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## **Insurance Contract Law Issues Paper 2 Warranties**

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**This paper should not be quoted as representing the fixed policy of either Commission.**

**The paper has been drafted by the teams working on the insurance contract law review at the English and Scottish Law Commissions and is intended simply to promote discussion before the formal consultation process begins. It has not been subject to formal scrutiny by Commissioners.**

**November 2006**

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# SUMMARY

## PURPOSE AND CONTENT

1. This is the second in a series of Issues Papers produced by the teams working on the insurance contract law review at the English and Scottish Law Commissions. These papers have not been subject to formal scrutiny by the Commissioners and their contents should not be quoted as representing the view of either Commission. Our intention is that they should promote discussion of some of the main matters within the review and give a focus for debate at the seminars we are holding.
2. The proposals outlined below are only tentative. Our formal proposals will be published in a Consultation Paper in summer 2007.
3. Below we start by looking at basis of the contract clauses (whereby answers on a proposal form may be converted into warranties). We then consider undertakings about past and existing fact, followed by warranties of future conduct.

## BASIS OF THE CONTRACT CLAUSES

4. In 1980, the Law Commission described basis of the contract clauses as a “major mischief”. Such clauses allow insurers to use a form of words that few policyholders understand to extend the protections already available to them for misrepresentation to cover answers that are not material to the risk, or are made without fraud or negligence. At our first working seminar on non-disclosure and misrepresentation, there was a widespread consensus that basis of the contract clauses should be rendered ineffective in consumer insurance. There was more debate about how far insurers in business insurance should be able to add to the proposed remedies for misrepresentation, so as (for example) to reject claims where there has been an innocent misstatement. However there are strong arguments that even if insurers are able to add to their remedies, this should not be done through basis of the contract clauses.
5. It will be seen that below we argue that for consumer insurance, and possibly for business insurance also, the only remedies that should be available when the insured has made a false statement of fact should be those for misrepresentation. This would make all basis of the contract clauses redundant.
6. We tentatively propose that:
  - (1) In consumer contracts “basis of the contract” and similar clauses that have the effect of turning statements of fact in general into warranties should be of no effect. (para 7.31)
  - (2) In business insurance, as a minimum, a “basis of the contract” clause in the proposal form should no longer be effective to turn the statements made by the proposer into warranties. If warranties of past or existing facts are to be permitted at all, each statement warranted should be set out either in the policy, or in some document incorporated by reference to the policy. This rule would be mandatory. (para 7.35)

## **SPECIFIC UNDERTAKINGS AS TO PAST OR EXISTING FACTS**

### **Consumer insurance**

7. We tentatively propose that:
- (1) The rules proposed in our first Issues Paper on materiality and non-fraudulent misrepresentation should be mandatory. (para 7.25)
  - (2) In consumer insurance, all statements of existing fact should be treated as representations rather than warranties. (para 7.43)

### **Business insurance**

8. We tentatively propose that:
- (1) Contrary to what we said in our first Issues Paper, the proposed rules on materiality and non-fraudulent misrepresentation should be mandatory. By this we mean that it would not be possible to exclude the rules by inserting a clause in the contract saying “the insurer should have the right to avoid the contract even if the proposer’s misstatement were made without negligence” or that “section x of the Insurance Contract Act 2xxx shall not apply to this contract”.
  - (2) We invite views on which of two possible proposals to adopt. These are either:
    - (a) that incorrect statements of past or existing fact should only amount to misrepresentations and not warranties (which would be a mandatory rule); or
    - (b) that insurers would be permitted to include warranties of specific facts. If the fact proved inaccurate, the insurer could use this as a defence to a claim even if the insured was not at fault, subject to the requirements for future warranties set out below. (These are that insured must be provided with a written statement, and that the claim must be causally connected with the breach). (para 7.55)

## **WARRANTIES OF FUTURE CONDUCT**

9. The law on breach of warranty has the potential to cause considerable unfairness to policyholders by allowing insurers to avoid paying claims for technical reasons, which are unconnected with the loss that has occurred. Our proposals are designed to bring warranties to the insured’s attention and to limit insurers’ right to reject claims where the breach of warranty has no connection to the loss that has arisen.

### **Written statement**

10. We tentatively propose that:
- (1) a claim should only be refused because the insured has failed to comply with a contractual obligation, if the obligation is set out in writing and included or referred to in the main contract document. (para 7.59)

- (2) in consumer insurance, there should be an additional requirement. An insurer may only refuse a claim on the grounds that the insured has failed to carry out a specific task (or refrained from a normal activity) if it has taken sufficient steps to bring the requirement to the insured's attention. In deciding whether the insurer has taken sufficient steps, the court should have regard to FSA rules or guidance. (para 7.65)

### **Causal connection**

#### 11. We tentatively propose that:

- (1) the law should afford policyholders some protection against claims being denied for reasons unconnected with the loss. (para 7.68)
- (2) the policyholder should be entitled to be paid a claim if it can prove on the balance of probability that the event or circumstances constituting the breach of warranty did not contribute to the loss. (para 7.76)
- (3) if a breach contributes to only part of a loss, the insurer may not refuse to pay the part not related to the breach. (para 7.81)

#### 12. We invite views on whether:

- (1) the causal connection rule should be mandatory in business insurance. (para 7.83)
- (2) the protection should apply to any term that purports to exclude or limit the liability of the insurer for events or circumstances that are thought to increase the risk of a loss occurring. (para 7.89)
- (3) the causal connection test should be subject to an exception where the insurance relates to one purpose, activity or place, and the loss arises from another purpose or activity or in another place. In these circumstances, we suggest that the claim should not be paid if the loss related to an activity which was so far outside the terms of the cover that a reasonable insured could not have expected the loss to be covered. (para 7.97)

## **THE SCOPE OF THE REFORMS**

### **Marine insurance**

#### 13. We tentatively propose that the causal connection test outlined above should also apply to:

- (1) express warranties in marine insurance contracts (para 7.108); and
- (2) the implied marine warranties set out in sections 39 to 41 of the Marine Insurance Act 1906 (para 7.119)

#### 14. We have not yet had time to study in detail those provisions of the Marine Insurance Act 1906 that provide that the risk will not attach (sections 43, 44), or that the insurer shall be discharged (sections 45, 46). We intend to consult on these at a later date. (para 7.123)

## **Reinsurance**

15. Are there any reasons why the reforms should not apply to reinsurance contracts? (para 7.130)

## **THE EFFECT OF A BREACH**

16. We tentatively propose that a breach of warranty should no longer result in the insurer being automatically discharged from liability. (para 7.135)
17. We ask whether the reforms should provide that:
  - (1) a breach of warranty gives the insurer the right to repudiate the contract? (para 7.135)
  - (2) the insurer has a choice between repudiating the claim only, or the policy for the future, or both? (para 7.138)
  - (3) where the insurer accepts the insured's breach of warranty (so as to terminate future liability), the insured should cease to be liable for future premiums? (para 7.145)
  - (4) an insurer who terminates a policy following the insured's breach of warranty should normally provide a pro-rata refund of the outstanding premium, less any damages or administrative costs (para 7.149)
  - (5) the insurer should be obliged to give notice that the contract is being terminated. If so, what would constitute a reasonable time for an insured to make other arrangements? (para 7.153)
18. If, as suggested above, a breach of warranty would give the insurer the right to terminate the contract for breach, the law of waiver would be affected. Loss by waiver of the insurer's right to repudiate the contract would be determined in accordance with the general rules of contract. We welcome views on whether it is necessary to include a specific provision on this point in any new legislation. (para 7.143)

## **AN UNFAIR TERMS APPROACH?**

19. We invite views on whether:
  - (1) Clauses that define the risk and exclusions in business insurance contracts written on the insurers' standard terms should be subject to a test of fairness.
  - (2) If so, should the protection apply to all businesses or only those defined as small? (para 8.23)
20. We would consider this option only if it were really needed. There would need to be evidence that businesses require better protection not only against warranties but also against unexpectedly narrow definitions of the risk or unexpectedly wide exceptions, and that the approach set out in paragraph 13(3) above is unacceptable.

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# **PART 1: INTRODUCTION**

## **BACKGROUND**

- 1.1 The English and Scottish Law Commissions are conducting a joint review of insurance contract law.<sup>1</sup> In January 2006 we published a Scoping Paper, explaining that the review would examine the law of misrepresentation, non-disclosure and breach of warranty in both consumer and commercial policies.<sup>2</sup> We asked whether any other topics also needed to be considered. A feedback paper setting out the results of this consultation exercise is available on our website.<sup>3</sup>
- 1.2 We intend to publish our first formal consultation paper in summer 2007, addressing misrepresentation, non-disclosure and breach of warranty. Before then, we are developing our ideas through a series of issues papers. The first paper considered misrepresentation and non-disclosure. This second paper deals with warranties and other similar contractual terms.

## **STATUS OF ISSUES PAPERS**

- 1.3 This paper has been drafted by the teams working on the project at the English and Scottish Law Commissions. It has not been subject to formal scrutiny by Commissioners and does not represent fixed policy. It is simply intended to promote discussion before the formal consultation process begins, and should not be quoted as representing the views of either Commission.

## **OUR OBJECTIVES**

- 1.4 Insurance works by pooling risks and resources. Our aim is to recommend reforms that strike a fair balance between the interests of insurers and insureds, so as to meet parties' legitimate expectations, without imposing unnecessary costs or restrictions.
- 1.5 Some of our proposals may result in more claims being paid, which would increase premiums. Where this corresponds to policyholders' legitimate expectations, consumers are probably willing to pay the small increase necessary to ensure that they are getting what they want. It does not make the insurance any less competitive. However, it is important that the impact should be considered. We will include an impact assessment in our final report. We have not included such an assessment in our issues papers, given that these papers merely indicate our provisional thoughts. Nevertheless, we would be interested in hearing views on the practical implications of the changes we are suggesting.

<sup>1</sup> It is intended that any reforms we recommend will result in the same law applying to England, Wales and Scotland. As far as warranties are concerned, the law is broadly similar in England and Scotland.

<sup>2</sup> Insurance Contract Law, A Joint Scoping Paper (January 2006).

<sup>3</sup> We were pleased to received 118 responses to the Scoping Paper. In August 2006 we published brief extracts from a selection of these responses and announced our decisions on scope: see [www.lawcom.gov.uk/insurance\\_contract.htm](http://www.lawcom.gov.uk/insurance_contract.htm).

## THE STRUCTURE OF THIS PAPER

### 1.6 The paper is divided into seven further parts:

- (1) Part 2 provides a background to the discussion, by explaining the current nature of an insurance “warranty” and where warranties fit within a hierarchy of terms in insurance contracts.
- (2) Part 3 summarises the English Law Commission 1980 report, setting out both its analysis of the problems and its recommendations for reform.
- (3) Part 4 asks whether warranties are still the problem they were in 1980. It discusses four developments since the report was published:
  - (a) the courts’ approach to construing warranties as other terms;
  - (b) voluntary statements of practice and Financial Services Authority (FSA) rules;
  - (c) the Unfair Terms in Consumer Contracts Regulations 1999; and
  - (d) the Financial Ombudsman Service (FOS).

It argues that each of these offers a partial solution to the problems, but difficulties remain.

- (4) Part 5 provides a brief evaluation of the current state of the law.
- (5) Part 6 looks at how other jurisdictions have dealt with warranties.
- (6) Part 7 sets out our provisional proposals, namely that basis of the contract clauses should be abolished, and that warranties should be set out in writing and made subject to a causal connection test. It asks whether these protections should apply to all insurance, including marine, aviation and transport insurance and reinsurance. Finally, it considers the consequences of our proposals for the Marine Insurance Act 1906.
- (7) Part 8 considers the arguments for and against making standard terms in commercial insurance contracts subject to a test of fairness, along the lines of sections 3 and 17 of the Unfair Contract Terms Act 1977. It asks whether in commercial policies on standard terms, warranties and terms having the same effect as warranties should be made subject to a fairness test.

### 1.7 Finally, Appendix A provides background to Part 7, with a brief summary of the implied warranties in marine insurance. Appendix B describes the approach taken by the Financial Ombudsman Services. It analyses 50 final ombudsman decisions concerning consumer disputes about policy terms.

## PART 2: BACKGROUND

### WHAT IS A WARRANTY?

- 2.1 The word “warranty” causes considerable confusion, as it is used in many different senses. In general contract law, a warranty is normally a term of minor importance, and a breach of warranty gives rise only to damages.<sup>1</sup> Within the insurance industry, the word may be used to connote a variety of obligations placed on the insured. As a matter of insurance law, however, warranties are extremely important terms: the insured must comply with them strictly or face harsh consequences. Here we summarise the main characteristics of a warranty within insurance law, as set out in the Marine Insurance Act (MIA) 1906.

### Undertakings for the future and affirmations of fact

- 2.2 A wide variety of obligations on the insured can be given warranty status if the contract makes this sufficiently clear. Section 33(1) of the Marine Insurance Act (MIA) 1906 describes “promissory warranties” as terms

by which the assured undertakes that some particular thing shall or shall not be done, or that some condition shall be fulfilled, or whereby he affirms or negatives the existence of a particular state of facts.

In other words, warranties may apply to past or existing facts, or to future conduct.

### Strict compliance

- 2.3 The MIA states that a warranty “must be exactly complied with, whether it be material to the risk or not”.<sup>2</sup> So if an insured has “warranted” that certain facts are true, the warranty will be broken even if the answer made no difference, or if the insured was not at fault in any way. As we shall see, the insurer will be discharged from liability.

### Later remedy irrelevant

- 2.4 Furthermore, once a breach has occurred, the fact that it has been remedied does not prevent the contract from being discharged. As section 34(2) states:

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.

<sup>1</sup> See e.g. Sale of Goods Act 1979, s 11(3) (“Whether a stipulation in a contract of sale is a condition, the breach of which gives rise to the right to treat the contract as repudiated, or a warranty, the breach of which may give rise to a claim for damages but not to a right to reject the goods....”)

<sup>2</sup> Marine Insurance Act 1906, s 33(3).

- 2.5 For example, in *De Hahn v Hartley*,<sup>3</sup> the insured warranted that the ship would sail from Liverpool with 50 hands. In fact, when the ship left Liverpool it had only 46 hands, though it picked up six more hands in Anglesey and had 52 hands at the time of the loss. The court held that the insurer's liability terminated when the ship left Liverpool. The insurer was not liable for any losses that arose after this date, however caused.

### **Automatic discharge from liability**

- 2.6 Section 33(3) spells out that a warranty must be complied with exactly. If not, the insurer is discharged from liability under the contract, which means that an insurer is not liable for any claims arising after the breach. It states that if a warranty is not exactly complied with, then

subject to any express provision in the policy, the insurer is discharged from liability as from the date of the breach of warranty, but without prejudice to any liability incurred by him before that date.

- 2.7 These words should be taken literally. In its 1980 report the Law Commission said that on a breach of warranty the insurer was "entitled to repudiate the policy".<sup>4</sup> In *The Good Luck*, Lord Goff criticised this formulation, saying that it was inappropriate to describe the insurer as "repudiating the policy".<sup>5</sup> It is more accurate to keep to "the carefully chosen words" of the 1906 Act and say that the insurer is discharged from liability as from the date of the breach.<sup>6</sup> This means that, following breach, the insurer has a good defence to any claim without taking further action. The insurer may, however, waive the breach and restore their liability.<sup>7</sup>

### **"Subject to any express provision"**

- 2.8 Section 33(3) is subject to any express terms of the policy. This means that the parties can contract out of automatic termination if they wish. For example, marine insurance contracts commonly include "held covered" clauses, which allow the policy to continue after the breach of warranty. Thus the Institute Time Clauses (Hull) include the following:

<sup>3</sup> (1786) 1 TR 343.

<sup>4</sup> Insurance Law, Non-Disclosure and Breach of Warranty (1980) Law Com No 104, para 6.2.

<sup>5</sup> *Bank of Nova Scotia v Hellenic Mutual War Risks ("The Good Luck")* [1992] 1 AC 233, at pp 263-4. Lord Goff said that the Court of Appeal had been "led astray" by passages in certain books and other texts which refer to the insurer being entitled to avoid or repudiate for breach of a promissory warranty.

<sup>6</sup> Above, pp 263, quoting Marine Insurance Act 1906, s 33(3).

<sup>7</sup> Marine Insurance Act 1906, s 34(3). The means by which such waiver can occur raises difficult legal issues, and is discussed further in Part 7.

Held covered in case of any breach of warranty as to cargo, trade, locality, towage, salvage services or date of sailing provided notice be given to the Underwriters immediately after receipt of advices and any amended term of cover and any additional premium required by them be agreed.<sup>8</sup>

- 2.9 In other words, once the insured gives prompt notice of the breach, the insurer is obliged to provide additional cover, if necessary on amended terms and for an additional premium. Where the parties cannot agree on the terms or premium, the matter may be referred to a court or arbitration.

### **Creating a warranty**

- 2.10 Most warranties are created expressly by the parties. There is no single form of words that confers warranty status on a term. The use of the word “warranty” has been said to be indicative but by no means decisive.<sup>9</sup> As Lord Justice Rix put it in *HIH Casualty and General Insurance Ltd v New Hampshire Insurance Co*,

It is a question of construction, and the presence or absence of the word “warranty” or “warranted” is not conclusive. One test is whether it is a term which goes to the root of the transaction; a second, whether it is descriptive or bears materially on the risk of loss; a third, whether damages would be an unsatisfactory or inadequate remedy.<sup>10</sup>

The case concerned film finance insurance, in which the original insured had undertaken to make six films. This was held to be a warranty, even though the word warranty was not used, because it was a fundamental term with a direct bearing on the risk.<sup>11</sup>

- 2.11 In marine insurance, the law will also imply certain warranties into the contract (which are set out in Appendix A).

<sup>8</sup> ITCH 1995, cl 3.

<sup>9</sup> *Barnard v Faber* [1893] 1 QB 340.

<sup>10</sup> *HIH Casualty and General Insurance Ltd v New Hampshire Insurance Co* [2001] 2 Lloyd’s Rep 161 at para 101; [2001] EWCA Civ 735.

<sup>11</sup> By contrast, courts have sometimes been prepared to hold that a clause described as a warranty is not a warranty. In *Roberts v Anglo-Saxon Insurance Ltd* (1927) 27 Ll L Rep 313, Bankes LJ argued that the phrase “warranted: used only for commercial travelling” did not create a true warranty:

When persons insert clauses, whether described as warranties or whether described as part of the description of the vehicle, indicating that the vehicle is to be used in some restricted way, my opinion... would be that the parties had used that language as words descriptive of the risk, and that, as a result, when the vehicle is not being used in accordance with the description it is not covered; but it does not follow at all that because it is used on some one occasion, or on more than one occasion, for other than the described use, the policy is avoided. It does not follow at all. (at p 314).

This was approved by Lord Buckmaster in *Provincial Insurance v Morgan* [1933] AC 240 at p 247.

## A HIERARCHY OF TERMS

- 2.12 Warranties are best understood in the context of a hierarchy of different sorts of terms that impose obligations on policyholders. Warranties are the most severe, though breaches of other types of term may also extinguish insurers' liability for particular claims.
- 2.13 Within English law, It is possible to identify the following types of terms in insurance contracts:<sup>12</sup>
- (1) *Warranties* carry the most severe consequences for policyholders if they are breached. A breach discharges the insurer from any liability under the contract, even if the breach is minor or remedied later. In effect, compliance with a warranty is a condition precedent to liability arising under the policy as a whole.
  - (2) *Conditions precedent to a claim*. Here breach will discharge an insurer from liability to pay a particular claim, but will not affect other possible claims under the policies. Such conditions are most likely to be procedural, requiring (for example) notice of claims.<sup>13</sup>
  - (3) Clauses which are "*descriptive of the risk*" for which the insurer is liable. These state that the insurer will only cover losses arising in particular circumstances, and if a loss arises in other circumstances, the insurer is not liable. Such terms are sometimes called "suspensive" conditions, on the basis that they merely suspend liability while a breach taking the risk outside the policy continues. If a policyholder remedies the problem the insurer resumes liability.

<sup>12</sup> Scots law may refer to some of these categories, but does not have a strict classification of terms. It retains flexibility by leaving the effect of a term to be determined according to its construction in the particular circumstances of the case.

<sup>13</sup> This category of term was recognised in *Alfred McAlpine Plc v BAI (Run-Off) Ltd* [2000] 1 Lloyd's Rep 437, at para 27. Here Waller LJ cited *Weir v Northern Counties of England Co* (1879) 4 LR 1r as "an example of a term not being a condition precedent, but on its language being a term which, until it is complied with, entitles the insurer not to meet the claim". In *K/s Merc-Scandia XXXXII v Certain Lloyd's Underwriters ("The Mercandian Continent")* [2001] 2 Lloyd's Rep 563 Longmore LJ confirmed the existence of "a further category of term" would give underwriters "the right to reject the claim without having to accept the breach of contract as being a repudiation of the contract as a whole" (para 14).

For example, in *Farr v Motor Traders Mutual Insurance* the policyholder insured two taxi-cabs, stating that they were only driven for one shift every 24 hours.<sup>14</sup> For a short time, one of the cabs was driven for two shifts while the other was being repaired. The cab was then used for one shift a day in the normal way and a couple of months later was damaged in an accident. The Court of Appeal rejected the insurer's argument that the assured had breached a warranty. Instead the words were merely "descriptive of the risk". This meant that if the cab was driven for more than one shift per day, the risk would no longer be covered, but as soon as the owner resumed one-shift working, the insurer again became liable.

- (4) *Innominate terms*, where the remedy for a breach depends on its seriousness. Where the breach is serious, the insurer may repudiate the policy (that is, treat the contract as terminated). Where it is minor, the remedy would be in damages only. In *Alfred McAlpine Plc v BAI (Run-Off)*,<sup>15</sup> it was suggested that a serious breach of a notification clause may lead to a rejection of the claim while a minor one may not. However, this has now been doubted,<sup>16</sup> and we discuss the issue further in Part 4.
- (5) *Mere terms*, breach of which gives rise to a claim for damages, but which do not affect the insurer's liability to pay claims.

2.14 The category a term falls into is a matter of construction for the courts. There are many statements within the cases that any ambiguity should be resolved in favour of the insured.<sup>17</sup> If the insurer wishes to treat a condition as a warranty or condition precedent, they must use clear words.<sup>18</sup> They should not escape liability unless terms are put before policyholders "in words admitting of no possible doubt".<sup>19</sup>

## **BASIS OF THE CONTRACT CLAUSES**

2.15 The problems with warranties are exacerbated by the use of "basis of the contract" clauses. This is a device whereby potential policyholders are asked to sign a clause at the bottom of the proposal form, declaring that they warrant the accuracy of all the answers they have given. The clause usually states that the answers "form the basis" of the contract. It is well established that such a clause may elevate the answers to contractual terms, even if the terms are not to be found in the policy itself.

<sup>14</sup> [1920] 3 KB 669. The case was approved in *Provincial Insurance v Morgan* [1933] AC 240. For further examples of cases where courts have rejected insurers' arguments that a term is a warranty and have instead declared it to be descriptive of the risk: see Part 4.

<sup>15</sup> [2000] 1 Lloyd's Rep 437.

<sup>16</sup> *Friends Provident Life and Pensions v Sirius International Insurance* [2005] 2 Lloyd's Rep 517; [2005] EWCA Civ 601.

<sup>17</sup> See the discussion in Part 4.

<sup>18</sup> *Provincial Insurance Company v Morgan* [1933] AC 240, per Lord Wright at p 255.

<sup>19</sup> As above, per Lord Russell, at p 250.

- 2.16 The use of basis of the contract clauses means that an insurer may avoid liability for an inaccurate answer, even if the answer was not material, and even if it was given innocently. For example, in *Dawson Ltd v Bonnin*,<sup>20</sup> the insured was asked where a lorry was garaged. They inadvertently gave the firm's place of business in central Glasgow, though the lorry was usually kept on the outskirts. This did not increase the risk in any way (and arguably decreased it). However, when the lorry was destroyed by fire, the insurers argued that the accuracy of the answer had been elevated to a warranty. Given the breach, the insurers were no longer liable. The House of Lords agreed (by a three to two majority) that even though the misrepresentation was immaterial, the insurers were not liable.
- 2.17 There has been widespread criticism of basis of the contract clauses. The 1980 report quoted judicial criticisms of such clauses dating from 1853.<sup>21</sup> In 1908, Lord Justice Moulton said he wished he could “adequately warn the public against such practices”.<sup>22</sup> In 1927, Lord Wrenbury described their use as “mean and contemptible”:

Here, upon purely technical grounds, [the insurers], having in point of fact not been deceived in any material particular, avail themselves of what seems to me the contemptible defence that although they have taken the premiums, they are protected from paying.<sup>23</sup>

- 2.18 Despite these criticisms, however, the use of basis of the contract clauses has been upheld as recently as 1996. In *Unipac (Scotland) Ltd v Aegon Insurance* the company answered two questions on the proposal form inaccurately.<sup>24</sup> They said they had been carrying on business for a year, while they had been incorporated for less than a year; and they said they were the sole occupiers of the premises, when they were not. Following a fire, the insurers refused to pay the claim. The policyholders brought an action arguing that they had not warranted the accuracy of the answers, only that they were true to the best of their knowledge and belief. In the absence of a specific warranty, the insurer could avoid liability on the basis of a misrepresentation only if it was material. The Court of Session rejected these arguments, stating that the words used were clear. The court stressed the importance of freedom of contract in ringing terms:

<sup>20</sup> [1922] 2 AC 413.

<sup>21</sup> para 7.2, referring to *Anderson v Fitzgerald* (1853) 4 HL Cases 484, 10 ER 551.

<sup>22</sup> *Joel v Law Union and Crown Insurance Co* [1908] 2 KB 863, at p 885.

<sup>23</sup> *Glicksman v Lancashire and General Assurance Co* [1927] AC 139 at pp 144-5. See also *Mackay v London General Insurance Co* [1935] Lloyd's Law Reports 201 and Lord Russell's comments in *Provincial Insurance v Morgan* [1933] AC 240 at p 250.

<sup>24</sup> 1996 SLT 1197.



We recognise that a consequence of holding that the declaration contains an express warranty of the truth of the answers to the questions in the proposal is that if there was an error in, for example, the postcode or telephone number of the proposer, the result would be that the defenders would be entitled to avoid the policy. That however is a consequence of the parties agreeing to an express warranty with the result that the defenders would have a right to avoid the policy if an answer was untrue whether or not the untrue item was material. We are not persuaded that that would be a ludicrous result. It is simply a consequence of what parties have agreed to by contract and parties are free to agree what they like.<sup>25</sup>

- 2.19 While it is true that parties are free to agree what they like, normally they must do so in the contractual document itself. “Basis of the contract” clauses form an exception to this normal rule.<sup>26</sup> Although in commercial policies the basis of the contract clause may often be referred to in the policy itself, this is not necessary under the current law.<sup>27</sup> Clarke comments that it is difficult to square basis of the contract clauses “with the notion underlying the parole evidence rule”, namely that a document such as a policy “which looks like the whole of the contract should be treated as the whole of the contract”.<sup>28</sup>

<sup>25</sup> as above, at p 1202.

<sup>26</sup> In Scotland, section 1 of the Contract (Scotland) Act 1997 now provides that where a document appears to comprise all the express terms of a contract, then unless the contrary is proved it shall be presumed that it does comprise all the express terms. Since this is merely a presumption it does not appear to preclude an insurer from arguing that a basis of the contract clause in a proposal constitutes an additional express term.

<sup>27</sup> Different rules apply to marine insurance, where we are told that basis of the contract clauses are rarely used. Under section 35(2) of the Marine Insurance Act 1906, “an express warranty must be included in, or written upon, the policy, or must be contained in some document incorporated by reference into the policy”. This means that the basis of the contract clause used in the *Unipac* case would not have been recognised in a marine insurance policy, as it was only printed on the proposal form and was not referred to in the policy itself. It seems anomalous that protection available to marine insured since 1906 should not be available to other policyholders.

<sup>28</sup> M Clarke, *The Law of Insurance Contracts* (4<sup>th</sup> ed 2002), para 20 –2A1, p 630.

## PART 3: THE LAW COMMISSION'S 1980 REPORT

- 3.1 In 1980 the English Law Commission produced a report on non-disclosure and breach of warranty which recommended major reforms to prevent the unreasonable use of warranties to deny claims.<sup>1</sup> In 2002, the British Insurance Law Association broadly endorsed the report's recommendations.<sup>2</sup> The 1980 report is the starting point of our present project. Below we summarise the problems the 1980 report identified, and describe the recommendations that it made.

### IDENTIFYING THE PROBLEMS

- 3.2 In 1980, the Law Commission set out four criticisms of the law of warranties and basis of the contract clauses:

- (1) It seems quite wrong that the insurer should be entitled to demand strict compliance with a warranty which is not material to the risk and to repudiate the policy for a breach of it.
- (2) Similarly it seems unjust that an insurer should be entitled to reject a claim for *any* breach of even a material warranty, no matter how irrelevant the breach may be to the loss.
- (3) Warranties are of such importance that policyholders should be able to refer to a written document in which they are contained.<sup>3</sup>
- (4) Basis of the contract clauses are "a major mischief" because they enable insurers to repudiate policies for inaccurate statements even though:
  - (a) they are not material to the risk, or
  - (b) the policyholder could not be reasonably expected to know the true facts, or to have the means of knowing them.<sup>4</sup>

<sup>1</sup> Insurance Law, Non-Disclosure and Breach of Warranty (1980) Law Com No 104.

<sup>2</sup> BILA, *Insurance Contract Law Reform: A report of the Sub-Committee* (2002).

<sup>3</sup> para 6.9.

<sup>4</sup> para 7.5.

## THE RECOMMENDATIONS

- 3.3 The 1980 report attempted to cure these defects by both procedural and substantive means. First, the Law Commission recommended procedural safeguards affecting how warranties may be created. These would have effectively abolished basis of the contract clauses and required insurers to provide policyholders with written documents containing any warranties they had given. Substantively, policyholders would have a right to have their claim paid if they could show that a breach of warranty was unconnected with the risk. They could do this by showing that it was immaterial to the risk, or immaterial to the particular risk that had occurred, or could not have increased the risk that a loss would occur in the way it did occur.
- 3.4 Below we look at each recommendation in more detail.

### Procedural safeguards

#### ***Basis of the contract clauses should be abolished***

- 3.5 The recommendation on “basis of contract” clauses was designed to prevent statements of fact within the proposal form from being converted into warranties. Clause 9 of the draft Bill applied to “any statements affirming or denying the existence of, or giving his opinion with respect to, any fact or state of affairs at any time past or present”. It provided that any such statement would not constitute a warranty if it were contained in a proposal form, or “made by reference to a provision in a proposal form”;<sup>5</sup> nor could it be converted into warranties by an incorporation clause within the contract itself.
- 3.6 The report states that the Commission did not “intend to ban specific undertakings by the insured as the existence of past or present facts”.<sup>6</sup> A specific fact could still constitute a warranty, provided it was in the policy itself. What insurers could not do was elevate the insured’s answers into warranties *en bloc*. In other words, if a particular fact were so crucial to cover that the entire existence of the policy depended on it, the insurer must say so specifically in the policy. For example, a policy may state that the insured warranted that a building was made of brick and slate. However, a policy term could not convert all the answers the insured had given on a proposal form into warranties. The Commission wanted to prevent minor inaccuracies (such as a wrong address or telephone number) from invalidating cover. Nor could an answer be given warranty status by a notice on the proposal form. The term had to be in the contract itself.

#### ***Insurers should provide written statements as soon as practicable***

- 3.7 This recommendation was set out in clause 8(2) of the draft Bill. It states that an insurer shall not be entitled to rely on a breach of warranty unless the insured was supplied with “a written statement of the provision which constitutes the warranty”. The statement must either be supplied at or before the time the contract was entered into, or “as soon thereafter as was practical in the circumstances of the case”.

<sup>5</sup> clause 9(1)(a).

<sup>6</sup> para 7.10.

- 3.8 The report explained that if an insured has completed a proposal form and given answers relating to the future, the insurer could comply with this obligation by giving the insured a copy of the completed form. Normally, the insured would do this at or before the contract was entered into. However, in some cases a warranty may be given and cover granted over the phone. Here the insurer should be required to confirm the warranty in writing as soon as practicable. This “may be done in a cover note, in a certificate of insurance, or even by letter”.<sup>7</sup>
- 3.9 It is clearly right that any promissory warranty should be brought to the insured’s attention as soon as possible. The problem with this provision, however, is that it could be complied with in a purely formalistic way. It does not ensure that the warranty is presented clearly or expressed in plain language. An insurer could comply with clause 8(2) even if they buried the warranty in a mass of small print.

### **Substantive safeguards**

#### ***The working paper test***

- 3.10 In its working paper the Law Commission had provisionally proposed a three-part test. For a term to be effective as a warranty, the insurer would have to show:
- (1) that it was material to the risk, in the sense that it would influence a prudent insurer in deciding whether to accept the risk and if so at what premium; and
  - (2) the type of loss that occurred fell within the commercial purpose of the warranty. For example, the commercial purpose of a warranty that a vehicle should be kept roadworthy is intended to relate to the risks that arise when the car is being driven. A breach should not affect liability if the car is stolen.

Once the insurer had established this, it would on the face of it be entitled to reject the claim. However, the insurer would still be liable to pay if the *policyholder* could prove:

- (3) that the breach could have had no possible connection with the actual loss that had occurred.
- 3.11 It was envisaged that this final test would place heavy onus on the policyholder. The working paper gave an example of a warranty in a fidelity policy that the insured employer would engage no one without first taking up satisfactory references. The employer failed to take up references on employee A, who stole the employer’s money. The paper argued that the insurer should “clearly be entitled to reject the claim, because the commercial purpose of the warranty was to guard against this very type of loss”. Furthermore, “it should not be open to the insured to resist this by seeking to show, for instance, that A would have produced satisfactory or forged references if he had been asked for any”. The court should not be invited to speculate on what might or might not have occurred. However, if the money were stolen by employee B, whose references were satisfactory, then the insured could show that there was no possible connection between the failure in relation to A and the actual loss.

<sup>7</sup> para 6.14.

### ***The test in the final report***

- 3.12 Following consultation, the Law Commission changed its approach. It was persuaded that insurers should not have to show that a warranty was material to the risk. Instead it should be assumed to be material unless the insured showed that it would not have influenced a prudent underwriter. Similarly, it was decided that the onus should be on the insured to show that the type of loss did not fall within the commercial purpose of the warranty.
- 3.13 This led to a convoluted approach. If a claim were rejected for breach of warranty, the policyholder would have a choice between three possible lines of attack. The draft Bill would allow the insured to challenge the decision on any one of the following grounds:
- (1) the warranty does not relate to a matter which is material.<sup>8</sup>
  - (2) the warranty was intended to safeguard against a risk of a description “which does not include the event which gave rise to the claim”;<sup>9</sup> or
  - (3) the breach of warranty could not have increased the risk that the event which gave rise to the claim would occur in the way in which it did in fact occur.<sup>10</sup>
- 3.14 It is likely that in practice most policyholders would focus on (3), showing that the breach could not have increased the risk that the loss would occur in the way it did in fact occur.
- 3.15 Finally, the report recommended that insurers should be able to rely on a breach of warranty to repudiate policies in the future. To do this, they would need to serve a written notice on the insured. But the notice would not affect past claims. The Law Commission argued that the issue of past claims and future repudiation should be treated separately. An insurer should be able to pay past claims and repudiate the policy for the future; it should also be entitled to reject claims, without repudiating in the future.

### **WHY JUST WARRANTIES? A PROBLEM WITH THE 1980 REPORT**

- 3.16 There is a problem with the recommendations and draft bill in the 1980 report. The defence available to a policyholder only applies if the term is classified as a warranty. If a term is merely descriptive of the risk, the policyholder may no longer argue that the breach did not increase the loss. Yet policyholders’ breach of such terms may also invalidate claims, even though there is no causal connection between the breach and the loss. Birds and Hird suggest that the fact the 1980 recommendations were limited to warranties in the strict sense was a major difficulty with the report. Its recommendations “might have been easily evaded by insurers resorting to the use” of other conditions and exceptions.<sup>11</sup>

<sup>8</sup> Draft Bill, clause 8(1).

<sup>9</sup> Draft Bill, clause 10(5)(a).

<sup>10</sup> Draft Bill, clause 10(5)(b).

<sup>11</sup> J Birds and NJ Hird, *Birds Modern Insurance Law* (6<sup>th</sup> ed 2004) p 166, note 36.

3.17 One example is where motor insurance is written on the basis that the vehicle will be used for one purpose and it is used for another purpose. A clause stating that a car is “insured only for private use” is usually construed as being “descriptive of the risk”, following the *Farr* case. In other words, insurance cover is suspended when the car is being used for other purposes, but revives once the car is again used for private purposes. The consequences are not as severe as for breach of warranty, where a single episode of commercial use would discharge the insurer from all further liability. However, it is possible for a claim to be denied even though the policyholder could prove that the breach could not have increased the risk that the loss would occur in the way it did in fact occur.

3.18 This point was established in 1927 in *Roberts v Anglo-Saxon Insurance Ltd.*<sup>12</sup> A car was said to be “warranted for commercial travelling”, but suffered a fire while being used for another purpose. The arbitrator held that the insurer was nevertheless liable to pay the claim because the change of use did not in any way contribute to the fire or to the loss. Bankes LJ said this was a clear error of law:

It is perfectly obvious that this is an error on the face of the award, because it is quite immaterial whether or not the fact that the car was being used in this way was or was not “a contributory cause of the fire or the actual cause or loss of the motor vehicle by the fire”.<sup>13</sup>

3.19 In *Murray v Scottish Automobile*, the car was insured for private use but was actually used as a taxi.<sup>14</sup> It was damaged by fire while parked overnight in a garage. Again, the Court of Session held that the “private use” term was descriptive of the risk. Nevertheless, the insurer was not liable to pay the claim. Lord Sands stated that the time the car was parked in the garage “must be attributed to one use or the other”. It was best seen as ancillary to the use to which the car has been put during the day. On this logic, the car was still being used as taxi when parked overnight, and the insurer was not liable to pay the claim.

3.20 This raises questions about how *Murray* would be decided if the 1980 report were to be implemented. If the term were to be construed as a warranty, then the policyholder could argue that the fire had nothing to do with the fact that the car had been used as a taxi during the day. If they succeeded, the insurer would be liable to meet the claim. However, if the term were merely descriptive of the risk, then the 1980 draft Bill would not apply. The insurer could successfully argue that the loss was outside the scope of the cover, as properly defined. This seems unduly formalistic. The *Murray* case raises difficult policy issues, which we discuss in Part 7. Whichever result is right, however, the same answer should apply to both warranties and descriptions of the risk. It should not depend on formalities about how the term has been written.

<sup>12</sup> (1927) LI L Rep 313.

<sup>13</sup> As above, at p 314.

<sup>14</sup> 1929 SLT 114.

- 3.21 A more recent example is *Seddon v Binions*.<sup>15</sup> Here a father was insured to drive for “social domestic and pleasure purposes”. He occasionally helped his son out with the son’s carpet laying business, although he did not get paid for it. One Sunday, the father, son and the son’s employee were laying a carpet, when the son’s employee suffered a toothache. The father drove the employee to the dentist in his son’s car and suffered a serious accident. The Court of Appeal held that the essential character of that journey was that the father was using the son’s car for a business purpose. The father’s insurance did not apply to the journey that had taken place, and the insurers were not liable to meet the claim.
- 3.22 In *Seddon*, the dispute was between two insurers. The son’s car was insured with a different company, who met the cost of the accident. If the policyholder had stood to suffer a large loss, the Court might have interpreted the facts in a more sympathetic light. However, the essential problem remains. Even a very minor and technical breach may take a loss outside the description of the risk. It cannot be right to apply one set of protections to warranties and a lesser set to exceptions.
- 3.23 The issue is not simply confined to use clauses. There are many other examples. It is common for motor insurance policies to state that a vehicle should not be driven in an unroadworthy condition. This may be written as descriptive of the risk, to say the insurer is not liable while the vehicle is being driven in an unroadworthy condition. Alternatively, it may be written as a warranty, that “the insured shall take all reasonable steps to maintain the vehicle in a roadworthy condition”.<sup>16</sup> There are cases where a car is in an unroadworthy condition, but the defect does not cause an accident. In *Conn v Westminster Motor Insurance*,<sup>17</sup> for example, a taxi was driven with worn tyres, but Lord Justice Salmon commented,
- If one thing is plain in this case it is that whatever did cause this accident, it had nothing to do with the dangerous and inefficient condition of the tyres.<sup>18</sup>
- 3.24 However, the insurer still escaped liability. In *Conn* it did not matter if the term was a warranty or an exception. As the defect was current at the time of the accident, the insurer was not liable. It would not make any sense to permit an insured to argue lack of causal connection in the case of warranties, but not in the case of exceptions.

<sup>15</sup> [1978] 1 Lloyd’s Rep 381.

<sup>16</sup> See the discussion in M. Clarke, *The Law of Insurance Contracts* (4<sup>th</sup> ed 2002), para 19.2D pp 594-6.

<sup>17</sup> [1966] 1 Lloyd’s Rep 407.

<sup>18</sup> as above, at p 414.

- 3.25 That said, if one extended the protections in the 1980 report to all exceptions that define the risk, the impact on the insurance industry could be considerable. Take for example, a standard exception in a fire policy, that the property is not covered if it is left unoccupied for more than 30 days. The risk of vandalism or arson is clearly increased if a property is left unoccupied; and there is a greater risk that a fire might spread. But many fires will not be related to the fact the property is unoccupied: suppose, at an extreme, that the fire is caused by an aeroplane crashing onto the premises.
- 3.26 The fact that the line between warranties and descriptions of the risk is so narrow has several implications for this area of law. On the one hand, it allows the courts to avoid the harsh effects of warranties by reclassifying terms as descriptions of the risk (a point we return to in Part 4). On the other hand, it would allow insurers to escape the effect of any reforms that were limited only to warranties (which we discuss in Part 7). The Unfair Terms in Consumer Contract Regulations (discussed in Part 4) may offer a partial solution, in that they permit a court to find that an unclear and unfair exclusion has no effect. However, they only apply to consumer insurance. Furthermore (as we discuss later) there is some uncertainty about the way the regulations apply to descriptions of the risk in insurance contracts.



## PART 4: ARE WARRANTIES STILL A PROBLEM? ALTERNATIVE METHODS OF PROTECTION

- 4.1 One argument against reform is that warranties are no longer a problem in practice. It has been suggested that any potential difficulties with the law can be dealt with by the courts as a matter of construction.
- 4.2 As far as consumers are concerned, three further types of protection are available:
- (1) voluntary statements of practice and Financial Services Authority (FSA) rules;
  - (2) an assessment of fairness under the Unfair Terms in Consumer Contracts Regulations 1999; and
  - (3) the Financial Ombudsman Service (FOS).
- 4.3 Below we outline the protections provided by each of these approaches, and consider how far they remove or change the need to reform the law of warranties.

### THE CONSTRUCTION APPROACH

- 4.4 As mentioned in Part 2, it is well-established that warranties should be construed strictly, against the party who has put them forward<sup>1</sup> (in practice, usually the insurer<sup>2</sup>). This common law rule is now supplemented in consumer insurance by the Unfair Terms in Consumer Contracts Regulations, which state that “if there is a doubt about the meaning of a written term, the interpretation which is most favourable to the consumer shall prevail”.<sup>3</sup>
- 4.5 The normal remedy against an insurer’s unreasonable use of a warranty is for the court to hold that the term is not truly a warranty, but something else (such as a clause descriptive of the risk) or that the term does not cover the issue in hand. Over the years, the courts have found several ways to attack the unreasonable use of warranties and these methods are used extensively in commercial cases.

<sup>1</sup> *Provincial Insurance Company v Morgan* [1933] AC 240.

<sup>2</sup> In some cases, the ambiguous wording may have been put forward by the insured's broker. Where this happens, it does not necessarily follow that the term should be construed against the insured, as the insurer may be partially at fault in not correcting ambiguous wording (see B Soyer, *Warranties in Marine Insurance* (2<sup>nd</sup> ed, 2006), at p 22). Soyer cites Coleman J's comment in *Zeus Tradition Marine Ltd v Bell* (“*The Zeus V*”) [1999] 1 Lloyd's Rep 703 at p 718, although the decision was reversed by the Court of Appeal on other grounds (see [2000] 2 Lloyd's Rep 587).

<sup>3</sup> SI 1999 No 2083, reg 7(2).

- (1) **The warranty applies only to past or present facts, and not to the future.**<sup>4</sup> For example, in *Hussain v Brown*, the insured had signed a proposal form to say that their premises were fitted with an intruder alarm.<sup>5</sup> This was said to be the basis of the contract. The statement was true at the time of the contract, though the firm later failed to pay the charges and the alarm service was suspended. The Court of Appeal held that the statement on the proposal form related only to present facts and did not make any promises about the future. Any continuing warranty would be a “draconian term” and “if underwriters want such protection then it is up to them to stipulate for it in clear terms”.<sup>6</sup>
- (2) **The warranty is relevant to only some sections of the policy.** For example, in *Printpak v AGF Insurance Ltd*, the insured had taken out a “commercial inclusive” policy, which covered a range of risks, including fire and theft.<sup>7</sup> The theft section included a warranty that the insured would maintain a burglar alarm. Meanwhile Condition 5 stated that a failure to comply with any warranty would invalidate any claim. The insured suffered a fire while the alarm was not working. The Court of Appeal held that the policy was not a seamless document, but instead consisted of separate schedules, each concerned with a different type of risk. Despite the wording of Condition 5, the alarm warranty only applied to the theft risk and not the fire risk.
- (3) **The clause is not a true warranty but merely descriptive of the risk.**<sup>8</sup> As we have seen, in *Farr v Motor Traders Mutual Insurance*, the Court of Appeal rejected the insurer’s argument that a statement that taxis were to be driven for only one shift a day was a warranty.<sup>9</sup> Instead, the statement described the risk. Cover was suspended while the taxi was used for two shifts a day; and once the owner resumed one shift the insurer became liable again.

<sup>4</sup> *Woolfall & Rimmer v Moyle* [1942] 1 KB 66; *Kennedy v Smith* 1976 SLT 110; *Hair v Prudential Assurance Co Ltd* [1983] 2 Lloyd’s Rep 667.

<sup>5</sup> [1996] 1 Lloyd’s Rep 627.

<sup>6</sup> per Saville LJ at p 630.

<sup>7</sup> [1999] Lloyd’s Rep IR 542.

<sup>8</sup> See, for example, *Kler Knitwear Ltd v Lombard General Insurance Co Ltd* [2000] Lloyd’s Rep IR 47.

<sup>9</sup> [1920] 3 KB 669. See also *Roberts v Anglo-Saxon Insurance Ltd* (1926) 26 Ll L Rep 154; and *CTN Cash & Carry Ltd v General Accident* [1989] 1 Lloyd’s Rep 299.

- (4) **The wording of the warranty does not apply to the facts in question.** The leading case is *Provincial Insurance Co v Morgan*.<sup>10</sup> Here coal merchants declared that their lorry would be used for coal, which became the basis of the contract. On the day of the accident, the lorry was also used to carry Forestry Commission timber. However, at the time, the timber had been unloaded and only coal was on-board. The House of Lords held an endorsement on the policy stating that the use was “transportation of own goods in connection with the insured’s own business” did not mean that the vehicle was to be used *exclusively* for the insured’s own goods. On “a strict but reasonable construction” the declaration and the clause only meant that transporting coal was to be the normal use. Transporting other goods would not terminate liability under the policy.<sup>11</sup>

#### **How far can construction be used to remove unfairness? *Kler Knitwear***

- 4.6 A difficult question is whether the courts should be prepared to disregard the clear language of the policy in order to achieve justice between the parties. *Kler Knitwear v Lombard General Insurance Co* is an example of a case where the judge arguably went beyond merely resolving ambiguity in order to protect the policyholder from an unfair outcome.<sup>12</sup> Here the policyholders had agreed that their sprinkler system would be inspected 30 days after renewal. In fact, the inspection was about 60 days late and showed that the system was working. The factory later suffered storm damage (which was wholly unconnected with the sprinklers). Mr Justice Morland accepted in principle that if on a proper construction of the clause, the parties intended it to be a warranty then the Court “must uphold that intention” however harsh and unfair the consequences. However, this particular clause was merely “a suspensive condition”, limiting the risk.
- 4.7 The surprising thing about *Kler Knitwear* was that the term was clearly stated to be a warranty and the policy later went on to spell out the consequences, namely that non-compliance would bar any claim, “whether it increases the risk or not”. Birds and Hird comment that

It is difficult to see how the insurer could have stipulated this in any clearer terms. The term itself was called a warranty and was drafted in clear and intelligible language and the consequences of non-compliance were spelled out.<sup>13</sup>

<sup>10</sup> [1933] AC 240.

<sup>11</sup> See also *English v Western* [1940] 2 KB 156; and *Houghton v Trafalgar Insurance Co Ltd* [1954] 1QB 247;

<sup>12</sup> [2000] Lloyd’s Rep IR 47.

<sup>13</sup> J Birds and NJ Hird, *Birds Modern Insurance Law* (6<sup>th</sup> ed 2004) p 161.

- 4.8 In *Kler Knitwear*, the judge would appear to be going further than merely resolving an ambiguity in contractual drafting in favour of the insured. Instead he is replacing a consequence that “would be utterly absurd and make no business sense”<sup>14</sup> with one that is fairer to the insured.
- 4.9 Cases such as *Kler Knitwear* provide a partial solution to the problem of warranties. We have been told that the courts’ approach to construction discourages insurers from taking purely technical points or attempting to use warranties in a wholly unreasonable way. However, it does so at the cost of introducing uncertainty and confusion into the law. As each clause must be interpreted on its own wording, it encourages similar issues to be litigated repeatedly. And in some cases, the reasoning required to produce a fair result is convoluted to the point of incomprehensibility.<sup>15</sup>

#### **The problem of notification clauses: the rise and fall of innominate terms**

- 4.10 The difficulties associated with “the construction approach” can be illustrated by looking at the way the English courts have approached a different sort of term – namely notification clauses. These have caused particular problems in insurance contracts. In some cases it may be wholly reasonable to make prompt notification a condition precedent to the insurers’ liability. In other cases, it may be disproportionate to deprive the policyholder of their entire claim simply because of a minor delay that caused the insurer no real prejudice.
- 4.11 In *Alfred McAlpine Plc v BAI (Run-Off)*,<sup>16</sup> Lord Justice Waller attempted to deal with this problem by developing the concept of “innominate terms”. He applied the principles set out in the *Hongkong Fir* case,<sup>17</sup> to say for some terms the consequences of a breach may depend on its seriousness. Some breaches may be so serious that they would entitle the insurer to repudiate the claim, while “minor failures” would result in damages only.<sup>18</sup> In the *BAI* case, the insurer remained liable to pay the claim as it had not been prejudiced by a late notification, which amounted to only a minor breach of the condition. However, if the insurer has suffered real prejudice because, for example, it has been prevented from preparing a defence to a liability claim, then it would cease to be liable to pay the claim.

<sup>14</sup> [2000] Lloyd’s Rep IR 47 at p48

<sup>15</sup> This criticism has been levelled particularly at the Supreme Court of Canada decision, *The Bamcell II*, cited in *Kler Knitwear*, and discussed in Part 6. Soyer comments that since the *Bamcell II*, “the legal status of certain clause in marine insurance policies has now become more problematic” as “a weapon has been given to the assured to challenge the warranty status of certain clauses” (p 205).

<sup>16</sup> [2000] 1 Lloyd’s Rep 437.

<sup>17</sup> *Hongkong Fir Shipping Co. Ltd. v. Kawasaki Kisen Kaisha Ltd* [1962] 2 QB 26.

<sup>18</sup> See *Alfred McAlpine Plc v BAI (Run-Off)* [2000] 1 Lloyd’s Rep 437. Here the Court of Appeal applied the general contractual principles set out in *Hongkong Fir Shipping* [1962] 2 QB 26 to say that a claims condition was not a condition precedent but an innominate term. The insurer remained liable to pay the claim as it had not been prejudiced by a late notification, which amounted to only a minor breach of the condition.

- 4.12 The “innominate term” classification was welcomed as providing greater flexibility in the remedies available.<sup>19</sup> However, a recent Court of Appeal judgment, *Friends Provident Life and Pensions v Sirius International Insurance*, has cast doubt on the reasoning in the BAI case.<sup>20</sup>
- 4.13 In *Friends Provident*, the insured had failed to notify the excess layer underwriters that a potential claim for pensions mis-selling may exceed the amount insured under the primary layer. This was a breach of Clause 5 of the policy. Clause 5 was not worded as a condition precedent; nor did it suggest that a breach would absolve the insurers from liability for the claim. However, the insurers argued that it was an “innominate term”. The breach should be regarded as sufficiently serious to absolve the insurers from liability to meet the claim.
- 4.14 Lord Justice Mance disagreed. He pointed out that breach of an innominate term would only entitle an insurer to repudiate the contract as a whole; it would not entitle an insurer to merely reject one specific claim. And it “was not easy to conceive” that a breach of an ancillary term could be fundamental to the contract as a whole. The argument that a serious breach of a notice clause would discharge an insurer from liability to pay that particular claim would introduce a new doctrine of “partial repudiatory breach”. No such doctrine existed and there was no reason to introduce it.
- 4.15 Lord Justice Mance argued that if the insurers had intended Clause 5 to operate as a condition precedent to liability for a particular claim, they should have worded it in those terms. As they had not done so, their remedy lay in damages only. Where insurers failed to draft notification clauses as conditions precedent, they did not require additional protection:

English law is strict enough as it is in insurers’ favour. I see no reason to make it stricter.<sup>21</sup>

Sir William Aldous agreed, though Lord Justice Waller dissented

- 4.16 It is true that if insurers do not draft clauses as conditions precedent to liability, then the decision that their remedy lies in damages only favours policyholders. The problem, however, is that the *Friends Provident* decision will encourage insurers to draft every ancillary provision as a condition precedent. And if the term is clearly a condition precedent, the courts will be required to interpret it as such, however minor and unimportant the breach. This could import an untoward element of technicality and rigidity into the law, whereby claims are denied for minor breaches by policyholders that cause no real prejudice to insurers.
- 4.17 Although the case law on notification clauses is not directly applicable to warranties, these cases illustrate some of the weaknesses of the construction approach. First, the law is uncertain, and is likely to cause further litigation. Secondly, each case depends on the particular words used. Insurers are likely to respond to unfavourable decisions by attempting to achieve the desired effect with different words.

<sup>19</sup> Macgillivray 10-13.

<sup>20</sup> [2005] 2 Lloyd’s Rep 517; [2005] EWCA Civ 601.

<sup>21</sup> Above, at para 33.

### **The construction approach: conclusion**

- 4.18 Courts' willingness to construe warranties against the interests of insurers provides a partial solution to the unfairness inherent in the existing law. It does so at the cost of adding complexity and uncertainty to the law. We anticipate repeated litigation over both warranties and notification clauses.
- 4.19 Furthermore, there are still harsh decisions that cause injustice to policyholders. In *Unipac (Scotland) Ltd v Aegon Insurance*, for example, the Court of Session upheld a basis of the contract clause which converted all the statements in the proposal form into warranties.<sup>22</sup> We do not think that courts' willingness to construe clauses against the interests of insurers removes the need for reform.

### **THE ABI STATEMENTS OF PRACTICE AND FSA RULES**

- 4.20 Insurance companies have long argued that the defects in the present law can be remedied through voluntary action. In 1977 the Association of British Insurers agreed to two statements of practice: one for general insurance and one for life. The 1980 report explained that the statements were the result of concern about the decision to exclude insurance from the Unfair Contract Terms Act 1977, and were designed to reassure consumers that they would not be dealt with unfairly.<sup>23</sup> The statements covered both warranties and "basis of the contract" clauses. Below we look at each issue in turn. We then consider the FSA's more general initiative to encourage insurers to treat their customers fairly.

#### **Provisions on warranties**

##### ***Statements of Practice***

- 4.21 The 1977 Statement of General Insurance Practice (SGIP) dealt with the perceived problems with warranties by stating that:

Except where fraud, deception or negligence is involved, an insurer will not unreasonably repudiate liability to indemnify a policyholder...

on grounds of a breach of warranty or condition, where the circumstances of the loss are unconnected with the breach.<sup>24</sup>

- 4.22 The references to deception or negligence were later removed, so as to confine the right to repudiate only where fraud is involved. The 1986 version of SGIP read:

An insurer will not repudiate liability to indemnify a policyholder

on the grounds of a breach of warranty or condition where the circumstances of the loss are unconnected with the breach unless fraud is involved.<sup>25</sup>

<sup>22</sup> 1996 SLT 1197.

<sup>23</sup> para 3.23

<sup>24</sup> Clause 2(b)(ii).

<sup>25</sup> Clause 2(b)(iii).

- 4.23 The 1977 Statement of Long-Term Insurance Practice (SLIP) did not specifically refer to warranties at all, and merely said that “an insurer would not unreasonably reject a claim”. However, in 1986 SLIP was revised, to be similar to SGIP.<sup>26</sup>
- 4.24 In 1980 we made three criticisms of the 1977 Statements:
- (1) The statements only covered private (that is, consumer) insurance, while the problems covered both consumers and businesses.<sup>27</sup>
  - (2) The provision in effect conferred “a discretion on insurers to repudiate a policy on technical grounds if they suspect fraud but are unable to prove it”.<sup>28</sup>
  - (3) The statements lacked the force of law “so that an insured would have no legal remedy if an insurer fails to act in accordance with them”.
- 4.25 We concluded that far from being an argument against reform, the statements were “evidence that the law is unsatisfactory and needs to be changed”.

### ***FSA rules***

- 4.26 The Statement of General Insurance Practice has now been abolished and replaced by ICOB 7.3.6. For long-term insurance, SLIP has been supplemented by COB 8A.2.6. ICOB Rule 7.3.6 states that insurers may not:

except where there is evidence of fraud, refuse to meet a claim made by a retail customer on the grounds:

(c) in the case of a general insurance contract, of breach of warranty or condition, unless the circumstances of the claim are connected with the breach.

- 4.27 COB 8A.2.6 is in similar terms, except that it only applies to breaches of warranty and not conditions. It goes on to state that the warranty must be “material to the risk” and must be “drawn to the attention of the policyholder before the conclusion of the contract”.
- 4.28 These provisions replicate the difficulties identified with the 1977 Statement. First they only cover retail (that is, consumer) insurance. Secondly, they continue to permit insurers to repudiate claims where they suspect but cannot prove fraud: although the insurer must show some evidence of fraud it does not have to be conclusive evidence.

<sup>26</sup> Clause 3(b) states that

Except where fraud is involved, an insurer will not reject a claim or invalidate a policy on grounds of breach of a warranty unless the circumstances of the claim are connected with the breach ...

It then goes on to deal with basis of the contract clauses by stating that these are permitted for “life of another” policies (provided they are material and within the knowledge of the proposer). Warranties for own life policies must relate to specific matters material to the risk and must be drawn to the proposer’s attention at or before the making of the contract.

<sup>27</sup> para 3.29.

<sup>28</sup> para 6.10.

- 4.29 Thirdly, the rules fail to give an insured a normal legal remedy if the insurer does not act in accordance with the rules. It is true that in the case of widespread breach, the FSA may bring disciplinary action against the insurer, leading to fines or (ultimately) withdrawal of authorisation. However, the issue is more likely to arise in the context of an individual claim. Individuals may have a remedy under section 150(1) of the Financial Services and Markets 2000, which states that

A contravention by an authorised person of a rule is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.

- 4.30 This would suggest that if the matter were to be raised before a court, the court would have to find for the insurer on the basis of the strict law. Then (in the same or separate proceedings) the consumer could claim damages on the ground that the point should not have been taken.
- 4.31 This is a solution of a kind but we wonder whether in practice any consumer would claim damages for breach of statutory duty because of the costs involved. In addition, the result is that the law is at best hard to understand and arguably is incoherent. The COB and ICOB rules are difficult to reconcile with the decision in *The Good Luck*, that following a breach of warranty, the insurer need not take steps to repudiate a policy but is instead automatically discharged from liability.<sup>29</sup> It would appear that an insurer may breach an FSA rule by doing no more than refusing to meet a claim for which they are not liable. This overlap of law and regulation is neither clear nor simple, and has the potential to bring the law into disrepute. We do not think that FSA rules remove the need for reform. Rather, like the statements, they appear to be evidence that the law is unsatisfactory and needs to be changed.

#### **Provisions on “basis of the contract” clauses**

- 4.32 This issue was not directly addressed in the 1977 statement. However, the 1986 SGIP effectively outlawed their use. Clause 1(b) said:

Neither the proposal form nor the policy shall contain any provision converting the statement as to past or present fact in the proposal form into warranties. But insurers may require specific warranties about matters which are material to the risk.<sup>30</sup>

- 4.33 In other words, insurers agreed that they would no longer put provisions on proposal forms that automatically converted the answers given into warranties. If they wished to include warranties in the contract, they would have to be specific and material to the risk.

<sup>29</sup> *Bank of Nova Scotia v Hellenic Mutual War Risks (“The Good Luck”)* [1992] 1 AC 233.

<sup>30</sup> Clause 1(b).



4.34 The Long-Term Statement, however, took a less robust approach. It made an exception where the policyholder took out a policy on the life of someone else (so called “life of another” policies). Here insurers could ask general questions about the life to be assured and convert them en masse into warranties. However, insurers undertook not to reject a claim on the basis of a misrepresentation unless the statement was both material and within the knowledge of the proposer. As the law allows insurers to avoid policies for material misrepresentations in any event, it is not clear exactly what life insurers gain by turning proposal form answers into warranties in these circumstances. Presumably, it removes the need to show that a particular statement induced them to enter into the contract: it would be enough that the statement would be material to a prudent underwriter.

4.35 In 2004, when SGIP was replaced by ICOB, the prohibition on basis of the contract clauses was removed. Rule 7 does not include any provisions relating to basis of the contract clauses. We have not been able to find any justification for this change at the time it was made. However, the ABI has since told us that they believe that use of such clauses would be prevented by the general principle that insurers should treat their customers fairly (see below). They therefore believe that specific provisions are unnecessary.

#### **Treating customers fairly**

4.36 The FSA publishes 11 high level “Principles for Business”, to be found in the PRIN sourcebook. They are part of a move away from prescriptive rules to principles-based regulation. Principle 6 states that:

A firm must pay due regard to the interests of its customers and treat them fairly.

As part of an FSA initiative, insurers are required to demonstrate that they are building the principle of treating customers fairly into all that they do.<sup>31</sup>

4.37 In July 2006, the FSA published the General Insurance Cluster report, highlighting examples of good and bad practice in this area. One example given of poor practice was that:

Some insurers refuse claims for unconnected breaches (eg not paying out on a claim related to an escape of water due to an alarm breach).<sup>32</sup>

<sup>31</sup> See FSA, General Insurance Newsletter, Issue No 10, September 2006.

<sup>32</sup> FSA, *General Insurance and Pure Protection Products: Treating Customers Fairly*, July 2006, p 18.

- 4.38 The FSA was particularly keen to improve the quality of information insurers give customers. They point out that although firms are required to make significant and unusual exclusions clear to their customers, they do not always do so, “but at times overwhelm them with information so they are unable to pick out the key messages”.<sup>33</sup> However, there are many examples of good practice in this area, where for example, home insurers make it clear “exactly what is expected of customers under a policy if they have a burglar alarm or other home security device”.<sup>34</sup>

#### **UNFAIR TERMS IN CONSUMER CONTRACTS: THE 1993 DIRECTIVE AND 1999 REGULATIONS**

- 4.39 A major change since the 1980 report is that unfair terms in consumer insurance may now be subject to review. Although insurance contracts generally are not subject to the Unfair Contract Terms Act 1977, consumer insurance is covered by the EU Directive on Unfair Terms in Consumer Contracts,<sup>35</sup> and the implementing Unfair Terms in Consumer Contract Regulations.<sup>36</sup> Unfortunately the impact of the Regulations on insurance contracts, and in particular on warranties, is complex. A detailed explanation is needed.

#### **Which terms may be reviewed?**

- 4.40 The Directive allows a court to review the fairness of all non-negotiated terms in a consumer contract, except for core terms. These are defined in Article 4(2):

Assessment of the unfair nature of the terms shall relate neither to the definition of the main subject matter of the contract nor to the adequacy of the price and remuneration, on the one hand, as against the services or goods supplied in exchange, on the other, in so far as these terms are in plain intelligible language.

- 4.41 This somewhat cumbersome sentence is re-written in Regulation 6(2):

In so far as it is in plain intelligible language, the assessment of fairness of a term shall not relate to

(a) the definition of the main subject matter of the contract, or

(b) to the adequacy of the price or remuneration, as against the goods or services supplied in exchange.

<sup>33</sup> As above, p 11.

<sup>34</sup> As above, p 14.

<sup>35</sup> Council Directive 93/13/EEC of 5 April 1993.

<sup>36</sup> The Directive was first implemented in the Unfair Terms in Consumer Contract Regulations 1994, which were later replaced by the Unfair Terms in Consumer Contract Regulations 1999.

4.42 In *Director General of Fair Trading v First National Bank Plc*, the House of Lords explained that the core terms provisions should be interpreted narrowly.<sup>37</sup> As Lord Bingham put it, the object of the Regulations and Directive “would plainly be frustrated” if the definition of core terms were “so broadly interpreted as to cover any terms other than those falling squarely within it”.<sup>38</sup> Lord Steyn confirmed that the provision must be given a restrictive interpretation, or “the main purpose of the scheme would be frustrated by endless formalistic arguments about whether a provision is a definitional or an exclusionary provision”.<sup>39</sup>

4.43 There has been some debate about how far these provisions apply to insurance contracts. The insurance industry has long opposed the idea that such terms should be subject to judicial review, and was very concerned at the possible impact of the Directive. To assuage their fears, the Directive included the following words in Recital 19:

For the purposes of this Directive, assessment of unfair character shall not be made of terms which describe the main subject matter of the contract nor the quality/price ratio of the goods or services supplied.... It follows, inter alia, that in insurance contracts, the terms which clearly define or circumscribe the insured risk and the insurer's liability shall not be subject to such assessment since these restrictions are taken into account in calculating the premium paid by the consumer.

4.44 This has been taken to mean that any terms which “clearly define or circumscribe the insured risk” are core terms within the meaning of the Directive and Regulations, and therefore exempt from review. We examine this argument in more detail below. To make the discussion easier to follow, we deal first with exceptions and then with warranties.

## **Exceptions and UTCCR**

### ***Are exceptions “price” terms?***

4.45 The words in Recital 19 do not mean that an exception within an insurance contract “relates to the adequacy of the price”. An insurer may well take such exceptions into account in calculating the price, but this could be true of any term within the contract. As Lord Steyn put it in *First National Bank*:

After all, in a broad sense all terms of the contract are in some way related to the price or remuneration. That is not what is intended.<sup>40</sup>

<sup>37</sup> [2002] 1 AC 481.

<sup>38</sup> Above, at para 12.

<sup>39</sup> Above, at para 34.

<sup>40</sup> As above.

- 4.46 *First National Bank* itself was about the terms of a loan. Clearly, the interest rate itself was the price (and not subject to review) but a clause stating that the same rate was payable on default was merely incidental to the substance of the bargain. The House of Lords held it was subject to review. A price escalation clause would also be subject to review “or there would be a gaping whole in the system”<sup>41</sup> (even if, presumably, the supplier had taken account of the presence of such escalation clause in calculating the initial price).

***Do exceptions “define the main subject matter of the contract”?***

- 4.47 Although an exception to the cover is not a price term, there is a strong argument that it does define the main subject matter of the contract. Clearly, the main subject matter of an insurance contract is the cover the policyholder receives. MacGillivray considers that the exemption extends to terms which describe the perils insured against and specify the measure of indemnity afforded by the cover, but not to procedural requirements to give notice of claims.<sup>42</sup> Birds and Hird also argue that the definition of the main subject matter should be taken to include both “the risks covered and excepted”. They point out that the Regulations must be read subject to Recital 19, which refers to terms which “clearly define or circumscribe the insurer’s liability”.<sup>43</sup>
- 4.48 This was the view taken by Mr Justice Buckley in *Bankers Insurance Co v South*.<sup>44</sup> A holiday-maker had taken out a travel insurance policy which exempted “compensation or other costs arising from accidents involving ... possession of any ... motorised waterborne craft”. Whilst riding a jet ski he had been involved in an accident which seriously injured another jet skier. The victim then attempted to argue, first, that the exemption did not apply to jet skis. Secondly, if it did, it was an unfair term within the meaning of the regulations. Buckley J held that the term was in plain intelligible language and therefore exempt from scrutiny.<sup>45</sup> Unfortunately for our purposes, he did not develop this point. The judge also said that in any event he could see nothing unfair in the term. It was available to the holiday-maker, and he could have read it if he had wished. He also pointed out that the insurance was relatively cheap.<sup>46</sup>
- 4.49 We accept that an exception to cover may be taken as defining the cover: for example, a clause that states cover is limited to roadworthy vehicles has the potential to be a core term. However, it does not follow that all exceptions are exempt from review as being core terms. There are two restrictions. First, the definition of the main subject matter of the contract is only exempt from review “so far as it is in plain intelligible language”. Secondly, a term cannot be “the definition of the main subject matter of the contract” if it is substantially different to what the consumer reasonably expected.
- 4.50 We take these points in turn in the paragraphs that follow.

<sup>41</sup> per Lord Steyn, above.

<sup>42</sup> MacGillivray on Insurance Law (10<sup>th</sup> ed 2003) para 11-36, p 294 and para 10-91, p 261.

<sup>43</sup> J Birds and NJ Hird, *Birds Modern Insurance Law* (6<sup>th</sup> ed 2004) p 208, note 24.

<sup>44</sup> [2004] Lloyd’s Rep IR 2, [2003] EWHC 380.

<sup>45</sup> at para 24.

<sup>46</sup> at para 24.

***Does an exception have to be in plain language?***

- 4.51 The exclusion from review only applies to core terms “in so far as these terms are in plain intelligible language”. If an exclusion is not clearly worded, it will not be treated as a core term, and will be subject to review for fairness. As MacGillivray states, “failure to word a core term of the insurance clearly will result in it losing its exemption from assessment for fairness”.<sup>47</sup>
- 4.52 This requirement of the Directive is not universally accepted. Clarke, for example, includes a footnote in which he refers to the argument that “if core terms are not plain and intelligible they shall be assessed for fairness”. He describes this result as “startling”, “new” and having “no basis in the Directive”. He refers to the opening words in Recital 19, that “assessment of unfair character shall not be made of terms which describe the main subject matter of the contract”. He points out that this opening phrase is “unqualified”, and does not state that the term must be in plain intelligible language.<sup>48</sup> We do not think this view is correct. Recital 19 must be subject to the clear words of Article 4(2), which states that the exemption from assessment only applies “in so far as these terms are in plain intelligible language”. Furthermore Recital 19 itself is confined to terms which “clearly define or circumscribe the insured risk”.

***Exceptions that are substantially different from what the consumer reasonably expects***

- 4.53 Recital 20 suggests that the requirement is not just one of plain language. It says that contracts should not only be drafted in plain, intelligible language but also that “the consumer should actually be given an opportunity to examine all the terms”.
- 4.54 This leads to the question of whether a term that is itself clearly worded can be exempt from review as a core term if it is not what the consumer reasonably expected, for instance if it is hidden among the small print of a contract where consumers are extremely unlikely to read it. When the two Law Commissions examined the law on unfair terms in contracts, we endorsed the view put forward by the Office of Fair Trading that a term only defines the main subject matter of the contract if it is part of the way consumers perceived the bargain. As the OFT put it:

A supplier would surely find it hard to sustain the argument that a contract’s main subject matter was defined by a term which a consumer had been given no real opportunity to see and read before signing.<sup>49</sup>

- 4.55 We explained that:

<sup>47</sup> MacGillivray on Insurance Law (10<sup>th</sup> ed 2003) para 11-36, p 294.

<sup>48</sup> M Clarke, *The Law of Insurance Contracts* (4<sup>th</sup> ed 2002), para 19 –5A, p 614, note 13.

<sup>49</sup> Unfair Contract Terms Bulletin 2 (OFT 170, September 1996) para 2.26. This is quoted in *Unfair Terms in Contracts* (2002), Law Com Consultation Paper No 166, Scot Law Com Discussion Paper No 119, para 3.23.

In a contract for a “holiday with travel by air”, a clause in the “small print” allowing the company, in the event of air traffic control strikes, to carry the consumer by rail and sea seems to be reviewable for fairness; but it can be argued that if the holiday is “with travel by air or, in the event of strikes, by rail and sea”, the option of mode of travel *might* be part of the definition of the main subject matter. In other words, whether the term relates to the definition of the subject matter depends (at least in part) on how the deal is presented to the consumer.<sup>50</sup>

4.56 Applying the same principle to an insurance contract, take a case where a policy was sold as “insurance for winter sports adventure holidays”, but one of the lengthy policy terms excluded off-piste skiing, and no particular attempt was made to bring this to the proposer’s attention. The exclusion of off-piste skiing would not be a core term. However, if the policy were sold as “suitable for skiing on piste”, the same term might be exempt from review, provided it was presented in a plain intelligible way.

4.57 Our draft Bill on Unfair Contract Terms sought to clarify the law in this area, without changing it. Under clause 4(2), a term is excluded from review if it defines the main subject matter of the contract provided the definition is-

(a) transparent and

(b) substantially the same as the definition the consumer reasonably expected.

4.58 The draft Bill goes on to define “transparent” as meaning

(a) expressed in reasonably plain language,

(b) legible,

(c) presented clearly, and

(d) readily available to any person likely to be affected by the contract term or notice in question.<sup>51</sup>

4.59 In other words, a clause that excluded fire cover if the house was unoccupied might be exempted from review, but only if it were what a consumer would reasonably expect, and if it were readily available, presented clearly, legible and expressed in reasonably plain language. If the clause were merely one of the small print terms, and no special steps had been taken to bring it to the consumer’s attention, it would no longer be a core term, and a court could review it to see if it was fair.

<sup>50</sup> Unfair Terms in Contracts (2002), Law Com Consultation Paper No 166, Scot Law Com Discussion Paper No 119, para 3.23.

<sup>51</sup> Unfair Terms In Contracts (2005), Law Com No 292; Scot Law Com No 199, draft Bill, clause 14(3).

- 4.60 It is not necessarily sufficient for the term to be in plain language. An exception or other clause defining the risk may be in plain language without necessarily being clearly presented, or even readily available. The Directive requires that the term relates to the main subject matter of the contract. It would be difficult to argue that an exception or definition of which consumers were quite reasonably unaware defined the main subject matter of the contract. Such a term would therefore be subject to review for fairness. It does not follow that a court will necessarily treat it as unfair, but if it is substantially different from what the consumer reasonably expected and it is not readily accessible, there must be a risk that the court will hold it to be an unfair term.
- 4.61 We would add that in practice it is probably necessary to include the exception in the documentation (the proposal form or descriptive summary of the policy) that the consumer is given before the contract is made. Merely to include it in the policy document will not suffice, even if the proposal form or summary refers to the policy document. Consumers' reasonable expectations will not be set by terms they only discovered after entering into the contract. Even if the consumer received the terms in advance, a term is unlikely to define the main subject matter of the contract unless it was highlighted in some way.<sup>52</sup>

#### **The effect on warranties**

- 4.62 Here we consider what effect the Unfair Terms in Consumer Contract Regulations have on warranties in consumer insurance contracts. The two limitations that may prevent an exception being a core term apply equally to a warranty. In the case of warranties, however, there are additional complications.
- 4.63 Take the example where the consumer warranted that they would fit a particular type of mortice lock. The question is whether the term is subject to review, or whether it is exempt because it "defines the main subject matter of the contract".
- 4.64 Just like an exception, the warranty would need to be in plain intelligible language. Equally, applying the reasoning we adopted in our project on Unfair Terms in Contracts, we think warranties, just like exceptions, would have to be part of the way the deal was presented to the consumer. The key terms document would need to make it plain that coverage was dependent on the lock being in place. However, with warranties there are possible restrictions that do not apply to exceptions.

<sup>52</sup> Cf *The Zockoll Group Ltd v Mercury Communications Ltd (No 2)* [1999] EMLR 385, 395. Also note UTCCR 1999 Sch 2, art 1, which includes in the list of terms "which may be regarded as unfair" terms which have the object or effect of "(i) irrevocably binding the consumer to terms with which he had no real opportunity of becoming acquainted before the conclusion of the contract."

***Do warranties define the subject-matter of the contract?***

- 4.65 First, we have wondered whether a warranty, however clearly worded and prominently set out, can ever be a “core term”, simply because it does not describe the subject-matter of the contract. In effect it circumscribes the insurer’s liability if the right lock is not installed, and might be thought of as the kind of “incidental” or “subsidiary” term that the House of Lords, in its decision in *DGFT v First National Bank plc*, recognised as not being “core”.<sup>53</sup> On reflection, however, we do not think this argument is correct. A warranty is correctly interpreted as an obligation on the insured, and there is no reason why (if it is clear and “reasonably expected”) it should not be as “core” as the obligation to pay the premium.

***The effect of warranties and reasonable expectations***

- 4.66 A second restriction does seem to bite on warranties. We think that unless the insurer expressly spells out in full the effect of a breach of the warranty, it will be subject to review because it will almost inevitably fail the “reasonable expectations” test.
- 4.67 Consider the legal effect of a breach of the warranty. It will discharge the insurer from liability under policy automatically, so that there is no liability for any loss even if the matter warranted was immaterial, or the loss was completely unrelated to the breach (for example, flood damage). The insurer is discharged from liability even if the breach of warranty has been cured before the claim arose. As we argued earlier, it is most unlikely that these results accord with the reasonable expectations of any insured, least of all a consumer - unless he or she happens to be an insurance lawyer. Thus for the warranty to be exempt as a “core term”, the consequences of a breach of a warranty would have to be spelled out in full, in clear and intelligible language and in a way that left the consumer in no doubt what to expect.<sup>54</sup>
- 4.68 If the term were not sufficiently central to the way the bargain was presented to be a core term, the court would need to consider whether it was fair. It should be noted that under the UTCCR, the court is required to assess the fairness of the term at the time the contract was made. It is not asked to assess whether the term has been applied fairly in the particular circumstances of the loss. Thus if the term gives the insurer the right to avoid even when the breach of warranty was immaterial, it will be no answer that in the particular facts the loss that has been incurred was caused directly by the breach of warranty. If the warranty as a whole was unfair, the insurer simply cannot rely on it at all.

<sup>53</sup> [2001] UKHL 52, [2001] 1 AC 481, esp at [12] and [34]. See further Unfair Terms in Contracts (2002), Law Com Consultation Paper No 166, Scot Law Com Discussion Paper No 119, para 3.25.

<sup>54</sup> We do not think it matters that it is the general law of insurance, rather than the term of the contract itself, that provides for these consequences. It is true that under the Regulations terms that merely reflect what would be the law anyway are probably exempt from review. see Reg 4(2) and recital 13 of the Directive, discussed in CP 166 para 3.37. However, the insurer would not be discharged from the contract unless the warranty term had been included, so this exemption does not apply.



- 4.69 It might be argued that most warranties are fair on their face. The unfairness arises only because of the way they are applied. However, before assessing the fairness of a term the court must interpret it. Suppose, for example, that an insurer seeks to rely on the lock warranty to reject a claim for flood damage. The court would first have to decide whether the term was a true warranty, and was intended to exclude flood claims in this way. If the court accepts the insurer's case that the term has a wide meaning, then it is likely to hold that the term is unfair. The court may be influenced by the fact that this use of the term specifically breaches ICOB Rule 7.3.6. As a result, the term would not be binding on the consumer, and the insurer could not rely on it to avoid paying the claim. If the court gives the term a narrow meaning, to merely except burglary claims while the lock is not fitted, then the term is more likely to be considered fair – but it would not assist the insurer to resist liability for flood damage.

### **Preventive powers**

- 4.70 A major innovation in the 1994 Regulations was that enforcement was not left to the parties alone. Instead, the Director General of Fair Trading was empowered to bring proceedings for an injunction (or interdict) against suppliers using unfair terms in their contracts with consumers. In 1999, the list of enforcement organisations was extended, and in 2001 the Financial Services Authority was added. The FSA is now the organisation primarily responsible for preventing insurers from including unfair terms within their contracts.<sup>55</sup>
- 4.71 The FSA has reached agreements with insurance companies to alter terms: for example, the FSA complained about a cash-back scheme underwritten by insurers, which only met claims if consumers submitted numerous forms within strict time limits. The insurers agreed that they would accept claims within 6 months of the specified dates and would issue replacement documents on request.<sup>56</sup>

<sup>55</sup> See the Concordat between the OFT and FSA, set out in OFT, Unfair Contract Terms Bulletin 16, December 2001. An account of how the FSA uses its powers is given in FSA Handbook Enforcement Manual (Chapter 20). See also, FSA, Fairness of Term in Consumer Contracts: Statement of Good Practice, May 2005.

<sup>56</sup> See: FSA website at: [http://www.fsa.gov.uk/consumer/updates/updates/unfair\\_contracts/cases](http://www.fsa.gov.uk/consumer/updates/updates/unfair_contracts/cases) (last checked 8 August 2006). The FSA has also taken action to prevent an insurer from varying long-term insurance premiums without giving reasons for the changes. It also took action against an insurance policy guaranteeing the return of deposits paid to home improvement suppliers. The cover ceased on the original installation date – which meant that if installation was delayed, the deposit could not be returned.

- 4.72 In July 2006 the FSA took action against a term in a legal expenses insurance policy which bore some similarities to a warranty. It stated that “cover will end at once” if the insured dismissed their appointed representative, or if the representative refused to act for the insured. This was thought to be unfair as the insured may have a legitimate reason for dismissing the representative (for example, in the event of fraud), or the legal representative may refuse to act for the consumer for reasons beyond the consumer's control. Following FSA intervention, the insurer rewrote the term to state that the cover will only end if the insured dismisses the representative without good reason, or the representative refuses to act for a good reason.<sup>57</sup>

### **The impact of the Unfair Terms in Consumer Contracts Regulations**

- 4.73 The regulations have been in place since 1994, applying to all contracts entered into after 1 July 1995. So far, they appear to have had surprisingly little impact on the insurance industry. With the exception of the *Bankers* case, we have not located any cases in which the issue was argued in the courts.
- 4.74 The Regulations have the potential to provide protection to consumers. However, we do not think that in practice they give consumers adequate protection. Here, we have attempted to spell out how the Regulations affect the case of a warranty applied to a non-causally connected loss, but it has not been an easy task: it has produced considerable discussion among members of the team and with our advisers. Any consumer attempting to argue such a case before the courts would need to overcome several hurdles: first, that the warranty was not a core term or, if it was, it was not in plain language; and secondly that it was unfair at the time the contract was entered into. We think that even in consumer cases it would be useful to spell out that a breach of warranty should not absolve the insurer from liability to pay an unrelated claim. This test looks not at the fairness of the term at the time of the contract, but at the way it is applied to the particular circumstances of the claim. We discuss this causal link requirement in more detail in Part 7.

### **THE FINANCIAL OMBUDSMAN SERVICE**

- 4.75 The Financial Ombudsman Service (FOS) has a general discretion to decide cases according to what is fair and reasonable. In practice, dissatisfied consumers are more likely to take a case to the FOS than to court.
- 4.76 To understand how the FOS currently approaches disputes over policy terms, we read 50 final ombudsman decisions concerning terms in consumer policies. We are very grateful to FOS for allowing us access to these cases. A fuller discussion of our findings is to be found in Appendix B.

### **Issues of causal connection**

- 4.77 Our brief analysis of ombudsman cases suggests that warranties are not common in consumer cases. Although a few exclusions appeared to be written in wide terms, it is doubtful if a breach is intended to discharge the insurer from all liability under the policy (as spelled out under section 33(3) of the Marine Insurance Act 1906).

<sup>57</sup> See FSA website, above.

4.78 However, issues of causal connection can arise for exclusion terms as well as for warranties. There were cases within the sample in which the FOS overturned an insurer's decision to reject a claim, where the breach the insurer relied on did not cause the loss in question.

4.79 In Case 42, the complainant claimed for a stolen bicycle, but the firm rejected the claim because at the time of the theft it was not locked to a secure structure. The complainant argued that this would not have made any difference: many bicycles were stolen at the same time, including locked bicycles. The ombudsman ordered the firm to pay the claim, commenting:

The Insurance Conduct of Business (ICOB) rules state that an insurer should not refuse to meet a claim as a result of a breach of warranty or condition, unless the circumstances of the claim are connected with the breach. Although the firm is relying on an exclusion to reject this claim, it is no different to a warranty in that it requires the complainant to do something to ensure that the cover applies. As I do not believe the lock would have made any difference, I am satisfied that the complainant has provided sufficient evidence to establish that his failure to lock his bicycle was not connected to his claim.

4.80 Case 8 concerned a travel policy that excluded pre-existing medical conditions. The complainant had to cut short her holiday when her mother suffered a heart attack, but the insurer rejected her curtailment claim on the grounds that her mother had a pre-existing medical condition. The evidence showed that her mother had suffered from hypertension for the last 50 years, but her condition appeared to be stable and controlled.

4.81 The ombudsman upheld the complaint and required the insurer to pay the claim. He commented that the insurers had provided no evidence to show that the longstanding hypertension caused the heart attack. An internet article suggesting a general link between the two was not enough.

I do not consider that the firm is able to demonstrate on the balance of probabilities that [the mother's] pre-existing medical condition was directly responsible for the cardiac arrest.

4.82 The decision is noteworthy, as it goes further than the recommendations in the 1980 report. First, it puts the burden of proof firmly on the insurer to show the causal connection. Secondly, it requires the insurers to show more than a statistical correlation between hypertension and heart attacks. Instead the insurer is required to prove that the pre-existing condition is directly responsible for the event which gives rise to a claim.

### **Issues of reasonable expectation and transparency**

4.83 It was relatively rare for ombudsmen to refer explicitly to the Unfair Terms in Consumer Contract Regulations in their decisions. Among the 50 cases we looked at, the regulations were mentioned in only two. Neither of these cases was directly relevant to the issues discussed here.<sup>58</sup>

4.84 However, we found several cases in which the ombudsman refused to uphold an exclusion clause contained within the policy small print, if it undermined consumers' reasonable expectation and was not brought specifically to the consumer's attention. In his 1990 report, the Insurance Ombudsman stated that he would apply the spirit of the Unfair Contract Terms Act 1977 to cases brought to the Insurance Ombudsman Bureau. FOS continues this tradition. This also reflects the requirement in ICOB Rule 5 that significant or unusual exclusions should be brought to the consumer's attention. When a term undermines consumers' reasonable expectations, the FOS is likely to regard it as significant or unusual. Ombudsmen will be reluctant to uphold such a term unless the insurer made sufficient efforts to bring it to the consumer's attention.

4.85 This is particularly important if insurers wish to require policyholders to install a particular security measure, or to exclude claims arising "indirectly" from an existing medical condition. Such terms are not generally considered to conform to consumers' reasonable expectations, and insurers are required to take additional measures to ensure that consumers know about them. For example:

(1) In Case 43, the policy required that "high value caravans" should have an alarm. The ombudsman held that it was not made sufficiently clear to the complainants that their £9,000 caravan would be classified as high value. It was not enough to include the requirement in the policy document. Instead, such an important term should be brought to the policyholder's attention before the contract was concluded.

(2) In Case 29, the complainant declared that her husband suffered from hypertension, diabetes and gout, and received notification that these were excluded from the travel policy. When her husband suffered a heart attack on holiday, the insurers relied on policy wording excluding any claim arising "directly or indirectly" from the pre-existing condition. The ombudsman pointed to discrepancies between the policy wording and the other documents the complainant had been sent, commenting:

If the firm intends to exclude claims that arise "indirectly" from any medical condition, this is a very significant restriction on cover and I consider the firm must make its meaning abundantly clear.

In this case, it was fair and reasonable that the insurers should pay the claim.

<sup>58</sup> For further details, see Case 25 and Case 9, set out in Appendix B.

4.86 Case 14 concerned a critical illness policy offering a defined sum in the event of a heart attack. A policy term defined “heart attack” as “the death of a proportion of heart muscle as a result of inadequate blood supply”, as evidenced by three symptoms: chest pain; “electrocardiograph changes”; and raised cardiac enzymes. The complainant was diagnosed and treated for a heart attack involving pain and elevated enzymes, but which did not show changes on an ECG. The insurers refused the claim on the grounds that one of the essential elements of the definition was not met.

4.87 The ombudsman pointed out that neither the key features document nor the headline illness highlighted that a heart attack was only covered if it was of a certain severity or if it involved satisfying a three-limb test.

When a definition significantly restricts the meaning of the headline illness in a way that is inconsistent with either a policyholder’s or a doctor’s reasonable understanding of when a critical illness or event has occurred, then I consider it would be unfair of a firm to rely on a narrow interpretation of a definition to defeat an otherwise valid claim. In my judgment, the complainant’s claim should be met because it falls within the spirit of what the policy was designed to cover and how it was sold.

4.88 It is worth noting that the FOS will be prepared to strike down a narrow definition of the risk contained within the policy small print if this was not in accordance with reasonable expectations and was not made clear to the consumer.

# PART 5: EVALUATION OF THE PRESENT POSITION

## INTRODUCTION

### The law

- 5.1 The law on insurance warranties in general is clearly set out in the Marine Insurance Act 1906. The Act states that warranties must be exactly complied with, whether material to the risk or not.<sup>1</sup> A breach cannot be remedied,<sup>2</sup> but automatically discharges the insurer from liability from that date.<sup>3</sup>
- 5.2 By including a “basis of the contract clause” in the proposal form, the insurer may convert every answer given by the proposer into a warranty. This means that any mistake discharges the insurer from all liability under the contract from the outset, even if the mistake is innocent and immaterial to the risk.

### The problems

- 5.3 The provisions of the Marine Insurance Act have the potential to lead to unfair results. They mean that insurers may refuse to pay a claim for actions or omissions that:
- (1) *are immaterial to the risk*. For example, an insurer may refuse to pay a claim because the insured innocently said that a lorry was kept at the wrong address, even though this did not increase the risk.<sup>4</sup>
  - (2) *are only relevant to other risks*. For example, a failure to employ watchmen may discharge an insurer from liability for a storm claim.<sup>5</sup>
  - (3) *have already been remedied*. For example, once a ship has entered an excluded zone, it remains uninsured even if it leaves that zone as soon as possible.<sup>6</sup>
- 5.4 The problems are exacerbated by the use of basis of the contract clauses. Proposers are unlikely to appreciate the legal effect of a clause giving warranty status to all the answers given on a proposal form.

<sup>1</sup> MIA 1906, s 33(3).

<sup>2</sup> s 34(2).

<sup>3</sup> s 33(3).

<sup>4</sup> *Dawsons Ltd v Bonnin* [1922] 2 AC 413.

<sup>5</sup> See *Forsikringsaktieselskapet Vesta v Butcher* [1989] AC 852.

<sup>6</sup> *Bank of Nova Scotia v Hellenic Mutual War Risks (“The Good Luck”)* [1992] 1 AC 233.

- 5.5 In 1980 the Law Commission described these results as wrong and unjust.<sup>7</sup> We agree. They are wrong because they do not accord with policyholders' reasonable expectations. If a proposer has given incorrect information but the true position does not alter the risk or reduces it, the policyholder may well not realise that the policy is ineffective. If a policyholder is slow in repairing a fire alarm, they may well think that their fire cover is suspended while the problem persists. However, those unfamiliar with the niceties of insurance law are unlikely to think that this also invalidates their flood cover. Nor are they likely to realise that they will continue without fire insurance after the alarm has been fixed.
- 5.6 Insurers have told us that they would rarely apply the strict letter of the law. They would not, for example, refuse to pay a claim because of a breach that had already been remedied before the loss. It is difficult to know how many claims are turned down each year for breaches of terms that are not causally connected to the loss. Our own small survey of complaints brought to the FOS does not suggest that the practice is widespread, though we note that the FSA reports cases where it has occurred.<sup>8</sup> The case for reform does not depend on evidence of widespread abuse. If insurers no longer think that the Marine Insurance Act 1906 embodies fair principles, this is itself strong evidence that the law should be brought into line with acceptable practice.
- 5.7 In the rest of this part we deal first with basis of the contract clauses, which cause the same problem in all types of insurance. We then consider specific warranties of fact or future conduct.

### **BASIS OF THE CONTRACT CLAUSES**

- 5.8 In our first Issues Paper on Misrepresentation and Non-disclosure we said that basis of the contract clauses should no longer be effective to convert a statement of fact into a warranty in any kind of insurance.
- 5.9 Although judges have severely criticised the use of basis of contract clauses for the last 150 years, their use has been consistently upheld. In 1996 the Court of Session justified them on the grounds that the parties are free to agree what they like.<sup>9</sup> We find this unconvincing. In most cases the insured's signature at the bottom of the proposal form containing a clause stating that "this proposal shall be the basis of the contract between us and the insurers" would not represent a true agreement because the proposer will have no idea of the implications of the statement. An insurer may have good reasons for making cover dependent on particular facts but, if so, it must make this clear to the insured.

<sup>7</sup> para 6.9.

<sup>8</sup> FSA, *General Insurance and Pure Protection Products: Treating Customers Fairly*, July 2006, p 18.

<sup>9</sup> *Unipac (Scotland) Ltd v Aegon Insurance* 1996 SLT 1197.

- 5.10 The FSA rules (unlike the Statements of Practice they replaced) do not cover basis of the contract clauses, and in any event they are geared primarily to regulation, not to the rights of the individual insured. No doubt the FOS would take a dim view of an insurer who tried to rely on a basis of the contract clause, but as we noted in our first Issues Paper, not all cases can be resolved by the FOS.<sup>10</sup> There is a need for legislation.
- 5.11 At the first working seminar, there seemed to be a widespread consensus that basis of the contract clauses should be rendered ineffective in consumer insurance. There was also considerable support for our argument that they should not be effective in business insurance. However, there was some doubt about our proposal to render them totally ineffective while still permitting the parties to a business policy to vary the rules on when a policy could be avoided for misrepresentation. We consider this issue in Part 7.

#### **SPECIFIC WARRANTIES OF FACT OR FUTURE CONDUCT:**

- 5.12 In Part 4 we considered how far the injustices inherent in the law on specific warranties of fact or of future conduct have been ameliorated. We saw that because of the Unfair Terms in Consumer Contracts Regulations 1999, and the existence of the FSA regulations and the FOS scheme, the position in consumer insurance is different to that in business insurance. Therefore we consider warranties in consumer insurance before we turn to warranties in business insurance.

#### **Consumer insurance**

##### ***The Unfair Terms in Consumer Regulations***

- 5.13 The 1993 Directive and the Unfair Terms in Consumer Contracts Regulations 1999 protect consumer insureds against the effect of unfair terms. The regulations are not widely understood, and appear not to have been used to their full potential in insurance cases that fall within the topics covered in this Issues Paper.
- 5.14 We have shown that they can be used to challenge warranties, descriptions of the risk and other forms of exclusion that are either not made obvious to the proposer (for example because the term is just one among many in the small print) or whose meaning or requirements are not clear. The terms will be open to challenge on the grounds of unfairness unless they are part of the “definition of the main subject matter” and are in plain, intelligible language. We have argued that they cannot be part of the main subject matter unless they are substantially in line with what the consumer reasonably expected. In other words, the insurer must take reasonable steps to ensure the consumer is aware of warranties, descriptions of the risk and other forms of exclusion. Simply including the warranty or exclusion in the contract documents is not enough.

<sup>10</sup> See Issues Paper 1, para 5.10-5.12.



- 5.15 The effect of the Regulations is not as clear as it should be. The two Law Commissions have already made recommendations to rewrite the Regulations in a clearer and more accessible way, so that the implications behind the Directive are made explicit.<sup>11</sup> The recommendations have been accepted in principle, subject to a regulatory impact assessment. We believe that if our draft bill were implemented, what is required of insurers would be made significantly clearer.
- 5.16 A consumer may be aware of the existence of a warranty but unaware of its implications. A consumer may realise that the insurer requires certain locks, but not realise that a failure to install these locks discharges the insurer from liability for flooding. We have argued that the Regulations are very likely to apply to a clause making a term into a warranty if it does not set out the insurer's rights should the warranty be broken, because its effects will almost always be substantially different from what the consumer reasonably expects. Then it is open to the court to hold the term unfair because it would give the insurer the right to treat itself as discharged for a breach that was immaterial, or where there was no causal link between the breach and the loss for which the claim was made.
- 5.17 However, we do not think that in practice the problem for consumers has been solved by the Regulations. We think that it is important that consumers are protected by a firm rule, that a breach of warranty should not absolve the insurer from liability if the breach was immaterial or there was no causal connection between it and the claim. The consumer should not be required to make the complex and difficult argument that the term permitting this first is not a core term and secondly is unfair.

### ***The FSA rules***

- 5.18 Is reform of the law along these lines needed? ICOB Rule 7.3.6 currently states that "except where there is evidence of fraud" the insurer may not refuse to meet a claim for a breach of warranty or condition "unless the circumstances of the claim are connected with the breach". However, the FSA rule suffers from two problems.
- 5.19 First, the FSA rule permits an insurer to refuse to pay a claim where there is inconclusive evidence of fraud. This effectively allows insurers to substitute their own opinion for that of the court. While inconclusive evidence of fraud may be a reason for excusing the insurer from a regulatory sanction, it is not a ground on which the insurer should be entitled to reject an individual claim where the breach of warranty and the claim had no causal connection.

<sup>11</sup> Unfair Terms In Contracts (2005), Law Com No 292; Scot Law Com No 199.

- 5.20 It could be argued that insurers should have some discretion not to pay claims where they have robust evidence that nevertheless falls short of proof. We will return to the definition and proof of fraud in a subsequent paper. However, we do not think that the problem insurers have in proving fraud is a good reason for permitting them to retain technical or unmeritorious defences to paying claims. Suppose for example, an insurer suspects (but cannot prove) that a policyholder has inflated the costs of repair following storm damage. If the insurer refused the claim because the burglar alarm was not working, it could undermine trust on both sides. The insured would be unable to defend themselves on the substance of the charge, while the insurer would not have established the substance of the wrongdoing.
- 5.21 Secondly, the FSA rule does not give the insured a ready remedy. In a private law contract claim, the court would be required to find for the insurer on the basis of strict law. The consumer may then have a claim to damages for breach of statutory duty under section 150(1) on the ground that the insurer should not have taken the point. However, it is difficult to reconcile this with the strict legal position that an insurer is automatically discharged from liability with no need for further action on its part. It is odd to think that an insurer may be sued for damages for failing to pay a claim for which it is not liable. It must be asked whether any consumer insured would understand the position, let alone actually make a claim.

### ***The Financial Ombudsman Service***

- 5.22 Our research did not reveal a case directly on the need for a causal connection between a loss and a breach of warranty. However the case of the stolen bicycle described earlier<sup>12</sup> (which involved an exception rather than a warranty) shows that the Ombudsmen would almost certainly insist that the insurer pay the claim.
- 5.23 We do not think that the existence of the FOS scheme is a sufficient reason for leaving the law as it is, however. The reason is just the same as in other cases we have considered. Not all cases will reach the FOS; and it makes no sense to have different rules for the courts on the one hand and the FOS on the other. This incoherence and complexity alone is a good reason for reform.

### ***Conclusion***

- 5.24 It is our conclusion that although the UTCCR, the FSA Rules and the FOS offer valuable protection to consumer insureds in relation to breaches of warranty, there is a clear need for reform of the underlying law in consumer insurance cases.

<sup>12</sup> Above, Part 4.

## **Business insurance**

- 5.25 The problems with the law on breach of warranty are not confined to consumer insureds. We do not think it accords with the expectation of any class of insureds that the insurer should be discharged by an immaterial breach of warranty, or one that has been cured before any claim arose. Nor would policyholders expect a claim to be rejected on the ground of a breach of warranty that had no connection to the loss. We discuss below whether the parties should be able to agree expressly that a breach of warranty should have such consequences. However, we do not think that this should be the “default” rule for breach of warranty (that is the rule that will apply if nothing different is provided in the contract).
- 5.26 Neither the FSA rules nor UTCCR cover businesses. For insured businesses, their only protection lies in inviting the court to construe a term to give it a fair meaning. The courts are often prepared to do this, sometimes finding ambiguities in the words used, even when the words appear firm and clear.<sup>13</sup> However, we do not think that it is an adequate substitute for law reform. The process of re-interpreting the effect of contractual terms can cause considerable complexity and difficulty, as is shown by the case law on whether a notification clause can be an innominate term.<sup>14</sup> And in some cases the courts are prepared to give terms their traditional (harsh) meaning.<sup>15</sup>
- 5.27 The problems caused by the harshness of the law can affect any business, but they appear most severe for small and medium businesses. They may not understand the import of words such as “warranty” and, even if they do, they lack the bargaining position to change the insurer’s standard wording. Furthermore, they are particularly vulnerable to legal uncertainty as they lack the legal knowledge and resources to argue cases before the courts. Insurers may therefore be able to use the harshness of the law as set out in the MIA 1906 as a negotiating tool.

<sup>13</sup> The clearest example of this is *Kler Knitwear v Lombard General Insurance Co* [2000] Lloyd’s Rep IR 47.

<sup>14</sup> See *Alfred McAlpine Plc v BAI (Run-Off)* [2000] 1 Lloyd’s Rep 437 and *Friends Provident Life and Pensions v Sirius International Insurance* [2005] 2 Lloyd’s Rep 517.

<sup>15</sup> See *Unipac (Scotland) Ltd v Aegon Insurance* 1996 SLT 1197.

5.28 Large businesses are more able to protect themselves. They have the resources to understand the issues, and the bargaining position to renegotiate terms. We were told, for example, that one large company refuses to agree to warranties in any circumstances. This does not suggest, however, that reform is unnecessary for large businesses. Rather it suggests that all businesses might benefit from the change we are proposing. The fact that businesses which are able to do so exclude the rule, and presumably pay any resulting increase in premium, suggests that it is a poor rule in the first place. We conclude that the law on breach of warranty requires reform in all types of insurance. The question is exactly what shape the reform should take.

## **PART 6: WARRANTIES IN OTHER JURISDICTIONS**

- 6.1 The notion of a warranty that has the effect prescribed by the Marine Insurance Act 1906 is unique to the common law. Many civil lawyers express astonishment at the idea that insurers can avoid liability for trivial breaches of obligations, even if the breach has been remedied or is unconnected with the loss. However, Australia, New Zealand and Canada built their insurance law on English common law principles, as set out in the Marine Insurance Act and its Commonwealth variants.
- 6.2 Below we begin by considering Australia and New Zealand. Both have attempted to correct the perceived defects in the law by legislation, and there are direct lessons to be learnt from their experience. We then look briefly at Canada, where the task of mitigating the harshness of the law has been left to the courts. In the USA, insurance law is largely a matter for each state. Some, such as Texas, have introduced legislation to require a causal connection between the breach and the loss. We conclude with a short comparison with the civil law approach.

### **AUSTRALIA AND NEW ZEALAND**

- 6.3 Both Australia and New Zealand faced similar problems to the UK. They started with the same common law principles, and both reformed their law by statute within five years of the Law Commission's 1980 report. New Zealand passed the Insurance Law Reform Act in 1977; Australia passed the Insurance Contracts Act in 1984. To some extent the various reforms influenced each other: the Law Commission's working paper refers to the New Zealand reform, while the Australian Law Reform Commission's 1982 report discusses the English Law Commission's recommendations in depth. The Law Commission's draft bill, the New Zealand Act and the Australian Act approach the same issues in slightly different ways, and therefore provide interesting commentaries on each other.
- 6.4 We look first at provisions to abolish basis of the contract clauses and then at the need for a causal connection between the breach of warranty and the loss. Finally we consider procedural requirements to bring terms to the notice of the insured.

### **Abolishing basis of the contract clauses**

#### ***New Zealand***

- 6.5 The Insurance Law Reform Act 1977 prevents insurers from using basis of the contract clauses to avoid liability for non-material representations made in proposal forms or other pre-contractual documentation.
- 6.6 Different rules apply to life insurance and other types of insurance, with the life insurance rules offering the insured greater protection. For general insurance, the insurer may avoid at any time, but only for representations that are substantially incorrect and material. For life policies, there is an additional requirement that, unless the misrepresentation is made fraudulently, the insurer can only avoid in the first three years.

6.7 The life provisions are set out in section 4:

- (1) A life policy shall not be avoided by reason only of any statement (other than a statement as to the age of the life insured) made in any proposal or other document on the faith of which the policy was issued, reinstated, or renewed by the company unless the statement—
  - (a) Was substantially incorrect; and
  - (b) Was material; and
  - (c) Was made either—
    - (i) Fraudulently; or
    - (ii) Within the period of 3 years immediately preceding the date on which the policy is sought to be avoided or the date of the death of the life insured, whichever is the earlier.
- (2) For the purposes of subparagraph (i) of paragraph (c) of subsection (1) of this section, a statement is made fraudulently if the person making it makes it—
  - (a) Knowing it is incorrect; or
  - (b) Without belief in its correctness; or
  - (c) Recklessly, without caring whether it is correct or not.

6.8 Section 5 covers other types of insurance contracts:

- (1) A contract of insurance shall not be avoided by reason only of any statement made in any proposal or other document on the faith of which the contract was entered into, reinstated, or renewed by the insurer unless the statement
  - (a) Was substantially incorrect; and
  - (b) Was material.

6.9 Section 6 defines the terms 'substantially incorrect' and 'material' for the purposes of sections 4 and 5:

- (1) ... a statement is substantially incorrect only if the difference between what is stated and what is actually correct would have been considered material by a prudent insurer.
- (2) ... a statement is material only if that statement would have influenced the judgment of a prudent insurer in fixing the premium or in determining whether he would have taken or continued the risk upon substantially the same terms.

- 6.10 In a 1982 case, the judge explained that the purpose behind sections 5 and 6 was to alleviate

the harshness and artificiality resulting from the common practice of insurers requiring proponents to warrant the complete accuracy of all answers to questions put by insurers, with the result that any inaccuracy, whether by way of positive misstatement or omission, and whether major or trivial, material or immaterial to risk or loss, voided the policy.<sup>1</sup>

- 6.11 Tarr and Kennedy comment that

The combined effect of these sections meant that an insurer could only avoid a policy when the difference between what was stated in the proposal and what was actually correct would have been considered material by a prudent insurer and would have influenced that insurer's judgment in fixing the premium or determining whether he or she would have taken or continued the risk upon substantially the same terms.<sup>2</sup>

### ***Australia***

- 6.12 The Australian Law Reform Commission (ALRC) recommended substantial changes to the law on non-disclosure and misrepresentation. It was concerned that an insurer may seek to evade these recommendations by converting any statement into a warranty of existing fact. Consequently, it argued that "all warranties of existing fact should be treated as representations".<sup>3</sup>

- 6.13 This recommendation has been implemented in section 24 of the Insurance Contracts Act 1984:

A statement made in or in connection with a contract of insurance, being a statement made by or attributable to the insured, with respect to the existence of a state of affairs does not have effect as a warranty but has effect as though it were a statement made to the insurer by the insured during the negotiations for the contract but before it was entered into.

This renders 'basis of the contract' clauses of no effect where the statement is about existing facts, as opposed to promises about the future.

- 6.14 The policy behind section 24 would appear to be similar to the policy behind Clause 9 of the Law Commission's draft Bill, though the wording is simpler and more all embracing. It covers all statements of current fact, not just those made in answer to pre-set questions. It would also cover specific statements made in the policy itself.

<sup>1</sup> *Preece v State Insurance General Manager* (1982) 2 ANZ Insurance Cases 60-493, by Thorp J at 77-807.

<sup>2</sup> AA Tarr and JA Kennedy, *Insurance Law in New Zealand*, 2<sup>nd</sup> ed 1992, p80.

<sup>3</sup> ALRC, *Insurance Contracts* (1982) at para 195.

### **Conclusion**

- 6.15 Given the level of criticisms of basis of the contract clauses, it is not surprising that both New Zealand and Australia have enacted provisions to abolish them. Such reform would also appear to be necessary to prevent evasion of any changes to the law of misrepresentation in insurance contracts. We discuss these further in Part 7.
- 6.16 We are not aware that either provision has caused problems. Abolishing basis of the contract clauses would appear to be practicable, and there are several legislative models to choose from in drafting appropriate provisions.

### **A causal connection between the breach and the loss**

- 6.17 Both New Zealand and Australia have enacted provisions to curb the insurers right to avoid liability for a breach of warranty if the policyholder is able to prove that the breach did not cause or contribute to the loss.
- 6.18 The first thing to note about these reforms is that they apply to all terms which exclude or limit liability – not just to warranties. As the ALRC put it, “the form in which the insurer seeks to protect itself from an increase in risk should not be allowed to affect the extent of that protection”. It said that its recommendations

should extend not only to strict warranties and other terms imposing obligations on the insured, but also to exclusions from cover of certain risks. Were they not to extend to temporal exclusions, legislation based on the present recommendations might be avoided simply by rephrasing an obligation (“the insured warrants that the car will be kept in a roadworthy condition”) as a temporal exclusion (“the insurer will not be liable while the car is in an unroadworthy condition”). The legislation might also be avoided if obligations and exclusions were omitted and the cover itself stated in such a way as to achieve the same ends (“cover is granted in respect of the roadworthy car”).<sup>4</sup>

- 6.19 The New Zealand and Australian provisions have a common core. However, the Australian Act goes further than the New Zealand one, and provides an additional level of protection for policyholders.

### **New Zealand**

- 6.20 The Insurance Law Reform Act 1977 forbids certain exclusions. Section 11 states:

Where –

- (a) By the provisions of a contract of insurance the circumstances in which the insurer is bound to indemnify the insured against loss are so defined as to exclude or limit the liability of the insurer to indemnify the insured on the happening of certain events or on the existence of certain circumstances; and

<sup>4</sup> As above, para 229.



(b) In the view of the court or arbitrator determining the claim of the insured the liability of the insurer has been so defined because the happening of such events or the existence of such circumstances was in the view of the insurer likely to increase the risk of such loss occurring, -

the insured shall not be disentitled to be indemnified by the insurer by reason only of such provisions of the contract of insurance if the insured proves on the balance of probability that the loss in respect of which the insured seeks to be indemnified was not caused or contributed to by the happening of such events or the existence of such circumstances.

6.21 In *Barnaby v South British Insurance Co*, Hardie Boys J explained the effect of the section as follows:

The key to this section is to be found in the last words of para. (b): the section is designed to deal with those kinds of exclusion clauses which provide for circumstances likely to increase the risk of a loss which the policy actually covers. The most common examples are found in the field of motor vehicle insurance, such as driving a motor vehicle whilst under the influence of alcohol, or driving a motor vehicle while it is in an unsafe condition. The section is not designed to deal with exclusion clauses which specify the kind of loss or the quantum of loss to which the cover does not apply at all.<sup>5</sup>

6.22 It has been accepted that section 11 applies to promissory warranties.<sup>6</sup> However, insurers may still avoid a policy for a breach of warranty before a loss occurs, and this has been criticised by academics.<sup>7</sup>

6.23 Section 11 is more generous to the policyholder than the test suggested in the Law Commission's 1980 draft Bill. This is because the New Zealand test allows the insured to recover if they prove that the loss was "not caused or contributed to" by the breach. By contrast, the English recommendation would require the insured to prove that the breach "could not have increased the risk that the event... would occur". The Australian Law Reform Commission explain the difference in the following example:

<sup>5</sup> *Barnaby v South British Insurance Co Ltd* (1980) 1 ANZ Insurance Cases 60-401, 77,008 per Hardie Boys J.

<sup>6</sup> *Norwich Winterthur Insurance (NZ) Ltd v Hammond* (1985) 3 ANZ Insurance Cases 60-637. This is despite some suggestions that originally the provision was only intended to apply to definitions of the risk: see the discussion in ALRC, *Insurance Contracts* (1982) at para 223.

<sup>7</sup> Borrowdale, "Insurance Law Reform in New Zealand: A Decade On" (1988) 1 *Insurance Law Journal* 261 at 268.

Suppose, for example, that a motor vehicle has been modified in breach of a warranty. The breach increases the risk of a malfunction of the vehicle's brake system. An accident occurs which is entirely the fault of a driver in not keeping a proper look-out. The brakes are applied too late but function admirably.<sup>8</sup>

- 6.24 The ALRC suggest that although the breach did not cause or contribute to the loss, the insured could not prove that the breach did not increase the risk that the loss would occur in the way it did in fact occur.

### ***Australia***

- 6.25 The ALRC dealt with these problems by recommending a two-part test. The causation test would only apply to provisions that could reasonably be regarded as capable of causing or contributing to the loss for which insurance cover was provided. For other breaches, a proportionality test would be applied, allowing the insurer to reduce its liability "by the amount that fairly represents the extent to which... [its] interests were prejudiced".
- 6.26 The ALRC also recommended greater protection to policyholders than the New Zealand Act provides where the breach caused only part of the loss. Here the insurer would still be liable for the part of the loss that was not caused by the insured's act. Suppose, for example, a site owner has two buildings: Building A, where the sprinkler system has been maintained, and Building B, where it has not. If fire spreads from Building A to Building B, the insurer would still be liable to meet the loss to Building A.
- 6.27 These recommendations were enacted in section 54 of the Insurance Contracts Act 1984:
- (1) Subject to this section, where the effect of a contract of insurance would, but for this section, be that the insurer may refuse to pay a claim, either in whole or in part, by reason of some act of the insured or of some other person, being an act that occurred after the contract was entered into but not being an act in respect of which sub-section (2) applies, the insurer may not refuse to pay the claim by reason only of that act but the insurer's liability in respect of the claim is reduced by the amount that fairly represents the extent to which the insurer's interests were prejudiced as a result of that act.
  - (2) Subject to the succeeding provisions of this section, where the act could reasonably be regarded as being capable of causing or contributing to a loss in respect of which insurance cover is provided by the contract, the insurer may refuse to pay the claim.
  - (3) Where the insured proves that no part of the loss that gave rise to the claim was caused by the act, the insurer may not refuse to pay the claim by reason only of the act.

<sup>8</sup> In ALRC, Insurance Contracts (1982) at para 228.

- (4) Where the insured proves that some part of the loss that gave rise to the claim was not caused by the act, the insurer may not refuse to pay the claim, so far as it concerns that part of the loss, by reasons only of the act.
- (5) Where –
  - (a) The act was necessary to protect the safety of a person or to preserve property; or
  - (b) It was not reasonably possible for the insured or other person not to do the act,

the insurer may not refuse to pay the claim by reason only of the act.

- (6) A reference in this section to an act includes a reference to –
  - (a) An omission; and
  - (b) An act or omission that has the effect of altering the state or condition of the subject-matter of the contract or of allowing the state or condition of that subject matter to alter.

#### SECTION 54 IN PRACTICE

6.28 This section has caused considerable litigation.<sup>9</sup> The main difficulty lies in the ALRC's desire to extend protection beyond clauses which impose obligations on policyholders, to those which limit the scope of the cover (as in the example where cover is granted only "in respect of the roadworthy car"). This has led to considerable debate about how far section 54 can be used to extend policies to cover risks outside the scope of the policy the insurer had written.

6.29 An example is *Kelly v New Zealand Insurance Co Ltd*, which concerned a home and contents policy.<sup>10</sup> Here the insured could have extended their cover by providing the insurer with a list of specified items, but chose not to do so. The question was whether this amounted to an omission within the terms of section 54(6), which (but for the section) would permit the insurer to refuse to pay. The Supreme Court of Western Australia drew a distinction between an "omission" and an "inaction". This, they said, was an inaction, whereby the insured exercised their right not to expand the scope of the cover. Therefore the section did not apply.

<sup>9</sup> For accounts of the case law see, ALRC, *Review of the Marine Insurance Act 1909* (2001) No 91; and A Cameron and N Milne, *Review of the Insurance Contracts Act 1984: Report into the Operation of Section 54* (2003), Commonwealth of Australia. See also Michele Muscillo, "The Lesser of Two Evils: FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd" (2001) 1 *QUT Law and Justice Journal* 304.

<sup>10</sup> (1996) 9 ANZ Ins Cas 61-317.

- 6.30 However, in *Antico v Heath Fielding Australia Pty Ltd*, the High Court reached the opposite conclusion.<sup>11</sup> This case concerned legal expenses insurance, where indemnity was conditional upon the insurer consenting to defend the claim. The policyholder failed to obtain consent, and the question was whether this amounted to an omission, which could be excused under section 54. The High Court found that section 54 applied: the word “omission” did just refer to a failure to discharge an obligation, but also included “a failure to exercise a right, choice or liberty which the insured enjoys under the contract of insurance”.<sup>12</sup>
- 6.31 However, most of the litigation about section 54 has been about “claims made and notified policies”. These policies are common in the professional indemnity market, and are a way in which insurers protect themselves against long-tailed claims that may not arise for many years after the policy has been issued. Typically, a “claims made” policy only applies if the claim is made during the period of cover. A “claims made and notified policy” usually extends cover to claims made after cover has ceased, provided that the claim arises from an occurrence which has been notified to the insurer during the relevant period. It is common for such policies to include a deeming clause, stating that where the facts have been notified to the insurer within the period of insurance it is deemed to be a claim made during the policy period.
- 6.32 There have been a series of cases in which policyholders failed to notify the insurer of an occurrence during the relevant period. Policyholders have argued that this failure amounts to an omission within the terms of section 54(6) and that the section offers them protection.<sup>13</sup> The leading case is the High Court’s decision in *FAI v Australian Hospital Care Pty Ltd*.<sup>14</sup> Here, the professional indemnity policy contained a deeming clause of the sort described above. The insured had been aware of facts giving rise to an injury during the period of cover, but had not notified the insurer because it did not expect that a claim would be made. It argued that this omission could be cured by section 54. To the alarm of the insurance industry, the High Court found for the insured. The Court drew a distinction between “an inherently essential element of the claim” (where section 54 does not apply) and other ancillary or procedural matters (where it does apply). Where the demand must be made within the period, or where the insured must become aware of facts within the period – and these requirements have not been met - the claim does not fall within the policy. No relief can be given. However, here the failure to notify was a procedural matter, and the relief applied.

<sup>11</sup> (1997) 188 CLR 652.

<sup>12</sup> Above, at pp 669-70.

<sup>13</sup> See *FAI General Insurance Co Ltd v Perry* (1993) 30 NSWLR 89; *Greentree v FAI General Insurance Co Ltd* (1998) 158 ALR 592; and *Permanent Trustee v FAI General Insurance Co Ltd* (1998) 44 NSWLR 186.

<sup>14</sup> [2001] HCA 38.

- 6.33 An added twist to these difficulties is that under section 40 of the Insurance Contracts Act 1982 a “claims made policy” is deemed to be a “a claims made and notified policy”. The statute states that the insurer must pay where the insured gave notice in writing to an insurer of the facts that might give rise to the claim. Section 54 goes one step further by opening up the possibility that claims must be paid even if the facts are *not* notified. The combined effect of sections 40 and 54 has made it difficult for professional indemnity insurers to limit their liability for long-tailed claims, and there have been extensive calls for reform.<sup>15</sup>
- 6.34 That said, it is possible to exaggerate the difficulties associated with section 54. First, even if the section applies, it does not necessarily require that the claim is paid. The claim may be reduced by an amount which “fairly represents the extent to which the insurer’s interests were prejudiced” as a result of the act or omission. In *Ferrcom Pty Ltd v Commercial Union Assurance Co of Australia*, the High Court found that the prejudice to the insurer was equivalent to its entire liability.<sup>16</sup> The owners of a mobile crane had failed to notify the insurer that there had been a change of circumstances, and that the crane was now registered to be driven on public roads. The court found that if the insurer had been told it would have exercised its right to cancel the policy and would not have been liable to meet any subsequent claim.
- 6.35 Secondly, in 2003 the Commonwealth Treasury Review of the section commented that “not a single stakeholder has sought the removal of section 54”.<sup>17</sup> It found that the section worked satisfactorily in relation to the vast majority of occurrence insurance, and “the prominent message from meetings and submissions is that the operation of section 54 in relation to ‘occurrence’ policies should remain unchanged”.<sup>18</sup> The review recommended reform only in relation to “claims made” and “claims made and notified” policies.

#### THE ALRC REVIEW OF MARINE INSURANCE

- 6.36 The 1982 Act did not cover marine insurance. In 2001, the ALRC considered whether similar reforms should be introduced for marine insurance.<sup>19</sup> The Commission concluded that as currently drafted, section 54 went too far to be suitable to the marine area. In important respects, its practical effect was “to allow the insured to unilaterally alter the bargain made by the parties, arguably to the extent of fundamentally changing the scope of the insurance”.<sup>20</sup> The degree of discretion involved in assessing the extent of prejudice the insurer had suffered allowed too much room for dispute.

<sup>15</sup> It is unlikely that the same issues would arise in the UK, where business is more usually written on a “claims made” rather than a “claims made and notified” basis, and where section 40 does not apply.

<sup>16</sup> (1993) 176 CLR 332.

<sup>17</sup> A Cameron and N Milne, *Review of the Insurance Contracts Act 1984: Report into the Operation of Section 54* (2003), Commonwealth of Australia, p 9.

<sup>18</sup> As above.

<sup>19</sup> ALRC, *Review of the Marine Insurance Act 1909* (2001) No 91; <http://www.austlii.edu.au/au/other/alrc/publications/reports/91/ch9.html>

<sup>20</sup> Above, at para 9.120.

- 6.37 Subsection (4) could also introduce unacceptable uncertainty. This allows “some part of the loss” to be paid where the insured proves that that act did not cause that part of the loss. The ALRC commented that “this approach may lead to practical difficulties in quantifying an insurer’s liability”, and could increase the cost of litigating disputes.<sup>21</sup>
- 6.38 Despite these problems, however, the ALRC found a wide consensus that marine warranties could operate in a harsh and unfair manner. The Queensland Commercial Fishermen’s Organisation were particularly concerned, and instrumental in prompting the review. Even submissions from insurers expressed considerable support for reform.
- 6.39 The Review concluded that an insurer should only be discharged from liability as a result of a breach of the insured’s obligations, if the loss was caused by the breach. Otherwise the remedy should lie in damages.
- 6.40 In some ways, the ALRC thought that section 54 did not go far enough. Section 54 talks about acts “causing or contributing to a loss”, which could cover any situation where there was a connection between breach and loss.<sup>22</sup> The ALRC thought that the test should require “proximate causation”, which is a well understood insurance law concept, and more generous to the insured.
- 6.41 For these reasons the ALRC recommended that
- the amended MIA should permit the parties to include a term that the insurer is discharged from liability to indemnify the insured for loss proximately caused by a breach by the insured of an express term of the contract. An express term providing for the insurer’s discharge from liability could be drafted to apply to the insured’s obligations generally or only to particular breaches. In the absence of such a term, breach of the contract will entitle the insurer only to such relief as may be available under the general law of contract, which would generally be the award of damages.<sup>23</sup>

### **Conclusion**

- 6.42 In both Australia and New Zealand there is a consensus that insurers should not be permitted to avoid liability for breaches of insurance terms that are unrelated to the loss. This consensus has endured, despite some serious problems with the way that section 54 has been drafted.
- 6.43 There does not appear to be a problem with drafting legislation to deal with terms where “the happening of such events or the existence of such circumstances was in the view of the insurer likely to increase the risk of such loss occurring”. In these circumstances, it is possible to provide that the policy should not be avoided where the breach did not in fact increase the risk, or cause the loss. These provisions have secured acceptance within the industry.

<sup>21</sup> Above, at para 9.121.

<sup>22</sup> Above, paras 9.125 - 9.127.

<sup>23</sup> Above, para 9.129.

- 6.44 The problems appear where the legislation goes wider than this, to cover acts or omissions that do not increase the risk of a loss occurring, such as notification clauses. It is often difficult to distinguish conceptually between an omission and the absence of a central element of the claim. If provisions are drafted widely to deal with all potential evasion techniques, they may permit the insured to argue that the cover they receive should extend beyond the cover they have bought.

#### **Procedural requirements to bring terms to the notice of the insured**

- 6.45 One problem with the existing law is that terms may be strictly enforced even if the insured was not fully aware of them. The Law Commission's draft Bill therefore included a requirement that the policyholder should be given a written statement of a warranty at or before the contract was entered into, or as soon as practicable thereafter. The difficulty with this proposal is that just because a term is in writing does not mean that it is clear or understandable, or even brought to the policyholder's attention.
- 6.46 We have not been able to find any general procedural requirements in New Zealand (although their 1985 Act does require insurers to disclose the existence and effect of a clause imposing pro rata averaging).
- 6.47 In Australia, the ALRC wrestled with the problem. How does one ensure that the important terms are brought to policyholders' attention, without burying them in reading matter? Their solution was to prescribe standard cover for the five main types of consumer policies: motor, householder, personal accident, consumer credit and travel. These terms would be set out in regulations, after consultation with the industry. Insurers would be free to market policies that offered less than the standard cover. But if so, they would be required to draw the policyholder's attention to every respect in which the policy offered less than the standard. We have not yet been able to find how these recommendations have worked in practice.
- 6.48 Prescribed standard cover is common in the USA and in several European jurisdictions. However, it has some weaknesses. It does not ensure that consumers are aware of their policy terms, as most consumers will not know what the standard terms provide. Terms may become known over time, but if policies are to keep pace with changes in the market, even standard terms will need to change frequently. The process of prescribing and updating terms adds to the regulatory burden, as every change will require insurers to adapt their contractual and marketing documents. Insurers also object that their marketing effort is required to concentrate on the negative – what is not covered, rather than what is.

#### **CANADA**

- 6.49 In other Commonwealth jurisdictions, the problem of warranties has been tackled by the courts rather than the legislature. As Lord Hobhouse said in *The Star Sea*:

It is a striking feature of this branch of the law that other legal systems are increasingly discarding the more extreme features of English law which allow an insurer to avoid liability on grounds which do not relate to the occurrence of the loss.<sup>24</sup>

- 6.50 In Canada, the Marine Insurance Act 1993 is based on the UK Marine Insurance Act 1906. However courts have limited it “to situations where the warranty is material to the risk and the breach has a bearing on the loss.”<sup>25</sup> Where cases do not meet this criterion, the courts tend to find that the clause is not a true warranty at all.

### **The Bamcell II**

- 6.51 The leading case is the Supreme Court decision in *Century Insurance Company of Canada v Case Existological Laboratories Ltd. (“The Bamcell II”)*.<sup>26</sup> The Bamcell II was a converted barge used for oceanographic experiments. The owners had negotiated a policy, which included the following term

Warranted that a watchman is stationed on board the BAMCELL II each night from 2200 hours to 0600 hours with instructions for shutting down all equipment in an emergency.

- 6.52 In fact, the owners never placed a watchman on board. However, there were no problems at night. The loss occurred mid afternoon, and therefore the breach had “absolutely no bearing whatever on the loss”<sup>27</sup>. As a result, Ritchie J held:

The clause would only have been effective if the loss had occurred between 2200 hours and 0600 hours, and it was proved that there was no watchman stationed aboard during those hours. To this extent the condition contained in the clause constituted a limitation of the risk insured against but it was not a warranty.<sup>28</sup>

<sup>24</sup> *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd and others (The Star Sea)* [2001] 1 All ER 743, at para 79. Lord Hobhouse specifically mentions “the most outspoken criticism of the English law of non-disclosure” found in the South African case of the *Mutual and Federal Insurance* [1995] (I) SA 419.

<sup>25</sup> Christopher Giaschi. “Warranties in Marine Insurance” Paper, Association of Marine Underwriters of British Columbia, Vancouver, 10 April 1997.  
<http://www.admiraltylaw.com/papers/warranties.htm> (24 May 2006)

<sup>26</sup> [1984] 1 WWR 97.

<sup>27</sup> *Century Insurance Company of Canada v Case Existological Laboratories Ltd. (The “BAMCELL II”)* [1984] 1 WWR 97, 104, per Ritchie J.

<sup>28</sup> *Century Insurance Company of Canada v Case Existological Laboratories Ltd. (The “BAMCELL II”)* [1984] 1 WWR 97, 104, per Ritchie J.



6.53 Soyer argues that on the facts there was a clear intention that the term should be a warranty. He thinks the English courts would have regarded it as an express warranty.<sup>29</sup> This is an open question. Some cases suggest that the English courts may take an approach which is similar to the Canadian one. For example, in *Kler Knitwear v Lombard*, Mr Justice Morland cited *Bamcell II* and used it to justify overriding the clear words of the policy. However, this decision is only at first instance and it has been subjected to academic criticism.<sup>30</sup> The English courts also tend to construe marine insurance contracts more strictly.

6.54 The reasoning in *Bamcell II* and *Kler Knitwear* is predicated on the existence of some ambiguity in the term, which is construed against the insurer. It is difficult to know how far the Canadian court will go in overriding unambiguous words simply to achieve fair outcomes. Soyer quotes the British Columbia Builders' Risk Clauses as an example of insurers' attempts to prevent the courts from applying *Bamcell II* to reinterpret warranties as descriptions of risk. Clause 1 is as unambiguous as possible:

This policy contains warranties and general conditions none of which are to be interpreted as suspensive conditions. The Underwriters have agreed to accept the risk of insuring the Vessel on the condition precedent that the Assured will comply strictly and literally with these warranties and conditions. If the Assured breaches any of these warranties or conditions, the Underwriters at their option will not pay any claims arising thereafter, regardless of whether or not breach is causative or in any way connected to such claim.

6.55 It is not clear how the courts would deal with a *Bamcell II* type case in the light of such clear, definite and unambiguous wording.

### **Conclusion**

6.56 As we have seen, the English courts have gone some way to temper the unfairness associated with the strict application of warranties, and these developments have been taken further by the Canadian Supreme Court. Although these developments prevent unjust decisions, they also introduce some uncertainty and incoherence into the law. The danger is of repeated litigation, as insurers respond to court decisions by rewriting their contracts in even less ambiguous terms.

### **THE USA**

6.57 Traditionally, US marine insurance law followed the British approach and was considered to be a federal matter. This, however, changed in 1955 following the Supreme Court decision in the *Wilburn Boat* case.<sup>31</sup>

<sup>29</sup> Baris Soyer, *Warranties in Marine Insurance* (2<sup>nd</sup> ed, 2006), p 45.

<sup>30</sup> See Part 4.

<sup>31</sup> [1955] AMC 467,

- 6.58 The case concerned a small houseboat, kept on a lake between Texas and Oklahoma. The policy contained various stipulations that the policyholders had breached. Contrary to the terms of the policy, the insured had pledged the boat, carried passengers on several occasions and had at times leased the vessel. A fire destroyed the boat while it was moored, in circumstances that had nothing to do with the breaches of warranty. The insurers argued that, under Federal law, there was no need for a causal link between the breaches and the loss. The policyholders, however, argued that the matter should be dealt with under Texan law, where breaches of the policy would not defeat the claim unless they contributed to the loss. Eventually the case found its way to the Supreme Court, which held that insurance law was a matter for each state.
- 6.59 The case has generated considerable debate within the US: some see it as a necessary part of the state/federal balance; others as a source of uncertainty and complexity.<sup>32</sup> One element behind the decision, however, may have been the Supreme Court's unhappiness with the harshness and rigidity of the English approach.<sup>33</sup>
- 6.60 The result is that the way warranties are to be interpreted and applied is largely a matter for state law. As we have seen, some states, such as Texas, require a causal connection between the breach and the loss before permitting the insurer to avoid paying a claim.
- 6.61 By contrast, in New York, the requirement is that a breach of warranty will avoid an insurance contract, provided that it "materially increases the risk of loss, damage or injury within the coverage of the contract".<sup>34</sup> If the contract specifies two or more kinds of loss (such as fire and theft) the breach will only avoid the particular kind of loss to which the warranty relates. This does not mean that the breach must cause or contribute to the specific loss, but it must be such that would materially increase the risk of a loss of the same sort. In other words, a breach of a burglar alarm condition would not affect a fire claim, but it would avoid a theft policy, so as to permit the insurer to refuse a claim for theft, however the thieves had entered the building.

#### **CIVIL LAW JURISDICTIONS**

- 6.62 UK law on breach of warranty diverges from that of most other European States, which require that a breach be causally connected to the loss in some way before it can absolve the insurer from payment.
- 6.63 Baris Soyer provides a detailed analysis of the English, German and Norwegian approach to breach of warranty in marine insurance.<sup>35</sup> He shows that in both Germany and Norway provisions exist to exempt the insurer from liability if the nature of the risk changes during the life of the policy. However, unlike the English law, these require some degree of culpability and causation.

<sup>32</sup> For a discussion, see B. Soyer, *Warranties in Marine Insurance* (2<sup>nd</sup> ed, 2006), p 182.

<sup>33</sup> T Schoenbaum, "Warranties in the Law of Marine Insurance: Some Suggestions for Reform of English and American Law", 23 Tul Mar LJ 267 (1998-1999), 314.

<sup>34</sup> New York Insurance Code, Article 31, section 3106(b).

<sup>35</sup> *Warranties in Marine Insurance* (2<sup>nd</sup> ed, 2006).

- 6.64 An example will illustrate the main differences. Under German law, the insurer is not normally liable if the insured put a vessel to sea in an unseaworthy condition. But this is subject to two important limitations. First, the exemption only applies to loss caused by the conduct. If, for example, the loss was unrelated to the unseaworthiness, the insurance policy continues. Secondly, it is open to the insured to show that they were not “responsible” for the unseaworthiness - ie that it was not a deliberate or negligent act.<sup>36</sup> Norwegian law is similar.<sup>37</sup> By contrast, under the Marine Insurance Act 1906, voyage policies contain an implied warranty “that at the commencement of the voyage the ship shall be seaworthy for the purposes of the particular adventure insured”.<sup>38</sup> This means that if the ship is not seaworthy at the beginning of the voyage, all liability is avoided even if the insured is not at fault; or the defect is remedied; or the loss is totally unconnected with the defect.
- 6.65 Trine-Lise Wilhelmsen, a Professor at the Scandinavian Institute of Maritime Law, comments that for most people in the Civil Law world, the UK concept of a warranty is “hard to understand and even harder to explain”. Although the words may seem “deceptively simple”, the consequences lack “logical reason” and cannot be explained in terms of either legal fairness or economic efficiency.<sup>39</sup>
- 6.66 John Hare, Professor of Shipping Law at the University of Cape Town is even more outspoken. He describes the Anglo-American marine insurance warranty as “a prodigal aberration from the European *ius communis* of marine insurance”. He suggests that “the prodigal, in whatever systems it has raised its unwelcome head, ought to be brought back into the fold in the interests of the very fairness, justice and equity to which English law so properly aspires”.<sup>40</sup>
- 6.67 UK warranty law is inconsistent with the mandatory, but milder, provisions concerning alteration of risk in several Civil Law countries. Wilhelmsen comments that if there are to be attempts towards harmonisation, it is unlikely that many other European States will move towards the British model:

<sup>36</sup> Above, pp 186-7. See also Comité Européen des Assurances, *Insurance Contract Law In Europe* (2004). This explains that German law requires an insured to notify details of an increased risk, but if they fail to do so, the insurer “may only refuse to pay compensation if there is a causal link between the occurrence of the risk insured against and the failure to notify details or the increased risk” (p 81): see article 23 and following of the “Versicherungsvertragsgesetz” or Insurance Contract Law of 30 May 1908, as amended 26 November 2001.

<sup>37</sup> Under section 3-33 of the Norwegian Marine Insurance Plans 1996, the insurer is not liable for “loss that is a consequence of the ship not being in a seaworthy condition, provided that the assured knew or ought to have known of the ship’s defects at such a time as it would have been impossible for him to intervene”.

<sup>38</sup> Section 39(1).

<sup>39</sup> “Duty of Disclosure, Duty of Good Faith, Alternation of Risk and Warranties: An Analysis of the Replies to the CMI Questionnaire”, CMI Yearbook 2000 pp 392 and 409.

<sup>40</sup> John Hare, *The Omnipotent Warranty: England v The World*, paper presented at International Marine Insurance Conference, November 1999, <http://web.uct.ac.za/depts/shiplaw/imic99.htm> (accessed 23 May 2006).

The mandatory provisions in Danish and Swedish ICA concerning alteration of risk do not seem to permit the far more harsh regulation of warranties. Also the French and Italian legislations are more favourable towards the assured than the common law principle of warranties. In an attempt towards harmonisation, this implies either that the common law systems are willing to soften their regulation, or that a double set of clauses are suggested. It does not seem realistic that the legislators in the four mentioned civil law countries will open the door for the stricter principle of warranties, ref. the Norwegian political attitude on this point. Also it would seem to go backwards into the future to adopt legal principles from 1906 instead of the principles of the far more modern insurance legislation in the civil law countries.<sup>41</sup>

- 6.68 In Part 7, we draw on this comparative material to consider a range of options for reform.

<sup>41</sup> Duty of Disclosure, Duty of Good Faith, Alternation of Risk and Warranties: An Analysis of the Replies to the CMI Questionnaire", CMI Yearbook 2000, p 393.

## PART 7: PROVISIONAL PROPOSALS

- 7.1 The law on breach of warranty in the United Kingdom has the potential to cause considerable unfairness to policyholders by allowing insurers to avoid paying claims for technical reasons which are unconnected with the loss that has occurred. We think it is wrong that insurers should still be entitled to avoid liability for a breach that has already been cured: for example, a delay in inspecting sprinklers should not affect liability for a fire that occurs after the sprinklers have passed their inspection. Nor should a policy be discharged for a breach that is unconnected with the loss: failure to employ watchmen should not affect a claim for storm damage that employing the watchmen would not have prevented or reduced. At the very least these should not be the “default” rules.
- 7.2 “Basis of the contract” clauses are a particular mischief. They allow insurers to use a form of words that few policyholders understand to extend the protections already available to them for misrepresentation to cover answers that are not material to the risk, or are made without fraud or negligence.
- 7.3 Insurance is based on trust, and when insurers deny liability for inappropriate reasons it may undermine faith in the industry. It does not accord with good practice. As we have seen, it may also bring UK law into disrepute.
- 7.4 In the discussion that follows we distinguish between warranties of past or existing fact, and warranties about future conduct. This is because a warranty of past or existing fact already takes effect as a representation. In Issues Paper 1 we explored the remedies currently available for inaccurate representations and how we think they should be reformed. Permitting such representations to be made into warranties would have the effect of entitling insurers to additional remedies, particularly if the representation was made innocently.
- 7.5 Below we start by recapping the tentative proposals on reform of the law of misrepresentation and non-disclosure that we made in our first Issues Paper. We also note one change in our thinking in the light of the discussion of that paper at the seminars. We then consider how far insurers should, in effect, be permitted additional remedies for misrepresentation, first through the use of basis of the contract clauses and secondly through specific warranties and other terms as to existing facts. We tentatively conclude not only that basis of the contract clauses should not be effective to turn all representations made by the proposer into warranties, but also that for consumer insurance, every statement of past and existing fact should be treated as a representation rather than as a warranty. This means that insurers should not be entitled to escape liability for misrepresentations that are made innocently and reasonably; and for negligent misrepresentations, the insurers’ remedy should be proportionate.

- 7.6 For business insurance we ask whether we should follow the same approach or whether warranties as to specific facts should still be a ground on which the insurer in business insurance policies may refuse to pay a claim, and possibly treat the contract as discharged. If warranties of specific fact are to be permitted, we later argue that they should be subject to certain formal requirements (such as the warranty being set out in a schedule to the policy). Furthermore, when the question is whether the insurer must pay a claim, the claim must be causally connected to the breach of warranty.
- 7.7 We then consider options for reforming warranties about future conduct. We make two tentative proposals:
- (1) to be valid, a warranty of future conduct should be set out in writing;
  - (2) insurers should only be entitled to avoid liability to pay a claim because of a breach of warranty if the breach bears some connection with the loss.
- 7.8 We discuss whether a causal connection should also be required for other types of term that limit the risk, such as definitions of the risk and exceptions. We tentatively conclude that it should be required, unless it would be unreasonable for the insured to assume that it was covered by the policy at the time of the event.
- 7.9 We then inquire whether the reform proposals should apply to all forms of insurance. We ask whether different arguments apply first to marine, aviation and transport insurance (MAT) and then to reinsurance. Our present thinking is that the reforms should apply in these areas, though we welcome views on whether there are good reasons to treat these forms of insurance differently. Marine insurance raises particular issues about the implied warranties set out in the Marine Insurance Act (which we discuss briefly). We ask if these should be subjected to the same causal connection test that we have proposed for other warranties.
- 7.10 Finally, we consider the implications these reforms would have for sections 33 and 34 of the Marine Insurance Act 1906. We tentatively propose that insurance policies should no longer be discharged automatically as the result of a breach of warranty. Instead the insurer should have the option to terminate the contract for the future (without prejudice to its liability to pay any claims that have arisen already). This raises questions about whether the insured should be entitled to a pro-rata return of any premium paid, and whether the insurer should give notice of the termination. An insurer may also lose the right to terminate an insurance contract, because they are taken to have “waived” their rights. We consider the implications for our suggested proposals for the law of waiver and affirmation.

## **OUR TENTATIVE PROPOSALS ON MISREPRESENTATION AND NON-DISCLOSURE**

- 7.11 In our Issues Paper 1 on misrepresentation and non-disclosure,<sup>1</sup> we made a number of tentative proposals. The principal proposals were as follows.

<sup>1</sup> Available at [http://www.lawcom.gov.uk/docs/insurance\\_contact\\_law\\_issues\\_paper\\_1.pdf](http://www.lawcom.gov.uk/docs/insurance_contact_law_issues_paper_1.pdf)

## **All insurance**

7.12 For both consumer and business insurance we proposed that:

- (1) Insurers should only be entitled to a remedy for an insured's non-disclosure or misrepresentation in so far as this is material, as defined below. The same test should apply to misrepresentation and non-disclosure.
- (2) First, the actual insurer must show inducement, in that had it known the true facts it would not have entered into the same contract on the same terms or at all.
- (3) Additionally, the insurer must show either
  - (i) that the proposer appreciated that the fact in question would be relevant to the insurer (in the sense that it would have an effect on the insurer's mind in assessing the risk) or, if not,
  - (ii) that a reasonable insured would have appreciated that the fact would be relevant to the insurer (in the sense set out above).
- (4) In assessing what a reasonable insured would appreciate, the courts should take into account the type of policy, the way the policy was advertised and sold, and the normal characteristics of consumers in the market. However, they would not look at individual circumstances, known only to the insured.

7.13 We tentatively proposed that:

- (1) Insurers should be allowed to avoid policies where the insured has acted fraudulently at the pre-contractual stage,
- (2) If the insured had reasonable grounds for believing the truth of what they said, or was not negligent in other ways (such as in failing to answer a question), the insurer should have no remedy for misrepresentation or non-disclosure.
- (3) If a consumer proposer has made a negligent misrepresentation, the court should apply a proportionate remedy by asking what the insurer would have done had it known the true facts. In particular:
  - (a) Where an insurer would have excluded a particular type of claim, the insurer should not be obliged to pay claims that would fall within the exclusion;
  - (b) Where an insurer would have declined the risk altogether, the claim may be refused;
  - (c) Where an insurer would have charged more, the claim should be reduced proportionately to the under-payment of premium.

For business insurance, on point (c), we asked whether the remedy for negligent misrepresentation should be proportionate, in that it should aim to put the insurer into the position it would have been in had it known the true circumstances.

- 7.14 “Basis of the contract” clauses, whether in the proposal form or the contract itself, should be ineffective to make all the answers given by the insured into warranties. (This was a provisional proposal to be discussed further in the current paper, and was without prejudice to the decision whether or not to permit specific warranties of existing fact contained within the contract.)

### **Consumers**

- 7.15 Our tentative proposal was that in the consumer market, insurers should ask consumers clear questions about any matter that is material to them and that there should be no duty of disclosure on consumers.
- 7.16 It should not be possible to contract out of the new rules governing consumer insurance except in favour of the consumer.

### **Businesses**

- 7.17 We tentatively proposed that:
- (1) The duty of disclosure should continue to apply to business insurance contracts in general.
  - (2) The law affecting business insurance should be changed to give the insured certain additional rights, but that the rules should in general not be mandatory.
  - (3) We tentatively proposed that our earlier proposals for business insurance should apply to MAT; and we asked if there is any reason not to apply our earlier proposals for business insurance to reinsurance.

### **Small businesses**

- 7.18 We asked:
- (1) To what extent small businesses should be treated in the same way as consumers.
  - (2) How small businesses should be defined for this purpose.

### **A change in approach: mandatory rules for business insurance**

- 7.19 In the light of the discussion of these proposals at the seminars, we have revised our approach on the question whether, in the case of business insurance, it should be possible for the parties to agree to vary the rules in favour of the insurer. We had suggested that in business insurance this should be permissible, but it should not be possible to agree to a ‘basis of the contract’ clause.



- 7.20 In the seminar we were asked whether it was consistent to permit business parties to alter the rules on misrepresentation by agreement while at the same time forbidding them to use basis of the contract clauses. To some extent they are just different ways of reaching the same result; why forbid one but allow the other? The same question will arise in relation to warranties as to specific facts: why should the parties not be able to create specific warranties, so that they have remedies even for non-negligent misstatements, if they can achieve much the same result by altering the rules on misrepresentation? Shouldn't both sets of rules be mandatory?
- 7.21 We had thought not. We had thought that there is a difference between remedies for misrepresentation and remedies for breach of warranty that justified a difference in treatment. In the context of insurance contract law, the parties' freedom of contract should not be interfered with unless strictly necessary. However we need to ensure, so far as reasonably possible, that the parties understand the effect of what they are agreeing to. This is the problem with warranties of fact: as we pointed out earlier, the effects are most unlikely to accord with the reasonable expectations of the insured. We thought that an insured was much less likely to be taken by surprise by a clause dis-applying the normal rules governing misrepresentation in favour of the insurer.
- 7.22 We were thinking of a provision such as that "the insurer should have the right to avoid the contract even if the proposer's misstatement were made without negligence". That kind of provision should put the insured on warning. It makes it reasonably clear to the insured what its position will be if it makes an inaccurate or incomplete statement. Therefore we had in mind to allow the parties to alter the rules on misrepresentation but not to give effect to specific warranties of fact, even in business insurance.
- 7.23 However we have to admit that our argument is only a good one so far as insureds will in practice become aware of the clause. Moreover, it was rightly pointed out that the rules on misrepresentation could be excluded by a clause stating simply "section 000 of the Insurance Contract Act 2xxx shall not apply to this contract". Even if they read this clause, few non-expert insureds would be much the wiser.
- 7.24 We now think our approach was incorrect. We suspect that a contractual clause that alters the rules on avoidance for misrepresentation is less likely to put the insured on notice of the risk being placed on it than is a statement that it warrants the truth of specified facts. In other words, we think we were wrong to suggest that the rules on misrepresentation could be varied by agreement. If it is desired to allow insurers to reserve the right to refuse a claim because of a wholly innocent misstatement of existing fact, it is probably better to allow it to do so via a warranty of the truth of the facts than by a clause altering the remedies for misrepresentation.
- 7.25 We return to the question of warranties as to specific facts below. Meanwhile, we tentatively propose that, contrary to what we said in our first Issues Paper, the proposed rules on materiality and non-fraudulent misrepresentation should be mandatory in business and consumer insurance.

## **WARRANTIES OF PAST OR EXISTING FACT**

### **Abolishing basis of the contract clauses**

7.26 There are three main problems with basis of the contract clauses:

- (1) The insurer is not required to distinguish between material and immaterial issues: instead, it can grant warranty status en bloc to all the answers in a proposal form, whether they are material or not.
- (2) Such clauses allow insurers to apply a remedy appropriate to warranties to statements that are really representations. If the law of misrepresentation were to be reformed to reduce the remedies available to insurers for non-fraudulent misrepresentations, insurers could use basis of the contract clauses to evade the reforms. They could, for example, avoid liability for misrepresentations that are innocent and non-negligent; for negligent misrepresentations, they could avoid all liability rather than applying a proportionate remedy.
- (3) The warranty does not need to appear in the policy itself. Policyholders will rarely understand the import of what may seem to be obscure words at the bottom of a proposal form.

7.27 There are several approaches to removing these problems.

- (1) The law could allow statements to be incorporated en bloc, but only if the incorporation clause were in the policy itself. This is the current law for marine insurance. Section 35(2) of the Marine Insurance Act 1906 states that the warranty must either be in the policy, or “contained in some document incorporated by reference to the policy”. This means that a policy may contain a clause that has the effect of converting all the statements in the proposal form into warranties. However, the incorporation clause must be in the policy itself. By contrast, in other types of insurance, the incorporation clause may be on the proposal form only.
- (2) The legislation could permit an insurer to convert a statement of existing fact into a warranty, but only if it did so as a specific term of the policy. This was the approach taken by the Law Commission’s 1980 report. It would allow a statement of existing fact to be treated as a warranty, but only if the statement itself were in the policy. It would prevent all statements on a proposal form from being incorporated as warranties en bloc.
- (3) The legislation could state that all statements of existing fact made by the insured should be regarded as representations rather than warranties. Thus if the statement were inaccurate, the insurer’s remedies would be those available for misrepresentation, not for breach of warranty. This means, for example, that an insurer could not avoid liability for an innocent misstatement, even if it was written into the contract. This is the approach taken by the Australian Insurance Contracts Act 1984, section 24. It provides that a statement by the insured about the existence of a current state of affairs should take effect only as a representation, not as a warranty.

- 7.28 The last option is the most radical, since it would mean that even specific warranties of existing fact would have no special status; they would merely be representations. This would be so whether they were warranties of specific facts or became warranties by virtue of a general “basis of the contract” clause. We consider this radical third option after discussing whether basis of the contract clauses should continue to be effective, without prejudice to the question of specific warranties. We consider consumer insurance first and then business insurance.

***Basis of the contract clauses in consumer insurance***

- 7.29 Even if warranties as to specific facts are still to be effective in business insurance, we are convinced that in consumer insurance, basis of the contract clauses should not be effective. We raised this question in our first Issues Paper on Misrepresentation and Non-disclosure, noting there has been widespread criticism of their use.<sup>2</sup> In 1997, for example, the National Consumer Council described them as “completely unfair”.<sup>3</sup> Although the ICOB Rules do not refer to basis of the contract clauses, their use was barred by the 1986 SGIP. The ABI has told us that the use of such clauses contravenes insurers’ duty to treat customers fairly.<sup>4</sup> They have been outlawed in Australia and New Zealand. At the first working seminar there seemed to be widespread agreement with the suggestion in our Issues Paper that basis of the contract clauses should always be ineffective in consumer insurance.<sup>5</sup>
- 7.30 In consumer insurance it would not be adequate to reform the law merely by requiring that the warranty must either be in the policy, or “contained in some document incorporated by reference to the policy”. If all that is required were that there should be a clause in the policy that the insured warrants the truth of every statement made in another document, such as the proposal form, consumers would be no more likely to understand the effect than if the “basis of the contract” clause were in the proposal form. At the very least (and as will be seen in the next section, we would go further) we think that in consumer insurance warranties of existing fact should be effective only if each fact warranted is specifically set out in the policy or in a schedule to it.
- 7.31 **We tentatively propose that “basis of the contract” and similar clauses that have the effect of turning statements of fact in general into warranties should be of no effect in consumer contracts.**<sup>6</sup>

<sup>2</sup> See, for example, the 1980 report para 7.2 and *Joel v Law Union and Crown Insurance Co* [1908] 2 KB 863, 885; *Glicksman v Lancashire and General Assurance Co* [1927] AC 139, 144 to 145; *Mackay v London General Insurance Co* [1935] Lloyd’s Law Reports 201 and Lord Russell’s comments in *Provincial Insurance v Morgan* [1933] AC 240, 250.

<sup>3</sup> NCC, *Insurance Law Reform*, May 1997, p 28.

<sup>4</sup> See the discussion in Part 4.

<sup>5</sup> See Draft Issues Paper No 1, para 6.104.

<sup>6</sup> If this were followed but specific warranties of fact were to be permitted (as to which see the next section), it might be necessary to draft the legislation by reference to what is permitted, since it is not easy to define a ‘basis of the contract’ clause. See 1980 report, Draft Bill cl 8 and 9.

### ***“Basis of the contract” clauses in business insurance***

- 7.32 Here we consider whether, if warranties as to facts are to remain effective, they should have to be created by the policy itself, rather than through a basis of the contract clause on a proposal form. Later we discuss whether to take a more radical approach, to say that all statements of existing fact made by the insured should be regarded as representations rather than warranties.
- 7.33 In the Issues Paper on Misrepresentation and Non-disclosure we tentatively proposed that basis of the contract clauses should no longer be effective in business insurance. There would need at least to be a provision that incorrect answers would not give rise to a remedy for breach of warranty unless there was a term to that effect in the contract itself, rather than merely a “basis of the contract” clause in the proposal form. In effect, if a statement made by the insured were to amount to a warranty it would have to be stated in the policy or in a document incorporated by reference. This is a rule that would have to be mandatory, otherwise the mere insertion of a “basis of the contract” clause might be taken as a ‘contracting out’ from all the rules proposed in this section.<sup>7</sup>
- 7.34 Again at the working seminar there seemed to be wide support for this, which is already the position in marine insurance. The only query raised was whether it was consistent to make this a mandatory rule while we had suggested that in business insurance it should be possible to contract out of the proposed restrictions on avoidance for misrepresentation. We discussed this question above. In any event, the thrust of the argument seemed to be that both sets of rules should be mandatory, so it does not affect the present discussion.
- 7.35 As will be seen below, we would consider going further than denying effect to basis of the contract clauses in business insurance; we ask whether all statements of existing fact made by the insured should be regarded as representations rather than warranties, as in the next section we will propose for consumer insurance. **However, as a minimum, we tentatively propose that in business insurance, a “basis of the contract” clause in the proposal form should no longer be effective to turn the statements made by the proposer into warranties. Each statement of fact warranted should be set out either in the policy, or in some document incorporated by reference to the policy. This rule would be mandatory.**

### **Specific warranties as to past or existing fact**

#### ***Consumer insurance***

- 7.36 In our first Issues Paper on the law of misrepresentation and non-disclosure, we suggested that the remedies proposed for misrepresentation should be mandatory in consumer insurance contracts, but default rules in business insurance contracts. In other words, for consumer insurance, an insurer’s remedies for a mis-statement of fact should be those set out in the new legislation: an insurer would not be entitled to add to those remedies by a term in the contract.<sup>8</sup>

<sup>7</sup> Issues Paper 1, Para 7.82.

<sup>8</sup> The insurer would be free to agree that the insured should have greater rights.

7.37 It would be consistent with this still to permit the insurer to rely on specific warranties of fact that were set out in a written document (or some similar formal requirement). This appears to have been the view of the Law Commission in 1980. The report recommended that basis of the contract clauses should be of no effect but specific warranties as to past or existing fact would be effective, subject to two provisos:

- (1) The warranty must be material (there would be a presumption that it was material); and
- (2) Once a claim had occurred, the insurer would not be entitled to refuse to pay the claim if the insured showed that the warranty was not intended to safeguard against the kind of event that materialised or that the breach of warranty did not increase the risk of the event occurring in the way it did.<sup>9</sup>

7.38 The requirements of materiality and of some connection between the warranty and the claim would limit the possibility for the insurer to use specific warranties as a way to avoid any restrictions on the current remedies for misrepresentation. Suppose, for example, that an insurance policy contained the following term:

The insured hereby warrants that the house in question is made of brick and slate.

7.39 If the house was in fact timber-framed under a brick skin, the insurer would be able to serve notice on the insured repudiating the contract from the date of the notice if no claim had yet arisen; but if an event giving rise to a claim had occurred, whether the insurer would have to meet the claim would depend on the facts. If the event were a flood, the insurer would have to pay. If the event were a fire, it would depend on whether the construction of the house had increased the risk of the event that occurred. So a claim for smoke damage caused by a chip-pan fire might have to be met whereas a fire that affected the main structure might be different.

7.40 We now think this “specific warranty” approach would offer insufficient protection to consumers. First, it would still provide the insurer with the right to refuse a claim even though the consumer had not been fraudulent or even negligent. Secondly, we doubt that consumers would derive much protection from the formal requirements. Merely requiring that the warranty is put into a written document which is given to the consumer within a reasonable time will only protect the consumer who reads the document. Even if the statements have to be in a separate document from the body of the policy, we doubt that many consumers will read them. Normally they will only receive the document after they have, in their view, completed arranging their insurance.

<sup>9</sup> CI 10 of the draft Bill. See further below.

- 7.41 This suggests that we should take the wide approach of the Australian Insurance Contracts Act 1984, namely that a statement of existing fact cannot be a warranty. The insurer's remedies should be those available for misrepresentation (which would not permit avoidance for an innocent, non-negligent misrepresentation, and would apply a proportionate remedy to a negligent one). If the clause were treated as a warranty it would allow an insurer to evade the reforms by applying a different (more insurer-friendly) set of remedies to any breach.
- 7.42 It might be objected that this restriction would be easy to evade. It would be open to the insurer to define the cover by stating that the insurance only applied to houses constructed of brick and slate. In consumer cases, we think current law provides adequate safeguards through the Unfair Terms in Consumer Contract Regulations 1999. The effect of these was explained in detail in Part 4. In the example above, if the restriction to brick houses was explained upfront and in a clear and transparent way, the term would be classified as a core term and would not be open to review. If the exclusion was only mentioned in the small print, it would be subject to a fairness test. We think that is a just result. A consumer who is told that the insurance offered applies only to certain types of risk and not others, or who is given documents that make this quite clear without the consumer having to read the small print, does not have legitimate grounds for complaint. With warranties of fact the situation is different. The reason for limiting the use of warranties as to existing facts is precisely because consumers are very unlikely to understand the effect of the warranty.
- 7.43 **We tentatively propose that in consumer insurance, all statements of existing fact should be treated as representations rather than warranties.**

### ***Business insurance***

#### SHOULD SPECIFIC WARRANTIES OF FACT BE EFFECTIVE?

- 7.44 We have already proposed, as we did in our first Issues Paper, that in business insurance basis of the contract clauses should not be effective to make every statement in the proposal form into a warranty and thus give the insurer the right to repudiate. The reason for this is that to allow basis of the contract clauses would permit the insurer in effect to exclude the regime we proposed for misrepresentation by means of a single clause,<sup>10</sup> which most business insureds would not understand. This rule should be mandatory.<sup>11</sup>
- 7.45 As we said in the case of consumer insurance, it would be consistent with rendering basis of the contract clauses ineffective still to permit the insurer to rely on specific warranties of fact that were set out in a written document (or some similar formal requirement). The question is whether this should also be prevented, as we have tentatively proposed for consumer insurance,<sup>12</sup> or whether it should be permitted, either as at present or subject to restrictions.

<sup>10</sup> Not necessarily even in the policy itself; except for marine insurance, the clause need only be in the proposal form.

<sup>11</sup> See above, para 7.33.

<sup>12</sup> See para 7.43 above.

7.46 There are two reasons why an insurer might want to turn a statement of fact into a warranty rather than rely on the remedies we have suggested for misrepresentation:

(1) It does not have to show that the statement was material.

(2) It will be discharged whether or not the insured was in any way at fault.

7.47 In neither case, under current law, does there have to be any connection between the incorrect statement and the loss for which the claim is made.

7.48 As to the causal connection, we explain below that we think a causal connection of the kind envisaged by the 1980 report should be required for warranties as to the future. A principal reason is that the insured will normally assume that it is still covered for risks that have nothing to do with the warranty. We see no reason to adopt a different approach with warranties as to existing fact. Again the insured is likely to assume that only risks to which the warranty is relevant will be affected. However the law on misrepresentation would not be changed in this respect. Unless the statement was immaterial or the insured otherwise acted reasonably, the insurer will be entitled to a remedy without having to show that the misstatement and the claim were linked. Thus in this respect the insurer's remedies for misrepresentation would be less restricted than those proposed for breach of warranty.

7.49 As to materiality, we saw that the 1980 report would have limited the insurer's rights where the matter warranted was not material. We too see no reason why an insurer should be entitled to remedies for something that a reasonable insured would think irrelevant, even if it is written into the contract. Again the insured may simply (and reasonably) not realise what is wanted. However we quite agree with the 1980 report's recommendation that a statement incorporated as a warranty should be presumed to be material unless the insured shows otherwise. In any event, it should not be difficult for the insurer to make it clear to the insured what facts are material to the insurer.

7.50 The principal question arises where the insured was not at fault. Do insurers need the right to turn a statement of fact into a warranty so that they will have a right to refuse to pay the claim, or treat the policy as discharged, even though the proposer's misrepresentation was innocent and not negligent? We do not see that they do. As we argued in our first Issues Paper, the risk of non-negligent misrepresentations is one that should normally be pooled. Therefore we think that the "default" position, at least, should be that if the untrue statement was made without fraud or negligence, the insurer should have no remedy whether for misrepresentation or breach of warranty.

#### SHOULD THE RULES BE MANDATORY?

7.51 That leaves a difficult question: should the parties be free to agree that the insurer should have the right to refuse to pay a claim or (to use neutral language) to end the policy because of an incorrect statement made without either fraud or negligence?

- 7.52 In our first Issues Paper we had proposed that, in business insurance, the insurer should be able to give itself the right to avoid for negligent or even wholly innocent misrepresentations, as in business insurance the new rules on misrepresentation would not be mandatory. As we explained earlier, we now think this was the wrong approach. If the insurer should be allowed to give itself remedies for “non-negligent” misstatements, the permitted way of doing this should be by the insured giving warranties of specific facts.
- 7.53 Were the law to be changed so as to prevent the insurer being able to rely on warranties as to specific facts (as in Australian law), that rule itself should be mandatory. To make it merely a default rule that could be altered by agreement would render it ineffective. Insurers could simply insert into their contracts a clause disapplying the relevant section of the new legislation and then continue to use specific warranties. Indeed the court might find that the parties had implicitly excluded the new rule simply because there is a warranty of fact in the contract. In either case, the insured who is not an expert will still not be aware of the potential consequences. In other words, any new “no warranties of fact” rule would have to be mandatory to have any effect at all.
- 7.54 So a choice has to be made. The alternatives are:
- (1) To continue to allow breach of warranties of specific facts to act as a defence to a claim provided the claim was causally connected with the breach. We think that specific warranties should be permitted only subject to formal safeguards, such as that the warranty is in a separate written schedule to the policy. We also think that an insurer should only be entitled to reject a claim on the ground of breach of warranty if there was a causal connection between the breach and the claim. We discuss these points in more detail in relation to warranties as to the future; or
  - (2) To provide both that the insurer’s remedy for a misstatement of fact should only be through the remedies for misrepresentation, and that the rules governing these should be mandatory. This is the position in Australian law.

This choice is difficult and we would welcome views.

- 7.55 **In business insurance, we invite views on whether:**
- (1) incorrect statements of past or existing fact should only amount to misrepresentations and not warranties (which would be a mandatory rule); or**
  - (2) breach of warranty of specific facts should continue to act as a defence to a claim provided the claim was causally connected with the breach, and that certain formal safeguards as to warranties generally had been satisfied when the contract was made.**



### **Other types of clause dealing with existing facts**

- 7.56 That leaves a question about policies that seek to achieve the same result by employing a narrow definition of the risk to be covered or an exception to the risk, for example by excluding from cover houses that are not built of brick and slate. The same issue arises in relation to warranties as to the future and is discussed below.

### **WARRANTIES AS TO THE FUTURE: A WRITTEN STATEMENT**

- 7.57 In 1980, the Law Commission recommended that insurers should not be entitled to rely on a breach of warranty unless the insured was supplied with a written statement of the warranty either at or before the contract was made, or as soon as possible thereafter. This recommendation is particularly relevant to promissory warranties, whereby the insured “undertakes that some particular thing shall or shall not be done”.<sup>13</sup> However it would have applied also to the specific warranties as to past or existing fact that the Law Commission then thought should be permitted.
- 7.58 The law already requires that in marine policies express warranties must be in writing.<sup>14</sup> We think that this requirement should extend to all forms of insurance. Where cover is conditional on an insured carrying out a specific task, or refraining from an activity that would be normal in the circumstances, it is important that there should be clarity on both sides about what is required. We think the insured’s obligations should be set out in writing and included or referred to in the main contract document. For these purposes, writing would include printed and electronic forms.<sup>15</sup>
- 7.59 **We tentatively propose that a claim should only be refused because the insured has failed to comply with a contractual obligation, if the obligation is set out in writing and included or referred to in the main contract document.**
- 7.60 For consumer insurance, it should not be enough for the warranty to be buried somewhere in the small print of an insurance policy. The insurer should take specific steps to bring the obligation to the insured’s attention. This is already regarded as good practice: ICOB Rule 5 requires that significant or unusual terms are brought to a consumer’s attention. And, as we discussed in Appendix B, the FOS already makes enforcement of the term dependent on this requirement. We found several cases where the FOS refused to uphold an unusual term if it was not brought to the customer’s attention.

<sup>13</sup> See Marine Insurance Act 1906, s 33(1).

<sup>14</sup> MIA 1906, s 35(2) states that “an express warranty must be included in, or written upon, the policy, or must be contained in some document incorporated by reference into the policy”.

<sup>15</sup> The Law Commission discussed the definition of writing at length in its 2001 Advice to Government, *Electronic Commerce: Formal Requirements in Commercial Transactions*. It argued that the definition of writing in Schedule 1 of the Interpretation Act 1978 would include any “words in visible form”, including those held electronically.

- 7.61 We think the same protections should apply in a court of law. Like the FOS, a court should only enforce a specific obligation on the consumer if the insurer took sufficient steps to bring it to the consumer's attention. The insurer should spell out both what the consumer must do (as in "you must fit a five-lever mortice lock") and the consequences of not doing so (as in "if you do not, we may refuse any claim connected with your failure").
- 7.62 There are different approaches to implementing this principle. One would be to impose detailed rules about how policyholders' obligations should be spelled out. For example, rules could state that the obligation should be in the product summary (required by ICOB Rule 5.3.1); or on the cover note; or in a separate letter; or in one of the three. The statement could be required to be in plain language, legible and clearly presented; or one could go further and specify a minimum point size and prescribed warning. The FSA already has powers to make rules of this sort.
- 7.63 The alternative would be to set out the general principle that unusual terms should be brought to the consumers' attention. It would then be left to the courts to decide whether the obligation has been complied with, bearing in mind any relevant FSA rules or guidance.
- 7.64 The first approach is more certain; the second is more flexible. It is more adaptable to new methods of sales and product information. Given the FSA's current emphasis towards a more principles-based approach, with fewer detailed rules, we are inclined to favour the second approach. This would mean that a court would be left to decide whether the insurer had met its obligation to bring the warranty or similar obligation to the policyholder's attention, having regard to any rules or guidance specified by the FSA.
- 7.65 **In consumer insurance, we tentatively propose that an insurer may only refuse a claim on the grounds that the insured has failed to carry out a specific task (or refrained from a normal activity) if it has taken sufficient steps to bring the requirement to the insured's attention. In deciding whether the insurer has taken sufficient steps, the court should have regard to FSA rules or guidance.**

#### **REQUIRING A CONNECTION BETWEEN THE BREACH AND THE LOSS**

- 7.66 The greatest and most obvious problem with the law on warranties is that it permits the insurer to escape liability for technical breaches that have nothing to do with the loss in question.
- 7.67 We think there is a need to introduce some form of causal connection test to protect policyholders from unfair treatment. An insured may readily agree to a warranty that their sprinkler system will be inspected, believing that if the failure of the sprinkler system causes a loss they will not be indemnified. However, policyholders would not understand this to mean that the insurers would refuse to pay if the breach were later remedied, or if the loss were totally unconnected with the sprinklers. This result defies logic and normal expectations, is inconsistent with good practice as recognised by the SGIP and risks bringing the UK insurance industry into disrepute. Whether we are discussing consumer or business insurance, the current law can properly be described as unjust.

- 7.68 **We tentatively conclude that the law should afford policyholders some protection against claims being denied for reasons unconnected with the loss.**
- 7.69 Although our general policy is clear, difficult questions arise about how this policy should be implemented. There are several possible models to follow. Both New Zealand and Australia have enacted statutes requiring some form of connection. Similarly, in 1980 the Law Commission proposed that an insured should be able to challenge the insurer's decision not to pay a claim if there were shown to be no links between the breach and the loss. Their recommendations were explained earlier.<sup>16</sup>
- 7.70 There are similarities in these three models. For example, all three put the burden of proof firmly on the insured to show a lack of connection. However, the provisions differ in the words they use to define the type of causal connection required. There are also differences in scope: the 1980 report applied just to warranties, while the New Zealand legislation, for example, applied to any term which limited liability for events or circumstances likely to increase the risk of a loss. Here we look first at how to define the causal connection required, and then at the scope of any reform.

#### **Defining the causal connection**

- 7.71 The three provisions use different words to describe the connection required between the breach and the loss. The Bill in the Law Commission's 1980 Report required the insured to prove that the breach did not "*increase the risk*" that the event giving rise to the claim would occur in the way it did. Under the New Zealand Act, the insured must prove that the event did not "*cause or contribute to*" the loss.<sup>17</sup> In Australia the insured need only prove that it did not "*cause*" the loss.<sup>18</sup>

<sup>16</sup> The 1980 report is summarised in Part 3, and the New Zealand and Australian approaches are discussed in Part 6.

<sup>17</sup> In New Zealand, the Insurance Law Reform Act 1977 s 11 states the insured has a right to be indemnified if he can prove, on the balance of probabilities, that the loss was not "caused or contributed to by the happening of such events or the existence of such circumstances".

<sup>18</sup> For example, the Australian Insurance Contracts Act 1984, s 54(3) states that "Where the insured proves that no part of the loss that gave rise to the claim was caused by the act, the insurer may not refuse to pay the claim by reason only of the act".

- 7.72 We have considered whether there is any substantive difference between “increasing the risk” of a loss, “contributing to” a loss or “causing” a loss. The Australian Law Reform Commission thought there was, and criticised the English wording as being too narrow. The ALRC pointed out that even if a breach did not cause or contribute to the loss, it might increase the risk that the loss would occur. It mentioned the example of modifications to a car that increased the risk that the brakes would fail. The ALRC suggested that if a collision was caused entirely by the driver’s carelessness, and the brakes worked admirably, the modifications might still be said to have increased the risk of a collision.<sup>19</sup> It thought that in such a case the insurer should have to pay, and so it recommended the insured need only prove that the breach did not “cause” the loss.
- 7.73 This result does not necessarily follow from the words used. A court could decide that “the way the accident did in fact occur” was that brakes worked perfectly. Therefore, the modifications did not “increase the risk” of this particular accident. However, examples given in the 1980 report suggest that the Law Commission did intend a restrictive approach. One example was a fidelity policy where the insured employer promised not to employ staff without first taking up satisfactory references. The Law Commission stated that if an employer failed to take up references on an employee, who then stole the employer’s money, the insurer should “clearly be entitled to reject the claim, because the commercial purpose of the warranty was to guard against this very type of loss”. It “should not be open to the insured to resist this by seeking to show, for instance, that A would have produced satisfactory or forged references if he had been asked for any”. Thus the Law Commission did not envisage that the insured would bring evidence of whether the breach affected this particular loss in these circumstances.
- 7.74 By contrast, the Australian approach appears more generous to policyholders. The insured need only show that the insured’s act or omission did not “cause” a claim. This might suggest that the breach must be a dominant or major cause of the loss,<sup>20</sup> or that the loss would not have happened but for the breach. For example, car insurance might include a warranty that the car should not be driven by someone under 25. Suppose that while the car was being driven by a 20 year old, it was involved in an accident caused primarily by the negligence of an uninsured cyclist. It is generally accepted that the youth of a driver increases the risk of an accident. However, in these particular circumstances it could be argued that the driver’s age did not “cause” the accident. Yet it might still seem fair to reject the claim. Unless there is strong evidence to the contrary, the fact that the driver was young and inexperienced would be a background factor contributing to the accident. Even if the cyclist was at fault, a more experienced driver might still have avoided a collision. The driver’s age might therefore be said to increase the risk of a loss or to contribute to the loss.

<sup>19</sup> ALRC, *Insurance Contracts* (1982) at para 228.

<sup>20</sup> For marine insurance, the ALRC did recommend that the breach should be the proximate cause (that is the effective or dominant cause) of the loss; see *Review of the Marine Insurance Act 1909* (2001) No 91;  
<http://www.austlii.edu.au/au/other/alrc/publications/reports/91/ch9.html>

### ***Our provisional view***

- 7.75 In our view, the onus should be on the insured to show that the breach did not contribute in any way to the accident. This means that in the modified car, the insured would be able to show that in fact the modifications did not “contribute” to the accident by proving that the brakes worked perfectly or that the car’s braking capacity was completely irrelevant to the accident. It would also be open to the insured to attempt to prove that the failure to take up references did not contribute to the loss because the employee’s references would have been satisfactory. However, the insured would need to prove this on the balance of probabilities. It would not be sufficient simply to invite the court to speculate about “might have beens”. Normally, a failure to follow proper procedures would contribute towards an employee theft. Similarly, the age and inexperience of a driver would be expected to contribute to an accident, even a no-fault accident. The insured would have to do more than merely show that the breach was not the main or dominant cause of the loss.
- 7.76 **We tentatively propose that the policyholder should be entitled to be paid a claim if it can prove on the balance of probability that the event or circumstances constituting the breach of warranty did not contribute to the loss.**

### ***Payment of premium warranties***

- 7.77 At present, insurers may include “payment of premium warranties”, under which the insured warrants that premium instalments will be paid within specific time limits. In *JA Chapman v Kadirga and others*,<sup>21</sup> it was held that if such a warranty was breached, the insurer is automatically discharged from any further liability under the contract, but the insured remains liable to pay all the premiums on the due date. This appears to be a harsh result.<sup>22</sup>
- 7.78 Late payment of a premium will almost never cause or contribute to a loss. It is therefore worth considering what effect a payment of premium warranty would have under our reforms. It would still be open to an insurer to make payment by the due date into a condition of the policy. Under normal contractual principles, if the insured breached the condition, this would be considered a repudiatory breach. It would be open to the insured to accept the repudiation and terminate the contract. Until a repudiatory breach is accepted, the contract continues and any claim must be paid. Once accepted, both parties’ obligations come to an end, so that an insured would not be liable for any payments arising after the termination (though the insured may be liable to pay damages for the insurer’s loss of profits). We think this is a fairer approach, and consider it in more detail below (see paragraphs 7.140- 7.149).

<sup>21</sup> [1998] CLC 860.

<sup>22</sup> In the *Chapman* case, the problems were compounded by section 53(1) of the Marine Insurance Act 1906, which places liability to pay marine premiums on the broker rather than the insured. This meant that if the broker went into liquidation, the insured could be deprived of the benefit of the insurance through no fault of their own. The Law Commissions will be considering the merits of section 53 at a later date.

### ***Partial loss***

- 7.79 The Australian provisions protect policyholders when a breach of warranty causes only part of the loss. Section 54(4) of the Australian Insurance Contracts Act 1984 states that:

Where the insured proves that some part of the loss that gave rise to the claim was not caused by the act, the insurer may not refuse to pay the claim, so far as it concerns that part of the loss, by reason only of the act.

For example, if a fire spreads from a well-maintained section of a building (A) to one where the sprinklers are not working (B), the insured is entitled to the part of their claim relating to the well-maintained section.

- 7.80 On balance, we think that such a provision is fair to policyholders, and a useful clarification of the causal connection test. If the fire spreads from section A to section B, the faults in section B cannot be said to have contributed to the loss in section A. It would, of course be different if the fire spreads from the faulty section. Here the breach would have contributed to the further loss. We welcome views.
- 7.81 **We tentatively propose that the law should provide that if a breach contributes to only part of a loss, the insurer may not refuse to pay the part not related to the breach.**

### ***A mandatory or default rule?***

- 7.82 We have said that the current rule is unjust because it defeats the reasonable expectations of the insured. We think this will almost always be the case in consumer insurance, and we recommend that for consumers the rule should be mandatory. For business insurance it is perhaps arguable that it should be possible to alter the rule provided very clear words are used to do so.
- 7.83 **We tentatively propose that the causal connection rule should be mandatory in consumer insurance. We invite views on whether it should also be mandatory in business insurance.**

### **OTHER TYPES OF CLAUSE**

- 7.84 The 1980 Report applied only to warranties. For example, if the insured “warranted to maintain the car in a roadworthy condition”, then it would be open to the insured to argue that a fault with the headlights could not have increased the risk of a loss in broad daylight. However, if the same provision were expressed as a description of the risk (that the insurance only applied while the car was roadworthy) then the insured could not take advantage of the defence, and the insurer would not be required to pay the claim.

- 7.85 We think it would be unduly formalistic to confine the causal connection test to warranties. Birds and Hird are right to argue that this would merely encourage insurers to find other means of achieving the same ends.<sup>23</sup>
- 7.86 Both the New Zealand and Australian legislation take a more purposive approach. For example, the New Zealand 1977 Act applies to a provision in an insurance contract that meets two tests.
- (1) They must “exclude or limit the liability of the insurer... on the happening of certain events or the existence of certain circumstances”; and
  - (2) this must be because the events or circumstances were (in the view of the insurer) “likely to increase the risk of such loss occurring”.<sup>24</sup>
- 7.87 A provision stating that the car was only insured while it was roadworthy would be caught by the section. This clause purports to exclude or limit the liability of the insurer in certain circumstances (that the car is unroadworthy) because when a car is unroadworthy, the risk of a loss increases. In contrast, the reform would not affect a notice clause. A failure to give notice could not increase the risk of a loss occurring as it would only apply once a loss had happened. Similarly, it would not affect a payment provision, as a failure to pay a premium does not increase the risk of a loss.

#### ***Our provisional view***

- 7.88 Our tentative proposal is that the reforms should follow the New Zealand approach: they should extend beyond warranties, to all terms that enable the insurer to refuse to pay a claim for events or circumstances that add to the risk of loss. It should not matter whether a clause is written as a warranty (“the insured warrants that the vehicle will be maintained in a roadworthy condition”) or as descriptive of the risk (“the insurance only applies if the vehicle is in a roadworthy condition”). In either case, the insurer should not be entitled to refuse a claim for a fault that has no connection to the loss: for example, a fault with the headlamps should not affect an accident in daylight. If the reform were confined to warranties, it would simply encourage insurers to draft policies in more ingenious ways.
- 7.89 **Should the protection apply to any term that purports to exclude or limit the liability of the insurer for events or circumstances that are thought to increase the risk of a loss occurring?**

#### ***A proviso: where an activity is wholly outside the policy***

- 7.90 That said, we have a particular concern where the insured has taken out a policy that is meant to be used for one purpose, activity or place and is trying to use the insurance for an entirely different purpose, activity or place.

<sup>23</sup> J Birds and NJ Hird, *Birds Modern Insurance Law* (6<sup>th</sup> ed 2004) p 166, note 36. See also the discussion in Part 3.

<sup>24</sup> Insurance Law Reform Act 1977, s 11. See Part 6.

- 7.91 The obvious example from the case law is where an insured has taken out a motor policy for a private car, and is using it for commercial purposes. If the insured has used the car for one business trip, the law should not invalidate the whole policy. However, if the car is being used full time as a taxi there comes a point where the activity generating the loss is so far removed from the activity covered by the policy that the policy should not apply at all. If the car is stolen when parked overnight in the insured's driveway, it is arguable that the insurer should not be liable for the claim even if the insured could prove that the theft was not related to its use as a taxi.
- 7.92 Another example would be third party, fire and theft car insurance limited to owners aged over 30. Suppose the car was owned and driven by a 20 year old at all times. Under the Road Traffic Act the insurers would be required to meet third party claims. We are not sure that the insured should be able to demand that a theft claim was also paid because the age of the driver did not contribute to the theft. Again there comes a point in which the purpose to which the loss relates is so far removed from the purpose covered by the policy that the claim is not within the terms of the policy at all.
- 7.93 A similar example from marine insurance would be an exclusion for a war risk area, such as the Gulf. If a ship enters the Gulf, this should not automatically discharge the insurer from liability. Instead, when the ship leaves the Gulf, cover should resume. However, if the ship is in the Gulf at the time of a loss, it is arguable that no claim should be paid, even if the loss was not related to a war risk and could have happened anywhere.
- 7.94 We think that the causal connection should not apply where the insurance relates to one purpose, activity or place, and the loss arises from an entirely different purpose or activity or in another place. In deciding whether the purpose, activity or place is entirely different, the court should ask whether the difference was such that a reasonable insured could have expected the loss to be covered. Thus we do not think that a 20 year old owner could reasonably expect to be covered by a policy limited to those over 30; nor would a reasonable ship owner expect to be covered in an excluded war risk zone. However, a car owner would expect to be covered for a car with broken headlamps that was driven during the day.
- 7.95 The court should also differentiate between occasional misuse and constant misuse. For example, if a car covered by private insurance were used occasionally for a business purpose, this would suspend cover for accidents related to the business use, but would not affect unconnected claims. However, if the car were always used for business purposes, this would take it outside the terms of the policy altogether.
- 7.96 We think the way to build in a limitation of this kind would be to use a test of what it was reasonable for the insured to expect. This would vary according to the facts and the nature of the insurance.



- 7.97 **Should the causal connection test be subject to an exception where the insurance relates to one purpose, activity or place, and the loss arises from another purpose or activity or in another place? In these circumstances the claim should not be paid if the loss related to an activity which was so far outside the terms of the cover that a reasonable insured could not have expected the loss to be covered.**

***An alternative approach***

- 7.98 We accept that requiring a causal link subject to a proviso adds a measure of complexity to the law. An alternative way of dealing with the same problem would be to take an “unfair terms approach”. This would ask whether the term that entitled the insurer to avoid liability met a requirement of fairness. We consider this approach in more detail in Part 8. The advantage of applying a fairness test to cases such as these is that it is more flexible. It looks at the heart of the matter – was the term fair in all the circumstances, taking into account what was reasonably expected, what the insured understood by it, and the legitimate interests of the insurer? The disadvantage is that a fairness test is more uncertain. The need to look at all the circumstances encourages greater litigation. In Part 8 we ask for views on this issue.

**SHOULD THE REFORMS APPLY TO MARINE, AVIATION AND TRANSPORT INSURANCE?**

- 7.99 In 1980, the Law Commission excluded Marine, Aviation and Transport (MAT) insurance from the scope of its reforms. It argued that the people working in this market were generally professionals “who could reasonably be expected to be aware of the niceties of insurance law”.<sup>25</sup> The law was certain and understood, and worked satisfactorily.
- 7.100 In our first paper on non-disclosure and misrepresentation we argued against making a distinction between MAT and other forms of insurance. We were not convinced that MAT was a separate and distinct market.<sup>26</sup> We thought it would be overly complex to require lawyers to apply one law to (for example) major constructions, and quite a different law to ships.

<sup>25</sup> para 2.8.

<sup>26</sup> In 1980, the Law Commission accepted that the line between MAT and other insurance was not a clear one, and that some individuals with pleasure craft did need additional protection. It expressed unease with the definitions of MAT used in previous regulations, and suggested some omissions. It also proposed that the Secretary of State should be empowered to vary the definition by regulation

- 7.101 That said, there are reasons why marine warranties may need to be considered separately from warranties in other contracts. First, the English courts have tended to construe warranties more strictly in marine cases than in other forms of insurance. Secondly, the MIA 1906 implies warranties into marine insurance contracts by operation of law. The voyage conditions may also require review. Below we start by considering whether there are any good reasons for continuing to take a particularly strict approach to marine warranties. We then look specifically at the warranties implied into the marine insurance contracts by the MIA 1906 to see if a causal connection test should be applied to them. Finally, we ask whether we should review those voyage conditions within the MIA that discharge insurers from liability for reasons unconnected with the risk.

### **The arguments for strict construction**

- 7.102 The doctrine that marine warranties should be strictly construed has a long history. Developed by Lord Mansfield in the Eighteenth Century,<sup>27</sup> it was enshrined in the 1906 Act and upheld by the House of Lords in *The Good Luck* as recently as 1992. Lord Goff justified the doctrine in the following terms:

The rationale of warranties in insurance law is that the insurer only accepts the risk provided that the warranty is fulfilled. This is entirely understandable; and it follows that the immediate effect of a breach of a promissory warranty is to discharge the insurer from liability as from the date of the breach.<sup>28</sup>

- 7.103 The difficulty, however, is that the breach is usually only discovered after a loss has occurred. Where the loss is related to the breach, the doctrine is clearly understandable. But where the breach relates to a different risk, and no loss has materialised from that particular breach, the remedy can seem arbitrary and excessive.
- 7.104 We can understand that a strict approach had some justification when the doctrine was developed. In 1786, insurers had almost no information about the ship or the risk, except for what the insured told them and what the insured promised he would do. If the insured promised to do something, and then did not do it, it undermined his credibility and therefore the whole nature of the risk. However, the amount of information available to insurers has changed beyond recognition. The ISM and ISPS Codes, for example, require a large body of records to be kept, including records of training, shipboard operations, security threats, potential hazards, internal audits and reviews. This means that marine risks are much more like other risks in the market. Insurers are less dependent on the good faith of the insured, but can verify the information given through a variety of surveys and audits. It also means that they are more aware of technical breaches, even if those breaches did not result in any loss.

<sup>27</sup> See *Eden v Parkinson* (1781) 2 Dougl KB 732, *Hore v Whitmore* (1778) 2 Cowp 784 and *De Hahn v Hartley* (1786) 1 TR 343.

<sup>28</sup> *Bank of Nova Scotia v Hellenic Mutual War Risks ("The Good Luck")* [1992] 1 AC 233, at p 263.

- 7.105 It has been put to us that a breach of warranty continues to undermine the credibility of the insured, and hence the nature of the risk, even in the absence of any specific causal connection between the two. In the *Bamcell II*, for example, the policyholders had specifically promised to place a watchman on board each night from 2200 hours to 0600 hours, but in fact had never hired a watchman at all. It could be argued that such behaviour fundamentally altered the nature of the risk. If the insured could not be trusted to do as they had promised, how many other unacceptable risks were they taking? Even without a direct causal connection between the lack of a watchman and the daytime loss, could there be said to be a connection through the addition of a moral hazard?
- 7.106 We have two concerns about this argument. The first is that behaviour that seems heinous to an insurer may seem innocuous to an outsider. There are several examples in the law reports, where (for example) insurers have argued that a minor conviction many years ago fundamentally alters the nature of the risk, in ways that the court has been unable to accept.<sup>29</sup> The doctrine of warranties allows the insurer to play judge and jury by denying a claim when they think that the insured has committed a morally reprehensible breach, even for matters that appear merely technical to others.
- 7.107 Secondly, we do not think that the present rules on warranties meet the needs and expectations of an international market. We have not found any commentators outside the common law sphere who consider it is fair for an insurer to fail to pay a claim for a breach which is not connected to the loss. Several criticise the rule in scathing terms.<sup>30</sup> Even within jurisdictions that share the legacy of the Marine Insurance Act, it is rare for a court to accept insurers' arguments that a claim unrelated to a breach should not be paid. It was rejected by the US Supreme Court in *Wilburn Boat*, and by the Supreme Court of Canada in *Bamcell II*.<sup>31</sup> The Australia Law Reform Commission reviewed marine insurance law in 2001, following complaints from the fishing industry and recommended that a breach of warranty should only justify avoiding a claim if it proximately caused the loss.
- 7.108 Given the international nature of the marine market, it is particularly important that its legal rules should correspond to internationally accepted notions of fairness. **For this reason, we tentatively propose that the causal connection test outlined above should also apply to marine insurance.**

<sup>29</sup> See *Roselodge Ltd v Castle* [1966] 2 Lloyd's Rep 113 and *Reynolds v Phoenix Assurance Co* [1987] 2 Lloyd's Rep 440.

<sup>30</sup> For example, Professor Trine-Lise Wilhelmsen comments that the English concept of a warranty is "hard to understand and even harder to explain" (Duty of Disclosure, Duty of Good Faith, Alternation of Risk and Warranties: An Analysis of the Replies to the CMI Questionnaire", CMI Yearbook 2000 p 392). Professor Hare calls the Anglo-American marine insurance warranty "a prodigal aberration from the European *ius communis* of marine insurance" which should "be brought back into the fold in the interests of very fairness, justice and equity to which English law so properly aspires" (*The Omnipotent Warranty: England v The World*, paper to the International Marine Insurance Conference, November 1999).

<sup>31</sup> See paras 6.51 and 6.52, above.

### **The implied marine warranties**

- 7.109 The Marine Insurance Act 1906 implies four warranties into marine insurance contracts: seaworthiness, portworthiness, cargoworthiness and legality. These are described briefly in Appendix A. The warranty of seaworthiness is by far the most important, though it operates differently in voyage and time policies.
- 7.110 A full review of the implied warranties is outside the scope of our project. In 1980 we commented that the rules were long-established and well-known, and that the professionals in the market could reasonably be expected to be aware of their niceties.<sup>32</sup> The rules are certainly well-established. How far they are well-known is difficult to say; even the short description in Appendix A reveals some complexities and uncertainties surrounding them. However, we have not received demands for their reform, and a full-scale review would take more resources than we have available.
- 7.111 Here we are concerned with only one limited question, which is whether the requirement for a causal connection set out above should also apply to the implied marine warranties. Our view is that it should. Below we consider the four warranties, to see if they raise any special issues.

### **Seaworthiness**

- 7.112 The main effect would be upon the warranty of seaworthiness in voyage policies. It would effectively reverse the ruling in *De Hahn v Hartley*,<sup>33</sup> by permitting warranties to be remedied. If, for example, a ship leaves port with insufficient crew, and later takes more crew on board, the insurer would be liable for subsequent losses. It would also mean that a technical breach (such as not carrying the required medicines, or not having the correct certificates on board) would not discharge the insurer from liability for an unconnected loss.
- 7.113 Our proposals are mild: in a voyage policy, the insured would only be paid if it could show, on the balance of probabilities that the breach did not contribute to the loss. This goes nowhere near as far as the requirement in time policies, where the *insurer* has to prove that the breach was a *real or dominant cause* of the loss. It does, however, go some way to lessening the difference between voyage and time policies. Given that the industry has lived with the time policy rule for over 100 years, we do not think that this lesser rule in voyage policies should cause undue difficulties.

### **Portworthiness and cargoworthiness**

- 7.114 These warranties are less likely to be a major cause of dispute, and we do not think that the proposed reform would have any great effect on the market.
- 7.115 At present, it may be possible for an insurer to argue that, if a problem in port is remedied before the ship is put to sea, the insurer is discharged from liability for an unconnected loss at sea. We do not think this result would be fair. Again, we believe that the insured should be able to put forward a defence that the breach did not contribute to the loss.

<sup>32</sup> para 2.8.

<sup>33</sup> (1786) 1 TR 343.

### ***Legality***

- 7.116 The warranty of legality raises more complex issues. Insurance contracts, like all other contracts are subject to the general doctrine of illegality. This means that if the parties agree to insure an illegal adventure, the contract would not be enforceable in any event. Similarly if, unbeknown to the insurer, the insured intended to engage in an illegal activity the contract would be unenforceable by the insured.<sup>34</sup> These results are independent of the law on warranties, and would not be affected by the proposed reforms. The insured would not be entitled to enforce an illegal contract even if the loss was unconnected to the risks posed by the illegal conduct.
- 7.117 There is some uncertainty about how far the implied warranty of legality under section 41 of the MIA imposes additional requirements on insurance contracts. Under normal contract law, if one party commits a statutory offence in the course of performance (such as overloading a ship) this does not affect the enforceability of the contract.<sup>35</sup> It is possible that section 41 goes further than normal contract law in these circumstances. If an insured could prevent the ship from being overloaded and fails to do so, this may be a breach of the implied warranty that “the adventure shall be carried out in a lawful manner”. If this is a correct interpretation of the law, we think the rule needs to be tempered. Under our proposed reform, it would be open to the insured to argue that the overloading was not intended at the outset, but was only a subsequent illegality. If the insured could prove that the overloading did not contribute to the loss, the insurer would remain liable.

### ***Conclusion***

- 7.118 Overall, we see no reason why our causal connection test should not apply equally to implied and express warranties.
- 7.119 **Is it agreed that the implied marine warranties should be subject to the same causal connection test as express warranties?**

### ***Implied conditions as to the voyage***

- 7.120 It has been brought to our attention that there are other provisions within the Marine Insurance Act 1906 that operate in a similar way to warranties. For example, section 43 states that

Where the place of departure is specified in the policy, and the ship instead of sailing from that place sails from any other place, the risk does not attach.

<sup>34</sup> *Archbolds (Freightage) Ltd v Spanglett* [1961] 1 QB 374.

<sup>35</sup> *St John Shipping Corp v Joseph Rank Ltd* [1957] 1 QB 267.

- 7.121 This can lead to very technical arguments. For example, in *Molinos Nacionales v Pohjola Insurance Company Ltd*,<sup>36</sup> the ship was said to sail from Tallinn, but instead sailed from Muuga, an adjacent part separated from Tallinn by a headland only 3 miles across, and managed by the same port authority. The difference in port had no bearing on the risk. Mr Justice Coleman described the insurer's argument that the risk did not attach as having "no merit whatsoever". However, the Act and earlier authorities permitted insurers to avoid a voyage policy for "trivial, entirely immaterial, deviations". He was therefore forced to conclude that the insurers should be allowed to defend the claim on these grounds, and were entitled to proceed to trial.
- 7.122 Other parts of the MIA raise similar issues. Under section 44, for example, the policy does not attach if the ship sails to the wrong destination. Under sections 45 and 46, if the destination is changed or there is a deviation, the insurer is discharged.
- 7.123 We intend to consult briefly about these sections at a later date.

#### **SHOULD THE REFORMS APPLY TO REINSURANCE?**

- 7.124 Our view is that unless there are very good reasons to the contrary, the law on reinsurance should follow, as closely as possible, the law that governs the original insurance contract.
- 7.125 An example of the problems that can be caused where the laws differ can be found in *Forsikringsaktieselskapet Vesta v Butcher*.<sup>37</sup> The plaintiffs were a Norwegian insurance company who had insured the owners of a Norwegian fish farm against the loss of their fish. The plaintiffs had then reinsured 90% of the risk with London underwriters. Both the original policy and the reinsurance policy stated that a 24-hour watch be kept of the farm, and that "failure to comply" would render the policy null and void. Although the terms were identical, the applicable law was not. The original policy was governed by Norwegian law while the reinsurance policy was governed by English law.
- 7.126 The fish were lost in a storm. The farm had failed to keep a 24 hour watch, but this was unconnected to damage caused by the storm. Under Norwegian law, the breach did not prevent liability from arising, despite the express words of the policy, because it was not causative of the loss. The Norwegian insurers paid the claim. However, when they sought to recover 90% of the loss from the London underwriters, the reinsurers pleaded breach of warranty. The House of Lords eventually held the reinsurers liable as, on a true construction of this particular policy, they had agreed to cover all the risks involved in the original policy. It was unfortunate, however, that the dispute took so long to resolve.

<sup>36</sup> (unreported) High Court, 5 May 1998.

<sup>37</sup> [1989] AC 852.

- 7.127 In 1980 the Law Commission recommended against extending the reforms to reinsurance contracts generally. It thought that the parties to reinsurance contracts would be “aware of the well-known and long-standing rules of law and practice governing the market in which they operate” and that its general recommendations on breach of warranty would be inappropriate to the market.<sup>38</sup> It did however, attempt to protect insurers against the sort of anomalies that arose in the *Vesta* case. It recommended that where the reassured “substantially repeats the warranty broken by the insured”, the reinsurer would not have greater rights against the reassured than the reassured had against the original policyholder.
- 7.128 We are not convinced that the parties to reinsurance are always fully aware of the differences between legal regimes. If they were, the difficulties in *Vesta* would not have arisen. The greater the variation in the law applying to different types of insurance contracts, the more scope there is for confusion to arise. We would not wish to create differences between insurance and reinsurance law unless those differences were clearly necessary. We fear that the specific provisions to prevent anomalies of the type suggested by the 1980 report would add to the complexity of the law.<sup>39</sup>
- 7.129 We are interested to hear from the industry whether there are any reasons to treat reinsurance contracts differently. Our current thinking is that the reforms suggested above should apply to both insurance and reinsurance contracts.
- 7.130 **Are there any reasons why the reforms should not apply to reinsurance contracts?**

#### **REFORMING OTHER PROVISIONS OF THE MIA 1906**

- 7.131 The reforms we have tentatively proposed have consequences for the Marine Insurance Act 1906. For example, the requirement for a causal connection is incompatible with section 34(2), which does not allow a breach of warranty to be remedied before a loss occurs.<sup>40</sup> Here we consider other implications of our proposals on reforming the MIA provisions on warranties.

#### **Automatic discharge or repudiation?**

- 7.132 The reforms we have proposed are incompatible with the idea that an insurer is automatically discharged from liability from the date of the breach. Section 33(3) states that

<sup>38</sup> para 8.12.

<sup>39</sup> There already appears to be considerable scope for argument about whether a clause in an insurance contract has been incorporated within a re-insurance contract in “manipulated” or “unmanipulated” form: see *HIH Casualty and General Insurance Ltd v New Hampshire Insurance Co* [2001] 2 Lloyd’s Rep 161; [2001] EWCA Civ 735. We would not wish to encourage disputes of this type, but imposing one set of legal rules where the reinsured gave an independent warranty and another where the reinsured “substantially repeated” the warranty given by the insured.

<sup>40</sup> S 34(2) states that “where a warranty is broken, the assured cannot avail himself of the defence that the breach had been remedied, and the warranty complied with, before loss”.

...subject to any express provision in the policy, the insured is discharged from liability as from the date of the breach of warranty, but without prejudice to any liability incurred by him before that date.

If an insurer is automatically discharged from liability from the date of the breach, it cannot logically be liable to pay a subsequent loss unconnected with the breach.<sup>41</sup>

- 7.133 If one were to repeal section 33(3) it would be necessary to put something in its place. If not, the repeal would only lead to confusion about how far the provision merely reflected the pre-existing common law position, which continued unchanged. The question is how far any statutory restatement should go in altering the current law.
- 7.134 If warranties are not to be given any special or pre-eminent status, then it would be more in keeping with general contractual principles to provide that a breach by one party merely gave the other party the choice. When an injured party becomes aware of the breach, it may either decide to repudiate the contract or to affirm it and continue with the relationship.
- 7.135 **Should the reforms provide that a breach of warranty gives the insurer the right to repudiate the contract, rather than automatically discharging it from liability?**
- 7.136 In 1980 the Law Commission argued that the issue of past claims and future repudiation should be treated separately. An insurer should be able to pay past claims and repudiate the policy for the future; it should also be entitled to reject claims, without repudiating in the future.
- 7.137 Under the tentative proposals in this paper, a breach of warranty would mean that an insurer was not liable for a loss causally connected to the breach (though, as we discuss below, it would be possible for the insurer to waive this breach). The breach would not affect any past unconnected losses. However, the question is whether the breach should also entitle an insurer to choose to bring the policy to an end. This means that the insurer would no longer be liable to meet any claims (whether causally connected to the breach or not) from the time the decision was communicated to the insured,
- 7.138 **Should the reforms provide an insurer with a choice between repudiating the claim only, or the policy for the future, or both?**

#### **The implications of termination: liability for premiums, notice and waiver**

- 7.139 If the reforms were to provide that a breach of warranty gives an insurer the right to bring a contract to an end, this raises three further questions. First, should the insured continue to be liable to pay premiums after the contract is terminated? Secondly, should the insurer's right to repudiate for the future be subject to a requirement to give reasonable notice? Finally, what effect would this have on the law of waiver? We explore these issues below.

<sup>41</sup> Furthermore, if we were to extend the Unfair Contract Terms Act 1977 to insurance policies, as discussed in Part 8, it would be incompatible with s 29, which provides that a party may rely on provisions that are specifically authorised by statute.



### ***Continued liability for premiums***

#### FUTURE PREMIUMS

7.140 Under general contract law, where one party accepts the other's wrongful repudiation, the effect is to bring to an end both parties' primary obligations under the contract. As Lord Diplock put it:

(a) there is substituted by implication of law for the primary obligations of the party in default which remain unperformed a secondary obligation to pay money compensation to the other party for the loss sustained by him in consequence of their non-performance in the future and (b) the unperformed primary obligations of that other party are discharged.<sup>42</sup>

7.141 This means that neither the innocent nor the guilty party are required to perform any further primary obligations under the contract (though ancillary clauses, dealing with matters such as arbitration, may survive).<sup>43</sup> If the guilty party has been paying by instalments, the normal rule is that the insured remains liable for any payments that fall due before the repudiation is accepted,<sup>44</sup> but not for payments due after that date. The primary obligation to pay the instalments is replaced with a secondary obligation to pay damages for loss of profits. This contrasts with the rule for breach of warranty under section 33(3), under which only the insurer is discharged from liability: the insured remains liable to pay future instalments of the premium. As we have seen, under the current law if the insured breaches a payment of premium warranty, the insurer is automatically discharged from further liability, but the insured must continue to make payments.<sup>45</sup>

7.142 The question is what would happen if we were to repeal section 33(3) and replace it with an insurer's right to accept repudiation? It is unclear whether the normal rule would apply, so that the insured would cease to be liable for the premium). The insurer might be able to argue that the separate instalments did not constitute different payments for divisible periods of cover (with, for example, each monthly instalment paying for each month's cover). Instead, it could be said that the premium was one single indivisible payment for one single period of cover: it was just that the contract permitted the single premium to be paid over the course of time.

7.143 This latter argument was accepted in *Chapman v Kardirga*.<sup>46</sup> Chadwick LJ commented:

<sup>42</sup> *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827 at p 849.

<sup>43</sup> See *Yasuda Fire & Marine Insurance Co of Europe v Orion Marine Insurance Underwriting Agency Ltd* [1995] 1 Lloyd's Rep 525.

<sup>44</sup> *Hundai Heavy Industries Co Ltd v Papadopoulos* [1980] 1 WLR 1129, where the party in default was entitled to claim an instalment which fell due on 15 July despite the fact that they had cancelled the contract on 6 September.

<sup>45</sup> In *JA Chapman v Kardirga and others* [1998] CLC 860.

<sup>46</sup> Above.

the Judge [at first instance] was wrong to hold that the effect of the payment of premium clause [which allowed payment by quarterly instalments]...was to apportion the premium payable under the policy to discreet periods of the term of the policy; that is to say, to convert what was (but for the payment of premiums clause) a premium payable in respect of the entire risk into a series of premiums payable in respect of risks during successive periods...The fact that the successive instalments are due and payable on dates which occur at three monthly intervals during the term of the policy does not, in my view, lead to the conclusion that the premium, which comprises the aggregate of those instalments, is itself divisible between successive three month intervals.<sup>47</sup>

7.144 If it were accepted that the premium became due immediately (with payment postponed into instalments) then the insured would remain liable to pay the whole premium even after the repudiation was accepted. We do not think that this result would be fair. It would allow the insurer to make a windfall profit from the insured's breach of warranty, by keeping the premiums and not incurring any liability. In our view, the normal default rule should be that the insured would no longer be liable to pay premium instalments that fell due after the contract has been terminated.

7.145 **Is it agreed that if the insurer accepts the insured's breach of warranty, so as to terminate future liability, the insured should cease to be liable for future premiums?**

#### PREMIUMS PAID IN ADVANCE

7.146 A more difficult question is what should happen if the insured has paid the premium in advance. Under normal contract principles, the insured would only be entitled to the return of the premium if there had been a total failure of consideration.<sup>48</sup> For this, the breach, and the acceptance of the breach, must have occurred before the cover started.

7.147 However, for many types of contract, the courts are prepared to divide the bargain into constituent parts. Where some of the advance payment can be attributed to a particular part of the contract, and the consideration for that part has wholly failed, the guilty party may recover that portion of money. This would apply in a yearly insurance contract where it was possible to divide the total cover into 12 separate monthly parts. It would mean that if a breach of warranty were accepted in Month 2, the insured would be entitled to be repaid 10/12ths of the advance premium, less any damages due to the insurer for administrative expenses and loss of profit.

<sup>47</sup> See above.

<sup>48</sup> See *Rover International Ltd v Cannon Film Sales (No. 3)* [1989] 1 WLR 912. In *Stocznia Gdanska SA v Latvian SS Co* [1998] 1 WLR 574 at p 588, Lord Goff stated that "the test is not whether the promisee has received a specific benefit, but rather whether the promisor has performed any part of the contractual duties in respect of which the payment is due".

7.148 The question is whether this is a desirable result. We are keen to improve communication and trust between insurers and insured, and we are concerned that allowing the insurer to retain the whole premium may operate to undermine such trust. Suppose, for example, a shop owner has warranted that the shop will be protected by a working burglar alarm at all times, and the burglar alarm breaks down. Ideally, the shop owner would contact the insurer to tell them about the problem as soon as possible. However, if this would permit the insurer to cancel the policy and retain ten months' premium, the owner would be better off keeping quiet. They might calculate that the alarm would be fixed soon, before any loss happens. Furthermore, under our reforms, the insurer would remain liable for losses unconnected with the problem, giving the insured a clear incentive not to alert the insurer.

7.149 **We would be interested to hear views on whether an insurer who terminates a policy following the insured's breach of warranty should normally provide a pro-rata refund of the outstanding premium, less any damages or administrative costs.**

#### ***Notice***

7.150 Under our proposals, once an insurer had communicated its acceptance of the breach to the insured, it would no longer be liable for future claims. This would not make any difference to claims for losses connected to the breach (for which the insurer would not be liable in any event) but it would terminate all the insurer's other liability for claims arising after the effective date.<sup>49</sup> This leads to the question whether the insurer should give reasonable notice of such a termination. Should the termination take place when it is received, or only after sufficient time for the insured to make other arrangements?

7.151 In Australia, the insurer cannot bring a contract to an end as a result of the breach, but it is entitled to terminate the contract using a cancellation clause. Under section 59 of the Insurance Contracts Act 1984, the insurer must give at least three days notice in writing. In Norway, circumstances covered by a warranty would normally be considered as an alteration in the risk. This would permit the insurer to terminate the contract, but only after 14 days notice.<sup>50</sup>

7.152 We think that a requirement for a period of reasonable notice would encourage insureds to report breaches of warranty. If a notice period is to be specified, it should reflect a reasonable period for the insured to make other arrangements. We would welcome views about whether this is more likely to be a few days or a couple of weeks, or somewhere in between.

7.153 **We welcome views as to whether the act should include any requirement for notice. If so, what would constitute a reasonable time for an insured to make other arrangements?**

<sup>49</sup> Claims arising before the effective date would not be affected.

<sup>50</sup> Norwegian Marine Insurance Plan, section 3-10.

### **Waiver and Affirmation**

- 7.154 The changes we have proposed to section 33 of the MIA 1906 would have consequences for the law on waiver. The 1906 Act specifically states that “a breach of warranty may be waived by the insurer”.<sup>51</sup> However, since the House of Lords decision in *The Good Luck*,<sup>52</sup> there has been a considerable academic debate over how breaches of warranty may be waived.<sup>53</sup>
- 7.155 In English contract law, there are two ways in which a party may be taken to have waived their rights when faced with the other party’s repudiatory breach.<sup>54</sup> The first way is by making a choice between two inconsistent courses of action. The wronged party has a choice: either to treat the breach as discharging the contract (ie to “repudiate” or “terminate” the contract), or to affirm the contract. If they affirm, it seems the right to repudiate will be lost provided that the wronged party knew of the facts giving rise to the right to repudiate and, it would appear, that they possessed the right in question.<sup>55</sup> The wronged party must then evince a decision to relinquish that right by words or conduct. Once the party has made the choice to affirm the contract, it is bound by that decision. This type of waiver is sometimes called “waiver by election”.
- 7.156 The second way is through “waiver by estoppel”.<sup>56</sup> This requires the wronged party to make an unequivocal representation by words or conduct that it will not rely on its legal rights. The other party must show that it relied on the representation by doing something or refraining from doing something, in circumstances where it would be inequitable for the wronged party to rely on its legal rights. Normally, the other party would have to show that it has altered its position to its own detriment.<sup>57</sup>

<sup>51</sup> See s 34(3).

<sup>52</sup> *Bank of Nova Scotia v Hellenic Mutual War Risks Association (Bermuda) Ltd* [1992] 1 AC 233.

<sup>53</sup> See Baris Soyer, *Warranties in Marine Insurance* (2<sup>nd</sup> ed, 2006), ch 6; Clarke para 20-7A; and MacGillivray, para 10-104.

<sup>54</sup> For a full discussion of the authorities on this point see *Peyman v Lanjani* [1985] 1 Ch 457. In *Habib Bank Ltd v Tufail* [2006] EWCA Civ 374; [2006] All ER (D) 92 (Apr) Lloyd LJ drew a distinction between affirmation, “where knowledge of the right to rescind is essential” (at [20]) and “acquiescence”, which requires the other party to show that it relied on the representation.

<sup>55</sup> See *Chitty on Contracts* (29<sup>th</sup> ed, 2004), para 24-003.

<sup>56</sup> See *Chitty on Contracts* (29<sup>th</sup> ed, 2004), paras 24-007 – 24-008.

<sup>57</sup> See *Tool Metal Manufacturing Co Ltd v Tungsten Electric Co Ltd* [1955] 1 WLR 761; and *Emery v UCB Corporate Services Ltd* [2001] EWCA Civ 675.

- 7.157 Often both forms of waiver involve similar types of inconsistent acts. For example, after learning of a breach an insurer may accept premiums,<sup>58</sup> or issue a policy document,<sup>59</sup> or handle a claim. For affirmation, the issue would be whether the insurer had the requisite knowledge and whether the act shows that it intended to continue with the policy. For “waiver by estoppel” the focus shifts to the policyholder’s perceptions and conduct. Did the act appear to show that the insurer did not intend to rely on its legal rights? If so, did the policyholder in fact rely on this representation by, for example, failing to take out another insurance policy? It is usually more difficult for the policyholder to show waiver by estoppel because it has to prove that it relied on the representation, usually to its detriment. The policyholder would not need to prove that the insurer knew that it had the right to deny liability, but the policyholder would need to show that a reasonable policyholder in their position would think that the insurer was aware of the right.<sup>60</sup>
- 7.158 It is now thought, following *The Good Luck*, that affirmation, or waiver by election, is not applicable to a breach of an insurance warranty of assurance. In *HIH Casualty & General Insurance Ltd v AXA Corporate Solutions*, Lord Justice Tuckey explained with apparent approval the reasoning of the trial judge:<sup>61</sup>
- where there is a breach of warranty there is no scope for traditional waiver by election because the insurer is automatically discharged from liability upon breach and therefore has no choice to make. This is why only waiver by estoppel availed HIH, if it did...<sup>62</sup>
- 7.159 This puts a heavier burden on the policyholder as they not only have to show that the insurer made an unequivocal representation, but also that they relied on it.

<sup>58</sup> As MacGillivray says “the acceptance of premium after receipt of knowledge of a breach of warranty or condition is an act so inconsistent with an intention to repudiate liability that it is frequently a ground of waiver”: para 10-109. See for example, *Yorkshire Insurance Co v Craine* [1922] 2 AC 541 and *Cia Tirrena Assiccurazioni v Grand Union Insurance Co* [1991] 2 Lloyd’s Rep 143

<sup>59</sup> See, for example, *Sulphate Pulp Co v Faber* (1895) 1 Comm Cas 146.

<sup>60</sup> As the judge of first instance said in *HIH Casualty & General Insurance Ltd v AXA Corporate Solutions* [2002] Lloyd’s Rep IR 325:

the point is not so much the awareness of [reinsurer] as to its rights to treat the cover as discharged but whether it appeared to a reasonable person in the position of [the reinsured] that the reinsurer was so aware and was prepared to forego its rights. That is a gloss that is important and can easily be overlooked in this analysis.

<sup>61</sup> [2003] 1 Lloyd’s Rep IR 1.

<sup>62</sup> Para 7. Note also Longmore J’s view in *Kirkaldy & Sons Ltd v Walker* [1999] Lloyd’s Rep IR 410 at p 422 that “since the breach of warranty does not give rise to any election by the insurer, eg, to choose to keep the contract on foot, the doctrine of waiver by election has no application”. We have some doubts whether these decisions are consistent with the wording of the Act, which refers simply to waiver without mentioning reliance, but the cases are clear. See Baris Soyer, *Warranties in Marine Insurance* (2<sup>nd</sup> ed, 2006), ch 6.

- 7.160 Scots law has not developed a classification equivalent to the English law distinction between waiver by election and waiver by estoppel. The decision of the House of Lords in *Armia Ltd v Daejan Developments Ltd*<sup>63</sup> has generally been regarded as authority for the proposition that a party relying on the other party's abandonment of a right must demonstrate that he has conducted his affairs on the basis of the waiver, although he need not go so far as to show that he has suffered prejudice as a consequence of relying upon it.<sup>64</sup> In reaching this decision, the House of Lords referred to certain English authorities while cautioning that the Scots law of personal bar should not be assumed to be the same as the English law of estoppel.
- 7.161 We think that if the change we have suggested to section 33 is put into effect, so that the contract is not discharged automatically by a breach of warranty but the insurer has the right to repudiate (or, as some prefer to say, terminate) for breach, whether the insurer is precluded by its subsequent conduct from exercising that right can be left to the general law of contract. Thus in English law, for example, the insurer might lose its right by either affirmation or estoppel. We think this is just. There is a case for allowing an insured to found upon a waiver by the insurer without having to show that they relied on the representation. Particularly in the case of an express statement by the insurer who is aware of the breach that it does not insist upon its rights consequent upon the breach of warranty, it is difficult to see why an additional requirement of proving reliance should be imposed upon the insured.<sup>65</sup> The same may be said where the waiver is clear from actions of the insurer.
- 7.162 We do not think it is necessary to include a specific provision on this point in any new legislation, but we would welcome views on the point.
- 7.163 **We tentatively propose that Marine Insurance Act 1906, section 33(3) should be repealed. Loss by waiver of the insurer's right to repudiate the contract would in future be determined in accordance with the general rules of contract. We welcome views on whether it is necessary to include a specific provision on this point in any new legislation.**

<sup>63</sup> 1979 SC (HL) 56.

<sup>64</sup> Lord Fraser of Tullybelton at 68-9; Lord Keith of Kinkel at 71-2. See eg *Moodiesburn House Hotel Ltd v Norwich Union Assurance Ltd* 2002 SLT 1069.

<sup>65</sup> This requirement in Scots law (see above) has been questioned (in non-insurance cases) in *Presslie v Cochrane McGregor Group Ltd* 1996 SC 289 and *Howden (James) & Co Ltd v Taylor Woodrow Property Co Ltd* 1998 SC.

## PART 8: AN UNFAIR TERMS APPROACH TO COMMERCIAL INSURANCE?

- 8.1 In this paper we have discussed ways in which warranties and unexpected definitions of the risk hidden within contractual small print may be used to produce results that are unfair to policyholders. As we have seen, consumer insurance is subject to the Unfair Terms in Commercial Contracts Regulations 1999, which require terms that go beyond the main definition of the subject matter to be fair. We have suggested that unexpectedly narrow definitions of the risk and unexpectedly wide exclusions can be challenged under the Regulations.<sup>1</sup> However, there is no similar protection for commercial insurance.
- 8.2 In other areas of commercial life, businesses are given protection against unfair terms by the Unfair Contract Terms Act 1977 (UCTA). When a business is dealing on its written standard terms of business, it cannot rely on a clause as entitling it to render a contractual performance substantially different from that which was reasonably expected, or to render no performance at all, unless the clause is fair and reasonable. However UCTA does not apply to insurance contracts.
- 8.3 For the purposes of this paper, we are primarily interested in whether an unfair terms approach could be substituted for the causal connection test outlined in Part 7, or added to it to deal with clauses that define the risk or provide exceptions to the cover.
- 8.4 As we have seen, we do not think that the causal connection test should apply only to warranties, but should extend to all clauses that define the risk. This, however, may be over-inclusive. We suggest that it should be subject to a proviso to allow the insurer to escape liability where the activity is so far outside the terms of the cover that a reasonable insured could not have expected the loss to be covered. A more direct approach may be to look at the fairness of the term. Thus the causal connection test might be confined to warranties, and other exclusions could be subject to a fairness test. Alternatively, the warranty itself might be subjected to the test of fairness if the insurer attempted to rely on it to render a performance that was substantially different from what the insured reasonably expected. The fairness test might apply to all standard term business insurance contracts, or might be confined to those entered into by small businesses.
- 8.5 It is possible that unfair terms protection could also be applied to other problematic terms in insurance contracts. In the first issues paper we raised the question of whether insurers should only be permitted to exclude our proposed reforms on misrepresentation and non-disclosure in small business contracts in so far as this was fair. In subsequent papers we intend to return to the question of notification clauses: one answer to the problems they cause might be to subject them to a test of fairness. In this paper, however, we raise general questions about an unfair terms approach only in relation to warranties, definitions of the risk and exclusions.

<sup>1</sup> Above, Part 4.

- 8.6 Here we begin by outlining the effect of sections 3 and 17 of UCTA on other types of commercial contract. We then consider the arguments for and against extending this protection to commercial insurance.

### **THE UNFAIR CONTRACT TERMS ACT 1977, SECTIONS 3 & 17**

- 8.7 In England and Wales, section 3 subjects certain clauses to a requirement of reasonableness. It applies between contracting parties where one of them deals as a consumer or on the other's written standard terms of business. Section 3(2)(b) prevents the party who wrote the standard terms of business from claiming to be entitled

(i) to render a contractual performance substantially different from that which was reasonably expected of him, or

(ii) in respect of the whole or any part of his contractual obligation, to render no contractual performance at all,

except in so far as... the contract term satisfies the requirement of reasonableness.

- 8.8 In Scotland, the issue is dealt with by section 17, which enacts the same substantive provision, using slightly different words. It provides that a term in a consumer contract or standard form contract "shall have no effect for the purpose of enabling a party to a contract...

(b) in respect of a contractual obligation, to render no performance, or to render a performance which is substantially different from that which the consumer or customer reasonably expected from the contract

if it was not fair and reasonable to incorporate the term in the contract.

- 8.9 In February 2005, the two Law Commissions produced a joint report and draft Bill to amend the law of unfair contract terms. As far as sections 3 and 17 are concerned, we did not intend to make any substantive changes in the law. However, we aimed to produce a single section to apply to the whole of Great Britain, written in clearer language. Clause 9(3) of the draft Bill applies where one party to a business contract ("A") deals on the written standard terms of business of the other ("B"). It states that

Unless the term is fair and reasonable, B cannot rely on any of those terms to claim it has the right –

(a) to carry out its obligations under the contract in a way substantially different from the way in which A reasonably expected them to be carried out, or

(b) not to carry out all or part of those obligations.



8.10 These provisions require the court to start with three questions:<sup>2</sup>

- (1) What contractual performance did A reasonably expect?
- (2) What contractual performance does B claim to be entitled to render?
- (3) Is there a substantial difference between the two?

8.11 Is so, the court must then ask whether the term satisfies the requirement of reasonableness, given the circumstances that were or ought to have been in the contemplation of the parties when the contract was made.

8.12 The first question must be approached broadly as a matter of fact. As Lord Bingham pointed out in *Zockoll Group Ltd v Mercury Communications Ltd*, the “answer cannot depend on the proper construction of the contract”.<sup>3</sup> If a party could only reasonably expect that which the contract actually provided there would never be any discrepancy between the two. Instead, in a case such as *Kler Knitwear* the court would need to start by asking whether the claimants reasonably expected that, if they were late in checking the sprinkler system, claims for storm damage would be paid. If so, the court would then ask whether this was what the contract in fact provided? If not, was the difference substantial? After this initial hurdle has been cleared, the court would then need to consider whether the clause introducing a warranty was fair at the time the contract was made.

### **Industry standard terms**

8.13 A difficult question about UCTA is how it applies to industry standard wording. In our 2005 report we discussed the meaning of “written standard terms of business”. If one party regularly uses industry standard terms, and puts them forward for the contract in question, then it is probable that they would be caught by sections 3 and 17. During consultation, several consultees suggested that there should be a special exemption for terms drafted by a trade association. However, we decided against such an exemption:

The reason is that there can be no guarantee that terms will be fair simply because they were drawn up by a third party and are used widely in the relevant market. The terms might have been drawn up by a trade association that represents the interests of one party and not those of the other party; and yet may be used in the vast majority of contracts in the market because, for example, the other party usually lacks the sophistication or the bargaining power to demand terms more favourable to it.<sup>4</sup>

<sup>2</sup> See *Zockoll Group Ltd v Mercury Communications Ltd* [1999] EMLR 385, per Lord Bingham.

<sup>3</sup> Above, at p 395.

<sup>4</sup> Unfair Terms in Contract (Law Co No 292; Scot Law Com No 199) (2005) para 4.61.

- 8.14 Although there would not be a blanket exemption, however, the provenance of the terms and the degree to which they are excepted in the market would be highly relevant to any decision about whether they are reasonable. If terms are the result of genuine negotiation by both sides of the market acting on equal terms, it is very unlikely that a court will find them to be unfair.

#### **THE ARGUMENTS FOR EXTENSION**

- 8.15 We do not think that extending sections 3 and 17 and their replacement to insurance would make any difference to consumer contracts. As discussed earlier, the Unfair Terms in Consumer Contract Regulations already require that a term must be fair, if it enables the insurer to render a contractual performance substantially different from that which was reasonably expected. Furthermore, in 1990, the Insurance Ombudsman stated that he would apply the spirit of the Unfair Contract Terms Act 1977, and the Financial Ombudsman Service has continued this tradition. However, the section would give substantially improved rights to small and medium businesses that are forced to contract on the insurer's standard terms of business.
- 8.16 We see three main advantages in extending sections 3 and 17 of the Unfair Contract Terms Act 1977 to insurance contracts:
- (1) The protection only applies to standard term contracts. It does not interfere with the freedom of large businesses to negotiate contracts on an individual basis. We would prefer to make a distinction on the basis of how the contract was negotiated rather than attempt to find some other proxy for those who need protection and those who do not, such as size or nature of the business.
  - (2) It applies to any term that defines cover in a way that policyholders would not reasonably expect, and to any term that allows the insurer not to pay a claim at all. Unlike section 54 of the Australian Insurance Contracts Act 1984, it looks at the substance of the term rather than its form. It therefore avoids the sort of semantic distinctions between, for example, "omissions" and "inactions" that have bedevilled section 54. In the case of claims made and notified policies, for example, the court would start with looking at what policyholders would reasonably expect. If the insurance had been sold in such a way that the policyholder should have realised that it was limited to claims made and notified during the contractual period, that would be the end of the matter. But if a "condition precedent" were written in such a way that an insurer could avoid paying a claim for which they were otherwise liable for a trivial delay, the court would need to examine how far the clause was fair and reasonable.

- (3) In examining whether a term was fair and reasonable, the court would need to take into account both the extent to which the term was transparent and its substance and effect. This means that a term written in plain language and brought to the policyholder's attention would be much less likely to be found to be unfair than one lost in obscure small print. The reform would provide a strong incentive to insurers to re-write their contractual documents in a way that policyholders understand.<sup>5</sup>

## **THE ARGUMENTS AGAINST EXTENSION**

### **Freedom of contract**

- 8.17 The first argument is that controls on unfair contract terms interfere with freedom of contract. A dynamic and innovative market is best served if the parties are allowed to agree what they want. This argument was put to the joint Law Commissions when we recommended the controls in 1975.<sup>6</sup> In 1975 we replied that:

It is valid only to the extent that there is true freedom of contract to interfere with, and the objection has no validity where there is no real possibility of negotiating contract terms, or where a party is not expected to read a contract carefully or to understand its implications without legal advice.<sup>7</sup>

- 8.18 It is of course difficult to distinguish between situations where there is genuine freedom of contract and those where there is not. The fact that the contract is on standard terms suggests that freedom is limited. We also thought that the strength of the bargaining positions of the parties and their understanding of the term in question should be taken into account in a test of reasonableness.

### **Uncertainty**

- 8.19 The second argument is that it introduces unacceptable uncertainty into the law. The insurance industry also put them with great force when it secured an exception from the Unfair Contract Terms Act in 1977.

<sup>5</sup> By contrast, the 1980 recommendations set out procedural and substantive safeguards separately. Procedurally, the insurer need only supply the insured with a written statement of the term. They need not ensure that the policyholder has actually understood it. If an insurer required a certain specification of lock which was not fitted, they would not be liable to meet a burglary claim where the thieves entered through the door - even if the specification was buried in small print, and expressed in such technical terms that few policyholders would have understood it.

<sup>6</sup> Exemption Clauses: Second Report (Law Com No 69; Scot Law Com No 39) 1975, paras 66 and 67.

<sup>7</sup> Above, para 67.

- 8.20 Before the 1977 Act was passed, fears were expressed that it would lead to great uncertainty and an unacceptable level of litigation. A problem with UCTA is that it can be used for its “nuisance potential”. In other words, debtors can buy more time in which to pay debts by putting in weak defences, claiming that terms are unfair even if they were readily agreed to at the time. However, this is less likely to be a problem with insurance, where the onus will be on the policyholder to bring the claim. There are already many deterrents to stop small and medium businesses from bringing weak claims against insurers.
- 8.21 In practice, UCTA has generated only moderate amounts of litigation.<sup>8</sup> Sections 3 and 17 have become generally accepted, and in our recent review of the legislation we received no demands for their repeal.<sup>9</sup> It must be remembered that the existing law is extremely uncertain: there is a danger that cases raising the same issues as *Kler Knitwear* will be litigated repeatedly, as insurers test out new and better wording to remove any possibility of ambiguity.

## CONCLUSION

- 8.22 We would consider this option only if it were really needed. There would need to be evidence that businesses require better protection not only against warranties but also against unexpectedly narrow definitions of the risk or unexpectedly wide exceptions, and that the approach which we advocate in Part 7 is unacceptable. If the only real problems are encountered by small businesses, the protection could be confined to small businesses (though this raises questions of definition discussed in the first Issues Paper). We would welcome further advice on whether such protection is needed, and what the consequences might be.
- 8.23 **We invite views on whether clauses that define the risk and exclusions in business insurance contracts written on the insurers’ standard terms should be subject to a test of fairness and, if so, whether the protection should apply to all businesses or only those defined as small.**

<sup>8</sup> A Westlaw search showed 86 reported cases in which section 3 has been cited since 1977. A similar search of the term “insurance warranty” showed 149 cases in the same period.

<sup>9</sup> Fujitsu argued against section 2(2), which applies a reasonableness test to exclusion clauses in all contracts, on grounds that it extends to contracts which have been individually negotiated. However, we did not receive any objections to the existing controls over standard term contracts.

# APPENDIX A: THE IMPLIED WARRANTIES IN MARINE INSURANCE

- A.1 Here we give a brief description of the implied warranties as set out in the Marine Insurance Act 1906. In the absence of provisions to the contrary, these are to be implied into all marine insurance contracts by operation of law.
- A.2 The most important implied warranty is that of seaworthiness, though the 1906 Act treats voyage and time policies very differently. The other warranties are less important. They cover portworthiness, cargoworthiness and legality.

## SEAWORTHINESS

### Voyage policies

- A.3 The most important implied warranty is that of seaworthiness, implied into voyage policies by section 39(1):

In a voyage policy there is an implied warranty that at the commencement of the voyage the ship shall be seaworthy for the purpose of the particular adventure insured.

- A.4 “Seaworthiness” is defined by section 39(4):

A ship is deemed to be seaworthy when she is reasonably fit in all respects to encounter the ordinary perils of the seas of the adventure insured.

- A.5 The concept is extremely wide. A ship may be unseaworthy for a range of factors, including for example, the design of the hull, the way it has been loaded, the competency and adequacy of the crew, or the lack of navigational equipment or fuel. Some breaches may be central to the risks posed by the voyage, while others may be technical. It has been held, for example, that a ship may be unseaworthy because it does not carry the correct documentation,<sup>1</sup> or has insufficient medicines.<sup>2</sup> Thus leaving port without medicines may amount to a breach of the implied warranty, which would automatically discharge the insurer from liability, even if it had no connection with the loss that occurred.

### Time policies

- A.6 By contrast, the term implied into time policies is much milder. Section 39(5) states that:

In a time policy there is no implied warranty that the ship shall be seaworthy at any stage of the adventure, but where, with the privity of the assured, the ship is sent to sea in an unseaworthy state, the insurer is not liable for any loss attributable to unseaworthiness.

<sup>1</sup> *Cheikh Boutros v Ceylon Shipping Lines (The Madeleine)* [1967] 2 Lloyd's Rep 224.

<sup>2</sup> *Woolf v Claggett* (1806) 3 Esp 257.

- A.7 Thus the insurer is exempted from liability only if it can show the ship was sent to sea in an unseaworthy state with “*the privity of the assured*”, and that the loss was “*attributable to unseaworthiness*”. Both concepts require explanation.
- A.8 “Privity” is taken to mean “knowledge or consent”,<sup>3</sup> and the definition of “knowledge” was considered at length in *The Star Sea*.<sup>4</sup> The House of Lords held that the insurer must show the insured had either actual knowledge, or “blind eye knowledge”. This is a demanding test. It is not enough that the insured failed to make enquiries from laziness or gross negligence. The insured must have had an actual suspicion that was firmly grounded and targeted on specific facts, and have then taken a deliberate decision to avoid confirming these suspicions.
- A.9 Furthermore, the loss is only excluded if it is “attributable to unseaworthiness”. It has been argued that this means the unseaworthiness must be a “proximate cause”.<sup>5</sup> In other words, it must be one out of only a few efficient, dominant or real causes of the accident.<sup>6</sup> Clearly if the unseaworthiness was the only cause of the accident, the loss would not be caused by one of the insured risks, and the insurer would not be liable in any event.<sup>7</sup> Section 36(5) applies when there are several causes: when, for example, a loss is caused both by bad weather and by a defect in the hull. It means that if the insured knew about the hull defect, the loss is not covered, even if the insurer would otherwise be liable for loss caused by the perils of the sea.<sup>8</sup>

#### **The difference between the two provisions**

- A.10 The difference in the way the law treats voyage and time policies is startling. In voyage policies, the insurer is discharged the moment the ship leaves port in an unseaworthy condition, even if the defect is minor, is later remedied, is unknown to the insured, or has nothing to do with the loss. By contrast, in a time policy the insured can act negligently in putting a ship to sea in a seriously poor condition. However, unless the insurer can show that the ship owner knew of the problem, section 39(5) does not bite. Furthermore, even if the insured knew that the crew was too few and this may well have contributed to the risk of an accident, the insurer is still liable unless it can show that the lack of crew was one of the main causes of the loss.

<sup>3</sup> On the issue of privity, see *Compania Maritime San Basilio SA v Oceanus Mutual Undertaking Association (Bermuda) Ltd (The Eurysthenes)* [1977] 1 QB 49;

<sup>4</sup> *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd* [2003] 1 AC 469.

<sup>5</sup> See B Soyer, *Warranties in Marine Insurance* (2<sup>nd</sup> ed, 2006), pp 92-7.

<sup>6</sup> *Leyland Shipping Co Ltd v Norwich Union Fire Insurance Society Ltd* [1918] AC 350.

<sup>7</sup> Except in the unlikely circumstances that unseaworthiness was a risk specifically covered by the policy, when section 36(5) would be expressly excluded from the policy.

<sup>8</sup> In *JJ Lloyd Instruments v Northern Star Insurance Co (The Miss Jay Jay)* [1987] 1 Lloyd's Rep 32, the insured was unaware of the defect. The insurer was therefore liable for a loss caused partly by a latent defect in the hull and partly by difficult though not exceptional weather. If the insured had been aware of the defect, the insurer would not have been liable.

- A.11 There are some reasons to treat voyage and time policies differently. In a voyage policy, the theory is that the insured can check the seaworthiness of the ship before the voyage starts. By contrast, in a time policy, if the ship is already at sea at the start of the policy, the insured cannot do this. However, if the insured knew that the ship was unseaworthy when the ship was put to sea, it would be unfair to hold the insurer liable. This difference, however, does not explain why the implied term for voyage policies does not require any causal connection, while section 39(5) says the loss must be attributable to the unseaworthiness.

### **OTHER IMPLIED WARRANTIES**

- A.12 The other warranties implied by the MIA are of less importance. There are said to be three:

#### **Portworthiness**

- A.13 Section 39(2) of the MIA states:

Where the policy attaches while the ship is in port, there is also an implied warranty that she shall, at the commencement of the risk, be reasonably fit to encounter the ordinary perils of the port.

- A.14 This section appears to have relatively little effect, and we have not been able to find any litigation on it. This is partly because it only applies to voyage policies which attach while the ship is in port ("at and from" policies), and not to those which attach after the ship leaves port ("from" policies).
- A.15 Some doubts have also been raised whether section 39(2) should be accorded full warranty status. Suppose, for example, that a ship is inadequately crewed and supervised while in port, but no damage is done as a result. A full crew then joins the ship, and it leaves port fully seaworthy. If the ship is lost in a storm, for totally unconnected reasons, should the insurer be discharged from liability as a result of the breach while the ship was in port? We have not been able to find any case in which this point has been argued. If a breach of section 39(2) does discharge the insurer from liability for claims that have no causal connection with the breach, we do not think that this reflects the normal expectations of professionals within the market.

#### **Cargoworthiness**

- A.16 Section 40(2) of the MIA states that:

In every voyage policy on goods or other moveables there is an implied warranty that at the commencement of the voyage the ship is not only seaworthy as a ship, but also that she is reasonably fit to carry the goods or other moveables to the destination contemplated by the policy.

- A.17 However, the provision no longer meets the needs of the market, and it is regularly excluded. As Soyer comments:

The implied warranty of seaworthiness has been severely criticised on the ground that it might create freakish results for the assured in cargo insurance. A claim under the policy will fail if the carrying vessel was unseaworthy at the start of the voyage, even though the assured has no means of ensuring whether the ship was seaworthy or not. For this reason, in almost all cargo policies, the implied warranty of seaworthiness has been waived provided that the assured or their servants are not privy to such unfitness.<sup>9</sup>

### Legality

A.18 The marine adventure itself must be lawful. Section 41 states

There is an implied warranty that the adventure insured is a lawful one, and that, so far as the assured can control the matter, the adventure shall be carried out in a lawful manner.

A.19 In 1906 this reflected the general doctrine in the law of contract that illegal contracts may not be enforced. It is difficult to say how the section continues to reflect that doctrine. There is some uncertainty over whether the section should be interpreted in line with more recent case law on the doctrine of illegality, or whether it should be regarded as a stand alone rule, frozen in time.

A.20 Clearly, if the parties agreed at the outset to insure an illegal adventure, the contract would be regarded as illegal and would not be enforceable in any event. Similarly if, unbeknown to the insurer, the insured intended to engage in an illegal activity it would be unenforceable by the insured.<sup>10</sup>

A.21 The difficulties arise when at the time of making the contract the parties intended to act legally, but later performed the contract or carried out some aspect of the adventure in an unlawful manner. In *St John Shipping Corporation v Joseph Rank Ltd*, Devlin J held that illegality in the course of performance did not generally render a contract illegal.<sup>11</sup> Here the ship owners had overloaded the ship, causing its load line to be submerged,<sup>12</sup> but no harm or loss had been sustained. The ship owners sued for their freight, but the cargo owners defended the action on the grounds that the contract had been performed illegally. Devlin J commented that caution was required at a time when “so much of commercial life is governed by regulations of one sort or another, which may easily be broken without wicked intent”.

<sup>9</sup> B Soyer, *Warranties in Marine Insurance*, 2<sup>nd</sup> ed, 2006, p117. See further cl 5.2 of ICC 1982 (type A, B, C).

<sup>10</sup> *Archbolds (Freightage) Ltd v Spanglett* [1961] 1 QB 374.

<sup>11</sup> [1957] 1 QB 267.

<sup>12</sup> This was an offence under the Merchant Shipping (Safety and Load Line Conventions) Act 1932, s 44, for which the master had been prosecuted.



To nullify a bargain in such circumstances frequently means that in a case - perhaps of such triviality that no authority would have felt it worth while to prosecute - a seller, because he cannot enforce his civil rights, may forfeit a sum vastly in excess of any penalty that a criminal court would impose; and the sum forfeited will not go into the public purse but into the pockets of someone who is lucky enough to pick up the windfall or astute enough to have contrived to get it.<sup>13</sup>

- A.22 The question is what effect section 41 would have if, for example, in the course of a voyage a ship is overloaded in a way that the ship owners could have prevented. Would this automatically discharge an insurer from liability for a loss that had no connection with the overloading?
- A.23 Baris Soyer argues that the principles in *St John Shipping* also apply to section 41. This means that a violation of shipping safety legislation does not render the performance of the adventure illegal.<sup>14</sup> On a policy level, the arguments Devlin J used in *St John Shipping* would appear to apply equally to an insurance contract. The breach may be trivial; it may bear no relationship to the loss; the insured may forfeit a sum vastly in excess of the criminal penalty; and the insurer may receive a windfall. The difficulty is exacerbated by the fact that the parties may not be able to contract out of the effect of section 41 if it does not suit their needs.<sup>15</sup> However, we have found no authority directly on the point.

<sup>13</sup> *St John Shipping Corp v Joseph Rank Ltd* [1957] 1 QB 267, at p 288.

<sup>14</sup> *Warranties in Marine Insurance*, 2<sup>nd</sup> ed, 2006, p 126.

<sup>15</sup> *Gedge v Royal Exchange Assurance Corp* [1900] 2 QB 214.

## **APPENDIX B: CONSUMER DISPUTES ABOUT POLICY TERMS BROUGHT TO FOS**

- B.1 We wished to gain a better understanding of the type of disputes over policy terms brought to Financial Ombudsman Service (FOS), and how ombudsmen approached such cases. We therefore asked FOS if we could read through 50 final decisions classified as policy term disputes, brought by consumers. FOS very kindly provided us with copies of final decisions reached between and January 2005 and August 2006.
- B.2 A few cases within the policy term category were mainly about other issues. We excluded one case because it was about mis-selling, and another because it was about a non-disclosure. We were able to replace these with other cases, and ended up with 50 consumer cases concerning a term in the policy. Given that disputes over policy terms can cover a wide variety of subjects, 50 is not a large number. The discussion below provides a feel for the sort of issues that cause problems and how ombudsmen approach them, rather than a quantitative analysis.
- B.3 Final ombudsman decisions are not typical of all cases. The FOS Annual Review for 2004/2005 shows that most cases do not reach an ombudsman: over half (58%) were resolved through mediation, and more than a third (38%) were resolved after an adjudicator had given a view on the merits. Only 7% were resolved by a final ombudsman decision. However, we thought that ombudsman decisions would give us the best understanding of the approach that the FOS takes to policy terms.
- B.4 We are very grateful to FOS for allowing us access to these cases. We undertook to preserve the anonymity of both complainants and insurers and we have been careful to remove any details that could allow the parties to be identified. In the examples that follow, we refer to complainants by changed initials and to cases by number rather than name. These numbers have been allocated by us for the purposes of this study, and bear no relation to FOS records.

### **TYPES OF POLICY**

- B.5 The 50 cases covered many different types of insurance, though some types were more likely than others to lead to disputes about terms.
- B.6 Disputes about travel insurance were particularly prevalent, and we discuss them in more detail below. Legal expenses insurance also appeared to be over-represented, compared with its importance in the market, and we provide a brief description of the issues it raises.

**Table 1: Type of policy**

	No	%
Travel	14	28
Building/contents	8	16
Income/loan protection	7	14
Legal expenses	6	12
Health	4	8
Critical Illness	3	6
Caravan	3	6
Other	5	10
<b>Total</b>	<b>50</b>	<b>100</b>

- B.7 There were also particular terms that appeared to cause problems. Five cases considered the definition of total disablement, an issue that can arise in income protection, critical illness or health cover. Issues about security requirements arose in five cases (including the three caravan cases within the sample). Two cases involved “changes in risk clauses” which attempt to impose a continuing duty on policyholders to disclose a change in circumstances. Again, we discuss these in more detail below.
- B.8 The “other” category included one of each of the following: motor, pet, breakdown assistance, mobile phones, and a car data check. Disputes can arise about a wide variety of policy terms. The sample included a dispute about whether pet insurance covered hydrotherapy for a pet dog, whether breakdown assistance covered driving into a ditch, and whether insurance on a car data check covered the risk that the vehicle was cloned.
- B.9 Given the prevalence of motor insurance, we were slightly surprised that our sample included only one such case. It may be that motor insurance includes more standard terms, and that these terms are better known and understood among consumers.

### **TRAVEL INSURANCE**

- B.10 Travel policies appear to cause particular problems: they are usually low cost products, sold by non-specialists, with minimum formality. Consumers are unlikely to invest much time or effort into understanding the policy terms, though some claims may be substantial. The FOS appeared willing to use its fair and reasonable discretion to require insurers to pay claims, even if the issue was excluded by the small print of the policy. Overall, nine of the 14 complaints about travel insurance were upheld. The figures are too small to be statistically significant, but they suggest a higher success rate: two thirds of travel policyholders won, compared with around half overall.

B.11 There are many different aspects of disputes over travel insurance which can give rise to a claim: the sample included disputes about whether a theft limit was £200 per claim or per item and whether someone was entitled to be repatriated by club class. However, we were struck that eight out of the 14 cases concerned claims for curtailment or cancellation of a holiday, and five involved disputes about pre-existing medical conditions. Several cases involved both: for example, where a family cancelled a holiday following the serious illness or death of a close relative, and the insurer rejected their claim on the grounds that the relative had suffered from a pre-existing medical condition.

B.12 Clauses about pre-existing medical conditions can be drafted extremely widely. For example, in Case 22 an annual travel policy included the following term:

It is a condition of this policy that no trip will be covered if at the time of taking out this policy you or anyone upon whom this trip depends has a pre-existing medical condition.

B.13 At first sight, this appears to be a warranty. It is drafted in such a way to suggest that if anyone involved has a pre-existing medical condition, the insurer would incur no liability at all under the policy. For example, if a child suffered from asthma, and the father was injured in road accident, the insurer would not be liable for the father's medical bills. However, it is highly unlikely that the insurer would actually apply the term in this way.

B.14 In this particular case, the family had cancelled a trip because the wife needed an emergency operation for a detached retina, and the insurer argued that at the time the policy was renewed (in November), she was aware that something was wrong with her eye. However, when she booked the holiday the previous January, nothing had been wrong. The ombudsman held that it was unreasonable for the firm to offer supposedly annual cancellation cover and then seek to exclude claims because the renewal date intervened between the booking and the need to cancel. Any such term would be a significant or unusual exclusion, which would only be valid if it had been brought to the policyholders attention.<sup>1</sup>

B.15 It is clear that a term does not have to be written as a warranty for issues of causal connection to arise. In Case 8 the exclusion for pre-existing medical conditions read:

The policy excludes:

.... claims where the person whose condition causes the claim is suffering from a pre-existing medical condition, unless declared to and accepted by us.

<sup>1</sup> This can be a general problem with annual travel policies: the policyholder can book a holiday in good faith, and then develop a medical condition. At the time of renewal, it is not clear whether the medical condition will require cancellation or not. The FOS discusses its approach to this issue in *Ombudsman News*, Issue 49, September/October 2005. FOS takes the view that if a firm tells a policyholder that it cannot provide future cover, it should also give them the option of cancelling the holiday and claiming under the valid policy, even though cancellation may not be medically necessary at that stage. If, as in this case, the policyholder acts in good faith but does not realise that disclosure is necessary, then the insurer should at least offer the cost of cancelling the holiday at the time of renewal.

- B.16 Here a breach of the term does not prevent any liability from arising. It does not exclude all claims, only those relating to the person with a pre-existing medical condition. However, the way the term is worded does not require that the pre-existing medical condition causes the claim. In theory, if a child suffering from asthma was injured in a road accident, the claim would be excluded even if there was no link between the asthma and the accident.
- B.17 What was particularly interesting about this case is that the ombudsman interpreted the term as requiring proof of a causal connection. The complainant had cut short her holiday when her mother suffered a heart attack, but the insurer rejected her curtailment claim on the grounds that her mother had a pre-existing medical condition. The evidence showed that her mother had suffered from hypertension for the last 50 years, but her condition appeared to be stable and controlled.<sup>2</sup>
- B.18 The ombudsman upheld the complaint and required the insurer to pay the claim. He commented that the insurers had provided no evidence to show that the longstanding hypertension caused the heart attack. An internet article suggesting a general link between the two was not enough.

I do not consider that the firm is able to demonstrate on the balance of probabilities that [the mother's] pre-existing medical condition was directly responsible for the cardiac arrest.

- B.19 The decision is noteworthy, as it goes further than the recommendations in the 1980 report. First, it puts the burden of proof firmly on the insurer to show the causal connection. Secondly, it requires the insurers to show more than a statistical correlation between hypertension and heart attacks. Instead the insurer is required to prove that the pre-existing condition is directly responsible for the event which gives rise to a claim.
- B.20 In Case 29, Mrs B had declared that her husband suffered from hypertension, diabetes and gout, and received notification that these were excluded from the policy. When Mr B suffered a heart attack on holiday, the insurers relied on policy wording excluding any claim arising "directly or indirectly" from the pre-existing condition. They rejected the claim on the grounds that the heart attack arose indirectly from the previous conditions. The ombudsman pointed to discrepancies between the policy wording and the other documents Mrs B had been sent, which did not use the word "indirectly", commenting:

If the firm intends to exclude claims that arise "indirectly" from any medical condition, this is a very significant restriction on cover and I consider the firm must make its meaning abundantly clear.

In this case, it was fair and reasonable that the insurers should pay the claim.

<sup>2</sup> In retrospect, her mother may have suffered a possible left ventricular failure the previous year, but there was no definite diagnosis and the doctor's suspicions were not conveyed to her mother.

- B.21 Another problem with clauses about pre-existing conditions is that policyholders may have only limited knowledge about their relatives' medical conditions. In Case 50, the policy stated that claims will not be covered if at the time of taking out this insurance you or any person whose condition may give rise to a claim...

is receiving or awaiting consultation, investigation, or treatment in a hospital or nursing home.

- B.22 At the time of taking out the policy, Mrs A's father-in-law was awaiting a colonoscopy. As a result of the investigation, he was diagnosed with cancer and he died shortly thereafter. Mrs A said she knew he had attended hospital, but had no idea he had been referred to a consultant or that he may be seriously ill.

- B.23 The ombudsman stated:

If a firm wishes to rely on this type of exclusion to reject a cancellation claim following the death of a relative, it must show that it is most likely that the policyholder was aware that the relative had the condition concerned or it was likely that they had it.

- B.24 As the firm had not established that Mrs A knew that her father in law was seriously ill, their rejection of the claim was not fair and reasonable.

- B.25 The FOS has commented to us that clauses concerning pre-existing medical conditions are particularly difficult for consumers to understand. Everyone has a medical condition (if only that they are alive and well). Because these clauses are written so widely, consumers rely on insurers to apply them in a fair and reasonable way. Pre-existing medical condition clauses therefore fall within the category of insurance terms that ombudsmen feel is appropriate to construe and apply in a fair and reasonable manner.

## **LEGAL EXPENSES INSURANCE**

- B.26 Legal expenses insurance can include a wide variety of different covers and exclusions. Our sample included five complaints about particular exclusions. In all five cases, the complaint was rejected:

- (1) In Case 2, the policy excluded ventures for profit. The complainant bred puppies and sold them for £450 each. The ombudsman found this fell within the exclusion.
- (2) In Case 27, the policy excluded any claims involving alterations to the structure of a building. The ombudsman held that this excluded defending a claim that the complainant's conservatory had been built too close to their neighbour's boundary.
- (3) In Case 21, the policy only included contractual claims if the agreement was entered into during the period of the insurance. The complainant instructed solicitors to purchase a house in August 2003, took out the insurance in April 2004, and completed in June 2004. They then discovered the solicitor had been negligent. The ombudsman found that the agreement was entered into before the policy was taken out.

- (4) In Case 20, the policy excluded “anything which happened before you took out” the insurance “and which you could reasonably have known you might claim for”. The evidence showed that the complainant had sought legal advice about her husband’s death before taking out the policy, and the ombudsman held that the claim was excluded.
- (5) In Case 6, the policy covered disputes which “were capable of being heard before an Employment Tribunal”. The complainant could have taken their dispute to a tribunal, but their damages would have been limited to £25,000. Instead, they issued court proceedings for £350,000. The ombudsman found that in the plain and ordinary sense of the words, this was not a claim capable of being heard in the Employment Tribunal.

B.27 In the final case, the ombudsman rejected the complainant’s request to be allowed her own choice of solicitor.

B.28 In these cases, the ombudsman took the view that the terms were relatively easy to understand, and corresponded with consumers’ legitimate expectations. In these circumstances, ombudsmen will apply the exclusions as they are written.

#### **DISABLEMENT COVER**

B.29 Five cases in the sample involved the definition of total disablement. This type of protection can be included within a variety of policies – including income protection, loan protection, critical illness and health policies. The definition of disablement raises similar issues, irrespective of the type of policy in which it is contained.

B.30 In three cases, the cover was available if the policyholder was prevented from carrying out their normal occupation. In all three, the complainants could not perform their previous jobs, and the question was whether they could perform the same occupation for other employers. In Case 11, the insured was a marketing manager. The ombudsman accepted that he could not do the substantial physical activity involved in his current job, but thought that he could perform other marketing manager jobs involving more sedentary, administrative duties. In Case 23 the insured was off work for stress and depression following workplace bullying. Again, the ombudsman found that she could work for another employer as a graphic designer. By contrast, in Case 15, the insured was a warehouseman. The ombudsman thought all warehouse jobs would involve substantial manual labour, which the insured was unable to perform.

B.31 In the other two cases, the policy term provided cover only if the insured was unable to do any job for which they were suited by education, training or experience. In Case 24, the complainant had lost a job involving public speaking following operations to remove a malignant tumour from her larynx. She worked part time doing clerical duties. The ombudsman held that there were other jobs she could perform. Similarly, in Case 13, the insured had lost his job following damage to his thumb, but worked voluntarily in a Citizens Advice Bureau. The ombudsman thought there were many jobs he was capable of doing.

- B.32 When faced with disablement cases, the FOS tends to apply the policy term as it stands. It can seem harsh to exclude a complainant from benefit because they could in theory perform another job, even if they stand no realistic prospect of obtaining such a job. However, ombudsmen accept that insurers are commercial entities, and that they have taken on the risk of disablement, not unemployment. As the ombudsman put it in Case 13,

An insurer applies different, more stringent criteria for benefit than the state and the thresholds for benefit tend to be higher; after all, insurers are commercial entities that do not have the same social welfare responsibilities as the government.

- B.33 In these cases, the complainants did not suggest that the policy had been mis-sold, or that the terms of the policy had been ambiguous. Within the industry, there is a well-understood difference between “normal occupation” cover and cover against disablement from any job for which the insured might be suited. These cases, therefore, were not treated as ones in which the ombudsman needed to scrutinise unusual or ambiguous terms.

### **SECURITY REQUIREMENTS**

- B.34 In five cases, the insurer refused to pay a theft claim because the policyholder had not used the required security devices. This was a particular concern in caravan policies, which often contain stringent requirements that the caravan is stored in a secure place. There were three cases where a caravan had been stolen and the insurer alleged a breach of security requirements.

- B.35 However, the FOS is not sympathetic to security clauses buried in the small print. In all five cases in the survey, the insurer was ordered to pay the claim. Ombudsmen argued that the security requirement was not clearly worded, or was not brought to the consumer’s attention, or was not causally connected to the loss that occurred.

- B.36 There were several cases in which the ombudsman stressed that if the consumer was required to comply with specific requirements, this must be brought specifically to the consumer’s attention:

(1) In Case 43, the policy required that “high value caravans” should have an alarm. The ombudsman held that it was not made sufficiently clear to the complainants that their £9,000 caravan would be classified as high value. It was not enough to include the requirement in the policy document. Instead, such an important term should be brought to the policyholder’s attention before the contract was concluded.

(2) In Case 40, the caravan was placed at a caravan site all summer, where the family visited it at weekends and for longer periods. The insurer argued that it was in storage, and should be subject to storage security requirements. The complainants argued it was in recreational use. The ombudsman found that the firm had not done enough to explain the security measures it required. The ombudsman stated that good insurance practice requires that



significant definitions, terms and conditions within policy documentation should be clear and unambiguous. Unless an insurer has brought such terms clearly to a policyholder's attention, I am unlikely to agree that it can rely on them.

- (3) In Case 30, the policy required that the caravan had to be stored at one of five possible locations – including “another person's place of residence on condition you have our express written agreement”. The consumer told the insurer that the caravan was stored at a nearby farm, and they noted its address on the policy. However, the insurer argued that this did not constitute express written agreement. The ombudsman held that the policyholder was entitled to believe that the firm had given express written agreement to the location by issuing a policy schedule recording the address. If the firm wanted the policyholder to take additional steps to obtain written agreement, it needed to make this clear before the policy was bought.

B.37 There were also suggestions that a claim should not be invalidated for breach of a security warranty unless the breach caused the loss.

- (1) In Case 42, the complainant claimed for a stolen bicycle, but the firm rejected the claim because at the time of the theft it was not locked to a secure structure. The complainant argued that this would not have made any difference: many bicycles were stolen at the same time, including locked bicycles. The ombudsman ordered the firm to pay the claim, commenting:

The Insurance Conduct of Business (ICOB) rules state that an insurer should not refuse to meet a claim as a result of a breach of warranty or condition, unless the circumstances of the claim are connected with the breach. Although the firm is relying on an exclusion to reject this claim, it is no different to a warranty in that it requires the complainant to do something to ensure that the cover applies. As I do not believe the lock would have made any difference, I am satisfied that the complainant has provided sufficient evidence to establish that his failure to lock his bicycle was not connected to his claim.

- (2) In Case 43 (above), the ombudsman noted that the police were called at the time of the theft but were unable to prevent it. Therefore, even if the caravan had been alarmed, it would not have made any difference. The ombudsman argued that “this is an additional reason why the firm should not rely on it in order to repudiate the claim”.

B.38 In Case 12, the household policy included a “security warranty”, which stated that there would be no liability under sections 2 and 3 of the policy for loss or damage by theft from the home unless:

the security devices fitted to the home are put effectively into operation immediately before you/your family... retire for the night.

- B.39 Although this is described as a “warranty”, the word is clearly not used in the legal sense. First, it applies only to some sorts of loss, rather than all liability under the contract. Secondly, it seems absurd to think that a breach could not be remedied; if the policyholder had gone to bed, and then got up to lock the door, the insurer would be liable for any subsequent theft.
- B.40 In this particular case, the front door had a yale lock, a metal door limiter and a chubb lock. The policyholder had engaged all but the chubb. Thieves broke down the front door and the insurer argued this would not have happened if the chubb had been locked. Nevertheless, the ombudsman upheld the complaint and ordered the insurer to pay.
- B.41 The ombudsman argued that good insurance practice required insurers to stipulate precisely what types of lock they wanted. Here, the more locks that were fitted, the more chance that one would not be engaged and that the claim would be rejected. If the policyholder had not fitted a chubb lock, for example, the insurer would have paid. The ombudsman thought this was not a fair and reasonable outcome.

#### **CHANGES IN RISK CLAUSES**

- B.42 Particular problems can be caused by clauses that require the policyholder to notify the insurer about changes in conditions.
- B.43 In Case 25, the complainant took out contents insurance through her local authority landlord in September. The policy included a term stating that “you must tell the Local Authority straight away” about a series of changes. These included “if someone lives in your home other than you or your household”, or “if any member of your household is convicted of an offence other than parking or speeding offences”. In October, the complainant’s partner moved in, who had a conviction for arson. When the complainant suffered an unconnected burglary, the insurers rejected the claim on the grounds that if they had known about the arson conviction, they would not have continued to provide cover.
- B.44 The ombudsman said that the FOS was unlikely to uphold increases in risk clauses of this type:

My fellow Ombudsman and I do not necessarily consider this type of clause to be fair and reasonable, particularly if it was not highlighted when the policy was sold. By issuing a policy, the firm has effectively promised to cover the policyholder against certain contingencies. In most cases, if the policyholder’s circumstances change during the term of the policy, that is generally just part of the risk the firm agreed to take on.

- B.45 The ombudsman found that expecting customers to recognise relevant facts and inform them of these facts was unfair. He quoted the Unfair Terms in Consumer Contracts Regulations 1999, arguing that the clause created a “significant imbalance in the parties rights and obligations”. There may be cases where a firm could rely on a change of risk clause, where the clause was clearly drawn to the policyholder’s attention and the change was so fundamental that it altered the very nature of the risk. However, this was not one of them.

- B.46 Although ombudsmen are unsympathetic to changes in risk clauses, such clauses may be upheld in some cases. Case 47 is one such case. Here Mr D took out an annual travel policy which stated that “if you have a medical condition, you must tell us about any changes in your medical condition before you travel”.<sup>3</sup> When he took out the policy, Mr D declared that he had controlled hypertension. In January, however, Mr D’s hypertension became uncontrolled: he visited his Accident and Emergency Department and saw a cardiologist. A few days later he travelled to the USA, where he became unwell and underwent a triple by-pass operation.
- B.47 In this case the ombudsman found that the policy requirements were clear: it was repeated throughout the policy and “cannot be said to be anything other than unambiguous”. Although it was unusual for insurers to expect continuing disclosure throughout the policy, it was not unfair “where the change in circumstances was so significant that it could be said to create a new insured risk”. Here the change in circumstances was “so significant that it created a new insured event”.

### **REFERRING TO THE UNFAIR TERMS IN CONSUMER CONTRACTS REGULATIONS**

- B.48 It was relatively rare for ombudsmen to refer explicitly to the Unfair Terms in Consumer Contract Regulations in their decisions. Among the 50 cases we looked at, the regulations were mentioned in only two.
- B.49 The first case was Case 25 about the change in risk, discussed above. The second, Case 9 involved a motor policy. This provided that if the insurer cancelled the policy, the premium would be refunded on a pro-rata basis. However, if the policyholder cancelled, the refund would be limited, so that after four months of cover, the insurer would refund only 40% and after more than four months, would refund nothing.
- B.50 The policyholder decided to sell his car and cancel his cover, at which he was told that he would receive nothing. The ombudsman referred to term (d) of Schedule 2 of the regulations, which specifically states that a term may be unfair if it permits the supplier to retain significant sums if the consumer cancels a contract, while the consumer is not given similar compensation if the seller cancels. The ombudsman held that there was no good reason why the consumer could not be given a pro rata refund, less an administration charge.

<sup>3</sup> In general, the FOS follows the law in refusing to give effect to a change in risk clause unless the effect is to create a significantly different or new insured risk. However, in periodic travel policies (such as this one) it has been suggested that this rule does not apply, as the cover is said to incept on a trip by trip basis. The FOS tell us that they will shortly be publishing an article in Ombudsman News to clarify the position in such cases.

- B.51 Although it appears to be relatively rare for the FOS to refer explicitly to the Regulations, there are many cases in which ombudsmen consider issues of reasonable expectation and transparency. As we have seen, ombudsmen often underline the importance of ensuring that significant exclusions are brought to the policyholder's attention. This is particularly important if insurers wish to exclude claims arising "indirectly" from an existing medical condition, or if they require policyholders to install a particular security measure, or if they wish to impose a continuing duty of disclosure. Such terms are not generally considered to conform to consumers' reasonable expectations, and insurers are required to take additional measures to ensure that consumers know about them. However, if they have made the clause sufficiently clear, there may be cases in which they are upheld.
- B.52 A further example can be found in Case 14. This was a critical illness policy which offered a defined sum in the event of a heart attack. A policy term defined "heart attack" as "the death of a proportion of heart muscle as a result of inadequate blood supply", as evidenced by three symptoms: chest pain, "electrocardiograph changes" and raised cardiac enzymes. The complainant was diagnosed and treated for a heart attack involving pain and elevated enzymes, but which did not show changes on an ECG. The insurers refused the claim on the grounds that one of the essential elements of the definition was not met.
- B.53 The ombudsman pointed out that neither the key features document nor the headline illness highlighted that a heart attack was only covered if it was of a certain severity or if it involved satisfying a three-limb test.

When a definition significantly restricts the meaning of the headline illness in a way that is inconsistent with either a policyholder's or a doctor's reasonable understanding of when a critical illness or event has occurred, then I consider it would be unfair of a firm to rely on a narrow interpretation of a definition to defeat an otherwise valid claim. In my judgment, the complainant's claim should be met because it falls within the spirit of what the policy was designed to cover and how it was sold.

- B.54 It is worth noting that the FOS will be prepared to strike down a narrow definition of the risk contained within the policy small print if this was not in accordance with reasonable expectations and what not made clear to the consumer. This also reflects the requirement in ICOB Rule 5 that significant or unusual exclusions must be brought to a consumer's attention. The FOS uses customers' reasonable expectations as a guide in deciding what terms are significant or unusual.