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EDWARDS ANGELL PALMER & DODGE

Insurance and Reinsurance Review

June 2009

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The New Regulatory Order

While the most significant consequence of the global economic crisis is the unprecedented volume of stimulus funds being pumped into the economy, calls for a global regulatory overhaul of the banking industry come a close second.

Inevitably, the insurance industry will not escape these regulatory changes, some of which are long-running projects predating the credit-crunch. In this article, we examine the various reports, initiatives and legislation from major insurance jurisdictions – the European Union (EU), UK, US, Bermuda and China's two special administrative regions of Hong Kong and Macau – that could shape the industry's regulation for the next generation. Before doing so, we will outline the global developments.

Global Developments – the G20

The G20 summit in April of this year provided a vital opportunity for world leaders to discuss the economic crisis. The most notable success was the agreement of a significant global stimulus package of over US$1 trillion. However, it was also seen as important that the G20 agreed on more than just cash injections and broad consensus was reached on a variety of issues. Key pledges included the reparation of the financial system and the rejection of protectionism. As expected, it was also agreed that financial regulation should be strengthened.

Prior to and following the summit, a number of bodies published open letters to the G20, including the Geneva Association, an organisation comprised of CEOs from the world's leading insurance and reinsurance companies. In relation to insurance supervision and regulation, the Geneva Association letter called for the future supervisory architecture to be built on a sound foundation of national regulation that took into account the differences between insurers and other financial service providers. The letter argued that uncoordinated national responses and protectionism were counterproductive to the proper functioning of the financial markets and harmed the international exchange of goods and services. Regulatory reform, it said, must be focused, measured and considered to avoid such pitfalls as excessive capital requirements, which were as dangerous as insufficient capital requirements.

Whether the various bodies tasked with implementing the G20 regulatory action plan take account of the various representations made to them will become clearer over the next six months. Progress will be measured at the next meeting of the G20 Finance Ministers in November 2009.

Europe

The main developments within the EU have been in relation to the ongoing Solvency II project and a recent report by a high-level group on financial supervision, chaired by Jacques de Larosière.

The de Larosière Report

The report, published in February 2009, acknowledged that some aspects of the European regulatory framework have been pro-cyclical and helped turn what was initially a liquidity problem into a solvency problem. The report made 31 recommendations, split between supervisory and regulatory issues, for the reform of financial services supervision. Some of the key proposals affecting insurers include:

- credit rating agencies should be regulated
- the Solvency II regime, including provisions for group support (as to which, see below), must be adopted urgently
- the powers of supervisory authorities should be strengthened where necessary
- core rules should be harmonised by removing national exceptions to European legislation which distort competition or promote regulatory arbitrage

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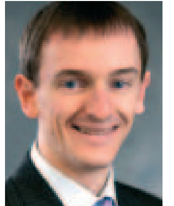
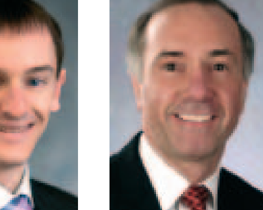

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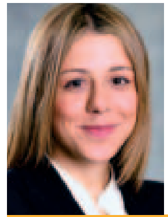

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- remuneration policies in financial services firms should be overseen by supervisory authorities, and
- there should be a greater focus on internal risk management, giving senior risk officers high ranks in institutions. The report calls on authorities to inspect internal risk management systems frequently.

Solvency II

Shortly after the publication of the de Larosière Report, the Solvency II framework directive was finally agreed, after significant delay, in March 2009. The proposals have been formally passed by both the European Parliament and the Council of Ministers.

The delay in agreeing the directive was due to a failure to reach consensus on two key issues: group supervision and equity market risk.

The group supervision proposals were seen as an important element of the proposed directive. These provisions would have enabled the regulator of the head office of an insurance group to oversee the regulation of, and set capital levels for, the entire group. Regulators in other jurisdictions where the group operated would have assisted the lead regulator as the need arose. However, ultimately the resistance to the proposals from Member States whose regulators feared being overshadowed by the likes of the UK, France and Germany (who would take the lead in the regulation of the majority of pan-European insurance groups) was too strong. The proposal to allow group capital levels was therefore omitted from the directive. While it was agreed that this could be reviewed three years after the framework is implemented in 2015, the EU has missed the best opportunity it has had to implement a system of international group supervision.

Another key area of contention was in relation to the 'duration approach' to equity market risk. The duration approach is based on the argument that the risk of holding equities declines on a long-term basis. Therefore the capital charge for holding equities should decrease as the length of the liabilities against which they are held increases. It was eventually agreed that member states could use the duration approach for certain life insurance products.

The approval of the framework directive keeps the timetable for implementation of Solvency II by 2012 on schedule.

UK

The Turner Review

The regulator of the financial services industry in the UK, the Financial Services Authority (FSA), published its much-anticipated review of global banking regulation, spearheaded by its Chairman Lord Turner, in March 2009. The review analysed the events that led to the financial crisis and recommended reform based on a 'macro-prudential' approach rather than focusing solely on specific firms.

Although the review concentrated on banking regulation, key areas of regulatory scrutiny, such as capital adequacy and liquidity, are likely to have implications for insurers too. The main causes of the crisis were identified as macro-economic imbalances, financial innovation 'of little social value' and important deficiencies in key bank capital and liquidity regulations:

"The approach [to reform] has to build on a system-wide perspective: failure to look at the big picture was far more important to the origins of the crisis than any specific failures in supervising individual firms," Lord Turner said. *"It must reflect the reality of a global financial system without a global government; we need both far more intense international co-operation and greater use of national powers."*

The review's key recommendations are:

- more and higher quality bank capital, particularly to support risky trading activity
- counter-cyclical capital buffers built up in good times to be drawn on in downturns
- tighter regulation of liquidity
- regulation of shadow banking activities and credit rating agencies
- changes to the FSA's supervisory approach, building on the Supervisory Enhancement Programme and centring on business strategies, system-wide risks instead of internal processes, and structures, and
- reform of the European banking market, including a new European regulatory authority, together with increased national powers to constrain risky cross-border activity.

The review also touched on credit default swaps, saying a full debate was needed on how to improve regulation in this area. As a start, however, it suggested that clearing and central counterparty systems should be developed to cover standardised contracts.

US

In the US, the federal government under the McCarran-Ferguson Act has authority to intervene in insurance regulation but, for the most part, it has left such regulation in the hands of each of the individual states. In recent years, the federal government has sought to exert greater control over the insurance industry and the states have fought back aggressively to hold on to their authority.

Optional Federal Charter

While the concept of an Optional Federal Charter (OFC) has generated some interest from larger property/casualty insurers and the life industry particularly, it has never proceeded much past the discussion stage due to strong opposition from the National Association of Insurance Commissioners (NAIC), i.e. state regulators, and various trade associations.

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The industry's reaction to an OFC, in very simplistic terms, is split based on size, with large insurers mostly expressing support for an OFC, while small and mid-sized carriers largely in opposition. The latter contend that an OFC would put them at a competitive disadvantage.

The OFC bill (first proposed in May and July 2007) and several other federal insurance bills were never even considered last year as Congress's sole focus in the remaining months of the 2008 legislative session was to address the financial credit crisis and the related government bailout of the banking industry.

Now in the aftermath of these financial rescue plans, the call for federal insurance regulation in the US has started to gain momentum. It received the support of a working group on financial reform appointed by President Obama known as the 'Group of Thirty', which was followed by a statement by Treasury Secretary, Tim Geithner, who said that a federal insurance charter had a lot of merit and should be reviewed carefully.

On the heels of these pronouncements from the Obama advisors comes the latest incarnation of federal regulation of insurance in the form of a broad insurance regulatory reform bill that would create an Office of National Insurance (ONI) to monitor the insurance industry for systemic threats. The new legislation, known as the National Insurance Consumer Protection and Regulatory Modernization Act, was introduced in the US House of Representatives in April 2009 by Representatives Melissa Bean of Illinois and Ed Royce of California. The bill would create a federal charter for insurance regulation that would allow insurers the ability to opt for federal rather than state oversight.

Under this proposed Act, the NAIC's model laws on consumer protection would be incorporated into the newly created ONI. This office would provide more uniform regulation of insurers across the country and oversee their financial and market conduct. The legislation would also:

- establish a national system of regulation and supervision for nationally registered insurers, agencies and producers
- create a new 'systemic risk' regulator to monitor insurers and gather financial data from insurers and other affiliates in a holding company structure, and
- create a national guaranty corporation that would assess national insurers if a state guaranty association did not provide policyholders with a level of protection equivalent to the NAIC model standards.

According to an independent study released in March 2009, the creation of a new federal insurance regulator would require a staff of roughly 2400 and an annual budget of US$465 million. The study also assumes that approximately one-quarter of regulated entities would opt for federal oversight rather than state regulation.

The Non-Admitted and Reinsurance Reform Act

Another federal initiative soon to be reintroduced in the US House of Representatives would establish national standards for the state regulation of surplus lines insurance. This bill, entitled The Non-Admitted and Reinsurance Reform Act, was approved twice before (in 2006 and 2007) in the House of Representatives, but never made it to the Senate and thus never became law. Among other things, the measure would make accessing the surplus lines market easier for qualified risk managers and create a uniform system of surplus lines premium tax allocation and remittance. Specifically, this bill would give regulators in an insured's home state authority over most aspects of surplus lines insurance, including the right to collect and allocate premium tax with respect to policies with multi-state perils.

"According to an independent study released in March 2009, the creation of a new federal insurance regulator would require a staff of roughly 2400 and an annual budget of US$465 million."

This legislation would also ease certain regulatory burdens on reinsurers by giving regulators in a reinsurer's state of domicile the sole responsibility for regulating the reinsurer's financial solvency.

This bill has enjoyed the broadest industry support of any recent insurance regulatory reform proposal with endorsements from insurers and producers, both large and small, as well as life and property and casualty insurers.

Opponents of federal regulation believe that the passage of a federal surplus lines bill would serve as a precursor to the federal government taking insurance regulation away from the states – or the proverbial 'camel's nose in the tent'. Some insurance commissioners, most notably New York's Superintendent of Insurance, Eric Dinallo, have come out strongly against any type of federal regulation of insurance because they believe it would lead to insurers shifting back and forth from federal to state oversight, seeking the most lenient regulator.

Future Tax Treatment of Offshore Reinsurance Companies

Offshore insurers and reinsurers, particularly those based in Bermuda and Ireland, are also under the microscope of the Obama Administration and Democratic Congress. The law they want changed allows large portions of premiums written by US-based affiliates of offshore insurers to be ceded to the reinsurance unit of their parent companies which are based in low-tax or no-tax jurisdictions, such as Bermuda. The affiliate deducts the premium while the foreign parent does not pay US or local tax on the premium and at the same time earns investment income subject to low or no taxes.

This occurs because related-party reinsurance does not result in a transfer of risk outside the global group. It is an efficient way of significantly reducing tax without transferring risk.

Under proposed new legislation, US ceding insurers would be denied a deduction for 'any premiums reinsured in excess of the industry average of reinsured policies', based on published aggregate data from annual statements of US insurance companies. Backers of this proposal contend that limiting the available deduction to ceding insurers will keep excess reinsurance premiums paid to affiliated reinsurers within the purview of US taxation.

Opponents of the legislation maintain that offshore companies play an important role in filling US insurance market needs and argue that it will be most likely to increase the cost of insurance to consumers and may also lead to capacity shortfalls in certain classes of business, particularly catastrophe reinsurance.

Despite these arguments, the Obama White House is likely to feel pressure to shore up the economy and find ways to fund the programs being promoted. This means that the new administration may target this tax revenue as a way to plug holes in the deficit. For this reason, many Bermuda based companies are now preparing for potential changes in tax structure, for example by moving their holding companies to or establishing underwriting platforms in jurisdictions which have tax treaties with the US, such as Switzerland.

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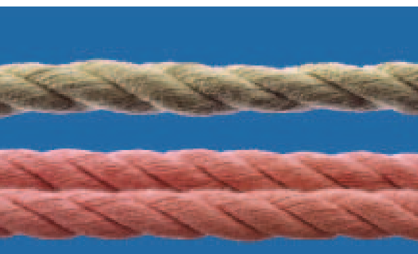

Insurance & Reinsurance Department (IRD) Highlights

- **Laurie Kamaiko** (New York) moderated a panel on *'Everyone's Nightmare: Privacy and Data Breach Risks'* at the Association of Professional Insurance Women April Luncheon in New York in April.
- **Antony Woodhouse** (London) and **Geoffrey Etherington** (New York) spoke at the EAPD webinar *'The Foreign Corrupt Practices Act and International Anti-Corruption for the Insurance Industry'*, which is available to download now from our website events section www.eapdlaw.com, in April.
- **Craig Stewart** (Boston) spoke at a panel session on *'Contract Workshop: Best Practice Indemnification Provisions'* at the Bio 2009 International Convention in Atlanta in May.
- **Vivien Tyrell** (London) spoke on *'Contract Wording and Part VII of the FSMA 2000'* at the Falconbury Seminar in London in May.
- **Mark Meyer** (London) spoke at a panel session on *'Coverage Specifics - Legal and Regulatory Aspects'* at the C5 Financial Institutions Conference in Munich in May.

For further details on any of these past events please contact Kalai Raj at: KRaj@eapdlaw.com.

Bermuda

At the beginning of the year, the Bermuda Monetary Authority (BMA) published its Business Plan for 2009, which was designed to chart a course to ensure that Bermuda succeeded as a leading financial market. As part of that plan, the BMA proposed to introduce group-wide supervision for certain higher risk insurers and to continue progress towards international mutual recognition for Bermuda.

In the first quarter of 2009, the BMA has worked towards achieving these goals and has published discussion papers on the following.

Group-wide Supervision

By the fourth quarter of 2011, because of their higher risk profile, the BMA proposes to apply its group-wide supervision regime to Class 3B and Class 4 insurers that form part of a financial group or mixed conglomerate. The adoption of group-wide supervision has emerged in light of the credit crisis to help ensure that groups are effectively regulated and that they conduct their operations in a prudent and financially sound manner. Part of the BMA's intention was to ensure that Bermuda's standards were broadly equivalent to international standards being developed in this regard. However, in light of group supervision being omitted from Solvency II, Bermuda may end up with a different regime. The paper includes a discussion on key issues such as the determination of group solvency, the treatment of intra-group transactions, eligible capital, reporting requirements, group corporate governance and risk management.

Roadmap to Mutual Recognition

In working towards mutual recognition, the BMA is concentrating its efforts on achieving equivalence with Solvency II in Europe. However, the BMA is also monitoring other regimes with which it seeks mutual recognition. The regime which the BMA is seeking to create has three core components:

- capital adequacy whereby capital requirements will take into account all aspects of risk (including group risk) and the quality of the capital supporting the business
- governance and risk management which reflects the integration of risk and capital management, and
- transparency and disclosure from the regulator, the firms themselves and the groups the BMA supervises.

The BMA is determined to ensure that implementation of its programme should be achieved in a manner that demonstrates flexibility, adapts the emerging international regulatory framework to the characteristics of the Bermuda market and adopts a risk based and proportionate approach to the different classes of insurer operating in the Bermuda market.

Proposed Enhancements to Insurance Supervision and Enforcement Powers

The BMA is also reviewing its enforcement powers in insurance. The proposals include:

- developing an express power for the BMA to publicise enforcement action it has taken against an entity which the BMA believes would have the potential for significant deterrence
- whether the BMA should seek a power to ban individuals from acting in roles in the industry for a specified period, and
- whether the BMA should have the power to impose a financial penalty on an individual or company and sue through the civil court system.

China's Special Administrative Regions

Hong Kong

For years, Hong Kong has been regarded as a key financial hub, renowned for its geographical location, credible legal system and effective regulatory framework. However, like many other financial centres, Hong Kong has been hurt by the recent global financial crisis.

The Hong Kong Insurance Authority (HKIA) recently released the provisional 2008 statistics of the Hong Kong insurance industry. According to these statistics, although gross and net premiums for general insurance business increased by 11.3% in 2008, the underwriting profit of motor insurance business drastically reversed from a profit of HK$11 million (US$1.4m, £968,500) in 2007 to a loss of HK$259 million (US$33.4m, £22.8m) in 2008.

As a result, on 24 February 2009, the HKIA issued a circular to all Chief Executives of authorised insurers carrying on general insurance business in Hong Kong, expressing concern over insurers' solvency positions and long-term market stability in light of the substantial underwriting loss suffered by the motor insurance business in 2008. The HKIA required all insurers carrying on motor insurance business to submit a 'breakdown of direct motor business by class of vehicle and type of coverage in terms of gross premiums and exposure' together with a quarterly return on Hong Kong business within one month after the close of each quarter, beginning with the first quarter of 2009.

As the financial markets show no sign of strong recovery, insurers are likely to be under intense pressure to ensure that the stringent solvency requirements to which they are subjected are satisfied. We expect the Hong Kong government authorities, including HKIA, to monitor the insurance industry carefully and assess continually the need for intervention.

Macau

On 31 March 2009, the New York State Insurance Department (NYSID) and the Autoridade Monetaria de Macau (AMM, the Monetary Authority of Macau)

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concluded a Memorandum of Understanding (MoU), which established a formal basis for cooperation and coordination between NYSID and AMM, including the exchange, handling, protection and return of information in their possession and, where appropriate, investigative assistance with respect to companies and persons engaged in the business of insurance.

Pursuant to the MoU, requests for assistance include, among other things, requests to:

- confirm or verify information
- obtain information about a specified person or entity
- discuss issues of mutual interest between NYSID and AMM
- question or take testimony of persons designated by the requesting regulator, and
- conduct inspections or examinations of regulated/related entities or persons.

The MoU provides for a special procedure where confidential information is requested. NYSID and AMM agree to make reasonable efforts to assist each other, subject to the laws and overall policy of the respective jurisdictions.

The MoU also facilitates cooperation in assisting each regulator in carrying out on-site inspections of regulated or related entities and persons in both jurisdictions.

The MoU does not create any legally binding obligations, confer any rights, modify or supersede any domestic laws or regulatory requirements in force in, or applying to, the State of New York or Macau.

Conclusions

It is apparent that a significant amount of work is being undertaken worldwide to ensure that the regulation of insurance is fit for the post-crunch global economy. What the restructured regulatory landscape will ultimately look like is not easy to predict at this stage. What is clear is that there will, in the future, be much greater uniformity of approach between different jurisdictions and co-ordination between national and international regulators.

This can be achieved through a variety of methods. Regulation that is applied internationally is the most effective approach, however the significant length of time it will take for Solvency II to come into force shows that this is impractical during or following a crisis situation, where change is required quickly.

The ability of regulators to declare other regimes as equivalent is a useful tool for ensuring standards can be applied internationally. If implemented properly, ad-hoc arrangements, such as Memoranda of Understanding, between regulators are also a useful tool.

Whichever approaches are taken, the regulation of insurance is likely to change considerably in the near to medium term.

"It is apparent that a significant amount of work is being undertaken worldwide to ensure that the regulation of insurance is fit for the post-crunch global economy."

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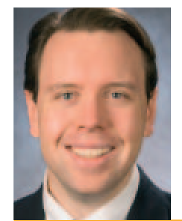
Cyber Spyware Found on U.S. Electric Grid Demonstrates Increasing Potential Exposures for Insurance Industry



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There have been increasing reports of cybercrimes in the past few years, many of them originating from sources outside the United States. Frequently, the attacks are by hackers targeting personal information for use in unauthorized financial transactions and other identity theft. Recently, however, there have been reports of a new target by "cyberspies": the U.S. electrical grid itself. These attacks demonstrate not only national security vulnerabilities, but also potential insurance exposures.

Recent reports that spies hacked into the U.S. electrical grid made instant headline news.[1] A grave vulnerability was exposed. Authorities investigating the intrusion reportedly found software tools left behind that could be used to destroy infrastructure components, and thus potentially disrupt service across the country.

Such exposure is not unique to our electrical grid. Potentially, other utilities including power and water companies with networked computer systems are vulnerable to cyber attacks. Hackers have taken advantage of this vulnerability in the past in other countries. In one reported case, a vandal infiltrated a computerized control system at a water-treatment plant in Australia, flooding parks and rivers with hundreds of thousands of gallons of sewage.[2] In

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another case, cyber-attacks caused a power outage, which was followed by a ransom demand from the hackers, in Central and South America.[3] The North American Electrical Reliability Corporation – the agency responsible for setting standards for the U.S. electrical grid – has stated that while it is working with the governments of the U.S. and Canada to improve the security of the electrical grid, "there is definitely more to be done." [4]

A disruption of the U.S. electrical grid or other utility system has the potential for causing a variety of substantial losses, many of which may be subject to insurance coverage or at least claims for coverage. The range of potential losses resulting from a power outage is illustrated by the "Northeast Blackout" of August 2003, when a massive widespread power outage occurred throughout the Northeastern and Midwestern United States, as well as the Canadian province of Ontario, affecting 55 million people. As might be expected, some of the resulting losses included disruption in industrial operations, retail sales, and other business interruption. Also attributed to the blackout was loss of water service due to the shutdown of electrical pumping systems; sewage spills into waterways; and the shutdown of the various railroad lines as well as regional airports. Spoilage of food due to the loss of refrigeration reportedly affected a large number of businesses and individuals.

Several recent decisions in coverage lawsuits arising from the Northeast Blackout demonstrate the potential exposure and coverage limitations for property as well as other lines of insurance. For example, one court held that an exclusion in a commercial property policy barring coverage for losses arising from off-premises failure of utilities precluded coverage for a grocery store's spoiled inventory as a result of the blackout.[5] However, in another case arising from the blackout, a federal court held that an exclusion pertaining to off-site power generation equipment in a boiler and machinery policy was ambiguous and therefore denied summary judgment to the insurer for a food company's claim for lost inventory.[6] Policies without such exclusions would potentially have significant exposures. Most recently, a New Jersey state court issued its ruling on a group of supermarkets' claim for food spoliation resulting from the blackout under a first party, all risk policy. [7] There, the court sided with the insureds and held that the interruption in electrical power was caused by "physical damage" to the electrical grid, thereby triggering the policy's "Services Away From Covered Location Coverage Extension" provision that extended coverage for consequential damages resulting from an interruption in electrical power caused by physical damage to certain types of electrical equipment. The court reasoned that the power generation was "physically damaged" because it became incapable of performing its "essential function" – generating electricity – due to "a physical incident or series of incidents." These cases demonstrate the coverage uncertainty facing insurers and insureds alike in the aftermath of a utility failure.

In addition to the potential first-party insurance policy exposures resulting from a blackout, there is some potential for third-party insurance policy exposures if those sustaining blackout-related losses assert claims against the affected utility companies. A pair of cases relating to the Northeast Blackout demonstrates that utility companies may be targets of suits after a service failure, but also shows that maintaining such suits may be an uphill battle for the plaintiffs. In one, a class action suit filed within days of the Northeast Blackout, the trial court dismissed the suit for lack of subject matter jurisdiction, and the appellate court affirmed, on the basis that a state agency has exclusive jurisdiction over various matters concerning public utilities, including whether service rendered by a public utility is in any respect unjust, unreasonable, or in violation of law.[8] A New York court reached a similar result in dismissing a plaintiff's claim against Con Edison for food spoilage caused by the blackout, when it held that under the relevant state statute a utility company will not be held liable for an interruption of service resulting from causes outside of its control or due to mere negligence.[9] Although these cases suggest that maintaining such suits against utility companies can be difficult and an insurer's duty to indemnify under a third-party policy may not ultimately apply, an insurer that issues a third-party policy may still be required to defend a covered utility. In addition, the *Schlesinger* case suggests that a lawsuit may be tailored to bypass the limitation of liability provision of a statute, for example by including a reckless conduct claim. In such a case an insurer's duty to indemnify may ultimately come into play.

Finally, apart from traditional property, business interruption and liability policies, cyber risk policies may also be implicated in a blackout caused by hackers, although the wordings and scope of coverages vary greatly and thus applicability of such policies is uncertain. A number of insurers have recently introduced cyber risk policies.[10] Many cyber risk policies are tailored to cover data and privacy breaches resulting in potential or actual identity theft or impairment of web or server services to customers, or intellectual property infringement, rather than industrial or retail shutdown. However, broadly worded coverages for losses arising from alleged breach of a duty of care to limit transmission of malware that results in a denial of service potentially could be implicated, depending on the scope of coverage intended and the policy wording.

Due to the substantial risks and large losses involved, insurers and insureds alike would benefit from keeping an eye on this developing issue.

Footnotes

1. *See, e.g.,* Siobhan Gorman, *Electricity Grid in U.S. Penetrated By Spies,* WALL STREET JOURNAL, April 8, 2009; and Martin LaMonica, *Report: Spies Hacked Into U.S. Electrical Grid,* C-NET NEWS, April 8, 2009, available at http://news.cnet.com/8301-11128_3-10214898-54.html.
2. *See* Marshal Abrams and Joe Weiss, *Malicious Control System Cyber Security Attack Case Study–Maroochy Water Services, Australia,* available at http://csrc.nist.gov/groups/SMA/fisma/ics/documents/Maroochy-Water-Services-Case-Study_report.pdf (last visited April 27, 2009).
3. William Lowther, *CIA Launches Hunt for International Computer Hackers Threatening to Hold Cities Ransom by Shutting Down Power,* MAIL ONLINE, available at http://www.dailymail.co.uk/news/article-509186/CIA-launches-hunt-international-hackers-threatening-hold-cities-ransom-shutting-power.html (last visited April 27, 2009).
4. *NERC Statement on Cyber Security & the Electric Grid,* April 8, 2009, available at: http://www.nerc.com/news_pr.php?npr=279 (last visited April 27, 2009).
5. *Four Star Bros., Inc. v. Allied Ins. Co.*, Docket No. 04-CV-73401, 2006 WL 148754 (E.D. Mich. Jan. 19, 2006).
6. *Tufo's Wholesale Dairy, Inc. v. CAN Financial Corp.*, Docket No. 03 Civ. 10175, 2005 WL 756884 (S.D.N.Y. April 4, 2005).
7. *Wakefern Food Corp. v. Liberty Mutual Fire Ins. Co.*, Docket No. A-2010-07T3, 2009 WL 1065979 (N.J. Super. A.D., April 22, 2009).
8. *Ippolito v. First Energy Corp.*, Docket o. 84267, 2004 WL 2495665 (Ohio App. 8 Dist., Nov. 4, 2004).
9. *Schlesinger v. Con Edison Co. of New York, Inc.*, Index No. 6142/03, 2003 WL 22964883 (N.Y. City Civ. Ct., Dec. 16, 2003).
10. Also known as E-Commerce Insurance, E-Business Insurance, Information Security Insurance, Cyber Insurance, Network Security Insurance or Hackers Insurance.

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Rebels Without a Cause (of Action) *Emerald Supplies v British Airways Plc:* Class Actions and Litigation Funding Present Opportunities for and Threats to Insurers

by Antony Woodhouse
London

The UK litigation landscape is changing and arguably heading West. Developments in the ways to share the risks of litigation and fund actions are providing both opportunities and also threats to insurers. Opportunities are there for insurers who want to enter this litigation market. Threats arise in increased exposure to liability cover, particularly D&O cover, in the form of multi-claimant actions of the type historically the preserve of the US, but also simply through an increased appetite for litigation. The recent decision of *Emerald Supplies v British Airways Plc* acts as a reminder of how the traditional differences between the UK and US approaches to litigation are disappearing. This article examines different aspects of this changing landscape with particular reference to their impact on the insurance and reinsurance industry.

Class actions - *Emerald Supplies v British Airways Plc*

This recent decision of the High Court (neutral citation [2009] EWHC 741) related to an attempt by a firm well known for representing claimants in class actions to use the English Civil Procedure Rules (CPR) to launch a class action style claim against British Airways. The attempt failed, but the firm has announced its intention to appeal the decision.

The claim which the firm wanted to bring was on behalf of air freight customers of British Airways and other airlines. The customers were said to have been affected by an alleged cartel, which is the subject of an ongoing investigation by the European Commission. It was a classic example of the type of claim regularly pursued in the US, but which, to date at least, has not often been run in the UK.

The named claimants were importers of cut flowers from Columbia and Kenya, but their claim was brought on behalf of all direct or indirect purchasers of air freight services from BA (and the other airlines who were alleged to be part of the cartel). The claimants brought their claim using CPR Rule 19.6, which allows a claimant to bring claims on behalf of a number of claimants who have the same interest.

On BA's evidence the potential class of claimants was *"not only unidentified, but unknowable, potentially comprising every conceivable so-called direct and indirect purchase worldwide who at one stage or another were arguably affected – directly or indirectly – by the cost of air transport shipping services during the relevant period (1999-2006)."* However, the judge, Mr Justice Morritt, Chancellor of the High Court, found that there was no limit to the number of persons who could be represented. However, as a result of CPR 19.6(1) and previous case law, the identity of interest of the persons had to be present at the time the claim was begun and the relief sought had to be beneficial to all the class. It was not sufficient, as the claimants argued, for the common interest to be present simply by the time of judgment.

The judge found that the way the class was defined in the claim, being *"direct or indirect purchasers of air freight services the prices for which were inflated by the agreements or concerted practices"*, meant that the class with the common interest could not be properly ascertained until the judgment of the court decided which prices had been inflated. He stated that the *"criteria for inclusion in the class cannot be satisfied at the time the action is brought because they depend on the action succeeding."*

Although this action has so far failed, it seems to have done so in large part because it was brought prematurely. This type of representative action could be successfully brought on behalf of a very large number of claimants, so long as the identity of the class can be properly formulated and pleaded. It seems appropriate, for instance, to product liability actions of the type which are common in the US, where many claimants make similar complaints, often where each individual complaint is of small value.

Before the Event and After the Event Insurance

Clearly the growing market for BTE and ATE insurance presents the insurance and reinsurance industry with significant opportunities for development of new products and becoming involved in new areas of risk. The growth of this market, however, also increases the likelihood of litigation being brought and the propensity

Continued on page 8

Who's Who Legal Insurance & Reinsurance Lawyers Latest Edition(2009)

EAPD is delighted to feature in this highly-regarded legal directory, with five lawyers from its international Insurance and Reinsurance Department recognised for their outstanding presence in the market. **David Kendall**, **Alan Levin**, **John Rosenquest**, **Nick Pearson** and **Vincent Vitkowsky** are all named in this most recent edition, based on the result of months of independent research of law firm clients and insurance and reinsurance lawyers around the world.

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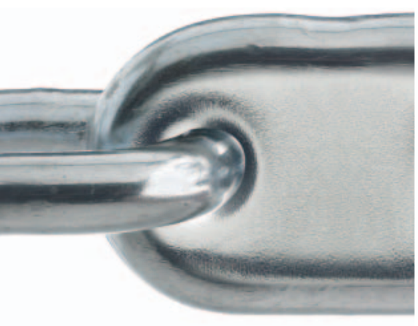

"ATE insurance is a funding arrangement which can be put in place to facilitate specific litigation."

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of certain parties to litigate in circumstances where they might otherwise have found alternative solutions. This affects the potential exposure of other insurers and reinsurers, perhaps particularly in the liability context, but certainly not exclusively so.

BTE insurance usually covers a party's own legal costs as well as the opponent's legal costs in the event of an unsuccessful action. It is a feature of domestic insurance policies (for example in household insurance) and also commercial policies (for instance D&O policies).

ATE insurance is a funding arrangement which can be put in place to facilitate specific litigation. It usually covers a party in the event that its action is unsuccessful and it has to pay the costs of the other side, but it can also cover a party's own costs. A peculiarity is that the premium for the ATE insurance can be a cost in the action, so that if the party is successful, it can recover that premium from the losing party. Accordingly, ATE insurance can take the other side's costs out of the equation, bringing the costs dynamic close to the usual US position, at least for the party with the ATE insurance. Couple ATE insurance with a CFA (see below) and a party may find itself protected (in part at least) on costs liability on both sides.

Conditional Fee Agreements

CFAs were the UK's answer to the US contingency fee arrangements and have been employed in the UK for more than ten years. A lawyer under a CFA is entitled to charge an uplifted fee in the event of "success" and a corresponding reduced fee (even nothing) in the event that the action is unsuccessful. Although the lawyer therefore shares in the success or loss of the action, the fees are not explicitly linked to the size of recovery, as they are in a contingency fee arrangement. The uplifted fee can be recoverable from the losing party. Also, as highlighted above, a CFA can be usefully combined with ATE insurance to try to protect a party from costs liability generally.

Although UK lawyers cannot share in the proceeds of an action through a contingency arrangement in the same way as US lawyers can, this particular role is being filled instead by the third party funder of litigation.

Third Party Litigation Funding

The UK has recently experienced a remarkable growth in professional funders of litigation. The attitude of the UK courts to third party funding has mellowed over the years and there are now many sources of funds available, whether they are hedge funds, accountancy firms or insurance companies. Allianz has been a notable insurance industry entrant into this market.

This type of funding has certainly enabled some actions to take place, in circumstances when they would otherwise not have got off the ground. As people become more and more aware of the funding available, the growth of this market is set to increase. Third party funders are also becoming more astute at seeking out opportunities or marketing themselves for specific types of action to increase profitability or to be able to offer more competitive arrangements or both.

Third party funders are adopting in the UK context part of the role of the plaintiff bar in the US as they are able to share fully in the proceeds of a successful action in a way that UK lawyers currently cannot. Again, the dynamics of UK litigation are moving towards the US model.

Summary

The growth of CFAs, BTE and ATE insurance, third party funding and multi-party actions in the UK should be of concern to some insurers and reinsurers and be closely monitored, as they do represent movement towards a litigation climate akin to that in the US. However, insurers and reinsurers should also be alive to the opportunities that these changes offer in terms of new markets and new products. If you are going to suffer in some areas as a result of a growing litigation market, at least take advantage of that growing market.

Edwards Angell Palmer & Dodge is delighted to announce that it will again this year host a half-day seminar which will be repeated in Bermuda, New York and Boston. This annual EAPD seminar is highly regarded by the insurance industry as providing a useful update on a variety of current legal issues in the US and UK. Topics that will be covered, focusing upon how they affect the insurance industry, include:

- security for reinsurance obligations
- the follow-the-settlements doctrine in the US
- UK asbestos liability
- privacy and data protection breach risks, and
- antitrust law developments affecting the insurance industry.

For further information please email Elizabeth Adorno at EAdorno@eapdlaw.com.

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"Plain English" Plain and Simple: The U.S. Securities and Exchange Commission's Attempt to Demystify Disclosures Under the '40 Acts

by Mary-Pat Cormier
Boston

These plain English amendments to Part 2 of Form ADV and related rules under the Investment Advisers Act are designed to require advisers to provide clients and prospective clients with clear, current, and more meaningful disclosures of the business practices, conflicts of interest (including those related to soft dollar practices) and background of investment advisers and their advisory personnel.

Federal Register/Vol. 73. No. 51/Friday, March, 14, 2008/Proposed Rules [Release No. IA-2711; 34-57419; File No. S7-10-00] Amendments to Form ADV.

In an effort to demystify disclosures and to make them more readily accessible to investors, the U.S. Securities and Exchange Commission is moving towards a system of more meaningful and transparent disclosures to investment advisory clients. What effect, if any, will this initiative have on the liability of investment advisers and investment companies?

The move to plain English disclosures is found in two key areas of disclosure obligations. First, the Commission has adopted new rules, which went into effect on March 31, 2009, that affect the format and method of filing mutual fund prospectuses. Second, the Commission has proposed new rules that would change the structure, updating, and delivery requirements for investment advisers in connection with their disclosure requirements to their advisory clients in their Part 2 of the Form ADV.

The Summary Prospectus

These rules are part of a broader Commission effort, dubbed its 21st Century Disclosure Initiative, to increase the quality and availability of investment-related disclosures. The first effort, which became effective on March 31, 2009, changes the Form N-1A to require that certain specific information appear in a standardized format at the beginning of a mutual fund's statutory prospectus, written in 3-4 pages of plain English under section 421(d) of the Securities Act. This summary section must include, in the following order, information about the fund's: investment objectives; costs; principal investment strategies, risks, and performance; investment advisors and portfolio managers; purchase, sale and tax information; and financial intermediary compensation.

Exchange Traded Fund prospectuses must also include disclosures regarding their unique characteristics and the relationship between their performance, Net Asset Value, and share price. Those funds that are used as investment options for retirement plans or variable insurance contracts may omit information in the summary section about the purchase and sale of fund shares and certain tax information that is not relevant to such funds.

In addition to their content requirements, the new rules also provide an additional option for the delivery of prospectuses to investors. Investment funds may continue to deliver their statutory prospectuses as they have under section 5(b)(2) of the Securities Act, which prohibits the sale of a security unless "accompanied or preceded" by a statutory prospectus. Under the new rules, delivery of a Summary Prospectus to an investor and posting of the lengthier statutory prospectus online would satisfy this requirement. A Summary Prospectus is the same as the summary section of the statutory prospectus, with the exception that it must also have a cover page identifying it as a Summary Prospectus and describing how an investor may obtain the fund's statutory prospectus. The new rules require that the Summary Prospectus be given "greater prominence" than other accompanying materials, and that a statutory prospectus be sent to anyone upon request. However, a failure to comply with either of these two requirements would result only in a violation of the new Commission rules, and not of section 5(b)(2), thereby precluding a private right of action for such violations.

While the new rules do not provide any general safe harbors for good faith compliance, they also do not create any new causes of action, enforcement mechanisms, or specific penalties. Funds are still liable under the Securities and Investment Company Acts for proper disclosure; the new rules simply modify the existing obligations under those laws. There are, however, two noteworthy provisions that will lessen a fund's compliance burden. First, there is a safe harbor for temporary technical difficulties with the internet posting requirement, provided that the fund has taken reasonable steps to ensure the materials are available online. Second, while

Continued on page 10

Upcoming Events

- **Vivien Tyrell** (London) is speaking at a panel session on *'Run-off Transactions Around the World'* and
- **Selinda Melnik** (Wilmington) is speaking at a panel session on *'Cross Border Challenges and Opportunities'* at the ABA Insurer Receivership & Run-off Conference in New York on 4-5 June.
- **Richard Hopley** (London) and **Mark Everiss** (London) are speaking on 'UK Asbestos Liability' at the ARC Forum in Norwich on 10 June.
- **Helen Clark** (London) is speaking on 'International Contract Issues' at the Reinsurance Association of America ReContracts Conference in New York on 14-17 July.

For further details on any of these upcoming events please contact Kalai Raj at: KRaj@eapdlaw.com.

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"The Commission's proposed changes to Part 2 of the Form ADV similarly would have investment advisers provide more information and greater clarity to their investment advisory clients."

the rules go into effect at the end of March 2009, full compliance is not required until 2010 or 2011, depending on whether the filings are for new or existing registration statements.

The new summary section of the statutory prospectus and the Summary Prospectus are both subject to the plain English requirements of Rule 421(d). Rule 421(d) of the Securities Act requires the issuer of a prospectus to use plain English principles in the organization, language and design of the front and back cover pages, the summary and the risk factors sections of the prospectus. Such principles include the use of short sentences; concrete, everyday words; the active voice; tabular presentation or bullet lists for complex issues, wherever possible; no legal or highly technical jargon; and no multiple negatives.

Part 2 of the Form ADV

The Commission's proposed changes to Part 2 of the Form ADV similarly would have investment advisers provide more information and greater clarity to their investment advisory clients. As a move away from the "check the box" approach to disclosure, an adviser would be required to discuss and to make specific disclosures in connection with 19 separate topics, including sources of compensation, soft dollar arrangements, and other types of compensation.

Proposed in March 2008, the Part 2[1] proposal would affect thousands of registered investment advisers. It would also affect hedge fund managers who are also registered as investment advisers. The proposed changes would require those hedge fund managers to make such disclosures in plain English to its investment advisory clients. Some commentators have noted that those disclosures could increase scrutiny of the conflicts of interest that may arise between an adviser's obligations to its hedge fund clients (who pay performance fees) and investment advisory clients (who may not).

For instance, one of the specific topics that must be disclosed and discussed is so-called side-by-side management of accounts of hedge fund clients and investment advisory clients. The Commission and commentators have suggested that this particular disclosure was motivated by the Commission's concern that advisers may favor hedge fund accounts or clients (over investment advisory clients) because of the fees associated with hedge fund accounts. By making the adviser disclose this information, the investment advisory clients are able to assess any purported conflicts of interest that arise when one adviser is managing both types of accounts – and collecting a higher, performance-based fee from one or more of its clients that it is not collecting from others.

Of course, what everyone wants to be assured of is that the new rules would somehow prevent another "Madoff." The plain English rules were proposed (and adopted in the case of the Summary Prospectus) long before anyone (other than Harry Markopolos, apparently) thought that Madoff was running a spectacular Ponzi scheme. When Madoff was not registered as an investment adviser, and only acting as a broker dealer, he was not required to make disclosures under Part 2 of the Form ADV. Moreover, it is questionable whether the new Summary Prospectus or proposed Part 2 rules would prevent anyone from falsifying their disclosures if that were their goal. Finally, as noted above, the goal of the plain English rule is not necessarily to catch fraud. It is meant to provide more accessible and current information to investors in the form of clear, current, and more meaningful disclosures.

In conclusion, given the requirements of the Summary Prospectus and that there is no private right of action for the failure to comply with the new rules, we anticipate that there will be little liability exposure directly arising from these new rules and regulations. As long as the prospectus disclosures are adequate, which has been a consistent requirement, then the new plain English rules will not generate any increased scrutiny or liability. Nevertheless, with respect to the Part 2 proposal, the disclosures required from investment advisers who charge performance fees on some accounts (such as hedge funds) but not others may lead to more intense scrutiny of these arrangements and the purported conflicts of interest that could develop as a result.

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With thanks to Christopher T. Saccardi who contributed to this article.

1 The Part 2 amendments have not yet been formally adopted by the Commission.

Best of the Best 2009

Three EAPD Insurance partners recognised as being amongst the *'Best of the Best'* practitioners worldwide.

EAPD is pleased to announce that three of its Insurance and Reinsurance Department (IRD) Partners have been recognised as being leading legal practitioners by the eminent bi-annual legal directory *'Best of the Best (2009 edn.)'*, published by Expert Guides. This directory is widely regarded as being the international legal market's leading independent guide to the profession.

The three EAPD partners recognised in this 2009 edition are:

- **David Kendall** (London)
  Co-Chair of the Insurance and Reinsurance Department
- **Alan Levin** (Hartford)
  Co-Chair of the Insurance and Reinsurance Department
- **Vincent Vitkowsky** (New York)
  Partner, Insurance and Reinsurance Department.

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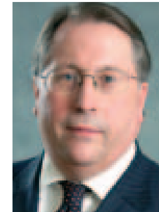
To Secure or not to Secure When You Reinsure, That Is the Question



by Geoffrey Etherington
New York

and Richard Spiller
London

At least two factors have led cedents and reinsurers to reconsider traditional approaches to the collateralization of reinsurance obligations in the last twelve months. First, the global recession has adversely impacted the financial condition of most international financial services groups, including both reinsurers and banks which provide letters of credit to secure reinsurers' obligations. Second, after years of industry discussions, the New York State Insurance Department (NYSID)[1] and the National Association of Insurance Commissioners (NAIC)[2] have recently proposed modification of the US approach to credit for reinsurance that would loosen the requirement of 100% collateralization by unauthorized reinsurers.

In this environment, cedents should recognize that the risk of non-performance by well-rated reinsurers and banks is not insignificant. As AIG's spectacular descent from its place astride the global insurance industry to the ignominy of government ownership demonstrates, it may be difficult to assess accurately reinsurer default risk. At the same time, demand for letter of credit facilities has caused the cost of reinsurance to rise significantly, as a result of which reinsurers may be well-advised to develop alternative approaches to secure their reinsurance obligations to address the concerns of their cedents. Indeed, offering security to cedents in a cost-efficient way may provide reinsurers with a relative competitive advantage over those who do not.

While the adoption of proposals similar to those advanced by the NYSID and the NAIC may make reinsurance more available or less costly, US cedents in such a modified landscape may well face greater challenges in structuring reinsurance programs. When negotiating reinsurance treaties with unauthorized reinsurers from whom they can no longer demand full collateral as a regulatory requirement, will US cedents weigh the relative financial strength of reinsurers or overall exposure of the cedent to a particular reinsurer and seek levels of security above what would otherwise be required under US insurance law?

Downgrade Triggers

One approach to securing reinsurance obligations is for reinsurance contracts to include provisions that trigger collateralization in the event of reinsurer downgrades. However, experience with swap obligation collateralization triggers of the non-insurance operations of AIG and Lehman Brothers, among others, raises concerns as to whether such arrangements provide effective protection.

Indeed, cascading collateral triggers can lead to a "death spiral" of the counterparty, as in fact occurred in the UK with Independence Insurance, which slumped from an "A" rating to insolvency in a period of three months in 2001. Insureds with policies which contained downgrade triggers never obtained collateral. The possible limited efficacy of a collateralization trigger imposed on a downgraded reinsurer due to its deteriorating financial condition or liquidity constraints, may result in little practical benefit to an insurer.

Collateralization Options

Reinsurance obligations can be secured through "funds withheld" arrangements, pledges of cash or security, trust arrangements or letters of credit or other third party surety arrangements. Below we discuss some of the issues each of these solutions raises for cedents and reinsurers.

Funds Withheld

A funds withheld arrangement is the most favorable method of collateralizing reinsurance obligations from the perspective of a cedent. It may be unattractive to reinsurers due to the risk that insolvent cedents will not transfer earned ceded premiums or investment returns on the funds withheld. Simply crediting the funds withheld to a separate account in the name of the cedent will not provide security or priority to the reinsurer if the cedent becomes insolvent.

Whether or not it is practical for the cedent to provide security for its obligations to pay earned premium or income to the reinsurer will depend on the particular circumstances. However, a cedent must hold sufficient unrestricted assets to support the issue of a letter of credit, to pledge collateral or fund a collateral trust. To have to provide security for unpaid premium may more than offset the benefit of withholding funds for the cedent.

Security Interests

A reinsurer may be more interested in securing its reinsurance obligations through the pledge or

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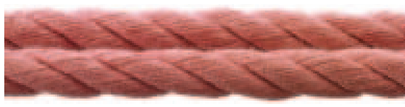
"In this environment, cedents should recognize that the risk of non-performance by well-rated reinsurers and banks is not insignificant."



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charge of cash or securities of the reinsurer to the cedent. It should be noted that such arrangements are not an acceptable method of securing obligations of unauthorized reinsurers under current US credit for reinsurance rules. A pledge is accomplished through a charge over, or security interest in, a bank or securities account of the reinsurer which it grants in favor of the cedent.

If the pledged account is in the US, the parties will enter into an account control agreement with the bank or broker that opens the account. If the charged account is in the UK, this is normally addressed through a letter, acknowledged by the bank. The account control agreement or acknowledgement ensures that the cash or securities held in the pledged or charged account cannot be removed without the cedent's consent.

Additionally, the parties must negotiate their relative rights to the pledged or charged assets and interest earned, the investment criteria and discounts applicable in respect of the pledged or charged assets (referred to as "eligible collateral") and the circumstances that trigger the right of the cedent to take control of the pledged or charged assets, or for the reinsurer to withdraw some or all of the collateral.

Such negotiations may materially increase the time taken to negotiate the terms of the reinsurance and the frictional costs. It is probable that there will be different forms of agreement between a cedent and each of its reinsurers or a reinsurer and its cedents, since the market has no standard documentation and each agreement must be individually negotiated.

Non-Regulatory Trusts

We noted above that reinsurance obligations can be secured through a trust arrangement. Many industry participants are familiar with a so-called "Regulation 114 trust" (the name refers to the applicable New York regulation, but similar trusts are authorized under other US state insurance laws), which must include required provisions and permit unrestricted withdrawals by the cedent. Such trusts are unattractive to reinsurers since, like funds withheld, they do not provide any security to the reinsurer for payment of premiums if the cedent becomes insolvent, and allow cedents to withdraw funds at any time.

However, cedents and reinsurers can also negotiate trust arrangements to secure reinsurance obligations with a financial institution serving as trustee. Such a non-regulatory trust can circumscribe cedent withdrawal rights. Trustee fees may be relatively inexpensive and trustees can manage funds and administer distributions from the trust and substitutions of assets. As with pledged and charged accounts, there are costs associated with negotiating the trust arrangements. Unlike a pledge or charge, however, the distribution or release of funds is within the control of the trustee (rather than relying on the consent of the parties in accordance with the terms of the reinsurance contract) and resort to judicial intervention or commencement of enforcement proceedings is unlikely to be necessary.

"An advantage to collateralizing reinsurance obligations through the pledge or charge of cash or securities or the deposit of assets in trust is that each approach eliminates reinsurer and cedent credit risk."

Bank or Trustee Insolvency

An advantage to collateralizing reinsurance obligations through the pledge or charge of cash or securities or the deposit of assets in trust is that each approach eliminates reinsurer and cedent credit risk. However, cedents and reinsurers may instead be exposed to risk of the insolvency of the bank or broker that opens the charged or pledged account and of the bank or trust company that acts as a trustee. The instability of the global banking industry and growing government control of major financial institutions suggest that parties should monitor and investigate the condition of banks, brokers or trust companies involved in collateral arrangements. Legal advice should be taken on the structures available to mitigate the impact of insolvency of the bank or trustee.

Letters of Credit

Letters of credit have been extensively used by the insurance industry to support obligations. Unauthorized reinsurers can offer them in the US as alternatives to Regulation 114 trusts for credit for reinsurance purposes. However, as with Regulation 114 trusts, the form of such letters of credit is prescribed by law and cedent rights to draw upon the letter of credit are unlimited.

Letters of credit can also be effective in securing reinsurance obligations even when not required by law – they are the standard way of securing reinsurance obligations in Europe - and can be tailored to meet the specific needs of a cedent and reinsurer. However, letters of credit can generally be drawn on demand (notwithstanding the terms of the reinsurance) and are considerably more expensive than trust or pledge arrangements, since the bank is assuming personal liability for making payment to the cedent (which is not the case with a pledge, charge or trust arrangement).

In addition, over the last year, banks have become less willing to issue letters of credit on an unsecured basis and to issue multi-year or so-called "evergreen" letters of credit, unless mandated by regulation. Reinsurers are now likely to be required to post collateral with the bank issuing the letter of credit and have limited options as to eligible collateral. As with a pledge or trust, a cedent is exposed to the insolvency risk of the bank that issues the letter of credit, but would have the additional risk that the obligation of the bank under the letter of credit is an unsecured liability in relation to the cedent. Against that, the reinsurer carries the credit risk of the bank failing, since it remains liable to pay under the reinsurance. As with pledged and charged accounts, there may be structures available to mitigate this risk from the reinsurer's perspective.

Conclusion

Cedents and reinsurers have a number of options in determining whether to secure or not to secure reinsurance obligations. Other than in the context of collateralization required by regulation, the parties have great flexibility in structuring such arrangements.

Cedents should consider the financial condition of reinsurers and the cedent's aggregate exposure as an institution to each reinsurer. Reinsurers must weigh the costs of such arrangements and evaluate whether collateralization can distinguish them from competitors. Both cedents and reinsurers must take account of the previously unconsidered risk that banks which hold collateral or issue letters of credit may themselves fail.

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1 "Proposed Tenth Amendment to Regulation No. 20 (11 NYCRR 125) Credit for Reinsurance from Unauthorized Reinsurers," released by the NYID on December 24, 2008. See our Client Advisory, "New York Releases Proposed Amendment to Regulation 20 Relaxing Collateral Requirements for Unauthorized Reinsurers and Prohibiting Arbitration" at www.eapdlaw.com.

2 NAIC press release, December 7, 2008. See "NAIC Adopts Reinsurance Modernization Proposal", December 8, 2008, blog posting on www.InsureReinsure.com: http://www.insurereinsure.com/BlogHome.aspx?entry=1212.

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Extra-Contractual Damages Still Problematic for Insurers in Rhode Island Ten Years After State Supreme Court's *Asermely* Decision

by Stephen M. Prignano
Providence

For more than ten years insurers conducting business in Rhode Island have faced the risk of extra-contractual liability without a finding of bad faith. In *Asermely v. Allstate Ins. Co.*, 728 A.2d 461 (R.I. 1999), the Rhode Island Supreme Court took the "opportunity to promulgate a new rule" and required insurers to pay any excess judgment where the insurer rejects a settlement demand within its policy limits.

Extra-contractual liability is imposed, moreover, even in circumstances where the insurer rejects the settlement offer in good faith. While the decision remains problematic for insurers in assessing settlement demands and determining litigation risk, few cases decided since *Asermely* have provided any meaningful guidance or attempted to restrict its scope. Ten years later, therefore, insurers continue to face significant uncertainty regarding extra-contractual liability in Rhode Island.

An Unprecedented Expansion of Extra-Contractual Liability

The *Asermely* Decision

Rhode Island long adhered to the traditional rule that a finding of bad faith was required before imposing extra-contractual liability on an insurer. Insurers were therefore exposed to extra-contractual liability for wrongfully refusing to pay or settle a claim, or failing to timely perform obligations under an insurance policy, among other things. Rhode Island codified a cause of action for bad faith in R.I. Gen. Laws § 9-1-33, and also recognized a bad faith cause of action at common law.[1] Prior to *Asermely,* Rhode Island permitted only a limited exception to this rule. In the event that an insurer rejected a settlement offer within its policy limits, R.I. Gen. Laws § 27-7-2.2 required the insurer to pay any pre- or post-judgment interest on an excess judgment.

Asermely expanded extra-contractual liability far beyond these well-recognized limitations. The plaintiff, Michelle Asermely, sought damages from an insured of Allstate Insurance Company ("Allstate") as a result of an automobile accident. Prior to trial, the parties submitted the matter to non-binding, court-annexed arbitration. That proceeding resulted an award in favor of Asermely in the amount of $47,557.37, which was within Allstate's policy limits of $50,000. Asermely accepted the award but, despite the award being within the policy limit, Allstate rejected it and proceeded to trial. At trial, the jury found that the plaintiff was sixty percent negligent and the defendant forty percent negligent. Ultimately, the jury awarded Asermely $86,333.57 in damages and interest. Allstate then issued a check to the plaintiff for $50,000, the limit of its policy. After cashing the check, the plaintiff brought suit against Allstate alleging, among other things, that Allstate acted in bad faith in settling the claim.

The Court began its analysis by concluding that the plaintiff's bad faith claim should be dismissed because it was "fairly debatable" whether Allstate had a "reasonable basis" for rejecting the award. However despite dismissing the bad faith claim, the Court then, *sua sponte*, announced that it was taking the "opportunity to promulgate a new rule to guide the trial courts in deciding these issues":

> It is not sufficient that the insurance company act in good faith. An insurance company's fiduciary obligations include a duty to consider seriously a plaintiff's reasonable offer to settle within the policy limits. Accordingly, if it has been afforded reasonable notice and if a plaintiff has made a reasonable offer to a defendant's insurer to settle within the policy limits, the insurer is obligated to seriously consider such an offer.

The Court went on to impose extra-contractual liability on insurers who fail to meet these requirements:

> [T]he insurer is liable for the amount that exceeds the policy limits, unless it can show that the insured is unwilling to accept the offer of settlement. ... Even if the insurer believes in good faith that it has a legitimate defense against the third party, it must assume the risk of miscalculation if the ultimate judgment should exceed the policy limits.

The "new rule" announced by the Court was not based on analysis of existing precedent, nor was it grounded in legislative history. Indeed, the existing legislation at the time, R.I.G.L. § 27-7-2.2, stopped short of imposing such obligations on an insurer. Rather, the rule announced by the Court appears to have been fashioned in response to the unique

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UK Legal Experts 2009 Directory Recognises Five EAPD Insurance & Reinsurance Partners

EAPD is pleased to announce that a number of its UK-based partners have been identified as "leading lights" in their respective fields by the legal directory *UK Legal Experts 2009*. Legal Experts produce this directory through a rigorous, independent research process, which results in individuals being highly recommended in their particular area of practice and featured in their publication. The five London-based EAPD Insurance and Reinsurance, Partners who are cited in the directory are: **David Kendall**, **Richard Spiller**, **Mark Everiss**, **Helen Clark**, and **Vivien Tyrell**.

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facts before it, and in an effort to regulate the conduct of insurers in future cases.

Aftermath of *Asermely*

Cases decided in Rhode Island since *Asermely* have provided only modest guidance to insurers seeking to avoid extra-contractual liability. Beginning with *Bolton v. Quincy Mutual Fire Ins. Co.*, 730 A.2d 1079 (R.I. 1999), the Court reaffirmed its decision in *Asermely* and demonstrated no retreat from the rule announced in that case. In *Bolton*, an issue arose regarding whether a plaintiff was entitled to discovery from his insurer regarding any investigation the insurer performed to determine whether the plaintiff should be given permission to settle with the tortfeasor. Relying on *Asermely*, the Court ruled that the plaintiff had a right to limited discovery to determine if the insurer performed an investigation, or whether it simply denied his request to settle within the policy limits. The Court reasoned that the insurer placed itself at risk for a bad faith claim because it denied its insured the right to settle within the tortfeasor's policy limits.

In *Travelers Ins. Co. v. Hindle*, 748 A.2d 256 (R.I. 2000), the Court again commented on the duty of an insurer to conduct a reasonable inquiry when considering a settlement offer. In *Travelers*, a motorist was injured when his car was struck by a vehicle owned by the defendant. After the accident, the plaintiff filed a claim for benefits with Travelers Insurance Co. ("Travelers") under a policy issued by his employer. Prior to trial, the defendant's insurance carrier offered to settle with the motorist for the policy limit. Pursuant to the underinsured motorist clause in his policy with Travelers, the plaintiff requested permission to settle with the defendant for his policy limits. Upon receiving this request, Travelers intervened in the action and asked for permission to conduct asset discovery of the defendant to assess its ability to maintain a future subrogation action. The Superior Court granted Travelers' request for asset discovery, but was reversed by the Rhode Island Supreme Court.

In reaching the decision that discovery was not permitted, the Court held that Bolton stands for the proposition that "an insurer's duty to its insured to seriously consider an offer by a tortfeasor to settle is deemed satisfied when that insurer has conducted a reasonable inquiry into the assets of the defendant to the extent permissible by means of private asset discovery", but "if the insurer then chooses to deny permission for its insured to settle based on that inquiry, that the decision should be supported by a reasonable and objective basis." Further complicating the analysis, the Court held that "the reasonableness standard in *Asermely* and its progeny, *Bolton*, is necessarily flexible, and we are reluctant to give it rigid judicial shape."

Following the decisions in *Bolton* and *Travelers*, the Court next addressed *Asermely* in *Skaling v. Aetna Ins. Co.,* 799 A.2d 997 (R.I. 2002). In *Skaling*, the plaintiff brought suit against Aetna Insurance Co. ("Aetna"), alleging breach of contract for refusal to pay underinsured motorist insurance benefits and bad faith, both in the handling of the claim and in refusing to settle. Following a trial on the breach of contract claim, Aetna moved for and obtained summary judgment on Skaling's bad faith claim. The Rhode Island Supreme Court reversed the Superior Court's decision to grant Aetna summary judgment reasoning that there was a triable issue of fact regarding the issue of bad faith. In reinforcing its prior determination that extra-contractual liability exists even in the absence of bad faith, the Court concluded that "[i]n *Asermely*, although we concluded that Allstate did not act in bad faith . . . we held that Allstate must bear the risks attendant to its failure to settle a claim within the policy limits" because the rule it announced placed the "risk of miscalculating the merits of a claim and proceeding to trial" on the insurer.

> *"The Rhode Island Supreme Court's decision in Asermely represents an unprecedented expansion of extra-contractual liability for insurers."*

Ten Years Later Uncertainty Still Persists

Although the Rhode Island Supreme Court articulated a "new rule" for extra-contractual liability, it has failed to provide guidance regarding what steps an insurer must take to comply with *Asermely's* mandate to "consider seriously" a settlement offer, or what constitutes a "reasonable" offer. First, an insurer that declines a settlement offer within the policy limit faces a significant hurdle in establishing that the offer was not reasonable. Essentially, the insurer must persuade a court that the offer, even though within the policy limit, was unreasonable despite a jury verdict that the claim was worth more than the offer. Although not impossible, it is difficult to envision a court holding that a settlement offer within a policy limit was unreasonable, where a jury later returns a verdict with an award that is higher than the original settlement offer. Because of this dichotomy, insurers must recognize the difficulty they will confront after denying a settlement offer within their policy limits.

Secondly, although language from subsequent cases appears to contemplate an insurer's need for adequate information in seriously considering the settlement offer, the decisions in *Travelers* and *Bolton* demonstrate that an insurer faces significant obstacles in gathering that information in certain circumstances. Moreover, the Court has provided no guidance on what steps an insurer must take to "seriously consider" a settlement offer, nor has the Court indicated that an insurer would be insulated from liability if it complies with this directive. Rather, because the insurer "must assume the risk of miscalculation if the ultimate judgment should exceed the policy limits", it appears that, under *Asermely*, an insurer is subject to extra-contractual liability if it simply comes to the incorrect conclusion in rejecting an offer within the policy limits.

Conclusion

The Rhode Island Supreme Court's decision in *Asermely* represents an unprecedented expansion of extra-contractual liability for insurers. Although Rhode Island courts still apply the bad faith standard, insurers face significant risk of liability for an excess judgment where they refuse a settlement demand within the policy limits – even if the insurer acts in good faith in declining the offer. Moreover, cases decided since *Asermely* reinforce its holding while failing to provide significant guidance on what steps an insurer must take to "consider seriously" a settlement offer, or what constitutes a "reasonable" offer. Simply put, as the Rhode Island Supreme Court succinctly stated ten years ago, an insurer that declines an offer within its policy limit "does so at its peril."

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1 See *Bibeault v. Hanover Ins. Co.,* 417 A.2d 313 (R.I. 1980); *see also Robertson Stephens, Inc. v. Chubb Corp.,* 473 F.Supp.2d 265, 271 (D.R.I. 2007) ("In *Bibeault*, the Rhode Island Supreme Court . . . recognized an independent cause of action in tort for an insurer's bad faith refusal to deliver payments."); *Skaling v. Aetna Ins. Co.*, 799 A.2d 997, 1003 (R.I. 2002) (noting that *Bibeault* "recognized the common law tort of insurer bad faith in the context of the wrongful refusal to pay an uninsured or underinsured (UM-UIM) claim").

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Disconnected Sprinkler Highlights the Argument for Reform of the Law on Breach of Warranty: *Qayyum Ansari v New India Assurance Ltd*

by Sam B. Tacey
London

A recent case in the Court of Appeal has reignited discussion about the reforms proposed to the law on breach of warranties by the Law Commission of England and Wales. Although the case does not directly address warranties, it touches on issues often raised in the context of criticism of the draconian nature of the remedy for breach of warranty.

In *Qayyum Ansari v New India Assurance Ltd* [2009] EWCA Civ 93 the Court of Appeal considered Qayyum Ansari's appeal against the decision at first instance that Ansari's claim under his insurance policy with New India Assurance (NIA) should be dismissed.

On 4 May 2005 Ansari had entered into a 12 month commercial property insurance policy with NIA. The proposal form for the policy stated that the premises were protected by an automatic sprinkler system. The policy itself contained a term which stated:

"This insurance shall cease to be in force if there is any material alteration to the Premises or Business or any material change in the facts stated in the Proposal Form..."

The policy also contained an extension which stated that cover would not be invalidated by act of neglect of which the owner was not aware.

On 7 September 2005 a fire broke out at Ansari's premises, causing considerable damage. At the time the premises were leased to a Mr Asim, who was using them for the purposes of his business. Ansari subsequently made a claim on his insurance, which was rejected by NIA when it became apparent that the automatic sprinkler system installed at the property had not been connected to the mains water supply at the time of the fire.

The Court of Appeal upheld the decision of the court below. The principal issue to be determined was whether the fact stated in the proposal form (that there was a sprinkler system) had changed, and, more importantly, whether this change was a "material change". The Court of Appeal held that the reference in the proposal form to protection by a sprinkler system meant that there had to be a properly functioning sprinkler system, not merely one that was capable of functioning. As Lord Justice Moore-Bick commented:

"to construe the completed form as meaning no more than that they [the premises] were fitted with an automatic sprinkler system which might or might not be functioning would be contrary to common sense."

Although it was conceded that temporarily switching off the sprinkler system would not necessarily mean that the statement in the proposal form ceased to be accurate, in the present case, where the system had been permanently switched off and a filing cabinet had been placed in front of the isolation valve connecting it to the mains supply, there clearly was a change in facts as stated in the proposal form.

Lord Justice Moore-Bick went on to consider whether this change was a material change. In so doing, he stated that in the present circumstances, materiality did not have the same meaning as pre-contractual materiality in the context of non-disclosure or misrepresentation. Rather it had the meaning as set out in the Court of Appeal case of *Kauser v Eagle Star* [2000] Lloyd's Rep IR 154. In that case it was held that in order to be material, a change must be such that it altered the nature of the risk insured. Moore-Bick LJ went on to hold that in the present case the change was indeed material, as *"turning off the sprinkler system did more than merely increase the risk of damage by fire and constituted a material alteration of the nature of the subject matter of the insurance."* As such, the absence of a sprinkler system took the risk *"outside that which was in the reasonable contemplation of the parties at the time the policy was issued."*

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"The law on warranties as it stands states that a warranty must be complied with exactly, whether or not it is material to the risk or to the loss actually suffered."

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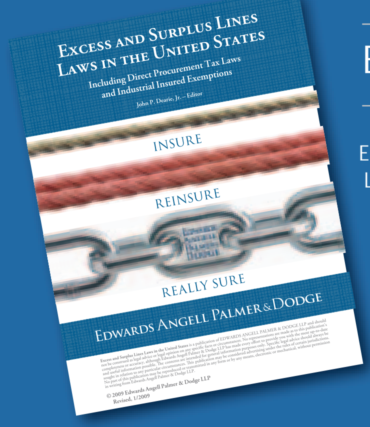

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Finally, the Court of Appeal held that on the facts, Ansari had been aware that the sprinkler system was not in operation, and as such could not rely on the extension to cover relating to acts done without the knowledge of the owner of the property.

Relevance to Warranties

The law on warranties as it stands states that a warranty must be complied with exactly, whether or not it is material to the risk or to the loss actually suffered. Upon breach of a warranty, the insurer is automatically discharged from liability from the time of the breach. As such, had there been a warranty as to the existence (and continuing existence) of a sprinkler system in the Ansari case, there would have been no need to discuss, as the Court of Appeal did at some length, whether the change in the proposal form had been a "material change". Indeed, even if the breach of warranty had no bearing on the risk at all, and the claim had been, for example, in respect of losses arising from a burglary, or for losses in respect of a fire which had occurred after the sprinkler had been switched back on, it may have been possible for the insurers to refuse cover for breach of warranty.

In the view of many commentators, the English law position on warranties is draconian, and unduly harsh on policyholders. As a result of these criticisms, the Law Commission commenced a review of the law on warranties (as well as various other aspects of insurance law) and published a consultation paper in June 2007. Responses have been received by the Law Commission and it continues to produce Issues Papers on its findings. A draft bill in respect of business insurance contracts is expected sometime in 2010 or 2011.

"A draft bill in respect of business insurance contracts is expected sometime in 2010 or 2011."

In relation to warranties found in business insurance contracts, two key changes have been proposed. The first proposal is that a new default rule should apply (although the default position can be contracted out of by the parties) such that a business would be entitled to be paid a claim even if there had been a breach of warranty, *"if it could prove, on the balance of probabilities, that the breach in question had not contributed to the loss"*. The second proposal suggests that the remedy for a breach of warranty should be altered so that upon a breach of warranty an insurer will have the option to terminate the contract, but only if the breach has *"sufficiently serious consequences to justify termination"*. It is unclear at this stage exactly how the proposed changes to the law would be interpreted by the courts. However, it would appear that the new rules could very well produce a test very similar to the test for materiality as set out by the Court of Appeal in the *Ansari* case.

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