

Archaic, unclear & unfair?

Part one: Consumer insurance law reform is long overdue, says

Peter J Tyldesley

IN BRIEF

- Consumer insurance law is archaic, unclear and unfair.
- Measures including industry codes, FSA rules and the existence of an Ombudsman do not provide a full solution.
- The Law Commissions are expected shortly to recommend reform of the law to bring it into line with current best practice.

Later this year the English and Scottish Law Commissions will publish a joint final report on consumer insurance law. This is the culmination of a four-year project to review an area of law which is widely regarded as archaic, unclear and unfair. It is anticipated that the report will recommend reform of the rules on non-disclosure, misrepresentation and breach of warranty.

The critical flaw in insurance law is that it provides insurers with remedies which in many circumstances will be disproportionate. Much of the current law was established in commercial cases in the 18th and 19th centuries. At that time there was no mass market for insurance. Types of cover commonly bought by consumers today, such as household and motor insurance, simply did not exist. Insurance was typically arranged face-to-face rather than by telephone or over the internet. It is perhaps not surprising that unjust results are produced when old commercial rules are applied to modern consumer insurance contracts.

Take, for example, the rules on non-disclosure in general insurance cases. Insurance policies are contracts of the utmost good faith. A consumer seeking cover is obliged to disclose to the prospective insurer all material facts, that is facts which would have an effect, not necessarily decisive, on the mind of a prudent insurer in assessing the risk. If the insurer is induced to offer cover on particular terms by a non-disclosure it may, on becoming aware of the true position, avoid the policy. Avoidance means the policy is set aside from outset

and any claims can be rejected. There are five main criticisms of these rules:

- The test of materiality requires the consumer to look into the mind of a prudent underwriter—few will have the expertise to do so.
- There is no obligation on the insurer to ask any questions.
- No allowance is made for the state of mind or conduct of the consumer—

“The critical flaw in insurance law is that it provides insurers with remedies which in many circumstances will be disproportionate”

avoidance is permitted regardless of whether the policyholder acted fraudulently, negligently or entirely innocently.

- Once a policy has been avoided, any claim can be rejected, even if there is no connection between the non-disclosure and the loss.
- The law encourages inadequate underwriting. An insurer can limit the questions it asks when a policy is sold, knowing that if a claim is made it can search for non-disclosures to escape liability.

The potential impact of the law is demonstrated by the case of *Lambert v Co-operative Insurance* [1975] 2 Lloyd's Rep 485. Brenda Lambert suffered a loss of jewellery. On investigating her claim,

the insurer discovered that her husband had been convicted of a criminal offence prior to the policy last being renewed. At no point had the insurer indicated that it wished to be informed of such convictions. Nevertheless, it avoided the policy for non-disclosure and rejected the claim. The court was obliged to find in the insurer's favour but Mr Justice MacKenna, as he then was, made clear his distaste: “The present case shows the unsatisfactory state of the law. Mrs Lambert is unlikely to have thought that it was necessary to disclose the distressing fact of her husband's recent conviction when she was renewing the policy on her little store of jewellery. She is not an underwriter and has presumably no experience in these matters. The defendant company would act decently if, having established the point of principle, they were to pay her. It might be thought a heartless thing if they did not, but that is their business, not mine.”

Those who oppose reform seldom argue that the current law is sound. Instead they point to measures which may mitigate the harshness of the law—industry codes of practice, rules issued by the Financial Services Authority (FSA) and the existence of the Financial Ombudsman Service (FOS) to deal with complaints. Are these measures really a satisfactory alternative to law reform?

Industry codes

In 1977 the British Insurance Association, predecessor to the Association of British Insurers (ABI) published the Statement of General Insurance Practice. It did so as the price of an exemption from the Unfair Contract Terms Act 1977. This statement, amended in 1986, remained in force until statutory conduct of business regulation was introduced for general insurance on 14 January 2005. In respect of non-disclosure, the statement required insurers to ask questions about matters commonly found to be material. It also included the following provision: “Except where fraud, deception or negligence is involved, an insurer will not unreasonably repudiate liability to indemnify a policyholder: (i) on the grounds of non-disclosure...of a material fact when knowledge of the facts would

not materially have influenced the insurer's judgement in the acceptance or assessment of the insurance."

This wording appeared to restrict the rights of insurers only in cases of innocent non-disclosure. Even then it seemed to contemplate that there might be some circumstances in which it would be reasonable to repudiate liability. The decision in *Pan Atlantic v Pine Top* [1995] 1 AC 501, [1994] 3 All ER 581 established that as a matter of law insurers had to show inducement before non-disclosure gave rise to a right to avoid. From that point onwards it must be doubted whether the statement offered the consumer any additional protection over the law. In any event the statement was not legally binding nor was there initially an ombudsman who could enforce it.

More recently, the ABI has conducted some worthwhile work in connection with the FSA's Treating Customers Fairly initiative. Arguably the greatest advance is guidance on non-disclosure drawn up in consultation with the FOS and published in January 2008. From 19 January 2009 this guidance was upgraded to a code, so that insurers are required to follow it as a condition of membership of the ABI. The code largely adopts the approach taken by the FOS but incorporates some useful additional guidance and examples. Unfortunately at present it applies only to life and health-related insurances and is not legally binding.

Financial Service Authority rules

When the FSA took responsibility for conduct of business regulation of general insurance it issued rules effective from 14 January 2005. The current version of those rules is to be found in the Insurance Conduct of Business Sourcebook (ICOBS). Under ICOBS 8.1 an insurer must handle claims fairly and not unreasonably reject a claim by avoiding a policy. In particular: "A rejection of a consumer policyholder's claim is unreasonable, except where there is evidence of fraud, if it is for: (1) non-disclosure of a fact material to the risk which the policyholder could not reasonably be expected to have disclosed."

Again the effects of this provision seem to be only to limit the rights of insurers in cases of innocent misrepresentation. If the non-disclosure was negligent then the policyholder could reasonably have been expected to disclose the fact concerned. There is a further difficulty in that the

rules are not directly enforceable by a consumer. Instead the consumer has two options:

- (i) to complain to the FOS; or
- (ii) to pursue a case against the insurer for breach of statutory duty under s 150 of the Financial Services and Markets Act 2000.

Financial Ombudsman Service

The most effective protection for the consumer is undoubtedly the service provided by the FOS. Under s 218 of the Financial Services and Markets Act the FOS is obliged in respect of its compulsory jurisdiction to make decisions that are fair and reasonable in all the circumstances. Consequently whilst the FOS takes account of the law it is not obliged to follow it. In fact the FOS takes a robust line—it does not enforce the duty of disclosure. In *Ombudsman News 46*, the FOS indicated that if an insurer requires information it should instead ask a clear question.

What's new?

This is not a novel approach. In December 1980 the Guardian Royal Exchange voluntarily declared that it would no longer rely on the duty of disclosure in consumer non-life insurances. The move was announced by Mike Harris, Assistant General Manager, who shortly afterwards established the insurance ombudsman bureau. His justification still rings true: "You cannot import into the way we handle bulk insurance products now the close contractual relationship derived from the time a ship or cargo owner dealt directly with an underwriter in a coffee house 300 years ago and bargained over a single voyage.

"Defence of the traditional duty implies that although for many years we have handled hundreds of millions of transactions we still do not know all the right questions to ask. If this be so, then surely many of us should be seeking a living in some less demanding walk of life?"

Unsatisfactory

However the FOS is not a complete solution. There is a high attrition rate with complaints—it takes persistence to pass through an insurer's internal complaints procedure and the possible stages at the FOS. And it is plainly unsatisfactory that anyone should have to

complain to obtain fair treatment.

A consumer may in any event find it necessary to pursue all or part of their claim in the courts where the full harshness of the law applies. The FOS has a limit on awards of £100,000. Also, under the FSA rules there are various grounds on which the FOS can decline to deal with a complaint. For instance, after a final decision from an insurer the consumer has just six months to refer the matter to the FOS. And if there are evidential issues—for example evidence is needed from an uncooperative third party the FOS may decide a matter should be dealt with by the courts.

In November 2005 Nick Kirwan, then protection market director at Scottish Widows, recognised that these problems should be addressed by law reform: "Over the years, a gulf has opened up between what the law says and what is actually happening in the insurance industry. There are some important reasons to close the gap as not everybody is enjoying the jurisdiction of the Ombudsman. Their only recourse is through the court. By closing the gap, these individuals could receive the same protection as those covered by the Ombudsman."

The need for reform

Reform holds little fear for the better insurers. They do not rely on their strict legal rights. Instead, in accordance with best practice, they follow guidance from the FOS. Indeed for such insurers reform may hold two attractions: removing the economic advantage their competitors gain by relying on bad law and preventing the damage that such reliance does to the reputation of the insurance industry as a whole.

Consumer interests

It is, though, the interests of the consumer which render law reform essential. Insurance is intended to bring peace of mind through the transfer of risk. If fair treatment is at the discretion of the insurer, that peace of mind may prove to be illusory. Consumers deserve enforceable rights under modern, clear and fair law. NLJ

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Archaic, unclear & unfair

Part 2: Peter J Tyldesley considers the proposals & prospects for consumer insurance law reform

IN BRIEF

- The Law Commissions' proposals for reform will be published in December 2009.
- If implemented, the proposals will abolish the duty of disclosure, modify the law of misrepresentation and render basis of the contract clauses ineffective.
- The major obstacle to reform is the opposition of the influential Association of British Insurers.

In December 2009 the English and Scottish Law Commissions will publish a report recommending the reform of consumer insurance law. The recommendations will be restricted to the pre-contractual provision of information by the consumer—that is non-disclosure or misrepresentation by the consumer and basis of the contract clauses. Appended to the report will be draft legislation, the Consumer Insurance (Disclosure and Representations) Bill.

Current law

Part 1 of this article considered the rules on non-disclosure (see *NLJ*, 3 July 2009, p 961). Some of the criticisms of those rules apply equally

Not content with these rights some insurers also use “basis of the contract” clauses. An apparently innocuous statement on an insurance application form that the answers given form “Basis of the contract” is sufficient to convert the answers into warranties. A warranty is a particularly stringent term of an insurance policy. Breach of a warranty terminates cover automatically and immediately. If an answer on the application form is incorrect, cover under the policy never commences and any claims may be rejected. The use of basis of the contract clauses has been the subject of judicial criticism since 1853. Supposedly outlawed from use in consumer insurance by revisions to the Statement of General Insurance Practice in 1986 they continued to be used—see for

will only be available if the representation is “qualifying”—that is if it was deliberate, reckless or careless. The remedies available to insurers will therefore depend on the type of misrepresentation:

- An innocent misrepresentation is not qualifying and so will give rise to no remedy—the policy will remain in force and any valid claim should be paid.
- A careless misrepresentation will entitle the insurer to a proportionate remedy, reflecting what it would have done had it known the true facts. So if the insurer would not have offered cover it may avoid the policy and reject any claims. It must however return any premium paid. If the insurer would have offered cover but on different terms, it may proceed as if those terms applied. This may affect claims. It may be, for example, that the insurer would have included an exclusion which, when applied, invalidates a claim. If the insurer would have charged a higher premium, the insurer may reduce proportionately the amount to be paid on a claim. For instance, if only half the correct premium has been received, only half the claim need be paid.
- A deliberate or reckless misrepresentation will entitle the insurer to avoid the policy and reject any claim as at present. It may retain the premiums unless it would be unfair to do so.

The basis of the contract clauses will be rendered ineffective. This is vital since they could otherwise be used to undermine the reforms proposed for non-disclosure and misrepresentation.

These proposals reflect best practice and the approach of the Financial Ombudsman Service (FOS) and so might be thought uncontroversial. Nevertheless, past experience suggested that there would be one major opponent to change. Recommendations for reform were made by the Law Reform Committee in 1957 and by its successor, the English Law Commission, in 1980. These earlier proposals were never implemented, in

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to misrepresentation. If an insurer is induced to offer insurance cover by the misrepresentation of a material fact by a consumer it may, on becoming aware of the true position, avoid the policy and refuse to pay any claims. As with non-disclosure, it is irrelevant whether the consumer acted fraudulently, negligently or entirely innocently. Nor does the insurer need to show a link between the misrepresentation and any claim which has occurred.

instance *Economides v Commercial Union Assurance Co Plc* [1998] QB 587 at 591, [1997] 3 All ER 636.

Proposals for reform

The starting point for the Law Commissions' recommendations is the abolition of the duty of disclosure. In its place will be a statutory duty on the consumer to take reasonable care not to make any misrepresentation to the insurer. If this duty is breached, a remedy





large part because of the influence wielded by the insurers' trade association.

The influence of the ABI

The Association of British Insurers (ABI) has a powerful lobby in Parliament. Like its predecessor, the British Insurance Association (BIA), it has shown itself to be adept at avoiding statutory intervention in the business of its members. Where necessary a voluntary code is offered as an alternative to changes in the law. For example, the BIA obtained an exemption from the Unfair Contract Terms Act 1977, even though it was intended that insurance contracts should be included. This exemption was described in 1984 by the then director general of the Office of Fair Trading, Gordon Borrie, as "amazing". In return for the exemption the BIA produced two Statements of Practice, one for general and one for long-term insurance.

When the Law Commission drafted its proposals for insurance law reform in 1980, the BIA objected in robust terms. A Department of Trade official noted that the insurers' trade association displayed at times "the objective disinterestedness of a Millwall supporter". Eventually, in 1986, the government agreed with the ABI that the Law Commission's proposals would be abandoned in return for minor amendments to the Statements of Practice. Peter North, who as Law Commissioner had been responsible for the 1980 review, described this behind-the-scenes deal as "a disgraceful way to proceed and a clear waste of public money".

Why have the demands of the ABI held such sway over successive governments? The answer undoubtedly lies in the extraordinary contribution that the insurance industry makes to the financial wellbeing of the UK. In 2007 insurers paid out a daily average of £59m in general insurance claims and £211m in life and pension benefits. The insurance industry

employs 309,000 people. In the 2006-07 financial year, insurers paid £9.7bn in taxes and as at 31 December 2007 insurers were managing £1,599bn in shares and other assets. Crucially insurers receive £48bn of overseas premiums per year, leading to a substantial contribution towards the UK balance of payments.

However, as Ben Parker observed: "with great power comes great responsibility". Is the ABI using its power responsibly? Its reaction to the Law Commissions' current review of insurance contract law has been disappointingly familiar. In July 2007 the director general of ABI, Stephen Hadrill, argued that

“ The Association of British Insurers has shown itself to be adept at avoiding statutory intervention in the business of its members ”

"more law is unlikely to provide a better deal for customers".

When the ABI gave evidence to the All-Party Parliamentary Group on Insurance and Financial Services in June 2008 it expressed concerns that "reform may be unnecessary and duplicative". And at a meeting of the All-Party Parliamentary Group on Consumers and Trading Standards in May 2009 the ABI suggested that "by updating the law we will be locked into a legal framework that we will be unable to update and adapt to ongoing changes".

This deep-rooted resistance to law reform is certainly not in the best interests of consumers. Nor does it benefit the better insurers, which routinely give consumers more favourable treatment than the law requires.

Such insurers see their less ethical competitors both damaging the reputation of the industry as a whole and gaining an economic advantage through reliance on bad law.

Voluntary codes v law reform

By 1999 there were 55 ABI codes, many of which directly or indirectly affected consumers.

The ABI argues that codes are more flexible than law and can be amended to suit a changing market. In reality changes to the codes may be few and far between.

A stark example of stagnation is to be found in the ABI Code on Application Form Design which includes part of the former Statement of Long-Term Insurance Practice.

Available from the ABI website, this code refers to the rules of the Life Assurance and Unit Trust Regulatory Organisation (LAUTRO) and the Financial Services Act 1986. LAUTRO was replaced by the Personal Investment Authority in 1994

which in turn was replaced by the Financial Services Authority as at 1 December 2001. The Financial Services Act 1986 was repealed on the same date.

Other criticisms of ABI codes may be made:

- The codes are legally unenforceable, though they may be taken into account by the FOS.
- There is no public consultation when a code is drafted.
- The need to secure the support of all ABI members means codes tend to be relatively weak.
- There is rarely any monitoring of compliance.
- Not all insurers belong to the ABI.
- There is no sanction for breach other than expulsion from ABI membership—a step which has never been taken.

Voluntary codes have their place, but they are no substitute for law reform.

Prospects for reform

The Law Commissions' decision to deal separately with consumer insurance is shrewd. Rules suitable for mass-market consumer policies may not be appropriate for bespoke business insurance purchased by large well-informed commercial concerns with the benefit of advice from a broker. Omitting business insurance from the report should also allay the fears of HM Treasury regarding the possible impact of reform on overseas earnings. And by focusing on pre-contractual provision of information by consumers the Law Commissions have limited

Executive of Which? recently spoke in favour of reform: "The current insurance law regime is failing consumers. We need greater protection for individuals and more certainty for both firms and those who need insurance.

I am strongly supportive of the work of the Law Commissions and want to see a clear legislative commitment from all parties to implementing their proposals."

Resistance to change

Regrettably the ABI continues to resist change. After the ABI gave evidence to the All-Party Parliamentary Group on Insurance and Financial Services, David

"Instead, the ABI pleaded that it should be left to a combination of the Financial Services Authority (and its Treating Customers Fairly regime) and the Financial Ombudsman Service. This reform of insurance contract law is suddenly in danger of becoming a huge lost opportunity for the industry to align itself with the interests of consumers to the benefit of both. An urgent rethink is required."

Privately some insurers have also expressed doubts about the wisdom of a negative response to what appear to be reasonable proposals.

Opportunity

There is one obvious opportunity for a reversal of existing ABI policy. A new director general takes office in November 2009. It would be welcome indeed if the incoming director general were to advocate reform as beneficial for insurers and consumers alike. NLJ

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their recommendations to an area where the law is plainly unsatisfactory and where the FOS has already successfully developed an alternative approach.

The consumer organisations are likely to support the Law Commissions' proposals. Peter Vicary-Smith, Chief

Worsfold, a respected commentator on insurance matters, wrote despairingly: "Many would say this regime [proposed by the Law Commissions] should provide a welcome degree of certainty based on no more than best current practice in the market.

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