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CONTRACT LAW AND IMPACT OF LEGISLATIVE CONTROL OVER INSURANCE CONTRACTS - AMERICAN AND EUROPEAN PERSPECTIVES

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ABSTRACT: *This paper is an attempt to shed light over legislative control over insurance contracts, in view of the past and present developments in law pertaining to American and European perspectives. Considering the complexities in the legislative functioning and frameworks of different legal systems, particularly in European perspective, this paper will present a fairly generalized outlook of legislative intervention with respect to the governing policies of insurance contracts. In addition, this paper will present a historical picture of development of state laws and regulations pertaining to insurance contracts. Brief aspect of this paper will also embark on the impact of recent changes in relevant legal framework of European countries followed by their accession to the European Union. Latter part of this paper briefly unfolds the comparative analysis of insurance regulations in both the European and American perspectives.*

KEYWORDS: Contract Laws, Insurance Laws, Legislative Control, American Insurance Laws, European Insurance Laws, EU insurance contracts.

INTRODUCTION

An insurance contract may well be defined as a contract through which one entity is assured financial security against any foreseeable losses from an insurance company. It may also be defined as an arrangement between two parties (one of which being a corporate entity or a State) whereby the other party is provided with a surety of compensation for certain losses for which the insurance cover is obtained in return of an agreed premium[1]. As a matter of general practice, insurance contract appears to of the nature of definite performance on part of the insured, i.e. payment of insurance premium. It, however, turns out to be of great safety for the insured in any unlikely event of loss, depending on the terms of the contract.

Until nineteenth century, the idea of freedom of contract for contracting parties was a norm, and as such, there were lesser areas where judicial and legislative intervention was implemented in contracts. The historical view about freedom of contracts is still regarded as being important aspect of contract laws, it has, nonetheless, become a norm that public authorities are getting more involved in the governance and formation of certain specialized contracts, leaving the contracting parties with several limitations that in some way dictate the terms and conditions of those contracts [2].

The scope and procedure by which any state body or regulations intervene differs considerably across the globe. Countries like Germany, France and the United States tend to have

[1] Definition of Insurance: Retrieved from https://www.law.cornell.edu/wex/insurance

[2] Kimball, Spencer L., and Werner P fennigstorf. "Legislative and Judicial Control of the Terms of Insurance Contracts: A Comparative Study of American and European Practice." *Indiana Law Journal* 39, no. 4 (1964).

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intervention oriented approach, whereby there is considerable intervention of State governed bodies in the insurance contract terms. On the other hand, countries like the United Kingdom and the Netherlands tend to be less interventionist with respect to this area. They tend to uphold their conventional idea of freedom of contracts in specialized areas like insurances. Their appears considerable resemblance in the regulatory system of the United States and the United Kingdom, foremost reason being the historical and procedural common law methodology. State intervention may vary in different forms; it may be certain legislative enactments which create certain overriding principles of laws, statute regulated compulsory terms of insurance contracts, certain limitations which would define the framework of terms of the contract, etc. Judicial interventions in insurance contract is a frequent practice in common law countries where the judges tend to have more inclination towards interpretation of certain terms of the contracts in the light of circumstantial incidents[3] .This paper is an attempt to elaborate on the legislative and judicial control over insurance contracts, alongside their comparison in the United States and European perspectives.

Contract Laws in a Nutshell

In the common law perspective, the essential elements that are required to execute a legally binding agreement (contract) involves a valid offer and acceptance, legality of the subject, bilateral obligations, sufficient consideration and the legal competence of contracting parties[4].

In the United States, contract law deals with the obligations of parties that have been set by a particular agreement executed by them mutually. There is no unified legislative enactment at federal level which would dictate about the governance and regulation of contracts between private parties[5]. However, there are certain laws pertaining to sale of goods that have been uniformly applied (to a considerable extent) throughout the States of the U.S. This has been done by adaptation of a standardized code pertaining to commercial transactions, which is known as Uniform Commercial Code[6].

In the same manner, an attempt to harmonize the laws and regulations across Europe has also been made in the form of the Principles of European Contract Law, being a consolidated paper of model rules pertaining to contract laws in Europe. These principles are founded with the underlying idea of creating a uniform system of laws governing the system of contract laws, as intended by the Commission of European Union.[7]

Despite the commission's attempt to harmonize contract laws to favor the European internal market, there remain several hurdles in the pathway of European harmonization. Most imminent amongst the rest is the difference of legal systems that exist in different European countries, majorly between the common and civil law jurisdictions.[8]

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[3] Ibid no.2.

[4] McKendrick, Ewan. *Contract law: text, cases, and materials*. Oxford University Press, 2014.

[5] Friedman, Lawrence M. *Contract law in America: a social and economic case study*. Quid Pro Books, 2011.

[6] Code, Uniform Commercial. "Uniform Commercial Code." *Uniform Laws* (2011).

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[8] European Commission website (As of March 2015): http://ec.europa.eu/justice/contract/index_en.htm

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CONTROL OF INSURANCE CONTRACTS IN THE UNITED STATES

Historical Perspective

As we turn the pages of history, it can be witnessed that much before the statutory enactments pertaining to regulation of insurances, there were certain legislatures which made attempts to employ control over certain insurance terms and conditions incorporated in policy contracts[9]. One such example would be the intervention of the General Court of Massachusetts in 1818, which provided "That this corporation shall not have power to pay over any sums to the heirs of those who shall die by the hand of justice, or by suicide, or in consequence of a duel.[10]" Similarly as early as during 1861, a state statute of Massachusetts enacted certain guidelines to govern the grace in payments of premium alongside regarding no-forfeiture if default occurs.[11]

Since the inception of the development of American insurance laws, legislations that moved across the country were mostly based on imitativeness. However, this uniformity was not certain; and the first formal attempt to produce uniformity beyond State borders started with the establishment of the National Convention of Insurance Commissioners. This formation took place in the early quarter of 1870s[12].

Following these gradual developments that have taken shape over the period of many decades, focus of the law makers towards regularizing insurance terms has substantially increased. It today's time, it would not be incorrect to assume that practically, the whole provisions and framework of insurance policies are subject to control of legislative enactments[13].

Regulation of insurance oriented matters through courts of law can be traced back from early 1940s; however, amongst the very first rulings in this regard can be traced back to as early as 1868. It was the case of Paul v Virginia[14] in which it was held by the Supreme Court that the insurance contracts were not general commercial contracts, and it also pronounced that this area was state exclusive, i.e. not subject to regulations incorporated by the federal government. This precedent engulfed a lot of impact on the development of insurance laws and regulations and to some extent, commenced the idea of state-level insurance regulation[15]**.** However, this stance continued to govern the policy approach until the case of United States v South-Eastern Underwriters Association[16], almost eight decades after the initial ruling. In the latter case, it was pronounced that insurance policies were similar to the policies of ordinary commercial contracts, therefore could be made subject to similar principles as those for ordinary commercial contracts.

[9] Ibid No.2.
[10] Ibid No.2.
[11] Ibid No.2.
[12] National Association of Insurance Commissioners, website: http://www.naic.org/
[13] Ibid No.2.
[14] Paul v State of Virginia, 75 U.S. 168 (1868)
[15] Meier, Kenneth J. (1988). The political economy of regulation: the case of insurance. Albany, NY: State University of New York.
[16] United States v. South-Eastern Underwriters, 322 U.S. 533 (1944)

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Present Perspective

At present, insurance policies along with insurance companies are governed by the relevant laws and regulations, which is no different from those as required for other business activities. Regulations of insurance policies are mostly governed at State level, with different nature of provisions that apply in various States across the United States. As regard insurance companies operating within the jurisdiction of U.S, they are required to follow certain standards which include a prescribed usage of land, laws and regulations pertaining to wages of workers and other safety and security matters. Certain States also have comprehensive legislative enactments which oblige the insurers to comply with certain standards. In general, every state legislature governing this area entails a provision that creates an administrative agency, which are commonly regarded as Department of Insurance. These departments are mostly headed by Insurance Commissioners, or other officers having same authority but varying titles. These state agencies further formulate administrative regulations that regulate the insurance companies which are registered and authorized by the State to carry out insurance business. As such, in the United States, governance and regulations of insurance is a local matter of State, and federal government has not interfered with the regulation of insurances. In case of default of liquidation of any insurance company, National Association of Insurance Commissioners[17], which is a not-for-profit association, majorly funded by its members, plays its role to expedite the situation as per circumstances. The objective of this association is to facilitate and substantiate the insured's interests in such events.

In the jurisdictions where insurance terms are highly regulated, like the United States of America, the scope of governance stretches farther from the regulations of capital adequacy and prudential supervision of insurance companies, and extends to further issues such as to ensure that the insured is safeguarded against any possible deceiving claims on the insurer's part. It also includes the matters involving the prudential regulation against unduly high premiums, or fixed premiums in certain cases, and that the insurance policies and contractual terms comply with the minimum standards. Any possible action in bad faith may give rise to several unfavourable prospects. It may give rise to a scenario whereby the insurer refutes any claim which would otherwise be valid under the terms and conditions of insurance policy. It may be so due to unreasonable delays in payment of the claim. The burden of proof lies with the insured; therefore such mechanism may stand burdensome for the insured, being impractical to be proven under certain circumstances. Furthermore, there may be other ancillary issues, such as distortion of fair market competition due to connivance of insurance companies, which may be detrimental for consumers creating unfair competition environment.

One famous such incident was that of Zurich Financial Services[18]. In this it had turned out that Zurich had paid certain commissions to brokers and prepared a particular scheme in connivance with those brokers with the inherent motive to overcharge the policy holders. It was contended that the company was involved in devising certain mechanism to portray an untrue impression of legitimate competition bidding on policies. However, in reality, the other company had secretly delegated particular insurers to win those bids. It was further alleged that the company

[17] Ibid No.12.

[18] News article 'Zurich, 9 States Settle Bid-Rigging Case for $171 Million' (2006). Retrieved from: http://www.insurancejournal.com/news/national/2006/03/19/66587.htm

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had showed its inclination to provide bogus quotes, against which it was assured with security from competition so it could be at a position to inflate the premiums artificially, without fearing any competition from its counterparts. Most of the victims of this scheme were corporate non-profit and for-profit organizations and some government offices[19].Relevant regulatory bodies in different states across the United States are entitled to issue fines if any insurance company is found guilty of any fraud or deception. In extreme cases, if there are many complaints received against a particular insurance company, these regulatory authorities hold the right to revoke or suspend the business license of the insurer.

Further Controls

In early stages, certain constitutional interventions were raised to counter intervention of legislature to govern insurance terms and policies. Amongst the earliest reasoning was the contention that suggested that any such intervention would vitiate the idea of freedom of contracts[20]. With the eventful development of laws and regulations mentioned earlier, most legislative enactments sought to attain control over most of the substantive terms and conditions of the contract, so it may be assured that the person or entity willing to obtain insurance was presented with a contract comprising of reasonable and equitable terms[21]. Yet, there are certain provisions which have been deliberately codified to govern the form of the insurance contract. The basic logic behind such provisions is to safeguard the insured from any sort of deception, ensuring that the policy holder is provided with complete information about his coverage. At the same time, certain statutory provisions are designed to frame a procedural methodology for enforcement of formal provisions.

Most insurance codes demand that certain insurances should be provided with effect of a contract comprising of all terms and conditions codified in one single document. This may be accomplished either directly or by insertion of some special provision in the policy[22]. These regulations attempt to assure that the prospective insurance holders are to receive complete information about their privileges and duties arising from that particular contract document and its annexure. It further provides that no further rights or duties can be annexed to the initial contract without being quoted in entirety. In addition to this, there are certain provisions which shed light on the subjects which are imminent to ensure that the policies are not misleading to any ill informed policy holder. One such example is that of New York insurance law, which requires life insurance contracts to entail a statement with respect to principle amount in entirety and other considerations, details about timings of its validity and termination, grace period (if any), details about premium payments, cancellation, duties of the insured and other such provisions[23]. Apart from these, there are certain statutory requirements which are strictly formal. According to such, the insurance policy should bear the name of the insurer, certain clauses are to be printed in bold font, that any exclusions and limitations inserted in the policy

[19] Ibid No.18.
[20] Ibid No.2
[21] Kimball, *The Purposes of Insurance Regulation: A Prelininary Inquiry in the Theory of Insurance Law*, 45 MINN. L. Rev. 471, 490 (1961).
[22] Ibid No.2.(example of New York Insurance laws)
[23] Ibid No.2 (example of New York Insurance laws)

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must be printed prominently or the fact that such clauses must be written under a special notice[24].

Foremost reason behind these strict provisions is to ensure that no policy holder could be misled or deceived. Likewise, there are certain provisions that are intended to prohibit unfair clauses in insurance policy terms. For instance, in life insurance contracts, it is usual to prohibit provisions that avoid insurance entitlement in any event of death that is caused in a particular manner, subject to certain exceptions[25].

In normal course, judicial pronouncements serve only to analyze whether a proviso or provisions of insurance contract are in compliance with the legislative enactments. However, this is not as simple as it looks like. There are certain factors which the judiciary has to take into account while deciding such cases. Such factors include public policy restrictions, customary trade practices and the variable interpretations of certain clauses.

CONTROL OF INSURANCE CONTRACTS IN EUROPE

Historical Perspective

The historical development of legislative and judicial control over terms of insurance contracts varied greatly across Europe. Such regulations were enacted earlier in countries like Germany and Switzerland as compared to other countries. Generally, the development of laws in European continent varied from that of the United States, mainly due to differing legal systems, with exception of the United Kingdom. Most of the development in European countries took place following the civil form of legislation; however, such statement stands extremely generalized and does not justify the real complexities of variations that existed across the European continent. For instance, in the United Kingdom, there are numerous statutory enactments that govern insurance policies of varying subject areas. Initially, there were considerable legislative enactments to govern the contract of insurances for industrial life insurances. These were enacted under the codified heading of Industrial Assurance Act[26], which was repealed later on. As regard marine insurance policy is concerned, this policy was codified in the form of act which is known as Marine Insurance Act[27].This legislative act contains certain rules that outline and affect the framework of insurance contract[28]. The essence of these legislative enactments is that the provisions serve as a guideline, as the form of best practice code, therefore putting it as guiding code for marine insurances.

The procedure of enactment of statutes varies greatly across European countries, there being several historical and constitutional factors behind it. Unlike America, there are wide ranging modes of legislations that are followed in Europe[29]. The legislative pattern of insurance regulation systems across Europe is partially related to generalize ideas about legislation and codifications, which is fairly different from the common-law approach. According to civil law

[24] Ibid No.2 (example of New York and Michigan Insurance laws/codes)
[25] Ibid No.2
[26] Industrial Assurance Act 1923 (repealed)
[27] Marine Insurance Act (1906) U.K. retrieved from http://www.legislation.gov.uk/ukpga/Edw7/6/41/contents
[28] Ibid No.27.
[29] Craig, Paul, and Gráinne De Búrca. EU law: text, cases, and materials. Oxford University Press, 2011.

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theories, statutes are regarded as the major source of law, and not the supplementary one alongside judicial pronouncements, as understood in common law regimes. The laws and policies that are codified in the form of codes are regarded as being complete, which provide a coherent system of its applicability, providing a comprehensive and reliable foundation of solutions to the problems relevant to the subject.

Present Perspective and Impact of European Union

European legal framework has undergone massive developments in the past couple of decades. Underlying idea being that of 'internal market', the regulations pertaining to insurances are divided into different segments, depending on the nature of insurance. For instance, there are separate legislations for vehicle, life and non-life insurances. The first non-life insurance directive was issued in mid 1970s, foremost aim of which was to ensure legislative harmonization amongst member states and to provide certain standards for consumer protection[30]. The second non-life insurance directive aimed to provide facilities and services beyond borders of member states (within the internal market), whereas the third of the list was inclined mostly towards the insurance business establishments within the European Union. The third directive of this list was ultimately able to achieve minimum harmonization, whilst providing a European passport for insurance companies[31]. The first life insurance directive was also issued in late 1970s and followed the footsteps of non-life sector in its subsequent directives[32].

In the same manner, motor insurances have also been subject to harmonization across the European continent, thereby strengthening the four principle freedoms intended by member states in treaty of European Union[33]. With regard to motor insurance, substantive rules of harmonization are found in directive 2009/103/EC[34].

By the beginning of 1990s, it had started to become obvious that the European insurance market had expanded dramatically, requiring updated rules and regulations in order to meet certain challenges of new era, which the prevalent laws of those times were unable to comply with. The financial markets of Europe had undergone considerable changes, with newly formulated rules and procedures following the harmonization efforts, thereby laying a remarkable effect in the functioning of insurance companies[35]. The rules which were in force during those times were in a way discouraging for the conduct of insurance business companies, exposing them to higher risks[36].

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[30] Bondesson, Isak. "Suitability assessment procedures in Solvency II." (2009)
[31] Impact Assessment Report SEC (2007) 871. Retreived from: http://ec.europa.eu/finance/insurance/docs/solvency/impactassess/final-report_en.pdf
[32] Ibid No.31
[33] Treaty of European Union [1992], Retrieved from http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:12012M/TXT
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[35] The review of the overall Financial Position of an Insurance Undertaking – Solvency 2 Review, European Commission, Internal Market DG, MARKT/2095/99
[36] Ibid No.33

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Directive 2009/138/EC

In this regard, an example of recent development has been portrayed to show the harmonizing approach of E.U. Directive 2009/138/EC was issued by the European Union in 2009, which pertains to the topic of insurance and reinsurance businesses (Solvency II)[37]. This directive sets out its aim to provide a framework for insurance businesses being conducted within the European market. This directive essentially consolidates the earlier directives which had been issued by the European Union within the field of insurance.

As suggested earlier, the inherent purpose behind the publication of the said directive is to create more harmony of laws and regulations pertaining to insurance industry amongst member states. It also projects its motive to provide framework to better channelize the gateway for creation of internal market for financial services. This would allow member states to mould their laws in such a way which would bring their policies in consonance with each other, thereby increasing competitiveness of European Union insurance providers. It is further submitted that the provisions of the said regulations and guidelines are consolidated to ensure the increasing protections available for the insured across European market. This law, as part of ever growing legislative and regulatory publications/enactments of European Union, further aims to create simplicity for consumers and to provide a fair market for SMEs (small and medium sized enterprises) to support growth at large[38].

Further Controls

Considering the exhaustive number of judicial pronouncements across different countries of Europe, this section would attempt to project a broader picture of statutory and judicial role in regulation of terms of the said policies. To facilitate this article, analysis would be made with respect to European civil law countries pertaining to the said topic. The major difference between civil and common law in decision making, as a matter of basic understanding, would be the difference of the presence of doctrine of stare decisis[39].

Unlike common law, public policy doctrines in civil legal systems are ordained much exhaustively by statutory provisions. In case of common law, such policies are framed and formulated by series of case laws. The apparent duty of judges in the civil law system is to apply the remedy that has previously been codified in the code/statute.

In German law, for instance, both the statutory and contractual interpretations of laws and regulations, in addition to statutory provisions, are formulated by way of academic discussion and court practices[40]. Foremost importance with respect to interpretation of contractual terms is laid down to project the real intentions of the parties rather than to the literal approach. The idea of good faith and customary trade practices are regarded as inherent in the interpretation.

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[37] Directive 2009/138/ec of the european parliament and of the council of 25 november 2009. retrieved from: http://eur-lex.europa.eu/lexuriserv/lexuriserv.do?uri=oj:l:2009:335:0001:0155:en:pdf

[38] Ibid No.37

[39] Glendon, Mary Ann, Michael Wallace Gordon, Christopher Osakwe, and Christopher Osakwe. Comparative legal traditions in a nutshell. West, (2012).

[40] Youngs, Raymond. English, French and German. Routledge, 2014.

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Similarly, in civil law concepts, there exists no space for interpretation of straightforward language. Regardless of literal interpretative approach, the civil law judges have also created uncertainty with respect to interpretation by blurring it by creating extensions in interpretations to avoid any mistreatment with policy holders[41].

Comparative Analysis

As a matter of basic understanding, contract law is a mechanism which defines the relationship between the two or more parties within the contract[42]. However, with the simplicity of words prescribed to it, the traditional view in this regard was based on the doctrine of freedom of intention of both parties, which has gradually developed into a fairly modified form. With the ever increasing usage of contractual relationships within personal and collective capacity, it was imminent to regulate certain standards to encourage such practices. Another factor behind regulation of certain contractual relationships has been the inequality of bargaining power between the contracting parties. A lay person in general, or most policy holders in particular, are usually at a weaker end of bargaining due to their lack of knowledge about legal complexities pertaining to most of the terms incorporated in policies of specialized contracts, insurance contracts being one of them. Considering their insignificance, it could be construed that such segment of the market needed special protection and supervision by certain regulatory authorities, which would help them overcoming their weaker bargaining position. This insecurity led to protective measures that in some way intruded to classical doctrine of freedom of contract in this regard, and settled certain standards as being mandatory for insurance policy makers, and so was done in both America and Europe.

On the contrary, it may be argued that vulnerability of one party is not the reason behind legislative intervention and regulation, but such regulatory interventions are made to harmonize and organize such specialized contracts. This argument may imply the basic idea of balancing the interest of commercial enterprise and safeguarding the interests of public. It also entails the idea of protecting the market from any sort of unfair competition which could be created artificially in the absence of such regulations.

In view of the historical development of legislative and judicial intervention in America, it can be analyzed that prior to State interventions, it was for the companies to prepare the policies and the role of commissioners was restricted to mere approval of them.

Additionally, in the United States, the parliament had traditionally been less interventionist with regard to private contractual relationships, limiting themselves to the extent only where public interests were at stake. On the contrary, most countries across European continent were traditionally inclined towards imposition of compulsory laws[43], tending to adopt more interventionist approach from the offset. Despite more reliance on literal interpretation (mostly in civil law countries of Europe), the statutory provisions entailing words like ‘good faith’ and ‘mutual intention’ of parties have given more room for the judiciary to take different interpretative approaches, which are novel to judicial practices of those countries.

[41] Ibid No.2

[42] Burton, Steven J. "Principles of contract law." (2012).

[43] Delfino, Rossella. “European Community Legislation and Actions.” *European Review of Contract Law* 9, no. 3 (2013)

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With the advent of the idea of 'internal market' in Europe, much of the efforts have been made to harmonize the rules and regulations pertaining to such subject matters that have cross border impact. Insurance laws are no exception to this. Since the foremost agenda of the European Union as to strengthen the four principle objectives, enshrined in the Treaty of European Union, was to remove the bars which act as impediment to trade between member states. The publication of Directive 2009/138/EC also supports this direction of law makers, as it seeks to reflect the same objective of harmonizing laws and regulations pertaining to insurance practices throughout Europe. As regards the European perspective, the legal systems operating within member states have been exposed to more complexities than ever before[44], mostly in relation to the tiers of hierarchy followed by accession to the European Union memberships.

CONCLUSION

It can be witnessed from the pages of history that the insurance contract regulations have witnessed gradual increase in state interventions, both in the U.S and the European countries. Indeed the impact of legislative control in fifty states of U.S and twenty eight countries of Europe (within the European Union) seem to be too exhaustive to be covered fairly within the scope of this paper. However, the legislative and judicial interventions in both continents seem to be accomplishing the same purpose, regardless of their approach. In all, the historical and present extent and impact of such legislative and judicial control have been highlighted in the aforementioned paragraphs. In this advanced era of development, more and more intervention of state is likely to be continued in relation to governing policies of insurance contracts.

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[44] Ibid No.42

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