

Insurance Contract Law Reform: Bringing the Underpinning Law into the Twenty-First Century

Peter Tyldesley

Summary

- Despite the substantial contribution that it makes to the financial well-being of consumers, the insurance industry achieves poor levels of trust.
- One cause of mistrust is the poor state of insurance law which is weighted against the consumer. Most insurers do not rely on their strict legal rights, but those that do damage the reputation of the industry as a whole.
- The Law Commissions are undertaking a review of insurance law which opportunistically coincides with the Chartered Insurance Institute's drive to promote ethical behaviour and professionalism in insurance.
- At the heart of professionalism is the obligation to act in the best interests of the client. It is clearly not in the best interests of consumers for unfair law to be retained.
- The current law was largely developed in the 18th and 19th centuries long before modern mass-market consumer policies existed and in more recent years a range of bodies has recommended reform.
- In a first report the Law Commissions have proposed changes which will bring the law of basis of the contract clauses, non-disclosure and misrepresentation broadly into line with the practice of the Financial Ombudsman Service. The report contains draft legislation which could be introduced early in 2011 if Government support is forthcoming.
- Should practitioners be pushing for a more ambitious project – the full codification of consumer insurance law?

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CII Introduction: There are certain anomalies in English Law regarding the treatment of insurance contracts, much of it stemming from trying to underpin a twenty-first century insurance market with law written in Georgian times. In response, the Law Commissions of England, Wales and Scotland have published a series of papers setting out proposals for reforming the current rules. Following an earlier thinkpiece by Law Commissioner David Hertzell (number 46) focusing on the work to review post-contractual aspects of insurance,¹ this article by Peter Tyldesley examines why these reforms are important for the insurance industry.

Practitioners can be proud of the achievements of the insurance industry. Employing over 275,000 people in the UK alone, the industry earns £54 billion in overseas premiums and contributes £8.2 billion in taxes. In 2009, insurers paid out £58 million per day in general insurance claims and £173 million per day in pension and life benefits.

Why then, does the industry face continued criticism, with a poll last year suggesting that just 17% of consumers had confidence in insurers? Undoubtedly one factor is the poor state of consumer insurance law. Consumers look to the insurance industry to provide them with peace of mind. By paying premiums consumers trust that they have effectively transferred risks to their insurers, with the certainty that if the worst occurs a claim will be promptly met. Above all consumers expect insurance to be governed by common-sense rules that are clear and fair. Regrettably the reality is that insurance law is archaic and weighted heavily against the consumer. Fair treatment is only forthcoming because reputable insurers do not rely on their strict legal rights, preferring instead to follow guidance from the Financial Ombudsman Service (FOS).

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Where the law is applied, the results are devastating to consumer confidence. Ethical practitioners will wince at certain cases reported in recent years by the FOS. A critical illness claim for leukaemia rejected for non-disclosure of mild

¹ See David Hertzell, [What Happens After the Ink is Dry? Claims and the Parties' Post-Contract Duties](http://www.cii.co.uk/thinkpiece), CII Thinkpiece no.46 (November 2010). www.cii.co.uk/thinkpiece

unrelated hearing loss, for example. Or the household policy avoided for locks wrongly described as meeting the insurer's requirements – even though there was no connection with the claim that had occurred, and the locks had been fitted by the insurer's own contractors following an earlier loss. Consumers treated in this way have a legitimate grievance which they are likely to share with family, friends, colleagues and, occasionally, the media. The actions of a minority of insurers dent the reputation of the industry as a whole.

Opportunely the English and Scottish Law Commissions' current review of insurance contract law takes place against the background of the Chartered Insurance Institute's drive to promote greater levels of ethical behaviour and professionalism in insurance and financial services. These initiatives should be seen as complementary moves towards the establishment of new standards with the potential to restore public confidence in insurance and transform the insurance industry into a true profession.

Central to professionalism is an inviolable commitment to work in the best interests of the client. In 2008, Lord Hunt, then President of the CII, stated that professionalism "goes to the heart of everything you do and the way you behave, your code of ethics, the way you treat the customer, the consumer, the client - putting their interest right at the heart of everything that you are doing". It cannot possibly be in the best interests of consumers for any risk to remain that their insurance arrangements will be subject to antiquated, obscure and unfair law. Voluntary forbearance by most insurers is insufficient — law reform is required.

Why is the law so unsuitable?

Insurance law was not developed with consumers in mind. Much of the law dates back to the 18th or 19th centuries and was hammered out in commercial litigation. This was long before the existence of modern mass-market consumer policies, at a time when most current types of cover had not been developed and before the emergence of the internet and telephone as major sales channels. The Marine Insurance Act 1906 codified the law but was not drafted with consumers in mind and has subsequently been allowed to stagnate. And whilst the existence of successive ombudsman schemes has been an undoubted boon to consumers, it has also cut off the flow of cases to the higher courts, limiting their opportunities to develop specific rules for consumer insurance.

The wider consumer law revolution has also had little impact on insurers. For instance, the industry gained an exemption from the Unfair Contract Terms Act 1977 in return for promulgating the

Statement of General Insurance Practice (SGIP) and the Statement of Long-Term Insurance Practice. These statements remained in force until the introduction of statutory conduct of business rules. However, they were not legally binding and until the Insurance Ombudsman Bureau was founded in 1981 there was no means by which they could be enforced.

Various organisations have considered insurance law and recommended change: the Law Reform Committee in 1957, the English Law Commission in 1980, the National Consumer Council in 1996 and the British Insurance Law Association in 2002. However, previous attempts at reform have been thwarted by the opposition of the ABI and its predecessor, the British Insurance Association.

The Law Commissions' Report

Are the Law Commissions' current proposals the right way forward? When the Law Commissions started their review back in 2005, the industry was understandably concerned as to the possible outcomes. However the three-stage procedure which was adopted allayed some fears. First, for each topic an Issues Paper sets out the law, the perceived problems and tentative solutions. Comments are welcomed and are taken into account when secondly a formal Consultation Paper with proposals for reform is produced. Thirdly, a final report with draft bill is published. The process therefore allows ample opportunity for the industry's views to be heard, and the Chartered Insurance Institute is playing an active part in consultations.²

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Practitioners have also been reassured by the sensible nature of the reform proposals. In particular, the Law Commissions have now issued a final report on the consumer's pre-contractual obligations. Drawing heavily on the work of the FOS, this proposes reform in three key areas: basis of contract clauses, non-disclosure and misrepresentation.

² See for example, [Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty](#), a response by the Chartered Insurance Institute to the Law Commission and Scottish Law Commission Joint Consultation, Dec 2007. See also [Our View On... Insurance Contract Law Reform](#), CII, Dec 2009. Both are available on www.cii.co.uk/policy

a) Basis of the Contract Clauses

The Law Commissions recommend that basis of the contract clauses should be rendered ineffective. This gives legal force to the commitment given by the ABI on behalf of the industry in 1986 that such clauses would not be used in consumer insurance. Although the commitment was backed by an amendment to SGIP, the clauses continued to be used, demonstrating the weakness of voluntary measures.³

Informally the FOS has indicated that it disregards such clauses in consumer cases. This is unsurprising — there are likely to be very few consumers who understand the impact of a statement on an insurance application form that the answers given form "the basis of the contract". In fact, this opaque wording converts the answers into warranties. Any inaccuracy is a breach of warranty which terminates cover immediately and automatically, regardless of whether or not the issue in question is material or not. The result is that unknown at the time to consumer or insurer, cover may simply never commence.

b) Non-disclosure

The Law Commissions recommend the abolition of the duty of disclosure. This step will bring the law into line with FOS practice as announced immediately after SGIP was withdrawn.⁴ Currently the duty is so onerous that it must be doubted whether any consumer ever makes full disclosure, though David Tench, Director of Legal Affairs for the Consumers' Association at the time of the last Law Commission review, should perhaps be commended for diligently reporting the death of his dog to his bemused household insurer!

c) Misrepresentation

The Law Commissions recommend that the remedy for pre-contractual misrepresentation should depend on the conduct of the consumer. Deliberate or reckless misrepresentation will entitle insurers to avoid the policy and reject any claim as at present. For careless misrepresentation, an insurer will be entitled to act as it would have done had it known the true position. For example, if it would have declined cover, it may set the policy aside. Or if it would have imposed an exclusion, it may treat any claim as if the policy contained such a term. For misrepresentation that was reasonable there will be no remedy – the policy will remain in force and

³ See, for instance, *Economides v Commercial Union Assurance Co Plc* [1998] QB 587.

⁴ See FOS [Ombudsman News issue 46](#), May/June 2005.

any valid claim will be met. Although the terminology differs, this is broadly in line with the approach taken by the FOS.

As noted, all these proposals are based closely on existing FOS practice and so contain nothing that should surprise or alarm insurers. Indeed practitioners are already required under the Chartered Insurance Institute's Code of Ethics to take account of FOS practice, and in CP10/21 the Financial Services Authority (FSA) has raised the possibility that it will issue guidance on the processes insurers should have in place to take account of ombudsman service decisions. Even the ABI has now withdrawn its opposition to implementation of the Law Commissions' first piece of draft legislation, the Consumer Insurance (Disclosure and Representations) Bill.

Current Consultations: Post-Contractual Issues

The Law Commissions are also working on proposals for business insurance and other issues which affect consumer insurance. A Consultation Paper is currently awaited on insurable interest for example. Work on post-contractual good faith is at an even earlier stage but the content of recent issues papers is promising.

The Law Commissions recently confirmed that of the 32 responses received to the issue paper, "the overwhelming majority agreed that damages should be available when the insurer has failed to pay a valid insurance claim, or has paid only after a considerable delay."

Late payment of claims

The Law Commissions have tentatively suggested in Issues Paper 6 that consumers should have a right to damages where the late settlement of a claim is unreasonable and causes further foreseeable loss. It may be thought curious that no such remedy currently exists — professionals would ordinarily expect to be liable for failings in the services they provide. As David Hertzell explains, the reason is a legal curiosity, namely that a policy of insurance is a contract by which the insurer undertakes to hold harmless the consumer.⁵ An insurance claim is therefore technically a claim for damages for breach of contract, and there is no right to damages for late payment of damages. Unsurprisingly the Law Commissions recently confirmed that of the 32 responses received to the Issues Paper "the overwhelming majority agreed that damages should be available where the insurer has failed to

pay a valid insurance claim, or has paid only after considerable delay".

Section 17 of the Marine Insurance Act 1906

The Law Commissions have asked in Issues Paper 7 whether s17 of the 1906 Act should be amended to allow for remedies other than avoidance in the event of post-contractual breaches of good faith. A strict application of s17 would mean that a policyholder making a fraudulent claim would lose not just the benefit of that claim but also any earlier legitimate claim. The Law Commissions suggest that should instead be a statutory duty not to make a fraudulent claim, with the definition of fraud being left to the courts to develop. Any claim where there is an element of fraud will be forfeited in its entirety which, as David Hertzell states, should provide both penalty and disincentive.

Should fraud terminate a policy?

The Law Commissions also ask what the effect of a fraudulent claim should be on a policy if avoidance is not permitted. This point is likely to be the subject of lively discussion. Under current law the insurer may cancel the policy at the date the fraud is discovered, meaning that the insurer is liable for any legitimate claims which occur in the intervening period. As an alternative, David Hertzell asks whether there should be automatic termination at the date of the fraud. This seems fair — no insurer wishes unknowingly to be bound into a contract with a consumer who is willing to commit fraud. However, it would inevitably produce hard cases where a minor element of fraud in one claim leads to the rejection of a much larger subsequent claim. Is there additionally a risk that it would provide an undesirable financial incentive for insurers facing a substantial loss to re-open previous claims and scour the files for evidence of some element of fraud — much as a minority of insurers currently approach pre-contractual non-disclosure and misrepresentation?

As yet the Law Commissions have not asked what should happen where a fraudulent claim is made but the policy is renewed before the fraud is detected. The renewed policy is of course a new contract in law. It would therefore be unaffected by any automatic termination of the preceding contract. As the duty of disclosure will be abolished for consumers there will be no obligation to disclose the fraudulent claim at renewal unless a specific question is asked. Insurers may understandably be reluctant to ask consumers bluntly whether they have previously committed fraud!

⁵ See David Hertzell, Footnote 1 above.

Issues and Next Steps

Practitioners are now pressing for the implementation of the Consumer Insurance (Disclosure and Representations) Bill and if this measure achieves Government support it could be introduced through a Parliamentary special procedure in the House of Lords as early as February 2011.⁶ In the meantime the industry and the Chartered Insurance Institute will continue to engage with the Law Commissions' ongoing consultations.

Should practitioners have a more ambitious objective in their sights? Given the Law Commissions' track record of sensible proposals in this area is it not time the industry pushed for a better-funded broader project, namely the full codification of consumer insurance law? The confused patchwork of old statutes, ancient case law, voluntary codes, FSA rules and FOS guidance could be swept away and replaced with a single source of modern, coherent and fair law that could be updated as necessary. Insurers and consumers alike would have a clear and accessible statement of their respective rights and obligations, disputes would be less common and

training and compliance costs could be reduced. Fair law would surely form the ideal basis for a new compact with consumers and the foundation of a profession to which practitioners can be proud to belong.

If you have any questions or comments about this thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact: Laurence Baxter, CII Head of Policy & Research: thinkpiece@cii.co.uk or by telephone: +44 (0)20 7417 4783.



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⁶ See for example, "Insurance law from Georgian times needs update," Letter from Laurence Baxter, CII, and others, *Financial Times*, 2/3 October 2010.

Recent articles in the series:

- No.46: [What Happens Once the Ink is Dry? Claims and the Parties' Post-Contract Duties](#) by David Hertzell, Law Commissioner of England & Wales (8 November 2010)

Law Commissioner David Hertzell examines his team's latest review of insurance contract law. He sets out some of the problems with the existing law underpinning insurance contracts, and discusses some solutions to clarify the insurer and policyholder responsibilities especially after the contract is signed.

- No.45: [The View from Singapore - Cautious Optimism about Asian Economic Recovery](#) by Mui Pong Goh, Research Fellow, Chatham House, [International Series no.12](#) (19 October)

Due to its unique vantage point at the heart of Southeast Asia, Singapore is well placed to provide an informed view of global economic developments and their implications for this influential part of the world. This paper discusses the tremendous growth surge underway this year, and reflects on the current wave of cautious optimism regarding the region's economic future.

- No 44: [A Passage to India: Towards Robust Economic Growth?](#) by Donald Hepburn, Associate Fellow in International Economics, Chatham House, [International series, no.11](#) (29 September)

Published in the backdrop of the Commonwealth Games, it unpicks some of the underlying economic trends with India's developing economy. The paper begins by identifying the reasons for India's relative success during the financial crisis, before outlining the future prospects for growth and the infrastructural and political barriers to prosperity.

- No.43: [Time for collective action? Redressing the damaging effects of cartels on small businesses](#) by Ingrid Gubbay and Antony Maton, Hausfeld & Co LLP (10 September)

This paper, by the authors examine some of the harmful effects of cartels on small businesses and discusses reasons why firms remain reluctant to claim for damages. The paper then moves on to highlight the affordable options open to SMEs for redress, and the opportunities for insurance firms to become the underwriters of collective action.

- No.42: [Speedy Recovery or Lingering Crisis in the Gulf Economies?](#) by Vanessa Rossi and William Jackson, Chatham House, [International Series no.10](#) (30 July)

Over a year after covering this region in an [earlier thinkpiece](#), the author returns to examine how the Gulf economies have fared especially following the Dubai property crisis last autumn. Despite the setback, Chatham House's forecasts nevertheless show much promise for significant growth in insurance and financial services over the next 5 to 10 years.

- No.41: [Charging fairly for pensions](#) by Steven Cameron, Head of Business Regulation, AEGON UK (20 July)

The Head of Business Regulation at AEGON UK summarises the 2012 pension reforms introducing a controversial new charging structure for the National Employment Savings Trust (NEST) scheme which will combine a fund management charge with a charge on contributions. Examining both sides of the argument, AEGON concludes that a combination charging structure is a positive move for all parties.

- No.40: [The Future of International Financial Regulation](#). by Eric Pan, Associate Fellow in International Economics, Chatham House, [International Series no.9](#) (8 June)

This thinkpiece summarises the challenges confronting attempts to strengthen the global financial regulatory architecture. Prepared by a prominent regulatory law professor based in New York, the paper helps readers make sense of the various interlocking institutions such as the G20, IMF and European Union, and sets out the key issues and challenges facing them as they deal with the effects of the financial crisis.

- No.39: [Financial Education: It's Everybody's Business](#). by Wendy van den Hende, Chief Executive, Personal Finance Education Group (pfeg) (24 May)

Van den Hende summarises the importance of financial education for young people in enhancing public trust and confidence in money matters. She goes on to describe efforts by government and the industry (including the Personal Finance Society) to help develop and promote this, and sets out what more needs to be done.

- No.38: [Successes, trials and tribulations in regional economic recoveries](#), by Rodrigo Delgado Aguilera, Chatham House, [International Series no.8](#) (22 April)

The developing world is seeing the same sort of multi-speed recovery as elsewhere. While the Asian economies have responded well following lessons learned from earlier crises, Latin America and the Middle East seem to have for the most part escaped the turmoil's major effects, but emerging Europe's recovery is still far from over.

- No.37: [UK Election 2010 Special: What the Parties Say](#), by Stephen Timms, Mark Hoban and Vince Cable (1 April 2010)
- We have compiled an election special as part of our regular CII Thinkpiece series. The three main parties – represented by the Rt Hon Stephen Timms MP for Labour, Mark Hoban MP for the Conservatives and Dr Vince Cable MP for the Liberal Democrats – set out their respective visions for financial services.
- No.36: [The End of Dollar Dominance? Signs of Change in the International Financial System](#), by Vanessa Rossi, Chatham House, [International Series no.7](#) (17 March)
- Changes in the international financial arena following the global recession could challenge the West's dominance the monetary system. In this latest addition in our special series of thinkpieces on global themes, Vanessa Rossi of Chatham House explores these changes.
- No.35: [Making Sense of it All: Convergence and Investor Protection in EU Financial Regulation](#), by David Doyle (9 March)
- While events in Brussels may seem far away to some, recent proposals for European financial regulation will have more impact than usual on financial practitioners in the member states. EU expert David Doyle looks at some of the proposals under consideration right now and discusses their implications.
- No.34: [Something Must Be Done! Sir Humphrey writes: Lessons for Financial Regulation](#), by Richard Hobbs (11 February)
- The author explores the government's response to the financial crisis. He warns that drastic, politically expedient intervention that is seen to be "doing something" risks stifling competition while failing to address the underlying causes of the crisis.
- No.33: [Too Big to Ignore: The Protection and Perception Gaps in Life and Health Insurance](#), by Ron Wheatcroft and Stephen Bale, Swiss Re (29 January)
- A consumer-focused view of the long-term insurance market with a particular emphasis on long-term protection business. The authors explain why the time is ripe for that industry to engage with all stakeholders in a concerted effort to close the protection and perception gaps.
- No.33: [Comfortable Retirement Goes with a Crunch?](#) by Gemma Tetlow and Matthew Wakefield, Institute of Fiscal Studies (IFS) (12 January 2010)
- Gemma Tetlow and Matthew Wakefield of the UK economics think tank the Institute of Fiscal Studies consider the extent to which resources of those near retirement have been vulnerable to asset price changes as a result of the credit crunch and recession.
- No.32: [Financial Regulation: What Good Really Looks Like?](#) by Karl Snowden (10 November 2009)
- How much financial services regulation is appropriate to protect the public while promoting a free market has been a key debate. Karl Snowden examines various aspects of regulation, including what can and cannot be done to avert crises and produce the best outcomes.
- No. 29: [Solvency II: Enabling Transformation Through Regulation](#), by Richard Jones, John Smith and Brid Meaney, IBM (8 October)
- Outlines the key decisions that need to be made now to design the appropriate Solvency II programme. Insurers need to understand the drivers that could influence both the scale of investment and the value to be derived from their Solvency II Programmes.
- No. 28: [Risky Business: Rethinking Risk](#), by Clare Sheikh, RSA Insurance Group (1 October)
- The economic downturn has affected people in many ways. One such example is the impact on perceptions towards risk, both in terms of businesses and individuals. This last in the Risky Business series on insurance and risk the ways in which attitudes have shifted and what this might mean for the future.
- No. 21: [Personal Accounts: Encouraging People to Save for Retirement](#), by Tim Jones of the Personal Accounts Delivery Authority (now National Employment Savings Trust: NEST) (21 August 2009)
- Tim Jones, Chief Executive of the Personal Account Delivery Authority, provides background to the personal accounts scheme which will be ready for the onset of employer duties in 2012, outlines the role of employer contributions and considers the investment strategy

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