

CURRENT LEGAL DEVELOPMENTS AFFECTING FINANCIAL REPORTING AND RESERVING FOR INSURANCE COMPANIES

1. Summary

The purpose of the Workshop is to provide delegates at the Convention with an opportunity to update themselves on current legal developments affecting financial reporting and reserving in the general insurance market.

This is an area that is moving reasonably quickly on several fronts. Whilst the volume of new legislation coming out of Europe has slowed down considerably, there is still important further legislation on the way, in particular in the draft Directive on Insurance Groups. Very few insurance companies will escape its effects, but many have as yet failed to take any active steps to prepare for its arrival.

On the other side, in the Courts, several judgments have recently emerged that will be influential in the manner in which London market companies and Lloyds syndicates, in particular, address their reserving in the future. Delegates will be familiar with many of these; it is impossible to predict which will be the "hottest topics" by the time of the Convention in October.

Our aim in the Workshop will be to react to the extent possible to the themes that are of greatest interest to delegates at the time and, in particular, to take account of any developments that take place over the summer. One of us is principally a corporate and regulatory solicitor; the other specialises in dispute resolutions. These written notes provide a memorandum of the two most important current developments in Europe and the most important case to have emerged from the Courts in the last month at the time of writing, *Axa Re v Field*. We have provided a summary in note form of other important cases decided during the last year.

Finally, as an appendix to this note, we have set out an aide memoire for delegates as to the significance of abbreviations beginning with an "E" now in use in Europe. More people than will admit it have to resort to bluff when dealing with these abbreviations, and it may be that the most useful service we can do for the Convention is to enable people to bluff more successfully!

2. Prudential Supervision Directive

On 19 June 1995 a Directive was adopted to amend a number of Directives applicable to financial undertakings, including the First and Third Non-Life Directives. Its purpose is to strengthen the powers of regulatory authorities following recent cases of fraud in the financial services sector and, in particular, the case of Bank of Credit and Commerce International. Member states must implement the Directive by 18 July 1996.

The First and Third Directives envisaged the authorisation of an insurer as an entity in its own right without reference to the group of which it formed part. It is now proposed that the group structure should be sufficiently transparent to enable the insurer to be supervised effectively. Accordingly, authorisation of an insurer may be withheld where "close links" exist between the insurer and any other natural or legal person which in the opinion of the supervisory authority prevent the effective supervision of the insurer. The term "close links" has been broadly defined to include control of 20% or more of the voting rights or capital of the insurer as well as a parent/subsidiary relationship. Regulatory authorities will have some discretion in the amount of information they may require about group structures.

Under the new Directive member states will be obliged to require that the "head office" of insurance undertakings be situated in the same member state as their registered offices. At the moment the Third Directive provides only that the taking up of the business of direct insurance is to be subject to prior official authorisation obtained from the regulatory authority of the member state in which the insurer has established its head office. The term "head office" is not defined in the Third Directive nor in the new Directive. The obligation is designed to enable regulatory authorities to maintain close contact with an insurer's decision-making body, thus avoiding a situation such as that which occurred in the BCCI case. There, BCCI had its head office in Luxembourg and its administrative offices in London. As a result, the UK regulatory authority and the supervisors of other local branches all limited their supervision to local operations, on the assumption that Luxembourg was supervising the worldwide activities of the Bank. In fact, this was not the case. The Luxembourg regulatory authority limited its supervision to the activities of the bank in Luxembourg, which were relatively minor. This requirement may cause difficulties for some well established insurance companies, the activities of which have expanded over time so that, for historical reasons, their registered offices are not in the same member state as their current centres of operation.

Member states will be empowered to authorise exchanges of information with other insurance regulatory authorities and between insurance regulatory authorities on the one hand and, on the other, bodies responsible for overseeing:

- the bodies involved in the liquidation and bankruptcy of insurers;
- statutory auditors; and
- independent actuaries.

In addition, member states may authorise the exchange of information between the regulatory authorities and the authorities responsible for investigating breaches of company law. Any information must be supplied only for supervisory purposes and subject to obligations of professional secrecy. Information originating in another

member state may not be disclosed without the consent of the competent authorities making the disclosure.

Finally, member states will be obliged to impose an obligation on auditors engaged in the preparation of an insurer's statutory accounts to report promptly to the regulatory authorities any fact or decision liable to constitute a material breach of the conditions upon which the insurer is authorised to do business, or to affect the running of the business, or to lead the auditor to refuse to sign the accounts or to qualify them. This duty extends to all undertakings having close links with the insurer in question. In exercising this duty, auditors cannot be held liable for the legal consequences of disclosing any such fact or decision.

3. Proposed Directive on Insurance Groups

At the end of last year a proposed Directive was published regarding insurance groups. In the past there have been proposals for dealing with the situation of "double gearing" within financial conglomerates arising where, for example, an insurer owns a bank and the same assets are used to support the solvency margin requirements for both the insurer and the bank. In fact the new proposal focuses specifically on insurance companies which belong to groups

The proposal is mainly aimed at keeping under review the extent of double gearing where the assets of the insurer derive in some way from a related company (relationship being judged by reference to a 20% shareholding). The primary effects are as follows.

Member states are required to extend their supervision of insurance undertakings so as to enable or require the production of information by related companies that may be relevant to the supervision of an insurance company.

Member states are required to monitor whether transactions between an insurance company and related companies to verify that they are being carried out according to "normal market conditions" (presumably, in other words, on an arm's length basis). The competent authorities have to be informed of such transactions at least by way of an annual reporting requirement. The precise details of the procedure to be followed are left to member states.

Member states are required to ensure that an adjusted solvency calculation in, addition to the normal annual solvency test, is carried out in relation to insurers in order to review the extent of "double gearing" of capital - in other words, the extent to which the asset base of the insurer derives ultimately from related companies. Various methods are proposed to calculate double gearing. If the adjusted solvency calculation turns out to be negative the supervisory authorities are required to take appropriate action (left undefined - so it may be that nothing is appropriate) in relation to the insurer.

Finally, Member states are required to apply a basic solvency test to holding companies whose subsidiary undertakings are wholly or mainly insurance or reinsurance companies with a view to ensuring that its intact capital at least exceeds the solvency requirements of insurers and reinsurers in which it holds shares and are related to it.

It is as yet unclear when the proposal is likely to come into effect and what the likely effect will be in the UK. However, it is clear that insurance companies who have in the past benefitted from "pyramiding" companies above each other may no longer be permitted to obtain double benefit from the same assets.

4. Axa Reinsurance (U.K.) plc v Roger Field

On 20 June 1996 the House of Lords gave judgment in the case of *Axa Re v Field*. The case is the latest to arise from the ever complex workings of the LMX spiral. The question at issue was that of the aggregation of losses for the purposes of an excess of loss reinsurance contract. In a unanimous decision, the House of Lords held that the term "originating cause" in an errors and omissions insurance policy was not to be equated with "one event" in an excess of loss reinsurance contract.

An outline of the decisions which led to the case of *Axa Re v Field* is helpful in setting the issues in context. The chain of authorities began with *Deeny v Gooda Walker Limited* [1994] CLC 1224. In that case Phillips J held that the underwriters of four syndicates managed by the two Gooda Walker companies had been negligent in the writing of excess of loss business between 1988 and 1990. Many of the managing and members' agents who were liable to the Names had the benefit of errors and omissions cover.

The next link in the chain was provided by *Cox v Bankside Members Agency Limited* [1995] CLC 180, in which a number of E&O underwriters sought a determination of their liabilities to the insured agents. The relevant policies provided coverage in respect of any claim arising from "*one originating cause or series of events or occurrences attributable to one originating cause*". The main question before the Court was the number of "originating causes" which had given rise to the liability of the agents to the Gooda Walker Names. Phillips J held that there were three. He based his decision on the fact that there were three separate individuals managing the underwriting for the Gooda Walker Names, and that each of the three concerned failed to arrange adequate protection against a catastrophe.

The E&O insurers had in turn reinsured the risk. One of the insurers, Syndicate 204, had excess of loss reinsurance cover with Axa Re. The contract provided that the reinsurers would pay an indemnity in respect of "each and every loss". The term "each and every loss" was defined to mean "*each and every loss and/or occurrence and/or catastrophe and/or disaster and/or calamity and/or series of losses and/or occurrences and/or catastrophes and/or disasters and/or calamities arising out of one event*". The

real question for the Court was whether "a series of events or occurrences attributable to one originating cause" had the same meaning as "a series of ... occurrences ... arising out of one event".

At first instance Phillips J found that, without the constraint of a specific context, the terms "event" and "cause" had different meanings. He noted that the dictionary definitions showed that each word described a particular attribute of a phenomenon. A phenomenon could be both an event and a cause, but this was not necessarily the case. The question that arose was whether, having regard to the wording of the relevant clauses, and to the context in which the clauses were used, the terms "cause" and "event" would necessarily refer to the same phenomenon. The reinsurers submitted that the term "originating cause" indicated a longer chain of causation than that suggested by "one event". Phillips J did not agree. In his view, the requirement in the "one event" clause that the losses to be aggregated arise out of one event could be re-worded to require the event to be the originating cause of the losses. He concluded that there were many circumstances in which the "cause" in the underlying policy could be the same phenomenon as the "event" in the reinsurance contract. Thus, his decision in *Cox v Bankside* that the Gooda Walker losses arose from three originating causes, determined the number of events for the purposes of the reinsurance. This decision was unanimously upheld by the Court of Appeal.

Lord Mustill gave the leading judgment with which Lord Mackay of Clashfern, Lord Goff of Chieveley, Lord Slynn of Hadley and Lord Hoffmann concurred. Lord Mustill identified three "themes" as the basis for the Court of Appeal's decision. He considered each theme in turn.

The first theme was the assumption that where an insurer takes out reinsurance, and where both policies contain provisions which permit aggregation of losses, the parties were likely to have intended the effect of both policies to be similar. Lord Mustill accepted that this assumption might be correct in reinsurance of a "proportionate" nature where the reinsurer was sharing the risk assumed by the insurer. Where a reinsurer wrote an excess of loss treaty for a layer of the whole account of the reinsured, however, he saw no reason to assume that an aggregation clause in one policy was intended to have the same effect as an aggregation clause in the other. Such insurances were not in any real sense back-to-back. If the aggregation clauses were intended to have the same effect, he suggested that they be written in the same terms.

The second of the Court of Appeal's themes was that limiting terms in reinsurance clauses should not readily be found to operate more stringently than those in the underlying policy. Lord Mustill found no basis for this assertion, except possibly where the policies were clearly intended to be back-to-back. He added that the expression "more stringently" might be inappropriate, as the effect of such a clause from the point of view of the reinsured would be impossible to determine prior to the actual claims experience.

The third theme was that the parties to the contract did not envisage a philosopher's meaning of "cause". Lord Mustill agreed with this point, and added that the interpretation of such clauses should not be approached in the manner of a "philologist or a pedant". It appeared to him that for many years the wording of insurance and reinsurance contracts had been "more lax than was healthy". He did not, however, accept that it was right to equate poor drafting with poor thinking, and refused to adopt the presumption that those who drafted such clauses were so indifferent to their meaning that whatever the phraseology, the intention was in every case much the same.

Lord Mustill concluded that the words "originating cause" had a much wider meaning than an "event". An event was something that happened at a particular time, at a particular place, in a particular way. A cause was much less constricted and could be a continuing state of affairs or the absence of something happening. In coupling "originating" with "cause" the drafter had made a conscious choice to "open up the widest possible search for a unifying factor in the history of the losses which it [was] sought to aggregate".

The case was remitted to the High Court for a determination of the number of events which gave rise to the Gooda Walker losses.

In the context of the vast litigation arising out of activities at Lloyd's the *Axa Re* case is, as Lord Mustill remarked, but a mere fragment. It is nevertheless a fragment of significance to all those who have become embroiled in the operations of the LMX spiral. In adopting a very literal approach to the wording at issue, the House of Lords have introduced an additional complication in the already tortuous progression from one level of the spiral to another. The impact of the decision on reinsurances of asbestos and pollution risks remains to be seen.

5. Other recent cases in summary

Wide Test of Material Non-Disclosure

To avoid an insurance policy for non-disclosure/misrepresentation, an insurer must establish that the undisclosed fact is material and that it induced him to enter into the contract. Whether a fact is material is not limited to matters which would increase the risk, but includes matters affecting the insurer's estimate and appreciation of the risk. Moreover, where there has been material misrepresentation or non-disclosure, there is a presumption that this was relied on or induced the insurer, thus entitle him to avoid.

- **St Paul Fire & Marine Insurance Company (UK) v McDonnell Dowell Constructors and Others**
Court of Appeal
Lloyd's List 8 June 1995

No Duty to Disclose "Moral Hazard"

The Court of Appeal has upheld that a failure by Names to disclose fraudulent payments by the directors of their underwriting agency did not entitle their reinsurers to avoid contracts of reinsurance. The Names had been unaware of the fraud, nor could they be deemed to have known. The Court also rejected the argument that the agent was duty-bound to disclose the fraud in accordance with Section 19 Marine Insurance Act 1906 as the fraud had been committed outside the agent's capacity.

- **PCW Syndicates v PCW Reinsurers**
Court of Appeal
The Independent 8 September 1995

As in *PCW Syndicates -v- PCW Reinsurers* (see above) the Court of Appeal upheld that reinsurers were not entitled to avoid for the "moral hazard" not having been disclosed that senior officers of the Weavers underwriting agency were perpetrating an alleged fraud on their principals, the reinsured stamp companies. Neither could reinsurers rely on illegality arguments because of section 132 Financial Services Act 1986. Paying claims under a reinsurance is not illegal, even though the reinsurer was not authorised at the time of the contract.

- **Group Josi Re -v- Walbrook Insurance Co & Others**
Lloyd's List 10 October 1995

Proposal Form Provides No Continuing Warranty

There is no special principle of insurance law that answers in proposal forms import promises as to the future. A positive answer by the insured to the question: "Are the premises fitted with any system of intruder alarm?" and provision to insurers of the alarm specification did not amount to a continuing warranty that the premises were fitted with an operational intruder alarm which the insured would habitually set to operate when the premises were unattended.

- **Hussain v Brown**
Court of Appeal
The Times 15 December 1995

Aircraft Loss Was One Occurrence

The loss of 15 aircraft and aircraft spares seized by Iraqi forces at Kuwait airport during the invasion of Kuwait on 2 August 1990, and their subsequent removal from that airport by the Iraqis over a period of days, arose out of one occurrence. The evidence suggested that the Iraqis intended from the very first to turn the Kuwaiti fleet into spoils

of war for Iraq and, therefore, the occurrence took place on 2 August 1990. It made no difference whether the occurrence was the invasion itself or the capture of the airport.

- **Kuwait Airways Corporation v Kuwait Insurance Co**
Rix J
Insurance Day 14 February 1996

Failure to Provide Inspection Thwarts Summary Judgment

A reinsured applied for summary judgment for non-payment of claims under a policy of reinsurance. Sometime before proceedings began reinsurers had complained that the reinsured had failed to comply with provisions of the Notice of Loss Clause and had demanded an inspection under the policy terms. Rix J considered the general principles relating to the inspection of records and held that, in such circumstances, a court ought to be cautious about giving summary judgment before an inspection had been allowed. Accordingly, the application was adjourned to permit an inspection.

- **Pacific & General Insurance Co Ltd v Baltica Insurance Co (UK) Ltd**
Rix J
Insurance Day 16 January 1996

Alcohol-Related Death Not Caused By Accident

A nurse who, to relieve severe back pain resulting from an injury at work, regularly consumed excessive amounts of alcohol and who one day suddenly died from its effects, had not died of a bodily injury "caused by accidental means" within the terms of her life insurance policy. She must have been well aware of the dangers of drinking alcohol to excess and must be taken to have foreseen what might happen.

- **Dhak v Insurance Company of North America (UK) Ltd**
Court of Appeal
The Times 8 February 1996

Meaning of "Caused By Use of Vehicle"

An accident that happened when a car driver negligently crossed a road to get help to restart her car was caused by or arose out of the use of the car and, therefore, fell within the driver's motor insurance policy.

- **Dunthorne v Bently and Others**
Court of Appeal
The Times 11 March 1995

Summary Judgment Against Reinsurers

Reinsurers failed to make payment in response to the reinsured's statements of account and had instead exercised rights of inspection at a leisurely pace. The reinsured was entitled to summary judgment. Longmore J held that under reinsurance treaties, statements of account spoke for themselves until they were met with reasoned objections by reinsurers. Summary judgment would be given even though it might subsequently become apparent that reinsurers did have grounds to contest payment.

- **Aetna Reinsurance Co (UK) Ltd v Central Reinsurance Corporation Ltd**
Longmore J
Lloyd's List 21 March 1995

Insurers Liable for Exemplary Damages

The House of Lords upheld that exemplary damages awarded against local authorities and chief constables who were vicariously liable for the criminal acts of employees or police officers were recoverable from insurers. There was no rule of public policy precluding an indemnity for exemplary damages.

- **Lancashire County Council v Municipal Mutual Insurance Ltd**
House of Lords
The Times 8 April 1996

Meaning of the Aggregate Extension Clause

Waller J considered the construction of the aggregate extension clause (AEC) in the context of claims on reinsurers for losses arising from policies issued under the Minet lineslip. Such policies were covered by the AEC. The AEC covers indemnity or liability policies having a limit fixed by reference to aggregated claims.

- **Denby v Marchant**
Waller J
10 May 1996

"Actually Paid" Means "Payable"

The House of Lords unanimously upheld that in a contract of excess of loss reinsurance, the words "actually paid" in the Ultimate Net Loss clause did not necessarily make a reinsurer's liability to pay its reinsurance conditional upon the reinsured having first paid out a sum of money to the original insured. As a

consequence, the reinsured merely had to demonstrate that it had become liable to make a payment and that its liability was of a kind that obliged the reinsurer to pay.

- **Charter Re v Fagan**
House of Lords
Lloyd's List 8 June 1995

APPENDIX

A bluffer's guide to European Groupings

A. European Union or European Community?

Over the last three years there has been not inconsiderable confusion as to the difference between the European Community and the European Union.

Originally, there were three separate European Communities, established by three separate Treaties:

- The European Economic Community ("EEC");
- The European Coal and Steel Community ("ECSC"); and
- The European Atomic Energy Community ("EURATOM").

They all still exist, and the member states of each of the communities are and always were identical.

As a result of the Treaty on European Union (also known as the Maastricht Treaty), which came into force on 1st November 1993, a number of changes occurred:

- The member states of the three original Communities are now all members of a new European Union ("EU");
- All nationals of these member states are also citizens of the EU;
- Various amendments have been made to the original three Treaties, including a major change to the EEC Treaty by the addition of a section on common economic and monetary policy; and

The EEC Treaty was re-named the European Community ("EC") Treaty.

The EU is based on a combination of the provisions of the existing three Treaties and new provisions set out in the Maastricht Treaty which provide the basis for a common foreign and security policy and for cooperation in justice and home affairs (asylum policy, immigration and combating fraud and drug addiction) between the member states of the EU.

The result is that the phrases EU and EC are sometimes interchangeable but sometimes not.

If we are talking about the member states in the context of their new common foreign and security policy, or the new provisions relating to cooperation in justice and home affairs, they should always be referred to as the EU.

However, if we are referring to the activities of the member states derived from the original EEC Treaty (now called the EC Treaty), the description EU is permissible, but it is still correct to refer to the EC.

Finally, most of the law deriving from the EU affecting businesses is based on the provisions of the EC Treaty and it is therefore still correct (and, indeed preferable) to continue to refer to EC law rather than EU law. Specifically, the Insurance Directives are still properly referred to as EC Directives as they are adopted under the EC Treaty. The official name of the Commission in Brussels remains "the Commission of the European Communities" (although as a matter of practice it has adopted the name "European Commission" in all non-legal documents). Confusingly the EC Council has decided to re-name itself the "Council of the European Union" for all purposes. This is to avoid having to call itself the EC Council for some purposes and the EU Council for others.

B. European Economic Area

The original EC Treaty sought to create a single market within which goods, services, capital and people could move freely. On 2 May 1992 the then twelve EC member states and the seven European Free Trade Association ("EFTA") countries (Austria, Finland, Iceland, Liechtenstein, Norway, Switzerland and Sweden) signed an agreement creating a European Economic Area ("EEA"). This was subject to ratification by each of the States concerned. The concept of the EEA was to extend the EC Single Market to include all the EFTA countries.

Ratification was considerably delayed as a result of the decision of Switzerland and (originally) Liechtenstein not to participate. This necessitated an amendment of the original EEA Agreement and re-ratification by the five remaining countries, so that the Agreement only finally became effective on 1st January 1994.

The EEA Agreement extends to Austria, Finland, Iceland, Liechtenstein, Norway and Sweden, the concept of a single market within which goods, services, capital and people can move freely. It effectively creates a sophisticated free trade area. The six EFTA States have not however become subject to all the provisions of the Treaty on European Union, nor are they members of the European Union. With effect from 1 January 1994 some 1500 EU Directives and Regulations adopted prior to 31 July 1991 (including the First and Second Non-Life Directives) became applicable throughout the EEA. As regards legislation adopted between 1 August 1991 and 31 December 1993, most of this became applicable throughout the EEA with effect from 1 July 1994. The Third Non-Life Directive was included in the package of legislation concerning financial services adopted in this way subject only to certain agreed exemptions and transitional arrangements.

As from 1 July 1994, the Third Insurance Directives were accordingly applicable not only as between the existing twelve member states, but also between those states and the additional five EFTA countries that had acceded to the EEA Agreement at that time.

Since 1 January 1995, Austria, Finland and Sweden have been member states of the EU (see below). On 1 May 1995, Liechtenstein joined the EEA. For the future therefore, the above mentioned provisions concerning the EEA will in practice only be relevant to Iceland, Liechtenstein and Norway.

C. Enlarged European Union

On 24 June 1994 the twelve then EU member states signed a Treaty of Accession which permitted Austria, Finland, Norway and Sweden to become members of the European Union. Subsequent referenda in each of these countries resulted in accession being approved everywhere except in Norway. As a result, only Austria, Finland and Sweden became members of the EU on 1 January 1995. Iceland, Liechtenstein and Norway remain EFTA states which are party to the EEA Agreement.

Because the three new member states are relatively wealthy countries their economic integration into the EU did not require major transitional adjustments (unlike, for example, the previous accession arrangements for Spain and Portugal). All Directives now are binding on the new member states.

D. Switzerland

The departure of Switzerland from the negotiations for the formation of the EEA resulted in the resurrection of an Agreement signed between the EC and Switzerland

in October 1989, which was intended to make reciprocal between the EC and Switzerland all the benefits of the then EC Insurance Directives.

For a long time it was hoped that this Agreement would be made redundant by the establishment of the EEA, but this proved not to be the case.

The result is that the First Non-Life Insurance Directive (but not the Second or Third Non-Life Directive) now apply as between the member countries of the EU and Switzerland, so that companies with their head office in Switzerland have the same rights to establish branches or agencies within the EU as were formerly available within the EU under the First Non-Life Directive. Conversely, Switzerland makes similar benefits available to EU insurers, including those with their head office in the UK.

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