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Briefing note March 2015

The countdown begins: The Insurance Act 2015

On 12 February 2015, the Insurance Act 2015 ("the Act") received Royal Assent. This follows years of detailed Law Commission consultations and Parliamentary scrutiny and, as it amends key sections of the Marine Insurance Act 1906, it will be the first significant change to commercial insurance law in more than a century.

Implementation follows an 18 month period, with the clock now counting down to 12 August 2016 – the date when the Act comes into force.

The forthcoming changes will impact on all those involved in the insurance market - insurers, brokers and the insured – see annex 1 for a list of considerations.

Early preparation is key for all parties. Steps should be taken now to ensure timely review of all relevant contract wording, policy documents and practices and IT systems. The Act is also another reminder of the importance of a dialogue taking place between the parties to ensure that the insured had properly described, and the insurer properly understood, the risk.

Background

On 17 July 2014 the Law Commission published a report on Insurance Contract Law: Business Disclosure; Warranties; Insurers' Remedies for Fraudulent Claims; and Late Payment[1]. The report was accompanied by a draft Insurance Bill, now the Act, which implemented the Law Commissions recommendations.

The Act is designed to ensure a better balance of interests between insurers and the insured. The Act also updates existing outdated insurance contract rules which no longer reflect good practice.

The Act applies mainly to non-consumer contracts of insurance, sitting as it does alongside the Consumer Insurance (Disclosure and Representations) Act 2012, although some provisions (notably those relating to the duty of good faith) apply to both consumer and non-consumer policies.

Key changes

- A new duty on the insured to make 'a fair presentation of the risk' and to disclose 'every material circumstance which the insured knows or ought to know'.
- New remedies available to the insurer in the event that the insured fails to discharge its 'duty of fair presentation'.
- 'Basis of contract' clauses, whereby representations are automatically converted into warranties are abolished.
- The Act sets out insurer remedies in the event that an insured commits fraud with regard to a claim.
- Contracting out is only permitted where insurers comply with the Act's transparency requirements.

The duty of fair presentation

This is possibly the most controversial change effected by the Act. It applies in relation to 'non-consumer insurance contracts' and requires a 'fair presentation of the risks' before an insurance contract is entered into[2].

Disclosures

The 'duty of fair presentation' is a concept derived from the existing case law[3] and will replace the

[1] http://lawcommission.justice.gov.uk/docs/lc353_insurance-contract-law.pdf

[2] Section 3(2) of the Act

[3] See judgement given in *Garnat Trading*

existing duty set out in the Marine Insurance Act 1906[4]. The new duty requires[5]:

- disclosure of material circumstances which the insured **knows** or **ought to know**.
- alternatively, disclosure of sufficient information in relation to those material circumstances as would put a prudent insurer on notice that it needs to make further enquiries.

The first limb of the duty is essentially an objective test given it is based on what the insured 'ought to know'. The Act retains the confusing notion of those circumstances which would 'influence the judgment of a prudent insurer', which forms part of the materiality test.[6]

The question of what the insured 'ought to know' or is 'presumed to know' has the potential to be a tricky issue in practice and likely to be an area of contention.

The second limb of the duty is intended to operate where the insured fails to satisfy the first limb but the insurer had sufficient information to put it on notice that it needed to make further enquiries to understand the risk.

The Act outlines a 'fair presentation of the risk' is a disclosure[7]:

- that is made in a manner which would be reasonably clear and accessible to a prudent insurer; and
- in which every material representation as to a matter of fact is substantially correct, and every material representations as to expectations or belief is made in good faith.

Requiring disclosures which are 'reasonably clear and accessible' should reduce the possibility of 'data dumping' – the practice of providing insurers with a vast amount of information where little or no attempt has been made to select the appropriate information.

In particular, it has been suggested that a lack of structuring, indexing and signposting may mean that a presentation is not regarded as 'fair' but at the other end of the spectrum, the Explanatory Notes to the Act make clear that neither would 'an overly brief or cryptic presentation'.

Exceptions

There are exceptions to the duty on the insured to make a fair presentation, in the absence of enquiry by the insurer. It is not necessary for an insured to disclose a circumstance if:

- it diminishes the risk;
- the insurer knows it;
- the insurer ought to know it;
- the insurer is presumed to know it; or
- it is something as to which the Insurer waives information.

Knowledge of insured

The Act draws a distinction between insured's who are 'individuals' and those who are not i.e. a company. It then elaborates on what the insured 'knows or ought to know'[8] for the purposes of 'fair presentation' disclosures.

Where the insured is an individual, knowledge is not limited to 'what is known to the individual' but extended to include what is known to those responsible for 'the insured's insurance'[9] so includes, for example, his or her insurance broker.[10]

Where the insurer is not an individual (i.e. an organisation), the relevant knowledge is:

- that of anyone who is part of the insured's 'senior management'[11]; or
- who is 'responsible for the insured's insurance (the risk manager is an obvious example)[12]

The Explanatory Notes explain that 'senior management' can extend beyond the Board, depending on the management structure in place.

To limit the scope for dispute, it is good practice for policy documentation to set out whose knowledge in an organisation is

& Shipping (Singapore) Pte Ltd and another v Baominh Insurance Corporation [2012] EWHC 2578)

[4] Section 18(2) of the Marine Insurance Act 1906

[5] Section 3(4) of the Act

[6] Section 7(3) of the Act

[7] Section 3(3)(b) and (c) of the Act

[8] Section 4(1) of the Act

[9] Section 4(2) of the Act

[10] Section 4(4) of the Act excludes from this duty confidential information which the broker has obtained through acting for a different client.

[11] Defined at section 4(8) of the Act as 'those individuals who play significant roles in the making of decisions about how the insured's activities are to be managed or organised'.

[12] Section 4(3) of the Act

relevant and tailor provisions as necessary.

Knowledge of insurer

An insured is exempt from the duty to disclose a circumstance if the insurer knows of it already. In this case, insurer knowledge extends to those individuals involved in the underwriting process.

Warranties

The Act changes the current law on warranties for non-consumer insurance contracts by:

- replacing the existing remedy for breach of warranty,
- abolishing 'basis of contract' clauses, and
- addressing the issue of breaches of a warranty or other terms which are not material to the actual loss suffered.

Existing remedy

Currently a breach of a warranty in an insurance contract entitles the insurer to avoid all claims under the policy from the date of breach – even if the breach is subsequently remedied.

Under the Act the insurer's liability is suspended until the breach is remedied.[13] The insurer will have no liability for any claim arising if the policy is suspended but once the breach has been remedied, the policy resumes. The timing of a breach and when it is remedied is, therefore, critical in determining whether a policy is 'live' and so should be evidenced and documented where possible.

Remedies

If the insured fails to make a 'fair presentation' of the risk, new remedies, as set out in schedule 1 of the Act, are available to the insurer. These remedies are far more flexible than the current avoidance remedy and are dependent on a 'qualifying breach'[1] which is either:

- deliberate or reckless; or
- neither deliberate or reckless.

If the 'qualifying breach ' is deliberate or reckless, then the insurer may avoid the contract, refuse all claims and return any premiums paid.

If the 'qualifying breach ' is not deliberate or reckless, then the insurer must show that it would have acted differently if the insured had not failed to make a fair presentation; that is, that the insurer would not have entered into the contract or variation at all, or would only have done so on different terms.

The remedies then reflect what the insurer would have done if he had known of the undisclosed information before entering into the contract. If it would not have written the policy on any terms, avoidance remains the remedy. If it would have written on different terms, those terms are deemed incorporated. If it would have increased the premium, the indemnity is reduced in proportion to the amount by which the premium would have been increased.

Proportionate remedies are a new concept and, from a litigation perspective, have the potential to generate legal action as it is likely to be difficult to determine with any certainty what premium the insurers would have charged.

Basis of contract clauses

Under the current law, an insurer may add a declaration to a non-consumer insurance proposal form or policy stating that the insured warrants the accuracy of all the answers given. An insurer can also achieve the same effect by stating that such answers form the 'basis of the contract'. This has the legal effect of converting representations into warranties. The Act abolishes these types of clauses and it will not be possible to contract out of this prohibition.

Terms not relevant to actual loss

The Act applies to any warranty or other term which can be seen to relate to[14]:

- a particular type of loss, or
- the risk of loss at a particular time, or
- in a particular place.

In the event of loss and non-compliance with such a term, the Act prevents an insurer from relying on that non-compliance to avoid liability - unless the non-compliance could potentially have had some bearing on the risk of the loss which actually occurred.

The Act is seeking to mitigate some of the unfairness from the absence of a causation requirement, by ensuring that a breach of a term of an insurance contract must at least be related to the particular type of loss in question.[15]

[13] Section 10(2) of the Act

[14] Section 11(1) of the Act

[15] A direct causal link between the breach and the ultimate loss is not required.

Fraudulent claims

The Act specifies that if an insured makes a fraudulent claim, the insurer[16]:

- is not liable to pay the claim,
- may recover sums paid in respect of the loss, and
- may give notice terminating the insurance as from the date of the fraudulent act.

The Act does not define 'fraud' or 'fraudulent claim' but leaves these to be determined in accordance with common law principles.[17]

Good faith

Section 17 of the 1906 Act provides that insurance contracts are contracts based upon the utmost good faith. Further that, 'if the utmost good faith is not observed by either party, the contract may be avoided by the other party'.

The Act removes avoidance of the contract as a remedy for breach of this duty of good faith, both from the 1906 Act and at common law.[18]

The Explanatory Notes confirm that the intention is that good faith will remain an interpretative principle rather than a remedy for breach.

Contracting out

The Act contains different contracting out provisions which are dependent on whether the insured is a consumer or non-consumer.

Consumers

In respect of consumer contracts, an insurer cannot agree terms which put the insured in a worse position than allowed for under the Act.[19]

Non-consumers

In respect of non-consumer contracts, parties will be entitled to agree terms which are less favourable to the insured than those set out in the Act subject to certain transparency requirements which require[20]:

- the insurer to take 'sufficient steps' to draw 'disadvantageous terms' to the insured's attention; and
- the 'disadvantageous term' must further be 'clear and unambiguous'.

Given these specific requirements, it seems unlikely that an insurer could 'contract out' from parts of the Act without bringing this specifically to the insured's attention.

Depending on the sophistication of the insured and the circumstances of the transaction, it may further be necessary for the insurer to spell out expressly the default position under the Act and any disadvantageous deviations from it.

Amendments to the Third Parties (Rights against Insurers) Act 2010

To date, the Third Parties (Rights against Insurers) Act 2010, which is intended to enable victims of insolvent parties and other 'relevant persons'[21] to proceed directly against the insurer, has not come into force due to a number of technical deficiencies. The Act rectifies the deficiencies and should allow the 2010 Act to come into force in the near future.

Law applicable to consumers

In April 2013 the Consumer Insurance (Disclosure and Representations) Act 2012 came into effect. This Act abolished the traditional rules of non-disclosure and misrepresentation in consumer contracts and instead introduced a duty of reasonable care not to make a misrepresentation. The Act is, therefore, mainly significant for non-consumer insurance contracts.

[16] Section 12(1)of the Act
[17] For example, see the test for fraud in *Derry v Peek* (1889) LR 14 App Cas 337.
[18] Section 14(1) of the Act
[19] Section 15 of the Act
[20] Section 16 of the Act
[21] Sections 4 to 7 of the Third Parties (Rights against Insurers) Act 2010

KEY CONSIDERATIONS

The key points for participants in the insurance sector to consider are:

The insured

- Ensure that a 'fair presentation' is given when taking out insurance - have all material matters been identified and disclosed to insurers?
- Make enquiries within the organisation about anything that may need to be disclosed - the duty extends to matters which an insured ought to know.
- Ensure that information is presented in a way which allows insurers to understand the risk - key points cannot be buried amongst less relevant information.
- Consider carefully any proposed 'contracting out' of the Act- is the additional protection provided by the Act necessary?
- Review the provisions of a policy carefully and ensure all terms identified as warranties can be strictly complied with.
- Consider whether provisions need to be included specifying the remedies for non-negligent non-disclosure or misrepresentation - the 'proportionate' remedies introduced by the Act may need to be tested in the courts before their exact impact is known.
- Procedures should be put in place to ensure all relevant employees know the requirements of the policy, particularly of warranties, and can comply with them.
- The timing of a warranty breach and when it is remedied is critical in determining whether a policy is 'live' and so should be evidenced and documented where possible

Insurers

- Consider whether to 'contract in' or 'contract out' of the new rules – will this be for all lines or open to negotiation on risk by risk basis?
- If 'contracting out' carefully consider how this will be perceived by brokers and risk managers.
- If 'contracting out' then consider whether new wording of provisions is necessary - Any opt-out will be subject to transparency requirements in the Act and it may be necessary to spell out expressly the default position under the Act and any disadvantageous deviations from it.
- Consider implications of 'contracting in' to the new rules – would there be a premium increase for 'contract in' polices?
- To limit the scope for dispute over the insurer's knowledge, consider revisions of policy documentation in order to set out clearly whose knowledge in an organisation is relevant and tailor provisions as necessary.
- Consider whether current system and controls satisfy the insurer knowledge test – insurers need to be confident that the underwriting team's knowledge is fully understood.
- A review of standard terms should be undertaken to ensure compliance with the transparency requirements of the Act.

Brokers

- Ensure insureds are fully aware of the scope of their duties under the Act and of the meaning of contractual provisions- in particular the impact of any contracting out provisions or warranties.
- Do current systems meet the new disclosure requirements? If not, consider necessary revisions.
- Consider developing a criteria for carrying out reasonable searches.
- Consider how to seek increased input from insurers in the underwriting stage.
- Compliance with Act will see insurers and the insured ask more questions of each other – are the necessary arrangements in place to meet an increased demand on the role and responsibility of a broker?
- Ensure compliance with the disclosure obligations placed on the broker.

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