Are you prepared?

Alexander Oddy, Greig Anderson, Paul Lewis and Tom Hutchinson of Herbert Smith Freehills review the major insurance issues facing in-house lawyers in the current market

Understanding your company's insurances and making the recoveries to which you are entitled can help transform the legal department from cost centre to profit centre. A solid grounding in the company's insurances will also support better risk management and in turn build resilience to the many risks which are uninsurable. By having an understanding of the key insurance law issues, an in-house lawyer might be the difference between a quick recovery of a sizeable insured loss and a lengthy, expensive piece of litigation to resolve the claim (or even the loss of the claim altogether).

The UK insurance market has seen a significant hardening in recent months, following a wider global trend. Global commercial insurance prices rose by 11% in the fourth quarter of 2019 marking the ninth consecutive quarter of price increases across the sector. In the UK, overall insurance pricing increased nearly 14% in the fourth quarter of 2019. Market hardening has been against the backdrop of a record period of low interest rates, resulting in increased pressure on insurers' capital which the recent market volatility will exacerbate. As reported recently, 'the message is not hard to decipher. Buyers are in a seller's market across most lines and we expect that to be the case throughout 2020.' (Willis Towers Watson, *Insurance Marketplace Realities 2020 Survey Report*)

From a policyholder's point of view, it is not simply a matter of an increase in the cost of insurance. Restrictions in insurance capacity and terms can impact on contracting strategies, while the claims environment typically gets tougher at this stage of the cycle.

The changing risk landscape

Effective communication lines between those responsible for designing the risk management plan is essential. The in-house legal function can be highly influential in this process as it frequently straddles multiple departments and interfaces with a wide variety of stakeholders. Yet too often it appears as though the placement of insurance and the design of the programme rests with the risk function and their appointed insurance brokers.

Recent industry data suggests that insurance programmes map poorly onto a business's assets. A global study found that, typically, only 16% of a business's intangible assets (for example brand and intellectual property) will be covered by insurance, compared to 60% of tangible assets (such as property, plant and equipment). This is despite the fact that another survey of the Fortune 500 companies' CEOs found that over 80% of a business's value was vested in its intangible assets.

The importance of intangible risks has been reflected by global business leaders who cited economic, technology and cyber risks as their biggest concerns for 2019 and 2020. This reflects the changing nature of business, which is increasingly global and technology driven. An awareness of the wide variety of risks which may be faced by the business, and a thoughtful approach to how events can aggregate risk or affect business operations, is important in developing a comprehensive risk management strategy.

How to add value – risk mapping and scenario planning

When a business sets about trying to map its potential risk exposures, it is likely that many of the risks it faces will be interconnected. An effective enterprise risk management strategy will build in planning for such eventualities and identify which risks can be transferred and which mitigated. Scenario modelling in which legal risks are analysed alongside commercial, operational and intangible risks to understand the full extent of such interconnectedness is critical to ensuring adequate insurance protection is put in place. This is a process which may be led by the risk and insurance function, often with the assistance of insurance brokers, but it is one in which in-house lawyers, with valuable insight not just on legal developments, but also commercial changes within the business, can make a significant contribution.

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The insurance market is responding with new products and solutions to try and address risk transfer needs. By their nature these products are untested and even more care needs to be taken in their arrangement. Who better to help understand whether the products fit with contracting strategies than in-house legal? Most commentators would agree that closing the gap between insured and uninsured risk is the biggest challenge facing the insurance industry, so this trend and opportunity for in-house lawyers is set to increase.

How to add value - placement

Duty of fair presentation

It is critical that stakeholders in a business understand that pre-contract obligations under insurance law are significantly different from other commercial contracts. Prior to entering into a contract of insurance an insured is required to make a 'fair presentation' of the risk for which insurance is required. A fair presentation is one which satisfies the necessary conditions as to its content and form, as recently set out in the Insurance Act 2015. As for its content, a fair presentation must:

- give disclosure to the insurer of every 'material circumstance' which the policyholder knows or ought to know; or
- failing that, give disclosure of sufficient information to put an insurer on notice that it needs to make further enquiries for the purpose of revealing those material circumstances; and
- ensure that every material representation as to a matter of fact is substantially correct and every material representation as to expectation or belief is made in good faith.

The threshold for what constitutes a 'material circumstance' is very low, the test being anything which would influence an insurer's judgement in determining whether to take the risk and, if so, on what terms.

A fair presentation must be in a manner that would be reasonably clear and accessible to an insurer. Effectively, this means an insured cannot 'bury a needle in a haystack'. The discipline of organising business information and recording it clearly (which is the in-house lawyer's bread and butter) can enhance this process.

Experience suggests that problems occur when business leaders are not engaged in the pre-contract process. In some situations the lawyers can have more success in securing that engagement than the risk team. In-house lawyers will very often be far closer to understanding recent or planned business changes that need to be disclosed to insurers and which influence choices made about limits and deductibles.

Inevitably the insurance placement process will only come under scrutiny at the claims stage when insurers will raise questions about what they were told. The remedies available to an insurer under the Insurance Act 2015 (provided it can prove it was induced to enter into the policy as a result of the breach of the duty of fair presentation) could involve avoidance of the policy altogether, a re-writing of parts of the policy, or a reduction in any recovery. All can be damaging to the business economically and in its dealings with counterparties.

Policy wording

The policy wording is the contract. It deserves the same attention as any important commercial contract a firm is entering into. It is easy after a few years without major claims for companies to become complacent and view insurance as a purchase of grudging necessity rather than strategic economic purpose.

Most insurers provide products on very subtly different terms where often a word or two can change the basis of coverage materially. It is critical that policy wordings are carefully evaluated and assessed regularly against the current requirements of the business. As a

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business develops it is likely that the risk challenges it faces will also evolve; a failure to adapt an insurance strategy to such evolutions or bespoke risks can leave a business critically exposed.

It is therefore crucial to ensure that the business is aware what insurance the company is buying and how the relevant policies operate. All too often the freshly purchased policy is filed away, with the business wholly unaware of policy requirements to preserve or access the coverage. This risk is especially acute for new products the business may be considering under which the claims process has yet to be tested or the coverage position might be complex, such as cyber insurance which may require a detailed understanding of the company's IT infrastructure with accordingly tailored policy wording.

Buying a good cyber policy, as the board may demand, is only part of the issue; losses arising from cyber perils are covered under a range of insurance policies, sometimes silently because cyber is not even mentioned. Insurers are adding a range of exclusions under pressure from regulators to price or exclude this risk. In-house legal can have a key role in understanding the impact of excluding a particular risk on the business. What the board may not know, for example, is that a cyber exclusion under a directors and officers liability insurance (D&O) policy would seriously increase the risk for senior management as companies become reliant on technology, and this is an important aspect of operational resilience.

Aside from ensuring a policy properly responds to an identified risk, there are other considerations which must be thought through. By way of example, policies should include a dispute resolution mechanism for contentious claims. If in-house lawyers engage with the wording they can ensure that their preferences for efficient dispute resolution are reflected where possible and that poorly drafted clauses (often by non-lawyers) are not unfair, onerous or damaging from the company's perspective. In practice these provisions rarely reflect positive policyholder choices and the consequences of not doing so can be a multiplicity of recovery actions on the same tower of insurance, sometimes in different jurisdictions, and a mixture of litigation and arbitration (sometimes with different governing laws) with repeated costs.

It is common for insurers to impose conditions precedent to either the attachment of risk or liability to pay claims in the policy. The former may be an obligation to pay premium and a failure to adhere means the insurer simply never comes on risk. The latter, conditions precedent to liability, may require submission of a claim within a specified time period or providing cooperation to insurers, breach of which allows insurers to decline the claim regardless of whether the breach was material or affected the insurer adversely. Although the Insurance Act 2015 provides limited protection for insureds who breach policy terms in ways which really do not affect insurers adversely, it is critical that the business understands what is required. In-house lawyers can add tremendous value by making themselves aware of such requirements and making connections between the business and the risk and insurance teams.

How to add value – claims

Notification

A common tripping point under insurance policies are notification obligations. The key is to make sure the right polices are kept to hand and are kept updated. Then it is a case of following the exact procedure prescribed under each policy being notified. Under English law, you must provide your insurer with information about the loss to enable the insurer to obtain evidence to meet the claim. For complex claims, it is likely that insurers will want lots of information – ensure that you are working closely with your risk and insurance management team to deal with such requests constructively and to ensure that the focus is on issues that really matter including, eventually, settlement. From a practical perspective, it is useful to set up retainers so that external firms can separate and track costs referable to different policies – this makes it easier to evidence any costs incurred when it comes to calculating the claim.

Gathering evidence

Once a claim is underway, there are many aspects which an in-house lawyer should be aware of. It is critical that information, data and evidence is secured and preserved from the outset of an incident which may give rise to a claim. It is likely that the in-house legal team will be centrally involved with this process and, at this point, consideration should be given to privilege. Insurance coverage can turn on non-privileged documents generated during the course of a claim including, for example, public statements made by senior directors, investigation reports and internal file reviews. Your insurers may appoint loss adjusters as their agents to investigate the loss,

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particularly in property and business interruption losses. You should engage constructively but thoughtfully as the adjusters are ultimately representing insurers’ interests. It is the policyholder’s job to put its claim together with the necessary evidence and it is therefore important to control what information is recorded. Communications with brokers are also unlikely to be privileged. Privilege concerns are heightened if the claim involves foreign jurisdictions and the possibility of foreign law applying.

Consent and co-operation

Insurance policies will typically contain consent and claims co-operation provisions. Consent will often be needed to incur pre-investigation, investigation or defence costs. There are also likely to be provisions controlling what information is to be provided to insurers, and, in some cases, an insurer may have the right (but not an obligation) to control the defence. There may also be a prohibition on making any admission of liability or reaching any settlement without the consent of insurers. It is critical that decision makers are aware of such provisions as a breach of any of these terms can have a disproportionate effect. It is therefore important to establish contact with insurers early (if required) and keep them informed of developments. You may also want to consider giving insurers access to external advisers if you are acting on their advice.

When a major incident occurs, in-house legal may be the only internal team with visibility on all external communications. This can be vital to ensuring that outside communications do not prejudice the insurance claim (for example, by waiving recovery rights – to which insurers may ultimately be subrogated – against a supplier whose help is needed in resolving the incident), but also to ensuring that communications with insurers do not prejudice other matters, for example through non-privileged communications which are damaging in regulatory investigations or in defending claims by customers or shareholders. If in-house legal are not in the loop with the insurance claim, and are not in a position to escalate risks to senior stakeholders, the unforeseen consequences could be very damaging.

Conclusion

In conclusion, there are multiple opportunities for in-house lawyers to add value to a business by having an awareness of potential insurance related issues. In our experience, the best claim results are achieved when in-house legal teams, the risk management team and insurance managers work closely together. It is also a reality of the claims environment that for larger and more complex losses, insurers will routinely retain lawyers at an early stage to assist them with claim investigation and coverage. The policyholder will not always need to follow suit but one of the key roles of the in-house lawyer is to keep an eye on the claim process and ensure that the company is neither out-manoeuvred nor out-gunned by specialists who know the process and the policy better than the policyholder itself.

In an increasingly unpredictable and rapidly evolving world, from the wildfires which have ravaged parts of the US and Australia to the recent global outbreak of Covid-19, the importance of insurance is only set to rise – planning ahead and being prepared will be critical. ■

Covid-19 response

Covid-19 losses are a significant concern for many businesses just now, and insurance response, while not a panacea, may be critical. Covers that might be engaged include business interruption (for loss of profit), event cancellation and trade credit. The full scale of claims and losses will take time to emerge, and a range of other liability and specific risk policies may provide valuation protection, including D&O, professional indemnity, crime, cyber, employment practices liability, employers’ liability and public liability.

In-house lawyers may have key knowledge about the potential Covid-19 exposures facing the business and its people, now or further down the line. Generally, insurers don’t want to bear such Covid-19 risk and are incorporating broad exclusions into policies on renewal. It will therefore be vital to leverage the knowledge of in-house legal to notify any claims/losses and circumstances to expiring policies to the maximum extent possible, otherwise the best opportunity to secure coverage may be lost.

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Why does a GC need to know about warranty and indemnity insurance?

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I am writing this from my home office, the world having been turned somewhat upside down in the last few weeks. I was expecting to be writing about warranty and indemnity (W&I) insurance trends and claims in 2020, but the form book has been very much disrupted, at least in the short term. I have therefore reframed my commentary with this in mind.

W&I insurance has been a prominent feature of M&A activity for the best part of a decade now, making an appearance more often than not in disposals and acquisitions. It is a great deal enabler and has gradually moved from a product used by private equity funds for domestic real estate deals to one used by corporates for global cross-border acquisitions, and is now regularly used in almost all sectors.

Effectively the W&I insurer steps into the shoes of the seller for the purposes of any claim for damages for breach of warranty, thereby allowing the seller a clean exit with limited or nil recourse absent fraud. This is particularly attractive to private equity funds and acquisitions involving management buy outs. It also allows a claim to be advanced against a well-funded insurer instead of a seller whose assets may be hard to access.

Without a doubt the use of W&I insurance changes the deal dynamic. Not all deals in all jurisdictions will be attractive to W&I insurers and the W&I insurer will have a limited appetite for certain risks which will likely be excluded – these may include matters such as known matters, pension underfunding, secondary tax liabilities and cyber/data issues. It will be a matter for negotiation as to whether the buyer has no recourse for these risks or can procure some protection from the seller or through bespoke insurance cover. The cover will also be subject to terms and conditions, which vary between insurers and should be closely negotiated in the same way as any other critical contract. After all, the buyer may be relying on the W&I policy document alone to recover the full claim value for any breach of warranty (potentially many millions of pounds) and it is the policy which sets out the terms for recovery. Informal or high-level buyer due diligence upon which a buyer might 'take a view' will likely lead to the imposition by the W&I insurer of additional deal specific exclusions, so the level of investment in diligence directly impacts the cover.

The choice of insurer (and broker) is also a very important one, and for some an insurer's claims performance, as well as its wording and risk appetite all play a role in selection. This has proved an attractive market with regular new participants. Selection based on price alone can prove to be a false economy.

The deal volume has increased significantly over the last few years and claims are starting to track this. Anecdotally many brokers and insurers report about a 20% rate of claims. Historically accounts and tax have been among the more frequent subjects of claims. My advice to an insured/buyer is to expect that an insurer will look to test any claim in the same way as the seller or warrantor would in relation to breach, causation and quantum. Indeed, the insurer will know far

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less about the deal than the seller, which can mean there is a need for some extra leg-work in progressing the claim.

There is complex case law in relation to all of these issues and an insured buyer that is not fully across all these legal issues will not gain proper value for its premium. Common matters which arise and are challenged include whether a matter was 'disclosed', the correct basis of valuation and whether events after the breach are to be taken into account. Having the right team of lawyers, accountants and brokers is key to maximising value.

Insureds not infrequently discount value in their W&I policy by not fully complying with the relevant terms and conditions, such as in relation to notification. At best non-compliance gives insurers some grey areas to found a price chip. At worst, cover could be lost. Some policies cover tax risks for seven years so the original deal team with institutional knowledge may well have moved on at the time of any claim leaving a less than perfect document trail.

It can therefore be seen that the value which an insured ultimately receives from a W&I insurance policy depends on a number of steps and decisions over potentially many years by many individuals – picking the right insurer, the right wording, setting the deal and diligence up to maximise cover, keeping the policy alive and complying with it and pressing the claim diligently and with knowledge of all the legal and valuation issues. That is why in my view W&I insurance is a general counsel issue.

Coming full circle, what impact will the inevitable financial fall-out of COVID-19 have? First and foremost, there may well be an uptick in claims activity. Liquidity is going to be sparse (and key) and those that have recently made acquisitions will likely be looking closely to see if there are hidden assets in terms of viable claims. Post completion quibbles that might have been overlooked may well assume greater significance in straightened times. Second, insurers will be feeling the liquidity pressure as well; their investment income if nothing –else will likely be impacted. That may affect both claims response and their appetite for new deals. Third, there will likely be increased distressed sales. On the one hand, such sales may not be a perfect fit for W&I insurance, as the diligence may be less than perfect and the 'known' issues fairly extensive. On the other, if insurers are able to be flexible and demonstrate a broad appetite, the product may be able to provide sufficient (if not complete) comfort to enable an otherwise difficult deal to progress. The W&I market was barely known at the time of the 2008 financial crisis. A combination of the global events of 2020 and its performance in the face of the steady increase in claims will enable all to see if it now comes of age. GCs should be watching carefully. ■