INSURANCE ACT 2015
SHIFTING THE BALANCE

Tony Dempster, Sarah Irons and Lachlan Harrison-Smith of Herbert Smith Freehills LLP explain how organisations can take advantage of major changes to UK insurance law brought about by the Insurance Act 2015.

For the past 18 months, insurance lawyers, brokers and industry leaders have been urging insurance buyers to get ready for the imminent arrival of the biggest change to hit UK insurance law in over 100 years. Now that the change is here, corporate counsel need to ensure that their organisations are ready.

On 12 August 2016, the Insurance Act 2015 (2015 Act) came into force, bringing with it significant changes to pre-contractual disclosure for insurance policies and a range of other changes that shift the balance in favour of insureds. Even if an organisation has not been paying close attention to these developments, there is still time to take steps to take advantage of the beneficial changes under the new regime and minimise the chance of claims disputes.

This article outlines the key features of the new regime for corporate policyholders.

The article:

- Provides a short background to the 2015 Act.
- Briefly explains the new duty of fair presentation of the risk.
- Covers practical aspects of pre-placement disclosure in light of the new regime under the 2015 Act.
- Outlines some other key changes brought about by the 2015 Act, including to the law on warranties and basis clauses.
- Examines negotiations for renewals and variations, including upgrading existing policies ahead of the renewal date and making sure not to lose advantageous existing provisions in any renewals.
- Introduces the Enterprise Act 2016 and the new remedy of damages for the late payment of claims by insurers.

BACKGROUND

The 2015 Act received Royal Assent on 12 February 2015, as the culmination of a nine-year consultation period started by the English and Scottish Law Commissions (the Commissions) in 2006. The 2015 Act aims to address a perceived imbalance in the law in favour of insurers, which is said to have put the English market at a competitive disadvantage.

Consultation papers released by the Commissions in 2007, 2011 and 2012 are likely to remain useful references, especially during the 2015 Act's infancy (*www.scotlawcom.gov.uk/files/6412/7892/7069/dp134.pdf; www.scotlawcom.gov.uk/files/3113/2429/7329/*

dp152.pdf; www.lawcom.gov.uk/wp-content/uploads/2015/11/Consultation-Paper-The-business-insureds-duty-of-disclosure-and-the-law-of-warranties-consultation-paper.pdf).

In particular, the 2015 Act has updated the statutory framework for insurance contracts in the following areas:

- Disclosure and misrepresentation in business and other non-consumer insurance contracts.
- Insurance warranties.
- Insurers' remedies for fraudulent acts.

The 2015 Act applies to insurance and reinsurance contracts governed by the laws of England and Wales, Scotland or Northern Ireland, wherever they are underwritten, entered into on or after 12 August 2016. The 2015 Act also applies to variations that were made to existing insurance contracts on or after that date.

In effect, the 2015 Act provides a new default regime governing non-consumer insurance contracts, although it is possible to contract out of the 2015 Act, subject to specified requirements (*see "Contracting out" below*).

DUTY OF FAIR PRESENTATION

As its centrepiece, the 2015 Act has brought about significant changes to the law of pre-placement disclosure by policyholders. It sets out a prescriptive regime which requires insured organisations to review carefully their policy placement and disclosure procedures and to think especially about what they disclose and how they disclose it.

Under the old common law position as codified by the Marine Insurance Act 1906 (1906 Act), the insured's duty was to disclose to the insurer all material circumstances before the contract was concluded. This duty still exists in the 2015 Act as part of the duty to provide a fair presentation of the risk, which encompasses:

- The insured's duty of disclosure.
- A requirement to make the disclosure in a manner which would be reasonably clear and accessible to a prudent insurer.
- The existing duty not to make mis-representations (which is unchanged).

Deemed knowledge and reasonable searches

Under the Insurance Act 2015:

- The insured is deemed to know every circumstance which in the ordinary course of business it ought to know.
- What an organisation ought to know includes what should reasonably have been revealed by a reasonable search of the information available to it.
- A reasonable search will be deemed to include information held by the broker and information held by other persons covered by the insurance, but does not include knowledge of agents acquired in a different capacity.

The new duty applies to disclosure before the policy starts as well as to variations of non-consumer insurance contracts (in the case of variations, "risk" means "changes in the risk relevant to the proposed variation").

Additionally, the duty of fair presentation brings with it a suite of new, more flexible proportionate remedies which are broadly more favourable to insured parties. These remedies are a significant development (*see "Remedies for insurers" below*).

The new regime aims to improve understanding and compliance, and to avoid passive underwriting of risk by insurers and problematic "data dumping" by policyholders; that is, bombarding the insurers with swathes of material whether or not it is relevant. Above all, it rewards parties that proactively engage with their insurance arrangements. Practitioners need to understand the new requirements both from a risk perspective and in order to take advantage of the benefits of the 2015 Act.

FAIR PRESENTATION IN PRACTICE

Some key practical questions for corporate counsel in relation to fair presentation of the risk are:

- What must be disclosed?
- Whose knowledge counts within a corporate entity?
- How should the risk be presented?

Disclosure

In order to satisfy its disclosure obligations under the 2015 Act, an insured must do one of the following:

- Disclose every material circumstance that the insured knows or ought to know.
- Give the insurer sufficient information to put a prudent insurer on notice that it needs to make further enquiries for the purpose of revealing those material circumstances.

A policyholder should not rely on the latter option as the primary route to satisfying the disclosure obligation; it should really be seen only as a safety net.

The meaning of "material circumstance" has not changed; it means a circumstance or representation which would influence the judgment of a prudent insurer in determining whether to take the risk and, if so, on what terms. There is, however, now some guidance on matters which may be material circumstances (*section 7(4), 2015 Act*).

Knowledge

When considering what material circumstances the insured knows or ought to know, a major issue is likely to be whose knowledge counts. Under the 2015 Act, there is additional guidance to help answer this question. "Knowledge" will include the actual knowledge of senior management and of the individuals in an organisation that are responsible for the insured's insurance.

The 2015 Act defines senior management as anyone who plays a significant role in the making of decisions about how the insured organisation's activities are to be managed or organised.

Senior management will include the board but may extend beyond this. Organisations should:

- Establish a defined list of positions or persons who fall into this category and provide the list to insurers with an explanation of how it was derived.

- Consider seeking insurers' agreement that these are the relevant positions and individuals.

An individual responsible for the insurance is an individual who participates on behalf of the insured organisation in the process of procuring the insurance. This includes risk managers, or employees who assist in the collection of data or negotiate the terms of the insurance. This will also include brokers, which should be asked about how they will demonstrate their knowledge to satisfy the organisation's insurers.

The concept of a reasonable search is a new requirement in the 2015 Act (*see box "Deemed knowledge and reasonable searches"*). What amounts to a reasonable search is not specified, which creates some uncertainty but also presents an opportunity to an informed policyholder to: engage with insurers; specify what steps it has taken; and seek insurers' agreement to those steps.

A reasonable search will include information held by brokers as well as information held by persons covered by insurance. This is significant, for instance, in the context of an organisation's directors' and officers' cover and is a major reason to direct the attention of both past and present board members to the organisation's insurance arrangements (*see box "Example of reasonable search checklist for liability policies"*).

Example of reasonable search checklist for liability policies

The information below may form part of a reasonable search for a liability policy. It will be essential to scope the reasonable search well in advance and to allow sufficient time to locate and gather the relevant data.

- ✓ Business sector and activities.
- ✓ Who to contact to identify potential claims and circumstances.
- ✓ Changes to business structure.
- ✓ Changes to organisational structure.
- ✓ Business resilience and data recovery.
- ✓ The organisation's response to any regulatory changes.
- ✓ Greater liability than normal or expected, possibly because of industry-specific contract terms of trade.
- ✓ Restricted rights of subrogation associated with claims or losses because of the business sector or specific products.
- ✓ Previous claims history or experience, especially in relation to historical, emerging or other unexpected risks.
- ✓ Previous policy cancellation, refusal of insurance or special restrictions or conditions applied to insurance contracts.
- ✓ Details of the trading profitability and financial status of the business, including insolvency or liquidation concerns.
- ✓ The status, reputation, length of service, qualifications and experience of board members, as well as details of any criminal convictions.

It will not benefit an organisation to conduct thorough searches in its pre-placement disclosure if it cannot later prove that it did so. A critical housekeeping step will therefore be to set up mechanisms for an audit trail to document carefully the reasonable searches that have been undertaken.

If there is an auditable trail, it will be much easier to justify and explain why the approach was reasonable several years later when key personnel may have left.

It may be possible to agree with insurers before the policy is concluded what amounts to a reasonable search, so eliminating any element of uncertainty over this issue.

In creating an audit trail, practical things to consider include:

- The best way of gathering information; for example, by email questionnaires, meetings with relevant individuals or site visits.

- The method of documenting questions and responses.

- The system for keeping a record of those contacted and chased.

- Creating a library of key information on, for example, locations and financial information.

Presentation

The duty to provide a fair presentation of the risk requires the insured to disclose information in a manner which would be reasonably clear and accessible to a prudent insurer.

Every material representation of facts must be substantially correct and every representation of expectation or belief must be in good faith.

One of the aims of these new requirements is to discourage data dumping. The explanatory notes to the 2015 Act make it clear that an overly brief or cryptic presentation would not be a fair presentation.

Insureds should consider with their broker whether they need to change or develop how they currently present information; in particular, to ensure that the information is structured, indexed and signposted to make it clear and accessible. Ultimately, a presentation of the risk should be readily navigable, for example with an index, and should fully respond to insurers' questions (*see box "Tips to ensure fair presentation"*).

The new provisions will be particularly important for the insurance of complex risks, for example, a global property policy covering multiple sites or portfolios.

Another important part of the role of corporate counsel will be to educate those in the organisation about what they will need to provide in order to comply with the duty of fair presentation. This extends beyond the mere content of the risk presentation to the way it is organised and accessed. With some advance planning and perhaps some early discussions with both brokers and insurers, counsel can ensure that their organisation is ready to comply with its duty of fair presentation of the risk before the next renewal.

Tips to ensure fair presentation

Do:	Do not:
• Organise an underwriting presentation. • Make it readily navigable with indices, headings and signposts, which as a fall-back, at least put insurers on notice to ask further questions. • Respond fully to questions raised by insurers.	• Provide insurers with CDs of information that is not organised. • Simply refer insurers to the organisation's website. • Be too brief or cryptic.

Remedies for insurers

The fair presentation regime may seem onerous for policyholders, but it comes with significant benefits. Firstly, it delivers greater certainty to those policyholders that are well-organised and engaged with their insurance arrangements. Secondly, where policyholders breach the duty of fair presentation, the 2015 Act allows for more commercially flexible remedies which are expected to be largely beneficial for insureds.

Under the 1906 Act, insurers had a strict remedy of avoidance of the policy for a breach of the duty of good faith, for example, for material non-disclosure. This was the case even for relatively minor breaches and where they would have covered the risk anyway. It was recognised that, in most instances, this was a draconian remedy which did not adequately distinguish between innocent and deliberate or reckless breaches.

The 2015 Act provides for a range of proportionate remedies (*see box "A worked example of a proportionate remedy"*). Unless the breach is deliberate or reckless, in which case the remedy of avoidance would still be available to an insurer, the onus is on the insurer to show what it would have done had it received a fair presentation of the risk. The following options will be available:

- The insurer will still be entitled to avoid the policy if it can show that had it received a fair presentation of the risk, it would not have entered into the contract.
- If the insurer would have entered into the contract but on different terms, the contract is treated as if those terms apply.
- If the insurer would have entered into the contract but only at a higher premium, the insurer may reduce proportionately the amount to be paid on a claim.

These beneficial changes might even persuade businesses to seek to upgrade their existing arrangements (*see "Upgrades" below*).

OTHER KEY CHANGES

Other key changes in the 2015 Act might have an impact on cover for businesses.

Warranties

Under the 1906 Act, a breach of warranty discharges the insurer's liability under the contract in its entirety, even if the breach is only trivial or does not in any way relate to the insured's loss (*section 33(3), 1906 Act*) (*see box "What is a warranty?"*). Under the 2015 Act, a breach of warranty no longer automatically takes the insurer off risk. The 2015 Act makes warranties "suspensive conditions"; that is, the insurer's liability will be suspended while the insured is in breach of a warranty but can be restored if the breach is subsequently remedied. However, this term will only assist if:

- The warranty is capable of remedy, as not all of them are.
- The business is aware of the breach of warranty and corrects it.

The fact that warranties are suspensive means that the insurer will come back on risk once the breach is rectified. There are two key steps here for corporate counsel: make sure that those responsible for risk management and those working in the business are aware of the warranties in the policy; and audit any breach and rectification so as to take advantage of the change in law.

Under the 2015 Act, warranties are potentially more advantageous for policyholders than conditions precedent because a breach of warranty may be capable of remedy, in which case the insurer will be back on risk. Policyholders should therefore be aware of insurers seeking to use a sweep-up clause to convert all of the insured's obligations to conditions precedent to liability.

Basis clauses

The 2015 Act also abolishes "basis of the contract" clauses, which operate to turn the insured's pre-contractual representations,

What is a warranty?

A warranty is a term of an insurance contract by which an insured:

- Undertakes to do or not do a particular thing.
- Undertakes that some condition will be fulfilled.
- Affirms or denies the existence of a state of facts.

A worked example of a proportionate remedy

In breach of the duty of fair presentation, an insured fails to disclose the presence of highly flammable materials at site A, one of three sites being insured. The non-disclosure is not deliberate or reckless. There is then a fire at one of the sites and the insured claims £10 million in respect of the damage.

If the insurer can show that it would have entered into the contract but with an exclusion for fire caused by the flammable material at site A:

- The policy is treated as if it included the exclusion from the outset.
- The claim would be excluded if the fire was at site A but if the fire occurred at a different site, the claim would be covered.

If the insurer can show that it would have charged a £100,000 premium instead of £50,000, the claim monies will be reduced proportionately so that the insured is entitled to recover only 50% of any claim, in this case, only £5 million of the claim.

including answers to questions on a proposal form, into warranties.

A basis clause is a declaration in a proposal form or policy that the insured warrants the accuracy of all the answers given or that the answers form the basis of the contract. This has the legal effect of converting the representations into warranties so that the insurer is discharged from liability for claims if any of the representations are incorrect, even if the misrepresentation was unintended and did not induce the insurer to enter into the policy.

In practical terms, under the old law, this meant that if there was a basis clause and the insured answered a question in a proposal form incorrectly, even if this was an innocent mistake, the insured would find itself without insurance cover as the insurer never came on risk.

Risk mitigation terms

Previously, the remedy for breach of a term was dictated by the nature of the term, irrespective of its connection to the loss. As a result, a policyholder's claim could be denied as a result of a breach which had no connection to the loss.

Section 11 of the 2015 Act (section 11) delivers an important new protection for policyholders in this regard, which should mean that breaches totally unrelated to a loss do not affect cover. It provides that if there is a breach of a term which is intended to reduce the risk of loss of a particular kind or at a particular time or location (that is, a risk mitigation term), insurers will not have a remedy if the insured can show that its breach could not have increased the risk of the loss that actually occurred. Section 11 does not apply to terms that go to the risk as a whole.

Some potential difficulties are likely to arise in practice, not least: determining which terms fall within the scope of section 11; and showing that the breach could not have increased the risk of the loss. The Commissions have given some examples of clauses that they suggest go to the risk as a whole, including a provision in a motor policy that the vehicle will not be used for commercial use.

It is difficult to be prescriptive about what this means for policyholders but clauses should be reviewed to:

- Determine if they could be drafted so as to increase the prospects that the protection under section 11 will apply.
- Confirm expressly that section 11 applies.

Fraudulent claims

The 2015 Act provides a new statutory regime for fraudulent claims which clarifies the existing law. The 2015 Act provides that the insurer:

- Is not liable to pay fraudulent claims.
- Can elect to terminate the contract and refuse to pay claims relating to losses suffered after the fraudulent act.
- Remains liable for legitimate losses suffered by the insured before the fraudulent act.

The Commissions considered the previous law to be confused and contradictory, particularly as to whether the insurer would be liable to pay other genuine claims in the event of a fraud. The 2015 Act has clarified the position from the pre-existing case law.

RENEWALS AND VARIATIONS

The changes introduced by the 2015 Act affect the commercial dynamic between the policyholder and the insurer as regards policy renewals and the practical implications of negotiations with insurers. Three broad issues arise:

- If the 2015 Act provides a more helpful regime than present arrangements, it may be possible to negotiate an upgrade of current policies with insurers to take advantage of some of the beneficial provisions in the 2015 Act; in particular, the changes to remedies and warranties.
- If terms in current policies are more advantageous than the provisions under the 2015 Act, policyholders might want to keep these terms in any renewals.
- In certain circumstances, a new policy may make modifications to the regime under the 2015 Act, and so contract out of the legislation.

Upgrades

It is possible for insureds to negotiate to upgrade existing policies by agreement with their insurers if they wish, for example, to take advantage of the more favourable remedies under the 2015 Act in relation to breaches of warranty rather than wait for renewal under the 2015 Act.

Other helpful provisions are: the prohibitions on basis clauses; the provision on terms not relevant to the actual loss; and remedies for non-disclosure and misrepresentation.

The Association of Insurance and Risk Managers in Industry and Commerce (Airmic) has produced a briefing paper and sample endorsement, which is a valuable resource for those looking to upgrade existing insurance policies to bring them in line with the provisions of the 2015 Act ahead of their next renewal (*www.airmic.com/system/*

Related information

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files/technical-documents/Insurance%20 Act%202015_WEB.pdf). The sample Airmic endorsement is a useful starting point for discussions with insurers and brokers.

Retaining advantageous terms

In some cases, the default regime under the 2015 Act might be less favourable than existing policy arrangements.

One of the clauses from existing insurance policies that insureds may wish to retain are innocent non-disclosure clauses. These clauses tend to limit the ability of the insurer to avoid liability or refuse a claim where a non-disclosure or misrepresentation is innocent or free from fraudulent intent, or both. These clauses may exist in current policies in a variety of guises. The policyholder protections created by these clauses may, depending on the wording, be more favourable than the new position under the 2015 Act.

There are therefore two key steps to make sure that the advantages of a current policy are not lost under any renewal:

- Do not assume that the clauses are no longer needed because of the change in law; review them carefully to see if they are still more beneficial than the 2015 Act.

- Review the policy for any changes needed to make the clauses sit properly with the 2015 Act.

For example, given that insurers may now have a suite of remedies available to them in the event of a failure to make a fair presentation, clauses which limit only the rights of "avoidance" may not suffice. Organisations should consider including wording such as "[the insurer] will not avoid the policy or refuse, reduce or qualify any claim".

More generally, insureds may want to disapply some of the proportionate remedies, given that they may be thought to have a disproportionately disadvantageous effect. In June 2016, Airmic published a helpful sample clause and explanatory note, which provides some clear wording to remove the insurer's right to reduce the amount payable under a claim where an insurer would have charged a higher premium (*www.airmic.com/news/insurance-act-clause*).

Contracting out

The 2015 Act was intended to be a default regime for non-consumer insurance contracts. However, it was recognised that some provisions may not be suitable for all markets and commercial parties. The 2015 Act therefore allows parties to non-consumer insurance contracts to contract out of the default regime, with the exception of the prohibition on basis clauses, as long as any disadvantageous term (that is, one that puts an insured in a worse position than under the default regime) meets the following transparency requirements:

- The insurer must take sufficient steps to draw the disadvantageous term to the insured's attention before the contract is entered into or the variation agreed.

- The disadvantageous term must be clear and unambiguous as to its effect.

An insured cannot rely on any failure by the insurer to take sufficient steps to draw the disadvantageous term to its attention if it or its broker was aware of the term.

While not strictly contracting out, policyholders should also be alert to any attempt by insurers to exclude the effect of certain parts of the 2015 Act in other ways; for example, by converting basis clauses into conditions precedent to liability (*see "Basis clauses" above*).

LATE PAYMENT OF CLAIMS

A clause providing policyholders with a remedy for late payments of claims was previously dropped from the draft Insurance Bill (now the 2015 Act) because of a lack of market consensus but has found its way into law in the Enterprise Act 2016 (2016 Act). The 2016 Act comes into force on 4 May 2017.

Under the 2016 Act, it will be an implied term of every insurance contract that the insurer must pay any sums due in respect of the claim within a reasonable time. A reasonable time includes time needed to investigate and assess that particular claim.

Breach of this term will give rise to a claim for damages for consequential losses. This remedy is in addition to, and distinct from, the right to interest on payment of the sums due in legal proceedings.

Proof of loss is likely to be the contentious issue under the 2016 Act. There are several other restrictions on claims against insurers:

- The 2016 Act provides a defence where the insurer can show that there were reasonable grounds for disputing the claim.

- A policyholder must bring its claim for damages within one year of the insurer paying all sums due in respect of the claim.

Given the various elements that a policyholder will need to prove in order to establish a successful claim, it seems unlikely that there will be a flood of damages claims for late payment. In particular, the meaning of what is a reasonable time for payment of a claim will depend on the particular circumstances of the claim and the impact of the provisions is likely to be limited by the reasonable grounds defence that is available to insurers.

The 2016 Act will apply only to contracts of insurance made after it comes into force on 4 May 2017, so it will be some time before any claims for damages for late payment come before the courts.

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