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PROFESSIONAL INDEMNITY FORUM CONFERENCE

HERBERT SMITH PRESENTATION

INSURANCE BROKERS

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"never send to know for whom the bell tolls; it tolls for thee" **- John Donne**

INTRODUCTION

1.1 The purpose of this paper is to review brokers' liability following the House of Lords decision in *Aneco Reinsurance Underwriting Ltd (in liquidation) v Johnson & Higgins Limited* [2001] 2 All E.R. (Comm) 929. In order to do so, it is helpful to start with a reminder of the *Aneco* case.

Aneco Reinsurance Underwriting Ltd v Johnson & Higgins Limited

1.2 Aneco's retrocessionaires successfully avoided Aneco's reinsurance because, at the time of placement of the reinsurance, they had been informed by the broker, Johnson & Higgins, that the reinsurance treaties written by Aneco were quota share, when in fact they were facultative obligatory contracts. It was held that excess of loss cover was either unavailable in the market at the relevant time or was unavailable on acceptable terms. The issue to be decided by the House of Lords was the measure of damages which flowed from the negligence of Johnson & Higgins.

1.3 The House of Lords held that in this transaction the brokers had taken on additional responsibilities to the placing of the risk; they had had set up the original transaction which Aneco was asked to reinsure and they had been involved in finding retrocession cover for Aneco. It was held that in advising Aneco on the non-availability of retrocession cover in the market, the brokers were advising Aneco of the current market assessment of the risk and on what course of action to take. Aneco successfully argued that had it known about the unavailability of the retrocession cover, it would not have written the underlying reinsurance and would not therefore have incurred the full extent of the losses under those contracts. The House of Lords agreed and awarded Aneco damages for all the foreseeable consequences of Johnson & Higgins' negligence, being US $35m.

Consequences of *Aneco*

1.4 The decision of both the Court of Appeal and the House of Lords in *Aneco* prompted a flurry of articles from leading commentators. The general thrust of those comments was typified in an article by Michael Graham of Barlows, who called it "*a double whammy for brokers wearing two hats.*"

1.5 Michael concluded that:

> *"The Aneco decision is a further example of the unfavourable legal climate in which brokers operate and the readiness of the courts to impose painful, financial consequences for brokers and their professional indemnity insurers when they are found to be in breach of their duties to their clients. The case also highlights the practical and legal difficulties faced by brokers when they act in the same transaction in a dual capacity for one client requiring reinsurance and another client indicating he will write the inwards reinsurance provided suitable outwards retrocession protection is available. The potential frictions which can arise when a broker is wearing two hats are not always easily resolved and it is clear that when disputes arise the courts are not sympathetic to brokers who decide to place themselves in this position."*

1.6 The House of Lords decision in *Aneco* was heralded as the high water point in relation to brokers' duties and it was predicted that the floodgates would open. The decision expanded the scope of brokers' duties of care, in certain situations, to advising on market conditions rather than merely obtaining insurance cover. The quantum of damages payable by a broker was likely to increase in such situations to reflect the greater role being played by brokers in the market.

In practice, has this happened?

1.7 So, have the comments and predictions made by those in 2001 following the House of Lords decision in *Aneco* come true?

1.8 Not surprisingly, given the catastrophic potential of the House of Lords decision for brokers, we are not aware of any significant reported decisions relating to brokers, in which the courts have been asked to apply the principles set out by the House of Lords in *Aneco* as to whether the scope of brokers' duties amounts to providing information or advice to insurers.

1.9 There may of course be many reasons for this and one reason may be that lawyers acting for brokers are negotiating settlements of claims where the facts give rise to an *Aneco* argument on scope of duty, in order to avoid the consequences that could otherwise befall a client.

Brokers' liabilities post *Aneco*

1.10 Although there have not been any recent reported cases involving brokers which have developed the *Aneco* decision in relation to the scope of brokers' duties, there have been other developments in relation to the liability of brokers. The following areas of liability will be considered:

- **Duties to the insured**

  The case of *Aneco* concerned the scope of brokers' duties to their client, i.e. the insured or, in that case, the reinsured, when the broker was placing the contract of reinsurance. This is the classic situation in which a broker may face a professional negligence exposure to the insured, i.e., when insurers successfully avoid liability under the insurance contract as the result of a breach of the duty of good faith by the broker when placing the risk and the insured is left without any insurance cover. There are other situations in which a broker may be found liable to the insured for failing to carry out its duties to ensure that insurance cover is available for the risks that the insured may face. Two recent cases have been selected for consideration; one involving the placement of the risk, *GE Reinsurance Corporation v New Hampshire Insurance Co* [2003] EWHC 302 (Comm), and the other involving duties owed by brokers to their clients in the claims process, *Alexander Forbes Europe Ltd (formerly Nelson Hurst UK Ltd) v SBJ Ltd* [2003] Lloyd's Rep. I.R. 432.

- **Contribution claims by brokers against third parties**

  In situations where a broker is found liable to the insured for failing to carry out his duties to arrange insurance cover, the broker will to be ordered to pay damages to the insured for the losses suffered by the insured as a result of the broker's negligence. A recent decision of the House of Lords, *Royal Brompton Hospital NHS Trust v Hammond and others (No. 3)* [2002] 1 W.L.R. 1397, has held that where a third party is responsible for the underlying loss suffered by the insured, the broker cannot seek a contribution to the damages, that it is ordered to pay to the insured, from the third party.

- **Liabilities to insurers**

  Over the last few years, there have been a growing number of cases which have discussed possible situations where brokers could be held directly liable to insurers for damages arising as a result of the placing of insurance business. The most well known case in this area is *Sphere Drake Insurance Ltd v Euro International Underwriting Ltd and others* [2003] Lloyd's Rep. I.R. 525 but in addition, some issues arising from film finance cases will be considered, including the leading film finance case, *HIH Casualty and General Insurance Ltd and others v Chase Manhattan Bank and others* [2003] 1 All E.R. (Comm) 349.

- **Premiums for marine insurance**

  Much London market business placed by brokers originates from foreign jurisdictions. Brokers' responsibilities to insurers for premiums for marine insurance in the London market, in circumstances where the policy is governed by the laws of a foreign jurisdiction, were considered in *Heath Lambert Ltd v Sociedad de Corretaje de Seguros & another* [2004] 1 Lloyd's Rep. 495.

- **Avoidance and the following market**

  In *Aneco*, the House of Lords was asked to rule on the sole question of whether the brokers' duty of care in that case was limited to obtaining satisfactory excess of loss protection on behalf of Aneco or whether the brokers had assumed a much wider duty of care. At first instance, however, Mr Justice Cresswell had to consider a number of other issues, one of which related to the common situation of the following market claiming to be able to avoid the policy on the basis of the presentation of the risk to the lead insurer. Cresswell J's decision on this particular issue was not appealed and has been referred to in other first instance decisions, these being:

  - *International Lottery Management v Dumas* [2002] Lloyd's Rep. I.R. 237;
  - *International Management Group (UK) Limited v Simmonds* [2004] Lloyd's Rep. I.R. 247; and
  - *Brotherton v Aseguradora Colseguros SA* (No. 3) [2003] Lloyd's Rep. I.R. 762.

2. DUTIES TO THE INSURED

GE Reinsurance Corporation v New Hampshire Insurance Co

Background

2.1 This case concerned the insurance of film financiers. The insurance arrangements in this case were slightly unusual, when compared to the majority of film finance cases. Here some US$100m had been loaned by investors to a film distribution and production company, Destination Films. The loans had been secured by the issue of notes to trustees acting for the noteholders. The noteholders engaged brokers, Willis, to place insurance for them against the risk that Destination Films would default on its obligations under the loan notes.

2.2 Willis conducted a series of presentations to potential insurers. At this stage Willis was concerned purely with obtaining a full subscription to the risk, not with the reinsurance. An insurance slip was completed with Axa subscribing to 40% of the risk, New Hampshire subscribing to 20% of the risk and other insurers subscribing to the remaining 40%. Shortly afterwards Destination informed Willis that it wished to have only two insurers, Axa and New Hampshire. Willis thus arranged for New Hampshire to take on the 40% risk held by the other insurers but on a fronting basis only.

2.3 While the direct policy wording was being agreed, arrangements were put in place for the conversion of the remaining insurers into reinsurers for New Hampshire. Unlike the slip for the direct policy it contained various conditions. The reinsurance slip was stated to be *'as original'* .

2.4 If the original co-insurance scheme had stayed in place the situation would have been different as far as New Hampshire was concerned. New Hampshire would have faced liability for its own 20%. of the total risk, but the remainder would have been covered by the other co-insurers. However, by reason of the fronting arrangement, for which New Hampshire received a 5% fee, New Hampshire faced liability for 60% of any loss, subject to the right to recover two-thirds of that liability from reinsurers whose contracts with New Hampshire contained terms not found in the direct policy itself.

2.5 Destination became insolvent and defaulted on its payments to the noteholders. A claim was made under the direct policy, and New Hampshire had no available defence as against the noteholders for the full amount of its 60% subscription as co-assured.

Issues

2.6 The reinsurers of New Hampshire sought declarations that they were not liable to New Hampshire under the reinsurance treaties as a result of alleged breaches of certain warranties. The reinsurance contract contained, *inter alia*, a clause, stipulating that the chief executive officer, a Mr Stabler, was to remain employed by Destination Films for the duration of the policy. The chief executive left during the policy period and the reinsurers contended that his continuing employment was a warranty, breach of which would automatically discharge them from any future liability. This clause was not contained in the direct policy, although it was contemplated by the agreements setting up Destination Films that Mr Stabler would continue in the employment of Destination.

2.7 The reinsurers raised a second defence based on the retention but it proved not to be necessary to resolve this issue.

2.8 New Hampshire counterclaimed for declarations that the reinsurers were liable and, in the alternative, if the reinsurers were not liable, New Hampshire claimed damages from Willis, the broker of both the insurance and the reinsurance.

Judgment

2.9 In the absence of clear wording to the contrary, the courts assume that the intention of a reinsured is to have his liability under the contract of insurance matched exactly by the reinsurer. Mr Justice Langley noted that the presumption of back to back cover as between the insurance and reinsurance was simply a rule of construction. Whilst the presumption could be used to modify the meaning of a reinsurance term which had a direct equivalent in the underlying insurance policy, it could not be used to delete an express provision in a reinsurance contract where there was nothing in the direct policy touching on the same matter. This meant that the wording in the reinsurance policy had to be given effect. As the term satisfied all the requirements of a warranty, the risk under the reinsurance policy ended at the date of the breach. Langley J said, *"The fact that one of the Conditions of the reinsurance slip was "As per Original Policy to be issued" cannot in my judgment have the effect of deleting or superseding or rendering "provisional" the Stabler wording. The Original Policy said nothing about Mr Stabler. It was not inconsistent with the Stabler wording."*

2.10 Willis, in effect, admitted liability to New Hampshire in the event of the claimant succeeding, but it also contended that New Hampshire were contributorily negligent in not questioning the terms of the insurance and reinsurance.

2.11 Willis asserted that New Hampshire had been guilty of contributory negligence in failing to spot the difference and that the damages against Willis should be reduced by an appropriate proportion. This argument was rejected on the grounds that the present cover was broker driven and of a novel type and the onus was on Willis "*to get it right"*. For example:

- It was Willis who had not only seen but drafted the terms of both the insurance and reinsurance slips and who failed to alert New Hampshire to any possible pitfalls or areas where the position was not clear;

- New Hampshire did not receive notice of the terms of the reinsurance until it was too late to pursue the discrepancy; and

- There was no standard language in use for covers such as this and so no special reason for New Hampshire to be alert to any particular wording.

Comment

2.12 From a brokers' perspective, a reasonable contention to make, when facing liability for drafting policy documentation, would be that the professional insurer owed some responsibility to check the terms of the cover. This argument plainly has more force in situations where the broker is acting for a professional insurer who is reinsuring a risk than when the broker is acting for an individual insured. For example, the argument has been accepted by the courts in such situations, e.g. *Youell v Bland Welch & Co (No. 2) – (Superhulls Cover Case)* [1990] 2 Lloyd's Rep. 431 where it was held that *"underwriters of great experience"* exercising reasonable skill and care should have queried the terms of the cover with the brokers.

2.13 The judge, in this situation, as in *Aneco,* was swayed by the fact that the broker was involved in setting up the whole transaction and was involved in placing both the insurance and reinsurance cover. It is becoming more common for brokers to take on a more involved role in the transaction and in such situations, any errors in the insurance arrangements that could reasonably have been avoided, are likely to be vested entirely on the broker.

Alexander Forbes Europe Ltd v SBJ Ltd

Background

2.14 In mid 1994, Nelson Hurst UK (NHUK) assumed the assets and liabilities of Nelson Hurst Financial Consultants Limited ("NHFC"), which had been part of the Nelson Hurst Group (the "Group").

2.15 The Group's professional indemnity brokers, SBJ Limited ("SBJ"), arranged E&O cover for the Group to run from March 1994 to February 1995. This cover comprised of both a Group policy and separate cover for NHFC, for regulatory reasons.

2.16 The NHFC policy was a conventional claims made policy and contained the usual notification clause as follows:

"1. Precedent to their right to indemnify the Assured shall give to the Underwriters immediate written notice of:- (a) any claim made against the Assured…(c) any circumstances of which the Assured shall become aware which may give rise to a claim."

2.17 In October 1994 the Securities and Investments Board issued a "Review of Past Business" (the "Review") concerning advice that had been given about investments in personal pension schemes. This was the forerunner to the pension mis-selling review, the purpose of which was to identify potential cases of bad advice and inform investors of their rights if they had been given bad advice.

2.18 In December 1994, Nelson Hurst and Marsh Limited, a subsidiary of the Group, wrote to SBJ with details of an individual pensions mis-selling claim for notification to the insurers under the NHFC policy. The letter was accompanied by various papers including a memorandum which detailed the background to the pension mis-selling review. These papers were not entirely consistent or clear in that, for example, the pivotal letter was entitled, *"Re: Our Group Errors and Omissions Cover"* and made no mention of the separate NHFC policy.

2.19 SBJ notified the insurers under the Group policy instead of the NHFC policy and did not realise its mistake until after the end of the NHFC policy period.

2.20 Although the insurers under the NHFC policy retrospectively accepted the individual claim, they declined to accept that there had been a wider notification of "any circumstances". This denied a block notification of all subsequent pension mis-selling claims which could be related back to the 1994/5 policy. NHUK therefore incurred and failed to recoup a professional liability loss of the kind which the policy had been designed to cover.

2.21 NHUK sought to recover this loss from SBJ and claimed that had the notification of the individual claim been properly considered by SBJ the claim itself would have been notified to the 1994/1995 NHFC policy and the circumstances of the pension mis-selling review would also have been notified, thus constituting a block notification of the subsequent claims.

2.22 In 1999 NHUK changed its name to Alexander Forbes Europe (AFE) and in 2001 the claim form was reissued in the name of AFE.

Judgment

2.23 SBJ accepted that it owed AFE both contractual and tortuous duties of care, but it fell to the court to decide what these amounted to and whether they had been breached.

2.24 The judge, David Mackie QC held that the brokers had a duty "*going beyond being a post box merely looking at a heading and passing material on".* It was for SBJ to *"get a grip on the proposed notification, to appraise it and to ensure that the information was relayed to the right place and in the correct form*". SBJ clearly failed to show reasonable care, in that SBJ as a company was well aware of the two separate policies and in 1994 had negotiated both of them.

2.25 The court therefore ruled that on the facts SBJ had breached its duty of care to AFE and there was no basis in the circumstances to reduce SBJ's liability to pay damages.

Comment

2.26 SBJ argued that it was relevant to their liability that their client was also a broker and submitted that "*there can be no duty upon SBJ to teach its expert grandmother to suck eggs*". The court, however, held that brokers acting for sophisticated and experienced insurance brokers do not owe a lower standard of care. Brokers should be aware that any strategies put in place and the levels of alertness adopted apply to all communications with clients; even if a client is a fellow professional no lesser level of detail is required in communicating on subjects which the broker and the client have common professional knowledge.

3. **CONTRIBUTION CLAIMS BY BROKERS AGAINST THIRD PARTIES**

3.1 A common scenario in relation to brokers' liability, is the broker being held liable to its insured for the insured's inability to claim on the insurance policy, which it instructed the broker to place on its behalf. The consequences are that the broker is liable in damages to the insured for losses suffered as a result of his negligence.

3.2 When an insurer makes a payment of a claim or liability under an insurance policy, it has the right to bring a subrogated claim against a third party who is liable to the insured for the loss suffered. Where a broker pays damages to an insured for professional negligence, there is no right of subrogation.

3.3 In *Hurstwood Developments Ltd v Motor & General & Andersley & Co Insurance Services Ltd and another* [2002] Lloyd's Rep. I.R. 185, the Court of Appeal held, however, that in a situation where an insured has suffered a loss at the hands of a third party and brings a claims for damages against the broker for failing to procure insurance on its behalf, the broker can bring a contribution claim against the third party under the Civil Liability (Contribution) Act 1978 section 1(1).

3.4 However, in the case of *Royal Brompton Hospital NHS Trust v Hammond and others* the House of Lords overruled the Court of Appeal decision in *Hurstwood.*

3.5 The facts of the cases were as follows:

Hurstwood Developments Ltd v Motor & General & Andersley & Co Insurance Services

3.6 This was a trial of preliminary issues so the stated facts were assumed.

3.7 The claimant was engaged to design and build offices and employed HBB to provide site investigation services and to report on the site. HBB's report concluded that the most economic method of providing the foundations for the development was a vibro floatation process. This advice was followed but the foundations proved inadequate as subsidence occurred and the factory was seriously weakened. The claimant was required to carry out remedial work, the cost of which exceeded £500,000.

3.8 The claimant had engaged the defendant insurance brokers to procure appropriate insurance cover in respect of any liabilities for work undertaken by the claimant. The defendant failed to do so and the claimant issued proceedings against the defendant. The defendant joined HBB into the proceedings, alleging that HBB was liable to the claimant for damages and was therefore liable to make a contribution under Civil Liability (Contribution) Act 1978 section 1(1), which states:

"any person liable in respect of any damage suffered by another person, may recover contribution from any other person liable in respect of the same damage".

3.9 The Court of Appeal overturned the first instance decision and held that there could be a contribution claim under the 1978 Act in cases where the liability of one party would discharge the liability of the other. In this case the damage for which the defendant was liable was the cost to the claimant of having to pay for the remedial building work and the damage for which HBB was liable for was the same. The terms of section 1(1) of the 1978 Act had been met and the defendant was able to recover a contribution from HBB in respect of damage suffered by the claimant for which the defendant may be liable to the claimant.

3.10 The effect of this ruling was to allow brokers to search around for someone against whom a claim for contribution could be brought and therefore diminish their exposure in a similar way as an insurance company might do.

3.11 The *Hurstwood* decision was, however, overruled by the House of Lords in the *Royal Brompton* case.

Royal Brompton Hospital NHS Trust v Hammond and others

3.12 The case of *Royal Brompton Hospital NHS Trust v Hammond and others* involved the construction of a hospital. The claimant had employed contractors to construct new premises, under a contract which required the contractors to make payments in the event of delays. There were substantial delays but the architect granted extensions of time, with the effect that the contractors were relieved from liability for their delays. The employer commenced proceedings against the architect for wrongfully granting the extensions of time and the architect brought contribution proceedings against the contractor, on the basis that the contractor's own defaults had given rise to the same damage under the Civil Liability (Contribution) Act 1978 section 1(1).

3.13 The House of Lords held that the architect was not entitled to seek contribution from the contractor and struck out the contribution notice. They again focused on the wording of the Civil Liability (Contribution) Act, section 1(1). For one party to successfully claim a contribution against another party, the defaults of both parties must have given rise to *"the same damage"*. It was held that as the word in the 1978 Act was "damage" and not "damages", it did not suffice that both the defendants were liable to the claimant in damages. What was required under the 1978 Act was a single loss caused by two or more defendants.

3.14 *Hurstwood* was overruled because, as stated by Lord Steyn, the brokers in *Hurstwood* had no responsibility for the remedial work and it could therefore not be said that the brokers and the contractors were liable for the same damage. The damage they had caused was the inability of Hurstwood to claim on its insurance which was a totally different type of damage.

4. **LIABILITIES TO INSURERS WHEN PLACING THE RISK**

4.1 The law has been developing so that in certain situations it is possible for brokers to be held liable to insurers for damages arising as a result of the placing of insurance business.

4.2 As discussed, when placing a risk, the broker is acting as agent of the insured and owes concurrent duties of care to the insured in contract and tort. A breach of duty by the broker which causes a loss to be suffered by the insured will give rise to a claim by the insured against the broker in contract and/or tort.

4.3 When the broker effects an insurance contract on behalf of an insured, a statutory duty of utmost good faith is imposed on the broker under section 19, Marine Insurance Act (MIA)1906. This duty is independent of the duty imposed on the insured under section 18 of the MIA 1906.

4.4 The duty of good faith states that the broker is under a duty to give a fair presentation of risk to the insurer by:

- disclosing to insurers all material circumstances known to the broker and to the insured (section 19, MIA 1906); and
- avoiding material misrepresentations (section 20, MIA 1906)

4.5 Every circumstance is deemed to be material if it would influence the judgement of a prudent insurer in fixing the premium, or determining whether he will take the risk (section 18(2), MIA 1906). Lord Mustill in House of Lords' decision in *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] 1 A.C. 501 held:

"(1) A circumstance may be material even though a full and accurate disclosure of it would not in itself have had a decisive effect on the prudent underwriter's decision whether to accept the risk and if so at what premium. But, (2) if the misrepresentation or non-disclosure of a material fact did not in fact induce the making of the contract (in the sense in which that expression is used for the general law of misrepresentation) the underwriter is not allowed to rely on it as a ground for avoiding the contract."

4.6 Breach of the duty of good faith by the broker gives the insurer a right to avoid the insurance contract, in the same way as if the insured had withheld or misstated material facts.

4.7 The insurers are not, however, entitled to claim damages from the broker as a result of a breach of the duty of good faith. In most cases, the insurers will not, in any event, have suffered any loss as they have the right to avoid the policy. Following a policy avoidance owing to a breach of the duty of good faith by the broker, the usual situation is that the insured will claims damages from the broker in contract and/or tort.

4.8 In some situations, however, the right of insurers to avoid the insurance contract may be lost, for example, as a result of the effect of a non-disclosure waiver clause. In such situations, the insurers may wish to have recourse directly to the brokers.

4.9 The courts have recently either held or recognised the possibility that a broker may be directly liable to an insurer for damages under the following areas of law, for misrepresentations or non-disclosures at the pre-contractual stage of a contract of insurance:

- In equity (e.g. for dishonesty)
- Tort of conspiracy
- Tort of deceit
- Tort of negligent misstatement

Equitable claim for dishonesty and the tort of conspiracy

Sphere Drake Insurance Ltd v Euro International Underwriting Ltd and others

4.10 The recent case of *Sphere Drake Insurance Ltd v Euro International Underwriting Ltd and others* is an example of a situation in which the broker was held directly liable to the reinsurers in equity for dishonestly assisting with a breach of trust and in the tort of conspiracy, as a result of the broker's failure to give a fair presentation of the risk. The decision had implications for the market as a whole but this paper concentrates on the implications for brokers.

Proceedings

4.11 These proceedings were brought by Sphere Drake Insurance Ltd ("SD") against its underwriting agent, Euro International Underwriting Limited ("EIU") and the brokers placing the business, Stirling Cooke Brown ("SCB").

4.12 SD, acting through Mr Broad, a director, had in 1997 granted a binding authority to Mr Whitcombe who was in the process of forming his own company, Euro International Underwriting (EIU). EIU became the holder of a binding authority from SD and the first defendant in the proceedings. EIU's underwriting activities were conducted by Mr Henton. SCB (through Nicholas Brown and Jeffrey Butler) offered Workers' Compensation (WC) carveout business to EIU. During the 18 months that the binder operated, SCB produced 112 out of the 119 contracts written by EIU on SD's behalf, which produced premiums of US$25m to SD, but also resulted in losses of US$250m.

4.13 SD's principal claim against EIU and its principals was that they acted in dishonest breach of the fiduciary duties owed to SD in that SD had been entirely unaware that EIU had been accepting business of this type and there had been misrepresentations by EIU as to how the binding authority was being exercised.

4.14 SD's principal claim against SCB was that they had known that EIU had been acting dishonestly and that they had knowingly assisted in the alleged breach of EIU's fiduciary duties.

4.15 SD's secondary claim against EIU and SCB was that they had both conspired together to use unlawful means with the intention of injuring SD.

4.16 SD claimed losses in excess of US$250 million. Owing to the gravity of these allegations, Mr Justice Thomas adopted the criminal standard of proof in respect of allegations involving dishonesty.

Background

US workers' compensation insurance

4.17 The *Sphere Drake* action arose out of the part of the reinsurance market which, during the 1990s, traded in losses generated by US Workers' Compensation (WC) insurance and related products.

4.18 The underlying insurance risks in this market consisted of contracts of indemnity to employers in the US who were liable to their employees for WC and WC related benefits. During the 1980s underwriters in London and in particular a small group of underwriters at Lloyd's, who wrote personal accident (PA) business became involved in an alternative WC product whereby US insurers of WC business could reinsure their liabilities under Section A of the original WC policy separately from Section B. Section B extended cover to the main types of occupational disease and cumulative trauma (i.e. injuries sustained over a period of time). The reinsurance of Section A was known as 'WC carveout business'. WC carveout business developed because it could be marketed to a broader market than original (or combined) WC business. This was because the carveout business was classed as "short tail" accident cover by Lloyd's which permitted, for example, life insurers to reinsure WC carveout business. The judge held that this classification was fundamentally wrong as in reality it is liability business.

4.19 During the 1990s, the US WC insurance market was a highly competitive market. Rates declined owing to insurers going for market share and overall loss ratios were negative, deteriorating to 115% in 1997 on an accident year basis. In order for smaller insurance companies writing this business to compete in this market they depended on under priced reinsurance and retrocessions and, in particular, on the development of a market in reinsurance that traded in losses generated by WC and related business.

Reinsurance market

4.20 The essence of insurance and reinsurance business is that the insurer/reinsurer determines the scope of the risk and fixes a premium which is designed to cover potential losses. However, it was a feature of the soft market that existed in the late 1980s and 1990s that it was possible for underwriters to obtain reinsurance at rates where the premium would not cover losses (i.e. "below the burn"). Where this reinsurance was obtained the losses would be paid by reinsurers who were prepared to write at a loss. The decision of the reinsurers to write below cost was the result of overcapacity in the market. Thomas J accepted that some underwriters in the PA market, wrote modest amounts of unprofitable business in order to enter a market, to maintain market share or to cultivate the cedant or the broker in order to obtain other business. This was usually a short term phenomenon designed to increase overall profitability.

4.21 The WC carve out business was quite different. The reinsurers wrote the business below cost and sought to make their profit by passing the losses to their reinsurers. This practice is sometimes described as "arbitrage" or "net underwriting".

Gross loss making business

4.22 Thomas J defined 'gross loss making business' as business on which it is a virtual certainty, from the information provided, that the losses under the reinsurance will far exceed the premium by a substantial margin. He distinguished this from business which turns out to make a gross loss but where the underwriter anticipated that there might be losses having written the reinsurance on the basis that he considered the premium which he charged (together with investment income) sufficient to pay the losses. Thomas J held that those who wrote gross loss making business did not assess the risk and the premium in the manner of conventional insurance.

4.23 Thomas J found on the evidence before him that some of those who provided reinsurance of WC carveout business were writing gross loss making business deliberately in the knowledge that the losses would exceed the premium by a significant amount. He found that reinsurers generally wrote WC carveout business on a large scale, where huge losses were inevitable, because there were other reinsurers who were prepared to reinsure them on terms which enabled these reinsurers to make a profit.

4.24 Thomas J found that those who provided the retrocession for WC carveout business made a greater loss than the underlying reinsurers because they received substantially less premium for a greater share of the losses but were prepared to do so on the basis they in turn had a retrocession from which they could make a profit or 'turn'. These reinsurers were trading in losses. The reinsurers at each tier would in effect be passing the bulk of the losses on to the reinsurer on the next tier for progressively less premium.

4.25 The brokers arranging the reinsurance would earn brokerage of between 10% and 15% on each turn (i.e. at each tier) which consequently reduced the premium available to each reinsurer at the next tier. The brokers were generating additional layers of cover with an objective of generating additional brokerage for themselves.

Spirals

4.26 This practice of passing or trading losses up a number of tiers became further complicated by the existence of a spiral. A spiral is said to arise where the result of XL on XL reinsurance is a complex intertwining network of mutual reinsurance where reinsurers pass on their liabilities in excess of their own retentions under their own excess of loss covers from one to the next. In relation to WC carveout business, Thomas J held that once the business became retrocession business (i.e. passed into the second tier) it was likely to contain XL on XL of those who reinsured WC carveout business.

4.27 Thomas J agreed that the spiral was unsustainable and that the market could be characterised as "pass the parcel" or "Russian roulette by proxy".

Thomas J commented that this was a market in which *"no rational and honest person would participate (either by committing his capital or by writing a line on a reinsurance of the business) if he had understood the market and proper disclosure had been made"*.

Decision of the court on fraud

4.28 Thomas J applied the criminal standard of proof beyond reasonable doubt (bearing in mind the seriousness of the allegations) and held:

- EIU and SCB had acted with grave dishonesty. They had engaged in a deception of SD which locked them into a loss making business that SD would not otherwise have touched.

- SD was unaware of what was going on. Mr Broad, the director of SD who had been the primary point of contact with EIU, had been grossly negligent, in that he had paid little attention to the bordereaux supplied by EIU and had been prepared to make decisions without seeing proper documentation and in venues such as wine bars and pubs. Had Mr Broad not acted with such gross negligence, the dishonesty of EIU and SCB would have been investigated and uncovered long before this actually happened.

Decision on the duties of the parties

4.29 Underwriting agents:

- Duty of care in tort

  It was accepted that EIU owed duties of care to SD.

- Fiduciary duties

  Thomas J held that EIU owed fiduciary duties to SD. Where there is a direct contractual relationship between an underwriting agent and reinsurer for the former to write business on behalf of the latter there is likely to be a fiduciary relationship. In the *Sphere Drake* case, the key points were, the manner in which Mr Whitcombe had been appointed; the understanding by SD and Mr Whitcombe that Mr Whitcombe would carry out the underwriting; and the nature of the responsibilities undertaken by Mr Whitcombe – the writing of contracts of reinsurance which put SD's capital at risk.

4.30 Brokers:

SCB broked the WC carveout business on behalf of their clients to EIU, as underwriting agent for SD. In placing the business, SCB owed a duty to their clients. The issue to be determined was whether SCB could be held directly liable to the reinsurer, SD, with whom SCB had no direct contact in the placement of the risks.

Thomas J found there to be liability on two grounds:

- In equity for dishonest assistance with breach of fiduciary duty

  In order for SD to succeed in its claim against SCB it first had to show that assistance was given by SCB and second that the assistance was dishonest. In order to prove that the assistance was dishonest the decision of the House of Lords in *Twinsectra Ltd v Yardley* [2002] 2 A.C. 164 was referred to where it was held that dishonesty consisted of objective and subjective elements which required SD to prove:

- SCB's conduct was dishonest by the ordinary standards of honest reasonable people (this limb is referred to as 'objective dishonesty'); and
- that SCB knew that it was transgressing ordinary standards of honest behaviour (this limb is referred to as 'subjective dishonestly').

As a matter of general principle, Thomas J held that it was neither objectively nor subjectively dishonest to place gross loss making business in the knowledge of that fact provided full disclosure is made. In this case EIU and SCB knew that writing gross loss making business on the back of reinsurance could only be achieved through a scheme involving either the deception of SD or of reinsurers who would ultimately have to pay the losses. Thomas J found that EIU and SCB fully understood that this was dishonest. Thomas J was sure that SCB knew that EIU were deliberately concealing what they were doing from SD and thus were dishonestly assisting EIU in their breach of fiduciary duties to SD.

- Tort of conspiracy

In view of the above, any decision on conspiracy was superfluous, although Thomas J was of the view that the elements of conspiracy (as laid down in *Kuwait Oil Tanker Co SAK v Al-Bader (No. 3)* [2000] 2 All E.R. (Comm) 271 had been made out as follows:

- There was a collusive arrangement between SCB and EIU the objective of which was to enable gross loss making business to be placed with SD. SCB's purpose was to find a source of reinsurance for their US business which they could ruthlessly exploit and earn commission.
- The breaches of fiduciary duty outlined above could constitute unlawful means.
- SCB and EIU deliberately embarked upon a course of conduct from early February 1997, the obvious consequences of which they appreciated would damage SD and any reinsurers of SD.
- Very serious loss was caused to SD.

Comment

4.31 The *Sphere Drake* decision does not alter the basic rule that the broker is the agent of the insured and owes duties to his client. Thomas J, however, recognised that this position does not absolve the broker from responsibility to insurers to make a fair presentation of the risk in accordance with the duty of good faith. This is the case whether the presentation is made directly to the insurers or to underwriting agents acting under a binding authority.

4.32 The making of misrepresentations or non-disclosures by the broker can, in some cases, give rise to a direct liability to insurers for damages in tort or in equity.

HIH v Chase Manhattan Bank

4.33 One of the leading Film Finance cases, *HIH Casualty and General Insurance Ltd and others v Chase Manhattan Bank and others* went all the way to the House of Lords and dealt primarily with the scope of the innocent non-disclosure clause or, so called, Truth of Statement clause contained in Chase's policy. The House of Lords and the lower courts had to consider a number of different scenarios as to what the Truth of Statement clause would or would not preclude. In doing so, the courts also considered whether the insurers were able to claim damages from the broker for non-disclosure.

Background

4.34 The facts of the case were that Chase Manhattan Bank were the financiers of a slate of films and took out insurance with HIH Casualty and others. Chase instructed Heaths as its broker for the placement of the insurance. HIH issued a line slip facility which it was agreed was a contract for insurance; under this line slip three declarations were made by off-slips in respect of three of the five films, these declarations being contracts of insurance.

Issues

4.35 The case concerned preliminary issues that centred on the ambit of a 'Truth of Statement' clause in the insurance policy.

Decision of the House of Lords

4.36 In relation to the Truth of Statement clause, the House of Lords held that:

- Avoidance for negligent misrepresentation and negligent non-disclosure can be excluded without any express reference to negligence in the wording of the clause.
- Avoidance for fraudulent misrepresentation or fraudulent non-disclosure on the part of the insured itself cannot be excluded on public policy grounds.
- It is still not decided whether avoidance for fraudulent misrepresentation or fraudulent non-disclosure on the part of the broker can be excluded in principle but, even if it can, very clear words must be used to achieve this (i.e. an express reference to fraud or dishonesty).

Tort of deceit

4.37 As the rights of HIH to avoid the policy had been restricted in the insurance policy, the courts considered other claims which could be brought by an insurer against the insured and the broker.

4.38 Giving the leading judgment in the House of Lords, Lord Bingham said:

"Since an agent to insure is subject to an independent duty of disclosure, the deliberate withholding from the insurer of information which the agent knows or believes to be material to the risk, if done dishonestly or recklessly may well amount to a fraudulent misrepresentation. If, in the present case, the insurers establish non-

disclosure by Heaths of this kind, nothing in the Truth of Statement clause deprives them of their ordinary right to avoid the policy and *recover damages against Chase* and *Heaths".*

4.39 In relation to the brokers, the House of Lords held that where a broker has fraudulently misstated a material fact, this could give rise to a claim for damages against the broker by the insurer for the tort of deceit.

4.40 The tort of deceit involves a false representation made by the defendant, who:

- knows it be untrue;
- has no belief in its truth; or
- is reckless as to its truth.

4.41 If the defendant intended that the claimant should act in reliance on the representation and the claimant does so, the defendant will be liable in damages for the damage caused.

4.42 In relation to fraudulent non-disclosure, it was recognised by the House of Lords in *HIH v Chase Manhattan* that a deliberate withholding of information from the insurer by the broker, which the broker knew to be material to the risk, if done dishonestly or recklessly, could also amount to a fraudulent misrepresentation. If a fraudulent non-disclosure amounts to a fraudulent misrepresentation, then insurers could claim damages from the broker for losses suffered.

Tort of negligent misstatement

4.43 This issue was considered by Mr Justice Aikens in the *Commercial Court in HIH Casualty and General Insurance Ltd and others v Chase Manhattan Bank and others* [2001] 1 All E.R. (Comm) 719.

4.44 The courts are generally reluctant to hold that the broker owes a duty of care under the tort of negligence to insurers for a negligent misstatement made when placing the risk, as this will conflict with the broker's duty of care in both contract and tort to his client, i.e. the insured.

4.45 For the insurers to establish a claim directly against the brokers for damages in this situation, the following points were made by Aikens J in the Commercial Court (and although the case was appealed to the House of Lords, Aikens J's ruling on these issues was not overruled):

- Duty of good faith

  Aikens J referred to the Court of Appeal decision in *Banque Financière de la Cité SA v Westgate Insurance Co Ltd* [1989] 2 All E.R. 952 where it was stated that as the nature of a contract of insurance was one of the utmost good faith, it could not "*be used as a platform to establish a common law duty of care*" as between the insurer and the insured. Aikens J held that the same reasoning should apply as between the insurer and the broker. The insurers could not claim damages from a broker for breach of the duty of utmost good faith by the broker. The only remedy for the breach of duty of good faith in relation to a contract of insurance is avoidance.

- Common law duty of care

  If a right to claim damages for non-disclosure cannot be based on the duty of utmost good faith, then it has to be based on a breach of the common law duty of care. Aikens J's judgment left open the possibility that a duty of care could be held to be owed by brokers to insurers if "special facts" existed. In HIH, it was not pleaded that any special facts existed which would give rise to an assumption of responsibility.

4.46 The legal principles behind this proposition are that in order to establish liability for negligent misstatement, it is necessary to show that a duty of care exists under one of the tests which have been developed by the courts. The tests used by the courts are:

- Voluntary assumption of responsibility

  This test was first propounded in the case of *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] A.C. 465 and was developed in subsequent cases. If a broker assumes a personal responsibility to an insurer the broker may be liable in damages to insurer for any losses suffered, as a result of the insurer relying on a negligent misstatement made by the broker.

- The *Caparo* test

  Four conditions were laid down by the House of Lords in *Caparo Industries plc v Dickman & others* [1990] 2 A.C. 605 which would have to satisfied before a broker could be held to owe a duty of care to an insurer for a negligent misstatement. The conditions are:

- The advice must be required for a purpose that is made known to the adviser when the advice is given;

- The adviser must know that his advice will be communicated to the claimant and used for that purpose;

- The adviser must know that the advice is likely to be acted upon without independent advice or enquiry; and

- The advice must actually be acted upon to the claimant's detriment.

4.47 We are not aware of any reported cases where the courts have held that a broker has assumed a responsibility to insurers for a placing presentation so as to establish a common law duty of care. The issue has, however, been argued in cases against brokers. There have been cases where a broker has been held liable to an insurer during a policy because of a particular responsibility that the broker took on. The closest the courts have come is finding a shipping broker liable for statements it made to a prospective buyer of a ship that were subsequently found to be inaccurate, in *Resolute Maritime Inc. v Nippon Kaiji Kyokai (The Skopas)* [1983] 1 W.L.R. 857.

4.48 In order to persuade a court that a broker has assumed a responsibility to insurers it will be necessary to show that the brokers went further than their duty under the Marine Insurance Act 1906 to make a fair presentation to the insurers. It will be necessary to show that the broker took on additional responsibilities to the insurer in order, for example, to set itself apart from other brokers.

5. PREMIUMS FOR MARINE INSURANCE

Heath Lambert Ltd v Sociedad de Corretaje de Seguros & another

5.1 The London market is increasingly prepared to consider writing policies which are governed by the laws of foreign jurisdictions and the responsibility of the London placing brokers for the premium in such situations is an important issue for the London market brokers.

5.2 This case involved an application by the defendants, Scort and Banesco, to set aside the order of Tomlinson J which granted the claimant, Heath Lambert, permission to serve the claim form on the defendants in Venezuela.

Background

5.3 In Venezuela insurance has to be placed with a local insurance company but local insurers can reinsurance the risks with foreign companies. This has led to a practice whereby the local insurer fronts the risk and reinsures the risk into the London market, which sets the premium. The reinsurance policies often allow the reinsured to "cut through" and make a direct claim against the reinsurer to protect the insured against the potential insolvency of the local insurance company.

5.4 In the this case, Banesco was the local fronting agent for the insured dredging company, INC. Banesco retained Scort to place its marine insurance and Scort was involved in obtaining reinsurance for Banesco in the London market. Heath was the placing broker and the 1996 reinsurance was placed by Heath with a number of Lloyd's syndicates and London market insurance companies. The cover note stated that the terms were "*Subject to Venezuelan Law and/or Venezuelan Jurisdiction if required*". The policy also contained a brokers' cancellation clause, entitling Heath to cancel the policy in the event of a premium not being paid to it.

5.5 Following the placement, the London reinsurers agreed a number of extensions. Heath funded the premiums due for these extensions but was not indemnified by Scort or Banesco. Proceedings were commenced by Heath for the total amount of the premiums due.

Issues

5.6 Scort and Banesco accepted the court had jurisdiction to permit service abroad but argued that permission for service of the claim form in Venezuela should be set aside because Heath could not show that the claim had a reasonable prospect of success.

5.7 There was a dispute between the defendants as to which one of them was liable for the premiums to Heath and both defendants contended:

- Heath had no liability to pay the premium under section 53 of the Marine Insurance Act 1906 (which states that where a marine policy is effected by a broker on behalf of the insured, the broker is directly responsible to the insurer for the premium) as this Act did not apply to the reinsurance contract because it was governed by Venezuelan law. Therefore, insofar as Heath had paid the premiums, it did so as a volunteer and had no right to be indemnified; and

- Heath's claim was time barred by section 5 Limitation Act 1980. This issue will not be considered in detail, save to say that the first instance decision has recently been upheld by the Court of Appeal.

Judgment

Liability for the premium

5.8 In relation to liability for the premium, the judge set out the general rule that where a producing broker employs a placing broker at Lloyd's, there is privity of contract between those two brokers and no privity of contract between the principal and the placing broker. The producing broker is therefore liable to the placing broker for the premium which the producing broker must collect from the principal.

5.9 There may be special cases where a principal could be contractually linked to a placing broker but that would require special circumstances such that there had been direct relations between the principal and the placing broker. Scort argued that this was one of those exceptional cases as Scort's role was to act as an intermediary not a broker, introducing and recommending Heath to Banesco. The judge decided that it was not possible at this stage to decide which defendant was liable to pay the premium to Heath, although both defendants did accept that one of them must be liable.

Voluntary payment

5.10 In this case the choice of law clause stated "*Subject to Venezuelan Law and/or Venezuelan Jurisdiction if required*". This was held to be a floating choice of law clause because it gave the reinsured, Baneco, an option to choose Venezuelan law, but it was by no means certain that the reinsured would prefer to have the case decided by a Venezuelan judge. In fact, during the currency of the policy, no such option was exercised by Banesco. The judge, however, proceeded on the basis that the policy was governed by Venezuelan law.

5.11 The judge commented that the MIA 1906 probably only applied to English law insurance and reinsurance contracts. However, where policies which are placed in the London market are governed by the laws of a foreign jurisdiction, the relationship between the placing brokers and their principals (in this case either Scort or Banesco) is usually governed by English law. The judge held that there was a very strong argument that, in 1996 when London placing brokers were retained to place a policy with the London market, in the absence of an agreement to the contrary, whatever the proper law of the insurance/reinsurance contract, the broker accepted responsibility for payment of the premium.

5.12 In this case, the judge was in no doubt that Heath was responsible for the premiums for two additional reasons:

- With a floating law policy, the broker's responsibility for the premium could not change depending on the proper law of the insurance policy ultimately chosen by the insured; that would be to create commercial chaos. In this case, at the time of placement, the contract was an English law contact and section 53(1) of the MIA 1906 applied.

- Whatever the proper law of the policy, the inclusion of the brokers' cancellation clause in the policy was consistent only with a recognition that the broker is responsible for the premium. Otherwise there is no reason why the broker should be entitled to a lien or to cancel the policy if payment has not been received from the principal.

5.13 The judge held that Heath did not pay the premiums as a mere volunteer; it was under a legal liability to do so and was entitled to be indemnified by the defendants.

Limitation

5.14 The decision in relation to limitation was the only part of the decision which was appealed and the Court of Appeal upheld the judge's decision that Heath's claims were time-barred, apart from the claim for the final extension, as the cause of action for the sums due did not accrue more than six years before the claim form was issued on 23 July 2002.

Decision

5.15 The service of the claim form was set aside for all claims except the one that was not time-barred.

Comment

5.16 This case arose out of a common situation. Much foreign business is reinsured into the London market which can give rise to issues relating to the relationship between the producing brokers, placing brokers and the principal. The general rule is that there is a contract between the producing and placing broker but only in special circumstances will there be a relationship between the placing broker and the principal. Where polices which are governed by foreign law are placed in the London market, the relationship between the London placing brokers and their principals is, in the absence of agreement to the contrary, governed by English law. In such situations, in relation to marine insurance, there may be an acceptance of responsibility by the brokers to pay the premium.

6. AVOIDANCE AND THE FOLLOWING MARKET

6.1 It is a fundamental principle of insurance law that an insured has a separate contract with each of its insurers. Following the comments made by Mustill LJ in *General Accident Fire & Life Assurance Corp. v Tanter (Peter William) (The Zephyr)* [1985] 2 Lloyd's Rep. 529, the principle had been that an insurer could not rely on what the broker has said or shown to any other underwriter because the slip creates a separate and distinct contract between each individual subscribing underwriter and the insured and each negotiation, presentation and contract formation is different. Therefore, if a particular insurer wished to avoid a contract on the basis of the presentation of a risk to it, then it had to demonstrate that it had been the subject of a particular non-disclosure or misrepresentation.

6.2 An alternative proposition was adopted by Mr Justice Cresswell in *Aneco* when he found that a broker, when presenting the risk in that particular market to any following reinsurer, made an implied representation to that prospective following reinsurer that the risk had been fairly presented to the lead. Therefore in *Aneco* the misrepresentation to the lead retrocessionaire entitled the following market to avoid. The decision of Cresswell J on this issue was not appealed and has implications in relation to the potential exposure for a broker, who may during the course of its detailed presentation to a lead insurer, make a particular statement to the leader that forms the basis of an avoidance for misrepresentation or non-disclosure. It may, however, be that such a statement is not repeated to the following market who receive a far shorter presentation and are happy to write the risk on the basis of the information they receive and, of course, the fact that a well respected lead is on board. Clearly, it could mean a significant difference to a broker's exposure if only the lead insurer was entitled to avoid in that situation.

6.3 This proposition has been followed in subsequent first instance decisions but has not received the approbation of the Court of Appeal.

6.4 In *International Lottery Management v Dumas,* the court also noted that where the risk was of a specialist nature, then the market expected that there would be reliance by the following market on the leading underwriter's decision to accept the risk.

6.5 In *International Management Group (UK) Limited v Simmonds* it was held that the following market was entitled to rely on the unfair presentation to the lead underwriters as they had placed reliance on the decision of the leads and the risk would not have been placeable without the leads' subscription, as the broker would not have been able to persuade the following market to write the risk without such leads. Reliance on the leads in the placement of specialist contingency risks in the Lloyd's market, where the leads were more familiar with the nature of the risk and had access to greater sources of information, seems to have been taken as self evident and it was held that an unfair presentation to the leads entitled the following market to avoid the risk as well.

Brotherton v Aseguradora Colseguros SA

6.6 In *Brotherton v Aseguradora Colseguros SA,* Mr Justice Morison followed the *Aneco* principle and held that the following market put their line down on the assumption that there has been no material misrepresentation to the lead underwriter and, therefore, if the lead is entitled to avoid the policy, the following market must also be entitled to avoid.

Background

6.7 In this case, London reinsurers commenced proceedings for a declaration against Colombian reinsureds that the reinsurers were entitled to avoid the reinsurance contract. The contract of reinsurance covered bankers blanket bonds and professional indemnity policies issued by the reinsured to a Colombian state-owned bank. Before the reinsurance contract was made there had been several reports in the media in Colombia of serious misconduct by officers of the bank, including its president. There were also reports that investigations were being carried out by the Contraloria General and by the Procurador General de la Nacion in Colombia in respect of such misconduct.

6.8 Reinsurers alleged that the reports alone and also the reports coupled with the fact of the investigations were material facts which should have been disclosed to them. One of the reinsureds responses to this allegation was that there was no proper basis for the investigations and that the underlying allegations had no foundation. As a preliminary issue, reinsurers applied to have these responses struck out on the ground that they were irrelevant. Reinsurers succeeded on that application and an appeal by the reinsureds failed. The Court of Appeal decided that where a reinsured has knowledge of allegations of misconduct on the part of an original insured and of official investigations into such misconduct, the question of whether such allegations are well founded is irrelevant to the determination of reinsurers' case of non-disclosure of such allegations and investigations.

Decision on avoidance by the lead underwriter

6.9 The case then reverted back to the trial judge, Mr Justice Morison, for his decision on avoidance. The earlier decisions meant that Morison J was only concerned with materiality of the allegations when the risk was placed and subsequently renewed; the fact that the allegations could later be disproved was irrelevant.

6.10 To avoid for non-disclosure, the reinsurers had to show that the information was material in that it would influence the judgment of a prudent reinsurer and that the actual underwriter concerned was, on the balance of probabilities, induced to enter into the contract.

6.11 Having found the allegations to be material, Morison J considered in relation to inducement, the leading authority which is the Court of Appeal decision in *Assicurazioni Generali SpA v Arab Insurance Group (BSC)* [2003] 1 W.L.R. 577. This decision firmly put the spotlight back on the decision making process of the insurer who wrote the business. It is for the insurer to demonstrate, on the balance of probabilities, that the non-disclosure or misrepresentation complained of was an effective cause of the ultimate underwriting decision. The Court of Appeal was basically of the view that there should be no presumption of inducement in favour of an underwriter who is able to give evidence as to his state of mind but chooses not to. The presumption is reserved for situations where the underwriter is unavailable for reasons beyond his control.

6.12 In this case, the test was satisfied as the leading underwriter had shown that the risk was unlikely to have been written if the allegations had been disclosed. In relation to the renewal, although the leading underwriter had no clear recollection of what had been said, inducement could be inferred as by that time senior representatives from the bank had either been suspended or dismissed and the business had proved to be riskier than when it was first placed.

The following market

6.13 The question was then, whether the following market was able to rely on the presentation made to the leading underwriter and to avoid the policies.

6.14 Morison J followed the approach of Cresswell J in *Aneco*, and held that the defendant's failure to disclose material facts to the leading underwriter was a material fact which ought to have been disclosed to the following market and accordingly that all of the underwriters (whether or not a presentation was made to them) were entitled to avoid. The view taken by Morison J was that there had been an assumption by the parties that the main presentation would be made to the leading underwriter, who was a known and respected leader in this specialised form of insurance, and that it was implicit that the following market would rely on his skill and expertise more so than they would in a more general field. Therefore, if a fair presentation had not been made to the leading underwriter, the assumption on the basis of which the following market had subscribed, would be defeated. Whilst the following market had exercised its own judgment, a part of that judgment was the attitude of the leading underwriter.

6.15 In commenting on the following market's case, Morison J said "*but the evidence shows, entirely as one would expect, that it was material to the following market that the leader, Mr Satterford, who was known and respected as a leader of this type of risk in this type of market, had accepted the risk for his own syndicate*." It is likely that most following markets are going to be able to demonstrate this.

Comment

6.16 Christopher Henley in *The Law of Insurance Broking, (2nd Edition)* comments that this decision in *Brotherton* "*…is out of kilter with accepted and clear legal principles and the position of the following market in such circumstances should remain in line with the view of Mustill LJ in The Zephyr.*"

6.17 However, the *Aneco* proposition has been followed in several first instance decisions where the courts seem to have placed reliance on the way the business was done in those particular cases. It may be that a different approach would be taken in relation to more standard forms of cover but many markets are likely to be able to demonstrate that they operate in the same way as in these cases.

6.18 Although the *Aneco* proposition has been followed, it has been suggested by Prof. R.M. Merkin in *Colinveux & Merkin's, Insurance Contract Law, Volume 1* and *Insurance Law Monthly, December 2003* that it is, in fact, wrong at law for the following reasons:

- An insured is not in breach of duty for failing to disclose a fact which is not known to him. Therefore, in this situation there can be no breach of duty if the insured or his broker do not disclose the innocent misrepresentation to the following market as they were unaware of it. The proposition would therefore appear to be confined to situations where there has been fraud.

- However, where there has been fraud, it has been accepted by the Court of Appeal (*PCW Syndicates v PCW Insurers* [1996] 1 W.L.R. 1136 and *Group Josi Re v Walbrooke Insurance Co Ltd)* [1996] 1 All E.R. 791 that an insured is not to be regarded as being in breach of duty because the broker has failed to disclosure his own fraud.

6.19 It remains to be seen whether there is some wider principle at work in the *Aneco* proposition and the approach the Court of Appeal takes in such situations.

7. FUTURE DEVELOPMENTS

7.1 Some issues relating to the scope of claims made against brokers and some trends for the future are as follows

Litigious environment

7.2 Brokers are likely to remain a target for claims from insureds and also from insurers. Brokers are seen as targets for a wide variety of claims. An example is the case of *William Jackson & Sons Ltd v Oughtred & Harrison (Insurance) Ltd* [2002] Lloyd's Rep. I.R. 230 where the claimant company, William Jackson Ltd ("WJ") brought a claim against the defendant insurance broker, Oughtred & Harrison Ltd ("OH") for loss resulting from the underinsurance of WJ's premises. Mr Justice Morison held that OH had not been negligent in failing to suggest that WJ should obtain a further valuation of the property. Morison J felt that no reasonably competent broker would advise that such valuations should be checked on every occasion. In this case the claim did not therefore succeed but it is an example of the diversity of claims which brokers could face in future.

Broker driven transactions can lead to increased liabilities

7.3 Every professional organisation wishes to "get ahead" of its competitor and one way to do so is to take on greater responsibilities and to offer services to clients which are not offered by competitors, for example, in relation to brokers, novel products and increased services to insurers in placing the business, such as carrying out due diligence. This behaviour is more likely to occur in a soft market where competition is greater. However, as can be seen from the recent cases, where a broker takes on greater responsibilities, it exposes itself to greater liabilities and damages, i.e. the greater the duties; the greater the damages. For example:

- **Brokers acting on both sides of the transaction**

  In *Aneco*, the brokers were acting in a dual capacity; i.e. for the client who required reinsurance cover and for Aneco who said it would write the reinsurance cover, provided suitable outwards retrocession protection was available. This situation can give rise to practical and legal difficulties.

- **Brokers driving the transactions**

  In situations where brokers are the driving force behind the transaction, they can expose themselves to greater liabilities both to the insured and, in certain situations, possibly also in damages to the insurer. For example, in relation to liabilities to the insured, the court in *GE Reinsurance Corporation* was influenced by the fact that the insurance cover was broker driven and of a novel type and held that the onus was therefore on the broker to "get it right". Liabilities in damages to insurers, become more important in a soft market conditions as non-disclosure waiver clauses are used frequently. In relation to damages for negligent misstatement, it may not be long before a situation arises where it is held that the broker has assumed a personal responsibility to insurers and the broker could therefore be liable to insurer for any losses suffered as a result of their reliance on the negligent misstatement by the broker. For example, this situation may arise from brokers carrying out due diligence in relation to risks presented to insurers and giving specific representations or undertakings.

New areas of claim against brokers - liability in damages to insurers

7.4 In extreme situations where the broker has acted dishonestly and/or is guilty of conspiracy, as in *Sphere Drake*, the broker can be held liable directly to insurers for damages. The possibility of brokers being held liable to insurers in the tort of deceit for fraudulent misrepresentation, or a non-disclosure which amounts to a fraudulent misrepresentation, was recognised in *HIH v Chase Manhattan.*

Greater scope for policy avoidance

7.5 Some examples of areas which may give greater scope for policy avoidance are:

- **Avoidance for inevitability of losses**

  In *Sphere Drake* it was held that significant gross losses were inevitable, rather than likely, and that disclosure of loss histories of the business was insufficient. This may be an area which insurers and reinsurers will seek to exploit in future. For example, in attempting to develop a case for policy avoidance, insurers or reinsurers may review books of business over a period of years to demonstrate that the business placed was historically unprofitable and that this was a material fact which should have been disclosed by the brokers placing the risk.

- **Avoidance by the following market**

  The *Aneco* proposition has been followed in several first instance decisions. The proposition is that if the presentation by the brokers to the lead insurer was unfair, then this constitutes a material fact that should have been disclosed to the following market and the non-disclosure of this fact entitles the following market to avoid the policy. Where *Aneco* has been followed, the courts seem to have been placed reliance on the way the business was done in those particular cases. The common factors were that:

  - The business to be underwritten was specialist business;
  - The lead underwriter was a known and respected leader in the field;
  - The following market relied on the leaders' subscription in making their underwriting decisions; and
  - The following market assumed (and was entitled to assume) that a fair presentation had been made to the lead.

  It may be that a different approach would be taken in relation to more standard forms of cover but there are likely to be many markets in which this approach to underwriting could be shown to exist. Although these first instance decisions have been criticised for being wrong at law, the authorities seem to be following *Aneco*, pending a ruling by the Court of Appeal.

Standard of care and damages

7.6 Some issues from recent cases are:

- **Standard of care and contributory negligence when dealing with "expert" clients**

  In *Alexander Forbes v SBJ,* the brokers argued that it was relevant to the standard of care that their client was also a broker, i.e. an expert in the field. The court, however, held that brokers cannot make assumptions about papers passed onto them by clients, even expert clients. It was for the brokers to *"get a grip on the proposed notification, to appraise it and to ensure that the information was relayed to the right place and in the correct form*".

  The status of the client, however, can sometime have an effect in relation to contributory negligence. For example, damages were reduced by 20% in *Youell v Bland Welch & Co* to reflect the fact that the clients were experienced insurers. Although, as seen in *GE Reinsurance Corporation,* depending on the involvement of the broker in the transaction, a reduction to damages for contributory negligence may not always be made, even where the client is an experienced insurer.

- **No contribution from third parties to limit damages**

  In the case of *Royal Brompton Hospital NHS Trust v Hammond and others* the House of Lords overruled Court of Appeal decision in *Hurstwood* so that in a situation where a broker has been instructed to obtain insurance for an insured but has been found liable for failing to do so, the broker cannot seek a contribution from a third party who was responsible for that loss.

New regulations for brokers

7.7 The Financial Services Authority (FSA) will assume responsibility for the regulation of the sale and administration of general insurance products. All organisations which wish to undertake regulated activities from 15th January 2005 onwards will need to be authorised by the FSA to do so.

7.8 In addition to complying with the prudential requirements for authorised firms (which include regulations as to the financial soundness and overall management of the organisation, e.g. capital provision, client money and professional indemnity insurance), brokers will have to comply with the Insurance Conduct of Business (ICOB) rules. The ICOB rules cover how the organisation deals with customers. The rules are wide ranging and, of particular significance for insurance brokers, are the rules in relation to product disclosure and claims handling.

7.9 Under the FSA regime, investigations will increasingly become a feature of management. Insureds may threaten brokers with referrals to the FSA. Investigations can form the first stage of an externally visible dispute and careful planning and handling is essential for both legal and public relations reasons.

7.10 In addition, under section 150 Financial Services and Markets Act 2000 (FSMA 2000), certain rules are actionable by private individuals and, in some cases organisations, who suffer a loss as a result of the contravention of a rule by an authorised person.

7.11 A detailed consideration of the rules and their implications, both in relation to regulatory issues and the impact on the handling of brokers' errors and omissions claims, is outside the scope of this paper. Save to note, however, that in relation to errors and omissions claims, breach of the rules may be either used as evidence to support a claim for professional negligence against a broker or an action may be brought against a broker for breach of statutory duty under section 150 of FSMA in situations where the statutory claim can be brought more easily than a claim in contract or tort.

8. RISK MANAGEMENT

8.1 Some risk management issues arising out of the recent cases are as follows:

Fair presentation of the risk

8.2 In *Sphere Drake*, the brokers were held directly liable to in damages to the reinsurers in equity for dishonestly assisting with a breach of trust by the underwriting agents and in the tort of conspiracy. The reasons for the finding were as a result of the broker's failure to give a fair presentation of the risk.

8.3 Are there any lessons to be learnt for brokers from *Sphere Drake* in relation to giving a fair presentation to insurers?

8.4 In considering this issue, it must be remembered that the business which was placed in the *Sphere Drake* case, was fundamentally different to conventional insurance business in that:

- It was gross loss making business. It was a virtual certainty that the losses under the reinsurance of WC carveout business would far exceed the premium, i.e. significant gross losses were inevitable, rather than likely.

- Tight spirals were deliberately created. Net underwriting (i.e. relying on outwards reinsurance to turn the "gross loss making business" into business which was profitable when reinsurance recoveries were brought into account) was the only way that smaller reinsurers could compete in the WC carveout market and make a profit. The levels of premium reduced as the risks were reinsured up the chain, so that reinsurers further up the chain would inevitably suffer catastrophic losses for negligible premium. These reinsurers were prepared to reinsure on such terms because there were other reinsurers who were prepared to reinsure on terms which enabled them to make a profit.

8.5 Both of the above were important factors in the decision in the *Sphere Drake* case.

Thomas J did not rule out the placing of gross loss-making business with a spiral element. He held:

"As I have set out this practice was unobjectionable provided that each participant was a knowing participant in the sense that a fair presentation of the risk was made and full disclosure was given"

8.6 It is not dishonest, therefore, for a broker to place business that is known to produce losses far in excess of the premium received by insurers, provided that there is full and specific disclosure to the insurer. What amounts to a full and specific disclosure in each particular case will depend on the circumstances. It will be a matter of judgment for the brokers in each particular case.

8.7 However, some issues arising out of *Sphere Drake* are:

- Fair presentation of the risk; not an underwriting decision

  The duty of the broker under the MIA 1906 is to give a fair presentation of the risk; the underwriting decision is made by the insurer. It is not the duty of the broker to inform the insurer that he should not write the business because it is bound to result in losses, provided the broker has disclosed the facts to the insurer to enable the insurer to reach that conclusion. In other words, the broker does not owe any duty of care to the insurer as to the quality of business presented, provided a fair presentation of the risk has been made by the broker.

- Business of a different nature to conventional insurance business

  As explained, in *Sphere Drake* the business placed was fundamentally different to conventional insurance business and significant losses were inevitable. Disclosure relating to the nature of the business to be insured and the loss histories on the individual contracts was made to Mr Broad of SD, but this was held to be insufficient. There may be other instances in the future, particularly in a soft market, where business is placed which is fundamentally different to conventional insurance business and which carries a high risk of losses. In these cases, as in this case, it may be held that standard disclosure of, for example, previous loss histories of the business to be insured, does not amount to a fair presentation of the risk. To make a fair presentation in relation to non-conventional business, the disclosure would also seem to have to cover the more commercial aspects of the transaction, for example, in this case, the tightness of the spirals and the fact that small losses would inevitably spiral up the chain.

- Market practice

  Brokers are not under a duty to disclose circumstances that are known or ought to be known to the insurer. Therefore if the insurers and reinsurers in the market are aware of particular market operations, then this may not be something which would need to be disclosed to satisfy the requirement to make a fair presentation. In Sphere Drake, EIU and SCB argued that in a soft market it was legitimate practice to place risks "below the burn" and to pass losses on to reinsurers who were aware of this practice. However, it was held that, although Mr Broad of SD was grossly negligent, SD was not aware of what was going on and had been deceived into becoming involved in business which they would not have had anything to do with if it had been properly explained. However, in other situations, the insurers and reinsurers may be aware of the procedures in operation in the market in which they participate.

- To whom should the fair presentation be made?

  The insurer to whom full and specific disclosure should be made is the individual or entity with their capital at risk (i.e. the insuring company or the Lloyd's Names) and the underwriting agent. If the broker knows that an underwriting agent has not disclosed the nature of the business to the principal then the broker will have dishonestly assisted the underwriting agent.

Claims process

8.8 Following the judgment in *Alexander Forbes v SBJ*, broker firms should be aware of the following when handing claims notifications:

- Brokers must consider any material that they receive and then give advice in the context of their overall knowledge, even where their client is also a broker and so could be expected to have similar knowledge;
- Brokers have a duty to be alert to possible desirable actions in response to correspondence from a client;
- Broker firms should have a firm-wide strategy in place which ensures that when such information is received from clients, the broker is alive to making such notifications accurately and promptly. The responsibility, however, falls on the broker company as an entity, rather than on individual brokers, to ensure procedures are in place so that documents are not read at face value and attention is paid to detail.