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Legal Issues in Political Risk Insurance Claims & Recoveries

Introduction

Commercial, as opposed to state-sponsored or multilateral, political risk insurance (PRI) as placed in the London Insurance Market in its wider definition comprises cover for losses caused to investments and projects by government confiscation, expropriation and nationalisation etc (CEND or 'PRI' strictly so-called); insurance against contract frustration or repudiation by government obligors (CF); and more recently structured trade credit has been insured against political risks as well as straightforward counterparty default (CR or TCI). Cover may also be provided for losses caused by political violence (PV) including terrorism.

The PRI market has been through a number of claims cycles since it started about 40 years ago. The Middle East petrodollar boom and the Iranian revolution in the 70s; the 1980s debt crisis; then in the 1990s, Kuwait; the last recession; the collapse of the USSR; the Balkans crisis; and later Asia, Russia, Cuba. In 2001-2002 Argentina came to the fore. Since 2007, we have seen the resurgence of 'resource nationalism', particularly in South America.

How has the PRI market been affected by the current recession and what claims issues have arisen as a result? Most banks were not affected by the first phase of the credit crunch in August 2007. In September 2008, however, with the collapse of Lehmann Brothers, there was a massive crisis of confidence throughout the World with the real economy being affected by November 2008 when global trade virtually stopped. In the commercial PRI sector the Market is facing what has been described as a "tsunami" of claims. Estimates vary as to the total number of notifications to the Market to date, but the top end of the scale is US\$4 billion. Many of these will not ultimately turn into claims. Most of those that do are straightforward trade credit insurance claims of the simple 'obligor can't pay variety', and have been or will be paid in full and promptly so the services of our profession will not be needed. The sheer size, number and complexity of some, however, mean that lawyers will need to be involved – usually initially by the insurers, and thereafter, should problems be perceived, also by the insured.

In this article we examine this PRI claims environment from the perspective of the London Market and some of the legal issues that arise.

What legal issues arise in PRI claims?

The principal forum for dispute resolution in PRI placed in the London Market is arbitration – usually the London Court of International Arbitration – rather than the London Commercial Court. Whatever the setting, however, the legal issues which have traditionally arisen again and again are the performance of policy preconditions,

conditions precedent and warranties; the extent of the coverage provided; misrepresentation and non-disclosure. But what about the claims the Market now faces? Are the legal issues arising the same? Is there anything new?

Claims today

The scale of the problem is undoubtedly bigger – not localised to any one particular country. This recession is a global issue and everyone and every country is affected. Nevertheless, we are still seeing the same legal issues – just, often, the focus has changed.

This time the bulk of the claims arise out of trade credit insurance, and the majority of the claimant insureds are banks. This, we believe, is having a major impact on the claims environment and the issues which are arising.

Banks, we suggest, have a different philosophical approach to doing business from either that of the Underwriter or indeed the traditional commodity trader insured. Banks have a 'cash against documents' mentality. Bankers are used to financial instruments that respond on presentation of compliant documents or first demand such as letters of credit. They are not used to the 'conditionality', whether express or implied, of long insurance policy wordings.

Another feature of banks – in some countries more than others – is their employment instability. Employees leave; they are posted to different departments and countries. Their companies are restructured. This can give rise to a lack of continuity with projects and deals that is not always encountered with other types of insured.

Also having an impact is the width of a bank's interests, so that responding to an insured default can have unwonted (and unwanted) results from a bank's perspective: reputational damage in an emerging, competitive market; more concretely, triggering cross-defaults on other instruments.

How do these features translate into claims issues?

Current claims issues

With trade credit insurance and its basic cover for counterparties that can't or won't pay, issues with coverage are likely to be rare. However, the following issues continue to arise.

Arguments about what was and should have been told to the Underwriter on placement of the risk will always be with us, but an increased feature is with policy renewals and amendments. In a recession, underlying contracts are often re-negotiated and payments rescheduled. Possibly because they are used to operational risks and the need to keep their Underwriters in the picture with regard to changes in circumstances, in our experience this has not been a huge problem with insured traders and contractors. With an insured bank, however, perhaps because it has not seen the need or because the policy has been metaphorically placed in the bottom drawer by an account handler who may have moved on, there seems to be a greater risk that Underwriters are not advised or fully or accurately advised of the amendment. If not advised this could be a breach of warranty. If not fully or accurately advised to Underwriters this could be non-disclosure or misrepresentation undermining the validity of any policy endorsement or renewal.

We have seen problems in the preparation and presentation of claims documentation to Underwriters. It may be a product of our age of electronic communication, and the employment instability mentioned, but particularly with banks there seems to be a lack of appreciation as to what Underwriters require in support of a claim and what they may want to satisfy themselves of its legitimacy. Linked with the perennial uncertainty an insured has as to the role of the Loss Adjusters who Underwriters appoint to investigate claims on their behalf, at best it delays settlement and at worst it creates suspicion in the minds of Underwriters, leading them to instruct lawyers.

There also seems to be a lack of understanding amongst insureds about the purpose of the 'Waiting Period', a policy fundamental for CF, CR and trade credit insurance policies. One feels that an insured bank is under the impression that it simply has 'to wait' to get its claim paid, not that under the terms of its policy it is under any continuing duty to avoid or minimise the loss in the exercise of 'due diligence': a concept that means something else in the world of finance anyway.

Perceived shortcomings in claims preparation may also have led to what we see as a change of practice on the part of some Underwriters: an insistence on detailed settlement agreements upon payment of the claim. Sometimes even with straightforward claims being paid in full, the insured is asked to sign a lengthy document requiring it to agree to terms that go further than required by the policy wording.

The impact of the current claims environment

We are confident that the private sector market will survive – with an enhanced reputation as a result of its response to the wave of claims, and will seek to take advantage in the medium term of the loss of creditability of the collateralised debt obligation and, more particularly, the credit default swap as a means to lay off risk. Indeed, we are told, as often happens after a period of intense claims activity, that there are going to be new entrants and new capacity, and this despite what we imagine will be a contraction in reinsurance availability at one end of the spectrum and at least a short-term losing of 'liquid appetite' on the part of trade finance banks. There must, however, be a question mark as to whether this is the time for marketing new insurance products, with reduced demand and many parts of the world virtually off risk. We have already been involved in requests to consider the implications of tighter (if you are an insurer)/less favourable (if you are an insured) wordings.

Finally, but importantly, we are not sure how far the Market has considered the issue of recoveries as the claims tidal wave recedes. Traditionally, the profitability of the Market is supported by the high rate of return on recoveries – in a strict PRI/CEND context following the attachment of the counterparty's assets, the favourable bilateral investment treaty award; the use of specialists in unorthodox recovery processes. We hear of anticipated recovery rates of the order of a third. With the exercise of trade credit insurance subrogation rights by Underwriters, however, there needs to be realism. Most of the claims are of the 'can't pay', not the 'won't pay' variety. When pursuing recoveries Underwriters may come to find themselves competing with other creditors, often legitimately with greater priority, but perhaps also in debtor-skewed winding-up processes in foreign-bank loathing jurisdictions.

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