# Chapter 6

# Guidance on the Identification of Contracts of Insurance

## 6.7 Examples

### Example 1: discretionary medical schemes

6.7.1 G Medical schemes under which an employer operates or contributes to a fund, from which the employee has a right to a benefit (for example, a payment) on the occurrence of a specified illness or injury, are likely to be insurance schemes. This will be the case whether the employee makes any contribution to the fund, or the scheme is funded by the employer as an emolument. The scheme would not be insurance, however, if the employer has an absolute discretion whether or not to provide any benefit to the employee. Absolute discretion requires, for example, that the employer has an unfettered discretion both as to whether the employee will receive a benefit and as to the amount of that benefit. The absolutely discretionary nature of the benefits should also be clear from the terms of the scheme and any literature published about or in relation to it. If these requirements are met, it may not be relevant that, in practice, the employer has never refused to meet a valid claim under the scheme.

### Example 2: disaster recovery business

6.7.2 G The disaster recovery provider sets up and maintains a range of IT and related facilities (PABX etc). The disaster recovery contracts so far considered by the *FCA* give the recipient, subject to certain conditions including an up front payment, priority access to all or a specified part of these facilities if a 'disaster' causes the failure of a similar business system on which the recipient relies. The provider sells access to the same facilities to a number of different recipients, both for use in response to 'disasters' and, more usually, for use in testing and refining the recipient's ability to switch to alternative systems in the event of a disaster.

6.7.3 G In principle, a significant part of disaster recovery business could potentially fall within the description of a *contract of insurance* set out in ■ PERG 6.3.4 G. The provider undertakes, in consideration of a payment, to provide the recipient with services (alternative facilities) in response to a defined event (a disaster), which is adverse to the interests of the recipient and the occurrence of which is uncertain. The risk dealt with under the disaster recovery contract is a pure risk (see ■ PERG 6.6.8 G (2)) and, at least at the commencement of the contract, the provider assumes that risk, within the terms of ■ PERG 6.6.2 G.

6.7.4 G However, the disaster recovery contracts considered by the *FCA* had two key features.

(1) Priority access to facilities in the event of a disaster was expressed to be on a 'first come, first served' basis. The contracts provided

expressly that if the facilities needed by recipient A were already in use, following an earlier invocation by recipient B, the provider's obligation to recipient A was reduced to no more than an obligation of 'best endeavours' to meet A's requirements. The entry into additional contracts of this kind did not increase the probability that the provider's existing resources would be inadequate to meet all possible claims. The terms of the contract were such that there was no pattern of claims that would cause the provider to have to pay claims from its own resources.

(2) In general, the contracts were priced so that the total consideration collected from the recipient over the life of the contract bore a reasonable and justifiable relationship to the commercial cost of the services actually provided to the recipient (see ■ PERG 6.6.5 G). This was achieved, for example, by post-invocation charges levied according to the actual usage of services.



**6.7.5** G Based on these features, the *FCA* reached the conclusion, with which the other terms of the contracts were consistent (■ PERG 6.6.8 G (3)), that these disaster recovery contracts were not *contracts of insurance*.

**6.7.6** G An important part of the conclusion in ■ PERG 6.7.5 G was that, although the provider assumed a risk at the outset of the contract, looking at the contract as a whole and interpreting the common law in the context of the *FCA* objectives (see ■ PERG 6.5.2 G and ■ PERG 6.5.3 G) there was no relevant assumption of risk.

(1) The presence or absence of an assumption of risk is an important part of the statutory rationale for the prudential regulation of insurance.

(2) In Medical Defence Union v. Department of Trade and Industry [1979] 2 W.L.R. 686, the court accepted that since there was no common law definition of a *contract of insurance*, the meaning of the term 'fell to be construed in its context according to the general law'. The court recognised that in deciding whether a contract was a *contract of insurance* for the purposes of the Insurance Companies Act 1974, the 'context' included the purpose of the regulatory statute.

(3) Accordingly, when the common law is unclear, the *FCA* will assess the desirability of regulating a particular contract as insurance in the light of the statutory objectives in the *Act*. The *FCA* will use that assessment as an indicator of whether or not a sufficient assumption of risk is present for the contract to be classified as a *contract of insurance* at common law.

(4) In the case of disaster recovery contracts, the fact that there was no pattern of claims that would cause the provider to have to pay claims form its own resources led the *FCA* to conclude that there was no relevant assumption of risk by the disaster recovery provider.

## Example 3: manufacturers' and retailers' warranties

**6.7.7** G Under a simple manufacturer's or retailer's warranty the purchase price of the goods includes an amount, in consideration of which the manufacturer undertakes an obligation (the warranty) to respond (without further expense

to the purchaser) to specified defects in the product that emerge within a defined time after purchase. When the warranty operates, the manufacturer or retailer provides repairs or replacement products in response to a defined event (the emergence of a latent defect in the product), which is adverse to the interests of the purchaser and the occurrence of which is uncertain. In summary, therefore, a simple manufacturer's or retailer's warranty is an identifiable and distinct obligation that is similar to and capable of being described as an insurance obligation in substance under ■ PERG 6.3.4 G.

**6.7.8** G Notwithstanding ■ PERG 6.7.7 G, the *FCA's* view is that an obligation that is of the same nature as a seller's or supplier's usual obligations as regards the quality of the goods or services is unlikely to be an insurance obligation in substance.



**6.7.9** G The *FCA* is unlikely to classify a contract containing a simple manufacturer's or retailer's warranty as a *contract of insurance*, if the *FCA* is satisfied that the warranty does no more that crystallise or recognise obligations that are of the same nature as a seller's or supplier's usual obligations as regards the quality of the goods or services.

**6.7.10** G For the purpose of ■ PERG 6.7.9 G, an obligation is likely to be of the same nature as the seller's or supplier's usual obligations as regards the quality of goods or services if it is an obligation of the seller to the buyer, assumed by the seller in consideration of the purchase price, which:

(1) implements, or bears a reasonable relationship to, the seller's statutory or common law obligations as regards the quality of goods or services of that kind; or

(2) is a usual obligation relevant to quality or fitness in commercial contracts for the sale of goods or supply of services of that kind.

## Example 4: separate warranty transactions and extended warranties

**6.7.11** G It follows from ■ PERG 6.7.10 G that the *FCA* is unlikely to be satisfied that an obligation in a contract of sale or supply is of the same nature as the seller's or supplier's usual obligations as regards the quality of goods or services, if that obligation has one or more of the following features:

(1) it is assumed by a person other than the seller or supplier (a 'third party'); or

(2) it is significantly more extensive in content, scope or duration than a seller's usual obligations as to the quality of goods or services of that kind.

**6.7.12** G Other things being equal, the *FCA* is likely to classify a contract of sale containing a warranty that has one or more of the features in ■ PERG 6.7.11 G as a *contract of insurance*. The features in ■ PERG 6.7.11 G (1) and ■ (2) typically distinguish a 'third party' warranty and an 'extended warranty' from a 'simple' manufacturer's or retailer's warranty.

6.7.13 G If a warranty is provided by a third party, the *FCA* will usually treat this as conclusive of the fact that there are different transactions and an assumption or transfer of risk. This conclusion would not usually depend on whether the provider is (or is not) a part of the same group of companies as the manufacturer or retailer. But it will be the third party (who assumes the risk) that is potentially effecting a *contract of insurance*.

6.7.14 G A manufacturer or retailer may undertake a warranty obligation to his customer in a separate contract with the customer, distinct from the contract of sale or supply of goods or services. The *FCA* will examine the separate contract to see if it is a *contract of insurance*. But the mere existence of a separate warranty contract is unlikely to be conclusive by itself.

6.7.15 G A manufacturer or retailer may undertake an obligation to ensure that the customer becomes a party to a separate *contract of insurance* in respect of the goods sold. This would include, for example, a contract for the sale of a freezer, with a simple warranty in relation to the quality of the freezer, but also providing insurance (underwritten by an *insurer* and in respect of which the customer is the *policyholder*) covering loss of frozen food if the freezer fails. The *FCA* is unlikely to treat a contract containing an obligation of this kind as a *contract of insurance*. However, the manufacturer or retailer may be in the position of an intermediary and may be liable to regulation in that capacity.

6.7.16 G The *FCA* distinguishes the contract in ■ PERG 6.7.15 G from a contract under which the manufacturer or retailer assumes the obligation to provide the customer with an indemnity against loss or damage if the freezer fails, but takes out insurance to cover the cost of having to provide the indemnity to the customer. The obligation to indemnify is of a different nature from the seller's or supplier's usual obligations as regards the quality of goods or services and is an insurance obligation. By assuming it, other things being equal, the manufacturer or retailer effects a *contract of insurance*. The fact that the manufacturer or retailer may take out insurance to cover the cost of having to provide the indemnity is irrelevant.

## Example 5: typical warranty schemes administered by motor dealers

6.7.17 G The following are examples of typical warranty schemes operated by motor dealers. Provided that, in each case, the *FCA* is satisfied that the obligations assumed by the dealer are not significantly more extensive in content, scope or duration that a dealer's usual obligations as to the quality of motor vehicles of that kind, the *FCA* would not usually classify the contracts embodying these transactions as *contracts of insurance*.

(1) The dealer gives a verbal undertaking to the purchaser that during a specified period (usually 3 months) he will rectify any fault occurring with the vehicle. No money changes hands, and the dealer is responsible for meeting the warranty obligation.

(2) The dealer undertakes warranty obligations to his customer. The warranty obligations are either included in the contract for the sale of the vehicle or are set out in a separate contract between dealer and customer at the time of sale. The dealer administers his own

warranty scheme and does not employ a separate company (for example a subsidiary) to run the scheme. In the event of a fault, the purchaser must contact the dealer, who is responsible for meeting the warranty obligation. The dealer decides whether or not to put money aside to meet potential claims.

(3) The dealer purchases proprietary warranty booklets issued by an administration company. These booklets contain 'terms and conditions' under which the dealer undertakes warranty obligations to the customer. The dealer sells these 'products' to his customer under a separate contract or inflates the price of the vehicle to include them as part of the sale of the vehicle. The administration company administers any claims that arise. The financial arrangements are that the dealer charges his customer for the warranty, passing a fee to the administration company for the purchase of the booklet and any administration relating to the processing of claims. The dealer retains all monies (less administration fee) received from the sale of the warranties and keeps any surplus after claims have been paid. The dealer is responsible for meeting the warranty obligation.

(4) The dealer undertakes warranty obligations to his customer. The warranty obligations are either included in the contract for the sale of the vehicle or are set out in a separate contract between dealer and customer at the time of sale. The dealer employs an administration company to handle all the claims and associated administrative work. The administration company usually has access to a bank account, funded by the dealer and specifically set aside to meet warranty claims. The administration company authorises and pays warranty claims from the bank account in accordance with the dealer's instructions. The dealer ultimately decides on the amount of claims payable from this account and retains all surplus monies. The dealer is responsible for meeting the warranty obligation.

## Example 6: tax investigation schemes

**6.7.18** G When self-assessment for income tax was first introduced, a number of providers set up schemes connected with their tax accounting and tax advisory services. In consideration of an annual fee, the provider undertakes to deal with any enquiries or investigations that HM Revenue and Customs might launch into the self-assessment that the provider completes for the recipient. The event covered by these schemes (an investigation) is both uncertain and adverse to the interests of the recipient, who would, if the scheme were not in place, have to devote resources to dealing with the investigation. Accordingly, these schemes fall within the description of a *contract of insurance* (see ■ PERG 6.3.4 G).

**6.7.19** G Some providers argued that these schemes amount to nothing more than a 'manufacturer's warranty' of their own work, within the scope of ■ PERG 6.7.7 G (Example 3: manufacturers' and retailers' warranties). However, HM Revenue and Customs is expected to make a significant number of random checks of self-assessment forms, irrespective of the quality of the work done by the provider. These random checks are also covered by the schemes. The *FCA* concluded, therefore, that these schemes were not analogous to manufacturers' warranties and that the better view was that they were *contracts of insurance*.

### Example 7: solicitors' retainers

6.7.20 G A contract under which a provider undertakes, in consideration of an initial payment, to stand ready to provide, or to procure the provision of, legal services on the occurrence of an uncertain event (for example, if the recipient is sued), is capable of being construed as a *contract of insurance* (see ■ PERG 6.3.4 G). Indeed, *legal expenses* insurance is commonplace.

6.7.21 G If, however, a contract of this kind were structured so that the recipient was charged at a commercial rate for any legal services in fact provided, the *FCA's* approach will be to treat the arrangement as non-insurance. This is principally because, by taking on obligations of this kind, the provider does not assume a relevant risk (see ■ PERG 6.7.6 G). The position might be different if the solicitor carries the additional obligation to pay for alternative legal services to be provided if the solicitor is unable to act. In that case, the *FCA's* approach will be to examine all the elements of the contract to determine whether the substance of the solicitor's obligation (see ■ PERG 6.5.4 G (2)) is to insure, or to give legal advice for a fee.

### Example 8: contracts providing for ultimate repayment of any indemnity ('time and distance cover')

6.7.22 G A contract under which a provider agrees to meet a specified obligation on behalf of the recipient (for example an obligation to pay for the re-purchase of shares or to meet a debt) immediately that obligation falls due, subject to later reimbursement by the recipient, would be a *contract of insurance* if in all other respects it fell within the description of such contract (see ■ PERG 6.3.4 G). This is principally because the provider assumes the risk that an immediate payment will be required and, depending on the terms of the contract, may also assume the risk that the recipient will be unable to make future repayments (see ■ PERG 6.6.2 G).