

Policyholder's Reasonable Expectations

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Introduction

I. An Anomaly

English insurance law has been unreceptive to the notion of ‘policyholder’s reasonable expectations’, a notion that is prominent in American insurance law. This book addresses the question of why English insurance law should instead be receptive to that notion or principle—if it could appropriately be characterised as a principle.

This, however, is certainly not mainly because English (insurance) law should be aligned with its American counterpart. Rather it is because in the first place there has been an arguably unjustifiable anomaly in this regard in English law. The anomaly is the stark contrast between general contract law and insurance law in the judicial attitude toward the notion of contractual parties’ reasonable expectations. More than two decades ago, Steyn LJ, as he was then, opined that ‘a theme that runs through our law of contract is that the reasonable expectations of honest men must be protected’.¹ In only two years, Lord Steyn extra-judicially professed fulfilling reasonable expectations as ‘an important subject for the future development of English contract law’.² Similarly, Dyson LJ opined that ‘an implied term is necessary in order to give effect to the reasonable expectations of the parties’.³ As recently as six years ago, Lord Hoffmann stated extra-judicially, ‘The purpose of the law of contract is to fulfil reasonable expectations and such expectations should therefore be self-fulfilling’.⁴

However, when it comes to insurance contract, judges take a markedly different approach to the concept of ‘policyholder’s reasonable expectations’. Whilst briefly argued for by the claimants, it was expressly rejected in the Court of Appeal in *Smit Tak Offshore Services Ltd v Youell*⁵ and in *Yorkshire Water Services Ltd v Sun Alliance & London Insurance Ltd*.⁶ Although soon afterwards, the

¹ *First Energy (UK) Ltd v Hungarian International Bank Ltd* [1993] 2 Lloyd’s Rep 194 (CA), 196.

² Lord Steyn, ‘Contract Law: Fulfilling the Reasonable Expectations of Reasonable Men’ (1995) 9 *LQR* 433, 433.

³ *Nash v Paragon Finance Plc* [2001] EWCA Civ 1466 [36].

⁴ Lord Hoffmann, ‘The Achilles: Custom and Practice or Foreseeability?’ (2010) 14 *Edinburgh Law Review* 47, 59.

⁵ *Smit Tak Offshore Services Ltd v Youell* [1992] 1 Lloyd’s Rep 154 (CA).

⁶ *Yorkshire Water Services Ltd v Sun Alliance & London Insurance Ltd* [1997] CLC 213 (CA), 221.

idea of (policyholder's) reasonable expectations in the context of insurance was arguably emphasised in the House of Lords in 1998 in *Cook v Financial Insurance Co Ltd*⁷ and later in 2000 in the more celebrated case *Equitable Life Assurance Society v Hyman*,⁸ English courts overall are far from receptive to a doctrine or a principle of 'policyholder's reasonable expectations'.⁹ Most recently in May 2015 in the Supreme Court, Lord Sumption mentioned reasonable expectations of policyholders as 'a consideration which, except as background to the construction of the policy, does not have the significant place in English insurance law as it has in many jurisdictions of the United States'.¹⁰

The reason for this contrast is perhaps not that insurance law is so different from general contract law that judicial acceptance of the notion of reasonable expectations in contract law shall not or cannot extend to insurance law. After all, as Malcolm Clarke maintains, the presumption should always be against those who assert that insurance law is, or should be, different from general contract law.¹¹ Rather, the English unreceptiveness is to a large extent due to concerns that are aligned with the controversies in the United States (US) over what has been known mostly as the American insurance law 'doctrine' of reasonable expectations. The controversies and the ensuing concerns over its drawbacks migrated across the Atlantic to the United Kingdom (UK) and became well-settled there.

The contrast is similar in English legal academia. In regard to general contract law, academics for the most part recognise the notion of reasonable expectations in the general law of contract. According to John Baker, there was an evolution to a doctrine of reasonable expectations; it has two major aspects: the reasonable expectation that a serious promise will be kept and that a contract will not operate unfairly; and that the reasonable expectations unite the parties and include the attainment by fair means of the main object of their agreement.¹² According to John Adams and Roger Brownsword, reasonable expectation 'is the key to contractual obligation'.¹³ However, in stark contrast, a principle or a doctrine of reasonable expectations in insurance law has been extremely under-researched. Professor Malcolm Clarke seems to be the only leading insurance law academic in the UK who has written a stand-alone piece on the topic, pointing out in 1989 that a similar doctrine was perhaps

⁷ *Cook v Financial Insurance Co Ltd* [1998] 1 WLR 1765 (HL), [1998] UKHL 42.

⁸ *Equitable Life Assurance Society v Hyman* [2000] 3 All ER 961, [2000] UKHL 39, [2002] 1 AC 408.

⁹ See J Lowry, P Rawlings and R Merkin, *Insurance Law: Doctrines and Principles*, 3rd edn (Oxford, Hart Publishing, 2011) 269.

¹⁰ *Zurich Insurance Plc UK Branch v International Energy Group Ltd* [2015] UKSC 33 [164].

¹¹ M Clarke, *Policies and Perceptions of Insurance Law in the Twenty-First Century* (Oxford, Oxford University Press, 2005) 357.

¹² JH Baker, 'From Sanctity of Contract to Reasonable Expectation?' (1979) 32 *Current Legal Problems* 17, 22, 24, 30, 33.

¹³ J Adams and R Brownsword, *Key Issues in Contract* (London, Butterworths, 1995) 153–54.

operative in disguise in English insurance law.¹⁴ He sticks to this idea, and over subsequent decades has argued for it moderately¹⁵ in his treatises. The other substantial academic research output¹⁶ in this regard is from John Lowry and Philip Rawlings, who are fairly pessimistic about and sceptical of the prospect of such a doctrine in English insurance law.

Given the current anomalous state of the law and relatively scant research into policyholder's reasonable expectations in English insurance law, this book seeks to address the anomaly and to advance the research in this regard.

II. Policyholder's Reasonable Expectations of Coverage and of Bonuses

Up to now in English insurance law, there have been two prominent cases in which the notion of policyholder's reasonable expectations carried weight in the judicial reasoning. Both were decided in the House of Lords, only two years apart. One is *Cook v Financial Insurance Co Ltd*,¹⁷ decided in 1998. The other is the more celebrated (or infamous) case *Equitable Life Assurance Society v Hyman*,¹⁸ decided in 2000. Although both concerned consumer policyholders' reasonable expectations, they were not really homogeneous. Instead they exemplified two meanings of 'policyholder's reasonable expectations'. In *Cook*, it was the policyholder's reasonable expectations of coverage (PREC) of particular risks—a medical condition in this case. This concept has been better known to and more controversial among insurance lawyers, especially in the US where it originated between the 1960s and the 1970s, and has since been the subject of judicial vacillation. The controversy and the vacillation in the US is a major reason why PREC has mostly been frowned upon, at least superficially. As has been mentioned above, in the UK, for the most part, only a few academics have briefly discussed PREC in the context of English insurance law, and it has seldom been argued, though it has received occasional mention, in the courts.

The meaning of policyholder's reasonable expectations in *Equitable Life Assurance Society v Hyman*¹⁹ is fairly different. This case did not concern PREC

¹⁴ M Clarke, 'The reasonable expectations of the insured—in England?' [1989] *Journal of Business Law* 389; M Clarke, 'Reasonable Expectations—Unreasonable Cost?' (1990) 16 *Managerial Finance* 25.

¹⁵ M Clarke, J Burling and R Purves, *The Law of Insurance Contracts*, 6th edn (London, Informa, 2009) 452–53.

¹⁶ Lowry et al, above n 9, 269.

¹⁷ *Cook v Financial Insurance Co Ltd* [1998] 1 WLR 1765 (HL), [1998] UKHL 42.

¹⁸ *Equitable Life Assurance Society v Hyman* [2000] 3 All ER 961, [2000] UKHL 39, [2002] 1 AC 408.

¹⁹ *Ibid.*

but a policyholder's reasonable expectations of bonuses (PREB) in the context of with-profits life insurance. *Equitable Life* was not a dispute over an insurance policy's coverage of risks; rather it was over the insurer's allocation of premium investment bonuses to policyholders. Many life insurance products or contracts are designed and sold purely as a personal financial investment plan, or with many elements of such. Under these plans, as in *Equitable Life*, life insurers use policyholders' premiums to make investments, and promise to allocate bonuses or investment returns to policyholders in a certain manner, as provided for in the insurance policies. Disputes arising under such life insurance policies are often over the allocation of bonuses or benefits.

The British actuary profession has appreciated PREB since the mid-1960s, but it has perhaps remained unnoticed by most lawyers, except those few who represented the parties and/or sat in on the hearing and appeals of the celebrated *Equitable Life* case. Compared with PREC, PREB seems much less familiar to lawyers due to its actuarial technicalities, which are to be introduced when we revisit *Equitable Life* in Chapter 7.

The two types of expectations—PREB and PREC—must be distinguished from each other; otherwise, unaware of the difference, one might actually use PREB to argue for PREC, or vice versa.

III. Structure of the Book

Most of the discussions in this monograph are concerned with PREC, with only Chapter 7 being devoted to PREB. In addressing the normative question whether English law should be receptive to the notion of policyholder's reasonable expectations (especially PREC), this book combines considerable normative arguments with more analysis of relevant positive contract law rules and principles that can build up an answer to that question. Such analysis is mainly found in Chapters 2 to 5. The largely normative argument for PREC per se is in Chapter 6. As mentioned before, Chapter 7 discusses PREB. Chapter 8 draws a conclusion as an answer to the normative question to be addressed in the book.

Chapter 2 is a response to the on-going assertion that insurance (contract) law is distinctive from (general) contract law, and therefore that the notion of 'reasonable expectations', which permeates contract law, should not necessarily have a place in insurance law. It is argued that although *insurance* does operate under a distinctive, if not unique, *economic* rationale or mechanism, such distinctiveness is cancelled out by contract, an almost universal vehicle for the business of insurance, and therefore makes *insurance (contract) law* not fundamentally different from general contract law. This chapter further expands on Clarke's submission that insurance contract law is not, and should not be thought to be, different from general contract law.

Chapter 3 rediscovers the role of expectations in contract law generally. It uncovers the subsumed role of expectations in the formation of contract, and also the relevance of expectation to damages for breach of contract. This chapter also responds to doubts²⁰ about the notion of reasonable expectations in contract law; for that purpose it uses, among others, the distinction made by John Rawls between the 'reasonable man' and 'rational man.' Necessarily, the chapter proceeds to find out the role of reasonable expectations in contract interpretation, in particular the relation of expectations to the contextual and purposive approach to interpretation of contracts. All these lead to an argument: now that expectations are fairly relevant to contract and in contract law, why should not reasonable expectations be so too?

Chapter 4 approaches PREC from the perspective of good faith in contract law. It first discusses the relationship between good faith and reasonable expectations, arguing that the purpose of requiring good faith in contract law is to ensure that the parties' reasonable expectations can be met. In this sense, judicial support of good faith in contract law indirectly endorses the reasonable expectations approach. Although good faith in contract traditionally has limited role in contract law, very recently it has re-emerged in the common law, for example in the High Court in the UK, in the final Court of Appeal in Singapore and in the Supreme Court of Canada. Following that, the rest of Chapter 4 proceeds to expound the relevance of the insurer's duty of good faith to PREC. For this purpose it highlights the insurer's duty of good faith, which has the the purpose and the effect of protecting PREC.

Chapter 5 revisits the American insurance law 'doctrine' of reasonable expectations (DRE), which is the original American version of PREC. The key query is, since DRE/PREC has fairly diffuse versions or formulations in its application in the US, should it actually be perceived more as a principle than as a doctrine? The answer to this query depends first on the distinction between legal principles and legal doctrines (or legal rules), and, secondly, on the US judicial treatment of DRE/PREC in state courts. It is noteworthy that in 1970, Keeton put forward DRE/PREC as a principle; more noteworthy but not widely noticed is that in 1976 he stressed and applied the general distinction between legal principles and legal doctrines in his further discussion of DRE/PREC, and stated a particular standard for characterising DRE/PREC as a doctrine. Given that standard, Chapter 5 examines how each American state jurisdiction treated DRE/PREC, and shows whether, by Keeton's standard, DRE has actually been judicially (dis) applied as a doctrine or as a principle.

Chapter 6 reassesses the pessimism about or objections to a principle of PREC in English insurance law, and argues for its incremental acceptance into business

²⁰ C Mitchell, 'Leading a Life of its Own? The Roles of Reasonable Expectations in Contract Law' (2003) 23 *OJLS* 639. See also similarly S Smith, "'The Reasonable Expectations of the Parties': An Unhelpful Concept' (2009) 48 *Canadian Business Law Journal* 366.

insurance in addition to (already effectively) in consumer insurance. The objections are that adopting PREC into English law will cause more uncertainty and inconsistency, that American-style considerations of public policies have few roles in English contract law, and that other doctrines in (insurance) contract law suffice to protect PREC and therefore there is no need for a stand-alone PREC doctrine or principle. It is argued that concerns over uncertainty are legitimate but excessive, that concerns over inconsistency fail to appreciate that insurance law in the US is state law, that there is what can be called 'enabling public policy', which can be considered in contract law and insurance law, and that those other doctrines cannot always operate to resolve insurance coverage disputes effectively. In addition, for discussing the applicability of PREC to business insurance, this chapter considers relational contract theory in connection with insurance, the core purpose of insurance and the implication of different conceptions of insurance. For consideration of positive law, the chapter particularly examines the implications of *Smit Tak Offshore Services Ltd v Youell*,²¹ which is thought to have tangentially rejected PREC in English business insurance law, as well as a few other recent commercial insurance disputes.

Chapter 7 singles out PREB as a new and distinctive meaning of 'policyholder's reasonable expectations'. Though not new to the British actuarial profession, it is perhaps new to most lawyers, and it is certainly distinctive from PREC. Its relevance is manifested through a revisit to the infamous case *Equitable Life Assurance Society v Hyman*²² in the House of Lords, and also through an examination of the judicial approach to PREB in this case.

The conclusion in Chapter 8 is that English courts and judges should be incrementally but definitely receptive to an interpretative principle of 'policyholder's reasonable expectations'. This is not simply to copy the American insurance law principle of reasonable expectations. Instead, the English approach to PREC and PREB will continue to proceed along the contextualist interpretation of contracts, which takes relevant background into account. This is not a deviation from but an alignment with general contract law.

²¹ *Smit Tak Offshore Services Ltd v Youell* [1992] 1 Lloyd's Rep 154.

²² *Equitable Life Assurance Society v Hyman* [2000] 3 All ER 961, [2000] UKHL 39, [2002] 1 AC 408.