MARSH

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ADVISER

THE INSURANCE ACT 2015 – WARRANTIES AND OTHER TERMS

When the Insurance Act 2015 (the "Act") comes into force on 12 August 2016, it will make some key changes to the law relating to warranties and other terms in insurance contracts. The changes will apply to all insurance and reinsurance contracts that incept or are renewed on or after 12 August 2016, and to variations of existing policies on or after that date, if the contract is subject to the laws of England and Wales, Scotland, or Northern Ireland, regardless of where the policy is placed and where the policyholder is situated.

KEY CHANGES

- Insurers will not be able to rely on breach of a warranty or similar "risk mitigation term" to reject a claim, if the breach is not connected to the actual loss that has occurred.
- Automatic and permanent termination of cover will no longer be the insurer's sole remedy for breach of warranty; instead, cover will be suspended while the insured is in breach of warranty.
- "Basis of contract" clauses will be completely abolished, and insurers will not be able to contract out of this.

This Adviser comprises three parts. Part 1 is a reminder of how insurance terms are classified; Part 2 sets out the changes to be brought in by the Act; and Part 3 sets out some issues for you to consider to ensure you are prepared to take full advantage of (and are not to be disadvantaged by insurers' responses to) the changes.

PART 1: CLASSIFICATION OF POLICY TERMS (THE CURRENT POSITION)

How an insurance contract term is classified is important, as it determines the insurer's remedy if the term is breached. Understanding how insurers' remedies for breach will change as a result of the Act, and what you can do to limit insurers' remedies, will be invaluable when looking to maximise the effectiveness of your policy.

Terms in insurance contracts can be split into three categories; warranties, conditions precedent, and bare conditions.

WARRANTIES – WHAT ARE THEY, HOW ARE THEY CREATED, AND UNDER CURRENT LAW WHAT HAPPENS IN THE EVENT OF NON-COMPLIANCE?

A warranty is a policy term that requires exact compliance; any departure from its requirements constitutes a breach.

Warranties can be created in various ways:

- **Express term**: A warranty can be created by expressly labelling it as such.
- **Construction**: A warranty can be implied into a policy where, for example, compliance with the term goes to the root of the insurance contract and where the term is material to the risk.
- **Basis of contract clauses**: A "basis of contract clause" is often found in proposal forms stating that the facts set out in the proposal form are the "basis of the policy" and are to be construed as being incorporated into it. This type of clause has the effect of conferring the status of a warranty on all of the pre-contractual representations made by the prospective policyholder.

Under current law, if a policyholder breaches a warranty, the insurer is permanently and automatically off-risk from the date of the breach, even if the breach is irrelevant to the loss that has occurred, and even if the breach is subsequently remedied. This is clearly a very harsh remedy and, as will be discussed below, is one of the key things that the Act seeks to address.

CONDITIONS PRECEDENT – WHAT ARE THEY, HOW ARE THEY CREATED, AND WHAT HAPPENS IN THE EVENT OF NON-COMPLIANCE?

Conditions precedent can be divided into the following categories:

- **Conditions precedent to the insurer coming on risk**: This type of condition precedent is imposed at the pre-contractual stage and provides that the insurer will not come on risk until certain conditions have been satisfied. For example, a payment of premium condition or a requirement that the insured provides a survey of the insured subject matter.
- **Conditions precedent to the insurer's liability to pay a claim**: This type of condition precedent is usually connected to the claims process. While the consequences of breach will depend on the precise words used, a breach will usually entitle the insurer to decline a particular claim, but will not impact the cover going forward. For example, if a policy contains a condition precedent that a claim be notified within a specific time period from the insured becoming aware of it, failure to comply will mean there is no cover for a late-notified claim, *even if* the insurer has not suffered any prejudice as a result of the late notice. However, the policy remains valid for future claims.

Conditions precedent can be created in a number of ways:

- **Express term**: The policy may expressly classify certain terms as being conditions precedent to an insurer's risk or to an insurer's liability for a claim.
- **If the consequences of breach of the condition are spelled out, it can indicate that the clause is a condition precedent** (for example, a clause stating that a claim under the policy will not be payable unless a particular condition has been complied with). Even though the condition is not expressly labelled as, or stated to be a "condition precedent", the wording of the clause requires the condition to be treated as such, by spelling out the consequences of breach.
- **Sweep-up clause**: A sweep-up clause (sometimes known as an "observance" clause) provides that all conditions in the policy are conditions precedent and that failure to comply with them prejudices the policyholder's cover in the event of a claim.

BARE CONDITIONS – WHAT ARE THEY, HOW ARE THEY CREATED, AND WHAT HAPPENS IN THE EVENT OF NON-COMPLIANCE?

A bare condition is a policy condition that is concerned with the policyholder's conduct during the currency of the policy (for example, a requirement that the policyholder renders all reasonable assistance to and co-operates with the insurer in the event of a claim). Breach of such a term will entitle the insurer to damages if it can show it has suffered prejudice as a result of the breach.

PART 2: WHAT CHANGES WILL THE ACT BRING ABOUT?

The changes to the law on warranties and other terms are contained in Sections 9 to 11 of the Act and are discussed in reverse order below. These changes are positive steps forward for policyholders, as they address some of the harshness of the current law, in terms of insurers' remedies for breach of warranty, and insurers' current ability to rely on irrelevant breaches of policy terms to avoid paying claims.

SECTION 11: "RISK MITIGATION TERMS"

Section 11 of the Act aims to prevent insurers from relying on breaches of policy terms that are unconnected to the actual loss the policyholder has suffered, as grounds upon which to decline or limit liability for paying the claim. It is very important to note that Section 11 applies to all policy terms (including warranties *and* conditions precedent) that would tend to reduce the risk of (a) a particular type of loss, or (b) loss at a particular time, or (c) loss at a particular place. These are called "risk mitigation terms".

As a result of this change in the law, insurers will no longer be able to rely on a policyholder's breach of a risk mitigation term to avoid paying a claim, if the policyholder can show that the breach of the term *"could not have increased the risk of the loss which actually occurred in the circumstances in which it occurred" (s11(3) Insurance Act 2015).* For example, if an insured property was damaged by flooding, it is unlikely that the insurer would be able to rely on a breach of a policy term which required sprinklers to be operational. On the other hand, the insurer would probably still be able to rely on this breach if the property was damaged by fire and the sprinklers had not been kept operational. Note that the burden will be on the policyholder to prove that the breach could not have increased the risk of the loss that occurred.

However, one major limitation for policyholders to bear in mind is that this new protection does not apply to policy terms that "define the risk as a whole". If the term that has been breached is one that "defines the risk as a whole", then depending on the precise drafting of the term and even after the Act comes into force, insurers may still be able to rely on a breach of the term as grounds for repudiating or limiting liability for the claim.

Although the changes being brought in by section 11 of the Act are good news for policyholders, the Act does give rise to some areas of uncertainty.

Which policy terms fall within the scope of Section 11? It will not always be easy to identify which policy terms are "risk mitigation terms" (and are, therefore, protected by Section 11) and which are terms that "define the risk as a whole" (and are, therefore, not protected). As examples of terms that could be regarded as defining the risk as a whole, the Law Commission cited terms that[1]:

- Define the geographical area in which a loss must occur, if the insurer is to be liable to indemnify the insured; or
- Require that a property or vehicle is not to be used commercially; or
- Define the age, identity, qualifications, or experience of a driver of a vehicle.

Although the Law Commission has provided these examples, whether a term is or is not one that "defines the risk as a whole" will ultimately be left to the courts to determine. Furthermore:

- **How far does Section 11 apply to exclusions?** Although the Law Commission's Explanatory Notes[2] suggest that Section 11 will apply to exclusions, it is not clear whether the courts would construe an exclusion clause as being a term with which the policyholder must "comply" for the purposes of Section 11(1). It could also be argued that an exclusion is a term which defines the risk as a whole (thereby falling outside the scope of Section 11), as it places limits on the scope of cover provided by a policy.

SECTION 10: CHANGES TO THE LAW ON INSURER'S REMEDIES FOR BREACH OF WARRANTY

One of the biggest changes that will be brought in by the Act is that, if a warranty is breached, automatic and permanent termination of cover will no longer be the insurer's sole remedy for breach of warranty. Instead, if a warranty is breached, cover will simply be **suspended** from the time of the breach until the breach has been remedied (provided the breach can be remedied). Once the insured has remedied the breach, the insurer will be liable for subsequent losses – *unless* the loss is attributable to something that happened during the period that cover was suspended.

WHEN IS A BREACH OF WARRANTY REMEDIED?

The following examples may assist in identifying when a breach of warranty has been remedied:

- **Time-specific warranties**: If a warranty requires something to be done (or not done) by an ascertainable time, a breach is remedied when the risk to which the warranty relates becomes essentially the same as that originally contemplated by the parties to the insurance contract. For example, if a property policy contains a warranty requiring a burglar alarm to be installed by 1 April and the policyholder does not install it until 15 April, the breach is remedied on 15 April; at that point, the risk becomes the same as that originally contemplated by the parties. In this scenario, cover will have been suspended between 1 and 15 April.

  This means the insurer will be on risk for losses that occur between inception and 1 April; will not be liable for any losses that occur between 1 and 15 April (unless the insured can show that the breach could not have increased the risk of the loss that actually occurred in the circumstances in which it did occur – a point to which we return below); and the insurer will be liable for losses that occur after that 15 April, *provided* they are not attributable to something that happened in the period 1 to 15 April.

- **Other warranties**: In any other case, the breach of warranty is remedied when the insured ceases to be in breach of warranty. For example, if a warranty requires a vessel to sail with a 20-strong crew and the policyholder sets sail with a crew of only 18, the breach is remedied as soon as the insured picks up two additional crew members. At that point, the insured ceases to be in breach of warranty.

However, it is very important to bear in mind that there will be breaches of warranty that can never be remedied; for example, a warranty relating to a duty of confidentiality cannot be remedied once confidentiality has been compromised. As a result, the insurer's liability would remain suspended for the remainder of the policy period, meaning that the policyholder has no cover from the date of breach.

For this reason, it is best for policyholders to resist, where possible, having warranties in their policies that are not capable of remedy. For example, policyholders should resist any term that provides that a certain state of affairs is "warranted at inception" as, in such circumstances, if there is non-compliance with the term at inception, this cannot be remedied, as there is only one policy inception date.

1 Law Comm No. 353 (dated July 2014) at #18.33; Explanatory Notes at #95.

2 At #95

IF A RISK MITIGATION TERM IS BREACHED AND A LOSS OCCURS BEFORE THE BREACH IS REMEDIED, IS THERE COVER OR NOT?

Finally, it is important to understand the link between sections 10 and 11 of the Act. A situation could arise where a warranty has been breached, meaning that the insurer's liability is suspended from the date of breach, and a loss that is unconnected to the breach occurs during the period when cover is suspended. In these circumstances, the starting point is that there is **no** cover for any loss that occurs during the period of suspension of cover, regardless of whether the breach has any causal connection with the loss (see Section 10). This is because the insurer's liability is suspended from the point at which the warranty has been breached. **However**, if the warranty is a risk mitigation term (rather than a term which defines the risk as a whole) and, if the policyholder can show that the breach could not have increased the risk of the loss that occurred in the circumstances in which it occurred then, because of Section 11 of the Act, the insurer will **not** be able to rely on the breach of warranty to escape liability. It is, therefore, possible that, while the starting point is that there is no cover for the unconnected loss, if the policyholder can rely upon Section 11, then cover may be available, even though the loss took place during the period in which the insurer's liability was suspended.

SECTION 9: ABOLITION OF "BASIS OF CONTRACT" CLAUSES

Section 9 of the Act will completely abolish "basis of contract" clauses, which is a significant step forward for policyholders. This means that, after the Act comes into force, insurers will no longer be able to convert representations made by the insured in pre-contractual documentation into warranties by means of a term in the policy or in the proposal form. However, it is important to note that this change in the law will only apply to policies that incept or are renewed on or after 12 August 2016, and to variations of existing policies on or after that date. In other words, if a policy that has been placed before 12 August 2016 contains a "basis of contract" clause, the Act will not automatically render that basis clause as being of no effect.

CONTRACTING OUT OF THE ACT

Apart from the abolition of basis of contact clauses, it will be open to policyholders and insurers to contract out of the Act. Policyholders can, therefore, seek to put themselves in a better position than they would be in under the Act, and insurers may try to exclude the positive changes brought in by it. However, if an insurer does seek to include such a "*disadvantageous term*" in a policy (that is, one that would put the policyholder in a worse position than it would be under the Act), then, in order for the disadvantageous term to be effective, the insurer must meet the following *"transparency requirements"* set out at section 17 of the Act:

- The insurer must take sufficient steps to draw the disadvantageous term to the insured's (or its broker's) attention <u>before</u> the policy is entered into; and
- The term must be clear and unambiguous as to its <u>effect</u>.

Therefore, as regards the second requirement, it would not be sufficient for a term simply to state that, for example, "*Section 10 of the Insurance Act 2015 is excluded in its entirety*". To comply with the Act's transparency requirements, the disadvantageous term would need to spell out the actual effect of Section 10 being excluded. A compliant term might, therefore, read: "*Section 10 of the Insurance Act 2015 is excluded in its entirety. As a result, if the insured fails to comply exactly with any warranty in the policy, the insurer is discharged irrevocably from liability from the date of the breach of warranty. Accordingly, the insured cannot avail itself of the defence that it remedied the breach of warranty before any loss occurred.*"

PART 3: PRACTICAL POINTS FOR POLICYHOLDERS TO CONSIDER

INSURERS' RESPONSES TO THE ACT

Some insurers have already made public statements that, in advance of August 2016, they will comply with "the spirit" of the Act. Although this sounds positive, policyholders should treat such statements with caution. Unless the policy wording does actually reflect the new law, there is ambiguity and uncertainty as to the meaning and practical effect of such generalised statements.

Other insurers are seeking to use their own clauses to bring in certain provisions of the Act. Again, caution should be exercised and policyholders should review carefully any clause(s) that an insurer seeks to use which purports to introduce certain aspects of the Act in advance of August 2016. The insurer's clauses may not be identical to the Act, and may even be disadvantageous to the policyholder.

Policyholders should also watch out for insurers trying to contract out of certain aspects of the Act. For example, the Lloyd's Market Association (LMA) has issued a number of clauses which aim to contract out of parts of the Act, including clauses which seek to:

- Revert to the sole remedy of avoidance for breach of the duty of fair presentation.
- Preserve the current remedy of automatic and permanent termination of cover for breach of warranty.
- Exclude the effect of Section 11, to enable insurers to rely on a breach of a risk mitigation term that is unconnected to the actual loss suffered.

These clauses are not in the interests of policyholders and, where possible, should be resisted.

THE TERMS AND CONDITIONS OF POLICY WORDINGS

So as to take full advantage of what the Act has to offer it is crucial that policyholders are familiar with their policy wordings, for example, to ensure that if a warranty is included policyholders are aware of its existence and how any breach can be remedied, so that insurers' liability is restored following a breach. In addition, policyholders will need to watch out for insurers seeking to:

- Convert warranties into **conditions precedent**, in an attempt to circumvent the effect of Section 10. (This is because, while under Section 10 a breach of a warranty can be remedied, a breach of a condition precedent cannot. Therefore, where the condition precedent is breached, the insurer may be able to argue that it has no liability).
- Include **exclusions**, to avoid the uncertainty as to what is and is not a risk mitigation term or one that defines the risk as a whole.
- Include conditions precedent to liability that certain matters are true and accurate, to get around the Act's abolition of basis clauses.
- Contract out of certain aspects of the Act, for example, by using the LMA clauses, which, in some cases, effectively retain the harshness of the existing law.
- Include clauses to bring in certain provisions of the Act in advance of August 2016, which are drafted in terms that are not identical to the Act and are less advantageous for policyholders (as referred to above).

HOW WILL THE ACT AFFECT YOUR POLICY WORDING?

It will also be important for policyholders to ensure they are familiar with the categorisation of policy terms and how certain policy terms are drafted, for example, whether the policy contains any terms that are categorised as (or could be deemed to be) warranties or conditions precedent, which, if not complied with, could prejudice coverage in the event of a claim. Remember – if a policy contains a warranty, even once the Act comes into force, the policyholder will still be required to comply – strictly – with its provisions; **it is only the remedy for breach** that the Act will change.

Other practical issues for policyholders to consider arising out of policy warranties include:

- Keep a record of all warranties and record compliance with them;
- Avoid, where possible, the inclusion of warranties that cannot be remedied following a breach; and
- If a breach of warranty occurs, record the date the breach was remedied, as this is the date when the insurer's liability is restored.

Remember: Even once the Act comes into force, if a **condition precedent** is breached, it may mean that the insurer has no liability to pay a claim or is even off risk permanently. Under the Act, it is only breaches of warranty that can be remedied. Policyholders should, therefore, be aware of any policy conditions that are stated to be, or could be construed as, conditions precedent to the insurer's liability.

Policyholders should ensure that their key operational personnel are also aware of the existence of any warranties or conditions precedent and that they understand what steps need to be taken to ensure compliance with them, and the potential impact on coverage in the event of non-compliance.

The Act brings benefits to policyholders under Section 11, by preventing insurers, in certain circumstances, from relying on a breach of a policy term that is unconnected to the actual loss suffered as grounds upon which to decline a claim. Policyholders should try to identify and agree with insurers those policy terms that are, on the one hand, risk mitigation terms, and those that are, on the other hand, terms that define the risk as a whole, so they have some clarity as to the terms to which Section 11 can apply.

BE AWARE OF WHAT THE ACT IS NOT CHANGING

Even once the Act is in force, it will still be possible for insurers to include conditions precedent and warranties in policies, and insurers will still not have to label them as such.

Also, even once the Act is in force, policyholders will still have to comply with the requirements of all policy conditions and warranties. Remember, it is only the insurer's remedies for breaches of risk mitigation terms and warranties that the Act will change.

For example, if a policy contains a condition precedent about notification of claims or losses within a certain timeframe this must still be strictly complied with, and failure to do so could prejudice the policyholder's ability to recover under the policy.

Policyholders should, therefore, use the time before 12 August 2016 to improve their notification provisions to ensure the following:

- The notification provision is only triggered by the knowledge of certain class(es) of individual within the insured (for example, the knowledge of the risk manager) and not the insured generally.
- There is a reasonable period in which to notify (as opposed to a short specified time limit). There is a clear threshold for a notification clause to be triggered, such as claims likely to be for more than a certain monetary amount.

Finally, it will still be possible to include condition precedent "sweep-up" clauses in policies. For the reasons discussed above, such clauses should be avoided.

We hope the above gives you some guidance on how the Act will have an impact on some of the terms and conditions within your policy wordings and what you can do now to address some of the issues that could arise. If you have any queries about any of the issues discussed in this Adviser or the other provisions of the Act, please do not hesitate to get in contact with your usual Marsh contact.

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