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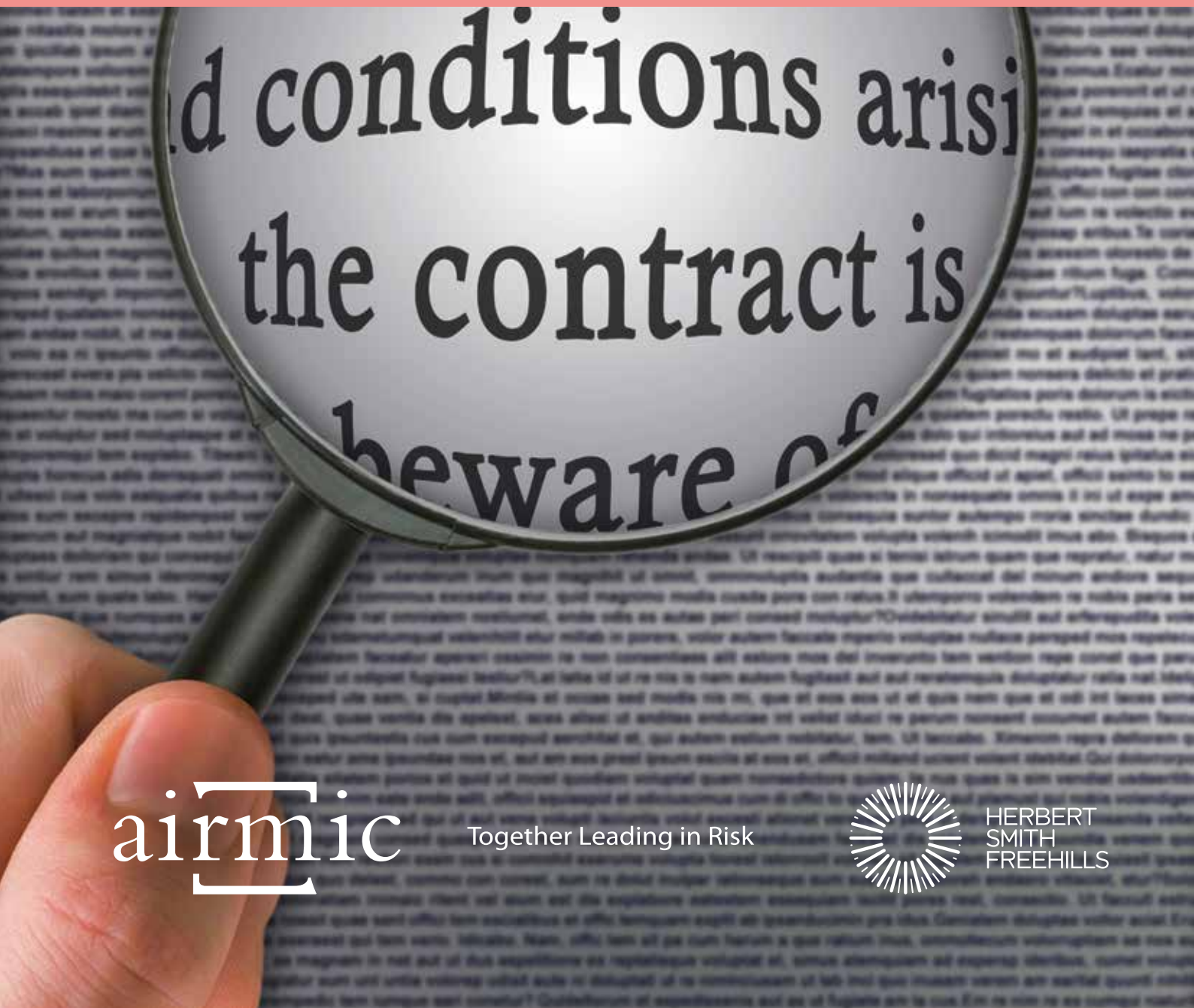
Basis Clauses

A practical guide to basis clauses in insurance contracts

Guide 2013



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Together Leading in Risk

HERBERT SMITH FREEHILLS

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1. Executive Summary

"The Law Commission recommends the abolition of basis clauses in business insurance, which position Airmic unequivocally supports."

Basis clauses in insurance contracts may enable insurers to disclaim liability under a policy where there is any inaccuracy in a proposal form or other underwriting information, no matter how trivial. As the inaccuracy will usually arise prior to the inception of the policy, in practical terms, the result may be that cover never attaches so that insurers are never on risk. Such clauses give insurers significant additional protection over and above the duty of disclosure owed by insureds. Although the effect of basis clauses can be very harsh, they are often not well understood by policyholders.

The Law Commission recommends the abolition of basis clauses in business insurance, which position Airmic unequivocally supports. However, given that a change in the law is still (as at April 2013) probably some years away, this guide assists members to identify and understand the effects of basis clauses, and explains why members should act now to remove them from their policies.

This guide builds on work undertaken by Airmic in 2011 and 2012 preparing guidance to assist members in complying with the duty of disclosure imposed on proposers in the context of insurance contracts. Together with the results of that work contained in the Airmic guide to Disclosure of Material Facts and Information in Business Insurance, this guide will assist members in complying with their disclosure obligations and mitigating the harshness of the law.

This guide has been produced with the assistance of Herbert Smith Freehills LLP as a preferred service provider to Airmic. The content of the guide relates to the position under English law and does not constitute legal advice. Members are advised to consult their lawyers should they require advice on any matter the subject of this guide.

2. Introduction to basis clauses

A basis clause is a declaration contained in either a proposal form (if submitted) or insurance policy that certain representations made by the insured (including answers given in a proposal form and any other information supplied) are true and accurate. This declaration is, by operation of the basis clause, incorporated into the policy as a warranty given by the insured.

A warranty is a term in an insurance contract which must be strictly complied with by the insured, breach of which will discharge the insurer from liability under the policy. The insurer does not need to take any positive action in order to rely on the breach of warranty.

By converting a pre-contractual statement into a policy warranty, a basis clause adds to an insurer's usual remedies in the event of a misrepresentation or non-disclosure by the insured in the course of placement of the policy. Where, by virtue of a basis clause, statements made in a proposal form or elsewhere in the information provided by the insured are warranted to be true, any inaccuracy or error will place the insured in breach of the warranty, and insurers will be discharged from any liability under the policy from the date of the breach. In practice, the breach may occur concurrently with the inception of the policy, so that cover never in fact attaches.

The insurer is not required to demonstrate that the information which has been warranted was material (in the sense that it would influence the judgment of a prudent underwriter in deciding whether to take the risk or fix the premium or other terms of the insurance) or in fact induced the underwriter to write the business on the terms he did. The warranty will be breached if the information is untrue, no matter how unimportant it may be. Further, a breach of warranty cannot be remedied by the insured.

The effect of a basis clause can therefore be to leave a business in a position where it has no cover, but it is not aware of the position unless and until it makes a claim under the policy, by which time it will be too late to arrange alternative insurance.

3. Identifying basis clauses – proposal forms and policy terms

“There are no specific words that must be used for a basis clause, and the language varies between proposal forms and policies, although the effect is largely the same.”

A basis clause may be included in a proposal form (if one is completed) and/or as a term(s) of the policy wording. If included in the proposal form, the basis clause often forms part of the preamble or the declaration wording to be signed by the insured.

There are no specific words that must be used for a basis clause, and the language varies between proposal forms and policies, although the effect is largely the same. The essential element to the wording is the statement that the representations form the “basis of the contract” between the insurer and insured. Set out below are some examples.

Examples of basis clauses in proposal forms

- “If a contract of insurance is agreed between us, this proposal form, and all other information given to us by you or anyone on your behalf, whether it is written, verbal or otherwise, will form the basis of the contract.”
- “I/We agree that this proposal form and all other written information which is provided are incorporated into and form the basis of any contract of insurance.”
- “I declare that the information submitted in this form and accompanying enclosures is true to the best of my knowledge and belief. I agree that this proposal will form the basis of the contract between the Insured and [the insurer].”
- “I/We agree that this proposal and declaration and any particulars given separately shall be the basis of the contract between the Insurer and myself/ourselves.”

Examples of basis clauses in policy wordings

- “The INSURED having made to INSURERS a PROPOSAL containing particulars and statements which shall form the basis of this contract and are incorporated herein and in consideration of payment of the PREMIUM.”
- “You have made to us a proposal which is the basis of and forms part of this contract.”
- “All information supplied by the insured in connection with the application for insurance including any proposal form, application form or otherwise and supplied by or on behalf of the insured will be incorporated into and form the basis of the policy.”
- “The proposal or application and declaration you have completed, and any other information supplied, form the basis of this contract.”
- “The basis of this contract is the information which You have sent to Us and/or the application form including the declaration which You have signed and which has been sent to Us and/or the Statement of Facts which You have examined and accepted.”

The development of basis clauses

The practice in the insurance market of requiring proposers to warrant the accuracy of statements in proposal forms seems to have begun in the 19th century, in relation to life insurance policies. Over time, the practice came to be adopted in a wider range of classes of business. The leading authority on basis clauses, Dawsons v Bonnin, relates to insurance of a motor vehicle, and was heard by the House of Lords in 1922.

In that case, a removals business insured a motor vehicle against fire and third-party liability. A proposal form was completed by the insurers' agent and signed by an employee of the insured. The form required the proposer to state where the vehicle was to be garaged and, in error, the response referred to the insured's business address rather than the address of the garage. A fire at the garage destroyed the vehicle, and the business sought to recover under the policy.

The House of Lords found that the error on the proposal form was not material to insurers and that they would not have been able to avoid the policy for material non-disclosure. However, the policy contained a statement to the effect that the proposal form was the "basis of the contract" and should be treated as incorporated into the policy. The Court held that the clause meant that the insured had warranted the truth of the answers in the proposal form: "when answers…are declared to be the basis of the contract, this can only mean that their truth is made a condition exact fulfilment of which is rendered by stipulation foundational to its enforceability."

Accordingly, the Court found (with some reluctance) that the insurers were not liable under the policy as a result of the insured's breach of warranty.

4. Consumer insurance and the view of the Law Commission

As members will be aware, the Law Commission (together with the Scottish Law Commission) has, since January 2006, been engaged in a wide-ranging review of insurance contract law, both in relation to consumer and business insurance contracts.

In relation to consumer insurance, the Law Commission criticised the use of basis clauses and recommended they be abolished. In response to their recommendation the Consumer Insurance (Disclosure and Representations) Act 2012 (which came into force on 6 April 2013) was enacted. It abolishes basis clauses in consumer insurance contracts, rendering them void.

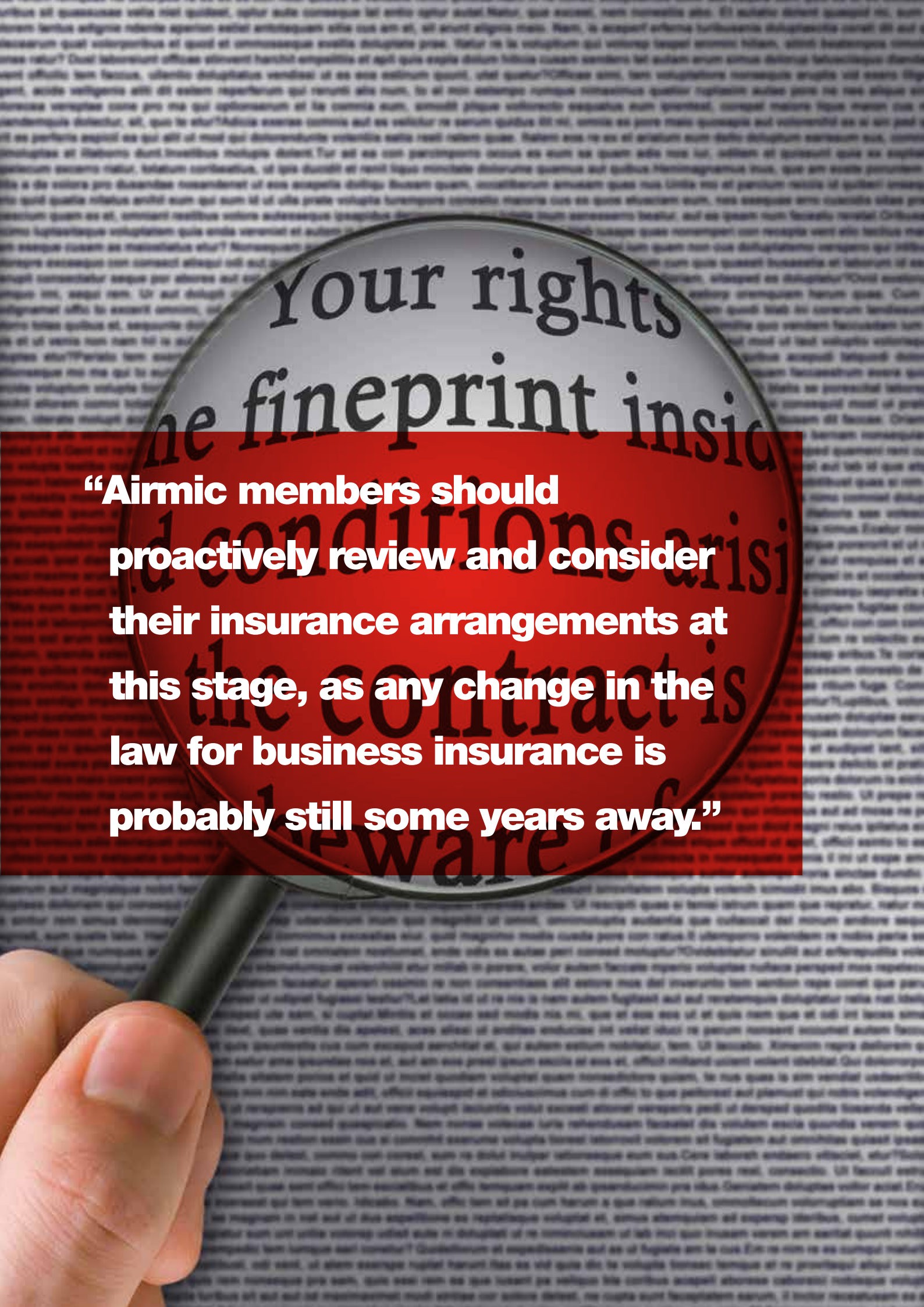
The Law Commission has been equally critical of the use of basis clauses in a business context:

"A statement may be converted into a warranty using obscure words that most policyholders do not understand. If, for example, a policyholder signs a statement on the proposal form that the answers given are "the basis of the contract", this can have draconian consequences.

These provisions bring the law in the UK into disrepute in the international market place. The consequences lack "logical reason" and cannot be explained in terms of either legal fairness or economic efficiency. "

Accordingly, the Law Commission has recommended the abolition of basis clauses in business insurance contacts. This would require that any particular warranties to which the insured is subject be set out in the policy wording. The Law Commission has not yet published its final report (which is expected in December 2013), but it appears that there is broad support for the proposed reforms. Airmic unequivocally supports the Law Commission's recommendations.

Plainly, however, Airmic members should proactively review and consider their insurance arrangements at this stage, as any change in the law for business insurance is probably still some years away.



“Airmic members should proactively review and consider their insurance arrangements at this stage, as any change in the law for business insurance is probably still some years away.”

5. Implications and options available for Airmic members

Members should review their insurances now and discuss the options with their insurance broker in the first instance. It may be the case that the broker has already negotiated the removal of basis clauses from some policies.

Insurers maintain a strong position under English law without the need for basis clauses, not least because of the draconian remedy of avoidance for material non-disclosure. In this context, the requirement for the insurer to show that the fact is material and that any non-disclosure in fact induced the particular underwriter means that there is a significant burden on an insurer seeking to avoid a policy. The presence of a basis clause can alleviate that burden on the insurer. Consequently, members should discuss with their insurance brokers the removal of basis clauses whenever there is an opportunity to do so.

Airmic emphasises to members that while removing basis clauses is strongly recommended, the best protection for putting in place and maintaining effective cover is a rigorous procedure to control the disclosure process at the point of placing the insurance. The June 2011 Airmic guide to non-disclosure and misrepresentation provides advice as to how a suitable and sufficient disclosure process may be implemented. It also includes and provides commentary on the Airmic non-disclosure clause.

Members who have used or are considering including the Airmic non-disclosure clause in their insurance policies should note that the clause expressly disapplies basis clauses. It states that no representation made by the insured (or on the insured's behalf) shall form the basis of the contract between the parties. For reference, the Airmic non-disclosure clause is set out in full in Annex A of this guide, and sub-clause 4 of the non-disclosure clause is drafted to ensure that it overrides the general operation of any basis clause included in the insurance policies to which it is added (whether in proposal forms or the wording itself).

Airmic members should note, however, that many other innocent non-disclosure clauses in use in the market do not expressly disapply basis clauses effectively. If members are unclear whether any particular innocent non-disclosure clause is effective to disapply a basis clause (or whether their policies are subject to effective basis clauses generally), they should speak to their insurance broker and/or take legal advice.

One option to consider would be for members to amend their policies by endorsement to expressly disapply any basis clause which might otherwise apply. Included at Annex B of this guide is a sample endorsement which might helpfully form the basis of discussions with insurers. In any event, however, members should consult with their broker and/or take legal advice if they are unclear as to the terms of their policies.

6. Conclusion

In case any members are uncertain as to whether this subject requires action, they should take note of the recent decision of the High Court in Genesis Housing v Liberty, discussed below, which is an up-to-date (November 2012) example of the Courts enforcing a basis clause in all its severity.

A recent cautionary tale on the operation of basis clauses

The recent case of Genesis Housing v Liberty Syndicate Management provides an example of the potentially draconian consequences of basis clauses.

A part of Claimant housing trust group contracted with a builder, Time and Tide (Bedford) Ltd for the redevelopment of a block of flats. As part of these arrangements, Time and Tide (Bedford) Ltd was to procure insurance, including cover against its insolvency. Time and Tide (Bedford) Ltd contacted the Defendant insurers' agents and they completed a proposal including a basis clause, which was signed on behalf of Time and Tide (Bedford) Ltd. The proposal mistakenly referred to another group company of TT Bedford, Time and Tide Construction Ltd as the builder.

The project ran into difficulties and Time and Tide (Bedford) Ltd became insolvent. The housing trust therefore sought to claim under the policy. The court found that the basis clause was effective, and that the statement as to the name of the builder was accordingly warranted in the policy. Since the warranty had been breached, the policy was void and accordingly there was no cover for the insolvency.

7. Annex A

Airmic non-disclosure clause

[Draft] Non-Disclosure/Misrepresentation Clause

1. In the event that the Insured or its agent to insure fails to disclose or misrepresents a material fact prior to inception of this insurance and the Insurer would be entitled to avoid this insurance, this clause shall apply except where any non-disclosure or misrepresentation by the Insured or its agent to insure is proven by the Insurer to be:

   (1) fraudulent; or

   (2) of such other nature that, if the material fact had been disclosed or had not been misrepresented, the insurer would not have underwritten this insurance.

2. The burden shall be on the Insurer to prove all matters set out in this clause. For the purposes of this clause the acts, omissions or knowledge of one Insured shall not be imputed to any other Insured.

3. If the Insurer would have underwritten this insurance on different terms (as to premium and/or otherwise) had the material fact been disclosed or not misrepresented, the Insurer shall not be entitled to avoid this insurance but:

   (1) in the event the Insurer would have underwritten this insurance on different terms as to the premium, the Insured shall be liable for such additional premium as would have been charged had the material fact been disclosed or not been misrepresented;

   (2) in the event that the Insurer would have underwritten this insurance on different terms in any respect other than in relation to the premium, the Insurer shall, in addition to any premium adjustment pursuant to sub-clause 3(1), be entitled to impose such terms on this insurance as would have been imposed at inception of this insurance if the material fact had been disclosed or had not been misrepresented by giving written notice of the term to the Insured. Subject to sub-clauses 3(3) and 3(4), any additional term so notified shall take effect as if imposed from inception[1];

   (3) any additional term imposed pursuant to sub-clause 3(2) shall not apply to any claim which has been finally agreed by the Insurer (whether paid or not) prior to the date of the Insurer's written notification to the Insured of the additional term[2];

   (4) for any additional term imposed pursuant to sub-clause 3(2) which would have the effect, if breached, of coverage under this insurance never attaching, being suspended or being discharged (whether at the election of the Insurer or otherwise), the Insurer agrees in each such case to vary the remedy for breach of the term so that the Insurer shall be entitled only to decline any claim that does not fall within 3(3). In the event that the Insured does not comply with any additional term imposed and falling within this subclause within [30/60] days of receipt of the Insurer's written notification imposing the additional term, the Insurer shall be entitled after the expiry of the specified time period to impose with prospective effect only the remedy to which it would have been entitled but for this clause[3].

4. The Insurer agrees that no representation by the Insured or by any agent of the Insured (including an agent to insure) shall be a term of any sort of this contract of insurance and that any provision in any other document to the effect that a statement or statements made by or on behalf of the insured in such document form part of or are the basis of the contract of insurance shall be of no effect[4].

[1] This would mean that if the term imposed from inception did not concern the claim which was the occasion for the non-disclosure or misrepresentation to be discovered, the claim itself would remain payable i.e. imposition of an exclusion in respect of an unrelated issue. Conversely, if the term would affect the claim (an adjusted deductible, sub-limit, the imposition of a new exception or a condition precedent to liability) then the indemnity would be adjusted accordingly or the claim be not payable altogether.

[2] This means that agreed claims should not be reopened in the interests of certainty. Of course the Insured may be said to have a "windfall" as a result, but that, it is suggested, is better than seeking to reopen claims which could include third party liability claims which might affect innocent third parties.

[3] For any warranty or suspensory condition imposed, the Insurer agrees to vary the remedy to declinature of any claim not finally agreed provided the Insured complies with the new warranty or suspensory condition within the specified time period. If the Insured fails to do so, the Insurer is then entitled to revert to the original remedy going forwards which could have included the Insurer being discharged from liability but without reopening any finally agreed claims.

[4] This sub-clause is necessary to avoid the effect of the clause overall being removed by an insurer arguing that a representation made during placement becomes a term of the contract giving the insurer a remedy in damages in the event of breach.

8. Annex B

Sample endorsement to disapply basis clauses

The Insurer agrees, with effect from inception, that notwithstanding any other term of this contract, any provision in this contract of insurance or any other document to the effect that a statement or statements made by or on behalf of the Insured (including but not limited to statements made in proposals for insurance) form part of or are the basis of the contract of insurance shall be of no effect.

All other terms and conditions remain unaltered

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