# INSURANCE BULLETIN
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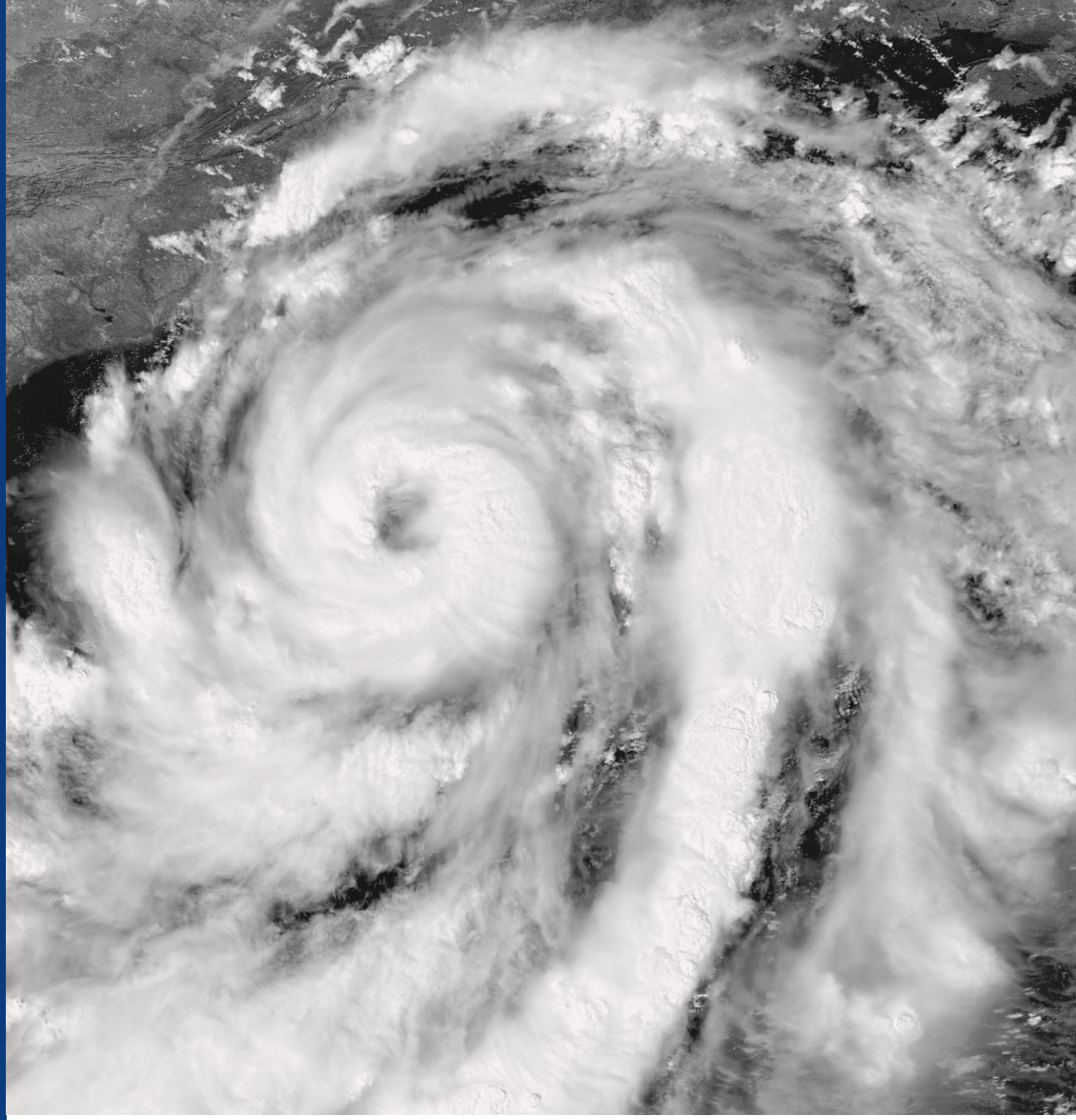

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**"The PRA considers that how firms outsource critical services is integral to a firm's safety and soundness. The PRA also expects a firm's board and senior management oversight of outsourcing to assess reliance on critical service providers, and to set proper risk tolerances."**

## 1. REGULATION AND LEGISLATION

### **UK:** PRA Penalty for Outsourcing Failures

**The PRA has imposed a penalty of over £1 million on an independent bank for breaches relating to the outsourcing of critical services. The outcome of the PRA's investigation into the bank's outsourcing risk management and incident response has implications for insurers and intermediaries across many areas of governance.**

In 2015, Raphael & Sons (Raphael) suffered an IT incident at one of its card processing service providers. For 8 hours, over 3,000 customers were unable to use their bank cards, and over £0.5 million worth of transactions were declined.

Following investigation of the incident and Raphael's management before and after it, the PRA considered that the bank contravened PRA Fundamental Rules 2, 5 and 6[1] by failing effectively to:

- manage its outsourcing risk;
- instruct, oversee and monitor its outsourced service providers; and
- manage and oversee its business continuity and disaster recovery arrangements.

#### Takeaways for insurers and intermediaries

The PRA considers that how firms outsource critical services is integral to a firm's safety and soundness. The PRA also expects a firm's board and senior management oversight of outsourcing to assess reliance on critical service providers, and to set proper risk tolerances.

While Raphael notified the PRA promptly, undertook remedial action, and cooperated with the FCA and PRA's joint investigation, all of these actions are expected by an authorised firm, such as insurer or insurance intermediary.

The PRA will look for timely, comprehensive and adequate remediation, otherwise it may increase its penalty (Raphael's penalty was increased by 40%).

In the end, Raphael benefitted from a 30% decrease to its final penalty thanks to early settlement.

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### **UK:** Climate Change + Insurance: PRA publishes a practitioner's aide for assessing financial impacts of physical climate change

**The PRA is continuing to publish papers on the impact of climate change on the financial industry and how it expects firms to respond.**

Following the PRA's supervisory statement "Enhancing banks' and insurers' approaches to managing the financial risks from climate change – SS3/19"[1], the PRA has published a framework for assessing financial impacts of "physical climate change"[2]. It is aimed at practitioners working with or at general insurance firms who are assessing the financial impact on the liability side of a firm's balance sheet caused by climate change. "Physical climate change risks" is a term used in the report to refer to increasing weather related losses from climate change rather than other climate change risk (e.g. a fall in the value of assets).

The report was written by a cross-industry working group with representatives from UK insurers, global reinsurers, Lloyd's and PRA internal specialists. The framework is expected to be used as a starting point for firms to develop their own assessment of the financial impact of

1. These require firms to act prudently, have effective risk strategies and risk management, and organise and control their affairs responsibly and effectively.

1. https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss
2. https://www.bankofengland.co.uk/prudential-regulation/publication/2019/a-framework-for-assessing-financial-impacts-of-physical-climate-change

physical climate change risk in order to understand how specific business decisions may be affected.

The report aims to address the lack of practical or analytical approaches to assess climate change risks by demonstrating how existing industry tools can be used for such assessments. It notes that the adaptation of insurance industry expertise in assessing natural catastrophe risk to reflect a changing climate is in its "infancy".

The report is structured as follows:

1. Proposed framework offering a practical approach to developing scenarios and assessing physical climate change risk;
2. Details on existing tools which can be used to assess physical climate change risk;
3. Case studies illustrating how to apply the framework; and
4. Recommendations for the future development of tools and processes necessary to assess the financial impacts from climate change risk beyond property, physical climate change risk, and insurance.

The PRA is expecting insurers to take a strategic approach to addressing climate change and to embed their approach in their existing governance structures and financial risk management. The PRA is encouraging firms to consider the report and provide any comments or views to the PRA by Friday 22 November 2019.

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## 2. COURT CASES AND ARBITRATION

### **England & Wales:** Sink or swim on notifications: *Euro Pools v Royal & Sun Alliance*

**In *Euro Pools v Royal & Sun Alliance*[1], the Court of Appeal considered the scope of a policyholder's notifications of circumstances for coverage for remedial works to mitigate potential claims.**

#### Background

The policyholder was a swimming pool installation and fitting company which installed a system of moveable 'booms'. The booms were designed to be raised and lowered to divide a pool into different swimming zones.

In February 2007, the policyholder became aware of problems with booms not rising properly and it notified its professional indemnity insurer under a policy for the year 2006-07 (**the First Policy**). In June 2007, the policyholder completed a renewal form which notified the insurer that the problems with the booms would be rectified using inflatable bags and that the notification was made *"on a precautionary basis should there be any future problems"*.

In late June 2007, the First Policy expired and a renewed policy for the 2007-08 year commenced (**the Second Policy**). In May 2008, the policyholder notified the insurer that the use of inflatable bags had failed to rectify the problems with the booms and that it would attempt further remedial works using hydraulic systems.

A dispute arose as to whether the remedial works fell within circumstances notified under the First Policy (and therefore subject to a £5m limit of indemnity), or the Second Policy (such that expenses related to the hydraulic systems would be subject a separate limit of

1. [2019] EWCA Civ 808.

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**"The Court of Appeal found that the trial judge erred in concluding that, as the policyholder was unaware of a fundamental problem in the air drive system of the booms, he could not therefore have notified the insurer of circumstances which ultimately gave rise to the decision to introduce the hydraulic system."**

indemnity). It is noteworthy that the policyholder had already received an indemnity under the First Policy for £4.3m and claimed £1,597,410 under the Second Policy.

At first instance, the trial judge found in favour of the policyholder. See our previous article at http://www.hfw.com/Insurance-Bulletin-February-2018-Edition-3.

### The Court of Appeal

The insurer appealed the trial judge's findings on various grounds and submitted that correspondence concerning remedial works during the Second Policy period were not new notifications, but related to the existing claim under the First Policy.

In considering the insurer's appeal ground regarding whether there was a causal link between the remedial works and the circumstances notified under the First Policy, the Court of Appeal considered and answered the following questions:

1. **What was the scope of the circumstance(s) notified in 2007?**

   The Court of Appeal held that the circumstances notified in February and June 2007 under the First Policy were that the booms had multiple failures and were not rising and falling properly.

2. **What were the potential third party *"Claims"* in respect of which [the policyholder] undertook the mitigatory works for which it now claims an indemnity?**

   The Court of Appeal noted that for the policyholder to be entitled to cover for remedial works to mitigate a potential third party Claim, such Claim must arise from circumstances notified during the period of insurance of the policy under which an indemnity is claimed.

   The policyholder argued that the February and June 2007 notifications were related only to rectifying problems using inflatable bags, whereas the subsequent indemnity claimed related to the use of hydraulic systems.

   The Court of Appeal disagreed and held that both claims for indemnity were for expenses incurred to mitigate potential third party Claims for the failure of the booms to rise (and not for a specific technical reason).

3. **Did those potential third party Claims arise from the circumstance(s) notified in 2007, in the sense of there being some causal link between the circumstance(s) and the claims?**

   The Policyholder argued that there was no causal connection between the circumstances notified under the First Policy and the Second Policy.

   The Court of Appeal disagreed and found that any potential third party Claim would arise from the circumstances notified in February and June 2007. The Court of Appeal was persuaded by the fact that although the policyholder hoped that using inflatable bags would rectify the problems with the booms, it had deliberately made a precautionary notification under the First Policy in the event that the remedial works were unsuccessful.

The Court of Appeal found that the trial judge erred in concluding that, as the policyholder was unaware of a fundamental problem in the air drive system of the booms, he could not therefore have notified the insurer of circumstances which ultimately gave rise to the decision to introduce the hydraulic system. The Court of Appeal confirmed that it is not necessary for a policyholder to understand the cause of a problem or the resulting consequences in order to make a notification of circumstances. Rather, it is possible to notify that there is a problem for which the remedy is not yet known (a "can or worms" or "hornet's nest" notification) as long as the problem may give rise to a claim.

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## **England & Wales:** The effect of governing law and jurisdiction clauses on subrogated claims: Airbus S.A.S. v Generali Italia S.P.A. & Ors [2019] EWCA Civ 805

**In a decision that will be of interest to anyone involved in insurance disputes, the Court of Appeal has recently ruled on the effect upon a subrogated claim of a jurisdiction clause connected to the insured's underlying cause of action.**

### Background

In October 2005, Airbus, a French company, sold aircraft it had manufactured to Air One, an Italian company. The aircraft were operated by Alitalia, which is also Italian.

A large number of contracts were executed in connection with what was a complex leasing and finance transaction. However, key for the purposes of this decision was the July 2010 Airframe Warranties Agreement ("AWA") between, amongst others, Airbus and Alitalia, and pursuant to which Airbus gave warranties about the aircraft to Alitalia.

The AWA contained the following jurisdiction clause:

> *"13.1 The parties hereto irrevocably agree that the courts of England shall have exclusive jurisdiction to settle any disputes arising out of or in connection with this Agreement or any non-contractual obligations connected with it (including a dispute regarding the existence, validity or termination of this Agreement)."*

In September 2013, one of Alitalia's aircraft was forced to make an emergency landing at Fiumicino Airport in Rome, because of what was later discovered to be a fleet wide defect. Airbus subsequently performed a retrofit for Alitalia, free of charge, to address the issue.

Alitalia's insurers (the "Insurers", and the respondents to this action) have indemnified Alitalia in respect of over US$11 million worth of damage caused by the defect. In July 2017, the Insurers commenced negligence proceedings against Airbus in Italy in an attempt to recover some of these losses (this was initially a subrogated action, but an independent claim by Insurers has subsequently been added).

Airbus commenced opposing proceedings in England, seeking a declaration that it is not liable to Insurers, and that the Insurers' negligence claim falls within the scope of the AWA exclusive jurisdiction clause and they have therefore acted in breach of that clause by starting the Italian proceedings.

### Issues

The Court of Appeal identified the key issues for consideration as follows:

1. The true construction of the jurisdiction clause and whether it extends to a substantive claim under the warranties;
2. Whether the commencement and pursuit of the Italian proceedings is contrary to the terms of the jurisdiction clause; and
3. Whether the English court can make a declaration to that effect against the Insurers in circumstances where they were not parties to, and do not bring their action under, the AWA.

#### 1. The AWA jurisdiction Clause

The Court of Appeal found that the AWA's jurisdiction clause does apply to the dispute between Airbus and Insurers because, *inter alia*:

- The AWA, although part of a series of contracts with alternative jurisdiction clauses, was the only agreement to which all those who were or might become interested in the warranties were parties;
- The terms of the jurisdiction clause are extremely wide, expressly extending not only to any disputes arising out of or connected to the AWA, but also to disputes relating to non-contractual obligations connected with it.

#### 2. Commencement of the Italian proceedings

Although Insurers' claim in Italy was founded not in contract but in tort,

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it nevertheless relates to Airbus's obligations under the AWA. The Court of Appeal therefore found that there was *"at least a good arguable case"* that the claim commenced by the Insurers in Italy was sufficiently closely connected with the warranties provided in the AWA to fall within the scope of that contract's jurisdiction clause.

**3. Declaration against Insurers?**

Perhaps of most interest to those involved in insurance disputes will be the Court of Appeal's analysis of this third issue.

The Court of Appeal summarised its view on this issue as follows:

- Insurers exercising rights of subrogation to make a non-contractual claim are bound by an English arbitration or jurisdiction clause to the same extent as their insured would have been.
- Whereas the commencement and pursuit of proceedings contrary to the terms of an arbitration or jurisdiction clause by the insured would constitute a breach of contract, the commencement and pursuit of such proceedings by insurers constitutes a breach, not of the contract but of an equivalent equitable obligation which the English court will protect.
- The remedies available in such a case include the grant of a declaration in an appropriate case.

Ultimately the Court of Appeal found in favour of Airbus's interpretation of the jurisdiction clause.

**Commentary**

Both insurers and the defendants to subrogated claims will find this decision of interest. It demonstrates the respect with which valid English jurisdiction and governing law clauses are treated by English courts, even where a third party who is not privy to the relevant contract is bringing the action.

The decision also serves as a reminder that, when bringing a subrogated claim, insurers should bear in mind that at the same time as obtaining the benefit of their insured's right of action they also inherit some of the insured's obligations relating to the conduct of that claim.

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## 3. MARKET DEVELOPMENTS

### **England & Wales:** IUA publishes two new model cyber exclusions

**Cyber risks create issues which many insurers may wish to exclude under their standard policies. However, some insurers have found that their policies unintentionally cover cyber losses, because the wording is "non-affirmative" or "silent" on cyber cover. The Prudential Regulation Authority (PRA) has recently expressed concerns about lack of clear insurance cover for cyber risks, and called for greater clarity of wording and specific limits of cover. To address these issues, the International Underwriting Association (IUA) has published two new model cyber exclusion clauses: IUA 09-081 and IUA 09-082.**

The first new clause is a Cyber Loss Absolute Exclusion Clause (reference: IUA 09-081). This excludes in the widest possible manner any loss caused by the use of computer systems, network or data, each of which is defined. The second new clause is a Cyber Loss Limited Exclusion Clause (reference: IUA 09-082). This exclusion is narrower, applying only to losses directly caused by cyber events (rather than "directly or indirectly").

Until now, the accepted market clause for cyber was the Institute Cyber Attack Exclusion Clause CL380, according to which "In no case shall this insurance cover loss damage liability or expense directly or indirectly caused by or contributed to by or arising from the use or operation, as a means for inflicting harm, of any computer, computer system, computer software programme, malicious code, computer virus or process or any other electronic system." This exclusion has attracted widespread

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criticism, for example with many seeing it as too broad-brush and draconian. The new clauses arguably offer more specific definition and clearer wording.

The IUA's Director of Legal and Market Services, Chris Jones, commented: "These two new model clauses provide broad policy exclusions which may be utilised as a starting or reference point for underwriters offering cover for traditional business classes that may include an element of cyber risk. By developing class-specific write backs insurers can then explicitly state the extent of any cover provided for such losses." Considering the factors which had led to the need for the new clauses, Mr Jones added "Silent cyber cover creates uncertainty for both insurers and clients and has been a hot topic in the London company market for some time now. Increasing regulatory scrutiny has, of course, further highlighted the issue, but IUA members have been considering different approaches even before it was first raised by the PRA. Many traditional policies were designed when cyber wasn't a major risk and often do not explicitly mention cyber. Some high profile cyber events and losses have clearly demonstrated, however, how important it is to address."

The two new clauses are available to download on the IUA's website: www.iuaclauses.co.uk.

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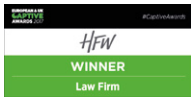


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