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Will Recent Nationalizations in Bolivia Give Rise to Claims Under Political Risk Insurance Policies?

by Christopher Cardona

On May 1, 2006, the Bolivian government passed a law, Supreme Decree 28701, announcing that it was taking over the oil and gas resources in the country. This nationalization policy sent shock waves throughout the oil and gas industry, especially foreign companies operating in Bolivia, including Repsol of Spain, B.P. of the United Kingdom, Total of France and Petrobras of Brazil.

There is growing concern that the newly elected Bolivian President, Evo Morales, has fallen under the spell of the populist and controversial Venezuelan President, Hugo Chavez. The Venezuelan State has already confiscated oil fields operated by E.N.I. of Italy and Total. It is no coincidence that Hugo Chavez travelled to Bolivia just days after the new nationalization decree was passed. The matter will not end here. Speaking at a May Day rally, the Vice President of Bolivia greeted the nationalization by boldly declaring that "the government of the people, the government of the workers, has taken the most important decision of this century: this is the first nationalization of the 21st Century." There are signs already that the nationalist fever running through South America is spreading to other countries in the region that are not traditional allies of Venezuela and Bolivia. In the last few weeks, Ecuador has taken control of over US$1 billion of assets owned by the US-based Occidental, the largest */ continued page 2*

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foreign investor in Ecuador.

The recent Bolivian nationalization has seriously dented Brazil's dominance in the region. Brazil's Petrobras has assets worth US$1.5 billion in Bolivia and it is ironic that the largest economy in the continent should have fallen prey to the nationalization policy implemented by Bolivia, the poorest country in Latin America.

Investors in Bolivia are actively exploring how to recover their substantial losses. Initially, Evo Morales announced that there would be no compensation for nationalized assets. At the recent Latin American summit in Vienna on May 11, 2006, Brazil reacted angrily to this announcement and Morales eventually agreed to consider claims for compensation later this year.

In the meantime, investors affected need urgently to consider whether to notify claims under available political risk insurance policies. Before considering the cover afforded by these policies and how they may respond to claims arising from the Bolivian nationalization, it is necessary to review the applicable Bolivian legislation.

The starting point is Law No. 3058 passed on May 17, 2005. Article 5 of this law provided that property in all oil and gas resources then in production vested in the State of Bolivia. All oil and gas companies operating in Bolivia were given 180 days from the date of this law to enter into new contracts with the state energy company, YPFB. Pursuant to these new contracts, YPFB assumed responsibility for the commercialization and production of oil and gas reserves.

This law was the precursor to the nationalizing statute of May 1, 2006. Supreme Decree 28701 recites that the 180-day period prescribed in Article 5 of Law No. 3058 has expired and that "as a measure of national sovereignty, and following the mandate from the Bolivian people expressed in the Referendum held on July 18, 2004 . . ., all oil and gas resources in the country are hereby nationalized." Significantly, Article 1 of the Decree declares that "the State acquires ownership, possession and total and absolute control of these resources." Article 3 provides that the only companies that can continue operating in the country are those that comply immediately with the terms of the nationalization Decree. These companies are given a further 180 days to enter into new contracts with YPFB, failing which they will not be able to continue operating in the country. During this transitional period, oil and gas fields that produce more than 100 million cubic feet per day will have to pay 82% of their production value to the State, leaving them with a mere 18% to cover the cost of operations and investment. Two important fields operated by Petrobras are immediately affected. Even if others are not affected by this onerous provision, they will have to enter into new contracts surrendering control to the Bolivian State within the allotted time and attempt to secure a negotiated solution to their claim for compensation. Otherwise, at the end of the 180-day period they will have to cease operating in the country.

> Article 3 of the nationalizing statute provides that the only companies that can continue operating in Bolivia are those that comply immediately with its terms. They are given a further 180 days to enter into new contracts, failing which they will not be able to continue operating in the country.

Can the companies affected by the nationalization recover their losses other than by securing compensation from the Bolivian State? Political risk insurance is designed to protect foreign investors from losses arising from expropriation, selective discrimination, currency inconvertibility and political violence. Policy wordings available in the commercial market vary. Some wordings require "total expropriation" suggesting that partial loss of title or "creeping" expropriation (that is, indirect acts of expropriation that do not immediately result in loss of ownership or control) that has not crept far enough to achieve total deprivation of the investment, is not sufficient. Other wordings provide cover for losses caused directly by an "Expropriatory Act." This is defined in one wording as "an act or series of acts occurring within the policy period not limited to

expropriation but including also confiscation, nationalization, requisition and sequestration by law, order or administrative action of the government of the Host Country." Additionally, some political risk wordings insist on the deprivation of the investor's ability to control or operate the project concerned which results in a default by the investor on a payment due to its lenders.

The key question is whether the steps taken by the Bolivian government satisfy the definition of expropriation in the applicable wording. Under article 7 of Decree No. 28701, the Bolivian State will acquire a controlling 51% stake in the main companies concerned—Chaco (part-owned by BP), Andina (controlled by Repsol of Spain), Transredes (controlled by Royal Dutch Shell) and Petrobras Bolivia. However, acquiring a controlling stake in a company does not amount to full nationalization. The rationale is that the Bolivian State does not have the finance, technology or know-how to fully exploit these resources and must therefore limit its participation to a 51% stake. The new contracts currently being negotiated do provide the Bolivian State with 82% of all revenue, but there is a reasonable argument that the proposed changes do not amount to expropriation or confiscation such as to trigger coverage under a political risk insurance policy.

The key question is whether the steps taken by the Bolivian government satisfy the definition of expropriation in the applicable political risk wording.

The debate will focus on whether the measures taken by the Bolivian government are tantamount to expropriation. Morales's view is that they are not. Speaking to a Committee of the European Parliament on May 15, 2006, he said: "I want people to understand that we are not expropriating or expelling anybody.... I understand that [the foreign investors] have to recover their investment and that they are entitled to profit. However, they cannot own the oil and gas reserves nor can they control them. The Bolivian State will control the wells and headquarters and [the foreign investors] will be partners but not owners of our natural resources."

The issue of what amounts to expropriation has been reviewed in a number of arbitrations before the International Centre for the Settlement of Investment Disputes ("ICSID"). ICSID was created by the 1965 Washington Convention and operates under the auspices of the World Bank.

In *Tecmed v. Mexico* (2003), it was alleged by Tecmed that the Mexican authorities had expropriated its investment by refusing to renew a license to operate a hazardous waste landfill site in Mexico. The Tribunal had to construe the terms of the applicable bilateral investment treaty between Mexico and Spain. It considered the meaning of the terms "indirect expropriation" and "tantamount to expropriation." The Tribunal held that expropriation includes "a number of situations defined as de facto expropriation, where ... actions or laws transfer assets to third parties different from the expropriating state or where such laws or actions deprive persons of their ownership over such assets, without allocating such assets to third parties or to the Government." Thus, a single act of expropriation by the state is not required: it is enough if the measures adopted by the State are permanent and irreversible and if the effect of these measures is that the assets and rights of the investor are affected in such a way that they cannot be exploited. Whilst direct expropriation is readily apparent, it is harder to identify interference with an investor's rights. It is a question of fact in each case whether the effect of the state action is such that the investor's rights can no longer be exploited. In the earlier case of *Metalclad v. Mexico* (2000), the Tribunal had also attached great weight to the effect of the government measures on the rights of the foreign investor. The Tribunal held that the measures were tantamount to expropriation because they "effectively and unlawfully" prevented the investor's operation of the project. However, the case */ continued page 4*

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demonstrates that arbitration awards on the meaning of "expropriation" are not immune from challenge. Mexico appealed to the Supreme Court of British Columbia and the Court held that it did not have jurisdiction to interfere with the Tribunal's interpretation though it did not adopt all of its reasoning.

Whilst these decisions show that arbitration tribunals and courts have adopted liberal interpretations of the term "expropriation," foreign investors affected by recent developments in Bolivia will first have to turn to their individual policy wordings to see how the term is defined. Only then will the aggrieved foreign investor be able to determine whether to notify a claim under the policy. The insured investor is generally required by the policy wording to notify his insurers of any circumstance likely to give rise to a claim within a short period, normally 30 days. Typically, policies will then require the act or acts of expropriation to subsist for a defined "waiting period" which can be as long as 180 days before payment is made. This gives the parties a window in which to settle with the government or obtain compensation from other sources.

Foreign investors would be well advised to notify circumstances that may give rise to subsequent claims even if they are currently in negotiations with the Bolivian government for compensation under the terms of a bilateral investment treaty or some other form of investor protection legislation. In fact, it may be more advantageous for the foreign investor to pursue a claim under a political risk insurance policy and allow the insurers to recover subsequently under any applicable investment treaty by way of subrogation. ◎

Inside the Reinsurance Sidecar

Carey Child and Shane de Búrca

As property catastrophe reinsurance companies suffer losses stemming from Hurricanes Katrina, Rita and Wilma, many have raised capital in the public markets to allow them to underwrite for 2006 renewals. The traditional means of raising capital include the issuance of equity or catastrophe bonds through public offerings. A company might also reduce its property catastrophic writings but that would require the reinsurer to give up position in the market, and thus reduce its ability to take advantage of any improved rates and terms post-Katrina. An alternative structure that offers certain advantages over traditional offerings is known as a "reinsurance sidecar."

Four sidecars have been established post-Katrina: Cyrus Re, Flatiron Re, Rockridge Re and Blue Ocean Re. All of these sidecars are Bermuda insurance companies established with funds raised in private placements to third-party investors. The newly created sidecar is intended to reinsure risks from an established reinsurance company and rely on the underwriting capabilities and market position of the established reinsurance company. For instance, Cyrus Re reinsures property catastrophe business of XL Re and Flatiron Re reinsures property catastrophe and marine risk of Arch Re. The investors in sidecars have primarily been hedge or private equity funds such as Highfields Capital, Farallon Capital and West End Capital.

The primary use for sidecars, from the perspective of the established reinsurance company, is that the reinsurer can write more business than it could have written without raising more capital. The reinsurer does not have to increase its level of long-term debt or undertake a dilutive equity offering. The reinsurer assures itself of the creditworthiness of the sidecar by requiring the sidecar to post a letter of credit or establish a collateral trust with funds commensurate to the projected risk of the ceded business. While the reinsurer loses some of the upside connected with the higher premium environment, it absorbs less downside risk and can negotiate with the sidecar for the payment of ceding and profit commissions. In addition, since the sidecar is a limited-life vehicle (two years typically) and has no underwriting capability, it does not represent competition for the reinsurer. In some structures, the reinsurer also has no governance or managerial responsibility for, or stockholder control over, the sidecar or exposure to losses experienced by the sidecar.

From an investor's perspective, the sidecar allows them to take direct exposure to a particular segment of the reinsurance market that is not possible through the purchase of the equity securities of a diversified reinsurer. This exposure is related to a catastrophe risk and therefore its returns are not directly correlated to interest rates, the equity markets and other economic factors. Compared to a catastrophe bond, a sidecar offers equity-like returns and is not limited to a specified yield. Investors' exposure is usually to short-tail, catastrophe business in a limited life vehicle which allows the investor to take profits during a higher-premium environment and to exit their investment once capacity returns to the market.

Investors in a sidecar can also leverage their return by borrowing against its pool of equity and accumulated premiums. This leverage, however, does not expose the reinsurer or policy holders to risk as the obligations of the sidecar to its lenders are subordinate to its obligations to the reinsurer.

Compared to establishing a new reinsurer (such as Ariel or Harbor Point), a sidecar needs little or no staff, no underwriting department, little management oversight and faces a comparatively quick regulatory approval process in Bermuda. Since all sidecars are established offshore, the sidecar is not considered to be conducting a trade or business in the United States and therefore, offers tax savings for certain kinds of investors.

Sidecars have been subjected to two contradictory objections; some suggest that sidecars are dumping grounds for undesirable risks; others compare them to the "baby syndicates" of Lloyd's that were made up of favored players and received favorable risks. The answer to both objections is that sidecars generally take a neutral slice of the reinsurer's business by way of a quota-share treaty. The reinsurer is bound to cede a share of a line of its business (without cherry picking) and the sidecar gets to piggyback on the reinsurer's underwriting skill. To the extent the reinsurer makes good or bad underwriting decisions, the sidecar will benefit or suffer proportionately.

A reinsurer might also be concerned that the sidecar is skimming the profits that would otherwise be earned by the reinsurer. In the case of a reinsurer whose balance sheet is sufficiently strong to take all new business, there is no need for a sidecar. For those reinsurers who would otherwise have to retreat from the market, it allows them to maintain market share and to earn a significant ceding and profit commission on all risk assumed by the sidecar. The reinsurer can avoid increasing its risk exposure and capital requirements but also increase earnings through the ceding commissions.

Sidecars are a byproduct of recent natural disasters and are designed to be formed relatively quickly to take advantage of the favorable premium environment. They are flexible, short-term investment vehicles that offer targeted catastrophe exposure for investors and an effective short-term solution for reinsurers to maintain market share and profitability. ◎

First in Time, First in Right: When Directors & Officers Liability Coverage Exhausts Before the Litigation Ends

by Kate McSweeny

Andrew Fastow pled guilty. Kenneth Lay and Jeffrey Skilling were convicted. Scores of other directors and officers who gathered around U.S. corporate conference tables in recent years have since become the subject of civil lawsuits or criminal indictments or both. The recent guilty verdict against Enron's top two executives is but one more domino to fall in a series of corporate scandals that have ricocheted through America's boardrooms and courtrooms during the past decade.

These same scandals were the catalyst behind the passage of *The Public Company Accounting Reform And Investor Protection Act of 2002* — better known as Sarbanes-Oxley — Congress's rapid response to what it perceived as an epidemic of corporate malfeasance, which has certainly added to boardroom pressures for corporations both large and small.

In the midst of this turmoil stands the D&O insurer, often the first line of defense for U.S. corporate directors and officers alleged to have engaged in wrong-doing. Undoubtedly, absent D&O insurance, American corporations would be hard-pressed to find experienced talent willing to sit on the boards of for-profit corporations, whether pub- / continued page 6

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licly or privately held. As noted by the United States District Court for the Southern District of New York, "Unless directors can rely on the protections given D&O policies, good and competent men and women will be reluctant to serve on corporate boards."[1] In fact, even directors and officers of non-profit corporations are beginning to recognize their personal risk in accepting board seats. A 2005 Tillinghast Survey reported that 30% of non-profit participants — compared to 50% of for-profit participants — responded in the affirmative when asked if potential directors inquired about D&O insurance.[2] This modern expansion of D&O insurance beyond high-priced corporate boardrooms shows just how deeply the idea of D&O protection has taken root in the collective American business psyche. While D&O insurance is intended to reimburse or advance a director or officer for costs incurred either in defending a civil suit or to indemnify them for any unfavorable judgment or settlement, the risk is that many of the director and officer beneficiaries of corporate D&O policies do not realize that their D&O safety net is sometimes stretched too thin. One significant risk an insured director often does not appreciate is that his or her D&O coverage might be exhausted by another director or officer or even the corporation reaching the policy limits first.

Considering the reliance U.S. industry has placed on D&O insurance, it is a surprisingly young insurance product. It originated during another turbulent era in the financial markets. First introduced to the American market by Lloyd's during the Great Depression in the 1930s, D&O insurance did not take hold in America until more than 30 years later. Then, spurred on by a spate of savings and loan scandals in the 1980s, it rapidly became a must-have in corporate director compensation packages. More than 90% of Fortune 500 companies now carry D&O protection, with increasing numbers of small and mid-sized companies and non-profit corporations adding it to their insurance portfolios.[3]

Three types of D&O insurance are commonly available in the United States.[4] Side A coverage protects directors and officers against claims for which the corporate entity is either prohibited from indemnifying its directors and officers by virtue of state or federal laws or under the corporation's bylaws (such as for shareholder derivative suits) or in situations where the corporate entity is not able to pay (such as when it is in bankruptcy). Side A coverage generally covers wrongful acts — even intentional wrongful acts — that occur in the performance of duties. Losses covered include judgments, settlements, and defense costs although usually not disgorgement or punitive penalties, for which reimbursement is frowned upon as a matter of public policy. Side A coverage broadens the protection for directors and officers.

Corporations frequently purchase Side A coverage in combination with traditional Side B coverage. Side B coverage is intended to reimburse the corporation for those claims that federal and state law and the corporate bylaws allow the corporation to indemnify its directors and officers. Courts have held that D&O policies are intended to "safeguard" the interests of

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1 *In Re Worldcom Securities Litigation*, 354 F. Supp. 2d 455, 469 (S.D.N.Y. 2005).

2 **See also** *Nonprofits Especially Need Protection Against D&O Liability Risks, Insurance Journal*, Sept. 17, 2001 at http://www.insurancejournal.com.

3 **See** Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?,* Delaware Journal of Corporate Law, 14 Del. J. Corp. L. (Winter 1989); Ira M. Millstein, *Directors' Institute on Corporate Governance: What Board Members Need to Know to Be Effective Today & Tomorrow* (Practicing Law Institute 2004); Carl H. Loewenson, Jr. & Randy Paar, *D&O Liability & Insurance 2004 — Directors & Officers Under Fire* (Practicing Law Institute 2004).

4 For descriptions of the types of D&O insurance that are available see *Professional Liability Insurance Vol. 1,* International Risk Management Institute, Inc. (2005).

directors and officers and not to act as "a vehicle for corporate protection,"[5] yet the issue of who owns the policy and, more importantly, who owns the policy *proceeds*, is the subject of frequent dispute when the corporation is in bankruptcy.

The majority of courts hold that D&O policies belong to the corporation even in bankruptcy. There is, however, a split of authority as to whether the *proceeds* of a D&O policy belong to a debtor corporation or to its directors and officers. [6] Some bankruptcy courts have interpreted Side B coverage as inuring to the benefit of the corporation, and have thus made the entire proceeds of the policy part of the bankruptcy estate. The risk of the proceeds being directed other than to the benefit of the directors and officers, however, is most likely to arise with regard to the third type of D&O insurance that is commonly available — Side C coverage, better known as entity coverage.

Side C coverage is a latecomer to the D&O product universe. Historically, the only insurance benefit to the corporation from D&O insurance was for reimbursement of indemnified claims. Side C is a creation of the 1990s and was a direct result of the surge in securities action during that decade. Side C coverage protects the corporate entity in respect of a director or officer's act or failure to act.

While a policy containing Side A, Side B, and Side C coverage might appear to be very broad, the additional coverage for the corporation can come at the expense of the coverage for the officers and directors. A policy that is subject to a single aggregate limit yet intended to protect the directors and officers and the corporation runs three risks. The first risk is that the policy limits will exhaust before an insured director or officer needs it. The other two risks involve the impact if the corporation files for bankruptcy. The D&O policy could become subject to the automatic stay in bankruptcy, thus preventing a director or officer from accessing defense funds and/or the proceeds of the policy might be made a part of the bankruptcy estate. Any of these outcomes can have serious ramifications for a director or officer who discovers that little or no coverage remains or is accessible when it is needed to cover defense costs or judgment or settlement amounts. Thus, when a corporate entity files for bankruptcy, the existence of Side C coverage could prevent any of the directors or officers from accessing the policy and, if the proceeds of the policy are made part of the bankruptcy estate, the claims in the bankruptcy proceeding could exhaust the limits. The question of ownership of the proceeds, therefore, is frequently litigated.

Of course, even if the policy proceeds are not made part of the bankruptcy estate, a director or officer is still not guaranteed that the proceeds will be available for his or her needs. In jurisdictions such as New York, that follow a "first in time, first in right" rule, the first settling defendant director or officer might take a substantial piece of the proceeds of the policy leaving little or nothing for the other directors and officers.

Even if the D&O policy proceeds are not made part of the bankruptcy estate, a director or officer is still not guaranteed that the proceeds will be available for his or her needs. In jurisdictions such as New York, the first settling defendant director or officer might take a substantial piece of the proceeds.

Frequently, an insurer will seek a court's aid in deciding how limited proceeds should be divided among numerous directors and officers. That was the case in the Southern District of Texas last year when Enron's D&O insurers filed an interpleader action in an effort to have the court decide how to divide the policy proceeds.

Enron had purchased one primary insurance policy and ten layered excess liability policies, totaling $350 million in coverage. By the time the insurance companies filed their interpleader action, the primary policy plus the first three excess policies had exhausted. The issue before the court involved the numerous demands on the remaining $200 million. As the court described it:

In October 2004 three different settlement demands from different insureds were made upon the / continued page 8

5 *In Re First Central Financial Corp.*, 238 B.R. 9, 16 (Bankr. E.D.N.Y. 1999).

6 *In Re Cybermedia, Inc., 280 B.R. 12* (Bankr. D. Mass. 2002) (citing cases on both sides of the argument).

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Excess Insurers for payment from these remaining proceeds. First, eighteen of Enron's former Outside Directors sent a letter dated October 12, 2004 informing the carriers that they had reached a settlement [in Action A], an agreement which would require payment of the entire $200 million, [plus contributions from the insureds]. Another letter dated October 14, 2004 informed the Excess Insurers of a settlement in [Action B] between the Official Creditors Committee and [certain Outside Directors] for payment of 17.2% of the remaining insurance proceeds, which would reduce the amount to be paid [in Action A] . . . . Finally, in a letter dated October 20, 2004, Kenneth Lay made a demand [for payment of] $10.25 million to settle claims against him in two Enron-related suits. [7]

Furthermore, Andrew Fastow sought to secure funds for his legal defense — even though he had pled guilty and the policy excluded coverage of criminal acts.

The non-settling insureds argued that depleting the policies in favor of the settling defendants would violate New York law, which they claimed governed the policy. The court disagreed — both with the theory that New York law applied and with the non-settling insured's argument. Under New York law, the Texas court noted, "an insurer may settle with less than all of the claimants under a particular policy even if such settlement exhausts the policy proceeds . . . ."[8] Ultimately, the court, among other rulings, granted a motion to stay the proceedings with regard to the interpleader and the partial settlements, thereby avoiding the need to deplete the policy limits, but this moment in the *Enron* litigation represents a colorful example of how an unwary director or officer might be taken by surprise when seeking the benefit of a D&O policy.

The development of the D&O insurance market has mirrored our times from its introduction in the U.S. following the 1929 crash to its rapid expansion during the 1980s savings and loan crises to the creation of Side C coverage to protect corporate entities against securities claims in the 1990s. Directors and officers — both at for-profit corporations and not-for-profit corporations — can help avoid the surprise of finding D&O coverage either unavailable or exhausted by becoming more knowledgeable consumers of D&O insurance. ◎

7 *In Re Enron Corp. Securities, Derivative & ERISA Litigation*, 391 F. Supp. 2d 541, 548 (S.D. Tex. Aug. 1, 2005).

8 *Id*. at 554.

It Always Pays To Win—But Sometimes It Pays More

by Julia Ford

Under the English Civil Procedure Rules the Court has discretion as to whether costs are payable by one party to any other, the amount of those costs and when they are to be paid. (CPR 44.3) The general rule is that the unsuccessful party will be ordered to pay the costs of the successful party (i.e., their legal expenses—covering solicitors' and counsel's fees, together with disbursements that usually include expert fees, Court fees, costs of transcribers, photocopying and other associated expenses), although the Court has the power to make a different order.

According to Parts 44.3(4) and (5) of the Civil Procedure Rules, in deciding what order (if any) to make about costs, the Court must have regard to all the circumstances, including —

(a) the conduct of all the parties;
(b) whether a party has succeeded on part of his case, even if he has not been wholly successful . . . ;
(5) The conduct of the parties includes;
(a) conduct before, as well as during, the proceedings . . . ;
(b) whether it was reasonable for a party to raise, pursue or contest a particular allegation or issue; and
(c) the manner in which a party has pursued or defended his case or a particular allegation or issue . . . ."

The Court has the option of assessing costs on the standard or the indemnity basis. In assessing costs on the standard basis the Court will only allows costs which are proportionate to the matters in issue, and resolve any doubt it may have as to whether costs were reasonably incurred or reasonable and proportionate in amount in favor of the paying party. On the other hand, if costs are assessed on the indemnity basis, the Court will resolve any doubt as to whether costs were reasonably incurred or were reasonable in amount in favor of the receiving

party. In either case, the Court will not allow costs which have been unreasonably incurred or are unreasonable in amount.

The circumstances in which indemnity costs can be awarded have been the subject of much judicial discussion recently. In *Tradigrain S.A. & Ors. v Intertek Testing Services Canada Ltd. & Anor* [2006] EWHC 926 (Comm), Mr. Justice Langley emphasized the general point, made in his earlier decision in Amoco v. BAO [2002] BLR 135, that "*a victory, however resounding, is not enough of itself to justify indemnity costs. There has to be some added factor to justify departure from what is and remains the general rule that costs are to be assessed on the standard basis.*" The basic principle is, therefore, that there must be some conduct or some circumstance which takes the case out of the norm. Indemnity costs are not intended as a punishment, rather as a device to ensure a more equitable result for the beneficiary of a costs award; the costs paid still have to have been "reasonably" incurred although the burden will be shifted to the paying party to prove that the relevant costs were not reasonably incurred.

The second recent case to discuss indemnity costs was handed down by Mr. Justice Tomlinson in respect of (1) *Three Rivers District Council And Others* and (2) *Bank Of Credit And Commerce International Sa (In Liquidation) v The Governor And Company Of The Bank Of England* [2006] EWHC 816 (Comm). BCCI was a bank based in Pakistan that collapsed in the early nineties causing considerable hardship for its creditors, many of whom were small investors. BCCI was founded in 1972 by Pakistani businessman Aga Hasan Abedi. It operated in 60 countries and its regulation was split between the Bank of England, the Cayman Islands and Luxembourg, which led to difficulties when it was being wound up. During the 1980s, evidence emerged of BCCI's links with terrorist organizations, arms shipments to Arab states and South American drug cartels. (The background to this murky affair is contained in A Report to the Committee on Foreign Relations United States Senate by Senator John Kerry and Senator Hank Brown December (1992 102d Congress 2d Session Senate Print 102-140).) The English liquidators of the collapsed bank, acting on behalf of 6,500 UK-based depositors, who lost money when it was shut down in 1991, sued the Bank of England (UK's central bank) for about £1bn for "knowingly or recklessly" failing in its supervisory role. The Bank was legally protected from negligence claims. The liquidators therefore pursued a claim of "misfeasance," which implied that Bank officials were not just reckless but acted dishonestly. Misfeasance is the "wrongful exercise of lawful authority." Various employees were accused of dishonesty in the pleadings, and in the extensive press reporting of the case that ensued. The case took 10 years to reach the Courts but the liquidators withdrew their claim after the (lengthy) cross examination of the Bank's first two witnesses. When a claim is discontinued in English proceedings, costs are usually payable by the claimant. In this instance the liquidators had already offered to pay the Bank's costs on an indemnity basis.

The Bank of England sought the above mentioned judgment, however, to confirm their legal, as opposed to commercial, entitlement to indemnity costs. Both sides no doubt understood that any ensuing judgment on the Bank's entitlement to indemnity costs would contain criticism of the liquidators' handling of the case, and this is why, despite the liquidators' agreement to pay on the indemnity basis, the Bank of England still sought confirmation from the judge that they were entitled to indemnity costs.

This judgment has excited considerable comment in both the legal and national press in the United Kingdom in particular because of the strident criticisms made / *continued page 10*

Indemnity costs are not intended as a punishment, rather as a device to ensure a more equitable result for the beneficiary of a costs award; the costs paid still have to have been "reasonably" incurred.

Indemnity Costs

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by the judge in relation to the conduct of the legal team representing the liquidators of BCCI. Given both its profile and the detailed analysis by Mr. Justice Tomlinson of the factors he considered in awarding indemnity costs to the Bank of England, the *BCCI* judgment provides a helpful restatement of the criteria adopted in awarding indemnity costs against a losing party. Above all:

The Court should have regard to all the circumstances of the case and the discretion to award indemnity costs is extremely wide.

There must be some conduct or some circumstance which takes the case out of the norm.

The Court can and should consider the conduct of an unsuccessful claimant both before and during the trial, in particular whether it was reasonable for the claimant to raise and pursue particular allegations and the manner in which the claimant pursued its case and its allegations. If the conduct of the unsuccessful claimant is relied on as a ground for ordering indemnity costs then the test is the "unreasonableness" of the conduct.

Although each decision will be based on its own facts, a claimant can expect to pay indemnity costs if it fails on a claim which contains one or more of the following elements:

The claim is speculative, weak, opportunistic or thin (e.g. a claimant who chooses to pursue it is taking a high risk);

The claim includes allegations of dishonesty or conduct meriting an award to the claimant of "exemplary" damages, and those allegations are pursued aggressively, inter alia by hostile cross-examination of witnesses:

The unsuccessful allegations are the subject of extensive publicity, especially where such publicity has been courted by the unsuccessful claimant: and

Conduct attracting moral condemnation is, in itself, a ground for an award of indemnity costs.

In the *BCCI* case, Mr. Justice Tomlinson took particular note of the fact that (as he saw it) the liquidators commenced and pursued large-scale and expensive litigation in circumstances calculated to exert commercial pressure on the Bank. During the course of the trial , they resorted to advancing a constantly changing case in order to justify the allegations made, only then to withdraw the claim. The allegations were "thin (and, in some respects, far-fetched) and irreconcilable with the contemporaneous documents." They effectively turned the case into an unprecedented factual enquiry by the pursuit of an unjustified case. They advanced and aggressively pursued serious and wide-ranging allegations of dishonesty or impropriety over an extended period of time against a large number of Bank officials (despite the lack of any foundation in the documentary evidence for those allegations. They maintained those allegations, without apology, to the bitter end. And the Court found that they actively sought to Court publicity for those allegations of dishonesty both before and during the trial in the international, national and local media.

Mr. Justice Tomlinson therefore held that an award of indemnity costs against the liquidators was justified.

The fact that the judgment was handed down at all was in itself significant, since the liquidators had already agreed to pay indemnity costs to the Bank and had sought to prevent Mr. Justice Tomlinson ruling on the question of indemnity costs (or awarding the costs of the Bank's application). Instead, Mr. Justice Tomlinson held that, although the claim had been withdrawn before he could make a judicial determination on the facts, *"In my judgment the Bank was fully entitled to pursue this application. It would have been an affront to justice and contrary to the public interest had the liquidators successfully stifled publication of the Court's conclusions. It was of itself unreasonable of the liquidators to deny the Bank's entitlement to the costs order which it sought*."

There is no doubt that the device of awarding indemnity costs provides some protection against the practice of bringing claims in the belief there is a "deep pocket" (often an insurer) who could be persuaded into an early settlement to curtail expenses. In the insurance context, under English law, ex gratia payments do not automatically attract the benefit of reinsurance protection; therefore, the settlement of such speculative litigation is unattractive to an insurer both from a commercial, as well as a moral, perspective. However, even an award of indemnity costs will leave some costs unrecovered. In most cases, whether costs are assessed on a standard or indemnity basis, a vindicated party will still end up bearing some of the costs of successfully defending a claim. If the party has insurance coverage it will still be responsible for the deductible. If it has no insurance coverage then it must bear all of the unrecovered costs.

The case law emphasizes that the award of indemnity costs is not intended to be punitive. The question, therefore the question remains: Does the threat of being charged with costs on an indemnity basis—coupled with the prospect of critical comments in the judgment awarding such costs—a deterrent, on its own, to the active pursuit of high value, but in some cases highly egregious, "nuisance" claims? ◎

Case Note

Can Sub-brokers Owe a Duty of Care to (Re)insureds?

by Mark Pring

BP plc v Aon Ltd [2006] EWHC 424 (Comm)

This recent English High Court decision has ruled that an assured (in this case, BP) may be able to establish that a sub-broker with whom it has no contractual relationship can, in certain circumstances, owe it a duty of care in tort.

The Issues

The Court had to decide two key points:

(1) whether Aon London, as sub-broker, owed BP any duty of care with regard to the performance of brokerage services, even though BP had separately entered into a contract relating to those services with Aon Texas, the "producing" broker; and

(2) whether the proper measure of damages payable by Aon London, if it was liable in tort, was

- as Aon contended, the cost of purchasing alternative insurance in the market (together with any shortfalls in the indemnity allowed by such replacement cover based on prevailing market conditions) or
- as BP contended, the losses it would have recovered from insurers, but for Aon London's negligence.

Background

Aon Texas had arranged for Amoco (with whom BP merged in 1999) a global construction insurance "open cover" facility, under which appropriate risks were to be declared. In effect, the open cover constituted a standing offer of insurance that was capable of acceptance during the period January 1, 1999 to July 1, 2000.

BP entered into a Service Agreement with Aon Texas regarding the operation of this open cover. In practice, Aon Texas delegated the declaration function to Aon London.

Aon London declared a series of risks to the leading underwriters. Only four declarations were made during 1999, whereas 26 projects were declared in the first half of 2000, the majority just before expiry of the open cover. By then the offshore construction insurance market had hardened and the low pre-agreed premium rates available under the open cover were increasingly attractive to BP.

In earlier proceedings, BP was obliged to pursue claims against a large proportion of the following market. Following the trial of certain preliminary issues, Mr. Justice Cresswell had held that the majority of the following market underwriters were not on risk because Aon London had failed to declare projects to them prior to the expiry of the open cover. Aon London had acted under the misapprehension that the "leading underwriter clause" in the open cover dispensed with the need for declarations to the following market.

As a result of these losses, and in view of Aon London's acknowledgement that it—not Aon Texas—was the correct defendant to any claim arising out of the action against the following market, BP commenced proceedings against Aon London in tort, alleging its negligent failure to declare projects and effect insurance under the open cover in accordance with BP's instructions.

The Decision

Issue (1)

Mr. Justice Colman held that Aon London owed a duty of care to BP (and its co-assureds). On the fact of the present case, the Judge was satisfied

- that the law recognized that an agent (here, Aon London) could owe a duty of care to a third party (BP) who had a contract with the agent's principal (Aon Texas), as long as the agent voluntarily assumed responsibility to the third party (see *Williams v. Natural Life Health Foods* [1998] 1 WLR 830) and
- on the facts, Aon London had voluntarily assumed responsibility to BP to make valid declarations.

The Judge also found that, although BP already had a Service Agreement with Aon Texas, this did not preclude Aon London's duty of care running in parallel with Aon Texas's contractual duties.

Issue 2

On the measure of damages point, the Judge considered that the starting point was that Aon London was liable for the amount that would have been recovered from the relevant underwriters had valid declarations been made. He accepted, however, that the alternative measure proposed by Aon London might be appropriate where failure to seek replacement insurance amounted to *"a complete departure* */ continued page 12*

Case Note

continued from page 11

from the conduct that could reasonably be expected from an oil company in that position knowing the information which it had," but, on the facts, this had not been established. BP's decision not to take out alternative cover was found to be entirely reasonable in view of the prevailing "hard" market conditions by that stage.

Comment

This is an important decision.

Whilst the Judge did not set out general principles in relation to a sub-broker's duties to the ultimate client, he clearly cast doubt on the previous line of authorities in which it had been assumed that a placing, as opposed to producing, broker (where separate entities are involved) did not owe a duty of care to the assured.

It should be noted, however, that the assured must also establish that it in fact placed reliance on the sub-broker's assumption of responsibility and, in situations where, for instance, the assured may even be unaware of the existence of a sub-broker, it would face clear difficulties in establishing a duty of care. ◎

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