



FRACTURING AND BUNDLING RISKS: THE COVERAGE EXPECTATIONS OF THE “REAL” REASONABLE POLICYHOLDER

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When interpreting insurance contracts, legal systems often make reference to the expectations of the reasonable insured. The extent to which this has justified bending—and sometimes breaking—the literal meaning of the text differs from jurisdiction to jurisdiction. This paper proposes an addition to this debate: what if we reflected on the 'real' reasonable person, and not merely the judicially framed legal fiction? Why not use the developments in behavioural science to determine what consumers actually understand?

Standard UK building and contents household insurance policies are used as the basis for the analysis. Cover can be purchased:

- 1. in a single document from a single provider; OR*
- 2. in two distinct policies from the same provider; OR*
- 3. entirely separate.*

The fracturing (or bundling) of these risks can have significant legal consequences where coverage disputes arise, in particular where there is conflict between the two types of cover. This paper considers the basic assumptions (heuristics) recognized by law & psychology as fundamental to much of human decision making to support a synergistic approach to

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insurance contract coverage decisions. This requires us to move from the single transactional model still favoured in much of English law, to a more nuanced interpretation of insurance coverage provided across a range of different contracts and providers. This would minimize the disparity of approach between an insured purchasing the cover in a single transaction and by multiple contracts.

This move - to an explicitly customer focused approach to coverage disputes - is framed by reference to regulatory pressures on insurance companies (the requirement to 'treat customers fairly' enforced by the Financial Service Authority), by the growth in alternative dispute resolution (particularly, the jurisprudence of the Financial Ombudsman Service) and by developments in contract law generally. The notion of a literalist approach to contract coverage questions is discredited. The move to a real world 'reasonable person' is the logical next step.

I. INTRODUCTION: THE SHAPE OF BUILDINGS AND CONTENTS INSURANCE

The market for residential property insurance is well established within most Western States, and beyond. Within the United Kingdom (“UK”), it is the second largest personal line, behind motor insurance.¹ The two dominant products are buildings insurance and contents insurance, although other forms are now appearing, such as ‘Home Emergency’ cover.² In the UK, a majority of adults hold both, with a slightly greater proportion buying contents cover than buildings cover.³ Although at first sight these might appear as property insurances covering real property (buildings) and personal property (contents), in reality they are an amalgam of real and personal property and liability insurances. There is no neat divide between land and chattels, as might be attempted in an undergraduate law class. Moreover, there is often no neat geographical divide between ‘home’ and elsewhere. Insurance cover often extends to personal property used beyond the home. Instead, these contracts have evolved over time to meet the disparate needs of home owners, landlords, property financiers and tenants. The process by which the risks have been assimilated into the form of “contents” and “buildings” insurance is in itself worthy of attention. However, even starker are the legal consequences of subdividing these risks into the two distinct contracts. We now face not only the inevitable difficulty of rationalising the internal conflicts between positive statements of cover and exclusion clauses within a single legal

¹ FIN. SERV. AUTH., ICOP REVIEW INTERIM REPORT: CONSUMER EXPERIENCES AND OUTCOMES IN GENERAL INSURANCE MARKETS 22 (2007), *available at* http://www.fsa.gov.uk/pubs/other/ICOP_review.pdf.

² *Id.* This covers the costs of urgent repairs to vital household appliances such as central heating boilers, cookers, etc. ASS’N OF BRITISH INSURERS, GUIDE TO HOME BUILDING AND CONTENTS INSURANCE 7 (2012), *available at* <https://www.abi.org.uk/Insurance-and-savings/Products/~media/2BFFB3476ABF449984B137EF43F1B335.ashx> [hereinafter GUIDE TO HOME BUILDING]. Such losses would normally be excluded under the “wear and tear” exclusion, although the consequences of such losses might trigger buildings or contents cover.

³ ICOP REVIEW INTERIM REPORT, *supra* note 1, at 22.

document, but also the possible interactions between two contracts which in practice will be need to be read together. Moreover, the products are normally available separately. This raises the distinct possibility that an insured will have contents cover from one provider and buildings cover with another. This provides genuine difficulties for lawyers and regulators: how to ensure the required synergy across two separate markets.

This part of the paper considers the scope of buildings and contents insurance, and identifies some interpretative difficulties. Part II then reviews the developing contextual model for contractual interpretation in general and insurance law specifically. Part III seeks to adapt the contextual model to reflect the evidence of human behaviour from behavioural science and empirical studies. Part IV provides a brief conclusion.

A. THE STRUCTURE OF THE RESIDENTIAL PROPERTY INSURANCE MARKET

The recent history of the British insurance market is one of consolidation. Current figures indicate a concentration of market share in a small cluster of leading insurers,⁴ with each often carrying more than one well established brand.⁵ For consumers browsing an insurance price comparison website, the appearance of a diverse, competitive market place is misleading. The “competing” brands displayed are often stablemates, with five insurers holding 64% of the market in 2006.⁶ The 2010 average household expenditure on buildings and contents insurance was equal, with a mean of £130 per year on each form of cover.⁷ Indeed, the balance between contents and buildings expense was broadly similar across all income groupings.⁸

⁴ *Id.*

⁵ See, e.g., *Our Brands*, DIRECT LINE GROUP, <http://directlinegroup.com/our-brands.aspx> (last visited Dec. 17, 2013).

⁶ *Id.*

⁷ OFFICE FOR NAT'L STATISTICS, FAMILY SPENDING 2011 EDITION 25 (2012), available at <http://www.ons.gov.uk/ons/rel/family-spending/family-spending/family-spending-2011-edition/family-spending-2011-pdf.pdf>. This is an average expenditure, and includes uninsured households. *Id.* The mean outlay

The development of two distinct forms of property insurance arises out of the variable nature of home ownership. The “contents insurance” policy is suitable for tenants and homeowners, whereas the “buildings insurance” would only be of relevance to homeowners (and landlords). Within the UK, most households are based on home ownership (around 66%), with 14% renting in the private sector and the remainder in social rented housing.⁹ Around two-thirds of households have buildings cover, which is highly correlated with home ownership, and around three-quarters have contents insurance.¹⁰

At a technical level, the insurances have differing characteristics. Contents insurance is normally for a lower insured value—commonly £50,000—and would tend to attract regular, small claims.¹¹ By contrast, the upper limit for buildings insurance will normally be much higher, to reflect the rebuild cost of the property.¹² It is not uncommon for buildings insurance to be set in the £300,000–£500,000 range.¹³ Buildings insurance claims are likely to be of a higher value than contents, but with a significantly lower frequency.¹⁴

on cover ranged from £120pa total for the lowest income decile to £473pa for the top income group. *Id.*

⁸ *Id.*

⁹ *Id.* at 170.

¹⁰ HOWARD C. KUNREUTHER, MARK V. PAULY & STACEY MCMORROW, INSURANCE & BEHAVIORAL ECONOMICS: IMPROVING DECISIONS IN THE MOST MISUNDERSTOOD INDUSTRY 60–61 (2013).

¹¹ See GUIDE TO HOME BUILDING, *supra* note 2, at 8.

¹² The UK trade body for insurers, the Association of British Insurers, provides a home rebuild calculator at <http://abi.bcis.co.uk>.

¹³ See GUIDE TO HOME BUILDING, *supra* note 2, at 8.

¹⁴ ASS'N OF BRITISH INSURERS, UK INSURANCE KEY FACTS 7 (2012), available at https://www.abi.org.uk/~/_media/Files/Documents/Publications/Public/Migrated/Facts%20and%20figures%20data/UK%20Insurance%20Key%20Facts%202012.ashx. “The pay-out for an average household fire claim was £10,200, for a theft claim it was £1,500 and for a claim following a major flood it is estimated at £30,000.” *Id.*

The UK does not have a standardised insurance product to match the HO3 policy¹⁵ in use in the US. In recent times, there has been a trend towards providing insurance cover on a “pick and mix” basis, whereby a single document offers a range of different insurances from which the insured then selects. This has led to buildings and contents insurance frequently being sold in a single document; although, the products can be “decoupled” by indicating that only buildings or contents cover is required. This reduces administrative costs and is likely to push passive consumers into purchasing both products from a single provider.

In *Printpak v. AGF Insurance*, the Court of Appeal noted the legal issues arising from a single contractual document to cover variable risks.¹⁶ There, breach of an insurance warranty relating to theft was found only to invalidate that section of the cover, and not the entire policy.¹⁷ This is contrary to the normal English rule that breach of warranty discharges the insurer from all liability as from the date of breach.¹⁸

B. SCOPE OF “CONTENTS” AND “BUILDINGS” INSURANCE

The Association of British Insurers issued a consumer guide to household insurance, which provides a useful template for the “implicit form” of the respective insurances. In answering “What is contents insurance?” the guide states:

Contents insurance covers just about everything you would take with you if you moved house – furniture, carpets, curtains, kitchen equipment (freestanding, not fitted), clothes, televisions, computers and other home electronics and so on. Every policy has limits on how much you can

¹⁵ For an excellent review of the nature of the standard U.S. standard home insurance HO3 contracts, and its many variants, See Daniel Schwarcz, *Reevaluating Standardized Insurance Policies*, 78 U. CHI. L. REV. 1263 (2011).

¹⁶ *Printpak v. AGF Ins.*, [1999] A.C. 1449 (Eng.); see James Davey, *Printpak v. AGF Insurance: No Need to Be Alarmed?*, J. BUS. L. 580 (1999).

¹⁷ *Printpak v. AGF Ins.*, [1999] A.C. 1449 (Eng.).

¹⁸ *Id.*

claim, so you need to make sure that you are covered for the full cost of replacing the things you own.¹⁹

Similarly, for buildings insurance, it explains:

As well as the structure of the property, a buildings policy covers permanent fixtures and fittings such as baths and toilets, fitted kitchens and bedroom cupboards and the decorations inside your home, including wallpaper. Buildings policies usually also include garages, greenhouses and garden sheds at your home. However, cover can differ between different insurers (for example, some policies may not cover things like boundary walls, fences, gates, paths, drives or swimming pools), so it is important to check whether policies meet your needs.²⁰

The difficulty with these generalities is that they provide a false sense of clarity and simplicity. In truth, the division between buildings and contents cover will be complex, and in some case, arcane. In order to show the interpretative difficulties within residential property insurance, we take three case studies. Each is designed to show the process of interpretation through three distinct perspectives: the regulator, the insurer, and the consumer.

- The coverage of damage to the structure of the building (and associated losses) due to earth movement (“subsidence”).
- The limits on cover for real and personal property where the loss is occasioned by a person on the premises with the insured’s permission. This includes cases where permission was obtained by deception.

¹⁹ See GUIDE TO HOME BUILDING, *supra* note 2, at 7.

²⁰ *Id.* at 5.

- The limits of cover for “flood.” As an exemplar, we look at damaged floor coverings, and the differing regimes for replacement laminate floor and carpets.

1. Did the Earth Move for You? Settlement & Subsidence

Our first scenario, subsidence, arises due to the relationship between positive cover for damage to properties due to subsidence and attempts by insurers to exclude liability for losses due to very similar facts. The UK insurance regulator, the Financial Services Authority, challenged terms contained in buildings insurance policies issued by Legal and General Insurance under the Unfair Terms in Consumer Contracts Regulations 1999.²¹ The original clause read:

The buildings are insured against loss or damage caused by:	We will not pay for loss or damage:
...	...
5. subsidence or heave of the site on which the buildings stand or landslip	4. Caused by settlement, shrinkage or expansion

The substantial difficulty faced here by consumers was the reliance by Legal & General on apparently technical (subsidence; heave; settlement) terms, yet defined by their own parameters. The FSA made its challenge to the original provision as follows:

The terms “settlement, shrinkage or expansion” are very broad and there is considerable uncertainty when considering how these exclusions might be interpreted and applied. For example, the average consumer may consider that subsidence will necessarily involve some kind of settlement/downward movement of the land/soil

²¹ FIN. SERV. AUTH., REVIEW OF HOME INSURANCE POLICIES OFFERED BY LEGAL & GENERAL INSURANCE, (Dec. 1, 2012), http://www.fsa.gov.uk/consumerinformation/unfair_contracts/uct_term_changes/landg-home-insurance.shtml.

on which the building stands. The average consumer might also think that subsidence/heave would involve some kind of shrinkage or expansion of the soil in adverse climatic conditions and shrinkage/ expansion of building materials as a consequence. In summary, in our view, the wording of the Original Term makes it very difficult for the policyholder to determine what he/she is or is not covered for under the subsidence clause.²²

What we have here is a standard policy from one of the leading UK insurers that is drafted in terms inconsistent with the meanings understood by the “average consumer.” In this case, the clause is challenged under unfair terms legislation and replaced. The changes to the policy included a new insuring clause, exception, and detailed definitions to properly explain the limits of cover.²³ Crucially, this is extra-judicial. It is not cited in the Law Reports and is not a precedent. Moreover, the approach to unfair terms taken extends beyond that predicted in most insurance texts. Most commentators assume that exclusions of liability are left to market forces and are not regulated by the Unfair Terms in Consumer Contracts Regulations 1999, in line with the stated objectives of the EU Directive that spawned the Regulations.²⁴

It shows the important role regulators are playing in the UK market, independent of the judicial standards of interpretation and enforcement.

2. Not Just the Dog Walked: Third Party Access and Theft Claims

In our second case study, we examine the standard approach taken by insurers in buildings and contents cover to theft or

²² FIN. SERV. AUTH., NOTICE OF UNDERTAKING 3 (Dec. 14, 2011), <http://www.fsa.gov.uk/static/pubs/other/lg-insurance-undertaking.pdf>.

²³ See REVIEW OF HOME INSURANCE POLICIES, *supra* note 21.

²⁴ See generally Robert Merkin, *Unfair Terms in Insurance Contracts: A Solution in Search of a Problem?*, 23 INS. L.J. 272 (2012) (providing recent discussion of unfair terms legislation in this context).

damage caused by persons on the premises with the insured's permission. These third parties can range from tenants with a proprietary right to residence through occasional visitors—such as workmen—to those only on the property by means of a deception or criminality. The lack of a clear standard for cover, and anecdotal evidence of insurer's attempts to defend claims on these grounds, is startling.²⁵ For claims handlers, a narrow interpretation of cover and a broad interpretation of exclusions are a necessary part of minimising costs.

The issue was brought to my attention by a sad state of affairs affecting a colleague at Cardiff Law School. As a working mother and faculty property lawyer, she had given keys to her house to her cleaner and to a dog walker. The dog walker required access to the property to take the dogs for their exercise. After a period of several months, it became evident that someone had been committing systematic thefts from the house of jewellery, clothes, and other valuables. The evidence pointed to the partner of the dog walker having committed these offenses, having obtained the key to the premises. He is, as they say, assisting police with their enquiries.

What then of the insurance cover? Some policies only cover violent theft, thereby requiring the use of force to enter the property, such as a break-in.²⁶ This policy had no such limit. The insurer denied liability for the thefts on two grounds, both written in as exceptions to coverage in cases of non-violent theft. First, that the property had been “sub-let” by providing the dog walker with a key to the premises. Given that her teaching duties include our undergraduate Land Law course, my colleague was a little perturbed to see this argument run. There may have been a contractual licence to access the ground floor granted to the dog walker, but a tenancy to a third party who had obtained the key without permission? It seems that “Delay, Deny, Defend” is not restricted to the US.²⁷

²⁵ JUDITH P. SUMMER, INSURANCE LAW & THE FINANCIAL OMBUDSMAN SERVICE 61 (2010).

²⁶ The restriction of household insurance cover was considered in the Financial Ombudsman Service, available at <http://www.financial-ombudsman.org.uk/publications/ombudsman-news/10/oct-case-roundup.htm>.

²⁷ See generally JAY FEINMAN, DELAY, DENY, DEFEND: WHY INSURANCE COMPANIES DON'T PAY CLAIMS AND WHAT YOU CAN DO ABOUT IT (2010).

The second basis for denying the claim was that the policy excluded thefts by guests. This we resisted on the grounds that a guest is a social visitor, and not someone employed to carry out duties at the premises. In any case, the partner of the dog walker was not invited into the premises.

The insurer denied liability by letter. When challenged, it reaffirmed by telephone call its refusal to pay on the same grounds. The internal complaints department did likewise. When my colleague replied: “Fantastic. Great news. So, let’s get this all in writing so I can proceed to the Insurance Ombudsman,”²⁸ the insurance company representative’s computer suddenly malfunctioned. Fortunately, I had been able to prime her with her options for challenging the insurer in front of the Financial Ombudsman Service, and a sample of its prior decisions in related areas. It was these details that she recounted to the representative just before his mysterious computer problem. An hour later, the call came: “We are Lloyd’s and we are sorry.” The claim has been paid in full, with a small additional sum as compensation for the inconvenience.

At the heart of this story lies a central truth. The phrases that insurers use to define cover and to deny liability do not have a single established meaning. The process of interpretation and definition is not concluded within the policy, even where definitions are provided. Moreover, these inconsistencies and ambiguities provide opportunities for overzealous claims handlers to deny liability without justification. Most consumers would not be expert land lawyers with an insurance law colleague to consult. This is further exacerbated when the event gives rise to possible losses under both the contents and the building cover. Each may have different approaches to losses caused by third party entry. This would arise, for example, in a situation where an “ex” returns to

²⁸ Insurers in the UK have to pay a fee for having a case investigated by the Ombudsman, are bound by its result—up to a set limit—and have little procedural advantage as it is informal and designed to be used by parties without legal representation. An excellent introduction to the UK Financial Ombudsman Service is provided by Judith Summer in *supra* note 25. For a comparison with the U.S. position, see Daniel Schwarcz, *Redesigning Consumer Dispute Resolution: A Case Study of the British and American Approaches to Insurance Claims Conflict*, 83 TUL. L. REV. 735 (2009). This is assumed to provide a very real incentive to pay genuine claims promptly.

the marital home and damages clothes, carpets, and walls by throwing around paint and drawing graffiti.

Ultimately, the lack of consistency of approach matters because consumers cannot be expected to be experts. The likely chilling effect of an insurer asserting a lack of coverage is well established. As the Financial Services Authority noted in the Legal & General “subsidence” case above: “The vagueness of the wording also makes it difficult for the consumer to determine whether he/she is or is not covered by the term and to challenge the insurer’s decisions.”²⁹

3. Flood and Damaged Floorings: Chattels vs. Real Property Revisited

As a final example of the bundling and fracturing of risks, we take an example directly concerned with the overlap between buildings and contents coverage: the damage of floor coverings by a flood. Such events represent a regular cause of loss.

Imagine the ground floor³⁰ of a residential house. Water damage occurs when a blocked outlet on the exterior of the building causes an overflow of water into the main premises, to a depth of several inches. The householder has both buildings and contents cover that insures against “flood,” but not on identical terms. The living room has a carpeted floor. The adjoining hall and downstairs cloakroom has been covered with a laminate floor. The laminate runs from wall-to-wall and the boards are glued together. At present, most insurers would treat the damage to the carpets as a contents insurance claim, but the damage to the laminate floor as a buildings policy issue.

Given that the definition of flood has proved so difficult to establish in English law, there is the very real possibility that the buildings and contents policies will have divergent interpretations of “flood” and that cover will not be seamless. This is not merely an issue within the United Kingdom and has been described in some depth in Australia and elsewhere.³¹

²⁹ See REVIEW OF HOME INSURANCE POLICIES, *supra* note 21.

³⁰ For Americans, the “first floor.” You say tomato, etc.

³¹ See Justine Bell, Flood Insurance, *Denials of Claims and the Financial Ombudsman Service*, 22 INS. L. J. 40 (2011); Justine Bell, *When Will a Flood Be Classified as a “Flood”? A Review of the Insurance Contracts Act Reform*, 23 INS. L. J. 312 (2012).

Let us take the first the division between real and personal property in household insurance. This is what makes the laminate flooring part of the land and the carpets part of the contents. The division between the two categories is a matter of law and “the subjective intention of the parties cannot affect the question whether the chattel has, in law, become part of the freehold.”³²

English law has developed a two-stage test for considering whether a piece of personal property has become affixed to the land: (1) The degree of annexation, and (2) the purpose of annexation.³³

What is clear from the texts is that this distinction is a fine one, and the judicial application of the test has not been entirely consistent. Pieces of art which could only be displayed by being nailed to the wall were considered to remain as personal property,³⁴ but even items standing under their own weight have been held to become affixed.³⁵ This explains the extension of many building insurance policies to ornamental statutes and other items designed to permanently improve the premises.³⁶ In a recent high value case concerning steel manufacturing machinery, Morgan J commented on the uncertain nature of the law:

The legal tests that apply to distinguish a chattel from a fixture and a removable fixture from a non-removable fixture are the subject of a large number of cases decided over the centuries. It has been said that it is not possible to reconcile all of the decisions. Further, whilst there are many illustrations in cases in the 19th century, and earlier, of these principles being applied, there are

³² CHARLES HARPUM, STUART BRIDGE & MARTIN DIXON, MEGARRY & WADE: THE LAW OF REAL PROPERTY 1103 (Charles Harpum et al. eds., 8th ed. 2012).

³³ *Id.* at 1105.

³⁴ *In re De Falbe*, [1901] 1 Ch. 523, *sub nom* Leigh v. Taylor, [1902] 127 (A.C.) at 161 (Eng.).

³⁵ *D'Eyncourt v. Gregory*, [1866] L.R. Eq. 382 (Eng.).

³⁶ *Id.* at 396.

rather fewer illustrations in the 20th or even the 21st century.³⁷

Once we have identified whether the floor covering is insured under the contents or buildings cover, we must determine the limits of the peril of “flood.”

The current interpretation of flood favoured by the courts—and the Financial Ombudsman Service—is found in *Rohan Invs. Ltd. v. Cunningham*.³⁸ In this case, the insured claimed for damage to the contents of his property caused by the entry of water through a flat roof.³⁹ He was insured for the perils of “storm, tempest or flood” and “the escape of water from fixed pipes.”⁴⁰

Whilst the owner was away from the property the water had accumulated to a height of 3–4 inches, causing substantial damage to the carpets and other contents.⁴¹ The court found that there had been adverse weather for a substantial period of time, and the accumulation of water on the flat roof had led to the internal water damage.⁴²

The insurer denied liability on the basis that this was not a “flood.”⁴³ It argued that flood required a sudden, violent entry of water.⁴⁴ In doing so, reliance was placed on the earlier authority of *Young v. Sun Alliance*.⁴⁵

In the *Young* case, the insured suffered damage to a downstairs cloakroom caused by the seepage of water from an

³⁷ Peel Land & Prop. (Ports No. 3) Ltd. v. TS Sheerness Steel Ltd., [2013] EWHC (Ch.) 1658 [3] (Eng.).

³⁸ *Rohan Invs. Ltd. v. Cunningham*, [1999] Lloyd’s Rep. 190. (A.C.)

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.* at 190–91.

⁴³ *Id.* at 190.

⁴⁴ *Rohan Invs. Ltd.*, Lloyd’s Rep. 190 (A.C.) at 191.

⁴⁵ *Id.*

underground source.⁴⁶ This caused the gradual accumulation of water within the property, to a height of around three inches.⁴⁷ In colloquial speech, it might have been said that the room “flooded.”⁴⁸ However, the policy covered “[s]torm, tempest or flood” in its insuring clause, and the Court of Appeal refused to apply the popular meaning of the word flood.⁴⁹

Shaw L.J. concluded:

[I]t seems apparent that what the policy was intending to cover, whatever may be the colloquial use of the word “flood” in common parlance, were three forms of natural phenomena which were related not only by the fact that they were natural, but also that they were unusual manifestations, certainly of those phenomena: that is to say, “storm” meant “rain accompanied by strong wind”; “tempest” denoted an even more violent storm; and “flood” was not something which came about by seepage or by trickling or dripping from some natural source, but involved “an overflowing or irruption of a great body of water” as one of the definitions in the Shorter Oxford English Dictionary, 3rd ed. (1944), puts it. The slow movement of water, which can often be detected so that the loss threatened can be limited, is very different from the sudden onset of water where nothing effective can be done to prevent the loss, for it happens too quickly.⁵⁰

In *Young*, the popular meaning of the word “flood” was displaced by two considerations: first, its immediate context within the policy alongside words denoting a violent weather event—tempest and storm—and second, by means of reference

⁴⁶ *Young v. Sun Alliance*, [1977] W.L.R. 104 (A.C.) at 104 (Eng.).

⁴⁷ *Id.*

⁴⁸ *Id.* at 106.

⁴⁹ *Id.* at 106–07.

⁵⁰ *Id.* at 107.

to a dictionary definition of flood.⁵¹ Combined, they produce the criterion alluded to by Shaw L.J. that a flood must be sudden and overwhelming, rather than intermittent or gradual.

In *Rohan*, the immediate context of the insuring clause was different. The accompanying perils were no longer limited to violent natural events—storm and tempests—but accompanied by “the escape of water from . . . fixed pipes.”⁵² This final event has no inherent violent element; indeed leakage from, rather than the total rupture of, a fixed water pipe must have been within the contemplation of the parties. Rather than seeking to lay down an exhaustive definition of “flood,” the Court of Appeal in *Rohan* suggested that it was a matter of degree whether any incursion of water could be described as a flood.⁵³

This pragmatic approach was followed by Jackson J. in the High Court in *Tate Gallery v. Duffy Construction*.⁵⁴ He synthesised the earlier approaches of the judiciary in *Young*, *Rohan*, and elsewhere as follows: “The judgments... do not lay down rules of law as to the meaning of the words ‘flood’ and ‘burst’ in every insurance policy or construction contract.”⁵⁵

The words must therefore, as expected, be interpreted in light of the contractual and market context in which they operate. He determined six criteria by which the nature of the peril could be established:

In determining whether the unwelcome arrival of water upon property constitutes a “flood”, it is relevant to consider (a) whether the source of the water was natural; (b) whether the source of the water was external or internal; (c) the quantity of water; (d) the manner of its arrival; (e) the area

⁵¹ *Id.*

⁵² *Rohan Invs. Ltd. v. Cunningham*, [1999] Lloyd’s Rep. 190 (A.C.) at 190 (Eng.).

⁵³ *Id.* at 191 (“I accept the importance of keeping a uniformity of words but the definition is not to be construed as statutory. . . . It is a question of degree and the size of the premises must be considered.”).

⁵⁴ *Tate Gallery v. Duffy Constr.*, [2007] EWHC (TCC) 361 [37] (Eng.).

⁵⁵ *Id.*

and character of the property upon which the water was deposited; (f) whether the arrival of that water was an abnormal event.⁵⁶

Where a judge considers a peril to be indefinable in precise terms, and a matter of judgment and degree, we can safely assume that it is beyond the comprehension of the ordinary insured when purchasing insurance. Given that small changes in the policy wordings are apparently capable of significant effects on coverage, there is a real danger that consumers are being asked to step into the unknown. We turn now to the judicial process of resolving contractual ambiguity.

II. THE QUIET REVOLUTION: ENGLISH LAW & THE CONTEXTUAL MODEL OF INTERPRETATION

Insurance, as with many commercial contracts, is dependent on a settled mechanism for interpreting the limits of the contractual promises contained within the document. In insurance, disputes may arise out of coverage issues, promises by the insured to maintain the risk with agreed boundaries (such as warranties), or claims conditions. In this paper, we are largely concerned with the first issue: the limits of coverage as determined by the insurer's positive statements of cover, and the exceptions expressed as limits on this. The need for interpretative guidance from the court can arise for a number of reasons: lack of clarity in the original policy; a disparity between technical and popular meanings of a word (think: "theft" or "flood"), and apparent conflicts between positive cover and exceptions to cover. In each case the court must resolve the dispute by determining the intentions of the parties.⁵⁷ This is rarely simple, as the insurer will normally have drafted the document and has the status of an expert, repeat player. By contrast, the insured may be completely ignorant as to the actual

⁵⁶ *Id.*

⁵⁷ See Oliver Brand, *Contract Terms: Judicial Approaches to the Interpretation of Insurance Contracts*, in RESEARCH HANDBOOK ON INTERNATIONAL INSURANCE LAW AND REGULATION 93, 93 (Julian Burling & Kevin Lazarus eds. 2011) (providing a useful comparative survey of approaches to insurance interpretation).

terms of the policy, and have only a basic sense of what has been promised. In such cases, the judicial discovery of mutually agreed limits to cover is likely to be fictitious. This legal fiction is often justified on the basis that it represents the understanding of the “reasonable man” or “reasonable insurer.”⁵⁸ This paper goes behind this fiction to explore the limits of what really is understood by insureds and insurers.

A. THE “WELL-INFORMED” REASONABLE MAN: LORD HOFFMAN’S BASIS FOR INTERPRETATION

The most significant recent shift in the interpretation of commercial contracts in English law came in *Investors Compensation Scheme Ltd. v. West Bromwich Building Society*.⁵⁹ In an otherwise unremarkable case, Lord Hoffman gave a comprehensive restatement of the principles of judicial interpretation, and thereby aligned the process of contractual interpretation with that of statutory interpretation.⁶⁰

His aim was to demystify the process of contractual interpretation, and his approach is broadly contextual in nature. In stating his objective, he made clear that he was returning to non-technical methods of construction:

The result has been, subject to one important exception, to assimilate the way in which such

⁵⁸ See Lord Johan Steyn, *Contract law: fulfilling the reasonable expectations of honest men*, 113 L.Q.R. 433 (1997).

⁵⁹ *Investors Comp. Scheme Ltd. v. West Bromwich Bldg. Soc’y*, [1997] 1 W.L.R. 896 (H.L.) (Eng.). For a review of U.S. principles, which are beyond the scope of this paper, see Michelle Boardman, *Risk Data in Insurance Interpretation*, 16 CONN. INS. L.J. 157, 169–72 (2009) (summarizing U.S. principles of interpreting commercial contracts). The *Investors Compensation* decision has generated a considerable amount of comment. See, e.g., Lord Anthony Grabiner, *The Iterative Process of Contractual Interpretation*, 128 L.Q.R. 41 (2012); David McLaughlin, *Common Intention and Contract Interpretation*, L.M.C.L.Q. 30 (2011); Lord Thomas Bingham, *A New Thing Under the Sun? The Interpretation of Contract and the ICS Decision*, 12 EDIN. L. REV. 374 (2008); Sir Christopher Staughton, *How Do the Courts Interpret Commercial Contracts?*, 58 C.L.J. 303 (1999). The number of judges writing extra-judicially on this case is probably unprecedented.

⁶⁰ *Investors Comp. Scheme Ltd.*, 1 W.L.R. at 897.

documents are interpreted by judges to the common sense principles by which any serious utterance would be interpreted in ordinary life. Almost all the old intellectual baggage of 'legal' interpretation has been discarded.⁶¹

This grounding of judicial practice in the everyday is crucial. Lord Hoffman is not asserting a technocratic model that can only be attempted by the expert. He is markedly tying his practice to that of the participants in the market in which the contract was made.⁶² This is not a normative exercise, but a mirroring of the real world. This is to explicitly make the inquiry a social one. Whether the contract was formed in the commodities market, or on the High Street, it is to be understood in its socio-economic context. As so often in socio-legal thought, the difficulty is in insuring that the legal process accurately assimilates the social circumstances.

Lord Hoffman's first principle of interpretation describes the nature of the inquiry: "(1) Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract."⁶³

It must be emphasised that Lord Hoffman is not stating how we are to discover the parties' actual intentions. This is an objective process by which the interpretation of a reasonable person acts as a proxy for the parties' actual understanding of the terms agreed.⁶⁴ It is a resurrection of the "officious bystander" test, whereby a reasonable person is introduced at the moment of contracting and shown the contractual document and the surrounding context.⁶⁵ The question, as in much of

⁶¹ *Id.* at 912.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.* at 913.

⁶⁵ The officious bystander test is prevalent in English law and imagines the contracting parties being interrupted by an interfering outsider, who questions them on whether they have agreed on a particular point. This thought

private law, is how to model the thought processes of the “well-informed” reasonable man.

Lord Hoffman continued by stressing the width of the surrounding context:

(2) The background was famously referred to by Lord Wilberforce as the “matrix of fact,”⁶⁶ but this phrase is, if anything, an understated description of what the background may include. Subject to the requirement that it should have been reasonably available to the parties and to the exception to be mentioned next, it includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man.

(3) The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification. The law makes this distinction for reasons of practical policy and, in this respect only, legal interpretation differs from the way we would interpret utterances in ordinary life.⁶⁷

This approach to interpretation has been widely accepted in successive judgments. Lord Clarke, in the Supreme Court in *Rainy Sky SA v. Kookmin Bank*,⁶⁸ confirmed the approach in the following terms: “[T]he ultimate aim of interpreting a provision in a contract, especially a commercial contract, is to determine what the parties meant by the language used, which

experiment can be traced to *Shirlaw v Southern Foundries* (1926) Limited [1939] 2 K.B. 206, 227.

⁶⁶ *Prenn v. Simmonds*, [1971] 1 W.L.R. 1381 (H.L.) 1384 (Eng.).

⁶⁷ *Investors Comp. Scheme Ltd.*, 1 W.L.R. at 912–13.

⁶⁸ *Rainy Sky SA v. Kookmin Bank*, [2011] UKSC 50, 1 W.L.R. 2900 (appeal taken from Eng.).

involves ascertaining what a reasonable person would have understood the parties to have meant.”⁶⁹

However, it has been criticised by some as giving too little focus to the terms of the contract itself. Two concerns have been expressed:

- That the contract will become ambiguous when read in light of its full context, although of plain meaning when read literally;⁷⁰ and
- That the court will be encumbered by the weight of the data to be considered.⁷¹

We are concerned with the second issue, the risk of data overload, as expressed by Sir Christopher Staughton L.J., writing extra-judicially:

It is hard to imagine a ruling more calculated to perpetuate the vast cost of commercial litigation. In the first of the *Mirror Group Newspapers* cases I said that, as it then appeared to me, the proliferation of inadmissible material with the label “matrix” was a huge waste of money, and of time as well.⁷²

This risk of wasted time and expense is disputed, not least by Arden L.J.:

When the principles in the *ICS* case were first enunciated, there were fears that the courts would on simple questions of construction of deeds and documents be inundated with background material... Speaking for myself, I am not aware that the fears expressed as to the opening of

⁶⁹ *Id.* at 2900.

⁷⁰ Lord Bingham, *A new thing under the sun? The interpretation of contract and the ICS decision*, EDIN. L. REV. 374, 384 (2008).

⁷¹ *Id.*

⁷² Staughton, *supra* note 59, at 307.

floodgates have been realised. The powers of case management in the Civil Procedure Rules could obviously be used to keep evidence within its proper bounds. The important point is that the principles in the *ICS* case lead to a more principled and fairer result by focusing on the meaning which the relevant background objectively assessed indicates the parties intended.⁷³

Whoever we agree with, the crucial point is that it is the judge that determines the evidence that ought to frame the context. If Hoffman is to achieve his “common sense” revolution, then the judicial sense of what a reasonable person would have used as relevant data must match that of the real world. Moreover, the data must be then understood in an identical fashion. This begs the questions: how do people think? And how do judges think people think?⁷⁴

Therefore, we are not concerned with the magnitude of the external data used in the process of interpretation, but the method by which that data is to be comprehended. It is not enough that the judge has the information that the parties had access to; he must use it in the same manner that the parties would have used it, if he is to mirror their understanding. If Hoffman is to achieve his goal -- to mirror the thought processes of the reasonable man -- then the judge must not only know what the parties knew, but think how they thought. That requires a further level of sophisticated analysis that *Investors Compensation Scheme Ltd.* lacks. In handling the background knowledge, Lord Hoffman gave little indication on how the data is to be utilised, other than recognising that normal people make mistakes, such that the apparent intent may conflict with the written terms of the contract:

(4) The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries

⁷³ Egan v. Static Control Components (Eur.) Limited, [2004] EWCA (Civ) 392, [29], 2 Lloyd's Rep. 429, 435 (Eng.).

⁷⁴ See *infra* Part III. 2. B.

and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean. The background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax: see *Mannai Investments Co. Ltd. v. Eagle Star Life Assurance Co. Ltd.* [1997] A.C. 749.

(5) The "rule" that words should be given their "natural and ordinary meaning" reflects the common sense proposition that we do not easily accept that people have made linguistic mistakes, particularly in formal documents. On the other hand, if one would nevertheless conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had.⁷⁵

Adding this to the contextual nature of the model, Lord Clarke summarised the interpretative model as a one step process:

[T]he exercise of construction is essentially one unitary exercise in which the court must consider the language used and ascertain what a reasonable person, that is a person who has all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract, would have understood the parties to have meant. In doing so, the court must have regard to all the relevant surrounding circumstances. If there are two possible constructions, the court is entitled to

⁷⁵ *Investors Comp. Scheme Ltd.*, 1 W.L.R. at 913.

prefer the construction which is consistent with business common sense and to reject the other.⁷⁶

A summary of the issues is needed. Lord Hoffman has sought to introduce a contextual model of interpretation that draws upon a wide range of data external to the written contract.⁷⁷ This has been supported and applied by further appellate court decisions.⁷⁸ It is not expressed normatively: this is expressly not “top down” instruction as to how the document ought to be read. Rather it claims legitimacy from its ability to hold a mirror to the real world and to replicate some “common sense” interpretation by placing it in its factual context.

There are two objections that can be made to this. The first is familiar and not dwelt on here. The British judiciary is often criticised for being unrepresentative—“male and pale”; educated in elite private schools and universities. This paper makes a second, wider point: that people do not generally understand how people think. Not because they are unrepresentative, but because the complexities of human behaviour are not always appreciated by humans, not even judges. This is crucial where a rule is designed to replicate the real. It is not enough to be a human, you need to understand human decision-making. Not all judges are persuaded that their senior colleagues can effectively operate common sense rules. One obvious example was Ward L.J., a senior Court of Appeal judge, doubting his colleagues’ ability to display the “common sense” called for under the Hoffman test: “It goes to prove what every good old-fashioned county court judge knows: the higher you go, the less the essential oxygen of common sense is available to you.”⁷⁹

What Hoffman does not seek to do is to imagine *what* the reasonable person would have done with this data. If the implicit assumption is that (s)he would have considered the context in close detail, then this appears to replace the prior legal fiction that words have a fixed and settled meaning with a

⁷⁶ *Rainy Sky*, 1 W.L.R. at 2908 21.

⁷⁷ *Investors Comp. Scheme Ltd.*, 1 W.L.R. at 912–13.

⁷⁸ *Rainy Sky*, 1 W.L.R. at 2900 21.

⁷⁹ *Oceanbulk Shipping & Trading SA v. TMT Asia Ltd.*, [2010] EWCA (Civ) 79, 41, 1 W.L.R. 103 (Eng.) (Ward, L.J., dissenting), *rev’d* [2010] UKSC 44.

fresh deceit: that parties frame their contracts in a highly efficient fashion following mutual and careful consideration of the surrounding circumstances. This suggests a level of rational thought and planning to be found in law and economics hypotheticals and not in the real world.

As David McLaughlan noted:

A high proportion of the contract disputes that come before the courts involve issues of interpretation [A] feature of the great majority of these cases is that at the time of formation the parties did not contemplate the situation that later arose, let alone give any thought to the effect of the relevant words in that situation. There is no question, therefore, of their having formed any intention as to the meaning of the word.⁸⁰

To complete Lord Hoffman's odyssey we need to consider the extent to which the context informs contractual decision-making. It is not enough to have the data; we need the code of the software by which we will process it.

B. THE INSURANCE CONTEXT⁸¹

In Part III, we will examine how the Hoffman model might be used to provide an extended range of evidence to judges interpreting insurance contracts. Before doing so, we will examine some examples of how the test has been used in prior cases.

1. Judicial Application of the Contextual Model in Insurance Disputes

Our first example applying the *ICS v. West Bromwich* model in an insurance context is found in a small scale commercial

⁸⁰ McLaughlin, *supra* note 59, at 30.

⁸¹ See generally MALCOLM A. CLARKE, THE LAW OF INSURANCE CONTRACTS Ch. 15 (looseleaf, 2013).

case, *The Resolute*.⁸² The case concerns a limitation on cover, which required that: “Warranted Owner and/or Owner’s experienced Skipper on board and in charge at all times and one experienced crew member.”⁸³

The proper interpretation to be given to this clause was not clear. A literal interpretation would require twenty-four hour per day crewing.⁸⁴ Given that fishing vessels of this type are often prevented from operating for substantial periods of the year—due to poor weather and/or licence restrictions on the number of days spent at sea—this would be uneconomic. In addition to the broader commercial context of the policy, Lord Clarke MR considered a specialist rule of interpretation of insurance warranties that required limits on cover to be expressed in the clearest possible terms.⁸⁵ He repeated with approval the approach taken in *Hussain v. Brown* that “if Underwriters want such protection, it is up to them to stipulate for it in clear terms.”⁸⁶ This is the product of the combination of two assumptions as to interpretation of insurance contracts. First, that as the insurer has normally drafted the terms, and is seeking to rely on them; they should be interpreted *contra proferentem*. Second, exceptions to cover should be read narrowly. Both of these principles are longstanding recognitions that insurance contracts are commonly contracts of adhesion, whether in pure consumer transactions, or SME contracts such as in *The Resolute*.⁸⁷

In establishing the context in which the insurance was to take place, Clarke MR considered the normal operating conditions of the trawler: “[T]he insured vessel was a trawler with a small crew, spartan living accommodation and the ability to fish at sea for only a limited number of days a year.”⁸⁸

⁸² *Pratt v. Aigaion Ins. Co. SA*, [2008] EWCA (Civ) 1314.

⁸³ *Id.* at 1.

⁸⁴ *Id.* at 19.

⁸⁵ *Id.* at 13.

⁸⁶ *Id.* (citing *Hussain v. Brown*, [1996] 1 Lloyd’s Rep. 627, 630).

⁸⁷ I estimate that her annual gross earnings at the time of loss would be in the £500,000 to £600,000 range.

⁸⁸ *Pratt*, EWCA (Civ) at 21.

In seeking the proper reading of the phrase “at all times,” which the insurer conceded could not have been meant literally, Clarke MR adopted a deliberately purposive approach, reliant on Lord Hoffman’s restatement:

As I see it, the principal time when at least two members of the crew including the skipper would be required was when the vessel was being navigated, including when she was manoeuvring. I can see that it would probably be held to apply when the vessel was, say, landing her catch, when again there might well be a need to have the skipper and a crew member on board.⁸⁹

The Resolute represents the high water of insurance contextual interpretation. The judge is attempting a purposive approach, but fails to go beyond the immediate factual situation to consider the level of sophistication of the insured. As we will see, in most insurance cases, the judge rarely goes beyond the policy language itself. The “four corners” rule may no longer be binding, but a literalist, formalist tendency remains in some judges.

Our second example of insurance interpretation arises in a home insurance policy issued shortly after the decision in *ICS v. West Bromwich* was reported. *Ronson International Ltd. v. Patrick*⁹⁰ was argued on the ordinary meaning of words, with only limited reference to the commercial and consumer context in which it arose.

In *Ronson*, the insured’s eleven year old son was found to have intentionally set a small fire in a derelict part of an industrial estate.⁹¹ Although the evidence was not conclusive, it is likely that this spread and caused substantial damage to business premises.⁹² The son was charged and subsequently

⁸⁹ *Id.* at 25.

⁹⁰ *Ronson Int’l Ltd. v. Patrick*, [2005] EWHC (QB) 1767.

⁹¹ *Id.* at 13.

⁹² *Id.* at 7.

acquitted of criminality, as it did not seem likely that he had intended the minor fire to spread.⁹³

Nonetheless, a civil claim was pursued against the Patrick family for compensation.⁹⁴ It was clear that this was intended to trigger liability under the household insurance policy, and that judgment would not be enforced beyond the limits of insurance cover. It was a composite buildings and contents policy, and the liability insurance element extended to members of the household for losses including “accidental damage to property neither belonging to nor in the custody or control of those insured under this section.”⁹⁵

The insurer denied liability on the basis of an express exclusion clause, withdrawing cover for “any wilful, malicious or criminal acts.”⁹⁶

On the facts as agreed, there was no possibility of defeating the claim on the basis of malice or criminality. This was a small fire, built of discarded wooden pallets, in a derelict part of an industrial estate.⁹⁷ The question for the court was whether it was wilful. The insurer asserted that “wilful” is a legal term of art, meaning that it was done intentionally of free will.⁹⁸ This was contrasted with inadvertently starting a fire. The court rejected this analysis, on the basis that most negligent acts involve a deliberate action done badly, or with limited appreciation of the likely consequences.⁹⁹ To interpret the exception so widely would be to deprive the insured of much of the cover granted under the insuring clause. Moreover, on a broader reading of the prior case law, HHJ Seymour QC thought the proper interpretation of “wilful” was “the person alleged to

⁹³ *Id.* at 24.

⁹⁴ *Patrick v. Royal London Mut. Ins. Soc’y Ltd.*, [2006] EWHC (Civ) 421.

⁹⁵ *Id.* at 3.

⁹⁶ *Id.*

⁹⁷ *Id.* at 1.

⁹⁸ *Id.* at 9.

⁹⁹ *Id.* at 14.

have acted wilfully intended to produce the consequences in fact produced by his conscious act.”¹⁰⁰

On this basis, the act was not a wilful one. The intent was to set a small, controlled fire and not to destroy valuable property. What is notable is that the interpretive model here does not reflect any attempt to capture the understanding of a well-informed “reasonable” outsider. Rather, we see technical discussion of case law and dictionaries. This seems ill-judged in the interpretation of a consumer policy. One might, at least, have expected some discussion of the insurer’s need to communicate its intentions. This is a classic contract of adhesion. If the insurer was not clear, it might not only suffer the burden of the *contra proferentem* rule, but might also have fallen below the standards set by regulators and Ombudsman. We now turn to that issue; the role in interpretation that the expectations of regulatory bodies will play.

3. Wider Regulatory Influences on Interpretation in the Insurance Context

The pattern of insurance regulation in the United Kingdom has focused around two key organisations. The Financial Services Authority (“FSA”) operates as a super regulator across the financial services industry and is the chief licensing authority.¹⁰¹ There are a set of general principles applicable to all businesses and specific codes of conduct for varying types of insurers and other financial services entities. In insurance, the current incarnation of the code is known as ICOBS.¹⁰² It provides a mixture of standards and guidelines for behaviour, including detailed provision for the disclosure of policy

¹⁰⁰ *Ronson Int’l Ltd.*, EWHC (QB) at 22.

¹⁰¹ Following a review of the FSA’s role in the regulation of financial services — including banks and insurers — during the banking crisis, it has been rebadged as the Financial Conduct Authority (under s. 6, Financial Services Act 2012). Some of its powers are to be returned to the central bank, The Bank of England, although this will have limited effect on the issues discussed in this article. See <http://www.fsa.gov.uk/static/pubs/other/journey-to-the-fca-standard.pdf> for details. Given the largely historical review in this piece, reference will be to the FSA.

¹⁰² FIN. SERV. AUTH., INSURANCE: CONDUCT OF BUSINESS SOURCEBOOK 1 (2013), available at <http://media.fshandbook.info/content/full/ICOBS.pdf>.

information to the customer.¹⁰³ This is mostly enforced *ex post*, with no prior approval of insurance policies.¹⁰⁴ Insurers are held to these standards across the market by the FSA and in individual cases by the Financial Ombudsman Service (“FOS”).¹⁰⁵ This is in contrast to the *ex ante* approach largely adopted in the United States.¹⁰⁶

We begin with two relevant general principles, Principles 6 and 7:

Principle 6: Customers’ interests

A firm must pay due regard to the interests of its customers and treat them fairly.

Principle 7: Communications with clients

A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.¹⁰⁷

These overriding principles of Treating Customers Fairly (“TCF”) and effective communication are at the heart of much of FSA decision-making. They guide the application of the specific codes in place for the individual sectors within financial services.

In respect of the design of the policy and any accompanying literature, ICOBS 6 provides a detailed series of principles on which the extent and scope of cover should be made clear:

¹⁰³ *See id.*

¹⁰⁴ *See supra* note 28.

¹⁰⁵ Daniel Schwarcz, *Redesigning Consumer Dispute Resolution: A Case Study of the British and American Approaches to Insurance Claims Conflict*, 83 TUL. L. REV. 735 (2009).

¹⁰⁶ *See generally* RESEARCH HANDBOOK ON INTERNATIONAL INSURANCE LAW & REGULATION 221–481 (Julian Burling & Kevin Lazarus eds., 2011) (comparing United States, United Kingdom, and European Union approaches to insurance regulation).

¹⁰⁷ FIN. SERV. AUTH., QUICK GUIDE FOR SMALL FIRMS 1 (last visited Dec. 18, 2013), available at http://www.fsa.gov.uk/smallfirms/resources/factsheets/pdfs/quick_guide.pdf.

Ensuring customers can make an informed decision

ICOBS 6.1.5 (06/01/2008)

A firm must take reasonable steps to ensure a customer is given appropriate information about a policy in good time and in a comprehensible form so that the customer can make an informed decision about the arrangements proposed.

ICOBS 6.1.6 (06/01/2008)

The appropriate information rule applies pre-conclusion and post-conclusion, and so includes matters such as mid-term changes and renewals. It also applies to the price of the policy.

ICOBS 6.1.7 06/01/2008

The level of information required will vary according to matters such as:

- (1) the knowledge, experience and ability of a typical customer for the policy;
- (2) the policy terms, including its main benefits, exclusions, limitations, conditions and its duration;
- (3) the policy's overall complexity;
- (4) whether the policy is bought in connection with other goods and services;
- (5) distance communication information requirements (for example, under the distance communication rules less information can be given during certain telephone sales than in a sale made purely by written correspondence (see ICOBS 3.1.14 R)); and
- (6) whether the same information has been provided to the customer previously and, if so, when.

ICOBS 6.1.8 06/01/2008

In determining what is "in good time", a firm should consider the importance of the information to the customer's decision-making process and the point at which the information may be most useful

...

ICOBS 6.1.9 06/01/2008

Cancellation rights do not affect what information it is appropriate to give to a customer in order to enable him to make an informed purchasing decision.

ICOBS 6.1.10 06/01/2008

A firm dealing with a consumer may wish to provide information in a policy summary or as a key features document (see ICOBS 6, Annex 2).¹⁰⁸

The full description of what is required in a "policy summary" or "key features" document is given in Appendix 1 at the end of this article. There are three key elements within the requirement to present certain information separate from the policy terms:

1. The policy summary must be "clearly identifiable as containing key information that the consumer should read."¹⁰⁹

This assumes that the contracting decision will not be based in most cases on a careful scrutiny of the full policy terms, but on the summary provided by the insurer.

2. The summary must contain the "significant features and benefits" and the "significant or unusual exclusions or limitations, and cross-

¹⁰⁸ FIN. SERV. AUTH., INSURANCE: CONDUCT OF BUSINESS SOURCEBOOK, *supra* note 102, at ch. 6, pp. 2–3.

¹⁰⁹ See Appendix 1, *infra*.

references to the relevant policy document provisions.”¹¹⁰

This is clarified in extent by:

3. “A significant exclusion or limitation is one that would tend to affect the decision of consumers generally to buy. An unusual exclusion or limitation is one that is not normally found in comparable contracts.”¹¹¹

The notion of significant “features” or “limitations” returns us to the notion of the “implicit form contract” of norm theory. It requires the insurer to draw to the customer’s attention provisions that would contradict the normal expectations of a product of this type. It does not, of itself, control the limits on cover that the insurer may include, but does place a significant burden on the insurer to properly communicate the limits of cover. Within contract theory, this would generally be characterised as a model of procedural fairness.¹¹² Issues of substantive fairness are dealt with elsewhere, as the insurer’s right to deny a claim on the grounds of breach of warranty or non-disclosure are heavily curtailed in ICOBS 8 (claims handling).¹¹³

In addition to the macro regulation of the financial services sector by the FSA, the UK operates an alternative dispute settlement process through the FOS.¹¹⁴ Its findings are binding

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² Procedural fairness is a key element of contractual good faith within European consumer law. See Hugh Collins, *Good Faith in European Contract Law*, 14 OXFORD J. LEGAL S. 229, 243 (1994).

¹¹³ See generally FIN. SERV. AUTH., INSURANCE: CONDUCT OF BUSINESS SOURCEBOOK, *supra* note 102, ch. 8.

¹¹⁴ Others have also reviewed the FOS approach as it applies in North America. See Daniel Schwarcz, *Redesigning Consumer Dispute Resolution: A Case Study of the British and American Approaches to Insurance Claims Conflict*, 83 TUL. L. REV. 735, 735 (2009) (analyzing the FOS approach from a North American perspective).

on an insurer (up to a limit of £150,000), but do not deprive the claimant of their legal rights if unsuccessful. Complaints are decided on a mixture of law and good practice, which normally provides a substantially better chance of success for insureds than judicial resolution of the dispute.¹¹⁵

FOS has accumulated a substantial expertise in insurance complaints, and provides detailed guidance on its approach to issues regularly before it. Take as examples the three issues seen above: subsidence, third party theft, and flooding. Both the natural events (flooding and subsidence) have specific webpages that detail the circumstances in which a complaint would be likely to be upheld, whatever the precise legal position.¹¹⁶

Take the definition of “flood” as we did above. Here, the advice is much clearer:

We take the view that a flood does not have to be a sudden and violent event. We generally say that flooding can happen where water enters (or builds up in) a property slowly and steadily—and it does not necessarily have to be caused by the forces of nature. So water escaping from something inside a property could be the cause of a flood just as a river bursting its banks can.¹¹⁷

We think this definition of a flood is in line with consumers’ expectations.

FOS does not deal with the exclusion of theft or malicious damage by third party entrants to a property, but analogous situations are discussed, such as leaving a motor vehicle with keys in the ignition. FOS does not necessarily permit insurers to rely on an exclusion of liability, and considers:

¹¹⁵ See SUMMER, *supra* note 25, at 28.

¹¹⁶ See FIN. OMBUDSMAN SERV., BUILDING AND CONTENTS INSURANCE – FLOODING, http://www.financial-ombudsman.org.uk/publications/technical_notes/flooding.html (last updated Jan. 8, 2013); see also FIN. OMBUDSMAN SERV., BUILDING INSURANCE: SUBSIDENCE, http://www.financial-ombudsman.org.uk/publications/technical_notes/building-subsidence.htm (last updated Jan. 8, 2013).

¹¹⁷ BUILDING AND CONTENTS INSURANCE – FLOODING, *supra* note 116.

- where the car was at the time of the incident;
- whether the driver was in a position to deter the thief, or make the theft unlikely;
- any mitigating factors that caused the driver to leave the car and keys; *and*
- the manner in which the policy was sold and whether the exclusion was drawn to the consumer's attention.¹¹⁸

It is clear that the mere presence of an excluding clause is insufficient, and this comes close to the “reasonable expectations” doctrine of contractual construction.

In conclusion, attempts by the judiciary to interpret insurance contracts must recognise that these contracts are made in a specific regulatory framework. Both consumers and small businesses may have legitimate expectations drawn from the Ombudsman’s past practice. It is unlikely that consumers will be aware of this protection, but they will be equally unaware of the strict boilerplate clauses to which they have agreed by signature. Certainly, these regulatory standards (information sharing under ICOBS and “good practice” in claims handling under FOS) ought to form part of the broader context of interpretation under the Hoffman test. Yet, reference to these standards is not made. In part III, we consider how this regulatory framework might be used to level the playing field in insurance contract law.

III. UNDERSTANDING THE LIMITS OF COVER: LOOKING BEYOND THE CONTRACT

It is now accepted that the limits of insurance cover cannot be found within the four corners of the page. Insurance is a

¹¹⁸ FIN. OMBUDSMAN SERV., MOTOR INSURANCE – KEYS IN CAR, http://www.financial-ombudsman.org.uk/publications/technical_notes/motor-insurance-keys-in-car.html (last updated Jan. 8, 2013) (emphasis in original).

relational contract,¹¹⁹ made within its socio-economic context. Performance will not normally be determined by the precise words of the document, but within a broader spectrum of expectations and norms. The question is how we determine those norms and expectations and deploy them in the process of contract interpretation.

The case for considering what *insurers* really understand to be the basis of the agreement has been well made by Michelle Boardman. One of the reasons for using actuarial data within the process of contractual interpretation is:

[A]ctuarial data can reveal, astoundingly, the actuarial purpose of the structure of coverage or the actuarial pressure behind an exclusion. Under several doctrines, courts reconstruct, misread, or refuse to enforce a clause because the court can either discern no meaning, no “reasonable reading,” or can discern only an illusory or devious meaning Between an insurer and a lone policyholder in court, the lone policyholder’s needs cry out sharply. Actuarial purpose can show where those needs are misaligned with the needs of other policyholders.¹²⁰

The attraction of the actuarial evidence is that it is verifiable, empirically derived, and not tied to the dispute in question. What is needed is an equivalent source of understanding of consumer intent. This is the attraction of behavioural economics: it provides us with a perspective on the view of the many. It is verifiable, empirically driven, and not tied to the dispute in question. Like actuarial evidence, it provides the meta-narrative. This is not the loose cannon of “reasonable expectations.” What we need is to include consideration of the insurance imperative—the reason these insurances are bought—within the interpretation process.

¹¹⁹ Jay M. Feinman, *The Insurance Relationship as Relational Contract and the "Fairly Debatable" Rule for First-Party Bad Faith*, 46 SAN DIEGO L. REV. 553, 557 (2009).

¹²⁰ Michelle Boardman, *Risk Data in Insurance Interpretation*, 16 CONN. INS. L.J. 157, 166 (2009).

A. THE INSURANCE IMPERATIVE: WHY DO PEOPLE (NOT) BUY HOUSEHOLD INSURANCE?

The decision to purchase insurance over a house or its contents is an important one. Done properly, it can provide a genuine safety net for a significant part of a person's assets. Done poorly, it can cause a "financial disaster" after a natural one.¹²¹ There is significant empirical evidence from the United States that many households are underinsured.¹²² Whilst this might have been the deliberate choice of savvy, risk aware consumers prepared to take a share of the risk, this seems unlikely. To understand how to interpret insurance contracts in context, as Lord Hoffman suggests, we need to understand the reasons they are made, and the level of information used in making them.

The classic law and economics account of the desirability of insurance centred on expected utility theory ("EUT"). The assumption was that the insured calculated the probability and magnitude of loss and compared it to the premium charged.¹²³ This calculation is complicated by the variable utility of money.¹²⁴ Each successive dollar is worth slightly less in value, but the cumulative effect is significant.¹²⁵ For example, a £10 note is of great significance to my daughter's pocket money fund, but of little significance to my bank account.¹²⁶ Put simply, the more affluent we are, the more we can rationally spend a small part of that wealth to protect our assets. So, it would be rational to spend £300 per annum to avoid a £500,000 loss,

¹²¹ References to the notion of a "safety net," or a "financial disaster" to follow a tangible one are numerous. I have drawn mine from Tom Baker & Karen McElrath, *Whose Safety Net? Home Insurance & Inequality*, 21 L. & SOC. INQUIRY 229, 245 (1996).

¹²² Kenneth S. Klein, *When Enough Is Not Enough: Correcting Market Inefficiencies in the Purchase and Sale of Residential Property Insurance*, 18 VA. J. SOC. POL'Y & L. 345, 345 (2011).

¹²³ See Daniel Schwarcz, *Regulating Consumer Demand in Insurance Markets*, 3 ERASMUS L. REV. 23, 23 (2010).

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ This does not mean that I give her the £10 note.

even for low probability risks, where that £300 is of less utility than the avoidance of risk to my substantial assets. This is generally described as “risk aversion.”

As a mathematical model, EUT provides a useful insight into risk. It is not an effective model of human behaviour, for a number of reasons:

- Even when rational, decision-making is limited by inadequate information and processing power. Human beings are often poor judges of risk, not least because they do not have access to the vast pool of actuarial data, which insurers use to estimate the likelihood of an insured loss.
- Humans are not exclusively rational. The rise of behavioural economics has sought to explain, by reference to observable patterns of behaviour, how people actually process information and make important decisions. The work of behavioural science is not complete, and may never be so, but the insights it provides ought to be considered when interpreting and regulating insurance contracts.

The purchase of household and contents insurance policy is therefore a context driven decision. It is not always, if ever, a welfare maximising considered decision. For starters, some buildings insurance is *de facto* compulsory. Most property purchases are financed by mortgage,¹²⁷ and the finance house will invariably seek to secure its position by requiring the homeowner purchase buildings insurance at least to the value of the mortgage.¹²⁸ The decision to insure is therefore often forced, although any additional coverage and the terms of the policy will

¹²⁷ As of 2011, 33% of households owned their property with mortgage support, and 31% owned outright. See the 2011 UK Census data at <http://www.ons.gov.uk/ons/rel/census/2011-census/key-statistics-for-local-authorities-in-england-and-wales/prt---ew-stb-table-4.xls>.

¹²⁸ See ASS'N OF BRITISH INSURERS, BUILDINGS INSURANCE, <https://www.abi.org.uk/Insurance-and-savings/Products/Home-insurance/Buildings-insurance> (last visited Dec. 17, 2013).

need to be chosen. There is substantial evidence from the United States and the United Kingdom that insureds do not routinely purchase full coverage for buildings and contents insurance.¹²⁹ This shortfall requires explanation.

In contents insurance, the explanation focused on insurer and claimant ignorance as to the true value of household goods. Historically, insurers had utilised the Retail Price Index (“RPI”) measure of inflation to estimate the increased replacement costs of household items.¹³⁰ However, this general inflation figure did not accurately represent the increased cost of consumer goods. The disparity was caused by a relative fall in the cost of key services and non-household goods.¹³¹ On this basis, lower fuel costs and mortgage payments would counteract the increased cost of insured items. Over time, this would leave insurers undercapitalised where insurance was offered on a replacement basis, and claimants underinsured where values were fixed. This has been corrected, following a report from the Institute and Faculty of Actuaries.¹³²

The buildings insurance shortfall in the United States is described in detail by Klein.¹³³ On one estimate, the majority of US homeowners were uninsured “by roughly 20–25%.”¹³⁴ This does not appear to have been a conscious decision by financially astute homeowners who were prepared to share in the risks of a substantial loss. It may be economically rational to agree to

¹²⁹ ROB COWLEY ET AL., UK HOUSEHOLD: FLOODS, INFLATION AND UNDER-INSURANCE, INST. & FACULTY OF ACTUARIES, WORKING PARTY REPORT 1 (2002), available at <http://www.actuaries.org.uk/research-and-resources/documents/uk-household-floods-inflation-and-under-insurance-working-party-rep>; Klein, *supra* note 122.

¹³⁰ *Id.* The UK government has a variety of measures for estimating inflation. Two of the leading measures are the RPI and the Consumer Price Index (“CPI”). *Id.*

¹³¹ The UK government has moved from the Retail Price Index to the Consumer Price Index. The differences between the measures are explained at <http://www.pensionsadvisoryservice.org.uk/media/939500/spoto11thechangeofromrpitocpi.pdf>.

¹³² *Id.*

¹³³ See generally Klein, *supra* note 122.

¹³⁴ *Id.* at 358.

insurance with a large excess, or where losses are capped at seventy-five percent of the total rebuild value. However, this is not a convincing explanation of the shortfall in household insurance.

More likely is Klein's description of market pressures on insurers in a price sensitive market. Rather than offer a full indemnity at a higher cost, insurers competed to offer limited cover, in the knowledge that total loss claims are a tiny fraction of all insured losses.¹³⁵ Market share can be gained by undercutting the competition. This outweighs the cost of losing the business of the small minority of consumers who discover the extent of their underinsurance when a large claim eventuates.

We might add to Klein's observations to answer why insurers do not seek to sell a more desirable, albeit more expensive product to claimants. Why does Company X not offer a full rebuild package and advertise the weaknesses of competitor's products? The simple answer is that whilst this might shift insureds from a seventy-five percent coverage policy to a full indemnity, it would not necessarily shift them to Company X's product. Consumers could simply pay the additional costs of coverage to their current insurer. Moreover, pointing out the prior lack of cover might harm consumer confidence in insurance and might reduce the overall market.

There is an equivalent market issue in respect of the divide between buildings and contract insurance. Within the United Kingdom, the products are sold individually, coupled (but capable of being sub-divided) and as joint cover.¹³⁶ Most insurers promote their joint and coupled policies above their individual policies.¹³⁷ An efficient insurance market would see consumers weighing in the balance:

¹³⁵ *Id.* at 356.

¹³⁶ For example, the Aviva policy is bundled, by default, but can be uncoupled, as found at <http://www.aviva.co.uk/static/library/pdfs/home/NHDHG6o8o.pdf>. The 'More Than' policy is in the same format, as found at <http://www.aviva.co.uk/static/library/pdfs/home/NHDHG6o8o.pdf>. The AXA site offers both products separately, or combined, as found at <http://www.axainsurance.com/home/cover/>.

¹³⁷ Many insurers promote their joint and coupled policies above their individual policies. *See id.*

1. The savings from purchasing a bundled product, including reduced insurer and claimant costs (both at formation and at the claims stage) where buildings and contents losses are triggered from a single event.
2. The likely consistency of approach to covered and excluded risks within a single policy covering buildings and contents insurance.
3. In marginal cases, the likelihood that ambiguities and inconsistencies at the buildings/contents margin will be interpreted so as to minimise the inconsistency, given that cover is provided in a single document.

Against these savings, the customer would need to consider the likelihood of savings from finding a superior combination of individual policies (either in price or coverage).

However, the insurer can exploit consumer ignorance. The insurer is incentivised to capture market share by providing buildings cover in a joint or coupled fashion even if its individual product is not the most efficient. The “tying” of these products is reminiscent of the *Microsoft* case from a competition perspective.¹³⁸ Consideration of that issue must await another paper.

Moreover, the insurer is under market pressure to design its contents insurance to fit with its buildings cover, and no other. If an insurer designs a product that is readily available as a stand-alone product and can be freely matched with a competitor’s, then the insurer faces direct competition on both markets. By presenting the products as a package, the insurer can focus its attention on a single market.

This allows for market segregation. A distinct “contents insurance” package can then be tailored for tenants, for whom buildings cover is not necessary. Alternatively, in a coupled (but severable) policy, the insurer can put the optional separation

¹³⁸ See, e.g., MICROSOFT ON TRIAL: LEGAL AND ECONOMIC ANALYSIS OF A TRANSATLANTIC ANTITRUST CASE (Luca Ribini ed., 2010).

line at a point that would meet tenants' needs, but not fit homeowners'. This makes it difficult for a market participant to actively compete on the basis of one component of the "household insurance" package.

This is noticeably different from the experience of the marine insurance market, in which the purchasers are also repeat players. The normal exceptions from standard marine cover usually matches perfectly the extension of cover available elsewhere in the market through war risks cover.¹³⁹ Moreover, the coverage of cargo claims (equivalent to our contents insurance) has evolved three clear levels of coverage, with one "all risks" and two differentiated "named risks" policies.¹⁴⁰ These are not the result of State intervention, but competitive market forces.

We face a conundrum. Given that our interpretation model assumes that contracts are made contextually, why is there so little evidence of information driven purchasing by insureds? What are the behavioural factors that lead customers to such poor contractual decisions? Moreover, what can be done to minimise this gap between the "law in the courts" interpretation as done by judges and the "real world" understanding of insureds?

B. FLOATING IN A SEA OF INFORMATION: THE BEHAVIOURAL ECONOMICS BEHIND THE PURCHASE OF HOUSEHOLD INSURANCE

The heuristics behind purchasing behaviour in insurance are complex, but have come under increased scrutiny in recent

¹³⁹ See, for example, how the "war and strikes" exclusions marine hull insurance are mirrored by the positive coverage in the associated War Risks policy. N. GEOFFREY HUDSON AND TIM MADGE, *MARINE INSURANCE CLAUSES* Ch.6 (5th ed. 2012).

¹⁴⁰ Hull and Machinery cover is generally offered on the basis of the International Hulls Clauses or Institute Time Clauses (Hulls). INT'L UNDERWRITING ASS'N, *INTERNATIONAL HULLS CLAUSES* (2003), available at <http://www.iuaclasses.co.uk> (last visited 12/18/2013); HOWARD BENNETT, *THE LAW OF MARINE INSURANCE* 893 (2nd ed. 2006). Cargo cover is available as Cargo Clauses (A), (B), or (C). *Id.* at 870 (Cargo Clause (A)); *Id.* at 875 (Cargo Clause (B)); *Id.* at 980 (Cargo Clause (C)). Sample policies can be obtained at www.iua.co.uk.

decades.¹⁴¹ Schwarcz has identified significant (non-rational) differences in the approaches to high frequency, low value losses and low frequency, high value claims.¹⁴² They come together in the bundled contents and buildings policy.

1. The Purchase of “Less than Full Indemnity” Household Cover

Before looking at individual risks, we need to consider how insureds signal the limit of cover they desire. In buildings insurance, it is not clear that most insureds appreciate that it is rebuild cost that they are insuring, rather than resale value. With the growth in direct insurance in the United Kingdom, this confusion is likely to grow. There is some evidence of confusion: the FSA found that nine percent of tenants interviewed had purchased buildings insurance cover, although this was entirely superfluous.¹⁴³

The level of ignorance in buildings cover is not surprising. Insureds will rarely have any available information on which to judge rebuild cost. Most properties are not built to order, but are purchased from prior owners or the builder (where new build). Insureds are likely to make frequent errors when estimating value and will often “anchor” to the default value suggested by the insurer or intermediary.

By contrast, contents insurance merely asks the insured to estimate the likely cost of repeating the tasks it has already carried out: furnishing the home. This is a task of a different order; the insured is both an expert and repeat player consumer of personal goods. It has no similar expertise in the cost of house building. The differential level of expertise justifies some minimal State intervention in the buildings insurance process.

Let us start with Schwarcz’s analysis of the under-consumption of low frequency catastrophe insurance, such as a total loss under a buildings policy:

¹⁴¹ See KUNREUTHER, PAULY & MCMORROW, *supra* note 10.

¹⁴² See Schwarcz, *supra* note 123, at 31.

¹⁴³ ICOB REVIEW INTERIM REPORT, *supra* note 1, at 24.

[I]ndividuals' strategies for assessing probabilities produce systematic biases when it comes to low-probability events. Most people tend to assess probabilities based in part on the cognitive salience and availability of the underlying event being estimated. Although this heuristic serves them well with respect to high-probability events, it produces systematic errors with respect to low-frequency events.¹⁴⁴

This would predict a high degree of suggestibility in respect of buildings insurance. The incidence of a significant natural disaster, such as a hurricane or flood, would trigger increased awareness of the risk, and a likely increased demand for insurance. This availability heuristic is more complex when we dealing with a composite policy, where the insured is facing large risks that it is likely to underestimate (household fire) and small risks that it is likely to overestimate (theft) and cover for risks that it has not considered (liability insurance). We will concentrate for present purposes on buildings insurance.

Moreover, simple “risk aversion” theories have tended to treat the decision to purchase insurance and the subsequent decision as to the terms on which to buy as unitary. The evidence from behavioural science, and in particular the ‘incompleteness’ heuristic, disputes this:

[P]eople tend to employ a sequential threshold approach to insurance decision-making. Under this approach, they refuse to consider the desirability of insurance when they perceive the probability of the underlying risk to be below a threshold level Unless the likelihood of a loss is perceived to cross this threshold, the consumer will not even consider the desirability of insuring against it, regardless of its anticipated magnitude.¹⁴⁵

¹⁴⁴ Schwarcz, *supra* note 123, at 31.

¹⁴⁵ *Id.*

Our expectations of consumers are that they will consider the likelihood of the loss. If this meets their risk threshold (and this will vary from person to person), then they will move to stage two and seek to meet that need. At this stage, we have an unformed desire for coverage, and this is the ‘implicit form’ contract. What is needed is a solution to the anticipated loss. “In particular, consumers’ sequential threshold approach . . . may actually reflect the sophisticated use of insurance to reduce the anxiety associated with the prospect of a potential catastrophic loss. There is good evidence that insurance is valuable to consumers precisely because it provides ‘peace of mind.’”¹⁴⁶

The disconnect between the insurance contract and its image and promise is well established.¹⁴⁷ Many doctrines, including the reasonable expectations approach to interpretation, have sought to bridge this divide, with varying degrees of success.¹⁴⁸

Rather than seek direct State intervention to guarantee that this need for insurance is met, the United Kingdom has deployed a range of information forcing techniques,¹⁴⁹ and these could be further developed in the U.S. The rise of behavioural economics has seen a growing awareness of choice architecture. Indeed, it has been used by Thaler and Sunstein among others to propose paternalistically selecting default rules that are thought to provide better outcomes.¹⁵⁰ These arguments are beginning to be used to shape insurance defaults.¹⁵¹ Let us

¹⁴⁶ *Id.* at 32.

¹⁴⁷ Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1408 (1994).

¹⁴⁸ See, for example, the U.S. experience of the reasonable expectations doctrine in Mark C. Rahdert, *Reasonable Expectations Revisited*, 5 Conn. Ins. L.J. 107 (1998–1999).

¹⁴⁹ Primarily, the requirements that insurers disclose the key features of insurance coverage prior to contracting. See Davey, *infra* note 160 and text accompanying note.

¹⁵⁰ RICHARD THALER & CASS SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH AND HAPPINESS* (2009).

¹⁵¹ My own work has focused on the failure to negotiate for a remedy for late notification of claims. See generally James Davey, *Claims Notification Clauses and the Design of Default Rules in Insurance Contract Law*, 23 INS. L.J. 245

assume that the concerns over the poor selection of household insurance coverage justify some form of State interference. Moreover, assume that we can show empirically that the “implicit form” contract that consumers hold in their heads shows a consistent approach to buildings and contents insurance exclusions. This should form part of the context for contractual interpretation, indeed should provide the default rule. Insurers, by proper use of “policy features” documents and advertising, can shift away from the default, but must overcome the inertial drag of the default. Let us amend Klein’s proposal for buildings insurance coverage to reflect this:

- Assume unless otherwise stated, that the buildings cover provides a full indemnity. Require, by licensing authorities, that full indemnity contracts and partial indemnity contracts are clearly differentiated by labelling.
- Before completion of the contract, whether electronically or otherwise, require insureds to complete a “rebuild calculator” website or equivalent. This is available in the United Kingdom as an industry accepted norm, and it calculates a figure based on postcode (zip code), number of stories and floor size, special features. Whilst inappropriate for unusual risks, it provides a ready reckoner for most properties.
- Display the results, as Klein suggests,¹⁵² with a simple grading system to show what level of indemnity is provided. Where a policy with less than an ‘A’ grade is selected, require a further box to be ticked to indicate awareness that less than a full indemnity is required.

(2012) (U.K.). In addition, my work has also touched on the framing effects of single defaults in commercial insurance statutes. *See generally* James Davey, *The Reform of Insurance Warranties: A Behavioural Economics Perspective*, J. BUS. L. 118 (2013) (U.K.). Daniel Schwarcz provides an American perspective on the same issue. *See* Schwarcz, *supra* note 123, at 38–40.

¹⁵² *See generally* Klein, *supra* note 122.

This ought to permit sophisticated insureds to deal as they wish. Whilst paternalistic, it seeks to put only low transaction cost hurdles in the path of the non-indemnity contract.

2. Seamless or Separate Cover: Gaps Between Buildings and Contents Contracts

A judge is faced with a series of coverage disputes arising from some natural disaster—a Hurricane in a Southern U.S. State, or a flooded Cornish town, or an Australian hamlet ravaged by firestorm. Amongst the claimants, he finds a mixture of insurance coverage, with some policyholders holding a single insurance policy for their losses, and others with two separate insurers.

In those situations where there is a single policy for contents and buildings cover, counsel for the insurer concedes that a word will normally have a consistent meaning across the document, unless expressly stated otherwise. He is able to dispose of these cases, applying a consistent meaning of the word “flood” or “fire” or “hurricane.”

What of those cases where the insured has purchased two policies and the standards of cover vary? In current litigation, “flood” would appear to be our most likely candidate. In only a small survey of policies, Justine Bell identified a number of conflicting definitions of “flood” in Australian practice and some policies with no definition at all.¹⁵³

The judges’ first job is to identify the interpretative context. How is (s)he to establish what is relevant? A case study of judicial psychology in respect of statutory interpretation suggested that there is a substantial element of *ex post* rationalisation in judicial decision making.¹⁵⁴ Rather than the context driving the interpretation, there is likely to be substantial feedback, by which propositions become convincing to the judge and then help to reframe the evidence that ought to be considered germane.

¹⁵³ See generally Justine Bell, *When Will a Flood be Classified as a “Flood”? A Review of the Insurance Contracts Act Reform*, 23 INS. L.J. 312 (2012) (Austl.).

¹⁵⁴ Dan Simon, *A Psychological Model of Judicial Decision Making*, 30 RUTGERS L.J. 1, 20 (1998).

It is not that judges are not human, but that they are not carrying out the same exercise as the contracting parties. They are, to a considerable degree, much less bounded than the parties or the “reasonable bystander” that they seek to emulate. The evidence is delivered before them by parties seeking to promote one of two conflicting end points. They then (subject to normal judicial constraints) can preselect the context to suit their decision. It becomes right and justified by the context. This confirmation bias is likely to be exacerbated by jury trials.

What regulators can do is to make more apparent the factors that they wish to see from the context. The FSA requires that all financial service providers “communicate information to [customers] in a way which is clear, fair and not misleading.”¹⁵⁵ This is detailed by the requirement of policy summaries in many situations. The form and function of the policy summary is prescribed¹⁵⁶ and must include “significant or unusual exclusions or limitations, and cross-references to the relevant policy document provisions.”¹⁵⁷

In judging significance, insurers are to be guided by a series of principles, including:

- “A significant exclusion or limitation is one that would tend to affect the decision of consumers generally to buy. An unusual exclusion or limitation is one that is not normally found in comparable contracts.”
- “In determining what exclusions or limitations are significant, a firm should, in particular, consider the exclusions or limitations that relate to the significant features and benefits of a policy and factors which may have an adverse effect on the benefit payable under it.”¹⁵⁸

¹⁵⁵ See QUICK GUIDE FOR SMALL FIRMS, *supra* note 107.

¹⁵⁶ See Appendix 1, *infra*.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

This is valuable context for interpretation and yet the author can find no record of it referred to in insurance litigation. Where there is an “implicit form” contract, it is clear that deviations from that would “affect the decisions of consumers to buy.” What we need is to reverse Michelle Boardman’s “Tested Language defence.”¹⁵⁹ If insurers use language that is ambiguous to a focus group, because it fails to make clear that the normal expectations of coverage will not be met, then this ambiguity must be identified and resolved in the policy summary. This is no easy task, and insurers may prefer to conform to expectations.

If proper disclosure is made, and the insured buys anyway, then we must confront the spectre of the “reasonable expectations” doctrine. English law has not gone so far, but it does provide the basis for forcing the insurer to disclose its limits in easily accessible form. It has not yet been done under the *Hoffman* principle, but the pathway is open.

IX. CONCLUSION

Insurance contract law is often concerned with information and risk. Too often, English law has concerned itself with the information the insurer requires to measure the risk, and the danger that the insured will fall foul of some “moral hazard.”¹⁶⁰

The Hoffman model of interpretation gives some scope to reverse that focus. Smart disclosure of information of use to consumers is a central tenet of insurance theorists.¹⁶¹ We can nudge insurers to properly disclose the risks they undertake. Regulators are already mindful of these issues: no more holiday travel policies with pictures of skiers and jet ski enthusiasts (when both activities are routinely excluded).¹⁶² What is needed

¹⁵⁹ Michelle Boardman, *Insuring Understanding: The Tested Language Defense*, 95 IOWA L. REV. 1075, 1077 (2010).

¹⁶⁰ For a United Kingdom perspective on the historical design of insurance law to protect the insurer from the insured, see James Davey, *Remedying the Remedies: The Shifting Shape of Insurance Contract Law*, L.M.C.L.Q. 476 (2013) (U.K.).

¹⁶¹ KUNREUTHER, PAULY & MCMORROW, *supra* note 10, at 204–05.

¹⁶² Famously, a campaign featuring Iggy Pop for an online UK insurer was banned because he would not have been eligible for cover. Sandra Haurant,

next is for judges to become familiar with the disparity between the promised (and sought) peace of mind and the contractual detail. Rather than imposing standard form terms from above, the court should seek evidence of consumer's real understanding of cover, in light of behavioural science. This would bring our best current model of human decision making to a hypothetical "reasonable man." The scientific method wins out. This "bottom up" approach to insurance contracts would not overcome all inequalities, but is an incremental step towards the rebalancing of insurance contract law in the United Kingdom, and perhaps, further afield.

Swiftcover's Iggy Pop advert banned, GUARDIAN (Apr. 29, 2009), <http://www.theguardian.com/money/2009/apr/29/iggy-pop-swiftcover-insurance-advert-ban>.

Appendix 1: ICOBS 6, Annex 2

1.1	R	(1)	A <i>policy summary</i> must be in writing or another <i>durable medium</i> .
		(2)	A <i>policy summary</i> must be in a separate document, or within a prominent separate section of another document clearly identifiable as containing key information that the <i>consumer</i> should read.
1.2	G	The quality and presentation standard of a <i>policy summary</i> should be consistent with that used for other <i>policy</i> documents.	
2	Content		
2.1	R	A <i>policy summary</i> must contain the information in the table below and no other information.	
		Policy summary content	
		<ul style="list-style-type: none">• Keyfacts logo in a prominent position at the top of the <i>policy summary</i>. Further requirements regarding the use of the logo and the location of specimens are set out in <i>GEN 5.1</i> and <i>GEN 5 Annex 1 G</i>.	
		<ul style="list-style-type: none">• Statement that the <i>policy summary</i> does not contain the full terms of the <i>policy</i>, which can be found in the policy document.	
		<ul style="list-style-type: none">• Name of the <i>insurance undertaking</i>.	
		<ul style="list-style-type: none">• Type of insurance and cover.	
		<ul style="list-style-type: none">• Significant features and benefits.	
		<ul style="list-style-type: none">• Significant or unusual exclusions or limitations, and cross-references to the relevant policy document provisions.	
		<ul style="list-style-type: none">• Duration of the <i>policy</i>.	
		<ul style="list-style-type: none">• A statement, where relevant, that the <i>consumer</i> may need to review and update the cover periodically to ensure it remains adequate.	
		<ul style="list-style-type: none">• Price information (optional).	
		<ul style="list-style-type: none">• Existence and duration of the right of cancellation (other details may be included).	
		<ul style="list-style-type: none">• Contact details for notifying a claim.	
		<ul style="list-style-type: none">• How to complain to the <i>insurance undertaking</i> and that complaints may subsequently be referred to the <i>Financial Ombudsman Service</i> (or other applicable named complaints scheme).	
		<ul style="list-style-type: none">• That, should the <i>insurance undertaking</i> be unable to meet its liabilities, the consumer may be entitled to compensation from the <i>compensation scheme</i> (or other applicable compensation scheme), or that there is no compensation scheme. Information on the extent and level of cover and how further information can be obtained is optional.	

2.2	G		A <i>policy summary</i> should properly describe the <i>policy</i> but, in line with <i>Principle 7</i> , should not overload the <i>consumer</i> with detail.
3	Significant or unusual exclusions or limitations		
3.1	G	(1)	A significant exclusion or limitation is one that would tend to affect the decision of <i>consumers</i> generally to buy. An unusual exclusion or limitation is one that is not normally found in comparable contracts.
		(2)	In determining what exclusions or limitations are significant, a <i>firm</i> should, in particular, consider the exclusions or limitations that relate to the significant features and benefits of a <i>policy</i> and factors which may have an adverse effect on the benefit payable under it.
		(3)	Another type of significant limitation might be that the contract only operates through certain means of communication, e.g. telephone or internet.
	Examples of significant or unusual exclusions or limitations		
	• Deferred payment periods		
	• Exclusion of certain conditions, diseases or pre-existing medical conditions		
	• Moratorium periods		
	• Limits on the amounts of cover		
	• Limits on the period for which benefits will be paid		
	• Restrictions on eligibility to claim such as age, residence or employment status		
	• Excesses		
4	Key features document as an alternative to a policy summary		
4.1	R		A <i>firm</i> may provide a document that has the contents of a <i>key features document</i> instead of a <i>policy summary</i> . The document must include contact details for notifying a claim but need not include the title "key features of the [name of product]."