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IN THIS ISSUE

This newsletter comments on the provisions of a new piece of legislation which is intended to bring the law as it relates to insurance and reinsurance contracts in the UK into line with developments in the common law and in commonwealth countries. It comments also on certain proposals which were considered to be too contentious for inclusion in a Bill destined for the statue book by way of an expedited procedure.

A Commentary on the United Kingdom's Reappraisal of the Law as it Relates to Insurance Contracts

ABOUT THE AUTHOR

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ABOUT THE COMMITTEE

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Introduction

The Law Commission of England and Wales and the Law Commission of Scotland began the process of researching improvements to the legal framework for insurance in January 2006. Following HM Treasury's short consultation the Insurance Bill ("the Bill") was introduced to the House of Lords on 17 July 2014.

The Bill seeks to correct the perceived unfairness of the law of insurance and the alleged favour it lends to the position of insurers. It addresses several key areas including the insured's duty of disclosure, warranties, remedies for fraudulent acts committed by the insured, contracting out of the provisions in the Bill and rectifying the procedural difficulties with the Third Parties (Rights against Insurers) Act 2010.

Effectively, the Bill seeks to partially codify the law of insurance. Given that the last successful attempt to do this was the Marine Insurance Act 1906 ("the 1906 Act"), the mere nine years it has taken to get the Bill before the House of Commons seems all the more remarkable.

The 1906 Act has creaked and strained in the face of modern developments in the law of insurance providing, as it does, for the draconian remedy of avoidance of the entire policy for often trivial breaches. It has also been interpreted to apply to all types of insurance law, despite a lack of this obvious intention at the time of its drafting. The Bill deals with this supposed imbalance with a more proportional and varied approach, but some commentators have questioned its application to the law of reinsurance. The Law Commissions' position is that reinsurance is insurance.

Progress of the Bill

From the outset the Bill was intended to be suitable for a faster form of parliamentary approval used for uncontroversial legislation. As a result, this means that the Bill could be passed before the end of this parliamentary session on 30 March 2015. In its current form the Bill provides for a period of 18 months from its passing until its provisions come into force (save for those in relation to the Third Parties (Rights against Insurers) Act 2010).

The House of Lords has completed its readings and the Bill was introduced to the House of Commons for its first reading on 16 January 2015. The Commons completed its third reading of the Bill on 3 February 2015.

Of the Law Commissions' recommendations, only two were left out from the initial draft of the Bill provided to the House of Lords. The Law Commissions had intended to introduce a new provision which would have entitled the insured to claim damages as a result of late payments made by their insurers. However, this was felt to be too controversial for the short form of parliamentary approval chosen for the Bill. Although discussions on this issue are ongoing, it seems highly unlikely that this proposal will be included in the Bill. Domestic insurers will doubtless be relieved that the spectre of bad faith litigation has abated for the time being.

The second provision which did not make it into the initial draft of Bill was one which prevented an insurer from relying on a breach

of any term to exclude, limit or discharge liability where the term was in relation to a different type of loss, or a particular location, or a time for loss.

However, an amended version of this provision was subsequently reintroduced to the Bill after it was amended on report by the House of Lords and was included in the updated draft of the Bill dated 9 January 2015. The wording of this provision has been amended so that it does not apply to terms which define the risk as a whole and includes a requirement that the insured show the non-compliance with that term did not increase the risk of the loss which actually occurred.

Impact on the Third Parties (Rights Against Insurers) Act 2010

In the same vein as the 1906 Act, the Third Parties (Rights Against Insurers) Act 1930 ("the 1930 Act") is a piece of legislation which required a great deal of modification in order to modernise it and to address its procedural weaknesses. The 1930 Act gives third parties the right to claim insurance proceeds from a liability insurer once the insured has become insolvent. This is achieved once the third party has established the insured's liability to them through a judgment, an agreement or an award, after which the third party is able to "step into the shoes" of the insured and acquires their rights against the insurer.

In 2001 the Law Commissions of England and Wales and Scotland determined that the 1930 Act was operating inefficiently. Chief amongst the concerns was the fact that a third party had to establish the liability of the insured before they could then bring proceedings against the insurer. This created an unnecessary increase in costs and time in bringing claims against an insolvent insured because the third party would then have to bring another set of proceedings directly against the insurer.

There was a further problem with the process of the 1930 Act in that it only allowed information relevant to the insured's insurance (for example, policy documents) to be made available to the third party once they had established the insured's liability. This meant a third party would have to go through the difficulties and expense of litigation without knowing whether the rights they would be receiving would be of any value against the insurer.

This issue was addressed by the courts in the Court of Appeal case of *OT Computers Ltd (in administration) First National Tricity Finance Ltd v OT Computers Ltd (in administration) [2004] EWCA Civ 653*. One of the questions before the court was whether the third party could obtain information about the insured's insurance arrangements upon the insured going insolvent, or whether he had to wait until he had established liability against the insured.

In the leading judgment, Lord Justice Longmore overruled the previous requirement that a third party had to first establish liability before it had a right to access information about the insured's insurance information under the 1930 Act. Instead there was said to be a contingent transfer of rights to the third party upon the insured's insolvency. In paragraph 38 of his judgment, Lord Justice Longmore specifically identified the Law Commissions' 2001 paper (*Law Com No. 272 Third Parties – Rights Against*

Insurers), which had recommended that this position be reversed.

This position has been continued by the Third Parties (Rights Against Insurers) Act 2010 ("the 2010 Act") and Schedule 1 specifically provides for the right of third parties to request information where they "*reasonably believe*" that an insured has incurred liability towards them. The information which can be requested by a third party in these circumstances is listed in clause 1 (3) of Schedule 1 and should allow a third party to make a decision as to whether or not to proceed before incurring the costs of litigation.

In keeping with the speed of evolution in dealing with pressing issues with the law of insurance, it was only a further nine years before the 2010 Act received royal assent on 25 March 2010. The updated legislation means it is now possible to bring an action against an insurer before having established the liability of the insolvent insured. That liability must still be established before the rights can be enforced against the insurer, but this can be done by way of a declaration of the Court, in addition to a judgment, agreement or award. This means that only one set of proceedings need be brought and an insurer can be added as a party to the proceedings. The process is intended to be far simpler and more efficient than before.

Or, rather, it would be if the 2010 Act was currently in force. Section 1 of the 2010 Act allows the transfer of the insured's rights to a third party when the former:

(1) incurs a liability to a third party which is covered by their insurance policy; and
(2) is already, or subsequently becomes, a "*relevant person*" under the 2010 Act.

To become a relevant person under the Act, the insured must go through one of the specified insolvency events listed in sections 4 to 7 of the 2010 Act.

For example, where a member of the public is injured at the insured's premises they will look to bring an action against the insured. Any claim made by the third party should be covered under the insured's public liability policy. The first of the conditions under the 2010 Act would have been met because a liability has been incurred (but not yet established).

If the insured were a corporate body, then in order for the third party to apply the mechanism under the 2010 Act, the Insured would have to undergo one of the insolvency events listed in section 6 (or would need to have already gone through one of them prior to incurring the liability to the third party).

Even by 2012 it was recognised that new forms of insolvency had been introduced since 2010 and the wording of the 2010 Act would not cover them. According to the Law Commissions' paper on the background to the 2010 Act (*Third Parties (Rights Against Insurers) Act 2010: Background To The Provisions In The Insurance Bill)*, it does not provide general descriptions of insolvency procedures which can be adapted, but uses specific legislative enactments. Given that several insolvency procedures were not

included on this list, they would not be within the scope of the 2010 Act.

The Law Commissions had recommended in 2001 that a provision containing a power of amendment be included in the 2010 Act so as to prevent it from falling away from legal developments. This provision was not included in the 2010 Act as enacted. The Bill adds a new section 19 to the 2010 Act which will allow the Secretary of State to amend the definition of a "*relevant person*" as and when is necessary. This power is designed to minimise the impact of legal developments in insolvency procedures on the function of the legislation.

Clause 20 and Schedule 2 of the Bill also aim to correct procedural problems with the 2010 Act. For full details of the changes to be made to the 2010 Act in the Bill, see the Law Commission's paper *Third Parties (Rights Against Insurers) Act 2010: Background To The Provisions In The Insurance Bill*. It is also intended that this will mean the 2010 Act can come into force before the Bill becomes an Act of Parliament.

Duty of Fair Presentation

In an attempt to address the perceived uncertainty of an insured's pre-contractual duty of utmost good faith, the Bill now requires that a "*fair presentation*" of the risk is provided. A fair presentation is one:

(1) in which every material representation to a matter of fact is substantially correct and every material representation as to a matter of expectation or belief is made in good faith;
(2) where the insured discloses every material circumstance which the insured knows or ought to know, or;
(3) failing that, discloses that which gives sufficient information to put a prudent insurer on notice that he needs to make further enquiries.

These changes are intended to make the duty of fair presentation a more reciprocal process and to encourage insurers to be increasingly responsive. The Bill addresses the concern that an insured will simply "data dump" information on an insurer by requiring that the disclosure be in a manner which is "clear and accessible to a prudent insurer".

An insured individual knows only what is known to the individual and what is known to these individuals responsible for his insurance. An insured business is deemed to know what is known to a member of its senior management or those who are responsible for its insurance. Both insured individuals and insured businesses ought to know that which would have been revealed by a reasonable search of the information available to it. This does not include information obtained by the insured's agent through an unconnected business arrangement.

The insurer is still deemed to know matters which are common knowledge and that which they ought reasonably to know in relation to the class of the insurance they have offered to the insured.

At present the only remedy available to an insurer for breach is avoidance of the policy,

regardless of whether it was an innocent or deliberate breach. In a direct attempt to offset this perceived harshness, the Bill now distinguishes between two types of "*qualifying breach*". Every qualifying breach is now either (1) deliberate or reckless or (2) neither deliberate nor reckless.

The onus is on the insurer to prove that a breach is deliberate or reckless and, if proven, the insurer is entitled to avoid the contract, avoid all claims and may keep all premiums.

Where the breach is neither deliberate nor reckless, if the insurer can show he would never have entered into the contract on *any* terms then he may avoid the contract (and refuse claims), but he must return the premium. If the insurer would have entered into the contract, but on different terms then the contract is to be treated as though it was entered into in accordance with those terms that would have been required by the insurer.

Oddly enough, the above provision is found in clause 5 of Schedule 1 and applies to terms of the contract *except* the premium. Therefore if the insurer subsequently discovers information which was not presented but which would, nevertheless, mean he would still have accepted the risk, but would have wanted a higher premium, the insurer does not have the ability to return to the insured to request an additional premium payment. However, the insurer's remedy comes into effect where a claim is then subsequently made by the insured.

If the insurer would have entered into the contract, but at a higher premium, then he may "*reduce proportionally*" the amount paid on a claim. For example, if the insurer charged £75,000 in premium where, but for the qualifying breach, he would have charged £100,000, then he is only required to pay 75% of the loss.

The principle of utmost good faith is retained as an overriding element of all insurance contracts. However, it is no longer possible to avoid a contract purely on the basis of breach of the principle of utmost good faith. The duty of good faith's application has been modified by the provisions in the Bill and the Consumer (Disclosure and Representations) Act 2012. But it is interesting that no new definition of utmost good faith is contained within the Bill and, presumably, the Court's interpretation of the principle will still play an active part in determining its effect.

Warranties

The present position is that representations made by the insured during the negotiation for an insurance contract, or a variation to the same, could be converted into a warranty through a "basis of contract clause". This was typically achieved by referring to the answers provided on the proposal form for the insurance.

However, the Bill now says that any warranties must be expressly agreed by the parties. The Bill further details that commercial parties may not agree to contract out of this provision by any agreement between themselves.

Under the current law, a breach of warranty terminates the insurance. This has been abolished. Instead the Bill gives warranties suspensory effect by providing that an insurer has no liability under a policy where the

warranty has been breached, but before it is remedied. Yet before the breach occurs, and after it has been remedied, the insurer continues to carry the risk and must respond where liability is incurred.

It is axiomatically stated in the Bill that the breach is remedied where the insured ceases to be in breach of the warranty. Where the warranty requires that something is done or not done by an ascertainable time, or a condition is to be fulfilled or something is (or is not to be the case), any breach is remedied when the risk which the warranty relates to essentially becomes the same as that originally contemplated by the parties.

However liability is not suspended where:

(1) because of a change of circumstances, the warranty ceases to be applicable to the circumstances of the contract;
(2) compliance with the warranty is rendered unlawful by subsequent law;
(3) the insurer waives the breach.

As stated above, the Law Commissions initially intended to include a provision that would prevent insurers relying on non-compliance with a term to limit or discharge liability where the term related to a loss of a particular kind, location or time if it did not increase the risk of the loss which actually occurred.

Despite its removal from the initial draft Bill owing to a lack of market consensus, the provision has since been reintroduced, with amendments, during the Bill's progression through the House of Lords. The amended provision now applies through clause 11 and means that if the insured can prove that non-compliance with the term would not have affected the loss which occurred, then the insurer may not treat the cover as suspended. This applies to terms which, if complied with, would tend to reduce the risk of one or more of a loss of a particular kind, location, or time.

Fraudulent Claims

The Bill has created a new framework for the appropriate remedy where the insured makes a fraudulent claim and this is intended to replace the current remedies available to the insurer of forfeiture and avoidance.

Where the insured makes a fraudulent claim the insurer will not be liable for that particular claim, it may recover sums paid to the insured in respect of that claim and may, by notice to the insured, treat the contract as having been terminated with effect from the time of the fraudulent act.

If the insurer does treat the contract as having been terminated then it may refuse all liability for any "*relevant event*" (anything which gives rise to a loss or liability) which occurs after the fraudulent act and it need not return any of the premiums paid under the contract.

However, the giving of notice after a fraudulent act does not permit the insurer to avoid legitimate losses or liabilities occurring before that act took place.

If the insured makes a legitimate claim followed by a fraudulent claim later in time, then the insurer may decline cover for the latter but must pay the former. It is not difficult to foresee a situation in which a legitimate claim is made in, say, January of a year of cover and, whilst awaiting payment

from the insurer, the insured makes a fraudulent claim in March.

The insurer may then spend considerable sums of money investigating and proving that the insured's second loss was fraudulent. Even though the insurer has successfully established the fraud, his "reward" is the ability to terminate the insurance rather than recover damages. It is not difficult to expert an insurer arguing that he should be able to offset the cost of investigating the fraud against the cost of the first, legitimate, loss suffered by the insured.

Contracting Out

In non-consumer insurance the parties to the contract have the ability to contract out of any provision specified by the Bill, except for clause 9 which forbids the insurer from turning any representations made during the formation of, or subsequent variations to, the contract of insurance. Therefore parties cannot contract out of any provision which prohibits the use of basis of contract clauses.

With regard to the other provisions in the Bill, whereby contracting out of any section puts the insured in a "*worse position*" than they would otherwise have been, then the insurer must meet the "transparency requirements". These compel the insurer to take sufficient steps to draw the disadvantageous term to the insured's attention and to make the term clear and unambiguous as to its effect.

Interestingly, the other section which the Law Commissions had intended to prevent the insured from contracting out of was that requiring damages to be paid to the insured where the insurer is late in making payment.

Conclusion

The Insurance Act when it comes into force in 18 months' time will not dispose of disputes arising from the formation and implementation of contracts of insurance. The Law Commissions have been quite open in saying that the Bill is intended to address matters of principle but the detail will have to be determined by the courts. We shall embark on interesting times.

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