

(Re)insurance Bulletin

July 2007

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Current issues

EU - REINSURANCE DIRECTIVE

On 26 July 2007, the UK Treasury invited comments on proposals to implement the Reinsurance Directive of 2005, which provides for a framework for pure reinsurance companies based on the existing regime established by EU direct insurance laws. The current consultation relates mainly to proposed changes to the Financial Services and Markets Act and related secondary legislation, which are considered necessary to complete implementation of the Directive. The changes deal primarily with passporting arrangements for EEA-based reinsurers and provisions governing transfer of reinsurance business.

The consultation period ends on 17 October 2007. For further information, go to www.hm-treasury.gov.uk.

LLOYD'S OF LONDON

Proposed legislation

On 21 June 2007, Ed Balls, then Economic Secretary to the Treasury, announced that, as part of wider work on reforms of the London insurance market, Lloyd's of London has been working with the Treasury to identify areas where its corporate governance arrangements are out of step with modern practices.

Following these discussions, the Treasury has decided to develop legislative proposals to modernise the governance arrangement for Lloyd's. These proposals will take the form of a Legislative Reform Order to amend Lloyd's Act 1982. The aim of the proposals will be to update the governance arrangements of the market to reduce costs and unnecessary bureaucracy.

The Treasury will have extensive consultation with interested parties and intends to publish proposals in the New Year, 2008.

AUSTRALIA

Proposed new legislation

The Australian government has announced that it will be amending the country's Insurance Act 1973 to make direct offshore foreign insurers subject to prudential

regulation in Australia. The effect of this is that any insurer carrying on business in Australia will have to be authorised there. Linked to this development is the intention of the Regulatory Authority to refine its prudential framework so that different prudential standards will apply to companies with different risk profiles.

The Australian government plans to amend the Insurance Act before the end of 2007 with an intended enforcement date of 1 July 2008 and new prudential standards to be in place by early 2008.

LAW COMMISSION

Consultation paper on insurance contract law reform

In previous editions of this bulletin, we have reported on the Law Commission's three issues papers on reform of UK insurance contract law, dealing with misrepresentation, non-disclosure, breach of warranty and the position of intermediaries in that context. Those issues papers were intended to give interested parties an indication of the Law Commission's thinking on those areas and, on 17 July 2007, the Law Commission published its more formal consultation paper.

The consultation paper covers much of the same ground as the preceding issues papers, but some of the areas that have been developed or clarified and where the Law Commission have taken note of comments received are as follows:

- The Commission has sought to clarify the proposed new test for what is "material" and needs to be disclosed to an underwriter to ensure the policy is not avoided for misrepresentation or non-disclosure. The proposed test is now to ask what a reasonable insured in the circumstances would think was relevant to the insurer. This is intended to be a flexible test and one which achieves a balance between the interests of insured and insurer. The test is proposed to apply equally to business insureds who are professionally advised.
- In relation to business insurance, the Commission believes that the position on warranties of existing facts should differ from that pertaining to consumer insurance (where it is proposed that all such warranties should be treated as misrepresentations, in which case the insurer would not have a remedy if the insured quite

- reasonably thought the warranted fact was correct).
- In the business context, the Commission proposes that the parties should be able to choose that the insurer will have one or more remedies for misrepresentation even if the insured was neither dishonest nor careless in making the representation; the insurer may obtain a warranty as to the truth of the facts represented, which would allow it to refuse claims if the fact turned out to be untrue, even if it was represented honestly and carefully. In each case, the parties to a business insurance are being given the opportunity to contract out of the proposed default regime.
 - In response to suggestions that its initial approach to causal connection was unduly complex, the Commission provisionally proposes that in both consumer and business insurance, the policyholder should be entitled to be paid a claim if it can prove on the balance of probabilities that the event or circumstances constituting the breach of warranty did not contribute to the loss.
 - The Commission had previously applied rules regarding intermediaries depending on whether the insured in question was a small business, but now feels that this leads to problems of definition. Accordingly, the proposal was amended to be that, in a business context, an intermediary should be regarded as acting for an insurer for the purposes of obtaining pre-contract information, if it deals only with a limited number of insurers and does not search the market on the insured's behalf.

The consultation period closes on 16 November 2007 and the proposals may give rise to new legislation on the topic in 2010. Further information is available at www.lawcom.gov.uk.

EUROPEAN UNION - REGULATION

Solvency II - current position

On 10 July 2007, the European Commission released a further memo on the subject of Solvency II. The Commission seeks to emphasise the purposes of Solvency II, that is to improve consumer protection, modernise supervision, deepen market integration and increase the competitiveness of European insurers. It

also has the admirable aim of cutting red tape and the Commission stresses that 14 existing directives will be replaced by a single directive. For solvency testing purposes, insurance groups will have to take account of all risks to which they are exposed and to manage those risks more effectively. In addition, each group would have a group supervisor dedicated to monitoring the group as a whole.

The aim is to have the new system in place by 2012 and further information is available at www.ec.europa.eu.

Case notes

BROKERS' DUTIES

HIH Casualty & General Insurance Ltd v JLT Risk Solutions Ltd [2007] EWCA Civ 0710 (12.07.07)

Brokers who acted for both insured and reinsured owed a continuing post-placement duty to alert the reinsured to any potential coverage issues arising out of possible breaches of warranty in the original policy. In the context of film finance insurance, JLT owed a duty to inform HIH that not as many films had been or would be made as first contemplated, which constituted a breach of warranty.

JLT had acted in breach of that duty but had not caused HIH any loss because such information would not have made any difference to reinsurers' decision not to pay HIH in respect of their liability to the original insured.

The parties and their contractual relationships

JLT placed insurance cover to protect Law Debenture Trust against the risk that certain films which it had financed would not generate sufficient revenue to repay that finance. HIH and others underwrote that insurance. As part of an overall arrangement, JLT placed reinsurance on back-to-back terms with New Hampshire, Axa and others. Accordingly, JLT was broker and agent both for the insured in relation to the original insurance and for the reinsured in relation to the reinsurance.

The finance was provided for three slates of films, H1, H2 and H3, which were intended to comprise six, ten and five films respectively. There were slip policies in respect of each slate and each slip contained a waiver of rights clause by which HIH agreed "to the fullest extent possible under applicable law" not to seek or avoid or rescind the insurance or reject any claim under it. The intention was that the insurance be as close as possible to being a guarantee.

In addition, HIH entered into side agreements with Flashpoint Ltd, the company responsible for arranging the financing and marketing of the slates of films, to be its risk manager, responsible for procuring the production of the films within budget and to schedule, to exploit the films commercially, and to provide status reports on the films and the revenues produced.

The films

The insured films, which were intended to be low-budget affairs, appear also to have been stinkers. In late 1999 and early 2000, it became clear that each of the three slates was not successful and their returns would fall far short of the projected revenues. More significantly, the risk management reports of Flashpoint, distributed by JLT in late 1998 and early 1999, demonstrated that five instead of six films would be produced on slate H1, six instead of ten on H2, and four instead of five on H3.

As a result of the shortfall in revenues, HIH paid out a total of \$54m in 1999 and 2000 in respect of the three insurances. HIH sought recovery from its reinsurers but New Hampshire and others did not pay up relying on a breach of warranty as to the number of films produced. The Court found that there had been such a breach and that the waiver of rights clause referred to above was not sufficient to protect HIH. Consequently, HIH found itself having paid out \$54m to its original insured but without the vast majority of cover from its reinsurers.

The claim against the brokers

Having failed to recover against reinsurers and with a massive shortfall in funds, HIH turned to its brokers to seek recovery. It alleged that, if JLT had alerted it to the potential increase in coverage risk for it resulting from the reductions in the numbers of films, it would have instructed JLT to seek reinsurers' agreement to maintain coverage notwithstanding the reductions or at least to take their views so as to any uncertainty on the matter.

JLT defended itself on the basis that it did not owe any such duty or that, if it did, it had not breached it, or that, if there had been a breach, it had not caused any loss to HIH, since it paid Law Debenture Trust's claim, in the case of H1, without having found out whether reinsurers would indemnify it, and in the case of H2 and H3, when it knew that reinsurers would not indemnify it.

The Court's decision

At first instance, the Court found that JLT owed HIH a post-placement duty to alert it to any coverage issues arising from the reduced number of films; that JLT had breached that duty; but that that breach had not caused HIH loss because even if JLT had brought the potential coverage issues to HIH's attention and HIH had sought the views of reinsurers, that would not have made any difference to reinsurers' rejection of liability to indemnify HIH. Both HIH and JLT appealed against the parts of the judgement that were adverse to them.

The Court of Appeal dismissed both parties' appeals, finding that, in the context of an overall scheme in which JLT had placed both insurance and reinsurance, the brokers did owe a duty to alert HIH to the possible coverage problems arising from the reduction in the number of films.

The duty required the brokers to do more than just act as a "post-box" passing information received from Flashpoint on to HIH without further comment. The fact that, in this as in many other situations, the brokers owed duties to both insured and reinsured and those duties might come into conflict, did not relieve the brokers from fulfilling their duty towards HIH.

While pointing out that there was not much evidence on the topic and indicating that it was decided by a "*fine margin*", the Court found that JLT had breached its duty because it failed to draw HIH's specific attention to the film reductions referred to in the update reports.

JLT escaped liability to HIH, however, because the Court found that JLT's breach of duty had not caused any loss to HIH. The Court held that the true cause of HIH's loss was that it paid the original insured's claims when it had no legal liability to do so. In the case of the H1 slate of films, it made the payments when it had not sought the views of reinsurers on their validity. In the case of H2 and H3, HIH made the payments even when it knew that reinsurers disputed the validity of the claims. The applicability of that cause was not affected by the breach of duty by the brokers.

Brokers' duties

This decision may highlight a few areas of concern for brokers:

- **Post-placement duties:** For some time now, brokers have been concerned about creeping increases in their duties to their clients and this case may add, or at least clarify, a duty to alert the client to the impact of information that may have a negative effect on the cover and obtain the client's instructions on it. This is more than a mere "*informational*" duty and particularly, applies where, as the Court said here, the broker "*has been at the centre of devising and structuring a risky scheme for insurers and reinsurers*". The Court also suggested that the existence of such a duty is even more apparent in the case of consumer insurance.
- **Conflicts of interest:** The Court of Appeal recognised that it is very common in the market for the same brokers to place associated

insurance and reinsurance cover and thereby to owe duties as agent to both the insured and the reinsured. As Auld LJ said, "*the role of the insurance broker is notoriously anomalous for its inherent scope for engendering conflict of interest.*" The Court stressed, however, that the fact that a broker may owe conflicting duties to different parties does not mean that it is exempt from carrying out those duties. As here, even though fulfilling a duty to inform a reinsured client of potential problems with a cover may be prejudicial to an insured client, the broker must still fulfil that obligation.

ARBITRATION - JURISDICTION

C v D [2007] EWHC 1541 (Comm) (28.06.07)

Where the parties had agreed to London arbitration under the provisions of the UK Arbitration Act, in circumstances where there is a governing law clause referring to the "*internal laws of the State of New York*", one party could not seek to challenge a partial award by the tribunal in the New York court.

The insurance policy

D, a US insurer, insured C, a US corporation, on the basis of the Bermuda form for \$100m xs \$190m. The arbitration clause in the policy provided that:

"Any dispute arising under this Policy shall be finally and fully determined in London, England under the provisions of the English Arbitration Act 1950 as amended."

The clause also provided for application to a Judge of the English High Court in the event that one party did not appoint an arbitrator.

The Governing Law and Interpretation Clause provided that:

"This policy shall be governed by and construed in accordance with the internal laws of the State of New York..."

The reference to arbitration and the award

Various claims were made under the policy and London arbitration was initiated by C with a Reference to Arbitration agreed by all parties in writing. This reference provided among other things that the parties all confirmed that the tribunal had been validly established. In relation to applicable law, the reference provided that the law governing the insurance policy

itself was the law of New York, while the seat of the arbitration was London and the law governing the arbitration itself was the English Arbitration Act 1996 ("the Act").

The tribunal heard a number of defences to the claims but determined that C succeeded in full on its claim under the policy. D then applied to the tribunal for it to correct the award, alleging that its findings constituted a "manifest disregard of New York law" and that the award fell outside the scope of the 1958 arbitration enforcement convention and as such could be reviewed for error by any US Federal District Court. Consequently, C sought an injunction to stop D's proposed challenge to the award in the New York Court.

The arguments

C maintained that, as a result of the parties' express agreement to London as the seat of arbitration and to the application of the Act and because of the English Court's power over arbitrations heard in this jurisdiction, D could not challenge the award other than as permitted by the Act. The only possible challenge to enforcement of the award in other countries could be made through the 1958 Arbitration Enforcement Convention ("the Convention").

By contrast, D focussed on New York law, as the governing law of the insurance policy, and argued that that law entitled D to a minimum standard of review of arbitration awards, when such arbitrations take place between US corporations in relationships without a significant international element. D also contended that the award was a non-Convention award in that it was made between US corporations, with the effect that it did not fall to be enforced under the Convention. Finally, D submitted that the arbitrators had made fundamental errors of New York law in their award.

The judgment

Applying English law principles of conflict of laws, the Judge found that the agreement to London as the seat of arbitration and the agreement to the Act as the procedural law of the arbitration necessarily meant that the parties had adopted the framework of the Act as applying to the arbitration. That included its mandatory provisions, including those relating to enforcement of the award and challenges based on substantial jurisdiction or serious irregularity.

Non-mandatory provisions would also be applied except where the parties had agreed otherwise. In this case, the parties had effectively excluded the non-mandatory appeal provisions by agreeing that the arbitrators'

decision would be "a complete defence to any attempted appeal or litigation of such decision in the absence of fraud or collusion" (neither of which was alleged).

The judge's findings on this topic were supported by previous authority, which indicated that agreement as to the seat of arbitration is akin to agreement to exclusive jurisdiction. By agreeing to the seat, the parties also agree that any challenge to an award is to be made in the place designated as the seat. Here, the parties had gone out of their way to agree that the award should be final and binding, subject only to challenge on the basis of the mandatory provisions of the Act or on the basis of fraud or collusion.

In response to the point that, apart from agreeing English law as the procedural law of the arbitration, the parties had also agreed New York law as the substantive law on insurance policy issues, the Court could not accept that the parties would agree to a limitation on the right of appeal (the "complete defence" referred to above) if that limitation would not be effective under New York law, as D contended. Accordingly, the parties' agreement to New York law as the substantive law of the policy could not dislodge the conclusion that the procedural law of the arbitration and any challenge to it was English law as embodied in the Act.

The attempt by D to challenge the award in New York was a breach of its obligations under the arbitration agreement.

The integrity of the arbitration

The Court's decision respects the integrity of the parties' express voluntary agreement to England as the seat of arbitration, to the Act as the procedural law governing the reference, and to any award being final and binding. It would have been a pity if that agreement had in effect been torn up by the Court just because one party found itself dissatisfied with the award that the tribunal had reached. It is not uncommon for contracts to contain different procedural and substantive law provisions but that does not mean that the latter should override the former when questions of appeal or challenge arise.

As with the recent decision in *West Tankers v Ras Unione*, in which the House of Lords indicated their preferred view that anti-suit injunctions should be available in support of voluntary arbitrations between commercial parties, this decision reinforces the belief of the English Court in the need for protection of the arbitration regime.

REINSURANCE - CEDING COMMISSION

United Insurance Company of Libya v Aon Ltd [2007] EWHC 1583 (Comm) (05.07.07)

Contrary to their evidence, Libyan insurers (UIC) had agreed the appropriate level of ceding commission in respect of a reinsurance placement and were not, therefore, entitled to a repayment of brokerage paid to Aon; nor were they entitled to repayment of additional reinsurance premium paid when the nature of a placement changed; nor to an account for brokerage paid to Aon as a result of it having placed cover via a rival Libyan insurer. On the facts of each claim, UIC's evidence did not match the relevant contemporary documents and was contradicted by Aon's evidence, which the Court accepted.

The three claims

NOC, the Libyan state-owned oil corporation required insurance for 2004 for its onshore and offshore assets. The cover had to be placed in the local market with 100% international reinsurance. Aon tendered successfully for the placement with UIC as the local insurer/reinsured. UIC remained dissatisfied with the proposed ceding commission they might be paid (2.5%) out of a total brokerage of 15% and claimed that Aon had misled them about the overall brokerage payable such that Aon should now repay all brokerage it had received.

The court found that UIC had freely agreed to the ceding commission level, in the knowledge of the overall brokerage level, and had not been misled by Aon in any way.

Another Libyan company, General Company for Chemical Industries (GCCl) required cover from 1 April 2005. Aon, as it said it was instructed to, placed the cover by way of an endorsement to the existing cover. In this context, it was led to believe that the two companies were linked. It was subsequently instructed to place a replacement standalone cover for GCCl, which it did at considerable additional premium. UIC sought recovery of that additional premium on the basis that they had never instructed Aon to place the reinsurance as an endorsement to the NOC risk in the first place.

Again, the Judge threw out UIC's claim, which cut right across the available contemporary documents.

In 2005, NOC put the renewal of its insurance out to tender. UIC and Aon discussed working together again, but UIC sought to insist on a 3% instead of a 2.5% ceding commission and Aon said that it could not do business with them on that basis. Aon then successfully tendered for the business via a different local carrier. UIC alleged that the Aon acted in breach of a continuing fiduciary relationship between the two companies by using information and opportunities derived from UIC for the benefit of another party. On this basis, they said, Aon should account to UIC for all brokerage earned on the placement.

The Court gave this claim short shrift, on the grounds that there was no continuing contractual or fiduciary relationship between UIC and Aon once it had proved impossible to agree on the level of ceding commission. Similarly there was and could be no other kind of "consensual" relationship of the kind alleged by UIC. Accordingly, Aon owed no obligations to UIC.

The evidence

The Judge was repeatedly critical of the evidence given by the UIC witnesses. He described their evidence as, among other things, unreliable, unsatisfactory, contradictory and disingenuous. By contrast, Aon's witnesses were found to be honest, truthful, straightforward and impressive.

This is particularly striking when taken with the judge's comments on the documents. He said that the evidence of the UIC witnesses was often inconsistent with the documents and their attempts to explain away those inconsistencies were incoherent and unconvincing. Again, Aon's witnesses were quite the opposite. This highlights the importance of accurate contemporaneous recording of events, discussions, meetings, and agreements, particularly where agreements as to payments or commission levels are involved.

When disputes as to recollected facts arise, the party who is able to rely on contemporaneous documents will always be in a much easier position than the party who is relying on pure memory or who is trying to contrive, as the judge put it, a version of events that does not match the contemporary documents.

DLA Piper news

The following seminar will be held at our London office at 3 Noble Street, London EC2V 7EE. For more information, or to book a place, please contact Amanda Ashworth at amanda.ashworth@dlapiper.com

INSURANCE / REINSURANCE LAW UPDATE

Members of DLA Piper's reinsurance team will give an update on legal developments in insurance and reinsurance since September 2006

Date: 26 September 2007

Venue: 3 Noble Street, London EC2V 7EE

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