CONDITIONS PRECEDENT TO LIABILITY IN INSURANCE CONTRACTS

PART TWO

The Impact of the Insurance Act 2015

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These materials are intended to generally educate the participants on current legal issues. Accordingly, these materials should not be relied upon without seeking specific legal advice on matters discussed herein.

This article is the second in a two-part series considering conditions precedent.

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In Part One, Andrew reviewed selected recent cases from England, Scotland, the Republic of Ireland, and Singapore. In Part Two, Andrew discusses the impact of the UK Insurance Act 2015 on conditions precedent.

Recap of the Traditional Position on Conditions Precedent

Part One of this two-part series explored the powerful remedy granted to underwriters on a breach by an insured of a condition precedent and considered court decisions from other parts of the UK and as far away as Singapore. The English law position that failure to comply with a condition precedent will entitle an insurer to escape liability even if the failure to comply was not in any way related to the loss was strictly applied in all cases. In some, the courts went even further, deeming that terms in insurance contracts that were not specified to be conditions precedent could still be relied on as such by insurers.

However, the recent change in the law has tipped the scales closer to insureds, in what had previously been a pro-insurer legal regime.

The Insurance Act 2015

The *Insurance Act* 2015 came into force in August 2016 and represents a significant transformation of insurance contract law in the UK. It amends sections of the seminal foundation of the UK's modern insurance law, the *Marine Insurance Act 1906*, an act that has had major influence on insurance law worldwide. However, it does not repeal the 1906 Act. Also, it is not retrospective, in that it only applies to insurance contracts concluded after 12 August 2016, or amendments to insurance contracts after that date.

A significant portion of the new Act is concerned with the insured's (either itself or via a broker) presentation of the risk, and the obligation on the insured to do so in a manner that is reasonably clear and accessible. Section 9 unravels the insurer's pre-Insurance Act ability to rely on pre-contractual representations (for example responses in a proposal form or questionnaire) as warranties in certain circumstances, and section 10 is specifically related to the effect of breaches of warranty. However, this article focuses on conditions precedent, which are directly impacted by section 11 of the Act, which states as follows:

> Terms not relevant to the actual loss
>
> (1) This section applies to a term (express or implied) of a contract of insurance, other than a term defining the risk as a whole, if compliance with it would tend to reduce the risk of one or more of the following — (a) loss of a particular kind, (b) loss at a particular location, (c) loss at a particular time.
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> (2) If a loss occurs, and the term has not been complied with, the insurer may not rely on the non-compliance to exclude, limit or discharge its liability under the contract for the loss if the insured satisfies subsection (3).
>
> (3) The insured satisfies this subsection if it shows that the non-compliance with the term could not have increased the risk of the loss which actually occurred in the circumstances in which it occurred.

The reference to a "term" is widely accepted to mean that it applies to both warranties and conditions precedent.

Specifically, section 11 will now prevent an insurer from making a complete denial of liability in situations where the term that has been breached is unrelated to the loss being claimed. This marks a very significant change in the law. As set out in Part One of this series, the previous position was that a breach of condition precedent, whatever that condition precedent was, entitled insurers to avoid liability in all circumstances. Now, the effect of section 11 is that the term breached must be related to the loss in order for an insurer to rely upon it.

Where an insurance contract includes a term that will have the effect of reducing the risk of (a) a particular type of loss, (b) loss in a particular location or (c) loss at a particular time, then breach of that term will **not** allow the insurer to avoid liability **if the breach would not have increased the risk of the loss that actually occurred**.

As the Insurance Act has only recently come into force, there is no case law applying it. Consequently, one way of examining the potential impact of this new legislation is in the context of existing case law pre-dating the Act. Part One of this series considered the 2016 case of *Milton Furniture Ltd v Brit Insurance Ltd*[1]. In that case, there was a fire at the claimant's property during the night. However, the claimant was unable to recover on its insurance policy with Brit because the burglar alarm had not been set, which was a breach of two conditions precedent — the obligation to have a burglar alarm set out of business hours or when the premises were unattended and to have relevant "protections" e.g., fire and burglar alarms, in place. Clearly, the failure to set the burglar alarm had nothing to do with the fire, or the resulting damage. However, the pre-Insurance Act principle of strict compliance with conditions precedent allowed insurers to escape liability.

If this case had concerned a contract of insurance issued after 12 August 2016, the outcome would most likely have been very different. Applying section 11, we can predict that the court may well have come to the following conclusion:

Compliance with the conditions precedent in the insurance policy in the context of burglar alarms would "tend to reduce the risk" of losses caused by theft i.e., a "loss of a particular kind." Furthermore, it is a fair assumption that the insured in this case would have been able to demonstrate that, in accordance with sub-section 11(3), non-compliance with the conditions precedent in the context of the burglar alarm could not have increased the risk of losses associated with fire. Consequently, Brit would not have been allowed to rely on a breach of those conditions precedent to exclude its liability.

It must be noted that section 11 of the Act does contain a carve-out for terms that define the risk as a whole, rather than reduce it. In these circumstances, an insurer relying on a breach of such a term can still deny liability. But what is a term defining the risk as a whole? While there is, as yet, no case law on this issue, the Law Commission has published some guidance, suggesting that terms of the following type may fall within the carve-out:

(1) A term defining a geographical area in which a loss must occur for liability to attach;

(2) A term defining the age, identity, qualification or experience of the operator of a vehicle, aircraft, vessel or chattel; or

(3) A term which excludes loss which occurs while a vehicle, aircraft, vessel or chattel is being used for a commercial purpose.

This appears to be an attempt by the Act's draftsmen to avoid a scenario whereby the law imposes a much more broad liability on insurers than was ever contemplated when the parties entered into the insurance contract. For example, considering a type (1) term above, if the parties only ever intended to insure European risks, the Act should not impose liability on insurers for losses occurring in Australia, for example. Another example might be a credit insurance policy in which an insured warrants that there will be no change to the contract insured post inception. Arguably such a clause is definitive of the risk as a whole, and would therefore fall within the carve-out.

However, the wording of section 11 leaves room for ambiguity. For example, a marine insurance policy may contain a condition precedent to liability that a vessel will not sail through Somalian waters. In these circumstances, the intention would be to reduce the risk of losses arising from piracy, for example constructive total loss, kidnap and ransom, cargo etc. On this basis, insurers could not rely on a breach of this term unless it was related to the loss caused. However, insurers could argue that the term defines the risk as a whole, because it defines the geographical area in which a loss must occur for liability to attach i.e., anywhere except Somalia.

Ultimately, it is up to the judiciary how to interpret the Act, and such decisions will, in practice, depend on the facts of each case, at least until some established precedent emerges.

If an insurer is concerned about the effect of section 11 on its policy, it should consider contracting out of the Insurance Act as we shall now discuss.

1 [2015] EWCA Civ 671

Contracting Out

The practice of contracting out of the Insurance Act is governed by sections 15 and 16.

Section 15 relates to **consumer contracts** e.g., health, travel, life, etc. It provides that any attempt to impose a term on an insured that would put it in a more disadvantageous position than it would be under the Act, regarding contractual terms and fraud, will be void. In other words, in **consumer contracts**, contracting out of the default provisions in section 11 of the Act, is prohibited.

Section 16 permits "contracting out" of parts of the Act in the context of **non-consumer** contracts i.e., where the insured is a business, and so the relationship between insurer and insured is likely to be more evenly balanced. It states that any disadvantageous term in an insurance contract is of no effect unless the provisions in section 17 are complied with. S.17 concerns the "transparency requirements," and they require the following:

> 17(2) The insurer must take "sufficient steps" to draw the disadvantageous term to the insured's attention before the contract is agreed to; and
>
> 17(3) The disadvantageous term must be "clear and unambiguous" as regards its effect.

Section 17 goes on to say that in order to determine whether or not the requirements in (2) and (3) have been met, consideration should be given to the characteristics of the insured, and the circumstances of the insurance contract.

The first thing to note is that any provisions contracting out of the Act must be **sufficiently drawn** to the insured's attention, bearing in mind its **characteristics**. The Law Commission[2] explained its intention when drafting the Act as follows:

> The requirement for bringing a term to the insured's attention must be interpreted flexibly to take account of the full range of participants in the insurance market. This is also implied in the word "sufficiently." What is sufficient for one type of insured may not be sufficient for another. The extent to which a term should be brought to the attention of a policyholder will vary considerably depending on whether the policyholder is, for example, a sole trader buying standardised retail public liability insurance or a charterer purchasing a voyage policy at Lloyd's using a broker.
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> Where the insured is using a broker, we think drawing the broker's attention to the disadvantageous term would be sufficient. In many instances there will be little or no direct contact between the insurer and the insured, with everything being done through intermediaries. In such a situation, it is the broker's responsibility to ensure the insured is aware of the term. This is not specified in the draft Bill, but is a matter of general agency law.

An insured will not be able to rely on an insurer's failure to draw attention to any disadvantageous term/contracting out provision if the insured **or its agent** had actual knowledge of the term at the time the policy was agreed. In practice, a commercial insured's agent is likely to be the broker, who may well have been involved in the development of the insurance product itself, meaning that this barrier may not be as difficult to cross as it seems at first blush. Nevertheless, in our view, to reduce the scope for argument, it will often be prudent for an insurer seeking to contract out of the Act to do so clearly by somehow highlighting the relevant provisions in the policy text.

Nevertheless, the second hurdle remains — the disadvantageous term must be "**clear and unambiguous as to its effect.**" The suggestion is that it is not enough that the wording itself is in straightforward language; that language must also communicate clearly the effect of the provision. In its 2014 commentary on the terms of the new Act, the Law Commission suggested that such language would have to go beyond simply stating that a particular provision of the Act would not apply, and would instead need to explicitly set out the practical implications of the exclusion of that provision. The Law Commission gives the following example:

> Section 14 of the [Insurance Act 2015] does not apply to this contract, meaning that we shall have no liability to you in respect of any loss or damage suffered by you as a result of our failure to pay sums due to you under this contract within a reasonable time.[3]

2 The Law Commission Report No. 353 (July 2014), page 311

3 The Law Commission Report No. 353 (July 2014), page 312.

Considering the Law Commission's guidance in the context of the new law on conditions precedent, or section 11 of the Act, it is arguable that, at the very least, language along the lines of the following would be required in order to meet the requirements of section 11(3).

> Section 11 of the Insurance Act 2015 does not apply to this contract, meaning that we shall have no liability to you in the event that you fail to comply with a term of this insurance policy which is expressed to be, or would ordinarily have the effect of being, a condition precedent to our liability to you, irrespective of whether or not that term is relevant to the loss or damage suffered by you.

In summary, therefore, it is possible for an insurer and a commercial insured to contract out of the majority of the provisions of the Insurance Act 2015 (but not the section that abolishes the insurer's ability to convert an insured's pre-contractual representation (e.g., in a proposal form) into a warranty by declaring that it forms "the basis of the contract"), meaning that a court would, logically, need to interpret the insurance contract in line with the pre-Insurance Act position discussed in Part One of this article series. In other words, it is possible for policies to contain the "old style" warranties and conditions precedent, where the transparency requirements are being met.

CONCLUSIONS

Warranties and conditions precedent will not be given effect unless they comply with section 11 Insurance Act 2015, or are "contracted out" under sections 16 and 17 of that Act.

In non-consumer contracts it is possible for insurers to contract out of the Act so as to ensure that conditions precedent and other terms are given the same force and effect as they would have been before the introduction of the Insurance Act. Insurers will need to ensure that those important clauses are redrafted so as to meet the transparency requirements. Conditions precedent that have not been adjusted to meet the transparency requirement may well be of little use.

Are underwriters in fact contracting out so as ensure their conditions precedent warranties are given the effect they expect? As one would expect, some insurers with proprietary wordings have invested effort in ensuring the wording meets their needs. In the London Market however, where non-standard wordings are often presented by the broker, or just inherited from previous years, the picture is very mixed. In our experience, in the months following the implementation of the Act, a surprising range of underwriters remain either unaware of the contracting out provisions, are aware but are reluctant to contract out, or do want to contract out but seem unsure how to do so. In some quarters it has been seen as a "compliance" issue, as opposed to a fundamentally important contractual issue. We have seen underwriters sending wordings back to a broker and asking him to make it "compliant" with the new Act. Unsurprisingly, the brokers in those situations have not changed the wordings so as to favour insurers.

Commercially, many conditions precedent are perfectly reasonable and provide a valuable method of delimiting risk. However, to be given the full force and effect that underwriters may wish them to have, they must take care to ensure that key conditions precedent and warranties are redrafted in light of the Act.