



Taking an interest in Insurance

This article briefly describes how a third party can take an interest in insurance cover and certain key issues to look out for when doing so. We look at mechanisms such as noting an interest, loss payee clauses, and co-insurance, and highlight factors to consider when determining the appropriate protection.

Introduction

In areas such as mortgage lending and construction, lenders and principals often look to protect their interests and manage risk by taking an interest in the insurance cover taken out by the borrower or project contractor.

The ways that principals and lenders can protect their interest in insurance vary, and the mechanism used will depend on a number of factors including the risks, costs involved and type of policy. The difference in protection between simply noting an interest to full composite insurance is significant. However, the implications of using each mechanism are not always fully understood which can lead to inadequate protection being obtained for the lender or principal.

Noting an interest

Noting a party's interest on an insurance policy used to be common practice among mortgage lenders and some contracts still require one party to "note" the other party's interest on a policy. However, it is often unclear what this noting requirement entails. There was an agreement between the ABI and BBA that provided some comfort for mortgage lending whereby insurers agreed to give notice of policy cancellation/amendment but that agreement has lapsed as banks look for more robust protection. Even if it is clear what the noting of the interest entails, it affords very little protection for the party whose interest is noted. The noted party has no rights under the policy itself and if the insured invalidates the policy the noted party will be left without any protection.

If the only right a noted party wants is warning of cancellation/policy amendment and time to find alternative cover then noting may be appropriate. However, the transaction documents should spell out what it is the noted party requires and the insurer should expressly agree to it.

Loss payee clauses

Some noted interests on policies are drafted specifically as "loss payee clauses". A co-insured may also require a loss payee clause in their favour. As their name suggests, such clauses typically provide that the policy proceeds are paid to the noted party, rather than the policy holder.

However, like noting, loss payee clauses offer no protection from any failure to comply with the policy's conditions by the insured and the loss payee has no rights under the policy itself to pursue a claim.

A loss payee should ensure that the policy does not exclude the Contracts (Rights of Third Parties) Act 1999.

Where a loss payee clause is sought, careful thought needs to be given as to how it will work in practice and with other terms of the policy, for example reinstatement in a property policy. It also may not be necessary or desirable for all payments, however small, to be paid to the loss payee.

This mechanism may be appropriate where the party seeking the security does not want to take on any obligations under the policy and is content for its protection under the policy to be dependent on the ability of the policyholder to recover.

Assignment of policy/Right to recover

This protection is often used where a policy, in which a party wants an interest, is already in place. It is often used in respect of life insurance policies. There are specific rules that must be followed in respect of assignments which are beyond the scope of this briefing. There are 2 types of assignment that might be offered - assignment of the policy itself and assignment of the right to recover under the policy.

If the subject matter of the insurance is being transferred then it may also be possible to assign the insurance related to it. In effect, the policy is being novated and therefore insurer consent is required.

If it is simply the right to recover that is being assigned, absent any express provision in the insurance policy, insurer consent is not required although notice of the assignment must be given. The assignee can then pursue the claim directly against the insurer (and will need to comply with the claims provisions of the policy) but the policy may still be invalidated by acts or omissions of the policyholder.

The policy should always be checked to see whether assignment is allowed and whether the insurer's consent must be obtained.

Co-insurance

The form of protection often favoured by lenders is being named as insured under the policy. To minimise the prospect of any act or omission of the insured impacting the lender's interests they will seek confirmation that cover is on a composite basis. This effectively means that the lender has a separate policy and the lender's cover should not be impacted by the insured's conduct.

Composite insurance is distinct from, and should not be confused with, joint insurance. In joint insurance the parties have the same interest in the insurance, while in composite insurance the lender's and borrower's interests are typically distinct. The question of whether or not a policy creates composite or joint insurance will always depend upon its exact terms and the interests of the insureds and specialist advice should be sought.

If the party seeking insurance is to be named as insured they will be subject to all the policy terms and conditions. It is therefore important when seeking to be named as an insured on a policy that careful thought is given to what obligations the additional insured is able to take on, in what circumstances and also whether the insurers will need to maintain the right to decline a claim or void the policy for certain breaches by the policyholder. This must be looked at on a case by case basis.

It is common for additional insureds to seek non-vitiating clauses and non-subrogation clauses as well.

A non-vitiating clause prevents the insurer from attributing any non-disclosure or misrepresentation or breach of policy by the insured to the lender. It may not be required in composite policies, as the insured's and lender's cover is distinct but each case should be looked at.

Similarly, a non-subrogation clause, preventing an insurer from stepping into the shoes of one co-insured to sue the other to recover its loss may not be required depending on the nature of the additional insured's interest and the terms of the original contract between the parties in relation to risk. Again, the specific transaction, the nature of the interest and the policy in question must be looked at in this context.

Broker's letter

Parties are sometimes prepared to rely on a letter from a broker confirming details of the insurance cover in place, any protection afforded to the interested party and confirming that premium has been paid. Brokers may also sometimes be prepared to advise the Lender of certain future events that may impact the lender's protection.

However, it should be borne in mind that in most circumstances the broker is the agent of the insured and this letter will not be binding on the insurer if it is not correct or its terms are not complied with. In addition, the broker will not typically be in a contractual relationship with the party seeking security so it will need to rely on tortious principles to pursue any claim against a negligent broker and the broker's professional indemnity insurance.

Getting the right protection

All of the options set out above are used in commercial transactions to protect the interests of lenders and principals. However, which option or combination of options is most appropriate must be considered in the context of the particular transaction, the type of insurance and the nature of the interest that is sought to be protected. Boilerplate wording in transaction documents or policies that is not tailored to the particular transaction may turn out to be ineffective when the insurance protection is needed.

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