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Insurance

Overseas Insurers Now Require Federal Approval

by Mark Brookes, Partner and Allison Stead, Solicitor

What's inside...

The Federal Government has passed amending legislation that will require direct offshore foreign insurers (DOFIs) to obtain authorisation to write insurance for Australian insureds or cease operating in the market as of 1 July 2008.

The Treasury has described the reforms as a means to address the risk to Australian consumers and businesses from unauthorised DOFIs that are unscrupulous or that fail. Acting on recommendations made following an enquiry into the high profile collapse of HIH in March 2001, the scope of the *Insurance Act 1973* ('the Act') will be extended to capture a broader range of activities in considering whether an insurer is 'carrying on insurance business in Australia'. The primary affect of these amendments is that DOFIs must become authorised general insurers under the Act and comply with the same prudential regime (imposed by the Australian Prudential Regulatory Authority (APRA) and under the Act) that applies to domestic general insurers.

Key Elements of Reform

Previously, DOFIs were not subject to regulation under the Act as they did not 'carry on insurance business in Australia' as it is currently defined. The amendments, made via the *Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Act 2007*, mean that DOFIs come within this definition if they are directly or indirectly through the actions of another (for example an agent or broker) carrying on insurance business in Australia. This includes marketing, risk assessment, claims management, acting as intermediary and holding records regarding an insurer's activities.

As a result of these new requirements, holders of Australian financial service licences such as agents and brokers will be prohibited from dealing in general insurance products issued by unauthorised DOFIs other than those who fall within the limited exemptions under the Act. These requirements will also apply to DOFIs carrying on business in Australia as captives or operating through local branches or subsidiaries.

Offshore reinsurers will not require authorisation to operate in Australia. However, reinsurers may be indirectly regulated as a result of the prudential standards being applied to insurers.

Authorised Insurers

To be authorised, DOFIs must establish a presence and assets in Australia. While the specific requirements are not altogether clear at this stage, at a minimum, insurers will need to have assets in Australia that meet necessary capital requirements.

From 1 July 2008, dealings with unauthorised DOFIs will be an offence that carries strict liability under the Act. APRA will have powers of investigation to monitor insurance activity, obtain injunctions against insurers and prosecute offenders.

Lloyd's underwriters will not be affected by these reforms, because they remain subject to regulation under Part 7 of the Act which specifically addresses and regulates insurance policies written by Lloyd's.

Exemptions

The reforms outline three limited exemptions that will apply when risks cannot be underwritten by insurers authorised under the Act or where special circumstances exist to restrict or deny an insured's options for cover.

Each exemption will only apply to that specific business covered by the exemption, and a DOFI may still need to be licensed if they conduct business in Australia that is not covered by the exemption. A brief discussion of each exemption follows.

Exemption 1:

The High Value Insureds Exemption

This exemption has been developed for large Australian businesses as they are considered to have adequate business acumen and risk management skills to engage appropriate insurers. Consideration was also given to the possibility that a business of this size has complex risk that may not be covered through authorised insurers.

According to a modified version of the *Corporations Act 2001 (Cth)* test for large proprietary companies, insureds will be exempt from having to obtain insurance cover from authorised insurers if they satisfy at least one of the following:

- Its consolidated gross operating revenue for the financial year is $200 million or more;
- Its consolidated gross assets at the end of the financial year are valued at $200 million or more; or

In Brief

- Amendments require overseas insurers to get approval to trade in Australia from 1 July 2008.
- Insurers are cautioned to take care when commissioning reports and statements to ensure privilege is retained.
- *HIH Insurance Limited* [2008] NSWSC 9 raises an interesting question under section 562A.

By Mark Brookes, Partner

- The insured has 300 or more employees at the end of the financial year.

Although the amendments come into operation on 1 July 2008, this test will be applied when insurers purchase or renew their insurance or materially alter the terms and conditions of their existing insurance contract. Insureds, or their financial services licence holder acting as an intermediary, will need to assess the availability of insurance to cover their risk and the applicability of this exemption.

The insured's licensed intermediary is responsible for assessing whether this exemption may apply. If so, it will be required to provide data to APRA regarding its dealings in insurance with non-authorised offshore insurers who fall within the exemption.

Exemption 2:

A Typical Risks Exemption

Those insureds who do not fall within the first category of exemption may be able to avoid the restrictions if they experience difficulty in obtaining insurance or coverage is difficult to obtain due to an unusual risk. This exemption recognises that DOFIs may be discouraged from obtaining authorisation to operate in Australia and choose to exit the market, leaving insureds who have less common risks unable to find adequate cover.

The Treasury has nominated a list of risks it considers to be unusual and therefore exempt from the restrictions which prohibit the purchase of insurance from unauthorised insurers. These include kidnap and ransom, malicious product tampering, commercial shipping hull, asbestos, nuclear, political and war and satellite or space cover. This list will be reviewed in three years but may be expanded in the meantime.

As with the first exemption, the insured's licensed intermediary will need to assess whether this exemption may apply. The intermediary will also need to draw the risks of insuring with an unauthorised insurer to the insured's attention at the time of entering a policy.

Exemption 3:

Customised Exemption

This final exemption may be used by insureds who do not come within the first two categories but, due to their unique circumstances, it would be unjustly harsh to require their compliance with the amendments. There are various reasons why an insured may be in this position, including a difficulty in obtaining coverage due to poor claims history, a significant rise in premiums on policies covering their risk, and exclusions that may occur against a crucial element of coverage.

Exemptions under this limb will be addressed on a case by case basis. The key consideration for this exemption is whether the insured's risk is reasonably able to be placed with an authorised general insurer. Criteria such as market capacity to insure, price of premiums, the appropriateness of non-financial terms and the continuity of an existing insurance relationship will be some of the factors considered in determining whether this exemption will apply.

Unlike the previous two exemptions, the availability of appropriate insurance under this exemption is not to be assessed by the insured. At this stage, it is uncertain who will carry out the assessment process, but the Treasury has proposed that a regulatory body such as APRA or The Australian Securities and Investments Commission (ASIC) undertake this task.

While the strict categories of exemptions will significantly restrict the unauthorised operation of offshore insurers from 1 July 2008, Australian customers who make direct contact with DOFIs outside of Australia without using an agent or broker will not be considered to be carrying on insurance business in Australia and will therefore not be subject to the amendments. New entrants to the Australian market after this time will be required to comply immediately by either applying for authorisation or receiving an exemption.

In a sign of enticement to DOFIs to continue operating in the Australian market, under the amendments, foreign insurers will be able to appoint a corporate body as their agent, where they were previously only able to appoint an individual.

Conclusion

To enable access to the global reinsurance market, the legislation will still exempt foreign reinsurers with no actual Australian presence from the requirement to be authorised unless they are a general insurer. However, they will still be affected by APRA's prudential standards that apply stricter controls on foreign insurers compared to their domestic counterparts. Individuals in Australia who obtain insurance coverage direct from DOFIs will not be considered to be carrying on insurance business in Australia and will therefore not be subject to the regulations, so long as the insurer did not induce the customer to enter the insurance contract. As noted above, Lloyd's underwriters are not subject to the reforms.

Strict adherence to the new requirements will be necessary to avoid penalty. Great caution will be required in the initial stages of the reforms to determine how the first two exemptions are to be applied by insurers to avoid a breach of the regulations. Prudent insureds will need to obtain advice regarding their risk to ensure adequate coverage is maintained and applications for any exemptions are made well in advance of the renewal period.

Difficulties Claiming Privilege in PIPA Claims

by Craig McIver, Special Counsel

The introduction of various pre-litigation processes, particularly where personal injuries are concerned, can create difficulties when reconciling the new concepts with age old legal principles like legal professional privilege. And it is this difficulty which is now giving rise to new problems, the most recent example of which is the Queensland Court of Appeal decision in *Watkins v State of Queensland*[1] .

The decision might be seen by some to clarify the application of legal professional privilege in some instances. But at the same time, the murky waters where new process and old principles meet, continues to create trouble.

Background

Mr Watkins (**claimant**) made a claim against the State of Queensland (**respondent**) under the Personal *Injuries Proceedings Act 2002 (Qld)* (***PIPA***). His claim was on behalf of his son, following severe injuries which were alleged to have been suffered by the boy during or as a result of the birthing process.

In the course of the pre-court process, the respondent made an offer to settle the claim ($nil) under section 20(3) of *PIPA* and provided a copy of an expert liability report by Dr MacLennan to support their offer.

Dr MacLennan's report included reference to three letters of instruction he had received from the respondent's solicitors. His invoice also mentioned a 30 minute conference he had with the respondent's solicitors. The claimant filed an originating application seeking orders for the disclosure of the three letters of instruction and any file note of the conference.

The respondent resisted the application, claiming the documents were subject to legal professional privilege because the documents were created for the dominant purpose of anticipated litigation[2].

The claimant succeeded at first instance in the Supreme Court (Justice Atkinson). The Court concluded that privilege had been waived because of the respondent's reliance on the report in making the section 20(3) offer. Justice Atkinson regarded it as "*unfair*" and "*misleading*" for the respondent to maintain its claim of privilege over the documents and she ordered the documents be disclosed.

The respondent appealed.

The Appeal

The three judges in the Court of Appeal dismissed the appeal. But not for the "waiver" reason relied on by the judge at first instance[3]. Rather, the conclusions reached by the Court were heavily premised on the intention of the legislature in enacting the *PIPA*. Justice Keane delivered the leading judgment and although the other two judges delivered separate reasons, they expressly endorsed the key elements of Justice Keane's reasons.

Section 20(3) of the PIPA requires any offer made under that section to be accompanied by

> "… *a copy of medical reports, assessments of cognitive, functional or vocational capacity and all other material, including documents relevant to assessing economic loss, in the offerer's possession that may help the person to whom the offer is made make a proper assessment of the offer.*"

Justice Keane noted that the process initiated by a claimant under the *PIPA* is a pre-cursor to litigation and is intended to provide a mechanism to ensure each side is fully informed about the strengths and weaknesses of the respective cases so that a fair and just resolution can be achieved[4].

The absence of intended litigation caused him to conclude that the existing or anticipated litigation requirement of legal professional privilege must be missing from documents commissioned for use in the *PIPA* process. Expressly, he said[5]:

> "*The purpose of the provisions of Div 1 to Div 3 of Pt 1 of Ch 2 of the PIPA is to ensure that … good claims are paid and bad claims are abandoned before proceedings are commenced in court; that is to say, the dominant purpose is that there should not be litigation of the claim at all if that is reasonably possible.*"

In other words, there was no basis to say the documents in dispute were created for a privileged purpose and no reason to prevent them from being disclosed in accordance with the requirements of section 20(3).

Implications and Opportunities for Insurers

Insurers ought to regard this decision as a welcome reminder of the need to exercise caution in the commissioning of reports and the creation of documents to ensure that documents which are intended to be subject to a valid claim of privilege retain that characteristic. It is not enough that a document be created by or on behalf of combatants in a dispute or indeed, their lawyers.

But, the decision is not a reason for panic amongst insurers. Justice Keane expressed the limitations of the decision well when he said[6]:

> *"… this conclusion is not as far reaching as it might first appear. … reports which are obtained for the dominant purpose of enabling a respondent to a claim to take legal advice on the claim will be privileged … [but] … it was not suggested that Prof MacLennan's report was obtained for the purpose of the State obtaining legal advice."*

Insurers (and uninsured respondents) should also take heart from the decision in terms of broadening their own challenges to the disclosure by claimants. Just as it may be difficult for some documents held by insurers to be classified as privileged, it may be difficult for claimants to rely on a claim of privilege in the disclosure of documents under *PIPA* and other pre-litigation schemes.

In fact, it could be argued that the decision may provoke more of an outcry amongst claimant's solicitors because much of their investigative work is, following the reasoning of the Court of Appeal, for the dominant purpose of the pre-court processes.

The role of legal professional privilege is far from decided by cases like *Watkins*. And whilst cases of this kind tend to focus the mind of lawyers on issues of privilege and purpose when documents are created, it is also likely to lead to more frequent challenges over the extent of disclosure that is made by both sides in pre-court disputes.

Insurers and claims management companies are encouraged to carefully consider the manner in which reports and statements are obtained in *PIPA* claims. Whilst the involvement of legal advisers isn't a guarantee of the success of a claim for legal professional privilege for the dominant purpose of actual or anticipated legal proceedings, it will assist in certain cases in upholding a claim for privilege for the purpose of obtaining legal advice.

[1] [2007] QCA 430

[2] A valid claim of privilege would normally permit a respondent to properly withhold a document from being disclosed to any other party.

[3] Keane JA criticised the conclusion reached by the judge at first instance, concluding that it was not unfair to present the claimant with the liability report whilst withholding the letters of instruction and the file note of the earlier conference.

[4] See paragraph 65

[5] See paragraph 67

[6] See paragraph 83

Authors

Mark Brookes
Partner
T: +61 7 3000 8301
mbrookes@carternewell.com

Allison Stead
Solicitor
T: +61 7 3000 8450
astead@carternewell.com

Craig McIver
Special Counsel
T: +61 7 3000 8326
cmciver@carternewell.com

Stephen Humphreys
Senior Associate
T: +61 7 3000 8439
shumphreys@carternewell.com

Some senior members of the Insurance Team

Paul Hopkins
Senior Partner
T: +61 7 3000 8355
phopkins@carternewell.com

Rebecca Stevens
Partner
T: +61 7 3000 8347
rstevens@carternewell.com

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Reinsurance and the *Corporations Act 2001 (Cth)*

by Stephen Humphreys, Senior Associate

The recent decision of the New South Wales Supreme Court in *Re HIH Insurance Limited* [2008] NSWSC 9 raises an interesting question for liquidator and insurers alike:

> *Can the liquidator of an insurer avoid the requirement to forward reinsurance payout to the parties it has insured?*

Background

The liquidators of HIH Insurance Limited ("HIH") applied to the Court seeking direction as to the distribution of funds received by them under an agreement styled "Cancellation of Reinsurance Agreement" between them and Swiss Reinsurance Company.

Prior to the liquidation of HIH it had taken out reinsurance as agent for its subsidiary insurance companies the premiums for which were paid by two subsidiaries, FAI General Insurance Company Limited and HIH Casualty & General Insurance Company Limited.

After the liquidation of HIH and its subsidiaries, and despite there being a clause in the reinsurance contract dealing with the notice that was required if HIH wished to commute the contract of reinsurance, the liquidator and the reinsurer entered into the cancellation agreement referred to above.

As a result of the cancellation agreement, the reinsurer deposited the sum of $214 million into the liquidators' trust account. At the time of determination of this matter this sum had risen to $332 million.

The Issue

The $332 million dollar question for determination by the Court was whether section 562A of the *Corporations Act 2001 (Cth)* applied to the funds. If section 562A applied then the funds would be required to be distributed directly to claimants under insurance policies issued by the HIH subsidiaries and not to those subsidiaries direct.

Determination by the Court

The Court essentially held that section 562A did not apply to the proceeds. Two reasons were given for this:

1. There was no evidence that either subsidiary had incurred a liability (under an insurance contract) that was covered by the reinsurance.
2. The payout had not been received "*under the contract of reinsurance*" (section 562A(1)(b)). It had been received under a contract that was not the original contract of reinsurance; viz., the Cancellation of Reinsurance Agreement.

Discussion

The decision appears to say that where a payment is received under an agreement to terminate a reinsurance contract, section 562A will not apply.

We are of the view that the decision should be treated with caution however. The facts of this case were somewhat unique in that the reinsured subsidiaries of HIH did not have any insurance liabilities at the time of the termination of the reinsurance contract.

In the reverse situation, where the reinsured companies does or did have insurance liabilities at the time of termination, it is far from certain that a Court would be willing to waive section 562A.

A Court faced with the prospect of interpreting and enforcing section 562A in this reverse context would appear to have two options:

1. To simply apply the decision of the New South Wales Supreme Court in Re HIH which could lead to insureds ultimately being disadvantaged and wait for an amendment to section 562A to deal with this specific situation; or
2. To broadly construe section 562A to apply to the reverse situation and to require the payout on termination to be paid to insureds.

Given the large amounts of money likely to be involved and the prospect of insureds possibly being left out of pocket, we will watch with interest the next move to be made by the Courts with respect to section 562A.

For further information contact Carter Newell:

Brisbane Office
Level 13 / 215 Adelaide Street Brisbane Qld Australia 4000
GPO Box 2232 Brisbane Qld Australia 4001

T: +61 7 3000 8300
F: +61 7 3000 8440
E: cn@carternewell.com

ABN: 70 144 715 010