

re:insurance

Contractual disclaimers and caveat emptor reign

Cassa di Risparmio della Repubblica di San Marino Spa v Barclays Bank Ltd.

Anthony Bailey examines a recent judgment, which indicates that sophisticated investors are increasingly finding it difficult to make out mis-selling claims in the English courts.

Overview

A claim was brought against Barclays Bank Ltd by Cassa di Risparmio della Repubblica di San Marino Spa (CRSM), San Marino's oldest bank. CRSM alleged that it was induced to buy structured notes from Barclays, and to agree to a subsequent restructuring of those notes, by misrepresentations made by Barclays, which, CRSM said, were fraudulent. CRSM sought damages of €92 million for:

- (1) deceit; alternatively
- (2) misrepresentation under s.2(1) of the Misrepresentation Act 1967; alternatively
- (3) breach of an implied term in the relevant contract.

The claims failed for various reasons and were dismissed by the court.

Mis-selling claims such as this may fall for consideration under the professional indemnity and civil liability sections

of many policies in the market today, (unless there is an express exclusion, such as that in NMA 3000). They are, therefore, of concern to insurers. Insurers can, however, breathe easy for now because the High Court has, once again, upheld the validity of contractual disclaimers, which are invariably found in complex structured products.

This case follows a growing number of judgments¹ in which such disclaimers have been upheld. In effect, the parties to a contract agree that a particular state of affairs is to be the basis upon which they are contracting, regardless of whether or not that state of affairs is true. Such an agreement may give rise to a 'contractual estoppel', precluding the assertion of facts inconsistent with those which have been agreed to form the basis of the contract.

In effect, by such disclaimers, the parties to the contract give up any right to assert that they were induced to enter into the contract by

misrepresentation (but not fraudulent misrepresentation). Clear words must be used given the significant impact that the disclaimers can have².

The practical effect of the case law now is that it will be difficult to bring claims based on allegations that are inconsistent with properly worded contractual disclaimers.

Facts

In 2004/early 2005, Barclays sold to CRSM four sets of structured notes. These had a nominal value of €406 million. The notes structured by Barclays had embedded within them credit derivatives known as collateralised debt obligations (CDOs) which gave exposure to the credit risk of a pool of reference assets through a portfolio of credit default swaps. The reference assets included further CDOs, each of which was in turn referenced to another pool of credit default swaps. This structure

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Welcome

Welcome to the autumn 2011 edition of re:insurance.

This quarter we consider two issues impacting the financial institutions sector: the fall out from the sale of sophisticated financial products and aggregation issues from PPI misselling. Whilst the latter may not impact insurers significantly, it has not prevented the making of precautionary notifications.

In addition, we also consider two issues emanating from France: the recognition of punitive damages (and their insurability) in certain instances and reform of arbitration law. Finally, Fred Hawke of Clayton Utz gives his own views as to the utility of civil liability coverages to Australian financial institutions.

In addition to the mediation booklets published in English and French which we publicised in our last edition, we are pleased to announce that an Italian edition is now available at:

<http://www.hilldickinson.com/PDF/Rhys%20Clift%20Italian%20Mediation.pdf>

We would invite readers to contact us with any queries on the issues discussed within the newsletter, suggestions for future articles topics or with any specific questions on insurance/reinsurance matters.

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is known as 'CDO squared' or 'CDO²'³.

The terms of the CDO²s were between 5 and 7½ years. CRSM paid the principal amount of each note to Barclays, and it was then entitled to receive a coupon (generally Euribor + 0.95%). CRSM intended to hold the notes until maturity. It was agreed that the reference assets would all be rated AAA. CRSM's key risk was the credit risk or risk of default of the CDO²s, i.e. the risk that a sufficient number and combination of 'credit events'⁴ would occur in relation to entities named in the portfolios underlying the CDO²s. CRSM asserted that it relied on the AAA credit rating assigned to the CDO components of the notes by Standard & Poor's and on representations allegedly made by Barclays as to the credit risk of these instruments.

In March 2005, CRSM expressed concern in relation to some of the companies included in the portfolios underlying the CDO²s as they were experiencing financial difficulties. This was at the time of the crisis in the US car industry; some of the companies in the portfolio were connected to that industry. Barclays and CRSM discussed the possibility of CRSM paying for the removal of certain names from the portfolio. The CDO²s were ultimately restructured by the substitution of some of the entities referenced in the portfolios. CRSM claimed that Barclays represented that this would be achieved without profit⁵ to Barclays and by reference to stated criteria which conveyed the impression to CRSM that the restructuring would be beneficial to CRSM in terms of credit risk.

Of the three CDO²s embedded in the notes, Barclays agreed to repurchase two of them from CRSM. The third lost its entire value.

CRSM's case

CRSM's case was that in selling the CDO² notes to CRSM, Barclays impliedly represented that:

1. the CDO² notes had a very low risk of default; and
2. Barclays believed and expected the CDO² notes to have a very low risk of default.

CRSM said that Barclays sold the notes on the basis of an AAA rating. It said that Barclays intended CRSM to rely on this, which it did, as indicating "an extremely strong capacity to meet financial commitments", i.e. minimal credit risk. CRSM said, however, that Barclays knew that the instruments that they had structured were far riskier than the AAA credit rating indicated. CRSM noted that Barclays' internal Expected Loss ("EL") financial modelling indicated that the CDO²s had a probability of default over their lives of around 30% (equivalent to a B rating or 'junk'). CRSM, therefore, asserted that the value of the investments at inception was approximately €50 million less than what it paid.

CRSM claimed that this was "alchemy" and was achieved by 'credit ratings arbitrage'. Barclays, it said, intended: (1) to obscure the actual risk of the instrument and (2) to create an instrument whose actual risk of default was far higher than its AAA rating implied. By exposing CRSM to much greater credit risk than CRSM appreciated and the AAA rating implied, it enabled Barclays to book large profits from the transactions. CRSM asserted that Barclays constructed and sold to CRSM financial products for which, on their own calculations, a coupon commensurate with the risk would have been around 5% above Euribor, while paying CRSM only the far lower coupon appropriate to an AAA-rated investment. It said that Barclays profited from the difference, and that this was achieved as a result of the misrepresentations relied upon.

In relation to the 2005 restructuring, it was CRSM's case that the effect of the restructuring was the opposite of what Barclays had represented it to be. CRSM asserted that the restructuring significantly increased the risk to which CRSM was exposed and reduced the value of CRSM's investments. CRSM said Barclays knew this and intended it.

Barclays' case

Barclays strongly rejected CRSM's assertions of fraud or dishonesty. In addition, it said that CRSM's claims (other than for fraud) are defeated:

- (1) as a matter of contract, by the terms of the purchase and restructuring transactions agreed between the parties. CRSM was contractually estopped from making such a claim by virtue of disclaimers in the contracts for the sale of the Notes;
- (2) as a result of the extensive pre-contract disclaimers, which removed any factual foundation for the claims; and
- (3) because there was no basis for the alleged implied terms, not least because they were inconsistent with the terms and structure of the contracts.

Barclays submitted that CRSM's "arbitrage" case was built on comparing the incomparable. An AAA rating is an expert opinion from a ratings agency that a debt instrument is of highest credit quality involving the lowest expectation of credit default. It is an expert opinion as to the actual prospects of a debt instrument as issued performing in full over time; that is highly relevant for all investors and sufficient for many (for making investment decisions). By contrast, internal EL modelling such as that carried out by Barclays is not concerned with risk but rather with deriving a price or value based on credit default swap market spreads to be used by banks to mark their books to market, to assist them in hedging and to calculate notional profit at the time of trading.

Barclays also noted that it was common practice among "other structurers in the field" to populate CDOs and CDO²s with reference names with higher credit spreads relative to the coupon being paid on the AAA-rated CDO² tranche (this is "credit ratings arbitrage"). This, Barclays argued and the judge agreed, was the basis of the CDO business.

The decision

The judge generally agreed with Barclays and rejected CRSM's claims. He found that:

- Barclays did not make any purchase recommendations to CRSM in respect of the Notes.
- Barclays' representatives who liaised with CRSM did not intend to mislead CRSM nor did they do so.
- Default risk is simply a matter of estimation: *"as both parties would have appreciated, no one can know what the default risk of an instrument actually is"*.
- Barclays' reference to the restructuring being "cost zero" was not a representation that Barclays would not make a profit from the restructuring. It simply meant that there would be no cost to CRSM: *"The natural meaning of the expression 'cost zero' is that it is addressing the costs to CRSM. Whilst there may be a link between costs to CRSM and profit to Barclays they are not the same thing"*.
- An implied probability of default derived from EL figures⁶ which were taken from the output of the pricing model used by Barclays did not provide a reliable measure of the real world probability of default. In any event, that was a reasonable view for banks such as Barclays to take at the time.
- CRSM said that it misunderstood the risks of the restructuring transaction because of representations made by Barclays. The judge held that these "representations" were statements as to the criteria to be applied in carrying out the restructuring and were not statements as to such risks.
- Had there been a misrepresentation (other than a fraudulent one), CRSM would have been contractually estopped from bringing a claim by the disclaimers in the contracts, which stated that CRSM understood the risks and had not relied on anything said by Barclays.

- CRSM wanted a term implied, namely that Barclays would not structure the CDO² incorporated in the relevant Note, with the deliberate intention that its risk of default would be materially different from that indicated by its anticipated AAA rating. CRSM said that Barclays breached that term by deliberately engaging in credit ratings arbitrage. The judge rejected this and noted that *"[c]ontracts between banks for the sale and purchase of complicated structured products work perfectly well on the basis of the principle of caveat emptor"*.

Implications

Sophisticated investors are realising that it is difficult to make out mis-selling claims in the English courts. Here, CRSM failed to make out its case even though Barclays had provided fact sheets and other information through conversations with Barclays' salespeople. *Caveat emptor* was repeated by the judge. That said, the evidence was tested and he found that the Barclays' employees had not misrepresented anything. This ruling will not save unscrupulous salespeople.

The judge also followed the growing number of cases involving the principle of contractual estoppel. Parties to a contract are free to agree whatever they want to and if they choose to include non-reliance/disclaimer clauses in their contracts, they should be held to them. Sophisticated investors are being forced to look after their own interests and cannot look to the banks when things go wrong. Here, CRSM was found by the judge to be in a position to assess the risk of default and CRSM relied on the AAA rating provided by Standard & Poor's; not Barclays.

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¹*Peekay Intermark Limited (2) Hamish Pawani v Australia and New Zealand Banking Group* [2006] EWCA Civ 386; *JP Morgan Chase Bank v Springwell Navigation Company & Ors* [2008] EWHC 1186 Comm; [2010] EWCA Civ 1221 (CA).

²In this case, the court did not agree that all of the disclaimers had the effect for which Barclays contended.

³A "CDO squared" or CDO² is a CDO which includes one or more tranches of one or more other CDOs in its reference portfolio. With such an instrument, the instrument itself is sometimes described as the "outer CDO", and the CDO tranches included in its reference portfolio are called the "inner CDOs". CDO tranches are less transparent than sovereign, bank or corporate debt, which makes it harder to obtain price information on them.

⁴E.g. insolvency or default on a debt.

⁵Barclays referred to the restructuring being achieved at "cost zero".

⁶CRSM said that Barclays' EL figures indicated that the Notes had a substantial risk of default. This, it said, was inconsistent with the impression given by the Notes' "AAA" rating and other statements that the investment had a very low risk of default. Barclays argued that the EL figures and credit ratings were not comparable, and the judge agreed.

PPI misselling - aggregation implications

John Barlow examines the complex area of aggregable v non-aggregable PPI claims.

The British Bankers Association (BBA) has decided to abandon its legal challenge against the handling of Payment Protection Insurance (PPI) complaints. Sellers of PPI, i.e. the banks, will now be making or renewing notifications to their insurers. Many issues will arise, not least whether such claims are covered under the banks' civil liability and professional indemnity policies. To the extent that they are (and consideration should be given to the application of exclusions, for the reimbursement of fees, commissions, costs and charges) insurers/reinsurers will need to consider whether such claims are aggregable.

This is all very similar to the pensions misselling cases of the 1990s.

The amounts involved are significant. The banks' current provisions for potential PPI claims are: Lloyds Banking Group £3.2 billion, Barclays £1 billion, RBS £850 million, Santander £731 million and HSBC £269 million.

The nature of the misselling appears to fall into two principal categories:

- (1) Sale of PPI policies to self-employed people (who could never make a claim under the policies).
- (2) Sale of PPI policies to borrowers who were incorrectly informed that purchase of the policies was a condition of any loan being granted.

Aggregation

The issue of aggregation in the context of pensions misselling was considered in the leading case of *Lloyds TSB General Insurance Holdings Ltd & Others v Lloyds Bank Group Insurance Company Limited* [2003] UKHL 48. There was much debate surrounding the aggregation clause which provided as follows:

"If a series of third party claims shall result from any single act or omission (or related series of acts or omissions) then, irrespective of the total number of claims, all such third party claims shall be considered to be a single third party claim for the purposes of the application of the Deductible."

The Court of Appeal took the view that it was the instruction/training of personnel which constituted the act or omission giving rise to the losses and, therefore, the losses **could** be aggregated. On appeal, however, the House of Lords held that the pension misselling claims could not be aggregated. Their Lordships held that there had to be a common causal relationship between the acts or omissions, and in the circumstances the **claims** arose from separate breaches of the regulatory rules, which required individuals within the bank selling pensions to assess customers' needs and comply with best practice requirements under the regulations. Whilst the claims may have arisen from the same underlying cause (i.e. lack of training/supervision) and the claims may have been similar, that was not sufficient to bring them within the terms of the aggregating provision in the policy.

The House of Lords held that the absence of adequate instructions and monitoring of the bank's personnel was irrelevant for the purpose of the aggregation provision. The absence of monitoring systems would not of themselves have given rise to the claims. It was the contravention of the LAUTRO rules which gave rise to the claims. Lord Hoffman (who gave one of the two leading judgments) noted:

"When one speaks of events being 'related' or forming a 'series', the nature of the unifying factor or factors which makes them related or a series must be expressed or implied by the sentence in which the words are used. It may sometimes be necessary to imply a unifying factor from the general context. But the express language may make such an implication unnecessary or impermissible."

On a practical level, the House of Lords made the following points:

- The means of interpreting these clauses and the devices used to aggregate claims (e.g. the unities of time, place and intention for "event" clauses) needed to be put into context – put simply the main test was one of *"intuition and commonsense"*.
- Whilst this issue has been addressed in previous litigation the touchstone was: *"it would very much depend on the facts"* (see *Thorman v New Hampshire Insurance Company* [1988] 1 Lloyd's Rep 7).
- For the purposes of construction, there was no effective ambiguity in the clause (the insured could not, therefore, invoke the *contra proferentem* rule) and therefore the clause should be interpreted in a "balanced fashion".
- Had the clause included a broader "originating cause" wording then the outcome may have been different.²

Application to PPI misselling

Given the complexity of the Lloyds TSB decision (and the significant amount of litigation generated by such a clause), it is understandably difficult to generalise as to aggregation outcomes. However, on the face of it, it would appear that the facts of PPI are similar to the pension misselling circumstances. For example, the FSA fined HFC Bank £1.085 million for PPI misselling:

"From January 2005 to May 2007, HFC's procedures did not require advisers in its branch network to gather sufficient information about customers' circumstances and take sufficient information into account when considering whether PPI was suitable. HFC also did not require advisers to explain fully why they recommended a particular policy or identify to customers any demands and needs which the policy would not meet. These and other failings meant that HFC put its customers at an unacceptable risk of being sold PPI when it was not suitable for them.

In addition, the FSA found that as a result of HFC's inadequate systems and controls:

- It did not have effective systems to train and monitor its staff and failed to ensure that its procedures for monitoring sales staff effectively identified and investigated potentially unsuitable sales;
- Management information provided to HFC's senior management was not sufficient to enable them to identify problems with the sale of PPI; and
- Its records were not sufficient to demonstrate its sales were suitable.

Whether PPI claims are aggregable or not, of course, depends on the aggregation wording in the relevant policies. The restrictive 'event' type wording such as that in the Lloyds TSB case, will likely prevent the aggregation of PPI claims (to the extent they are covered at all). Where, however, 'cause' type wording has been used, it may be that PPI claims are aggregable.

Examples of aggregation wordings and judicial pronouncements on those wordings include:

- **"Arising out of one event"**⁴: an event was "something which happens at a particular time, at a particular place, in a particular way". This is restrictive.
- **"[a]ll occurrences of a series consequent on or attributable to one source or original cause ..."**⁵: as long as an act, event or state of affairs could be identified which could be properly described as the cause of more than one loss then the losses could be aggregated.
- **"Arising from one originating cause"**⁶: this contemplates a continuing state of affairs or "absence of something happening". Further, the use of the word "originating" "open[s] up the widest possible search for a unifying factor".

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¹R (on the application of the British Bankers Association) v The Financial Services Authority and The Financial Ombudsman Service [2011] EWHC 999 (Admin)

²It was observed by Lord Hobhouse that the wording had been negotiated between the parties and alternative broader wording was available (no doubt at a price).

³E.g. "One source or original cause" and "same or similar originating clause".

⁴Axa Reinsurance (UK) Plc v Field [1996] 1 WLR 1026.

⁵Municipal Mutual Insurance Ltd v Sea Insurance Co Ltd [1998] Lloyd's Rep IR 421.

⁶Cox v Bankside Members Agency Ltd [1995] 2 Lloyd's Rep 437.



What use is liability insurance to a financial institution?

Fred Hawke of Clayton Utz questions the usefulness of liability insurance for banks.

The simple answer may be none at all, if the institution (be it a bank, trustee company, responsible entity of a managed investment scheme, brokerage house or whatever) does not incur loss as a result of a legal liability, and this should not really surprise anyone. Nearly all forms of financial liability insurance, especially professional indemnity and the like, expressly assume, as the basis of coverage, that a 'claim' (as defined) will be made upon the insured in respect of a matter for which the insured is legally liable. The formal adjudication of that claim or its settlement by or with the informed concurrence of the insurer are pre-conditions to the crystallisation of a loss and an indemnity entitlement in respect of it, under such a policy. This is not objectionable in principle; however, in practice it can give rise to some very significant practical limitations on the utility of the insurance, in high profile cases.

Most insureds, including financial institutions, recognise and accept that civil liability insurances such as professional indemnity, errors and omissions, directors and officers' liability and the like are just that and cover only liabilities of the organisation to pay compensation or to make restitution according to law for established misfeasance. They do not respond to the cost of decisions prompted by commercial considerations, reputational risk or simple cost-effectiveness, to meet or pre-empt claims against the organisation which are not based upon a recognised, legal cause of action and at least some factual evidence.

It follows, therefore, that in order to have a claim under such a policy, the insured must have a legal liability of the sort to which the insurance applies and, if the loss results from settlement of such a liability rather than from a

judgment in respect of it, the settlement must be objectively reasonable in all the circumstances. In most policies, there will be an explicit requirement for something fitting the description of a formal 'claim' to have been made upon the insured by a third party, or by a public authority acting on behalf of third parties, as an essential requirement of the coverage.

Where claims are formulated on the basis of legal or factual propositions which are arguable but of uncertain merit, the organisation should accept the need to engage with its liability insurers and agree upon a robust, independent process, whereby the merits of the claims and the probable monetary range of the insured's liability can be objectively established. Once that is done, the fact of the policy's response to the claim and the amount of the insured's entitlement under it can generally be determined without too much difficulty. Liability insurance policies will often contain some form of mechanism, usually involving an opinion or some sort of expert determination by an appropriate external consultant, such as a senior legal practitioner with experience in the relevant field, for resolving the questions of the insured's legal liability and the reasonableness of any proposed settlement of it.

This process pre-supposes, however, that an insured with putative liabilities asserted against it will have the luxury of the time and discretion to enable it properly to prepare and present an insurance claim to its Underwriters, in an orderly and structured form supported by all necessary evidence and legal advice. It also assumes that the insured will either obtain the underwriters' confirmation of indemnity and concurrence to any proposed settlement, or invoke the policy's procedure to determine these issues.

Where the insured is in a position to proceed in this manner, or, better yet, simply to hand over the claims against it to its insurer for resolution, indemnity having been confirmed, the insurance works very well. It is a different matter, however, when the insured is confronted with a large and sometimes indeterminate number of potential claims against it, combined with the threat of major reputational damage and possible regulatory intervention, justified or otherwise. In that situation, the insured may or may not be under a legal obligation to take active measures to resolve putative claims pre-emptively, but critical business considerations (and perhaps even corporate survival) will almost certainly demand that it do so.

If so, then depending upon the terms of the insurance policy, the insured may find itself in a situation where it is simply not in a position to comply strictly with the policy's requirements or even, in some cases, to bring its loss within the terms of the coverage. Statutory remedies in Australia, such as Section 54(1) of the Insurance Contracts Act 1984 (Cth), and the implied term of 'utmost good faith' in insurance contracts imposed by Section 13 of that Act, provide some protection where conduct of the insured which has not caused or contributed to the insured loss nevertheless entitles the insurer, under the terms of the policy, to refuse to indemnify. They are of doubtful value, however, where losses incurred by the insured in settling putative legal liabilities fall outside the very scope of the insurance contract, because one or more defined elements of the insuring clause has not been met. The most likely candidates for this problem are the definitions of 'claim', 'loss' and 'civil liability'.

If 'claim' is defined in terms which posit the making of individual, formal written demands upon the insured for compensation, by each of the persons putatively affected by its conduct, or even worse, the issue of formal legal proceedings by them or on their behalf, then the claim under the policy may fail at the outset. If 'loss' is defined exclusively in terms of compensation, then an obligation to make restitution may fall outside cover.

As regards 'civil liability', a strict interpretation of this term by the underwriter can leave the insured in the position where in order to claim under the policy it must prove, on the balance of probabilities, both the fact of its liability and the amount of a reasonable settlement in respect of each individual claimant in order to establish the aggregate amount of covered loss. This may or may not still be feasible after it has settled with the claimants as a class, assuming that reputational and other considerations allow it to make the attempt.

This problem cannot be eliminated entirely, since the concept of a legal liability, as opposed to business risk, is fundamental to the nature of the coverage. It can, however, be minimised by careful attention to the language of the insuring clause and definitions in a 'claims made' policy.

Specifically, the term 'claim' (as in claim made against the insured) must not be defined in terms which require legal proceedings to be commenced or personal, individually quantified and articulated demands to be made upon the insured by all persons to whom the insured may be liable in respect of the relevant conduct. 'Liability' must clearly encompass settlements with regulators acting in the interests of such persons, whether or not court proceedings have been commenced, except for criminal fines and penalties.

Finally, the terms 'loss' and 'civil liability' must not include the insurer's consent to settlements, as an essential element of the definition. It is perfectly

acceptable for an insurer to stipulate, elsewhere in the policy, that it is not obliged to indemnify in respect of settlements which have not been consented to or ratified by it. However, for the insured's statutory protections against an unreasonable application of this requirement to work effectively, it is highly desirable that it be a condition, even if necessary a condition precedent of the cover, and not a component of the insuring clause which defines the essential nature of the cover.

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The French Cour de Cassation (Supreme Court) recognises punitive damages

In contrast to the common law approach, civil systems including French law have traditionally refused to entertain claims for punitive damages. As **Patrick Hann** explains, this may be about to change as a result of a recent decision of the Cour de Cassation, which in turn follows reform proposals by the French Law Commission.

The traditional approach of French Law

French law insists on a strict separation of civil and criminal proceedings. It is the function of the criminal law to punish. The purpose of an award of damages is strictly compensatory and not punitive. The quantum of an award of damages is assessed solely with the intention of indemnifying the victim so as to place him in a position where he will neither suffer loss nor make a profit. The degree of fault of the defendant is irrelevant (see article 1149 of the Code Civil in relation to contractual matters and article 1382 du Code Civil in relation to torts). Thus, for example, in 2006 the French Court of Appeal refused to award punitive damages to the victims of an air crash.

Proposed law reform

In 2005, a proposal by the Catala group (a group of university professors headed by Pierre Catala) envisaged amending the Civil Code so as to provide that the perpetrator of an obviously deliberate tort, in particular an act calculated by reference to the profit to be gained, could be made liable to an award of punitive damages. Insurance of punitive damages would not be permitted. The Catala proposals were not however adopted.

In 2009, a report by Messrs Anziani and Bételle, in the name of the French equivalent of the Law Commission, recommended incorporating into French law an award of punitive damages, but only within limited legal fields, namely privacy and image rights, competition and environmental laws. The authors of the report considered it appropriate, for example, to sanction the press and the media who might make a calculated choice to publish because the potential gain through sales would outweigh their potential liability. The availability of punitive damages in the context of environmental law would be designed to fill any voids left by existing EU environmental laws. However they also recommended that Parliament should determine the financial limits of punitive damages, having regard to the traditional refusal of the Cour de Cassation to regulate matters of quantum.

Unlike the previous report, Messrs Anziani and Bételle envisaged that punitive damages should be insurable. In the course of the consultation process the Fédération française des entreprises d'assurance (FFSA) and the Groupement des entreprises mutuelles d'assurance (GEMA), pointed out that significant premiums might result from the introduction of punitive damages into French law because of the additional uncertainty as to the extent of potential liability. Messrs. Anziani and Bételle considered that the likelihood of significant premium increases might in itself deter potential tortfeasors from taking calculated risks.

Judgment n°1090 of 1 December 2010 (09-13.303) - Cour de cassation

US claimants sought to enforce in France a judgment obtained by them from the Supreme Court of California against Fountaine Pajot, a French boat manufacturer. The boat had been purchased by the claimants from the manufacturer for US\$826,009. The court found that after the purchase and before delivery the manufacturer had effected certain repairs to the boat after it had been damaged by a storm, but had concealed these facts from the buyers, without regard for their safety. The judgment was for US\$3,253,734, being US\$1,391,650, for the cost of further repairs to the boat, US\$402,084 in respect of costs and US\$1,460,000, as punitive damages.

The Cour de Cassation, departing for the first time from the traditional French approach, accepted that the enforcement in France of an award of punitive damages of a foreign court does not offend French public policy. However it considered the amount of the punitive damages to be disproportionate (notably in relation to the purchase price). Rather than allow enforcement of the judgment in part, it therefore refused to enforce the judgment of the Californian court entirely. The implication is that if the punitives were proportionate then they might have been accepted. This conclusion has been criticised, as has the relevance of a comparison between the levels of the respective heads of damage, given that the rationale behind an award of punitive damages is to constitute a deterrent as opposed to compensating the victim.

Insurability

As punitive damages are a sanction for unacceptable conduct, it is pertinent to have regard to Article L 113-1 of the French Insurance Code which prohibits insurance of deliberate torts or fraud.

In the context of third party liability, for this prohibition to apply the insured must intend to cause bodily or property damage to the third party and must intend his actions and their consequences. *Cass. Civ. I, 6/12/1994; G.P. 1995, I, p.283. ;and Cass. civ. I, 3/12/1995; G.P. 1995, II, p.540.*

The fact that an act is particularly serious does not of itself mean that it will be regarded as deliberate and it remains insurable.

Nor can an insurer exclude cover, where the insured e.g. an employer, is held liable for the deliberate acts of an employee in the course of his employment.

A deliberate failure to comply with contractual obligations is regarded as fraudulent and uninsurable. *Cass. Civ. I, 4 Février 1969, D.1969, p.601 (Comédiens Réunis) - Cass. Civ. I, 22 October 1975, D.1976.*

Where are we now?

Provided that the activity which has given rise to an award of punitive damages is not deliberate or fraudulent so as to be excluded from cover altogether by virtue of the provisions referred to in the previous section, insurers and reinsurers providing cover subject to French law now have an additional risk/opportunity arising from the potential enforcement against assureds in France of foreign judgments for punitive damages.

On the basis of the approach of the Cour de Cassation this liability will only arise if the level of punitive damages is commensurate with the commercial value of the underlying transaction (if any).

At present there is no indication that the reforms proposed in 2009 will be adopted. If they were to be adopted, their scope would be limited to liabilities relating to the laws of privacy, competition and the environment.

As things stand, the context in which punitive damages can be awarded by a foreign court and enforced in France is unlimited. However it is important to stress that we are only at present concerned with the enforcement of a foreign court judgment in France as opposed to an award of punitive damages by the French court itself.

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Comparison: Exemplary damages under English law

The current law relating to exemplary damages is derived from the judgments in *Rookes v Barnard (1964)* and *Cassell and Co. Ltd. v Broome (1972)*. Exemplary damages can only be awarded in connection with certain torts, probably only trespass, defamation, and intimidation. They cannot be awarded in respect of breach of contract.

One situation where such damages can be awarded is where 'the defendant's conduct has been calculated by him to make a profit for himself which may well exceed the compensation payable to the plaintiff'. In *Cassell and Co. Ltd v Broome* the defendants had published a book which was defamatory of the plaintiff, and the profits expected from the sale of the book might well exceed the normal compensatory damages awarded to the plaintiff.

Generally under English law an insured cannot claim under an insurance policy if the insured has committed an act with the deliberate intention of bringing about the insured event, or the loss flows from a criminal act.

In *Lancashire County Council v Municipal Mutual Insurance Ltd [1997] QB 897*, the Court of Appeal held that English law does not prohibit insurance of liability for punitive damages. In that case, the liability to pay punitive damages was vicarious, leaving open the question whether a tortfeasor whose personal conduct was opprobrious could recover.

French arbitration reform

Patrick Hann warns insurers and reinsurers operating in the French market to be aware of the new arbitration law which, in addition to directly affecting dispute resolution within the industry, is also likely to impact the speed with which (re)assureds incur a quantified liability.

French arbitration reform

A new law, Decree No. 2011-48, which came into force on 1 May 2011, has amended the arbitration provisions of the French civil procedure code, making a number of significant procedural changes to French domestic and international arbitration law. (All references to Articles refer to the newly amended civil procedure code).

Confidentiality

Whereas the civil procedure code provides that unless parties agree otherwise, domestic arbitration proceedings are confidential (Article 1464) this does not appear to apply to international arbitration. Accordingly, parties who wish to preserve confidentiality now need to provide for this in the arbitration clause and/or rules.

Form and content of international arbitration agreements.

Significantly, Article 1507 provides that an international (as opposed to a French domestic) arbitration clause “is not subject to any condition as regards its form”. It is therefore unnecessary for the clause to be in writing, provided that sufficient evidence of the arbitration agreement can be adduced. However it should be noted that an arbitration clause not in writing will be incapable of enforcement under the New York Convention of 1958.

- The principle that an arbitration clause is a separate agreement is enshrined in Article 1447. French case law

provides that an arbitration clause is separable from the main contract and its validity is independent of that of the main contract (*Cass. civ. 1ere, 7 May 1963, Gosset v Carapelli, Rev. arb. 1963, p 60*).

- An arbitration clause and the main contract can be subject to different laws (*Cass. civ. 1ere, 4 July 1972, Hecht v Buisman’s, Rev. arb. 1974, p 89*).

The Decree recognises the validity of an arbitration clause contained in a master agreement or in groups of contracts

An arbitration agreement which does not stipulate a procedure for the appointment of arbitrators will still be effective. The new legislation supplies the missing procedures.

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In most cases only the arbitrators have the right to declare that they lack jurisdiction over a dispute. Article 1448 provides that a state court shall not have jurisdiction in a case related to an arbitration agreement, unless (i) the arbitrators have not yet been appointed and (ii) the arbitration agreement is manifestly void or inapplicable. Examples of agreements “manifestly void or inapplicable” are rare but include an arbitration clause contained in general conditions supplied after the date of performance of the contract at issue (1^{re} Civ., 27 avril 2004, Bull. 2004, I, n° 112) and an attempt to arbitrate disputes under two separate contracts, one of which contained a jurisdiction clause instead of an arbitration clause. (1^{re} Civ., 7 juillet 2006, Bull. 2006, I, n° 337).

However, Article 1520-1 permits the setting aside of an award if “the arbitral tribunal wrongly accepted or declined jurisdiction”.

Loss of right to object

Article 1466 provides that a party, which knowingly and without a legitimate reason fails to object to an irregularity before the arbitral tribunal in a timely manner, shall be deemed to have waived its right to avail itself of the irregularity.

This article introduces a form of estoppel into French law applicable to international arbitration. A party cannot adopt a position contrary to that which it adopted previously if the change of position prejudices a third party.

Powers of arbitrators

Already established by case law, arbitrators’ powers have been codified for both domestic and international arbitrations. Arbitrators can hear evidence from any person. The Decree refers to arbitrators being able to compel the production of evidence but does not say in terms that they can order the attendance of witnesses, order disclosure of documents and impose sanctions for non-compliance (Article 1467). Arbitrators can also grant interim relief (Article 1468).

Universal jurisdiction

The new law states that the French courts have jurisdiction over any case in which a party is denied justice in an international arbitration, even where there is no connection with France (Article 1505).

Judicial support to arbitration

The new law creates a ‘supporting judge’ (the *juge d’appui*). The default ‘*juge d’appui*’ is the President of the Civil Court of Paris (‘*tribunal de grande instance*’). The supporting judge has the power to deal with the issues relating to the appointment of arbitrators and the constitution of the arbitral tribunal (Articles 1452-1454), the retirement of arbitrators (Article 1456) and the interruption of their mandate as a result of resignation or withdrawal (Article 1457). These rules can be modified by agreement between the parties to international disputes.

If the arbitral tribunal is not yet constituted and urgent relief is needed, the state courts have powers to order interim or conservatory measures, with the exception of sequestration (*saisie conservatoire* and *sûreté judiciaire*) (Article 1468).

The supporting judge has jurisdiction to make orders in relation to documents in the possession of a third party (Article 1469). The judge’s power to order the disclosure of evidence held by a party to the arbitration ceases as soon as the arbitral tribunal is constituted (Article 1449).

Notification/Service of award

Previously, notification of an award to a party required a prior “*exequatur*” order from the court, followed by service of the award and the order by a bailiff, a time consuming process. Under the new rules, the notification of the award is no longer dependent on the prior “*exequatur*” order (Articles 1484, 1494, 1519, 1522). Notification can be given as soon as the award is published. The parties are also able to agree to dispense with service by a bailiff and to substitute an alternative form of service. In the first instance, an application to court to set aside an award will not suspend enforcement of the award (Article 1526).

No appeal

Article 1518 excludes the possibility of appeal in international arbitrations.

Consensual exclusion of right to set aside

As no appeal is possible the only recourse against an arbitration award is an application to set aside. Parties can now agree in advance to waive the right to set aside an international arbitral award (Article 1522). This can be provided in the arbitration agreement or the arbitration rules. Although such an agreement will make it impossible to set aside an international arbitral award made in France, an application for revision of an award will remain available if fraud is alleged (Article 1502).

It will remain possible to appeal against a refusal to order the enforcement of an award based on the grounds set out in article 1520 (ie where “the arbitral tribunal wrongly upheld or declined jurisdiction”).

Article 1522 also provides that the parties to an arbitration agreement cannot waive their right to appeal any decision granting leave to enforce the arbitral award in France by the grant of an *exequatur* order.

Entry into force

The new provisions apply to arbitration agreements entered into after 1 May 2011; in part, to arbitral tribunals constituted after 1 May 2011 and to the enforcement of international awards made after that date.

Consequences?

The reforms are designed to introduce greater informality, speed and support particularly in the case of international arbitrations. In theory it may be thought that the combination of the various reforms may produce some acceleration and cost reduction in the process of obtaining an enforceable award. It remains to be seen whether this will be the case in practice.

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Case commentary - The application of 'mysterious disappearance' exclusions

Stacey Sheargold considers the use of a 'mysterious disappearance' exclusion in the case of *AXL Resources Ltd v Antares Underwriting Services Ltd and Another* [2010] EWHC 3244 (Comm).

- A 'mysterious disappearance' is a disappearance in which the cause of loss cannot be identified or is hard to explain such as misdelivery or unauthorised delivery to an unknown recipient or purchaser.
- Insurers cannot rely on a 'mysterious disappearance' exclusion merely because the assured cannot establish **all** of the facts of a loss, such as date and circumstance, in the absence of a specific wording requiring this.
- The onus in an all risk policy is on the assured to establish that a loss has occurred; the burden of proof is on insurers to bring themselves within any exception in the policy.

AXL Resources Ltd (AXL), a metal trader, was insured by Antares Underwriting Services Ltd and Another (Antares) under a Lloyd's Marine Open Cargo all risks policy. The policy covered "all risks of loss and damage to the subject matter insured" and contained an exclusion for "mysterious disappearance and stocktaking losses".

At some time between October 2008 and January 2009 ten pallets of insured cobalt, valued at over US\$1.8 million, were removed from a warehouse in Belgium operated by Vollers Belgium NV (Vollers). On discovery that the cobalt was missing Vollers reported the loss as a theft to the Belgian police and notified to AXL on the same day.

AXL claimed under the policy and Antares declined cover on the basis that the loss fell within the 'mysterious disappearance' exclusion. AXL brought an application for summary judgment in which Gloster J considered the evidence that the loss was a theft and the application and meaning of the 'mysterious disappearance' exclusion.

An extensive police investigation, involving multiple metal thefts, was ongoing at the time of the application and an employee of a road carriage company working for Vollers had confessed to disabling the alarm at the warehouse where the cobalt was stored so that it could be removed using a bulldozer and placed into a stolen container whereupon it was reportedly driven to Holland.

Antares argued that AXL had not proved the loss was a theft and that determination of the claim should wait until the outcome of the Belgian criminal investigation. Gloster J held that the circumstantial evidence strongly pointed to theft and Antares had no real prospect of succeeding at trial in the defence that AXL had not proved theft, even if the burden of proof was on them to do so.

Antares also sought to rely on the decision in *Widefree Limited v Brit Insurance Ltd* [2011] Lloyd's Rep IR 63. In *Widefree* it was held that an assured jewellery retailer's claim for stock loss under an all risk policy fell within an exclusion for "Property Insured found at stockholding where the insured is unable to prove the date and circumstances of any loss". Gloster J distinguished *Widefree* on the basis that the particular wording had imposed an obligation on the assured to prove "the date and circumstances of any loss" which was absent in the current case. Thus, if insurers want to place a burden of greater particularity on an assured they should expressly do so.

In the absence of any express wording such as in *Widefree* the assured must only prove the fact and circumstance of his loss whereupon the burden of proof shifts to the insurers to establish that a loss falls within any exclusion clause.

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