

ADVISER

THE INSURANCE ACT 2015 – THE NEW REGIME OF PROPORTIONATE REMEDIES

The Insurance Act will come into force on 12 August 2016 and will affect all policies subject to the laws of England and Wales, Scotland, and Northern Ireland. Under the Act, when taking out, renewing, or varying a business insurance policy on or after that date, the insured will have a new duty to make a “fair presentation” of the risk. If the insured breaches this duty, insurers will have a new range of “proportionate” remedies available to them. This Adviser looks at:

- The current law.
- The new law.
- The new duty of fair presentation – a reminder.
- How proportionate remedies will work in practice.
- Proportionate remedies in relation to variations of policies.
- How insurers will have to prove what they would have done.
- Whether you have to accept proportionate remedies.
- The potential impact of proportionate remedies on claims handling.
- Steps you should consider taking now to start preparing for the new regime.

THE CURRENT POSITION

Under the Marine Insurance Act 1906, before a policy is placed, a prospective insured must disclose to insurers all material circumstances that it knows, and an insured is deemed to know every circumstance which, in the ordinary course of business, it ought to know. A prospective insured must also ensure that every material representation made before the contract is concluded is true.

If the insured fails to comply with either of these duties, the only remedy available to the insurer, unless the policy provides otherwise, is avoidance of the policy ab initio. This means the insurer can treat the policy as if it never existed, and may refuse all claims, even if the non-disclosure was innocent and even if, had the insurer known all the facts, it would still have provided cover but charged only a small increase in premium.

THE NEW LAW

The Insurance Act 2015 (the “Act”) will apply to all policies that incept, renew, or are varied on or after 12 August 2016 and are subject to the laws of England and Wales, Scotland, and Northern Ireland¹. The Act seeks to address this overly harsh, inflexible remedy of avoidance. Under the Act, the insured will have a duty to make a “fair presentation” of the risk and, if it fails to do so, the insurer will have a range of “proportionate” remedies (which include avoidance in some instances). The remedy available to the insurer will depend on whether or not the breach of the duty of fair presentation was deliberate or reckless and what the insurer would have done had the duty not been breached.

While the removal of the sole remedy of avoidance is a positive step for policyholders, a number of issues arise out of the new regime of proportionate remedies. We hope this Adviser will give you some practical guidance on how to address some of these issues in advance of the Act taking effect on 12 August 2016.

¹ The Act applies to both insurance and reinsurance contracts and, therefore, references in this Adviser to the provisions of the Act relating to an “insured” and “insurer” should be read to include “reinsured” and “reinsurer” respectively.

A REMINDER ABOUT THE NEW DUTY OF FAIR PRESENTATION

In our *Adviser – Issue 4*, we discussed the new duty of fair presentation and gave some practical guidance on steps you can take now as part of your preparations. By way of a reminder, once the Act comes into force, before entering into a business insurance contract² the insured must make a “fair presentation” of the risk to the insurer, which means it must:

1. (a) Disclose every material circumstance that it knows or ought to know, or (b) failing that, provide the insurer with sufficient information to put a prudent insurer on notice that it needs to make further enquiries for the purposes of revealing those material circumstances; and
2. Present the disclosure in a manner that would be “reasonably clear and accessible to a prudent insurer”; and
3. Not make a misrepresentation, so that “every material representation as 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”.

If the duty of fair presentation is breached, “proportionate remedies” will apply.

PROPORTIONATE REMEDIES

Under the Act, if the insured’s failure to make a fair presentation is deliberate or reckless, the insurer can still avoid the contract (in other words, it will be able to cancel the contract from day one and treat it as if it never existed) and will not have to return the premium. The Act defines a “reckless” breach as one where the insured did not care whether or not it was in breach of the duty to make a fair presentation of the risk.

However, if the failure to make a fair presentation was not deliberate or reckless (for example, if it was simply the result of a careless or innocent oversight, or due to defective reporting standards), then the insurer has the following range of remedies available to it, which are based on what the actual underwriter can show they would have done had a fair presentation been made:

- i. If the insurer would not have entered into the contract on any terms, it can still avoid the contract but must return the premium.

- ii. If the insurer would have entered into the contract but on different terms (other than relating to premium), the contract will be treated as if it included those terms from the outset.

- iii. If the insurer would have entered into the contract but would have charged a higher premium, then, rather than pay additional premium, the insurer’s remedy is to reduce proportionately the amount paid on a claim. This means the insurer need only pay “X%”, where “X%” is calculated as follows:

$$X = \frac{\text{Premium actually charged}}{\text{Higher premium}} \times 100$$

HOW WILL PROPORTIONATE REMEDIES WORK IN PRACTICE?

Take an example where an insured wishes to purchase a property policy to cover commercial premises that have a history of subsidence. Before inception, the insured fails to mention the prior history of subsidence to the insurer, but the failure to mention this is not deliberate or reckless. Had the insurer been aware of the prior history, it would have included an exclusion for loss or damage caused by subsidence. In the event of a claim, the policy would be treated as if that exclusion had been included from the outset. No claims caused by subsidence will be covered and any such claims that have already been paid by the insurer under the policy will have to be re-paid by the insured.

Alternatively, take a scenario where a firm of architects purchases a liability policy with a GBP10 million limit (including defence costs) and, prior to inception, innocently fails to disclose that it has started working on projects in the Middle East. When the insured presents a claim under the policy and the insurer becomes aware of the Middle East projects, the insurer argues that, had a fair presentation been made it would have doubled the premium. In these circumstances, the insurer need only pay 50% of the claim. The insurer’s reduced liability will also apply in respect of any additional coverage afforded by the policy, such as cover for defence costs. In this example, if the insured had incurred GBP1 million of defence costs, it would only be able to recover GBP500,000 of these.

In this scenario, what determines the level of additional premium due (and therefore the proportionate reduction of the claim payment) is not the size of the claim but rather the insurer’s attitude to the non-disclosed fact, in this case the fact that the insured was carrying out projects in the Middle East.

It is very important to note that where the insurer seeks to reduce a claim payment proportionately it cannot also charge the additional premium. The insurer can, however, combine proportionate remedies (2) and (3) above.

² A business insurance contract is any contract that is not a consumer contract. A consumer contract is an insurance contract taken out by an individual for purposes that are wholly or mainly unrelated to their business, trade, or profession.

That is, it could proportionately reduce a claim payment and also amend the terms and conditions of the policy, for example, by adding an exclusion.

PROPORTIONATE REMEDIES AND VARIATIONS OF POLICIES

Proportionate remedies also apply to variations of policies. For example, if a policy incepts on 1 July 2016 but is varied on 1 September 2016, if there is a breach of the duty of fair presentation in respect of the variation, the following remedies will apply:

- i. If the failure to make a fair presentation was deliberate or reckless, the insurer may avoid the entire policy, with effect from the time the variation was made;
- ii. If the failure to make a fair presentation was not deliberate or reckless, then:
 - a. If the insurer would have agreed to the variation on different terms (not relating to premium), the variation will be treated as if it had been entered into on those different terms.
 - b. If the insurer would not have agreed to the variation on any terms, it may treat the contract as if the variation was never made. Any extra premium paid for the variation must be returned and, if the total premium was reduced as a result of the variation, then the insurer may reduce proportionately the amount paid on claims arising out of events after the variation.
 - c. If the insurer would have increased the premium/not have reduced the premium/reduced the premium by less than it did, then it may reduce proportionately the amount paid on claims arising out of events after the variation.

The diagram below illustrates how proportionate remedies could apply where, for example, an insured purchases a property policy covering four locations, which is then varied to cover an additional fifth location, and, prior to inception, the insured fails

to disclose that the fifth location had been burgled twice in the previous year.

PROVING THE HYPOTHETICAL

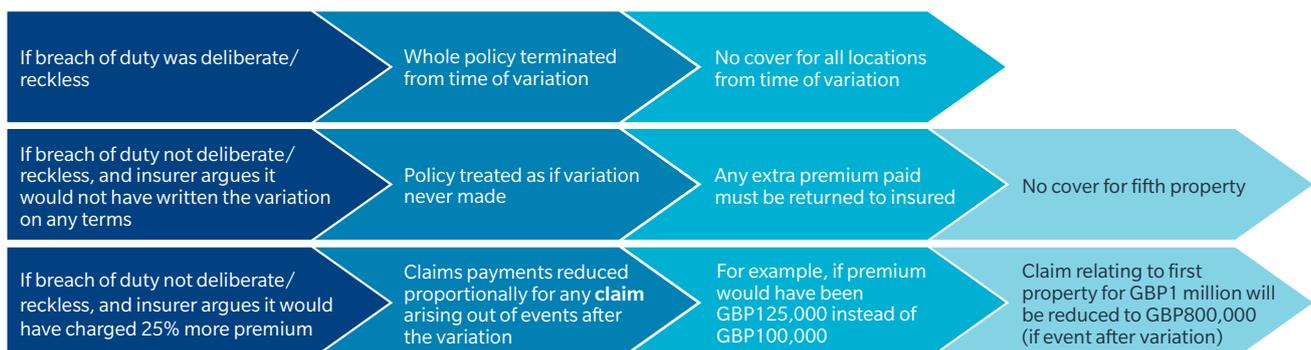
In order to rely on proportionate remedies, the burden will be on the insurer to show what it would have done had a fair presentation been made, and in this context it is what the “actual” underwriter would have done which needs to be proved. This may present some challenges for insurers, since what the “actual” underwriter would have done if given all the material information depends on a number of elements, such as the existing relationship (if any) between the insured and the insurer, the nature of the market (that is, whether it is a hard or soft market), and the insurer’s capacity at the time. It remains to be seen how insurers will address this issue of proving what they would have done had a hypothetical fair presentation been made.

PRACTICAL ISSUES TO START CONSIDERING NOW

YOUR CURRENT POLICY PROVISIONS

One of the key issues to consider is the existing language in your policy that deals with the remedies that are available to insurers if there is a non-disclosure or misrepresentation. If your policy is silent on this, then insurers’ remedies will be determined by the law that governs your policy. So if, for example, your policy is governed by the laws of England and Wales, Scotland, or Northern Ireland, then, if your policy incepts, renews, or is varied on or after 12 August 2016, the new regime of proportionate remedies will apply in the event of a breach of the duty of fair presentation.

Currently, because the sole remedy of avoidance is so harsh, it is sometimes possible to negotiate enhanced non-avoidance language into policies. This language seeks to limit the remedy of avoidance by restricting insurers’ right to avoid, for example, only to situations where the non-disclosure or misrepresentation is fraudulent.



Alternatively, some policies include a range of remedies where there is non-disclosure of material information, for example, enabling the insured to pay additional premium in circumstances where a higher premium would have been charged. We recommend that you review your policy wording with your broker, to identify whether you already have any such enhanced non-avoidance language.

If you do have any preferential language that puts you in a better position than you would be under the Act, you may want to try to preserve it in your policies after the Act comes into force. For example, if you currently have the language which limits the insurer's remedy for non-disclosure only to situations where the non-disclosure is fraudulent, this puts you in a better position than you would be under the Act. This is because, under the Act, if there is a non-fraudulent failure to make a fair presentation, the insurer may still be able to argue that, had it known about the non-disclosed fact, it would have included an additional term or charged a higher premium. We therefore recommend that you consider with your broker what amendments need to be made to your existing policy language to ensure that you retain any language that puts you in a more advantageous position than under the Act, in particular, where you are seeking to limit the remedies available to insurers in the event of a breach of the duty of fair presentation.

DO YOU HAVE TO ACCEPT PROPORTIONATE REMEDIES?

As under the current law, the Act will not detract from your right to try to negotiate different policy terms and to put yourself in a better position than you would be under the Act. It will still be open to insureds to try to negotiate more beneficial terms with insurers.

Therefore, we recommend that you consider your policy with your broker to identify whether or not you currently have such enhanced non-avoidance language, its scope, and what remedies you want insurers to have where there is a breach of the duty of fair presentation. For example, do you want to try and limit insurers' remedies so that the only remedy available for breach of the duty of fair presentation is avoidance in the event of the breach being deliberate or reckless (thereby removing insurers' ability to apply an exclusion or reduce a claim payment)? Alternatively, would you rather have the ability to pay any additional premium that the insurer would have charged had a fair presentation been made, than face a proportionate reduction of claim payments? (Remember, however, it may not always be more beneficial to pay additional premium. For example, it could be more than the reduction in the claim payment.)

Once you have decided what remedies you want insurers to have, you will need to think about how far you want to go in pressing for this in the negotiations with insurers.

Remember, when negotiating cover with insurers, there are other important factors to take into account, such as the scope of cover, the availability of extensions, the level of the excess or deductible, and the nature of the exclusions. Identify which factors are of most importance to you.

Also, be prepared for possible insurer resistance to requests for enhanced language. Under the current law, it is sometimes possible to obtain enhanced non-avoidance language, as insurers recognise that the existing sole remedy of avoidance is very harsh. Once the Act comes into force, insurers may be less willing to provide it, given there will be a new regime of more balanced remedies.

POTENTIAL IMPACT ON CLAIMS HANDLING

From a practical perspective, proportionate remedies could impact how insurers handle disputed claims in a number of ways. For example:

- Going forward, as there will be a new range of remedies, and not just the "nuclear" option of avoidance, insurers may be more inclined to take non-disclosure points and to impose additional policy terms or reduce claim payments.
- Where more than one insurer takes a share of the same risk and multiple insurers provide cover, there is a possibility that, in the event of a disputed claim, each insurer will argue it would have taken a different course of action from the other, and so different insurers may argue for different remedies. For example, one insurer could argue that it would have added an exclusion, whereas another could argue that it would not have provided cover at all. One way to try to reduce the risk of this is, by way of enhanced language in your policy, to seek to limit the number of remedies available to all the insurers on the placement and try to agree a consistent approach from all the insurers as regards the remedies that can be applied.
- Where there are excess layers sitting above a primary policy, and insurers on the primary layer only pay a proportion of the limit, it could have an impact on whether the excess layer policies respond. For example, if there is a proportionate reduction of a claim payment on the primary policy, the first excess layer insurer could seek to argue that, because the limit of the primary policy has not been fully exhausted, the excess layer cover is not triggered.

- In practice, the impact of proportionate reduction of claim payments is no different to the situation that could arise today where, on a primary policy, the insured settles a claim with its primary insurers for less than 100% of the policy limit, so that the primary policy limit has not been fully exhausted. We recommend that you consider with your broker the language in your excess layer policies, so that you look to address the situation where a claim is substantial enough that the excess layer policies would be expected to respond, but, because only a partial payment on the primary policy has been made, there is a potential argument that the excess layer cover is not triggered.
- Proportionate reduction of claim payments could impact on the claims control of insurers on liability policies. For example, if an insurer is able to show that, had a fair presentation been made, there would have been a 50% increase in the premium, it will be entitled to reduce the claim payment by one-third. This will also reduce the defence costs recoverable under the policy by one-third, so you could have a situation where the insurer has selected the defence lawyers and retains the conduct and control of any negotiations and proceedings, and yet the insurer is only paying two-thirds of the defence costs. Accordingly, we recommend insureds consider with their broker any claims control provisions in their policies and what amendments are necessary, or consider including a costs-sharing provision to address such a situation.
- In the context of reinsurance there is a risk for reinsureds and captives where the remedies in, respectively, the insurance and reinsurance policies are not back to back. For example, consider the situation where there has been a breach of the duty of fair presentation because the insured has innocently failed to provide some material information to the insurers prior to inception, and where the non-disclosure was replicated when the reinsured purchased its reinsurance cover. If the insurance policy limits insurers' right to avoid only to situations where the failure to make a fair presentation is deliberate or reckless, but the reinsurance policy does not contain such a limitation and the full regime of proportionate remedies applies, the reinsured could find itself with limited or no reinsurance cover. This would be because the reinsured would not have a remedy in the event of the insured's innocent breach of duty and would be required to pay the underlying claim in full, but the reinsurers could apply one of the proportionate remedies and limit their liability to the reinsured. For example, if reinsurers could show that had they received a fair presentation they would have charged an additional premium, the reinsured would have paid the insurance claim in full but would face a proportionate reduction of its reinsurance claim.

KEY TAKEAWAYS – WHAT CAN YOU DO NOW TO PREPARE FOR THE NEW REGIME OF PROPORTIONATE REMEDIES?

It is a positive and welcome step for policyholders that the sole, harsh, and inflexible remedy of avoidance has been replaced with a more balanced regime of proportionate remedies. However, there is going to be uncertainty as to how the new regime will work in practice.

To prepare for the new regime, we recommend that insureds do the following:

- Work with your broker to consider the terms of your current policies to ascertain what, if any, enhanced non-avoidance language you already have and what amendments will be necessary to preserve such language and negotiate any required amendments with insurers.
- Think about whether you wish to try to limit the range of remedies available to insurers where there is a breach of the duty of fair presentation.
- Consider with your broker whether you want to try and agree with insurers that, in the event of a failure to make a fair presentation, you will pay the additional premium insurers would have charged, rather than taking a proportionate reduction of claims payments.
- Consider with your broker whether any amendments are necessary to excess layer policies to deal with the situation where the primary insurance policy limit is not exhausted due to the application of proportionate remedies by the primary layer insurers.
- If you are a captive and you purchase reinsurance, check that the reinsurers' remedies are consistent with the insurers' remedies.
- Ensure you have a robust process in place to address the duty of fair presentation prior to inception, to limit insurers' ability to argue there has been a breach of the duty.

We hope the above gives you some guidance on how the new regime of proportionate remedies will apply and what you can do now to address some of the issues that could arise. If you have any queries about the new regime of proportionate remedies, or the other provisions of the Act, please do not hesitate to get in contact with your usual Marsh contact.

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