Briefing

BURGES SALMON

Insurance

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When is a contract insurance and why does it matter?

Introduction

Insurance contracts are among the most commonly used agreements in the world, from widely distributed consumer contracts such as car insurance to bespoke high value contracts dealing with risks worth £billions.

If a contract is a 'contract of insurance', this will have an effect on:

- **Regulation** - Providing and distributing insurance contracts are regulated activities that fall within the scope of the FCA. Therefore, businesses engaged in these activities must (subject to limited exceptions) be FCA authorised and ensure they are complying with the applicable regulatory rules.
- **Law** - There is a distinct body of contractual law that relates to insurance contracts only, including particular rules around the formation of insurance contracts and the remedies available to insurers for breach.
- **Tax** - The premium taken under an insurance contract is subject to insurance premium tax (typically 6%).

Determining which side of the line a business's contracts fall can be a difficult exercise, for example in the context of warranty products and the determination of whether a particular contact is insurance may have significant consequences for a business. If a business will be providing contracts of insurance, it needs to factor in the costs and time involved in seeking FCA authorisation and ensuring on-going regulatory compliance. To engage in unauthorised insurance activity is a criminal offence.

Consequently, if a business is providing products that bear similarities to insurance, it should take care to understand whether their contracts are contracts of insurance or not. If proper care is not taken, a business may find itself facing enforcement action from the FCA for carrying out a regulated activity without authorisation. In such situations the FCA's enforcement powers include the right to bring criminal prosecutions against individuals and the ability to apply to Court to have businesses wound up.

A recent example is the *Digital Satellite Warranty* case, where the FSA (as it was then) successfully applied to have two providers of "extended warranty products" wound up on the basis that their products were actually contracts of insurance and the providers lacked authorisation.

An obvious definition?

What then, is a contract of insurance?

At first blush defining a contract of insurance appears a simple exercise. The very heart of an insurance contract is commonly perceived to be an obligation by one party to indemnify another in respect of certain risk or liability.

However the simple existence of an indemnity does not indicate a contract of insurance. Indemnities are commonly included in all types of contract that would never properly be construed as contracts of insurance, such as M&A transactions (share or asset purchase), leases, licences, and so on.

It is perhaps a surprising feature of English law that there is not, nor has there ever been, a statutory definition of a contract of insurance.

Some prudent guidelines

Unsurprisingly the Court has stepped in to fill the gap left by statute and there is a body of case law that seeks to provide guidance on the factors that will determine whether a contract is likely to be considered insurance, starting with *Prudential v Commissioner of Inland Revenue (1904)*, and augmented by later decisions.

The *Prudential* Test

A contract is one of insurance where a 'provider':

- in return for one or more payments from a 'recipient';
- agrees to provide the recipient with money (or a corresponding benefit);
- on the happening of a specified event which is uncertain to occur and is adverse to the interests of the recipient.

continued overleaf

The regulatory approach

The Financial Services and Markets Act, under which the FCA regulates the effecting and carrying out of insurance, also does not define insurance. However, in PERG 6 of the Handbook, the FCA provides detailed guidance on how it assesses whether a contract is one of insurance for regulatory purposes, together with examples of contracts the FCA considers to be insurance.

Helpfully, the FCA has largely adopted the Prudential Test (above) as its starting point for determining whether a contract is insurance. However, the FCA has made it clear that if the common law is unclear as to whether a particular contract is a contract of insurance the FCA will interpret and apply the common law in a way consistent with its statutory objectives, in particular the protection of consumers. It should also be borne in mind that the regulatory framework extends and limits the general common law meaning of insurance in respect of certain contracts.

In its guidance the FCA gives some helpful examples of contracts it is likely to classify as insurance and those that it will not. For example, the FCA does not consider as insurance warranty schemes administered by suppliers for repair or replacement of defective products, provided they are no wider than the usual obligations as to quality implied by statute. However, extended warranties or standalone warranties administered by third parties on similar terms (such as in the *Digital Satellite Warranty* case) are more likely to be considered as insurance.

While the FCA's guidance is helpful, it also goes to show that the classification of insurance turns on fine distinctions and, when considering complex contracts and distribution arrangements, can be a difficult exercise. Seeking appropriate legal advice can offer some measure of protection.

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