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Warranties in Insurance Policies

A practical guide to warranties in insurance policies

Guide 2013

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1. Executive Summary

“The Law Commission has made a number of recommendations to reform the law in relation to warranties, including that warranties should become ‘suspensive conditions’”

A breach of warranty within an insurance contract, no matter how immaterial to the insured risk, operates automatically to discharge the insurer from all liability under that contract as from the date of breach. The effect of this is expanded by the existence of ‘basis clauses’ which operate so as to turn certain pre-contractual representations made by the insured into warranties.

The Law Commission has made a number of recommendations to reform the law in relation to warranties, including that warranties should become ‘suspensive conditions’ so that the breach of a warranty, once it has been remedied, does not discharge the insurer of liability.

Airmic unequivocally supports all of the Law Commission’s recommendations on warranties. However, Airmic believes that one of the proposals – amending warranties to be suspensive conditions – is something that members should seek to address immediately. It is fundamentally unfair that a breach of warranty which is remedied prior to any loss (and is in no way causative of that loss) should, on the current law, allow an insurer to escape liability.

Given that any changes to the law may still be years away (as at December 2013), this guide assists members in mitigating the implications of a breach of warranty by way of draft endorsements to (i) disapply all warranties or (ii) convert warranties to suspensive conditions.

This guide builds on work undertaken by Airmic earlier in 2013 preparing guidance to assist members in understanding the effect of ‘basis clauses’ and taking steps to remove them from their contracts. This guide has been produced with the assistance of Herbert Smith Freehills LLP as a preferred service provider to Airmic. The content of this guide relates to the position under English law and does not constitute legal advice. Members are advised to consult their lawyers should they require advice on any matter relating to the subject of this guide.

2. Introduction to Warranties

A warranty is a term in an insurance contract which must be exactly and literally complied with by the insured. Departure from the exact requirements even for reasons of necessity constitutes a breach. Breach of a warranty will discharge the insurer from liability under the policy automatically – no action by the insurer is required for the insurer to become ‘off-risk’. Such discharge occurs from the date of breach and does not affect claims prior to that date.

The automatic discharge of the insurer from liability results because warranties are typically fundamental terms of the contract that go to the nature and scope of the risk which an insurer has agreed to cover. However, the insurer is not required to demonstrate that the breach is either material or causative to any loss which arises. For example, breach of a fire alarm warranty means that the insurer is off-risk and would not need to pay a claim for losses resulting from a flood, even though the fire alarm warranty, if complied with, would have done nothing to prevent the loss.

Further, an insurer is discharged from liability even where a warranty has only been breached for a short period of time and the breach has been cured at the time of a subsequent loss. For example, the insurer would be discharged from liability arising from a theft in July if a fire alarm warranty had been breached for one week earlier in the policy period.

A breach of a warranty can only be waived by an insurer by the insurer making an unequivocal representation that it will no longer rely on its legal right to be discharged from liability under the policy, and requires the insured to have relied upon that unequivocal representation in such a way that it would be inequitable for the insurer to renege from the representation.

Pre-contractual statements may be converted into warranties, through so-called ‘basis clauses’. A basis clause incorporates into the policy, as warranties, certain representations made by the insured (including pre-contractual information supplied to the insurer). Any inaccuracy or error in these representations is a breach of warranty, resulting in discharge of liability for the insurer.

The effect of the current law governing breach of a warranty is that an insured may lose cover and be unaware of this until a claim is made under the policy. The insured may breach a warranty, remedy it shortly after the breach, and still be without cover for an unrelated loss occurring well after the remedy.

3. Identifying Warranties

“A term need not be described as a warranty to constitute one, and conversely the use of the word ‘warranty’ is not conclusive of the true status of a particular term”

There is no particular form of words necessary to constitute an express warranty. A term need not be described as a warranty to constitute one, and conversely the use of the word ‘warranty’ is not conclusive of the true status of a particular term of a policy.

Although terms are often labelled warranties, a true warranty is a term by which the insured:

- undertakes that some particular thing shall or shall not be done (for example, concerning the use of premises for a particular type of activity);
- undertakes that some condition shall be fulfilled (for example, the maintenance of security at a premise); or
- affirms or negatives the existence of a particular state of facts (for example, the existence of no known claims).

The seriousness of the effect of a breach of warranty means that the Courts have construed warranties strictly: ambiguities are construed against the insurer and warranties have been construed as applying only to one section of a multi-section policy. Where the word “warranty” or “warranted” is not used, that the materiality of the term to the risk of loss will be a factor for consideration.



4. The Law Commission's Recommendations

As members will be aware, the Law Commission (together with the Scottish Law Commission) has put forward wide-ranging proposals for reforms to the law on misrepresentation, non-disclosure and breach of warranty.

The Law Commission has made three main proposals in relation to the law on breach of warranty:

- warranties should become 'suspensive conditions', with the insurer's liability suspended during a breach of warranty (rather than automatically discharged as of the date of breach) and restored if the breach of warranty is remedied;
- where any term designed to reduce the risk of a particular type of loss, or the risk of loss at a particular time or place, is breached by the insured, then the insurer should only be able to refuse claims for losses falling within that type of risk; and
- 'basis clauses' should be prohibited.

The Law Commission is expected to publish its final report (along with a draft bill) in the first half of 2014, but it has stated that it has received "strong support" for the recommendations.

Airmic unequivocally supports all of the Law Commission's proposals in relation to warranties. However, Airmic believes that the proposal to amend warranties to become suspensive conditions is one that should be put into practice immediately and in advance of any change in the law. The current effect of the law is fundamentally unfair given that it allows an insurer to escape liability even where a breach of warranty is remedied prior to any loss (and is in no way causative of that loss).

Effect of Law Commission's Recommendations - Case Study

In **Sugar Hut v Great Lakes Reinsurance (UK) plc**, the policyholder claimants sought indemnity in respect of substantial loss caused by a fire to one of four nightclubs insured under the same policy. The policy contained warranties which, it was established, had been breached in respect of at least one of the four insured nightclubs. The cause of the fire was unknown, but unrelated to any of the breaches of warranty. It was held that the defendant insurer would have been discharged of liability by virtue of breach of any one of the warranties (although, in the event, they were entitled to avoid the policy for material non-disclosure).

One of the warranties required certain kitchen equipment to be kept free of contact from combustible materials. Although only a small area of the kitchen equipment was in contact with combustible material, the Court still held that this was a breach with the result that the insurer was off-risk (notwithstanding that this breach did not cause the loss). The insurer would have been off-risk even if the breach had been remedied at the time of the loss.

If the Law Commission's recommendations had been in place, this breach of warranty would have suspended the insurer's liability for the period of the breach only, so that (subject to the other coverage defences) the insurer would have been back on risk if the breach was remedied.

5. Implications and Options Available for Airmic Members

In advance of any changes to the law, members should review their existing insurance policies and discuss the options available to them with their insurance broker.

In the first instance, members should consider whether their insurance policies contain any warranties (noting that warranties may also arise by the operation of 'basis clauses'). If they do, members may wish to attempt to remove all warranties from their insurance policies. A sample endorsement to this effect is included at Annex A.

If it is not possible to negotiate the removal of warranties altogether, members should consider whether their broker has already negotiated the inclusion of policy terms which mitigate the draconian consequences of a breach of warranty. If not, members may wish to consider amending their policies by endorsement so as to mitigate the effect of a breach of warranty by amending any warranty to be a suspensive condition. A sample endorsement to this effect is included at Annex B.

Members may also wish to disapply expressly any basis clauses contained in their insurance policies. A sample endorsement to this effect is included at Annex C and members are referred to the guidance produced by Airmic earlier this year for further information.

The sample endorsements at Annexes A to C will be primarily of assistance in the context of first party property policies. Neither Airmic nor Herbert Smith Freehills recommends adopting any of the endorsements contained in Annexes A to C without members properly consulting their broker and/or legal advisors as to the terms of their policies.

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6. Annexes A-C

ANNEX A – Sample endorsement removing all warranties

The Insurer agrees, with effect from inception, that no term in this contract shall take effect as a warranty such as to discharge automatically the Insurer from any liability upon its breach.

ANNEX B – Sample endorsement rendering warranties suspensory¹

The Insurer agrees that where there has been a breach of a term in the contract, which would result in the Insurer being automatically discharged from any liability, such a breach shall result in any liability of the Insurer under the policy being suspended only from the date and time at which the breach occurred, and up until the date and time at which the breach is remedied.

ANNEX C – Sample endorsement disapplying basis clauses

The insurer agrees, with effect from inception, that notwithstanding any other term of this contract, any provision in this contract of insurance or any other document to the effect that a statement or statements made by or on behalf of the Insured (including but not limited to statements made in proposals for insurance) form part of or are the basis of the contract of insurance shall be of no effect.

¹ NB. The effect of a breach of warranty may also be mitigated through the use of “held covered” clauses, which are beyond the scope of this guide.



6 Lloyds Avenue
London
EC3N 3AX
Ph. +44 207 680 3088
Fax. +44 20 7702 3752
email: enquiries@airmic.com
www.airmic.com

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