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INSURANCE AND REINSURANCE

NewsWire

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Third-Party Litigation Funding Under English Law

by Adrian Mecz and Hoi-Yee Chan, in London

Third-party litigation funding is a relatively new breed of investment in the UK. A funder, typically a professional investor such as a hedge fund, invests funds into specifically selected litigation in return for an agreed proportion of any proceeds of that litigation. The potential return can be extremely attractive to investors and, with the Courts taking a fresh approach towards litigation funding, this form of investment is set to see significant growth in the next few years.

Until 1967, funding litigation for investment purposes was a criminal offence under English law, as it was considered to encourage unnecessary and vexatious litigation. The offence of "maintenance" prohibited third parties from being materially involved in the disputes of others and this included "champertous" agreements in which third parties shared in the proceeds of litigation. It was therefore only possible to fund litigation if the funder had a legitimate interest in the case — for example, liquidators or administrators of a company obtaining funding to litigate the claims of an insolvent company.

The criminal offences of maintenance and champerty were abolished by the Criminal Law Act 1967 but the legal principle remained that all contracts must be made in accordance with public policy. In recent years, general provisions for litigation funding agreements have been made by statute[1] and the Courts have clarified the boundaries of public policy in respect of acceptable third-party funding agreements. The general position of the Courts is that when third-party funding is used within the proper framework it can be an important way of enabling access to justice. The 2005 English Court of Appeal case of *Arkin*[2] dealt with the role and use of third-party funding agreements in litigation and, specifically, the costs liability of a third-party funder when the funded party was unsuccessful. In that case, an impecunious claimant brought a claim for alleged breaches of Articles 81 and 82 of the EC Treaty, funded by conditional fee agreements and in part by a third-party funder. The claim was unsuccessful / continued page 2

1 s28 Access to Justice Act 1999

2 [2005] EWCA Civ 655

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but the Court held that the defendants who successfully defended the claim should not be able to recover any costs from the claimant's third-party funder as to do so would generally discourage the funding of litigation. The defendants appealed this decision. The Court of Appeal allowed the appeal, holding that, if the third-party funding agreement was not objectionable (i.e., was not champertous), the third-party funder of an unsuccessful party could be held liable for the other side's costs, albeit limited to the extent of the funding provided.

In its judgment, the Court of Appeal made it clear that, in principle, third-party funding can be an acceptable form of funding litigation:

> *"Our approach is designed to cater for the commercial funder who is financing part of the costs of the litigation in a manner which facilitates access to justice and which is not otherwise objectionable. Such funding will leave the claimant as the party primarily interested in the result of the litigation and the party in control of the conduct of the litigation."*

In determining whether a funding agreement is "objectionable", the factors which the Courts have previously taken into account include:

- whether the funder attempts to assert any form of control over the proceedings;
- whether the agreed recovery percentage is fair; and
- whether the agreement facilitates access to justice.

The Court of Appeal in *Arkin* referred to the costs consequences of entering into an "objectionable" agreement, commenting:

> *"A funder who enters into such an* [champertous] *agreement will be likely to render himself liable for the opposing party's costs without limit should the claim fail."*

This is a useful warning, but in the current climate of acceptance of third-party funding, it seems that third-party funders should be able to avoid the pitfalls of entering into an "objectionable" agreement without undue difficulty.

As a result of the growth in third-party litigation funding, it is likely that regulation in this sector will follow. The Law Society Gazette recently reported that a forum of lawyers, judges, insurers, funders and regulators was convened by the Civil Justice Council in February 2008 to consider third-party funding going forward. The Gazette also reported that "*There was also a consensus that more formal regulation may be required*" and one of the main proposals discussed was to augment the security for costs provisions in the English Civil Procedure Rules. This would ensure that funders could not withdraw from their obligations under funding agreements. At present, no regulation has been formalised, but it is something that is likely to happen in the very near future.

Claimants Galore?

With the option of third-party funding, claimants with good claims, who would otherwise have been unable to fund claims, may now be in a position to pursue these claims. But litigation is rarely as simple as this. From a claimant's perspective, not all claims are guaranteed to find a third party willing to fund them, irrespective of their merit. Anecdotal evidence suggests that only about 10% of the cases put forward to professional funders are accepted. This may be because a high proportion of weak claims are submitted, but the professional funder will have its own criteria as to the claims that it is prepared to fund. This is an investment after all and the funder will consider the nature of the claims, the amount of risk it can and will take, the likelihood of recovering funds and the quantum of the claim. It may also have a limit on the length of time it will allow its funds to be tied up in a piece of litigation. But, despite the current limits in the availability of third-party funding, this is, again, a growth investment area. Potential claims with merit are sure to be considered by funders, particularly as confidence in this area grows and more investors enter the marketplace. If the choices for a party are to abandon a good claim or be given the chance to enter into a third-party funding agreement, then the answer appears obvious. Furthermore, once an impecunious claimant does find a financial backer, then at best the claimant stands to share in the proceeds of litigation it could not otherwise have afforded. Generally the funder will want a return of around 200-300% (but this varies and can be more) on its original investment in order to invest in a piece of litigation. If the claim is lost, then, as indicated above, the funder is likely to be liable for the costs in the usual way.

Mass claims for collective redress are also likely to be affected by the availability of third-party funding. In appropriate situations, the professional funding model can provide a beneficial means by which mass claims may be funded. For potential claimants who do not have the funds to mount claims individually, this provides access to justice. If the claimants have suffered identical damage, or liability can be shown in relation to a class

of claimants, the claims can be dealt with together and the funder will have far less case analysis to carry out. If the claims are being dealt with as a series, once one claim has been established as having merit, it can apply the same set of criteria to each claim in the action. In either case, an economy of scale can then be applied to the recovery in the action.

A recent Civil Justice Council report[3] recommended changes to the system to enable formal group litigation to be commenced more easily. The report suggested a move towards a system, as used in the US, where potential claimants "opt out" of a formal group claim instead of the current system where a claimants must "opt in" when the litigation commences. In the US, the "opt out" class action system has been much more heavily utilised than the UK "opt in" group litigation system, which has seen only 62 certified group actions[4] since its introduction in 2000. The changes may be some time away but, if they are implemented, the consequent increase in the number of group actions would inevitably lead to a growth in the requirement for professional funding in such actions.

Of course, there is a word of warning to potential claimants. Not all group actions can be conveniently bundled together and litigated collectively. In some cases the cause of damage may differ, even subtly, from case to case. For instance, in a disease-related claim, the damage may have been caused by environmental factors as well as the alleged cause. In those cases, the economy of litigating claims together may be lost and the outcome of each individual claim may vary. In this situation, the likelihood of securing professional funding is likely to be assessed in the same way as a stand-alone claim.

Defendants

Increased access to justice through litigation funding means that parties may find themselves facing claims that might not otherwise have been pursued. However, most companies will at least have a risk management strategy in place already. If not, now is definitely the time to ensure that a strategy is developed, or in the case of an existing strategy, that it is reviewed and updated. These measures may seem to be overly protective, time consuming and costly in the short term but if they are not put in place, in addition to the increased risk of litigation, there may also be other knock on effects such as increased insurance premiums.

Prospective defendants will undoubtedly be concerned that the availability of professional funding will increase the possibility of group actions being mounted. For example, a single employee or customer with a complaint, could now escalate into a group action that costs a company thousands if not millions. This is an area however, in which an entity can prepare itself to some extent. Potential claimants that might bring a group action can be identified: customers, employees, shareholders, directors, etc. The entity can then ensure that it has in place measures to reduce the likelihood of litigation being brought. Practical suggestions include having adequate and up to date complaints procedures, having in place alternative dispute resolution options and ensuring that the relevant people are notified of the procedures.

So what will be the impact if a party does end up facing opposition with third-party funding? In the current market, funders appear to be fairly cautious about accepting claims so parties facing a funded opposition can assume that the claim has been analysed as having a significant likelihood of success. Aside from this, the litigation should be conducted in the usual way as the professional funder is not permitted to take control of the proceedings. Nevertheless, there may be a psychological difference in the approach taken by the funded side. As a result of the evaluation that will have taken place prior to securing funding, they are more likely to be knowledgeable, less emotional and realistic about the litigation. This is not necessarily a disadvantage to the unfunded party. With the opposition being highly focussed on costs at an early stage, the opposition may be more prepared to enter into meaningful settlement negotiations as they will almost certainly have agreed with their funder the potentially acceptable settlement options.

The Future

When used within the legal framework set out by statute and by the Courts, third-party funding is an acceptable means of funding litigation for impecunious parties. For funders it is an attractive investment as, in most cases there is a significant level of predictability in the range of outcomes. For parties without financial means, professional funding agreements allow a more even playing field for litigation. The types of funding arrangement range in sophistication from the straightforward funding of claimants or defendants to more complex funding arrangements that may be designed to improve the flow of funds through a company. Of course, an increase in the number of claims will be a worry to those who may */ continued page 4*

[3] A research paper for submission to the Civil Justice Council of England and Wales dated 8 February 2008 entitled, "Reform of Collective Redress in England and Wales: A Perspective of Need".

[4] p9 "Reform of Collective Redress in England and Wales: A Perspective of Need" taken from HMCS official figures.

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end up facing them. However, the present legislative and judicial support for greater access to justice by means of third-party funding suggests that it is a valuable tool which is set to stay and indeed grow. ◎

The Sub-Prime Soup and Regulatory Reform in the US

by Richard Liskov, in New York

Insurers, along with other players in the financial services sector, face the deepening consequences of the collapse of the market for collateralized debt obligations and credit default swaps built on the shifting sands of sub-prime mortgages. The likely results of the current crisis for insurers will include some or all of the following:

Regulation of financial guaranty insurers will tighten considerably. No longer will insurance regulators leave it to the rating agencies to give their vaunted seals of approval and blithely accept the companies' assertions that so few defaults in the public sector bond business allows for only cursory oversight of their portfolios. State insurance departments in the US will strain to recruit specialists in highly complex asset-backed securities to be able to closely monitor those insurers' solvency.

Rating agencies themselves will undergo more stringent scrutiny. Considering the tremendous impact they can cause just by dropping major insurers one or two notches, the rating agencies will face demands from regulators for greater transparency and candor. Although First Amendment, free speech principles in the US will preclude the imposition of a detailed regulatory regime over their operations, rating agencies are likely still to undergo scrutiny from state attorneys general as to whether their published statements were misleading in violation of state deceptive trade laws because they had reason to know of the looming defaults. Indeed, one such inquiry, by New York's Attorney General, is now underway.

Credit default swaps will no longer be immune entirely from regulation. Spurred by securities lobbyists, in 2004 the New York State Legislature expressly exempted credit default swaps ("CDS") from insurance regulation of any kind in 2004. California's lawmakers acted similarly, although leaving open the possibility that a CDS could be deemed insurance in certain circumstances. Given the massive explosion in CDS deals in the past ten years and the impact on the markets, it should not be surprising if legislators in state capitals and Washington DC begin considering who should supervise them and how that supervision should occur. Whether federal banking supervisors, such as the Federal Reserve and Comptroller of the Currency, or the SEC acts as the regulator remains to be seen, but greater oversight in this area is certain, even if it is more likely to occur at the federal level than with state insurance departments.

State regulation of insurers will be under the microscope. Beyond the specific effects on financial guaranty insurers, the whole system of state regulation in the US is under challenge, although the prospect of having to "bail out" huge insurance losses will in all likelihood deter Congress from having the federal government take over from the states. Instead, proponents of an optional federal charter will gain more ammunition for their arguments that state regulators are just not equipped to properly regulate such a complex arena, while adherents of the current system can point to the alacrity with which New York and other states licensed Warren Buffett's new financial guaranty insurer as evidence that the system isn't (yet) broke.

In the meantime, other firms in the market, or seeking entry into it, are surely taking notes on how thoroughly responsive and efficient state regulators can be when they want to be. Having waived all kinds of licensing requirements for Mr. Buffett in record time, regulators will face similar demands for speedy approvals in a variety of contexts from other companies. ◎

Do Parties Require an Insurable Interest to Claim Under an Insurance Contract? Proposals for Reform in the UK

by Sally Mant, in London

On January 14, 2008, the Law Commissions of England and Wales and of Scotland (together the "LC") jointly published its fourth "issues" paper entitled "*Insurable Interest*" as part of the second phase of its review of UK insurance law. The first three issues papers and consultation paper, forming the first phase of this

review, dealt with reform proposals in relation to misrepresentation, non-disclosure and breach of warranty, as discussed in the November 2007 edition of our *NewsWire*. In short, the overall aim of the LC review is to ensure that UK insurance law balances the interests of insured and insurer, reflects the needs of modern insurance practice and allows both insured and insurer to appreciate their respective rights and obligations. The second phase of the LC's review will also encompass post-contractual good faith (including fraud and damages for late payment of claims). The LC ultimately aims to present a Bill to Parliament for approval in 2010.

Introduction

The fourth issues paper sets out the LC's preliminary thinking on insurable interest. It is not a formal consultation paper, although the LC seeks views on its proposals for reform by April 11, 2008.

The fourth issues paper presents specific proposals in relation to (i) indemnity insurance (such as liability or property cover) where the insured may only recover the amount it has lost (the "indemnity principle") and (ii) non-indemnity insurance (such as life and critical illness cover), where the insured receives a set amount, following a certain event. In this article, we focus on the law of insurable interest as it affects indemnity insurance and in particular, non-marine indemnity insurance.

What is an Insurable Interest?

The current law in relation to insurable interest derives from both statute and common law and, broadly defined, it requires that the insured must gain a benefit from the preservation of the insured subject matter or suffer a disadvantage if it is lost. Therefore, unless the insured has an "equitable" or legal relationship with the insured subject matter, it cannot enforce the insurance contract. The concept of insurable interest exists to define what insurance is and to differentiate it from other financial contracts and from gambling. It evolved due to concerns surrounding undesirable social effects arising from insurance, such as gambling and "moral hazard" (which is the risk that allowing a person to insure creates an incentive to destroy the subject matter of the insurance).

The Current Law in Relation to Indemnity Insurance

Non-marine indemnity insurance was governed until recently by the Gambling Act 1845, which provided that the insured must have an insurable interest, in other words a legal or equitable interest in the insured subject matter or a right to it under contract, in order to enforce the insurance contract. Without that interest, the insurance contract became unenforceable.

The Gambling Act 2005 (the "Act"), which came into force on September 1, 2007, appears, however, to have removed the requirement for insurable interest from non-marine indemnity insurance contracts. Under English law, it appears likely that there is no longer any need for a policyholder to demonstrate an insurable interest at the time of loss in order to have an enforceable contract. The change in law may have been accidental rather than intentional, as the effect of the Act on indemnity insurance contracts was not considered by Parliament when the Act was passed; as a result, the impact of the Act expressly on indemnity insurance is unclear.

Marine indemnity insurance is governed by section 4 of the Marine Insurance Act 1906 (the "MIA"), which defines insurable interest in terms of a marine "adventure" where the potential assured *"stands in any legal or equitable relation to the adventure or to any insurable property at risk therein"*.

Insurable Interest and the Indemnity Principle

In indemnity insurance contracts, the indemnity principle operates so that an interest in the insured subject matter must exist at the time of the loss for the insured to be able to enforce the insurance contract. Whether the indemnity principle can allow the insured to recover under an indemnity policy where there is no legal/equitable interest or pecuniary loss (in other words, no insurable interest) is not certain, as the principle has only been tested in the context of statutory definitions of insurable interest. Therefore, the amount the insured could recover was limited to its legal or equitable relationship with the insured subject matter and it has not been investigated whether the indemnity principle would enable the insured to be compensated for any loss that did not arise out of a legal or equitable relationship.

The indemnity principle applies, by implication or express provision, to all contracts of indemnity insurance and, as it is a contractual term, it may be possible to amend or waive the requirement for loss. Consequently, in practice the law appears to recognise losses under the indemnity principle that do not involve legal liability. For example, a reinsurance contract (by way of a "follow the settlements" clause) can provide that the reinsurer shall pay a reinsured's claim without forcing it to prove actual legal liability where the reinsured has entered into a bona fide and businesslike settlement.

Why is There a Need for Reform of the Law Relating to Insurable Interest?

The LC has concluded that the law on insurable interest is not always consistent and is governed by different statutes depending on the subject matter of the insurance. As outlined above, insurable interest for marine insur- / continued page 6

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ance is defined in the MIA, whereas non-marine indemnity insurance is (it appears) governed by the Act, whilst non-indemnity life insurance is governed by the Life Assurance Act 1774. Furthermore, there is no single rule as to whether proof of an insurable interest is required and, if so, whether it is required when the policy is taken out or when the loss is suffered. The LC has also concluded that the law on insurable interest is overly complex and often difficult to analyse — therefore it is equally difficult for insurers to understand and apply the law.

In the light of the LC's review and, in particular, the recent changes in the law concerning non-marine indemnity insurance, the LC questions whether the concept of an insurable interest remains necessary, in its present form, for the insured to enforce the insurance contract.

Is Insurable Interest Necessary to Define Insurance?

As discussed above, the concept of an insurable interest came into existence to define insurance and differentiate it from other financial contracts and from gambling. As part of the LC's review, the Financial Services Authority has stated that it believes that it would still be possible to distinguish insurance from other products without insurable interest. Moreover, Australia has managed since 1995 without a statutory requirement for insurable interest, both for indemnity and non-indemnity insurance and the LC has not found any evidence that this has caused problems in Australia when distinguishing insurance from other contracts. (It should be noted, however, that insurable interest remains relevant in Australia for underwriting purposes; for example, it is used by underwriters to assess proposals and to determine risk.)

The LC Recommendations for Non-Marine Indemnity Insurance

- The LC points out that, as the indemnity principle requires the insured to have suffered a loss, this principle is therefore sufficient to distinguish insurance from gambling and to prevent any moral hazard associated with insurance contracts.
- The LC also highlights that the traditional concept of insurable interest has been expanded in recent years, so that it is possible to argue that there is no longer much difference between it and the indemnity principle. Consequently, if a statutory definition of insurable interest is not reintroduced, the emphasis will be on the insurance contract and its definition of loss which, the LC believes, would bring about greater certainty for insureds and insurers that the contract is valid.
- The LC's tentative view is that it would be difficult to justify reintroducing a statutory requirement for insurable interest for indemnity contracts, as this could lead to fresh confusion and bring little benefit.

Conclusion

As well as asking whether insurable interest is still necessary to define insurance and to enforce the insurance contract, the LC asks whether there should be a legal requirement on indemnity insurers themselves to check whether there is sufficient possibility of an indemnifiable loss before the insurance contract is concluded, in order to ensure that the contract will be enforceable and to prevent the risks associated with moral hazard. The LC understands that most insurers would do this already for underwriting purposes, but it asks for opinions as to whether this should be made a legal requirement or left to regulation. It would be particularly worthwhile for indemnity insurers to consider the implications for them if this underwriting step became a legal requirement, rather than merely being left to some form of regulation. ◎

22 Years and Holding: A Spotlight on Supervision of Insolvent Companies as the Union Indemnity Insurance Liquidation Awaits an Order of Distribution

By Donald J. Mros & Kate McSweeny, in Washington

When the insolvent Union Indemnity Insurance Company was taken over by New York regulators in July 1985, no one would have predicted that 2008 would ring in without a single dollar having been paid out of the estate. But that is what happened. Now, after more than 22 years, it seems the first distribution from the Union Indemnity estate may occur this year.

On October 10, 2007, the New York Department of Insurance ("Insurance Department") filed a motion with the New York Supreme Court to approve the liquidator's initial report on Union Indemnity, to set November 15, 2007 as the bar date for claims to be presented (other than administrative costs and expenses) and to pay administrative costs and expenses incurred to date. It also asked the court to permit a distribution to the extent of the available assets to creditors with allowed claims.[1]

The next step calls for a hearing for any creditors and other interested persons who wish to argue against granting the Insurance Department's motion. Although originally set for December 18, 2007, the hearing and a decision on the Insurance Department's motion have been stayed pending assignment of the Union Indemnity matter to a new judge, the original judge having been elevated to the appellate bench. At the time of this writing, a new judge has not been assigned.

Union Indemnity, a wholly owned subsidiary of broker Frank B. Hall, Inc., was incorporated and licensed in New York as a stock casualty insurer on October 10, 1975. It concentrated its business in personal and commercial lines, with a particular focus on nine insurable risks, including automobile, general liability and fire. It also reinsured other insurer's risks. By the time the New York State regulators placed it into liquidation less than ten years later, Union Indemnity was insolvent by more than $16 million.

In 1987, the State of New York filed a first-of-its-kind lawsuit against Frank B. Hall & Co. alleging that the broker had "neglected and abused" Union Indemnity, had used it as a loss leader to bolster its other business units and, in doing so, had defrauded Union Indemnity's policyholders and violated New York insurance laws. Also named were 29 of the broker's and insurer's directors and officers and the broker's auditor.[2] The suit settled for $48 million in June 1989, and payments were made to the Union Indemnity estate for the benefit of policyholders over the next ten years. Still no distribution was made.

The Insurance Department lays the blame for the 22-year delay in filing an initial report or making any distributions squarely at the door of the New York Liquidation Bureau ("NYLB"), which acts as the receiver for insolvent insurance companies.[3] According to the Insurance Department, the NYLB has a history of management problems, which have directly conflicted with its duties. In the Union Indemnity matter, the NYLB's duties included identifying and notifying interested parties; marshalling Union Indemnity's assets; adjudicating claims and determining Union Indemnity's liabilities; distributing Union Indemnity's assets; and otherwise liquidating Union Indemnity's business. The Insurance Department has the obligation to file an initial report but, as it informed the New York Supreme Court, poor management at the NYLB delayed it in doing so.[4]

The new Special Deputy Superintendent, Mark G. Peters, has been charged with making sweeping reforms at the NYLB. The NYLB's 2007 Year-End Report made commitments to, among other matters, increasing distributions to policyholders and creditors and improving estate management.[5] It specifically identified the resolution of the Union Indemnity liquidation as a priority for the NYLB, which has "taken the steps necessary to begin paying policyholders and other creditors who have waited decades to be compensated for past injuries."[6]

To date, more than 31,000 proofs of claim have been filed in the Union Indemnity liquidation, including more than 25,000 claims from the New York security and guaranty funds and general credit policyholders. Their collective claims alone total over $273 million. In addition, there are 3,450 claimants holding policyholder protection claims that were made in a timely fashion although no specific claim was identified. Protected long-tail claims have thus continued to be filed in the 22 years since the liquidation proceeding began. Other creditors include general creditors, cedents and those with non-policy related claims.

Under New York's priority scheme for distribution of an insolvent insurer's assets, creditors are divided into nine classes, each of which must be paid in full before making any distribution to the next class. The first class of creditors is the liquidator itself, for reimbursement of the estate's administrative costs. In the Class 2 position are policyholders, including the security and guaranty funds. With approximately $100 million available in the Union Indemnity estate, however, only Class 1 creditors are likely

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1 See In the Matter of the Liquidation of Union Indemnity Ins. Co., Index No. 41292/85 (Sup. Ct. N.Y. Co. 2007).

2 See Corcoran v. Frank B. Hall & Co., Index No. 5273/87 slip op. (Sup. Ct. N.Y. Co., Nov. 2, 1988) aff'd 149 A.D.2d 165 (1st Dep't 1989). Furthermore, the specter of fraud raised by the Frank B. Hall litigation ultimately led to Union Indemnity's reinsurers successfully retaining $200 million in what would have otherwise been Union Indemnity's reinsurance recoverables.

3 *Initial Report on the Status of the Liquidation of Union Indemnity*, annexed to In the Matter of the Liquidation of Union Indemnity Ins. Co., Index No. 41292/85 (Sup. Ct. N.Y. Co. 2007).

4 Id.

5 See NYLB 2007 Year-End Report, Jan. 24, 2008, available at http://www.nylb.org.

6 Id.

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to be paid in full. Class 2 policyholders will receive a pro rata share of the remainder of the estate. The remaining creditors, whose claims have also waited 22 years to be satisfied, are unlikely to receive anything at all when the first distribution is finally made.

The Union Indemnity matter is but one example of the time it can take for distributions to be made in US insolvency proceedings and the length for such proceedings is a key criticism frequently leveled at the US system. Only time will tell whether reforms such as those proposed for the NYLB will work in practice to alleviate such concerns. ◎

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