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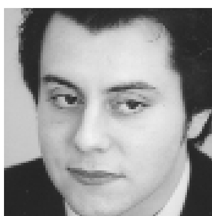
MADOFF: POTENTIAL IMPACT ON THE LONDON INSURANCE AND REINSURANCE MARKETS?

by Anthony Lennox and David Parker



Summary

This article considers the types of claims that may arise from the Madoff scandal and the issues that London market insurers and reinsurers may have to deal with when considering such claims.

Article

Since the FBI announced that New York financier Bernard Madoff ("Madoff") had been arrested and charged with conducting an alleged US$50 bn fraud in the United States, the confirmed list of financial institutions, pension funds, hedge funds, asset managers, private individuals and charities affected by the alleged fraud grows almost daily. These include many in the UK.

As sure as night follows day, the Madoff scandal will have a major impact on insurance and reinsurance over the forthcoming year. The size and number of claims will inevitably mean that those who have lost out will pursue the advisors and financial institutions involved. Indeed, a number of class actions have already been commenced in the United States and the SEC (in the US) and FSA (in the UK) have launched investigations.

Madoff, who began work as a lifeguard and also installed garden sprinkling equipment, graduated to running his own business, Bernard L. Madoff Investment Securities LLC ("Madoff Securities"), which operated as a securities broker/dealer in the global money market, headquartered in New York. Madoff was also one of the world's largest hedge fund managers, handling billions of dollars for a client base reading as a "Who's Who" of the investment market.

Madoff's "success" appears to have been founded on his charm, coupled with the consistently high investment returns he promised (and paid) thanks (supposedly) to savvy investments in equities.

It now appears that the real secret to Madoff's "success" was a "Ponzi" or pyramid scheme, in which returns to investors were paid out of the capital receipts from new investors. With the financial sector booming, there was a steady stream of people clamouring to invest monies with Madoff, but as the levels of new investment dwindled (partly owing to the current financial climate) to levels insufficient to allow Madoff to continue paying investors out of new investment monies, the whole scheme came crashing down.

Professional indemnity insurers and reinsurers of the advisers and financial institutions involved, and those offering D&O and E&O cover, are bracing themselves for an influx of claims. So, how (potentially) will London market insurers and/or reinsurers be affected by the Madoff scandal?

It is necessary to identify those entities that are likely to have been caught up in the Madoff Securities scandal and to analyse the nature of claims that might be brought against them to understand potential insurance/reinsurance issues. Many insurers/reinsurers underwriting business of this nature will have recent experience of the claims-related issues that might arise following the high profile collapses of Enron and Worldcom (amongst others).

Potential Claims

Investigations into Madoff's business are only just getting underway. The "scam", if it is a "scam", although simple in its general nature involves a detailed fact pattern. For example, it is reported that it will take at least six months to decipher Madoff's

March 2009

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accounts. As a consequence, the full range and extent of claims remains unclear and is likely to remain so for some time.

Most claims are likely to be made in the US given the favourable environment which the US courts provide for claimants and the possibility of enhanced awards (including punitive damages). However, Madoff's reach is likely to transcend national boundaries and claims might be made in many jurisdictions. There has already been talk of UK claims by, for example, UK investors who were advised by UK institutions (who may not be able to claim in the US).

As to the type of claims themselves we have already seen a number of class actions commenced in the US (against a combination of Madoff companies and fund managers) and this is likely to be only the tip of the iceberg.

The most obvious targets will be the Madoff companies themselves. Their assets will be limited and claims will inevitably fall on their insurers. They will only have limited insurance available and it may be that the insurers (who no doubt were not told about Madoff's "practices") may have policy and coverage defences.

In terms of other targets, the entities that advised upon investments in Madoff Securities (including investment advisors, accountants and law firms) are also likely to face allegations of negligence and failing to carry out due diligence. Claims of this type seem particularly likely in light of reports which suggest that proper due diligence might have shown up deficiencies in the way that Madoff operated his business. At least one major investment bank has confirmed that it has no exposure to Madoff as he failed to pass its due diligence criteria and an investigative journalist published an article casting doubt on whether Madoff really did have the "Midas" touch (or rather, it was all too good to be true) as long ago as 1999.

Shareholders of companies which have suffered losses by virtue of investing in Madoff Securities might also seek to bring actions against the company (and possibly against the directors) in respect of any fall in the value of shares. In addition, investors in funds who have suffered losses might look to make claims against those persons with whom they entrusted monies arising for those entities' alleged negligence and/or alleged breaches of contract and/or alleged breaches of fiduciary duties and/or fraud. As an example, one class action lawsuit which has already been filed in the Southern District of New York against an investment partnership, its manager and its auditors[1], alleges violations of United States securities' laws, negligent misrepresentation and breach of fiduciary duty. In a further example, the Fairfield Greenwich Group is being sued in New York by investors for failing to protect their assets and "failing to perform even a minimum level of due diligence regarding the activities of Madoff".

No doubt, the nature of claims and the cast list of defendants will become clearer over the coming weeks and months.

Potential issues facing London insurers

Given London's leading role in the international insurance market (notably, for international professional indemnity and financial institution insurance and reinsurance), many claims will find their way into London. Reports have suggested that the London market has written less such business in the past few years (particularly following the losses which ensued from the collapse of Worldcom and Enron). Also, reports have suggested that in the "soft" market, insurers have purchased less reinsurance to cover such eventualities. Nonetheless, Madoff will have a significant impact on the market and coverage will be looked at very closely. This will be particularly true of any direct insurer of a Madoff company where as, already stated, insurers may have a host of defences based upon lack of disclosure.

For other insureds (and reinsureds) there are likely to be several potential issues. Of course, we are still at a very early stage and the primary concern for insurers and reinsurers is to try to establish what exposures they have. However, as time moves on other issues which may tax them include, notification, aggregation of claims and the obligations of reinsurers to follow their reinsureds' settlements.

The discussion below concerns the application of English law to these issues.

Notification of claims

In terms of the direct policies, the notification provisions may be conditions precedent requiring the insured to notify claims or circumstances within a set period, failing which its claim will fail. The form of such notice may also be important as was demonstrated by a recent English case (*Kidsons v Lloyds*) where the insured believed it had given sufficient notice in telling its insurers of concerns which had arisen, but the court disagreed and the claim failed in part.

On reinsurances, there may be claims co-operation or control clauses which require notice to be given to the reinsurer (and to allow the reinsurer to be involved in

[1] *New York Law School v Ascot Partners LP, J Merkin and BDO Seidman LLP*

the inwards claims). Such provisions have also been the subject of reported cases in the UK. The results of these cases differ on their facts, but the lesson to reinsureds is clear: if they do not notify there is a risk their claims may fail.

Aggregation of claims

In essence, "aggregation" is the name given to the mechanism whereby several losses are added together for the purposes of making a single claim on an insurance or reinsurance policy. In the case of Madoff, an advisor who had several clients, which it advised to invest in Madoff, may want to aggregate the claims in order to avoid paying several deductibles. There are numerous ways in which aggregation is often achieved, with the most common method used in the London market being inclusion of language providing that losses arising from an "event", "occurrence" or a "cause" can be aggregated. Typically, policies of the type potentially exposed to claims arising from the Madoff scandal are likely to allow losses arising from an "event" or "occurrence" to be grouped together as a single claim.

For something to be classified as an "event" the four "unities" must be present i.e. (1) cause, (2) place, (3) time and (4) (where relevant) intention of any human agents involved.

Each case will be judged on its own facts, which will differ from insured to insured. However, as a starting point, given the general requirement that the "event" or "occurrence" be causative in some sense of the losses, it is unlikely that reinsureds will be able to group together all losses which are related to Madoff (for example, losses related to different underlying insureds are unlikely to be capable of aggregation). In addition, losses relating to different activities/decisions/actions of the same underlying insured (for example, two separate investments in Madoff Securities) are unlikely to be capable of being aggregated under an "event" or "occurrence" based wording. On the other hand, a "cause" based wording may allow the aggregation of Madoff claims. The issues for reinsurers will be much the same. However, in recent "soft" market conditions some reinsurers have been offering much wider cover which allows the aggregation of claims by reference to a far more generic source.

"Follow the settlements"

In recent years, the importance of "follow the settlements" language in reinsurance contracts (for both reinsureds and reinsurers) has been brought sharply into focus by experience gleaned from the financial collapses of prominent financial institutions such as Enron. There are many instances of settlements being reached by insurers without reinsurers' consent, with the result that, in some circumstances, recovery from those reinsurers has been difficult. In these circumstances, and subject to the reinsurance wording, proof that a reinsured was liable in law to its cedant/insured in respect of the relevant underlying loss/claim can be required and is often the major stumbling block.

Whilst the wordings of "follow the settlements" clauses differ markedly, in general, where a follow the settlements clause appears, the reinsured can recover from the reinsurer in respect of a settlement reached with the reinsured provided that the reinsured has acted in a bona fide and businesslike fashion and, as a matter of law, the claim falls within the risks covered by the reinsurance agreement. Under such circumstances, reinsureds would be best advised to notify reinsurers of any potential settlements prior to their conclusion (and as early as possible) and to obtain their prior consent if at all possible.

Conclusion

Despite it being early days in the development of the Madoff scandal, it seems certain that claims arising from his business activities will hit the London market at both a direct and reinsurance level. Insurers and reinsurers will, over the forhtcoming months, be analysing their exposures to Madoff claims. They should also start to formulate their strategies for dealing with these claims and should learn from issues raised in other claims in the past. In a hardening market, Madoff's impact is likely to stretch beyond claims too, premiums are likely to rise and the availability of cover of this type might be restricted in the future.

A version of this article first appeared in Post Magazine.

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D&O INSURANCE: TIME TO REVIEW THOSE POLICIES *by Pollyanna Deane*

Summary

The extension and codification of directors' duties under the Companies Act 2006 means that companies should reassess their D&O policies in view of the increased risks for directors and officers. This article examines the changes brought about by the Act and contains a checklist for reviewing a company's D&O policy.

Article

D&O insurance-Companies Act changes

The extension and codification of directors' duties under the Companies Act 2006 ("2006 Act") means that companies should reassess their Directors' & Officers' (D&O) liability insurance policies in view of the increased risks directors and officers could now face (see box "Checklist").

A review of policies should also take into account the risks faced by directors under the Financial Services and Markets Act 2000 ("FSMA"), the Corporate Manslaughter and Corporate Homicide Act 2007 ("2007 Act") and the Extradition Act 2003 ("2003 Act").

In addition, the current credit crunch may raise issues: claims against public company executives can be expected to increase when stock values drop because of significant write-downs of the value of assets, which in turn decrease earnings.

D&O Insurance

D&O insurance is used to provide personal cover for directors and other executives for losses resulting from claims made against them by third parties.

Companies Act Changes

Under the 2006 Act, some of the common law and equitable duties have been codified as general duties and apply to all directors including "de facto" and shadow directors (sections 171-177); some of the duties also apply to former directors (sections 175 and 176).

Of the seven general duties, the two that present the greatest risk to directors are the duty to promote the success of the company (section 172) and the duty to exercise reasonable care, skill and diligence (section 174) (see box "Key duties").

The consequences of a breach (or threatened breach) of any of the general duties are the same as those that previously applied under the corresponding common law rule or equitable principle (section 178). But while the general duties and the remedies for their breach may be familiar, it is the increased risk of derivative claims under the 2006 Act which will probably lead to the widest re-evaluation of D&O cover.

Derivative claims. As the general duties of a director are owed to the company, the company alone has the right to enforce them. However, Part 11 of the 2006 Act provides for members of a company to bring an action on its behalf against a director for an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust.

Significantly, a derivative claim may be brought against a director for breach of duty even if he has not benefited personally from the breach. This is a departure from the common law position and has wide implications for directors, as the removal of the common law defence enables derivative claims to attach to a wider set of circumstances.

New safeguards have been included in the 2006 Act. For instance, a member must satisfy the court as to a prima facie case, and a derivative claim may only proceed with the court's permission. However, it is yet to be seen how effective such safeguards will be against, for example, special interest groups or activist members.

Reviewing policy cover

The new requirement to promote the success of a company and the extension of directors' duties will need to be catered for in D&O insurance policy wording; in particular, the policy should take into account risks related to employment, health, safety, and environmental issues, as well as to hostile takeovers.

In a highly charged takeover situation, directors will need to pay careful attention to the duty to promote the success of a company. If resisting a takeover, they must ensure that the path they are taking chimes with that duty. At the very least, the definition of "wrongful act" in D&O insurance policies should cover breach of the general duties.

For derivative claims, D&O policies need to be reviewed to take account of the wider circumstances under which such a claim may be brought. In particular, as these claims will be pursued on behalf of a company, the exclusions in D&O insurance policies should be carefully checked, as it is common to

exclude cover for a claim brought against a director by the company or other directors (the "insured vs insured exclusion").

Additionally, as members are entitled to take action against a director for an alleged breach made before they became a member (section 260(4)), D&O policies need to be reviewed to ensure outgoing directors are adequately covered in the event of a successful hostile takeover as well as for resignation.

Costs and expenses which may be incurred by directors settling or defending derivative claims need to be adequately covered, including those resulting from a derivative claim which is refused permission to proceed, or which is settled with an order that each party bear their own costs.

Financial Services

In the past, the Financial Services Authority (FSA) has responded to breaches of its rules by pursuing disciplinary action against the authorised firm only. However, in 2007 the FSA pursued cases against individuals: significantly, against approved persons with responsibility for the area of the business in which there were systems and controls failings. For example, the Chief Executive of Hadenglen Home Finance Plc was fined £49,000 for breaches of the FSA Principles and Code of Practice for Approved Persons. The company was also fined. The FSA has stated that it intends increasingly to target senior management in this way.

While a fine cannot be covered, the cost of defending allegations made against an individual and the cost of an FSA investigation (for example, the impact of suspension from the individual's job) will need to be covered by the D&O insurance.

Action may also be brought against directors as a result of very serious breaches of the FSA rules.

Section 232(2) of FSMA restricts the circumstances in which a company may indemnify its directors for legal action against them as individuals. Consequently, directors of authorised firms may wish to ensure that the D&O policy adequately covers them against the costs of regulatory action pursued against them by the FSA, whether or not they are approved persons.

Corporate Manslaughter

Under section 1 of the 2007 Act, only an organisation may be convicted of the offence of corporate manslaughter. Under standard D&O policy wording, cover is only provided for a director or senior officer of a company for legal action for management failings leading to the death of an individual. To that extent, it may be considered that insurance is desirable to cover an organisation in the event of an unsuccessful prosecution against it under the 2007 Act. An extension of D&O insurance may be considered appropriate.

In the wake of a successful prosecution for corporate manslaughter, it is foreseeable that legal action may be taken against individual directors under the 2006 Act for breach of the general duties, as well as under health and safety or environmental legislation. It is yet to be seen how aggressively the relevant authorities will pursue such actions, but D&O policies should be reviewed to ensure that adequate cover is provided to directors for the potential increased risk from legal action under other UK legislation as a result of the 2006 Act.

Extradition

In recent years, some directors have had concerns about the increasing risk of prosecution under the laws of foreign jurisdictions as a result of the 2003 Act. The original purpose of the 2003 Act was to facilitate the extradition of suspected terrorists. However, the US has displayed increasing willingness to extradite UK citizens for alleged white collar crime.

Directors face an increased risk of fighting extradition proceedings at their personal cost and fighting an extradition order in the UK makes it less likely that the US courts will grant bail. If directors are granted bail, their assets may be exhausted by their use as collateral security for bail, leaving legal and related costs still to be covered. Accordingly, D&O insurance policies should be reviewed to ensure that adequate cover is provided to directors for the potential increased risk of extradition proceedings being pursued against them from foreign jurisdictions.

Directors may be particularly interested to ensure the policy covers not only travel and legal fees, but medical and mental health related expenses, as well as the expenses of their families while they await and undergo trial.

Checklist

When reviewing a company's Directors' & Officers' liability insurance policy, check that:

- ✔ The term "Directors & Officers" includes "de facto" and shadow directors, as well as former directors.
- ✔ The definition of "claim" covers: corporate manslaughter as defined under the Corporate Manslaughter and Corporate Homicide Act 2007; and any criminal, civil, regulatory or administrative investigation or proceedings arising in any jurisdiction.
- ✔ The policy provides cover for "defence costs" and that this definition covers: all costs incurred in defending legal actions arising in the UK, and arising in foreign jurisdictions as a result of the Extradition Act 2003; and related costs such as medical and mental health costs, and living costs arising from residence in a foreign jurisdiction. The loss covered includes liability for legal costs, damages, charges, expenses and judgments, irrespective of the jurisdiction in which the liability arises.
- ✔ Any definition of "pollution" covers: all claims that may be brought under applicable UK or EU environmental legislation; and claims against the company based on any form of radiation produced by the company, including electro-magnetic radiation, for example, wireless broad-band radiation.
- ✔ Ensure "pollution" is not included under "exclusions". The policy provides cover for a "wrongful act" and that this is defined to refer to the general duties under the Companies Act 2006.
- ✔ "Employment-related wrongful act" is defined to cover actual or suspected breaches of Financial Services Authority rules where an authorised firm is involved.
- ✔ In the applicable exclusions, the following are not excluded: claims brought by or on behalf of the company or an insured person; derivative claims; takeovers or mergers resulting from any "wrongful act" or "employment-related wrongful act" or "professional duties" owed to the company or third parties.

Key duties

Success of the company. A director must, acting in good faith, behave in a way that he considers most likely to promote the success of the company, and for the benefit of the members as a whole (section 172, of the Companies Act 2006) ("2006 Act"). In doing this, a director

is under a statutory obligation to have regard to:

- The long-term consequences of a decision.
- The interests of employees.
- The need to foster the company's business relationships with suppliers, customers and others.
- The impact of company operations on the community and the environment.
- The need to maintain a reputation for high standards of business conduct.
- The need to act fairly between shareholders.

Care, skill and diligence. Under section 174 of the 2006 Act, a director must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with both:

- The general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company (the "objective" test).
- The general knowledge, skill and experience that the director actually has (the "subjective" test).

This provision codifies the common law position in terms of the law of negligence and its scope is wide.

This article was first published in PLC.

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THE DANGERS OF BEING COY *by David McCarthy*

Summary

This article discusses the impact of the Court of Appeal decision in the *Kidsons* litigation and the issues which arise for insureds when failing to provide adequate notifications.

Article

The case of *HLB Kidsons v Lloyd's Underwriters and Others (2007)* concerns efforts made by chartered accountants - former partners of Kidsons - to inform underwriters about tax avoidance schemes marketed by Kidsons' subsidiary, Solutions at Fiscal Innovation. These efforts occurred in the run-up to the expiry of Kidsons' liability insurance, around the time of its merger with Baker Tilly in 2002.

The dispute was a contest about notification, based upon a claims made policy that was described as "*unsatisfactory*" and as having a "*a patchwork of provisions [that] do not all fit well together*". The policy had an extension of coverage for circumstances first notified during the policy period. General Condition four said:

"*The Assured shall give to the underwriters notice as soon as practicable of any circumstance of which they shall become aware during the period specified in the schedule, which may give rise to a loss or claim against them. Such notice having been given any loss or claim to which that circumstance has given rise, which is subsequently made after the expiration of the period specified in the schedule, shall be deemed for the purpose of this insurance to have been made during the subsistence hereof.*"

Kidsons now faces substantial mis-selling claims relating to the schemes. The essential issue for the appeal was, therefore, whether Kidsons gave effective notification of a circumstance, of a sufficient width, for the policy to now respond to these claims.

Voicing concerns

The difficulty about identifying whether a circumstance had been notified stemmed from the fact that no claim was ever intimated against Kidsons during the policy period. Rather, the potential notification occurred due to the voicing of internal concerns by a tax manager, Mr Torrance. Kidsons set up an independent review body to investigate, starting with a product known as the discounted option scheme ("DOS").

A letter about Mr Torrance's concerns of 31 August 2001 was sent by Kidsons to their placing broker. The trial judge described the terms of this letter as "*coy in the extreme*".

By late September 2001, the draft report from the independent review body had been presented. Kidsons appeared satisfied that implementation of the discounted option scheme was the only concern.

A further letter of 28 March 2002 was sent by Kidsons, which advised of a general view that this scheme was technically effective, but in some instances there might have been procedural difficulties with its implementation.

Based upon Kidsons' two letters, there were four presentations:

1. On 27 September 2001 the placing broker showed the 31 August letter to the underwriter for the lead syndicate.
2. During October 2001 material, including the 31 August 2001 letter, was presented to claims staff of the two lead syndicates.
3. During April 2002 material, including the 28 March letter, was presented to the lead syndicate and the company market.
4. In July 2002 material, including the 28 March letter, was presented to XCS on behalf of the following Lloyd's market.

The trial judge held that the third presentation was the only effective notification, but it was limited to procedural problems in relation to Solutions at Fiscal Innovation's discount option schemes, and only to the two lead syndicates and the company market. In the case of the first and second presentations, she took the view that the 31 August letter was not effective because it was "*too vague and nebulous*" and was deliberately written in "*coy and restrictive terms*". The judge concluded the fourth presentation was too late.

The Court of Appeal

Lord Justice Rix in the Court of Appeal noted that General Condition four said nothing about how a notification was to be made, other than that it must be in writing and be given "*as soon as practicable*" after awareness. This he characterised as a "*fairly loose and undemanding test*". In his judgment, it was entirely irrelevant that Kidsons, from late September 2001, may have lacked "*a genuine belief*" - based upon the draft internal report - that claims might ensue.

Lord Justice Rix also commented that if there was a valid point about the ineffectiveness of Mr Torrance's

concerns, by themselves, as "circumstances", this point had not been taken by the underwriters. On that basis, the majority of the Court of Appeal held the letter of 31 August 2001 was, in the absence of any allegation of breach of good faith, an effective notification.

Kidsons argued that the second presentation was a notification that extended to the whole gamut of Mr Torrance's concerns.

The Court of Appeal rejected this argument and held that a reasonable reader of the 31 August letter would only believe underwriters were being notified of Mr Torrance's view that the "procedures" relating to the schemes could be criticised, rather than the actual "products". They concluded the second presentation notified the two lead syndicates that implementation of the schemes might be criticised, not just the DOS one.

The Court of Appeal regarded the 28 March 2002 letter as merely updating the second presentation with respect to the concern about the implementation of DOS.

The Court of Appeal agreed with the trial judge that this presentation to the Lloyd's following market was not made as soon as practicable. It also construed the second sentence of general condition four as a condition precedent extending to the timing of the notice required. It is clear that this conclusion was driven, in large part, by the concern that to find otherwise would have turned a claims made policy on its head.

Points to consider

The strong message to insureds is that in notifying circumstances, they must ensure the terms of any notification is a fair summary of what they know. Attempts to water down the terms of any notification run the risk it will not, when construed objectively, be effective to trigger coverage. Attempts to "*test the waters*" by notifying underwriters on the placing side, rather than through their claims department, could also detract from the objective appearance of a circumstance being notified.

Substantial delays occurring between notifying lead underwriters and the following market of circumstances need to be avoided. Brokers, therefore, need to ensure that notifications are timely to all underwriters in the market.

In this era of contract certainty, this case also serves as a timely reminder that having a full policy wording in place is not the answer to all evils. Care needs to be exercised to ensure that all of the provisions in the policy sit comfortably together. This will minimise the risk that extensive - and expensive - arguments about how the policy is to be construed are needed after the event.

A version of this article first appeared in Post Magazine.

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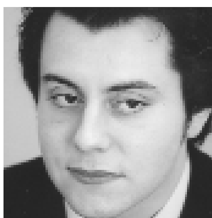
ARBITRATION AWARDS AND APPEAL: IF AMERICA IS ON HALL STREET, WHICH STREET IS ENGLAND ON? *by Jonathan Sacher and David Parker*



Summary

This article considers the differences between arbitration in the USA and arbitration in England following the American Supreme Court decision in *Hall Street Associates v Mattel Inc*.

Article

Where commercial parties agree that disputes between them should be referred to arbitration (rather than courts), the law chosen to govern any arbitration is often agreed with one eye on achieving a final and binding determination at arbitration without recourse to the courts. A major consideration in choosing English law or the laws of a US state (or US federal arbitration law) is that English law allows the parties to appeal a decision of an arbitrator to the English court on a point of law, unavailable in America.

A recent decision of the US Supreme Court (*Hall Street Associates v Mattel Inc*) confirms that where parties submit a dispute to arbitration under federal arbitration law, the grounds on which the arbitrator's decision can be appealed are limited to those set out in section 10 of the Federal Arbitration Act ("the FAA") and confirms that there can be no appeal to a US federal court on a point of law (even in the face of agreement between the parties).

Hall Street

In *Hall Street*, the US Supreme Court decided (by majority), based on an analysis of the wording of the provisions of the FAA, that the statutory grounds of review at sections 9 to 11 of the FAA were exclusive.

The Court rejected a construction of the FAA which would "…*expand the stated grounds to the point of evidentiary and legal review generally…*".

Whilst confirming that it is not open to parties to arbitrations under the FAA to agree between themselves additional grounds upon which an arbitration award can be vacated by the federal court (and by implication to contract out of any of those grounds), the Supreme Court expressly stated that parties are free to pursue "*state statutory and common law… where judicial review of a different scope is arguable*". In this way, it might be possible for parties to agree expanded grounds on which American courts are able to review arbitration awards by careful selection of a state law governing the arbitration, whose courts are favourable to interpreting their own laws more widely than the Supreme Court.

England?

The English Arbitration Act ("AA") includes three statutory mechanisms for "contesting" a domestic award: (a) a challenge based on the tribunal's substantive jurisdiction; (b) a challenge based upon serious irregularity; and (c) an appeal on a point of (English) law. The first two "challenges" are mandatory and parties cannot just agree to oust them in an arbitration agreement.

The Parties are free to agree to exclude an appeal to the court on a point of English law, however. This can be done expressly, or by agreeing that an award shall not be supported by written reasons (English arbitration awards are supported by written reasons unless otherwise agreed).

The right to appeal is severely restricted by the provisions of the AA. Before an appeal can be brought (unless an appeal is agreed, see below), the court must grant permission to appeal. Leave to appeal will only be granted if the applicant can satisfy the court: (1) that the determination of the question of law "will" (not "may") substantially affect the rights of one or more parties; (2) that the question of law is one which the tribunal was asked to determine; (3) that, on the basis of the findings of fact in the award, the decision of the tribunal on the question of law is obviously wrong or the question is one of general public importance and the decision of the tribunal is at least open to serious doubt, and (4) that, despite the agreement of the parties to resolve the matter by arbitration, it is just and proper in all the circumstances for the court to determine the question.

The extent to which parties are free to expand/limit the grounds set out above by contract appears to be untested in the English courts. It is likely that an English court would be unwilling to find that any attempt to do so was effective. Constitutionally, the court would be reluctant to allow parties to agree expanded grounds affecting its discretion and grounds at odds with the limits imposed by the AA.

That said, one important avenue is open to parties as regards appealing an English arbitration award which might be seen to extend the scope of appeal in practical terms. The AA allows the parties to agree that there can be an appeal on a point of law, and by so doing, the requirement to obtain the permission of the court is circumnavigated. Any appeal must be on a point of English law (e.g. it is not open to agree that there will be an appeal on a question of fact), but the restrictions on when a court can grant permission to appeal are avoided.

Conclusion

In the light of the restrictions on potential appeals in *Hall Street* in federal arbitrations, and the wider scope available in England, even greater importance is attached to the law chosen to govern any arbitration dispute. This is especially so where parties want to have the option of reverting to the courts where they consider that an arbitrator has made a mistake on a point of law.

A version of this article was first published in ARIAS Quarterly.

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NOT PAYING AN INSURANCE CLAIM - IS IT A FRAUD? *by David McCarthy*

Summary

This article considers the ways that assureds may seek to commence proceedings in another jurisdiction in an attempt to obtain a more favourable result and how insurers can respond to such attempts.

Article

All insurers require advice on policy defences that could potentially be taken against assureds. Obtaining advice in any jurisdiction agreed for dispute resolution in the insurance policy is obviously important. English lawyers also need to keep in mind the potential for an assured to seek a remedy outside of the jurisdiction agreed in the insurance policy.

The US courts can be a destination of choice for such disenchanted assureds. Proceedings alleging the insurer has committed a fraud in the course of either underwriting the policy or investigating the claim may be how the assured seeks to get before the US courts. In the present economic climate, insurers are likely to experience an escalation in such attempts to mount commercial pressure upon them.

Why make such allegations in the US?

There is a subtle, yet significant, difference in what can be alleged as a fraud claim in many US courts, as compared with England.

In many US states, an allegation of fraud encompasses a much wider range of alleged conduct. The English tort of deceit generally requires positive conduct, such as the making of a misrepresentation. Under English law mere silence or omission to act in isolation is generally not good enough. Meanwhile, many US states, such as New York or Massachusetts, recognise fraud as capable of being committed by omission to act: the concept of "fraudulent concealment".

This subtle difference can prove significant for a client insurer that has denied a claim. Any information not disclosed to the assured could potentially lead to allegations of fraudulent concealment being made against them in the US courts.

It can prove very difficult to bring such fraud claims, despite their potentially frivolous nature, to an end. It may not be straightforward to compel the provision of further details concerning the alleged "fraud" or to strike out the Complaint.

The US courts also generally require a very low threshold of connection with any particular US state before a US court will take jurisdiction over such a fraud claim. Arguments may also be made in the US courts that any express choice of either law, jurisdiction or venue for dispute resolution in the insurance policy does not apply to fraud claims.

There are also generally no cost consequences for parties to US litigation in the nature of those that apply in English litigation or arbitration. US courts will only award costs to a winning party in exceptional circumstances.

How to respond?

There are, at least, three potential responses to actions of this type.

The first "stock" response is to seek an anti-suit injunction in the English courts against the US proceedings. This course of action is available where an English exclusive jurisdiction clause exists and there is no delay.

Where there has been delay, or there are concerns about how the US court may react to an application for an anti-suit injunction, an alternative is to commence a damages action in the English courts. Such an action would seek damages for breach of the exclusive jurisdiction clause and would continue to run parallel to the US proceedings, provided no anti-suit injunction is issued out of the US court (see for example *Union Discount v Zoller*). The damages action will create pressure because the potential damages and costs in that action will mount as time goes on. The damages action will not itself, however, prevent the US proceedings from being pursued.

A further alternative to consider is to commence negative declaratory relief proceedings in England or elsewhere in the EU. In light of the decision of the European Court of Justice in *Owusu v Jackson* the courts of member states in the EU do not appear to have a discretion to stay such proceedings. The benefits can be that the US court may, ultimately, be bound to accept findings of fact obtained more speedily in the EU proceedings. The assured seeking to make the "fraud" allegations may also be forced to make those same allegations in the EU proceedings by way of counterclaim. This may open up the ability to seek further particulars of the allegations of fraud and/or apply to strike out the allegations elsewhere than in the US. It may also cause some further reflection by the assured concerning the making of the allegations, especially if cost penalties could flow from bringing such allegations within the EU.

A version of this article was first published in Legal Week.

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LAW COMMISSION REFORM SET TO IMPACT ON DISPUTES *by Matthew Line*

Summary

This article considers how three important recent cases might have been decided if the Law Commission's proposals for the reform of insurance law had already been enacted.

Article

In 2009 the Law Commission ("LC") will publish its final recommendations for consumer insurance reform and an issues paper on business insurance. By looking at how three recent cases might have been decided if the LC's recommendations had already become law, we can see the impact these proposals might have.

Limit No. 2 Limited v Axa Versicherung

Prior to the agreement of a reinsurance treaty, the reinsured's broker sent a fax stating that: "*As a matter of principle they* [the reinsured]…*would not normally write construction unless the original deductible was at least £500,000…*". The reinsured was unaware of the fax and its contents. The treaty was later extended by endorsement and a second treaty was also entered into.

The reinsurers discovered that most of the relevant risks ceded by the reinsured had deductibles lower than £500,000. On the basis of the apparent misrepresentation in the broker's fax, the reinsurers sought to avoid.

The Court of Appeal decided that the fax constituted a misrepresentation, so the first treaty (including the endorsed extension) could be avoided. However, the misrepresentation was not considered to be a continuing one so the reinsurers could not avoid the second treaty.

Longmore LJ stated that "*The entirety of a contract can be avoided for… innocent misrepresentation …material to the risk in the eyes of a prudent underwriter.*" Under the LC's proposals, materiality would be assessed by the standard of the reasonable reinsured. Therefore, to have a remedy for misrepresentation, the reinsurer would have to show (amongst other things) that had it known the truth it would not have entered into the same contract on the same terms or at all.

In this case there was no allegation that the reinsured had acted in bad faith. If the misrepresentation was "innocent", then under the LC's proposals the reinsurer could not have avoided the treaty and would have to pay the claims (assuming there were no other relevant defences). If the misrepresentation was negligent, then the remedy would be a "*proportionate settlement*" to put the reinsurer into the position it would have been in had it known the truth.

Laker Vent Engineering Limited v Templeton Insurance Company Limited

Laker twice renewed a Constructor's Protection Service Policy, which included legal expenses cover. Laker were a specialist subcontractor and notified their insurer of a claim for legal expenses in an arbitration against the main contractor. The insurer asserted that the policy was void for non-disclosure because Laker had failed to disclose this "dispute", which constituted a material circumstance known to Laker before renewal.

The policy stated that "*on any renewal declaration …the Insured must advise the Insurer of any potential claims*". The court held that this clause simply reminded the insured of the duty to disclose any material potential claim. A material claim was one that would influence the judgment of a prudent underwriter in fixing the premium or deciding whether to take the risk. The court found that there had been no material non-disclosure. It considered that an insurer providing legal expenses cover under this type of policy must be presumed to know that construction contracts nearly always involve disputes that may lead to legal action. If every dispute was material, then almost every aspect of a major construction contract would have to be disclosed. For disclosure to be required, there had to be some objective aspects of the relationship that demonstrated a real risk of the dispute escalating to formal procedures for dispute resolution.

The LC's proposals for business insurance will change the materiality test. To be entitled to a remedy for non-disclosure, the insurer would first have to show that had it known the fact in question it would not have entered into the same contract on the same terms or at all. Secondly, the insurer would have to show that either: (a) a reasonable insured in the circumstances would have appreciated that the fact in question would be one the insurer would want to know about; or (b) the proposer actually knew the fact was one the insurer would want to know about.

If the LC's proposals had been in force, the court would have taken a very different approach to this case. The result may have been different, under the

LC's proposals, if the insurer had been able to show that it would not have written this policy if it had known about this particular dispute (or would have written it on different terms) and that the insured knew, or a reasonable insured would have known, that the dispute was one that the insurer would want to know about.

Ansari v New India Assurance Limited

Mr Ansari let his premises to a friend and took out a commercial property policy. Mr Ansari's proposal form stated his friend's business as "wholesaling kitchenware" and that the premises were protected by sprinklers. General Condition 2 in the policy stated that "*This insurance shall cease…if there is any material alteration to the Premises or Business or any material change in the facts stated in the Proposal Form…*".

A fire damaged the premises and it was discovered that the sprinklers were off and many of the stored goods were not kitchenware. The insurer asserted that the insurance had been terminated, because there had been a material alteration to the premises or business or a material change in the facts stated in the proposal form.

The court found evidence that Mr Ansari must have known that the sprinklers were not active before the fire. This breach of General Condition 2 terminated the cover prior to the fire. Changes to the physical state of the building and its use were both relevant to the underwriter's assessment when the cover was granted. The court stated that the principle that a warranty or representation as to the condition of the insured premises was not to be treated as covering the future, without clear wording to that effect, should not operate to prevent the insurer from requiring notice to be given of any subsequent material change of fact.

The LC proposes that an insurer should not be able to rely on the breach of warranty: (1) if it was not material to the contract; or (2) as a defence to a claim for a loss that was in no way connected to the breach. For breaches of warranties as to the future, the LC proposes that insurers should be discharged from liability only where there is a causal connection between the breach and the loss. However, for businesses this will be part of a default regime and the parties will be able to contract out of it (subject to certain restrictions).

If Mr Ansari contracted as a business and warranted that the sprinkler system was operational and that the premises only stored kitchenware, the LC's proposals may not have altered the court's decision. Even if Mr Ansari could have shown that there was no connection between the breaches and the loss, the court may still have considered that General Condition 2 still stood or maybe even that it contracted the parties out of the LC's proposals (although it is likely that the LC's final proposals will require more specific wording to contract out).

No matter how well drafted the LC's final proposals are, there will inevitably be a transitional period after they come into force when insurers will have to grapple with how they should be applied (just as I have tried to do in this article). This should provide insurers with every incentive to provide their comments to the LC on the current proposals.

A version of this article was first published in Insurance Day.

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UPCOMING EVENTS

Reinsurance Law Seminar - Fraud in the current economic climate from an Insurance perspective

- Wednesday 25 March 2009 at 4.30pm
- Thursday 26 March 2009 at 8.30am

If you would like to attend the Seminar on either of the above dates, then please contact Tanya Godsave on 020 7760 4788 or tanya.godsave@blplaw.com.

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