

Conflicts of interest faced by reinsurance brokers and duties owed by producing and placing brokers to the reinsured - Australian Response.

Conflicts of interest faced by reinsurance brokers

What is a conflict of interest?

Put simply, conflicts of interest are typically considered to be circumstances where some or all of the interests of persons a reinsurance broker provides a service to, are inconsistent with, or diverge from, some or all of the reinsurance broker's interests.

Who are producing and placing brokers?

The producing broker is the broker instructed by the cedent/retrocedent (called cedent for convenience hereafter) to place the risk.

The placing broker is the broker that the producing broker uses to carry out that task.

Australian Issues summarised

In Australia, the responsibilities of the producing and placing broker and what conflicts of interest may actually arise will always depend on the precise circumstances and will be affected by:

- the agreement in place between the relevant parties;
- any relevant legislation;
- general law obligations (to the extent the above does not qualify or otherwise affect these obligations); and
- the relevant circumstances of the parties and transaction.

Relevant Australian legislation on conflicts of interest and reinsurance brokers

There is no legislation in Australia specifically governing the conduct of reinsurance brokers as there is in other jurisdictions. There is significant legislation affecting insurance brokers in Australia, but it does not apply to reinsurance brokers.

There is general consumer protection legislation that may have an impact on a reinsurance broker's conduct, were a broker to act in conflict of interest without the knowledge and consent of its principal.

For example the *Trade Practices Act 1974* (Cth) which contains anti competitive conduct provisions e.g. provisions relating to horizontal and vertical restraints, price fixing, and collusion between competitors and misleading and deceptive conduct.

There is also secret commissions legislation in Australia which is State based that does impose disclosure obligations on agents of principals to disclose any remuneration or benefits received from a third party. The level of disclosure differs in each State.

Contractual obligations

In Australia nothing prevents a placing broker and producing broker or cedent and producing broker and possibly cedent and placing broker (in unusual circumstances), from entering into an agreement which allows the relevant conflicted entity to act in a way that is in conflict with the obligations it would otherwise owe the principal.

However, great care would obviously need to be taken in drafting the contract and obtaining such agreement. Its enforceability will very much depend on whether the disclosure of the conflict was adequate when negotiating the contract. There is also the commercial matter of getting a client to agree to the entity acting in a way that may be contrary to its own interests. In some cases the above will effectively mean that the reinsurance broker will practically have to avoid the conflict.

General Law

There are no Australian cases in relation to conflicts of interest specifically relating to producing reinsurance brokers. Australian courts would typically look to the law applied in relation to fiduciary obligations owed by Australian financial intermediaries (there is some recent case law relevant to financial advisers that would be relevant) and also foreign case law (typically the UK and US) to form a view.

The general law fiduciary duty requires a person to act in the best interest of their principal, with undivided loyalty. This essentially means that a fiduciary must not:

- put themselves in a position where their personal interest conflicts with that of the principal; or
- use their fiduciary position, or any opportunity or knowledge resulting from that position, to derive a benefit for themselves (see *Chan v Zacharia* (1984) 154 CLR 178 at 198-199 (High Court of Australia, Deane J)).

It is likely that in Australia (subject to contractual agreement to the contrary and the nature of the tasks involved and client instructions):

- producing brokers would, in most cases, be found to be acting in a fiduciary capacity for cedents;

- placing brokers would, in most cases, be found to be acting in a fiduciary capacity for the producing broker; and
- in certain cases, placing brokers could in rare cases be found to be acting in a fiduciary capacity for a cedent.

Examples of types of conflicts of interest that could be faced by reinsurance brokers

Where reinsurance brokers (whether producing or placing) provide services on behalf of another entity (in the present case this would be the cedent or producing broker) they may put themselves in a position of conflict of interest.

Some examples include the following:

- a placing broker receiving commission remuneration or other benefits from reinsurers where the rate and amount varies between reinsurers – it is in the broker's interest to obtain the highest rate/benefit but this may not be in the producing broker's and/or client's interest. To the extent the producing broker has any control or right to remuneration/benefits from reinsurers, the same issue would arise;
- a placing broker receiving remuneration based on the volume or profitability of the reinsurance business arranged by it with reinsurers - it is in the broker's interest to provide the business to the reinsurers but this may not be in the producing broker's and/or client's interest. To the extent the producing broker has any control or right to similar remuneration from reinsurers, the same issue would arise;
- a placing broker acting as agent of the reinsurers and not the producing broker or client in arranging or entering into the relevant reinsurance – If the producing broker or client is not made aware of this role and the placing broker is seen as having acted in this or a dual capacity in the transaction, a conflict of interest may arise. To the extent a producing broker may act for an reinsurer in relation to a transaction the same issue would arise;
- a placing or producing broker's association with reinsurers e.g. they are related - it is in the broker's interest to provide the business through the reinsurer but this may not be in the client's interest;
- a placing or producing broker's association with other entities associated with the transaction e.g.:
 - the producing broker is related to the placing broker;
 - the producing or placing broker is related to:
 - ▶ other reinsurers the reinsurer will obtain retrocession from;
 - ▶ other brokers (including retail brokers); and
 - ▶ other service providers (e.g. claims administration, premium/reinsurance collections, statutory/accounting,

regulatory compliance, advice/consulting services and auditing).

For example, the broker knows the reinsurers the business will be placed with will utilise the related broker as their reinsurance broker to retrocede the risk or seek retrocession from a related reinsurer or a reinsurer or other entity that is paying a related advisory entity to advise them.

In the above cases it is clearly in the broker's interest to provide the business through the chain that results in the related third party being utilised but this may not be in the client's interest.

- a disclosure of confidential information relating to a client to a third party other than for the purposes of the transaction e.g. disclosure of underwriting or pricing information, remuneration or other program information (e.g. retail brokers) or for the purpose of the transaction but in a conflicted capacity (e.g. broker may organise for a report on behalf of the reinsurer but faces a conflict of interest situation if the cedent requests a copy of the report).
- the use of systems and procedures or use of entities (e.g. reinsurers) that results in a greater interest component on moneys held by the producing or placing broker. This is clearly in the interest of the brokers but may not be for the client.
- the placing of a client into a facility which is administratively cost effective for the broker but may not be the most appropriate arrangement for the client.

A relatively recent example of the conflict of interest issues that can arise is the action commenced in October 2007, by Connecticut Attorney General Richard Blumenthal against Guy Carpenter ("Guy Carpenter"), an international reinsurance intermediary of Marsh & McLennan Companies, Inc. and Excess Reinsurance Company, for whom Guy Carpenter acts as a general manager. It was alleged that the reinsurance broker acted in conflict of interest and engaged in a series of conspiracies within the reinsurance industry to fix prices and output, foreclose competitors from access to markets, and allocate markets to eliminate competition for the purpose of substantially increasing profits in the market for reinsurance.

The alleged conduct and conflicts/breaches of duty included:

- the trading of access to a lucrative book of business for certain reinsurers in exchange for excessive fees and benefits by creating a series of reinsurance facilities aimed at a large block of the reinsurance broker's smallest clients. The above meant that the reinsurance broker was failing to seek competitive quotes on behalf of the client and this was not disclosed.
- failing to act in the best interests of its clients by working to enhance and maintain the profitability of the reinsurers by reason of the above. There was no disclosure of the relationship with the reinsurers or the fact that

the reinsurance broker often set the price and terms of the reinsurance contracts entered into by its clients.

- Acting in a management role and having an ownership interest in a reinsurer used in the arrangements. This self dealing was not disclosed and neither were the significant additional fees and benefits that were received by reason of this arrangement.

How to manage conflicts of interest

The choices, once a conflict of interest is identified, are to either avoid it or seek to manage it. Most reinsurance brokers would seek to manage it by way of disclosure to the client (See for example the current Guy Carpenter Disclosure Policy <http://www.guycarp.com/portal/extranet/commitment/disclosure.html?vid=11>.)

The question is always going to be what disclosure is sufficient to ensure the client is fully informed as to the nature of the conflict of interest before proceeding and when is express consent required.

What needs to be disclosed and how it needs to be disclosed depends on the circumstances, such as:

- the type of transaction;
- the nature of the conflict (e.g. type of remuneration, role or association);
- the level of sophistication or pre existing knowledge or consent of the client; and

There is not a simple solution that applies to all.

What is appropriate disclosure will depend on the circumstances and can vary according to the experience of the insured and type of business as well as the practices of the relevant profession.

For example, it has been found that in the situation where an agent, at the direction of the principal, looks to a third person for its remuneration, the agent is entitled to receive and retain such benefits, as they are usual and customary and the principal cannot object merely on the grounds that he or she was unaware of the actual amount. What is a reasonable custom or usage is a question of law, whereas the existence of the custom itself is a question of fact which must be strictly proved¹.

1 Con-Stan Industries of Australia Pty Ltd v Norwich Winterhur Insurance (Aus) Ltd (1986) 160 CLR 226.

At the end of the day a broker will usually need to be able to at least establish that:

- the client was sufficiently aware of the conflict (this may be the subject of a great deal of debate and evidence); and
- agreed to the broker providing the service on that basis.

Ultimately, if the disclosure is not likely to be sufficient or commercially the client will never be likely to agree, avoidance is the likely end result. Many brokers seek to put in place procedures and policies regarding benefit limits etc that aim to mitigate client concern regarding conflicts of interest, especially regarding receipt of remuneration from reinsurers and others.

If an agent breaches the duty, the principal may either:

- affirm the contract and seek an account of damages or profit; or
- rescind the contract provided restoration to the original position is possible.

An agent may not be able to recover any remuneration where the agent has made a secret profit/breached any fiduciary duties.

If an agent accepts a secret commission the principal can also potentially sue the third party for the tort of fraud². It is irrelevant whether the agent had been influenced by the secret commission³. The liability of the agent and the briber can arise in respect of the amount of the secret commission as a liability in debt⁴. The agent becomes liable in tort, directly and severally with the briber, for any loss actually sustained by the principal in consequence of any breach of duty on the agent's part and by reason of fraud.⁵

An affected principal may be able to rely on other causes of action such as an action for misleading or deceptive conduct under the Trade Practices Act and these are also likely to be restrictive trade practices issues that arise.

2 Mahesan v Malaysia Government Officers' Co-operative Housing Society Ltd [1978] 2 WLR 444 at 450-1.

3 Lucifero v Castel (1887) 2 TLR 371.

4 Lister & Co v Stubbs (1890) 45 Ch D1.

5 Mahesan v Malaysia Housing Society [1979] AC 374

Duties owed by reinsurance producing and placing brokers to cedents.

As noted above there is no specific law in relation to reinsurance brokers in Australia so by and large, the law of principal and agency will govern the legal relationship between:

- a reinsurance producing broker and the cedent;
- a placing broker and producing broker;
- a placing broker and the cedent (in very limited cases); and
- the broker and the cedent on the one hand and a third party (such as the reinsurer) on the other.

Whilst there are no Australian cases on reinsurance brokers we have identified, it is likely that the position taken by Australian courts in relation to insurance brokers, adapted where appropriate for the particularities of the reinsurance market and particular reinsurance transaction, would apply to reinsurance brokers.

The position is likely to be as follows:

- It will be an implied term of the contract that the reinsurance broker is under a duty to exercise reasonable care and skill in the performance of their obligations. The duty also arises in tort;
- The duty can be affected by the contract between the parties;
- What constitutes a breach is a question of fact depending upon all the circumstances of the case. The test for breach of duty of care is whether the broker has failed to meet "the standard of care, when viewed objectively by the court, expected of a competent, experienced well informed broker" (See *Mitor Investments Pty Ltd v General Accident Fire and Life Insurance Corp Ltd & Allot- Anor* (1984) 3 ANZ Ins Cases 60-562);
- What is reasonable skill and care is assessed in light of the standards of professional conduct and practices prevailing at the relevant time but the position and experience of the client may be relevant (see *In Claude R Ogden 6' Co Pty Ltd v Reliance Fire Sprinkler Co Pty Ltd* [1973] 2 NSWLR 7 and *Norlympia Seafoods Ltd v Dale & Co Ltd* [1983] I.L.R. 1-1688).
- The reinsurance broker does not, in the absence of an express provision to the contrary, agree to exercise an extraordinary degree of skill but rather a reasonable degree of skill. The standard is likely to be higher for a reinsurance broker than for a non expert and a specialist in a particular field may be expected to exercise a higher degree of skill than an ordinary reinsurance broker.

Typically, producing and placing reinsurance brokers would be expected to (subject to agreement to the contrary):

- make reasonable enquiries about the client and its needs to determine what risks are to be covered. A broker should ensure that they have all relevant information in relation to the client.

For the producing broker, the challenge is to obtain this information from the cedent and appropriately liaise with the placing broker in case they do not have the knowledge or experience to be able to do so in an appropriate way. The placing broker will have to liaise with the producing broker to ensure it gets the information it needs to appropriately carry out its obligations. A failure to do so exposes it to a claim by the producing broker that it did not properly advise it on what was required from the cedent

- follow the client's instructions clearly and to use reasonable care and skill in carrying out the instructions. Where the instructions given are ambiguous, if their interpretation is reasonable in all the circumstances they may not be liable for breach of duty. A reinsurance broker may be under a duty to seek clarification and point out the pitfalls that might arise in the course of effecting the reinsurance arrangement in a particular way. Where no specific instructions are given to obtain particular reinsurance, if the broker acts upon the best advice they can obtain in the circumstances or in accordance with industry usage, they may not be liable for any resultant loss.

The challenge for producing and placing brokers is similar to that in the first point.

- advise the client of the duty to disclose material facts to the reinsurer, although this is debatable depending on the sophistication of the client. The producing broker would owe this obligation to the cedent but given the sophistication of cedents a failure to do so may not always result in a breach;
- pass on information disclosed by the client. There is some debate in Australia (see *Permanent Trustee of Australia Co Ltd v FAI General Insurance Co Ltd* (2003) 214 CLR 514 (High Court)) as to whether the principle that the acts of the broker are the acts of the insured and the broker's state of mind will be treated as the state of mind of the client as well will always apply. i.e. a broker had to disclose all material facts within his or her knowledge, regardless of where the knowledge has come from and whether they were known to the client or not.
- advise on the legal pitfalls that arise in the normal course of effecting insurance which, as a reinsurance broker, they will be expected to be familiar with. The involvement of a producing and placing broker apply this rule to both. If the producing broker passes on information provided by the placing broker to the cedent and does not adopt it as its own, it may not be exposed. The placing broker may be exposed to an action by the cedent for misleading and deceptive conduct. Consideration of the information

flow and responsibility for representations made (and possible restrictions on what can be passed on) is crucial for placing brokers when acting for producing brokers.

- make reasonable enquiries about the availability of a particular type of reinsurance cover and secure the best rates available on the market and the best terms and conditions of reinsurance contracts. Merely placing the business with a facility without seeking competition quotes will not be enough;
- advise if cover is unobtainable. A failure to do so which means that replacement cover cannot be renegotiated in sufficient time exposes the reinsurance brokers involved to risk;
- prepare appropriate wording where required and review the wording to ensure that it is unambiguous and covers the risks as intended. The division of responsibility between producing and placing brokers is crucial. If a producing broker is reliant on the placing broker in this regard it should be made clear;
- advise on the conditions/exclusions under the reinsurance contract. Whilst it is not necessary to explain every term or condition, in most cases there is likely to be positive obligation on a reinsurance broker to explain the important terms. How important the term or condition is to the client, and the extent of that explanation, will depend upon a number of factors, including:
 - the extent to which the condition might be regarded as unusual
 - the relevance of each condition to the specific needs of the client; and
 - the extent of knowledge and experience of the client.
 - Again, it is in the interests of the producing and placing broker to be clear on what is required and who will have this ultimate responsibility. If not a placing broker may be able to assert that if the placing broker failed to do this, it could reasonably have expected the producing broker to have done so;
- procure written authorisation from the cedent before negotiating or accepting reinsurance. A placing broker should be able to rely on the instructions of the producing broker in this regard. The main risk for the producing broker is the provision of instructions which have not been given by the cedent;
- not to delay in arranging cover or advise if there will be an unreasonable delay. This risk arises for the producing broker in passing on the client's instructions to the placing broker and the placing broker in effecting the cover on receipt of instructions from the producing broker;
- not place reinsurance cover with reinsurers of doubtful financial standing or stability (see *Beck Helicopters Ltd v Elizabeth Lumley and Sons (NZ) Ltd* (1990) 6 ANZ Insurance Cases 60-995; and *Zisopoulos v Barry Johnston*

(Insurance Brokers) Pty Ltd (1992) 2 ANZ Insurance Cases 60-461, where a broker was found liable in circumstances where it knew that the insurer had ceased trading, but had accepted an implausible explanation from a director of the insurer). The duty is probably continuing, so that where there are doubts about the insurer's solvency or financial position after cover is placed, the client should be advised so that it has the opportunity to consider whether to take out other insurance). Allocation of responsibility between the producing and placing broker is crucial in this regard, in particular regarding the ongoing obligation aspect;

- check the documentation thoroughly to make sure that it complies with its instructions. This would apply to both the producing and placing broker. However, where the client does have insurance expertise, the reinsurance broker's duty of care may be diminished somewhat and the client is likely to have some responsibility to check the reinsurance broker's work;
- hold all funds in a fiduciary capacity and transmit funds between the cedent and reinsurer and account properly for all funds received and transmitted. The producing broker may be exposed where funds are transmitted to a placing broker and the funds are not remitted to the reinsurers. Where advance payment is made by a reinsurance broker, care needs to be taken as to whether the money can be recovered if the cedent chooses not to pay;
- maintain books and records for such period after termination as is reasonable (typically reinsurance brokers aim to keep the records for at least the statutory limitation period or such longer period in which claims under the relevant reinsurance contract could be made). If the reinsurance brokers do not want to do so they need to agree otherwise in their contracts;
- maintain the reinsurance in force. This is an interesting area. What duties are owed post-placement is open to some debate. The recent case of *HIH Casualty and General Insurance Ltd v JLT Risk Solutions Ltd* (2006) EIVHC 485 (Comm), although based on very specific facts, has raised issues in this regard by imposing a duty of "potential materiality" i.e. to read the information and alert their clients to matters that insurers may consider to be material to cover;

As a final point, in relation to duties owed to persons other than the client a reinsurance broker will generally only be liable to a third party (e.g placing broker to cedent) if they can prove negligence or misleading or deceptive conduct.

In establishing whether there is a duty of care to a particular third party will depend on a number of factors such as, any assumption of responsibility taken by the reinsurance broker to the third party, reasonable foreseeability of loss and ensuring that any duty imposed does not create indeterminate liability to an indeterminate class or persons, or interference with the commercial freedom of the broker (*Pen v Apand* (1999) 198 CLR 180).

Given the disconnect between the cedent and the placing broker, the risk of miscommunication, confusion and debate over what duty each broker owed each other and the cedent etc is significantly higher than when one reinsurance broker is involved. A careful consideration of the issues and relevant responsibilities:

- the producing broker wants in relation to the cedent (especially where it is in effect reliant on the placing broker's expertise and advice); and
- the producing broker and placing broker have in relation to each other and the cedent,

is crucial and the terms of agreement between the relevant parties should be clearly documented wherever possible to avoid what would be costly litigation when something does go wrong.

Mark Radford
Partner

02 8281 4442
mar@cbp.com.au

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T 61 2 8281 4555
F 61 2 8281 4567
E law@cbp.com.au
I www.cbp.com.au

Level 42, 2 Park Street
Sydney NSW 2000
Australia

DX 280 Sydney
Advoc Asia member

Colin Biggers
& Paisley

LAWYERS