Policy briefing

April 2015

The Insurance Act 2015: Bringing Commercial Insurance into the Twenty-First Century

On 12 February 2015, the *Insurance Act 2015* became law, signifying the end of a detailed review of the legislation underpinning insurance law in the UK. This latest round of reforms focused on commercial (non-consumer) insurance. This was essential because the existing law:

- **undermined market trust and confidence:** the unbalanced nature of the law exacerbates disputes between insurers and business, reducing trust and confidence in insurance by UK economy; and
- **threatened the credibility of UK business law:** very fact that the law is so antiquated and inconsistent with current practice threatens the long established credibility of UK business law itself.

The 1906 Act the new law replaced was arguably designed to protect a then-fledgling insurance market from exploitation by long-established client firms: at a time when customers knew their business while the insurers did not. It gave insurers wide-ranging opportunities to avoid insurance policies at any sign of wrong-doing by the customer.

The Insurance Act 2015 seeks to achieve these aims and benefits by clarifying commercial insurance law in three key areas:

- The pre-contractual duty of disclosure and the effect of (mis)representations at that stage;
- The effect of warranties contained in the policy; and
- The insurer's remedies for fraudulent claims.

Scope and next steps: the 2015 Act goes into force on 12 August 2016, and will apply to all consumer and non-consumer insurance contracts placed or varied after that date. Certain provisions including the duty to make fair presentations of risks only apply to non-consumer (commercial) insurance. Firms are expected to introduce the necessary systems changes in time for that date.

Overview

On 12 February 2015, the *Insurance Act 2015* became law, signifying the end of a detailed review of the legislation underpinning insurance law in the UK.[1] The reform had been ongoing since 2006. The Act will change the UK's commercial insurance law and ensure that it is fit for the Twenty-First century.

The old regime underpinned the *Marine Insurance Act* 1906 (MIA) will continue to apply to policies incepted or renewed for a period of 18 months but thereafter the 2015 Act will apply, by default, to commercial (or in the terminology of the legislation, 'non-consumer') insurance policies.

[1] For a full text of the final *Insurance Act 2015*, see www.legislation.gov.uk/ukpga/2015/4/contents/enacted

Background

The Law Commission of England and Wales and the Scottish Law Commission (the Law Commissions) have been undertaking a root and branch review of the underpinning law of insurance contracts since 2006. It has involved nine issue papers discussing the various areas of reform, three consultation papers, and two major final reports.[2] This work has culminated in the Insurance Act 2015 as well as two previous Law Commissions legislative pieces:

- **the *Third Parties (Rights against Insurers) Act* 2010**: makes it easier for a third party to pursue a claim directly against liability insurers if the insured is or becomes insolvent; and more notably
- **the *Consumer Insurance (Disclosure and Representations) Act* 2012 (CIDRA)**: this focuses on misrepresentation, disclosure and breach of warranty in consumer general insurance contracts.

The case for reforming non-consumer insurance

Following the CIDRA, the Law Commissions focused on the various aspects of non-consumer insurance, which evidence suggested was as problematic as the well publicised retail general insurance issues. Part of the problem is that current UK law is based on principles such as 'utmost good faith' which were developed in the eighteenth and nineteenth centuries and codified in the MIA.

The MIA was arguably designed to protect a then-fledgling insurance market from exploitation by long-established client firms: at a time when customers knew their business while the insurers did not. It gave insurers wide-ranging opportunities to avoid insurance policies at any sign of wrong-doing by the customer.

Why reforming the law is so important:

- **The law undermines market trust and confidence**: the unbalanced nature of the law exacerbates disputes between insurers and business, reducing trust and confidence in insurance by UK economy; and
- **The law threatens the credibility of UK business law**: very fact that the law is so antiquated and inconsistent with current practice threatens the long established credibility of UK business law itself. Whereas insurance law in many other key jurisdictions such as in North America and Asia has been modernised, UK law is now out of line with the international marketplace.

The Law Commissions published their final report in July 2014 making recommendations for reform in three key areas: duty of disclosure, breach of warranty, and 'basis of contract' clauses.

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Pre-Contractual Duty of Disclosure

Problem: non-consumer insurance is based on the principle of 'utmost good faith' whereby the insurer relies on the customer disclosing every material circumstance. However, many insurance customers (including business customers) are unaware of what is materially important. Once a claim is made, an insurer may find circumstances and details which were not mentioned, and then proceed with outright avoidance of the contract. Consequently the Law Commissions observed anecdotal evidence of some insurance contracts actually underwritten at claim stage.

[2] The Chartered Insurance Institute had submitted responses to separate consultations on the consumer insurance and business insurance proposals, and have published related briefings and articles; many can be accessed on the CII website, see for example www.cii.co.uk/35287

Solution: fair presentation of risks: the Act takes several steps to address this problem, and the solution is derived (albeit appropriately tailored) from the approach taken in the CIDRA:

Fundamental to the review and the new Insurance Act is the replacement of that 'utmost good faith' principle from the MIA. Whereas commercial policyholders were required to live up to utmost good faith and answer all questions honestly and truthfully otherwise be met with serious consequences; the new regime imposes the obligation on the business customer to make 'a fair presentation of the risk':

- this applies only to non-consumer (i.e. commercial) insurance contracts, not consumer insurance;
- the manner of presentation should be "reasonably clear and accessible to a prudent insurer"; and
- the substance of what constitutes 'fair presentation' will be determined by case law in the fullness of time.

The legislation states clearly that a 'fair presentation of the risk' requires "disclosure of every material circumstance which the insured knows or ought to know, or… gives the insurer sufficient information to put a prudent insurer on notice that it needs to make further enquiries".

Knowledge

The 2015 Act revisits the issue of the knowledge of both parties to the insurance contract. Thus, for an insured who is not an individual, its knowledge includes knowledge of its senior management and of the persons responsible within the organisation for arranging the insurance for the business.

Knowledge includes what ought to be known in the ordinary course of the insured's business. It is also imputed where there was a suspicion about something but a deliberate decision to not enquire further about that suspicion.

This effectively sets out a more structured framework than the previous duty of disclosure regime. It includes granularity about *whose* knowledge (especially senior management), and the amount of information sufficient for the insurer to make those further enquiries.

The knowledge imputed to an insured also extends to include information that "should reasonably have been revealed by a reasonable search", which covers the insured's own organisation and may include information held by others. While this may include information held by an agent, the insured will not be imputed to know confidential information acquired through a business relationship unconnected to the contract of insurance in question.

Warranties

Warranties are important terms of an insurance contract. They are used by insurers to control risk, ensuring that they remain liable for risks only for as long as policyholders keep to their promises. The 2015 Act makes two changes of note to the law relating to insurance warranties.

"Basis of contract" clauses

Problem: some insurance proposal forms contain clauses using the 'basis of the contract' principle, a statement that effectively turns everything on that form into a warranty, licensing the insurer to void the claim if any information on the form, however immaterial, is inaccurate. This simple but obscure feature of insurance law has been a thorny issue since 1906, and costly and expensive actions have been pursued over issues as trivial as a mis-spelt address line.

Solution: Clause 9 of the 2015 Act abolishes such 'basis of contract' clauses from business insurance contracts, reflecting the approach already taken in CIDRA.

Breach of warranty

Problem: warranties are supposed to be risk-mitigating promises that the policyholder must undertake. However the law allows insurers to discharge their overall contractual obligation or liability even if a breach of warranty is remedied, and even if that warranty is unrelated. It takes this further and allows total avoidance of a policy in a range of circumstances, such as denying a flood claim because a burglar alarm had failed and was repaired years earlier.

Solutions:

- **Breach of a warranty merely suspends rather than discharges, insurers liability:** a breach of warranty will be taken as remedied where the risk becomes essentially the same as that contemplated by the parties (eg: an insured doing missing a time limit in a warranty). The legislation also covers situations in which a breach of warranty cannot be remedied.
- Claims for breaches of warranties cannot be claimed if the insured can show that its breach could not have increased the risk of the loss that actually occurred.
- **Implications for claims handlers:** there needs to be a clear understanding about their position had they been told the full details. As one expert put it: "it is not enough to know that the policy would have been written on different terms, what exactly would it have said? Nor can they just say the premium would have been higher; they need to know by how much."[3]

Fraudulent Claims

Problem: some of these harsh rules in insurance law are sometimes deployed when the insurer suspects but cannot prove fraud. This results in wrongful accusations of fraud, and policies being voided after years of paying premiums.

Solution: a set of remedies for fraudulent claims that are meant to be both proportionate and appropriate in deterring fraudulent behaviour while minimising the risk of undue punishment:

- **No liability to pay a fraudulent claim:** if the insurer finds that a claim is fraudulent, the 2015 Act confirms what already takes place in case law that they can forfeit the claim, and retain any premiums which have already been paid.
- **An option to terminate the contract at the time of the fraudulent act:** the insurer may treat the contract as terminated at the point of the fraudulent act, and "it need not return any premiums which have been paid prior to this right being exercised". This addresses uncertainty in current case law.
- **Protected legitimate losses prior to the fraudulent act:** if a policyholder makes a fraudulent claim, the insurer would not be allowed to withhold any payouts from prior legitimate claims that may be outstanding. This is the case even if the contract has been treated as terminated at the time of the fraudulent claim.

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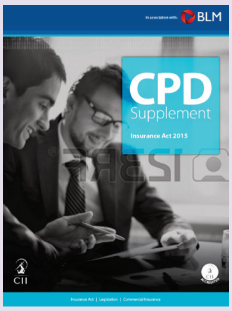

CII members: more information on the *Insurance Act 2015*

See our **Continuing Professional Development (CPD) Supplement** we prepared in association with BLM. Co-written by former Law Commissioner and current member of the CII Professional Standards Board David Hertzell, it goes into further detail about the reforms and also sets out learning outcomes and reflective questions so it can be used by qualified CII members as Structured CPD. The full document is available here: www.cii.co.uk/35285

David Hertzell also spoke at a **lecture of the Insurance Institute for London**, a video and presentation slides of which can be downloaded as CII member-only resources: www.cii.co.uk/34801

[3] "Beware the Insurance Act interregnum," by Nick Brown (partner at DAC Beachcroft), *Post Magazine*, 26 Mar 2015.