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2015

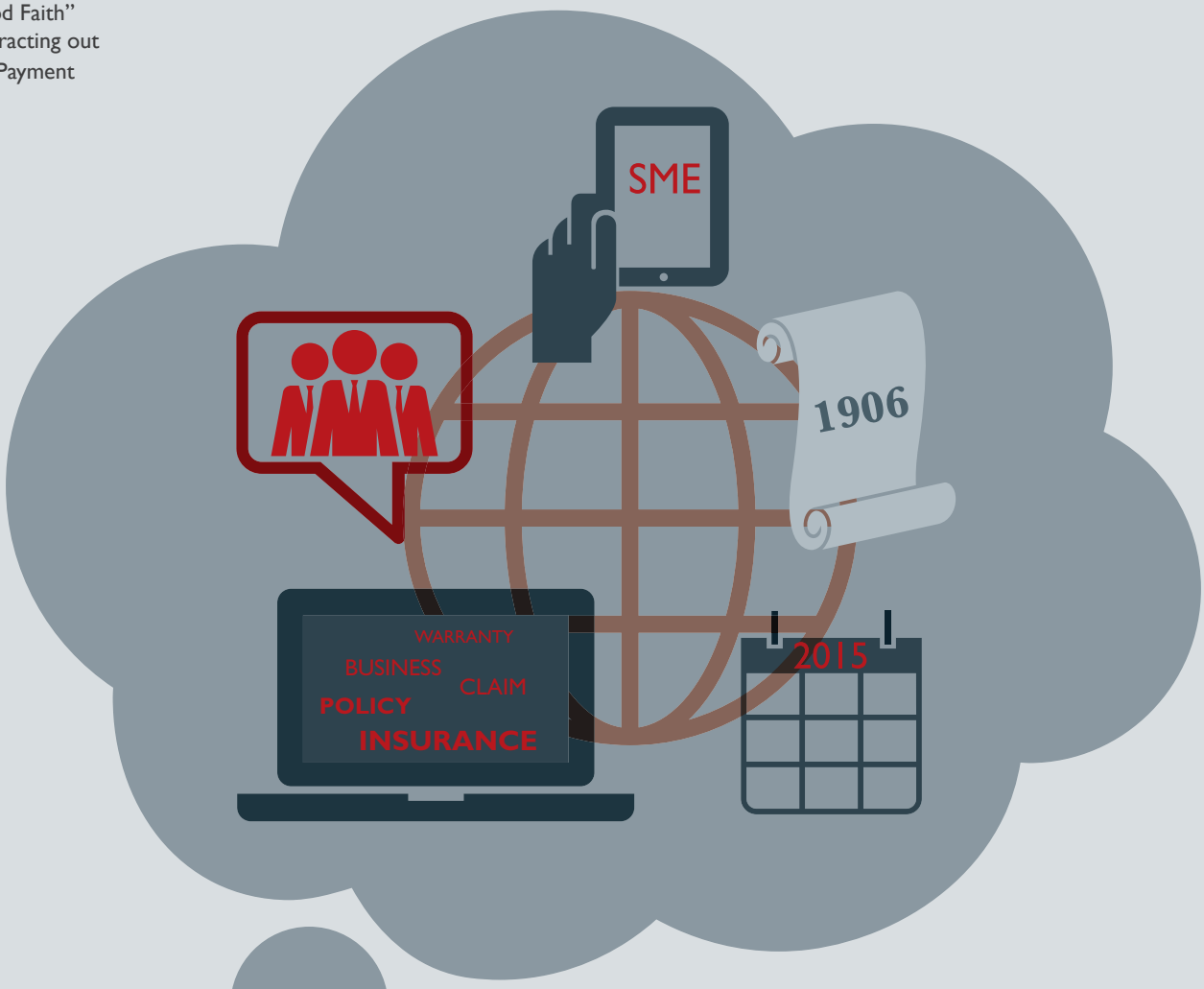
TIME FOR CHANGE

UPDATED

BLM GUIDE TO REFORM OF COMMERCIAL INSURANCE LAW

1906

Contents



We hope you find this guide to the reforms useful, relevant and thought-provoking.

To discuss in further detail, please contact
Alistair Kinley, alistair.kinley@blmlaw.com,
Terry Renouf, terry.renouf@blmlaw.com or
John O'Shea, john.o'shea@blmlaw.com

There is further Insurance Act 2015 information at blmlaw.com/timeforchange

FOOTNOTE
This is the third edition of 'Time for Change'. The contents are very similar to the earlier editions but reflect the changes that were made during the consideration of the Insurance Act by Parliament and the addition of a late payment clause by the Enterprise Bill 2015. Soft copies and commentaries, links and other information and a CII CPD Supplement with video commentary by the authors of the enclosed articles are available at **www.blmlaw/time for change**

FOREWORD

The UK's commercial insurance law has had a makeover in order to make it fit for the twenty first century market. The existing regime - founded on a 1906 statute which itself codified case law from the eighteenth and nineteenth centuries – has been refined to reflect modern business relationships and to rebalance rights and remedies when things go wrong.

The law has already been changed to bring the personal lines insurance market up to date. The Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA) consolidates in law the broad impact that the role of the Financial Ombudsman Service and market-wide statements and practices have had, over the last two decades at least, on how policies are written and how they should respond at the claims stage. This 2012 Act stems from joint recommendations by the English and Scottish Law Commissions.

Commercial policies then formed the next module of the Commissions' insurance law project, with a report and draft legislation being published on 17th July 2014. The Government introduced the legislation in Parliament on the same day and has provided Parliamentary time and resource to steer the Bill quickly towards enactment on 12 February 2015.

The Treasury's press release, entitled: 'Government takes action to modernise 100 year-old insurance industry rules', refers to the introduction of a more modern legal regime; one designed to benefit insurers and commercial customers alike by offering greater clarity about the rules applying to policies and claims and one which should, over time, reduce the number of legal disputes. Materials published by the Treasury accompanying the introduction of the Bill offer the following narrative on the case for change and the aim of the measures now proposed.

The [1906 Act] rules were designed to protect a fledgling insurance industry against exploitation by the insured. They therefore provide insurers with several mechanisms to refuse to pay claims, even when this does not reflect the commercial merits of the case … [although] it is rare for insurers to refuse claims for commercially unmeritorious reasons. However, this remains a possibility, leading to problems of 'quality certainty'.

The aim is to update the default regime for commercial insurance, by removing rules which no longer reflect good commercial practice and replacing them with ones which are broadly neutral between insurer and insured … The new rules reflect what is considered to be broadly right for the generality of the market. They may not meet the needs of all parties, especially in sophisticated and specialist markets. In these cases, commercial parties will remain free to contract on different terms, provided that they do so on a transparent basis.

How are these aims and benefits to be realised in practice?

Insurance Act 2015 seeks to clarify commercial insurance law in three key areas:

- the pre-contractual duty of disclosure and the effect of representations at that stage
- the effect of warranties contained in the policy, and
- an insurer's remedies for fraudulent claims

"ONE SIZE FITS ALL"

The key change in the first area is the introduction of a 'duty of fair presentation of the risk', which refines the existing duty of full disclosure, by the insured, of every material circumstance. John O'Shea deals with this change at page 3 below. Under the new law, breach of the duty of fair presentation will give rise to proportionate remedies, meaning that the insurance policy may survive the breach but that the claims settlement may be adjusted in light of it. Philip Adamis examines this aspect at pages 4 and 5.

On the second topic, warranties, there are three points of note: the blanket ban on 'basis of contract' clauses, which seek to turn all the insured's representations into warranties, a potentially significant change meaning that the insured's breach of a warranty merely suspends, and no longer necessarily discharges, the insurer's liability under the policy, and a provision that an insurer may not rely on a policyholder's breach of an irrelevant warranty. Philip also covers these changes at pages 6 and 7.

The law as regards the third point above, ie fraudulent claims, is to be clarified and will provide that the insurer has no liability for a fraudulent claim (as at present) and, further, that the insurer is entitled to refuse all claims arising after the fraudulent act, but should meet legitimate claims arising before it. Mark Aitken looks at the operation of these remedies at pages 8 and 9.

The Insurance Bill passed through Parliament under a special procedure for non-controversial Law Commission Bills. In order to keep to this procedure, one area of possible reform was omitted from the final Bill: a proposed remedy of damages payable by the insurer for late payment of a claim.

The reform was resisted by certain specialist market sectors, given their poor experience of 'bad faith' litigation in the United States and given concerns over the extent of the potential liability in damages. Despite this, Parliamentary debates on the Bill and commitments by all the principal political parties confirm that the point may well be revisited. Hanna Martindale deals with the issues arising at pages 12 and 13.

The passage quoted above, from the Treasury material, emphasises that the Act is a 'default regime', such that parties may contract out of its provisions (save for the prohibition on 'basis of contract' clauses). Note also that the new regime is very much 'one size fits all' and makes no distinction based on the size of the risk. Thus it will, where carriers do not opt out of it, apply as much to micro SME insurance business as to global commercial programmes written in the UK market.

At this stage, it is impossible to predict the extent to which contracting out will happen in the commercial insurance market. On the one hand, it is entirely foreseeable that specialist and bespoke markets will continue to write business on many, if not all, aspects of the 1906 Act regime. On the other, it is equally foreseeable that SME and scheme-type commercial business is likely to be written to a large extent under the new rules set out in this guide, given that this part of the market operates on somewhat standardised placement processes, standard question sets and standard policy terms. The detail is considered by Hanna at page 11.

Where the probable extent of contracting out may be less clear is in what might be termed the commercial mid-markets. Participants in this large segment of the market might have reason to reflect on the view of Thaler and Sunstein that "Research shows that whatever the default choices are, many people stick with them, even when the stakes are much higher than choosing [something else]". (From 'Nudge', Thaler and Sunstein's highly influential book on behavioural economics.)

The Insurance Act 2015 received its Third Reading in the House of Commons on 3rd February 2015 and Royal Assent on 12 February 2015. It will apply to policies incepted or renewed from 12 August 2016: thus there is just one full annual renewal cycle in which to plan for the new default regime for commercial insurance.

We very much hope you find this guide to the reforms useful, relevant and thought-provoking. It is intended to be something you will refer to from time to time as the market's level of preparedness for the new regime evolves over the next year and a half. Please do not hesitate to contact me, or any of our contributors, should you wish to discuss these reforms in greater detail.

Alistair Kinley
alistair.kinley@blmlaw.com

DISCLOSURE AND THE "FAIR PRESENTATION OF RISK"

Background

From as far back as 1766 and the case of Carter v Boehm there has been an explicit duty of disclosure placed upon policyholders to inform an insurer of any fact that would be relevant to their estimation of a risk.

140 years later, the Marine Insurance Act of 1906 codified marine insurance law and by extension, non-marine law. One of the most famous Latin doctrines in insurance was founded here: uberrima fides or utmost good faith. This imposed a clear duty on the insured to answer questions honestly. Failure to meet the duty of ubberima fides brought about harsh penalties.

Latterly, however, there has been a balancing of the rights and obligations of the parties in the area of consumer contracts, in the form of the Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA). This set aside the strictness of the Marine Insurance Act duties and introduced the need for proposers to take only 'reasonable care' not to make a misrepresentation.

Whilst CIDRA is focused upon the requirements of consumer contracts, the Insurance Act 2015 imposes a duty on the insured to make a 'fair presentation of the risk' to the commercial insurer. The "fair presentation of risk" includes the manner of presentation, which should be "reasonably clear and accessible to a prudent insurer". In addition while the substance of what constitutes 'fair presentation' will be determined by case law in the fullness of time, the Act states that: 'a fair presentation of the risk requires disclosure of every material circumstance which the proposer knows or ought to know, or gives the insurer sufficient information to put a prudent insurer on notice that they need to make further enquiries'. It is the latter requirement, imposing an obligation on insurers to make their own enquiries, that is the most significant change to existing duties.

Knowledge

One hundred years after the codification of insurance law in the Marine Insurance Act 1906 the world is an almost immeasurably different place. The volumes of data available to insurer and insured and the complexity of business has increased by factors that could not have been imagined in the Edwardian era. The Insurance Act therefore sets out principles dealing with the knowledge of both parties to the insurance contract.

Thus, for a proposer who is not an individual, knowledge includes knowledge of senior management and persons responsible within the organization for arranging the insurance for the business and knowledge includes what ought to be known in the ordinary course of business. Knowledge will be imputed where there was a suspicion but there was a deliberate decision to refrain from or enquiring further about that suspicion. Knowledge also includes what should reasonably have been revealed by a reasonable search of information available to the insured.

Similar tests will be applied to an insurer but the complexity and extent of large insurance businesses, together with the duties of client confidentiality, are reflected in the Act because the extent of knowledge that will be attributed is limited to the individuals who participate on behalf of the insurer in whether to take the risk. Similar protections are afforded to brokers in respect of client confidentiality.

Insurers remedies for breaches

The final section of the part of the Act that covers the duty of fair presentation deals with remedies for breaches. Insurers may continue to refuse the insured's entitlement to indemnity where there is a breach of this duty, but only if the insurer would not have entered the contract at all had the information which subsequently came to light been disclosed at inception or renewal. If, given such information at the time, the insurer would nevertheless have entered the contract but on different terms, then the insurer's remedy will be determined by the action the underwriter would have taken, had 'fair presentation' been made in the first place.

Conclusion

The new Insurance Act reflects a widespread view that the present law weighed too heavily in favour of commercial insurers rather than the insured. However, it should be noted that, subject to some tests of transparency, willing parties may still choose to opt out of the Insurance Act requirements and continue to contract on the basis of the Marine Insurance Act 1906.

It is also worth considering the risk that a change in the law may lead to increased litigation as the new law beds down and becomes familiar.

"Britain's insurance industry is a major success story, employing over 300,000 people across the country, helping millions of British people and businesses every day and exporting across the globe. We want the industry to continue to grow and provide better services to customers, which is why we need to bring insurance contract law into the 21st century.

The Insurance Bill that the government is introducing today will ensure that Britain's insurers can succeed in the future, while business customers can take advantage of lower costs."

Andrea Leadsom
Economic Secretary to the Treasury

John O'Shea
john.o'shea@blmlaw.com

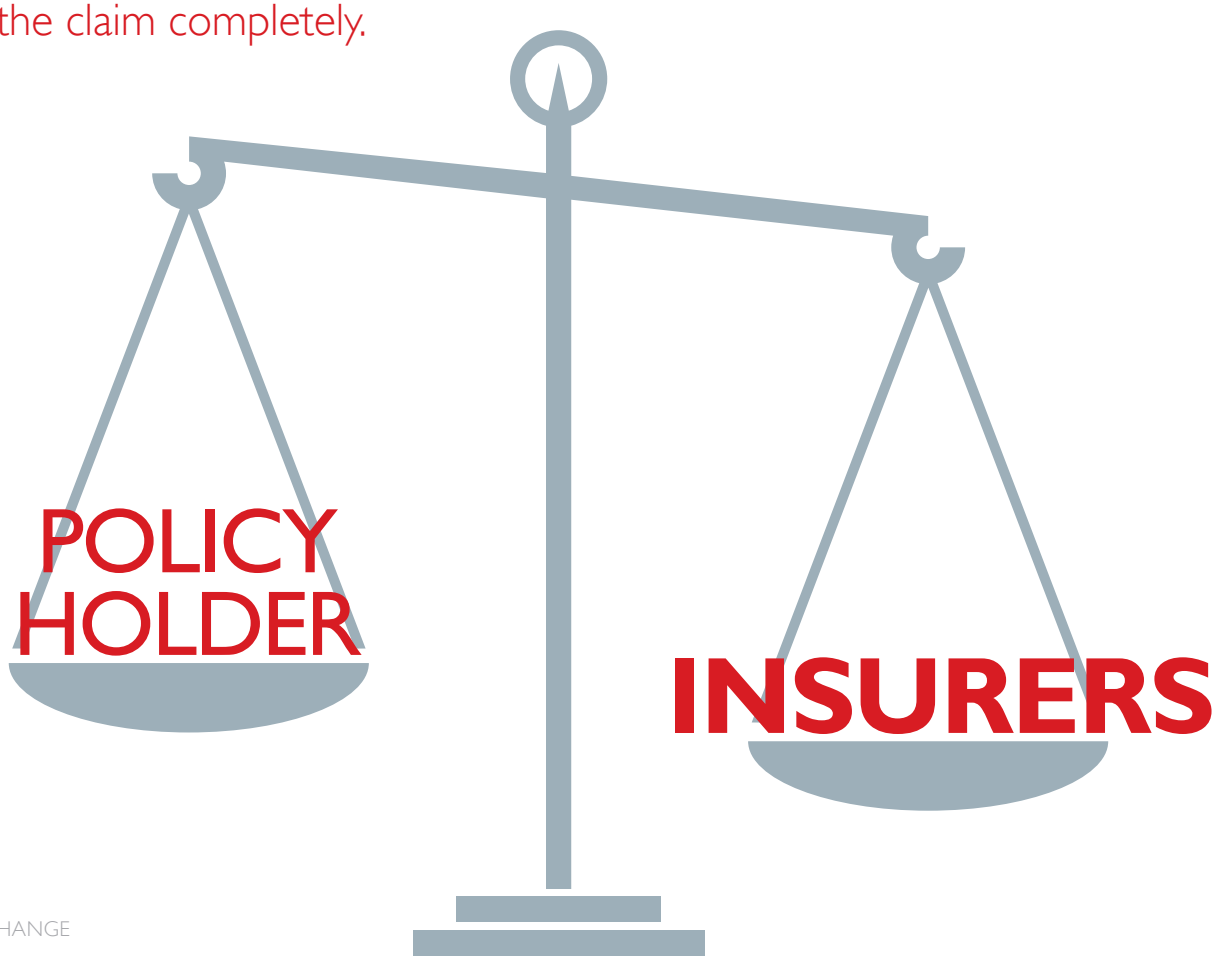
It goes without saying that this is an 'all or nothing' position, which means that a policyholder may find themselves without any cover at all, even for the most trivial or accidental act of non-disclosure. All that an underwriter must be able to do is satisfy a court that their assessment of the risk, and therefore the premium, was influenced by the non-disclosure; which leaves the law heavily weighted in favour of insurers.

For example, under the current law, if a commercial insured fails to disclose to underwriters, at inception, an outstanding county court judgment registered against them, an underwriter simply has to demonstrate that a higher policy excess or premium would have been charged if that fact has been disclosed, enabling them to deny any claim by avoiding the policy from inception. Crucially, the underwriter would have no other remedy available, which might well be considered unjust to the insured in minor cases of non-disclosure.

The Insurance Act redresses this imbalance between insurers and commercial policyholders in cases of material non-disclosure or misrepresentation by introducing the concept of 'proportionate remedies': which have already been introduced into consumer insurance contracts by the Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA).

REMEDIES FOR BREACH OF DUTY OF FAIR PRESENTATION

The current law allows an insurer, in the event of material non-disclosure or misrepresentation by an insured, to avoid the policy from its inception. To put it another way, they can act as if the policy never existed, returning the premium, minus any claims paid, and denying the claim completely.



Under the Act, an insurer will have a remedy against an insured for breach of the insured's duty of fair presentation, but only where the insurer can show that, but for the breach, it would:-

a) Not have entered into the contract of insurance at all; or
b) Have done so only on different terms.

However, before an insurer can even consider its remedy, it has to establish that there has been a 'qualifying breach' which will be defined as either:-

a) Deliberate or reckless
b) Neither deliberate nor reckless.

A qualifying breach is 'deliberate or reckless' if the insured (a) knew that they were in breach of their duty of fair presentation, or (b) did not care whether or not they were in breach of that duty. Importantly, the onus is on the insurer to show that a qualifying breach was deliberate or reckless. Innocent or careless breaches of the duty of fair presentation would fall under the category of 'neither deliberate nor reckless.'

The Act distinguishes between these two categories of breach in order to preserve rights for insurers where there has been a deliberate or reckless breach but also to provide certain rights for policyholders where the breach is neither deliberate nor reckless.

Proposed remedies for deliberate or reckless breaches

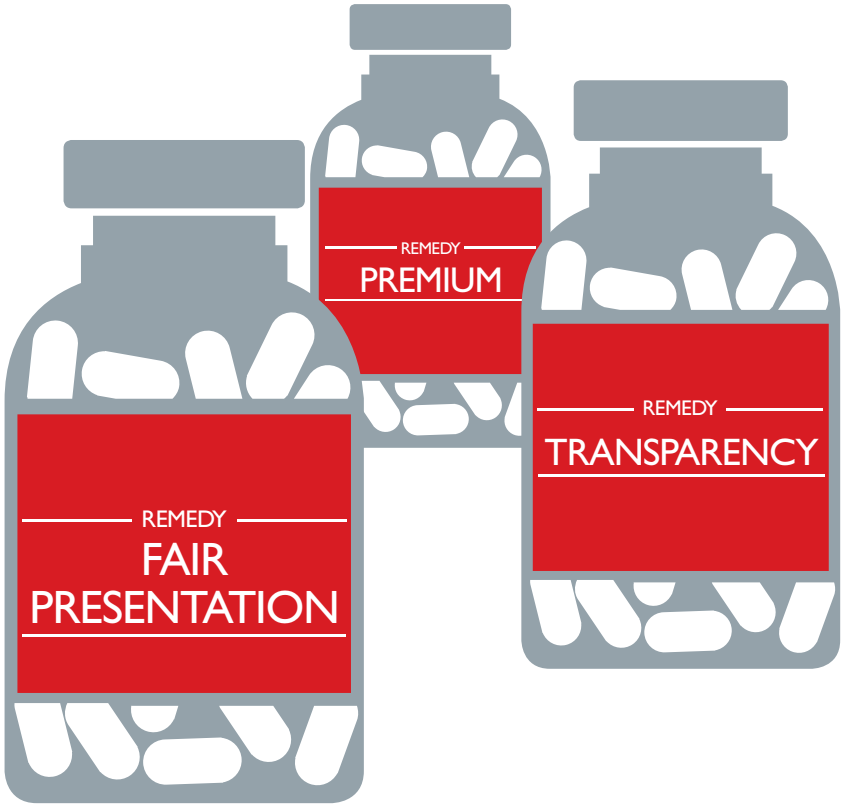
If a qualifying breach has been deliberate or reckless, the insurer:-

a) May avoid the contract of insurance and refuse to pay all claims; and also
b) Need not return any of the premiums paid.

This means that the new remedy for a deliberate or reckless breach of the duty of fair presentation goes further than the existing law where the insurer currently has to return the premium unless fraud has taken place.

Remedies for innocent or careless breaches

Where the qualifying breach has been neither deliberate nor reckless these 'proportionate remedies' will be applied:-



1. If the insurer would not have entered into the policy on any terms, the insurer may avoid the policy and refuse to pay all claims, but must return the premiums paid.

2. If the insurer would have entered into the contract of insurance but on different terms, other than terms relating to the premium, the policy is to be treated as if it had been entered into on those different terms. For example, if the underwriter would have imposed a theft exclusion had there been fair presentation, the claim would have to be dealt with under the policy but subject to the theft exclusion. Therefore, if the claim submitted was for theft of equipment, for example, the insurer could refuse the claim. It could not, however, seek to avoid the policy..

3. If the insurer would have entered into the policy but would have charged a higher premium, the insurer is entitled to reduce, proportionately, the amount to be paid on a claim, e.g. if the premium would have doubled if fair presentation had taken place, then the amount of the claim payable would be reduced by 50%.

Conclusion

Importantly, in respect of all these remedies, it will be necessary for underwriters to provide cogent evidence, supported by underwriting manuals, guidelines etc. to establish exactly how they would have underwritten the risk in the hypothetical case of fair presentation having been given.

Phil Adamis
philip.adamis@blmlaw.com

- Adoption of "qualifying breach" from consumer insurance
- Two types of qualifying breach
  - Deliberate or reckless
  - Not deliberate or reckless
- Insurer to prove a qualifying breach is deliberate or reckless
- Remedies vary depending on type of qualifying breach
- Claims may be adjusted where a qualifying breach is not deliberate or reckless

WARRANTIES

Commercial insurance warranties are often controversial in English law. Even a minor breach of a warranty, whether or not it is the direct or even indirect cause of a loss, will generally discharge the insurer from liability.

This is because, in insurance law, a warranty is usually described as a promissory term of a policy. This means the insured promises to the insurer that certain pertinent facts are true: e.g. that a fully working sprinkler installation will remain in place.

Warranties are therefore used by insurers as a way of controlling risk; ensuring that they only remain liable for risks for as long as insured parties keep to their promises.

Identifying a warranty

As with many aspects of insurance law, the starting point for the nature of warranties is the Marine Insurance Act 1906, and specifically sections 33 and 34.

SECTION 33 – NATURE OF WARRANTY

(1) A warranty, in the following sections relating to warranties, means a promissory warranty, that is to say, a warranty by which the assured undertakes that some particular thing shall or shall not be done, or that some condition shall be fulfilled, or whereby he affirms or negatives the existence of a particular state of facts.

(2) A warranty may be express or implied.

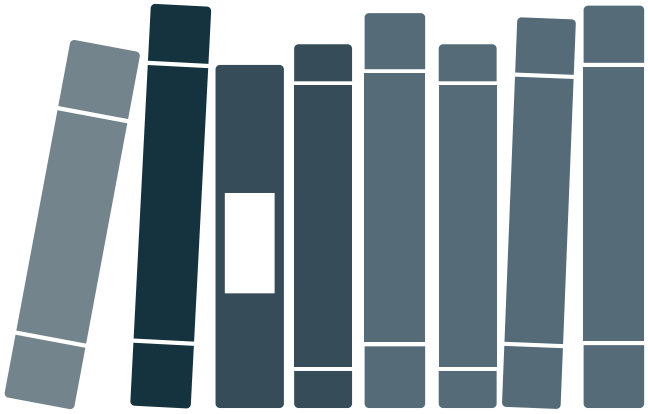
(3) A warranty, as above defined, is a condition which must be exactly complied with, whether it be material to the risk or not. If it be not so complied with, then, subject to any express provision in the policy, the insurer is discharged from liability as from the date of the breach of warranty, but without prejudice to any liability incurred by him before that date

SECTION 34 – WHEN BREACH OF WARRANTY IS EXCUSED

(1) Non-compliance with a warranty is excused when, by reason of a change of circumstances, the warranty ceases to be applicable to the circumstances of the contract, or when compliance with the warranty is rendered unlawful by any subsequent law.

(2) Where a warranty is broken, the assured cannot avail himself of the defence that the breach has been remedied, and the warranty complied with, before the loss.

(3) A breach of warranty may be waived by the insurer.



- "Basis of contract" clauses are abolished
- Warranties may still be agreed in commercial contracts of insurance
- Breaches will suspend cover
- Breaches may be remedied
- A breach is remedied if the risk becomes essentially the same
- "Irrelevant" warranties may not be relied upon

The following points must therefore be understood:-

- Warranties currently demand absolute compliance. Even minor breaches, which do not affect the risk, or temporary breaches which are remedied by the insured before a loss occurs, provide insurers with a defence to a claim.
- An insurer is not required to demonstrate that the warranty was in any way material to the risk, or that its breach in any way contributed to the loss.

The effects of a breach of warranty, even when minor or having been remedied before the loss occurs, can therefore be severe which makes them unpopular with the courts.

How warranties are currently created

1. As an express term of the insurance contract is the most common way in which they are created.
2. As an implied term of the insurance contract, although this is uncommon outside marine insurance.
3. Through 'basis of contract' clauses, which turn any representations made by an insured into a warranty.

In light of their unpopularity the courts have adopted strict and narrow interpretations of wordings and applied a number of legal doctrines to dilute the draconian effects of warranty breaches. The most pertinent case in the context of the Insurance Act 2015 is that of Kler Knitwear Ltd –v- Lombard General Insurance Co. Ltd [2000] Lloyd's Law Rep. I.R. 47 where a doctrine known as a 'suspensive' condition was adopted.

The insured renewed the insurance covering its factory, with a clause within the policy requiring the sprinklers to be inspected within 30 days of renewal. There was also a clause headed: 'Warranties', which stated that warranties were to apply throughout the policy period and to all sections of the policy.

The insured did not arrange for the sprinklers to be inspected until 60 days after renewal, ie outside the 30 days stipulated by the insurer. Sometime later, there was storm damage to the factory resulting in Kler submitting a claim to its insurer who sought to rely on breach of the 'sprinkler alarm warranty'.

The court found that the term was a suspensive condition, not a true warranty, meaning that the insurer was off risk during the period the clause was not complied with, but back on risk once the insured had complied.

Reform of the law on warranties and the Insurance Bill 2014

The Insurance Act therefore takes its lead from the various legal doctrines and precedents that have arisen, changing the law on warranties in order to make it more equitable. The legislation provides that :-

1. Warranties become 'suspensive' conditions, meaning that while the insurer will not be liable for losses occurring when the insured was in breach of the warranty, its liability will be restored once the breach is remedied.
2. The legislation anticipates that there will be situations where a breach cannot be remedied
3. A breach of warranty will be taken as remedied where the risk to which the warranty relates becomes essentially the same as that contemplated by the parties. This covers the situation where for example an insured does something later than anticipated by a warranty which includes a time limit.
4. Where a warranty relates to a loss of a particular kind, location or time, the insurer cannot rely on a breach by the insured to discharge its liability if the insured can show that its breach (of that warranty) could not have increased the risk of the loss which actually occurred
5. 'Basis of Contract' clauses are prohibited and any warranty in the policy will have to be expressly agreed between the parties.

Conclusion

The draft proposals therefore seek to abolish the existing common law and statutory remedies for a breach of warranty, ensuring that in future the rights and responsibilities of both insured and insurer will be easier to understand, enabling insured parties to have a clearer understanding of warranties and therefore increased confidence in their insurance policies.

Phil Adamis
philip.adamis@blmlaw.com

A case resembling insurance fraud can be traced back to 300 BC when a Greek merchant called Hegestratos tried to profit by scuttling his vessel, but actually drowned while trying to escape his angry crew. More than 2,000 years later, insurance fraud is firmly established as one of our most prevalent crimes, resulting in an ever increasing number of prosecutions every year. Yet while the legal definitions of fraud are firmly established, the remedies to be applied against fraudulent insurance claims are far less clear.

FRAUDULENT CLAIMS

Problems of definition

The definition of the remedies for 'fraud' in the conditions of insurance policies still vary widely, from the robust 'claim repudiation, voidance from the outset and retention of premium' type clauses to the simple 'we will not pay your claim'. Other policies state that claimants will 'forfeit all benefit under the policy' as a consequence of fraud. Yet regardless of how these conditions are phrased, they all leave a certain amount of room for uncertainty about whether they apply to all claims made under a given policy, or simply the particular claim under consideration.

This lack of clarity in policy wording also means that the question of what remedy – or sanction, to put it in more modern terms – should be imposed on the insured for making a fraudulent claim remains a grey area. That is largely because the alternative to an all-encompassing fraud clause is section 17 of the Marine Insurance Act 1906, the strict application of which allows the insurer to avoid the policy from the outset in the event of any fraudulent claim.

While this seems fair in principle, the courts have often been reluctant to apply section 17 where it would lead to a perceived injustice: i.e. to an insurer being allowed to treat the whole policy as avoided following presentation of a modest but fraudulent claim and the insured in that situation then having to return any payments made on earlier but genuine claims, which might involve a return of significant sums to the insurers.

In an attempt to make sure that the punishment fits the crime, the courts now tend to steer away from this approach, preferring a 'contractual remedy' instead. This generally means that the insurer is treated as being under no contractual liability from the date of the fraudulent claim. However, the overall position with regard to fraud claims remains uncertain.

The Law Commission and Parliament have addressed this uncertainty. Part 4 of the Insurance Act now codifies the consequences of a making a fraudulent claim. However, there is no definition of a fraudulent claim, leaving the courts to continue to apply the principles of common law to each case as they see fit.

The law under the 2015 Act

The most important points to note from the Insurance Act are that:

1. The remedies proposed are universal, in that they apply to both consumer and non-consumer insurance contracts; as opposed to those other parts of the Act that apply only to non-consumer contracts.
2. Where an insured commits any fraud in relation to a claim, the insurer will have no liability to pay that claim. This is a codification of the established legal principle that fraud taints the whole claim: e.g. even a fraudulent exaggeration of an otherwise genuine claim will forfeit the entire claim.
3. As a consequence of 2. any payments already made in relation to the fraudulent claim are recoverable by the insurer.
4. The insurer, on giving notice to the insured, may treat the contract as having been terminated with effect

from the time of the fraudulent act.

5. Upon termination of the contract, an insurer's liability under the contract arising before the time of the fraudulent act is unaffected; but they may refuse any liability in respect of a claim which occurs after the time of the fraudulent act.
6. Premiums are non-refundable at the discretion of the insurer.

Points 4 and 5 above therefore resolve the current uncertainty by making it clear that the insurer may only terminate the contract with effect from the time of the fraudulent act.

Nature of fraudulent act	Effect of fraud on the claim	Effect of fraud on the policy	Effect on pre-fraud "honest" claim	Effect on post fraud "honest" claim
For a fraudulent claim from the outset	No liability	May be terminated from outset of fraud	Payable	Not payable if policy terminated
For a fraudulent exaggeration	No liability	May be terminated from the date of the exaggeration which constitutes the fraudulent act	Payable	Not payable if policy terminated
Where a lesser loss, or the fact that no loss has occurred, is discovered subsequent to the initial claim	No liability	May be terminated from the date of the act which constitutes the fraud	Payable	Not payable if policy terminated
Fraudulent misrepresentation to suppress a policy breach/ defence to a claim	No liability	May be terminated from the date of the act which constitutes the fraud	Payable	Not payable if policy terminated

Therefore:Therefore:

Individual fraud under a group policy

Previously, insurance fraudsters within a group policy might not have been caught by general common law principles, as they were not party to the contract. However, the Insurance Act enables any member of a group policy who engages in fraud to be separated from the other members and treated exactly as if they had been a party to the insurance contract, (regardless of whether the group policy is a commercial or consumer insurance policy).

Contracting out

As with other parts of the Insurance Act that are applicable to non-consumers, insurers may still choose to contract out of the Act, enabling the robust fraud conditions of many commercial policies to prevail, providing that they meet all of the Act's conditions with regard to transparency.

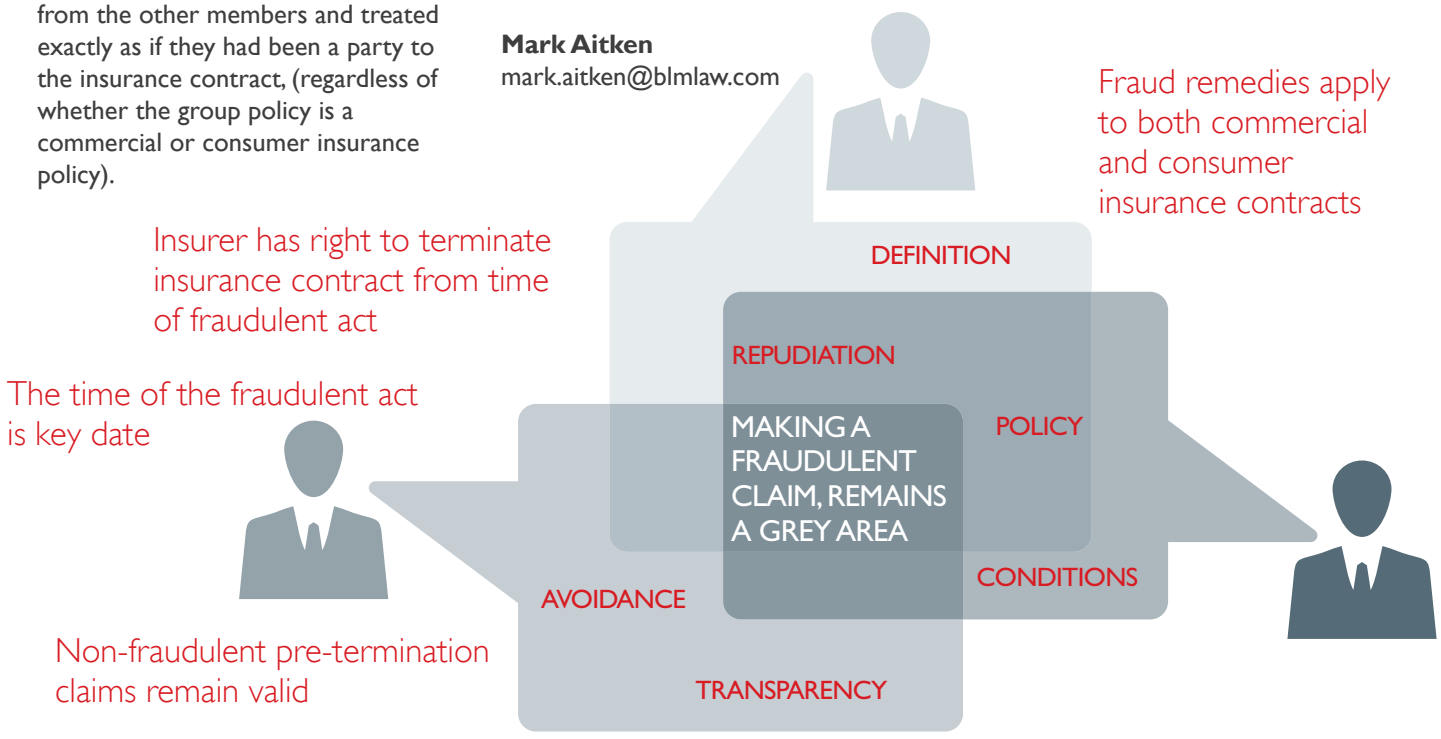
Mark Aitken
mark.aitken@blmlaw.com

Group policies: insurers have remedies against fraudulent member of group scheme

Fraud remedies apply to both commercial and consumer insurance contracts

Insurer has right to terminate insurance contract from time of fraudulent act

The time of the fraudulent act is key date



Non-fraudulent pre-termination claims remain valid

GOOD FAITH

The essence of an insurance contract requires that the nature of the risk, where knowledge rests with the party placing the risk, is fully understood by the party accepting the risk. It is therefore the case that an insurance contract is an exceptional contract which is governed by the legal duty of utmost good faith. This long-standing rule of common law was codified in s17 of the Marine Insurance Act 1906 which provides that:

"A contract of marine insurance is a contract based upon the utmost good faith, and, if the utmost good faith be not observed by either party, the contract may be avoided by the other party."

This duty extends to the pre-contractual stages of disclosure and would cause problems to the new duty of "fair presentation of risk" discussed above if it were not slightly modified. The Insurance Act retains the duty of good faith as an "interpretative principle" under Section 17 of the Marine Insurance Act as The Law Commission recognises that mutual duties of good faith are a commercial necessity in insurance.

However, it abolishes the remedy of avoidance for breach of the duty of good faith, explicitly providing that "Any rule of law permitting a party to a contract of insurance to avoid the contract on the ground that the utmost good faith has not been observed by the other party is abolished." This means that avoidance under the new regime will only be available to insurers as a remedy for breach of 'the duty of fair presentation'.

Hanna Martindale
hanna.martindale@blmlaw.com

CONTRACTING OUT

The Law Commission recognised that there is considerable legal certainty that is based on the present law and that parties may therefore wish to "opt out" of the new legislation. The Insurance Act is a 'default regime' for commercial insurance contracts but will enable businesses to contract out of almost all of the new legislation on the condition that the insurer must make any disadvantageous changes clear to the insured.

While the Law Commission does not want to 'interfere with the smooth running of insurance markets', neither does it wish insurers to use 'boiler plate clauses' which opt-out of the default regime as a matter of routine and so insurers will be obliged to comply with transparency requirements in relation to "opt outs". Parties to an insurance contract will need to carefully consider whether contracting out of any or all of the default regime is appropriate; however in sophisticated markets, such as marine insurance, it is expected that contracting out will be prevalent.

Consumer insurance

The Insurance Act prohibits contracting out of the default provisions in the consumer context, therefore provisions on warranties and remedies for fraudulent claims will remain compulsory in all consumer contracts.

Business insurance

In respect of business insurance the Insurance Act permits parties to contract out of its provisions (save in respect of "basis of contract clauses" – see below). However, contracting out will only be permitted if insurers comply with the following transparency requirements:

1) The insurer must take sufficient steps to draw any disadvantageous term which it intends to include to the insured's attention before the contract is entered into; and
2) Any disadvantageous term must be clear and unambiguous as to its effect.

Business insurers will also have to provide an opt-out clause for each contract change in the policy, which will require careful drafting to ensure that the transparency requirements are met.

When is contracting out prohibited?

One provision is still subject to a mandatory minimum protection for insureds: parties cannot contract out of the prohibition of 'basis of the contract' clauses, although they can of course still agree a warranty in respect of any specific matter.

There is no section in the Act relating to damages for late payment of claims (covered in the following section of this guide). This was a controversial topic during Law Commissions' consultations as well as during the Parliamentary debates. In fact, it was the only topic forced to a vote in Parliament - the vote being lost - and it remains on the political agenda with all major parties committed to revisiting the issue when Parliamentary time allows.

It is worth noting, therefore, that earlier draft provisions from the Law Commission covering this point anticipated that while business insurers would be able to contract out of the remedy of damages for late payment of a claim, they would not be able to do so if their failure to pay a claim within a reasonable time was 'deliberate or reckless'.

Finally, the contracting out provisions will not apply to settlement agreements: hence an insured will still be able to enter into a settlement on less favourable terms than the default rules, while the transparency requirements will not apply to cancellation clauses.

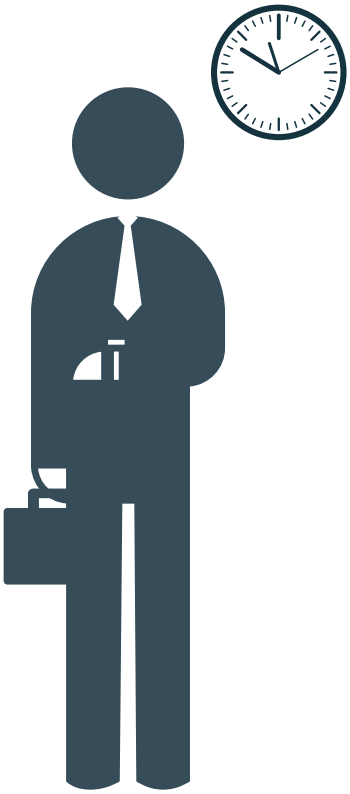
Conclusion

The Insurance Act reflects the Law Commission's proposals for contracting out which were supported by a large majority of participants in the industry and believed to balance the interests of insurers and policyholders fairly. The Law Commission clearly appreciated the need for certainty and flexibility and the Act therefore:-

1) Encourage insurers to consider whether opting out of the default regime is necessary or appropriate in the circumstances.
2) Encourage policyholders to make an informed decision about whether to take out insurances under the 'default regime', to agree to clearly understood 'opt-out clauses', or to seek an alternative provider.
3) Provide the courts with room to differentiate between commercially aware insurance buyers and small businesses buying 'off the shelf' when considering transparency requirements.

Hanna Martindale
hanna.martindale@blmlaw.com

- Insurance Act intended to be the "default regime" for business insurance
- Contracting out is permissible but subject to transparency requirements
- Parties may not contract out of "basis of contract" clauses



LATE PAYMENT

The Insurance Act 2015 contains no provisions to amend the law so as to provide a remedy of damages for late payment of claims although clauses were included in earlier, pre-legislative, drafts of the Bill prepared by the Law Commission. There was adverse criticism made during the Parliamentary scrutiny of the Bill about the absence of these clauses and the Government has now, through the Enterprise Bill 2015, taken steps to introduce an amendment to the Insurance Act to change the law to allow damages to be awarded by the Courts for late payment of damages. This would bring the law of England and Wales and Northern Ireland in to line with that of Scotland and would apply to policies of insurance incepted or renewed 12 months after the Enterprise Bill is enacted.

Background

In general contract law, where one party breaches a contract, the other party can usually claim damages for consequential as well as actual losses.

In contracts of insurance, however, while a policyholder who has not been paid a valid claim can sue the insurer for the money owed, together with discretionary interest and costs, they cannot recover damages for any further loss suffered as a result of any delay in payment of their claim.

This anomaly arises from the fact that, in law, an insurer's primary obligation is to promise that the insured will not suffer any loss. This means that an insurer is in breach of contract as soon as the insured party suffers a loss, and the payment of the insurance claim is therefore regarded as 'damages for breach of contract' and not as 'debts due' under the contract.

The problem

Treating insurance payments as 'damages' rather than as 'debts due' was considered by the Law Commission to be unrealistic. After all, policyholders do not pay insurers for the prevention of losses, they pay for the promise that, if something does go wrong, insurers will pay valid claims under their policies.

Another anomaly in this approach is that life insurance policies and policies which provide for reinstatement of property are characterised as contract debts, and so the normal rules of contract law apply, including damages for consequential losses caused by late payment.

English law presently therefore remains out of line with modern contractual principles and contrasts with the law of Scotland and other common law jurisdictions, which offer greater protection to the insured, and where an insurer's primary obligation is to pay a claim once it has had the opportunity to verify its validity.

Proposals for reform

The Law Commission took the view that the unavailability of damages for the late payment of insurance claims is 'unprincipled and unfair' as it rewards inefficiency and leads to injustice. This concern was also reflected in debates during Parliamentary scrutiny of the Act.

The Implied term 'reasonable time'

The Enterprise Bill includes an amendment to the Insurance Act which, when adopted, will introduce a new implied term into all insurance contracts requiring insurers to pay valid claims within a 'reasonable time'. Any insurer who failed to meet this obligation will be liable for actual losses caused by the breach, provided the loss was foreseeable at the time the insurance contract was made and that the insured party acted reasonably to mitigate the loss.

Investigation of claims

In order to protect every insurer's right to investigate claims fully, the 'reasonable time' would only start to run once the insured had provided the insurer with all material information requested. This would suggest that should more information come to light at a later date, the 'reasonable time' in which insurers must pay a valid claim might start to run again from that point.

Notably, what is to be considered a 'reasonable time' will depend on 'relevant circumstances.' The Law Commission understood that insurers need time to investigate and assess claims, and the Bill includes examples of things which may need to be taken into account. These included the type of insurance, the size and complexity of the claim, compliance with statutory or regulatory rules and factors outside the insurer's control, such as where a claim involves investigation in another country.

Defence against damages for late payment

An insurer will have a defence to a claim for breach of an implied term requiring them to pay valid claims within a reasonable time if it could show that it had reasonable grounds for disputing the validity of a claim, though what amounts to 'reasonable grounds' is not defined. Further, insurers will be able to defend an allegation of failure to pay within a reasonable time, even if they have incorrectly refused to pay a claim, as long as they could demonstrate that they acted reasonably in making their decision, by taking legal advice, for example.

Limiting liability by contracting out

The new term relating to late payment will be implied in to all insurance contracts whether consumer or commercial. Business insurers will be able to 'contract out' where the breach of the requirement to pay a claim within a reasonable time is not deliberate or reckless. The definition of deliberate or reckless (which is the same as that adopted earlier within the Insurance Act in relation to remedies for breach of the duty of fair presentation) is that the insurer knew that it was in breach or did not care that it was in breach of its obligations to pay the claim. However to contract out, where the breach was not deliberate or reckless the business insurer will need to show the terms were understood and accepted by the insured and that the transparency requirements outlined in the Insurance Act were complied with.

Thus, where there had been unreasonable delay and the insurer sought to rely on a provision contracting out of the implied term, the insurer would face a number of hurdles: first to explain whether it should be allowed to rely on the 'opt out' and second to justify why it acted as it did.

The question of limitation

The normal limitation rules will continue to apply under the new Act: i.e. the limitation period for insurance claims will continue to run from the date of the loss. It was, however, proposed that the limitation period, for an action for damages for late payment of the principal claim, should run from the point at which the obligation to pay the principal claim within a reasonable time had been breached. This is not adopted in the Bill.

Conclusion

There was considerable discussion about, and support for, the Law Commissions' proposals for the reform of the law on damages for late payment of claims, generally on the basis that the proposals would bring the law into line with general commercial contractual principles. The Government undertook to review the position and has done so and introduced an amendment adopting the changes in the Enterprise Bill.

Concerns will of course remain that the amendment could initiate a move towards what might be seen as the kind of punitive damages awards that are regularly made in the USA, or even a flood of speculative actions (for damages for late payment), perhaps driven by claims management companies, that might result in higher premiums.

The draft amendment contains a number of safeguards for insurers against this possibility. It is however fair to assume that the definition of 'reasonable' in this context and the defences available to insurers will be tested in the courts at an early stage once the change to the law has been brought in to force. Although some insurers will be disappointed by the change in the law on late payment it does mean that the perhaps greater danger for insurers which would have arisen from a judicial reconsideration of the common law by the Supreme Court will have passed.

Hanna Platt
hanna.platt@blmlaw.com

- New clause for 'late payment' damages in Insurance Act to be inserted by the Enterprise Bill and to apply to all insurance contracts incepted or renewed 12 months after Enterprise Bill is enacted.
- Anomaly between law on the point between England and Wales and Scotland to be ended
- Proposed clause requires payment of a claim 'in reasonable time'
- Opt out proposed as permissible in non-consumer contracts save where late payment 'deliberate or reckless'
- No opt out in consumer insurance contracts
- Significant barriers to 'late payment' damages and defences available for insurers

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