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Legal and regulatory aspects of conflicts of interest in the operation of wholesale insurance intermediaries

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ABSTRACT: When conflicts of interest exist between an agent's fiduciary duty to its principal; other principals, or its own interests, the law is called upon to provide an equitable resolution to disputes. The diffusion, via multiple layers of market participants, of insurable risks and financial rewards in the insurance market, in order to maximize the efficient use of available capital, including market participants domiciled offshore or under non-UK or EU regulatory regimes, makes traditional legal remedies focused on resolving bilateral disputes between directly contracting parties difficult to apply to London's international insurance market. Through critical analysis of the functioning of the wholesale insurance market in London (and the role of intermediaries), it is clear that the law of agency and regulatory law both fail to create an effective paradigm for resolving complex transactions. In some instances, regulatory law appears at odds with the doctrine of agency (itself derived from simpler relationships than exist in the wholesale insurance market today) and there are examples of market practices that exacerbate conflicts of interest further. Legislative responses have focused on agency where it has a direct impact on paying insurance claims, but have not created a doctrine that reflects or addresses the complex web of agency relationships found today. As a matter of social policy it is suggested that by re-shaping the doctrine of agency, legislators could provide clarity to situations usually put before the courts to decide on the basis of facts, previous dicta and the binary structure of agency i.e. who is acting for whom?

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Chapter 1: Introduction

i) Overview

This dissertation is a critical analysis of the law as it relates to the conflicts of interest which face insurance intermediaries trading in London's wholesale insurance market. The market comprises of participants who seek to either transfer or accept risks through contracts in exchange for remuneration known as premiums. The functioning of the market is dependent on intermediaries, who act for different principals within the same transaction - being remunerated by both for separate but interrelated services. This complex web of services has developed over centuries of trading, and is today a market with annual turnover in excess of $100 Billion. It is likely that any major natural or man-made catastrophe of significant scale, wherever in the world, will include an element of insurance or reinsurance that was underwritten in London, and placed by an intermediary.

Although referred to as the 'marketplace' it is not a common platform or system, as, say, a regulated stock exchange might appear to be. Indeed, the insurance market (like foreign exchange) is semi-virtual in that it consists of many participants who compete in common with each other, but together form a group whose commercial objectives are economically aligned. 'It' as a market exists as a complex web of bi-lateral agreements or contracts that are bound together on a single 'slip' that the intermediary or broker will present to the market in the hope it accepts all or a portion of the risk in exchange for premium. Indeed, those willing to accept economic exposure to risks are themselves represented by agents and specialists, meaning that the underlying parties - transferor and acceptor of risk - will never meet. This process of presenting a risk to those willing to accept a potential liability, in exchange for premium, is often layered - participants subscribe for an element of exposure, following the terms set by a specialist underwriter. The specialist underwriter will act as a 'leader,' using their expert knowledge and experience to assess the probability of risk and the necessary reward or remuneration for accepting the potential liability. What are known as the 'following' underwriters effectively defer much of the technical and administrative burdens of the contract to the leader. The physical absence of those who transfer and accept risk is contrasted by the less arms-length nature of the participants who do the broking and accepting of risk for their clients in face-to-face transactions.

The process of transferring risk is crucial to commerce and society more generally and has therefore become a matter of social policy, which legislators have sought to influence in a variety of ways. Initially this came about because contracts of insurance and wagers were superficially similar. The primary difference between the two, that was established in law, is that someone seeking insurance must have an interest in that property which suffers the unforeseen event or peril; i.e. they cannot simply hope to benefit without first having some form of interest that may sustain or suffer some kind of loss or damage.

Following this, the next series of legislative changes related specifically to insurance of certain perils like fire, and then the formalisation through legislation of marine insurance, which was developed to support the growing mercantile trade of the eighteenth century. The movement towards codification through detailed legislative acts sought to ensure that insurers could not avoid a claim by placing fault upon the broker or the insured. To an extent the most recent legislative changes have not altered their legislative intent in that law makers have sought to limit the grounds for avoidance of claims by insurers, often decided by the courts, by narrowing the permissible set of circumstances where such a contract never existed *ab initio*. These legislative changes have not sought to alter the standing of intermediaries (despite their having a significant and intertwined role in the insurance value chain) and has not created or amended agency law - other than those already extant in regulatory law and through market custom and practices.

ii) The core question

It is suggested that (i) the importance of agency law to the legislative framework governing the operation of intermediaries (and their conflicts of interest); (ii) the courts' resolution of major insurance claims, where fault must be established on the part of the intermediary; (iii) the wider issue of insurance as the key basis for economic relationships; (iv) the stability of society protected from perils such as fire, weather and other natural disasters; and (iv) as an economic activity in its own right, require a standard of skill, care and diligence that is very likely to be greater than the duties and responding ability of agents to alter the property or contracts of their principals.

The core question can be defined and explained further through the description of when a dispute may occur and how it may be remedied in the courts. For example, in the event of a dispute, 'fault' on the part of the intermediary may be established with reference to the usual expectations of market practices and the tort of negligence, whose corollary is to act with skill and care (in addition to contract law i.e. terms of engagement).

However, it is possible to act for multiple parties in the same transaction and be remunerated by them all simultaneously - provided they all consent to such an arrangement. From an existential perspective, this would appear to be inconsistent if the intention of the law is to prevent such a situation occurring, or to at least as a matter of social policy to recognise a distinction between the differing roles and corresponding duties of principals and their agents. This confused situation is made worse because the number of intermediaries in the chain of the transaction may extend to sometimes a dozen, thereby making the simple question ‘who is acting for whom?’ awkward to answer and, therefore, the assigning of fault and corresponding liability and restitution even more so.

iii) Hypothesis

The hypothesis is that the law of agency developed to address trading relationships (whilst agents of those seeking insurance actually offer services akin to professional advisers), but whose commercial ‘norms’ are based on trading rather than ethical duties to those who wish to transfer risk from themselves to another party. Fundamentally it is a service of advice about how to transfer risk based on knowledge and expertise of the (re)insurance market, which is exercised by a person who is regulated and is required to act with reasonable skill and care. However, the expectations placed upon an insurance broker go wider than simply giving good advice to their client: they also act to fulfil a transaction; can negotiate for insurers, and accept risk of costs for both their client and the insurers with whom they place insurance. They are both a factor (or mercantile agent), as well as being an adviser, and brokers are also in some respects the extension of an insurer who grants risk transfer to the broker against certain liabilities in the event of the broker's own insolvency.

This mixture of 'pure' advisory duties, to which clear and fair tests of acting with good faith and contractual duties of reasonable skill, care and diligence, like any professional who is competent and admitted to a profession, when contrasted with an intermediary who extends credit to their clients on the basis that they are indemnified by the insurers from whom their clients purchase (re)insurance, whilst also acting to fulfil the placement and claims-handling of the market place, creates a mixture of roles for the broker, who must do all this work in return for a commission that their client is aware of, but is actually paid by the counter-party to the contract i.e. the insurer (who may also pay further revenues on top that relate to the amount of profitable business the broker produces for the insurer). At a transactional level, there is hardly a clear distinction between market participants to which an absolute test of professional service may be applied. Indeed, the UK's Financial Conduct Authority (FCA) has recently gone further to consider the relationship between insurance brokers, their clients and insurers at the level of the business model, and has concluded that the "models may not demonstrate sufficient controls to manage conflicts of interest."[1] It is not unreasonable to suggest that law makers face the same challenge, and have (in the case of the Financial Services Authority or 'FSA'), reduced the application of agency law to insurance brokers by

[1] FCA Thematic Report publication TR 14/6

removing the need to inform retail clients[2] of their to request information regarding how their insurance intermediary is paid.[3]

[2] FCA rules Insurance Conduct of Business Sourcebook (ICOBS) is silent on the matter

[3] Policy Statement PS 07/24 *Insurance selling and administration: Feedback on CP07/11 and final rules* (2007).

Chapter 2: The wholesale insurance market

In order to explain the role played by intermediaries, it is first necessary to explain the nature of the wholesale market, which owes its development and current form to a number of legislative acts, as well as how the insurance industry has evolved to reflect economic and social trends in the twentieth and twenty-first centuries.

Before explaining the individual components of the market, it is important to understand that the physical location is centred around Lime Street in the City of London, whilst the nature of the perils being insured are global in nature, and may from a tax and accounting point of view be recognised in other jurisdictions. However, it is in almost all cases true to say that disputes are settled according to the law of England and Wales wherever possible, and hence why the law and regulatory rules of the United Kingdom are relevant to discussing a market whose clients are mostly resident outside of the UK.

i) The Society and Corporation of Lloyd's

The Society and Corporation of Lloyd's was created by Act of Parliament, and is treated for the purposes of UK and European Union regulation as if it were an 'insurance undertaking,' a *de facto* provider of contracts of insurance, like a large composite insurance company, the likes of which are found in both the UK and elsewhere. However, this may be regarded as an act of social policy to give a market place a corporate form, in order to impose regulation on a group of persons and their agents involved in the transfer of risks in exchange for payment.

In practice the Society and Corporation of Lloyd's is overseen by its Council, which represents both the market participants (known as 'managing agents') and the persons who provide capital to the market. Unlike a private or public company limited by guarantee, the Society has no shareholders, trustees or partners; its capital providers are simply known as 'members,' and their interest is akin to an annual venture. Until recently, it was possible for private individuals to enter into unlimited personal liability by pledging assets as collateral to meet claims as they became due, the net returns from each year of account being distributed to members according to their stake. This practice continues, although no private individuals or 'names' have been admitted since 1992, with approximately ninety percent of capital now being provided by corporations.[4]

The activity of the Lloyd's market takes place in 'the room' a physical space where managing agents rent desk space (known as a 'box') at which intermediaries physically present contracts of insurance for negotiation. This is also where amendments to live contracts and the notification of losses occurs. Above each box is a branded sign giving the name of the managing agent, who underwrites on behalf of names who join together in syndicates for the purpose of administrative and economic scale.

[4] Lloyd's Annual Report 2015

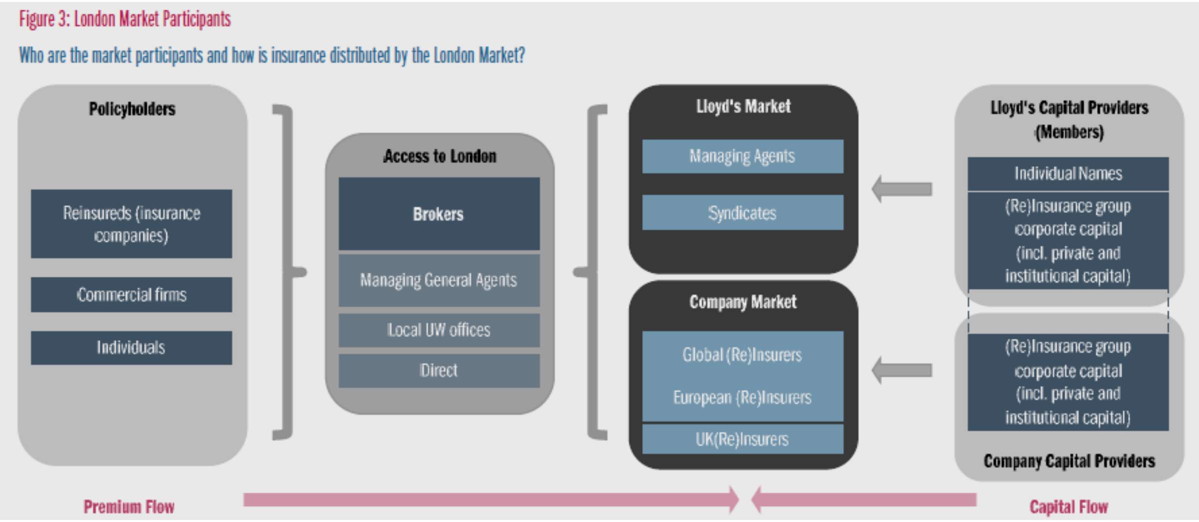
The Council of Lloyd's is required by statute to oversee the business of the Society and the market place, and has functions such as: setting strategy; reporting; business planning; maintaining a central fund (as a last resort for the solvency of the market); rule-setting, and enforcement powers, as well as the provision of the operations required for the market to function. Following the introduction of regulation in 1986, and various initiatives since to consolidate the role into a single and / or small number of oversight bodies, the Society and its Council has in effect been an insurer on behalf of a market with self-regulating powers.

ii) Subscription market

In practice the size and scale of the risks underwritten in the wholesale market are often simply too large for any one insurer to bear, and therefore the market operates on a subscription basis where a lead underwriter will set terms and conditions, which other underwriters agree to follow. This may vary from small to large exposures known as 'lines,' expressed as percentages of the insurance cover provided, an administrative process that is facilitated and fulfilled by intermediaries, who act on behalf of the party that is seeking to become insured. It is customary that the intermediary will create the contractual documentation and provide copies to the insured person, who usually will have appointed an agent in their own jurisdiction - who instructs the broker acting within the wholesale market where the risk is presented.

The web of duties and responsibilities is complicated due to the nature of the services being provided (at various points in the process – especially where situations arise such as a claim – or in the event of a dispute following a claim being refused). The web of duties is not clearly segregated between principal and agent, as agency law envisages, and requires a level of explanation and transparency given that the work of placing the risk is paid for in commission from the underwriter to the intermediaries known as 'brokers.'

A typical 'chain' of intermediaries, the insured and the underwriter may appear, as follows[5]:



The activity of business flowing from a region into London may include as many as a dozen agents whose roles and duties are to their principals, making the end insured a somewhat distant party to a transaction that may be a material issue in the unfortunate event that they suffer a major loss, such as a ship or oil rig sinking, or a major city being destroyed by an earthquake.

[5] London Matters: The competitive position of the London insurance market (London, 2014). JOINT STUDY OF THE LONDON MARKET GROUP (LMG) AND THE BOSTON CONSULTING GROUP. http://www.lmalloyds.com/lma/market_processes/London_Matters.aspx

The result of the market operating as members (whose interests are represented by their agents - who advise on which syndicates to join), and the syndicates in turn being run by a managing agents who acts as underwriters (who effectively subscribe to particular contracts) is that many parties receive information, and must act for their own principal in the chain. This creates explicit and implied agency relationships, which can also lead to knowledge being imputed in some circumstances. There are also situations where the broker may act for the parties wishing to insure against a peril, as well as insurers wishing to re-insure their own exposures, known as cedents – a secondary market to the primary market of those who provide insurance.

Those who broker and underwrite risks within Lloyd's are subject to bye laws created by the Council of Lloyd's and are admitted to the market on the basis that they provide capital to a central fund, as well as additional margins known as 'funds at Lloyd's,' for the day-to-day purpose of solvency. There is also a business planning process conducted each year whereby syndicates must present, and have approved, a plan for the activities they intend to undertake in the year ahead. In addition to this central process of solvency monitoring the syndicates, through their managing agents, may go into a process known as 'run off' where they cease to accept new risks and simply pay claims as and when they fall due, the underlying members having gone through a process called 'reinsuring to close' whereby their contractual liabilities are transferred to a third-party in exchange for a premium. However, whilst managing agents at Lloyd's must adhere to the bye laws, there is no longer a requirement that only admitted brokers may place business at Lloyd's and there is no prohibition on the subscribers to particular ‘lines’ being solely from within Lloyd’s. In the streets situated around Lime Street there are also insurance companies, who also participate in the process, known as the ‘company market.’

iii) Company market

To illustrate the scale of the company market, in 2014 some $100 Billion of insurance premiums were underwritten in London, of which $65 Billion was written at Lloyd’s, and the remainder was either as primary insurance, or reinsurance, underwritten by the company market. There is no aggregate total for the potential gross exposure that was accepted in exchange for the total gross premiums, but it would likely run into the USD Trillions if all the contractual liabilities were to crystallise to their full extent simultaneously. It is for this reason that wholesale insurance (written either by managing agents at Lloyd’s, or their equivalent competitors on behalf of insurance companies) is carefully monitored and regulated by the Prudential Regulatory Authority (PRA), an agency of the Bank of England.

To slightly confuse the distinction further, it is perfectly possible for risks that are underwritten at Lloyd’s, or within the company market, to be reinsured back to other Lloyd’s entities, the company market or overseas reinsurers. Some of that business may also be placed into facilities operated by brokers on behalf of insurers, meaning that in some cases elements of the exposure may be borne entirely by parties whose headquarters are in for example Bermuda, New York or Dublin.

The operation of a marketplace based on syndication, subscription and managing ultimate exposures in return for remuneration is clearly complex and competitive, but is also highly attractive to those seeking to diversify financial risks and rewards following the tenets of portfolio theory. From an economic perspective this creates opportunities to participate in the value chain at many different stages, and to offer services and advice that ranges from underwriting risks based on engineering plant, through to managing exposures to perils on a global basis, and searching out capital providers willing to accept liabilities in the hope of returns often far greater than established nations' economies.

From the perspective of the law, the relatively simple notions of agency, that are derived from mercantile activity, is that where other duties and earnings exist, they must be disclosed and the client's consent obtained.

iv) Role of insurance intermediaries

Insurance brokers or intermediaries have a key role in the functioning of the London wholesale insurance market, both from an economic as well as administrative perspective. Indeed, the full gambit of their responsibilities is both within and outside the regulatory perimeter around the insurance industry, given the breadth of the role they can play in large transactions.

The wholesale brokers will typically handle orders either from those seeking to be insured through a direct relationship or through another intermediary; this can include surveying the property to be insured, discussing what types of insurance meet the economic needs of their client, and what structure that programme may take, which can include forms of co-insurance where the client (a corporation) may create their own ‘captive’ insurance company that retains an element of risk exposure and meaning that the corporation’s balance sheet provides some of the insurance capacity or capital. Once a structure and programme has been designed, intermediaries will approach markets for indications of interest, and may go through several rounds of negation prior to creating a contract or ‘slip’ which is presented to underwriters. This negotiation is typically done face-to-face, and for Lloyd’s underwriters must be concluded ‘in the room’ – as mentioned previously a physical place where underwriters sit at desks within the Lloyd’s building.

Depending on the size and scale of the risks to be insured, there may also be re-insurance placed on behalf of the underwriters, whose limits of capacity are set by the business planning process overseen by Lloyd’s, or in the case of stand-alone company market participants by their Risk Committee under authority from the Board of directors. Again, depending on the nature and scale, the risk may be re-insured again, known as retrocession, to further spread the potential exposure, and ultimately to provide the insured person with the best possible combination of economic price and risk-transfer that meets their appetite for exposure to risk. For specific geographies where hurricane and earth quake is common, there may be a State programme, which is then re-insured by London and other wholesale markets around the world with sufficient capacity, and some countries maintain protectionist regimes that require insurance to be written locally, and then ‘fronted’ to overseas markets.

Once a programme has been agreed and the underwriters are on risk, the intermediary is responsible for ensuring all the necessary contractual documentation is in place, retained on file, and copied to their client for their records. As the nature of exposure may change (for instance whether or not an oil well is being actively drilled), this may mean multiple amendments throughout the lifetime of the contact, and the payment of premium may be phased to reflect both the nature of the changes and the economic realities of an insured's cash flow. Intermediaries will also handle the book keeping for such large and complex transactions, which may be in several currencies and include complex tax computations, creating the need for large middle and back office functions to process transactions and agree statements with multiple counter-parties.

In the unfortunate event of a claim, the intermediary acting on behalf of the insured must notify the relevant insurers of their potential or actual receipt of a claim, and often becomes involved in advocacy of the claim to the market in the event there are technical or contentious issues. The broker will also typically receive the claims payments and remit these to the client, on behalf of the insurers, and will have to pass their placement files to the insured's legal advisers in the event that there is a dispute put before the courts.

As well as acting as an administrator of the contract of insurance, the intermediary may offer the insured other associated services such as risk management consultancy, health and safety related services and also act for the insured in respect of other insurances they hold either as a corporation or where they provide accident and health benefits to employees. This can move into other spheres, such as management of longevity risk associated with Defined Benefit pension schemes, and other forms of actuarial and human consulting services. The largest intermediaries are structured like professional services firms with practices devoted to specific disciplines.

Intermediaries typically perform a number of roles, which are: potentially in conflict with their duties as agent of their principal; problematic when applying the law of agency, and conflict with regulatory law that requires intermediaries to act fairly and disclose any potential conflicts of interest. As a matter of social policy, in 1982, the UK government enacted legislation to separate the ownership of underwriters and brokers in order to legislate against conflicts of interest at an institutional level.

Notwithstanding the legislative attempts to separate the interest of brokers and insurers, there are legal disputes in the courts centring on individuals restrictive covenants within contracts of employment.

Chapter 3: The law of agency

i) Types of agent – broker, factor and tied

The notion of an agent being able to affect the property or legal standing of their principal, who indemnifies the agent from personal liability with contracting parties, is a long-established relationship that was developed for trading and mercantile purposes. These trading relationships were adversarial dealings that were conducted at arm's length by parties, who traded using a set of existing customs and normative standards.

There exist different types of agents who are responsible for different transactions in different ways, and although this thesis fundamentally focuses on the role of insurance brokers, the types are worthy of consideration because they explain some of the main differences between a trading and a professional services relationship.

Agents can gain their authority with or without their principal's knowledge or consent, and can exercise different levels of authority depending on particular circumstances, meaning that they may hold limited or wide authority to act and for short or long periods of time, with a varying degree of expectations placed upon them by their principal. The expectation of their services is largely dependent (apart from when it is expressly specified) by the general customs and practices of the market in which they operate.

A further key aspect of agents is not just their own authority to act, and the expectations of their principal, but also what authority those who trade with them may assume that the agent holds and to what extent they may assume that their contract is with an agent, or is in fact with his principal. Although it is based on social values that have now disappeared, a similar conundrum existed for 'masters' and 'servants,' where a servant was an extension of their master's wishes. You will see from this that the basis of agency law is mercantile and has developed historically as trading customs have evolved. A key part of that development was the evolution of trade by sea. Due to the risks, and the need for owners to delegate authority to the ship's captain, there developed both insurance and admiralty law which covered situations of both trading and insurance to indemnify ship owners if the vessel and its cargo were lost.

ii) Duties of fiduciary and fidelity

Although agency is a widely accepted and understood concept, it is usually defined with reference to an American publication *The Restatement of the Law of Agency*[6]. Agency is usually described in terms of being a fiduciary relationship that affects the rights of third parties with the principal, because the agent has authority to do so. These characteristics can be seen as external (i.e. effecting third parties), and internal in that they create a fiduciary obligation between the agent and principal. Generally, however, agents must act with due

[6] Fridman (1996) p.12

skill and care, and receive a commission for their services as opposed to making a profit themselves.

Agency law creates vicarious liability for principals who are subject to tortious liability for the acts of their agents, although the distinction between an agent and a servant is relevant: an agent acts with skill and care, whereas a servant is obedient, and hence may create a liability for their master, which could be avoided if an agent acted in bad faith. The agent's acts are those of the principal.[7]

There is also a special class of agent, called a *del credere* agent, who in return for a special commission, undertakes to act as surety to the principal for the principal's performance of the contract. In turn, the principal cannot litigate with their *del credere* agent for contracts made on his behalf by their agent.

There is also a reverse of this situation, sometimes referred to as a factor or commission agent, whose principal may be undisclosed to the third party dealing with him and whose liability to that party may be more challenging to establish under a common law system.

As can be seen from the above, there is a wide variety of agency relationships which are characterised by some significant distinguishing characteristics. First, the degree to which the agent is a 'route' or legal passageway to the principal in the event that a third party wishes to bring a claim. Second, the extent to which the agent is indemnified for his acts by his

[7] Holt CJ in Boston v Sandford (1690) 2 Salk 440.

principal, and how far the indemnity extends in civil law. Third, the converse to a wide privilege is (in return) what duties the agent owes to his principal as a result of this privilege, including the obligation not to make secret profits, or to trade on their own account. The role played by insurance brokers in London covers all of the three key elements above, which represents a challenge for anyone wishing to analyse the law of agency in that market, because regulatory law also refers to obeying the law of agency. In effect this means that regulation has gone from being specific to referring back to a general position, which is itself a derivation of the law of equity.

iii) Implied or explicit agency

The creation of agency can be overt, i.e. through contract, but may also be implied through custom and practice of a market place; may be ratified or conferred retrospectively by a principal for acts done on his behalf; and, under the doctrine of apparent authority, a person may become liable or estopped from denying agency. This legal framework relates in much of its construction, to preventing parties from abandoning their relationship in the event of a dispute, and is framed in terms of negatives (such as to avoid secret profits) as much as it is in positives (such as to act with skill and care). There are also a plethora of points to consider when assessing the creation of agency, especially given that it may be ratified post event, and may as a legal relationship be implied rather than explicitly created.

iv) Context of insurance brokers

The issue for insurance brokers in the wholesale market is that they do not act on their own behalf, but are the agent of their principal. In the event of a dispute, this governs how the principal may bring action for their agent's negligence, but also how a third-party may impute that the principal's knowledge and acceptance of a particular matter based on what the agent has done. As agents, brokers are subject to fiduciary duty, which is generally held to mean that they must act in the interests of the principal, and must avoid conflicts of interest, which, if unavoidable must be accepted and agreed by the principal. The issue of agency becomes very relevant where insurers may seek to avoid a claim on the basis of a material fact not being disclosed, or that a breach of warranty has occurred meaning the contract may be avoided as if it never existed.

Where a claim is disputed there may be arguments put before the courts that the intermediary failed to either ask the right question, or made an error when creating the proposal to underwriters. In such a circumstance the intermediary may have to put the insured into the position they would have been had they not made the mistake; but such restitution would still have to be equitable so that a peril that would not have been insured by a prudent person cannot afterwards be made insurable by a decision of the courts. There is extensive case law which turns on the general principles of agency and generally these actions have been brought as a result of a claim being disputed or rejected by the insurer. This is particularly so when claims are brought by third-parties (rather than the insured) because it is normally held that the insured subrogates their right to dispute a third-party's claim against them if it covered by a contract of insurance. Where an insured is aggrieved to find they are not insured they will clearly be even more so on discovery that there were multiple agents and principals, each receiving commission, the identities and earnings of whom may have been a mystery up until the point of a dispute.

In addition to the commissions paid by insurers to the intermediary, there will also be interest earned on the client's money, which the broker retains, and there may be opportunities for currency swaps between offices if the broker has an international network of offices, thereby avoiding foreign exchange costs. These margin benefits can also be increased where insurers pay intermediaries commissions based on profit across a portfolio, or where other similar benefits (such as marketing costs, work-transfer payments, claims-handling authority to name a few) are paid by the insurer to the broker. Typically the insurer will also grant an indemnity to the intermediary, the effect of which is that once a client has remitted the premium it is guaranteed by the insurer, in the event of the intermediary's insolvency, irrespective of whether the insurer has received the money themselves – known as risk transfer agreements. In some cases, the intermediary may be wholly or partially owned by an insurance company, a distinction no longer prohibited by the bye laws set by the Council of Lloyd's. In many cases the insurers will delegate authority for underwriting and claims-handling to intermediaries, known as delegated authority or coverholders. The final limb is an intermediary may appoint another intermediary as their 'Appointed Representative' thus making that party their agent who may trade using the principal's regulatory licences.

It therefore is held that the capital base of insurers may be very great (to meet the very large potential losses that could occur), whilst the human cost base associated with such a long and complex value chain resides in the hands of intermediaries, without which the market could not function and settle its liabilities to the insured as they fall due. This economic, administrative and legal 'living in each other's pockets' inevitably creates multiple conflicts of interest which the general law, regulatory law and various initiatives from either the European Union or Parliament have sought to address by either focusing on the payment of claims (and circumstances where repudiation may occur), or by specifically separating the ownership of intermediaries and underwriters, in an effort to ensure that the market functions in a way that is appropriate. Legislators and regulators have not sought to go as far as to change how intermediaries are remunerated, but instead have sought to promote transparency for customers so that they at least know how the service they receive is paid for and what other remuneration their agent may receive from the third-party providing the contract of insurance. It is not clear what if any changes increased transparency will have on the formation of price, but, the general need to act in the clients' best interests may come under greater pressure (in the event that the United Kingdom exits the European Union and the relevant directives governing insurance intermediaries are withdrawn, effectively rewinding the law to pre-2000, when Lloyd's brokers were regulated, but those outside that system were subject to self-regulation via voluntary codes of practice). This would leave the law of agency, the more prescriptive regulatory law and the more recent consumer and commercial insurance acts to govern the nature of conflicts of interest within the wholesale insurance market in London.

Chapter 4: Regulatory law

The present situation of regulatory law that applies to intermediaries that operate in the wholesale London market has emerged through two different initiatives, one that originated in Parliament and the second which came about as a result of the European Union directives relating to insurance intermediation.

Prior to 1977 there was no form of formal regulation of insurance brokers other than whatever bye laws were created and repealed by the Council of Lloyd's. The Insurance Brokers Registration Act (1977) was superseded by the Lloyd's Act (1982) that was untouched by the Financial Services Act (1986), itself then subsumed into the Financial Services and Markets Act (2000), which came about because of pensions and endowment mortgage mis-selling in the later decades of the last century.

Through all of these legislative instruments the intention was that insurance brokers should continue to be self-regulating under a general code that set certain basic norms of behaviour and service. Indeed, this remained the intention of H.M. Treasury until the European Union announced a directive to harmonise the intermediation of insurance across the common market as part of its wider plan to increase cross-border financial services trading activity. The Financial Services Action Plan announced in 1998 was intended to harmonise and open up access to markets across European Union member states and was the precursor to a number of directives designed to promote this broad aim. It was also subsequently enlarged to include actions to prevent the financial system from being used to launder money, and other forms of financial crime.

The result was that whilst only those admitted as a broker by the Society and Corporation of Lloyd's could negotiate and present risks to underwriters in the 'room' at Lloyd's, who themselves were only permitted to deal with Lloyd's brokers, the wider population of insurance brokers were subject to self-regulation through codes issued by trade bodies. This split was swept away by the Insurance Mediation Directive, in response to which H.M. Treasury announced that all insurance brokers would be regulated by the FSA and that prudential and conduct of business rules would be created specifically for the sector.

The regulatory law introduced in 2005 by the FSA sought to impose 11 principles for businesses to follow, as well as more detailed conduct of business rules and minimum capital and solvency thresholds depending on whether the intermediary held money on behalf of clients. There was also a separate and detailed set of rules for agents holding money on behalf of their principals, depending on whether they were insurance companies or clients purchasing insurance.

The regulatory law introduced in 2005 was subsequently reviewed, simplified (and in keeping with the intention of the time to move towards principles-based regulation) made shorter, leaving more to the judgement of individual firms as to how they should best comply with them. Those rules remain unchanged to the present and are briefly summarised below in order for the reader to appreciate the impact of the regulatory law on those already required to follow the law of agency when acting in the wholesale insurance market.

The current regulatory law requires intermediaries to identify conflicts of interest and to manage such conflicts fairly, acting in the best interests of the customer, but does not specify if, or how, any disclosure and consent on the part of the principal, may take place. The detailed rules governing the production of documentation are waived for the large and complex risks typically underwritten in the wholesale market, but do make some specific provisions for classes of business where the client is acting in their personal capacity, and access to the Financial Ombudsman is mandatory where a dispute or complaint cannot be settled within a specified period of time. There are also detailed rules covering matters like when a contract is concluded by the telephone, and grants the insured a 14 day period in which they may cancel their insurance.

The holding of money as agent on behalf of the principal is generally understood but in the case of the regulatory law for handling such monies, there is a distinction between monies held on behalf of insurers (regarding which the rules are silent), and monies held on behalf of 'clients' seeking to acquire insurance. This distinction is important because monies belonging to clients must be held in a segregated trust account and reconciled with the intermediary's own books every 28 days on a gross basis. There must also be a periodic reconciliation to identify all balances held on behalf of specific clients (as opposed to a gross removal of brokerage from the money held on behalf of clients every 28 days), so fiduciary assets can be quickly identified. The regulatory law also includes a provision for insurance companies to indemnify intermediaries from their liabilities to clients in respect of monies they hold as agent of those clients. This is known as a ‘risk transfer agreement,’ meaning that the intermediary whose duty as agent is to the insured is also paid and indemnified by the insurer.

Although the regulatory rules make reference to meeting agency law obligations, there is no requirement to disclose to retail clients that they have a right to request information regarding the remuneration received by the intermediary from the insurer. The rules go further, and state that clients who are commercial (acting in a capacity other than their own personal benefit) must advised that they have a right to request such details of commission as can reasonably be given. There is no specific rule that requires clear and transparent disclosure of the quantum and or basis for commission, or other remuneration, to be given to the insured and the rules go on to prohibit the giving of inducements.

By bringing insurance intermediaries into the wider regulatory scope of the Financial Services and Markets Act (‘FSMA’), a further limb of agency was created, in that it is permissible for agents to be considered exempt from regulation. Within FSMA there is a general prohibition on conducting regulated activities in respect of specific investments (which includes general insurance) without either holding authorisation, or enjoying an exemption. The exemption is extended to Governments, local authorities and certain professions, which may incidentally conduct a regulated activity (such as accountants, solicitors and surveyors). However, the exemption also extends to Appointed Representatives – a category created by FSMA and which infers the duties of Principal over an Agent for whom the Principal is wholly responsible. In order to create the duties, regulatory law requires a minimum level of contractual wording between the Principal and their Appointed Representative and there are further requirements relating to the Principal's oversight and control of the Appointed Representative. However, there is no limit on the number of Appointed Representatives a Principal may have, and likewise the extension of agency is not limited to a single Principal. In other words, an agent may have multiple Principals, there being no duty of fidelity to the Principal owed by the Appointed Representative. In total there are 190 principals operating as networks to over 6,000 Appointed Representatives.[8]

The other important change which the introduction of regulation through the Insurance Mediation Directive was to apply 'equivalence' status to other European Union regulatory regimes. As a result, it is permissible for an intermediary to create a branch or subsidiary in another member state without first seeking the authorisation of the local regulator to do so. This is because the branch is effectively a branch or subsidiary of the entity in another member state, and is considered to be an extension of that person i.e. whilst not explicitly an agency relationship there is nonetheless a right to change the property or contractual obligations of oneself in another country which is considered legitimate and represents a form of quasi agency relationship when dealing with a third-party.

[8] FCA Thematic Review TR 16/6 *Principals and their appointed representatives in the general insurance sector.*

Chapter 5: Challenges created by conflicts of interest

i) Who acts for whom?

The analogy often used to describe relationships where fiduciary duty is owed by an agent to multiple principals is 'changing hats' whereby the agent may, in various different stages of the value chain, be wearing a different 'hat' or acting for a different principal, depending on their role. This situation is based on the fundamental question of who is acting for whom and is one that has formed the basis of many judicial decisions when put before the courts.

Properly speaking, the agent should when first appointed identify any potential conflicts of interest, and following proper steps, must either avoid the conflict by declining the appointment or seek the explicit consent of the principal by disclosing the conflict of interest. However, the duties of an agent can be created with or without the existence of an agency agreement (because agency can exist explicitly or implicitly) – hence why identifying an agency relationship is key in a dispute – because agency law states a fiduciary duty is owed and must be obeyed at all times by the agent to their principal.

There are a number of ways to establish the answer to the issue of establishing whether or not a duty exists and between whom. First, there is a strictly contractual analysis based on agreements between parties, which, in the context of insurance intermediaries, is very likely to be drafted in such a way that they seek by all means possible to limit duties and obligations wherever possible and to strongly avoid any rights of third parties to bring claims against them as broker. However, the manner of drafting can actually become a cause of duty if the documents remain silent on matters such as commission – as we will discuss later in the *Plevin*[9] case. In other words, it is not possible to avoid fiduciary duty by enjoying the rights of being an agent whilst at the same time denying all of the respondent duties to the principal.

The other manner by which the question may be answered is to apply the paradigm of agency law to a particular set of circumstances, and through which it may be established that party 'A' is the Principal and party 'B' is said to be the Agent et cetera. Where no contract exists, the law of agency allows for such a relationship to be implied and / or ratified after creation to crystallise such a bond. The nature of the relationship would need to be considered in the context of the trade or operation being undertaken, whether there was consideration (and where it went) and what the norms and expectations of a particular market place were at the time.

If applying either a contractual or agency lens to a particular situation, the role of expert witnesses can often be important, especially when there are imputed knowledge, or agency issues (where knowledge of specific information is said to have been imputed from agent to principal), because this may come down to a judgement as to what could have reasonably been expected for a prudent insurer to know at the time that they accepted a risk[10]. It has been held by the courts that knowledge can be held as agent of the principal, and that it is reasonable to say that the principal was aware irrespective of whether or not the agent had in fact passed the information on.

[9] Plevin v Paragon Finance Ltd [2015] 1 All ER (Comm) 1007
[10] Ground Gilbey Ltd v JLT UK Ltd [2011] EWHC 124

ii) Fiduciary duty

The privilege of being able to alter the property or contractual position of another gives an agent unique powers, and also protections, in that they are not incurring cost or contractual obligations in their own right, rather doing so on behalf of another party. This unique power and protection is a form of privilege and the corollary to it, in terms of the tort of equity, is to owe a fiduciary duty to the principal. There is no statutory definition of fiduciary duty, but, it is generally held to be based on trust, being similar to the duties undertaken by directors and officers of companies limited by guarantee or partnerships. The judiciary has also applied principals of agency law to reach the same end – a means by which that qualitative and ethical duty may be expressed.

The Companies Act 2006[11] defines the duties of directors, replacing the previous common law definition, as seven general duties to act in good faith for the benefit of the company's members when making decisions by having due regard to: promoting success of the company; long-term consequences of decisions and actions; interests of employees; relationships with suppliers, customers and others; impact on the community and environment; reputation for high standards of business conduct; and, acting fairly between members of the company.

[11] Companies Act (2006) Part 10, Chapter 2, Section 172

In defining the fiduciary duty, reference is made first to avoid conflicts of interest and not to profit to the detriment of the principal's activity, but also generally goes further into the tort of equity, and is generally seen as a duty to act with loyalty or fidelity. This is further defined as a duty not to make a secret profit. The most practical way to avoid breaching that duty (as required in law) is to seek the informed consent of the principal. The bye laws created by the Council of Lloyd's make reference to agency law, and in particular seek to control any particular trends such as a managing agents that underwrite on behalf of syndicates being able to own an intermediary, and that there are limits on the amount of business which any managing agent may accept from a particular broker of twenty percent of its total business book. However, this quantitative limit is not applied by the rules set by the FCA with regard to those insurers trading in the company market, where the general rules of agency obviously apply, but without the level of prescription found within the bye laws of Lloyd's.

It is also worth noting the difference between a trustee of say a pension fund, and the fiduciary duty as commonly held by an insurance intermediary, with regard to fiduciary assets. Trustees normally act with a duty of care with regards to property, and have a trust deed that establishes the nature and purpose of the trust with which the trustees must comply. Likewise, the trust (especially where they manage assets), may use the services of a third party to act as custodian of the assets, and where investment decisions require day-to-day oversight, a manager may be appointed whose decisions will be subject to an investment mandate that will outline the limits of their authority to manage the investment portfolio held by the trust.

In respect of insurance intermediaries, the largest of whom may hold several Billion US Dollars of cash on behalf of clients at any one time, they act in a fiduciary duty with regards to those monies, and must place them in a segregated trust account in compliance with detailed rules established by the regulatory law[12]. In the event of an administrator being appointed, the assets are held to be outside of the funds available to creditors, and are distributed to clients in accordance with the terms of the trust. In summary, it may be said that while prescription of the general duty is very high level, the detail of implementing fiduciary duty can be very detailed in specific circumstances – the intention of both regulatory and agency law being to clearly define certain aspects whilst leaving other matters open to interpretation.

iii) Dual agency

Perhaps the most significant area of interpretation and judgement that is left open to insurance intermediaries is when as an agent they enter into a relationship that conflicts with a duty owed to an existing principal. In the case of insurance intermediaries, they hold a number of agency relationships at any one time, and, as has already been discussed, these relationships extend to a number of different steps in the value chain whilst also being remunerated by commission paid by the insurer.

A simple diagram of the insurance value chain illustrates the duties that an intermediary may owe to both the parties seeking insurance, and those who provide insurance:

[12] FCA Client Assets Sourcebook (CASS) Chapter 5

<table>
<tr><th><u>Placement – negotiating insurance cover and price</u></th><th><u>Underwriting – analysing the proposal and offering terms</u></th><th><u>Changes – Adjustments following changes</u></th><th><u>Renewals – renewing the contract</u></th><th><u>Claims – Notifying of possible or actual loss</u></th><th><u>Reinsurance – transferring an element or all of the risk to a third-party</u></th></tr>
<tr><td>Agent of insured</td><td></td><td>Agent of insured</td><td>Agent of insured</td><td>Agent of insured</td><td rowspan="4">Agent of insurer seeking to reinsure either a single risk (known as facultative) or where a block of risks are transferred through a treaty or quota share arrangement.</td></tr>
<tr><td></td><td>Agent of insurer (if Coverholder[13])</td><td>Agent of insurer (if Coverholder)</td><td>Agent of insurer (if Coverholder)</td><td>Agent of insurer (if Coverholder)</td></tr>
<tr><td colspan="4">MONIES held as agent of the person seeking insurance but the agent is indemnified by the insurer in the event the monies are not received by the insurer.

Where monies held on behalf of clients are used to ‘fund’ premiums to the market or claims payments this is a debt of the broker they seek to recover as if it were a loan. In some cases premium credit is provided by a third-party and the intermediary receives an additional commission.

COMMISSION is paid by the insurer to the intermediary as a percentage of premium.</td><td>CLAIMS PAYMENTS can be made by the broker on behalf of the insurer.</td></tr>
<tr><td colspan="5">ADDITIONAL EARNINGS received by the intermediary based on:
• overall profitability from the insurer;
• contributions towards marketing and promotional costs from the insurer;
• transfer of work from the insurer; and,
• extra services provided to the insurer.

FROM THIRD PARTIES:
• for referrals to lawyers (via ‘alternative business models’) for legal claims; and,
• for providing credit via a premium credit provider.</td></tr>
</table>

[13] When an intermediary holds authority to act on behalf of an insurer this is either known as a ‘Coverholder’ or ‘Delegated Underwriting Authority’.

From the diagram above it can be seen that in the normal course of business wholesale intermediaries will at least have dual agency and may hold multiple agency relationships in relation to the same underlying risk being insured or reinsured.

The complex web of duties between multiple principals creates inherent conflicts of interest for intermediaries whose function within the wholesale market is integral to normal day to day trading activity. Indeed, without the work undertaken by brokers, the complex workings of the subscription market would most likely cease to function given that insurers (for the most part managing agents at Lloyd's) do not have the scale of economic or human capital required to individually assess and underwrite as a 'leader' each and every risk presented as a line slip in the subscription market placement process. (Indeed, were such a situation to occur, it is probable that the consolidation required would mean the largest players would emerge as so scaled-up they would begin to encroach on competition law as to the dominant position they would potentially hold in the market place). Putting aside monopoly theory, it is nevertheless evident that dual agency is not an accident of history, but in the context of a multi-layered risk transfer process a means by which economic capital is utilised across a range of portfolios to create diversity of exposure and limit overall aggregate exposure. These are matters which are fundamental to the nature of insurance, but on which agency law is silent, and is not meant by either the courts or government to address.

iv) Disclosure

It is widely held by commentators and the courts that disclosure by agents, and the explicit and informed consent of principals (where conflicts of interest exist), is required as a matter of law, which, taking into account the economic rationale explained above, suggests the inherent challenges faced by insurance intermediaries have and will remain so.

However, the exact nature of the disclosure and the extent of loyalty owed by agents to principals depends on the specific circumstances, and the relative expertise of the parties – in some cases an agent may simply act on instructions to place an order whereas in others they may become so deeply involved as to make themselves integral to the eventual position they effect on behalf of the principal, that they are likely to be the ‘mind’ and ‘fulfiller’ of their principal’s wishes. In such cases where, between the agent and their principal, there is such unequal skill and expertise of the activity undertaken then the courts have taken a view based on equity as much as the contract in play, and in some cases deciding that the contract was unfair.

In the case of intermediaries in the wholesale market, their principal will often be another intermediary, who understands the market place and nature of the insurances being sought – thus creating a level of balance in the expertise between principal and agent. What this does not necessarily address is the relative skill and expertise of the wholesale intermediary when compared to the end insured, whose actual knowledge and expertise of wholesale insurance is likely to be considerably less than a ‘peer-to-peer’ type of relationship. This is especially an issue where errors or omissions occur, because the persons creating the proposal may pass that information on to the wholesale broker that accepts such information in good faith, even though it could at a later date prove material to a dispute. The nature of the fiduciary obligations must therefore reflect the circumstances within which those obligations arise.

v) Remedies

The remedies available to principals (and vice versa as an agent may seek damages from their principal), come from a number of different sources. First, there is regulatory law which creates an independent Ombudsman, who depending on the scale and status of the complainant has powers to make awards. Second, there is the route to seek arbitration, as an alternative to costly and prolonged court actions. Third, there is remedy available through the law of contracts which will turn on the nature of the agreement, the relative standing of each party, and what was said and done, including the basis of the alleged failing or misdemeanour. Fourth, there are third-party rights in statute, which if the contract has not extinguished, may allow an avenue for remedy to be pursued. Fifth, there is the tort of equity, which allows third parties to bring action by establishing they are not bound by the doctrine of privity of contract, meaning they can sue an intermediary where their failings on behalf of the principal have had a direct impact on the third-party. The other limb to equity is where an agency contract may be unfair, and hence its terms may be overturned where appropriate, or perhaps where the intermediary has in fact been responsible for some kind of secret profit the proceeds of which they are deemed (generally speaking) to hold as trustee for the principal, and is therefore to be disgorged. This final duty to account for the principal's property and not to profit from it, is, in general terms held in agency law but is commonly reversed by intermediaries who will contract with their principal to retain any interest they earn on cash earned as fiduciary although they must as agent meet any charges levied by the banks on the segregated accounts where they hold their client’s money.

Perhaps the most significant remedy available to the principal is avoidance of a contract where the agent has failed to act with diligence and care, a matter which government has sought to address in recent legislation aimed at narrowing the circumstances where the insurer may disassociate themselves.

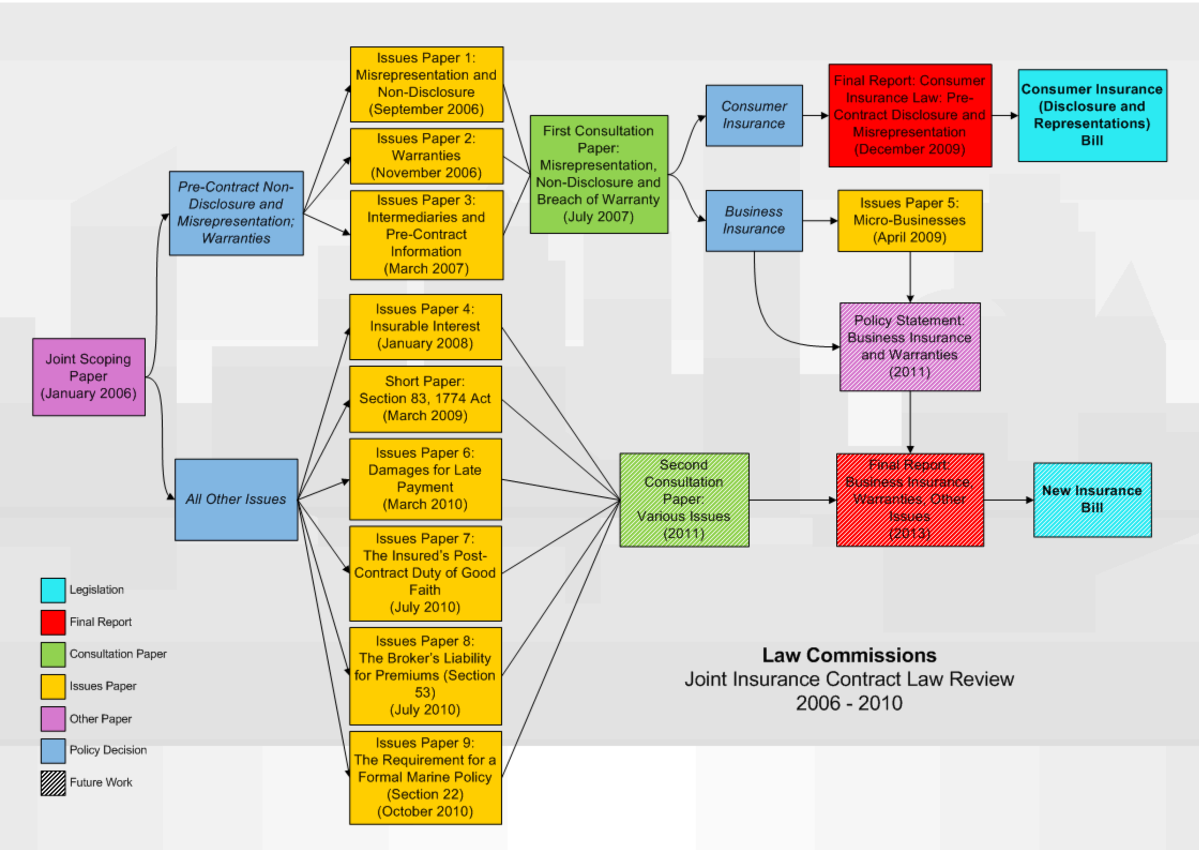
Chapter 6: Recent policy initiatives – to serve customers better?

This chapter offers a brief overview of the recent legislative changes to insurance law which have a direct bearing on intermediaries. This has been added to by a plethora of case law, following the mis-selling scandals which took place over the last quarter of a century – the most recent being the sale of insurance protecting customers from the default of their loan re-payments often under pressure and without assessing the usefulness of the insurance.

i) Law Commission review

The Law Commission of England and Wales undertook a review of insurance law which culminated in separate pieces of legislation aimed at narrowing the circumstances where a claim may be avoided. As a by-product it sought to address the nature of a broker's role in explaining the cover by modifying the doctrine of *uberrimae fidei*, or utmost good faith, to redress the balance of disclosure and enquiry owed by both parties to the contract of insurance. The Consumer Insurance (Disclosure and Representations) Act 2012 sought amongst other things to remove basis of contract clauses, and address the relatively strict position with regards to what a 'prudent insurer' would consider material to his judgement, which had been in place since the Marine Insurance Act 1906. The more complex changes required, to achieve similar aims for commercial and wholesale customers, were introduced in the Insurance Act 2015. Further legislative amendments to address other matters (such as the costs associated with late payment of claims), were subsequently addressed in the Enterprise Act 2016.

The law commission's project was very wide in scope, was jointly undertaken with the Scottish Law Commission, and took four years to complete its work, which is illustrated in the flowchart below[14]:



The objective was ultimately to rebuild trust in the insurance industry, which had developed a poor reputation with consumers, and was a matter of public policy to address insofar as the Cameron government sought wherever possible to encourage the voluntary and private sectors to provide social services like care and housing. Although primarily aimed at protecting retail customers from the *caveat emptor* approach of wholesale insurance markets

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[14] http://www.lawcom.gov.uk/wp-content/uploads/2015/03/ICL_project_flowchart.gif

that had been enshrined in law by the 1906 Act (and which had led to a confusing mix of case law, voluntary codes and regulatory law) the project included consideration of the needs of customers served by the wholesale markets too.

The impact of the changes was to introduce the limb that fair representation can be disclosure of sufficient information to notify a prudent insurer that they ought to carry out more analysis before accepting a risk. There is also a clarification as to what agency may be applied to knowledge, in that whilst information held by the insurer, or available in the public domain, is deemed ‘known’ there are other circumstances where an insured may have a junior member of staff, who is aware of a material issue, but has not reported it to senior management, it is not deemed as reasonable to have disclosed this unless it would have been revealed by a reasonable search. In the event that remedies are sought, the most significant change is to introduce a proportionate response, i.e. rather than avoiding the contract as if never existed, the terms or price may instead be amended from the outset of the contract so as to continue providing the benefit of insurance, but on terms that an underwriter would have written the risk as presented. The legislation is silent regarding conflicts of interest.

ii) European directives and UK regulation

Whereas the Law Commission project sought to address identified shortcomings in the extant legislative and case law, the introduction of a European Directive covering the intermediation of insurance transposed into regulatory law by the FSA, has not led to discernable clarity with regards to what may be expected of an intermediary acting as an agent of their principal. This may be the result of the reversal in approach to self-regulation following the proposal by the European Commission to issue the directive. Before offering a more detailed analysis of the extant European and UK regulatory law, it is necessary first to explain the current position, particularly as it relates to wholesale intermediaries.

The first European Directive covering insurance broking, called the Insurance Mediation Directive (IMD) was issued in 2002 and took effect in 2005. It was recast as the Insurance Disclosure Directive (IDD) with effect from 2018. The original directive sought to create a minimum level of harmonisation across multiple member state jurisdictions, and was mostly concerned with basic minima such as ensuring an officer was allocated responsibility for insurance intermediation, registration, complaints handling and information that must be provided to the customer, including the status of the intermediary. The wording of the directive is intended to require member states (within the scope of their own legal systems) to enact laws and processes to meet what could be described as a basic regulatory system to establish equivalent status between member states' regulatory frameworks. The directive when conjoined by freedom of services and trade directives, creates the right for intermediaries in one member state to either establish a presence, or on an inwards services basis, conduct insurance intermediation in other member states, who accept that intermediary's status as being equivalent to the regulatory status of intermediaries in the member state's own jurisdiction.

Importantly, during the implementation of IMD into UK regulatory law, no requirement to inform retail customers (natural persons acting on their own behalf) about the right to request disclosure of commission paid by the insurer to the intermediary was inserted. How exactly the re-cast directive which comes into effect in 2018 will be transposed into UK regulatory law remains to be seen, particularly following the referendum regarding Britain's membership of the EU in the middle of 2016.

iii) Lloyd's Acts

The various Acts relating to Lloyd's are the longest-standing legislation insurance law in Britain reflecting the continuous 325 years of trading by underwriters in and around the location of the coffee house run by Edward Lloyd. The initial intention of legislation was to differentiate gambling from insurance, following which there were acts to formalise fire and marine insurance given the importance of both to the activity of the City of London.

The Marine Insurance Act (1906) went further to establish rights and duties in respect of a complex and sophisticated wholesale market, and dealt with a wide number of issues relating to the insurance of a ship, its cargo or the economic transactions associated with maritime perils. The Act is in comparison to historic legislation a large body of administrative detail and was created to codify an international mercantile network for which the Pool of London was the central hub. The intention of the Act was to correct previous case law in places, but for the most part to codify a significant financial market. The development of this legislation has come through various standard wordings relating to the specific subject matter of such policies like cargo, voyages, hulls and time of the cover.

Interpretation of the policies of marine insurance is for the most part based on the Act and accepted case law, but introduces doctrines and terminology that have subsequently become more widely accepted in other classes of insurance – such as the impact of 'fair wear and tear' as the cause of a claim. There are also examples of where standard wordings adopted by the market have attempted to limit the impact of case law, for example the Inchmaree case[15], which related to a latent defect in the machinery of a ship that led to a loss occurring which the House of Lords heard. On the face of it this appears to be an example of underwriters adopting more generous commercial terms than they necessarily need to when considering the strict interpretation of the judgement. However, it is unlikely that a marine insurance that excluded losses that could just as well happened on land is practical for the purposes of insuring cargo carried many thousands of miles by ships powered by rotating mechanical engines.

Likewise, the doctrine of average was codified, an example being that if a ship's master acted to salve the whole enterprise then all parties involved contribute on average to whatever costs were incurred to ensure there was not a greater or complete loss (such as soaking cargo near a fire to prevent the fire from spreading and destroying the entire vessel and cargo). Indeed, there is an extensive set of rules regarding average that are complex and would involve the broker in such a negotiation, a last example being cession whereby the insurer takes possession of the lost vessel or cargo – a principle now also used in motor insurance for example. Perhaps the most significant aspects of the Act, which later legislation curbed, was to allow insurers to avoid the contract for breaching express or implied warranties. The Act

[15] The Thames and Mersey Marine Insurance Co Ltd v Hamilton, Fraser & Co (1887) 12 App Cas 484

also made the broker responsible for meeting premiums in the event the insured failed to remit payment to underwriters – something of a reversal of the notion an agent is able to alter the contractual standing of their principal.

iv) Claims Management Regulation

Civil justice reforms under the Blair government allowed for the introduction of so-called 'no win – no fee' arrangements whereby companies brought and managed claims on behalf of the claimant, who would typically seek recovery for a loss from a third-party and their insurers. In 2007, a unit within the Ministry of Justice was established to regulate the activities of claims management companies.

An independent report to Government by Carol Brady in March 2016[16] led to the regulation of claims management companies being transferred with the overall objective of improving regulation by curbing practices such as cold-calling individuals. In particular, Government has proposed a cap on fees the claims manager may charge their clients, and has also created fast-track for smaller claims related to industrial illnesses. This may be seen as an attempt to change of the nature of agency-principal relationship between client and advocate, and like the narrowing of avoidance, may be seen as shifting of the balance between first and third parties.

[16] Independent review of claims management regulation (Crown Copyright 2016) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/508160/PU1918_claims_management_regulation_review_final.pdf

Chapter 7: Critical analysis of the system of regulatory and agency law

The core question explained in chapter one turns on the hypothesis that agency law developed for mercantile relationships and is today inadequate for the complex role undertaken by intermediaries in the wholesale insurance market. The intermediaries function as advisers, contract administrators and claims advocates in the event of a loss. Regulatory law has sought to address the complexity by differentiating between retail and wholesale markets, but has blurred the principle of agency law (that duties are fiduciary in nature and commissions must be transparent) for retail markets. Further, regulatory law created other agency relationships which the intermediary can hold whilst being the agent of the insured by (for example): (i) allowing agents to become Appointed Representatives of another regulated entity; and, (ii) risk-transfer of client money from insurers.

i. Law as a system of social policy

Recent government initiatives have sought to redress the balance of agency relationships in favour of consumers, whose understanding of insurance law, and the nature of the contract they are entering into may be highly limited. Indeed, these trends can be seen in the manner that avoidance *ab initio* was curbed to specific circumstances, as a shift that was introduced to advance fairness across all types of customers (irrespective of their sophistication and scale – a blanket definition which in regulatory law is often split between those acting in their own capacity, and those in a trade or profession). However, the shift has not sought to address the complex web of agency relationships in the wholesale insurance market - instead attempting to alter contract and case law in favour of the consumer rather than producer of insurance. There are also other limbs of government intervention that have sought to encourage growth in the insurance-linked securities (ILS) market, which are discussed further on, but in the counter-party to counter-party market the general principle of *caveat emptor* and contract law are as likely to be applied, as any notions of agency, in the event of a dispute – the intention of government being to encourage economic growth, and not to disrupt agency relationships either in a specific or wider set of circumstances.

ii. Patchwork 'map' of law and regulation

The quilt work of statutory, regulatory, case and doctrines of law that governs the nature of wholesale intermediaries dealings with their principals has led in some quarters to a notion that brokers act 'as common agents' rather than for a specific principal given there are so many within any given set of circumstances.[17] This notion would align the legal and mercantile paradigms, something which regulatory law has failed to do, by removing the fidelity or loyalty from an agent's responsibilities owed to a single principal and instead would replace it with a notion that there is a group of stakeholders whose needs must be met. Whilst the idea that an intermediary may owe its duties to multiple principals may resolve multiple agency relationships, there are some fundamental issues which would need to be addressed: if all principals' interests are equal how would that be reconciled with contracts that rank interests *pari passu*, a common clause to protect the interests of preferred creditors? Likewise, in the event of a dispute, how are third-party rights (traditionally decided by the

[17] Prentis Donegan v Leeds & Leeds [1998] 2 Lloyd's Rep 326

courts with regard to the doctrine of *privity of contract*) to be differentiated from those who are first-party i.e. the principal and their agent? This particular issue turns on the equality of parties, and is a reflection that if an agent enjoys particular privileges, such as to alter the property or contractual position of their principal, then it cannot be equitable to hold such a privilege and at the same time in return offer the party conferring such a privilege no duty of loyalty or fidelity. The suggestion that an agent can be acting for their principal (as a patchwork of parties that make up a market) is itself demonstrative of the confusion and unresolved issues that exist between a system of trading that neither reflects, nor is regulated on the basis that agency law is the governing doctrine, and principals' rights are watered-down in favour of their intermediary's convenience.

iii. Failings

Where an intermediary is deemed responsible for an error or omission in the carrying out of their principal's instructions, they are able to recover from their own insurance against such events. However, the limited relevance of extant statutory or case law (in such proceedings with regards to agency) is indicative of the complexities that agency law fails to address in a complex marketplace – particularly in respect of causes of an error or omission. To put it another way, there is no cause of action if a conflict of interest led to an error or omission on the part of the intermediary, they being brokers (rather than professionals) who owe a duty of care – but not to the same degree[18] as say a surgeon whose judgement is governed by the overall objective of preserving human life.

[18] Empress Assurance v Bowring [1905] 11 Com Cas 107

By comparison, an intermediary may carry out their principal's instructions knowing and informing the principal that another course of action in the eyes is better. This practice is particularly adopted where risks are placed with unrated markets (a market that is not rated by a Ratings Agency), an less-known insurance being preferable to none on economic terms.

iv. Disputes and resolution – reasonable person test

Where a dispute has been brought before the courts the matter is decided on the basis of the facts - in general disputes involving wholesale intermediaries are decided on the basis of extant case law, there being little or no relevant regulatory law, which is applicable (other than very high level principles). Of particular relevance is a recent decision in the *Plevin* case, where the court held that commission levels were unfair and that the contract was void, thus making specific reference to agency relationships, but this was unusual and the typical outcome is that courts avoid reshaping agency, but instead applying it to a given set of circumstances before them.[19]

Where government has sought to directly confer a solution to disputes is by introducing the reasonable person test, which is what a prudent insurer would consider when underwriting a risk – thus where disclosure of information either by the insured or their intermediary did not

[19] Pryke v Gibbs Hartley Cooper [1991] 1 Lloyd's Rep 602

occur, then the contract never existed. As discussed above, government has recently sought to rebalance this test to a more equal basis between disputing parties – and to create a middle ground (between cover existing and having never existed) by offering resolution where an insurer may re-assess the risk proposing terms that they would have done had they been in possession of all the relevant facts. This change should provide swifter resolution to disputes insofar as courts may award costs against the repudiating insurer if they have not gone to the effort of considering all relevant information, and proposing to put the contract on a more sound commercial footing, before denying the contract altogether.

Chapter 8: Solutions

The Law Commission, European Commission, regulators, academics and the courts have all considered solutions to the issue of agency relationships and conflicts of interest within the overall objective that the wholesale market functions efficiently. The structural solutions are broadly similar to those seen in other professional services relationships, and are based on Keynesian economics of a private sector where government intervention is limited to encouraging competition and managing the economic cycle – rather than fundamental interference in the supply chain other than where necessary. These broad economic aims perhaps go some way to explain why statutory interventions, and what the courts have sought to construe from them and previous *dicta*, is something of a blend of pragmatic outcomes rather than an absolute reshaping of how $100 Billion moves round the wholesale market on an annual basis.

i. Intermediaries are legally independent

The European directives of 2002 and 2016 both required intermediaries to disclose where 10% or more of the entity is owned by an insurance provider, and in the UK at least there are separate reporting requirements for controllers and other close links between regulated entities including those who conduct insurance intermediation activities. This is because ownership (even if a minority interest) is seen to confer rights to control as well as potentially benefit from the enterprise's activity, company directorship itself being an extension of agency as explained in the Companies Act. The balancing of stakeholders' interests in the enterprise is one of the core duties of directors, and in some respects can be applied to intermediaries owned by insurers, in that in the short-term prospects may improve by pushing business to their owners – but this will lead to a monopoly that will become inefficient as a result of economic forces – causing long-term harm to the enterprise and reducing the benefit of ownership, which, typically, is expressed as the Balance Sheet asset 'Goodwill' (or the implied value of the business and its relationship with customers and markets). There are economic studies which show a direct correlation between personal conflicts of interest (such as a CEO's benefits), short-term profit growth followed by an adjustment that has a significant impact on shareholder value. Legal remedies have sought to increase personal accountability and the EU directives required that an individual must be allocated responsibility for the company's insurance mediation, a measure that has not been tested in the courts.

ii. End-to-end transparency of the value chain

In some respects this is not a solution worthy of mention because in effect agency law already prevents an agent from making a secret profit of which their principal is unaware, and has not consented to. However, as discussed in previous chapters, the regulatory law has removed basic elements of this disclosure such that customers who instruct an intermediary to arrange insurance on their behalf are not required by regulatory law to inform the principal of his right to request details of the commission payments the agent receives. The 2016 directive in Article 19 requires disclosure of the 'nature' and 'basis' of remuneration received by the intermediary to all of their clients, and whilst it is left to member states to transpose these requirements into local law, it is possible this may address the loss of transparency in 2008.[20]

iii. Best interests of the customer

The current regulatory law does not impose a duty to act in the best interests of the customer. Regulatory law says that customers' interests should be treated fairly, and that any product must be suitable – although it may not be a recommendation based on advice, and does not have to be derived from a fair analysis of the market provided the customer is informed the search was limited to as little as one available product. However, Article 17 of the new directive that must be transposed into member states' law by 2018 introduces a positive requirement to act in the best interests of customers, and that intermediaries must not be incentivised in a way that discourages them from fulfilling this duty. Although some would argue this is no different to the requirements that already exist, it must be remembered that Lloyd's bye laws only apply to insurers, and intermediaries enjoy broad exemption from conduct of business of rules which do not apply to international and large or complex risks – as a result the exemption predominantly leaves the wholesale market free to adopt market norms and practices in line with competitive rather than legal forces, which will only become apparent in the event of a dispute some years a down the line.

[20] See 3.

iv. Status quo

Finally, there is the solution of maintaining a market place whose disputes are settled before the courts, which, in the context of a complex and technical market, seems likely. The complex rules contained in the Marine Insurance Act 1906 are unlikely to be seen on the draft statue book soon. Indeed, often such detailing is left to committees of specialists to promulgate, and are as much matters of self-regulation as they are regulatory law *per se*.

Chapter 9: Conclusion

In conclusion, it is suggested that there are a number of core issues, which the law as it currently stands does not address and that as another legislative framework emerges for complex capital market products, the need for an agency paradigm for wholesale insurance continues.

i. Dichotomy of expectations and duties

For the purchasers of wholesale insurance the over-riding presumption is that they are complex and sophisticated organisations, often publicly-owned, and with sufficient commercial standing and experience to act on their own initiative without burdensome protections in law other than what is already in existence through the tort of equity and negligence, contract law, and recent legislation – none of which seeks to alter the nature of agency. The client's expectations is covered in a terms of business agreement. The creation of a bargain based on a dichotomy between the client's expectations, and the duties of their agent to the principal, is an issue that the law has not sought to address and, therefore, remains unresolved.

ii. Law and regulation rules at odds

The law of agency is clear, even if it is not a paradigm that actually addresses the nature of relationships in the complex wholesale market and is, as a result, a matter which regulatory law ought to address when transposing EU directives and self-regulation regimes into UK regulatory law. It is proposed that that by dis-applying the majority of conduct of business rules to wholesale insurance intermediaries, and by removing rule to inform retail customers of the right to be informed of commission paid to their agent, the regulatory law and the law of agency are at odds as things currently stand.

Whilst the architectural aspect of the regulatory law may overshadow the intentions of agency law, there are deliberate references in the regulatory law to following agency law, even if in the minutiae of rule-making in certain instances appears to be at odds with this intention. Indeed, the consultation that followed the first set of rules the created for insurance intermediaries was foreshortening of the regulatory law, as a result of feedback that argued transparency of commissions was neither material to clients nor possible for intermediaries to accurately disclose on the basis of cost-benefit.[21] On the face of it, this would appear to be a case of disjointed governmental approaches, the UK being proponents of self-regulation before being required by EU directive to transpose measures into its national law that largely do not apply in the wholesale market.

[21] See

iii. Resolution from the Courts or through social policy

The *Plevin* case has been referred to in several parts of this dissertation because it is a timely example of the shortcomings of agency as a paradigm that may be used by regulatory law to ensure that there are clear distinctions in relationships, which ultimately serve the principal's interests. In short, Mrs Plevin, a retired university lecturer, brought action under the unfairness provisions in the Consumer Credit Act thus creating a new cause of action that was not included in previous action by the FCA to bring payment-protection insurance (PPI) claims to an end under limitations. The result was the FCA issued a policy statement drawing boundaries around the impact of the decision requiring relevant agents to assess if they earned more than 50% commission, and if as a result the contract was unfair. A compensation formula based on amounts in excess of 50% was also introduced and a rationale for drawing narrow boundaries around the Plevin judgement was published at the same time.

On the face of it the policy statement following Plevin was seen by commentators as potentially favouring the lenders whose loans were sold as a bundle with the insurance, the cost of which including commission was included in the total sum of the loan. The other response has been to suggest the FCA was trying to achieve an equitable balance between the interests of lenders to be beset with a further slew of PPI-related claims - under a new cause of action, and the claimants whose interests are served by claims management companies.

There is however a broader issue of who is protecting whom, and from what do they need to be protected i.e. unfair treatment by their agents, providers or being offered commoditized services which fail to meet their specific needs?

The reality is that an agent acts for their principal and the law is clear in its intent that the agent has a duty of loyalty, fidelity and honesty to their principal, which cannot and should not be diverted for reasons of necessity or pragmatism – to do so is to make the agent the party with absolute authority and no accountability. It is particularly telling that the actual accounting for commissions was such that it was claimed to be disproportionately expensive to reveal individual sums to individual clients – some way at odds with the general duty to account for and protect the principal's property or assets from which the commission was deducted.[22]

iv. New and emerging catastrophe capital market

In February 2016 Her Majesty's Treasury issued a consultation paper[23] regarding insurance-linked securities (ILS), a form of structured capital market product whose purpose is to introduce insurable risks to alternative supplies of capital. The intention of the paper was to call for evidence for creating a statutory regime to formalise and encourage ILS activity to London, and away from the overseas hubs such as Bermuda. The paper notes:

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[22] Bowstead & Reynolds on Agency Article 51 'Duty to account' pp 266-269

[23] Insurance linked securities: Consultation (HM Treasury, 2016) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/504046/Insurance_linked_securities_consultation.pdf

“The Treasury and FCA believe that ILS deals offer specialist investment opportunities that are appropriate for knowledgeable and sophisticated investors only. As such, we envisage an ILS framework which restricts the purchase and trading of investments to sophisticated investors… This will likely require deal arrangers to structure ILS deals so that investment offers are only available to ‘Qualified Investors’ as defined in EU securities law. We imagine in practice deal arrangers would also wish to restrict offerings to ‘Qualified Institutional Buyers’, as defined in US securities law.”

It must surely be a matter of social policy that time-limited special purpose vehicles to which investors can only apply for their stake when all reserves have been distributed, and which must be fully-funded at the outset, in preparation for exposure to catastrophic degrees of risk is subject to a degree of regulation if no other reason than to protect agents from the liabilities and duties they may implicitly or explicitly owe their principals.

In conclusion, agency is clear and simple but the way wholesale intermediaries operate needs to be complicated because of the market they intermediate; the business of insurance has not been subjugated to agency and it is suggested that the law ought to be developed to reflect the market.

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