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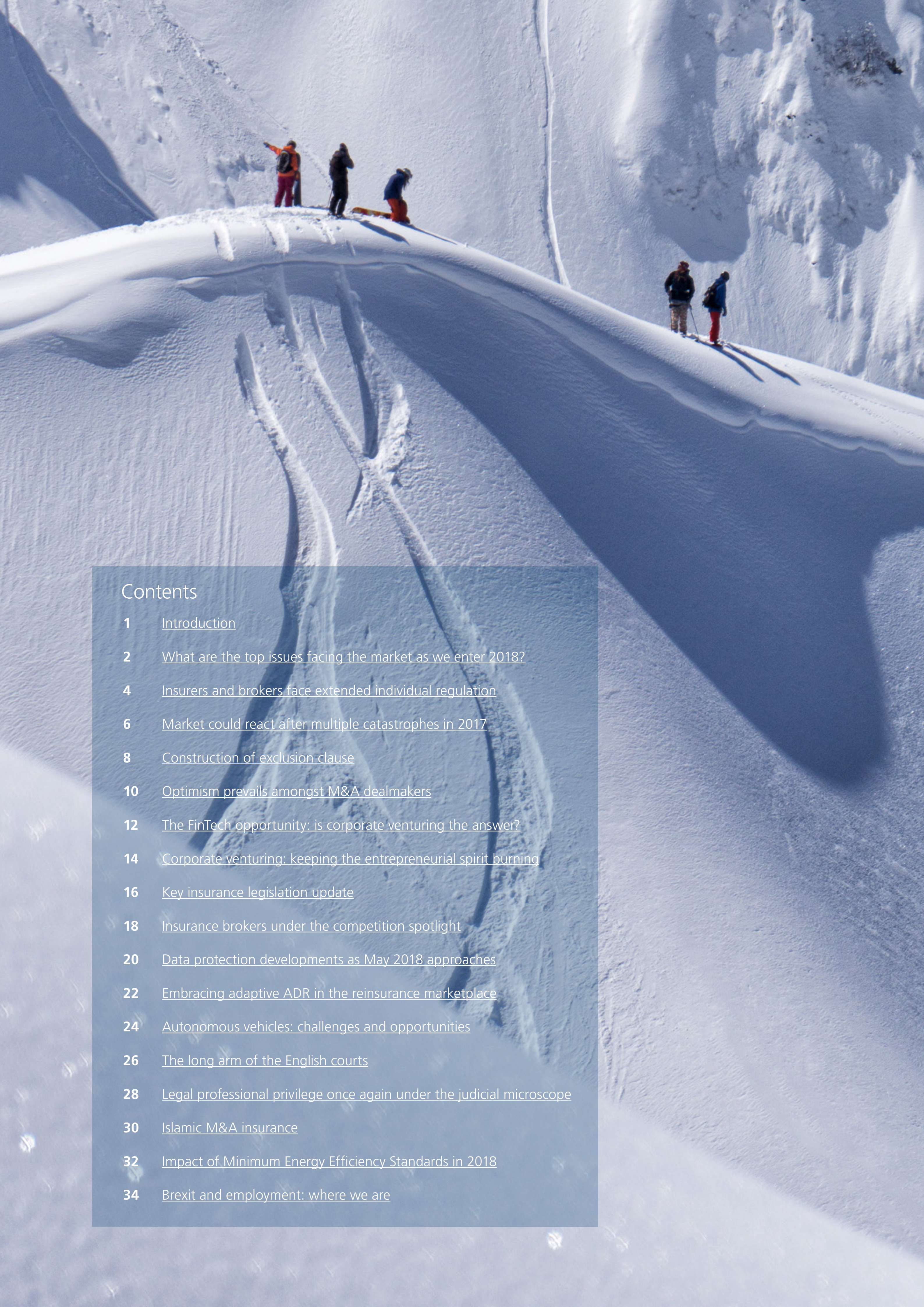
Winter 2017/2018

RISK MATTERS

Insurance sector update



Contents

A very warm welcome to this

RISK MATTERS

Winter 2017/2018 edition

Inside you will find more than a dozen articles from across the CMS practice areas, which we have curated especially for risk managers and insurance professionals. Starting with my top 10 current market issues, we look towards what 2018 may herald.

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At the heart of this publication are articles on insurance claims, including an analysis of the current state of play in the game of push and pull between policyholders or cedents and their (re)insurance supply chain. Nowhere is this better illustrated than by our review of the year's catastrophe claims in North America, where estimates at the time of writing valued claims potentially north of $100bn.

Beyond the issues of dispute resolution, a large number of our lawyers have been helping clients get to grips with the twists and turns of regulation, particularly in relation to new technologies. One of the most immediate developments in this area will be connected vehicles, about which we have a comprehensive review from Neil Beighton, Simon Kilgour and Caroline Cooper.

Following closely behind in the list of technologies disrupting established sectors is InsureTech, whose practical applications are now beginning to bear fruit. Corporate Insurance Partner Chris Southorn has considered the questions for investors in this space, given that it is populated by a tantalising mix of start-ups looking to disrupt a market full of large, established companies. Chris asks quite simply, 'Is corporate venturing the answer?'.

Off the back of these challenging dynamics, we are keen to make sure clients are addressing the most pressing issues. With less than six months to go, GDPR will surely have crossed your path and our round up from expert data lawyers Ian Stevens and Emma Burnett will tell you everything you need to know.

And finally, to the law. As insurance law practitioners, we had anticipated a number of pieces of new legislation in recent years and have watched on with some frustration as their impact appeared to fall with a whimper, rather than a crash. Nevertheless, it is our prediction that key legislation like the Insurance Act, the Third Parties (Rights against Insurers) and Enterprise Act will finally begin to face genuine tests in the courts of England and Wales. We look forward to being involved with, and discussing the implications of, those decisions as they occur.

We do hope you enjoy this edition of Risk Matters. I look forward to hearing any feedback you may have and do feel free to contact any of the contributors as well if you have any questions or points arising from what you read.

What are the top issues facing the market as we enter 2018?

As we welcome 2018, there seem to be numerous business critical issues facing the market. Here are my top 10 for the next 12 months:

1 Making a profit in a soft market

Cycle profit management has always been about shaving expenses and reserve releases to offset low investment returns and low technical pricing of all direct classes of insurance. 2017 turned into a year with significant catastrophe losses and for the reinsurance market in particular, it will be difficult for some entities to make a profit with trade-offs needing to be made between increased retentions and decreasing reinsurance costs. Moving forwards, is managing claims and claims leakage rather than expenses likely to make a greater difference to results?

2 Brexit

The probable loss of passporting rights in the UK after Brexit, as matters stand, has sent companies seeking alternative homes with many having already identified their relocations of choice. In stark contrast, there has been little, if any, progress in clarifying what will happen to the EU legal structure post-Brexit and in respect of the UK market in which (re)insurance currently operates.

UK regulators have required firms to be ready for Brexit but cannot offer any guidance on what Brexit means or its timetable, so the worst case scenario (the crash landing in late March 2019), has to date been the only basis for firms to model. Everybody is now more familiar with WTO rules, but these are predominately in relation to trading goods; market access (in WTO/FTA terminology) is not the real or immediate priority for financial services. Can the negotiations facilitate a regulatory acceptance by the EU of the UK post-Brexit regulatory regime or must businesses effectively decide right now to de-risk the possibilities of this happening by planning to irrevocably relocate relevant business operations?

3 AI/Robotics

It is happening. It is transformational. The cost-savings and efficiencies generated by embracing AI can transform the economics of a business. In what seems an interminably soft cycle could it offer business a way to stay relevant and profitable in the future? Questions remain as to how disruptive it will be to existing distribution and supply models in the sector, and to future staffing. First mover advantage will generate the greatest rewards and may be the key to many businesses' survival and profitability. Who will lead the way?

4 GDPR

Launch date of the new regime is 25 May 2018. The key message given to the industry at the start of the journey to its application was that it needs a greater command over the data it holds, why it is held and how long it is held for. That message remains, but how far are businesses along the road of that journey? There is no scope for further delay; the insurance market must urgently look towards this date and the way it treats personal data, to assess and understand organisational exposures and take steps to develop, build and implement GDPR compliant documentation, processes and systems.

5 Ogden rates

If ever there was an event you could describe as 'seismic', the UK Ministry of Justice announcement in February 2017 that moved the Ogden 'Discount' Rate from 2.5% to minus 0.75% was it. One only had to track the series of first quarter and half-year charges throughout the market to see the impact it had. However, is there light at the end of the tunnel and a balance sheet bounce back to be had, with the Government's recent announcement in September that the discount rate could be set between 0% and 1% under new draft legislation? Motor insurers in particular are anxious to avoid any further inflation given the imposition of 12% Insurance Premium Tax. The sector's reputation has taken a hit, through no fault of its own, so here's hoping for a quieter year in 2018.

6 Cyber risk

Cyber is an acknowledged risk throughout our interconnected society – for individual, consumer and business alike. Whoever is at risk, there is one common consequential thread: it can generate complete catastrophic loss and in WannaCry and Petya, 2017 resulted in significant damage to the bottom lines of numerous global multi-nationals. Interestingly, ratings agency Fitch reported in November 2017 that the influence of cyber risk on insurer ratings is 'likely to be gradual' reminding investors that overall exposures remain low as the market continues to take a cautious approach to underwriting.

7 Regulation

Regulation is here and it will not go away - as the recent announcement of the FCA's investigation into the wholesale market in the UK and the coming into force in 2018 of provisions relating to the Senior Managers Regime demonstrate in such a timely manner. As always where will the pendulum rest between consumer protection, and business cost and business flexibility? Management of regulatory risk is a zero sum gain for insurers – the market must continue to embrace and adapt to the regulators' demands – or die.

8 The war for talent

As margins tighten, the cost of capital rises and there is increasing market competition. Allied with the potentially seismic disruptive forces of technology and automation, ensuring that businesses have the highest quality talent and personnel is a necessity. It is not just about meaning that tapping into the best talent from within the market place - but ensuring the best young talent enters it. The technological change that this industry will face will bring with it demand for the very best talent to be working in conjunction with it. However, that battle is potentially a fight with the gig economy as the tech industry offers young graduates a description of an exciting future.

9 Fintech and new product development

The world has gone through interesting times in the recent 12 to 18 months. More so than at any point before, there is pressure on insurance companies to provide products and to deliver services that meet social need and new price expectations. The industry must remain on top of its game to come up with the right products, to sell them in a user-friendly way and at a user-friendly price. If a business does not remain relevant to its market, it will not survive. Developing the right products for customers, identifying opportunity and responding to that opportunity – swiftly – is simply a necessary business imperative.

10 Capital

Capital demands are also increasing, as regulators (and rating agencies) demand increasingly embedded levels of capital to match increasing expectations of solvency and counter party protection. Surplus capital abounds but that is also another challenging risk –too much capital, chasing too many deals, can itself promote imprudent risk taking.

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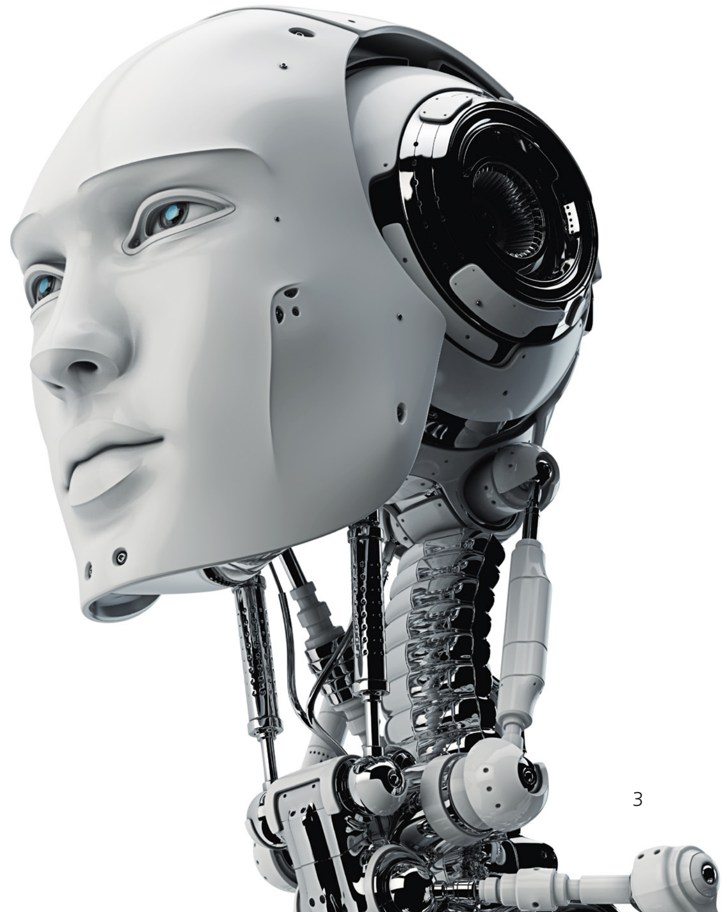

Insurers and brokers face extended individual regulation

*The FCA is proposing to extend across the financial services sector the Senior Managers Regime (**SMR**) and Certification Regime (referred to as '**SM&CR**') originally introduced by the FCA and the PRA on 7 March 2016 to strengthen individual accountability in the banking sector.*

It is expected that the extended regime will come into force in late 2018 and will affect:

- Insurers and reinsurers – by replacing the current Senior Insurance Managers regime with the SM&CR bringing about fundamental changes.
- Insurance intermediaries– by extending the SM&CR to apply to all FCA-only regulated financial services firms.

These changes reflect the FCA's determination to hold senior managers across the financial services sector responsible for breaches in their areas of responsibility and to ensure that staff at all levels are fully alert to regulatory requirements.

What is currently in place?

Since 7 March 2016, insurers and reinsurers have been subject to the Senior Insurance Managers Regime (**SIMR**). Concurrently, the FCA amended the Approved Persons Regime (**APR**) to implement the governance requirements of Solvency II.

A small sub-set of senior individuals within intermediaries who perform one or more 'controlled functions' is currently subject to the APR.

Who will the changes affect?

The proposals will affect all insurers and reinsurers regulated by the FCA and the PRA. It has been proposed that the full regime will apply to Solvency II firms and large non-directive firms (**NDFs**) and a streamlined regime will apply to small NDFs, small run-off firms and Insurance Special Purpose Vehicles.

Intermediaries will fall within one of three categories depending on their size and risk. We expect most intermediaries will be considered to be 'core regime firms'. Small insurance intermediaries will be treated as 'limited scope firms' and will be subject to fewer requirements. High impact firms which satisfy certain criteria will be known as 'enhanced regime firms' and will be subject to extra requirements. Most relevant to intermediaries is whether the total intermediary business revenue is £35 million or more per annum.

What is the practical impact?

The SM&CR has three key components of which insurers, reinsurers and intermediaries should be aware.

1. SMR

For insurers/reinsurers: The senior manager elements of SM&CR will be similar to what is currently in place as part of the SIMR; however, there are some key changes:

— Senior Insurance Manager Functions (**SIMFs**) are due to be renamed as Senior Management Functions (**SMFs**) for consistency with the SM&CR for banks.

— A new set of SMFs will replace the current significant influence functions (**SIFs**) under the APR.

— Additional prescribed responsibilities will need to be allocated to senior managers.

— Senior managers will be subject to a statutory duty of responsibility and must take reasonable steps to prevent a regulatory breach occurring in order to avoid being found guilty of misconduct by the FCA.

— Management responsibility maps will replace governance maps.

— Statements of responsibilities will replace scope of responsibilities for senior managers.

For intermediaries: The top layer of executive management and all directors must be pre-approved by the FCA as Senior Management Function **(SMF**) holders. SMF holders will be subject to first and second tier conduct rules, which are substantially similar to the current Statements of Principle for Approved Persons (**APER**). In addition:

— A senior manager must prepare a statement of responsibilities setting out his/her duties. An enhanced firm must also prepare a management responsibilities map linking these together and describing its governance arrangements.

— A senior manager is subject to the duty of responsibility and must take reasonable steps to prevent a regulatory breach occurring in order to avoid being found guilty of misconduct by the FCA.

2. Certification regime

The Certification Regime will be introduced to insurers, reinsurers and intermediaries. Individuals below the level of senior manager who can cause significant harm to the firm or its customers, such as managers of significant business areas, customer advisers and their managers, will not be individually approved (even if they are currently performing a controlled function under the APR). Instead, the firm is responsible for ensuring and certifying their fitness and properness. They are termed certified staff and are subject to first tier conduct rules.

3. Conduct rules for all staff

For insurers, reinsurers and intermediaries: The vast majority of employees working for insurers (except ancillary staff e.g. cooks, cleaners, receptionists) will be subject to the same first tier conduct rules as certified staff. This is a significant change; currently conduct rules only apply to staff who have been individually approved by either the FCA or the PRA under the SIMR or APR.

Firms must make individuals who are subject to the conduct rules aware of their personal responsibility and the rules themselves.

What is the timetable?

SM&CR extension announced

Deadline: October 2015

Regulator's consultation on SM&CR extension

Deadline: Ended 3 November 2017

Further consultations from the PRA and the FCA regarding transitional measures/consequential changes

Deadline: Expected Q4 2017/Q1 2018

Commencement Order - Bank of England and Financial Services Act 2016

Deadline: 2018

FCA and PRA policy statements and final rules

Deadline: Summer 2018

Extended SM&CR enters into force

Deadline: Late 2018

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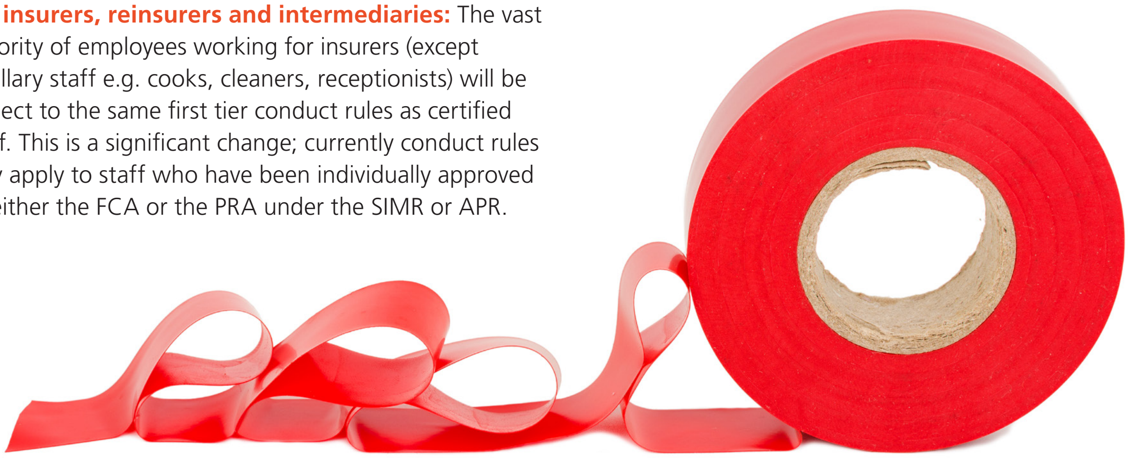

Market could react after multiple catastrophes in 2017

The disasters that struck North America in the second half of 2017 put unrelenting pressure on reinsurers and insurers of US Property & Casualty.

The devastation caused by Hurricane Harvey, Irma and Maria was followed by some of the most destructive Californian wildfires in the State's history. The unprecedented severity of events in Texas, Florida and California prompted uncertainty as to whether insurers would have sufficient reinsurance cover.

Wildfires - cause of loss

By early November, data was still being collected. Moody's most conservative estimate during October was of total insured loss from the Californian wildfires rising to $4.6bn, based on the number of structures now believed to have been destroyed. On 13 November Aon Benfield Impact Forecasting cited CalFire, which expected up to $8bn, representing 'on an aggregated basis, the costliest insured wildfire event ever recorded.'

The term 'wildfires' is potentially misleading as it suggests that the fires have arisen from natural causes. In reality, they appear to be mostly the result of human intervention, ranging from deliberate arson to discarded cigarettes and power line failures. The shortage of adjusters in the US following the recent series of catastrophe losses (or the unwillingness of hard-pressed direct carriers to incur adjusters' fees) may result in difficulty distinguishing between different causes of loss. A fire started by an accidentally dropped cigarette or out-of-control campfire will by its nature be an isolated incident, lacking any causal connection with other nearby fires.

The power line failures have created liability exposure for electricity companies, which in turn creates difficulty for reinsurers when aggregating property and casualty losses. Furthermore, without definite causes of loss, reinsurers will be unable to ascertain whether losses are non-elemental or elemental for the purposes of excess of loss cover based on those distinct towers.

CMS has considerable experience of arbitrating these issues in the reinsurance market following the 2007 Californian wildfires. Similar issues have arisen in Canada following the 2016 Fort McMurray fires and apply equally to the recent 2017 Iberian wildfires.

Number of events

Further comparisons with the 2007 Californian wildfires include establishing not only the cause of the fires, but the number of different events. The wildfires are not concentrated to a particular location. By contrast, areas spanning the length of the geographically diverse Californian terrain were ablaze in early October, with more than 200,000 acres burned.

The question will arise as to whether multiple fires can be classified as a single event. In many excess of loss treaties, losses occurring within a specified number of hours – typically 168 – will be deemed to constitute a single event (the reinsured normally elects when that begins). Several of the fires have now exceeded the scope of cover under the 168-hour clauses. However, thanks to the prevailing soft market, certain reinsureds may benefit from an extension of cover to 504 hours.

Order or presentation of losses

Sometimes, the order in which losses are presented can have a direct impact on the cost of a series of disasters for cedants and reinsurers. In *Teal Assurance Company Limited v. W R Berkley Insurance (Europe) Limited* [2013] UKSC 57, the UK Supreme Court determined that a cedant does not have the complete freedom to present losses in any order it chooses. Typically, this is circumscribed by a Loss Date Order clause. In property treaties, this will often specify date of loss order, but in casualty risks, date of settlement order may be preferred.

Accumulation of exposures

A genuine concern for insurers with North American exposures is that multiple further events combined with earlier catastrophe losses may lead to the exhaustion of reinsurance cover. Whilst none of the catastrophes has been sufficient on its own to exhaust the vertical limits of reinsurance cover, the unprecedented frequency of large loss events in 2016 may lead to the exhaustion of horizontal limits.

Many cedants will be scrutinising their reinsurance wordings to determine whether further reinstatements are available.

In particular, cedants were concerned about the potential for more events during the remainder of 2017. It is likely they will be considering whether their programmes need to be redesigned to reflect increased risk exposures in 2018 and beyond.

For example, there is a high concentration of earthquake and fire exposures in Napa Valley, which is one of the areas worst affected by the wildfires which relatively recently was impacted by the 2014 earthquake.

Business interruption losses

Napa Valley wine producers have been affected by physical damage with business interruption. Some producers may also suffer contingent business interruption loss, even if there is no physical damage to their property. Catastrophe modelling firm RMS noted the significant uncertainty around BI losses, particularly for the wine industry, when issuing a preliminary estimate for both insured and economic losses of approximately $3bn-$6bn. Coverage under certain catastrophe excess of loss treaties will be triggered by the Original Insured Market Loss. Whether or not that threshold has been exceeded may lead to the usual uncertainty (and therefore disputes), particularly where the wording does not provide for a reliable index for the loss.

The same can be said for electricity companies, who may be subject to their own first-party losses due to the inevitable disruption to networks, but also third-party claims by households and businesses left without power.

California as a plaintiff-friendly jurisdiction

The pressures for insurers and reinsurers are only increased further by the plaintiff-friendly juries in California. Insurers and reinsurers will encounter difficulty when navigating the complexities of these losses in a courtroom dominated by jurors who have not only been affected by this catastrophe but the multitude suffered by Californians in the past decade.

Under English law, the case of *Commercial Union Assurance Co Plc v NRG Victory Reinsurance Ltd [1998] C.L.C. 920* provided that the English Courts will normally treat the judgement of a court of a competent jurisdiction as decisive. However, where a settlement has been concluded following legal advice as to a likely liability due to an unfavourable judicial climate (e.g. a plaintiff-friendly jury), that may create problems for a cedant when recovering from its reinsurers.

2017 may therefore come to be remembered not only for the frequency and severity of catastrophes in the USA and elsewhere, but an additional layer of complexity in determining legal liability or the losses incurred.

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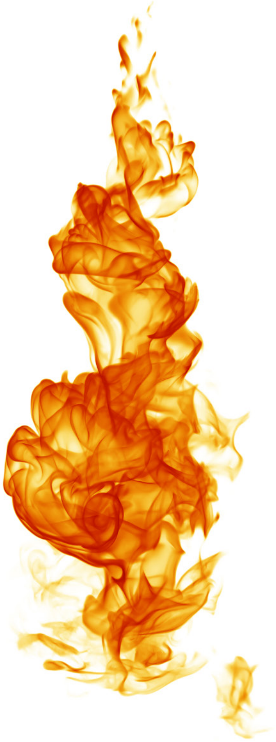

Construction of exclusion clauses

A recent Commercial Court decision has confirmed that the contra proferentem approach should not automatically be applied to exclusion clauses in insurance policies.

This follows the Supreme Court's decision last year in *Impact Funding Solutions Ltd v AIG Europe Insurance Ltd* that the courts will not routinely take a narrow approach to the interpretation of exclusion clauses, and is a trend that seems likely to continue looking forward to 2018. Some received assumptions about how certain insurance clauses will be construed by courts will need to be revised.

In *Crowden v QBE Insurance (Europe) Ltd* the claim was brought directly against the professional indemnity insurer of an insolvent financial advisor under the Third Parties (Rights against Insurers) Act 1930. Although the 1930 Act has been repealed by the 2010 Third Parties (Rights against Insurers) Act 2010, it continues to apply where – as in this case – the insured became insolvent and incurred liability to the claimants before 1 August 2016.

Under the 1930 Act, the third-party claimant's rights against the liability insurer are only as good as the insured's rights would have been. One of the grounds on which the insurer applied to strike out the claim was that the insured's liability to the claimants was excluded from cover under the insolvency exclusion in the policy. The insurer argued that, as it was not liable to indemnify its insured, under the 1930 Act it could not be liable to the claimants.

The insured financial advisor had advised the claimants in relation to investments in a Keydata bond and securities issued by Lehman Brothers. Following the administration of Keydata (and liquidation of the company that had issued the underlying bond) and Lehman entering into Chapter 11 protection in the US, the claimants suffered significant losses. They obtained judgment against the insured for negligent advice and, as the insured was by that time in liquidation, issued proceedings against the financial advisor's PI insurer. The professional liability policy contained an exclusion of cover for claims, liability, loss, costs or expenses:

> ” arising out of or relating directly or indirectly to the insolvency or bankruptcy of the Insured or of any insurance company, building society, bank, investment manager, stockbroker, investment intermediary, or any other business, firm or company with whom the Insured has arranged directly or indirectly any insurances, investments or deposits.

The insurer applied for summary judgment, alternatively to strike out the claim against it. The general principles that apply to the construction of insurance contracts were not in dispute: where the parties have used unambiguous language, even if contrary to commercial common sense, the courts will give effect to it. If, however, there is a genuine ambiguity so that there are competing constructions of a contractual provision, the court will favour the construction most closely aligned with business sense.

The claimants argued, however, that the exclusion clause should be interpreted narrowly, pointing to the principles governing the construction of exemption clauses in ordinary contracts (including the *Canada Steamship* line of authorities). The judge, Peter MacDonald Eggers QC, disagreed, noting that he was not aware of any authority where that line of thought had been applied to exclusion clauses in insurance policies. This, he said, was unsurprising as such clauses were not the same. Exclusion clauses in insurance policies define the risk that the insurer is prepared to assume, rather than excluding, restricting or limiting a party's legal liability.

This follows the approach of the Supreme Court in *Impact Funding Solutions Ltd v AIG Europe Insurance Ltd* (2016), which concerned the construction of a Trade Debts exclusion in a solicitors' professional indemnity policy. In *Impact*, the Supreme Court held that the terms of the policy, including the exclusion clause, had to be construed against the factual matrix and in the context of the contract of insurance as a whole. In particular, the court rejected the argument that a term expressed as an exception meant that it should be approached with a pre-disposition to construe it narrowly and, where there was no ambiguity, the court should not adopt the contra proferentem approach (that in the case of ambiguity a clause will be construed against the party who drafted it).

In the present case, the judge found that the language of the insolvency exclusion was relatively clear and rejected the claimants' arguments for a narrow interpretation. The combination of the use of two differently expressed causative links ('*arising out of*' and '*relating... to*') and the use of the phrase '*directly or indirectly*' indicated that the relevant insolvency could be more remote than a proximate cause, although it nevertheless had to '*stand out as a contributing factor*'.

The conclusion that, on the facts of the case, the exclusion applied, was reinforced by the fact that the policy covering the previous year (underwritten by the same insurer) had contained an exclusion clause in materially different terms. In both policies, the exclusions had been set out in the wordings (and not incorporated by reference) and the court was entitled to assume that the parties had read the terms and been aware of the difference. That was especially so where the insured had been represented by a professional insurance broker. Further, although the exclusion had a broad effect, it did not leave the insured without substantial cover.

The decision confirms the trend of the courts in rejecting a narrow approach to the interpretation of exclusion clauses. Except in the case of genuine ambiguity in the language used or potentially, where the language is unambiguous, where the result would be absurd or where something has clearly gone wrong with the language of the contract, the courts will give effect to the words of the clause.

Insurers will also welcome that the court was willing to determine the issue on a summary judgment/strike out application, without the need for (and cost of) a full trial. The judge dismissed the claimants' arguments that summary judgement would be inappropriate because there were factual matters that should be explored at trial relating to (1) the extent to which the insurer had represented that the policy was compatible with the insured's obligation to maintain professional indemnity insurance under the FSA Handbook, and (2) whether the change in the wording of the insolvency exclusion had been drawn to the insured's attention. The proper construction of the exclusion did not depend on either point and there was no reason not to grant summary judgment.

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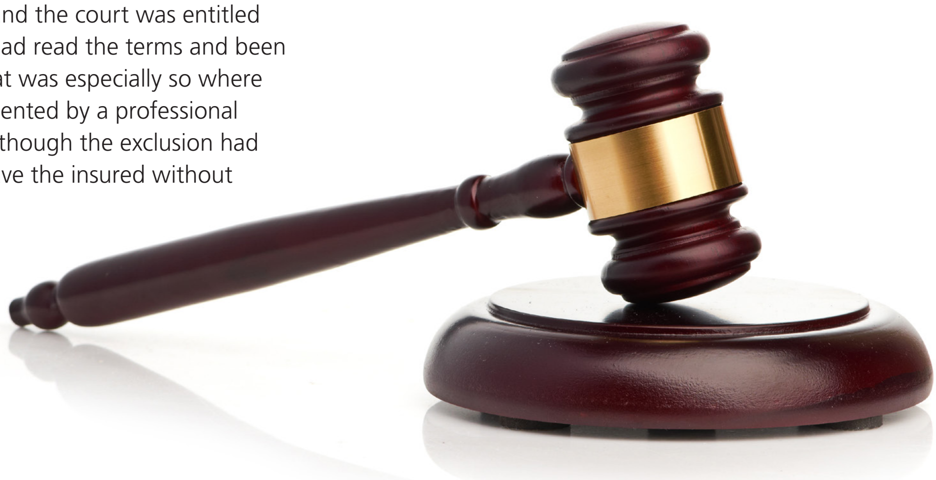

Optimism prevails amongst M&A dealmakers

The recent CMS European M&A Outlook reveals optimism amongst M&A dealmakers as we head into 2018. The report canvassed the opinions of 230 Europe-based executives, from corporates to private equity firms.

While acknowledging some of the challenges they face, respondents were largely optimistic about dealmaking prospects for the coming year, with many suggesting they are ready to take advantage of opportunities stemming from dislocations that result from Brexit and from a return to economic growth in the Eurozone.

What a contrast to the CMS European M&A Outlook 2016 which reflected shock following the UK's vote to leave the European Union (**EU**) and the uncertainty of the impending US presidential election. Back then, most were very uncertain about the future prospects for Europe and its economies and had mostly placed their M&A plans on hold.

Key findings from our research include:

M&A set to rise

Over two-thirds of respondents are expecting M&A in Europe to increase over the coming year, with the overwhelming majority (90%) suggesting that non-European buyers will be active acquirers across the continent. Deals will be driven by the need to diversify away from existing markets to manage volatility, take advantage of Europe's relatively lower valuations and access the EU's large market.

Transformational deals on the cards

In line with the rise of larger, €1bn+, deals seen in the first half of 2017, two-fifths of corporates and nearly half of PE firms are seeking out large transformational deals over the next year. This is partly in response to rapid technological change, with the vast majority of respondents saying that technology and IP are among the top two aspects under consideration when acquiring.

Favourable financing conditions

European companies now benefit from a range of financing options for their deals, from newly-emerging private credit funds that can provide an alternative or addition to bank finance, to more traditional private equity. Respondents are highly positive about the prospects for raising capital over the coming year, with 88% expecting similar or more favourable financing conditions.

Greater confidence is also borne out by experience. In the first half of 2017, the value of European M&A activity was 33% higher than in the same period a year earlier, even with a lower volume of transactions, with Britain and Ireland taking the largest share of the market. Q3 of 2017 has, however, shown a slowdown in global and European M&A with Mergermarket statistics showing a dip in both deal value and deal count.

Uncertainty can be good for M&A

Although uncertainty over Brexit and other issues may be bad for corporate investment, M&A can nevertheless thrive in this environment. The risk-averse owner of an asset will want to sell, but others will sense an opportunity fuelled by significant dry powder in the PE industry, economic resurgence in the Eurozone or, in the case of the UK, a favourable exchange rate. A price that satisfies both sides can be easier to find.

UK dominates M&A in Europe

The UK once again proved in Q3 2017 that it was the dominant country in Europe for M&A with a total of US$44.2bn invested across 318 deals, topping the charts for both deal value and count.

The recent EY Global Capital Confidence Barometer (October 2017) reveals that the UK is 'the third most popular investment destination in the world behind the US and China'. It records that 'Domestic combinations, inbound acquisitions targeting assets in technology and industrials, and outbound deals targeting higher growth markets have all featured prominently in 2017'.

Even though the pace of economic growth is declining in the near term, and negotiations with the European Union are still uncertain, the openness of the UK to dealmaking has supported its position as the third-largest M&A market in 2017.

Regardless of the uncertainty surrounding Brexit, the UK remains a powerhouse of intellectual property-rich companies across a range of sectors. This is especially true in consumer products, financial services, technology and industrials. These companies, with their global reach, will continue to be attractive as targets, but will also be looking to extend their market access through acquisitions.

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The FinTech opportunity: is corporate venturing the answer?

The insurance sector is increasingly at the forefront of the technology revolution. As new solutions offer efficiencies to distribution and delivery, the management and interpretation of data and claims and the systems on which insurance business depends, insuretech is opening up customer propositions and opportunities for brokers and underwriters.

As a result, discussion about the opportunities and threats which technology innovation presents is at the top of the financial services agenda and its impact in the wider financial services sector has been dramatic.

Investment in the right technologies is vital but hard to achieve. This generation of technology innovators values entrepreneurial independence, nimble decision-making, a wide available market, the ability to take risks and the opportunity to benefit financially from the value their skills generate.

The competition for talent is high; for large corporates hiring and retaining complete teams of innovators is close to impossible. There are plenty of start-ups and early stage technology companies seeking to disrupt the sector, presenting its own challenges in understanding the competitive landscape and likely winners, and M&A is not often an option. There are limited reasons for entrepreneurs to sell technologies or businesses early in their development or to narrow the market into which they can sell, particularly in a sector generating significant interest from the broader investment community.

The benefits of scale

On the other hand, insurance providers have significant assets that technology companies need and that no start up can achieve alone: capital; management and sector expertise; customers and data; market knowledge and access; products; brand value; regulatory status.

A corporate venture, bringing together those entrepreneurial and institutional strengths in a co-investment, appears to offer the perfect solution.

However, these transactions are difficult to put together and too many fail. Challenges arise from the respective strengths each party brings (which the other lacks) and the expectations that each has of the other. There are lessons for both to learn, but we have set out below some factors relevant to strategic planning and deal execution for an insurance investor considering a technology corporate venture.

Time value of money

Early stage companies are difficult to value. An investment will require payment for the opportunity to build business that does not yet exist. Due diligence information on which to base that risk may be limited. Founders may take an aggressive view of opportunity value.

Agreement on initial valuation is one part of the challenge, but for an early stage company, speed of deployment is vital. £1 today is not worth £1 three months later. If the business is not self-funding, delays in execution could break it by starving it of funds; if it is, then its value may be increasing rapidly, even while its growth potential is constrained. Exclusivity periods available to an investor will often be shorter than you will have seen on other transactions.

An insurance investor brings many benefits beyond the money it invests, but as a provider of capital, is competing with venture capital funds and others who are organised to execute investments quickly in order to preserve value. An ability to address due diligence and agree commercial terms quickly will enhance prospects of success.

Risk appetite

Start-ups have small teams, limited governance and compliance structures, and take risks as they focus on growth. A certain amount of disorder will be inevitable in every early stage business, and information and records may not be readily available in the form you would expect. Identifying and dealing with this lack of diligence can be uncomfortable, particularly given the requirements of regulatory responsibility and brand management, but it is something for which you should be prepared. The additional rigour an external investor can introduce is a value-enhancing opportunity if properly presented and constructively addressed going forwards.

Agreeing the parameters of the venture is important. Entrepreneurs may have unrealistic expectations of your ability or willingness to take risks on your own side, for example in relation to brand use, customer or data access, or to closing off other routes to market for your products. They may have similar reservations about limiting the independence of the venture. Striking the right balance between protecting an investment and allowing a new technology to flourish is critical to success.

The future relationship

Corporate ventures take a variety of forms and can be pure joint ventures, minority or majority investments. In essence, though, they share an element of partnership by which the parties expect to be co-dependent for some time. Creative solutions may be required to joint venture issues on which the parties may have differing ambitions or constraints, such as deadlock resolution, introduction of new investors, future fundraising commitments and exit or liquidity routes for you or the founders. The sooner that common ground is reached, the greater the likelihood that the relationship and the venture will succeed.

Governance and reporting requirements going forward are also important. Entrepreneurial counterparties will seek as much freedom to build and manage future business and technology solutions as your risk appetite will allow, and often push those boundaries. Monitoring your investment is vital, but reporting and decision-making protocols need to recognise not only your conventional structures but also the limited resources the venture may have available and the speed and freedom with which it may need to move to maintain its success.

Your commercial rationale

An investment may also be an opportunity to secure a route to market for products or first-user advantage with a technology. Founders may also have commercial priorities outside of their equity investment. As ever in transactions, potentially competing objectives require trade-offs. Each dollar of value extracted through negotiation of the commercial and legal arrangements with your investee venture may reduce the value of the investment itself.

Incentivising the team

Employee incentives are vital to early stage companies. They cannot compete for staff on salaries or job security, and options or other equity upside arrangements are the currency with which they hire and often the key focus and motivation for staff in the venture. Creating and maintaining incentives and presenting a viable path to realising value is a strategic imperative. This may require structures that are potentially dilutive to your investment and may be incompatible with the way in which you compensate your own staff, but they reflect the entrepreneurial nature of the business and the people who work for it.

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Corporate venturing: keeping the entrepreneurial spirit burning

As highlighted earlier in this publication, corporate venturing is a great way for big business to get involved in and benefit from the advances being made in the start-up community. A key challenge of corporate venturing, however, is not to kill the entrepreneurial spirit and to ensure that the founders and other senior managers remain hungry to drive the venture forwards.

For the original founders, entering into the corporate venture may have allowed them to take some cash for the value generated to date. They are also likely to continue to hold an equity stake, although at a reduced level and with less control over the future direction of the business. Other senior managers may not have immediately benefitted from the corporate venture and may not yet have an equity stake. They may also look enviously at other companies in the start-up community and their generous share incentive arrangements.

Having the right equity structure and involving the right individuals is critical to the ongoing success of a corporate venture. These matters must be addressed at the outset, with particular consideration given to how the structure will ensure that the team running the corporate venture continues to be engaged and motivated for the long term.

Keeping the founders motivated

Earn-out arrangements are commonly used to keep founders engaged and driven in the years immediately following an investment. Such arrangements can vary widely but, under a typical structure, a proportion of the cash received by the founders for any shares that they sell as part of the deal will be dependent on the achievement of key performance indicators during the first three to five years of the new venture. Earn-out arrangements not only incentivise the founders but can also help to move a deal forwards, particularly where there is uncertainty over the value of the company for whatever reason. Whilst early stage companies may have significant growth potential, they also have little operating history and founders and corporate venture partners are likely to have different thoughts on value.

How any earn-out arrangement and continuing equity stake held by the founders is structured will depend on the company's commercial drivers for the future. Is a future exit event likely or is the investor looking for a longer-term venture? If the focus is on an exit, a ratchet mechanism may be appropriate whereby the proportion of proceeds received by the founders is increased to reflect the value achieved on the exit. If no exit is envisaged, thought will need to be given to providing an internal liquidation opportunity enabling founders to realise value from their equity.

Looking after the other senior managers

The structure of a corporate venture and its commercial aims ultimately drive the design of share incentive arrangements for senior managers. The standout arrangements to implement in a company with a minority investor are not, for example, available if a majority interest is being taken. Regardless of the level of investment, in a world where cash may not be king, share incentives play a critical, low-cost role in attracting and retaining key talent. They do not have to be highly bespoke or complex and, in many cases, the more simple the arrangement, the more effective the incentive delivered. In practice, founders will want complete flexibility as to how they reward and incentivise their senior team. Provided that the corporate venture partner's interests are protected from the outset, they should have little concern about the day-to-day operation of a management incentive arrangement.

Minority investments

Enterprise management incentive (**EMI**) options are a flexible and extremely tax-favoured share option arrangement designed by the UK Government to help smaller companies recruit, incentivise and retain employees. It is often assumed that companies in the insurance sector cannot use EMI but this is not necessarily the case for companies providing services connected to insurance rather than the provision of insurance.

There are various requirements that must be satisfied in order for a company to operate an EMI plan, one of them being that the company is not under the control of another company. Where the requirements are satisfied, however, EMIs can be operated in a very flexible way. With no income tax or national insurance contributions on the option 'gain' and the potential benefit of entrepreneurs' relief regardless of the level of shareholding, EMIs are the incentive of choice. There are plenty of ways to structure incentive arrangements where EMI is not available for whatever reason. A Company Share Option Plan (**CSOP**) is another UK Government approved arrangement (that can be used by insurance companies). Whilst not quite as flexible as EMI, CSOP offers similar tax benefits (without the automatic entrepreneurs' relief).

Majority investments

Where a tax-favoured arrangement is not available, including where a majority investment is being made, companies should consider incentivising managers with real shares. Such arrangements can be structured to minimise the up-front tax burden for participants (and the company) and/or ensure that the management team has real 'skin in the game'. Giving managers an opportunity to acquire equity immediately closely aligns their interests with those of the founders and the corporate venture partner and can send a very powerful message.

Careful thought needs to be given to the rights attaching equity held by managers and, as with the founders, the ability of managers to realise value from their equity. Corporate venture partners will need to consider how comfortable they are (or not) with managers having voting rights and rights to dividends. Unlike an option, which may simply lapse on cessation of employment, mechanisms must also be in place from the outset to deal with taking shares off departing managers. It is also worth bearing in mind that a complex share capital structure with a large number of small management and employee shareholders can unnecessarily complicate an exit. There are numerous ways in which incentives using actual shares can be designed to mirror the commercials of an option and the art of the possible is always worth exploring.

When and how much

A common misconception is that the value of a company's shares on an investment must be the value of a company share for all purposes. This is not the case and the value of a share to an employee for tax purposes is often less. This means that fewer shares may deliver the same financial reward. That is not to say that, commercially, managers should receive shares for 'free' but corporate venture partners should be open to striking the right balance.

If EMI is available, it not only provides companies with an attractive and cost-effective way of rewarding managers, it also presents the only opportunity now offered by HM Revenue & Customs to agree the value of a company's shares. As previously mentioned, valuing early stage companies can be difficult. Having the ability to agree a value with HMRC makes EMI options all the more attractive as both companies and managers have certainty around the tax treatment of their incentives.

It is never too early to implement share incentive arrangements. On the contrary, the prize for implementing an arrangement at a time when there is little or no value in a company's equity cannot be overstated.

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Key insurance legislation update

Could 2018 be the year when recent legislation like the Insurance Act is finally tested in the courts? Will disputes emerge from the Act's Damages for Late Payment provisions in the New Year? These and many questions could soon be answered as we look ahead to the next 12 months.

The majority of policies underwritten since August 2016 are now governed by the Insurance Act 2015, either wholly or – where sections of the Act have been contracted out of – in part. The Act covers the pre-contractual duties owed by non-consumer insureds, establishing a duty of fair presentation of the risk and introducing a new scheme of 'proportionate' remedies available to insurers where that duty is breached. The law relating to warranties in insurance policies (and, in some circumstances, other policy terms) has also been changed for both consumer and non-consumer insurance, as have the remedies available to insurers faced with fraudulent claims.

To date there have been no reported decisions on cases where the Insurance Act applies. The market, particularly with a soft cycle upon us, appears to have had few practical issues adapting to what are arguably the biggest insurance law changes for 100 years, but this will inevitably change and we expect to see the courts grapple with some difficult issues in the near future.

Potential for disputes

These may include the insured's knowledge for the purposes of the duty of fair presentation, terms covered by section 11 of the Act (which requires a causal link between a breach and the loss where a term is intended to reduce risk of a particular kind), and the effectiveness of wording designed to contract out of the Act.

In another important statutory development where we have yet to see cases come before the courts, since 4 May 2017 the Insurance Act has introduced a requirement- a statutory implied term- into insurances issued from that date that insurers must pay valid claims within a reasonable time.

Again, in a soft market there may be little appetite for insurers to seek to exclude or limit their liability. However, we anticipate that damages for late payment may commonly be added as a head of loss where claims are disputed. The question of what is a reasonable time to investigate and pay claims is likely to be a contentious area and it can only be a matter of time before the issue reaches the courts.

Third Parties Act already tested

In the other main area of recent statutory change relevant to insurance law, some judicial guidance has already been given. The Third Parties (Rights against Insurers) Act 2010 came into force in 2016. The 2010 Act (and 1930 Act that it replaced) were introduced to make it easier for third parties to claim compensation for losses directly against the insurers of insolvent insureds. In particular, under the 2010 Act a third-party claimant can bring a single set of proceedings against both the insolvent insured and the liability insurer. The court will determine both the insured's liability to the third party and the insurer's liability under the policy in the same action.

Although the 2010 Act has repealed the 1930 Act, under the transitional provisions the 1930 Act continues to apply in situations where both the insured became insolvent and the liability was 'incurred' before 1 August 2016. In *Redman v Zurich* the High Court clarified that (for the purposes of establishing which Act applies under the transitional provisions) liability is incurred when the damage is caused, not when liability is established by judgment or otherwise. Therefore, the 1930 Act applies where both the insolvency event and the damage giving rise to the liability occurred before 1 August 2016. The judge also rejected an argument that the provisions in the 2010 Act apply retrospectively and run in parallel with the 1930 Act. The effect of the decision is that, for some time to come, in a large number of situations the 1930 Act will continue to apply.

In another decision earlier this year, *BAE Systems Pension Funds Trustees Ltd v Royal & Sun Alliance Insurance plc*, the court considered an application to join an insurer as a co-defendant to existing proceedings against an insured that had gone into administration after the claim was served. The application in this case was made under the 2010 Act. The judge dismissed the insurer's argument that the Act was not engaged because the claim was not covered under the policy. The decision confirms that, under the 2010 Act, insurers may be joined as a party to proceedings notwithstanding the existence of strong coverage defences.

As we move into 2018, we expect to see further case law as the courts and the market come to terms with the interpretation of the new statutory regime. The legislative changes have, in large part, been the result of a Law Commission project that began in 2006. While the main work of the project has finished, it is worth noting that the Law Commission has previously consulted on proposals to reform the law on insurable interest. This included consultation on draft clauses in 2016. That element of the Law Commission's work is currently on hold but they have said that they aim to publish a revised draft bill in due course. It may well be that further changes to insurance legislation will appear on the horizon and we may learn more about that in 2018.

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Insurance brokers under the competition spotlight

*On 8 November 2017, the Financial Conduct Authority (**FCA**) launched a market review of the wholesale insurance broker sector The FCA had signalled its intention to investigate the sector in its 2017/2018 Business Plan.*

London is one of the world's leading insurance markets, in particular for large scale, complex commercial and specialist risks. With an estimated market value of more than £68 billion, the FCA notes that its size and the scale of the risks it covers have a potentially wide-ranging impact on the economy. Brokers have a key role in this market in ensuring customers get coverage and good value. The FCA therefore wants to scrutinise the sector and assess how effectively competition and innovation are working for customers.

The FCA has a range of competition tools at its disposal to review specific markets within its area of competence. We discuss these, the particular issues the FCA is focusing on in the context of the current market study and expected next steps in further detail below.

The FCA's competition toolkit

The FCA has had full concurrent competition powers in relation to financial services since 1 April 2015. It shares these powers with the UK Competition and Markets Authority (**CMA**). These powers enable the FCA to launch investigations into suspected infringements of both UK and EU competition law, carry out unannounced inspections ('dawn raids') to gather evidence, impose fines and apply for director disqualification for breaches of competition law. The FCA can also carry out market studies to assess holistically whether competition in a market is working well, and if not, either impose remedies or refer that market for a more in-depth 'market investigation' by the CMA.

The FCA has been particularly active with market studies and has used them to inform and direct its use of its regulatory and competition law powers within financial services markets. For instance, in 2015 the FCA concluded its market study into retirement income products which resulted in the introduction of a number of remedies designed to support consumer choice, e.g. an 'annuity comparator' and improved 'wake-up packs' to encourage shopping around in the run-up to retirement. The study also led the FCA to identify behaviour that raised its concerns about compliance with competition law. To address these, the FCA issued a total of 23 'on-notice letters' which required addressees to explain and report back within a specified deadline on steps taken to remedy its concerns.

Areas of focus of the study

The FCA's predecessor reviewed the wholesale insurance broker sector a decade ago. Since then, the FCA has identified that there have been a number of significant changes. For instance, brokers now offer clients and insurers a range of new and additional services (e.g. data and analysis services, the development of facilities) to generate revenue in response to a steady decline in earnings from commissions on premiums. The FCA repeatedly notes that many stakeholders have raised concerns about potential competition issues in this sector, in particular in relation to certain of these new products and services. Further, in the FCA's view a market that is working well would keep brokers' remuneration at 'a competitive level'. This suggests the FCA may be suspicious of high profit margins, as it has been in other market studies. It certainly indicates that both broker remuneration and broker facilities will be a focus in this market study.

The FCA plans to assess both how effectively competition is working in wholesale insurance brokerage and how brokers influence competition in the underwriting sector. It highlights three main topics that it will explore as part of the market study:

— **Market power.** The FCA wants to understand whether individual broker firms have market power and, if so, what effect this has on competition. It will consider whether the picture is any different in any sub-segments where there may be fewer active players.
— **Conflicts of interest.** The FCA will explore how conflicts may arise (mainly as a result of the revenue streams brokers generate from new products or services) and how they affect competition and client outcomes. The FCA notes particular business practices that may negatively affect customers, such as channelling underwriting services in-house to keep premium within the group.
— **Broker conduct.** The FCA highlights certain practices that may exclude certain (typically smaller) insurers, such as placing risks through facilities rather than in the open market. It will also consider whether there is any evidence of coordination between firms. In this regard, the FCA highlights that it is concerned that the common practice of stakeholders sharing brokers' pricing information with a rival broker when tendering for business may soften competition between brokers and allow an anti-competitive coordinated outcome. The FCA was already investigating five aviation insurance brokers on suspicion of sharing competitively sensitive information and conducted dawn raids at the premises of at least two of the five brokers in April 2017. This investigation has now been taken up at EU level by the European Commission. It is therefore likely that compliance with competition law will feature heavily in this market study.

Next step

The FCA is inviting feedback (but not formally consulting) on the Terms of Reference for the market study highlighted above, by 19 January 2018. It will soon begin gathering data and information from stakeholders (insurers, brokers and buyers). As well as holding meetings and roundtable events with stakeholders, this is likely to mean that the FCA will shortly be sending out detailed questionnaires to collect information and financial data from market players. Its plan is to publish interim findings in autumn 2018. A final report would follow in 2019.

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Data protection developments as May 2018 approaches

*In a data-heavy business like insurance you would have had to have your head buried in the sand not to have at least a passing awareness of the General Data Protection Regulation (**GDPR**).*

But have you been keeping abreast of the developments in guidance and local legislation? Guidance is emerging all the time at both a European and domestic level, so here we provide a snapshot of some of the latest developments.

European Commission (Commission) guidance

The Commission adopted its work programme for 2018 on 24 October 2017. The Commission aims to provide guidance on GDPR before it applies from 25 May 2018.

ICO guidance

The ICO consultation on its draft GDPR guidance on contracts and liabilities between controllers and processors closed on 10 October 2017. The guidance contains practical guidance for UK organisations including the minimum contractual terms to be included to ensure contracts are GDPR compliant. We expect revised guidance to be issued in the coming months.

The ICO has confirmed that data controllers will be required to pay a fee under the new data protection regime next year. A three-tier fee system based on organisational size and turnover is proposed, that will take account of the amount of personal data processed by an organisation. More detailed information is expected by the end of 2017.

Article 29 Working Party (WP29) Guidelines/ Opinions

*Data protection impact assessments (**DPIAs**)*

The Article 29 Working Party adopted revised Guidelines for DPIAs on 4 October 2017. The new Guidelines stress the fact that where conditions triggering the obligation to carry out a DPIA are not met, this does not diminish a data controllers' general obligation to implement measures to appropriately manage risks for individuals.

Data breach notifications

The WP29 published Guidelines explaining the mandatory breach notification and communication requirements of the GDPR and some steps controllers and processors can take to meet these obligations. The WP29 invited feedback on these Guidelines with the closing date for responses being 28 November 2017. Following review of the responses, a revised version of the Guidelines may be issued.

Automated individual decision-making including profiling

The WP29 Guidelines on automated individual decision-making, including profiling, recognise the tension between the benefits of profiling activities in increasing efficiencies and resource savings, and the risks posed by profiling, for example, in advancing stereotypes and black box decision making. The WP29 invited feedback on these Guidelines with the closing date for responses being 28 November 2017. Following review of the responses, a revised version of the Guidelines may be issued.

Administrative fines

On 3 October the Article 29 Working Party adopted Guidelines on the application and setting of administrative fines under the GDPR. The Guidelines detail the assessment criteria for supervisory authorities when deciding whether to impose an administrative fine and, if so, the amount of the fine.

Processing data in an employment context

The WP29 published an Opinion on 29 June 2017 concerning processing data in an employment context. Opinions carry less weight that formal guidelines, but are useful indicators as to the regulatory approach on particular issues.

UK data protection bill

Statement of Intent

In August, the UK Government published a Statement of Intent summarising its proposal for the repeal and replacement of the Data Protection Act 1998 (**DPA**) with a new Data Protection Bill which will address the GDPR, including details of new criminal offences for non-compliance.

Draft Data Protection Bill

The UK Government issued the new draft Data Protection Bill in September 2017. The new law is set to replace the DPA and will address the GDPR, with stronger sanctions for malpractice. The Bill aims to demonstrate that the UK is an adequate jurisdiction for EU data so as to achieve uninterrupted data flows once the UK has left the EU.

The Bill is currently progressing through Parliament and is currently at the Committee Stage in the House of Lords.

ICO Guidance

The ICO published a checklist entitled 'Preparing for the law enforcement requirements (Part 3) of the Data Protection Bill: 12 steps to take now'. The checklist provides steps that companies should be taking now to ensure compliance with the provisions of the new Data Protection Bill.

Case law

On 3 October 2017, the Irish High Court made a preliminary reference to the Court of Justice of the European Union (**CJEU**) on the validity of three Commission decisions that apply to international data transfers. CMS's Law-Now on the decision can be found **here**.

Other updates

Free flow of non-personal data

On 13 September, the Commission issued a Proposal for a Regulation to establish a framework for the free flow of non-personal data in the EU. The proposed regulations will be developed under the Commission's work programme in 2018.

EU/US Privacy Shield

On 18 October 2017, the Commission published its report on the first annual review of the EU-US Privacy Shield. The Privacy Shield provides a framework to ensure the protection of EU citizens' personal data transferred for commercial purposes from the EU to the US. The Report shows that the Privacy Shield continues to ensure an adequate level of data protection for personal data transfers for commercial purposes from the EU to the 2,400 participating companies in the US, but notes that there is room for improvement.

e-Privacy Regulation

On 8 September 2017, the Presidency of the Council of the European Union published its proposed amendments to the draft Commission ePrivacy Regulation (**ePR**). The ePR will replace the current e-Privacy Directive (aka EU Cookie Directive). We understand that the Council of the European Union is finalising its amendments to the ePR before they go into final negotiation with the EU Parliament. It is anticipated that the ePR will be published next year in line with the GDPR but will apply one year after its publication in Summer 2019.

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Embracing adaptive ADR in the reinsurance marketplace

With every (re)insurer seeking ways to extract profit from a soft cycle, the hunt to save legal costs is an increasingly strategic priority.

The historic approach for reinsurance disputes has been formal default to arbitration, with agreed arbitration clauses in parties' reinsurance arrangements. But who is to say 'pure' arbitration (or litigation) should be the default choice? An adaptive approach can deliver material upsides of cost and time saving along with the preservation of goodwill between the relevant parties.

How does Adaptive ADR work?

Dispute escalation clauses are increasingly common in commercial agreements bringing benefits to contractually obliging parties so they discuss issues very early and before a legal process begins. In our experience, these most commonly lead to mediation, but should parties exit the process as they are perfectly entitled to do, disputes remain unresolved.

One growing trend is adaptation of the 'pure' mediation process to take the form of 'Med/Arb' or Binding Mediations, in which parties choose a mediator but agree that if they cannot consensually procure an agreement in a mediation held first (stage 1), they will proceed to instruct the mediator to make a binding determination in, effectively, an arbitral procedural framework (stage 2).

The Med/Arb is agreed by the parties not to be susceptible to court legal challenge (save for due process issues), and is thus akin to an arbitration award. This is something that can work and help generate early resolution and thus become an effective tool in the reinsurance market to resolve claims and other disputes and differences.

The process agreed carries additional pressures on the parties to settle their differences, if possible, in stage 1 or at least before the conclusion of stage 2. They know that if they do not, then the mediator will proceed to make a binding decision – but they know that the mediator will have seen their insights, and made assessments on what they have heard in the 'pure' mediation process. It also means that within that stage 1, the parties cannot disregard what a mediator then says or reveals if they have to proceed to stage 2: there is no other tribunal or person to whom a party can hope to hold a differing view.

Building trust

There has to be a lot of trust in such an arrangement – trust in the mediator's technical and legal knowledge of the substantive issues, that the mediator will do what he needs to do and will do it fairly and competently.

There also needs to be trust between the parties that they are accepting a 'cards on the table approach'. The mediator's terms and the agreement for any decision made to be binding need to be carefully drafted and agreed; they will also confer more leverage on the mediator to exert pressure on the parties to settle consensually, permitting them the right to make comments and express views on parties' strengths and weaknesses.

What are the upsides?

Despite opening up a few vulnerabilities above, the increased settlement pressures on both parties and cost savings that should result are a real upside. As an alternative to formal arbitration or litigation, it also helps to preserve ongoing business relationships.

There is no reason not to consider adaptive ADR procedures to improve settlement outcomes. When solving a problem quickly is a real concern, and where a confrontational approach should be avoided, or where sums in issue do not really commend a full-blown 'pure' arbitral or legal process, it provides a cost-effective choice.

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Autonomous vehicles: challenges and opportunities

New technologies in the automotive sector are being developed at a rapid pace and traditional concepts of vehicle and driver may soon be obsolete. This has generated significant challenges for the established Motor insurance sector and opportunities for Product Liability and Cyber insurers to develop new policies to adapt to technological change.

Autonomous or connected?

Media attention has tended to focus on the concept of driverless cars. These are often referred to as autonomous vehicles, meaning they are autonomous of human driver control.

The current state of technology is, however, much more fluid, with increasing numbers of vehicles already on the road being capable of some degree of technological control. For example, many vehicles already have sensors to detect the risk of collision, which can in certain cases already activate braking.

Moreover, vehicles are increasingly becoming connected to the internet – a prime example of the 'internet of things' – both for the purposes of navigation and electronic functionality.

United Kingdom

Governments in a number of jurisdictions are seeking to keep pace with technological change, and newly developing threats giving rise to exposure to injury and damage to the public.

In the UK, the Automated and Electric Vehicles Bill was re-introduced to Parliament in October 2017. As drafted, the Bill provides that if an accident is caused by an insured vehicle driving itself, the vehicle owner's motor insurer will be liable to the owner/passengers and to third parties. Where the vehicle is uninsured, the owner will be liable.

The Bill will allow motor policies to exclude liability if the accident is a direct result of software alterations or failure to install safety-critical software updates.

Misuse of vehicles both physically and (potentially) digitally, is an area of concern for the Motor Insurance Bureau exposure. Deliberate use/terrorism exclusions are permitted in commercial policies, but cannot currently be excluded by the MIB (following the *RoadPeace* judicial review).

Liability thus reverts to the MIB as a statutory back-up and must be funded by the industry as a whole.
This appears likely to be the outcome of the recent Westminster Bridge attack.

Europe, Asia and USA

On 21 June 2017, Germany enacted an Autonomous Vehicle Act legalising automated vehicles. This does not alter the general concept of liability under German law. Both the driver and the 'owner' remain liable even if the vehicle is in automated driving mode.

Under the Act, automated vehicles must be equipped with a black box to identify whether the driver or the system had control at the time of an accident. This technology may help the 'owner's' insurance company to prove that the vehicle caused the accident. If so, manufacturer and product liability insurers will be exposed to subrogated claims.

Other advanced jurisdictions such as Japan and Singapore are allowing on-road testing of autonomous vehicles. In the USA, 33 states already have some form of legislation allowing autonomous vehicles onto the roads, mainly for testing. In Nevada, 'platooning' of trucks (one driver controlling a convoy of vehicles) is already legal.

Opportunities and exposures for insurers

Traditional motor insurance is only one area for evolution. Legislation to date suggests that at least in the early stages of development the owner will be expected to take out a statutory motor policy. This form of motor insurance assumes that for each 'driverless car' there will still be a single owner. However, unlike the current model, there will not necessarily be a single driver.

From the motor insurer's point of view this adds a degree of complexity to what has traditionally been regarded as one of the more standardised insurance products.

While the vast majority of accidents are at this stage still covered by the traditional motor insurance market, the exposures for motor manufacturer, their parts suppliers and (increasingly) software providers and ISPs are likely to increase exponentially.

Technological malfunctions are likely to become increasingly common. There is a huge opportunity for insurers providing cover for manufacturers and suppliers, but currently massive exposures are likely to be carried uninsured or self-insured by manufacturers.

Nature of exposures

The most high-profile exposures that have been highlighted by attacks in other areas, are the risks of technological failure due to hacking or malware, for political, ecological or, at worst, terrorist purposes.

If a carmaker is connected to all of its vehicles, then there must be a risk of those vehicles being hacked. Failsafe designs are likely to default to vehicles being brought to a standstill (or unable to be started), which could cause significant human and economic disruption.

Equally, however, a manufacturer's own negligence (or that of a supplier) could cause massive disruption. Manufacturers are already exposed to numerous product recalls, and the risk of computer failure adds to the danger of vehicles being left stranded.

Data

Technological advances will also result in exponential growth in data. Many motor insurers already offer products which depend on the collation of data to monitor the insured's driving habits, in the form of either a 'black box' device fitted to the vehicle or a mobile app tracking the driver's movements.

Before long, similar data may be generated by all vehicles and continually fed back to motor companies and/or insurers, particularly if vehicles are in 'autonomous' or semi-autonomous mode (as required by the German legislation outlined above).

The risk of hacking or misuse of this personal data should be an area of concern for insurers and others. Civil liberties concerns will be paramount if police or other state agencies are able to access this data.

Uberfication

Even for non car-owners, data as to their movements may be traceable both through their own mobile technology and from companies tracking their customers' whereabouts.

Already, online companies such as Uber need to consider the need to insure against real world exposures. If vehicles become genuinely driverless, then the line between pooled vehicles and taxi cabs may disappear completely. The passenger's relationship will be with the app, and insurance cover both for the passenger and third parties will shift towards the provider rather than the owner (most likely a leasing company with no involvement in the operation of the vehicle).

The variety of new opportunities for the insurance market is therefore extensive. However, formulating and pricing the products will require increasing creativity from the insurance market.

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The long arm of the English courts

Insurers with exposures to corporates in developing jurisdictions overseas need to consider the issues raised from liability, reputation and insurance perspectives, after a recent case saw English courts showing themselves willing to entertain claims arising out of harm suffered in a foreign jurisdiction.

The recent Court of Appeal case of *Lungowe & Others v Vedanta & Others [2017] EWCA Civ 1528* is the latest in a line of cases in which the English courts have shown an interest.

In this case, the claimants were Zambian citizens who suffered a variety of injuries and other losses due to discharges from a copper mine. Vedanta was the English parent of the Zambian company, KCM, which owned and operated the mine. The claimants argued that Vedanta assumed responsibility for the safety of the mining operations by exercising a high degree of control over KCM, that KCM relied on Vedanta's superior expertise in health and safety and environmental matters, and that Vedanta knew or ought to have known that the operations were unsafe. In the Technology & Construction Court (**TCC**), Coulson J dismissed challenges by both KCM and Vedanta to the jurisdiction of the English courts.

The Court of Appeal has now upheld his decision, allowing the claims to proceed to the defence stage and it did so as follows.

The Court of Appeal held, firstly, that the English courts not only could hear the claim against Vedanta, but were obliged to do so by virtue of the ECJ decision in *Owusu v Jackson [2005] QB 801* on the interpretation of the Brussels Convention (now Regulation). This decided that EU courts have no discretion to decline to hear a claim against a defendant who is domiciled within their jurisdiction simply because another forum would be more appropriate. The Court of Appeal left open the possibility that there might be an exception if a claimant abused EU law to get its claim heard in its chosen jurisdiction, but found that was not what these claimants were doing.

Secondly, in order to proceed in the English courts against KCM the claimants had to show that:

1. the claim had a real prospect of success;
2. there was a real issue to be tried against Vedanta;
3. it was reasonable for the English courts to try that issue;
4. KCM was a necessary and proper party to the claim against Vedanta; and
5. England was the proper place in which to bring that claim.

The Court of Appeal discussed most of these issues relatively briefly before resolving them in the claimants' favour and in line with the first-instance decision, but considered in some detail whether or not there was a real issue to be tried against Vedanta. The Court of Appeal considered that this meant a properly arguable case or serious question to be tried under the applicable law, in this case that of Zambia. The claimants had expert evidence to the effect that they had a case against Vedanta for breach of Zambian statutory obligations due to the degree of responsibility and control it exercised over the mining operations.

The claimants also argued that the Zambian courts followed the English courts on issues of negligence, raising the prospect that Vedanta could be liable under the principles set out in *Chandler v Cape Plc [2012] EWCA Civ 525* regarding assumption of liability by a parent company. This is an application of the more general principles established in *Caparo Industries plc v Dickman [1990] 2 AC 605* as to the requirement for proximity between claimant and defendant. The claimants produced a number of public statements, intra-group contracts and training materials by Vedanta indicating that it had undertaken responsibility for the safety of KCM's operations, as well as a witness statement from a former employee as to the arrangements in practice. The Court of Appeal found that this was sufficient to give rise to an arguable case.

In relation to the proper place in which to bring the claim, the Court of Appeal also took into account the lack of legal aid and funding options available to the claimants in Zambia and difficulties they had encountered in finding a suitably qualified lawyer to argue their case there.

Comment

This decision comes on the heels of *Okpabi v RDS & Others [2017] EWHC 89* in which the TCC declined jurisdiction. As a Court of Appeal authority, the analysis in this case should be preferred as to when the English courts will accept jurisdiction.

It signposts that the courts are willing to exercise long-arm jurisdiction over foreign subsidiaries of English companies where there is an arguable case against the parent that can be heard in the same proceedings. The existence of an arguable case is highly fact specific, but is more likely to be present where the parent company has represented itself as having responsibility for or expertise in matters relevant to the claim. The lack of adequate access to justice in the subsidiary's domicile will also be a relevant consideration.

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Legal professional privilege once again under the judicial microscope

*In May 2017, the High Court held that certain documents created by legal and other advisers of Eurasian National Resources Ltd (**ENRC**) during an internal investigation into allegations of wrongdoing, were not protected by legal professional privilege.*

The documents, which were largely created during a period of dialogue and cooperation with the Serious Fraud Office (**SFO**) as part of its self-reporting regime, must therefore be disclosed to the SFO.

This judgment is a further blow to the assertion that privilege should apply in such cases. The judgment will have significant implications for internal investigations and the SFO's self-reporting regime. At the time of writing this article, the Court of Appeal has given ENRC permission to appeal the High Court judgment, but the Court of Appeal has not yet made its own decision. It is possible that these issues, which go to the heart of legal practice, could end up in the UK Supreme Court in 2018. Lawyers and General Counsel will have to make sense of further judicial pronouncements into this vital area of law and protection of business rights.

Between 2011 and 2013, ENRC and an external law firm conducted an internal investigation into allegations of fraud, bribery and corruption involving ENRC's operations in Kazakhstan and Africa. It disclosed a final report on the Kazakhstan investigation to the SFO in February 2013, but not the underlying interviews or other work product. In 2013, the SFO opened a criminal investigation and requested disclosure of documents (including lawyers' work product), which ENRC sought to resist on the grounds of both litigation and legal advice privilege.

On 8 May 2017, Mrs. Justice Andrews rejected ENRC's claim to privilege in relation to interview notes and to work product by forensic accountants assessing ENRC's internal controls. However, she upheld the claim in relation to a presentation to the Board on the investigation findings, which also involved the giving of legal advice. The judgment, which considers the leading cases of *Three Rivers (No. 5)* and *The RBS Rights Issue Litigation*, restricts the scope of legal advice privilege over documents created by lawyers during an internal investigation. It also confirms that the ambit of litigation privilege (not considered in *Three Rivers (No. 5)* or *RBS*) is strictly confined (particularly in criminal proceedings).

What is privilege?

1. Litigation privilege attaches to confidential communications made with the dominant purpose of obtaining or receiving advice in connection with adversarial proceedings that are reasonably in prospect.
2. Legal advice privilege attaches to confidential communications between a lawyer and a client for the purposes of seeking or receiving legal advice (including advice as to what should be prudently and sensibly be done in the relevant legal context).

Key points from the ENRC judgment are:

— The evidence to support a claim of privilege should demonstrate the contemporaneous analysis of why privilege was thought to apply, with that evidence coming from the client representative responsible for instructing the lawyers.

Litigation privilege

- The basis of litigation privilege is contemplation of adversarial proceedings; the likelihood of a criminal investigation is not sufficient unless the facts also indicate that a criminal prosecution is reasonably contemplated.
- The threshold for criminal proceedings being reasonably contemplated is higher than for civil proceedings, as there is a threshold test for a criminal prosecution. This is probably something that many practitioners had not previously considered.
- Documents created during an internal investigation to assess whether there is substance to an allegation, or with the purpose of avoiding an external investigation or prosecution, cannot have been created with the dominant purpose of defending a prosecution and so cannot be covered by litigation privilege.
- Litigation privilege also cannot apply to documents created for the specific purpose of showing them to the SFO as part of any agreed cooperation or self-reporting exercise.

Legal advice privilege

- Where legal advisers are instructed in a purely investigatory, 'fact-finding' role, their work product will not be privileged as it does not involve legal advice. For example, a mere record of an interview would not be protected.
- Documents prepared with the purpose of giving legal advice will be privileged, even though they contain reference to factual information or findings that would not otherwise be privileged.

Who is the client?

Employees authorised to speak to lawyers for the purpose of a fact-finding investigation do not constitute the 'client' for the purpose of legal advice privilege. Only communications with individuals authorised by the client to seek or obtain legal advice will potentially be covered by the privilege. This was established in an earlier case of *Three Rivers*.

So what should businesses now do as a result of this judgment when conducting a fact-finding investigation into whether they may have a liability risk? Steps may include the following:

- **Who is the client?** Identify and possibly record in writing who will be responsible for seeking/obtaining legal advice and for what purpose. This will assist in a later claim to privilege by identifying 'the client' and the reason for seeking the lawyers' work.
- **What is the purpose of the document being created?** Consider why the lawyers (internal and/or external) are being instructed and what privilege may be relevant in that context, if any. If only certain elements of the work are likely to be privileged, consider delineating them separately. A much more 'granular' approach is required from the client and its lawyers at each stage of the investigation with regard to identifying which categories of documents may be privileged.
- **Recording witness interviews** must be considered carefully in terms of the approach to interviewing individuals and what record will be taken of such interviews (if any) and by whom.
- **What type of record?** If a record will be taken, consider whether it should be a verbatim or similar note of the interview (which is unlikely to be privileged unless litigation privilege applies) or can be recorded as part of a wider note of advice in which the record and the advice cannot be easily separated.
- **Ongoing consideration of privilege** Consistently repeat the process of considering what privilege may apply as the work/matter develops and whether at any given stage the privilege claim may have evolved (e.g. because of facts learned). Record any changes of view and why it has changed.
- **Departing employees** Where those involved in seeking/obtaining the advice are due to leave the company, consider obtaining a statement from them before they do so that records their understanding and assessment of the privilege available in respect of the work product. (ENRC's claim to privilege was hampered by their inability to persuade ex-employees to give relevant witness statements.

Every case will be fact-specific and some of the facts in the ENRC case were unusual. However, the effect of the High Court decision will have had marked effects already on the way clients and their lawyers manage internal investigations. It should be added though that in cases where the SFO invites the defendant company to enter into a Deferred Prosecution Agreement with it, the SFO will both expect and demand complete cooperation with it, which means that a defendant's attempt to rely on legal privilege in order to shield evidential documents generated during an investigation will be regarded very dimly by the SFO.

For more information about CMS' risk and investigations expertise, please click **here**.

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Islamic M&A insurance

Shariah-compliant insurance known as Takaful is an increasingly important growth area in the $1.8 trillion global Islamic finance industry.

The market offered further signs of innovation recently when a Shariah-compliant warranty and indemnity insurance policy was sold out of London's M&A insurance market. The development of such a policy also demonstrates the UK's position as the leading centre for Islamic Finance in the Western world.

The reported buyer of that £5 million policy was a Gulf-based financial institution run on Shariah principles, which acquired an industrial property in the north of England. The Shariah-compliant insurance policy was developed through a partnership with a Shariah-compliant managing general agent.

The purpose of warranty and indemnity insurance is to protect buyers and sellers from financial losses that may occur due to misrepresentations or inaccuracies in representations or warranties in a corporate acquisition. By the market offering a Shariah-compliant warranty and indemnity insurance policy, it, AIG, is potentially tapping into Shariah-compliant customers particularly in the Middle East, North Africa and Asia who may not have previously considered utilising such a product in their acquisitions.

The Shariah (Islamic law) provides guidance on how practising Muslims ought to conduct their business and financial affairs. Traditional insurance is considered incompatible with the Shariah for a number of reasons:

- The payment of small premiums paid in exchange for a potentially greater claim are seen as an unjustified increase in money.
- The insured and insurers cannot know whether there will be any losses or the size of any losses requiring compensation to be paid, whereas the premiums are payable regardless. This uncertainty is unacceptable under the Shariah.
- It can be considered to include an element of gambling or speculation because the insurer will gain if the insured's risk does not occur.

Islamic insurance follows a *takaful* system. '*Takaful*' is derived from the Arabic word '*kafala*', meaning helping each other or joint guarantee, and is a cooperative system of reimbursement which compensates its 'participants' (policy holders) for losses they may incur. In brief:

- Participants make small and regular contributions (tabarru) to a cooperative fund operated by a takaful operator.
- A proportion of these contributions is placed in a takaful fund which is then used to compensate the participants for their losses. The balance of the contributions is placed in an investment/savings fund for the participants and invested by the operator in assets that must comply with Shariah principles.

— In addition, the takaful operator is paid an investment management fee, and sometimes a fee in respect of operational costs and expenses, and/or a performance fee based on the underwriting surplus, if any, in the fund.
— At the end of the financial year, after calculating all insurance payouts, payment of all fees and taking account of any investment losses, if the takaful fund has a surplus then this may be distributed to participants usually by means of reduced contributions for the following year. If the takaful fund has a deficit at the end of the financial year, the shareholders of the operator may and usually do make an interest-free loan to the fund, which is then repaid out of future surpluses (before any distributions).

It is the distribution of the underwriting surplus to participants, which distinguishes the takaful model from conventional insurance products. By way of further comparison with the components of traditional insurance which are not Shariah compliant:

— Instead of premiums, participants donate money to a fund that is used to compensate other participants.
— The uncertainty of payouts is considered to be eliminated or offset because the payments are structured as donations.
— As the takaful fund belongs to the participants, rather than a third party, the participants are both the insured and the insurers of a risk, and the focus is on paying claims to compensate participants for losses. The maximum amount which participants may be paid for a proven claim would only put them in the position they were in prior to the loss and the participants do not gain if the insured events do not occur.

As the number of participants in Islamic Finance continues to grow, so too will the demand for Shariah-compliant insurance products.


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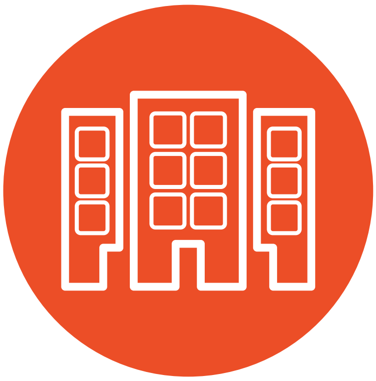

Impact of Minimum Energy Efficiency Standards in 2018

New laws are coming into force in April 2018 that are relevant to energy performance certificates or EPCs as they are known for short, which have become a mainstay of property transactions, whether residential or commercial.

Businesses need to obtain an EPC, if they are selling or letting property or carrying out certain types of alterations. The purpose of an EPC, which is produced by an accredited energy assessor, is to record the energy efficiency of a building. The certificate will provide a rating of the energy efficiency and carbon emissions of a building from A to G, where A is very efficient and G is very inefficient.

Each energy rating, known as an '**asset rating**', is based on the characteristics of the building itself such as its age and condition and its services such as heating and lighting. The asset rating shows the intrinsic performance of the building, as opposed to the actual energy used.

So the EPC provides prospective buyers, tenants, owners, occupiers and lenders with information on the energy efficiency of and carbon emissions from the building, so that they can consider energy efficiency and fuel costs as part of their investment.

In the context of climate change imperatives, EPCs form part of the property industry's response, which also includes the not infrequent introduction into leases of light and dark green drafting to cover off energy-related issues.

However, the ratings in EPCs have taken on a whole new lease of life with the so-called Minimum Energy Efficiency Standards for private rented buildings.

While the EPC provides useful information about energy efficiency, and the obtaining of the EPC became a box to be ticked on transactions, it was not having a transformational impact on the property industry in energy terms.

Impact of Minimum Energy Efficiency Standards

Some property companies have a very strong corporate ethos of promoting green issues and introduce behavioural change in their portfolios without any element of stick being needed.

However, the Government clearly thought the pace of change was too slow and more needed to be done. As a result, legislation was enacted which created the so-called Minimum Energy Efficiency Standards. The Standards impact on both domestic and non-domestic property and we will focus on how it will affect commercial property.

This new law is not in force yet but will come into force in April 2018 and its consequences mean that everyone in the property industry needs to be focusing now on what their EPCs are saying and if they say the wrong thing, radical action may be needed.

If the EPC shows a rating of 'F' or 'G', a landlord starting on 1 April 2018, subject to certain exemptions, is not permitted to grant a new lease or extend or renew an existing one of the relevant property. From 1 April 2023, this restriction is expanded so that a landlord is not permitted to continue to let such a property.

So if the property is below an 'E' rating, the basic position is that you are not permitted to let your property. That is a big deal and if you choose to ignore the restriction and let the property, a not insignificant penalty could be coming your way.

If there is less than three months of non-compliance from the time the relevant penalty notice was served by the local trading standards officer, the landlord will receive a penalty of the greater of £5,000 or 10% of rateable value up to £50,000. If three months or more of non-compliance, the penalty is the greater of £10,000 or 20% of rateable value up to £150,000.

For many landlords, this is a significant financial disincentive to grant new lettings of properties with an F or G rating. However, it is curious that while the landlord may be granted a penalty for granting the lease, the lease itself is legally valid. In any event, landlords need to be deciding their strategy now for how to deal with such energy-inefficient properties.

Exemptions and exclusions allowing for the grant of leases

There are certain exemptions, which would mean that the landlord would not be restricted from granting leases. The exemptions include the consent exemption and the devaluation exemption.

The consent exemption is available if, within the preceding five years, a landlord has been unable to increase the EPC to band E as a result of the tenant refusing to consent to any relevant energy efficiency improvement, or the landlord, despite reasonable efforts, being unable to obtain the necessary consent of a third party including for planning. This exemption accounts for why some landlords are beginning to introduce drafting into leases making landlord's rights to enter the property dependent on the tenant's consent – we will say something more on that shortly. Relevant energy efficiency improvements are identified in the legislation and many qualify if they achieve a simple payback within seven years.

The devaluation exemption is available if, within the previous five years, the landlord has not achieved band E by making the relevant energy efficiency improvement, because the landlord has obtained a report from an independent surveyor which states that making the improvement would result in a reduction of more than 5% in the market value of the property.

It is important to note that landlords can only rely on the relevant exemption where they have registered the information concerning the exemption in a particular register and this may be done from **1 April 2017**, although the register currently appears to be only in a pilot form.

There are also exclusions for properties that do not require an EPC, or for leases with a term not exceeding 6 months or for 99 years or more.

All of this highlights that the landlord may well be able to let an F or G property from April 2018 without incurring a penalty, but that may not be the case. So how should property owners respond to the new legislation both in terms of actions and lease drafting?

The property owner knows that, if there is no exemption, he needs to upgrade his property to at least an 'E' to avoid a penalty if he grants a lease.

Lease drafting for MEES

An important question is whether the cost of upgrading to at least an 'E' rating can be covered by the service charge. The answer is usually not. Many service charge provisions do not allow for the recovery of the cost of improvements. There also appears to be a prevailing view in the industry that tenants will not allow for the service charge to cover improving the property's energy efficiency to at least an 'E'. They know that the landlord is usually doing this not to benefit the building, but because he wants to let without being penalised. It will, therefore, be difficult to pass the cost to tenants.

An increasing area of concern for landlords is control over the obtaining of EPCs for the property. Producers of EPCs have varying degrees of expertise and landlords would not want a less expertly drawn EPC produced, that shows an F or G rating.

So when it comes to what drafting should go in leases, control over EPCs obtained by tenants is a big factor. For example, the tenant should not obtain an EPC without the landlord's prior written approval, not to be unreasonably withheld, to the energy assessor who will provide the EPC. The tenant should also provide copies of the EPC and other relevant information.

The 'light green lease drafting' that was mentioned earlier and is already often encountered also provides helpful drafting in this context, for example, a typical provision is the tenant's obligation not to do anything that will adversely impact on energy ratings.

One drafting change over which caution should be exercised is making the landlord's right to enter to carry out works subject to the tenant's absolute consent. The immediate response to this type of provision is what happens if the landlord wants to carry out the works regardless of the legislation? This drafting is trying to enable the landlord to benefit from the consent exemption, but it misses the bigger picture that the landlord may need to preserve rights to manage its property. It may also be regarded as an artificial attempt to satisfy the consent exemption.

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Brexit and employment: where we are

There were many mixed messages during the Brexit campaign as to what would happen with UK employment laws, many of which derive from membership of the EU.

Following the referendum, the Secretary of State for Exiting the EU stated 'the Great British industrial working classes voted overwhelmingly for Brexit. I am not at all attracted to the idea of rewarding them by cutting their rights'. Latterly in May this year, the Prime Minister announced that no EU workplace protections would be repealed.

We now have the European Union (Withdrawal) Bill 2017 that, at the time of writing this, is just beginning its Committee stage. Key provisions in the Bill as presented are:

— **Section 2.1 EU-derived domestic legislation**, as it has effect in domestic law immediately before exit, continues to have effect in domestic law on and after exit day.
— **Section 3.1 direct EU legislation**, so far as operative immediately before exit day, forms part of domestic law on and after exit day.

There has been some academic debate on what these sections really mean. Taking them at face value and having regard to the Prime Minister's statement, we can be confident that nothing will change on day one should the UK leave the EU. The extent to which the UK would then have a free hand to repeal and amend EU-derived legislation will largely turn on what agreement may be reached on our future relationship with the EU. The price of a two-year transitional arrangement, which represents current government policy, might well be maintaining existing workplace laws and the incorporation of any new EU directives or other measures during that period. Then, of course, beyond transition membership of or access to the single market might involve similar commitments.

The main UK employment laws that come from the EU are:

— Transfer of Undertaking (Protection of Employment) Regulations (**TUPE**)
— Collective redundancy consultation
— Agency Workers Regulations
— Working Time Regulations
— Works councils
— Data protection
— Anti-discrimination laws

Subject to the points made above, all of these could in time be candidates for repeal or amendment. Speculation as to which is complicated by the obvious point that much may depend upon which party is in government at the time. All one can do now is identify areas where we might see change.

It is surely inconceivable that there would be a wholesale repeal of the panoply of laws preventing discrimination in the workplace. It would, however, be possible to cap compensation for discrimination should we leave the EU. Originally, compensation for discrimination was capped at the same level as the compensatory award for unfair dismissal. That changed following the decision of the ECJ on a public sector case brought by a woman who had suffered losses way in excess of the then cap of £6,250, as a result of discriminatory treatment in relation to her pension. The ECJ held that EU law required that she be fully compensated. The government of the day moved quickly to scrap the cap. A recommendation of the Beecroft Report commissioned by the then coalition government some six years ago was that discrimination claims should be capped. Another change could be an extension of circumstances in which affirmative action and positive discrimination can be taken to address inequalities.

TUPE is an example of 'gold-plating' – in other words the domestic legislation goes further than required by the underlying Acquired Rights Directive. The case in point is the service change provisions that have served to bring clarity to the application of TUPE on outsourcings (although some difficulties remain). A challenge posed by TUPE is uncertainty over when changes in terms and conditions of employment can be made post-transfer often in the context of harmonising terms and conditions of different parts of the same workforce. The current straightjacket of the Acquired Rights Directive prevents any meaningful change.

The Agency Workers Regulations have proved problematic in their application in a number of respects. Whether the protection they afford such workers is necessary is debatable. They could be a prime candidate for simplification or possibly wholesale repeal.

The effect of some controversial decisions of the ECJ could be reversed by legislation. They will otherwise continue to have effect as part of what the Withdrawal Bill describes as retained EU case law. Two decisions in particular that might not stand the test of time are *Pereda*, whereby an employee who becomes ill whilst on holiday can retrospectively book the time as sick leave (this may be right in principle but is almost impossible to police) and *Gomez*, whereby a woman on maternity leave accrues holiday and effectively has a double holiday allowance in the first year after her return.

Similarly, the complications over calculation of holiday pay and the need in some cases to include overtime could be unwound. There have been a number of decisions in this area, in part based on the supremacy of EU law and by reference to the working time directive. Any change would be politically controversial especially with some unions.

We might also see the end of European works councils in this country in the longer term, although it is fair to say that they have not really caught on and are certainly not an established part of the industrial landscape.

One well-established protection for workers under EU law is the possibility of a *Francovich* claim. An individual can obtain damages where a member state commits a serious breach of a rule of EU law that was intended to confer rights on individuals, and there was a direct link between the breach and damage sustained by the individual. There have been a number of significant Francovich cases in the employment field. The Withdrawal Bill, perhaps unsurprisingly, provides '*the right to claim damages against the State for breaches of EU law (Francovich damages) will not be available after exit'*. What is unclear is the status of the claims that arose before exit and whether they could still be pursued. There has been a suggestion that the protection given in the European Convention for Human Rights to accrued rights might come to the rescue. Our courts would seek to interpret the Withdrawal Bill compatibly with the ECHR under Section 3 of the Human Rights Act.

A key issue, of course, for many employers would be freedom of movement of workers. It seems clear that the present government, once it is in a position to do so, will introduce controls on citizens of the 27 EU states. No proposal has been tabled yet. A plan was recently leaked whereby unskilled workers could come here for a maximum of two years and skilled workers for up to five years. But this was only a leak and it may be some considerable time before we know what rules will apply. Again, the extent to which the UK has a free hand will turn on its future relationship with the EU.

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