

Major Changes to the Systems & Controls Regime for Insurance Intermediaries

From 1 April 2009, insurance intermediaries will be subject to a more stringent systems and control regime. As a matter of urgency, they should therefore focus attention on the size of fines given out by the FSA to firms in breach of Principle 3 of the general “Principles for Business” in the FSA Handbook. This Principle states that “a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.”

The Common Platform

The FSA is extending the common platform at chapters 4 to 10 of the FSA’s Senior Management Arrangements Systems and Controls sourcebook (SYSC) to almost all firms regulated by the FSA. Notably the common platform will not apply to insurers, managing agents and the Society of Lloyd’s until the outcome of the Solvency II Directive is known. At that point a consultation will be undertaken on extending the common platform to them.

What does the Common Platform Cover?

The common platform covers key areas of business, being:

- Business structure and contingency planning
- Training, competence and expertise
- Compliance, internal audit and financial crime

- Risk control
- Outsourcing
- Record keeping
- Conflicts of interest

We now look at the application of SYSC in some of these key areas.

Outsourcing

Outsourcing arrangements are useful but logically increase operational risk because a firm may transfer responsibility for risk management and compliance to a third party which may not be managed to the same standards. The current guidance is very minimal when compared with the rules which are set out at SYSC8. These specify a requirement for proper supervision and the taking of appropriate action if there is a failure by that firm to comply with law or regulation, a difficult task if the outsourcer is in a different jurisdiction. However, SYSC8 will not apply to existing outsourcing arrangements.

Critical Functions

There is an additional layer of rules where a firm outsources critical or important operational functions or any of its regulated activities. In those circumstances the firm remains fully responsible for discharging all of its regulatory obligations, notwithstanding the outsourcing. A function is critical or important if a defect or failure would materially impact the firm’s continuing compliance



with its regulatory obligations, its financial performance or the continuity of its regulated activities.

Conflicts of Interest

Intermediaries already understand the obligation upon them to manage conflicts of interest fairly, both between themselves and their customers, and between customers (Principle 8). In what may be the biggest change in terms of effect, SYSC10 will now apply to intermediaries and requires the implementation of a formal regime for recording, managing and disclosing conflicts. In addition firms are given guidance on the establishment of a conflicts policy.

Recommendation

Whilst SYSC will largely reinforce the good business practice of many firms, those responsible for risk management in firms should assess rigorously the requirements of SYSC against their commercial practices going forward.

kapil.dhir@hfw.com

Requirements for commencement of arbitration: Bulk & Metal Transport (UK) LLP v Voc Bulk Ultra Handymax Pool LLC

This charterparty time-bar case demonstrates that great care should be taken to ensure that the formal requirements for commencing (as opposed to merely threatening) arbitration are observed in the drafting of the notice.

S.14 of the Arbitration Act states that contracting parties are free to agree the method of commencing arbitration but that in the absence of agreement, arbitration in respect of a matter is commenced when *"one party serves on the other party ...notice in writing requiring him ...to appoint an arbitrator or to agree to the appointment of an arbitrator in respect of that matter."*

In this case, the first relevant solicitor's letter stated that *"we are instructed to notify you that failing payment ...within 7 days ...we are instructed to commence arbitration against youFurther in*

the absence of agreement to settle this outstanding claim we hereby invite you ...to agree one of these following arbitrators... as sole arbitrator."

A later letter said *"As your members have failed to pay the outstanding balance and have decided not to agree to appoint a sole arbitrator we are now instructed to appoint our client's arbitrator in order to commence arbitration proceedings...we hereby give you notice of our appointment of[BW]. Please appoint your member's arbitrator within 14 days."*

The arbitration tribunal ruled that the first letter was a demand for payment and only in default of payment were the solicitors instructed to commence arbitration, hence this was not a valid notice and the complaint was time-barred. The second letter did constitute valid notice but was too late to save the claim.

On appeal to the Commercial Court the Applicants were relieved. The Court affirmed that s.14 was to be interpreted in a broad and flexible way and since the first letter made it clear it was invoking the arbitration agreement and required the Respondent to appoint an arbitrator, it was valid and complied with s.14's requirements. The fact that the second letter explicitly appointed the Applicant's arbitrator did not detract from this, since the commencement of arbitration under s.14 is to be distinguished from taking a step to constituting the tribunal.

Sometimes arbitrations are commenced simultaneously with court proceedings where, for example, a reinsurance contract wording cannot be found, but is suspected to contain an arbitration clause and a "belts and braces" approach is required. Great care needs to be taken in drafting a notice in these and other situations where the arbitration is contingent upon something happening or existing, or not, as the case may be.

andrew.bandurka@hfw.com



Trends in Class and Derivative Actions - Should we be concerned?

The economic downturn has led to an increase in speculation of likely investor and shareholder action. Whilst this may be true for the US, what about in England and Wales or wider Europe? There have been calls for the introduction of a class action system but what form if any will it take? US commentators warn of the impact their class action system has on US industry not to mention the insurance market. Similarly, since 1 October 2007 there has been concern that the Companies Act 2006 will open up the floodgates to shareholder derivative claims in England and Wales. What are the trends?

In November 2007 the European Union Commissioner responsible for consumer policy announced plans to explore an EU wide strategy for collective redress and enforcement. She made it clear that a US system was not on her agenda. In November 2008 the European Commission announced the publication of a Green Paper on consumer collective redress. 1 March 2009 is the deadline for comments on the Green Paper. In England and Wales the Civil Justice Council responsible for advising the Lord Chancellor on the modernisation of the law has called for reform of the group litigation model. Its recommendations published in December 2008 include: expanding the number of bodies with the statutory power to bring class actions; making the judiciary the gate keeper of the procedure; permitting claims to be brought on an opt out basis; and, changing the law to permit the award of aggregate damages.

Many consider that any system introducing class actions will have the effect of increasing claims, which will in turn impact upon the insurance market. There are however, considerable hurdles that will need to be overcome to implement a class action system, whether similar to that in the US or not. In Europe for example there are potentially significant changes required to legal systems which currently differ considerably. Given the importance of this to the insurance market it will be important to monitor the debate and any action taken as a result whether by the European Commission or the Lord Chancellor.

When the provisions as to director's duties and shareholder derivative actions set out in the Companies Act 2006 (the Act) took effect on 1 October 2007 there was a fear that the floodgates would open on claims against directors. So far the safeguards in

the Act for shareholder claims appear to be working, principally due to the strict approach adopted by the courts. If, as many suggest, there is to be an increase in investor and shareholder litigation in the next year or so it will be interesting to monitor the courts' approach to shareholder derivative claims. This will be of particular interest to D&O insurers.

These issues will be debated at the C5 16th D&O Liability Insurance conference on 24-25 March. HFW's Costas Frangeskides will be on the panel and other members of our D&O team will be in attendance.

graham.denny@hfw.com

Anti-Suit Injunctions: Allianz SpA and Another v West Tankers Inc Case C-185/07

Background

Here, *Front Comor*, a vessel owned by West Tankers Inc and chartered by Erg Petroli SpA (under a charterparty governed by English law and containing a London arbitration clause) collided with Erg's jetty at Syracuse, Italy, causing damage to the jetty.

Erg's insurers, claiming the money they had paid to Erg, and relying on their rights of subrogation under the Italian Civil Code, brought proceedings against the shipowners (i.e. West Tankers) in the Tribunale di Syracuse in Sicily.

Consequently, the shipowners commenced proceedings in the English High Court, seeking an anti-suit injunction restraining the insurers from pursuing proceedings other than arbitration – due to the existence of the arbitration agreement between the parties. The High Court granted the injunction. However, the insurers then appealed to the House of Lords, arguing that the granting of the injunction was contrary to Council Regulation (EC) No 44/2001 of 22 December 2000 ("the Regulation") which provides that the EU court "first seised" of an action will have exclusive jurisdiction and will decide any challenges to that jurisdiction. However, arbitration is excluded from the scope of the Regulation, pursuant to article 1(2) (d). Accordingly, the House of Lords referred the question to the European Court of Justice, that being – does the Regulation preclude a court of a Member State from making an order (i.e. an anti-suit injunction) restraining a person from commencing or continuing

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proceedings before the courts of another Member State because such proceedings are in breach of an arbitration agreement?

Findings of the ECJ

In short, the European Court held that an anti-suit injunction preventing proceedings in another Member State (i.e. Italy) from being prosecuted because they were against an arbitration agreement (i.e. England) was incompatible with the Regulation.

In that regard, the Grand Chamber of the European Court of Justice held that

"if, because of the subject matter of the dispute, i.e. the nature of the rights to be protected in proceedings, such as a claim for damages, those proceedings came within the scope of the Regulation, a preliminary issue concerning the applicability of an arbitration agreement, including in particular its validity, also came within its scope of application".

Therefore, the Grand Chamber found that an injunction such as the one granted by the High Court would be contrary to the principle that every court seized of a dispute should itself determine the issue of jurisdiction, under the rules applicable to it. It therefore ruled that it was incompatible with the Regulation for a court of a Member State to make an order, restraining a person from commencing or continuing proceedings before the courts of another Member State on the ground that such proceedings would be contrary to an arbitration agreement. In this case, it was for the Sicilian court to determine whether it had jurisdiction to determine the dispute, or to decline jurisdiction in favour of the stipulated arbitration

This case was recently considered and applied in *DHL GBS (UK) Ltd v Fallimento Finmatica Spa* [2009] EWHC 291 (Comm).

The practical effect of the judgment remains to be seen but although it could potentially undermine the autonomy of English arbitration clauses, it is unlikely to have a significant impact on the construction of contracts containing London arbitration clauses. Parties choose London as a seat because of the procedural certainty that it provides. For parties based outside Europe there still remains the prospect of English anti-suit injunctions in respect of proceedings commenced outside of the EU. For parties based inside Europe, however, whilst English anti-suit injunctions may not be available against related proceedings in another EU state, if the English arbitral body also declares that it has jurisdiction then those English arbitration proceedings may still be pursued.

alexandra.cottrell@hfw.com

shamir.khimji@hfw.com

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VAT: LeadX v HMRC

In a decision that may give intermediaries and especially aggregators cause to reassess their VAT position as a matter of urgency, this recent VAT tribunal ruling highlights that merely providing intermediaries with an internet link to customers may be an insufficient service to benefit from the VAT exemption enjoyed by insurance intermediaries.

LeadX provides an internet service whereby brokers can buy and sell details of potential customers for insurance and other financial products. The issue before the VAT tribunal was whether LeadX's services were exempt from VAT because they provided intermediary services relating to insurance and the negotiation of credit and therefore fell within the exemption for VAT set out under Article 135.1 EC Directive 2006/112/EEC (VAT Directive).

The tribunal identified two elements to the role of an insurance agent under the VAT Directive: (i) a relationship with both the insurer and the insured (ii) in order to bring the two parties together with a view to the insurance of risks and activities typically undertaken by an insurance agent.

The VAT tribunal concluded that LeadX's services did not fall within the exemption. LeadX was not an insurance agent or broker because it had not have the appropriate relationship with either insurer or insured and did not bring together potential parties to an insurance contract. The Chairman noted:

"The information gathering and sorting exercise was for the purpose of making the lead marketable not to facilitate an insurance transaction. The suppliers did not form a close nexus with an insurance transaction and effectively constituted a separate deal outside any insurance negotiations."

A link to the tribunal's decision is:

[http://www.bailii.org/cgi-bin/markup.cgi?doc=/uk/cases/UKVAT/2008/V20904.html&query=title+\(+leadx+\)&method=boolean](http://www.bailii.org/cgi-bin/markup.cgi?doc=/uk/cases/UKVAT/2008/V20904.html&query=title+(+leadx+)&method=boolean)

nicholas.hutton@hfw.com

andrew.carpenter@hfw.com



Australian exclusion clauses: Baulderstone Hornibrook Engineering Pty Ltd v Gordian Runoff Ltd & Ors [2008] NSWCA 243

The NSW Court of Appeal in this case looks at and confirms the established rule in *Wayne Tanks* that where an event is within an insuring clause but specifically excluded, the exclusion will prevail.

It also provides some interesting analysis of the concept of “construction work” and what this meant when referred to in the relevant exclusion. In particular, “construction work” in the exclusion meant the performance of the work, rather than the finished product. Furthermore, the court considered a distinction based on “construction method” and “construction technique”. The former referred to the specification of steps necessary to be taken in the construction process (which may give rise to a professional duty), while the latter concerned matters that should be left to the builder to develop and employ, for example, the way in which the work was in fact performed (giving rise to a construction duty). Under the insured’s professional indemnity policy, loss arising out of a construction risk or “construction technique” is not covered. In addition, when the insured is also responsible for defective specifications but would have adopted a defective method of work irrespective of the specifications, the specifications are causally irrelevant. Finally, insured and insurers alike should be cautious not to rely on communications with a broker concerning the meaning of particular clauses before the contract was entered into as such evidence is unlikely to be admissible in court for the purposes of assisting the court’s interpretation of contractual term(s).

The Facts & Issues

Baulderstone Hornibrook Engineering Pty Ltd (“BHE”) entered into a contract with Sydney Airport Corporation Ltd (“SAC”) for the design and construction of a third runway at the Kingsford Smith Airport, Sydney (“the project”). The relevant policy covered the insured for liability for errors and omissions for breach of professional duty in relation to the project; however, liability arising out of construction work was excluded.

Exclusion 1(p) provided as follows:

“This Policy shall not indemnify the Insured in respect of any claim made against them.....arising out of construction work performed involving the means, methods, techniques, sequences, procedures and use of equipment of any nature whatsoever which are employed by the Insured’s contracting staff or others in executing any phase of any Project.”

In 1996, subsidence of backfill behind the facing panels of the reinforced earth walls forming the perimeter of the third runway was discovered. SAC sued BHE for damages in 2002 with regards to alleged defects in the design and construction of the retaining walls of the third runway. A settlement was reached in 2004 whereby BHE agreed to rectify the defects. Consequently, BHE claimed under the insurance policy for the rectification works. Two insurers, Gordian and CGU, persisted in their denial of liability on the basis that the loss should be properly characterised as arising from a construction risk and thus either did not come within the insuring clauses or was excluded under Exclusion 1(p).

Prior to policy inception, the brokers had provided to the insured some written explanations on what the brokers believed the policy to mean. These documents were ultimately found to be inadmissible in court because pre-contractual communications between the insured and the broker cannot be used to assist in the interpretation of the policy.

The insurers won at first instance and on appeal. The Court of Appeal upheld the trial judge’s view that the insuring clause was not engaged, but also made the following findings on the other grounds of appeal:

As to Exclusion 1(p) the Court of Appeal held that:

1. “Construction work” referred to the performance of work, not the finished product or the notion of the contractual task.
2. The exclusion should not be narrowly construed. In determining the correct interpretation of the clause, the court will look to factors such as the actual wording of the term; the evident commercial purpose(s)/objectives of the term; and whether, on each individual proposed construction, the effect would be to render the term redundant in practical operation. In addition, the court found that the expression “arising out of” was broad and that in the particular circumstances of this case, there were factual situations where the exclusion operated despite the absence of fault on the part of the contractor.



3. If the cause of the loss resulted from the design/specification of the method in which the work was to be implemented, there is cover under the policy. However, if the loss is caused by the way in which the work was in fact performed, there is no cover under the policy.
4. When the insured is responsible for defective specifications but would have adopted a defective method of work irrespective of the specifications, the specifications are causally irrelevant.
5. Where there are two or more causes and one falls within the insuring clause (i.e. the insured was in breach of professional duty) and the other within an exclusion (loss caused by construction risk), the exclusion prevailed: *Wayne Tank and Pump Co Ltd v The Employers' Liability Assurance Corp Ltd* [1974] QB 57.
6. Evidence of pre-contractual communications between the insured and the broker as to what they thought the policy meant was not admissible. This is because a document cannot be used to help the court interpret the words of the policy: *Codelfa Construction Pty Ltd v State Rail Authority (NSW)* (1982) 149 CLR 337 at 347 and 352.

The Court of Appeal also noted a distinction raised by one of the engineers in the case, Mr Boyd – namely, that there is a difference between construction method and construction technique. Construction method meant the specifications of steps necessary to be taken in the construction, for example, a statement as to how each element in the construction process had to be incorporated in the right place and in the correct sequence. Construction technique, on the other hand, concerned the matters left to the builder to develop and employ. This distinction laid the foundation of the trial judge's approach and was approved by the Court of Appeal.

richard.jowett@hfw.com

celina.fang@hfw.com

Conferences and Events

Denying Coverage for Illegitimate Claims Conference

Grange City Hotel, London (18-19 March 2009)
[Andrew Bandurka](#), [Paul Wordley](#), [Nigel Wick](#)

12th Annual D&O Liability Insurance Conference

Grange City Hotel, London (24-25 March 2009)
[Costas Frangeskides](#), [Nicholas Hutton](#)

HFW Insurance Brokers Seminar

Friary Court, London (May 2009)
[Kapil Dhir](#), [Paul Wordley](#), [Andrew Bandurka](#),
[Nicholas Hutton](#)

JLT CommTech Forum

Hotel Schloss Fuschl, Salzburg, Austria (5 - 8 May 2009)
[Paul Wordley](#)

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