The "Member State of the Risk": Legal and Regulatory Significance

By Jonathan Goodliffe

What is the "Member State of the Risk"?

The concepts "Member State where the risk is situated" and "Member State of the commitment" are defined in the Second Non-Life and Life Directives (referred to hereinafter as "2NLD" and "2LD"). For the sake of brevity, I shall refer to "Member State of the Risk" hereinafter. Identifying the Member State where the risk is situated in relation to any contract of general insurance, or the Member State of the commitment in relation to any contract of long term (or "life") insurance is significant for a number of different legal and regulatory purposes, as will be shown in this paper.

In most cases, under Article 2(d) of 2NLD and 2(e) of 2LD, the Member State of the Risk is:

> *"the Member State where the policyholder has his habitual residence or, if the policyholder is a legal person, the Member State where the latter's establishment to which the contract relates is situated".*

In relation to general insurance this is subject to the following exceptions:

for buildings insurance the Member State of the Risk is the Member State where the property is situated;

for vehicles it is the state of registration of the vehicle;

for policies of a duration of four months or less covering travel or holiday risks it is the state where the policyholder took out the policy.

There is a Protocol between Member States *"relating to the collaboration of the supervisory authorities of the Member States of the European Community in particular in the application of the Directives on life assurance and non-life insurance".* It indicates, at Appendix VI, that the Member State of the Risk or commitment is ascertained at the time of the conclusion of the contract. This makes sense. A "floating" Member State of the Risk would surely be unworkable.

The concept of "habitual residence" was considered by the Court of Justice of the European Communities in *Swaddling v The Adjudication Officer* (Case C-90/97 [1999] ECR 1-1075) in the context of social security legislation. The view was expressed that habitual residence presupposes not only an intention to reside in the state in question, but also the completion of an appreciable period of residence

there. So, for instance, an English au pair, who took up a 6 month contract in Germany, might perhaps be regarded as still being "habitually resident" in England.

What Turns on the Definitions?

The definitions are perhaps most significant in the following contexts.

First, an insurance undertaking, A, authorised in one EEA Member State ("the home state") may wish to enter into insurance contracts in respect of which some other Member State is the "Member State of the Risk", in this context more usually referred to as the "host state". In that event the Second Directive requires A to "passport" by notifying its home state and supplying certain information. If satisfied that it is appropriate to allow A to provide services into the host state, the home state supervisor will notify the host state supervisor and A may then start to provide those services.

Secondly, Article 46(2) of the Third Non Life Directive and 44(2) of the Third Life Directive (92/49/EEC and 92/96/EEC – hereinafter referred to as 3NLD and 3LD) provide that:

> *"every insurance [assurance] contract shall be subject exclusively to the indirect taxes and parafiscal charges on insurance premiums in the Member State in which the risk is situated [Member State of the commitment]".*

Thirdly 2NLD and 2LD contain detailed rules (the "Directive Rules") for identifying the law applicable to contracts of insurance covering risks and commitments situated in an EEA Member State (Article 7 2NLD and Article 4 2LD. These rules are now implemented in the UK in the Financial Services and Markets Act 2000 (Law Applicable to Contracts of Insurance) Regulations 2001 ("The Applicable Law Regulations") as amended by the Financial Services and Markets Act 2000 (Law Applicable to Contracts of Insurance) (Amendment) Regulations 2001).

In relation to the insurance of such risks the Rome Convention on the law applicable to contractual obligations does not apply. Suppose, for instance, a policyholder under a general insurance contract has his/its habitual residence or central administration within the territory of the Member State in which the risk is situated. In that event the applicable law is the law of that Member State unless that Member State allows the parties to choose the law of another country.

Fourthly, an insurance undertaking authorised in an EEA Member State may apply for the sanction of its competent authority to the transfer of a portfolio of insurance

contracts under Article 12 3NLD or Article 11 3LD. In that event the consent of the competent authority for the Member State of the Risk in relation to each contract comprised in the transfer must be obtained.

Insurance Policies Covering Multiple Risks

The Court of Justice of the European Communities considered the definition of "Member State of the Risk" in *Kvaerner plc v Staatssecretaris van Financiën* (C-191/99 [2002] QB 385).

A, a company established in the UK, took out a policy of insurance covering all undertakings in its group. The insurance was for professional indemnity, "worldwide umbrella insurance" and worldwide catastrophe insurance. The insurance was taken out with B, an insurance undertaking established in the UK. One of the companies benefiting from the cover was C, a Netherlands subsidiary of A. B was assessed to tax by the Netherlands tax authority on C's share of the premium.

The Court held that in the primary definition of "Member State of the Risk" the reference to the *"Member State where the policyholder's establishment to which the contract relates is situated"* should be taken to include a subsidiary (or indeed any member of the group) on whose behalf a risk or risks comprised in the cover had been taken out. This rule would apply whether or not A sought recoupment of a proportion of the premium from C (in Kvaerner it did). The Advocate-General, Mr. Francis Jacobs, quoted with approval from a declaration by the Insurance Committee created pursuant to Article 1 of Directive 91/675/EEC:

> *"In the event that a single insurance contract covers risks/commitments belonging to a policyholder's subsidiaries or branches, the location of the various risks/commitments covered by this contract must be determined on an individual basis for each risk/commitment, according to the provisions of article 2(d), in particular the final indent, of Second non-life [insurance] Directive 88/357/EEC, and of article 2(e), in particular the final indent, of the Second life [assurance] Directive 90/619/EEC."*

So, for the purpose of taxation, a complex policy of this kind, covering various risks and various corporate entities, has to be broken down into its constituent parts. How far this process has to go is not clear. Sometimes the separate elements of a policy of this kind are easily severable. Sometimes they are not. If the group takes out, for instance, directors' liability insurance, should the risks be treated as being covered in each of the Member States where the directors have their habitual residences?

American Motorists Insurance Co. v Cellstar Corporation and another

A similar issue to that arising in Kvaerner was considered by the Court of Appeal in *American Motorists Insurance Co. v Cellstar Corporation and Another* [2003] All ER (D) 26 *"Cellstar"*. The question in that case was whether the English Court should accept jurisdiction to determine a dispute under an insurance contract providing cover to a number of companies in a group, some based in the USA and some in the UK. The Court of Appeal made a primary finding that the contract contained an implied choice of Texas law. It referred to the Court of Justice of the European Communities the question whether it had power to stay the proceedings in favour of the Texas courts, as the United States of America which was not a party to the Brussels Convention. The Court of Appeal had held in *Re Harrods (Buenos Aires)* Ltd [1991] 4 All ER 334 that it did have such a power, but the correctness of that judgment has since been questioned.

The leading judgment of Mance LJ contains a full discussion of the Directive Rules and of the *Kvaerner* ruling, both of which were relevant for the purpose of establishing whether the implied choice of Texas law was effective for the contract as a whole (as opposed to just being effective for the non-EEA risks).

Where the Contract of Insurance is not Effected in the EEA

Mance LJ's judgment points out that the Insurance Directives generally and Directive Rules in particular do not apply to insurance contracts effected by insurance undertakings which:

- cover risks arising in the EEA, but
- are from an establishment outside the EEA.

So the rules would not apply, in particular, to contracts effected by the claimant in *Cellstar* since it did not have an establishment (or indeed authorisation) in the UK. Mance LJ points out, at paragraph 26 of his judgment, that it does not follow that, when implementing the Directives in section 94B and Schedule 3A to the Insurance Companies Act 1982, the UK did not intend that the Directive rules should apply wherever and by whomsoever the relevant policy might be issued. Such an intention was inferred by the editors of Dicey & Morris on the Conflicts of Law (13th edition at paragraph 33-144).

It was the Insurance Companies Act 1982 implementation of the Directive Rules which applied at the time when the dispute in *Cellstar* arose. Since 1st December 2002, however, section 94B of the 1982 Act has been replaced by section 424(3) of the Financial Services & Markets Act 2002 ("FSMA") which provides:

"The law applicable to a contract of insurance, the effecting of which constitutes the carrying on of a regulated activity, is to be determined, if it is of a prescribed description, in accordance with regulations made by the Treasury".

The wording of this subsection, unlike that of 94B of the Insurance Companies Act 1982, does not support the analysis proposed in Dicey & Morris. The intention seems to be that the proposed regulations, now the "Applicable Law Regulations" – see above) should only apply in relation to insurance activities regulated under FSMA. Where a US insurance undertaking covers UK risks otherwise than through an establishment in the UK, it will not usually be regarded as effecting contracts of insurance, (a regulated activity under Article 10 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001), in the UK. However, this narrower view of the effect of the implementation of the Directive Rules under FSMA may not be entirely uncontroversial. Section 424(3), unlike section 19, for instance, does not explicitly require that the regulated activity be carried on in the UK.

If it is right that the Applicable Law Regulations made under FSMA do not go beyond implementing the Directives, it would follow that there are three distinct sets of rules by which the law applicable to an insurance contract may be ascertained:

1 the Directive Rules where the state of the risk is an EEA member state and the contract is effected from an establishment in the EEA;

2 the Rome Convention when the state of the risk is not an EEA member state;

3 the common law conflict of law rules and any relevant statutory provisions when the state of the risk is an EEA member state and the contract is not effected from an establishment in the EEA and does not amount to the effecting of an insurance contract in the UK.

The discussion of significant differences between the operation of the rules identified in 1, 2 and 3 is beyond the scope of this paper.

Mance LJ's Analysis of Kvaerner

Should the *Kvaerner* analysis of the Directive Rules on ascertaining the Member State of the Risk be applied *mutatis mutandis* to ascertain the applicable law of an insurance contract covering multiple risks and multiple policyholders/insureds? If so the consequences would be perverse, as Mance LJ pointed out in his judgment in Cellstar:

"I have already given reasons for concluding that the facility provided by the policy in favour of Cellstar and its subsidiaries cannot be regarded as severable into a series of separate contracts. Cellstar and its subsidiaries have separate insurable interests. But there is a significant composite element which makes the policy incapable of severance (cf. also Bank of Scotland v Butcher [1998] EWCA Civ. 1306, where under article 4(1) of the Rome Convention this Court gave short shrift to the idea that a joint and several guarantee could be severed according to the countries of residence of the two guarantors). It may well be that the draftsmen of the Directive did not address their minds to complex policies of the present nature, or simply left it to the courts to develop sensible solutions; but it can be said that, when, in article 7(1)(c) of [2NLD] (paragraph 1(3) of Schedule 3A of the Insurance Companies Act 1982)), they dealt with risks situated in different member States, they did so in terms which envisaged that only one law would govern the single contract covering all such risks."

At first instance ([2002] 2 Lloyd's Rep 216) in *Cellstar* David Steel J (to whom *Kvaerner* was not cited) had pointed out:

"The claimant submitted that the court was solely concerned with two specific EU risks. The existence of what were termed hypothetical risks in other EU jurisdictions or, more significantly outside the EU altogether, could be disregarded, so the argument ran, as being "divisible". But the effect of this submission was to invite the court to sever the contract into seventeen separate contracts, determined according to the legal regime relevant to each of them. This outcome does not attract me for two particular reasons:–

(a) A separation of this contract into a large number of different contracts is in complete contradiction to the concept of a global contract.

(b) It gives rise to the potential for startling inconsistencies: the impact of the valuation warranties on the range of claims put forward in the Texas proceedings is one example: even more problematic would be the implications of non-disclosure or misrepresentation as regards the risks covered by, say, one of the 17 contracts.

... I agree with the defendants' submission that the risks should only be treated as situated in a Member State if they are predominantly so."

In the Court of Appeal Mance LJ concluded his discussion of the Directive Rules by articulating the following conclusion in favour of the view that there could be only one applicable law:

"I would in these circumstances approach the application of Schedule 3A on the basis that the policyholder is Cellstar, with its subsidiaries being insureds. If that is wrong, then I would prefer an analysis treating the policyholder under this policy as the whole group located in Texas (rather than one which recognises as many policyholders as there are subsidiaries). On either of these two analyses, the central administration is in Houston, Texas, rather than in any member State of the European Union. This leaves unresolved the question whether the policy can be said to cover risks situated within the European Union at all, in circumstances when it covers multiple risks situated inside and outside the European Union (cf. paragraphs 22-27 above). But, assuming that s.94B and Schedule 3A of the 1982 Act apply, the potentially relevant sub-paragraphs in Schedule 3A could not include sub-paragraph (1); they would clearly include sub-paragraph (2), clause (b) of which would on any view enable the parties to choose, or the court to select as the law of the country of closest connection, the law of Texas."

Although this analysis avoids treating insurance contracts as governed by multiple systems of laws it does not follow that the law of the Member State of the Risk is irrelevant. Article 7(2) 2NLD provides:

"Nothing in this Article shall restrict the application of the rules of the law of the forum in a situation where they are mandatory, irrespective of the law otherwise applicable to the contract."

The conduct of insurance business is in general more heavily regulated in Continental jurisdictions than in the UK. The heavier the system of regulation the more the mandatory rules. Hence the importance to insurance undertakings of using appropriate dispute resolution clauses (where these are effective) to avoid disputes coming before the courts of jurisdictions where unfavourable mandatory rules may apply. In many cases, however, under Chapter II section 3 of the Brussels Regulation, (Council Regulation (EC) No 44/2001) and/or by virtue of Member State rules implementing the Council Directive on Unfair Terms in Consumer Contracts (93/13/EEC) such clauses will be ineffective. The Member State of the Risk will usually be the same as the member state of the domicile of the policyholder, insured or beneficiary. In general and subject to the exceptions in that section, policyholders, etc. have the right to sue in the courts of that state. In that event insurance undertakings may have no alternative but to comply with the law of the Member State of the Risk, even if it is not the applicable law.

Impact of *Kvaerner* on passporting rules

In any event Mance LJ's elegant solution to the *Kvaerner* problem cannot be invoked in relation to passporting obligations. These obligations are as closely linked to the Member State of the Risk as are the rules on taxation of insurance premiums. They do not refer to the "habitual residence or central administration of the policyholder" as do the conflict of law rules. Neither the Court nor the Advocate-General in *Kvaerner* appear to have considered the full implications of the ruling on the passporting rules.

Group policies of the kind described in *Kvaerner* or *American Motorists* are often issued on the London insurance market. Before such a policy is issued, in principle the insurance undertaking in question should, if it has not already done so, passport into every Member State where any member of the group benefiting from the cover is established. Where a new company joins a corporate group and starts to benefit from group insurance cover, an additional obligation to passport may arise if any new risks arise in a Member State where the insurance undertaking has not already passported.

Implications of not passporting correctly

It is unlikely that, before the Kvaerner judgment, many insurance undertakings on the London, or indeed any market, kept records identifying each distinct risk arising under the insurance contracts in their portfolios on the basis required by that judgment. Indeed it may be that they are still not doing so. The records of insurance undertakings may not be entirely reliable, not only in cases where the insurance undertaking provides insurance to groups of companies but for other reasons. These might include difficulties in identifying the original habitual residence of the policyholder and problems with computer systems.

If a UK authorised insurance undertaking finds itself providing services into an EEA Member State without complying with the passporting formalities now transposed into Schedule 3 of the Financial Services and Markets Act 2000 ("FSMA"), it will have committed a breach of paragraph 20 of that Schedule. In theory this may lead to a financial penalty being imposed on it under section 206 as well as to other disciplinary consequences. It may also find itself in breach of civil and criminal rules in the host state.

The Commission's Interpretative Communication on Freedom to Provide Services and the Public Good expresses the view that:

> *"the purpose of the notification [i.e. passporting] procedure is to ensure the exchange of information between supervisory authorities; it should not affect the*

validity of any insurance policy concluded without the procedure having previously been followed."

This principle has been given effect in the UK by paragraph 16 of Schedule 3 of FSMA. In theory at least it should also apply in the law of other Member States.

Transfers of Business

The consequences for a UK insurance undertaking which fails to identify in a systematic way the Member State of the Risks which it underwrites and to passport accordingly are perhaps most significant when the insurance undertaking is seeking to transfer a part of its business. Article 12 3NLD and Article 11 3LD require Member States to establish a mechanism for the authorisation of transfers of insurance business. Before any such transfer of business is authorised the agreement of the competent authorities of the Member States in which the risks are situated must be obtained.

These provisions were originally implemented in Schedule 2C of the Insurance Companies Act 1982. Under Part I of that Schedule, applicable to transfers of long term business, the Court was vested with power to authorise transfers of business. Paragraph 1(3) provided that no such transfer might be carried out without the sanction of the Court.

There was no provision equivalent to paragraph 1(3) in Part II of the Schedule applicable to transfers of general business. So an insurance undertaking seeking to transfer a portfolio of general insurance business only needed to apply under Part II if it required the exercise of the FSA's powers under paragraph 10 to give effect to the transfer. Those powers would not have been required if, for instance, the transfer took the form of a novation.

Schedule 2C was replaced by Part VII FSMA in relation to all applications made on or after N2. Section 104 provides that *"no insurance business transfer scheme is to have effect unless an order has been made in relation to it under section 111(1)"*. Section 111 provides for all transfers of insurance business to be sanctioned by the Court. So obtaining the sanction of the Court became, in effect, compulsory from N2 for transfers of general as well as long term business, even if such transfers would otherwise be effective without any court order. This does not apply to schemes which are "excluded schemes" within the meaning of section 105(3).

Why this change was made is not clear. It does not appear to be required by the Directives.

Section 111 and Schedule 12 provide that, before a transfer of business can be sanctioned, certificates attesting to, inter alia, the consent of the Member State(s) of the risk(s) in relation to the contracts comprised in the transfer must have been obtained. There is no *de minimis* provision, so the transfer can be blocked by any EEA competent authority for the Member State of any risk covered in any of the contracts. Alternatively, such competent authorities may require that any outstanding regulatory breaches should be rectified before any such consent is given.

Before giving the certificates under Schedule 12 the FSA must be satisfied that all the relevant competent authorities have been applied to. Where the records of the insurance undertaking seeking to transfer its portfolio are unreliable for any of the reasons discussed above it may not be able to confirm to the FSA that it has not been providing services into any specified Member State. It may have no alternative but to ask the FSA to apply for consent to all the EEA competent authorities and to send passporting notifications to the competent authorities for any Member State into which the insurance undertaking has not yet passported. The practice of the FSA, in such circumstances, is to allow the firm to passport into any jurisdiction for which a risk has been identified in respect of any policy included in the portfolio to be transferred.

Why then, should not insurance undertakings who may be faced with this problem not routinely passport into every EEA Member State even before any question of transferring portfolios arises? The answer lies in the fact that passporting is not a formality. When the FSA as home state regulator receives a passporting notification from a UK insurance undertaking it may refuse to forward it to the host state if, for instance, it is not satisfied that the insurance undertaking has the appropriate resources, systems, controls and personnel to underwrite risks in that state, including systems to ensure that contracts which insure risks in the host state comply with the law in that state. (Any such refusal is subject to challenge in the Financial Services and Markets Tribunal. See FSMA Schedule 3 paragraph 20(4A) (inserted by the Financial Services (EEA Passport Rights) Regulations 2001)).

The only effective way of minimising such problems, therefore, may be for insurance undertakings to establish systems and controls which ensure that they apply to the FSA to passport when the obligation to do so arises. At the same time they should as far as possible systematically identify in their records the Member State for each of the risks which they underwrite, consider including appropriate choice of law and dispute resolution clauses in their contracts, and take advice on whether those clauses are effective or how they can be made most effective.

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