wished, they could agree that the insurer should have specified remedies, even for misrepresentations that were neither dishonest nor careless.

58. The easiest and clearest way of agreeing different rules would be through a specific fact warranty. It may, for example, be particularly important for an insurer to know that none of the senior managers of a company have criminal convictions. The insured may represent this, but under the default regime this would not protect the insurer if the insured genuinely and reasonably did not know about a conviction. It would be open to the insurer to ask the business to "warrant" that none of its senior managers had convictions.

59. Under our proposals, a warranty of this type would have the following effects, in the absence of an agreement to the contrary:

    (1) Liability for the breach would remain "*strict*". In other words, it would not matter whether the insured should have been aware of the conviction.

    (2) If the fact warranted is not true, the insurer may refuse to pay the claim, provided that

        (a) the breach is *material*. For example, the insurer could not refuse a claim for a minor conviction (such as speeding) that would not have influenced its decision;

        (b) it had some *connection to the loss*. For example, a manager's conviction for dangerous driving would be unconnected to a flood damage claim.

60. If the parties wished to agree other consequences (such as avoidance for immaterial breaches), they would need to spell this out explicitly in the contract.

61. However, the parties should not be allowed to convert all the answers on a proposal form into warranties en bloc, as in a basis of the contract clause. The contract would need to specify which facts were to be given warranty status. There should also be controls on contracting-out of the default regime when the parties dealt on the insurer's standard terms (see below).

Controls on standard term contracts (paras 5.133 to 5.147)

62. Problems may arise where less sophisticated businesses buy an "off-the-shelf" product written on the insurer's standard terms. The business may have little understanding of what the terms mean, or how they would be applied in a given situation.

63. We propose special controls to prevent insurers from contracting out of the default regime in standard terms contracts, where this would defeat the insured's reasonable expectations. We suggest a three-limb test:

    (1) Did the insured contract on the insurer's "*written standard terms of business*"? This borrows the test in the Unfair Contract Terms Act 1977, and looks at the set of terms as a whole.

    (2) Does a standard term purport to give the insurer *greater rights than the default regime* to refuse claims for a failure to provide accurate pre-contractual information?

    (3) If the insurer were allowed to rely on such a term, would it defeat the insured's *reasonable expectations* of cover?

Small businesses (paras 5.162 to 5.177)

64. Those running small businesses often have little understanding of insurance. It has been argued that they should be given the same rights as consumers (and this has been partly recognised by their inclusion within the FOS jurisdiction).

65. Although in the Issues Papers we suggested separate regimes for small businesses, we are concerned at creating arbitrary thresholds of protection. On balance, we think that our proposed default regime, coupled with the controls on standard term contracts, would be sufficient to protect the interests of vulnerable small businesses. However, we welcome views on whether greater protection is needed.

PRE-CONTRACT INFORMATION: GROUP INSURANCE, CO-INSURANCE AND INSURANCE ON THE LIFE OF ANOTHER (Part 6)

Group insurance (paras 6.3 to 6.41)

66. Typically, in a group insurance scheme, an employer arranges insurance in respect of employees and their dependants. The policyholder is the employer, and the members (employees) rarely have legal rights under the policy. Although the sector is extremely important (providing, for example, around 40% of life-cover), the law on group insurance appears under-developed. If, for example, an individual member misrepresents their health, the legal effect is uncertain.

67. We provisionally propose that the law should reflect accepted good practice. A misrepresentation made by a group member should be treated as if the member were the policyholder. This means that:

    (1) it would have consequences only for the cover of that individual; and

    (2) if the insurance would have been consumer insurance had the policyholder arranged it directly, any dispute about a misrepresentation would be determined according to our proposals for consumer insurance.

Co-insurance (paras 6.42 to 6.52)

68. Where two or more people take out insurance together the law distinguishes between “joint” and “composite” policies. Typically in joint policies, the policyholders insure a joint interest or right (such as the contents of the matrimonial home). If one spouse has behaved dishonestly or negligently, this affects the other. In a composite policy, each policyholder insures a separate interest or right (such as flat sharers insuring their separate possessions). One tenant’s dishonesty will not affect the others (unless the dishonest tenant has acted as agent for the rest).

69. We intend to review the law of co-insurance in our second consultation paper, in the context of fraudulent claims. We ask consultees whether they are aware of any particular problems with the law of co-insurance in relation to non-disclosure and misrepresentation.

Insurance on the life of another (paras 6.53 to 6.75)

70. Where A insures B’s life, it is common for the insurer to ask B questions about their health. If A acts reasonably, but B is dishonest or negligent, the insurer may seek to refuse the claim. The insurer cannot rely on the law of misrepresentation, because the duty not to misrepresent applies only to the policyholder (A). Instead, it is common for insurers to ask A to sign a warranty, stating that B’s answers form “the basis of the contract”.

71. As explained above, we propose to abolish basis of the contract clauses and warranties of fact in consumer insurance. Instead, we propose that representations by the person whose life is insured should be treated if they were misrepresentations by the policyholder. If the insurer can show that either A or B (or both) behaved deliberately, recklessly or negligently, it should have the remedy appropriate for that kind of conduct.

WARRANTIES AS TO THE FUTURE (Parts 7 & 8)

72. We have already discussed warranties of past or current fact. It is also possible to give a warranty as to the future, often that the insured will take precautions against a risk. The 1906 Act sets out harsh consequences for any breach. If the warranty is not strictly complied with, the insurer is automatically discharged from liability, and may refuse to pay any claim that arises after the breach.

73. These rules have the potential to be applied arbitrarily, so as to defeat the insured's reasonable expectation of cover. A policyholder who warrants to maintain a sprinkler system might expect that the insurer will not pay for fire damage while the sprinkler was not working. They would not expect the insurer to refuse a storm damage claim or a fire claim that arises after the sprinkler has been repaired.

74. The 1906 Act is also out-of-line with the expectations of an international market-place. The provisions on warranties have no equivalent in civil law systems, and many common law systems have reformed them.[17]

75. We think that reform is needed to prevent insurers from relying on technical breaches that have no connection with the claim, where this result defeats the reasonable expectations of the policyholder.

Distinguishing between warranties and other similar terms

76. One problem with reforming the law of warranties is that it is not always easy to distinguish between a warranty and another type of contractual term. A precaution may be phrased as a warranty (where, for example, the insured warrants that a vehicle will "be kept in a roadworthy condition"). It may also be phrased as an exception (the accident will not be covered "unless the vehicle is in a roadworthy condition").

77. The consequences of an exception are not as draconian: once the car is repaired, cover resumes. However, even exceptions can defeat reasonable expectations. If a car has a broken headlight, it may not be "roadworthy" in a technical sense. But an insured may reasonably expect to be covered for an accident in broad daylight, which has no connection to the broken headlight. (paras 8.27 to 8.39)

[17] For example, statutory reforms have been introduced in Australia, New Zealand and many states in the USA. In Canada, the courts have modified the rules: see paras 7.52 to 7.66.

78. In Issues Paper 2 we proposed a causal connection test that would have applied not only to warranties but also more broadly, to most exceptions to the risk. However, we accepted that a causal connection should not apply to some provisions, such as the age of a driver or the geographical limits of coverage. Our proposals were criticised for being overly complex and for extending too widely. We have therefore re-thought our approach, as outlined below.

Warranties in consumer insurance

79. Consumers are already protected against having claims refused for unconnected matters - partly by FSA Rules, partly by FOS practice, and partly by the Unfair Terms in Consumer Contracts Regulations 1999. We found that, in practice, the FOS will require a causal connection between the breach and the loss, not only for warranties but for other terms. The FOS will also prevent an insurer from relying on unusual terms that were not brought to the customer's attention.

80. As far as consumers are concerned, our aim is to bring the law into line with accepted good practice, rather than to introduce changes in practice. We propose to enshrine existing FOS guidelines into law by stating that:

    (1) A warranty should be set out in *writing*. (paras 8.8 to 8.12)

    (2) An insurer may only refuse a claim for a breach of warranty, if it had taken sufficient steps *to bring the requirement to the consumer's attention*. (paras 8.13 to 8.19)

    (3) The consumer should be entitled to be paid a claim if they can prove on the balance of probabilities that the event or circumstances constituting the breach *did not contribute to the loss*. (paras 8.40 to 8.48)

81. These rules would be mandatory, in the sense that the parties would not be free to change them by contract. (paras 8.49 to 8.50)

82. They would apply only to warranties, as narrowly defined, and not to other terms such as exceptions. However it is open to a court or ombudsman to use the Unfair Terms in Consumer Contracts Regulations 1999 to prevent other terms from being used unfairly, in a similar way. (paras 2.72 to 2.107)

Warranties in business insurance

83. Warranties may cause more problems in business insurance. The courts may prevent injustice in individual cases by construing the wording of a warranty against the insurer. However, this does little to introduce certainty or coherence into the law.

84. We think there is a need to change the default rules, as set out in the Marine Insurance Act 1906. We propose that for businesses the following rules should apply to warranties (as narrowly defined):

    (1) A warranty should be set out in *writing*. (paras 8.8 to 8.12)

(2) A business should be entitled to be paid a claim if it can prove on the balance of probabilities that the event or circumstances constituting *the breach did not contribute to the loss*. However, unlike for consumer insurance, this would be a default rule. The parties could agree other consequences if they wished (subject to controls on standard term contracts). (paras 8.12 to 8.48)

(3) A breach of warranty would not automatically discharge the insurer from liability, but would instead give the insurer *the right to terminate cover for the future*. We ask whether an insurer who terminates future cover should normally provide a pro-rata refund of outstanding premiums, less damages and reasonable administrative expenses. (paras 8.81 to 8.100)

Standard term contracts that defeat reasonable expectations (paras 8.54 to 8.80)

85. Terms such as exceptions can also result in an unexpected loss of cover. In business insurance there is no equivalent to the Unfair Terms in Consumer Contracts Regulations 1999. Other business contracts are subject to protections under sections 3 and 17 of the Unfair Contract Terms Act 1977. However, these sections do not apply to insurance contracts.

86. This means that insurers may apply exclusions in an unfair way where, for example, there is no connection with the loss. The problem is particularly acute for standard term contracts, which were not negotiated between the parties. We are therefore proposing special controls on such contracts.

87. We provisionally propose that where the parties contract on the insurer's written standard terms of business, the insurer should not be permitted to rely on a warranty, exception or definition of the risk if this would render the cover substantially different from what the insured reasonably expected. In practice, this will depend on how the insurer presented the policy to the insured.

Marine insurance: implied warranties and conditions (paras 8.111 to 8.132)

88. The Marine Insurance Act 1906 states that certain warranties and conditions are to be implied into marine insurance contracts. Sections 39 to 41 set out implied warranties of seaworthiness, portworthiness, cargoworthiness and legality. Sections 42 to 48 set out voyage conditions, including conditions that the risk only attaches if the ship sails from the port of departure and to the destination specified in the policy.

89. We ask if there are any reasons to retain the implied warranties or voyage conditions. Alternatively, should the onus be on the parties to agree the policy terms they want in express terms?

90. If the implied warranties and conditions are to be retained, we provisionally propose that they should be made subject to the same causal connection test as would be applied to other warranties.

PRE-CONTRACT INFORMATION AND INTERMEDIARIES (Parts 9 & 10)

The insurer's agent or the insured's agent?

91. Insurance is often bought through brokers and other intermediaries, who give guidance on application forms and pass information to insurers. The law makes an important distinction between intermediaries who act for the insurer and those who act for the policyholder. A mistake by the insurer's agent is the insurer's responsibility. However, if an intermediary acts for a policyholder, any mistake or dishonesty by the intermediary is treated as a mistake or dishonesty by the policyholder. The insurer may refuse the policyholder's claim, and the policyholder is left to pursue a complaint against the intermediary.

92. Under current law, it is often unclear for whom an intermediary is acting at any given time. An intermediary will normally be regarded as the insurer's agent if they are their appointed representative, or have authority to bind the insurer to cover. However, it would seem that most other intermediaries act for the policyholder, even if they are members of insurers' panels and sell the products of only a few insurers. There are situations where consumers and businesses might reasonably think that they dealing with the insurer's agent, only to find that they are responsible for the intermediary's mistakes. (paras 9.22 to 9.57)

93. We do not think that an intermediary should be considered to act for an insurer just because it makes it easier for policyholders to obtain a remedy. However, it is appropriate to treat an intermediary as the insurer's agent if a policyholder would reasonably regard them as the insurer's agent, or if the insurer is in a better position to monitor and control the intermediary's actions. (paras 10.7 to 10.25)

94. We provisionally propose that an intermediary should be regarded as acting for the insurer unless they are clearly independent of the insurer and acting on the insured's behalf. We ask whether the right test for whether an intermediary is independent should be whether the intermediary conducts "a fair analysis" of the market, as defined by the Insurance Mediation Directive. (paras 10.26 to 10.34)

95. Our proposals would apply to both consumer and business insurance, but they would have much more effect on consumer insurance. In business, arrangements such as "single-ties", "multi-ties" and "panels" are relatively rare, and only important in the small business market. Our reforms would not affect large businesses who use brokers to search the market for them; nor would if affect cases where the insured pays the broker a fee. (paras 10.53 to 10.60)

An end to "transferred agency" (paras 10.35 to 10.44 & 10.61 to 10.64)

96. The issue of whom an agent is acting for at any given time is made more difficult by some old cases.[18] These appear to suggest that an intermediary who helps a policyholder to fill in a form acts as the policyholder's agent for that task, even if they are the insurer's agent for all other tasks. We do not think this can be right.

[18] See in particular, *Newsholme Brothers v Road Transport and General Insurance Co Ltd* [1929] 2 KB 356 and the discussion at paras 9.58 to 9.71.

97. We propose that the statute should clarify that where an intermediary would normally be regarded as acting for the insurer in obtaining pre-contract information, they should remain the insurer's agent while completing a proposal form.

98. There are also suggestions within the case law that if the insurer's agent makes a mistake on a form which the policyholder then signs, the policyholder should be held responsible for the agent's mistake. As explained above, we propose to abolish basis of the contract clauses, which means that signing an incorrect statement would no longer give an insurer an automatic right to avoid the policy. A signature would be good evidence that a policyholder has made or adopted the representation, but the court or ombudsman should still consider whether the policyholder acted reasonably, carelessly or recklessly.

Section 19(a) of the Marine Insurance Act 1906 (paras 10.44 to 10.52 & 10.65 to 10.74)

99. Section 19(a) is a surprising provision. It appears to state that an agent placing insurance must disclose every material circumstance that the agent knows, even if the insured does not know it. If the agent fails to do so, the insurer may avoid the policy against the insured, even though the insured is innocent of wrongdoing. Take an example where a retailer arranges product insurance on its washing machines. If the retailer was aware of a potential fault with the washing machine, section 19(a) appears to allow the insurer to avoid all the policies it has sold to consumers, even if the consumers are innocent of any wrongdoing.

100. For consumer insurance, we ask whether section 19(a) should be repealed. For business insurance, we are proposing that breach would give the insurer a right in damages against the intermediary, rather than the right to avoid the policy. We are interested in hearing about consultees' experience of section 19(a) and in views about how a reformed section might work.

ASSESSING THE COSTS AND BENEFITS OF REFORM (Part 11)

101. In our final report, we intend to provide an analysis of the costs and benefits of our recommendations. In the consultation paper we set out a possible model for how such an analysis might work, and ask for data.

102. In the consumer market, our proposals largely reflect existing FSA Rules and FOS practice. For firms that already follow the FSA and FOS, the impact will be minimal (though they should find it easier to understand what is required of them). The main impact will be on firms who currently disregard FSA Rules and FOS practice, but who would find it more difficult to disregard clear law. We are particularly interested in receiving evidence about the nature and extent of firms who currently fail to follow FOS practice.

103. For consumers, the main change over FOS practice would be the possible adoption of a five-year cut-off period for negligent misrepresentations in life insurance. This would need to be costed separately, and we would particularly welcome help with this from reinsurers in the life sector.