Lunchtime Talk: Friday 15 March 1991
"IF IT'S NOT COVERED, SUE YOUR BROKER"
(A synopsis of a paper given by Peter Madge)

Fortunately in over 30 years of acting as an insurance broker I have never been sued for professional negligence. But about five years ago I began to take on work as an expert witness involving insurance disputes (mostly broker negligence cases) and I got involved in more and more of them. My advice was based on my usual thinking and practice as an insurance broker and I gave my views based on that knowledge and experience. But I began to find that my views were being challenged by the insurance expert on the other side – and in areas where both law and practice were unclear. And on several occasions I was involved in cases alleging non-disclosure or misrepresentation by the insured which breached the principle of utmost good faith. This is an area of the law which I have long regarded as being in need of revision.

Hence this address today is not so much a paper but more an opportunity to ask some questions and invite some discussion in areas which I believe are unclear. I should add that I speak as a retail broker practising in the United Kingdom and I claim no expertise in reinsurance.

First a few brief comments on what the broker's duties are and the basis of his liability.

The duties of the broker are to exercise reasonable skill and care, a duty which he owes to his client in contract. He does not guarantee results and does not guarantee that claims will always be paid under policies. His job is to understand his client's business, help him identify the risk the business faces, carry out his client's instructions by arranging adequate insurance at competitive prices with good insurers who are financially sound and to keep the insurances under review. His conditions of engagement will either be verbal, in writing (long or short letters), specific or vague or may not even exist. A good broker will take care to see that what he has been asked to do is carefully recorded in writing. If his instructions are not clear they should be clarified. In several of the cases I was involved in the broker's conditions of engagement did not exist or were not recorded. The business was transacted on the telephone both with the client and with the insurer. It's a hopeless position for a broker being sued to find himself in. It's also unprofessional.

The broker is usually paid a commission for his services. The commonly accepted view is that the insurer pays it. But does he? He might in the case of small personal lines business but is that necessarily so in the case of large commercial risks? If an industrial client is paying say £10 million of premium and the broker is receiving

£1 million commission, can it seriously be suggested that the broker's remuneration comes from the insurers? The industrialist (probably with an in-house experienced insurance manager) will know the broker's remuneration. He knows the broker will deduct his commission before settling the premium with the insurers. Does the insurer really pay the premium or is it more correct to say that he merely decides the rate, e.g. 10%? Isn't it more accurate to say that the industrialist accepts a 10% mark-up on his premiums and gives it to his broker?

Many brokers these days work for a fee rebating all commissions, or rebate part of the commission after retaining what they think they are worth following discussion with the client. I think that the view that the modern broker these days is remunerated by insurer is open to argument.

The services provided by a modern broker go far beyond that of insurance broking. He may operate a claims recovery service, draw up a statistical analysis of risk and claims, carry out fire, burglary, property and business interruption surveys; he may advise on the formation of captive insurance companies, engage in contract risk analysis, carry out health and safety surveys or give advice on risk management. The recorded broker negligence cases in the law reports do not look at this aspect of his duties. If he does go beyond insurance broking services he will be judged by the standards applicable to professionals in those areas in which he engages, e.g. the standards applicable to accountants in relation to captive insurance companies.

Where the broker gets involved in these additional professional services then his conditions of engagement should be clear on what he is offering and how he is being remunerated for them. More and more brokers describe themselves as Risk Management Consultants without having the expertise to do so. Risk management is an enormously wide area. The pitfalls of getting it wrong can be heavy.

All of us in this room today know about the principle of good faith and the duty on the proposer to disclose material facts. The non-disclosure rules were decided over a century ago in different circumstances. The duty to disclose all material facts and not to make any misrepresentations is clearly on the insured. It is the broker's duty to remind him of this (unless he is dealing with a professional buyer who will know the rules as well as the broker). It is also the broker's duty to remind the insured that the duty of disclosure arises at renewal date. It is the broker's duty to collate all underwriting information and to make a full and accurate presentation of the risk to the underwriter. I submit, however, that the broker has no independent duty *to the underwriter* since the broker's duty is to the client. If the broker makes a misrepresentation of the risk to the underwriter, then the underwriter voids the policy

and the client will sue the broker for what he would have got under the policy. A broker may accept an independent duty to the underwriter in specific cases, e.g. when he has been instructed to appoint an adjuster and may incur a *Hedley Byrne* type liability for negligent statements.

In my experience individuals insuring in a private capacity, say, for motor or house insurance, do not understand the non-disclosure rules. Who can blame them when you look at today's modern advertising aimed at them by the marketing departments of insurers? The message is that it's all so easy and simple. But we know it isn't. Yet those very people may go to work the next day to run a business.

A material fact is anything that would influence the mind of a prudent insurer or has a bearing on his judgement in deciding whether to underwrite the risk or not. Judgement does not mean making the final decision but simply the formation of an opinion. Thus a fact is material if it is shown that a prudent insurer would wish to be aware of it. It does not have to be shown that in fact his final decision would have been different if he had known of it. A material fact is something that the underwriter runs through his mind and may later ignore. In my view that test is too harsh since how does the insured know how the mind of a prudent insurer works?

It seems to take no account of underwriting cycles and hard and soft markets. It ignores the insurer who deliberately comes into a line of business to increase his market share or market penetration or who is underwriting for investment income or cash flow not necessarily for underwriting profit. In hard markets the holding insurer will increase his premium, perhaps reduce his policy limits, impose excesses or other restrictions. Does the insured or the broker have a duty to tell any new insurer he goes to for alternative quotations? Yes, according to the text books because they are material facts but it doesn't happen in practice. In soft markets where the insurer's main concern may be to get the business or hold on to that which he already holds, underwriting standards slip. Things which should be asked are not. This lowering of underwriting standards presents enormous problems to the insurance broker because there may well be non-disclosure of material facts that would have been regarded as material in normal circumstances or in a hard market. When the claim is being negotiated (in times of hard market) there is a tendency to forget the business was underwritten in soft markets.

And what about the modern trend of direct marketing? A year ago I bought my wife a new car which came with one year's free insurance. I didn't want the insurance but the price was the same whether I took it or not. So I took it. I was asked nothing about where the vehicle was garaged, the claims experience of the regular drivers, whether

previous insurers had imposed terms and conditions, etc., in other words the usual underwriting information. Was I guilty of non-disclosure?

Several of the cases in which I have been engaged as an expert seemed to overlook the fact that a material fact becomes immaterial if it is common knowledge, known to the insurers or that they could have obtained information had they asked, or they had waived information. Here are some examples upon which I would welcome your comment:

- A manufacturer did not disclose to his fire insurers that he had engaged contractors to work on his premises who would use welding and cutting equipment. When a fire took place the fire insurers refused to pay arguing that there was non-disclosure of a material fact. But isn't it common knowledge that manufacturers frequently have contractors working on their premises and they will sometimes use burning and cutting equipment? What about painters burning off old paint?

- Another case involved a group accident and sickness scheme. The insurer was inexperienced in this class of business but wanted to enter the market. The underwriter was guilty of a bad piece of underwriting and after a year the claims far exceeded the premiums. He tried to avoid the policy for non-disclosure on various grounds some of which were:-

  1. The insured knew the premium was too low!
  2. The insured knew that other companies in the same line of business were paying higher premiums.
  3. The insured had not disclosed that another insurer approached by his broker had said that he "preferred not to quote".
  4. The broker did not disclose to the underwriter that quotes from other insurers were higher.

  On a strict definition of material fact I suppose all these were matters which would influence the mind of a prudent insurer and were, therefore, disclosable. I was taught that a good broker does not disclose to one underwriter the terms and conditions obtained from another underwriter and thus bring about a Dutch auction and indeed underwriters themselves understandably get cross when this happens.

- In another case involving the usual dialogue between friendly brokers and underwriters an underwriter refused to meet claims under a policy arguing that

there was misrepresentation. The misrepresentation was that when the broker went to see the underwriter he said, "This is super business – I can place it anywhere." Relying on that misrepresentation!! (so it was said!) the underwriter accepted the business. It wasn't "super" and lots of claims came in.

If the insurers are seriously going to plead that type of defence in the future (no reputable insurer would – this was an insurer at the bottom of the fifth division) then the broker should make a note of those underwriters who say to the broker – as they often do – "what rubbish have you got to show me today?" Thus the underwriter will be estopped from denying that he underwrote rubbish when the claims come in!

– In another case a broker wrote to the insurers for a house contents insurance saying: "Please hold covered – we are obtaining a proposal form." The insurers wrote back and said: "We are holding covered for 21 days pending receipt of the proposal form." On day 20 the broker sent the proposal form to the insurers which disclosed a previous theft claim and that the risk was in the London area. On day 21 the insurers wrote back to the broker declining the risk.

  On day 20 (unknown to either broker or insurer) thieves broke in. Insurers declined to pay on the basis of non-disclosure of material facts and that they were not on risk. Was their cover in force? Was it subject to the duty of good faith?

  In my view the intent of the insurers was to hold covered subject to the proposal form being satisfactory when received. It followed that as the proposal form was not satisfactory there was no insurance. The view from the other expert was that this type of temporary holding covered arrangement was not really insurance but a commercial way for the insurers to attract business. He said that the usual disclosure rules did not apply *until* the insurers received the proposal form.

– What about the interpretation of the policy? Does the broker have a duty to explain the policy to his client? One view is that as the client can read it is up to him to read the policies and understand them. However, a client may have up to twenty different policies and it is a fair bet that he will not understand all of them. (I am ignoring those circumstances where the client has his own insurance expertise in-house).

  My view is that the broker does not have a duty to point out special or important clauses on the policy, but that begs the question: what is a special or important clause? Often that question is only answered with hindsight after the claim.

- In one case in which I was involved the broker had arranged public liability insurance for a contractor. Since he used blow torches and burning equipment the policy contained a warranty to the effect that he had to take some risk management precautions like having buckets of water and buckets of sand close by. The contractor did none of these things and caused a substantial fire for which he was sued. The public liability insurers refused to indemnify him. The contractor said he was unaware of the warranty since the broker had never pointed it out to him. The broker agreed that was the case, saying that the insured could read as well as he could.

  My view was that the broker did have a responsibility to point out the warranty. I thought I was on fairly strong ground until the insurance expert for the broker disagreed. His view was that the broker had no duty to point out the special warranty calling in aid the Insurance Brokers' Registration Council Code of Conduct which states that: "insurance brokers shall *on request* from the client explain the difference in and relevant costs of the principal types of insurance..."

- In another case a broker arranged a public liability policy for a contractor which contained a cancellation clause. Due to bad management on the part of the contractor claims poured in and the insurers invoked the cancellation clause. As soon as the employer (principal) realised this he stopped the contractor from working. The contractor lost time and money and sued his broker for not pointing out the cancellation clause. Was the broker under a duty to point it out?

  When insurers refuse to deal with a claim because of a breach of a policy condition or a policy exception the insured will often say: "my broker never told me." So what is the broker's duty? And how will the broker's duty be affected in the future by the House of Lords' decision in *Banque Financiere de la Cite SA -v- Westgate Insurance Company Limited, 1990,* a case where the *insurers* were held to be in breach of the duty of utmost good faith. It was a very good reminder that the good faith principle applies both ways. It confirmed the judgement of the Court of Appeal that a breach of the duty of good faith by the insurer can result in an avoidance of the contract by the insured but not in an award of damages in his favour. The insurer returns the premium and that's that. In the Court of Appeal, however, the judges had said that the duty on the insurer must at least extend to disclosing all facts known to him which are material either to the nature of the risk to be covered or the recoverability of a claim which a prudent insured would take into account in deciding whether or not to place the risk with that particular insurer.

How the duty of good faith on the insurer will be interpreted in practice in the future we all wait to see. Will the insurer have a duty to point out that he is inexperienced in the class of business or that it is deliberate company policy to delay paying claims or it is management policy to be tough on claims? Will the insurer have a duty to point out that his cover is inferior to others in the market and contains severe restrictions?

These are all matters which a prudent insured would take into account in deciding whether to place his business with that particular insurer. How will the law on this subject develop in the future? If the judges construe the good faith principles applicable to insurers as strictly as the present good faith principles apply to insureds, insurers are in for a rough ride.

In conclusion, claims against brokers inevitably will increase. They are particularly vulnerable in soft markets when underwriting standards on the part of insurers drop, something which in the heat of the battle they all too frequently forget.

If an insured is not covered then the tendency is to go to litigation. His lawyer's automatic reaction is to see whether a claim can be made against a broker. Brokers often have only themselves to blame. Many of them need to set up simple but sensible risk management precautions such as agreement on their terms of engagement, recording important telephone conversations, keeping records and being precise in correspondence. And they have to recognise that they do have a duty to point out to their clients the principles of good faith and disclosure.

Insurance law in my view operates unfairly at the moment against the insured since the definition of a material fact and the duty of disclosure is so wide.

And finally for the litigation lawyers in the audience, the broker's duty is to exercise reasonable skill and care – he does not underwrite the policy if for whatever reasons the insurers refuse to pay.