INSURANCE ACT

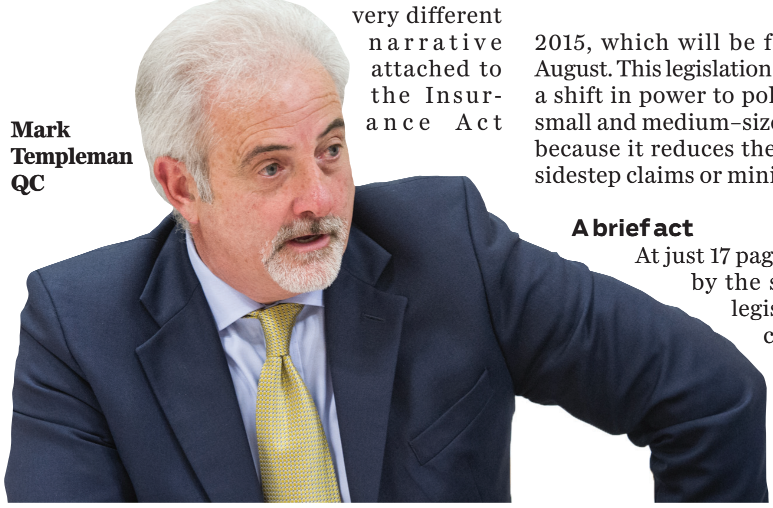
Playing the percentages

A fundamental change in insurance legislation will give policyholders more power and place risk under renewed scrutiny. **Eduardo Reyes** reports from the latest *Gazette* roundtable

At the 'consumer' end of the insurance market, there is a popular narrative. Our society is plagued by people who watch daytime TV ads bringing claims that have no merit against businesses, councils and motorists. Their cynical opportunism is costing the rest of us dear. The insurance industry would dearly like to make claims harder to bring, and in that respect is not so much pushing at an open ministerial door as being loudly encouraged to enter.

A caricature, of course – though reforms to civil litigation since 2013 show it is one that exaggerates all the right features of its subject.

There is a very different narrative attached to the Insurance Act 2015, which will be fully implemented in August. This legislation would seem to embody a shift in power to policyholders, including small and medium–sized enterprises (SMEs), because it reduces the ability of insurers to sidestep claims or minimise payouts.



Mark Templeman QC

A brief act

At just 17 pages, the act is very brief by the standards of modern legislation. A key element centres on 'fair presentation' of risk by policyholders, which was drafted to place a more positive duty of enquiry on insurers.

Crucially, the act also strengthens the hand of policyholders where they have breached a warranty by failing to provide accurate information. If such an omission did not increase the risk of a loss, it cannot be used by an insurer to avoid liability.

The act is intended to become the 'default regime' for non-consumer insurance, and there are tight limits on contracting out of the regime.

Lesley Harding is head of insurance risk solutions at BP International, which has opted largely to 'self-insure' its risks by setting aside funds for unexpected losses. 'It's something policyholders have been urging for some time,' she begins.

Currently, she explains, 'when you enter a big claim, a lot of time elapses before that claim is finally settled, and generally you don't recover fully on the policy. There's always some negotiation. The rule of thumb in my world – the energy insurance sector – is you generally recover around 60 cents in the dollar'.

BP took the decision principally to self-insure 20 years ago, 'partly because of the inefficiency of the insurance model'. BP has no current plans to change its self-insured arrangements.

From a broker's perspective, Lockton general counsel Sam Clark confirms that the act should secure 'a better deal for policyholders'. But he cautions: 'It's very much dependent on how the law is interpreted when claims start going to court.'

Clark describes the act as a 'skeleton' that will develop a 'body' through litigation and industry practice. 'I would rather that this be driven by the insurance market than [litigation],' he avers. 'It's incumbent on us [in] the insurance market to make sure that it goes the right way.'

From an insurer perspective, RSA legal counsel James Mills points to the ramifications for SMEs: 'Large corporates, larger insureds have always had the ability… to ride out problems with the current law,' he says. For their category of insureds, recouping 60p in the pound may feel like a raw deal, 'but they can live with it'.

By contrast, 'if you're an SME or a mid-market-type business, 60p in the pound – and waiting four years for that – is the difference between you being in business or being out of business. That's where I think you're going to see the real benefit.'

The market is currently working under legislation passed in 1906. Waiting more than a century for an upgrade has complicated matters, says Essex Court Chambers' Mark Templeman QC: 'One of the criticisms of the 1906 [Marine Insurance] Act was that it was all so black and white. There was no scope for courts to do anything [to develop the law].

'Certainly, the Law Commission contemplates that the courts will do something with the new act. But in order to do so, they are going to be dependent on some helpful policyholders and insurers taking disputes before them, so that uncertainties can become certainties.'

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> — Lesley Harding, BP

RPC partner Richard Breavington advises a client base mainly comprised of insurers.

'Inherent in this idea that [the act] benefits policyholders is that it's worse for insurers,' he notes. 'Actually, it's not necessarily worse. Most insurers welcome much of what's in it. They're not now reliant on out-of-date tests and out-of-date remedies. These don't represent the commercial deals that are done in the vast majority of claims, where there are doubts as to whether there's been a proper presentation of the risk, or whether there has been misrepresentation.'

At present, he says, 'insurers are in the unenviable position of either: [choosing] avoidance [refusal to pay a claim], which is a really draconian remedy and puts them right on the back foot commercially and in terms of any prejudicial position going forward; or paying the claim. Now we have a suite of remedies that more accurately reflects what would be done in negotiations anyway.'

RSA's Mills responds that commercial pressures are key to the way claims play out: 'The reality is as soon as you avoid [paying out on] a policy in its entirety and walk away, your relationship with that customer is gone forever. So you end up having discussions about pence in the pound, which comes down to a commercial weighting of who holds the balance of power.'

Fair presentation

Covington partner Alex Leitch turns to one

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From bottom left (clockwise):

Mark Templeman Essex Court Chambers
James Mills RSA
Richard Mattick Covington
Gary Marshall Polestar UK Print Limited
Carlo Kostka Covington
Eduardo Reyes Law Society Gazette
Richard Jacobs Essex Court Chambers
Lesley Harding BP
Alex Leitch Covington
Sam Clark Lockton Companies
Richard Breavington RPC

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grey area in the new legislation, which is the issue of 'fair presentation'. A policyholder will want to make sure that they have 'discharged the duty of giving a fair presentation of the risk which is going to be underwritten', he stresses. Will they therefore seek confirmation from the insurer that they have met the standard for fair presentation?

'I wonder if one of the benefits will be a more informed dialogue with insurers,' he speculates, 'so that you have insurers who better understand the risk, and can tailor the premiums and service more accurately to that risk.'

Mills responds: 'We're already being asked by customers and brokers to "sign off" that a customer has provided a fair presentation of the risk. Our response to that is: "We can tell you what you need to do to satisfy that test, but we are not signing off on that being a fair presentation of risk."'

Carlo Kostka, former co-head of group legal at bank UniCredit, and now of counsel at Covington, puts a question he says will be in the mind of any corporate client: 'Is it sufficient for a public company to say that the material risks of the business are those which are publicly disclosed in the annual report?'

Mills responds: 'Given the size of some annual reports, I don't think that would be sufficient. One of the things that the act is expressly trying to get around, and to which the guidance notes make specific reference, is "data dumping", and trying to avoid [it].'

If a public company's disclosure is 'everything that an investor should know before they invest in the company', Kostka argues, that company should be able to 'hand over the annual report [to an insurer] and say, "Here, read this. Ask any questions you want"'.

His concern is managing information flows: 'You have one set of risks, not four sets of risks for different people.'

Mills cites one hypothetical example. There will be a major difference between 'a 300-page annual report where there is one line that says, "we have a concern about some issues in Latin America" in small print at the bottom of a spreadsheet on page 257'; and a scenario where the company says 'please be aware of this line item in the annual report' in order to 'put an insurer on notice that they would need to ask more questions'.

INSURANCE ACT 2015

This latest round of insurance reforms focused on commercial (non-consumer) insurance. This was because the existing law:

- **undermined market trust and confidence: the unbalanced nature of the law was held to exacerbate disputes between insurers and business, reducing trust and confidence in insurance within the UK economy; and**
- **threatened the credibility of UK business law: the very fact that the law is so antiquated and inconsistent with current practice was seen as a threat to the long-established credibility of UK business law itself.**

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

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

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

Source: Chartered Insurance Institute

He adds: 'If that was brought to the attention of the insurer, and the insurer said, "thank you for telling me, I'm not going to question any further", then the insurer has waived its right to know any more, in effect.'

Mills adds that there will be pressure on the insurer to show what they would have done differently if omitted information had been provided. There will need to be clear guidance and documentation to support any such assertion.

BP's Harding, a former underwriter, underlines the complexities. Underwriters' views change over time as context alters: 'What might have been an acceptable risk at point A in time may be an unacceptable risk at point B, based on the performance of the portfolio, which is obviously ever-evolving.

'Documentation is the key, but it's a really difficult area. Policyholders are going to be looking for those comparables which are in the market. They're going to be putting pressure on brokers to find comparables which support their position, and you on the other side are going to be looking for comparables within the underwriter's portfolio to support your decision.'

RPC's Breavington continues: 'This is an area where you could see early litigation in terms of working out what evidence can be brought to bear regarding what an insurer would have done in a particular situation. Maintaining the integrity of the evidence that's being provided by the underwriter, which would be your starting point, is going to be absolutely critical.'

Mills adds: 'The people running scared in this new world are brokers, because they will have to satisfy this new [fair presentation] obligation. Customers are going to say "you're my broker, you didn't tell me what my duty of fair presentation was. Now my claim has been reduced". That's where it's going to get tested [in litigation].'

Clark agrees: 'We [the brokers] are unprotected in this. We are the adviser to, and in most cases the agent of, the client.'

A professional adviser but not a legal adviser, he stresses: 'That distinction has to be understood. The Insurance Act is [law that] requires legal interpretation. We cannot say to a client what a "reasonable search" is, or what "senior management" is. We can direct them but we can't say, "tick the box, this is definitely what it's going to be".'

So brokers could undoubtedly end up in the line of fire.

Clark says: 'At the moment, when the insurer goes for avoidance, [the broker can go from] "zero" to "hero". We do what we do best – we come up with the 60p in the pound, [for example], which everyone agrees to. Everyone feels a little bit hurt, but [the client] goes away on the basis they've got some money out of their claim.'

From August, an insurer is more likely to offer that 60% as a 'proportionate remedy' at the outset, Clark notes: '[So] a client's expectation has gone from zero, which they had at the old law, to 60%. Now, [starting] at 60%, the client's attitude is, "where's the rest of my money? I want 100%". That's my concern. We've done our job exactly how we should have done it, both ways, but under the new act we end up being the bad guy.'

'The insurance broker is exposed whenever there is an avoidance,' Essex Court Chambers' Richard Jacobs QC reflects. 'If you look at what the courts have said about [their] duties, they're extremely extensive, including [a duty to], "make sure the client isn't exposed to the unnecessary risks of litigation".'

While the act seems to make an avoidance harder, he adds, 'that doesn't reduce your exposure. The act isn't there to help you [the broker]. It's there to help the policyholder.'

Richard Mattick, of counsel at Covington, adds: 'I presume the perceived vulnerabilities will mean that [brokers] may be trying to tie down their relationship with the policyholders much more closely, and perhaps introduce limitations that might not have been there before.'

Kostka, drawing on his experience in-house at a bank, continues: 'From a public company perspective banks have to answer to regulators, providing them with information. They have to answer to the public, if they're a listed company.

'If there's a third flow of information to the brokers, I'm not sure that everybody has thought through what that means… how to manage that information is going to be critical. People aren't tooled up to do it.'

Presenting risk is even more complicated when the assessment covers risks relating to outsourced activities. Clark observes: 'From a cyber-risk perspective, lots of people have IT contractors who are external. What are you going to ask them? What are they going to provide and how are they going to provide it? They're going to have lots of disclaimers in relation to the information they provide – so how does that work through the chain?'

Litigation and dialogue

Reflecting on the cases that have shaped common law, Jacobs has a warning for parties focusing solely on the novel elements of the new act. 'There are all sorts of things that can bite you on an insurance claim which have nothing to do with non-disclosure or misrepresentation,' he cautions.

James Mills and Richard Mattick

'I haven't seen that many misrepresentation or non-disclosure cases in the last 10 years. What I do see is a lot of cases about coverage; about wording; about the exclusions; and whether, in liability insurance, you've got to prove the loss against yourself.

'None of these things are dealt with or addressed by the act. You've got to pay a huge amount of attention to the policy wording, which I think is more important than [for example] the level of search you do [for risks], or whether the engineers who are looking at the data on an oil rig have got it right.'

One issue central to the insurance market's response to the act is the erosion of underwriting skills across the industry – skills necessary for the more engaged approach the act aims to foster. Clark explains: 'There are insurers acting as if they don't know how to underwrite anymore. Suddenly, the act comes in, and you ask them what a reasonable search might be in relation to such-and-such a situation, and they respond, "I don't know. I haven't got a clue what I might want to look at". It's crazy.'

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– Richard Breavington, RPC

Mills reflects that the 'law itself does not reflect where the insurance market is going… Insurers, particularly in the intermediated business sphere, are becoming capacity providers, and are outsourcing or delegating the underwriting capability to brokers. The insurer is literally just there with the money, and that's all they are doing. There is little or no involvement in the underwriting process.'

The 2015 act originally included measures to penalise insurers for late payment of claims. But that section was removed, in order to be introduced instead through the Enterprise Act, which comes into force next year. That is another measure that seems set to strengthen the hand of the policyholder and SMEs in particular.

Currently, Leitch notes, delay is only rarely attributable to avoidance. Instead, 'it's usually a reservation on the issue of cover pending further enquiries. At the moment there is no particular time frame for the resolution of those issues. A lot of my clients, even the biggest financial services institutions in the world, say, "look, we just cannot afford the working capital burden of fighting [underlying] litigation and then having the same fight on another side of the fence against insurers"'.

However, viewed from an insurer's perspective, Breavington says 'there is a lot of commercial pressure, even now, to get things done quickly'.

He adds: 'Increasingly, quite apart from the act, people know that if you can reach a satisfactory commercial deal, it's far better than having an expensive debate that gets anywhere near the courtroom. I think damages for late payment will only reinforce that message, because it does create an extra layer of risk if you're disputing a claim without reasonable grounds for doing so.'

Insurer Mills concludes by suggesting the Enterprise Act will have the desired effect of improving the conduct of some insurers. At the moment, 'the insurer can sit there on its hands, not write that cheque, and watch as the customer starts to go to the wall, and know that they can have a discussion in a month's time, when the [policyholder is] really up against it and will settle for X in the pound [because] there is nothing they can do about it.

'I think that's unconscionable.'

● *This roundtable was kindly hosted by Covington's London office*