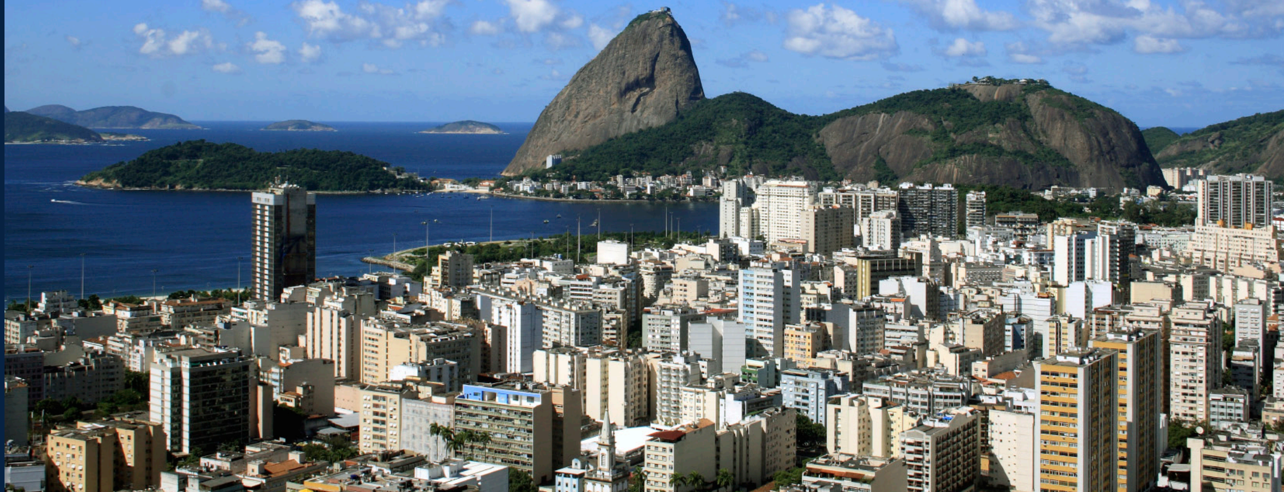
International Commerce

May 2013

LATIN AMERICA BULLETIN



Welcome to the first edition of our Latin America Bulletin, which focuses on key issues in international commerce across the region.

In this first edition, we start with a review of the Brazilian reinsurance regulatory environment and discuss the impact some key changes may have on this rapidly growing market. We then look at the proposed revisions to WELCAR 2001, highlighting likely changes and where problems may arise if these changes are accepted, and follow with a review of the rapidly changing airline market in Latin America, highlighting some key issues that both airlines and insurers should be aware of when operating within the region and when using the region as a hub for travel to other parts of the world. Finally, we review an issue raised recently in a Venezuelan Supreme Court ruling on the topic of overbooking on flights.

I'd also like to highlight our upcoming Summer Party, which is in São Paulo on 6 June 2013, and encourage any readers in the region at the time to come along and say hello. There will be plenty of HFW people there on the night, both from our São Paulo office, as well as other offices – details are on the last page of this Bulletin, for anyone interested.

Finally, HFW's São Paulo office is growing, with the recent promotion to partnership of Fernando Albino, plus the move to the office from London of Senior Associate, Geoffrey Conlin - all part of our firm's continued investment in this highly dynamic region.

All that remains is for me to thank you for reading our Bulletin and I hope to see as many of you as possible on 6 June 2013.

Jeremy Shebson, Partner & São Paulo Office Head

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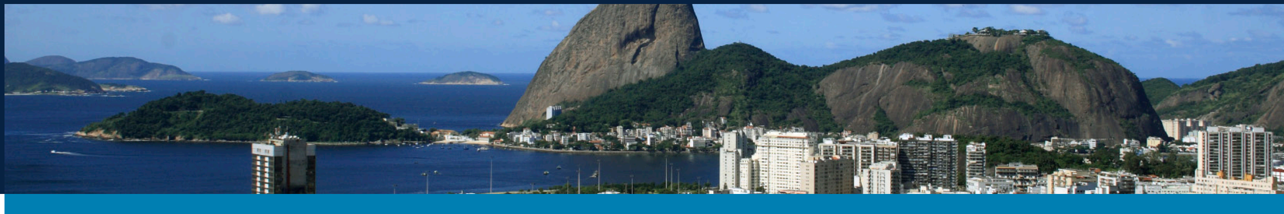


Brazil - a regulatory perspective

Six years have passed since the opening of the Brazilian Reinsurance Market and where are we now with deregulation of the market?

For 70 years the state controlled IRB-Brasil Resseguros (the IRB) had a monopoly over the Brazilian reinsurance market. The IRB maintained its monopoly until 2007 when, through Complementary Law 126 of 15 January 2007 (Law 126/07), Congress opened the Brazilian reinsurance market to international reinsurers, classifying the IRB as a local reinsurer.

Brazil has in place the "National System of Private Insurance", instituted by Law Decree 73 of 21 November 1966[1]. The National System of Private Insurance is comprised of the National Council of Private Insurance (CNSP), the Superintendent of Private Insurance (SUSEP), reinsurance (previously, only the IRB) and insurance companies and brokers authorised to operate in the Brazilian market.

Prior to the opening of the market, the IRB acted as both regulator and the only company authorised to write reinsurance in Brazil. These days the CNSP determines the policies and guidelines concerning reinsurance operations in Brazil and SUSEP is responsible for supervising and regulating the Brazilian reinsurance market . Both the CNSP and the SUSEP are government entities reporting to the Ministry of Finance.

Categories of reinsurer

Under the current regime (Law 126/07 as implemented by CNSP Resolution 168), reinsurers are required to obtain one of the three licenses in order to write business in the country. Each license is subject to different entry and operational requirements and restrictions, which limit the volume of business which can be ceded to reinsurers depending on the type of licence held. The three licenses available to reinsurers are identified below. This structure continues to make up the operating platform for reinsurers in Brazil today.

- Local reinsurers are incorporated under Brazilian law as Brazilian corporations registered by SUSEP to carry out reinsurance and retrocession transactions. They are subject to all local laws and regulations generally applicable to Brazilian insurers (including registration requirements), save for those that do not apply for contractual or operational reasons.

- Admitted reinsurers are non-resident reinsurers (foreign) that maintain a representative office in Brazil and are registered by SUSEP to effect reinsurance and retrocession contracts. To be eligible, the company must have, among other things, certain minimum solvency ratings and a net equity of not less than US$100 million. It must also maintain a bank account in Brazil linked to SUSEP, with a minimum amount e.g. US$5 million for reinsurers conducting transactions in all lines of business, and show that it has underwritten reinsurance risks which it intends to cover in Brazil for at least five years.

- Occasional reinsurers are non-resident reinsurers (foreign) without a representative office in Brazil and registered by SUSEP to effect reinsurance and retrocession contracts. Foreign companies based in "tax havens"[2] or in countries whose domestic legislation imposes secrecy regarding the identity of the shareholders or their percentage ownership cannot be registered as occasional reinsurers. To be eligible, the company must, among other things, present documents showing that it has minimum solvency ratings and a net equity of not less than US$150 million, and that it has underwritten reinsurance risks which it intends to cover in Brazil for at least five years.

Mandatory cession, the intra-group limitation and the retention rules

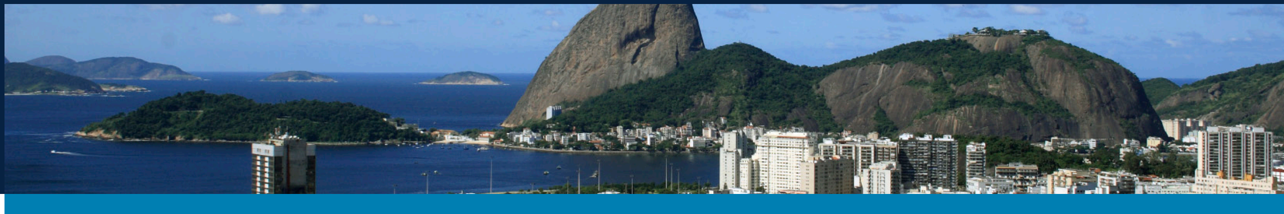
The principle restrictions concerning the transfer of risk by insurance and reinsurance companies are set out below. In December 2010, the CNSP published Resolution 224 and Resolution 225, which came into force on 31 January and 31 March 2011 respectively, and which provided as follows.

- Resolution 224: local insurers (to include foreign insurers operating in Brazil) and local reinsurers were prohibited from reinsuring or retroceding their business within their own financial group located outside of Brazil (the intra-group prohibition).

- Resolution 225: local insurance companies must place at least 40% of each facultative or treaty

1. Law 126 had the effect of revoking various provisions under Law Decree 73 of 1966 concerning the IRB monopolist powers.

2. Those countries which do not tax income or tax it at a rate lower than 20%.



- reinsurance cession with local reinsurers (the mandatory cession) and reinsurance contracts may include a claims control clause in favour of the local reinsurer, where they have the largest proportional share of risk.

These resolutions were met with substantial opposition by local insurers and foreign reinsurers. Both were viewed in some quarters as protectionist measures aimed at creating a partial monopoly for the benefit of local reinsurers, and/or against the Brazilian constitutional principle of freedom of contract and a set back to the development of the Brazilian Reinsurance market in line with other international markets.

As a result of the strong lobbying by foreign reinsurers, Resolution 224 was revoked and replaced by Resolution 232. Resolution 232, which came into force on 31 March 2011, watered down the intra-group prohibition, by providing that an insurance company or local reinsurer may not transfer more than 20% of the premium applicable to a contract to related companies, or to companies belonging to the same financial conglomerate. For these purposes, a 'related company' or a 'company belonging to the same financial conglomerate' is defined as a set of directly or indirectly related legal persons, with either:

- A shareholding of 10% or more in capital in the company.
- Active operational control of the company, to be characterised by the company's management or joint management, or by its activity in the market under the same brand or trading name.

The 20% cap provided by Resolution 232 does not apply to surety, export and domestic credit, rural and nuclear risks insurance. Contracts that incepted prior to 31 March 2011 were subject to these terms on renewal or as from 31 March 2012, whichever came first. From a Lloyd's market perspective, companies with reinsurance operations in Brazil are limited in ceding reinsurance to related party Syndicates, though they are permitted to cede reinsurance to other non-related Syndicates.

The mandatory cession rule (Resolution 225) was maintained, however the rules also address the situation where, as a result of lack of capacity in the local market, all or part of an insurance risk cannot be borne by local reinsurers. In this scenario, the risk can be ceded to foreign reinsurers registered as admitted and occasional reinsurers. Also, where there is a lack of capacity in the local market as a whole (i.e. local, admitted and occasional), it is possible to cede the risks to foreign reinsurers that are not registered in Brazil, provided that they comply with minimum requirements.

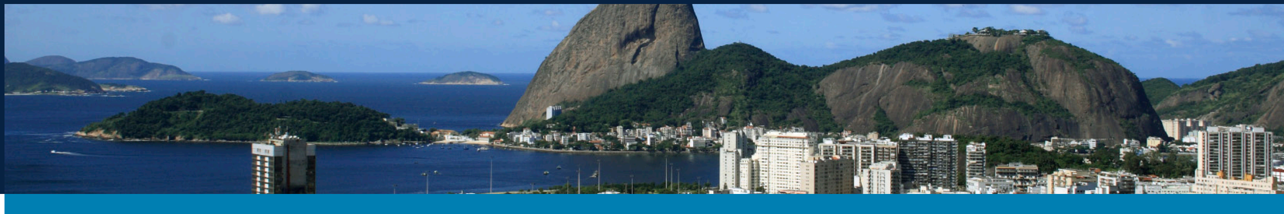
The following retention rules also exist:

- Regulations prevent Brazilian insurance companies from ceding more that 50% of the total amount of premium earned during their operations in a calendar year. This limitation does not apply to surety, export and domestic credit and nuclear insurance, which can be freely ceded by local cedants, provided they are in compliance with other applicable restrictions.
- Brazilian insurance companies are prohibited from ceding to occasional reinsurers more than 10% of the aggregate value ceded in reinsurance during the calendar year. For surety bonds related to obligations towards governmental entities, and oil and gas, the limit is 25%.
- Local reinsurers are allowed to cede to occasional reinsurers up to a minimum of 50% of the aggregate value of the premiums issued in relation to risks underwritten by them, taking into account all of their operations in each calendar year.

Response of international reinsurers and policyholders

In April 2011, a coalition of 18 international insurance and reinsurance associations from the Americas, Asia and Europe (including the ABI and the IUA) sent a letter to the Brazilian government expressing their continued opposition to Resolutions 225 and 232 and petitioning the Government to reconsider their enactment. On the policy holder end, many international companies operating in captive insurance and reinsurance operations were concerned that the new regulations would mean more intermediaries, more transactions and greater costs. There are three principal areas of criticism from the international market in relation to the most recent rules:

- First, the rules - in particular Resolutions 224 and 225 - were passed after minimum consultation with foreign reinsurers and without any public hearings.



- Second, the rules lack clarity and are ambiguous. creating difficulties from a compliance perspective. For example, under Resolution 225, must 40% of each facultative or treaty reinsurance cession be placed regardless of pricing? If so, and if the reinsurance with a local reinsurer is too expensive, there is an argument that the insurer could not be able to accept the original risk in the first place. This would be counter-productive.
- Third, they make little commercial sense. For instance, the 20% intra-group rule reduces the diversification of reinsurance risks in Brazil into the global market and complicates the business plans of multi-national insurers who spread their risks using intra-group cessions.

Notwithstanding such criticisms, Reinsurers have flooded into Brazil since the opening of the market. These arrivals are largely a consequence of the perceived need for capacity owed, at least in part, to the 2014 World Cup and the 2016 Olympics, but also because of major infrastructure projects associated with the Programa de Aceleração do Crescimento ("Growth Acceleration Programme"), which involves estimated investments of US$526 billion for the period 2011 to 2014. Relative economic and political stability, and positive credit trends have also contributed to the new entries.

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Revision of the offshore construction policy

Since 2009, the Joint Rig Committee (JRC) at Lloyds has been working on revisions of the standard 2001 Offshore Construction Project Insurance Wording (WELCAR). In September 2011, the new WELCAR wording was released into consultation with the market. Publication was due in January 2012, but has been delayed due to the significant amount of feedback received and pending a second consultation phase. The aim of the new wording is to reflect ten years of underwriting experience on the basis of WELCAR 2001 and to improve the quality of the wording by bringing greater clarity and consistency through the use of more contemporary language. The new wording and the potential impact of the revisions will be of interest to insureds with offshore construction projects in Latin America, their contractors and sub-contractors. It will also be of interest to those insuring or reinsuring such projects and their intermediaries.

Generally speaking, the new WELCAR wording, whilst seeking to clarify matters, appears more restrictive of the coverage provided to the insured, making for a generous policy for the insurer.

We comment below on some of the proposed changes which we feel could be less welcome to insureds and which may therefore potentially lead to disputes between insurers and their insureds. This is not an exhaustive list, but includes what we think are the main changes.

Scope of insurance

The policy language has been strengthened, with a new requirement that the list of activities covered under the policy must be included within "declared" values and the coverage for initial operations is no longer included in these activities. All activities will therefore need to be properly listed in order for the insured to be fully covered.

The limitation has been introduced so that those drafting contracts with "Other Insureds" must expressly give the benefit of the insurance to them. This raises the possibility that some contractors may not be insured, where an inadvertent error has occurred in not conferring the benefit or as a result of ambiguous language.

Definitions

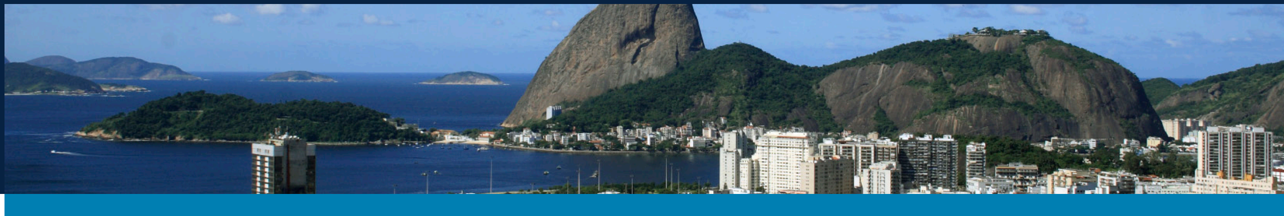
Although "Defective Part" is defined, "Part" is not. This has been the crux of issues in respect of the aspect of coverage and remains an issue.

General conditions

"Special Conditions Applying to Other Insureds":

Clause A is restrictive in terms of cover for contractors during the "Maintenance Period", during which time contractors will need to be careful to have their own cover for situations that may arise, but are not covered by this policy. This is likely to be welcomed by insurers.

Clause B restricts cover for any "Other Insured" where "any act or any failure to act (whether before or after the Period of Insurance



commences) by or on behalf of the Principal Insured which prevents recovery by the Principal Insured... or would prevent recovery”. Again, this is likely to be welcomed by insurers.

Clause D states that the rights of “Other Insureds” can only be exercised by a “Principal Insured”. This suggests that any failure on the part of the “Principal Insured” to comply with the conditions precedent could prevent cover for other insureds. This could lead to disputes between contractors and their sub-contractors, which may spill over into coverage disputes.
There is a significant change under “Due diligence”, as new duties in respect of due diligence and compliance are placed on the “Principal Insured”, their contractors and sub-contractors. QA/QC has been replaced by these clauses. These requirements might require contractors to increase their own cover.

“Survey Requirements” are stated to be a condition precedent to liability. A compliance obligation is placed on the “Insureds”, meaning that a technical breach by an “Other Insured”, for example, has the effect of removing cover for all insureds. This would leave other insureds potentially uninsured and again reduces insurers’ liability.

“Notification Of An Occurrence Which May Result in A Claim” is now expressed as a condition precedent to liability and therefore breach of this will absolve insurers of liability. This is new and is a change very much in the insurer’s favour.

“Waiver of Subrogation Rights” is removed where an “Other Insured” is not entitled to policy cover for an event of loss, damage, liability or expense. This waters down the hold harmless principles that are increasingly agreed between principals and contractors. As such, it is likely that the market will not perceive this as a practical clause and this change will likely be rejected by insured and contractors.

Section one

“All risks” coverage has been removed from the “Insuring Clause”, creating a limitation. It increases the burden of proof on “Insureds”.

“Minimising Losses/Additional Work Required” replaces “Sue & Labour” language under limited cover, but the costs to be borne by insurers are only for a proportionate amount and capped at 50% of the value at the time. The allocation of proportion across respective interests could well be problematic. This clause also provides that insurers will not pay for the cost of “imminent Physical Loss of or Physical Damage” arising from a “reasonably foreseeable” cause. Although this change appears to reduce insurers’ exposure, imminent loss/damage must necessarily be reasonably foreseeable and whether something will be deemed “imminent” is a matter of fact and degree. This therefore leaves scope for disputes.

As to additional exclusions, the exclusion of costs of repairing, correcting or rectifying wear and tear, gradual deterioration, “scouring” is new.

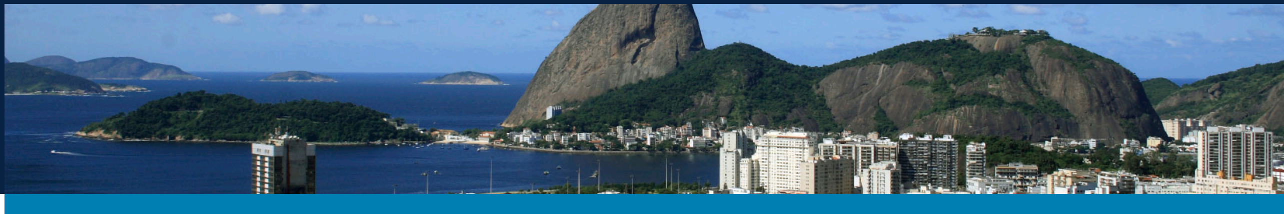
Also, the Defective Part exclusion has been broadened to include “defect in plan or defect in specification”.

General

The new proposed WELCAR wording has been produced with the best of intentions, and it was time to upgrade it. Insurers are likely to welcome the broad thrust of these revisions, as their exposure to claims under the new WELCAR wording would be significantly less than under WELCAR 2001. The proposed wording is particularly favourable to insurers, as the inclusion of all the new conditions precedent makes it a much more onerous policy under English law, since a technical breach of any of these may result in a right for the insurer to terminate cover, even where this did not cause any loss.

However, concerns have been expressed by insureds, many of whom feel that the revisions amount to a rewrite of the policy wording, propose a considerably narrower form of cover, and with more hurdles to overcome to secure cover.
While the revisions are broadly favourable to insurers, they will want to be aware that the new wording significantly increases the scope for commercial disputes between contractors, for example where the fault of one subcontractor leads to the complete loss of insurance cover for all the others involved in the project.

There is concern that energy companies and contractors may seek broader coverage elsewhere if further amendments are not made, and uptake of the policy will be limited. Following strong criticism from some quarters, we understand that the latest wording is likely to be substantially reworked before becoming a settled wording.



Hopefully, many of the above issues will be addressed. In any event, the above gives an idea of the current status of WELCAR 2012 and the types of issues that can actually arise whenever a new wording is introduced.

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Airline consolidation and competition law in Latin America

Latin America has recently been labeled as “a bright spot for aviation”. Studies reveal that the aviation market in the region is growing faster than the world average, and that this trend is expected to continue.

Ten years ago, this was unthinkable. For many years, airlines in the region struggled to find competitive business models as a result of a rigid and fragmented regulatory environment. But with the gradual relaxation of the regulatory framework, there has been a clear trend towards consolidation.

This trend has exposed the challenges involved in cross-jurisdictional mergers in the region. Unlike the two major aviation markets (the United States and Europe), competition in Latin America is not regulated by a uniform legal framework whose application is entrusted to a single enforcement agency. This is a burden for airlines, which can be forced to obtain regulatory approval in each country in which they operate. It also creates the risk that the same transaction will be subject to different, and even conflicting, rules of interpretation.

We explore below some of the concepts applied by the competition authorities of some of the more important aviation markets in Latin America in order to illustrate the different approaches which are adopted.

Market definition

When looking at the geographical scope of a market, competition authorities in Latin America have normally followed a city-pair approach, restricting the analysis to overlapping routes. This has been the approach adopted by the competition authorities in both Argentina and Brazil. By contrast, Chile has taken a slightly different approach. In the context of the LAN-TAM merger, Chile’s competition authority considered that connecting services were ‘markets in themselves’. Accordingly, the potential impact of the merger was analyzed not by reference to routes to or from Chile, but rather by the routes which provided feeder traffic for the networks of LAN and TAM. In addition, for long-haul flights, the Chilean authority decided to follow a city-continent and city-country approach, considering Santiago-Europe and Santiago-United States as relevant markets.

When examining the market by type of product, relevant markets are typically defined as passenger or air cargo services (thereby excluding other means of transport from the analysis). Both the Brazilian and Chilean competition authorities have viewed distance from the city centre as the determining factor when assessing whether airports are substitutable. Those competition authorities do however differ with regard to the substitutability of direct and indirect flights. In Brazil, only direct flights have been considered interchangeable, whereas in Chile, a slightly broader approach has been adopted.

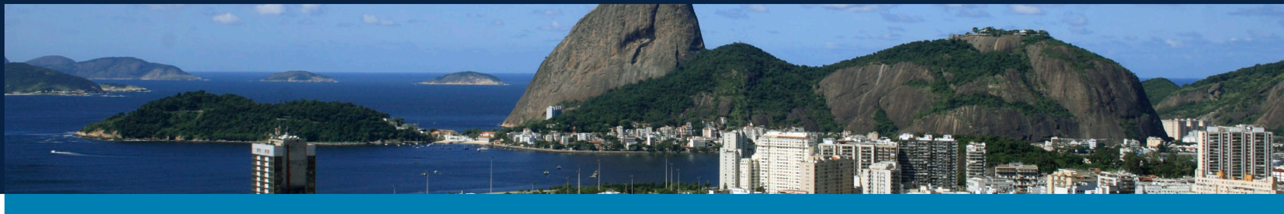
The LAN-TAM merger is perhaps a good example of the different outcomes which may arise from different interpretations of the same transaction. The different approaches of the competition authorities in Chile and Brazil were reflected in the remedies which each authority imposed: a significant number of conditions were attached to the approval of the merger in Chile, whilst there were only a few such conditions in Brazil.

Market power

When the Mexican Competition Commission analysed the proposed merger between Aeromexico and Mexicana, it concluded that the merged company would be able to set prices unilaterally or restrict output. In addition, the scarcity of slots was a high barrier for new entrants to the market. As a result of those two factors, the merger was rejected.

The degree of concentration in hub-to-hub routes and entry barriers as result of infrastructure constraints were also important concerns for the Chilean and Brazilian competition authorities in the LAN-TAM merger, which led them to impose remedies to mitigate the effects of the transaction.

However, concentration can actually be seen as stimulating competition. In the recently approved merger between Azul and Trip, the Brazilian competition



authority believed that the transaction would improve competition, as the merger would allow the merged airline to compete with the market leaders, GOL and TAM.

Remedies

The array of remedies used by competition authorities in airline merger cases in the Latin America region are similar to those adopted in other parts of the world. Typical measures include obligations to interline, to allow competitors to participate in loyalty programmes, and to surrender slots.

A slightly different approach was recently adopted by Brazil when assessing the Webjet-GOL merger. The airlines were not required to surrender slots to competitors, but instead the merged company is required to operate at 85% efficiency at Santos Dumont Airport in Rio de Janeiro. If these standards are not met, the company will then be forced to surrender slots.

Restrictions on cooperation agreements are also common. To fulfil the conditions imposed by the Brazilian competition authority, Azul-Trip will have to withdraw gradually from the code-share agreement Trip had signed with TAM. Meanwhile, following the LAN-TAM merger, the merged entity LATAM must choose between LAN's OneWorld and TAM's Star Alliance in order to comply with the conditions imposed by the Chilean competition authority.

Conclusions

Analysis of airline mergers by Latin American competition authorities increasingly draws on the thinking of the European and American competition authorities. Although this is a positive step, it does not eliminate the risk of competition authorities in Latin America interpreting the same concept in different ways. In summary, differences in the existing regulatory framework, disparities in the development of competition regimes, and little coordination between competition authorities are just some of the challenges faced by airlines in relation to mergers in Latin America.

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Venezuela: Supreme Court upholds ruling saying that overbooking is unlawful

The Venezuelan Supreme Court of Justice upheld a ruling of its Constitutional Chamber which had ordered Iberia to pay material and moral damages to a passenger who was denied boarding on a flight from Caracas to Lisbon because the flight was overbooked.

The plaintiff claimed material and moral damages for extra-contractual liability under the Venezuelan Civil Code, arguing that Iberia acted with knowledge that its conduct was unlawful.

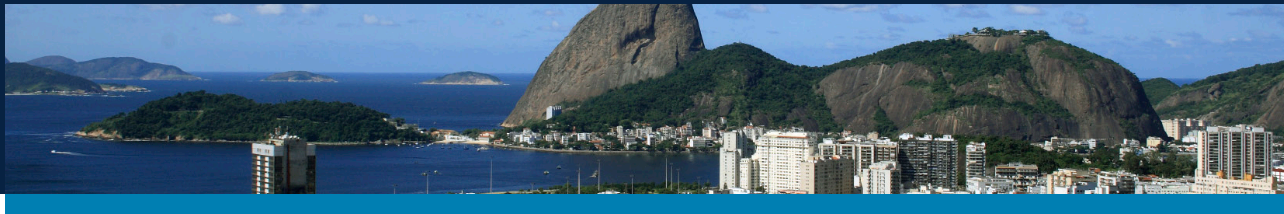
In response, the airline requested the application of the liability regimes of the Warsaw Convention - as amended by The Hague Protocol - and the Venezuelan Civil Aeronautics Act, seeking to avail itself of the limits of liability contained therein.

After five years of litigation, the Supreme Court finally decided to put an end to the discussion and issued a binding ruling in which it cleared all doubts as to which legal regime should apply in claims related to overbooking events.

In its decision, the Supreme Court observed that neither the Warsaw Convention - as amended by The Hague Protocol - nor the Civil Aeronautics Act, addressed the issue of denied boarding, which was a precondition for the application of the liability limits.

It was then emphasised that the existence of a special regime regulating the liability of air carriers does not mean that passengers can be deprived of compensation if they sustain damages which result from conduct that is not expressly covered by such regime. The Supreme Court therefore concluded that the liability limits set out in the Civil Aeronautics Act only apply to those cases expressly regulated in articles 100 and 101 of the Act, i.e. damages resulting from delay or cancellation of flights, damages sustained as a result of accidents and incidents, and loss, delay or damage to cargo.

The court acknowledged that overbooking was a common practice in the airline industry, but agreed with the lower courts' reasoning in finding that overbooking constitutes *'a deliberate breach of contract'*, *'willfully and recklessly undertaken by the carrier'*, which contradicts *'the requirements of professional diligence and the rights of passengers.'*



In the same vein, the Supreme Court concluded that overbooking was an *'unlawful practice'* resulting in both contractual and extra-contractual liability, and that, as such, the provisions of the Venezuelan Civil Code governing such liabilities applied simultaneously. As a result, Iberia was held liable to compensate the passenger for material and moral damages.

The court declared this ruling to be a binding interpretation on the contractual and extra-contractual liability of air carriers. Therefore, it became a legal precedent which must be observed by every court in Venezuela when dealing with cases which involve overbooking.

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Conferences & Events

Major losses in Latin America - claims and underwriting issues
HFW London
(21 May 2013)
Speaking: Jonathan Bruce, Rebecca Hopkirk and Geoffrey Conlin

HFW Summer Party
Festivo, Rua Cônego Eugenio Leite, 1098 Pinheiros, SP, Brasil
(6 June 2013)
Please contact Luciana Spedine on +55 (11) 3179 2911 or email events@hfw.com if you wish to attend.

LABACE 2013
São Paulo, Brazil
(14-16 August 2013)
Attending: Fernando Albino

Alta Aviation Law Americas
Miami, Florida, USA
(25-27 September 2013)
Attending: Fernando Albino

Marine Money's Brazil Offshore Finance Forum
São Paulo, Brazil
(9 October 2013)
Attending: Adam Shire

News

The firm has continued its investment in the Latin America region with the promotion to Partner of aviation specialist Fernando Albino in the São Paulo office, having also recently announced the relocation of Senior Associate Geoffrey Conlin to the office from London.

Lawyers for international commerce hfw.com

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