AN EXAMINATION OF SOME CURRENT PROBLEMS IN U.K. INSURANCE CONTRACT LAW

by

A Sub - Committee of The British Insurance Law Association

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1. Terms of Reference

1.1 We have been asked to examine the current insurance contract law in the U.K. In the course of this we have looked at the legal position in leading E.C. Countries as well as Australia and USA but have only considered selective areas of insurance contract law where we, in our opinion, considered the majority of disputes occur. Our object is to expose the problems and point to possible solutions.

1.2 It is for others to propose changes in the law by statute or by, for example, extending the ABI Statements of Insurance Practice to Commercial Insurances.

1.3 Our conclusions are summarised at the end of this report and it is our hope that they will stimulate discussion which eventually will result in a more equitable state of insurance contract law.

2. Introduction.

2.1 Few problems in the comparatively recent past have led to more difficulties between British insurers and their insurers that the application of the rules of "utmost good faith." In this report the rationale of the principle is examined, together with examples of the problems encountered, the steps taken to ameliorate the apparent severity of its application, the approach of insurers in other jurisdictions to the basic concept and some thoughts are given as to possible solutions to the difficulties which exist at present.

2.2 Lord Mansfield's famous judgement in *Carter v Boehm* (1766) Burr 1905 is

often believed to have placed the complete onus on the insured for full disclosure of all the circumstances "in his knowledge" of the risk. He stressed that suppression, wilfully or innocently, deceives the insurer because "the risk run is really different from the risk understood and intended to be run at the time of the agreement".

2.3 However, he also pointed out that there was a two-way obligation and the insurers could not always rely upon disclosure by the insured of matters as to which the insured may be innocently silent. The matters which did not have to be disclosed were as later set out in statutory form in the *Marine Insurance Act 1906* which states that in the absence of inquiry, circumstances which diminished the risk or where information was waived by the insurer need not be disclosed. In addition the insurer should be aware of matters of common knowledge, particularly those which fell within the ordinary course of his business as an insurer. Finally, any circumstance which is superfluous to disclose by reason of any express or implied warranty need not be disclosed in the absence of inquiry (see S.18(3) of the *Marine Insurance Act 1906.*)

2.4 The intention, therefore, was to create a situation in which both sides contributed to an accurate and fair understanding of the risk but with the implication that the insured always know more about the precise nature of his business than the insurer and should be entirely honest in disclosing material facts about it when seeking insurance cover. To this must be added the point that even innocent misrepresentation of the facts could mislead an insurer and so change his understanding of the risk.

2.5 The consequence of the failure to observe utmost good faith was and is that the policy is void. Usually this comes to light when a claim is made and, upon investigation, the insurers state that there has been non-disclosure or misrepresentation.

2.6 Over the years, insurers have sought to strengthen their hands by introducing "basis of contract" clauses and warranties as to materiality so that any breach, however insignificant, would allow them to avoid the policy.

2.7 Both Lord Mansfield's ruling and the *Marine Insurance Act 1906* were established in periods when commercial considerations were very different from today. The underwriter's current knowledge of matters material to the risk together with his greater experience makes him a better able to ask the right questions when the risk is presented. Court decisions on these matters in the nineteenth century, while varying in some respects, tended to support insurers although doubts were sometimes expressed about the unequal relationship between insurers and "men in humble conditions in life".

2.8 By 1908 *(Joel v Law Union Ins. Co. and Crown (1908) 2 K.B. 431)* this unease gave rise to the concept in life assurances cases that the test of materiality was to

ask whether a reasonable man in the position of the insured and with knowledge of the facts in dispute, ought to have realised that they were material to a risk and subsequently in *Condogianis v Guardian Assurance Company Ltd. (1921)* 2 A.C. 125 it was ruled that if insurers asked ambiguous questions in proposal forms, they could not rely upon the answers as grounds for avoiding a contract. Thus, doubts about the fairness of the basic principle had begun to grow.

2.9 By 1954 matters had reached such a pitch that the Law Reform Committee was asked to consider the problems. The Report concluded that materiality should be judged on the basis of (a) a reasonable insured and (b) where statements by the insured were true "To the best of his knowledge and belief". No action was taken on these recommendations and in the case of *Lambert v Co-operative Insurance Soc. Ltd. (1975)*, 2 Lloyd's Rep. 485 the notion of the "reasonable insured" was dismissed. The ruling also confirmed the application of the rule of utmost good faith to non-marine insurance and held that "a fact was material if it would influence the mind of a prudent insurer". However, the appellate judges expressed their dissatisfaction with the law as it then stood and said that it should be reformed.

2.10 Two years later, the insurance industry, mainly to avoid the provisions of the *Unfair Contract Terms Act, 1977*, proposed its own solution to the problems by the introduction of "Statements of Insurance Practice" which principally provide help to individual insured persons by the way in which proposal forms are phrased, give notice of questions of materiality, warnings on renewal notices and above all, state that insurers will not act unreasonably to repudiate liability for non-disclosure except in cases of fraud or the like. The statements do not, of course, have the force of law and not every insurer abides by them. They do, however, represent a real attempt by the major companies and Lloyd's to restore the balance between insurers and individual. The following year the Law Commission was asked to look again at this topic, particularly in view of the proposed European Community legislation on insurance contract law (fifth draft) not proceeded with. In its report, (Law Commission No., 104) the Commission concluded that the current law of non -disclosure was defective and it considered ways in which it might be improved.

2.11 "Proportionality" as practiced particularly in France was not thought, by the Law Commission, to be the solution as it was not certain by what amount claims should be reduced and they also took into account the fact that, with full knowledge an insurer might have declined the risk altogether, imposed warranties or excesses, or excluded parts of the risk. Instead, it was proposed that the law should be changed to limit an insured's obligation to disclosing those material facts which he knows or could be assumed to know and which a reasonable person would disclose. This report also recommended that (a) prominent warnings about the effects of non-

disclosure should be placed on proposal forms and renewal notices and (b) limitations should be placed on the effect of warranties unless there was fraudulent action on the part of the insured. No action was taken on the report.

2.12 In 1981, conscious of many complaints about insurers handling of claims and " reliance on the fine print" to avoid losses, a group of insurers established the Insurance Ombudsman's Bureau. Others, including Lloyd's, have since joined the scheme but not all insurers are members. Over the years the Ombudsman's reports have revealed a consistently high level of problems between insurers and insureds, not all relating to non-disclosure and not always the fault of the insurer. In many cases the unequal positions of the two parties have been demonstrated and to some extent alleviated by the Ombudsman's decisions, sometimes by a measure of proportionality (see Ombudsman's 1989 Report page 8 paragraph 2.17). The scheme has been successful but not all insurers subscribe and it might be argued that the existence of the Bureau is in itself a hindrance to proper legal changes being introduced.

2.13 Meanwhile, cases before the courts still demonstrate the problems of applying the rules of utmost good faith. Doubts have been expressed about the opinion of "a prudent underwriter" as compared with that of the "particular underwriter' who accepted the risk *(Berger v Pollock* (1973 2 Lloyd's Rep. 442 and *CTI v Oceanus* (1984) 1 Lloyd's Rep. 496 CA) and of the respective duties of brokers and underwriters when a risk is places *(Pan Atlantic v Pine Top Ins. Co. Ltd. 1993* Lloyd's Rep 476 CA). In *Banque Financière de la Cité S.A. v Westgate(1990)* 2 WLR1279 the limited recompense by way of refund of premium available to the insured in the case of a lack of good faith by the insurer was criticised. It is hardly surprising that in the forward to the BILA 1992 prize winning book, ("Construction Insurance" Marshall Levine & Jeremy Wood) R.J.L. Thomas Q.C. suggested that contractors should seek agreement with insurers to avoid the effects of non-disclosure!

How can these problems be addressed to provide the equality originally sought by Lord Mansfield? Have other countries fared better in this quest? We have examined the various systems adopted and suggest some ways forward for the U.K.

3. The Rules.

3.1 The Working Party took as its starting point the basic principles of utmost good faith viz. that a proposer may be in breach of the rules by:

(a) concealment: i.e. deliberately concealing a material fact; whether innocently, fraudulently, negligently or recklessly.

(b) non-disclosure: failing to disclose a material fact, either deliberately or inad-

vertently:
(c) fraudulent misrepresentation: making an inaccurate statement
either in error or believing it to be true;
(d) innocent misrepresentation: making an inaccurate statement either in error or believing it to be true;
(e) negligent or reckless misrepresentation: making an inaccurate statement without checking the facts.
Facts that need not be disclosed are those that;
(a) lessen the risk;
(b) should have been inferred by underwriters because they are normally associated with the type of risk proposed;
(c) are public knowledge or should be known by underwriters in the ordinary course of their business;
(d) are matters of law;
(e) are possible of discovery where the underwriters are put on enquiry;
(f) underwriters have waived information about;
(g) are unnecessary because of a warranty;
3.2 In English law, these rules are applicable prior to the completion of the contract, but some Judges have suggested that there is a duty of disclosure during the currency of the policy when making a claim and at renewal and any breach may lead to avoidance of the contract. The existence of proposal forms does not change the nature of these obligations, although the "Statements of Practice" adopted by many insurers do lessen their impact for some areas of personal insurances, in that:-
(a) Insurers must ask clear questions on proposal forms on matters which they have commonly found to be material;
(b) questions should relate to knowledge which the proposer should be reasonably expected to possess;
(c) declarations as to the truth of answers given should be restricted to "completion according to the proposer's knowledge and belief";
(d) claims should not be repudiated;
(i) on grounds of non-disclosure of a material fact that the policyholder could not reasonably be expected to have disclosed;
(ii) on grounds of misrepresentation unless it is deliberate or negligent;
(iii) for a breach of warranty unconnected with the event unless fraud is involved.
Thus, in the case of individuals insuring in their *private capacity*, the concept of the "reasonable insured" may be said to have been introduced.

4. Comparative Law.

4.1 Most countries of the World have laws which govern matters of good faith between insurers and insured but they differ in a number of respects. It is common ground that insurers must be told of all matters that are material to the risk. In the U.K., however, the onus to disclose rests with the prospective insured, whereas in Germany, the insurer is obliged to ask for the information. Proposal forms, not always used here, are obligatory in Denmark, France and some States in the USA., where ambiguous or "non" answers must be investigated. A similar position exists in Australia. The question arises; should all the facts be disclosed or only those known to the insured, taking into account the fact that some lay people may be ignorant of some aspects of insurance and may not be aware of the materiality of a particular circumstances of a risk? The importance of surveys seems to have diminished in recent years but the Working Party believes that they still have a vital role in establishing the whole nature of a risk in certain areas.

4.2 Regulations also differ between countries as to disclosure once a risk has commenced. In the U.K. the basic rule is that the duty arises at each renewal or as requested by, say, a warranty or an increase in risk clause or when making a claim.

4.3 In France, any change in the circumstances of the risk must be reported within eight days, whereas in Germany, except for liability cover, there is a continuing duty of disclosure. Australian law requires a statement in the policy as to the obligation. Of course, in some Continental countries, policies are issued for periods longer than one year so that different rules are required. Our system is quite sensible provided that it is understood by the insured, hence the requirements in the Statements of Practice for clear warnings on renewal notices.

4.4 When non-disclosure is alleged, the problems of its effects arise. Should one consider them in relation to the actual parties to the contract or by regard to a notion of a standard by which all cases can be judged? In the U.K. we take the latter approach and use as our standard "the impact on the judgement of a prudent underwriter". This concept has often been attacked in the courts as well as by consumer associations and others who feel that it does not accurately reflect the circumstances in particular cases.

4.5 However, it has stood the test of time, having been upheld particularly in recent times by the cases of *CTI v Oceanus (1984)* (supra) and and as modified by *Pan Atlantic v Pine Top (1993)* (supra). In the Appeal Court in the latter case, Lord Justice Steyn ruled at page 506 "that as the law now stands, the question was whether the prudent insurer would view the undisclosed material as probably tending to increase the risk. That does not mean that it is necessary to prove that the

underwriter would have taken a different decision about the acceptance of the risk". Thus, questions about the actual underwriter's lack of professionalism, his desire to write business for commercial rather than sound underwriting reasons or simply his lack of experience are irrelevant. Also irrelevant is the fact that there may be no link whatever between the matter undisclosed and a subsequent loss.

4.6 An example of current problems is the recent case of *Forsikringsaktieselskapet Vesta v Butcher and Others (No. 1)* (1989) AER 1 All ER 403 which has highlighted the different approach of Norwegian Law compared with that in the U.K. with regard to breach of warranties. Although a reinsurance case, it demonstrated the fact that there had to be causal effect resulting from the breach for the warranty to apply in Norway whereas in this country no such causal effect was necessary. Whilst it was held that the insured in the U.K. had to pay the loss due to the reinsurance cover being on a "back to back'' basis, the decision did not alter the law.

4.7 In France, Denmark, Holland and Germany, as well as Australia, on the other hand, the impact on the judgement of the actual underwriter is the test and the Germans go further by insisting on a causal link between non-disclosure and a loss before a policy can be avoided.

5. Proportionality

5.1 Before reaching any conclusions and bearing in mind the "all or nothing" aspect of the law relating to non-disclosure, misrepresentation or breach of warranty, the group considered the application of Proportionality as exercised in various countries.

5.2 As has been discussed, allowing insurers to avoid an insurance contract for innocent non-disclosure or misrepresentation can work unfairly. Hence, there have been calls for applying a principle of proportionality to such cases so as to reduce the amount recoverable by an insured, but not depriving him of the whole of this claim. There are different formulations of the proportionality principle, the respective merits of which we do not propose to dwell upon here. The essence of the principle is that the insured's entitlement should be determined as though the insurer has been aware of the undisclosed facts at the time of the proposal and had fixed the premium or the amount of the cover on that basis.

5.3 Advantages of the proportionality approach.

The greatest merit of the "proportionality" approach as opposed to the "avoidance" approach is that it does not have the "all or nothing" result that avodance has in English Law. It should also reflect more clearly the commercial attitude that under-

writers would have taken if they had had the requisite facts when first taking on the risk. Further, some formulae may provide a measure of mathematical certainty when it comes to assessing the appropriate sum according to the ratio between the premium paid and the premium that the policyholder should have paid if he had declared the risk correctly.

5.4 Disadvantages of the proportionality principle.

Deciding cases according to a principle of proportionality would lead to greater uncertainty. The principle may work satisfactorily even in cases where it is shown that if the insurer had been given the non-disclosed facts, he would have charged a higher premium. In such cases the insured's claim can be reduced in proportion to the ratio between the actual premium and the notional higher premium. There are, however, various situations when such a simple formula would not work. We give some examples below:-

(1) **Where an insurer would not have written the increased risk in any event.** It has been suggested that in such a case the solution would be to decide that the insurer would have charged a premium equivalent to the amount of the claim, with the result that the insured would just recover his premium. This would seem unfair to insurers, as they would have incurred the costs involved in issuing the cover and dealing with the claim. In the present climate of low interest rates, such costs may well not be offset by the amount earned by insurers in vesting the premium.

(2) **Where insurers might have been prepared to write the risk if they had known the "undisclosed facts", which would not have involved a higher premium, but might have involved additional warranties, exclusion clauses, an increased "excess" or accepting a lesser proportion of the risk.** These possibilities do not lend themselves to a simple mathematical calculation and would lead to varying assessments as to the appropriate result.

Even in those cases where it can be shown that an insurer would have charged a high premium if he had known the "undisclosed facts", there may be considerable difficulties in establishing the level of the higher premium. In some cases the use of premium tables or tariffs may prove to be of assistance; for example, in life assurance cases it would be fairly easy to make a proportional reduction in the amount paid under the insurance where there has been a mis-statement regarding age. It would not, however, be so easy to prove what would have been charged in many other cases, which might lead to more litigation as to an appropriate figure with experts giving differing views as to what this might be.

5.5 Use of the proportionality principle.

Despite the difficulties highlighted above, the proportionality principle is used in other jurisdictions and to some extent by the Insurance Ombudsman in this country. Other countries, such as France, have had to face the problems of calculating the premium that would have been paid if the risks had been properly declared at the outset. Apparently, when such disputes reach Court in France the Court can appoint an independent expert to assist in making such a calculation.

5.6 *The Law Commission in their 1980 Report No. 104* set out all the difficulties in providing the notional premium and the problem of dealing with a situation where the insurer would have declined the risk had he known of the true situation. They came firmly to the conclusion that "We consider that these difficulties constitute a compelling case against the introduction of proportionality into our law". However, if a judge were to be given discretion to apply a principle of proportionality, the Working Party would favour the use by the judge of the guidelines suggested in paragraph 4.103 of the Law Commission's Report when it came to exercising his/her discretion, namely:-

(a) whether the undisclosed facts are connected with the loss;

(b) the degree of the insured's blameworthiness in failing to make full disclosure; and

(c) the way in which the insurers would have assessed the risk had they been aware of the undisclosed facts at the date of the contract.

5.7 If such a principle were to he put into statutory form, S.31 (1) of the *Australian Insurance Contracts Act 1984* may serve as a useful model. It applies to fraudulent misrepresentation, whereas we would wish insurers to retain the remedy of full avoidance in cases of fraud. We would suggest that S.31 (1) might be adapted to cover innocent and negligent misrepresentation and non-disclosure. S.31 (1) provides:

> "In any proceedings by the insured in respect of a contract of insurance that has been avoided on the ground of fraudulent misrepresentation, the court may, if it would be harsh and unfair not to do so ... disregard the avoidance and, if it does so shall allow the insured to recover the whole, or such part as the court thinks just and equitable in the circumstances, of the amount that would have been payable if the contract had not been avoided".

5.8 The Vice Chancellor in the *Pan Atlantic Insurance Company Ltd. v Pine Top Insurance Company Ltd.* observed:-

"The introduction of a judicial discretion into this field would not be without its advantages. These were considered by the Law Commission in 1980 in its report on non-disclosure and breach of warranty in insurance law: see Law Commission No.

104 esp. paragraph 4.98 to 4.108. But the present case is an unhappy example of a case where, in the absence of discretion, the law manifestly does not produce a satisfactory result."

5.9 The Working Party agree that due account should be taken of the knowledge and background of the insured. A distinction should be made between non-disclosure by the insurance department of a leading industrial Company as compared with that of a small Company on the industrial estate whose knowledge of insurance matter is likely to be limited. There has been an attitude by some insurers that if they are justified in avoiding the loss, the insured should sue his broker. We do not consider that this is helpful in resolving disputes (unless the broker is really to blame) and in any case the loss will inevitably end up in the professional indemnity market.

6. *The Way Ahead*

6.1 Harmonisation of Insurance Contract Law in E.C. Countries in accordance with the proposal published in OJ No.C190 on 28th July 1979 has not proved possible. The Working Party believes that every effort should be made to enable all insurers (and insurer's) to operate on a level playing field and whilst some areas may still remain unresolved such as proportionality, nevertheless there must be areas of common ground on which agreement should be possible.

Having considered all these matters it is our opinion that in an attempt to find a system that provides fairness between insurers and insureds, changes in U.K. law would be appropriate and the following matters are identified as requiring urgent consideration.

7. PROPOSED CHANGES IN INSURANCE CONTRACT LAW.

7.1 **Prudent Insurer's Test.**

It was felt that this should be retained as a test of materiality.

The insured has the protection of evidence showing the established practice in the market that is not limited solely to what the particular insurer would have done had the correct facts been known. The Working Party preferred the following definition of materiality:-

> "an undisclosed fact is material if it would cause a prudent insurer to appreciate that the risk *had increased* from that actually presented to him."

Two of the working party favoured the approach that the insured should disclose

every matter that a reasonable person should be expected to know to be relevant. They considered that large organisations (such as ICI with its own insurance department) should be expected to be subjected to wider exposure. Thus the test would have to be the "reasonable insured in his particular circumstances" (or as in the Insurance Contract Law Act 1984 Australia Part IV Section 21(1)

> "An insured has a duty to disclose to the insurer, before the relevant contract of insurance is entered into, every matter that is known to the insured, being a matter that -
>
> (a) The insured knows to be a matter relevant to the decision of the insurer whether to accept the risk and, if so, on what terms; or
>
> (b) a reasonable person in the circumstances could be expected to know to be a matter so relevant".

7.2 Different types of misrepresentation and non-disclosure.

The Working Party consider that fraudulent misrepresentation (or non-disclosure) should still entitle the insurer to avoid the policy. Innocent, negligent or reckless misrepresentation (or non-disclosure) should be dealt with by a form of judicial discretion based on proportionality where there was sound basis for application of this principle. The present situation of "all or nothing" has no flexibility and should be changed.

7.3 Obligation on Insurers to make enquiries.

In German Law, there is a clear obligation upon the insurers to make enquiries concerning the risk. They cannot thereafter plead non-disclosure or misrepresentation concerning matters that would have come to light had they made the proper enquires Two members of the Working Party were not in favour of such a rule but the third member felt it was fair as it prevented insurers cutting corners for commercial reasons by, for example, avoiding the expense of a survey.

7.4 Proposal Forms.

The Working Party believe that unanswered questions or unambiguous answers should put insurers on enquiry. If Insurers choose not to follow up such matters they should **not** be able to complain about any such non-disclosure or misrepresentation later. Australia:law deals with this matter as follows and is to be commended:-

"The duty of disclosure does not require the disclosure of matter–

21(3) Where a person-

a) failed to answer; or

b) gave an obviously incomplete or irrelevant answer to, a question included in a proposal form about a matter, the insurer shall be deemed to have waived compliance with the duty of disclosure in relation to the matter".

French Law, when considered in relation to this point, requires that if the insurer has failed to ask a question on the proposal form he is deemed to have waived enquiry into the matter. This law inevitably leads to massive proposal forms whereas some U.K. insurers are using proposal forms with a very limited number of questions. In domestic insurances this has been dealt with by a new ABI guidance note issued on 18th June 1993. According to the note the insurer is obliged to point out the effects of non-disclosure otherwise he cannot rely on non-disclosure of matters normally dealt with by questions on the proposal form about facts which insurers have found generally to be material. It would be desirable to have this incorporated into U.K. law.

The Working Party are concerned that with proposal forms restricting the number of questions asked, more onus is put upon the individual insured to declare matters which the insurer will find material without specific questions being asked on the proposal form.

7.5 Renewal.

There was a minority view that insurers should have an obligation to invite renewal, as in Australia, where an insurer is bound to notify an insured in writing in respect of cover that will expire and if it fails to do so, the policy will remain in force. However, it was agreed that any renewal notice should contain a warning about the renewed duty to make disclosure at renewal.

7.6 Warranties.

The Working Party are of the opinion that breach of warranty should not automatically entitle the insurer to repudiate a claim or avoid the contract from the date of the breach. It was felt that this should only occur where there was a causal connection between the breach of warranty and the loss concerned. It was also agreed that if there were "non causal" continuing breach of warranty, it reflected on the moral

attitude of the insured. In such a case the insurer should pay the particular claim but be entitled to cancel the policy after this becomes apparent (without refund of premium).

7.7 Statement of General Insurance Practice.

The current ABI Statement of General Insurance Practice 1986 applies only to private insurances and has no legal effect but does reflect the "best practice" amongst ABI members which represent 90% of the market.
It is the opinion of the Working Party that the principle contained in the Statement should be incorporated into U.K. law and should apply to commercial insurance albeit with some modification directed to the small and medium sized business. An opportunity may arise to deal with this when legislation is introduced to implement the European Community Directive on Unfair Terms in Consumer contracts (39/13/EEC) (due to be in force by 1st January 1995). It will be recalled that the Unfair Contract Terms Act 1977 did not apply to insurance contracts and will now require some amendment in the light of the Directive.

8. Conclusions.

8.1 The Working Party are concerned that notwithstanding the Law Commission Report of October 1980, and their recommendations, no attempt has been made to rationalise insurance contract law which has resulted in the U.K. falling behind developments taking place in other parts of the world. This could have a serious knock-on effect by discouraging foreign industrialists placing business in the London Market subject to U.K. law. It is appropriate to quote here from an article by Mr Justice Mance writing in the May 1993 issue of the BILA Journal:-

> "Its a sad fact if you ask a German insurer what will be its best defence against the incursion of English insurers into traditional German insurance territory pursuant to the liberalised open market introduced by the European Court in the Schleicher decision and the Third Directive, he is likely to say two things: First, if you insure in London, when will you get you policy issued? Second, if you have a claim, will it be paid? The hard commercial reality is that insurers will often use any tools which they may have to defend claims, and brokers will then be the clients' next target."

8.2 **If we wish to avoid this type of situation and other problems detrimental to the market, reform is necessary and urgent.**

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