

INSURANCE AND REINSURANCE

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Section 1782: Big News for International Reinsurance Arbitrations

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There is big news in the world of private international arbitration, and this news should be of particular interest to those engaged in reinsurance disputes.

It should now be considerably easier for parties embroiled in a foreign dispute to obtain disclosure from non-parties in the United States. This could be especially helpful to reinsurance arbitrations with a London or Bermuda seat that are in need of evidence from witnesses who are not subject to the arbitration clause. Disclosure applications in such disputes can be made to U.S. federal courts under 28 U.S.C. § 1782 (“Section 1782”), and recent developments in U.S. law hold great promise for their success. Although relief under Section 1782 in private international arbitrations is not a certainty, Section 1782 has come to light as a less cumbersome and more helpful alternative to current procedures for accessing third-party disclosure.

Section 1782 has several noteworthy features in addition to not needing to apply to the courts in the foreign jurisdiction for letters rogatory or the like. An applicant need not obtain the approval of an arbitration tribunal before making its Section 1782 request directly to the U.S. federal court. Also, relief under this statute can be requested by an “interested party” before an arbitration has been initiated, as long as an arbitration is reasonably contemplated. The application can be made on an *ex parte* basis, meaning that the adversary and the party from whom the discovery is sought do not need to be notified in advance of the filing.

Moreover, although a controversial point, relief under Section 1782 is technically broader than what is available in U.S. arbitrations subject to the U.S. Federal Arbitration Act (“FAA”).¹ The latter grants authority to arbitrators to compel evidence from U.S. third parties, but the parties to the arbitration — and certainly not parties

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¹ 9 U.S.C. § 1-16 (1999).

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merely contemplating litigation — have no ability on their own to subpoena testimony and documents. Additionally, an applicant for Section 1782 relief may conceivably obtain disclosure broader than what it would have been entitled to in the foreign jurisdiction under foreign rules, as U.S. federal standards of relevance, i.e., what appears reasonably calculated to lead to the discovery of admissible evidence, can be significantly more liberal than the rules of disclosure in certain foreign jurisdictions.

Section 1782 is not new but only recently has attracted attention in commercial arbitration circles. Since 1964, the statute has provided assistance to foreign tribunals, litigants, and parties anticipating arbitrations in gathering evidence from persons residing or located in the United States.² At that time, the U.S. Congress amended Section 1782 to assist “foreign or international tribunals” and not just “judicial proceedings in any court” as the statute was enacted in 1958. This change caused much controversy as to whether *private* arbitration tribunals and *private* parties could take advantage of this statute. Two federal appellate courts that issued decisions in 1999 rejected this proposition, holding that Section 1782 assistance extended only to *governmental* entities acting as state instrumentalities or with the authority of the state and thus was not available to those involved in private foreign arbitrations deciding commercial disputes.

In 2004, however, the U.S. Supreme Court in *Intel Corp. v. Advanced Micro Devices, Inc.*, 542 U.S. 241 (2004), took an expansive view of “foreign or international tribunal,” albeit only in *dicta*. This was enough to encourage four federal district courts — as well as several commentators and the New York City Bar — to endorse an interpretation of Section 1782 that would allow a party to a private international arbitration to obtain disclosure from U.S. third parties under U.S. discovery rules. While no definitive pronouncement has yet come from a U.S. circuit court, these recent developments regarding Section 1782 suggest that tribunals, litigants, and parties contemplating arbitration may have increased access to disclosure in private international disputes. Correspondingly, U.S. non-parties may have increased exposure to disclosure demands from such foreign disputes.

These developments are particularly meaningful for parties to international arbitrations in the reinsurance and insurance industry when a U.S. party plays an important role in the transaction but is not a party to the contract and thus is outside the

reach of the disclosure process. This is frequently the case when companies or business associations form captive insurers, negotiate reinsurance for their captives, and handle their claims, yet do not sign the reinsurance agreement and thus are not within the authority of an arbitration tribunal acting in a contract dispute. Section 1782 may be employed to obtain evidence from the captive’s parent. It may also be used in contingent cost insurance arrangements where non-party related entities originate and service the business underlying the insurance and are likely to have information critical to the dispute. Section 1782 may be a useful mechanism in these situations. It may also be used to compel disclosure in traditional insurance and reinsurance situations where non-party intermediaries, agents, and pool managers play an important role in the placement and management of the business at the heart of the dispute. Section 1782 may well be a blessing for the disclosure applicant in these situations — and, correspondingly, a curse for the recipient of the disclosure demand.

NBC and Biedermann

This anticipated use of Section 1782 in private arbitrations was a long time coming. For the last decade, Section 1782 relief was off limits to private litigants and tribunals in foreign arbitration proceedings, at least according to the Second and Fifth Circuit Courts of Appeals. The decisions of these courts in *National Broadcasting Co. v. Bear Stearns & Co.*, 165 F.3d 184 (2d Cir. 1999) (“NBC”), and *Republic of Kazakhstan v. Biedermann International*, 168 F.3d 880 (5th Cir. 1999) (“Biedermann”), were clear that Section 1782 did not extend to international arbitrations with no public or governmental affiliation.

In *NBC*, the U.S. Court of Appeals for the Second Circuit upheld the district court’s ruling that a private commercial arbitration in Mexico administered by the International Chamber of Commerce did not qualify as a “proceeding in a foreign or international tribunal” under Section 1782(a),

² Section 1782 of Title 28 of the United States Code, entitled “Assistance To Foreign And International Tribunals And To Litigants Before Such Tribunals,” provides in pertinent part that:
The district court of the district in which a person resides or is found may order him to give his testimony or statement or to produce a document or other thing for use in a proceeding in a foreign or international tribunal, including criminal investigations conducted before formal accusation. The order may be made pursuant to a letter rogatory issued, or request made, by a foreign or international tribunal or upon the application of any interested person and may direct that the testimony or statement be given, or the document or other thing be produced, before a person appointed by the court.

thereby precluding NBC from compelling third-party financial institutions to produce documents. The appellate court reasoned that the language of the statute, i.e., “foreign or international tribunal,” was sufficiently ambiguous so as not to include or exclude the arbitral panel at issue.³ Turning to the legislative history and purpose of Section 1782 to resolve the perceived ambiguity, the Court concluded that the drafters of the revised statute intended “tribunals” to include only “governmental entities, such as administrative or investigative courts, acting as state instrumentalities or with the authority of the state.”⁴ Additionally, the Court reasoned that the drafters’ silence with respect to private dispute resolution proceedings such as arbitration meant that Congress did not intend an extension of the statute to private arbitrations.⁵

The *NBC* Court did not find it appropriate to authorize discovery in foreign arbitration proceedings that would be broader than what U.S. arbitration panels would be allowed under the Federal Arbitration Act (“FAA”).⁶ The FAA allows *arbitrators only* to subpoena witnesses and direct those witness to bring documentary evidence with them to an arbitral hearing within a 100-mile radius of where the witness can be found. Also, the federal courts are split on interpreting the FAA to allow documents and testimony to be compelled from third parties before the arbitration hearing takes place.⁷ There is no similar restriction under Section 1782.

The Court of Appeals for the Fifth Circuit in *Biedermann* adopted the *NBC* reasoning. The *Biedermann* court, too, made much of the fact that federal courts under Section 7 of the FAA enforce arbitrators’ subpoenas only and only within the district in which the arbitrators, or a majority of them, are sitting.⁸ The Court referred to the *NBC* Court’s point that third-party pre-hearing discovery may not be available in certain federal courts.⁹ The *Biedermann* court did not think it likely that Congress intended that federal courts would give broader discovery rights to foreign arbitrations than to those at home.¹⁰ There was simply no evidence, according to the Court, that Congress revised Section 1782 in 1964 to accommodate private

international arbitrations. Rather, the statute was expanded to help foreign government-sanctioned tribunal and to further “comity among nations.”¹¹

Neither the *NBC* nor *Biedermann* Courts thought much of the opinion of Professor Hans Smit, considered by some to be the “dominant drafter” of the revision to Section 1782 in 1964.¹² Professor Smit asserted repeatedly that the “substitution of the word ‘tribunal’ for ‘court’ was deliberate, claiming that the drafters wanted to make the assistance provided for available to all bodies with adjudicatory functions. Clearly, private arbitral tribunals come with the term the drafters used.”¹³ Other commentators agreed with Smit,¹⁴ but the *NBC* and *Biedermann* Courts dismissed Smit’s view as not relying on “any special knowledge concerning legislative intent”¹⁵ and as unsupported by any contemporaneous notes that private commercial arbitrations were contemplated at the time Section 1782 was revised.¹⁶ Moreover, the *NBC* Court saw potential problems with determining what was an *international or foreign tribunal*. Smit had said that the statute would apply if any of the parties or arbitrators were not citizens or residents of the U.S., or if the arbitration was held outside of the U.S. or / continued page 4

³ *NBC*, 165 F.3d at 188.

⁴ *Id.* at 189.

⁵ *Id.* at 189-190.

⁶ *Id.* at 191.

⁷ *Id.* at 188.

⁸ *Biedermann*, 168 F.3d at 883.

⁹ *Id.* at 883 & n.8.

¹⁰ *Id.* at 883.

¹¹ *Id.*

¹² Professor Smit served as Director of the Columbia Law School Project on International Procedure, the entity that drafted the 1964 revisions to Section 1782 and functioned as the reporter for the U.S. Commission and Advisory Committee on International Rules of Judicial Procedure. Professor Smit has been referred to as the “dominant drafter of, and commentator on” the 1964 revision of Section 1782 and its “chief architect.” *In re Letter of Request from the Crown Prosecution Service of the United Kingdom*, 870 F.2d 686, 689 (D.D.C. 1989); *In re Application of Euromepa*, 51 F.3d 1095, 1099 (2d Cir. 1995).

¹³ Hans Smit, *American Assistance to Litigation in Foreign and International Tribunals: Section 1782 of Title 28 of the U.S.C. Revisited*, 25 *Syracuse J. Int’l & L. Com.* 1, 1-6 (Spring 1998); *The Supreme Court Rules on the Proper Interpretation of Section 1782: Its Potential Significance for International Arbitration*, 14 *Am. Rev. Int’l Arb.* 295, 314 (2003).

¹⁴ *E.g.*, Lawrence W. Newman, “*Obtaining Evidence in the United States for Foreign Proceedings*,” 90 *Am. Soc’y Int’l L. Proc.* 62, 70 (March 27-30, 1996) (“it is hard to think of an international tribunal other than a court or an arbitration panel”); Walter B. Stahr, “*Discovery Under 28 U.S.C. § 1782 for Foreign and International Proceedings*,” 30 *Va. J. Int’l L.* 597, 619-20 (Spring 1990) (“[i]t is clear ... that the term ‘international tribunal’ includes an international court, arbitration or other tribunal located in a foreign country.”); Peter F. Schlosser, “*Coordinated Transnational Interaction in Civil Litigation and Arbitration*,” 12 *Mich. J. Int’l L.* 150, 170 n.84 (Fall 1990) (the scope of ‘tribunal’ should include international arbitrations).

¹⁵ *NBC*, 165 F.3d at 190 & n.6.

¹⁶ *Biedermann*, 168 F.3d at 882 & n.4.

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under foreign laws.¹⁷ The *NBC* Court thought that this interpretation would lead parties to game the system by appointing a non-U.S. arbitrator to render a purely domestic dispute an international or foreign arbitration.¹⁸ There would be more disputes, according to the Court, as the parties debated the correct characterization of the tribunal and the availability of Section 1782 and thus provide another reason why the statute's scope should not include private arbitrations.

Intel

Five years later, however, came the decision of the U.S. Supreme Court in *Intel Corp. v. Advanced Micro Devices, Inc.*, 542 U.S. 241 (2004). The Supreme Court's decision in *Intel* made several pronouncements on Section 1782 that cast doubt on the narrow views held by the Second and Fifth Circuit Courts.¹⁹ The Court first decided that an applicant for Section 1782 relief need not be a party to a pending or imminent proceeding. Rather, the Court found that "interested persons" entitled to invoke the statute could be those parties who reasonably contemplated that the requested evidence would be used in an adjudicative proceeding.²⁰

Additionally, the Court rejected the idea that the discovery permitted by the federal court under Section 1782 should not be broader than what would be permitted in the foreign jurisdiction. The U.S. Congress which enacted the statute did not impose such a restriction, according to the Court, and there is no reason to believe that a country that did not have the discovery mechanisms available in the United States would be offended at their use. Moreover, reasoned the Court, the for-

eign arbitration tribunal could always place restrictions on the admission of evidence gathered under U.S. rules to maintain whatever parity it thought was appropriate with local procedures.²¹

Most noteworthy about the *Intel* decision, however, was the ruling about the types of foreign tribunals covered by the statute. Because *Intel* concerned the issue about whether Section 1782 could be used in connection with a complaint before the European Commission, the executive and administrative organ of the European Communities,²² the issue of whether *private* international arbitrations were covered under the statute was not squarely before the Court. However, in determining whether the European Commission qualified as a tribunal under the statute, the Court found that Section 1782 relief had been extended to "quasi judicial" agencies, as recorded by the U.S. Senate in its legislative report and by Professor Smit.²³ Because the European Commission not only conducted investigations but acted as a "first-instance decisionmaker," the Court reasoned it exercised quasi-judicial powers and was included within Section 1782's ambit.²⁴

The Court's broad reading of "tribunal," its refusal to place categorical limitations on the statute's applicability, and its rejection of making comparisons between foreign and domestic disclosure law, called into question the decisions in *NBC* and *Biedermann*. Four federal courts did just that in the wake of *Intel* and have laid the groundwork for arguments that Section 1782 should be available in private arbitrations.

Oxus Gold

The first such decision was that of the U.S. District Court for New Jersey in *In re Oxus Gold PLC*, No. 06-82-GEB, 2007 WL 1037387 (D.N.J. Apr. 2, 2007). *Oxus Gold* arose from an international arbitration between private litigants disputing alleged violations of an international bilateral investment treaty. The Court upheld the magistrate's decision to grant the petitioner's Section 1782 application based on the broad definition

¹⁷ Hans Smit, 25 Syracuse J. Int'l & L. Com. at 1-6, as cited in *NBC*, 165 F.3d at 190, n.9.

¹⁸ *NBC*, 165 F.3d at 191, n.8.

¹⁹ *Intel* involved an antitrust complaint filed against Intel Corporation with the Directorate-General for Competition of the European Commission (the "Commission"). The complainant asked the Commission to compel Intel to produce documents that it had produced in a private antitrust lawsuit in Alabama. The Commission declined to seek judicial assistance from U.S. courts, so the complainant filed a Section 1782 application seeking production of the documents. The U.S. District Court for the Northern District of California denied the application. The U.S. Court of Appeals for the Ninth Circuit reversed that determination and remanded the case. The Supreme Court accepted the case to resolve "the question whether Section 1782(a) contains a foreign-discoverability requirement." *Intel*, 542 U.S. at 253.

²⁰ *Id.* at 256.

²¹ *Id.* at 259-263.

²² *Id.* at 258.

²³ Justice Ginsburg examined the legislative history of Section 1782 and quoted the 1965 article authored by Professor Smit, which states that "[t]he term 'tribunal'...includes investigating magistrates, administrative and arbitral tribunals, and quasi-judicial agencies, as well as conventional civil, commercial, criminal, and administrative courts." *Id.* at 258, citing Hans Smit, "International Litigation Under the United States Code," Colum. L. Rev. 1015, 1026-27, n. 71, 73 (1965).

²⁴ 542 U.S. at 258.

of “tribunal” in *Intel* and the fact that the arbitration was required by an international treaty, rather than by a private contract as in *NBC*. While not rejecting *NBC* or *Biedermann*, the Court stretched their requirement that an arbitration tribunal for Section 1782 purposes had to be a governmental or inter-governmental adjudicatory body. Because the arbitration in *Oxus Gold* was being conducted pursuant to the adjudicatory authority and procedures specified in an agreement between nations, the Court found that the magistrate’s ruling that the arbitration panel was a foreign tribunal for Section 1782 purposes was not “clearly erroneous or contrary to law.”²⁵

Roz Trading

The U.S. District Court for the Northern District of Georgia took an even bolder position by upholding the finding that Section 1782 could be used in private international arbitrations and by criticizing *NBC* and *Biedermann* as inconsistent with the U.S. Supreme Court’s guidance in *Intel*. At issue in *In Re Roz Trading Ltd.*, 469 F. Supp. 2d 1221 (N.D. Ga. 2006), was whether Section 1782 relief would be available to a private international arbitration before a private institution whose proceedings were voluntary. The Court found that “common usage” and the “widely accepted definition” of “tribunal” as used in the 1964 revision to the statute encompassed private foreign arbitration panels.²⁶ According to the Court, there was no basis in the text of Section 1782 to distinguish between public and private arbitration tribunals. Because the term “tribunal” was not ambiguous, the Court said it was unnecessary and unpersuasive for the Second Circuit Court in *NBC* (and the Fifth Circuit Court in *Biedermann*) to have examined the statute’s legislative history as to the definition of “tribunal” and to impose its own interpretation of that term.²⁷ However, even if the statute’s legislative history were considered, the Court found that the 1964 amendments opened up Section 1782 to administrative and quasi-judicial proceedings. Also, in light of *Intel*, the Court found that the tribunal at hand acted as a “first-instance decisionmaker” that issues decisions “both responsive to the complaint and reviewable in court.” As such, according to the Court, it must be considered a tribunal under Section 1782.²⁸

²⁵ *Oxus Gold*, slip op. at *5.

²⁶ *Roz Trading*, 469 F. Supp. 2d at 1225.

²⁷ *Id.* at 1228 & n.6.

²⁸ *Id.* at 1225-6.

Hallmark and Babcock

The next year, the U.S. District Court for the District of Minnesota also embraced the *Intel* ruling – noting that the views of Professor Smit had been cited approvingly six times by the *Intel* Court — and concluded that the assistance provided by Section 1782 could extend to private foreign arbitration panels. In *In re Hallmark Capital Corp.*, 534 F. Supp. 2d 951 (D. Minn. 2007), the Court rejected the *NBC* and *Biedermann* view that the potential differences in discovery between what would be allowed under the FAA and the foreign arbitration worked against permitting Section 1782 to be available in private foreign arbitrations.²⁹ The Court also relied on the common-usage definition of “tribunal” and agreed with the *Roz Trading* Court’s observation that Congress in enacting the 1964 statutory amendments could easily have put the word “governmental” before “tribunal” to indicate that private arbitrations did not qualify for relief under the statute.³⁰

Similarly, the U.S. District Court for the District of Massachusetts *In re Babcock Borsig AG*, No. 08-mc-10128-DPW, 2008 WL 4748208 (D. Mass. Oct. 30, 2008), rejected the reasoning of the decisions in *NBC* and *Biedermann*. Although the Babcock Court ultimately denied the Section 1782 application on discretionary grounds,³¹ the Court found that the private arbitral body operated by the International Chamber of Commerce qualified as a “tribunal” under the statute as a “first instance decisionmaker” that conducts proceedings “which lead to a dispositive ruling.”³² The Court specifically rejected the reasoning in *NBC* and *Biedermann* which made a distinction between public and private tribunals, finding that that reasoning had been rejected by the U.S. Supreme Court in *Intel*.³³

A Dissenting View: El Paso

One federal court, however, has not / continued page 6

²⁹ *Hallmark*, 534 F. Supp. 2d 951, 956-957.

³⁰ *Id.* at 954.

³¹ Although the *Babcock* Court noted that Section 1782 authorized it to order the requested third-party discovery without waiting for an arbitration to be pending or imminent and without knowing whether the tribunal would be receptive to it, the Court did not order the discovery at that stage, perhaps questioning whether this application represented a tactical maneuver more than a sincere need for the third-party discovery, as the Court cited the “bad blood” between the parties and the fact that two years had passed after the alleged misconduct had been discovered with no arbitration having been demanded. *Babcock*, slip op. at *8.

³² *Id.* at *4.

³³ *Id.* at *5.

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jumped on the Section 1782 bandwagon, nor could it realistically be expected to depart from controlling precedent in its circuit. In *La Comision Ejecutiva Hidroelectrica Del Rio Lempa v. El Paso Corp.*, Misc. Action No. H-08-335, 2008 WL 5070119 (S.D. Tex. Nov. 20, 2008), the U.S. District Court for the Southern District of Texas first granted a Section 1782 application but then reversed its order, claiming an error on its part and citing its lack of authority to consider Section 1782 relief in a private international arbitration.³⁴ On the motion for reconsideration, the court gave its reasons for belatedly disagreeing that *Intel* gave the “green light” to federal courts to grant Section 1782 applications in private arbitrations. Likely the most influential reason for the court’s reversal, however, was the *Biedermann* ruling in the Fifth Circuit. As the court explained, in *Biedermann*, “the Fifth Circuit [spoke] precisely on this issue and resolved that ambiguity against use of Section 1782 for arbitral tribunals. Thus, the course charted for this court is clear.”³⁵

New York City Bar

Taking a different view, however, and supporting the availability of Section 1782 in private foreign arbitrations was the New York City Bar, whose International Commercial Disputes Committee published a Report on the issue in 2008 (“28 U.S.C. § 1782 As A Means of Obtaining Discovery In Aid of International Commercial Arbitration — Applicability And Best Practices” (the “Report”). Albeit lacking judicial clout, the legislative review and analysis in the *Report* may well have some influence as courts face this issue in the future, perhaps even in the world outside of New York.

The *Report* squarely rejected the reasons advanced by the *NBC* and *Biedermann* decisions for denying Section 1782 assistance in private arbitrations.³⁶ However, presumably to placate concerns expressed by those courts and commentators³⁷ opposed to an expansive view of Section 1782, the *Report* suggested that federal district courts use the discretionary authority they have under the statute in considering Section 1782 applications and grant those applications only with certain restrictions.

For example, the *Report* recommends certain “best practices” such that Section 1782 discovery be granted only if the application has been approved by the tribunal, ostensibly to keep the parameters of the discovery under the tribunal’s control and direction.³⁸ This would mean that applications made

by interested parties before the tribunal had been constituted would likely fail, even though the statute permits such discovery. Also, to avoid litigation on the issue of whether an arbitration was a *foreign* or *international* proceeding within the purview of the statute, the *Report* proposes an objective test based on the seat of the arbitration. This would mean that only arbitrations located outside the United States would be eligible proceedings under Section 1782. These self-imposed restrictions may indeed make it easier for a court in the Second or Fifth Circuits to take issue with the *NBC* and *Biedermann* rationale, but this remains to be seen in the cases to come.

The State of Play

Notwithstanding the “best practice” recommendations of the New York City Bar, Section 1782 remains on the books with

³⁴ *El Paso*, slip op. at *1-2.

³⁵ *Id.* at *5.

³⁶ *Report* at 25-27.

³⁷ Certain practitioners and commentators do not agree that extending Section 1782 aid to private international arbitrations is a good idea. E.g., Eric Schwartz & Alan Howard, *International Arbitration Discovery Applications to Rise?*, 237 N.Y.L.J. 4 (2007) (noting that, if applicable to arbitration proceedings, Section 1782 “opens the door to possible judicial interference by U.S. courts with the arbitral process, contrary to the parties’ legitimate expectations when agreeing to arbitration” and hands foreign companies operating outside the jurisdiction of U.S. courts “a weapon against U.S. opponents that could not, in turn, be deployed against them”); Anna Conley, “A New World of Discovery: The Ramifications of Two Recent Federal Courts’ Decisions Granting Judicial Assistance to Arbitral Tribunals Pursuant to 28 U.S.C. § 1782,” 17 Am. Rev. Int’l Arb. 45, 46, 72 (2006) (opining that extending Section 1782 relief will “give parties to international arbitration proceedings a vastly different set of rights and obligations than parties to domestic arbitrations or those seeking judicial assistance from foreign courts” and will “undermine many of the policies underlying arbitration”). One commentator echoed the policy concern that “a broad reading of Section 1782 would yield the anomalous result that parties to foreign arbitrations could obtain broader discovery than parties to proceedings before ‘domestic arbitration panels’ could under Section 7 of the Federal Arbitration Act (FAA).” John Fellas, “Using Section 1782 in International Arbitration,” 23 Arbitration International 379, 399-400 (2007). The author argued that “if [S]ection 1782 were to apply to international arbitration, different standards for the taking of evidence would apply to international and domestic arbitrations without there being any principled reason for the difference.” *Id.* at 400-01. Another commentator opposed allowing parties to apply for Section 1782 relief without the tribunal’s approval, noting: “extending assistance to the parties when the arbitrators have not requested the information risks undermining the arbitration by unnecessarily increasing expenses, delaying the process, and inviting abuse.” Daniel A. Losk, “Section 1782(A) After *Intel*: Reconciling Policy Considerations And A Proposed Framework To Extend Judicial Assistance To International Arbitral Tribunals,” 27 Cardozo L. Rev. 1035, 1062-1068 (November 2005).

all of its features and awaits invocation by parties engaged in or at least reasonably contemplating private international arbitration. The argument for the statute's availability will be easier in Georgia, New Jersey, Minnesota, and Massachusetts where the federal courts have indicated their receptivity to Section 1782 relief in private proceedings. However, a convincing argument can certainly be made in the Second and Fifth Circuits for departing from *NBC* and *Biedermann*, assuming appeals are taken from the district courts in those circuits whose hands may be tied at present. It is indeed possible that the U.S. Supreme Court's ruling in *Intel* and the reasoned opinions of the federal courts addressing the issue since *Intel* will change the state of play in those jurisdictions. It may be just a matter of time. ☺

What Happens Now the (Anti-)Suit No Longer Fits?

Allianz SpA (and others) v West Tankers Inc.
(Case C-185/07). ("West Tankers")

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If two parties agree to arbitrate a dispute, or a potential dispute, it may reasonably be assumed that they want the resolution of any future disputes to be a private matter.

Should a party which then changes its mind be able to resort instead to the courts for a remedy, in direct contradiction of a previous agreement to arbitrate? Under English law, the answer is "no," unless the parties have agreed otherwise. Section 30 of the Arbitration Act 1996 holds that, unless otherwise agreed by the parties, an arbitral tribunal can rule on its own substantive jurisdiction, i.e. on whether there is a valid arbitration agreement, whether the tribunal is properly constituted and whether matters have been properly submitted to arbitration in accordance with the arbitration agreement. As a result of this, English Courts have to date been willing to grant anti-suit injunctions to prevent parties bringing applications before foreign courts in

apparent contravention of arbitration agreements.

The recent (10 February 2009) high-profile decision of the European Court of Justice ("ECJ") in *West Tankers*, however, transfers the tribunal's power to make such a determination, even if this right has been voluntarily bestowed by the parties at the time of the original agreement, to the European Union ("EU") Court "first seised" of a dispute, if one of the parties decides to bring the issue before an EU court.

Background

The ECJ's decision in *West Tankers* followed the issuing, in September 2008, of the Opinion of the Advocate General. The dispute related to a vessel, the *Front Comor*, which was owned by West Tankers ("WT") and chartered to Erg Petroli SpA ("EP") and which collided with and caused damage to EP's wharf. It was common ground between WT and EP that disputes under the relevant charter party agreement should be referred to arbitration in London (as the designated "seat"), and an arbitration was initiated in relation to uninsured losses.

EP's insurer, Allianz, indemnified EP in relation to some of its losses and, in July 2003, commenced subrogation proceedings against WT in Syracuse (Siracusa), Italy, as a result of which the court in Syracuse was the court first seised of the dispute between Allianz and WT. In response, in September 2004, WT commenced Court proceedings in England against Allianz, seeking an anti-suit injunction and declaratory relief to the effect that Allianz was bound by the arbitration clause in the underlying charter party agreement.

The Reference

In March 2005, the English High Court granted both the declaration and the injunction requested by WT. In view of the importance of the issues raised in this dispute, Allianz's appeal was fast-tracked to the House of Lords. Allianz sought to argue that Council Regulation 44/2001/EC, the successor to the Brussels Convention (the "Regulation"), provides that, when the courts of one EU member state become seised of a matter, all other member state courts must stay proceedings on the same matter until the court first seised has ruled on its jurisdiction, even if the proceedings in that court have purportedly been brought in breach of a jurisdiction / arbitration agreement.

Whilst supporting the use of anti-suit injunctions as an interim remedy in such circumstances, the House of Lords decided to refer to the ECJ the question of whether the grant of anti-suit relief was compatible with the Regulation.

The Advocate General ruled that anti- / continued page 8

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suit relief to enforce an exclusive jurisdiction clause (arbitration agreement) was not permitted because (following *Turner v Grovit* [2004] ECR I- 3565) the first seised rule in Article 23 of the Regulation required the court first seised of proceedings to determine its own jurisdiction. Further, the Advocate General considered that the exclusion of “arbitration” by Article 1(d) of the Regulation did not make any difference. The correct question was whether the anti-suit injunction infringed the first seised rule and *not* whether the application for the anti-suit injunction was permitted by article 1(d) because the injunction related to an arbitration agreement. If the subject matter of the dispute between the parties (in this instance, liability under the charter party) fell within the Regulation, then the court first seised had to decide for itself whether the arbitration exclusion in the Regulation applied.

The Judgment

The ECJ followed the Advocate General and held:

“It is incompatible with Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters for a court of a Member State to make an order to restrain a person from commencing or continuing proceedings before the courts of another Member State on the ground that such proceedings would be contrary to an arbitration agreement.”

The Court seemingly ignored the potential prejudice to the party seeking to enforce an apparently valid arbitration agreement and instead wrung its hands over the possibility that

“if, by means of an anti-suit injunction, the Tribunale di Siracusa were prevented from examining itself the preliminary issue of the validity or the applicability of the arbitration agreement, a party could avoid the proceedings merely by relying on that agreement and the applicant, which considers that the agreement is void, inoperative or incapable of being performed, would thus be barred from access to the court before which it brought proceedings under Article 5(3) of Regulation No 44/2001 and would therefore be deprived of a form of judicial protection to which it is entitled.”

Both before and after this decision, many commentators have suggested that, in the absence of relief by way of an anti-suit injunction, parties wishing to circumvent an arbitration agreement will make a tactical strike by issuing proceedings in an EU member state other than England. The ECJ, however, does not appear to have given much credence to this, despite the potential costs and delay involved in the additional proceedings.

Commentary

Whilst the ECJ may consider this decision to be merely a reiteration of the “first seised” rule under Article 23 of the Regulation, the ruling may, again, have far-reaching cost and time consequences in relation to the enforcement of arbitration clauses, by potentially adding a “second stage” to the determination of the appropriate jurisdiction for a dispute. The ECJ’s judgment is not explicit as to whether, if the court first seised concludes that it is not the Court entitled to jurisdiction in relation to the substantive dispute, it is that *second* court that gets to rule, under article (2)(d) of the Regulation, whether the Regulation should in fact apply to the dispute or it should be arbitrated. Nonetheless, this seems to be the logical extension of the ECJ’s ruling.

Where then does this leave, for example, an English company which has a dispute with a German company, in relation to a claim for damages arising from both a breach of contract and damage to goods that occurred in Italy? (In this scenario, the “place of performance of the obligation in question” in respect of the breach of contract claim, for the purpose of the Regulation, is Germany.) The contract contains an arbitration clause with London as the designated seat or place of arbitration. Although it has requested arbitration, the English company hears that the German company may bring proceedings in Italy. Without any possible recourse to an application for an anti-suit injunction (bearing in mind that the ECJ’s ruling covered injunctions seeking to prevent a party from both “*commencing or continuing proceedings*”), the obvious step would be for the English company to take preemptive action by starting proceedings in the English courts for “seizure” purposes, seeking a declaration of the validity of the arbitration agreement.

Arguably, if such an application was brought, without touching on any substantive claim, then all the English Court would have to do in order to determine its own jurisdiction would be to establish whether or not the Regulation applied at all — and, if not, whether it is the Court or the arbitral tribunal

(if already constituted) that has the power under Section 30 of the Arbitration Act 1996 to rule on jurisdiction. In reality, however, it is unlikely that any party would seek such a declaration in the absence of any substantive dispute and if the counterparty was indeed determined to dispute the applicability or validity of an arbitration agreement, it seems unlikely that the “substantive” issues between the parties could be separated from any consideration by any Court of the factors determining the choice of jurisdiction.

If, therefore, the proceedings in front of the English Courts set out the substantive claim, as well as the validity of the arbitration clause, then, before an English Court can even determine whether it can make a declaration of validity and remit the decision to the arbitrator, it must first consider whether or not it has jurisdiction to determine the substantive claim for damages. In the above scenario, applying the Regulation to the substantive issues, it is likely that the English Court would determine that, under the Regulation, either Italy or Germany is the proper jurisdiction for the substantive claim(s). If the English Court decides that it does not have jurisdiction to hear the substantive issues, it presumably also has to hand over the decision on the validity of the arbitration and then the Italian or German Court would get to decide that issue. As a result, despite the initial “seizure” of the case in the English Court, if the German company wishes to litigate the dispute and, hence, dispute the validity of an arbitration clause, a determination would potentially be required in the courts of two EU member states before any arbitration provision could be enforced (if at all).

The impact of this decision on London as a “seat” for international arbitrations will be the subject of significant debate for some time to come. Anti-suit injunctions have traditionally been viewed as protecting parties against undue delays in foreign courts whose involvement appears contrary to the contractual intention. Whilst anti-suit injunctions clearly sat uncomfortably with the first seised principle, it is equally clear, given that EU member states also permit alternative dispute resolution, that a solution should be found that better supports the contractual rights of EU-domiciled parties, and minimises both the potential costs of enforcing the contractual agreement to arbitrate and any delay in a party obtaining adequate redress under that agreement. ☉

Regulating Credit Default Swaps As Insurance: New York Yields to the Feds

By Richard Liskov, New York, rliskov@chadbourne.com

Warren Buffett has famously compared credit default swaps (“CDS”) to weapons of mass destruction.

They certainly have proved lethal to banks, hedge funds and insurers. After years of willfully refusing to regulate them, the G-20 countries have now pledged to develop a clearinghouse for backing them, and even one of the architects of financial deregulation in the U.S., former Senator Phil Gramm, has admitted that some oversight is needed to ensure that protection sellers can meet their counterparty obligations. SEC Chairman Christopher Cox has also testified in favor of more federal regulation of CDS.

New York Governor David Paterson and Insurance Superintendent Eric Dinallo started the regulatory bandwagon rolling in September when they announced that the Insurance Department intended to regulate as insurance any CDS in which the protection buyer had, or reasonably expected to have, a material interest in the underlying obligation for which the protection was sought. They declared that, starting in January, those protection sellers who knew — or could reasonably be expected to know — that its counterparty had an ownership stake in the underlying obligation would be required to become licensed as an insurance company, thereby attracting the myriad solvency, governance, investment, tax, and contract form regulations applicable to insurers just as if they were monoline financial guaranty carriers such as MBIA.

On November 20th, however, Superintendent Dinallo announced an indefinite suspension of New York’s CDS regulatory plan, ostensibly in reaction to the likelihood that effective federal regulation of the entire CDS marketplace will be put in place soon. What the Superintendent did not say, however, was that various banking and financial groups had complained about the State’s unilateral assertion of power over a market that, for years, it had expressly left unregulated.

In originally declaring his intent to regulate certain CDS contracts as insurance, Superintendent */ continued page 10*

Credit Default Swaps

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Dinallo referred to a 2000 Opinion of the Department's General Counsel which stated that a CDS issued to a counterparty that was not required to suffer an actual loss in order to demand performance would not be treated as an insurance contract. Characterizing that analysis as incomplete, Dinallo stated that, whereas "naked" swaps (in which the protection buyer didn't own the referenced underlying obligation) constituted the vast majority of outstanding swaps and would continue to be exempt, New York was determined to regulate as insurance those CDS contracts in connection with which the CDS counterparty retained an interest in the referenced underlying obligation.

By way of legal authority to legitimize this new assertion of regulatory oversight, the Department's supporting statement cited Section 6901(j-1) of the Insurance Law, enacted in 2004, which defines the term "credit default swap" and contains an interesting *proviso*. The statutory definition reads:

[A]n agreement referencing the credit derivative definitions published by the International Swap and Derivatives Association, Inc., pursuant to which a party agrees to compensate another party in the event of a payment default by, insolvency of, or other adverse credit event in respect of, an issuer of a specified security or other obligation; provided that such agreement does not constitute an insurance contract and the making of such credit default swap does not constitute the doing of an insurance business.

The Department deemed the word "provided" in the foregoing definition to mean that, under the 2004 amendments, financial guaranty insurers were allowed to insure credit default swaps only so long as the credit default swap was not itself an insurance contract. That interpretation would surely come as news to the industry groups that had sought the 2004 changes to liberalize the regulation of financial guaranty insurers, and there is no evidence in the amendments' legislative history that the Legislature intended that investment banks and other financial institutions would become subject to the panoply of Insurance Department rules and regulations simply by virtue of having issued a credit default swap in New York.

The Department's view seemed a curious way to apply the definition of "credit default swap" — *i.e.*, a contract is a credit

default swap only if it references ISDA definitions *and* is not an insurance policy *and* the issuance of such a contract does not constitute the transaction of an insurance business. Nowhere else in the insurance law has the New York Legislature used the definition of a term to prescribe whether a particular type of contract should or should not be deemed to constitute insurance. By way of illustration (and contrast), when the Legislature determined to render funding agreements subject to Insurance Department regulation, it did not employ such a *proviso* to accomplish its goal; rather, the enabling amendment to the insurance law simply declared, with no ambiguity, that "the issuance or delivery of a funding agreement by an insurer in this state shall constitute doing of an insurance business herein." See N.Y. Ins. L. § 3222(a).

The Department's adventurous construction of the 2004 amendments was likely to be litigated; New York courts have in the past invalidated other Department rules that lacked clear statutory authority. Furthermore, even if its position regarding prospective CDS regulation were sustained, the Department would have been powerless to oversee CDS trades with *de minimis* links to New York, inasmuch as CDS issuers with facilities located outside of New York presumably would have exploited a basic principle of U.S. insurance regulatory law to avoid the impact of New York's new position: a state cannot assert control over an insurance transaction if the subject contract is solicited, negotiated, issued, delivered, paid for and adjusted outside of that state's territory. This rule, expressed in the Supreme Court case *State Board of Insurance v. Todd Shipyards Corp.*, 370 U.S. 451 (1962), would have afforded the means for multinational firms to continue their CDS business free of New York's regulation if they and their customers were willing to follow certain procedures to tailor their CDS transactions to the *Todd Shipyards* guidelines.

Of course, with Congress and the Obama Administration poised to legislate national supervision of CDS, and the G-20 countries on record as pledging global regulatory cooperation, New York's aborted attempt to oversee even part of the CDS marketplace has now become a mere footnote. So long as Congress makes clear that state insurance laws are preempted by the new national regime, CDS marketplace players, while not necessarily applauding the new federal oversight, at least will not be forced to navigate the cumbersome and conflicting rules of individual states that were intended to apply to financial guaranty insurers, not other types of financial institutions.

This episode is but the latest illustration of the negative impact of the fragmented system of state-based insurance

regulation in the U.S. Although bills have again been introduced to allow for unitary federal supervision, and the Administration has spoken of the need for a single federal overseer of financial risk including insurance, the prospect of significant change in this area in 2009 is doubtful: Congress is unlikely to be eager to assume financial responsibility for the solvency of thousands of insurers in the current economic climate, and its agenda will be filled with proposals that most Members and their constituents will consider far more pressing than the issue whether Albany, as opposed to Washington, should regulate insurance companies. ☉

Section 172 Companies Act 2006: Potential New Liabilities for Financial Institutions?

By John Barlow, London, jbarlow@chadbourne.com

Directors of financial institutions have all suffered a torrid 12 months. In addition to being reviled by public and press and blamed for the global financial meltdown, they now have to operate in a new legal landscape. John Barlow explores in this article the new landscape for directors in the changed economic and legal environment.

The Companies Act 2006 (“the Act”) represented the first major consolidation of companies legislation since 1985. In consolidating the legislation the Act served to introduce new notions of directorial responsibility and duties (which had previously been identified by English common law during the past 200 years). Whilst common law duties still exist (and the English Court will take into account such common law duties when interpreting the liabilities of directors¹ — which raises the initial question as to whether we are going to see a major sea change in directorial duties), Section 172 of the Act now

sets out the main statutory directors’ duties:

- ☉ To act within powers (i.e. in accordance with the company’s constitution) (Section 171);
- ☉ To promote the success of the company for the benefit of its members having consideration to:
 - (a) The likely consequences of any decision in the long term;
 - (b) The interest of the company’s employees;
 - (c) The need to foster the company’s business relationships with suppliers,² customers and others;
 - (d) The impact of the company’s operations on the community and the environment;
 - (e) The desirability of the company maintaining the reputation for high standards of business conduct; and
 - (f) The need to act fairly as between members of the company. (Section 172.)

The remaining duties reflect common law duties under the Act (Sections 173-177) e.g. the duty to exercise independent judgment (which may present difficulties for nominee directors of subsidiary companies); to exercise reasonable care, skill and diligence (which reflects the previous objective/subject test i.e. directors are required to show the care and skill that can be expected of them (the subjective test) or that which is to be objectively expected of such a director (whichever is the higher standard)). Nascent companies law jurisprudence illustrate more extreme examples of the application of director’s duties and responsibilities: *Re Cardiff Savings Bank*, *The Marquis of Bute’s Case* [1892] where the Marquis had been appointed to the board aged 6 months and attended one board meeting in 38 years (at the time this was not sufficient to give rise to liability). Certainly, such an extreme example is no longer a defence and, it is arguable, that with the advent and promotion of the non-executive directors means that the benchmark for directorial duties is now set at a significantly high level. However, as before the duties are owed to the company and are enforceable by the company (including by way of a derivative action). Further, the civil consequences / *continued page 12*

¹ S170(4): “The general duties shall be interpreted and applied in the same way as common law rules or equitable principles and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties.”

² This does not mean that suppliers as creditors have a direct personal remedy against directors (obviously creditors’ rights are completely different once insolvency takes place).

Section 172 Companies Act 2006

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of a breach of these duties remains the same as if the claim was based on a corresponding common law rule or equitable principle (e.g. damages; disgorgement).

In analysing the application of these provisions, connoisseurs of the Act will note, for example, the similarity between Section 310 of the Companies Act 1985 which required directors to have consideration to the interest of the company's employees and (b) above. The fact that Section 310 was regarded by commentators as being completely ineffective given that it was incumbent upon the company enforcing such rights only served to suggest that the considerations set out in the Act would be equally toothless. Contemporary commentators now argue that this is now not a duty per se, but operates as a defence to the directors should they choose to take the interests of the employees into account. For example, were the directors to resolve to make payment of bonuses (to retain quality personnel – itself a cotemporary political hot potato) then the “duty” would act as a defence to any complaint by members (i.e. shareholders) with regard to such payment.

Whilst the suggestion that interested groups would seek to obtain *locus* through derivative actions (see below for a discussion in this regard), when the Act was first enacted it was difficult to anticipate there would be widespread use (or the threat of use) of the enforcement of such duties. However, much has been made in the English press about the conduct of financial institutions which have been recapitalised at the expense of the taxpayer. Given the significant shareholdings taken by the Government in certain financial institutions there clearly appears to be some latitude for the enforcement of such duties, for example, the directors are required to consider any long term decision, the company's employees and the duty to foster relationships with third parties (i.e. customers).

As noted above, in determining these considerations and obligations, the Court can have a regard to pre-existing common law and equity. Obviously, plentiful common law jurisprudence exists in connection with, for example, the duty to exercise reasonable care, skill and diligence and duty to avoid conflicts of interest. However, the difficulties which the Court may experience is that there is no common law jurisprudence to determine how these new duties are defined and their parameters. Moreover, it is difficult to see how one reconciles the legal applications and jurisprudence which has evolved with the political environment in which the Government seeks to flex their muscles as major investors in financial institutions

where political/socio-economic considerations need to be taken into account (and what of the minority shareholders who also require similar and equally balanced consideration). Moreover, there appears to be a fundamental conflict between these considerations and the rather more general consideration that the directors should exercise independent judgment (section 173) (a carve-out exists where the company enters into an agreement that restricts the exercise of the directors' discretion or as authorised by the company's constitution). Accordingly, it remains to be seen how duties which appear to be, on their face, quite nebulous now appear to be substantive duties capable of enforcement against the directors.

Enforcement of the Duties

Under the Companies Act 1985, a derivative action was permitted on a statutory basis. Such derivative actions are an exception to the rule in *Foss v Harbottle* (1843) and the new procedure does not change the established rule. Whilst the ability to bring an action remains available under the Act, it will require the leave of the Court (the White Paper to the Act encouraged the judiciary to exercise control over derivative claims by respecting commercial judgments and encouraging members to resolve disputes under the company's constitution). Derivate claims can now be brought if three conditions are met:

- The action is brought by a member of the company;
- The cause of action is vested in the company; and
- Relief is sought on the company's behalf.

A derivative claim may be brought only in respect of a cause of action arising from

“an actual or proposed act or omission involving negligence, default, breach of duty or trust by a director.”

It should be noted that a claim can also be brought against a former director or a shadow director. In bringing such an action (and the Court will be required to grant an permission to proceed if a *prima facie* case is made out), the Court may make necessary directions as to the evidence required and may adjourn the proceedings for such evidence to be obtained.

Whilst the jurisprudence with regard to a derivative claims is generally concerned with private companies, it remains to be seen as to what a stance a Court would take in relation to public companies and, in particular, companies where the majority shareholders are Governmental institutions. Nevertheless, it seems that in the current economic environment there is sig-

nificant latitude for claims to be now brought under Section 172 for a breach of the new directorial duties and obligations.

In addition to these new duties, directors should not forget that there are many other legal pitfalls which exist beyond the Act and these duties and liabilities are identified and discussed in the 2009 Edition of "UK Directors and Officers Liabilities" by John Barlow which is now available at Chadbourne & Parke's website at www.chadbourne.com. ©

Heated Debate: The Market Reacts to the Proposed Reforms of Business Insurance Law

By Sally Mant, London, smant@chadbourne.com

On 13 October 2008, the Law Commission of England and Wales and the Scottish Law Commission (together the "LC") published a summary of responses to their July 2007 Consultation Paper, "Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured."¹

The Consultation Paper (which covered misrepresentation, non-disclosure and breach of warranty by and on behalf of the insured) is part of the LC's review of Insurance Contract Law Reform, the aim of which is to ensure that the law balances the interests of the insured and the insurer and reflects the needs of modern insurance practice.²

The Consultation Paper proposed the creation of two new statutory regimes one for business insureds and one for consumer insureds.³ The intention being that the business regime would be the default position, but it would be possible for the parties to contract out of it in specific ways. The consumer regime would be mandatory, with no right to contract out except in favour of the insured.

Introduction

The consultation closed in November 2007 during which time the LC received 105 written responses and attended over 50 meetings with insurers, insureds, brokers, lawyers and representative groups. The summary of responses to the Consultation Paper provides a factual account of the opinions expressed and the arguments raised to the proposals. The LC has not included its own views on the responses nor has it formulated its final recommendations. At this stage, the LC is not inviting comments to the summary of responses but if anyone has further comments, the LC would be pleased to receive them.

The LC's proposals for consumer insurance law set out a mandatory regime for consumers which largely reflects the FSA rules and the Financial Services ombudsman guidelines and the proposals draw a distinction between those who act deliberately or recklessly, and those who act carelessly and those who act reasonably. The consumer proposals received widespread support and the LC is working on a draft bill and report for the summer of 2009.

However, there has been less widespread support for the proposed reform of business insurance law and there has been a general lack of agreement on how the reforms should be put into practice. Predictably, buyers of insurance and brokers were more in favour of change. The LC's main proposals for the reform of business insurance law are set out below, together with a summary of the consultees' responses.

The Duty of Disclosure and the Test for Materiality

Proposal: Under the proposals set out in the Consultation Paper, the duty of disclosure would continue to apply to business insurance contracts but the test for materiality would change from what the "*prudent insurer*" would want to know, to what the "*reasonable insured*" would have appreciated that the insurer would want to know or actually knew that the insurer wanted to know. / continued page 14

¹ The November 2007 edition of the *Insurance and Reinsurance NewsWire* (at pages 5 to 11) discussed the Consultation Paper.

² The LC's review of Insurance Contract Law Reform is due to conclude in 2010/2011. Next year, the LC intends to publish a second Consultation Paper on insurable interest (in respect of which Issues Paper 4 has been published by the LC) and post contractual good faith (in respect of which an Issues Paper will be published by the LC in the first half of 2009). The March 2008 edition of the *Insurance and Reinsurance NewsWire* (at pages 4 to 6) included an article on Issues Paper 4.

³ This article will focus largely on the former type of insurance.

Reforms of Business Insurance Law

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Responses: The responses to the Consultation Paper show that 81% of consultees were in favour of retaining the duty of disclosure but only 52% approved the new “*reasonable insured*” test. Those in favour welcomed its flexibility and the extra protection it afforded to unsophisticated businesses but those against thought it added too much uncertainty with regards to the standard of disclosure applicable to particular policyholders. The Association of British Insurers commented that the insurance industry “*remains to be convinced of the need for reform of the law in this area.*” Some insurers expressed the opinion that by removing the “*tried-and-tested*” regime, English insurance law would be less attractive to business insureds. In addition, several insurers said that it was “*inappropriate*” for businesses to be given extra protection when they should instead take steps to protect themselves and obtain expert advice before purchasing insurance.

Remedies for Non-Disclosure and Misrepresentation

Proposal: Unlike the position under current law where insurers can avoid cover for any non-disclosure, the proposed remedies distinguish between innocent, negligent and dishonest non-disclosure. Consequently, an honest and reasonable insured would not lose cover for an innocent non-disclosure/misrepresentation. However, insurers would retain the right to avoid the policy if a business insured has deliberately or recklessly made a non-disclosure/misrepresentation. With regards to negligent non-disclosure/misrepresentation, the LC has suggested that there should be a proportionate remedy which aims to put the insurer into the position it would have been in, had it know the correct position. For example, if the insurer would have excluded the claim, it should not have to pay the claims which would fall within the exclusion; alternatively if the insurers would have charged a higher premium, the claim should be reduced accordingly.

Responses: The majority of consultees said that in the case of innocent non-disclosures and misrepresentations, the claims should be paid and that proportionate remedies for negligent non-disclosures should be introduced. However, many insurers thought that if the insured made a negligent non-disclosure/misrepresentation and the insurer would not have accepted the risk had he known the true facts, then the insurer should be entitled to avoid the policy.

Others saw practical problems in showing that a business

insured had acted dishonestly or showing that an insurer would have done something differently had he known the true facts.

Warranties

Proposals: The LC made three proposals for the reform of insurance law in relation to warranties. Firstly, the LC proposed a new requirement for a “*causal connection*,” whereby insurers would not be able to rely on a breach of warranty to deny cover, if it was not material to the contract or the loss claimed was unconnected with the breach. In short, the insurer would only be permitted to avoid paying all or part of a claim if the breach of warranty caused or contributed to all or part of the loss. This differs from the position under current law whereby if a warranty is breached the cover automatically terminates from the moment of the breach, regardless of whether the warranty is connected with the loss. Under the LC’s proposals, business insureds’ liability for breach of warranty would remain strict and the onus would be on the insured to prove on the balance of probabilities that the breach of warranty did not contribute to the loss.

Secondly, the Consultation Paper highlighted that many unsophisticated policyholders are unaware of the existence of warranties and that their breach terminates cover. Therefore, the LC proposed that warranties are brought to the insured’s attention and that a test be introduced based on the insured’s “*reasonable expectations*” in relation to mass-market insurance policies.

Thirdly, the LC proposed the abolishment of “*basis of contract*” clauses, which convert all an insured’s answers in a proposal form into warranties. The reason for this proposal is that such clauses leave insureds without cover as result of immaterial or innocent misstatements. Therefore, in line with the “*causal connection*” test outlines above, the LC proposed that insurers should not be able to rely on a breach of warranty unless it is material to the contract or the loss claimed was connected with the breach.

Responses: In response to the LC’s first proposal, 73% of consultees agreed that a “*causal connection*” test should be introduced and there was general support for continued strict liability for business insureds that breached warranties of fact. Many consultees said that the current law was uncertain and that reform to ensure that insurers would be liable for losses unconnected to breaches of warranty would improve certainty for all parties. However, some consultees felt that such a test could have a negative impact on moral hazard, in particular

with respect to warranties concerning the maintenance of safety standards. For example, some insureds may breach warranties more freely and take a gamble that they would still be paid for unconnected losses.

With regards to the LC's second proposal there was general support for the requirement to bring warranties to the insured's attention but consultees were unsure about the approach and practicality of the "*reasonable expectations*" test.

The LC's third proposal found widespread support among consultees, with 78% favouring the abolishment of "*basis of contract*" clauses.

Standard terms

Proposal: The Consultation Paper included a proposal that a default regime should be put in place which would apply to all business insurance, from small tradesmen to large corporations. However, sophisticated businesses would be able to contract out of the default regime. The proposal is intended to address the problem of small businesses who may not be any better informed than consumers when purchasing insurance and who are likely to buy off-the-shelf insurance cover without obtaining advice. Consequently, the proposal is designed to prevent insurers contracting on standard written terms, which give them greater rights to avoid claims than under the default regime, if this would defeat the insured's reasonable expectations of cover.

Responses: Some consultees thought that small businesses did need the protection of a default regime but some questioned how it would work in practice. For example, how would a small business in need of protection be identified for the purpose of deciding whether an insured's reasonable expectations of cover have been defeated when he contracted on the insurer's standard written terms. Furthermore, what would constitute "*the insurer's standard terms*" for the purpose of this test, particularly as the insurance market frequently uses combinations of tried and tested wordings. Consequently, only 28% of consultees agreed with the LC's proposed default regime.

Intermediaries

Proposal: The LC identified that it can be difficult to decide whether an intermediary is acting for the insured or the insurer when passing on pre-contractual information. The LC is keen to clarify the position for small and medium-sized businesses and therefore proposed in the Consultation Paper that the intermediary would be regarded as acting for the insurer if it deals with only a limited number of insurers and does not

search the market on the insured's behalf. The result would be that if the intermediary made a mistake, the insurer would bear the risk and have to pay the claim.

Responses: This proposal was very unpopular with respondents, largely because it could catch large businesses as well as the smaller businesses it was aimed at. Most felt happier with the common law governing the situation, despite the uncertainties involved. The main concern with the proposal was that in specialist markets, there may be only a few potential insurers. Eighty percent of consultees therefore thought the question should be left to the common law.

Conclusion

Although there appears to be general support within the industry for the proposals relating to business insurance law, there are clearly divergent views among consultees on a number of issues ranging from remedies, the materiality test and freedom to contract. For example, consultees expressed concern over the negative impact that the proposed materiality test may have on the English insurance market and, although the proposed remedies for non-disclosure/misrepresentation received general support, many consultees noted the difficulty in proving that an insured was acting dishonestly or that the insurer would have acted differently if the correct facts had been disclosed.

In an attempt to achieve a better consensus of views across the market, the LC intends to consult further and publish an Issues Paper with revised proposals for business insurance law reform. In light of the differing views expressed by consultees, it will be interesting to see how the LC presents its initial opinions on the proposed business insurance law reforms. The Issues Paper is due to be published during the first half of 2009. ☺

Directors' & Officers' Liability

The Legal Position in the United Kingdom

In these tumultuous times who would want to be a director of a financial institution?

In hock to the government and boards under attack for senior executive payoffs it's a brave man or woman who takes on the position of being a director. The new legal landscape also presents a daunting and, to a great extent, unknown challenge. John Barlow explores in this publication the key issues for directors in the changed economic and legal environment.



To obtain your copy, please download it from our website at www.chadbourne.com/DandOLiability.pdf

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