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Optimal rules of negligent misrepresentation in insurance contract law

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ABSTRACT

Rules of misrepresentation in insurance contract law differ widely between jurisdictions. When the insured has negligently misrepresented a fact prior to contracting, common law allows the insurer to rescind the contract if the misrepresentation was material, while civil law countries apply more lenient rules. The article compares the efficiency of the common and the civil law rules in an adverse selection model in which the insurer separates types of risk not only through a deductible but also by requiring the insured to represent their type. A strict rule of misrepresentation increases the incentive for policyholders to represent truthfully but also exposes them to risk when they may misrepresent by mistake. While the economic literature has tended to defend the strict common law rule, because it makes it easier for the insurer to separate types, the present article demonstrates that the more lenient civil law rules may be more efficient, especially when the cost for the insurer of auditing types is low.

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1. Introduction

When a policyholder presents a claim under an insurance policy, the insurer sometimes audits the claim and finds that the insured pre-contractually misrepresented a fact relevant to her[1] risk. If the insurer can prove that the insured did so intentionally in order to obtain a lower premium, all legal systems allow the insured to rescind the contract. If, however, the insurer cannot establish sufficient proof of intent, if e.g. the insured may have remembered the fact incorrectly, or may have been wrongly informed of her risk, consequences differ widely between legal systems.[2] For such misrepresentation, termed negligent, common law allows for a rescission of the contract if only misrepresentation was 'material',[3] whereas the German Insurance Contract Act (2008) does not allow the insurer to reduce the indemnity at all.[4] As an intermediate rule, some civil law countries[5] apply the pro rata rule, which restricts coverage to what the paid premium would have secured if the insured had represented her type correctly.

These rules are all controversial. In the US,[6] critics of the common law rule have pointed to the unreasonableness of cases such as Henwood v. Prudential Insurance[7] where a woman had seen a psychiatrist for emotional problems when she was a teenage, and later before taking out life insurance had denied having any 'nervous or mental disorder'. Although her death in a car accident was unrelated to the misrepresented fact, the contract was voided by the court. In Germany, the lenient rule has been said to not sufficiently discourage fraud[8] that constitutes a significant problem for some insurance markets.[9]

In this debate, the economic literature, e.g. Dixit (2000), Gravelle (1991), and Picard (2009), has tended to favour the strict common law rule, arguing that it enables effective separation of risk types and expands the set of parameters for which an equilibrium exists.[10] The present article argues, in contrast, that the more

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[1] For convenience, the insured is female and the insured male in this article.

[2] So, in fact, do the legal consequences when the insured can prove that the misrepresentation was an honest, non-negligent mistake. In the model of the present article, it is clearly inoptimal to allow for a rescission in this case.

[3] A misrepresentation is material when the insurer would not have entered the contract on its given terms if there had been no misrepresentation; if this condition is met, the insurer can even void the contract in case of honest misrepresentation.

[4] Except when the insured is found to have acted in a grossly negligent manner, see below for a closer description of the rules.

[5] See Tarr and Tarr (2001).

[6] Barnes (2010) gives an overview of the American academic debate.

[7] 64 D.L.R. (2d) 715, S.C.C., 1967. This example is mentioned by Rea (1993).

[8] This criticism is mentioned by Heiss (2013).

[9] See e.g. Derrig (2002).

[10] Rothschild–Stiglitz (1976) demonstrated that one cannot be certain that there exists a Nash-equilibrium in the insurance market under adverse selection.

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lenient of two rules may be more efficient when the insured may misrepresent by mistake, in particular when the cost for the insurer of auditing is low. This may appear obvious, since the insurer must be less risk averse than the insured (otherwise there would be no reason for the contract), and one would therefore expect it to be optimal for the insurer to bear the risk of inadvertent mistakes on the part of the insured. However, if the insurer can commit to an auditing strategy, he can undo the strictness of a rule by lowering the probability of auditing, and thereby save on auditing costs. It is therefore not obvious that a lenient rule can be better than a strict rule. Yet, when the cost of auditing is low it will be shown to be more efficient, for reasons to be explained, that the insurer audits often and applies a low sanction to misrepresentation than that he audits rarely and applies a high sanction. Likewise, for the case where the insurer cannot commit to a level of auditing, it will be shown that a strict rule can provide too strong an incentive to audit ex post when the claim is raised, and that too much auditing may create greater inefficiencies than too little or no auditing which may be the result of a lenient rule.

Before introducing the model, the following sections offer a more detailed description and illustration of the legal rules, and a review of the literature.

2. The legal rules

The main rules concerning negligent misrepresentation are in decreasing order of strictness: the common law rule, the contribute-to-the-loss or causation rule, the pro rata rule, the pro rata rule requiring causation, the recovery rule, and the German rule.

The common law rule allows rescission for 'material misrepresentation', regardless of whether it is innocent, negligent or intentional. As mentioned, misrepresentation is said to be material when a reasonable insurer would not have issued the insurance on its given terms had he known the misrepresented fact.[11] It should be mentioned that the rule is not universally applied in the US, as some States have statutorily limited reduction of coverage to cases of intentional or reckless misrepresentation (see American Law Institute, Tentative Draft, 2013, p. 84 (h)), and that it is no longer the rule applied in England for consumer insurance contracts, for which the Consumer Insurance (Disclosure and Representations) Act 2012 now applies the pro rata rule to negligent (but not reckless) misrepresentation.[12]

The contribute-to-the-loss rule covers fully if the unstated or misrepresented fact was irrelevant to the insurance event but not at all when the fact caused the event. The concept of causation can take different meanings. In German law, it is taken to mean that the misrepresented fact had some influence on the event, see Heiss (2013).[13]

The pro rata rule applies in several countries (e.g. Denmark)[14] and sets the indemnity equal to what the paid premium would have secured if there had been no misrepresentation.[15] If the premium would have been twice as high, the indemnity is reduced to 50%. If the insurer would have altered the terms in some other way, those altered terms apply; thus, if the insurer would have excluded accidents resulting from a nervous condition if the insured had admitted to suffering from this condition, the insurer shall not pay in case of such accident.

The combination of the pro rata rule and the contribute-to-the-loss rule, which is suggested in the Principles of European Insurance Contract Law (PEICL, 2009) for negligent misrepresentation, and applied in Germany for grossly negligent misrepresentation, requires causation for there to be reduction in cover, but then reduces the indemnity only pro rata.

The recovery rule, as proposed in a draft from the American Law Institute[16] allows the insurer to reduce the indemnity by the extra premium which the insured would have paid in case of correct disclosure.

As mentioned, the German rule allows no reduction for negligent misrepresentation.

It is worth noting that these rules concerning negligent misrepresentation are supplemented by rules that apply to innocent, grossly negligent, reckless or intentional misrepresentation. To judge the strictness and working of any two sets of rules, the adjacent rules must also be considered, as must the standard of proof required for showing mainly grossly negligent, reckless or intentional misrepresentation. For example, when comparing the strictness of the German rule and the ALI draft proposal (2013), it is worth noting that if the insured has misrepresented in a grossly negligent manner, the pro rata rule requiring causation applies in Germany, whereas in the ALI draft proposal, the insurer can void the contract in case of reckless misrepresentation.[17] Whether this means that the ALI proposal is stricter than the German rules cannot be decided without knowing the standard of proof applied to recklessness in the ALI proposal (namely the same as that applied to fraudulent misrepresentation under applicable state law, see §7.4) and the standard applied to grossly negligent misrepresentation under German law.

Moreover, a full comparison of the sets of rules would involve other aspects by which the rules differ, such as the conditions under which the insurer can cancel a policy prospectively in case of either innocent, negligent, grossly negligent or reckless misrepresentation.

2.1. An illustration of the rules

To gain an impression of the relative strictness of the rules, we now compare what pay-outs would be under the different rules for the woman whose contract was voided in the example above, if we assume that her report amounted to negligent misrepresentation. We can assume, for the sake of illustration, that the woman's emotional problems were in fact severe and that her probability of dying before a certain age was 6%, whereas for other women resembling her in other respects but without emotional problems, the same probability would be only 4%. We can also set the indemnity at 100 and assume, to simplify, that the insurers always audit the insured's type when the insured presents a claim. Under these assumptions, we can consider the possibility that the insurers offer two contracts: one at a premium of 4 for the women of low risk, and the other at a premium of 6 for the high risk, and we can ask what the consequences would be for the woman under the different rules if she would choose the contract intended for the low risk although her risk was in fact high. In particular, it is of interest whether the

[11] There is also a requirement that the actual insurer reasonably relied on the stated fact, i.e. that he would (reasonably) not have entered the terms of the contract on its given terms if he had known the true fact. See The American Law Institute (2015) §8 and §9.

[12] See http://www.legislation.gov.uk/ukpga/2012/6/contents. See also Ruehl (2006) for how German and English rules differed less in reality than in the books even before the new English rule.

[13] It may therefore be better, as done by ALI, to use the term contribute-to-the-loss rather than causation.

[14] See Tarr and Tarr (2001).

[15] The Danish Insurance Contract Act (1930), §6.

[16] American Law Institute, Tentative Draft (2013). The proposal for harmonisation was issued before the ALI's project on insurance contract law turned into a Restatement project.

[17] Which according to §7.4 applies not only to indifference concerning the truth of a statement but also to cases where proof of fraudulent misrepresentation is difficult.

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