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DUTY OF DISCLOSURE IN INSURANCE LAW

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Authorship Declaration

I hereby declare and confirm that this thesis is entirely the result of my own work except where otherwise indicated. I have acknowledged on page 4 the supervision and guidance I have received from Dr. H.O. Kerkmeester.

Rotterdam, July 15, 2002

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If individuals were willing or able too reveal their information, everybody could be made better off.¹

1. Introduction to the Thesis

The central law and economics problem in the area of the insurance law is avoidance of consequences of asymmetric information. Traditional solutions proposed by the market are various underwriting techniques, incomplete coverage and observation of behaviour of a contractual party. The aim of this paper is to analyse *how the design of the rules in the law can assist to avoidance of asymmetric information consequences*.

The thesis concentrates only on the general duty of disclosure between two parties to the insurance contract (the policyholder and the insurer). The special aspects of the duty of disclosure related to the third parties (insured persons, beneficiaries, injured third parties in liability insurance cases, and insurance intermediaries) are excluded from the analysis due to limitations to the extent of the thesis.

The analysis in the paper consists of three Chapters:

The Chapter 2. *Insurance and Asymmetric information* introduces concept of asymmetric information, forms of asymmetric information present in the insurance area, and the duty of disclosure in insurance law as one of the means to cope with consequences of asymmetric information.

In the Chapter 3. *Duty of Disclosure* the law and economics analysis of the aspects of duty of disclosure is mostly based on the Proposal for a Council Directive of the Coordination of Laws, Regulations and Administrative Provisions Relating to Insurance Contracts² (further in this text - “the Proposal”) and the EU directives 92/49/EEC and 92/96/EEC³. Event being not adopted as a directive, the Proposal is significant because it expresses the developments of European insurance contract law in the end of the twentieth century and it tries to find the compromise between different legal systems of European countries.

Chapter 4. *Lithuania and England Compared* analyses the duty of disclosure in the insurance law of Lithuania, EU membership seeking country, and in the insurance law of England,

¹ Rothschild M., Stiglitz J.; *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, The Quarterly Journal of Economics, 1976, Vol. 90, pp. 629-649, at 629.

² *Amendment of the Proposal for a Council Directive of the Coordination of Laws, Regulations and Administrative Provisions Relating to Insurance Contracts*, Official Journal, C355/31/12/1980.

³ *Codification CEA des Directives europeennes sur l'Assurance*, Paris, 1994.

(the U.K. is the EU member state). Also it can be viewed as the comparison of the duty of disclosure in the insurance law of two legal traditions: civil law tradition (Lithuania) and common law tradition (England).

2. Insurance and Asymmetric Information

2.1. Introduction

Asymmetric information can be understood as the situation where “some parties know more than the others⁴”. In a case of insurance the policyholder has better information about the risk, which he wants to insure, and the insurer hardly can monitor the post-contractual behaviour of the policyholder. Because of the asymmetry in information there is a possibility of two problems: the problem of adverse selection and the problem of moral hazard.

2.2. Adverse Selection

If the policyholder has better knowledge about his risk level than the insurer it is difficult for the latter to assess the risk level (high or low) of the particular policyholder. The insurer has to set the premium somewhere in between the premium for high-risk policyholders and low-risk policyholders. Consequently, high-risk policyholders will pay less and low-risk will pay more than it should be without asymmetry in information about risk levels. Because of the rise in insurance premiums low-risk policyholders will decide not to purchase insurance at all; they will leave the market. This phenomenon is called *adverse selection*. G. A. Akerlof was one of the first who analysed the problem of adverse selection and its presence in the insurance area⁵.

The problem of adverse selection can constitute a real danger for insurance markets. As the idea of an insurance business for the insurer is based on identification and aggregation of independent risks brought by different types of policyholders, the withdrawal of low-risk policyholders will result into the insurance pool based only on risks brought by high-risk policyholders. Then the probability of insured event is sufficiently high, the insurer has to keep

⁴ Pindyck, R.S.; Rubinfeld D.L.; *Microeconomics*, 3rd ed., Prentice-Hall Int., New Jersey, 1995, p. 593.

⁵ Akerlof, G.; *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Quarterly Journal of Economics, 1970, pp. 488-500.

reserves, which are “equal or, perhaps, exceed the reserves individuals would have to maintain if uninsured⁶”. The insurer can fail to pay all the insurance claims and become insolvent.

Adverse selection also can be viewed as the negative externality caused by high-risk policyholders to the low-risk policyholders: “the low-risk individuals are worse off than they would be in the absence of the high-risk individuals. However, the high-risk individuals are no better off than they would be in the absence of the low risk individuals⁷”.

2.3. Moral Hazard

How does the behaviour of the policyholder change after conclusion of the contract? Definitely, he can feel himself more secure and therefore he can be less careful. Also, knowing that now the insurer will face financial consequences of the insured event, the policyholder can use provided insurance cover more than it is expected by the insurer (e.g. for excessive medical treatment in health insurance cases, excessive litigation in legal expenses insurance cases). Because of asymmetric information the insurer cannot monitor the behaviour of the policyholder properly, therefore, the policyholder’s incentives for less careful and more costly behaviour increase. The phenomenon described above is called *moral hazard* in the economic literature.

It should be stated that some legal literature has different understanding of moral hazard: moral hazard is the negative characteristic of the policyholder related to his past (his insurance claims history, criminal convictions and etc.)⁸, but not to his post-contractual behaviour (behaviour after the conclusion of the contract). In this paper the understanding of moral hazard is linked to its economic definition.

The social cost of moral hazard can be seen as the deadweight loss associated with insurance subsidy, because the policyholder doesn’t meet the full actuarial cost related with excess usage of the coverage⁹. But moral hazard can have broader consequences on the whole insurance market, such as premium increases and, more radically, the refusal of insurers to provide certain type of coverage¹⁰.

⁶ Priest, G. L.; *The Current Insurance Crisis and Modern Tort Law*, The Yale Law Journal, 1987, Vol. 96, pp.1521-1588, at 1543.

⁷ Rothschild M., Stiglitz J.; p. 629, see footnote 1.

⁸ *Mac Gillivray on Insurance Law*, 9th ed., Sweet and Maxwell, London, 1997, p. 411.

⁹ Marshall, J. M.; *Moral Hazard*, The American Economic Review, 1979, Vol. 66, pp. 880-890, at 880.

¹⁰ Pindyck, R.S.; Rubinfeld D.L.; p. 605, see footnote 4.

2.4. Critique

Most of literature focuses on one-sided asymmetric information – the failure of the insurer to determine the risk level of the policyholder. The existence of bilateral asymmetric information practically is not analysed, and it's serious deficiency of all the theories of unilateral asymmetric information.

The economic understanding of insurance is based on the idea that risk-averse policyholders are willing to give a part of their income for loss avoidance. The insurer cannot charge higher premium than the policyholder's expected loss (amount of damages multiplied by probability of these damages), because the policyholder's utility will be higher without the insurance and he will simply choose not to buy the coverage. If the policyholder knows the exact probability of his damages, he will be at the same position as the insurer, who knows the statistics and actuarial methods to calculate the probability of damages.

So it seems that the insurer is better off when he doesn't reveal his professional information to the policyholder, because full professional information supplied to policyholders may result into their decision not to buy insurance and then the insurer will lose his clients. A. Andersson presents the mathematical proof of this statement¹¹.

Also the advantage of non-disclosure of professional information is the possibility for the insurer to bring the risks of uninformed low-risk policyholders into the insurance pool, thus diminishing the possible consequences of adverse selection.

However, the negative effect of this information asymmetry is that policyholders are worse off, because they will be forced to buy insurance in cases when it is not really necessary for them, and the insurer will have the possibility to charge the higher premium than the fair actuarial premium. *It is not taken to account that professional information disclosure in many cases can cope with adverse selection and moral hazard.* If the policyholder is informed what information is necessary for the insurer and why it is necessary, the policyholder can exercise his duty to disclose this information more accurately.

Another important moment of the critique is that the literature basically concentrates on moral hazard from the policyholder's side. *The insurer's moral hazard is practically not analysed.* The examples of the insurer's moral hazard could be refusal to pay large claims, requirement for the policyholder to pursue a claim against any other party before offering settlement, where settlement is required, wrongful threats of non-payment of the insurance compensation, cancellation of the

¹¹ Andersson, F.; *Adverse Selection and Bilateral Asymmetric Information*, Journal of Economics, 2001, Vol. 74, pp. 173-195.

contract when the policyholder is not at fault, and etc¹². *The insurers' moral hazard can affect the adverse selection*: the suffered moral hazard can foster the incentives for low-risk policyholders to leave the market. Therefore, the attention should be paid to this aspect of asymmetric information too.

2.5. Medicine for Consequences

As asymmetric information is the form of market failure, the avoidance of the consequences of asymmetric information can be linked to the degree of the state intervention. Libertarian approach suggests that market itself can cure its failures¹³, while the other approaches suggest that some degree of government intervention is necessary in cases where market failure cannot be resolved through private bargaining¹⁴.

Traditional market solutions to mitigate the problems of moral hazard for the insurer are incomplete insurance coverage¹⁵ (it is believed that if the policyholder has to face a part of the risk, his personal incentives to avoid the loss will be beneficial to the insurer too), examination of the policyholder's activity before conclusion of the contract, and monitoring his activity during the period of coverage¹⁶.

Adverse selection can be avoided by using costly risk sorting devices, which can help to assess the individual risk level of the policyholder (e.g. genetic testing, see Chapter 3.4.2). Also the introduction of the compulsory insurance where the policyholders are obliged to purchase coverage preferably at the regulated insurance rates can solve the problem, because then low-risk policyholders could not simply leave the market.

Another approach how to avoid adverse selection relates to the signalling theory. "By limiting the amount of insurance available at the low price, and offering more insurance at a higher price, firms may succeed in attracting high-risk consumers to the high-priced insurance and low-risk consumers to the lower-priced insurance¹⁷". However, there are two problems of this theory: the purchase of insurance policies designed for low-risk policyholders by high-risk policyholders, and

¹² Johnston M.; *The Bad Faith Top 40*, <http://www.quatloos.com/traps/badfaith.htm>

¹³ Chandler, S. J.; *Insurance Regulation*, Encyclopedia of Law and Economics, 2000, Vol. III, pp. 837-863, at 845.

¹⁴ Pindyck, R.S.; Rubinfeld D.L.; p. 605, see footnote 4.

¹⁵ Pauly, M.V.; *The Economics of Moral Hazard: Comment*, The American Economic Review, 1968, pp. 531-537, at 536.

¹⁶ Faure, M.G., *The Limits to insurability from a Law and Economics Perspective*, The Geneva Papers on Risk and Insurance, 1995, No. 76, pp. 454-462, at 456-458.

¹⁷ Wilson, Ch.; *A Model of Insurance Markets with Incomplete Information*, Journal of Economic Theory, 1977, Vol. 16, pp. 167-207, at 168.

the behaviour of the competitors, who may sell the additional coverage for these policyholders. If it happens, the signalling theory doesn't work properly.

Market solution to the problem of asymmetric information is also suggested by the game theory. In the case of so-called multiperiod (or repeated) insurance contracts the pay-offs of long-term relation for the both contractual parties are higher than the pay-offs of cheating at the first round, so in the first round their dominant strategy is not to cheat¹⁸. However, this approach can be ambiguous, e.g. in the case of adverse selection the “high-risk client may play strategically in the first period by not reporting an accident, in an attempt to influence the second-period probability that the principal attaches to him being low risk¹⁹”. Therefore, even the game theory cannot give proper solutions for avoidance of asymmetric information.

This paper analyses how rules of mutual information disclosure between the insurer and the policyholder could assist to the avoidance of the asymmetric information problems. Such point of view combines the market approach and government intervention approach because of the nature of contractual rules: parties to the contract design contractual rules in the legal framework set by the law (mandatory and default legal rules of the duty of disclosure).

3. Duty of Disclosure

3.1. *Uberrimae Fides*

Insurance contracts belong to the special type of contracts based on mutual trust and reliance (*contractus intuitae personae*) where the principle of *uberrimae fides* (utmost good faith) is applied. The concept of *uberrimae fides* can be defined by the words of Lord Mansfield: “Insurance is a contract of speculation. The special facts upon the contingent chance is to be computed lie most commonly in the knowledge of the assured only; the underwriter trusts to his representation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge to mislead the underwriter into a belief that the circumstance does not exist²⁰”.

The economic justification of this important principle is quite clear. Definitely there is a case of recognised asymmetry in information between the two parties. The insurer bears the policyholder's risk and the insurer's costs depend on the characteristics of the policyholder²¹. In

¹⁸ Watt R.; Vazquez F.J.; *Full Insurance, Bayesian Updated Premiums, and Adverse Selection*, The Geneva Papers on Risk and Insurance Theory, 1997, 22, pp. 135-150, at 137.

¹⁹ Watt R.; Vazquez F.J.; p. 136, see footnote 18.

²⁰ *Mac Gillivray on Insurance Law*, 9th ed., Sweet and Maxwell, London, 1997, p. 390.

²¹ Rea, S.A.; *The Economics of Insurance Law*, International Review of Law and Economics, 1993, Vol.13, pp.145-162, at 153.

exchange of the premium the policyholder can get the insurance compensation, which is usually bigger than the premium paid. In order to apply the laws of large numbers the insurer should be entitled to the precise information about the risk: "the viability of the insurer's business depends upon an accurate computation of the contingency of the loss and the risk undertaken, and therefore the assured cannot in all fairness and good sense expect the insurer to perform his side of bargain if he is deprived of the information he needs to estimate the risk, of which he is ignorant and the assured is not²²".

Namely the *uberrimae fides* principle of insurance law raises insurance contractual relations in the higher degree of mutual confidence than compared to other types of contractual relations. *The requirement of the higher degree of confidence by the law is the first important step for avoidance of the asymmetric information.*

However, the serious deficiency in application of this principle is that it is orientated to the avoidance of the consequences of the asymmetric information from the policyholder's side. Despite the fact that the mutual character of *uberrimae fides* is stressed²³, the insurer's duties arising out of this principle are quite unclear, in the insurance contract law of European countries they mostly concentrate on the supply of consumer information, as it is required by the EU directives 92/49/EEC and 92/96/EEC²⁴.

3.2. Duty of Disclosure: General

Do doubt that the most important contractual duty related to the principle of *uberrimae fides* is the duty of disclosure.

It has to be stated that some legal literature understands the duty of disclosure too narrowly: only as a duty to provide oral or written information before the conclusion of the contract²⁵, thus not taking into account that presentation of the property/health for the insurer's examination and information supplied after the conclusion of the contract are also the important aspects of the duty.

Two different stages of the duty of disclosure have to be considered: the duty of disclosure before the conclusion of the contract (pre-contractual duty of disclosure) and the duty of disclosure after the conclusion of the contract (further in the text this type of duty is called the post-contractual duty of disclosure).

²² *Mac Gillivray on Insurance Law*, p. 428, see footnote 20.

²³ *Colinvaux's Law of Insurance*, 7th ed., Edited by Robert Merkin, Sweet and Maxwell, London, 1997, p. 125.

²⁴ *Codification CEA des Directives europeennes sur l'Assurance*, Paris, 1994.

²⁵ *Mac Gillivray on Insurance Law*, p. 397, see footnote 20.

The information provided by the policyholder appears to be relevant in all stages of the contractual relation: formation of the contract, execution of the contract, and assessment of the insured event, therefore *it is difficult to agree to some opinions that only pre-contractual disclosure really matters*: “insurance companies want to know their customer’s characteristics in order to decide on what terms they should offer to let them buy insurance. Information that accrues after purchase may be used only to lock the barn after the horse has been stolen.²⁶”. Of course, this can be true in case of the adverse selection, but not in the case of moral hazard. Information about post-contractual behaviour supplied to the insurer limits incentives for the policyholder’s moral hazard.

Because of the existence of the duty of disclosure the law and economics argument about the permission for one contractual party to withhold information if it is productive (if information advances social welfare) and if it is costly to acquire is not applicable to the insurance contracts due to their nature – existence of the duty to disclose the information for another party to the contract²⁷ (the party cannot choose to provide or withhold information, because he is *obliged to provide* it); therefore, these questions are excluded from further analysis.

3.3. Incentives to Disclose

More detailed analysis of the duty of disclosure has to be started with description of the incentives to disclose faced by both parties to the insurance contract.

Economic understanding of asymmetric information suggests looking for purely economic reasons why some people benefit of non-disclosure. High-risk policyholders will pay the smaller premium if they withhold the information about their risk level. Moral hazard also seems as rational economic behaviour²⁸ of the policyholder who maximises his utility by using excessive coverage. The insurer is better off if he can charge higher premium from low-risk policyholders that it is actuarially justified.

This is true, if there are no constrains of such utility maximization. What can serve as possible constrains, in other words, why the disclosure is chosen instead of non-disclosure?

1) *Morals and ethics*. The point of view, which concentrates only on rational economic behaviour, is hardly objected by K. J. Arrow, who sees non-market control mechanisms (such as

²⁶ Rothschild M., Stiglitz J.; p. 632, see footnote 1.

²⁷ Kotz, H.; *Precontractual Duties of Disclosure: A Comparative and Economic Perspective*, European Journal of Law and Economics, 2000, Vol. 9, pp. 5-19, at 15.

²⁸ Pauly, M.V.; p. 535, see footnote 15.

morals and ethics) as important additive, “because of the moral hazard, complete reliance on economic incentives does not lead to an optimal allocation of resources in general²⁹”.

2) *Legal consciousness*. People execute their contractual duties because it is their accepted principle to do so (*pacta sunt servanda*).

3) *Adversative economic incentives*. If the competitive insurance market limits the insurer’s incentives to charge higher premium than it should be according to actuarial methods, the insurer is better off if the policyholder knows that the premium charged is according to his risk level, because then policyholders will not change this particular insurer into another one for the reasons related with the amount of the premium. Disclosure of information to the policyholder also can help to reveal his true risk level and thus to avoid the consequences of asymmetry in information: “so long as the low-risk people would be made better off by distinguishing themselves, they will do so, and competitive firms will find it profitable to offer them lower insurance rates³⁰”. Adverse selection and moral hazard can be avoided if the policyholder has incentives to have more insurance relations with the same insurer (the case of so-called multiperiod contracts)³¹, therefore, the policyholder will choose to disclose in the first contractual relation; non-disclosure in the first contractual relation can affect the possibility of future contractual relations with the same insurer.

4) *Deterrence of the legal remedies*. If the contract terms are clear and enforceable, possible legal remedies for the breach of duty of disclose can cope with the problem of non-disclosure.

There is a need of clearly defined legal and contractual provisions because the incentives can exist only in the framework of these provisions. The understanding of the provisions by parties to the contract is very important to foster the incentives: e.g. “if policy conditions are adapted optimally the insured will, in principle, have the same incentive to take prevention action as he had when he was not insured³²”.

²⁹ Arrow, K.J.; *The Economics of Moral Hazard: Further Comment*, The American Economic Review, 1968, pp. 537-539, at 538.

³⁰ Borenstein, S.; *The Economics of Costly Risk Sorting in Competitive Insurance Markets*, International Review of Law and Economics, 1989, Vol. 9, pp. 25-39, at 25.

³¹ Dionne, G., Lassere, P.; *Adverse Selection, Repeated Insurance Contracts and Announcement Strategy*, The Review of Economic Studies, 1985, Vol. 52, pp. 719-723, at 719.

³² Faure, M.G., p. 456, see footnote 16.

3.4. Policyholder's Pre-contractual Duty

3.4.1. Group or Individual?

According to the Proposal (par. 1, Art. 3) the policyholder has to disclose “any circumstances of which he ought reasonably to be aware and which he ought to expect to influence a prudent insurer’s assessment or acceptance of the risk”. What information can influence the insurer’s assessment and acceptance of the risk? Of course, the insurer has to distinguish between different risk types of policyholders in order to avoid the consequences of asymmetric information. Only the proper distinction can constitute Pareto improvement: “if only the high-risk individuals would admit to their having high accident probabilities, all individuals would be made better off without anyone being worse off.”³³

The insurer possesses statistical information, which is based on assumption that certain groups of policyholders are more risky than the others; and on approximate calculation to what extent the “membership” in the group influences the probability of the insured event. In addition the insurer needs to receive the information, which could help him to:

- 1) Determine to which risk group does the particular policyholder belong;
- 2) Determine the policyholder’s, who belongs to the certain risk group, other individual features, which can also be relevant to the probability of the insured event.

It seems that optimal insurance contract law should allow the insurer to receive information needed to the determination mentioned above.

However, the problem is that statistical data possessed by the insurer can be based on correlation, but not causation³⁴. Using such data may impose discrimination on certain groups of policyholders. That’s why the law sometimes even forbids the classification of policyholders on such “suspicious” criteria as the gender, sex, sexual orientation, race, and nationality³⁵. H. Gravelle is quite straightforward about the categorised data: “One method of identifying good and bad risks is *statistical discrimination*. Certain characteristics of individuals are correlated with their risk class and can be used to set the premium³⁶”.

The solution to the problem of possible discrimination can be costly risk-sorting devices such as genetic testing in life and health insurance, which help to assess the individual risk level of

³³ Rothschild M., Stiglitz J.; p. 638, see footnote 1.

³⁴ Wils, W.P.J.; *Insurance Risk Classifications in the EC: Regulatory Outlook*, 14 Oxford Journal of Legal Studies, 1994, pp. 449-467, at 457.

³⁵ Chandler, S. J.; p. 843, see footnote 13.

³⁶ Gravelle, H.; *Insurance Law and Adverse Selection*, International Review of Law and Economics, 1991, Vol.11, pp. 23-45, at 25.

the particular policyholder. The problems and disadvantages of using one of the costly risk-sorting devices - genetic testing are analysed in the next Chapter.

The other not so costly way to evaluate individual risk level of the policyholder is the introduction of the *bonus malus* (no-claim bonus) system, which is based on disclosure of past accident/claim history. The absence of accidents/claims in the past results in reduction of the premium for the policyholder. *Bonus malus* system can be viewed as:

1) Solution for moral hazard, because many claims due to excessive usage of coverage will result into premium increase for the next insurance contract. Therefore, due to existence of *bonus malus* system “the client is given a chance to alter his type in exchange for a saving in his premium³⁷” ;

2) Solution of adverse selection problem: past accident/claim history shows the risk level of the particular policyholder. By exercising *bonus malus* system “company updates its believes for its client type³⁸”.

The combination of individualised (preferably based on not so costly *bonus malus* system) and categorised (group) risk sorting devices seems to be optimal. The discrimination argument used against categorisation is quite exaggerated, because many types of categorisation are assumed to be discriminatory even if they are not. The statistics cannot give the reasons why one group of policyholders is more risky than the other; it is just the matter of interpretation. The prudent insurer in the competitive market won't interpret the statistical results in discriminatory manner. If statistically one group is more risky, it is reasonable to require the policyholder of that group to pay higher premium. *Therefore, the insurer has to be allowed to ask the policyholder to disclose the information in order to determine the risk group.* Of course, to avoid discriminatory interpretation of statistical results it is necessary to assure that the insurer takes other individual features of the particular policyholder into account.

The solution to avoid the possibility of discrimination could be the control of the insurer *ex post*, not the simple prohibition of categorisation *ex ante*. E.g. the victim of discrimination could file a claim to the state institution whose primary function is to cope with discrimination. This should deter some insurers who try to impose categorisation only in discriminatory manner, with lack of statistical evidence, without reasonable interpretation of them or without the assessment of the policyholder's individual risk level.

³⁷ Watt R.; Vazquez F.J.; p. 136, see footnote 18.

³⁸ Watt R.; Vazquez F.J.; p. 136, see footnote 18.

3.4.2. Genetic Testing

The disclosure of the genetic testing results is one of the most important issues recently analysed by lawyers and economists. The opinions are quite controversial: genetic testing is considered very costly and inefficient, besides, it also reinforces negative stereotypes and discrimination on the group of persons who have passed the test³⁹; the permission to use genetic testing in underwriting “may lead to delayed diagnosis and treatment of the disease⁴⁰”; but the abolition may lead to “serious problems of adverse selection⁴¹”. Lawyers see predictive genetic tests in case of private insurance contracts as “disproportionate interference in the right of privacy⁴²”.

It has to be stated that one of the fundamental principles of insurance is *uncertainty of the insured event*. Elimination of the uncertainty can result into non-insurability of the some risks and this can be socially undesirable.

Introduction of genetic testing device is a crucial step in the underwriting technique:

1) The insurer relies on factors, which were not known before the appearance of genetic testing and which influence the risk;

2) The insurer turns from the risk assessment based on statistical data of a large group of policyholders into the risk assessment based only on more precise data of one person;

3) Analysis of the genetic testing information gives more certainty in prediction of occurrence of the insured event. The higher is the degree of certainty, the lower is the possibility to provide the cover for some individuals.

K. Lavelle gives an example “of a man suffering from haemochromatosis, a condition, which raises iron levels in the blood, which can lead to serious damage to other organs. By giving blood frequently he is able to lower the levels of iron to normal, and he is very well. Yet he is unable to obtain income insurance and his travel insurance premiums are loaded⁴³”. This is typical undesirable effect of genetic information disclosure.

The opponents can argue that in life and health insurance the detection of certain illness due to health examination also makes impossibility of insurance cover, and hardly is there any difference between genetic testing and health examination. But the difference exists: after the health

³⁹ Borenstein, S.; p. 38, see footnote 30.

⁴⁰ Chandler, S. J.; p. 847, see footnote 13.

⁴¹ Chandler, S. J.; p. 847, see footnote 13.

⁴² Brewe, M. *German Legislative Response to Scientific Development in Human Genetics*, <http://www.bibliojuridica.org/libros/1/211/10.pdf>, p. 11.

⁴³ Lavelle K.; *Bioethics: Advances in Genetic Leave the Law Behind*, Law Society Journal, (2000) 38 (9) LSJ 56, <http://www.lawsocnsw.asn.au>.

examination the person is detected to be ill of a certain disease, and after genetic testing the person is still healthy, but the possibilities to become ill are known.

Another important argument is the economic one: the costs of genetic testing. Genetic testing can be justified if the following condition holds: “the deadweight loss due to adverse selection must be greater than the resource cost of imposing the test⁴⁴”. However, according to S. Borenstein, if it is very costly for the policyholder to acquire and provide such information, it leads to inefficient results: “the decline in the welfare of those who do not take and pass the test is not considered when a competitive company offers a low rate to people who can show that they are low risk. Because this loss is ignored, tests may be used that benefit a low-risk group only slightly and harm the remaining customers much more⁴⁵”.

However, the prohibition of the usage of the genetic information in underwriting techniques and the disclosure of the genetic testing results is more a question of the social policy, especially when the economic pros and cons are quite ambiguous. *If there are no clear economic arguments of the benefit of the genetic testing, the preference should be given to the traditional underwriting techniques.*

3.4.3. Partial Coverage

As it was mentioned before one of the solution for moral hazard could be partial coverage. Therefore, if the policyholder who has partial coverage can buy additional coverage from another insurer, the proposed solution doesn't make sense. “An insurer who sells additional insurance to a customer with existing insurance coverage will raise a probability of the loss occurring and will reduce the profits of the first insurer⁴⁶”. Also the purchase of additional coverage is a signal of possible moral hazard. “Companies want to see that their customers do not purchase so much insurance that they have an interest in an accident occurring. Thus, companies will want to monitor the purchases of their customers⁴⁷”. *Therefore, the policyholder has to be obliged to disclose the information about the existing insurance contracts.*

⁴⁴ Borenstein, S.; p. 28, see footnote 30.

⁴⁵ Borenstein, S.; p. 39, see footnote 30.

⁴⁶ Rea, S.A.; p. 152, see footnote 21.

⁴⁷ Rothschild M., Stiglitz J.; p. 642, see footnote 1.

3.5. Policyholder's Post-contractual Duty

The Proposal obliges the policyholder to declare the insurer “any new circumstances or changes in circumstances of which the insurer has requested notification in the contract” (par. 1, Art. 4).

The insurer takes into account that some type of information due to its nature can be disclosed only after the conclusion of the contract (e.g. information about the risk increase and information about the insured event). However, some information can be received before the conclusion of the contract (*ex ante* observation) and after the occurrence of the insured event (*ex post* observation), e.g. information about the installation of the alarm system in the house.

The central law and economics question is to find the optimal time of disclosure of the information. In general *ex post* disclosure can be considered as less costly than *ex ante* disclosure, because *ex post* disclosure appears only then the insured event takes place.

Another element, essential for choosing *ex ante* or *ex post* disclosure is the insurer's ability to observe care taken by the policyholder. S. Shavell in his study on moral hazard and insurance⁴⁸ considers 3 possible states of the world:

- 1) Care of the policyholder is not observed by the insurer (solution: partial coverage);
- 2) Care of the policyholder is observed by the insurer with perfect accuracy (solution: full coverage, *ex post* observation of care);
- 3) The insurer observes care of the policyholder with less than perfect accuracy (solution: less than complete coverage, *ex ante* observation of care).

As the duty of disclosure is one of the means of the policyholder's care observation, the *ex post* duty of disclosure can be optimal if the insurer is sure that the duty is designed and exercised properly. But in some cases it could be impossible to check if the information provided by the policyholder is true, especially when it comes to serious damage or destruction of the insured property.

Maximum intervention by the legislator in defining the information that has to be disclosed *ex ante* or *ex post* is not justified due to imperfect information about the possible state of the world; this distinction definitely should be made in contractual provisions, which can be adapted to the existing state of the world more easily.

Some authors look sceptically to the disclosure of the information after the conclusion of the contract: “information that the insured acquires after purchasing insurance cannot be the source of

⁴⁸ Shavell, S.; *On Moral Hazard and Insurance*, The Quarterly Journal of Economics, 1979, Vol. 93, pp. 541-562.

adverse selection. The insurer simply faces a more heterogeneous risk pool⁴⁹”. However, the *information acquired during the execution of the contract is the important tool to control policyholder’s moral hazard*: e.g. the Proposal (par. 1, Art. 3) requires disclosing risk increase due to the policyholder’s intentional acts before the risk increase takes place; this provision generates the incentives for the policyholder to avoid unnecessary acts under the purchased coverage.

3.6. Insurer’s Pre-contractual Duty

The insurer’s pre-contractual duty of disclosure still remains very undefined area of the insurance contract law. In the case *Banque Keyser Ullman SA v. Skandia (U.K.) Insurance Co. Ltd (1990)* it was stated that ”the duty falling upon the insurer must at least extend to disclosing all facts known to him which are material either to the nature of the risk sought to be covered or the recoverability of a claim under the policy which a prudent insured would take into account in deciding whether or not to place the risk for which he seeks cover with that insurer⁵⁰”.

According to this decision the main aim of the insurer’s pre-contractual disclosure is to assist the policyholder in deciding about the conclusion of the contract with that insurer; basically the assistance is in disclosing the type of coverage offered and the conditions of the contract.

Nearly the same position is expressed in the EU directives, which have not so many provisions of the insurance contract law, and the significant part of them is devoted to information, which has to be disclosed for the policyholder – natural person. European Court of Justice stated that “if he (a consumer) is to profit fully from the greater choice and diversity in the single market for assurance, and from increased competition, the consumer must be provided with whatever information is necessary to enable him to choose the contract which best meets his requirements⁵¹”.

Article 31 of the EU directive 92/96/EEC states that the insurer has to provide the policyholder-natural person of the life assurance contract:

- 1) Details about the insurer (name, legal form, member state, address);
- 2) Details about the life assurance product (definition of each benefit and each option, including amounts of premiums payable, surrender and paid-up values, calculation and distribution of bonuses, if policyholder chooses unit-linked type of life assurance contract - information about assets where premiums can be invested);

⁴⁹ Rea, S.A.; p. 155, see footnote 21.

⁵⁰ *Mac Gillivray on Insurance Law*, p. 424, see footnote 20.

⁵¹ *Case C-386/00 (Axa Royale Belge SA and Georges Ochoa, Stratégie Finance SPRL)*, The Court of Justice of European Communities, <http://curia.eu.int/>, 2002.

3) Details about contractual obligations (term of the contract, means of terminating the contract, means of payment of premiums and duration of premiums, arrangement for application of the cooling-off period);

4) Details about the law (tax arrangements applicable to the type of insurance contract, law applicable to the contract and the procedures of handling the policyholder's complaints).

The first serious deficiency is that directives give special protection for the policyholder of the life assurance contract, but not to the policyholder of the non-life insurance contract. The insurer, according to the Article 31 of the EU directive 92/49/EEC, has to provide information for the latter only about the law applicable to the contract and the procedures of handling policyholder's complaints.

However, *the improved insurers' pre-contractual disclosure can be a tool to cope with the consequences of asymmetric information:*

1) Directives do not oblige the disclosure of the details about non-life insurance cover. As it was mentioned before, according to some theories such *disclosure can be a signalling effect for the policyholders* to choose such type of the policy, which reflect their level of risk;

2) *The legal remedies for non-disclosure can have effective deterrence if they are known*, therefore it could be reasonable to require their disclosure;

3) Minimal information on the methods used to determine the policyholder's level of risk could help the policyholder understand that he is not discriminated, that will allow to *use categorisation as not so costly risk-sorting device more widely*;

4) The policyholder's knowledge of the provided coverage and contractual rights could *limit the insurers incentives for his moral hazard*, which basically is the result of the policyholder's limited knowledge about the provisions of the contract.

Of course, this improvement will make the contracts more costly. However the insurer already has a duty of disclosure, so the disclosure of every additional unit of information has the decreasing marginal costs; and the benefits (effect on the consequences of asymmetric information) should outweigh the costs.

3.7. Insurer's Post-contractual Duty

It is also very undefined area of the insurance contract law, e.g. the EU directive 92/96/EEC requires the insurer to inform the policyholder basically about the relevant changes of pre-contractual information.

However, *post-contractual disclosure also can be a tool for the policyholder to avoid the insurers moral hazard*. A good example is the section 8 of the Danish Insurance Contract Act, which requires the immediate notification of the insurer how he intends to act in the case of negligent non-disclosure. This precludes from one form of the insurer's moral hazard: avoidance of the contract after the occurrence of the insured event. Nearly the same reasoning is used in the Proposal, which sets the time limits for insurer's reaction to the non-disclosure of the policyholder: 2 months from the date of awareness of the fact. After the expiration of this period the insurer's right to react is waived.

Another important information is the notification of the unpaid premium (Article 6 of the Proposal), the policyholder can be penalised only if he didn't pay the premium within at least 15 days from such notification.

3.8. Means of Disclosure

The policyholder's duty of disclosure can be exercised:

1) Orally;

2) In the written form, e.g. filling in the questionnaire, providing the written information upon the request of the insurer; duty of disclosure exercised by the means of the Internet is also a form of written disclosure.

3) By presenting property, health to the insurer's examination.

The insurer's duty of disclosure can be exercised basically only in two forms: written and oral.

Oral form of disclosure usually is met in cases of insurance sales by telephone. It is the cheapest means of disclosure, but in a case of the legal dispute it is very difficult to prove breach or proper execution of the duty. In order to avoid possible problems, the solution could be additional written communication between the parties: "Details taken over the telephone are basically answers to questions from the salesperson. The proposer then receives in the post the proposal form with the details which they are asked to amend if incorrect and then to approve the details by signing and returning the form⁵²". Other suggested solutions could be to "record all telephone inquiries and install the necessary equipment to do so⁵³". The efforts of the contractual parties to avoid possible disputes are quite costly; therefore, oral form of disclosure is not the optimal solution.

⁵² Bowyer, L. M.; Selling "Void" Policies: Dealing with Legal Loopholes, *Business Law Review*, December 1996, pp. 256-259, at 257.

⁵³ Bowyer, L. M.; p. 259, see footnote 52.

Of course, the evidence of examination of property and health is the best to assess the risk and avoid possible disputes. However, the procedure of examinations is quite costly itself, therefore it can be applied only in particular cases: e.g. in the long-term health insurance contract the examination of the health of the insured could be really necessary.

From the law and economics point of view *the written form of disclosure could be the most preferable*, because it is less costly than examination of property and health, and in case of the breach of the duty it is easier (and less costly) to prove the breach if the written evidence exists.

3.9. Rules in the Law or in the Contract?

V.I. Serebrovskij observes, that there were some legislative efforts to establish the list of circumstances material for risk determination (e.g. Prussian State legislation), but there are some problems of such legislative intervention: the list can be incomplete and cannot reflect the developments of underwriting technique⁵⁴. Therefore, “it would not be feasible for any European legislator to cover all the ground necessary to facilitate modern insurance practice⁵⁵”.

However, despite the impossibility of total regulation, some level of government intervention exists nearly in every state. S. Rea sees two reasons for the government to intervene in the area of insurance contractual relations:

1) Complexity of insurance contracts (solution: the law has to provide standard terms of insurance contracts);

2) Private parties cannot negotiate efficient contracts (the law has to alter such market outcomes as asymmetric information and negative third party effects)⁵⁶. This statement represents traditional economic justification for the state intervention - market failure.

Third justification, closely related to the first two, can be the protection of consumers. K.J. Arrow states that “the choice of intervention depends on the degree of difficulty consumers have in making the choice unaided, and on consequences of errors of judgement⁵⁷”. The complexity of insurance relations requires protection of the consumer who has unequal bargaining power if compared with the insurer: “the essential role of legislation regarding insurance contracts is to take effective measures to control and limit freedom of contract: this has to be done for reasons of public

⁵⁴ Serebrovskij, V.I.; *Strachovanije (Insurance)*, Moscow, 1997, p. 534.

⁵⁵ Project Group "Restatement of European Insurance Contract Law", *Re: Communication from the Commission on European Contract Law*, 12 October 2001, <http://europa.eu.int>

⁵⁶ Rea, S.A.; pp. 145-146, see footnote 21.

⁵⁷ As cited in Bowyer, L. M.; pp. 256-259, see footnote 52.

policy, notably that of protecting the policyholder (or those third parties for whose benefit the insurance is taken out) against unfair contract terms⁵⁸.

What is the optimal minimum of the government intervention in regulating the duty of disclosure in order to cope with the consequences of asymmetric information?

1) Pre-contractual duty of disclosure exists *before the conclusion* of the contract. Therefore, theoretically the contractual provisions have no legal power on the pre-contractual duties of the parties; the regulation of the pre-contractual duty of disclosure is a matter of law, not of the contract⁵⁹;

2) As the standard policy conditions are drafted only by one contractual party, there is a risk that insurer can describe the provisions (and the provisions on the duty of disclosure in particular) in a manner detrimental for the policyholder. Therefore, these governmental efforts should be taken:

- *Introduction of the contra proferentem rule* in explanation of the contractual provisions;
- *Protection of consumer policyholders from the unfair contract terms*⁶⁰ (e.g. in Europe the EU directive 93/13/EEC has to be implemented by the member states);

- *Description of provisions on the insurer's duty of disclosure*, because the insurer himself hardly will be willing to describe it in the contract properly;

- *Establishment of the list of possible remedies for the breach of the duty of disclosure*, because the insurer has the incentives to establish too harsh duties for the policyholder and not so harsh for himself;

- *Introduction of the rules of onus probandi (burden of proof)*;

3) The *requirement of confidentiality and personal data protection should be introduced*, especially for the information provided by the policyholder; the belief that provided information is kept confidentially could foster additional incentives for disclosure, especially when it comes to disclosure of privately sensitive information or information which can be regarded as a commercial secret (e.g. history of illnesses in health insurance, the driver's record of administrative offences for careless driving in motor insurance, information about the debtors in credit insurance);

4) *Clear limits between categorisation and discrimination have to be set* when it comes to the underwriting techniques based on categorised statistical data. Clear limits set by the law could allow the insurer to use categorisation as the underwriting tool and require the disclosure of information about the policyholder's belonging to the certain risk group without possible speculations.

⁵⁸ Project Group "Restatement of European Insurance Contract Law", see footnote 55.

⁵⁹ Serebrovskij, V.I.; p. 532, see footnote 54.

3.10. Breach of Duty: Insurer's Remedies

3.10.1. Breach of Pre-contractual Duty

3.10.1.1. Intentional Breach

Traditional common law remedy in the case of the breach of the pre-contractual duty of disclosure is the insurer's right to avoid the contract *ab initio*⁶¹. Avoidance of the contract is the only remedy⁶², and "it makes no difference whether the breach was innocent or fraudulent⁶³". Also according to the Proposal (par. 4, Art. 4) in the case of intentional breach the insurer is entitled to terminate the contract within two months from the awareness of the breach, no insurance compensation is payable, the insurer has a right to retain the received premiums and claim for damages for losses he incurred due to the breach;

H. Gravelle makes the economic analysis of the severe sanctions for the breach of the pre-contractual disclosure; here are the brief conclusions of his analysis:

- 1) Terms that appear harsh *ex post* may be efficient *ex ante* due to their deterrence effect;
- 2) The harsher is the penalty; the greater are the incentives for policyholders to provide accurate information;
- 3) Reforms that mitigate the harshness of the insurer's remedy can reduce welfare; honest policyholders are made worse off, especially due to the increase of premiums (as the reaction of the insurers to the presence of more high-risk policyholders in the insurance pool);
- 4) Intervention can increase welfare in some circumstances but only if based on precise information about the interaction amongst all the terms of the insurance contract⁶⁴.

3.10.1.2. Negligent Breach

As it was mentioned, common law gives the insurer the right to avoid the contract *ab initio* in all cases of non-disclosure. However, the Proposal (par. 3, Art. 3) states quite different rule, originated in France. In case of the negligent breach the insurer has a right to propose amendments or termination of the contract within to months of the awareness of the fact. If amendments or

⁶⁰ Merkin, R.; Rodger, A; *EC insurance Law*, Longman, London, 1997, p. 45.

⁶¹ *Mac Gillivray on Insurance Law*, p. 401, see footnote 20.

⁶² *Colinvaux's Law of Insurance*, p. 116, see footnote 23.

⁶³ Gravelle, H.; p. 24, see footnote 36.

⁶⁴ Gravelle, H.; pp. 23-45, see footnote 36.

termination are rejected, the insurer can terminate the contract unilaterally. In the case of the insured event, which takes place before the termination, *proportionality rule* is applied.

Can H. Gravelle's arguments be accepted in the case of the negligent breach? His arguments represent traditional law and economics justification of severe sanctions: only the expected sanction (probability to face the sanction multiplied by the amount of the sanction) really matters. However, the harshness of the remedy in the case of unintentional non-disclosure hardly seems to be justified:

1) The doctrine of non-disclosure was developed in 18th century, then "given the boundaries of the non-technological world, [...] information was almost entirely within the province of the assured; with the rapid development of computer and electronic networks, databases and information systems which promote the comprehensive and indiscriminate circulation of information, this principle is less true⁶⁵". By these modern means the insurer could assure more proper execution of the duty; now *this old approach makes insurers passive in obtaining the information*;

2) This doctrine is speculative, *it gives the instrument for the insurer's moral hazard*: "the courts have developed a system which has armed the insurer with the means to avoid the contract if it turns to be a bad bargain⁶⁶";

3) H. Gravelle's views harsh remedies as a tool to cope with adverse selection, but according to S.A. Rea, "if the applicants do not appreciate that some information affects the probability of loss, there can not be adverse selection⁶⁷". *Therefore, the penalisation of such policyholders in order to avoid adverse selection is not fully justified from economic point of view*;

4) *The policyholder is put into unequal position*: it is recognised that the duty is mutual, but policyholder's remedies are incomparable to the harsh remedies of the insurer;

5) *Not the harshness of the sanction, but its unavailability is important for deterrence*; this classical statement of the criminal law theory should be the task in designing proper contractual rules.

The proportionality rule seems to be preferable more than the rule of avoidance *ab initio* in the case of the negligent non-disclosure. The Proposal (par. 3, Art. 3) recognises the policyholder's right to "a proportion of the compensation which would have been payable had the policyholder not failed to fulfil his obligations under paragraph 1 equal to the ratio between the agreed premium which a prudent insurer would have fixed if the policyholder had fulfilled his obligations under

⁶⁵ MacDonald Eggers, P.; Foss P., *Good Faith and Insurance Contracts*, LLP, London and Hong Kong, 1998, p. 8.

⁶⁶ Fletcher, R.; *Non-Disclosure and Materiality: A Lose All Situation for the Insured?*, Business Law Review, February 2000, pp. 38-41, at 41.

⁶⁷ Rea, S.A.; p. 155, see footnote 21.

paragraph 1". Note that paragraph 1 establishes the policyholder's duty to disclose information. Definitely, the rule itself is not perfect:

1) The amount of compensation payable still has to be determined by the unilateral decision of the insurer, and in the case of a dispute *the courts will face the difficulty to assess the amount of the insurance compensation*;

2) The rule presumes, that the *full disclosure leads to the increase of the premium, but this is not true in all cases*. For example, if the policyholder discloses certain facts, it will not necessarily lead to the increase of the premium, the insurer can insert the deductible or to widen the list of the exclusions of the cover;

3) The rule is orientated only to the risk premium, it cannot be applicable to the saving premium; therefore *the proportionality can hardly be applicable in the area of life assurance*, where the part of the premium allocated for saving doesn't depend on the insurance risk.

However, the positive effects of the rule are the following:

1) The rule distinguishes between types of non-disclosure (intentional or negligent), *policyholders who are guilty of the unintentional non-disclosure are not left without the insurance compensation*;

2) The policyholders who are liable for the un-intentional breach of the duty can receive *the insurance compensation, which depends on the degree of their fault*, the higher is the degree of negligence, the lower is the compensation;

3) The rule gives *monetary incentives for the insurer to underwrite the risk more carefully*, because he cannot deny the insurance compensation in all cases. The active insurer is one of the preconditions to avoid the adverse selection.

4) The rule also provides *incentives for high-risk and low-risk policyholders*. The insurance compensation usually is much higher than the premium paid; if the high-risk policyholders know that there is the direct relation between the undisclosed information and the insurance compensation, also for them it will better to reveal the true level of risk.

3.10.1.3. Innocent Breach

From the law and economics point of view the contractual remedies should serve as the deterrence tool. If the party to the contract is penalised for the breach of the contract when the party was not at fault, the deterrence effect cannot be achieved. *Therefore, it is reasonable not to penalise policyholder in the case of innocent non-disclosure.*

This is reflected in the Proposal (par. 3, Art. 3): if the policyholder failed to declare circumstances of which he was aware but which he did not expect to influence the prudent insurer's assessment of the risk, party to the contract has a right to propose amendments or termination of the contract within two months of the awareness of the fact. If amendments or termination are rejected, the party can terminate the contract unilaterally, and the insurer is obliged to provide agreed cover for the insured event, which takes place before the termination.

3.10.2 Breach of Post-contractual Duty

The Proposal (Art. 4) recognises 3 different legal remedies in the case of the policyholder's breach of the post-contractual duty; the remedies, as in the case of the pre-contractual non-disclosure, are classified according to the degree of fault:

1) Intentional breach. The insurer has a right to terminate the contract within two months of the awareness of the fact, the paid premiums are retained, no insurance compensation is possible and the insurer can claim for damage compensation;

2) Negligent breach and innocent breach. The insurer has a right to propose the amendment or terminate the contract; also in the case of the insured event the proportionality rule is applied;

These consequences are quite similar to those in the case of the breach of the pre-contractual duty; however, there is no difference in consequences of negligent and innocent breach. As it was mentioned, the penalisation of the party, which is not at fault, doesn't lead to the deterrence effect, therefore, it could be optimal to apply the remedies for innocent breach in a manner, which exists in the case of the breach of the pre-contractual duty.

Due to similarity of the legal remedies for the breach of the post-contractual duty to the remedies for the breach of the pre-contractual duty analysed earlier, the deeper analysis of the remedies for the breach of the post-contractual duty is omitted.

3.10.3. Causal Relationship

Another important question to be analysed is the reduction/refusal of insurance compensation in cases where non-disclosure has no causal relationship with the insured event. The Proposal is silent about this causal relationship. In common law the fact that non-disclosure had no causal relationship with the insured event doesn't affect the insurer's rights to avoid the contract and refuse insurance compensation. According to S.A. Rea, "the lack of causal relationship between

the fact non-disclosed and the specific event that is insured adds another punitive element to the law⁶⁸.

Is this punitive element justified? In case of intentional non-disclosure, where the policyholder has an intention to deceive the insurer, this legal rule is clearly acceptable, but in the case of negligent non-disclosure it raises some questions. On one hand the requirement to prove the causation could seem to be fair from the legal point of view. However, this requirement could lead to some negative consequences:

1) *The incentives for disclosure can be diminished*, policyholder may assume that particular information can have no relation to the insured event and choose non-disclosure;

2) *If non-disclosed information had no causal relationship in one type of circumstances, it doesn't mean that it will be so under the other*. The policyholder is not the insurance professional; he cannot know all possible relations between non-disclosed information and the occurrence of the insured event;

3) *The insurer's possibilities to use categorisation would be diminished*; the law, which requires the proof of causation, gives additional tool for the policyholder to complain for the discrimination if he believes that certain categories used by the insurer to determine the premium hardly can affect the insured event.

Insurance deals with probability. Assuming that certain factors *may* influence the insured event, the insurer determines premium. If the policyholder negligently does not disclose some factors, which may influence the occurrence, the lower premium can be set. If lower than actuarially justified premium is set, the insurance compensation is proportionally diminished. This is the sanction for the policyholder who fails to supply all the facts relevant to calculate the probability of the insured event and, consequently, the amount of premium. *Due to this reasoning the proportionality and the requirement of causation seem to be mutually exclusive legal rules*. Therefore, if the legislator prefers the proportionality rule, the requirement of causal relationship between undisclosed information and the occurred insured event should not be introduced.

3.10.4. Damage Compensation

General rule in the area of civil law requires the compensation of damages incurred due to the breach of the contract (e.g. Art. 7.4.1. of the UNIDROIT Principles of International Commercial Contracts⁶⁹).

⁶⁸ Rea, S.A.; p. 154, see footnote 21.

However, in a case of breach of the duty of disclosure the insurer already affects the policyholder in a monetary manner (reduction/refusal of insurance compensation, no refund of the paid premium), so the possible damage compensation is under big question marks. What kind of damage can the insurer incur? There are two types of possible losses due to non-disclosure:

1) Insurance compensation in cases where should be no compensation or the smaller compensation if full disclosure took place (but if there is a right to refuse or reduce the compensation, the losses don't appear);

2) The insurer's administrative costs (but the part of the paid premium is allocated to cover them, therefore, if the premium is received, the losses don't appear again).

If the law recognises the right for damage compensation, due to the reasons mentioned above this rule is hardly realisable; but the positive feature can be a *deterrence effect for the policyholder*, therefore the existence of it is justified from the economic point of view.

The Proposal (par 4.b. Art. 3) recognises the right for damage compensation in the case of intentional breach of the pre-contractual duty, in other cases the Proposal is silent about that possibility, however, it should be a matter of general rule in the law of the member countries.

However, the law, which clearly doesn't allow the damage compensation, cannot meet the efficiency criteria. E.g. common law knows only one remedy related to pre-contractual non-disclosure: avoidance of the contract *ab initio*. There is no right to claim damage compensation for the pre-contractual non-disclosure: "non-disclosure does not confer a remedy in damages, and there is high appellate authority that avoidance is the insurers sole remedy⁷⁰". Also the insurer is obliged to refund the paid premium, which could at least cover his administrative costs.

The reason why there is no damage compensation lies in the ambiguous legal interpretation of the duty in common law. The law recognises the right to claim for the damage compensation in the case of the breach of the contractual duties, but pre-contractual duty doesn't result from the terms of the contract. Therefore, the breach of the duty is not the breach of the terms of the contract, and no damage compensation can be asked. However, by its essence the breach of the pre-contractual duty could be a tort in common law, but "courts were disinclined to create such a novel tort⁷¹".

⁶⁹ Bonell, M. J.; An International Restatement of Contract Law: The UNIDROIT Principles of International Commercial Contracts, 2nd ed., Transnational Publishers Inc., New York, 1997, p. 290.

⁷⁰ Mac Gillivray on Insurance Law, p. 400, see footnote 20.

⁷¹ Birds, J.; *Modern Insurance Law*, Sweet and Maxwell, London, 1997, p. 126.

3.10.5. Right of Recovery

Sometimes the aim of the insurance contract is to protect not the policyholder, but the third parties (e.g. in compulsory liability insurance). The policyholder is a party to the insurance contract, and the execution of his duties can affect the payment of the insurance compensation to the third parties (the victims). Therefore, if the policyholder breaches his contractual duties and the insurer has the right to refuse to pay insurance compensation, the goal of the victim protection is not reached in this case.

However, the solution for the problem exists: e.g. § 158 c of German Insurance Contract Law stipulates the duty of the insurer to indemnify the victim despite the fact that the policyholder has violated terms of the compulsory liability insurance contract⁷². After the insurance compensation the insurer has a right to *recover* the amount up to the sum paid from the policyholder. The right of recovery is a special legal remedy, which can be applied also in cases of non-disclosure (pre-contractual and post-contractual).

In the case of the policyholder's non-disclosure the insurer will have no right to refuse to compensate the victim. Of course, this type of the legal rule exists due to the social reasons; economically it is controversial:

- 1) *Victim is protected by the costs of insurer*, who has to pay in cases where insurance compensation will not be possible according to the non-compulsory insurance contract;
- 2) The recovery will involve the *costs of litigation*;
- 3) The recovery from the policyholder could not be possible due to the *judgement proof problem*: policyholder could have no assets to compensate the insurer. Compulsory insurance is introduced because injurers cannot always compensate the victims, from monetary point of view now the insurer has to stand in the position of the victim and face the risk of under-compensation;
- 4) It will lead to the *shift of the insurance premiums*.

However, the rule *has no effect on the adverse selection*, because the rule exists in compulsory insurance, where the policyholder is obliged to buy the insurance anyway, he cannot simply leave the market. The rule *gives positive deterrence effect from the possible moral hazard*, the policyholder has incentives to execute contract very precisely, because he faces the risk of recovery.

For the monetary consequences of this rule for the policyholder, the rule is quite similar to the rule of avoidance of the contract *ab initio* and no possibility for the insurance compensation (the rule analysed in Chapter 3.10.1.1.). If full right of the recovery is allowed, the rule could lead to too

harsh consequences for the policyholders who are guilty of the negligent non-disclosure. However, there are two significant differences:

1) According to the first rule the insurer has no obligation to pay the insurance compensation, and according to this rule he has the obligation of the full compensation followed by the recovery right;

2) The first rule can be applicable in all types of insurance, and this rule – only in compulsory liability insurance, which should not eliminate the injurer’s incentives for the optimal level of care.

Therefore, if it is socially justified to oblige the insurer to compensate victim in all cases, it should be justified to have the insurer’s right of full recovery in cases when analogous breach of contract will lead to no insurance compensation according to non-compulsory insurance contract. *Then from the economic point of view the costs of victim will be borne not only by the insurer, but also by the injurer.* The insurer will have to face costs in two cases:

1) When contractual obligations are executed by the policyholder properly;

2) When contractual obligations are not executed properly and the judgement proof problem exists.

The injurer (the policyholder) will have to face the costs of the victim when contractual obligations are not executed properly and there is no judgement proof problem.

Despite the controversy of the rule (possible advantages and disadvantages), if due to social reasons the rule is introduced, the best solution could be the insurer’s full right of recovery against the policyholder.

3.11. Policyholder’s Remedies

The Proposal is silent about the consequences of the insurer’s breach. In general, there should be at least two possibilities: the right of the avoidance (or termination) of the contract and the right for damage compensation⁷³. According to common law “the assured cannot recover damages but may only rescind the contract⁷⁴”.

The disproportion of possible remedies is obvious, because insurer can affect very sensitive field for the policyholder – payment of the insurance compensation. Damage compensation for the policyholder hardly is imaginable because the loss suffered due to the breach is quite undefined category in many cases. Avoidance (termination) is not a proper solution too, because in some cases

⁷² Gesetz über den Versicherungsvertrag, <http://jurcom5.juris.de/bundesrecht/vvg/htmltree.html>

⁷³ Hansell, D.S.; *Introduction to Insurance*, LLP ltd., London, 1997, p. 183.

the policyholder would like to continue coverage; also there is the risk that the insurer will retain the paid premium.

The limited remedies from the policyholder's side *have no real deterrence effect on the insurer, this is the serious deficiency of the insurance contract law* in the area of the policyholder's available remedies. Also such limitation affect the consequences of asymmetric information:

1) Insurer's moral hazard can become uncontrollable due to diminished deterrence effect;

2) The lack of sanctions affects adverse selection (as it was mentioned, the insurer's disclosure is one of the tools to cope with it), which is not a problem of the particular insurer but of the whole market.

In the case of breach of pre-contractual disclosure the solution can be the rule met in Finnish Insurance Contract Act (section 9): if the insurer has failed to provide the necessary information or has given incorrect or misleading information to the policyholder when marketing the insurance, "the insurance contract is considered to be in force to the effect understood by the policyholder on the basis of the information received⁷⁵". Then the insurer *will have full incentives to disclose*, because he will face the consequences of non-disclosure himself.

In the case of breach of post-contractual duty of disclosure there could be possibility of the punitive damages awarded in cases there such non-disclosure affected the policyholder's right to get the insurance compensation. The U.K. Insurance Ombudsman Bureau applies very similar legal norm in a closely related area: "unjustified attempts by the insurer to avoid a policy for misrepresentation might merit a maladministration award, in addition to the normal consequences of our affirming that the policy stands and claims under it must be met⁷⁶".

E.g. the punitive damages rule could be applied effectively in the typical case of the insurer's moral hazard: during the contract term the insurer had known about the breach of the policyholder's pre-contractual duty, but he informed about the avoidance of the contract only after the insured event. Punitive damages could make the insurer's and the policyholder's positions more equal, because the policyholder also is penalised in the manner monetary detrimental to him (reduction or refusal of the insurance compensation). Also punitive damages could foster the insurer's incentives for proper disclosure due to the deterrence effect of punitive damages.

⁷⁴ *Colinvaux's Law of Insurance*, p. 120, see footnote 23.

⁷⁵ *Finnish Insurance Contracts Act No. 543*, June 28, 1994, <http://www.vakes.fi>

⁷⁶ Insurance Ombudsman Bureau. *Digest of Annual Reports and Bulletins*, Second Edition. *AR (93) para 6.69-6.71*, <http://www.theiob.org.uk/digest/>.

3.12. Closing Remarks

The analysis in the Chapter 3 reveals many problems related with various aspects of duty of disclosure: no equal attention to the pre-contractual and post-contractual duty of disclosure, existing contradiction between categorisation and discrimination, controversial application of genetic testing in underwriting area, unequal position of the insurer and the policyholder despite the fact that mutuality of *uberrima fides* is recognised, and ambiguous legal remedies for the breach of the duty of disclosure. However, the conclusion of the thesis cannot be drawn and the analysis cannot be complete without a look into existing practical situation in the concrete countries.

The comparative method is chosen in the next Chapter: the provisions on duty of disclosure existing in Lithuanian law are compared with similar provisions in English law in the light of findings of previous analysis.

4. Lithuania and England Compared

4.1. Description

Lithuania is a country of the civil law tradition; the first significant codification of civil law (based on legal norms of Roman civil law and Canonical law) appeared in the Statutes of the Grand Duchy of Lithuania in 16th century. After the occupation of the state by the Russian Empire in 1795, the Statute of 1588 was valid till 1840, but then it was replaced by Russian legislation. The second Republic's (1918-1940) efforts to reform civil law were stopped by the Soviet occupation; following it the Soviet civil laws were introduced. After the re-erection of the independent state in 1990 the civil law reform took place; it resulted into adoption of the new Civil Code⁷⁷ in 2000, which finally has replaced the Civil Code of the 1964.

The provisions on the insurance contract law are in two Acts: Civil Code of 2000 (Book 6th *Law of Obligations*, Chapter LIII) and the Law on Insurance of 1996 (Chapter II)⁷⁸. The provisions on the insurance contract law contained in the Chapter II of the Law on Insurance have the additional character to the provisions of the Civil Code. In particular, they implement the requirements of consumer information of the EU directives 92/49/EEC and 92/96/EEC; also they detail provisions of the Civil Code on standard insurance policy conditions, co-insurance, reinsurance, insurance portfolio transfer, payment of insurance compensation and surrender value.

⁷⁷ *Lietuvos Respublikos Civilinis kodeksas (Civil Code of the Republic of Lithuania)*, Vilnius, 2000.

Both Acts partly implement the requirements of the Proposal. The experts of the Association of German Insurers concluded the similarity of Lithuanian insurance contract law to the German/Austrian insurance contract law⁷⁹.

England is a country of common law (“the body of customary law, based upon judicial decisions and embodied in reports of decided cases, which has been administered by the common-law courts of England since the Middle Ages⁸⁰”). Legal rules that are understood to be the rules of civil law (from the point of view of civil law countries) are derived from judicial precedent in England.

The same is valid for the insurance contract law, the codification of the insurance contract norms exist only in marine insurance area (Marine Insurance Act 1906), other legislation in insurance area is “almost exclusively regulatory, and much of legislation was adopted to implement EC directives⁸¹”.

4.2. Policyholder’s Duty

Art. 6.993 of the Lithuanian Civil Code regulates the pre-contractual duty of disclosure. 1 par. states an obligation for the policyholder before the conclusion of the contract to provide all known information about circumstances which can have the essential influence on the insured event and possible losses due to the insured event (insurance risk), except in cases where these circumstances are known or supposed to be known by the insurer.

Quite similar definition exist in English law too: “the assured must disclose to the insurer all facts material to an insurer’s appraisal to the risk which are known or deemed to be known by the assured but neither known nor deemed to be known by the insurer⁸²”. However, 2 differences exist:

1) English law defines more strict duty: the policyholder has to disclose facts, which are supposed to be known by him, not only the facts which are known, this imposes the remedies for non-disclosure if the policyholder failed to discover the circumstances of which he ought reasonably to be aware;

2) English law uses *materiality* standard (and so does the Proposal), Lithuanian law the standard of *essential influence*. The difference between these two standards is the following: the

⁷⁸ Lietuvos Respublikos draudimo istatymas (Law on Insurance of the Republic of Lithuania), State Gazette, 1996, No. 73-1742, with later amendments.

⁷⁹ Neuhaus, G. Preliminary remark on the Draft Law Concerning the Insurance Contract and on the Chapter LIII of the 6th Book of the Civil Code, submitted to the State Insurance Supervisory Authority of the Republic of Lithuania by the Association of German Insurers (GDV) on 28.07.2000.

⁸⁰ Common Law, Encyclopaedia Britannica Article <http://www.britannica.com>.

⁸¹ Merkin, R.; Rodger, A.; p. 28, see footnote 60.

circumstance is considered material if it influences the judgment of the prudent insurer in fixing the premium or accepting the risk⁸³, the circumstance is considered to be of essential influence if it affects the insured risk.

In general, provisions of Lithuanian law are more orientated to the policyholder protection. Limitation of the duty of disclosure only to the facts known by the policyholder doesn't give proper incentives for the policyholder for full disclosure; therefore *this provision doesn't cope with asymmetric information efficiently*; in this case English rule is preferable.

However, the provision on materiality of the circumstances imposes the duty for the policyholder to judge what is important for the prudent insurer. This, due to the fact that the policyholder is not an insurance professional, can result in penalisation of policyholder and passiveness of the insurer in obtaining the information. In this case Lithuanian rule is preferable because *it gives the incentives for the insurer to underwrite the risk more carefully* (precise questionnaires and etc.); this is also a precondition for avoidance of asymmetric information.

Another feature not known to Lithuanian law is warranty (the "unconditional promise given by the assured at the conclusion of the contract⁸⁴"); breach of warranty gives the right for the insurer to avoid the contract. Warranties in the field of the duty of disclosure were a tool of unjustified penalisation of the policyholders for a long time, especially by using so-called "basis of the contract" clauses, when all statements of the policyholder in the proposal form were turned into warranties. E.g. "any inaccuracy on the form, whether material or not, innocent or fraudulent, enabled the insurer to avoid the contract. Thus the person suffering from unknown tumour would have been in breach of a warranty if he had disclosed that he was in the good health⁸⁵". However, the Statements of Insurance Practice by British Insurers restricted the use of warranties, the terms of the proposal cannot be turned into warranties anymore, but the insurer "may require specific warranties about matters which are material to the risk⁸⁶". The existence of harsh warranties hardly is justified, because *the incentives for the insurer to obtain information are lowered*.

Only two laws valid in England set the limits between *discrimination and categorisation* of the certain groups of policyholders. Sex Discrimination Act 1976⁸⁷ and Disability Discrimination Act 1995⁸⁸ allow different treatment of women and people with disabilities if:

⁸² *Mac Gillivray on Insurance Law*, p. 391, see footnote 20.

⁸³ *Mac Gillivray on Insurance Law*, p. 403, see footnote 20.

⁸⁴ Merkin, R.; Rodger, A.; p. 32, see footnote 60.

⁸⁵ Hansell, D.S.; p.182, see footnote 73.

⁸⁶ Butterworths Insurance Law Handbook. 6th ed. London, Edinburgh, Dublin, 2000, [8305].

⁸⁷ *Sex Discrimination Act 1976*, <http://www.pfc.org.uk/legal/sda.htm>

⁸⁸ *Disability Discrimination Act 1995 (c. 50)*, <http://www.hmsso.gov.uk/acts/acts1995/95050--b.htm#18>

1) Such treatment is based on statistical/actuarial data and it is reasonable to rely on that data;

2) The treatment is reasonable after taking into account that data and other relevant information.

However, the categorisation on the racial grounds (colour, race, nationality or ethnic or national origins) is treated as discriminatory by the Race Relations Act 1976⁸⁹, therefore it is forbidden to use such categorisation. Also the Rehabilitation of Offenders Act 1974 entitles the policyholder to withhold the information about spent convictions⁹⁰; the insurer cannot categorise between ordinary policyholders and the policyholders with spent convictions, it could be treated as discriminatory.

Lithuanian law lacks the provisions related to distinguishing between categorisation and discrimination in underwriting area. The Art. 29 of the Constitution⁹¹ on prohibition of discrimination is too general, the law should set the clear limits between categorisation and discrimination in underwriting area (see Chapter 3.9.).

Another important aspect to mentioned is the *disclosure of genetic testing results*. Following the Science and Technology Committee's of the House of Commons report, which concludes that "the insurance industry has failed to give clear and straightforward information about its policy on the use of genetic test results to the public, and appears to be uncertain itself about what exactly its policy is⁹²", on 24 October 2001 the Association of British Insurers proclaimed the 5 years moratorium for using the genetic testing results in underwriting area⁹³. Although earlier the Association was in favour for such underwriting method⁹⁴.

The non-existence of the clear legislative position and the position of insurers in the field of the disclosure of genetic testing results seems to be a serious deficiency in Lithuanian law and insurance practice.

According to English law the policyholder is obliged to inform the insurer about the *existing coverage* (other insurance contracts)⁹⁵. The non-existence of the similar provision in Lithuanian law could seem as deficiency (see Chapter 3.4.3), however, this is a matter solvable by the means of a

⁸⁹ *Race Relations Act 1976*, <http://www.homeoffice.gov.uk/raceact/racerel1.htm>

⁹⁰ *Mac Gillivray on Insurance Law*, p. 413, see footnote 20.

⁹¹ *Constitution of the Republic of Lithuania*, <http://www3.lrs.lt/cgi-bin/preps2?Condition1=21892&Condition2=>

⁹² Science and Technology Committee, *Fifth Report*, <http://www.parliament.the-stationery-office.co.uk/pa/cm200001/cmselect/cmsctech/174/17402.htm>

⁹³ *Extract from the 'Government Response to the Report from the House of Commons Science and Technology Committee: Genetics and Insurance'*, <http://www.ukfgi.org.uk/Moratorium%2024%20October%202001.htm>

⁹⁴ *Joint statement with ABI, BSHG on Genetic Research Projects*, 24 April 2001,

<http://www.ukfgi.org.uk/joint%20statement%20abi.%20bshg.%20ukfgi%2024%2004%2001.htm>

⁹⁵ *Mac Gillivray on Insurance Law*, p. 416, see footnote 20.

contract. The insurer is protected by the provision of the Civil Code (Art. 6.1001), which treats the coverage above the real insurance value as void (cases of over-insurance and double insurance).

The minimal attention to the *policyholder's post-contractual duty* is similarity of the laws of both countries, economically it is justified (see Chapter 3.5.).

The policyholder's post-contractual duty is quite controversial area of English law. Traditional concepts acknowledge only pre-contractual duty: "there is no general duty to disclose material facts which occur [...] during the period of insurance⁹⁶", however, some authors recognise the extension of the duty beyond the time of the contract formation, but "the scope of such duty is unclear⁹⁷". However, the post-contractual duty obviously refers to the cases of renewal, risk increase, consideration of the claim, because in such cases information received from the policyholder is really relevant.

Lithuanian law only recognises the post-contractual duty to inform the insurer about risk increase (Art. 6.1012 of the Civil Code) and provide all relevant information about the insured event (Art. 14 of the Law on Insurance).

4.3. Insurer's Duty

As both countries have implemented the requirements of the EU directives 92/49/EEC and 92/96/EEC on consumer information (in the U.K. this is regulated by the Insurance Companies Act 1982 with later amendments⁹⁸, in Lithuania – by the Law on Insurance), the insurer's *pre-contractual duty* mainly consists in providing this information. However, Lithuanian legislation requires additional information to be provided by the insurer:

- 1) Information on possible remedies of the insurer in the case of the policyholder's breach of contractual duties (par. 3, Art. 6.993 of the Civil Code);
- 2) The conditions and means termination of the contract (par. 1. 3), Art. 8 of the Law on Insurance);
- 3) The list of uninsured events and other circumstances, which give the insurer the right to refuse or reduce the insurance compensation (sub par. 4, par. 1, Art. 8 of the Law on Insurance).

These provisions are important tool to cope with the insurer's moral hazard (see Chapter 3.6.), the non-existence of similar provisions in English law can be seen as its deficiency.

⁹⁶ Birds, J.; p. 116, see footnote 71.

⁹⁷ *Colinvaux's Law of Insurance*, p. 119, see footnote 23.

⁹⁸ *Insurance Companies Act 1982 (1982c50)*, Butterworths Insurance Law Handbook, [200], see footnote 86.

The *post-contractual* duty basically is limited to the requirements of the EU directives in both countries, however, Lithuanian law (Art. 11 of the Law on Insurance) contains the provision met in the Proposal but strange to the English law: the legal remedies of the insurer for the unpaid premium can take place only after written reminder and the period of grace for the premium payment; it is another important tool against moral hazard of the insurer.

4.4. Insurer's Remedies

English law distinguishes between 4 types of the breach of the *pre-contractual* duty of disclosure:

- 1) Non-disclosure (failure to disclose a material fact, either by accident or because the fact was not considered to be important);
- 2) Concealment (wilful failure to disclose material fact);
- 3) Fraudulent misrepresentation (intentional misleading information on a material fact);
- 4) Innocent misrepresentation (unintentional incorrect information about the material fact)⁹⁹;

The only possible remedy for the insurer in the case of these 4 types of breach is avoidance of the contract *ab initio*. Despite the efforts to modernise the old doctrine of the pre-contractual non-disclosure (e.g. Statements of Long-Term and General Insurance Practise by British insurers¹⁰⁰, Law Commission Working Paper No 73¹⁰¹) the situation still remains the same.

The English courts also tried to modify the old rule slightly. In the case *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* (1994) House of Lords decided that “a contract may not be rescinded for failure to disclose unless the underwriter can prove that he was induced by the assured’s silence to enter into the policy on the terms laid down¹⁰²”. However, according to I.C. Hardcastle, this ambiguous ruling “is unlikely to radically alter normal market behaviour [...]”, it is better to have the test of “materiality that would permit avoidance only if the facts withheld would have caused the prudent underwriter to decline the risk proposed or at least to load the premium¹⁰³”.

The non-existence of proportionality rule for the negligent breach in English law cannot be considered efficient (see Chapter 3.10.1.2.) Even after rejection of the proportionality rule by the Law Commission in the U.K., there were efforts to introduce this rule. E.g. in the case *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* (1994) Sir Donald Nicolls, the Vice Chancellor of

⁹⁹ Hansell, D.S.; p. 183, see footnote 73.

¹⁰⁰ Butterworths Insurance Law Handbook, [8306] and [8303], see footnote 86.

¹⁰¹ Merkin, R.; Rodger, A.; p. 43, see footnote 60.

¹⁰² Hardcastle, I.M.; *Starting Revelations in Insurance Contracts*, Business Law Review, July 1995, pp.153-156, at 156.

¹⁰³ Hardcastle, I.M.; p. 156, see footnote 101.

House of Lords, expressed his opinion that “an insured who had not acted fraudulently should be allowed to recover a proportion of his loss based on the amount of premium actually paid, expressed as a proportion of the premium that would have been paid had full disclosure been made¹⁰⁴”. But this point of view was rejected again. However, the U.K. Insurance Ombudsman, who is not bound by judicial precedents, states that “proportionality may be applicable if we are satisfied that it would be too harsh an outcome for the policyholder to be deprived of all benefit under the policy¹⁰⁵”. So there is a possibility to apply the proportionality rule in solution of the consumers’ disputes with the U.K. insurers who recognise the authority of the Insurance Ombudsman.

Art. 6.993 of the Lithuanian Civil Code partly reflects provisions on remedies for the breach of the pre-contractual duty of disclosure found in the Proposal. Some significant differences if compared with English law exist:

1) Lithuanian law recognises only intentional and negligent breach of the duty (par. 4 and 5, Art. 6.993 of the Civil Code), it is reasonable, because the general rule for the contractual liability is the requirement that one of the parties to the contract has to be at fault. Therefore, contrary to English Law, no legal remedies can be applied in case of innocent breach;

2) If the insurer exercises the right to claim for avoidance of the contract *ab initio* after the insured event in the case of intentional non-disclosure, the circumstances which had disappeared before the insured event or had not affected it can not be the ground for avoidance; the contract can be avoided *ab initio* only by the court decision, not by unilateral notice of the insurer as in English law.

3) The proportionality rule is applied in the case of negligent breach. However, from the provisions of the Civil Code it is not clear whether proportionality rule is applicable in the case of life assurance, which has the element of savings; however, systematic analysis of the provisions of Law on Insurance (Art. 17) and the Civil Code allows to state that even if the proportionality rule could be applicable, the sum received by the policyholder has to be not less than the amount of the surrender value.

Requirement that remedies can be applied only for a party responsible for the faulty breach of the duty seems to be justified from the point of view of deterrence effect (see Chapter 3.10.1.3.).

The requirement of Lithuanian law for the insurer to address the court for avoidance *ab initio* is clearly based on the argument of the policyholder protection; however, it is also justified from efficiency point of view:

¹⁰⁴ Insurance Ombudsman Bureau, *AR (90) par. 2.3*, see footnote 76.

¹⁰⁵ Insurance Ombudsman Bureau, *AR (93) par. 6.69-6.71*, see footnote 76.

1) The rule *deters the insurer from some forms of moral hazard* (e.g. groundless avoidance of the contract);

2) If the contract is avoided by the insurer for non-disclosure, it leads to the dispute (especially when the avoidance takes place after the insured event), however the policyholder's financial position is not comparable to the insurer's position, the *latter can start civil action comparatively cheaper* than the policyholder;

3) *It gives the incentives for both parties to terminate the contract bilaterally* in the case when the breach of disclosure is clear, thus the costs of litigation can be avoided.

According to Lithuanian law the breach of the *policyholder's post-contractual duty* could lead to two possible consequences: termination of the contract when breach was substantial (Art. 6.217 of the Civil Code), reduction/refusal of the insurance compensation (par.7, Art. 14 of the Law on Insurance), and damage compensation for the losses suffered by the insurer (par. 3, Art. 6.245 of the Civil Code). However, analysing the provision of the par. 7, Art. 14 of the Law on Insurance, it is possible to conclude that the latter two remedies are actually one: the insurer can reduce the insurance compensation by the amount of losses suffered.

Lithuanian law is silent about the applicability of the proportionality rule in the case of post-contractual non-disclosure about the risk increase. As the law recognises the proportionality rule in the case of the pre-contractual non-disclosure, it should be optimal to apply the same rule in the case of the post-contractual non-disclosure, because the rationale of the proportionality rule is the same in both cases (see Chapter 3.10.2).

The breach of the post-contractual duty is the controversial area of English law; still there is a discussion about the existence of the post-contractual duty, whether the principle of avoidance *ab initio*, the single remedy in a case of non-disclosure, could be applied or not¹⁰⁶. However, the application of avoidance *ab initio* seems to be very problematical, because the breach takes place during the execution of the contract; avoidance *ab initio* cannot be justified if the contract was concluded in good faith.

The unclear legal remedy for post-contractual non-disclosure is the serious deficiency of English law. As one of the main functions of the remedy is the deterrence effect, the effect cannot be reached if the remedy is unclear, therefore, this can turn into *additional motives for the policyholder's moral hazard*.

Another significant difference in the law of two countries is the *rule of causation*. English law doesn't recognise the relevance of causation between non-disclosure and the insured event.

¹⁰⁶ *Colinvaux's Law of Insurance*, p. 129, see footnote 23.

Lithuanian law (par. 5, Art. 17 of the Law on Insurance) obliges the insurer to evaluate the causal relationship between the breach of the contract and the occurrence of the insured event. However, this rule should not be applied in the case of the breach of the pre-contractual disclosure due to mutual excludability with the proportionality rule (see Chapter 3.10.3). Post-contractual non-disclosure should lead to the application of the causation rule, because the principle of proportionality is not applicable in such cases.

If the proportionality rule is not fully recognised, English law should introduce causation rule to mitigate the effect of harsh remedies for negligent non-disclosure (see Chapter 3.10.1.2).

English law also doesn't recognise the *right of recovery against the policyholder* (described in the Chapter 3.10.) in compulsory liability insurance; breach of a contract can lead to refusal of the insurance compensation, therefore, the idea of victim protection by costs of the private insurer is not accepted by English law.

Contractual provisions of four types of compulsory insurance are established by regulation in Lithuania (motor third party liability insurance¹⁰⁷, biomedical research third party liability insurance¹⁰⁸, construction contractors' liability insurance¹⁰⁹, and construction projectors' liability insurance¹¹⁰), the contractual provisions of the other types of compulsory insurance existing in Lithuania are not regulated, the law just states the obligation to have liability cover, especially when it comes to various types of professional liability.

The right of recovery up to amount of the paid insurance compensation is recognised only in motor third party liability insurance and biomedical research third party liability insurance. However, despite the controversy of the right of recovery rule, the non-existence of the rule in the other types of compulsory liability insurance is an indication of lack of the systematic view to liability insurance in Lithuania, especially to its aim – victim protection, but in general such non-existence has no effects on asymmetric information (see Chapter 3.10.).

¹⁰⁷ *Del transporto priemoniu savininku ir valdytoju civilines atsakomybes privalomojo draudimo taisykliu ir tipiniu paprastuosiu, pasienio ir grupines transporto priemoniu savininku ir valdytoju civilines atsakomybes privalomojo draudimo sutarciu draudimo liudijimu (polisu) formu patvirtinimo (On Approval of the Motor Third Party Compulsory Liability Insurance Policy Conditions and Policy Forms (Insurance Certificates) for Regular, Frontier and Group Motor Third Party Compulsory Liability Insurance Contracts*, Decree No 1100 of the Government of the Republic of Lithuania, 13 September 2001, <http://www.vdpt.lt>

¹⁰⁸ *Del pagrindiniu tyreju ir biomedicininiu tyrimu usakovu civilines atsakomybes privalomojo draudimo taisykliu patvirtinimo (On Approval of the Main Researchers' and Biomedical Research Sponsors' Compulsory Liability Insurance Policy Conditions)*, Decree No 745 of the Health Minister of the Republic of Lithuania, 20 December 2000, <http://www.vdpt.lt>

¹⁰⁹ *Del rangovo civilines atsakomybes privalomojo draudimo taisykliu patvirtinimo (On Approval of the Construction Contractor's Compulsory Liability Insurance Policy Conditions)*, Resolution No 79 of the Board of the State Insurance Supervisory Authority, 30 April 2002, <http://www.vdpt.lt/valdybos.nutarimai.2002.phtml>

4.5. Policyholder's Remedies

J. Birds states that in English law the duty of disclosure “is in reality a meaningless duty because of the absence of an effective remedy for the insured faced with a breach by the insurers¹¹¹”, termination of the contract is the single remedy in case of the breach of duty¹¹².

The lack of adequate legal remedies is the characteristics of Lithuanian law too. Termination of the contract when the breach was substantial (Art. 6.217 of the Civil Code) and damage compensation (par. 3, Art. 6.245 of the Civil Code) consist possible remedies.

Due to the non-existence of comparable legal remedies (see Chapter 3.11) the situation in both countries cannot be considered efficient.

4.6. *Onus probandi*

Classical legal text, Colinvaux's Law of Insurance, states that “the burden of proving non-disclosure or misrepresentation is on the insurers”¹¹³. This statement is based on the analysis of two cases, *Davies v. National Fire (1891)* and *Joel v. Law Union (1908)*. However, courts not always follow the rule. L. M. Bowyer notices that “presently onus of proof is on the party guilty of misrepresentation or non-disclosure, typically the insured¹¹⁴”.

In Lithuania the insurer has to prove all circumstances, which allow him to refuse to pay or to reduce the insurance compensation (par. 6, Art. 14 of the Law on Insurance), therefore, the insurer has to prove that the policyholder has breached the duty of disclosure; this is an exception from the general rule which presumes the fault of the debtor (par. 1, Art. 6.248 of the Civil Code).

The *onus probandi* applied for the insurer is another method of protection of the policyholder, but it is also justified from the economic point of view:

- 1) *The deterrence effect for the moral hazard* of the insurer appears;
- 2) *The insurer can exercise the duty cheaper* due to the fact that all records related to the contract are kept by him (as the business professional) and not necessarily by the policyholder;

¹¹⁰ *Del statinio projektuotojo civilines atsakomybes privalomojo draudimo taisykliu patvirtinimo (On Approval of the Construction Projector's Compulsory Liability Insurance Policy Conditions)*, Resolution No 78 of the Board of the State Insurance Supervisory Authority, 30 April 2002, <http://www.vdpt.lt/valdybos.nutarimai.2002.phtml>

¹¹¹ Birds, J.; *Uberrima Fides – What use is the general principle any more?*
<http://www.shef.ac.uk/law/law343/starsea.htm>

¹¹² *Colinvaux's Law of Insurance*, p. 120, see footnote 23.

¹¹³ *Colinvaux's Law of Insurance*, p. 130, see footnote 23.

¹¹⁴ Bowyer, L. M.; p. 259, see footnote 52.

3) *It is relatively easier to prove the negative fact than the positive*, because in case of the policyholder's *onus probandi* the latter will have to prove that he disclosed *all* circumstances; and in the case of the insurer's *onus probandi* the insurer will have to prove that *some* circumstances were not disclosed.

Therefore, from law and economics point of view the rule of the insurer's *onus probandi* is preferable.

5. Conclusion

The duty of disclosure in insurance law can be an important tool to cope with asymmetric information. However, to make this tool more functional the following conditions are needed:

1) The requirement of the higher degree of confidence set by the law is the first important step for avoidance of the asymmetric information. Recognition of mutual *uberrima fides* principle is relevant; therefore, the law should pay attention to the insurer's duties arising out of this principle too;

2) The law should pay equal attention to pre-contractual and post-contractual disclosure. Information acquired during the execution of the contract is the important tool to control moral hazard of another party to the contract;

3) As in some cases the incentives of both parties to disclose information exist, the existence of clearly defined legal and contractual provisions is relevant to make these incentives functional;

4) The written form of disclosure is the most preferable;

5) The law should set the clear limits between categorisation and discrimination in underwriting area. This would allow the insurer to use categorised (group) risk sorting devices without possible speculations. The optimality is achieved when the combination of individualised (preferably based on not so costly *bonus malus* system) and categorised risk sorting devices is used. The policyholder has to receive the minimal information about the insurer's techniques used in assessment of the policyholder's risk level;

6) If there are no clear economic arguments of the benefit of the genetic testing disclosure, the preference should be given to the traditional underwriting techniques;

7) The *onus probandi* for the policyholder's breach of the duty should lie on the insurer;

8) The law should establish clear legal remedies for non-disclosure. As one of the main functions of the remedy is the deterrence effect, the effect cannot be reached if the remedy is unclear;

9) The legal remedies should be according to the degree of the fault, too harsh penalisation especially in cases of the policyholder's innocent non-disclosure doesn't reach deterrence effect; it is the unjustified punishment, which also results into passiveness of the insurer in obtaining the information;

10) The limited remedies from the policyholder's side have no real deterrence effect on the insurer, this is a serious deficiency of the insurance contract law; the law should balance the positions of the both parties to the contract.

Analysis of the duty of disclosure in England and Lithuania shows the existence of some significant differences; the situation is non-optimal in both countries. However, theoretical advantages of some provisions of Lithuanian law still have to be proven by long practical experience. The main differences in understanding of the duty of disclosure consist in different approach to insurance law: should it serve as a tool for the policyholder protection (Lithuania) or efficient operation of the insurance market (England)?

The idea that "divergences in insurance contract law are indeed a hindrance to the establishment and the functioning of the internal insurance market¹¹⁵" is not new in the EU level; sooner or later it should result in unification of the insurance contract law. The Project Group "Restatement of European Insurance Contract Law" established in Innsbruck, Austria acknowledges that the ideas of effecting risk bearing on the part of the insurer and good functioning of insurance business have to be balanced with a modern trend to grant a relatively high degree of protection to the policyholder¹¹⁶.

The aim to reach optimality gives some optimism that proper understanding and regulation of the duty of disclosure will take place too; this is an essential precondition for reduction of obstructions in insurance market – the problems of asymmetric information.

¹¹⁵ Project Group "Restatement of European Insurance Contract Law", see footnote 55.

¹¹⁶ Project Group "Restatement of European Insurance Contract Law", see footnote 55.

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