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# REFORMING INSURANCE WARRANTIES—ARE WE FINALLY MOVING FORWARD?

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## 1 INTRODUCTION

The function of warranties in insurance law is to define the risk insured by ensuring that a particular state of affairs, past, present or future, would, as the case might be, either exist as a factor tending to reduce the probability of the occurrence of an insured event, or would not exist as a factor tending to increase the probability of the occurrence of an insured event.<sup>1</sup> Therefore, breach of an insurance warranty renders the risk materially different from that which the insurer agreed to cover, entitling the insurer to treat themselves as discharged from future liability automatically.<sup>2</sup> The role warranties play in insurance law has been emphasised in a categorical fashion by Lord Goff in *The Good Luck*:

“ . . . if a promissory warranty is not complied with, the insurer is discharged from liability as from the date of the breach of warranty, for the simple reason that fulfilment of the warranty is a condition precedent to the liability of the insurer. This moreover reflects the fact that the rationale of warranties in insurance law is that the insurer only accepts the risk provided that the warranty is fulfilled.”<sup>3</sup>

Over the years, warranties have gained a prominent place in insurance practice as a result of insurers making increasing use of them in policies in order to reduce the burden or extent of their promise of cover. This has

1. Section 33(3) of the Marine Insurance Act 1906 (MIA) stipulates: “A warranty, in the following sections . . . means a promissory warranty, that is to say, a warranty by which the assured undertakes that some particular thing shall or shall not be done, or that some condition shall be fulfilled, or whereby he affirms or negatives the existence of a particular state of facts.”

2. *Bank of Nova Scotia v. Hellenic Mutual War Risks Association (Bermuda) Ltd (The Good Luck)* [1992] 1 A.C. 233. It has always been the case, since the days of Lord Mansfield, that the obligation stipulated in a marine warranty must be complied with exactly, so that, as he said, *obiter dictum*, in *Pawson v. Watson* (1778) 2 Cowp. 785, 787, “. . . nothing tantamount will do or answer the purpose”.

3. *Ibid.*, 262–263.

brought the warranty regime under close scrutiny, and several of its features have attracted criticism both in judicial<sup>4</sup> and academic circles.<sup>5</sup> First, the regime has been regarded as too rigid because it takes no account of the magnitude of the breach and its relevance to the loss. In *Hibbert v. Pigou*,<sup>6</sup> the insured ship, warranted to sail with a convoy, in fact, sailed without one and went down in a storm. The underwriter was held not liable even though the breach had no connection with the loss. Similarly, in *Forsikringsaktielselskapet Vesta v. Butcher*,<sup>7</sup> it was held that the failure of the assured owner of a fish farm to comply with a warranty whereby a 24-hour watch had to be maintained was fatal to his claim for loss from storm damage, although it was conceded that the presence of watch could not possibly have in any way lessened the likelihood or degree of loss by storm. Secondly, the penalty for breach is considered to be disproportionately severe for the assured, as they lose their insurance cover once the warranty is breached even though the breach is remedied before any loss arises. In *De Hahn v. Hartley*,<sup>8</sup> when the insured vessel commenced the intended voyage the warranted number of crew were not on board. The insurer was held not to be liable, although the warranted number of crew had been recruited before the vessel sailed on the leg of the voyage during which the casualty occurred. Thirdly, the market practice of demanding warranties of all manner of matters, many of which would have had little or no bearing on the risk has been regarded as an abuse of the original conception.<sup>9</sup> The prime example is premium warranties which require the assured to pay the premium within a certain period. Last, but not least, it has been suggested that the harshness of the warranty regime might have catastrophic consequences particularly for small and medium businesses which are not always aware of the legal implications of “warranties”. Even if they do, they might lack the bargaining position to change the insurer’s standard wording, or the resources to argue cases before courts.<sup>10</sup>

4. Lord Griffiths in *Forsikringsaktielselskapet Vesta v. Butcher* [1989] A.C. 852, 893–894, said: “It is one of the less attractive features of English insurance law that breach of a warranty in an insurance policy can be relied upon to defeat a claim under the policy even if there is no causal connection between the breach and the loss.” In a similar fashion, writing extra-judicially, Sir Andrew Longmore forcefully criticised the current warranty regime in “Good Faith and Breach of Warranty: Are We Moving Forwards or Backwards?” (2004) LMCLQ 158.

5. T. J. Schoenbaum, “Warranties in the Law of Marine Insurance: Some Suggestions for Reform of English and American Law” (1999) Tulane M.L.J. 267; J. Hare, “The Omnipotent Warranty: England v. The World”, in M. Huybrechts, E. V. Hooydonk and C. Dieryck (eds), *Marine Insurance at the Turn of the Millennium*, Vol. 2 (Antwerp, 1999) p. 37 and B. Soyer, “Marine Warranties: Old Rules for the New Millennium?”, in D. R. Thomas (ed.), *Modern Law of Marine Insurance*, Vol. 2 (London 2002), p. 161.

6. (1783) 3 Doug. K.B. 213.

7. [1989] A.C. 852.

8. (1786) 1 T.R. 343. See, also, *Quebec Marine Insurance Co. v. Commercial Bank of Canada* (1870) L.R. 3 P.C. 234.

9. Section 33(3) of the MIA 1906 indicates that a warranty need not be material to the risk.

10. See para. 7.49 of the Law Commission and Scottish Law Commission, *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured* (LCCP No. 182, SLCDP No. 134, 2007), hereinafter referred to as the Consultation Paper 2007.

Having recognised that the current warranty regime could militate against reasonable expectations of policy holders, the courts have developed various techniques of construction to relieve the harsh effects of the regime. It has been observed that the courts, on numerous occasions, have been prepared to construe the obligations imposed by warranties in a narrow fashion. For instance, in *Hide v. Bruce*,<sup>11</sup> an express warranty, which required the insured vessel to commence the intended adventure with 20 guns, was held to be satisfied even though there were 20 guns on board but not the men necessary to work them. Similarly, in *Hussain v. Brown*,<sup>12</sup> the assured, in the proposal form which was said to be the basis of the contract, indicated that their premises were fitted with an intruder alarm. The statement was true at the time of the contract, though the assured later failed to pay the charges and the alarm service was suspended. The Court of Appeal held that the warranty was not breached since the statement on the proposal form related only to present facts and did not make a promise about the future.<sup>13</sup>

Canadian courts have been more adventurous in the manner in which they have employed judicial construction to curb harsh consequences of the warranty regime. On several occasions, courts were led to seek alternative legal categories for the clauses in question, particularly in cases where the insurers sought to rely on a warranty defence when the breach had no bearing on the loss. The case that immediately springs to mind is the Canadian Supreme Court decision in *Century Insurance Company of Canada v. Case Existological Laboratories Ltd (The Bamcell II)*,<sup>14</sup> where it was held that a clause which read: "Warranted that a watchman is stationed on board *The Bamcell II* each night from 2200 hours to 0600 hours with instructions for shutting down all equipment in an emergency", was a clause delimiting the risk and not a true warranty. Accordingly, the assured was allowed recovery, as the insured vessel sank during daytime as a result of the negligence of an employee who opened the air valves and failed to close them later.<sup>15</sup> It is clear that the judges in the *Bamcell II* were desperate to circumvent the rule that a breach of warranty that causes no loss allows the insurer to escape liability. This type of construction achieves fairer results, but it does so at the cost of introducing uncertainty and

11. (1773) 3 Doug. K.B. 213.

12. [1996] 1 Lloyd's Rep. 627.

13. Saville L.J. at 630, said: "... it must be remembered that a continuing warranty is a draconian term. As I have noted, the breach of such a warranty produces an automatic cancellation of cover, and the fact that a loss may have no connection at all with that breach is simply irrelevant. In my view, if the underwriters want such a protection, then it is up to them to stipulate for it in clear terms." Cf. *Agapitos v. Agnew (The Aegeon) (No. 2)* [2002] EWHC 1558; [2003] Lloyd's Rep. IR 54 and *Eagle Star Insurance Co. Ltd v. Games Co. S.A. and others (The Game Boy)* [2004] EWHC 15, [2004] 1 Lloyd's Rep. 238.

14. [1983] 2 S.C.R. 47.

15. In case of breach of a clause that delimits the risk, the insurance cover is suspended while the breach continues. The insurance cover becomes effective as soon as the breach terminates. See, also, *James Staples v. Great American Insurance Co. New York* [1941] S.C.R. 213 to the same effect.



confusion into the law by blurring the distinction between warranties and other clauses describing the risk.<sup>16</sup>

In some other common law jurisdictions, the warranty regime has gone through a transformation through statutory modification. For example, in certain American states underwriters are required to establish either a causal connection between the breach and the loss before permitting the insurer to avoid paying a claim,<sup>17</sup> or that the breach materially increases the risk of loss, damage or injury within the coverage of the contract.<sup>18</sup> Similar developments have taken place in Australia<sup>19</sup> and New Zealand.<sup>20</sup> Inspired by the changes taking place in the international arena and also in general contract law,<sup>21</sup> the Law Commission prepared a report in 1980 advocating a reform of the warranty regime.<sup>22</sup> Although a draft Bill was introduced to Parliament for the reform of the regime regulating non-marine warranties, it did not come to fruition. The draft Bill was withdrawn after the Government reached agreement with the Association of British Insurers (ABI) to the effect that ABI would take up the Law Commission's recommendations on a self-regulatory basis in non-marine insurance.

Despite this setback, calls for law reform in this area have continued and gained momentum in the new millennium, particularly with the publication of a report by the Australian Law Reform Commission (ALRC) in 2001 proposing substantial amendments to the Australian Marine Insurance Act 1909 (which is the equivalent of the MIA 1906), including the regime regulating marine insurance warranties.<sup>23</sup> The following year, the British Insurance Law Association submitted a report to the English Law Commission in which it

16. For a detailed discussion on the matter, see, B. Soyer, *Warranties in Marine Insurance*, 2nd edn (London, 2006) at paras 2.86–2.91.

17. *United States Fire Insurance Co. v. Cavanaugh* [1985] AMC 1001 (6th Cir., 1950); *Highlands Insurance Co. v. Koetje* 651 F. Supp 346 (W.D. Wash., 1987).

18. New York Insurance Code, Art. 31, s. 3106(b).

19. Section 54 of the Insurance Contracts Act 1984 makes significant changes to the manner in which insurance warranties operate and will be closely looked at later in this paper. This Act applies to insurance contracts other than marine insurance, reinsurance, workers' compensation, export credits and—unless otherwise provided—compulsory third party motor vehicle insurance.

20. Section 11 of the Insurance Law Reform Act 1977 provides: "... the insured shall not be disentitled to be indemnified by the insurer by reason only of such provisions of the contract of insurance if the insured proves on balance of probabilities that the loss in respect of which the insured seeks to be indemnified was not caused or contributed to by the happening of such events or the existence of such circumstances."

21. The introduction of innominate terms by the Court of Appeal in *Hong Kong Fir Shipping Co. Ltd v. Kawasaki Kisen Kaisha Ltd* [1962] 2 Q.B. 26 has given courts a degree of remedial flexibility in deciding whether or not the breach of a contract was repudiatory by having regard to the consequences of the breach rather than the nature of the term. The development clearly demonstrates a fundamental shift in general contract law by allowing courts to link the right of termination to the seriousness of the breach. In this way, the potential injustice of the automatic right to terminate for a minor breach of the relevant contractual term can be side-stepped.

22. Law Commission Report No. 104, *Insurance Law—Non-Disclosure and Breach of Warranty*, Cmnd. 8064 (1980). The striking point in this report is the exclusion of marine, aviation and transport insurance from the scope of a possible law reform.

23. Australian Law Reform Commission, *Review of the Marine Insurance Act 1909* (Report 91, 2001).



recommended reform of various aspects of insurance contract law, including warranties. These developments, coupled with the possibility of further developments at the EU level,<sup>24</sup> led the English and Scottish Law Commissions (the Law Commissions), at a meeting at Lloyd's in January 2006, to announce a wide-ranging review of insurance contract law. The initial scoping exercise revealed the need to investigate several controversial aspects of the current regime. As a result the Law Commissions announced an ambitious programme consisting of short-term reforms followed by separate codes of consumer insurance and business insurance. Whether it is a viable prospect for this project to deliver two draft codes of insurance law is questionable, but in the meantime the Law Commissions have published three consultative Issues Papers on misrepresentation and non-disclosure (June 2006), warranties (November 2006) and intermediaries and pre-contractual information (March 2007). Based on responses, in July 2007 the Law Commissions published their first Consultation Paper,<sup>25</sup> a significant part of which deals with reform of warranties.<sup>26</sup> Having completed the consultation process in late 2007, the expectation is that the Law Commissions will publish their final report on the subject in 2009–2010. The purpose of this chapter is to evaluate, from a critical standpoint, the proposals put forward by the Law Commissions with a view to reforming the warranty regime. As part of this exercise, it is essential to consider the other possible models which the Law Commissions could have adopted as the basis of a new warranty regime. It is hoped that such an analysis will provide the necessary background to evaluate the appropriateness of reform proposals.

## 2 FUNDAMENTAL PRINCIPLES GUIDING A POTENTIAL LAW REFORM ON WARRANTIES

Before embarking upon an examination of the proposals of the Law Commissions on reforming the warranty regime, and of possible alternatives to those proposals, there is merit in setting out essential principles which one would expect an ideal reform model to fulfil.

24. The EU has indicated that it intends to put forward proposals of its own for the reform of insurance law, and there are worries that what will emerge will be unacceptable to the UK. It is believed that the UK might have a chance to lead any harmonisation debate in Europe if it takes pre-emptive action by producing a contemporary insurance legislation.

25. For a general evaluation of the proposals of the Law Commissions, see, R. Merkin and J. Lowry, "Reconstructing Insurance Law: The Law Commissions' Consultation paper" (2008) 71 M.L.R. 95. The work of the Law Commissions is ongoing, and another Issues Paper on insurable interest was released in January 2008. It is the intention of the Law Commissions to publish a second consultation paper focusing on the issues of insurable interest and post-contractual good faith (including fraud and damages for late payment of claims) at a later stage.

26. Reforming the law in relation to pre-contractual information duties is another associated subject considered in depth in the Consultation Paper 2007.

## 2.1 Certainty

Achieving “certainty” has traditionally been the primary objective of legal rules pertaining to commercial matters. Many believe that the international success of English commercial law is due mainly to the fact that it provides certainty in terms of outcome in commercial transactions, compared with laxer systems which do not provide the same degree of certainty.<sup>27</sup> The position is no different in the context of commercial insurance. Particularly from the perspective of corporate assureds, legal certainty is a vital concept which rational business planning can be built upon.

That said, one should not lose sight of the fact that there is a remarkable shift in the fundamental values underpinning various aspects of commercial law. The introduction of innominate terms is a prime example of this change, which does not discard the need for “certainty” but rather qualifies it by allowing courts to assess the degree of prejudice caused by the breach to the injured party. In similar fashion, as manifested in the restatement of Lord Hoffmann in the landmark case of *Investors Compensation Scheme Ltd v. West Bromwich Society*,<sup>28</sup> there is a move away from a formalist approach when construing contractual terms, which is a clear indication of the courts’ readiness to put other values ahead of “certainty”.

Therefore, it is desirable that the new model that will replace the current warranty regime strives to achieve legal certainty by providing clear and coherent principles. However, one should not overlook the changes taking place in commercial law over the course of last few decades. Even in areas of commercial law that once regarded “certainty” as paramount, there is room to make small sacrifices from this concept in pursuit of other normative understandings, such as fair dealing and protection of parties’ reasonable expectations, which have become dominant in contract law.

## 2.2 Freedom of contract

Freedom of contract has been at the heart of the development of contemporary contract law. Although some limitations have been imposed on the extent of this freedom in certain types of contracts such as consumer contracts, for various policy reasons, in business contracts intervention on parties’ contractual freedom is not a frequent occurrence.<sup>29</sup> Intervention has been justified in cases where there is a need to protect one of the contractual parties which does not hold a strong bargaining position. With the exception of small businesses, a majority of the corporations seeking insurance cover do not

27. *Shogun Finance Ltd v. Hudson* [2004] UKHL 62, [2004] 1 A.C. 919 at 49, *per* Lord Hobhouse.

28. [1998] 1 W.L.R. 896.

29. See, however, s. 6(1) of the Unfair Contract Terms Act (UCTA) 1977, which precludes parties in contracts of sale or hire purchase from excluding or restricting the implied undertakings as to title of the seller or owner expressed in s. 12 of the Sale of Goods Act 1979 and s. 8 of the Supply of Goods (Implied Terms) Act 1973.



belong to this category. Most business contracts concluded in the London market are the result of a lengthy negotiation process, and there is evidence to suggest that a majority of businesses can dictate the contents of their insurance contract.<sup>30</sup> Under these circumstances, it is difficult to see any reason justifying a departure from this principle in the process of reshaping the new warranty regime.

### 2.3 Reasonable expectations of the assured

It is undeniable that confidence in the market-place can be undermined if coverage offered by the main providers does not correspond with the reasonable expectations of the assured. Defining the precise ambit of this concept is not straightforward, but it is obvious that the expectations of a small business will be different from those of a large company, which would probably have at its disposal lawyers who could provide guidance on the limitations of the insurance product purchased.

If the confidence in the market is shaken, this might have adverse consequences for the London market in areas which face intense competition from other international markets (e.g. marine insurance). In those areas, insurance conditions put forward to potential assureds play a significant role in the competition for market shares. If potential assureds feel that insurance conditions offered in the London market do not respond to their reasonable expectations, it is likely that they might turn away from the London market to markets which adopt more assured-friendly legal rules.

The challenge for the new warranty regime will be to identify the expectations of various sections of the market and respond to them in an appropriate fashion. This might necessitate deviation from the general principles to accommodate the needs of certain types of policy holders.<sup>31</sup>

### 2.4 Reform not revolution

Views have been expressed to the effect that a legal reform in the field of contract law may achieve more efficient results if policy-makers work within the system, *albeit* an imperfect one, rather than scrapping it.<sup>32</sup> It is submitted that this approach holds true also for insurance law. A sweeping reform which would change all parameters of underwriting practice is likely to unsettle the fine balance in the market. Various consequences might emerge as a result. For example, it might be possible that the underwriters contemplate re-drafting of a majority of the standard clauses to overcome consequences of the new legislation that they regard as "adverse" from their own perspective. Rewriting

30. See, para. 7.50 of the Consultation Paper 2007.

31. For example, it might be necessary to offer more protection for small- and medium-sized insurance companies.

32. See, R. A. Hillman, *The Richness of Contract Law: An Analysis and Critique of Contemporary Theories of Contract Law* (Boston 1997), 271.



terms of cover might not only increase transaction costs to extravagant levels,<sup>33</sup> but it also has the potential to increase room for dispute as to whether a claim is payable.<sup>34</sup> A potential law reform should, therefore, aim to cure defects in the current warranty regime by avoiding, if possible, turbulence and uncertainty which will naturally follow the introduction of novel legal concepts.

### 3 REFORM OPTIONS

It hardly needs saying that the insurance market will approach any legislative reform initiative cautiously, as parliamentary interference in commercial affairs is not usually welcomed with open arms. The usual response would be that the severity of the common law doctrine is mitigated in practice by contractual devices such as “held covered clauses”,<sup>35</sup> or in cargo insurance by clauses limiting implied warranty of seaworthiness to cases where the assured and their servants are privy to unseaworthiness.<sup>36</sup> There is a degree of force in this argument, but it is also undeniable that breach of warranty defence is capable of being used in a technical manner to defeat reasonable expectations of the assured. If we proceed on the assumption that contractual devices are not adequate to protect the reasonable expectations of the assured and establish confidence in the market, it is essential to identify which legal model a potential statutory reform can be built upon. Drawing upon the experience of other jurisdictions and academic research conducted in the field, four viable reform options can be identified which will be further elaborated below.

#### 3.1 Adopting the doctrine of “alteration of risk”

There is a fundamental difference between common law and continental legal systems in the sense that increase of risk in insurance contracts during the

33. It has to be borne in mind that the cost-benefit analysis conducted for the Law Commissions by an independent economic consultancy firm has not expanded its deliberation to business insurance. It is appreciated that collecting the required data for this kind of analysis can be more challenging but, nevertheless, is essential to be able to make predictions regarding the potential impact of the suggested reform proposals.

34. Section 54 of the Australian Insurance Contracts Act 1984, which is designed to replace the warranty regime, has generated a great deal of litigation.

35. Clause 3 of the Institute Time Clauses Hulls 1995 reads: “Held covered in case of any breach of warranty as to cargo, trade, locality, towage, salvage services or date of sailing provided notice be given to the Underwriters immediately after receipt of advices and any amended terms of cover and any additional premium required by them be agreed.”

36. See, cl. 5(2) of the Institute Cargo Clauses 1982 (A, B and C). It should also be noted that some of the warranties have been converted into suspensory provisions in the International Hull Clauses 2003. For a detailed analysis of the new clauses, see, B. Soyer, “A Survey of the New International Hull Clauses 2002” (2003) J.I.M.L. 256.

currency of the policy is permitted under the former.<sup>37</sup> The common law tolerance of post-contractual increases of risk is normally modified by express provisions such as warranties. In continental legal systems, on the other hand, the starting point is that the insurance is made implicitly on a particular basis (which may also be partly express), and that an alteration of risk which amounts to a departure from that basis will provide certain remedies for the insurer. For example, under the Norwegian Marine Insurance Plan (NMIP) 1996 (2003 version), if the risk is intentionally altered by the assured, or the assured agrees to such alteration, or the assured neglects to notify the insurer regarding an alteration, the insurer is free from liability, provided that the insurer would not have written the policy if he had known that the alteration in risk would take place. However, if the insurer would have accepted the insurance on other conditions, for example, by charging an increased premium, or if he had known that the alteration in risk would take place, he is only liable to the extent that the loss is not caused by the alteration of the risk.<sup>38</sup> In either case, the insurer may terminate the contract by giving 14 days' notice.<sup>39</sup>

One could argue that the position of the assured could be improved dramatically if insurance warranties are replaced by a doctrine of "alteration of the risk" on the lines of continental legal systems. Even though this comes across as an attractive proposition at first sight, the viability of a reform of this nature becomes questionable under close scrutiny. First, introducing a new concept into English insurance law to remedy the severity of present warranty doctrine would mean that the fundamental parameters of underwriting need to change; this would inevitably disturb the sensitive equilibrium between the assureds and insurers. Secondly, it is inevitable that the law would become rather uncertain as a result of such a reform, as it would be left to the courts to determine whether an alteration has taken place, and if so, what type of remedy would be appropriate in the circumstances. Finally, the effectiveness of such a reform in protecting the reasonable expectations of the assured could be called into question, considering the fact that the "alteration of risk" doctrine does not prevent parties from incorporating terms similar to marine warranties into their contracts by agreement. Even the NMIP 1996 (2003 version) itself allows the insurers to be discharged from liability automatically

37. *Pim v. Reid* (1843) 6 Man. & G. 1. Pollock C.B. in *Baxendale v. Harvey* (1849) 4 H. & N. 445 at 449, 452, said: "If a person who insures his life goes up in a balloon, that does not vitiate his policy . . . A person who insures may light as many candles as he please in his house, though each additional candle increases the danger of setting the house on fire."

38. See, ss. 3.9–3.11 of the NMIP 1996 (2003 version). By virtue of s. 3.12, the insurer has been prevented from invoking the alteration of risk defence when such alteration has ceased to be material to him and if the alteration has occurred for the purpose of saving human life, or while salving or attempting to salve ships or goods during the voyage.

39. Similar provisions appear in other continental insurance codes: see, for example, ss. 23–25 of the German Insurance Law Act (*Versicherungsvertragsgesetz*) 2007 and Art. L.113-2-3 of the French Insurance Code (*Code d'assurance*).

in cases where the insured vessel loses its class, or where the classification society<sup>40</sup> or ownership<sup>41</sup> is changed during the currency of the policy.

### 3.2 Equating warranties with other risk definition clauses

A more radical reform would be to remove all distinctions between various types of terms (this would effectively mean that insurance warranties would be scrapped) and to concentrate on the relationship between the operation of contractual terms and the loss suffered by the assured. This approach has been adopted by section 54 of the Australian Insurance Contracts Act 1984. By virtue of section 54(1), if the policy term, which excludes or restricts cover by reason of an act or omission of the assured, could not reasonably be regarded as being capable of causing or contributing to a loss, in case of its breach the insurers are not entitled to refuse to pay a claim but instead are entitled to damages for any loss suffered by reason of the breach.<sup>42</sup> In contrast, if an act or omission of the assured could reasonably be regarded as being capable of causing or contributing to a loss covered by the policy,<sup>43</sup> then under section 54(2) the insurers might refuse to pay the claim unless: (a) the assured proves that no part of the loss was caused by the assured's act or omission, in which case the claim must be paid in full (section 54(3)); or (b) the assured proves that some part of the loss was not caused by the act or omission, in which case they recover that part (section 54(4)); or (c) the assured proves that their act or omission was necessary to protect the safety of a person or to preserve property, or it was not reasonably possible for the assured or some other person not to do the act or to avoid omission (section 54(5)).<sup>44</sup>

Undoubtedly, the solution adopted by section 54 affords an increased level of protection for the assured, as any attempt by underwriters to re-introduce under a different name clauses that have an effect similar to warranties—whether condition-precedent, risk-defining or exclusion clauses—will not be successful. It is also true to say that the Australian solution, which is based on the premise that clauses with the same object and effect should be treated in a similar manner no matter under which contractual category they fall, has strong supporters in academic circles.<sup>45</sup> Nevertheless, the following criticisms

40. See, s. 3.14 of the NMIP 1996 (2003 version).

41. See, s. 3.21 of the NMIP 1996 (2003 version).

42. Generally speaking, provisions relating to claims (see, for example, *Antico v. Heath Fielding Australia Pty Ltd* (1997) 188 C.L.R. 652) and procedural obligations arising from the assured's use of the insured subject-matter (see, for example, *Ferrcom Pty Ltd v. Commercial Union Assurance Co. of Australia Ltd* (1993) 176 C.L.R. 332) will normally be within s. 54(1).

43. Section 54(2) would be relevant in cases, for example, where the assured modifies the insured vehicle without requesting the permission required of the insurers (*Australian Associated Motor Insurers Ltd v. Ellis* (1990) 54 S.A.S.R. 61) or where the assured fails to set an alarm as required by the policy (*McNeil v. O'Kane* [2004] Q.S.C. 144).

44. Whatever the nature of the breach, insurers have the right to cancel the policy as to the future under ss. 59 and 60.

45. R. Merkin and J. Lowry, "Reconstructing Insurance Law: The Law Commissions' Consultation Paper" (2008) 71 M.L.R. 95 at 109–112.



can be made. First, it should not be overlooked that section 54 has generated a good deal of litigation over the years.<sup>46</sup> The courts, apart from dealing with issues of causation, are also expected to identify whether or not the term in question is one whose breach is capable of causing or contributing to a loss.<sup>47</sup> This might present serious difficulties, particularly in liability policies<sup>48</sup> giving rise to uncertainty. Secondly, the ethos behind section 54 seems to be a protectionist one, which seems to disregard parties' freedom to regulate their affairs by contractual devices in a manner which they deem appropriate. One could argue that such restriction is not desirable in a wholly commercial context. Finally, adopting section 54 would be a sweeping reform which would unsettle the market for a considerable period of time. One should not lose sight of the fact that the Australian non-marine market, which has been introduced to section 54, is still to a certain degree in a flux after almost two decades. This instability is not something which can be tolerated when it comes to insurance business with international dimensions. Also, it is important to note that the ALRC in its 2001 report on marine insurance disregarded the possibility that the provisions of the 1984 Act could be extended to the marine market.<sup>49</sup>

### 3.3 Converting warranties into suspensory provisions

The warranty regime can be reformed in a straightforward fashion if the consequence of breach is modified so that it merely suspends coverage. The cover then can be reinstated if the breach is corrected by the assured at a later stage. This represents the position in some states in America,<sup>50</sup> and the same approach has also been adopted by the International Hull Clauses 2003 in respect to some traditional warranties.<sup>51</sup>

Admittedly, this model, in terms of application, is not likely to create any serious difficulty. However, the question remains whether it is capable of

46. See, particularly, D. Derrington and R. S. Ashton, *The Law of Liability Insurance*, 2nd edn (Australia, 2005), pp. 641–798.

47. See, particularly, *Stapleton v. ATI Ltd* [2002] Q.D.C. 204.

48. See, particularly, *FAI General Insurance Co. Ltd v. Australian Hospital Care Pty Ltd* [2001] H.C.A. 38.

49. Australian Law Reform Commission, *Review of the Marine Insurance Act 1909* (Report 91, 2001), paras 9.117–9.121.

50. *Fireman's Fund Insurance Co. v. Cox* 742 F. Supp. 609 (M.D. Fla., 1989) (Florida law); *Lineas Aereas Colombianas Expresas v. Travelers Fire Insurance Co.* 257 F.2d 150 (5th Cir., 1958) (Louisiana law) and *Commercial Union Insurance Co. of N.Y. v. Daniels* 343 F. Supp. 674 (S.D. Tex., 1972) (Texas law).

51. For example, even though geographical limits imposed on the movement and operation of insured vessels by the Institute Warranties (1/7/1976) are retained by cl. 32 of the IHC 2003, compliance and sanctions for breach are now governed by cl. 10 and 11, which read:

#### 10 NAVIGATION PROVISIONS

Unless and to the extent otherwise agreed by the Underwriters in accordance with Clause 11

10.1 the vessel shall not breach any provisions of this insurance as to cargo, trade or locality (including, but not limited to, Clause 32)

10.2 the vessel may navigate with or without pilots, go on trial trips and assist and tow vessels or craft in distress, but shall not be towed, except as is customary (including



curbing the severity of the warranty regime and protecting reasonable expectations of the assured, considering that suspensory provisions operate in a similar fashion to exclusion clauses; that is to say, they would not take into account whether the breach has caused or contributed to the loss. This point can be illustrated by building around the facts of the celebrated case *For-sikringsaktielselskapet Vesta v. Butcher*.<sup>52</sup> Let us assume that the owner of a fish farm obtains insurance cover against marine perils for their farm. The contract includes a warranty that requires the owner to have a watch on the premise for 24 hours a day. During a period when the watch is away, as a result of a storm the insured fish farm is destroyed. If the effect of breach of a warranty is equated with the effect of breach of a suspensory provision, it is clear that in this case the assured could not recover their loss even though absence of the watch had, in all probability, no impact on the loss.<sup>53</sup>

### 3.4 Making alterations in the current warranty regime in line with general contract law

Most commentators appear to think that a majority of the criticisms made to the current warranty regime can be avoided if the insurers' right to rely on breach of warranty defence is restricted to cases where there is a causative link between the breach and loss.<sup>54</sup> The causal link requirement would come to the assistance of the assured especially when warranties which have no bearing on the risk, such as premium warranties, are incorporated into the contract.

It is also indisputable that insurance warranties have gained a distinctive contractual status following the reasoning of the House of Lords in *The Good Luck*. The remedy of automatic discharge is the consequence of insurance warranties being classified as contingent condition precedents and has been regarded as "draconian" by many critics. Considering that the subject-matter

customary towage in connection with loading or discharging) or to the first safe port or place when in need of assistance, or undertake towage or salvage services under a contract previously arranged by the Assured and/or Owners and/or Managers and/or Charterers

10.3 the Assured shall not enter into any contract with pilots or for customary towage which limits or exempts the liability of the pilots and/or tugs and/or towboats and/or their owners except where the Assured or their agents accept or are compelled to accept such contracts in accordance with established local law or practice

10.4 the vessel shall not be employed in trading operations which entail cargo loading or discharging at sea from or into another vessel (not being a harbour or inshore craft).

#### 11 BREACH OF NAVIGATION PROVISIONS

In the event of any breach of any of the provisions of Clause 10, the Underwriters shall not be liable for any loss, damage, liability or expense arising out of or resulting from an accident or occurrence during the period of breach, unless notice is given to the Underwriters immediately after receipt of advices of such breach and any amended terms of cover and any additional premium required by them are agreed.

52. [1989] A.C. 852.

53. See, also, A. Longmore, "Good Faith and Breach of Warranty: Are We Moving Forwards or Backwards?" (2004) LMCLQ 158 at 162.

54. See, B. Soyer, *Warranties in Marine Insurance*, 2nd edn (London, 2006), pp. 214–215. The ALRC also makes a similar proposal *Review of the Marine Insurance Act 1909* (Report 91, 2001), Ch. 9.

of most insurance warranties is promissory in nature, one could argue that insurance warranties should be equated with promissory terms in general contract law. This achieves fairer results, as courts would have to pay regard to the seriousness of the breach to determine the remedy available.

There are several advantages in pursuing a modest reform agenda designed to align insurance contract law with general contract law. Given that the general contract law is the educational and intellectual background of most lawyers,<sup>55</sup> this approach will ensure that the reform proposals are understood and applied without creating any difficulty in practice. Therefore, the possibility of the new regime fuelling litigation will be reduced. It is also clear that such a reform initiative would meet the reasonable expectations of the assured by curbing the severity of the warranty regime. On the negative side, introduction of the causal link requirement might create a degree of uncertainty in law; but perhaps that can be seen as the price to pay for a fairer warranty regime.

After careful deliberation, the Law Commissions seem to have opted for this moderate approach. The following section offers a critique on the main proposals of the Law Commissions.

## 4 A CRITIQUE OF THE LAW COMMISSIONS' MAIN PROPOSALS ON THE WARRANTY REGIME

### 4.1 Warranties as to the future (future warranties)

Most warranties require the assured to undertake that some particular thing shall or shall not be done, or that some condition shall be fulfilled at a later stage after the attachment of the risk.<sup>56</sup> Warranties of this nature are commonly referred to as "warranties as to the future" (or "future warranties") and are invariably incorporated into insurance contracts to ensure that the assured takes specified precautions either to prevent an alteration in the risk or to reduce the moral hazard of insurance.<sup>57</sup>

Although the doctrine of strict compliance with warranties was vigorously defended by traditional common law lawyers,<sup>58</sup> a glance at the law reports reveals the unjust results caused by its application. Also, a comparative study demonstrates unambiguously that the stand taken by English law on the

55. M. Clarke, "Insurance Warranties: The Absolute End?" [2007] LMCLQ 474 at 493.

56. See, s. 33(1) of the MIA 1906.

57. Once an individual purchases insurance, their incentive to control losses decreases. Moral hazard is the resulting tendency of an assured to under-allocate to loss prevention after purchasing insurance.

58. J. A. Park, *A System of Law of Marine Insurances* (London, 1796), p. 318: "And though the condition broken be not, perhaps, a material one, yet the justice of the law is evident from this consideration: that it is, absolutely necessary to have one rule of decision, and that it is much better to say, that warranties shall in all cases be strictly complied with, than to leave it in the breast of a judge or jury to say, that in one case it shall, and in another it shall not. The very meaning of a warranty is to preclude all inquiries into the materiality, or the substantial performance of it, and although sometimes partial inconveniences may arise from such a rule; yet upon the whole, it will certainly produce public salutary effects."

matter is rather uncompromising and tilts the balance significantly in favour of the insurers. Furthermore, it has to be stressed that the effect of breach of a future warranty creates several practical and legal problems. Many critics have argued the point that it is difficult to justify why an assured in breach of an insurance warranty loses their insurance cover automatically, while in general contract law breach of an essential term gives the innocent party merely the right to elect to terminate the contract. From a legal perspective, there is a tension between the automatic discharge principle and the right of the underwriters to waive breach of a warranty stipulated in section 33(3) of the MIA 1906. As the occurrence of the breach discharges the insurer from liability automatically, one finds it difficult to explain how it is possible for an insurer to make an election as to whether it wishes to continue providing insurance cover or not. The courts have attempted to deal with the apparent contradiction by regarding waiver in this context as estoppel.<sup>59</sup> Therefore, it is questionable, to say the least, whether a deviation from general contract law principles can be justified for insurance warranties.

With a view to addressing these problems, the Law Commissions are proposing two fundamental changes in law. First, it is proposed that the assured should be allowed to recover despite a breach of a future warranty if the breach did not actually contribute to the loss that occurred and for which they seek indemnity. Secondly, in an attempt to bring the consequences for breach of a warranty closer to normal contract principles, the Law Commissions are proposing that a breach of a warranty should give the insurer the right to terminate the contract, rather than automatically discharging it from liability, but only if the breach has sufficiently serious consequences to justify termination under the general contract law. The proposed regime will be a default regime in business insurance contracts,<sup>60</sup> so it will be open to parties

59. Mr Jules Sher Q.C., sitting as a deputy High Court judge in *HIH Casualty & General Insurance Ltd v. Axa Corporate Solutions* [2002] Lloyd's Rep. IR 325 at 330, said: "The plea is put in terms of waiver or estoppel. It is necessary to distinguish two, quite different, concepts that lie behind these words. The first is waiver by election. The second is waiver by estoppel. The traditional common law concept of waiver by election involves a choice by the waiving party between two inconsistent courses of action. Outside the insurance sphere, when there has been a repudiatory breach of a promissory warranty by one party the other has a choice whether to accept the breach as discharging the contract or to waive it and affirm the contract. If he does not accept it the contract continues in force. That is an example of a true election between two inconsistent courses. In the case of an insurance contract, on the other hand, breach of the promissory warranty discharges the cover (though not, technically, the entire contract) automatically, without any action or election on the part of the insurer. There is no choice involved at all. There is no election to be made. So much comes out of the 'Good Luck' and is not disputed before me as applicable to the insurances and reinsurances here. It follows that waiver by election can have no application in such a case and the waiver, therefore, referred to in section 34(3) of the Marine Insurance Act 1906 must encompass waiver by estoppel, the second of the two concepts above-mentioned, rather than waiver by election . . ."

See, also, *J. Kirkaldy & Sons Ltd v. Walker* [1999] Lloyd's Rep. IR 410 at 422–423, per Longmore J.; *Brownsville Holdings Ltd and another v. Adamjee Insurance Co. Ltd (The Milasan)* [2000] 2 Lloyd's Rep. 458 at 467, per Aikens J.; *Kosmar Villa Holidays plc v. Trustees of Syndicate 1243* [2008] EWCA Civ 147.

60. It is proposed that the causal connection rules should be mandatory in consumer insurance; see, para. 8.50 of the Consultation Paper 2007.



to modify the rules to alter the relevance and causal connection principles subject to statutory controls in cases where the assured contracts on the insurer's standard terms. The former two changes will be deliberated at length here, and statutory controls will be considered later.

#### 4.1.1 *Requiring connection between the breach and the loss*

Under the current proposals, the policyholder should be entitled to be paid a claim if he can prove on the balance of probability that the event or circumstances constituting the breach of warranty did not contribute to the loss.<sup>61</sup> Before going into the details of this proposal, it is essential to evaluate whether a statutory modification requiring a connection between the breach of a warranty and the loss represents a refined scheme of risk distribution which is theoretically sound. The answer seems affirmative.

When a risk is proposed to an underwriter, his or her priority is to rate it with a view to determining whether they will undertake it and, if so, how much premium will be charged for it. The premium determined, therefore, reflects the underwriter's measurement of the scope of the risk undertaken. Naturally, it is the priority of any prudent underwriter to ensure that the risk remains unaltered during the currency of the policy, because it is presumed that any alteration would mean that the underwriter has to provide cover for eventualities not covered by the premium determined at the outset. Warranties are among the main contractual devices underwriters make use of to prevent an alteration in the risk undertaken. In case of their breach, therefore, it is undisputable that an alteration in the risk takes place; it does not necessarily follow, however, that the relevant underwriter's coverage will be extended beyond the premium rate set at the outset. If breach of the warranty does not cause or contribute to the resulting loss, the insurer suffers no prejudice in terms of the premium charged, i.e. they are not expected to provide additional coverage for the same rate of premium.

This point can be illustrated with a hypothetical example. Suppose that A stands for a property which is used as a newsagent and also a dwelling for the assured's family, and B stands for a type of building similarly designed and otherwise similarly situated, except that in B large quantities of fireworks are stored in the part of the building used as the newsagent, which obviously creates an increased fire hazard. Now the individual members conforming to type A may be taken to represent a group: A1, A2, A3, . . . An.

Assume further that the premium charged for each insurance in this group is £a per £100. Assume that this premium charge is based on definite statistical evidence showing the losses in that group. If we make another fictitious assumption, that there is a loss experience of buildings of type B sufficient to show that the premium should be £b per £100, then the difference (b - a) is due to fire losses caused by the existence of fireworks in the premises. Next,

61. See, para. 8.45 of the Consultation Paper 2007. A similar formulation has been adopted by s. 11 of the New Zealand Insurance Law Reform Act 1977.



assume that property B suffered a fire loss which was started by ashes blown from a fire in an adjacent building and destroyed only the part of the building used as a dwelling, so that the existence of the fireworks did not cause or in any way contribute to this loss. Then fire losses of that type occurring in group B should be treated as equivalent to fire losses in group A, and hence this particular assured has paid an adequate premium for the type of loss sustained. What this line of reasoning comes down to is a reclassification of loss experience so as to take into account the causes of fires that were not related to the storage of the fireworks in the premises. Granted this mode of analysis, and granted the assumption that all facts can be ascertained and proved, it can be concluded that this claimant should not be precluded from recovery on the ground that they violated a warranty requiring them not to store fireworks on the premises.

Having established that the theoretical foundations of the proposed causation test are firm, the author wishes to consider its practical and legal implications. The proposal puts the burden on the assured to demonstrate the lack of connection between the loss and breach of a warranty. It is true that the proof of a negative proposition is usually more difficult than the proof of an affirmative one,<sup>62</sup> but the assured is in a much better position than the insurer to adduce evidence as to the origin of the loss. On this principle of relative convenience, it is not an onerous task to defend the manner in which the burden of proof has been allocated by the proposed rule.

One should not lose sight of the fact that the “causation formulation” is carefully chosen by the Law Commissions to ensure that breach of a warranty will operate against the assured regardless of how minor its contribution is to the loss. It would, therefore, not be necessary that the breach must be a dominant (proximate) or major cause of the loss.<sup>63</sup> That said, it is beyond doubt that the proposal is capable of curbing the harshness of the warranty regime in most cases. For example, the assured will be allowed recovery in cases where the insured premises are destroyed as a result of fire even though at the time of the loss the burglar alarm was not working in violation of a warranty requiring it to be in operation at all times. In similar fashion, breach of a warranty requiring the assured to have a 24-hour watch on a fish farm would not possibly prevent recovery under a marine policy if the loss arises as a result of a storm.

On a negative note, potential difficulties that the proposed causal connection test could create should not be overlooked. Questions of causation in law

62. Professor Clarke, criticising this aspect of the proposal in “Insurance Warranties: The Absolute End?” [2007] LMCLQ 474 at 487, writes: “The surprise is that a reform which seeks to redress the balance of black letter law in favour of policyholders should make their position so difficult.”

63. See, on the other hand, s. 54(3) of the Australian Insurance Contracts Act 1984 which states that: “Where the insured proves that no part of the loss that gave rise to the claim was caused by the act, the insurer may not refuse to pay the claim by reason only of the act.”

are not always easy to answer, and courts would undoubtedly find it challenging in several instances to determine whether breach of a warranty has caused or contributed to the resulting loss. Trying to capitalise from the uncertainty that may arise, assureds may be tempted to invest substantial resources in litigation for rent-seeking purposes. This might cause a flood of litigation with the potential to lead to an increase in insurance premiums to cover the additional litigation cost. However, there is always a risk that potential difficulties can be over emphasised. At the end of the day, questions of causation can be addressed by using "common sense"; and in insurance law the track record of commercial judges in dealing with causation issues has been very satisfactory.<sup>64</sup> Appreciating the fact that introduction of the causal link test might have an adverse effect on certainty, the author nevertheless sees it as a vital step in creating a fairer warranty regime.

One significant omission from the Consultation Paper 2007 is a discussion on the relationship between the proposed rule and section 34(2) of the MIA 1906, which provides that once a warranty is breached it is not a defence to the assured that the breach has been remedied before a loss has occurred. One can argue that the proposed rule would make section 34(2) redundant. Conversely, one can contemplate instances where a breach, although remedied, might still be instrumental on the resulting loss. Let us suppose that a vessel in breach of a locality warranty navigates for a short while in waters covered by ice and sustains a minor damage (e.g. a crack in the hull) which remains undetected. After the breach of warranty ceases, if the crack in the hull further develops and causes the total loss of the insured ship, it will be difficult to argue that the breach of warranty has not contributed to the loss. It is likely, therefore, that the proposed change would not have an impact on section 34(2), but in order to avoid any controversy and ambiguity it is essential that the Law Commissions do clarify their position on the matter in their final report.

#### 4.1.2 *Modifying section 33(3) of the Marine Insurance Act 1906*

Apart from recommending a causation test, the Law Commissions are also proposing that the remedy available for insurers in case of breach of a future warranty should be altered. Accordingly, in case of breach of a warranty the insurer will not be automatically discharged from liability from the date of breach, but instead will have the right to repudiate the contract if the breach has sufficiently serious consequences to justify termination under the general contract law.<sup>65</sup>

64. In the process of applying several sections of the MIA 1906, such as ss. 39(5) and 55(2)(a), courts have not experienced any difficulties in dealing with the issues of causation.

65. See, para. 8.89 of the Consultation Paper 2007.

The obvious advantage of modifying the automatic discharge remedy is that it enhances the prospect of recovery for the assured for losses arising after the breach of a warranty. For example, if the insured property suffers two losses during the currency of the policy, the first of which is caused by the breach of warranty and the second of which is not, the assured might be able to recover for the second loss as long as breach of warranty does not give the insurer a right to repudiate the contract. From the underwriter's perspective, the proposed regime introduces remedial flexibility which is not available under the current regime. In the example above, under the current warranty regime the options available for an underwriter are either to waive the breach of the warranty and indemnify the assured for both losses, or to rely on the breach of warranty defence to reject both claims. If the current proposal finds its way into the statute book, an underwriter in that situation will have the option of rejecting the first claim connected to the breach and paying for the second one. He or she would also have the option of repudiating the contract for the breach of warranty as long as they could demonstrate that the breach has had serious consequences.

This is not to say that the proposal is free from controversy. The main difficulty will be ascertaining how serious the consequences of breach of a warranty must be before an insurer is entitled to terminate. Drawing an analogy with frustration, Diplock L.J. suggested that the breach must be such as to deprive the innocent party substantially of the benefit that they intended to obtain from performance.<sup>66</sup> Given the generality of the test, it is inevitable that the outcome will depend to a large extent upon the facts of the individual case. To this end, in deciding whether or not the breach is sufficiently serious, courts are likely to have regard to a range of factors, such as the amount of previous breaches committed by the assured, the likelihood of further breaches, the losses caused by the breach and the willingness of the assured to make good the consequences of breach. One positive consequence of the proposed change is that underwriters may possibly be prevented from terminating on grounds that are technical or unmeritorious.<sup>67</sup> However, the fact remains that the parties cannot predict with any kind of accuracy the outcome of any case. The desire to create a fairer regime can carry with it a real price in the shape of uncertainty.

For the sake of completeness, one also needs to point out potential legal implications of the decision to modify the automatic discharge remedy available to underwriters in case of breach of a warranty. First, in terms of the availability of waiver by election for breach of an insurance warranty, the modification marks a return to the pre-*Good Luck* position that "the insurer has a right to elect to waive breach of a warranty after the occurrence of such

66. *Hong Kong Fir Shipping Co. Ltd v. Kawasaki Kisen Kaisha Ltd* [1962] 2 Q.B. 26 at 66.

67. See, for example, *Reardon-Smith Line Ltd v. Hansen Tangen* [1976] 1 W.L.R. 989 at 998.



breach by making an unequivocal representation to that effect with the knowledge of such breach".<sup>68</sup> Secondly, it is not essential to give notice to the assured before electing to terminate the contract for breach of a warranty. The Law Commissions deliberated the matter at length, and although there was some support for the notice requirement in order to avoid a situation where the assured is left unexpectedly without cover,<sup>69</sup> in the end the Law Commissions decided against it on the basis that the assured's predicament in that case arises as a result of their own fault.<sup>70</sup> However, this does not mean that parties are prevented from incorporating a cancellation clause in their contract giving the insurer a right to cancel the policy following breach of a warranty, even in cases where the breach is not serious. No restriction on the parties' freedom of contract in that respect has been proposed. Thirdly, it is worth noting that the proposed change, in effect, amounts to a significant transformation in the legal nature of insurance warranties. The current warranty regime creates a condition on the insurer's promise.<sup>71</sup> That contingency is the reason why there is no authority in favour of insurers being able to sue assureds for breach of an insurance warranty. However, the proposed regime creates a duty on the assured to ensure that the "undertaking" forming the subject-matter of the warranty is fulfilled (in other words a promissory condition is created). This would enable the insurer to claim damages for breach of a warranty—for example, to reimburse expenses incurred in investigating a claim that were wasted because the insurer was in any event not liable. In similar fashion, in cases where the breach is not repudiatory the insurers would still be allowed an action for damages as far as they can prove loss.<sup>72</sup>

Concerning the return of premium once a warranty is breached, the Law Commissions have made a final attempt in their quest to bring this area of law closer to general contract law. In general contract law, in cases where one party accepts the other's wrongful repudiation, both parties' primary obligations are brought to an end.<sup>73</sup> Applying this principle in the context of insurance law, one would expect that the assured remains liable for the payment of any

68. Lord Goff summarised the elements of waiver by election, in a general sense, in *Motor Oil Hellas (Corinth) Refineries S.A. v. Shipping Corporation of India (The Kanchenjunga)* [1990] 1 Lloyd's Rep. 391 at 398, in the following manner: "In particular, where with the knowledge of the relevant facts a party has acted in a manner which is consistent only with his having chosen one of the two alternative and inconsistent courses of action open to him—for example, to determine a contract or affirm it—he is held to have made his decision accordingly . . . It can be communicated to the other party by words or by conduct, though, perhaps because a party who elects not to exercise a right which has become available to him is abandoning that right, he will only be held to have done so if he has so communicated his election to the other party in clear and unequivocal terms . . ."

69. Paragraph 8.86 of the Consultation Paper 2007 makes reference to s. 59 of the Australian Insurance Contracts Act 1984 and s. 3.10 of the Norwegian Marine Insurance Plan 1996 (2003 version) which require the insurer to give notice before terminating the contract.

70. See, para. 8.87 of the Consultation Paper 2007.

71. The requirement of a condition is an "if" requirement; if you want performance of the insurer's duty to pay, then you must make sure that the condition is fulfilled.

72. For example, it might be possible to claim the amount of additional premium that would have been charged if the warranty had not been given.

73. *Photo Production Ltd v. Securicor Transport Ltd* [1980] A.C. 827.



premium payments that fall due before the repudiation is accepted, but not for payments due after that day. However, insurance law has developed in a different direction. In cases where the insurer is discharged from liability on the policy after inception of the risk, the insurer is still entitled to the full premium<sup>74</sup> even though the contract provides for instalment payment of premium and the discharge occurs before the date when one or more of the instalments fall due<sup>75</sup>—unless, of course, the contract is concluded on a severable basis.<sup>76</sup> The Law Commissions are proposing to change the insurance rule to the effect that if the insurer accepts the insured's breach of warranty, so as to terminate future liability, the assured should cease to be liable for future premiums. This proposal, which is clearly designed to prevent the insurer from making a windfall profit from the assured's breach of warranty, is essential to put the new warranty regime in line with the general contract law principles. It is also not controversial as it takes into account that the insurer's liability to provide cover will come to an end at the moment the insurer elects to terminate the contract.<sup>77</sup>

#### 4.2 Warranties of present or past facts (warranties of fact)

With a warranty relating to present or past facts, the assured affirms or negatives the existence of a particular state of facts. Warranties of this nature are used essentially for two purposes: (i) to provide an additional remedy if information given by the proposer was incorrect; and (ii) to assist the underwriter in defining the scope of the risk. One fundamental flaw in the current warranty regime is that the same remedy can be deployed in case of breach regardless of which purpose a warranty has been created for in the first instance.<sup>78</sup>

74. See, *Annen v. Woodman* (1810) 3 Taunt. 299; *Moses v. Pratt* (1815) 4 Camp. 297 and *Stone v. Marine Insurance Co. Ocean Ltd of Gotenburg* (1876) 1 Ex.D. 81. S. 84(3)(a) of the MIA 1906 stipulates: "Where the policy is void, or is avoided by the insurer as from the commencement of the risk, the premium is returnable, provided that there has been no fraud or illegality on the part of the assured; but if the risk is not apportionable, and has once attached, the premium is not returnable; . . ."

75. *Chapman (JA) & Co. Ltd v. Kadirga Denizcilik ve Ticaret* [1998] Lloyd's Rep. IR 377.

76. Section 84(2) of the MIA 1906. In insurance practice, a severable contractual structure is rare. It is crystal clear that the mere fact of instalment payment does not render the policy severable.

77. The Law Commissions are also proposing that the premium paid in advance should be refunded on a pro rata basis if the insurer elects to terminate the policy following the assured's breach of warranty. It should be noted that similar provisions appear in standard contracts. For example, cl. 5 of the Institute Time Clauses Hulls (1/11/95) provides that the assured shall receive a pro rata daily return of the premium if the events specified there trigger an automatic prospective discharge of the insurer's liability.

78. In case of breach of a warranty of fact(s), the insurer is prevented from coming on risk. Compliance with a warranty of this type was regarded as "condition precedent to the attaching of the risk" by Lord Blackburn in *Thomson v. Weems* (1884) 9 App. Cas. 671 at 684.

In consumer insurance, warranties of present or past facts are normally used in order to equip underwriters with a potential defence of an action on the policy much wider than that arising by virtue of the pre-contractual duty of utmost good faith.<sup>79</sup> For example, in *Mackay v. London General Insurance Co.*,<sup>80</sup> the proposer for motor insurance stated on the proposal form that he had never been convicted of a motoring offence, even though he had been fined ten shillings many months previously for driving without efficient brakes because a nut had become loose on his motorcycle. Even though this was held not to be a material fact for the purposes of the disclosure duty, the insurers were entitled to be discharged from liability for breach of warranty.<sup>81</sup> Perhaps an attempt can be made to justify the decision on the ground that the nature of the relationship between the parties has changed as a result of the decision of the parties to create a contractual obligation which requires strict compliance. However, one should not lose sight of the fact that consumers do not normally possess an adequate amount of knowledge to appreciate the legal effect of clauses of this nature being incorporated into their contracts. It is precisely for this reason that section 24 of the Australian Insurance Contracts Act 1984 stipulates that "a statement made in or in connection with a contract of insurance, being a statement made by or attributable to the insured, with respect to the existence of a statement of affairs does not have effect as a warranty but has effect as though it were a statement made to the insurer by the assured during the negotiations for the contract but before it was entered into". The Law Commissions are proposing a similar solution. Accordingly, in consumer insurance contracts warranties of fact should be treated as representations. This means that the insurer would need to show that the statement induced it to contract on those terms and the insurer's remedies would be dependent on the gravity of the breach, whether the misrepresentation was deliberate or reckless, negligent or reasonable.<sup>82</sup>

Taking into account the growing significance of the social function of consumer insurance, one could sympathise with the stand taken by the Law Commissions on the matter. However, this does not automatically mean that a similar solution will be appropriate in the context of business insurance contracts. Business assureds are usually regarded as possessing an advanced level of sophistication to appreciate the limits of their contractual undertakings.<sup>83</sup> More fundamentally, in deliberating a possible reform in this field,

79. The most common form of creating warranties of this nature is to incorporate the "basis of the contract" clauses into the proposal forms. The effect of such a clause is to turn representations made in the proposal form into warranties. The use of "basis of the contract" clauses in consumer insurance is restricted by the Statements of Practice, and the Financial Ombudsman Service would not regard them in line with good practice.

80. (1935) 51 Ll.L. Rep. 201.

81. See, also, *Thomson v. Weems* (1884) 9 App. Cas. 671; *Dawsons Ltd v. Bonnin* [1922] 2 A.C. 413.

82. See, para. 4.228 of the Consultation Paper 2007.

83. It is appreciated that the position might be slightly different for small-sized businesses.

one should approach the issue without losing sight of the fact that in business insurance contracts warranties of fact are primarily used as an alternative method of defining the risk. For example, a warranty in a marine policy stipulating that the insured vessel is classed with a particular classification society at the inception functions as a contractual device to assist underwriters in determining the scope of the risk undertaken. The effect of breach of a warranty of this nature is that the underwriters' initial risk assessment is in tatters. Of course, it may well be possible that the consequence of breach of a warranty of fact is that the risk undertaken by the relevant underwriter becomes substantially different than the risk they once believed that they were undertaking, and a loss occurs as a result of the increase in the scope of the risk undertaken. In that case, it is not objectionable if liability for breach of a warranty of fact remains strict. The current regime, however, allows underwriters to escape liability in cases where breach of a warranty of fact has no serious impact on the risk assessment exercise of the underwriters, or in cases where breach could possibly affect the risk assessment of the underwriter substantially but not to the extent to cause a loss under the policy. The judgment of the Privy Council in *Yorkshire Insurance Co. Ltd v. Campbell*<sup>84</sup> provides a good illustration of this point. There, the insurance was taken on a horse, against marine perils and risks of mortality, during a sea voyage. The pedigree of the insured horse was misstated in the proposal form that was incorporated into the contract. The Privy Council held that, on its construction, the description of the insured horse was a warranty, and, accordingly, the inaccuracy in the insured horse's pedigree provided underwriters with a defence to the owner's claim when the horse died on the voyage. It is indisputable that any inaccuracy in the description of the subject-matter of insurance could, *prima facie*, affect the risk assessment of the underwriter, but there was no evidence in the present case that the horse's actual pedigree adversely affected it in this regard or had made any difference in the actual circumstances of the loss.

It is pleasing to see that the Law Commissions' current proposals are designed not only to deal with the harshness of the current regime but also to offer a solution that is in line with the general insurance theory on risk assessment. Accordingly, in business insurance the parties will be allowed to make use of warranties of fact, and the liability for breach of a warranty of this nature will remain strict. However, unless the contract provides otherwise, the insurer should not be able to rely on the breach of warranty of fact: (i) if it was not material to the contract; or (ii) as a defence to a claim for a loss that was in no way connected to the breach of warranty.<sup>85</sup>

84. [1917] A.C. 218.

85. See, para. 5.132 of the Consultation Paper 2007. A similar recommendation was made in the previous report of the English Law Commission, *Insurance Law—Non-Disclosure and Breach of Warranty*, Cmnd. 8064 (1980), para. 10.36.



The effect of the proposed change is that underwriters will not be able to rely on breach of a warranty of fact unless the fact was material and had some causal connection to the claim that had arisen.<sup>86</sup> For example, if it is warranted that during the construction of the insured property piled foundations had been used, and later the building collapses as a result of a structural defect, the insurer would be able to rely on breach of the warranty to deny liability for the loss if it transpires that spread foundations not suitable for that type of building had, in fact, been used.

On a negative note, it is inevitable that the introduction of a "causal test" will inject a degree of uncertainty into law.<sup>87</sup> More significantly, it is not clear how "materiality" will be assessed in this context. Taking into account the fact that the function of a warranty of fact is to define the risk, it is conceptually appropriate to require the existence of a link between the breach and risk assessment; for example, the warranty should be material to the risk, in the sense that it would influence a prudent insurer in deciding whether to accept the risk, and if so, at what premium. In any event, it is possible that the materiality of a statement incorporated as a warranty can be presumed so the assured might be put under a burden to show otherwise. Surprisingly, any debate on this point is absent from the Consultation Paper 2007. Perhaps, the significance of the "materiality" debate is diminished as a result of the introduction of the causal link test but, nevertheless, a clarification on this point would be welcomed.

Another matter which requires further clarification is: who would carry the burden of proof to demonstrate that the warranty was material or had connection to the claim that had arisen? As far as future warranties are concerned, the burden is on the shoulders of the assured to demonstrate the lack of causal link between the breach and the loss. On the other hand, in cases where the underwriters allege non-disclosure at the pre-contractual stage, the burden is on their shoulders to prove that the fact alleged not to be disclosed was material. Taking into account the fact that there are fundamental differences between future warranties and warranties of fact, it is not fanciful to suggest that it should be the underwriter who should prove that the warranty was not material or that breach of warranty had a connection with the loss. In any event, guidance from the Law Commissions on this point is essential.

### 4.3 Statutory Controls

#### 4.3.1 *Transparency*

Section 35(2) of the MIA 1906 requires an express warranty to be included in or written upon the policy, or contained in some document incorporated by

86. Again this is only the default position, and it is open to the parties to a business policy to modify the rules so that the relevance and causal connection principles can be dispensed with.

87. The issue has been deliberated earlier when considering the proposed law reform on future warranties.

reference to the policy. A warranty may, therefore, be written in any part of the policy, either at the top or bottom,<sup>88</sup> or transversely on the margin,<sup>89</sup> or on the back. In contemporary standard policy forms, there is a section under which terms, including express warranties, of the contract are normally set out.

Section 35(2) is satisfied by a reference in the policy to a written proposal, even though the proposer was not supplied with a copy. In consumer insurance, on the other hand, the insurers are not allowed to rely on warranties or similar provisions unless they have taken steps to bring such terms to the attention of the buyers.<sup>90</sup> The Law Commissions are proposing to bring business insurance in line with consumer insurance with the object of enhancing transparency. Accordingly, the assured should be supplied with a written statement of the warranty either at or before the contract was made, or as soon as possible thereafter.<sup>91</sup> There is no doubt that the proposal would bring the law into line with good practice, but it would not amount to a significant change in practice, as insurers will always put significant terms in writing.

#### 4.3.2 *The “reasonable expectations” approach*

Restricting the law reform to insurance warranties only has been perceived as a major weakness of the Law Commissions’ recommendations.<sup>92</sup> It has been argued that the impact of the law reform could be diminished if insurers are allowed to replicate the effects of a warranty by making use of similar terms, such as exclusion clauses or clauses describing the risk.<sup>93</sup> There is certainly force in this argument, and it should be noted that New Zealand and Australian legislation<sup>94</sup> that has been designed with the object of curbing the harshness of the warranty regime applies not only to terms written as warranties but also to other terms that have a similar effect. However, as discussed earlier, this solution would impede the freedom of parties and could also introduce its own interpretation problems. Accordingly, the Law Commissions have come to the conclusion that the “reasonable expectations” approach would be more satisfactory than applying the law reform to a wide range of terms. It is proposed that in business insurance an insurer should not be permitted to rely on warranties, exceptions or definitions of risk in standard terms of business

88. *Blackhurst v. Cockell* (1789) 3 T.R. 360.

89. *Bean v. Stupart* (1778) 1 Dougl. 11.

90. See, Association of British Insurers, *General Insurance Business—Code of Practice for all Intermediaries, General Sales*, Principle B(iii).

91. See, para. 8.10 of the Consultation Paper 2007. For these purposes, writing would include printed and electronic forms.

92. R. Merkin and J. Lowry, “Reconstructing Insurance Law: The Law Commissions’ Consultation Paper” (2008) 71 M.L.R. 95 at 110.

93. J. Birds and N. J. Hird, *Birds’ Modern Insurance Law*, 6th edn (London, 2004), p. 166.

94. See, particularly, s. 54 of the Australian insurance Contracts Act 1984 and s. 11 of the New Zealand Insurance Law Reform Act 1977.

if the term renders the cover substantially different from that which the assured reasonably expected in the circumstances.<sup>95</sup>

The controls proposed will be relevant in two instances:

- (i) if the contract is on the insurer's written standard terms of business; and
- (ii) if the term (warranty, exception or clause defining the risk) defeats the "reasonable expectations" of the assured.

The concept of "written standard terms of business" seems to have been borrowed from the Unfair Contract Terms Act (UCTA) 1977. Although the concept has not been defined in the UCTA 1977, a vast amount of case law exists on the subject which would possibly be relevant when considering the extent of the proposed statutory control mechanisms. One relevant consideration is whether standard terms used on a particular occasion could be regarded as the insurer's written standard terms if they are drawn by a third party, such as a trade or market association. The mainstream judicial view essentially holds that terms drawn up by such trade associations are capable of being regarded as one of the parties' standard written terms as long as it can be shown, either by practice or by express statement, that the relevant contracting party has adopted the relevant form as its standard terms of business.<sup>96</sup> In any event, the terms might as a whole cease to be the party's written standard terms if they are amended to a great extent following negotiations. It is certainly a question of degree whether the variation in terms is such that the parties are not contracting on the standard terms.<sup>97</sup>

It is maintained that under the proposed "reasonable expectations" test, the fairness and reasonableness of a term shall be considered simply from a procedural standpoint. The relevant consideration is whether the assured appreciated the existence of the term before entering into the contract. A significant feature of this analysis will be whether the insurer has done enough to bring the term to the attention of the assured in the contract. At the same time, factors such as how much the term is known and understood throughout the relevant market will obviously be relevant. On the other hand, under the proposals, courts are prevented from evaluating the fairness and reasonableness of a term, taking into account the strength of the bargaining position of the parties relative to each other, or considering the effects of the terms for the assured. Put another way, in ascertaining the fairness of a term contracting out of the default regime, it is not open to courts to declare such a term invalid on

95. See, para. 8.79 of the Consultation Paper 2007. No such statutory controls have been proposed for consumer insurance contracts, on the premise that the Unfair Terms in Consumer Contracts Regulations 1999, which implement the EU Directive on Unfair Terms in Consumer Contracts (Council Directive 93/13/EEC), require terms other than the main definition of the subject-matter to be fair. Accordingly, if the effect of a warranty is to define risk unexpectedly narrowly, it can be challenged under the Regulations.

96. *British Fermentation v. Compare Reavell* [1989] 2 All E.R. (Comm) 389.

97. *St Albans City and District Council v. International Computers Ltd* [1995] F.S.D. 606



the basis that the assured, who was aware of it, nevertheless lacked the power to resist it.

The statutory controls would apply also in cases when the parties decide to alter the proposed default rules on warranties by agreement if the contract is on the insurer's standard terms and the term makes the cover substantially different from that which the assured reasonably expected.<sup>98</sup> In other instances, it is open to parties to incorporate a term into the contract purporting to give greater rights than the default regime. For example, a clause stipulating that the insurer would be discharged from liability automatically, regardless of existence of a causal link between breach of a warranty and the loss, would be deemed valid if the contract is not on insurer's standard terms, or even if it is on insurer's standard terms such a term is well known and understood throughout the industry.

The proposed statutory controls are open to criticism from various perspectives. The utility of the proposed controls, for example, can be questioned considering that the objective behind them is not so-called substantive fairness (to control the fairness of the terms), but only so-called procedural fairness (the manner in which the terms were introduced into the contract). It is very likely that a warranty or a term contracting out of the default regime will be upheld if the insurer expresses its effect plainly in the contract. In any event, when cover is obtained for commercial risks from the market through a broker—even assuming that the contract is on industry-standard terms which opt out of the new default regime—from the assured's perspective it will be very difficult to argue that the terms were not well known and understood throughout the industry.

A more fundamental question relates to the appropriateness of the proposed test and its desirability in commercial insurance. The doctrine of "reasonable expectations of the assured" has expanded rapidly, particularly in the United States, in the course of the last four decades.<sup>99</sup> Generally speaking, the doctrine gives courts the opportunity to take a more interventionist and reconstructive role in relation to insurance contracts, their terms and conditions and the assured's reasonable expectations. The impact of the doctrine has also been felt at the legislative level, particularly when regulating insurance contracts which are made compulsory due to their social function. For example, the legal regimes that apply to workers' compensation and third-party motor vehicle insurance prescribe the standard terms and conditions that all policies in the relevant market must contain so that reasonable expectations of the assured are met.<sup>100</sup> Identifying reasonable expectations of an assured who is required to obtain a compulsory insurance product is much easier than

98. See, para. 8.53 of the Consultation Paper 2007.

99. Its formal recognition as a principle arose initially out of a two-part *Harvard Law Review* article published in 1970 by Professor Keeton (R. Keeton, "Insurance Law Rights at Variance with Policy Provisions" (1970) 83 *Harvard Law Review* 961 and R. Keeton, "Insurance Law Rights at Variance with Policy Provisions: Part Two" (1970) 83 *Harvard Law Review* 1281).

100. J. A. Tarr, "The Insured's Reasonable Expectations" (2001) 12 *Insurance Law Journal* 1, p. 11.

identifying expectations of a commercial entity that chooses to subscribe to a policy of its own will, taking into account various commercial considerations such as market conditions, the nature of the cover on offer, premium levels, etc. There is force, therefore, in the argument that the “reasonable expectations of the assured doctrine”, being inherently vague, is not appropriate in a commercial setting. One should also not lose sight of the fact that the “reasonable expectations” test is capable of creating uncertainty in practice, as the meaning of policy terms would remain unclear until tested in the courts.<sup>101</sup>

If the current proposals find their way into the statute book, it is inevitable that this would encourage underwriters to rewrite their contractual documents so that the statutory controls do not operate against them. Although this might be, at first, seen as a positive development, it should also be borne in mind that there is a strong possibility that the sector would pass the transaction costs on to the market, causing an increase in the premium levels. It is, therefore, essential that the Law Commissions further consider the potential impact of the proposed statutory controls on the efficiency of the insurance market.

It is apparent that the controls proposed will not apply in professional markets such as Lloyd’s, where a broker usually puts forward terms on behalf of the assured, and where it would be up to the broker to negotiate the terms that best reflect their client’s interests.<sup>102</sup> On the other hand, they will give improved rights to small- and medium-sized businesses that are forced to contract on the insurer’s standard terms of business, normally without the assistance of a broker. In those circumstances, the assured might have a better understanding of the legal regime they are signing up for, as the insurers will be obliged to make the effect of such terms more explicit in their standard contracts. However, the critical question is whether the “reasonable expectations” approach is the most effective and uncomplicated way of offering the protection required for small- and medium-sized businesses. An alternative would be to treat small businesses as if they were consumers. Admittedly, this solution is likely to create difficulties, as it may be hard to find an appropriate statutory definition, which may result in convoluted demarcation problems. It is submitted, however, that difficulties of this nature would be more bearable compared with the uncertainty which the “reasonable assured” approach is capable of creating.

## 5 CONCLUSION

Sir Andrew Longmore, in his fascinating article<sup>103</sup> analysing the need to reform the current warranty regime and the manner in which this can be done,

101. R. Merkin and J. Lowry, “Reconstructing Insurance Law: The Law Commissions’ Consultation Paper” (2008) 71 M.L.R. 95 at 111.

102. See, para. 5.133 of the Consultation Paper 2007.

103. “Good Faith and Breach of Warranty: Are We Moving Forwards or Backwards?” (2004) LMCLQ 158.

posed the question: "Are we moving forwards or backwards?". Having evaluated the recent proposals of the Law Commissions and considered their legal and practical implications, there is every reason to believe that we are now finally moving forwards. The strict nature of the current warranty regime has attracted criticism from various circles and has not done much favour to the London market in terms of enhancing its reputation, even though it has often been alleged that insurers in practice have a tendency not to rely on breach of warranty defence where the breach has not affected the claim.<sup>104</sup> Clauses equivalent to warranties are not so common in other jurisdictions, and there is clear statistical evidence to suggest that other markets have grown at the expense of the English market in recent years, possibly due to the uncompromising stand taken by English law on various legal concepts such as warranties. Therefore, an attempt to curb the severe edges of the warranty regime is welcomed, even though one has to concede that the proposed "causation" test is likely to fuel a degree of uncertainty. Perhaps, at this stage, we should remember the words of Samuel Johnson, who once suggested: "Change is not made without inconvenience, even from worse to better."

As a final point, it should be noted that the Law Commissions firmly believe that the proposals made for warranties should apply to all types of business insurance contracts, including marine, aviation and transport insurance, in the hope that awkward boundary issues can be avoided.<sup>105</sup> However, the Law Commissions also appreciate the difficulties small businesses face in understanding the legal implications of the policies they purchase. The vulnerability of small-sized businesses is the main reason why the Law Commissions are proposing statutory controls to limit the use of warranties and similar provisions. However, the effectiveness and appropriateness of the statutory controls proposed create serious doubt, and one feels that the Law Commissions will encounter stubborn resistance from the insurance sector if they insist on building their reform on vague concepts such as "reasonable expectations of the assured". Perhaps a way forward would be to treat small businesses in a similar manner to consumers.

104. R. H. Brown, *Marine Insurance: Hull Practice*, Vol. 3, 2nd edn (London, 1993), p. 427.

105. The implied warranties, which appear in the MIA 1906 (particularly seaworthiness warranty and warranty of legality), would be subjected to the same "causation test". By the same token, it would possibly be necessary to apply the causal connection test to implied voyage conditions, which are contained in ss. 43–46 of the MIA 1906, assuming that it is decided to retain them.