



**Law
Commission**
Reforming the law


Scottish Law Commission
promoting law reform

Reforming Insurance Contract Law

A Summary of Responses to Issues Paper 5: Micro-businesses

This document summarises the responses to the Law Commissions' Issues Paper 5: Micro-businesses: Should micro-businesses be treated like consumers for the purposes of pre-contractual information and unfair terms?

November 2009

CONTENTS

	<i>Paragraph</i>	<i>Page</i>
PART 1: INTRODUCTION		1
Background	1.2	1
Issues Paper 5: summary of the proposals	1.17	3
Responses	1.23	4
Approach taken in this paper	1.25	5
Comments and Freedom of Information	1.29	5
Thanks	1.32	6
PART 2: MISREPRESENTATION AND NON-DISCLOSURE		7
Treating micro-businesses as consumers for the purposes of pre-contractual information	2.1	7
PART 3: THE POSITION OF SMALL BUSINESSES		14
Introduction	3.1	14
Responses	3.3	14
Overview of responses	3.8	15
PART 4: UNFAIR TERMS AND WARRANTIES		16
Extending the Unfair Terms in Consumer Contracts Regulations 1999 to micro-businesses	4.1	16
Warranties of future conduct and the causal connection test	4.15	18
PART 5: DEFINITION OF A MICRO-BUSINESS		22
The proposed tests for defining a micro-business	5.1	22

	<i>Paragraph</i>	<i>Page</i>
Option 1 – Turnover definition	5.5	22
Option 2 – Employee definition	5.19	25
Option 3 – Financial Ombudsman definition	5.27	26
PART 6: EXCLUDING SOPHISTICATED BUSINESSES FROM THE DEFINITION		29
Introduction	6.1	29
Associated businesses	6.6	30
Extra filters	6.17	31
Filter 1 – Insurance premium spend	6.20	32
Filter 2 – High asset and turnover levels	6.26	33
PART 7: CONSEQUENCES OF FAILURE TO ASK SUFFICIENT QUESTIONS OR TO PROVIDE ACCURATE INFORMATION ABOUT SIZE		35
Introduction	7.1	35
Insurers who ask insufficient questions about the size of a business	7.4	35
Misrepresentations by policyholders about the size of their business	7.17	38

PART 1

INTRODUCTION

- 1.1 This paper summarises the responses we received to Issues Paper 5, “Reforming Insurance Contract Law: Micro-Businesses”,¹ published in April 2009. The Issues Paper asked whether micro-businesses should be treated like consumers for the purposes of pre-contractual information and unfair terms.

BACKGROUND

- 1.2 The Law Commission and Scottish Law Commission are undertaking a joint review of insurance contract law. In July 2007, we published a Consultation Paper on pre-contractual information and warranties in all insurance contracts² and received over 100 responses.
- 1.3 There was a general consensus that reform was needed for consumer insurance. In December 2009 we intend to publish a Report and draft Bill to reform the law of pre-contractual disclosure and representations in consumer insurance, based on our 2007 proposals.
- 1.4 There was less consensus over reforming business insurance contract law. Business insurance covers a wide range of policyholders, from a self-employed window cleaner to a multi-national business. The challenge is to design a system of law which is suited to both extremes. This is a particular issue in the UK where we have both a domestic business market and a large international insurance and reinsurance market.

Our 2007 business proposals

- 1.5 The 2007 Consultation Paper proposed that before entering into an insurance contract, business policyholders should be required to disclose such information as a reasonable insured would disclose in the circumstances. This was intended to be a flexible test, which would adapt to the size and sophistication of the business. Larger, advised and more sophisticated businesses would need to disclose to a higher standard than others.

¹ Reforming Insurance Contract Law, Issues Paper 5: Micro-Businesses (April 2009).

² Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper No 182; Scottish Law Commission Discussion Paper No 134.

- 1.6 Our proposals were designed as a default regime: businesses and insurers could contract out of the reforms if they agreed to do so. We also proposed a safeguard to protect more vulnerable businesses. If a contract was on standard terms and one of those terms gave the policyholder fewer rights than it would have had under the default regime, then an insurer could not rely on that term unless it met the policyholder's reasonable expectations.³ If the term had not been properly brought to the policyholder's attention when it entered into the contract, then the insurer could not rely on it.
- 1.7 Insurers criticised the reasonable insured test as being too uncertain. Many were adamant that larger businesses did not need further protection. Many consultees also felt that it would be too difficult to identify standard term contracts.
- 1.8 Nearly half of our consultees told us that they preferred the certainty of clear distinct lines between different types of business. Most accepted that at the smallest end of businesses, there was a case for giving greater protection. For example, Endsleigh wrote:

It is our view that there is indeed a case for greater protection for small businesses and we would suggest that the protections extended to the individual consumer should likewise be extended to small businesses. Some small businesses are so similar to consumers that they should not be expected to volunteer information and, in our view, there is no justification for a greater expectation of knowledge in terms of disclosure requirements.

Developing our proposals

- 1.9 The proposals in Issues Paper 5 were developed in light of responses to our 2007 paper.
- 1.10 The term micro-business is used to refer to small businesses with 9 or fewer employees. There are 4.5 million such businesses in the UK. Most are structured as sole proprietorships (66%), rather than as companies or partnerships. Their average turnover is less than £500,000. Research by CRA International for the Financial Services Authority found that a business with a turnover of less than £500,000 a year spends on average between 1.2 and 1.3% of its annual turnover on insurance.⁴
- 1.11 As these businesses have few (if any) employees, they are unlikely to have specialist insurance expertise in-house. CRA found that:

³ "Meeting reasonable expectations" meant that the policyholder had to be aware of the term in order for it to be effective. The substance of the term could be "unreasonable" so long as it had been properly brought to the attention of the policyholder.

⁴ CRA International, *Commercial insurance commission disclosure: Market Failure Analysis and high level Cost Benefit Analysis* (December 2007), p49.

The purchase of insurance is not undertaken by risk specialists but it is rather a component of another role (most likely the owner-manager). The result is that these clients are also the least financially sophisticated.⁵

1.12 These businesses are also the least likely to use brokers. CRA found that around half of the smallest companies bought insurance directly from insurers, often through the internet. Insurers are keen to increase this proportion. CRA found that some brokers are starting to withdraw from the micro-business sector, as insurers develop their direct sales channels.⁶

1.13 Several respondents to our 2007 Consultation Paper also stressed that many small businesses are no more sophisticated than consumers when buying insurance. The Royal Institution of Chartered Surveyors said:

Our membership will have both very sophisticated buyers and far less sophisticated buyers; all will be businesses. However, the latter, who more often than not will be sole practitioners, may be little more sophisticated than 'consumers'.

1.14 If these businesses are no more sophisticated than consumers and buy insurance in a similar manner, we thought that it was fair that they should be treated as consumers.

1.15 Small businesses with a turnover of less than £1 million already have the opportunity to take a disputed claim to the Financial Ombudsman Service. The Ombudsman will judge each case according to what is fair and reasonable. This means that treating micro-businesses as consumers is a development of existing practice rather than a major new step.

1.16 The scheme also has the advantage of removing the smallest businesses from the regime of law to be applied to larger businesses. Including micro-businesses within the consumer regime would enable us to consider a different legal approach for larger businesses.

ISSUES PAPER 5: SUMMARY OF THE PROPOSALS

1.17 If micro-businesses were treated as consumers, they would no longer be under a duty to volunteer information. Instead, micro-businesses would only need to answer the questions insurers asked.⁷

1.18 Where a micro-business gave an insurer inaccurate information, the insurer's remedy would depend on the insured's state of mind:

- (1) Where the micro-business acted deliberately or recklessly, the insurer could avoid the policy and refuse to pay all claims.

⁵ CRA International, *Commercial insurance commission disclosure: Market Failure Analysis and high level Cost Benefit Analysis* (December 2007), para 5.1.

⁶ Some brokers have challenged CRA International's findings on this in their responses to us.

⁷ For a fuller explanation of our proposals for consumers, see the Law Commissions' Report and draft Bill on consumer insurance which is due to be published in December 2009.

- (2) Where the micro-business acted negligently, the insurer would have a compensatory remedy, based on what it would have done had it known the true facts. For example, if the insurer would have imposed an exclusion, the policy would be treated as if it included that exclusion. If the insurer would have charged more, the business would receive only a proportion of its claim.
 - (3) Where a micro-business acted reasonably, the insurer would be required to pay the claim in full.
- 1.19 In relation to warranties and other potentially unfair terms, we pointed out that micro-businesses, unlike consumers, do not currently have the benefit of the protection afforded by the Unfair Terms in Consumer Contracts Regulations 1999. We asked whether, if micro-businesses were to be treated as consumers, the Regulations (or terms to their effect) should also apply to micro-businesses.
- 1.20 We also asked whether a causal connection test should be applied to warranties. This would mean that, when a micro-business breached a warranty, an insurer would only be discharged from liability if the breach and the loss claimed were causally connected.
- 1.21 Finally, we discussed different ways of defining a micro-business. We asked for views on three tests, based on:
- (1) turnover;
 - (2) the number of employees; or
 - (3) the jurisdiction of the Financial Ombudsman Service. The Ombudsman can currently hear cases from small businesses if their turnover is less than £1 million, although this will change shortly to a turnover of less than €2 million and fewer than 10 employees.
- 1.22 It is important to note that we were not proposing to treat micro-businesses as consumers more generally. We did not suggest, for example, that micro-businesses would be given the same cancellation rights as consumers.

RESPONSES

- 1.23 We received 49 responses, as shown in the table below:

Type of respondent	Number
Insurers and insurance associations	10
Lawyers, lawyers' associations and the judiciary	6
Brokers and broker associations	2
Business insureds and business associations	26
Academics	1
Other	4
Total	49

- 1.24 The largest number of responses came from business insureds. We sent a short questionnaire based on our Issues Paper through the Small Firms Consultations Database,⁸ and 25 of the responses were to that questionnaire. It asked three questions: whether businesses understood their disclosure obligations; whether they had had an insurance claim turned down due to misrepresentation or non-disclosure; and whether they were aware that they could take a disputed claim to the Financial Ombudsman Service if their turnover was less than £1 million.⁹ We used this approach because micro-businesses rarely have the resources to respond to more complex consultation.

APPROACH TAKEN IN THIS PAPER

Describing responses

- 1.25 This paper describes the responses we have had to each proposal or question. We give a short description of why we made the proposal, but for a fuller explanation, we refer readers back to the Issues Paper, by giving references in brackets.
- 1.26 We then state how many consultees responded, together with the numbers who agreed and disagreed. However, we treat these statistics with caution. Some consultees are organisations representing hundreds of members. Other consultees are individual businesses. We have looked at the quality of argument rather than simply counting numbers.
- 1.27 Next we outline the arguments raised both for and against our proposals. We provide a few quotations from those responses not sent on a confidential basis, to give a flavour of the arguments raised. However, we have needed to be selective. Many other points were made which we have not quoted, but which will be taken into account when formulating our policy.
- 1.28 Finally we give an overview of responses.

COMMENTS AND FREEDOM OF INFORMATION

- 1.29 We are not inviting comments at this stage. However, if, having read the paper, you do wish to put additional points to the Commissions, we would be pleased to receive them.
- 1.30 Please contact us by email commercialandcommon@lawcommission.gsi.gov.uk or by post, addressed to Elizabeth Waller, Law Commission, Steel House, 11 Tothill Street, London SW1H 9LJ.

⁸ The Small Firms Consultation Database is an opportunity for small firms to influence new regulations at an early stage, by providing feedback on their potential impact. Small firms sign up to the database and are contacted by the Department for Business, Innovation and Skills for their views.
<http://webarchive.nationalarchives.gov.uk/+/http://www.berr.gov.uk/whatwedo/enterprise/enterprisesmes/regulation-and-tax/consultation/page38032.html>.

⁹ See footnote 2 to para 2.2 below for the full text of the questions.

- 1.31 As the Law Commission will be the recipient of any comments, the Freedom of Information Act 2000 will apply and all responses will be treated as public documents. We may attribute comments and include a list of respondents in future reports. Those who wish to submit a confidential response should contact the Law Commission before sending it. Automatic confidentiality disclaimers generated by an IT system will be disregarded.

THANKS

- 1.32 Many people have devoted considerable time and resources to this project. We would like to thank all those who have sent written responses to the Issues Paper and who met us to discuss their views.

PART 2

MISREPRESENTATION AND NON-DISCLOSURE

TREATING MICRO-BUSINESSES AS CONSUMERS FOR THE PURPOSES OF PRE-CONTRACTUAL INFORMATION

The proposals and questions

- 2.1 In the Issues Paper, we provisionally proposed that micro-businesses should be treated as consumers for the purposes of pre-contractual information (Issues Paper, paragraph 4.12).
- 2.2 In the questionnaire sent out to the Small Firms Consultation Database¹ we also asked small businesses if they understood the current law and whether they would support a change so that micro-businesses were treated as consumers.²
- 2.3 Treating micro-businesses as consumers would mean that they would no longer be under a duty to volunteer information if the insurer had not asked a question about it. If they misrepresented the true position in an answer to a question then the insurer's remedy would depend on whether the micro-business made that misrepresentation reasonably, negligently or deliberately/recklessly.³

Responses

- 2.4 Seventeen consultees responded to the proposal in the Issues Paper that micro-businesses should be treated as consumers for the purposes of pre-contractual information. Of these, ten (59%) agreed with our proposal or thought we should have gone further and included larger businesses within the proposed reform.
- 2.5 Of the seven who argued against, three (18%) thought that reform was unnecessary because the Financial Ombudsman Service (FOS) could resolve unfairness in the current regime. They accepted that the Marine Insurance Act 1906 may be inappropriate but were concerned about legislative reform. The four other consultees (23%) told us that micro-businesses should not be given extra protection. Instead they should take advice from a broker if they were unsure of their rights and obligations.

¹ See para 1.24 for further information.

² The questions were: (1) Did you know that when you apply for insurance for your business you have to volunteer all information that your insurer considers relevant? This is the case even if your insurer has never asked you a question about it. If you do not volunteer the correct information, your insurer can turn down any claim you later make. (2) Have you ever had a claim turned down because you didn't provide enough information to insurers when you took out the policy? Have you ever found unexpected terms in your insurance policy? (3) Did you know that you can refer a disputed insurance claim to the Financial Ombudsman Service if your turnover is less than £1 million a year?

³ See paras 1.17 to 1.18 above for further details.

- 2.6 Twenty-five individual small businesses responded to the questionnaire sent to the Small Firms Consultation Database. Of those 19 (76%) supported reform. Four (16%) (one of whom was involved in the insurance industry) were not in favour of reform as they felt it would raise premiums or increase paperwork. The remaining two (8%) made comments without expressing a preference either way.

The correct approach?

- 2.7 Some argued that giving more protection to micro-businesses did not address the fundamental problems with the role of the underwriter. Derrick Cole and Geoffrey Lloyd, for example, argued that “the conduct of the underwriter is responsible for much of the current difficulties arising from non-disclosure or misrepresentation.” They argued for a general duty on underwriters to investigate the risk thoroughly and felt that to give protection only to micro-businesses (instead of all policyholders) would not remedy the problem:

There should be a general duty on the underwriter to ask questions, to probe and play an equal part as between proposer/insured and the insurer in unearthing all the information the underwriter claims he needs to underwrite the risk properly.

- 2.8 They felt that this should apply when an insurer deals with a large or a small business alike and that no distinction should be made on the ground of the size of the policyholder.
- 2.9 Others felt that “lack of sophistication” was not a proper ground on which to give legal protection. Insurers argued that businesses have the option to take accountancy and legal advice and they should do the same for insurance if they do not feel confident about buying the product. They pointed out that whilst the trend may be for brokers to withdraw from the micro-business market, at present it is easy for any micro-business that wishes to use a broker to find one. An article in Post Magazine written by lawyers at Beachcroft said:

It is not suggested that [micro-businesses’] lack of sophistication avoids any need to appoint accountants to deal with tax issues and lawyers to provide advice on contracts, so why should they not use a broker to advise on insurance issues to make sure cover matches the risk being run and the premium quoted is competitive?⁴

- 2.10 Our preliminary work on an impact assessment shows, however, that direct sales from insurers to micro-businesses (without using a broker) are increasing.⁵

Views of small businesses

- 2.11 In response to the questionnaire, many small businesses said that they were unaware of the current law. The following give a flavour of the responses received:

⁴ Post Magazine, “*The micro scope*”, 30 April 2009, p14.

⁵ See para 1.12, above.

I am HORRIFIED to learn that I might have an insurance claim turned down because I hadn't supplied information that I had no idea I was supposed to guess I might have needed to provide! [an IT consultancy]

I am shocked to learn that we are supposed to volunteer information that the insurers consider relevant, and failure to do so could result in a rejected claim. How can this be fair? [a communications company]

Seems like a no-brainer to me; if they can't figure out what's important to ask, how are we supposed to guess? [an IT consultancy]

The law seems to be a bad law. If information is important to an insurer, the insurer must ask for it. Why is a purchaser expected to know which facts are important to a prudent insurer and which facts are not important? [a business providing guides for IT programmes]

- 2.12 Some small businesses did appear to be aware of the current law and the majority of these supported reform too:

The difficulty comes with being aware of what they consider "any other information which might affect the quotation" – I have a good broker who walks me through the paperwork but this service is not available/affordable for everyone so reform is required. [an education business management company]

We were very much aware of this clause and welcome the proposals by the Law Commission, in fact it is surprising that in a country where in general laws are fair, such an obvious amendment hasn't been made ages ago. [a consultancy firm]

I have always considered it grossly unfair that an insurer can refuse a claim because of non-disclosure of information that they haven't asked about. [a security firm]

- 2.13 The Forum of Private Business represents 25,000 UK-based businesses and responded to the Issues Paper to say that it welcomed the reform of insurance law, although it did have reservations about some of the proposals. It said:

The FPB welcomes reforming insurance to allow time-starved entrepreneurs the same legal protection as consumers... Due to the complexity of some insurance products, time constraints and/or the lack of access to financial advice there are a significant number of businesses needing additional protection to ensure that contracts are fair and reasonable.

- 2.14 Our small sample of businesses shows that the majority are unaware of their obligation to disclose under the present law and of the consequences for their insurance contract if they fail to do so.

Views of insurers

- 2.15 A few insurers agreed with our proposals and felt that smaller businesses would need more protection than the law currently provided. They also appreciated that if micro-businesses were treated as consumers, the rest of business insurance law would not have to accommodate both micro-businesses and large multinational corporations within the same scheme.

- 2.16 The International Underwriting Association of London wrote:

This would be fairer for micro-business insureds who generally can be classed as 'consumers' for the purposes of how they purchase insurance products and their overall sophistication in dealing with insurers. It would also provide clarity to the industry... Moving micro-businesses within the remit of consumer insurance should also have the benefit of allowing the Law Commission to be more focussed on the genuine business to business insurance relationships and not on the parties having an inequality in their negotiating position when purchasing insurance.

- 2.17 Other insurers felt that sole traders (or businesses structured as sole proprietorships) should be treated like consumers. The Investment and Life Assurance Group, ILAG, told us that:

Irrespective of size, all businesses should be treated as commercial entities rather than consumers other than in the possible case of a sole trader who for all practical purposes could be treated as an individual.

- 2.18 The Group Risk Development Group (GRiD) agreed, stating:

We can see that there might be logic for providing additional protection for an individual but a small limited company or limited liability partnership has deliberately taken on a legal status which implies a degree of professionalism and sophistication.

- 2.19 Other insurers, however, felt that reform was not necessary and would be impractical. We describe their arguments below.

Costs

- 2.20 Insurers and some micro-businesses alike were concerned that the proposals would lead to an increase in the costs of insurance. The Association of British Insurers (ABI) pointed out:

[The proposal] would impose additional costs on insurers. Although it is difficult to quantify these costs at this stage, they are likely to be substantial. The proposals would entail (amongst other things) implementation costs, process, documentation and IT changes, additional compliance/regulatory issues, ongoing administrative costs, large-scale staff training and the likelihood of an increased number of disputes. These additional costs would have to be passed on to consumers in the form of higher premiums.

- 2.21 However, insurers have already made these changes to their consumer insurance policies.

Practical difficulties

- 2.22 Another issue raised by insurers was that it is impossible for insurers to ask micro-businesses specific questions. The ABI said:

...it is good industry practice to ask consumers specific questions on matters material to the risk. This is not overly onerous on insurers because there is some homogeneity of risk between consumers, thus the same questions are applicable to most consumers. The same is not true of micro-businesses, where the type and size of risk will differ considerably. By way of illustration, it is often the case that two businesses may have a similar size turnover and/or number of employees, but would present very different risks to an insurer (eg a hairdresser compared to a small builder...).

- 2.23 However, other insurers told us that they are already asking specific questions of micro-businesses when they buy insurance. Aviva confirmed this, stating:

We note that it is already common practice in the insurance industry to treat the smallest of micro-businesses as individuals seeking personal line products, particularly for non-corporates (ie sole traders). In these instances, standard pre-contractual questions covering areas applicable to most consumers for that type of insurance product would be asked.

Suitable for all types of business?

- 2.24 Some consultees felt that particular types of micro-business would not be suitable for the scheme. GRiD argued that any business that bought group risk insurance products should not be given the protection given to micro-businesses. Group risk policies are typically set up by employers for the benefit of their employees. The policyholder arranges the scheme directly with an insurer to provide employees with life cover or health insurance, for example. The relevant question is which regime should be applied where the entity taking out the policy makes a misrepresentation.⁶

⁶ In our forthcoming Report on consumer insurance we look at the related issue of what should happen if the beneficiaries of a group policy (ie not the entities who take them out) make a misrepresentation. In that Report we state (broadly speaking) that any misrepresentations made by employees in group policies should be treated as if they were made by consumers. For further details, see our Report on Consumer Insurance, which is due to be published in December 2009.

- 2.25 GRiD argued that micro-businesses taking out group risk policies should not be given the benefit of the consumer regime. They argued that there are key differences between group risk products and other policies which mean that micro-businesses should not be given extra protection when they buy them. The insurance is usually long term cover that is, according to GRiD, almost entirely sold through intermediaries. The period of cover can be indefinite and a policy which starts as cover for a small firm can remain in force as it grows and its business changes.⁷ GRiD argued that it was inappropriate for businesses buying these kinds of products to be given the same protection as consumers. We do not know, however, how many micro-businesses buy such policies.
- 2.26 Another consultee felt that it was inappropriate for professionals buying professional indemnity insurance cover to be given the same protection as consumers. He pointed out that the terms of their professional indemnity cover were already regulated by the professions themselves. We are exploring this issue further, but we understand that many professions already require modifications to the duty of disclosure to be included within policy terms.

Does the Financial Ombudsman Service solve the problem?

- 2.27 Some (but not all) insurers argued that micro-businesses did not need extra legislative protection. Instead, they felt that the right to take a case to the FOS was sufficient. Aviva, for example, wrote:

Instead of legislative reform, we would favour an awareness campaign by the FSA that would see small businesses made aware of their rights to bring claims to the FOS for unfair claims handling.

- 2.28 The ABI, like Aviva, argued that one of the reasons reform was unnecessary was that businesses with a turnover of less than £1 million were able to take their complaints to the FOS:

While we recognise that the smallest businesses may need more protection than larger ones, they are afforded this by virtue of the fact that the FOS's jurisdiction extends to small business policyholders. Under the DISP rules, the FOS can deal with complaints brought by businesses that have a group annual turnover of less than £1m at the time of the complaint. We do not believe that further additional protection through primary legislation is necessary.

- 2.29 Micro-businesses may not know that they are entitled to bring their complaint to the FOS. We only had two responses to the question "did you know that if you have a turnover of less than £1 million you may take a complaint against an insurer to the Financial Ombudsman Service?" in the questionnaire sent out by the Department for Business, Innovation and Skills. The two that did respond, however, said that it was "useful to know" and that "it is good to be reminded" that they had a right to take their complaints to the FOS.

⁷ The opposite is also true. A business can buy a long term policy when it is large and then shrink to become a micro-business (in which case, according to our proposals, the larger business regime would apply).

- 2.30 The Financial Services Authority (FSA) requires insurers to tell consumers at the point of sale in the policy summary that they have a right to take a complaint against the insurer to the FOS.⁸ This requirement is clearly set out in the FSA Handbook that applies to insurance. There is also a requirement for insurers who offer policies to micro-businesses to tell them about their right to take a complaint to the FOS. This requirement is less clearly set out in the FSA Handbook. In order to find it, the insurer first needs to look at the DISP rules⁹ (not the insurance-specific ICOB rules), then work out that a micro-business is an eligible complainant¹⁰ and then look at a chapter headed “consumer awareness rules”¹¹ and work out that it does not solely apply to consumers but to eligible complainants as well.¹² Insurers fulfil this requirement by placing a reference to the FOS in the small print of the policy.¹³ This is in contrast to consumer policies, where the information about taking a complaint to the FOS would be highlighted in the policy summary.¹⁴

Overview of responses

- 2.31 Our proposal that micro-businesses should be treated as consumers for the purposes of pre-contractual information was welcomed by over half of the consultees. Insurers were worried about the potential cost implications of a change in the law and felt that being able to take a complaint to the FOS provided micro-businesses with sufficient protection. Others felt that it would not be appropriate for group risk products or for professional indemnity cover.
- 2.32 Against this, most micro-businesses, some brokers and some insurers felt that the law should be reformed. Many micro-businesses were surprised by the current law¹⁵ and felt that reform was long overdue. Those who argued in favour of a change recognised the similarities between consumers and micro-businesses. Several made the point that this would enable a more balanced scheme of insurance law to be drawn up to deal with other types of businesses.¹⁶

⁸ FSA Handbook, Insurance: New Conduct of Business Sourcebook Rule 6.2.2.

⁹ FSA Handbook, DISP 1.2.3.

¹⁰ FSA Handbook, DISP 2.7.3.

¹¹ FSA Handbook, DISP 1.

¹² FSA Handbook, DISP 1.2.1(2).

¹³ We looked at 16 micro-business policies which were available to buy on the internet. In all of those policies, the ability to take a case to the FOS was mentioned only in the small print.

¹⁴ FSA Handbook, Insurance: New Conduct of Business Sourcebook Rule 6.2.2.

¹⁵ See para 2.11, above.

¹⁶ See para 2.15.

PART 3

THE POSITION OF SMALL BUSINESSES

INTRODUCTION

- 3.1 Small businesses are usually defined as those with between 10 and 49 employees. In the Issues Paper we argued that the consumer regime was less suitable for small businesses, particularly those with close to 50 employees. Our reasoning was that small businesses are usually set up as companies and use more sophisticated methods of accounting and administration. The average turnover of a small business is approximately £2.5 million, whereas the average turnover of a business with between zero and nine employees is approximately £400,000.¹ We argued that small businesses are therefore more likely to have obtained insurance through a broker or to have sought professional advice. Therefore, we proposed that the extra protections we argued should apply to micro-businesses were less suitable for small businesses.
- 3.2 In the Issues Paper, therefore, we provisionally proposed that small businesses should be treated as businesses for the purposes of pre-contractual information (Issues Paper, paragraph 4.13).

RESPONSES

- 3.3 Twelve consultees responded to our question. Of those, seven (58%) agreed with our proposal and thought that small businesses should not be treated as consumers for the purposes of pre-contractual information. Four consultees opposed the proposal and one made comments without expressing a preference either way.
- 3.4 The Forum for Private Business argued that small and medium-sized businesses were also vulnerable and that more general protection should be available. The British Insurance Law Association found that:

It is our experience that many small businesses are not much better informed than micro-businesses so far as insurance law is concerned and do not necessarily use brokers to advise them on their insurance cover. They are unlikely to realise the draconian consequences of failing to provide full disclosure of material information or of being in breach of warranty.

- 3.5 The Law Reform Committee of the Bar Council was also concerned about a failure to protect small businesses. It wrote:

¹ Averages calculated from figures in BERR, Table 1, UK Private Sector, number of employees divided by number of enterprises, <http://stats.berr.gov.uk/ed/sme/>.

In our experience many small (and medium size) businesses are not much better informed than micro-businesses so far as insurance law is concerned and do not always engage brokers to advise them. These businesses rarely have in-house risk managers or in-house lawyers to advise them on their duties of disclosure. If they do consult brokers, such brokers are often high-street brokers or drawn from smaller brokerage firms who may not have sufficient expertise in certain types of insurance, for example, directors and officers insurance. It is our view that generally the people running small businesses are unlikely to appreciate the drastic legal consequences of their failure to provide material information to insurers.

3.6 Two categories of consultees agreed with our proposal. The first category was made up of five consultees who had argued against giving extra protection to micro-businesses in the first place and, following on from that, felt that small businesses should not be given extra protection either. The second category was made up of two consultees who had stated that micro-businesses should be treated as consumers but that small businesses did not need and should not be given the same extra protection. The Association of British Insurers fell into the first category, stating that “any distinctions between sizes of businesses are arbitrary, overly complex and would cause uncertainty.”

3.7 The International Underwriting Association fell into the second category. It felt that there was a case for treating micro-businesses as consumers but that similar protection should not be extended to small businesses. It wrote:

We believe that it is right that small businesses are included as a business risk... it would create unnecessary uncertainty to introduce a third tier of regulation for small businesses.

OVERVIEW OF RESPONSES

3.8 Twelve consultees responded to the question which asked whether small businesses should be treated as businesses for the purposes of pre-contractual information or whether, like micro-businesses, they should be treated as consumers.

3.9 The majority were in favour of treating small businesses like businesses, not as consumers. Those who argued against stated that small businesses were unlikely to be any more familiar with insurance contract law than micro-businesses, that they tended not to use experienced brokers and that they were therefore just as vulnerable to the current state of the law as micro-businesses.

3.10 The majority, however, agreed with our proposal. This was for one of two reasons; consultees felt either that there should be no extra protection for any form of business at all, or that even if micro-businesses were granted extra protection then small businesses were significantly wealthier and should be expected to assess and manage their risk better.

PART 4

UNFAIR TERMS AND WARRANTIES

EXTENDING THE UNFAIR TERMS IN CONSUMER CONTRACTS REGULATIONS 1999 TO MICRO-BUSINESSES

Introduction

- 4.1 In Part 5 of our Issues Paper, we asked consultees for their views on extending protection under the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCR) to micro-businesses for the purpose of insurance contracts (Issues Paper, paragraph 5.39).
- 4.2 Since 1994, the UTCCR, and their predecessor, have provided consumer policyholders with legal protection against unfair terms in insurance contracts. However, this protection does not extend to business policyholders.
- 4.3 We asked consultees for their views on whether it was right for micro-businesses to be given the same protection as consumers under the UTCCR in relation to insurance contracts.
- 4.4 Applying the UTCCR to micro-businesses would provide protection against unfair terms in two ways. First, terms in micro-business contracts would have to be drafted in “plain and intelligible language” (Regulation 7(2)). Second, terms in a micro-business insurance policy could be assessed for fairness, unless the term was individually negotiated, reflected mandatory statutory or regulatory provisions, or was a “core term”. Under Regulation 5(1), a term is said to be fair if:

Contrary to the requirement of good faith, it causes a significant imbalance in the parties’ rights and obligations arising under the contract, to the detriment of the consumer.

- 4.5 In the Issues Paper we examined the policy arguments for and against extension of the UTCCR to micro-business insurance contracts.¹

Responses

- 4.6 Fifteen consultees replied to our question about whether the UTCCR should be extended to micro-businesses. Eight (53%) were in favour of the extension, five opposed it (33%) and two made comments but did not express a preference either way.

¹ See paras 5.34 to 5.37 of the Issues Paper (Reforming Insurance Contract Law, Issues Paper 5: Micro-Businesses (April 2009)).

- 4.7 Most consultees made comments about the uncertainty of the standards imposed by the UTCCR. The majority of those who made a specific response to this question felt that, despite the uncertainty of the Regulations, it would still be better for the insurance industry as a whole if micro-businesses and consumers were treated exactly the same, rather than treating them differently when assessing whether terms in their contracts were unfair. The British Insurance Law Association wrote:

Although we have reservations about the wording of UTCCR and the vagueness of the Regulations we consider that the UTCCR should be extended to micro-businesses if the latter are to be treated in the same way as consumers.

- 4.8 By contrast, some felt that this uncertainty meant that they should not be extended to micro-businesses. One respondent argued that insurance contracts were technical documents and that meanings would not necessarily be clear on a first reading. It felt that applying the UTCCR would not be helpful as it is not possible to predict with certainty whether particular clauses are core terms and are amenable to review. It felt that action by the Financial Services Authority (FSA) as part of their Treating Customers Fairly initiative would be a better way to deal with the problem.
- 4.9 The FSA is, however, not keen to deal with unfair terms in micro-business contracts. Its view was that the Regulations should not be extended as micro-businesses were not showing any evidence of detriment. It also felt that it would run counter to the purpose behind the Unfair Terms Directive, which was explicitly concerned with protecting consumers. It was worried that the proposal would dilute the focus of the Office of Fair Trading, FSA and Trading Standards departments.
- 4.10 Some felt that it was anomalous for micro-businesses to be granted protection by the UTCCR when they entered insurance contracts but not when they entered other financial contracts, for example banking agreements. Insurance is, however, already in a unique position as all other financial contracts are covered by the Unfair Contract Terms Act 1977, which does not apply to insurance.²
- 4.11 The Association of British Insurers and Aviva both concluded that micro-businesses do not face risks in relation to the purchase of insurance that would justify extending the UTCCR. They felt that the wholesale review of their contracts with micro-businesses that the extension of the UTCCR would necessitate would be too costly.
- 4.12 One of the arguments raised against the proposal was that the Financial Ombudsman Service (FOS) does not currently apply the UTCCR. The FOS itself wrote:

² Unfair Contract Terms Act 1977, Schedule 1, section 1.

We are neutral on the question of extending the ambit of the Unfair Terms in Consumer Contracts Regulations to cover insurance contracts with micro-businesses. We do not apply these Regulations to those commercial policyholders who presently fall within our jurisdiction, but we still feel that we are able to reach decisions that prevent insurers taking advantage of onerous provisions in their standard term policies where we believe that it would be unfair or unreasonable to do so, for example because the insurer knew that the micro-businesses were not permitted the opportunity to become aware of such terms.

Overview of responses

- 4.13 Consultees who were insurers were generally not in favour of extending the provisions of the UTCCR to micro-businesses, saying that a review of their terms and conditions to bring them into line with the Regulations would be too costly and that the UTCCR were too uncertain.
- 4.14 The majority of other consultees (and some insurers) felt that, whilst the UTCCR were not as helpful as they could be in terms of providing guidance on what could be reviewed for fairness, it would be worthwhile extending their scope to micro-businesses. This was in the interests of having a consistent regime.

WARRANTIES OF FUTURE CONDUCT AND THE CAUSAL CONNECTION TEST

Introduction

- 4.15 In the Issues Paper we explained that there were particular problems with warranties and the causal connection test.³ The consequence of a breach of warranty in an insurance contract is that the insurer is discharged from liability. This is the case where the policyholder has remedied the breach or where the loss suffered bears no relation to the breach of warranty.
- 4.16 In the Issues Paper we explained that it was difficult to predict how the UTCCR would be able to deal with warranties of future conduct because the effect of breach (automatic discharge from the contract) reflects statutory provisions. Sections 33 and 34 of the Marine Insurance Act state that:

A warranty...is a condition which must be exactly complied with, whether it be material to the risk or not. If it be not so complied with, then... the insurer is discharged from liability as from the date of the breach....⁴

Where a warranty is broken, the assured cannot avail himself of the defence that the breach has been remedied and the warranty complied with, before loss.⁵

³ See paras 6.3 to 6.13 of the Issues Paper (Reforming Insurance Contract Law, Issues Paper 5: Micro-Businesses (April 2009)).

⁴ Marine Insurance Act 1906, section 33(3).

⁵ Marine Insurance Act 1906, section 34(2).

- 4.17 The UTCCR state that a term cannot be assessed for fairness if it reflects a statutory provision. Regulation 4(2) states that the Regulations do not apply to contractual terms which reflect:

Mandatory statutory or regulatory provisions (including such provisions under the law of any Member State....)

- 4.18 It is therefore possible that Regulation 4(2) could prevent warranties of future conduct being assessed for fairness under the UTCCR. In the Issues Paper we argued that warranties should be assessed on their merits rather than being excluded from assessment simply because they reflect sections 33 and 34 of the Marine Insurance Act.
- 4.19 In our 2007 Consultation Paper⁶ we therefore proposed a causal connection test for all warranties of future conduct as the effect of the UTCCR was both cumbersome and uncertain. We proposed that a policyholder should be entitled to be paid a claim if the policyholder can prove, on the balance of probability, that the event or circumstance constituting the breach of warranty did not contribute to that loss.
- 4.20 When this proposal was set out in the 2007 Consultation Paper (in the context of both business and consumer insurance), seventy-four consultees responded and fifty-seven (77%) of them agreed that a causal connection test was desirable.
- 4.21 As explained in the 2007 Consultation Paper, we proposed that the causal connection test should be confined to warranties in the narrow sense; that is, to terms by which the insured promises that a certain thing should or should not be done. The problem is that the word “warranty” is used carelessly in insurance contracts. As well as being used to describe promises that certain things will be done (for example “warranted: a burglar alarm shall be maintained”) insurers also use the term to define the risk (“warranted: the car shall not be used for commercial purposes”). One of the aims of our proposal was to encourage insurers to use the word warranty more carefully. A breach of warranty discharges the insurer from all liability under the contract and, once it has been breached, the contract cannot be revived. If an insurer intended breach of a term to have such strict consequences then we did not think that it was appropriate that they could achieve this simply by the use of the word warranty. Instead we argued that they should describe the term as a limitation of cover, a condition precedent or an exclusion. If they described the term as a warranty we thought that most micro-businesses would not understand the consequences of breach. We felt that it would be fair if, when insurers described the term as a “warranty”, they could only refuse to pay a claim where there was a causal connection between the breach and the loss.

⁶ Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper No 182; Scottish Law Commission Discussion Paper No 134.

- 4.22 We asked two questions about this in the Issues Paper on micro-businesses. First, whether, in addition to the UTCCR, a causal connection test should be imposed for terms described as warranties which apply to future conduct (paragraph 6.24 of the Issues Paper). The second point was whether consultees agreed that, if a test were to be imposed, it should be that a policyholder should be entitled to be paid a claim if it can prove on the balance of probability that the event or circumstance constituting the breach of warranty did not contribute to the loss (paragraph 6.25 of the Issues Paper).

Responses

- 4.23 Twelve consultees responded to the question about whether a causal connection test should apply to terms described as warranties. Ten of these (83%) agreed that a causal connection test should be applied to these terms. Only three consultees responded to the second question and all agreed that the test should be that a policyholder should be entitled to be paid a claim if it can prove on the balance of probability that the event or circumstance constituting the breach of warranty did not contribute to the loss.

- 4.24 Six of the ten consultees commented that a causal connection test should be applied to all warranties, regardless of the size of the business. The Forum of Private Business wrote:

A causal connection test is necessary, in the short-term at least, to restore confidence in the insurance industry which has been damaged by adverse publicity regarding financial services in general. There is a perception by small business owners that insurers try to use such terms as a method of delaying or even avoiding payment to small businesses, and this can have an impact on the company's cash flow which in turn could impact on the viability of the company. In fact a causal connection test should be applied to all insurance contracts irrespective of size to restore confidence in financial services companies.

- 4.25 Many insurers also agreed that a causal connection test would be a good idea. Aviva wrote:

We are of the view that a causal connection test should apply at law for all claims, whether written under commercial or personal lines.

- 4.26 However, some insurers (including Aviva) felt that it should be possible for insurers and businesses to agree to contract out of causal connection provisions. For some, this was because they wanted to continue to rely on certain warranties. The Export Credit Guarantee Department (ECGD),⁷ for example, argued that certain warranties should be excluded from the reform.

⁷ ECGD has for the last 18 years facilitated the export of capital goods and related services from the UK through the provision of bank guarantees and insurance.

Our concern relates to the possible impact of that proposal on the use of warranties in furtherance of public policy objectives. In ECGD's insurance policy, the Insured warrants (amongst other matters) that it has not engaged in any corrupt activity and will not engage in any corrupt activity in relation to the underlying contract. Breach of such a warranty permits ECGD to avoid the policy from its inception. ECGD would wish, as a matter of public policy, to be able to rely on such a warranty to avoid the policy regardless of the characteristics of the insured, even if the corrupt activity in question had not caused a loss under the policy, since the Department would not wish to put taxpayer's money at risk to support a contract procured by corruption.

- 4.27 We did not want to make exceptions for certain types of warranty. We simply wanted to prevent the insurer relying on a term which merely described itself as a "warranty" without explaining what the consequences of breach were. Insurers would still be able to avoid the contract from inception when, for example, the policyholder was found to have engaged in corrupt activity. An insurer would no longer be able to do this, however, by simply stating "warranted the insured has not engaged in corrupt activity" without more. It would need to spell out the consequences of breach in a clearly drafted term.

Overview of responses

- 4.28 A few consultees argued against the causal connection test stating that warranties were necessary to moderate behaviour and insurers should be permitted to rely on them without spelling out the consequences. However, most consultees were in favour of a causal connection test and the majority of those thought that the causal connection test should be applied to all insurance contracts regardless of the size of the policyholder.

PART 5

DEFINITION OF A MICRO-BUSINESS

THE PROPOSED TESTS FOR DEFINING A MICRO-BUSINESS

- 5.1 If we are to place micro-businesses within the consumer insurance regime, we need a simple definition of a micro-business. As we made clear in the Issues Paper, this definition of micro-businesses is purely for the purposes of pre-contractual information and unfair terms in insurance contracts. We are not proposing a change to the definition of retail and consumer customers for any other purposes.
- 5.2 We described three options and asked consultees to tell us which definition of a micro-business they would find most practical. Option 1 defined a micro-business by looking at its turnover, option 2 defined a micro-business by looking at the number of employees in the business, and option 3 defined a micro-business according to whether it fell within the jurisdiction of the Financial Ombudsman Service (FOS). Currently businesses with a turnover of less than £1 million can bring a claim to the FOS, but this is soon to be changed to businesses with a maximum of 10 employees and a turnover of less than €2 million.
- 5.3 Fifteen consultees gave their views on the appropriate definition for a micro-business. Twelve consultees (80%) found option 3 the most practical test; the option which defined a micro-business by reference to the FOS jurisdiction limit. Three consultees (20%) were in favour of option 1, the definition based on turnover, and none were in favour of option 2, based on the number of employees.
- 5.4 Below, we look at the options and the arguments.

OPTION 1 – TURNOVER DEFINITION

Is a turnover test sufficient to define a micro-business?

- 5.5 We asked consultees whether a turnover test is sufficient to define a micro-business (Issues Paper, paragraph 7.16). Of the 15 consultees who responded to our questions on how a micro-business should be defined, three (20%) were in favour of a definition based on turnover.
- 5.6 Those consultees in favour appreciated that it posed problems but were of the view that a turnover test provided a higher degree of precision and simplicity than the other options.
- 5.7 However, five consultees (all of whom favoured another test) stated that a turnover definition was too simplistic and would need to be supplemented with additional tests. The British Insurance Law Association made the following comment:

We feel that a turnover test alone is likely to be too crude a test (as is suggested by the fact that the test adopted by BERR¹ to identify a “micro-business” is more sophisticated).

- 5.8 Some expressed concern that a low turnover does not necessarily indicate that a business is less sophisticated and in need of extra protection. Aviva commented:

A turnover test may be appropriate in certain circumstances, but in other circumstances may have no material impact on the risk profile of the commercial enterprise (ie a start-up construction company with multiple contracts versus an existing software company generating increased royalty income).

We therefore consider that a turnover test must be used in conjunction with other tests.

From what point should turnover be assessed?

- 5.9 We asked consultees whether they agreed that turnover should be assessed from the most recent accounts available at the time of entering into the contract (or projected turnover in the case of a new start-up business) (Issues Paper, paragraph 7.17).
- 5.10 Three consultees agreed with our proposal. The Association of British Insurers (ABI), however, disagreed:

Recent accounts provide no certainty and may soon be out of date. Further, where the business is a start-up there would be no accounts to indicate turnover; any projected figure would clearly be unreliable. In addition, if projected turnover is to be taken into account, there needs to be more clarity about who is responsible for making the projection. Finally, for sole traders it would be difficult (without imposing some sort of standard) to determine what insurers should accept as accounts.

At what level should turnover be set?

- 5.11 In the Issues Paper we suggested three options for the level at which turnover should be set for the purpose of defining a micro-business (Issues Paper, paragraph 7.18):
- (1) the level used by the European Commission and BERR² as one of the signifiers of a micro-business. This level is currently set at €2 million.
 - (2) the level of the current FOS jurisdiction limit. This is currently a turnover of less than £1 million.
 - (3) an independent level which will need to be amended from time to time. We asked consultees for views on what level this should be.

¹ The Department for Business, Enterprise and Regulatory Reform, which has since changed its name to the Department for Business, Innovation and Skills.

² See footnote above.

- 5.12 Several consultees who did not favour using a turnover definition at all nevertheless responded to our questions concerning the appropriate level at which turnover should be set. We received seven responses in total.
- 5.13 Four consultees were in favour of the first option, tying the level of turnover to the level used by the European Commission and BERR; currently €2 million. Consultees thought that the current FOS jurisdiction limit of a turnover of £1 million was too low, and that as the FOS definition is to be aligned with the Department for Business, Innovation and Skills threshold in the future, €2 million was the most appropriate option.
- 5.14 Three consultees were in favour of option two; tying the turnover level to that of the current FOS jurisdiction limit of £1 million. A further two consultees did not expressly state that the turnover level should be linked with the FOS jurisdiction limit, but commented that a level of a maximum turnover of £1 million was appropriate.
- 5.15 Three consultees expressed concern that the turnover limit could be expressed in Euros. They envisaged serious practical problems with a limit expressed in currency which is not currently legal tender in the UK and queried its application to UK businesses. The International Underwriting Association felt, however, that these problems could be overcome:

Whilst putting the threshold in Euro is not ideal it would not be difficult to establish at inception of the contract. We would also note that requirements expressed in Euro are not uncommon, for example intermediaries' insurance requirements under the Insurance Mediation Directive.

- 5.16 None of the consultees held a firm position on an independent level at which turnover should be set.

Overview of responses to a turnover definition

- 5.17 Only three consultees were in favour of defining a micro-business by reference to turnover. Five were actively opposed to it, commenting that it was crude, overly simplistic and insufficient by itself.
- 5.18 Only a few consultees answered the sub-questions on when and at what level to assess turnover. However, small numbers of consultees favoured assessing it from the most recent accounts available at the time of entering into the contract, or from projected turnover in the case of a new start-up business. Consultees were fairly evenly split on whether the turnover definition should be tied to the level of the Department for Business, Innovation and Skills definition of a micro-business (currently an annual turnover of €2 million) or whether the turnover definition should be set at the current level of the FOS jurisdiction limit (an annual turnover of £1 million).

OPTION 2 – EMPLOYEE DEFINITION

Is an employee test sufficient to identify a micro-business?

- 5.19 The second option we proposed for defining a micro-business was by the number of employees the business has, assessed at the time the insurance contract was entered into (Issues Paper, paragraph 7.33).
- 5.20 Six consultees gave their views although none of them favoured an employee test. They were of the view that an employee test alone was overly simplistic and would need to be combined with another test. They were also concerned that small but sophisticated businesses would fall within the definition of a micro-business. The ABI replied:

An employee test alone is too simplistic and, therefore, insufficient.

Having few employees is not necessarily a qualification for a business to receive consumer status. A firm with few employees could have a high level of sophistication (eg boutique fund managers, firms of niche solicitors and insurance brokers). Therefore if the test for a micro-business was based on number of employees alone it would mean that some sophisticated businesses would be treated as consumers, which again would go against the stated purposes of the Commissions' proposals.

Should a micro-business be defined as a business with fewer than 10 employees?

- 5.21 We asked consultees whether a test of fewer than 10 employees was a suitable threshold for defining a micro-business (Issues Paper, paragraph 7.34). Five consultees responded to this question and all agreed that, if an employee test were to be adopted, fewer than 10 employees was an appropriate number for the purposes of the definition. The International Underwriting Association replied:

An employee test of fewer than 10 employees seems straightforward and consistent with other existing (non-insurance) and proposed legislation. It seems from the published data that there is very rarely a dispute on the 9 or 10 employee threshold and their 'consumer' status. On that basis we are quite comfortable on the assessment options.

How should the number of employees be assessed?

- 5.22 We asked consultees which method they preferred for assessing the number of employees in a business (Issues Paper, paragraph 7.35). We gave three options:
- (1) using the figure in the most recent annual return to HM Revenue and Customs available at the time of entering into the contract;
 - (2) using a business's own assessment of its payroll records for the 12 months immediately preceding the application for insurance; or
 - (3) using some other way.

- 5.23 Four consultees responded to our question. One consultee was in favour of option (a). Three consultees preferred option (b).

Should the number of employees in the case of a new start-up business be assessed from projected numbers of employees?

- 5.24 Three consultees responded to this question (Issues Paper, paragraph 7.36) and all agreed that the number of employees for a start-up business should be assessed in this way.

Overview of responses to an employee definition

- 5.25 None of the consultees were in favour of defining a micro-business by number of employees alone and six actively opposed it.
- 5.26 Nonetheless a few consultees did reply to the other questions about the employee definition. All who did so agreed that, if an employee definition was to be used then fewer than 10 employees would be the best threshold. One consultee thought that the number of employees should be assessed from the most recent annual return to HM Revenue & Customs available at the time of entering into the contract. Two consultees thought that it should be assessed from a business's own assessment of its payroll records for the 12 months immediately preceding the application for insurance. No consultees suggested that it should be assessed in some other way.

OPTION 3 – FINANCIAL OMBUDSMAN DEFINITION

- 5.27 The final option we proposed was tying the definition of a micro-business to the FOS jurisdiction limit. Currently a business is entitled to have an insurance dispute heard by the FOS when that business has a turnover of less than £1 million at the time of the claim and this will shortly change to fewer than 10 employees and a turnover of less than €2 million at the time of the claim. We proposed, however, that in order for the scheme to work, the relevant time would need to be at the time the insurance contract was entered into.

In theory, should the definition of a micro-business be the same as the FOS jurisdiction limit?

- 5.28 We asked consultees whether, in theory, the definition of a micro-business should be the same as the definition of a business that can take a claim to the FOS (Issues Paper, paragraph 7.41). This option was by far the most popular; 12 consultees (80%) were in favour of a definition based on the FOS jurisdiction limit.
- 5.29 Consultees told us that it was important for there to be “symmetry” between the law and FOS rules and standards, and that it was both sensible and logical to bring the law and FOS jurisdiction limit into line. Aviva stated:

The definition of a micro-business must be aligned with the FOS interpretation if the Law Commissions’ proposal to extend the consumer regime is to become workable.

- 5.30 Consultees were also of the view that aligning the legal definition under insurance contract law and the FOS definition of a micro-business would simplify matters for businesses and policyholders:

It seems a sensible option, if change is essential, to align the law and the regulatory (FSA/FOS) arrangements. Otherwise there might be a great deal of confusion for business customers and insurers in the event of a dispute. [The Institute of Insurance Brokers]

In practice, however, should a micro-business be defined as a business that (at the time it enters into a contract of insurance) has fewer than 10 employees and a turnover of less than €2 million?

- 5.31 In the Issues Paper we said that, whilst in theory it might be a good idea for the law and the FOS regime to be aligned, we were concerned that a two-limb test which incorporated the Euro rather than the national currency could, in practice, be too complex for policyholders and insurers alike (Issues Paper, paragraph 7.42).
- 5.32 Ten consultees responded to this question. One consultee did not agree that the micro-business definition should in practice operate in this way; this consultee was altogether opposed to a micro-business regime. Nine consultees (90%) agreed that, in practice, a micro-business should be defined by this two limb test.
- 5.33 The responses to the Issues Paper indicated that a one-limb test based on turnover or employee numbers was overly simplistic; a more sophisticated test that combined turnover and employee level was preferable. The advantages of aligning the micro-business definition with the FOS jurisdiction limit easily outweighed the added complexity it involved. The International Underwriting Association commented:

It makes sense to align the pre-contractual threshold to the overall FOS threshold and adds certainty for parties. A two-limb test would be slightly more complex than an employee or turnover test but would not in our view be overly difficult to implement for either party. It would be more complex for consumers to consider one set of rules in relation to pre-contractual information and another for access to the FOS.

- 5.34 The responses we received also indicated support for our proposal that the size and turnover of the business should be assessed at the time the business enters into the policy rather than at the time at which it makes a claim.

Overview of responses to a FOS jurisdiction definition

- 5.35 A definition which stated that a micro-business was one which fell within the FOS's jurisdiction had the support of most consultees (80%). We then asked whether the intended changes to the FOS's jurisdiction limit meant this would remain a practical option, as we had had concerns about it being too complex. Ten consultees answered this question and 90% of them confirmed that they would prefer defining a micro-business as a business that (at the time it enters into the contract of insurance) has fewer than 10 employees and a turnover of less than €2 million.

5.36 Consultees told us that it was the most sensible and logical option of the three. Despite our concerns that the test might be too complicated, consultees told us that it would in fact simplify matters for policyholders and insurers by ensuring a consistent approach by the FOS and the law. A test based solely on turnover level (option 1) or number of employees (option 2) would be overly simplistic.

PART 6

EXCLUDING SOPHISTICATED BUSINESSES FROM THE DEFINITION

INTRODUCTION

6.1 If the rationale for including micro-businesses in the consumer regime is that they are similar to consumers in their understanding of insurance law and the way they purchase insurance, then sophisticated micro-businesses must be excluded from the definition. In the Issues Paper we suggested three ways in which this could be done and asked for comments. The ways were that:

- (1) The turnover or the number of employees for the purposes of the definition would be that of the business plus any associated business. This prevents a business falling within the micro-business definition simply because it is a small part of a larger business structure.
- (2) A business that spends more than a particular amount on its insurance premium could not be a micro-business.
- (3) A business that has particularly high assets or high turnover would not fall within the definition of a micro-business.

6.2 Eleven consultees in total responded to some or all of the questions in this part of the Issues Paper.

6.3 Six consultees gave general views on whether these extra filters for the definition of a micro-businesses were necessary. While they appreciated the need for filters, five (83%) expressed concerns about how they would work in practice. One consultee thought that the filters would be too complex. Another was concerned that they would not be sufficient to catch all sophisticated businesses, commenting that “it is inevitable that in the future more filters will be needed to account for new sophistications” (the Association of British Insurers (ABI)).

6.4 The Institute of Insurance Brokers thought that the filters would entail extra work:

We feel that none of the filters suggested are foolproof and we would wish to avoid imposing additional burdens on brokers, their customers or insurers in having to establish the appropriate category of the business, whether at inception or at some other point.

6.5 The main argument in favour of extra filters, however, is that it would prevent highly specialised micro-businesses who are in no way similar to consumers and in no need of extra protection from being included in the regime.

ASSOCIATED BUSINESSES

- 6.6 Most tests for micro-businesses state that, when calculating the numbers of employees or the amount of turnover, the numbers or amounts of associated businesses are to be included.¹ The association to the larger company can be, for example, through voting rights or shareholding or powers conferred by the articles of association.
- 6.7 In the Issues Paper we proposed that the number of employees or turnover of a business should include those employed by, or the turnover of, any associated person (Issues Paper, paragraph 8.17).
- 6.8 Six consultees responded. Four were in favour of our proposal and two were opposed. The ABI was concerned that the proposal would add complexity to the definition of a micro-business. It continued:

We also believe it would be prone to considerable error and is almost certain to lead to quite complex disputes at the claims stage.

- 6.9 However, the British Insurance Law Association felt that such disputes would be rare:

This test seems to us potentially productive of dispute. This may not be a particular problem in practice, however, since such disputes are presumably only likely to arise in relatively few cases involving more sophisticated businesses.

- 6.10 A further consultee, Aviva, recognised a need for sophistication filters, but said they saw no simple answer to the problem of associated businesses. They commented that insurers would find it difficult to ascertain the status of an associated business, particularly at the pre-contractual stage. They wrote:

The commercial reality is that such a test would be investigated more thoroughly at claim stage than at pre-contract stage. For this reason, it would be important that micro-businesses have an incentive to provide all information that may be relevant. We consider that it is impracticable and unduly onerous to expect an insurer to fully investigate any associated links at pre-contract stage.

- 6.11 We were not, however, suggesting that insurers should be responsible for investigating links. Instead, they would have a duty to ask proper questions of their policyholders and, once that had been done, they could rely on the answers given.

¹ The European Commission and Department for Business, Innovation and Skills include associated enterprises within their definition of a micro-business. See European Commission and Enterprise and Industry Publications, *The new SME definition, user guide and model declaration*: ec.europa.eu/enterprise/enterprise_policy/sme_definition/sme_user_guide.pdf.

The “associated person” test in the Law Commissions’ draft Bill on Unfair Contract Terms

- 6.12 We asked whether the test for defining an associated person should be the same test as that set out in the Law Commissions’ draft Bill on Unfair Terms in Contracts² and in Appendix A to the micro-business Issues Paper (Issues Paper, paragraph 8.18). The definition in the draft Bill applies to bodies corporate or partnerships and control is defined as securing that a party’s affairs are conducted according to another party’s wishes, direction or instructions.
- 6.13 Seven consultees responded to this question. Four consultees (57%) were in favour of using the test set out in the draft Bill and three consultees (43%) opposed the use of the test in the draft Bill, stating that it was too detailed or confusing to be workable in practice.

Overview of responses

- 6.14 We questioned consultees on the most appropriate way to exclude sophisticated businesses from the micro-business regime.
- 6.15 We asked whether, when calculating the number of employees or turnover, micro-businesses should add the number of employees or turnover of any associated person to their total. The majority of consultees were in favour of this proposal.
- 6.16 We also asked consultees whether they agreed that for these purposes we should use the definition of an “associated person” set out in the Law Commissions’ draft Bill on Unfair Contract Terms. This definition would include those who have de facto ability to dictate how the business is run. A majority of consultees agreed but several were concerned about complexity.

EXTRA FILTERS

- 6.17 In the Issues Paper we identified a particular problem with “orphan companies” whose shares are often settled on charitable trusts and whose directors are provided by an administration company. These orphan companies would escape any definition of associated company and are set up deliberately to do so.
- 6.18 We asked consultees whether they agreed that, in addition to the associated business filter, there must be additional filters to exclude these businesses from the definition of micro-business (Issues Paper, paragraph 8.19). Seven consultees responded to the question and all agreed that extra measures were needed.
- 6.19 The two extra filters we proposed were that:
- (1) If a business spends more than a certain amount on any one insurance premium, it should fall outside the definition of a micro-business for that policy. We provisionally proposed a maximum premium level of £15,000.

² Unfair Terms in Contracts (2005) Law Commission Consultation Paper No 292; Scottish Law Commission Discussion Paper No 199.

- (2) If a business has assets which are worth more than £10 million or an annual turnover of more than £10 million, it should not be defined as a micro-business.

FILTER 1 – INSURANCE PREMIUM SPEND

- 6.20 If a business spent more than a certain amount on its insurance premium, we proposed that it would automatically fall within the business regime and not within the consumer regime.
- 6.21 Research carried out by CRA indicated that a business with a turnover of less than £500,000 spent on average between £6,000 and £6,500 on its annual insurance. We suggested a higher figure would better take into account the different sizes and types of business and would avoid penalising those who buy combined commercial insurance rather than separate policies. We therefore provisionally proposed that a suitable level for this filter could be a premium level of £15,000 per policy, to be updated periodically. We argued that businesses that spent more than £15,000 on an insurance policy were likely to take advice from a broker, and would certainly not be buying a standard insurance policy over the internet. It was therefore appropriate to exclude them from the consumer regime, and doing so would grant them more freedom to agree terms.
- 6.22 We asked consultees whether they agreed that a business that spends more than a certain amount on any one insurance premium should fall outside the definition of a micro-business for the purposes of buying that policy (Issues Paper, paragraph 8.20). We also asked whether £15,000 was an appropriate level. Seven consultees responded to this question and four (57%) answered that there should be a premium filter.
- 6.23 Three consultees (43%) disagreed with our proposal and were of the view that premium spend was not a good gauge of sophistication. Some also misunderstood the question and thought that we were suggesting that an insured's annual spend on all its insurance policies should be aggregated. In fact we intended the limit to be judged per policy. The ABI told us that a disadvantage of this approach was that:

For some products the customer would be treated as 'micro' and others not. This could also result in penalising micro-businesses who have greater insurance risks as a result of the nature of their business or location.

- 6.24 We felt that this was more straightforward, however, than trying to aggregate spend. As Aviva told us:

One business may be risk adverse and buy insurance covering many aspects, whereas another business may self insure and only seek cover for compulsory insurance. Despite being a complex risk, the latter business might still be treated as a micro-business.

- 6.25 We asked consultees whether a premium level filter set at £15,000 was appropriate. Two consultees told us that they were not in a position to comment on what an appropriate level would be. Two consultees were of the view that £15,000 was too high a threshold. The International Underwriting Association considered it likely that professional advice would be sought for risks incurring less premium. The ABI suggested a figure of £2,500 per policy.

FILTER 2 – HIGH ASSET AND TURNOVER LEVELS

- 6.26 The second filter we proposed was based on a very high asset and turnover level.
- 6.27 We explained that if we recommended an employee-only definition of micro-business, the majority of sophisticated project companies and SPVs would be defined as micro-businesses because they have few, if any, employees. These companies may not be excluded from the consumer regime by the definition of associated business either. Therefore we suggested that an alternative way to exclude these sophisticated businesses would be to introduce an extra, very high asset and turnover filter.
- 6.28 We also explained that a high asset filter would be important if either of the plain turnover or employee tests were adopted to define a micro-business. Some sophisticated micro-businesses will not have any turnover for periods of their life; they will simply hold assets. A high asset filter would therefore prevent these companies from being defined as micro-businesses. It may be that if a test aligned with the Financial Ombudsman Service (FOS) is adopted, these extra filters would not be necessary.
- 6.29 We asked consultees whether, if extra measures are necessary, they agreed that a business that has assets worth more than £10 million or an annual turnover of more than £10 million should not be defined as a micro-business (Issues Paper, paragraph 8.21).
- 6.30 The responses we received were again fairly evenly divided. Seven consultees responded and four (57%) thought that a high assets or turnover test was required to filter out those businesses which were not in need of the extra protection of the consumer regime. Three consultees (43%) opposed the extra tests. Of these, the International Underwriting Association thought that there was insufficient need for this filter and that it would be burdensome on insureds:

In undertaking a FOS aligned test for micro-businesses, there is less need for additional tests beyond the associated person and premium paid criteria. An asset and/or turnover test might add some benefit but would also add additional complexity and information requirements on the insured. The potential £10 million annual turnover or £10 million assets would also need to be carefully assessed as to whether this is the correct threshold and would likely need regular revision. Therefore, on balance we do not feel that these additional tests are required.

- 6.31 We appreciate the difficulties of establishing assets for micro-businesses, particularly for micro-partnerships and sole traders who may find it difficult to separate their business and personal assets. However, if the asset level is set at a very high level, the majority of businesses will not need to consider their asset levels. The test will only catch those specialised companies carrying out high value business or holding a very expensive asset, such as SPVs in a securitisation structure, or those holding aircraft in an asset finance structure.

Overview of responses

- 6.32 We asked consultees whether a micro-business that spent over a certain amount (possibly £15,000) on a policy should not be defined as a micro-business for the purposes of that policy. Four out of seven consultees thought that insurance premium spend was a good way of filtering out sophisticated micro-businesses which were likely to spend more on insurance and seek professional advice while doing so, although several were concerned that £15,000 was too high a figure.
- 6.33 Finally, we also asked consultees for their views on a filter based on very high annual turnover or assets (possibly £10 million). This was particularly necessary if consultees had preferred a basic test based on turnover alone or the number of employees alone but is perhaps less necessary if the FOS jurisdiction test is used. Again, four out of seven consultees agreed that it was necessary but there was concern that this could add complication to otherwise simple tests.

PART 7

CONSEQUENCES OF FAILURE TO ASK SUFFICIENT QUESTIONS OR TO PROVIDE ACCURATE INFORMATION ABOUT SIZE

INTRODUCTION

- 7.1 In Part 9 of the Issues Paper we asked questions about what should happen when an insurer fails to ask sufficient questions about the size of a business and wrongly classifies it. We also asked what should happen when a business misrepresents its size, either deliberately or otherwise.
- 7.2 The questions contained in this part of the Issues Paper did not implement a new regime. It was envisaged that the normal rules relating to misrepresentations and non-disclosures would apply. We wanted to make consultees aware, however, of what these were in this context so that consultees had a clear picture of what would happen if an insurer did not ask sufficient questions or a policyholder misrepresented information. We also wanted to check that consultees felt that the consequences were fair in all circumstances.
- 7.3 Only a few consultees answered the questions in this section of the paper and their responses are described below.

INSURERS WHO ASK INSUFFICIENT QUESTIONS ABOUT THE SIZE OF A BUSINESS

Asking questions of micro-businesses

- 7.4 An insurer cannot, under the consumer/micro-business regime, rely on the micro-business to volunteer the fact that it is a micro-business; it must ask questions. In the Issues Paper we therefore proposed that if an insurer does not ask sufficient questions and sells a micro-business a policy which gives it fewer rights than it would have had under the consumer/micro-business regime, the insurer should not be able to rely on those terms and must apply the consumer/micro-business regime instead (Issues Paper, paragraph 9.6).
- 7.5 Eleven consultees responded to this proposal. Five agreed (45%) with it, two disagreed (18%) and four (36%) commented without expressing an opinion.
- 7.6 Those who objected took a strong line. The Institute of Insurance Brokers, for example, wrote “we strongly disagree with the prospect of insurers having to determine the status of the firm for underwriting purposes”. For the majority, however, it was accepted that insurers should have a duty to ask micro-businesses relevant questions and that they could not rely on stricter terms if they did not. Aviva, for example, wrote:

We agree that the onus must be on insurers to ask the relevant questions of insured parties in order to assess the risk profile of that party, pricing and appropriateness of an insurance product.

- 7.7 The Association of British Insurers (ABI) was confident that the situation of an insurer asking insufficient questions should not arise. It felt, however, that when asking questions, it should be sufficient for the insurer to ask whatever is set out in the test for a micro-business. It also warned against placing a requirement on the insurer to verify the answers given by the policyholder. It wrote:

An insurer must be able to rely on the answers/data given by a business. There should not be a requirement on the insurer to verify the answers/data. If insurers have to verify every answer given by businesses in relation to their size, there is a danger of some insurers withdrawing from the market altogether, with the ensuing detriment to customers.

- 7.8 We did not propose that an insurer should be responsible for verifying the data given to it by policyholders. If an insurer has asked the questions set out in the definition (for example “how many employees did you record on your most recent return to HM Revenue and Customs?”) then we would not expect the insurer to check this data.

Asking questions of larger businesses

- 7.9 We then went on to consider what the situation should be for larger businesses. Larger businesses will still have a duty to volunteer material information so it is likely that they would tell insurers about their turnover or the number of employees. It is also likely that insurers would ask for this basic information as it would be difficult to underwrite risks accurately without it.
- 7.10 There is, however, a remote possibility that a business could fail to volunteer information about its size and an insurer could fail to ask. In these circumstances, it is possible that the insurer could sell a policy to the large business that reflects the micro-business regime. When the non-disclosure comes to light, it would be open to the insurer to argue that the information was material, that the lack of it induced this particular contract and to avoid the policy altogether on the ground that had it known the truth it would never have sold the business this policy in the first place.
- 7.11 We asked whether, if a business fails to volunteer whether it is a micro-business or a larger business and the insurer does not ask sufficient questions to find out, the insurer should be able to rely on the business’s duty to volunteer this information. We asked whether in these circumstances consultees felt it was fairer that the insurer should abide by the terms of the contract it sold, even when that contract gives the business more rights than it would otherwise have given under the business regime (Issues Paper, paragraph 9.7). The grounds for this were that we felt that insurers should be expected to “know their customers” and that to avoid a policy when it had not asked for such basic information was inconsistent with this principle.
- 7.12 Seven consultees responded to this question. Three said that the insurer should abide by the terms of the contract it sold. Two said it should not. Two more made comments without expressing an opinion.

- 7.13 Those who thought the insurer should abide by the terms of the contract it sold felt that insurers should as a matter of principle be expected to ask questions about relevant matters, whatever the size of the policyholder. For example, the Federation of Independent Insurance and Risk Managers stated:

Insurers should ask questions that are contract relevant but, unless they provide guidance to anything else they might need, shouldn't be allowed to rely purely on non-disclosure to reject a claim. This should apply to all insurance contracts and it would be wrong to assume micro-businesses are a special case.

- 7.14 On the other side, however, strong arguments were put forward for retaining a strict duty of disclosure with no exceptions. The International Underwriting Association and the British Insurance Law Association wrote the following:

we strongly believe that business insureds should have a duty of disclosure. Therefore if a 'large' business, as opposed to a micro-business, fails to disclose that it is a business and that information is material to the risk then the insured should not be able to rely on that non-disclosure and benefit under the consumer provisions. [International Underwriting Association]

If it has been decided that larger businesses should not benefit from a more favourable regime, we do not see a case for allowing it to benefit from such a regime in circumstances where it has failed to disclose that it is not a micro-business. [British Insurance Law Association]

Overview of responses

- 7.15 Most consultees agreed that when dealing with a micro-business an insurer had a duty to ask questions about material matters. They agreed that if an insurer does not ask sufficient questions and sells a micro-business a policy which gives it fewer rights than it would have had under the consumer/micro-business regime, the insurer should not be able to rely on those terms and must apply the consumer/micro-business regime instead.
- 7.16 A smaller group of consultees responded to the question about larger businesses. Here, three out of the five consultees felt that the onus should be on an insurer to ask basic questions about size and that it could not avoid a contract or refuse to rely on more favourable terms if it did not do so. Others, however, made strong arguments against this, stating that business insureds have a duty of disclosure and that if they did not disclose material information the insurer should have a right to avoid, even if the insurer had not asked any questions about size.

MISREPRESENTATIONS BY POLICYHOLDERS ABOUT THE SIZE OF THEIR BUSINESS

Misrepresentations by micro-businesses

7.17 In the Issues Paper, we set out what would happen if a micro-business makes a mistake when answering a question about its size. We proposed that that misrepresentation should be treated in the same way as all misrepresentations are treated under the consumer regime. Therefore, if the micro-business acted deliberately or recklessly, the insurer could avoid the contract. If the micro-business acted negligently in giving the wrong answer then the insurer would be entitled to apply what it would have done, had it known the truth. There are two possibilities when a negligent misrepresentation is made:

- (1) The first is that the micro-business would not have been sold a policy on those terms. In these circumstances we thought that a normal proportionate remedy should apply. Where, for example, the premium would have been higher, the claim should be reduced proportionately; where exclusions or limitations or other terms would have been applied then the policy would have these terms implied into it.
- (2) The second, and more difficult, scenario arises when the micro-business would not have been sold a policy at all. The normal proportionate remedy in these circumstances would mean that the micro-business would be left without a policy for a negligent misrepresentation. We asked whether this would be too harsh a remedy in circumstances where the size of the business may have had no bearing on the risk itself.

7.18 Seven consultees responded to our proposal to apply the normal regime for dealing with misrepresentations when a micro-business made a mistake about its size (Issues Paper, paragraph 9.11). Four (57%) agreed and three (43%) disagreed. Some of those that disagreed did so in the context of their overall objections to giving protection to micro-businesses. Some felt that insurers should not have to bear the risk of any sort of misrepresentation about size and that whatever the type of misrepresentation, the micro-business should not be given the protection of the micro-business regime. The ABI wrote for example:

If a micro-business erroneously portrays itself as a larger business, then the insurer should be entitled to treat it as a larger business for all purposes.

7.19 Others agreed that it would be simpler if, as a general rule, the normal rules on misrepresentation applied when a micro-business made a misrepresentation about its size, so that deliberate or reckless behaviour entitled the insurer to avoid the contract and negligent behaviour entitled it to apply a proportionate remedy.

7.20 In relation to our specific question about what should happen when a proportionate remedy would lead to the micro-business being left without a policy (Issues Paper, paragraph 9.12), nine consultees responded. Four (44%) disagreed with the proposal, three (33%) made comments which did not indicate a preference and two (22%) agreed that alternative arrangements might be a good idea but did not agree with the arrangement we proposed.

- 7.21 The International Underwriting Association was one of those that strongly objected to an exception being made to the basic rules on misrepresentation in these circumstances. It wrote:

We do not feel there is a need to specify the consequences if a micro-business makes a negligent misrepresentation about its size and the insurer would not have sold it a policy at all had it known the truth. In particular we do not believe that statute should specifically state that in certain circumstances of negligent misrepresentation the parties should abide by the terms of the policy.

- 7.22 The alternative suggestion was made by the Law Reform Committee of the Bar Council and the British Insurance Law Association. They wrote:

If the insurer can prove that it would never have sold the policy to a micro-business if it had known the true position, then we consider that the insurance should not be subject to the consumer regime. Any policy issued in those circumstances should be governed by the law applicable to larger businesses.

Overview of responses

- 7.23 The majority of consultees felt that where a micro-business made a misrepresentation as to its size, the insurer should be able to treat this like all other misrepresentations under the contract. The effect would be that if the micro-business made the misrepresentation deliberately or recklessly the insurer would be able to avoid the contract and if the micro-business made the misrepresentation carelessly the insurer would apply a proportionate remedy.
- 7.24 In answer to the question whether special provision needed to be made for circumstances in which a proportionate remedy would leave the micro-business without a policy, most consultees felt that no special provision should be made. They felt that no exception should be made to the rule whereby if an insurer can prove it would not have entered into the contract at all in the first place, it should be released from its obligations under the contract.

Misrepresentations made by larger businesses

- 7.25 In the Issues Paper we stated that if a small, medium or large business (that is, any business that does not fall within the definition of a micro-business) (a larger business), portrays itself as a micro-business, then the misrepresentation should be treated the same as all misrepresentations are treated under the business regime.
- 7.26 We have not yet finalised our proposals for misrepresentation for the larger business regime, but it is clear that any deliberate or reckless behaviour on the part of the larger business should entitle the insurer to avoid the contract.
- 7.27 The Issues Paper provisionally proposed that the general rule should be that if a larger business made a misrepresentation or failed to disclose information about its size and that information was held to be material then the insurer should have the same remedy as it would for all other misrepresentations under the larger business regime (Issues Paper, paragraph 9.16).

- 7.28 We then asked whether a specific rule needed to be made for the circumstances where a proportionate remedy would leave the policyholder without a policy (Issues Paper, paragraph 9.17).
- 7.29 Five consultees answered each of these questions and all felt that the normal rules under the business regime should apply to misrepresentations about size made by larger businesses, and that it was not necessary to make special provision if a proportionate remedy left the policyholder without a policy.
- 7.30 Comments from the ABI and the International Underwriting Association summarised those made by other consultees.

We agree that if a small, medium or large business makes a mistake in answering a question about its size and portrays itself as a micro-business, that answer should be treated in the same way as all misrepresentations and non-disclosures are treated under the proposed business regime... . We do not feel that there is a need to specify the consequences if a larger business makes a non-deliberate or reckless misrepresentation that it is a micro-business and the insurer would not have sold it a policy at all had it known the truth. [International Underwriting Association]

If two different regimes apply to larger businesses depending upon the purposes of the questions asked, this is likely to lead only to confusion. While questions about turnover, employees and assets will be relevant for deciding whether a business is a micro-business or not, those same questions are also likely to be directly relevant to the level of risk. It would not be sensible to invite disputes about whether or not a question was asked for one purpose or another because it would permit an insurer to avoid the policy for one reason but not for the other. [ABI]

Overview of responses

- 7.31 All consultees agreed that where a larger business did not disclose information about its size or misrepresented that information then that misrepresentation should be treated in the same way as all other misrepresentations under the regime of law applying to larger businesses. They all agreed that no special provision needed to be made for circumstances where applying a proportionate remedy would lead to a larger business being without a policy.