INSURANCE BULLETIN
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REGULATORY

First Full Review of the UK SM&CR by the FCA, PRA and HM Treasury

In December 2022 it was announced that, as part of the Edinburgh Reforms[1], the FCA and the PRA (together, the "regulators") and HM Treasury (HMT) would be undertaking a review of the Senior Managers and Certification Regime (the SM&CR). More recently, on 30 March 2023, the regulators published a joint discussion paper seeking responses from firms, consumers and other stakeholders on the effectiveness, scope and proportionality of the SM&CR (the Paper). Alongside the release of the Paper, HMT has launched a call for evidence in respect of the legislative framework of the SM&CR.

The underlying aims of the SM&CR are to promote safety and soundness of firms, reduce harm to consumers and strengthen conduct and market integrity. The regime holds financial services professionals, particularly senior decision-makers, accountable to their employers and the regulators.

This is the first full review of the SM&CR since it was implemented. The regulators and HMT are looking to gather input from stakeholders on the effectiveness, scope and proportionality of the SM&CR, as well as identifying potential policy and procedural improvements. The regulators state in the Paper that the review will be conducted, amongst other things, in the context of the new secondary objective of advancing long-term UK economic growth and international competitiveness, which was introduced in the Financial Services and Markets Bill.

The regulators have posed a number of questions in the Paper looking at:

1. the interaction between the regime's rules and guidance and internal processes, including whether the SM&CR has promoted accountability and made it easier to hold individuals accountable;
2. the appropriateness of the current scope of the regime, and its impact on competition and international competitiveness; and
3. whether the SM&CR has been applied proportionately across the firms and individuals that fall within its scope.

Additionally, the regulators are looking at potential improvements to the regime. In particular, the regulators have recognised in the Paper that concerns have previously been raised over delays in the Senior Manager approval process. Although they note that work is already underway to address these issues, they are seeking views on how the approval process can be further improved.

Separately, HMT seeks views on the overall functioning of the regime from a legislative perspective. The call for evidence also questions whether there are opportunities to deliver better on core objectives of the SM&CR in order to enhance the attractiveness of the UK for financial services business, by asking, among other things whether:

1. the core objectives of the SM&CR remain right for the UK;
2. the SM&CR impacts the UK's international competitiveness;
3. there are any aspects of the SM&CR that are a deterrent to UK firms and individuals; and
4. there are any low-risk activities or firms that could be removed from the scope of the SM&CR.

It is noted in the Paper that previous feedback on the regime from stakeholders has been predominantly positive. Therefore, at this stage it seems unlikely that the review will result in any drastic changes to the regime. The focus within the Paper on specific parts of the regime, such as the senior manager approval processes, also suggests that the regulators are focussing on smaller enhancements rather than wholesale changes.

The deadline for submitting responses to the regulators and HMT is Thursday 1 June 2023.

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1 See our January 2023 edition of the Bulletin **here**.

Points to watch in the Insurer Resolution Regime

As the consultation period for HM Treasury's proposals for a resolution regime for insurers closes, we share our thoughts on some of the points that will need to be addressed as the regime is developed.

On 26 January 2023, HM Treasury issued its "Insurer Resolution Regime: Consultation" (available **here**) which is intended to fulfil the government's commitment to introduce a dedicated insurer resolution regime (**IRR**) in the UK and to implement the Key Attributes of Effective Resolution Regimes for Financial Institutions published by the Financial Stability Board and the Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups of the International Association of Insurance Supervisors.

Separately, HM Treasury is proposing various changes to the arrangements for insurers in financial difficulties through amendments to the Financial Services and Markets Act 2000 contained within the Financial Services and Markets Bill 2022 (the **Bill**), which is currently at the Report stage in the House of Lords. However it was felt that those changes may not be sufficient to deal with certain scenarios, including the rapid failure of one of the largest insurers, the failure of multiple insurers concurrently and the failure of a "niche" insurer where alternative cover may be hard to find.

Whilst an IRR in some form is laudable (and, with the European Commission proposing an Insurance Recovery and Resolution Directive, perhaps inevitable), we believe that certain aspects of the proposed regime require further thought and will be closely monitoring the way in which these are implemented.

Interaction between the IRR and the changes in the Bill

While they ostensibly serve different purposes, the IRR and the write-down powers contained in the Bill have the potential to overlap, which could lead to a complex situation with different authorities pursuing different mechanisms. This potential is exacerbated by the fact that there are different triggers. Under the Bill, the Court may make a write-down order if it is satisfied that the insurer is or is likely to become unable to pay its debts as they fall due. Although that situation would also satisfy the first of the conditions which must be satisfied for the stabilisation powers under the IRR to be available, that condition can also be satisfied if the Prudential Regulation Authority (the **PRA**) has assessed that an insurer is failing or likely to fail (FOLTF) the Threshold Conditions or that extraordinary public financial support is required. It can be seen therefore that in any given situation, which is likely by its nature to be fast moving, it will be difficult for an insurer to be able to take decisions with any certainty.

Compatibility of bail-in with effective transfer of risk

Insurers are only able to take credit for reinsurance within their solvency calculations if there has been an effective transfer of risk. It cannot be the intention that reinsurance ceases to be eligible as a risk mitigation technique simply because the reinsurer may in the future be subject to bail-in, but Article 210 of Commission Delegated Regulation (EU) 2015/35 refers to conditions "which could undermine the effective transfer of risk, the fulfilment of which is outside the direct control of the [insurer]". It would be helpful therefore if it could be made clear that the possibility of bail-in does not of itself undermine effective risk transfer.

Comity and due process

One of the government's proposed tools in a resolution scenario is to transfer the business of a failing insurer to a willing third party. This would override any right of veto by third parties and would take effect without involvement of the courts. It is customary when undertaking an insurance business transfer under Part VII of the Financial Services and Markets Act 2000 which has a non-negligible amount of US business to obtain a comity opinion to the effect that US courts are likely to recognise the effect of the transfer. One of the key points in such an opinion is that, in accordance with the due process clause of the US constitution, affected parties have been given notice of the proceedings and have had an opportunity to make representations to an impartial decision-maker. Whilst decisions may need to be taken very quickly in the scenario of a failing insurer, removing procedural safeguards such as the requirement to notify affected parties and the involvement of an impartial judiciary will make it much less likely that such a transfer would be recognised in other jurisdictions, which could have significant consequences for the ability of the transferee to claim under any inuring reinsurance.

Tax groups

Insurance groups often have complex structures, and they frequently rely on the existence of tax groups. If the effect of a bail-in is to award creditors whose interests have been written down with equity in the affected insurer, there is a real risk that this could result in a tax group ceasing to exist, which may itself accelerate any potential insolvency (for example if intra-group services were to attract VAT as a result of a VAT group ceasing to exist).

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DISPUTES

Arbitration Act – Law Commission consults again on changes to the Arbitration Act

The Law Commission has published a second consultation in its project to review arbitration law.[1] The most significant change proposed is a default position that the law of the arbitration agreement is the law of the seat, unless the parties expressly agree otherwise. This would represent a welcome simplification of the current position, and ensure that English law is in line with international practice.

Law of the arbitration agreement

The Law Commission proposes to amend the Arbitration Act to make the default position that the law of the arbitration agreement is the law of the seat, unless the parties expressly agree otherwise in the arbitration agreement itself. This proposal follows 31 responses to the first consultation asking the Law Commission to reconsider this issue.

The arbitration agreement is usually a clause in a main contract (also referred to as the matrix contract). It is possible for the matrix contract and arbitration agreement to be subject to different laws, and for the law of the seat (i.e. where the arbitration takes place) to be different again. The courts of the seat will supervise the arbitration, and in England & Wales apply the Arbitration Act 1996.

The current position, in England & Wales, where the arbitration agreement is silent as to its governing law (something which, in our experience, is very common) is complex.

The existing law is set out in the Supreme Court decision in *Enka v Chubb*[2] . In summary it was held that:

- An express or implied choice of law directed to the arbitration agreement will apply unless contrary to public policy.
- If there is no choice but the arbitration agreement forms part of a matrix contract with an express or implied choice of law then that will also govern the arbitration agreement. However, that chosen law may be displaced where:
  - The law of the seat itself provides that the arbitration agreement is governed by the law of the seat;
  - There is a serious risk that the chosen law may render the arbitration agreement invalid, not binding on one party or (according to the majority) of reduced scope;
  - The choice of a seat in E&W, in combination with reference to a local association or practice implicitly indicates the choice of E&W as the governing law.
- If there is no choice of law anywhere, the arbitration agreement will be governed by the law with which it has the closest and most real connection which, according to the majority, will be the seat of the arbitration.

Some arbitral rules provide for a governing law unless the parties agree otherwise, but there is a risk of being trumped by the implied choice of law applying *Enka v Chubb*.

The consultation sets out the problems with the current approach. This includes the fact that the law as it stands results in more arbitration agreements being governed by foreign law – i.e. where they provide for a seat in England, but have a foreign choice of law clause in the matrix contract. The disadvantages of this position include the need for foreign experts to present on the law, driving up costs; the potential loss of the ability to arbitrate if the foreign law stipulates that the dispute is not arbitrable; and potential concerns as to whether confidentiality applies.

1 We discussed the first consultation in our October 2022 Bulletin **here**.

2 [2020] EWCA Civ 574

There were some arguments against reform including: that parties may expect the law they have chosen for the contract to govern all terms of the contract including the arbitration agreement; and that if the law of the matrix contract and arbitration clause do not align this can cause difficulties such as potentially treating different people as parties to the matrix contract and arbitration clause.

However, the Law Commissions' provisional conclusion is that a default rule that the arbitration agreement is governed by the law of the seat unless agreed otherwise is simple and certain, removing argument and satellite litigation. Any dispute regarding the governing law of the matrix contract will then not affect the arbitration agreement.

Challenging jurisdiction

The issue here is whether a challenge to an award on the basis that the arbitral tribunal lacked jurisdiction under s67 of the Arbitration Act should be a full rehearing rather than an appeal. The Law Commission proposed in its first consultation that the challenge should be an appeal. However, it has now evolved its position and proposes limits to the extent of the challenge as follows:

- The court should allow the challenge where the decision of the Tribunal on its jurisdiction was wrong;
- The court should not entertain new grounds of objection or new evidence unless even with reasonable diligence the grounds could not have been advanced or the evidence submitted before the tribunal; and
- Evidence should not be reheard save exceptionally in the interests of justice.
- It is said that this should be enacted through rules of the court rather than a change to the Act.

Discrimination

Following its first consultation, the Law Commission has identified some further areas for consultation. The proposal is retained that a term is unenforceable that requires an arbitrator to be appointed by reference to a protected characteristic unless that requirement can be justified as a proportionate means of achieving a legitimate aim. It is now in addition proposed that it should always be justified that an arbitrator is a different nationality from the parties, as this is a common international practice to assist impartiality. It is also suggested that discrimination should be prohibited generally in an arbitration context (i.e. that this should not be limited to discriminatory terms). The consultation also asks what remedies should be available for discrimination in this context.

Conclusion

The Law Society seeks comments on the proposals by 22 May 2023. HFW responded to the first consultation, and intend also to respond to the second. We look forward to the Law Commission's final recommendations with interest, although it will ultimately be for the Ministry of Justice to decide whether to take forward any necessary changes to legislation.

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Court considers application of a war exclusion in relation to an uncovered World War II bomb

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> "*Leyland* made clear that the proximate cause was not simply that nearest in time, and there was no suggestion that the passing of time had reduced the potency of the explosive load of the bomb."

In *Allianz v University of Exeter*, the Court considered whether an exclusion in a policy for damage occasioned by war applied where a World War II bomb was detonated 80 years later, causing damage to property.

Facts

In 2021, an unexploded World War II bomb was discovered in Exeter during building works. Bomb disposal experts determined that the bomb could not be safely removed and instead had to be exploded there, adopting safety measures to limit the consequences of the explosion. Damage, described as "inevitable" due to the size of the bomb, was caused to buildings in the immediate vicinity.

The defendant notified a claim under its property policy to the claimant insurer in respect of physical damage to student halls of residence and business interruption due to the temporary re-housing of students.

The insurer declined the claim on the basis that it fell under the War Exclusion clause in the policy.

The relevant exclusion read: "*War....Loss, destruction, damage, death, injury, disablement or liability or any consequential loss occasioned by war....*"

The issue to be determined by the court was therefore whether the damage was "*occasioned by war*".

The insurer sought a declaration that it was entitled to decline the claim under the policy. The court therefore had to consider what the "*proximate cause*" of the loss was.

Parties' submissions

The insurer submitted that the proximate cause of the loss was the dropping of the bomb i.e. an act of war.

The insured's case was that the proximate cause of the loss was the deliberate act of the bomb disposal team in detonating the bomb. This was said to be shown by the language of the policy, the fact that the parties could not have intended for the exemptions to apply to historic wars and the relevance and purpose of the exclusion.

Court's judgment

The proximate cause

His Honour Judge Bird referred to previous well-known authorities *Reischer v Borwick*[1] and *Leyland Shipping Company v Norwich Union*[2] as well as the decision of the *Supreme Court in Arch v FCA*[3] (the COVID-19 test case), to determine the law on proximate cause.

The Judge noted that causative events do not always follow in a linear fashion, but may at any point be seen as a net of "*influences, forces and events*" converging from all directions. Further, an earlier "*cause*" may be more potent than a later "*cause*". The case law demonstrates that the modern approach is to undertake a practical exercise to ascertain what the cause would be to the man in the street taking a broad view, not to undertake a microscopic analysis.

In Arch the court said that "*It is not a matter of choosing a cause as proximate on the basis of an unguided gut feeling......The question whether the occurrence of [an event] was the proximate (or "efficient") cause of the loss involves making a judgment as to whether it made the loss inevitable - if not, which could seldom if ever be said, in all conceivable circumstances - then in the ordinary course of events. For this purpose, human actions are not generally regarded as negativing causal connection, provided at least that the actions taken were not wholly unreasonable or erratic.*"

Applying this to the facts, the Judge found that if the reasonable human act of detonating the bomb could be left out, then the dropping of the bomb was the proximate cause.

Alternatively, if the human actions were looked at as part of the net of causation, the common sense analysis was still that the loss was caused by an explosion, triggered by the reasonable decision to detonate it, that was necessitated by the presence of the bomb. Dropping the bomb was the obvious proximate cause of the subsequent damage.

The court dismissed the argument that the passage of time of almost 80 years between the dropping of the bomb and the damage made this conclusion wrong. *Leyland* made clear that the proximate cause was not simply that nearest in time, and there was no suggestion that the passing of time had reduced the potency of the explosive load of the bomb.

Concurrent proximate causes rule

In the alternative, the court held that if the dropping of the bomb was not "*the*" proximate cause, it was still "*a*" proximate cause. Therefore, following established case law in *Wayne Tank and Pump v Employers Liability Assurance Corp*[4], as one of the proximate causes was insured but the other excluded, the exclusion prevailed and the loss was not covered.

The insured put forward a further argument that this concurrent proximate cause rule, as set out above, had been excluded by the policy. This was on the basis that certain other policy exclusions (terrorism and cyber), excluded loss "*regardless of any other cause or event contributing concurrently or in any other sequence to the loss or damage*". It was said by the insured that this wording described the concurrent causes rule, and that as the war exclusion did not make such a reference, and taking the policy as a whole, the war exclusion should be read as having disapplied the rule.

The Judge rejected this argument, finding that the words in the other exclusions were seeking to clarify the position if the concurrent causes in question were a combination of the direct (proximate) and indirect (non-proximate), and in any event a reasonable person would expect express wording to be used in the war exclusion to disapply the concurrent proximate cause rule.

The court therefore found in favour of the insurer.

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1. 1894 2 QB 548
2. [1918] AC 350
3. [2021] UKSC 1

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"The Judge held that there was no authority directly on the point of how the *Patel* considerations would apply in a case of a strict liability criminal offence where the narrower rule is engaged (i.e., an indemnity is sought against a criminal fine)."

The illegality principle in professional negligence cases – Owadally v Planology

This case provides an interesting illustration of a professional negligence claim where the claimants allege they were convicted of a strict liability (i.e., no-fault) criminal offence, due to the defendants' negligence. The application of the illegality principle (or *ex turpi causa*) where the insured has acted illegally, albeit without any wrongdoing, remains less than straightforward, despite a number of Supreme Court rulings. As a result - as the Judge found here – the issue will not usually be apt to be dealt with by strike out or at summary judgment stage.

Background

The claimants were convicted for strict liability offences relating to the development of a listed building without consent. They subsequently claimed against the professionals that advised them in relation to the development, including the planning consultants, solicitors, and engineers. The claimants argued that the professionals' negligence was the cause of the prosecution and conviction, because they had gone ahead with the works on the basis of inaccurate professional advice.

The claimants sought to recover the criminal fine and other costs, sums relating to regulatory proceedings taken against them by the ACCA (as both were accountants), and consequential losses from the interrupted development.

Two of the defendants (the planning consultancy and structural engineers) sought to strike out parts of the claim and/or for summary judgment as an abuse of process on the basis that it was a collateral attack on the criminal judgment, and secondly that it was barred by the illegality principle, i.e., the principle that it would be contrary to public policy for a claimant to recover damages arising from its own illegal behaviour. This application was rejected by the county court and there was an appeal.

Judgment

Collateral challenge

Mrs Justice Collins Rice found firstly that the claim was not a collateral challenge to the criminal proceedings. The claim as pleaded was consistent with the legal and factual ingredients of the criminal convictions (even if the claimants' credibility and consistency was in issue). The civil proceedings concerned issues of fault not decided in or considered by the criminal courts, and were intended to redistribute the financial consequences of undertaking the redevelopment without the necessary consent.

Illegality

On the issue of illegality, the Judge considered the existing case law, including the various decisions on this issue of the Supreme Court/ House of Lords and noted in particular the following points:

- In *Gray v Thames Trains*[1], Lord Hoffman set out two principles. The narrower principle is that an offender cannot recover an indemnity against the consequences of the criminal court's sentence (so, for example, cannot recover a criminal fine). The wider principle is that a claimant cannot be compensated for the consequences of his or her criminal conduct.
- In *Les Laboratories Servier v Apotex*[2] Lord Sumption described the illegality principle as meaning that the courts will withhold a remedy, leaving the loss to lie where it falls, where to do otherwise would lend the authority of the state to the enforcement of an illegal transaction or the determination of the legal consequences of an illegal act. However, Lord Sumption noted that there may be exceptional cases, where even criminal acts may not constitute "turpitude" for the purposes of

the illegality offence. He identified strict liability offences, where an innocent claimant was not privy to the facts making the act unlawful, as one such potential case, and an inquiry into the claimant's moral culpability may be necessary.

- In *Patel v Mirza*[3] Lord Toulson JSC held that the rationale of the illegality principle is that it would be contrary to public interest to enforce a claim that would be harmful to the integrity of the legal system. He devised a three part test which required the court to consider: (a) the underlying purpose of the prohibition that has been transgressed and whether that purpose will be enhanced by denial of the claim; (b) any other relevant public policy on which denial of the claim will have an impact; and (c) whether denial would be a proportionate response to the illegality, keeping in mind that punishment is for the criminal courts. Lord Sumption found that "significant exceptions" to the illegality principle depended on whether the act was properly regarded as involuntary and whether it was the act of another for which the claimant is responsible only due to strict liability. The case of *Osman v J Ralph Moss Ltd*[4] was cited by Lord Sumption, in which the Court of Appeal approved recovery of a criminal fine for driving without insurance, in a civil claim against brokers who negligently advised the claimant he was insured.

The Judge held that there was no authority directly on the point of how the *Patel* considerations would apply in a case of a strict liability criminal offence where the narrower rule is engaged (i.e., an indemnity is sought against a criminal fine). It was not clear whether strict liability offences were exceptions to the *Patel* test, or just the playing out of applying those principles, but it appeared that the trial judge would need to still think about the nature and purpose of the offence, public policy considerations and proportionality.

It may also be that, following Lord Sumption's comments, the degree of knowledge and moral responsibility of the claimant were relevant. In relation to the facts of this case, the trial judge would need to make findings of fact about the claimants' knowledge of matters such as the listed status of the building, the particular works, the legal requirements for authorisation and its absence. If the claimants' knowledge was incomplete it may also be necessary to consider the underlying legislative policy for imposing strict-liability for the offence including for deterrent and enforcement purposes, and whether this was inconsistent with recovering civil damages.

The Judge found therefore that the question of whether the illegality principle applied would require careful and contextual statutory interpretation, with perhaps no one-size-fits-all answer apt for summary judgment.

In the circumstances, it was correct that the matter should go forward to trial.

Conclusion

The judgment demonstrates that the illegality principle must be considered carefully in light of the particular factual circumstances of each case and the thoughtful approach set out in *Patel* applied, and this likely includes circumstances where the narrow principle is engaged.

The illegality principle is also relevant to whether a fine or penalty may be recoverable under a contract of insurance. Some policies provide cover to the extent that the fine or penalty is insurable by law.[5] Any final judgment in this matter could be relevant to the question of whether sanctions for strict liability offences are insurable.

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1. [2009] AC 1339 HL
2. [2015] AC 430
3. [2017] AC 467
4. [1970] 1 Lloyd's Rep 313
5. Certain regulatory fines may be prohibited from being insured. Provisions in GEN 6 of the FCA Handbook provide that no insurance can be taken out covering an FCA penalty.

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