

## INSURANCE AND REINSURANCE

## NewsWire

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**Non-Executive Directors' Liabilities  
and the New Statutory Landscape in  
the UK: An Update***by John Barlow*

The role of a non-executive director within a public company in the UK has changed considerably in recent years and the potential for non-executive directors to become embroiled in "Kafkaesque" litigation has also risen considerably. In this article, John Barlow considers the changing role of the non-executive director and the future legislative pitfalls awaiting the unwary director.

**IN THIS ISSUE**

- 1 Non-Executive Directors' Liabilities and the New Statutory Landscape in the UK: An Update
- 4 Finite Risk Reinsurance
- 6 Breach Of Claims Provisions Under English Law: A "Sirius" Issue for the Insurance Industry
- 8 Guidance on Intervention of English Courts in Arbitration Decisions
- 9 Guidance From the English Courts on Avoidance for Material Non-Disclosure
- 11 New York Courts Confirm Flexibility of Liquidators in Fashioning Plans to Close Estates of Insolvent Insurers

**The Scope of Non-Executive Directors' Duties**

In principle, the duties owed by a non-executive director do not differ from those owed by an executive director. In *Re D'Jan of London Ltd*<sup>1</sup> it was held that the:

*"...duty of care owed by a director at common law is accurately stated in Section 214 (4) of the Insolvency Act 1986. It is the conduct of:*

*...a reasonably diligent person having both:*

- (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company [an objective test], and*
- (b) the general knowledge, skill and experience that director has [a subjective test]."*

On the face of it, the definition does / continued page 2

<sup>1</sup> [1993] BCLC 646.

## Non-Executive Directors' Liabilities

*continued from page 1*

not address the fact that the activities of non-executive directors and the information they may receive often differs from those of executive directors. Nor, indeed, does the proposal in the Department of Trade and Industry consultation document entitled "Company Law Reform"<sup>2</sup> distinguish between classes of directors. It aims to put directors' duty of care on a statutory footing mirroring section 214. Further, the recent raft of European Union Directives, UK legislation and derivative legislation does not draw a distinction between the role of the non-executive director and the executive director.

In considering the duty of care to be exercised when a director (whether in an executive or non-executive capacity) wishes to delegate certain functions, the test was set out in *Re City Equitable Fire Insurance Company Ltd*<sup>3</sup> and provided:

"In respect of all duties [...], having regard to the exigencies of business, and the articles of association, [which] may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly."

Mr Justice Langley in *Equitable Life Assurance Society v. Bowley and others*<sup>4</sup> questioned whether this statement represented the modern law, instead preferring the judgment given by Mr Justice Jonathan Parker in *Re Barings PLC (No. 5)*<sup>5</sup> (and approved by Morritt LJ on appeal) in which he stated:

- (i) Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.
- (ii) Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.
- (iii) No rule of universal application can be formulated as to the duty referred to in (ii) above. The extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director's role in the management of the company."

Whilst this centered on the discussion of delegation to those below the directors "in the management chain," it acknowledged that non-executive directors could delegate their responsibilities to executive directors and other officers of the company,

although each case is "fact sensitive." Whilst this represents a welcome distinction between executive and non-executive directors' responsibilities, its implications in relation to statutory "hold harmless" provisions (discussed below) remains uncertain.

In the same case, Parker J made two further observations in connection with the assessment of a director's duties and potential liabilities:

- (i) anyone accepting the office of a director was required to understand the nature of the duty which he/she was called upon to perform. The nature of that duty would depend on the size and business of that company and the experience the director held himself out as having; and
- (ii) the level of reward might well be a relevant fact in determining the extent of a director's responsibilities.

The context in which the question of delegation took place was in the consideration of an application by Equitable Life's non-executive directors under Section 727 of the Companies Act 1985, which permits an officer of a company (or an auditor), where proceedings are brought (or are contemplated) against him for "negligence, default, breach of duty or breach of trust," to apply to the Court for an order that he be excused from liability. Successful applications under this section, where a director is negligent but should be excused, are comparatively rare, but not unknown. Langley J observed that the Court would have to be satisfied that the officer had acted "reasonably" in "all the circumstances." Given that "all the circumstances" need to be considered, most applications would have to go to a full trial and would be unsuitable (certainly in the Equitable Life case) for summary determination. In his landmark review of non-executive duties, Sir Derek Higgs suggested that to overcome these difficulties, the Lord Chancellor's Department consider steps to "promote active case management in cases applying to directors" and that such claims be fast-tracked.<sup>6</sup> To date nothing concrete has come of this suggestion.

### Company Indemnity for Directors

A "safety net" for directors (and a product, in part, of the Higgs' recommendations), are the amendments to Section 310 Companies Act 1985. Prior to the implementation of the Companies (Audit,

<sup>2</sup> 17 March 2005.

<sup>3</sup> [1925] 1CH.407.

<sup>4</sup> [2003] EWHC 2263 (COMM).

<sup>5</sup> [2000] 1BCLC 523 at p. 535.

<sup>6</sup> Review of the role and effectiveness of non-executive directors — January 2003 (which can be accessed via: [http://www.dti.gov.uk/cld/non\\_exec\\_review/](http://www.dti.gov.uk/cld/non_exec_review/)).

Investigations and Community Enterprise) Act 2004 (“the 2004 Act”), a company could indemnify a director’s legal expenses where he is found not guilty in criminal proceedings or his defense prevailed in civil proceedings. However, under the original section, it was unclear whether a company could indemnify a director on an ongoing basis or whether a director would have to await a final determination before indemnification. The amendments clearly permit a company to indemnify a director in respect of proceedings brought by third parties on an *ongoing* basis. However, where the directors are *unsuccessful* in respect of criminal proceedings and where fines or penalties are imposed or judgment is rendered against the director in civil proceedings then such fees will have to be repaid.

It should be noted that, if such indemnities are given to directors, then they must be disclosed in the directors’ annual report. Underwriters will obviously look carefully at the breadth of the indemnity given that it will impact the corporate reimbursement section (“Side B”) of a D&O policy.<sup>7</sup> Nevertheless, the availability of an indemnity can only be a positive step (subject to an assessment of its value) in the effort to recruit non-executive directors.

## Transparency in Reporting

Whilst the United Kingdom has not suffered corporate failures on the same scale as in the United States (or in mainland Europe), nevertheless it is aligning its corporate governance regime with that of the United States through its own domestic legislation and the implementation of European Union Directives. Directorial responsibility and transparency are the buzz words under this new regime. A raft of new Directives have been introduced by the European Union which have been or are in the process of being implemented (principally by the Financial Services Authority in its rule book rather than through primary legislation). The enhanced requirements for the public disclosure of information by companies (see the EU Prospectus Directive) requires greater scrutiny by the directors and their advisers.

All of these developments have created an enhanced risk environment for directors (and their insurers). In particular, recent domestic legislation has placed significant new responsibilities on directors. The 2004 Act requires that directors of quoted companies make certain disclosure statements in the directors’ report. This

applies not only to information which the officer *actually* knew of but also information he *would have known* about if he had conducted a reasonable inquiry. However, the provision goes further and requires the director to confirm that, so far as the director is aware, there is no relevant audit information of which the company’s auditors are unaware.<sup>8</sup> In determining the extent of the director’s duty, the statutory test (under section 214) is applied: every director who knew such a statement was false or was reckless as to its falsity is liable to a fine and/or imprisonment. Whilst there is no criminal sanction for a confirmation given negligently, there clearly may be civil sanctions (as well as sanctions under the Company Directors Disqualification Act 1986). Underlying this legislation are domestic statutory liabilities under the Financial Services and Markets Act 2000, e.g., general duties of disclosure by those responsible for prospectuses pursuant to section 80 of that Act.

Again, this provision makes no distinction between executive and non-executive directors (unlike the common law position at present), nor does it state what would constitute material disclosure for these purposes. Whilst those involved in the day to day running of the company are clearly best placed to address these issues, non-executives may find themselves considerably disadvantaged and, naturally, will want to consider the assurances they receive from executive officers.

Whilst acknowledgement of the differing responsibilities of executives and non-executive directors is a welcome step forward, both primary and secondary legislation fail to recognize this distinction. It will remain to be seen how the courts will distinguish their roles when applying such legislation. At present, much will turn on the facts, although the discretion allowed to the courts when interpreting section 727 of the Companies Act 1985 means that no certainty can be given to non-executives joining the board of a public company.

One of the central recommendations by Higgs (which recommendations were incorporated into the “Combined Code”) was for the board of directors to be supplied, in a timely manner, with “information in a form and of a quality to enable it to discharge its role.” Higgs’ recommendations were intended to empower non-executives, through recommending that they constructively challenge executives, scrutinize management performance and determine appropriate levels of remuneration. Those non-executives who fail to observe these recommendations do so at their own peril. Whilst Higgs suggested that the failure to observe these recommendations should not result in legal action, nevertheless, in the current environment, they represent a tempting means by which claims can be brought against directors (however unmeritorious) with the attendant rise of wasted legal costs and management time. ☺

<sup>7</sup> Coverage under a D&O policy will generally consist of:  
**Side A:** the insurer indemnifies a director in relation to liabilities arising from their activities as a director. Normally, deductibles are not applied; and

**Side B:** the insurer indemnifies a company where it indemnifies a director and officer, generally pursuant to the Articles of Association. Deductibles may be applied.

<sup>8</sup> Section 234 ZA of the 2004 Act.

# Finite Risk Reinsurance

by David M. Raim and Joy Langford

Finite risk reinsurance has increasingly taken front stage over the past few years. In the United States, both federal and state authorities — most notably the Securities and Exchange Commission (SEC) and the New York Attorney General’s Office — are conducting investigations into the alleged misuse of finite risk reinsurance. A number of additional investigations are underway in Europe and Australia. These investigations have resulted in civil and criminal actions against several companies due to the alleged improper accounting for certain finite risk transactions where underwriting risk was not transferred to improperly mask adverse financial results. In response, regulatory bodies across the world have proposed and, in some instances, already put into effect new regulations to curb perceived abuses. In this article, David Raim and Joy Langford of the Washington office review these developments.

## What is Finite Risk Reinsurance?

There is no generally accepted definition of finite risk reinsurance within the industry. Broadly speaking, it is a form of reinsurance that carefully controls and limits the amount and type of risk transferred to the reinsurer, hence the use of the word “finite.” It can be distinguished from other non-finite or “traditional” types of reinsurance based on the extent to which there are limitations on the risk that the amount of losses will exceed ceded premiums. This risk is generally referred to as “underwriting risk.” While traditional reinsurance may limit the amount of underwriting risk transferred to the reinsurer, finite risk reinsurance does so to a greater extent. Instead, finite risk reinsurance focuses primarily on financial risks, such as timing risk (the risk that losses will need to be paid sooner than expected), investment risk (the risk that the reinsurer will earn less investment income than expected on the reinsurance premium) and credit risk (the risk that the cedent will not make the required premium payments). Sometimes, the principal risk assumed by the finite risk reinsurer is that losses will develop more quickly than expected and the reinsurer will lose the benefit of anticipated investment income on the reinsurance premium.

Finite risk reinsurance contracts are typically treaties that are manuscripted to meet the particular needs of a cedent. They may be quota share or excess of loss treaties and may cover prospective losses or retroactive losses that have already occurred, but where the amount and timing of the loss is not yet known. There are some key features, however, that are present in many finite risk reinsurance contracts. Most contracts cap

underwriting risk, include an explicit recognition of the time value of money, contain a profit sharing mechanism and/or span several years. Each of these aspects of finite risk reinsurance contracts are discussed in turn below.

First, finite risk reinsurance contracts cap the amount of underwriting risk assumed by the reinsurer. In the case of quota share contracts, this is often achieved through the use of a loss ratio cap which limits the reinsurer’s losses to a percentage of the insurer’s written premium. Excess of loss contracts typically reflect a set dollar amount that places a ceiling on losses.

Second, the time value of money is often recognized in finite risk reinsurance through the use of experience account provisions. An experience account is funded by a relatively large reinsurance premium, minus some fees, which then accumulates investment income over time. The parties intend for a significant percentage of loss payments to be funded by the experience account, thereby limiting the risk that the reinsurer will need to pay losses out of its own pocket.

Third, finite reinsurance contracts often contain a commutation clause that allows for profit sharing between the cedent and reinsurer. Such commutation clauses typically allow the cedent to terminate the contract if the experience account balance is positive. The reinsurer is released from any future obligation to pay losses and, in exchange, the cedent receives all or part of the positive balance in the experience account.

Lastly, finite risk reinsurance contracts generally span several years. This allows an individual cedent to mitigate volatility by recognizing a loss gradually, rather than all at once.

## Accounting for Finite Risk Reinsurance

In the United States, a finite risk reinsurance contract, like any other reinsurance contract, may only be accounted for as reinsurance if it (1) transfers significant underwriting and timing risk, and (2) creates a reasonable possibility of a significant loss. Over the years, the accounting profession has developed a numerical rule of thumb requiring at least a 10% probability of a 10% loss to assist in applying this subjective standard. This rule has been criticized by some in recent months. While other countries have their own accounting rules, most generally track the basic principles underlying those in place in the United States.

## Regulatory Investigations and Proposals

Regulators have responded to the investigations into the alleged improper accounting for certain finite risk reinsurance transactions, and ensuing civil and criminal proceedings, by proposing new regulations. The regulations appear to be designed to generate greater transparency and disclosure regarding the use of finite risk reinsurance. The following is a brief summary of the regulatory developments to date in Australia, Bermuda, the European Union, Ireland, the United Kingdom and the United States:

**Australia:** The Australian Prudential Regulation Authority (APRA), the regulator of the Australian financial services industry, initially turned its attention to finite risk reinsurance when it concluded that the alleged misuse of finite risk reinsurance contributed to the 2001 collapse of the HIH Insurance Group — Australia's largest corporate failure to date. In May 2005, APRA proposed strict requirements for the approval and documentation of "limited risk transfer arrangements." See <http://www.apra.gov.au/Policy/Draft-Prudential-Standards-General-Insurance-Risk-and-financial-management.cfm>. Companies would have to seek the approval of APRA prior to entering into such arrangements. APRA has proposed that the new regulatory requirements take effect in January 2006.

**Bermuda:** Regulators at the Bermuda Monetary Authority (BMA) have announced that they intend to tighten laws on how certain finite risk reinsurance arrangements are reported.

**European Union:** The European Union (EU) is planning to create a single reinsurance market through the adoption of a proposed reinsurance directive. The directive contains provisions requiring the disclosure of finite risk reinsurance contracts to regulators. Moreover, it permits the country where the reinsurer is domiciled, referred to as the company's "home state," to promulgate additional requirements for finite risk reinsurance. See <http://www2.europarl.eu.int/oeil/file.jsp?id=243432>.

**Ireland:** The Irish Financial Services Regulatory Authority (IFSRA) has asked each reinsurance group in Dublin's International

Financial Services Centre (IFSC) to verify that there are no "issues" with finite risk reinsurance contracts they have written.

**United Kingdom:** The Financial Services Authority (FSA) has requested that insurers provide information on their use of finite risk reinsurance and certify by the end of April 2005 that they have not entered into finite risk reinsurance contracts which might "obscure the firm's financial position or which could put [the] firm at risk of breaching any applicable regulatory requirements." See [http://www.fsa.gov.uk/pages/about/media/pdf/engineering\\_letter.pdf](http://www.fsa.gov.uk/pages/about/media/pdf/engineering_letter.pdf). The FSA has also announced that it intends to review current regulations to determine whether to require companies to provide additional disclosures.

**United States:** The Securities and Exchange Commission (SEC) and the New York Attorney General, as well as a number of state insurance departments, have subpoenaed many companies as part of an investigation into finite risk reinsurance. These investigations have prompted the Financial Accounting Standards Board (FASB), National Association of Insurance Commissioners (NAIC) and New York Insurance Department, among others, to propose new rules to govern the use of finite risk reinsurance.

- The FASB is currently considering modifying the risk transfer criteria for finite risk reinsurance contracts.
- At the June 2005 meeting of the NAIC, the NAIC Property and Casualty Reinsurance Study Group approved enhanced disclosure requirements for insurers that utilize reinsurance with limited risk transfer features. The latest proposed disclosures would require an insurer to report to state insurance regulators any finite reinsurance agreement that has the effect of altering policyholders' surplus by more than three percent, or representing more than three percent of ceded premium or losses. The Study Group also approved a standard attestation form to be signed by the insurer's CEO and CFO attesting that there are no side agreements and that risk transfer has occurred. See News Release 6-12-05 at [http://www.naic.org/pressroom/issues/finite\\_re.htm](http://www.naic.org/pressroom/issues/finite_re.htm).
- In March 2005, the New York Insurance Department issued Circular Letter No. 8 requiring that the CEO of a company attest that there are no side agreements to a reinsurance contract that could limit its downside risk and that the company has an underwriting file documenting the economic intent of the transaction as well as a risk transfer analysis "evidencing the proper accounting treatment." See Circular Letter No. 8 (March 2005) at <http://www.ins.state.ny.us/year05.htm>. In early August, the Department stated that in light of the NAIC's new national attestation requirements (noted above) and in the interest of uniformity, it will discontinue / continued page 6

## Finite Risk

*continued from page 5*

the requirement for the attestation for property/casualty insurers established by Circular Letter No. 8. However, until the filing of the 2005 annual statements, these attestations will be required on examination of property/casualty insurers. See Supplement No. 1 to C.L. No. 8 (2005) at <http://www.ins.state.ny.us/year05.htm>. The Department also proposed changes to the statutory accounting rules that would require finite reinsurance contracts to be bifurcated to separately reflect their financing and risk transfer components.

## Guidance from the IAIS

The International Association of Insurance Supervisors (IAIS)

has recognized the need for supervisory awareness and guidance in the area of finite reinsurance. The IAIS Subcommittee on Reinsurance and Other Forms of Risk Transfer accordingly plans to issue a guidance paper outlining the key areas that supervisors should focus on, surveying a world-wide network of insurance supervisors and including case examples of finite risk reinsurance policies where there have been regulatory problems. Following consultation with IAIS members and observers later this year, the supervisory guidance paper will be proposed for adoption by IAIS members in October 2006 and will subsequently be made available to the public. See [http://www.iaisweb.org/050317\\_Final\\_Press\\_-\\_Finite\\_risk\\_reinsurance\\_\\_\(2\).pdf](http://www.iaisweb.org/050317_Final_Press_-_Finite_risk_reinsurance__(2).pdf). ©

# Breach Of Claims Provisions Under English Law: A “Sirius” Issue for the Insurance Industry

*by Mark Pring*

The recent English Court of Appeal decision in *Friends Provident Life & Pensions Ltd - v - Sirius International Insurance Corp* [2005] EWCA Civ 601 (“*Sirius*”) has significant implications for the insurance (and reinsurance) industry. The Court was asked to consider what remedy should be available to an insurer in circumstances where the legal consequences of breach of a claims provision had not been made clear in the insurance contract. In this article, Mark Pring considers the background to and implications of the Court of Appeal’s decision.

## Background

In the original first instance hearing in *Sirius*, Mr Justice Moore-Bick had been asked to determine a number of preliminary issues regarding the construction of notification provisions in the “primary” and “first excess” layer professional indemnity (“PI”) insurance contracts. The cover had been provided to Friends Provident by Sirius and others, following Friends Provident’s acquisition of London & Manchester Assurance Company Limited.

As a consequence of regulatory investigations into the alleged “mis-selling” of pensions plans, Friends Provident was required to pay over £9 million in compensation to clients. It therefore sought to recover these amounts from its insurers under the PI contracts. Those contracts operated on a “claims made” basis, whereby insurers agreed, subject to the contract terms, to indemnify Friends Provident against losses arising from claims notified to insurers during the relevant policy period.

The notification provision considered was as follows:

### *Excess layer (Clause 5)*

*“Any claim(s) made... or... discovery... of any... circumstances of which the Assured becomes aware during the subsistence hereof which are likely to give rise to a claim... shall, if it appears likely... such claim(s)... may exceed the indemnity... of the [underlying insurance]... be notified immediately... in writing to the Underwriters hereon.”*

The preliminary issue relevant to the appeal was whether Clause 5 of the Excess Layer was (1) a condition precedent to liability under the excess policies, or (2) an “innominate” term (i.e., a term which cannot be identified at the inception of the contract as either fundamental to the contract or minor), or (3) a term, breach of which gives rise to a right to damages only.

Compliance with Clause 5 was not described in the excess layer contracts as a condition precedent to liability (by contrast with the notice provision in the primary layer policy). Moore-Bick J. instead

found, following the reasoning of the Court of Appeal in *Alfred McAlpine Plc v BAI (Run-off) Ltd* [2000] Lloyd's REP IR 352 ("BAI"), that it was an "innominate" term, breach of which, if "sufficiently serious," would entitle the insurers to reject Friends Provident's claim.

In *BAI*, the Court of Appeal had wrestled with its concern that policy conditions, unless classified as conditions precedent, may be all but meaningless to an insurer (or reinsurer) if proof of actual loss, required to sustain a damages claim, cannot be established. Lord Justice Waller, delivering the leading judgment in *BAI*, therefore put forward the concept of the "repudiation of a claim." He accepted that a serious breach of a claims condition (both in terms of the "culpability" of the assured in breaching the condition and the effect of the breach on the insurer) gave insurers the right to treat the relevant claim as repudiated, while leaving the contract as a whole unaffected. In one case - *Bankers Insurance Co Ltd v- South* [2004] Lloyd's Rep. IR.1 - this reasoning was applied to deprive the assured of a right to claim.

## The *Sirius* appeal

In *Sirius*, however, a majority of the Court of Appeal (with Lord Justice Waller, unsurprisingly, dissenting) restored what many commentators consider to be the more conventional analysis of terms in insurance contracts.

Lord Justice Mance (now Lord Mance, following his elevation to the House of Lords) gave the leading judgment. He first of all accepted the conclusion of Moore-Bick J. that Clause 5 was not a condition precedent.

Proceeding on the basis that Clause 5 was, instead, an innominate term, Lord Justice Mance forcefully rejected the conclusion reached by the separate Court of Appeal panel in *BAI* that breach of such term, if "sufficiently serious," could allow insurers to avoid liability for the claim in question. He considered, as a starting point, that "English insurance law is strict enough as it is in insurers' favour. I see no reason to make it stricter." As a consequence, because insurance contracts are not severable (Lord Justice Mance noted that in normal circumstances "the premium ... is incapable of being severally allocated to any risk or claim"), the Court of Appeal should not introduce "a new doctrine of partial repudiatory breach" as a "novel form of protection for insurers." A (sufficiently) serious breach of an innominate term could only result in the discharge of the entire contract, not any individual claim.

In support of his position, Lord Justice Mance stated that the comments made in *BAI*, along with arguably supportive comments in subsequent cases, regarding the possible "repudiation of a claim" were strictly "obiter dicta" - and therefore not binding on the same Court in *Sirius*. Equally, focusing on the specific con-

tract in issue in *Sirius*, he held that he was "unable as a matter of construction or implication to find in [Clause 5] any provision that insurers will be free of liability in the event of a serious breach and/or a breach with serious consequences." He therefore saw no hurdle to reaching his wider conclusions regarding the potential remedies for breach of an innominate term in the context of an insurance contract.

## Implications of the decision in *Sirius*

At a practical level, the judgment in *Sirius* highlights the importance of clear drafting by the parties to insurance contracts of not only the wording of a term but also the agreed remedy in the event of a breach of that term. If an insurer (or reinsurer) considers a claims condition to be sufficiently important, it should negotiate "condition precedent" language, however tricky that might be in particular market conditions. In this way, any breach would automatically deprive the assured of his rights to press his claim, while leaving the remainder of the policy untouched.

The judgment in *Sirius* has been characterised by some commentators as "anti-insurer," on the basis that, absent condition precedent language, the only remedy for breach of a notice provision in the vast majority of cases will be damages. Lord Justice Waller's concern, as expressed in his dissenting judgment in *Sirius*, is that the calculation of such damages (identification of actual loss or prejudice) will prove too difficult and the remedy, therefore, illusory. The counter-argument is that the possibility of arguing that there was a "sufficiently serious" breach of an innominate term in the insurance context raised equally difficult practical issues. How could the conduct leading to the breach be proven to be serious and (similar to the damages issue) how could the insurer be shown to have suffered serious prejudice?

Lord Justice Mance considered that there was a clear commercial rationale for returning to the legal position pre-*BAI*: "For my part, I do not think that it is obvious that the broking and underwriting sides of the market would regard even as reasonable a provision such as suggested in *BAI*, and I do not see any reason why the court should impose it on them. A test of 'serious breach' and/or 'serious consequences' might have some drastic and unfair consequences."

If, despite the conflicting Court of Appeal decisions, *Sirius* comes to be the accepted authority — it has been followed in one subsequent first instance decision, *Ronson International Limited v Patrick* (H H Judge Seymour QC, 6 July 2005) — then the current position, in the absence of condition precedent language, appears to be:

The Courts are unlikely to imply condition precedent language — and, as shown in the recent

/ continued page 8

## Breach Of Claims Provisions

*continued from page 7*

*Bonner v Cox*<sup>1</sup> decision, do not seem willing to imply terms of any kind into reinsurance contracts in particular.

Even if a claims condition is characterized as an innominate term, breach of that term is not likely to be considered as going to the “root” of a contract justifying the repudiation of the contract as a whole. (This was the case even before *BAI*.)

After *Sirius*, insurers must still pay an individual claim in the

event of a breach of the claims condition. If they cannot repudiate the contract as a whole, their only remedy would be damages.

Fraudulent claims stand entirely outside these principles. As decided by the Court of Appeal in *Axa v Gottlieb*<sup>2</sup>, overriding public policy considerations require that an assured cannot recover any sums in respect of a fraudulent claim, regardless of whether the fraud post-dated the loss itself.

The House of Lords Judicial Office has confirmed that no petition for appeal has been lodged with it in relation to the *Sirius* decision. ©

# Guidance on Intervention of English Courts in Arbitration Decisions

*by Michelle Radom*

## *Lesotho Highlands Development Authority v. Impregilo SPA & Ors* [2005] UKHL 43

The English House of Lords ruled in July of this year, that, where arbitrators had misinterpreted the original contract between the parties, an appeal from the award would only be allowed on the ground that the arbitrators had made an error of law. No appeal would be allowed on the ground that the arbitrators had exceeded their powers. This decision is significant in particular because parties may agree to exclude appeals based on a question of law but they cannot choose to exclude an appeal based on an excess of power.

### Facts

Seven contractors claimed reimbursement from the Lesotho Highlands Development Authority. The contract between the parties was governed by the law of Lesotho but provided for arbitration under the rules of the International Chamber of Commerce (ICC). The parties agreed that the arbitration would take place in London and any dispute would be settled in accordance with the UK Arbitration Act 1996.

The arbitrators found in favor of the contractors and made an award in European currencies. The arbitrators also awarded simple interest from the date payment had been due under the contract between the parties.

The House of Lords was asked to consider the following issues:

- 1 Should the award have been made in European currencies when the contract had provided for payment of sums due in Lesotho currency?
- 2 Should the award have included pre-award interest? The contract was silent on this point, but Lesotho law would not have allowed this.

- 3 If the arbitrators had erred, could it be said that they had exceeded their powers? Under the Arbitration Act, an award can be challenged on this ground and the parties cannot agree to exclude appeals based on this ground. An award can also be challenged under the Arbitration Act if the arbitrators make an error of law but, crucially, the parties in this case had agreed that this right would be excluded.

### Decision

- 1 Under the Arbitration Act, an award could be made in any currency “unless otherwise agreed by the parties.” As the contract had specified for payment in Lesotho currency, the arbitrators could not award any other currency.
- 2 Under the Arbitration Act, an award can include simple interest from such date as is just in the case, “unless otherwise agreed by the parties.” The House of Lords held that the mere

<sup>1</sup> [2004] EWHC 2963 (Comm)

<sup>2</sup> [2005] EWCA CIV 112

fact that the contract was subject to Lesotho law (which did not allow pre-award interest) was not enough to show that the parties had “agreed” to exclude such an interest award.

- 3 Given that the arbitrators had made an error of law on the currency issue, what was the effect of that error?

Under the Arbitration Act, an appeal against the arbitrators’ award can be made i.) on a question of law, or ii.) on the ground of serious irregularity (which is defined as including an excess of the arbitrators’ powers). The parties can (and in this case, did) only agree to exclude appeals based on a question of law. The issue was therefore whether the misinterpretation of the contract constituted an excess of power.

The court held that an “excess of power” means that arbitrators have sought to exercise a power which they did not have. It does not mean that they have mistakenly exercised a power which they

do have. In other words, where the arbitrators simply “get it wrong,” the only challenge can be on the basis of error of law (provided the parties have not agreed to exclude such challenges).

### Comment

This case confirms the tendency of the English courts to adopt a non-interventionist approach to arbitration proceedings. As one of the Law Lords in the case noted, the purpose of the Arbitration Act “was to reduce drastically the extent of intervention of courts in the arbitral process.” The courts will find “serious irregularities” only in extreme cases. Parties should therefore bear this in mind when deciding to include an agreement to arbitrate in their contracts. Moreover, if parties want to be able to appeal a decision by the arbitrators on the ground that arbitrators have misinterpreted the contract wording, they will need to ensure that right is not excluded by their contract. ☺

## Guidance From the English Courts on Avoidance for Material Non-Disclosure

by Michelle Radom

### *ERC Frankona Reinsurance v. American National Insurance Co*

[2005] EWHC 1381

The English High Court considered various issues relating to alleged material misrepresentations and non-disclosure by a reinsured. Some helpful guidance was given as to what facts known by a reinsured/insured’s agent must be disclosed by the reinsured/insured prior to inception of a policy. The Court also found, on the basis of evidence of market practice, that a slip scratched “TBE” (“to be entered”) was still a binding contract.

### Facts

ESR (the “Reinsurer”) was the quota share reinsurer of American National Insurance Co. (the “Reinsured”). The Reinsured participated in an accident and health insurance pool managed by National Accident Insurance Underwriters Inc. (“NAIU”). NAIU’s chairman and chief operating officer was Mr. Drobny. Prior to the Reinsured’s (or the Reinsurer’s) participation, the reinsurance placing brokers had been Bradstock, which had been replaced by another firm of brokers by the time the Reinsured participated in the pool.

The Reinsurer sought to avoid the policy on the grounds of various alleged misrepresentations and non-disclosures, including the following:

- (i) The Reinsured had failed to disclose that Drobny had, several years before the Reinsured’s or Reinsurer’s participation, faced two charges of fraud;
- (ii) When the quota share reinsurance was originally placed, Bradstock had represented that the pool wrote only direct business and not reinsurance. It was alleged that by the time of the renewal (and the Reinsured’s participation), that was no longer the case and this representation had not been corrected by the Reinsured; and
- (iii) When the Reinsurer had been asked to increase its line, it scratched the slip “TBE” (“to be entered”) in April 1999. Certain losses had been sustained by the pool by that time. The slip was scratched again in June 1999 (with / continued page 10

## Material Non-Disclosure

*continued from page 9*

“TBE” removed) after the losses had increased further. It was argued that these losses ought to have been disclosed.

### Decision

(i) The Court had no difficulty in finding that the alleged dishonesty of Drobny was material. Because NAIU had authority to underwrite and handle claims and the Reinsurer was bound to follow the Reinsured’s settlements, the Reinsurer would want to know about the prior dishonesty of NAIU’s chairman and chief operating officer. The Court also found that the Reinsured itself (and not just its agent) had the requisite knowledge concerning the prior fraud charges against Drobny, since the Reinsured’s Senior Vice President was found to have known this information prior to placing (or at least ought to have known this information in the ordinary course of business). Hence the Court concluded that the Reinsurer was entitled to avoid the policy because of the non-disclosure of Drobny’s prior misconduct.

The Court went on to consider what the position would have been had only the Reinsured’s agent, NAIU, but not the Reinsured itself, known this information. In other words, under what circumstances would the Reinsured be *deemed* to know what its agent knows. Under English law there are three circumstances when knowledge of an agent is attributed to an (re)insured and must be disclosed to Underwriters. However the Court ultimately concluded that none of these circumstances was applicable on the facts of this case:

(a) Where the (re)insured relies on the agent for information concerning the subject matter of the insurance, i.e. the agent is an “agent to know.”

The court rejected the argument that the Reinsured, when appointing NAIU as its agent, had intended to rely on NAIU for information about NAIU’s officers.

The Reinsured had also argued that it could rely on an exception to the rule that it would be deemed to know what its “agent to know” knew. This exception applies in a situation where the agent knows about his own fraud (and hence would not have disclosed that to his principal). However, the Court found, on the facts, that, had NAIU been an “agent to know,” the exception would not have applied because there was no reason for NAIU not to disclose Drobny’s prior alleged misconduct to the Reinsured.

(b) Where the agent is in such a predominant position in relation to the (re)insured that his knowledge is to be regarded as the knowledge of the (re)insured.

On the facts, the Court rejected that NAIU was in such a predominant position with respect to the Reinsured.

(c) Where the agent is used to effect the insurance (an “agent to insure”). In such cases, the agent himself must disclose the relevant information.

The Court agreed with previous authority that only a placing broker, and no other intermediary, can be an agent to insure.

(ii) The Court found that the Reinsured did in fact write reinsurance business and that this was material to the Reinsurer. Generally, a reinsurer will want to know if the risk being ceded was controlled and individually written by the reinsured.

In this case, the misrepresentation concerning the business written had been made by Bradstock on the initial presentation of the reinsurance and before the Reinsured agreed to participate in the pool. Ordinarily, the Reinsured would be obliged to correct any representation which was true when originally made but which had become untrue by the time of a subsequent renewal. However, as the original presentation had been made orally, neither the Reinsured nor the replacement brokers could have known about it and hence there was no obligation on the Reinsured to disclose that the information provided on the initial presentation was no longer accurate.

(iii) The Court accepted that the letters “TBE” did not prevent the slip from becoming binding. The letters merely demonstrated that the Underwriter did not have his records available to mark up his entry. The information regarding losses which was known to NAIU but not to the Reinsured was deemed to be known by the Reinsured. As NAIU was obliged to report losses monthly to the Reinsured, it was an “agent to know” for this purpose (see above). The Court concluded that the information regarding the pattern of losses up to the date when the slip was first scratched was material. Accordingly, the information ought to have been disclosed by the Reinsured. Nor would the exception referred to under (i)(a) above apply. The losses might show that NAIU was incompetent, and hence be embarrassing for it, but there was no reason to suppose that NAIU would withhold that information.

This therefore gave the Reinsurer another ground to avoid the policy.

### Comment

The case gives valuable guidance as to when the knowledge of an agent must be disclosed to potential insurers/reinsurers prior to inception of a policy, even in the absence of actual knowledge on the part of the insured/reinsured. ☺

# In Novel Case Handled by Chadbourne, New York Courts Confirm Flexibility of Liquidators in Fashioning Plans to Close Estates of Insolvent Insurers

by James C. La Forge

In a case of first impression in New York, on March 15, 2005 the Appellate Division of the New York Supreme Court, First Department, handed down a decision in *B.D. Cooke & Partners Limited v. Nationwide Mutual Insurance Company*, which addressed the issue of whether a liquidator of an insolvent insurer may assign the reinsurance assets of the insolvent company to a creditor as part of a plan to close the estate of the insolvent. The appellate court affirmed a lower court's decision upholding the validity of the subject assignment under New York law.

The assignment was the key element of a liquidation plan proposed by the liquidator of Citizens Casualty Company of New York, which had been declared insolvent and placed into liquidation in 1971. Due to the amount of outstanding and IBNR (incurred but not reported) claims against Citizens as of 1971, the Citizens estate remained open to process these claims until 1997, when the proposed liquidation plan and assignment received court approval, thereby allowing partial payment of claims against Citizens by its reinsurance creditors together with closure of the Citizens estate.

In 2002, Chadbourne commenced a lawsuit against Nationwide Mutual Insurance Company on behalf of B.D. Cooke & Partners Limited. B.D. Cooke, which had been the largest creditor of the Citizens estate, had received from the liquidator of Citizens an assignment of Citizens' reinsurance assets in exchange for B.D. Cooke's withdrawal of over \$30 million in claims against the Citizens estate. Nationwide was one of several companies that had participated with Citizens in a reinsurance pool beginning in the early 1960s and, as such, Nationwide had reinsured numerous policies issued by Citizens. Nationwide had refused to pay amounts billed to it by B.D. Cooke pursuant to the assignment.

In the litigation, Nationwide challenged B.D. Cooke's right to collect reinsurance from Nationwide under the assignment. In 2003, each party moved for summary judgment in its favor. The trial court rejected Nationwide's effort to dismiss B.D. Cooke's complaint and dismissed all of Nationwide's defenses except its contention that Nationwide could offset amounts for claims it purported to have against the insolvent estate of

Citizens. Both parties appealed the court's decision.

On December 14th, 2004, oral argument of the parties' appeals was heard by a panel of five appellate judges in Manhattan. Carey Child of Chadbourne's DC office argued the appeals on behalf of B.D. Cooke. In March 2005, the appellate court found unanimously for B.D. Cooke, upholding the validity of the subject assignment and dismissing Nationwide's sole remaining defense of offset. The New York Insurance Department has praised Chadbourne for obtaining this ruling, which will aid the Department in crafting and implementing plans to liquidate insolvent insurers in the future.

Nationwide has indicated that it will seek review of this decision by the New York Court of Appeals, New York State's high court, after the trial court has entered a final judgment. ©

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**Partners – Washington**



**David M. Raim**  
(202) 974-5625  
dram@chadbourne.com



**William K. Perry**  
(202) 974-5611  
wperry@chadbourne.com



**Joy L. Langford**  
(202) 974-5647  
jlangford@chadbourne.com



**Ellen H. Woodbury**  
(202) 974-5718  
ewoodbury@chadbourne.com



**Carey G. Child**  
(202) 974-5730  
cchild@chadbourne.com



**Philip J. Goodman**  
(202) 974-5621  
pgoodman@chadbourne.com



**John J. Sarchio**  
(212) 408-5225  
jsarchio@chadbourne.com



**Adrian Mecz**  
+44 (0)20-7337-8040  
amecz@chadbourne.com



**Christopher Cardona**  
+44 (0)20-8041  
ccardona@chadbourne.com



**Michelle George**  
+44 (0)20-7337-8042  
mgeorge@chadbourne.com



**John Barlow**  
+44 (0)20-7337-8044  
jbarlow@chadbourne.com



**Mark Pring**  
+44 (0)20-7337-8043  
mpring@chadbourne.com

**Counsel – Washington**



**Donald J. Mros**  
(202) 974-5692  
dmros@chadbourne.com



**Susan C.M. Aldridge**  
(202) 974-5643  
saldridge@chadbourne.com



**James C. La Forge**  
(212) 408-5511  
jlaforge@chadbourne.com



**Ellen MacDonald Farrell**  
(202) 974-5694  
efarrell@chadbourne.com



**Lori Hildebrand**  
(202) 974-5759  
lhildebrand@chadbourne.com



**Thomas Klemm**  
(202) 974-5723  
tklemm@chadbourne.com



**Kate McSweeny**  
(202) 974-5745  
kmsweeny@chadbourne.com



**William C. O'Neill**  
(202) 974-5680  
wo'neill@chadbourne.com

**Associates – London**



**Joshua N. Weiner**  
(202) 974-5726  
jweiner@chadbourne.com



**Anthony Bailey**  
+44 (0)20-7337-8047  
abailey@chadbourne.com



**Carlos Fane**  
+44 (0)20-7337-8055  
cfane@chadbourne.com



**Julia Ford**  
+44 (0)20-7337-8067  
jford@chadbourne.com



**Rebecca E. Huggins**  
+44 (0)20-7337-8061  
rhuggins@chadbourne.com



**Eugene Matveichuk**  
+44 (0)20-7337-8049  
ematveichuk@chadbourne.com



**Jonathan P.N. Ogle**  
+44 (0)20-7337-8068  
jogle@chadbourne.com



**Anita M. Rivera**  
+44 (0)20-7337-8064  
arivera@chadbourne.com

**Other Attorneys**



**Kathryn L. Cervon**  
(202) 974-5716  
kcervon@chadbourne.com



**Nancy Monarch**  
(202) 974-5796  
nmonarch@chadbourne.com



**Michelle Radom**  
+44 (0)20-7337-8054  
mradom@chadbourne.com

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**Chadbourne & Parke LLP**

30 Rockefeller Plaza  
New York, NY 10112  
(212) 408-5100

1200 New Hampshire Ave., NW  
Washington, DC 20036  
(202) 974-5600

350 South Grand Ave.  
Suite 3300  
Los Angeles, CA 90071  
(213) 892-1000

1100 Louisiana, Suite 3500  
Houston, TX 77002  
(713) 571-5900

Chadbourne & Parke  
a multinational partnership  
Regis House  
45 King William Street  
London EC4R 9AN  
+44 (0)20-7337-8000

Riverside Towers  
52/5 Kosmodamianskaya Nab.  
Moscow, Russian Federation 115054  
+7 (095) 974-2424  
Direct line from outside C.I.S.:  
(212) 408-1190

Chadbourne & Parke  
Radzikowski, Szubielska and Partners LLP  
ul. Emilii Plater 53  
00-113 Warsaw, Poland  
Telephone +48 (22) 520-5000

11 Mykhailivska Street, 4th Floor  
Kyiv 01001, Ukraine  
Telephone +380 (44) 230-2534

90 Shevchenko Street, 3rd Floor  
Almaty 050022, Kazakhstan  
Telephone +7 (3272) 585-088

Beijing Representative Office  
Room 902, Tower A, Beijing Fortune Centre  
7 Dongsanhuan Zhonglu, Chaoyang District  
Beijing 100020, China  
+86 (10) 6530-8846

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