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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 113 – INSURANCE CONTRACTS, ROME I

Draft Rome I Regulation
Position re Applicable Law of Insurance Contracts

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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 113 WORKING GROUP

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Introduction

1. The role of the Financial Markets Law Committee ("FMLC") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

2. In May 2005 HM Treasury contacted the FMLC to seek its views on the European Commission's recommendations for a revised conflict of laws regime for insurance contracts. These proposals were made in the wider context of the Commission's proposals for a Rome "I" Regulation, which would incorporate into European law the conflict of laws rules currently contained in the Rome Convention on the Law Applicable to Contractual Obligations. A Green Paper was published by the Commission in January 2003, followed by a Discussion Paper outlining the terms of the proposed instrument in February 2005.

3. The FMLC responded to HM Treasury's enquiry by producing a paper on the specific proposals outlined in the Commission documents.[1] Since that time, however, the Commission has produced a Final Proposal for a Regulation on the Law Applicable to Contractual Obligations (Rome I) ("the Final Proposal"),[2] which appears to depart from the suggestions raised for discussion in the earlier Commission documents. The purpose of this paper is to set out the views of the FMLC on the treatment of insurance contracts under Final Proposal. *It should not be taken to express a view on the merits of the Proposal more generally.* The FMLC has been assisted in its consideration of this issue by a Working Group, the members of which are listed above.

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1 Available at www.fmlc.org

2 This now falls to be considered by the European Parliament and European Council under the co-decision procedure.

Background

4. In Member States of the European Union the prevailing conflict of laws rules regime for insurance contracts distinguishes between contracts governing risks located in the EU and contracts governing risks located outside the EU. The former are covered by conflicts rules contained in the Life and Non-Life Insurance Directives ("the Insurance Directives");[3] the latter by the substantive conflicts rules of the Rome Convention itself.

5. The Green Paper and the Discussion Paper published by the Commission contained proposals for the rules set out in the Insurance Directives to be incorporated into the Rome I instrument. The Green Paper canvassed opinion on whether the rules in relation to insurance contracts should be brought within the Rome I instrument and whether the rules currently in the Rome Convention could be applied to the particular circumstances of insurance contracts or whether special rules were required for insurance contracts.

6. The Discussion Paper developed the issues outlined in the Green Paper and included specific proposals for incorporating the conflicts rules for insurance contracts into the Rome I Regulation. The rules for insurance contracts proposed in the Discussion Paper represented a substantial revision to the regime for insurance contracts under the Insurance Directives and tracked suggestions made by the Max Planck Institute in its Comments on the Green Paper. These suggestions, which applied to "mass risks" (not "large risks") restricted the ability of the parties to disapply the default choice of law (the law of the policyholder's central administration or residence) in only a few exceptional circumstances.

7. The conclusions of the FMLC in relation to the proposals in the Discussion Paper were that, broadly, the FMLC approved of the Commission's plan to move the relevant private international law rules out of the Insurance

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[3] Specifically, the Second Non-Life Directive of June 1988 (88/357/EEC, see Article 7); the Third Non-Life Directive of June 1992 (92/49/EEC) (and related Motor Insurance Directives); as well as the three Life Insurance Directives consolidated and revised by the Life Insurance Directive of November 2002 (2002/83/EC, see Article 32). These provisions are now implemented in the UK by way of Regulations: see the Financial Services and Markets Act 2000 (Law Applicable to contracts of Insurance) Regulations 2001.

Directives and into the proposed Rome I Regulation. This would improve transparency, make the rules more accessible and contribute to certainty overall. In particular, the Commission's approach would have ended the distinction between EU risks and non-EU risks, which would improve the current regime. However, the Committee believed that the draft rules proposed by the Max Planck Institute, as adopted in the Discussion Paper, would result in a serious reduction in party autonomy and would accordingly be unsatisfactory.

8. The Commission's recently published Final Proposal largely maintains the status quo for Member States in respect of insurance contracts. It expressly preserves the application of the conflicts rules contained in the Life and Non-Life Insurance Directives for contracts governing EU risks by providing, in Article 22, that the Regulation "shall not prejudice" the application of certain existing legislative measures,[4] including the Insurance Directives. According to the Final Proposal, the substantive provisions of the Regulation itself will apply to contracts covering non-EU risks, in the way that the provisions of the Rome Convention do under the current regime.

9. This paper considers the position of insurance contracts under the proposed Rome I Regulation and examines specific issues raised by the move to a Regulation (which has direct effect in European law) from a Convention (which does not).

General Comments

Transparency

10. As averred in the previous FMLC paper on this issue, the Committee believes that the Commission's earlier suggestion of bringing all the conflicts rules on the law applicable to insurance contracts into the Rome I Regulation would

[4] Inter alia, those measures listed in Annex 1 of the Regulation. The words "shall not prejudice" should almost certainly be taken to mean that the Regulation will apply *where not inconsistent* with the Directives. This may have the effect that where the provisions of the Regulation are more generous - for example in upholding the formal validity of contracts – the Regulation may still apply even though the Directives contain provisions relating to the same issue.

have proved beneficial in terms of improving transparency, making the rules more accessible and contributing to certainty. From this perspective, the chief objection to the Final Proposal is that it fails to further promote these objectives. The FMLC remains of the view that there would be benefit in rationalising the law applicable to contractual obligations and insurance contracts in this way.

The Status Quo

11. Notwithstanding this objection to the current proposal, the FMLC has been given to understand that the old regime under the Life and Non-life Directives, which will now be preserved, did not appear to present any significant problems for the insurance markets. As a consequence, the Committee does not believe there is any overriding objection to be raised, from a financial markets perspective, to the substantive approach adopted in the Final Proposal.

Article 5 (Consumer Contracts)

12. As far as the text of the Final Proposal is concerned, a focus of the Committee's attention has been the *revised* Article 5 (revised, that is, vis-à-vis both the original Rome Convention and the Commission's earlier papers) on consumer contracts.

13. The Discussion Paper suggested that the provisions of Article 5 of the existing Rome Convention should be disapplied in the new Rome I instrument, so far as insurance contracts were concerned, following suggestions made by the Max Planck Institute. Although the FMLC did not in general favour the approach suggested by the Max Planck Institute, this specific suggestion was considered by the Committee to be helpful, given the widespread criticism of the operation of the consumer contract provisions contained in Article 5 of the Rome Convention.

14. Article 5 of the Rome Convention provides that a choice of law made by the parties shall not have the result of depriving the consumer of the protection afforded to him by the mandatory rules of the law of the country in which he has his habitual residence, where one of the contracting parties is a consumer and subject to certain other provisos. The operation of this Article leads, in effect, to a hybrid legal regime applying to the terms of the contract, which promotes uncertainty and leads to a lack of transparency (for example, it is not always clear, or easy to ascertain, what is covered by "mandatory rules of law").

15. The Committee notes that the *revised* Article 5 of the Final Proposal will apply to insurance contracts, since no exemption is included. However, the new provisions take a slightly different approach to consumer protection than that taken originally by the Rome Convention. Under the proposed Regulation, the law of the Member State in which the consumer has his habitual residence becomes the applicable law of a consumer contract, rather than a supplementary set of applicable rules. Therefore, the danger of hybrid or overlapping legal regimes (i.e. the chosen law and the mandatory rules of the country where the consumer has his habitual residence) is removed, at least as far as Article 5 is concerned.

16. It may be that the *revised* Article 5 raises other issues in a wider context (i.e. beyond insurance law). Consideration of any such issues is beyond the scope of this paper and the FMLC has not considered to date whether any such issues exist.

Specific Comments: Position of EU risks covered by non-EU established insurers

17. The Green Paper published by the Commission in January 2003 observed that as things stand, in cases where the risk is located in the EU but is covered by an insurer not established in the Community, Member States do not adopt a uniform approach to the application of the European conflict of laws regime.[5] Although some Member States (including the UK) accept that, in these cases, the Insurance Directives are to apply, other Member States do not.[6]

18. In theory, where the Insurance Directives do not apply, the rules of the Rome Convention should do so. Thus, according to the divergence noted in the Green Paper, in some Member States the Insurance Directives' conflicts rules must apply to contracts covering risks located in the EU carried by non-European establishments whilst in other Member States the Rome Convention rules presumably apply. The question arises of how this undesirable lack of harmonisation will be dealt with under the Regulation, which aims to preserve the status quo but which has direct and supposedly, therefore, uniform effect in all Member States.

19. In order more fully to understand how the divergence between Member States' approaches has come about and to aid discussion of the difference that might be made by replacing the Rome Convention, to all intents and purposes, with a directly effective Regulation, it will be helpful to examine the relevant legislative provisions of the Insurance Directives.

The Scope of the Insurance Directives

Position under the Second Non-Life Directive

20. Article 7.1 of the Second Non-Life Directive provides that "*[t]he law applicable to "contracts of insurance referred to by this Directive and covering risks situated within the Member States is determined in accordance with the following provisions (…)*".

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5 *See* COM(2002) 654 final, paragraph 3.2.2.1. c), page 21

6 The Insurance Directives are themselves silent on the point.

21. There is no provision in the Directive directly clarifying its scope in relation to non-EU establishments carrying "risks situated within Member States".

22. It should be noted that the object of the Directive, as set out in Article 1, is to "*lay down provisions relating to freedom to provide services* for the *undertakings and in respect of the classes of insurance covered by the First Non-Life Directive*." The relevant undertakings are identified by Article 1 of the First Non-Life Directive as being those "*established in a Member State or which wish to become established there […]*" This persuasively suggests that the Directive applies solely to insurers based in the EU.

23. On the other hand, the rule on choice of law appears to be of a more general application, since it contains elements of policyholder protection (the choice depends on the circumstances of the policyholder and not on those of the insurer). This may reflect an expectation on the part of the legislators that the Directive would capture risks arising within Member States, for policyholders there, regardless of the location of the insurer.

24. In short, the position under the Second Non-Life Directive is unclear on the question whether risks within the EU but covered by non-EU established insurers should be governed by the Directive.

<u>Position under the Life Insurance Directive of November 2002 (2002/83/EC)</u>

25. Article 32(1) of the Consolidated Life Directive provides that "*the law applicable to contracts relating to the activities referred in this Directive shall be the law of the Member State of the commitment […]*".

26. There is no provision in the Directive directly clarifying its scope in relation to non-EU establishments carrying "risks situated within Member States".

27. It should be noted that the "concern" of the Directive, as referred to in Article 2, is "*the taking–up and pursuit of the self-employed activity of direct insurance carried on by undertakings which are established in a Member state or wish to become established there […]*" Again, this persuasively suggests that the Directive applies solely to insurers based in the EU.

28. However, a broader interpretation of the scope of this Directive arguably dovetails better with the fact that the choice of rule in Article 32 focuses on the location of the commitment rather than the location of the insurer. (By implication the choice of law rule emphasises the European nature of the risk, rather than the European location of the provider and so is consistent with an approach to implementation which extends the Directive to non-EU establishments carrying EU risks).

29. To sum up, the position under the Consolidated Life Directive is ultimately unclear on the question whether risks within the EU but covered by non-EU establishments are covered.

Position in the United Kingdom

30. The UK implementing legislation concerning the Consolidated Life and the Second Non-Life Directive, contained in the Financial Services and Markets Act 2000 (Law Applicable to Contracts of Insurance) Regulations 2001, does not, as far as choice of law rules are concerned, limit itself to an insurer with an establishment in a Member State.

31. For non-life insurance, the UK implementing legislation generally refers to "*a contract of insurance which covers risks situated within the State or within other Member States* (…)". For life insurance, the UK implementing legislation generally refers to "*a contract of insurance which covers commitments situated within the State or within other Member States* (…)".

32. Therefore, in the UK, the rules contained in these Directives are applicable even if the insurer is based outside the EU and has no establishment or branch in any Member State.

33. This approach has been adopted despite the fact that the two Directives are substantially aimed at extending freedom of services across the European Community but not outside the Community itself.

34. However, this approach is aligned with the rationale behind the choice of law rules in enhancing the protection of policyholders who are assumed to be in a weaker position vis-à-vis the insurer.

Implication of the rules relating to EU risks covered by non-EU insurers

35. Clearly, alternative interpretations of the Insurance Directives are at least theoretically possible, leaving it uncertain as to whether they should or should not apply to EU risks covered by insurance carriers established outside the EU. These theoretical alternatives have been reflected in the position that there is no harmonised solution across the different Member States of the Union, as noted by the Commission in the Green Paper.

36. The current lack of harmonisation in relation to EU risks covered by non-EU insurers, and the underlying uncertainty about the scope of the Insurance Directives, is undesirable from the perspective of efficiency in the European insurance markets. This problem should be addressed in the context of the reform opportunity provided by the proposal for a Regulation.

37. It may be that uncertainty about the scope of either the Insurance Directives or the Regulation will be resolved at some point by the ECJ, which may provide an authoritative interpretation. However, waiting for the matter to be resolved in this way is a far from ideal approach, because it is not possible to predict when (if at all) the issue may come before the ECJ and leaves the final outcome uncertain in the meantime.

The Exercise of the UK Option

38. Since the Regulation, according to the Final Proposal, will apply without prejudice to the Insurance Directives by virtue of Article 22 and Annex 1, its scope to some extent depends on the compass of these Community instruments. However, as we have seen not only is it fair to say that the ambit of the Directives is uncertain but also that, in practice, divergent approaches

exist in different Member States. The uncertainty in the scope of the Insurance Directives has the logical consequence that the scope of the proposed Regulation is also uncertain and may be subject to different interpretation in different national courts.

39. If, after the Regulation has been adopted in the EU, the Commission or the ECJ does clarify the extent to which the Insurance Directives or the Regulation itself cover EU risks written by non-EU insurers, this interpretation will have, so far as the Regulation is concerned, direct effect in those Member States to which it applies. If the question at hand is the scope of the Insurance Directives, a wider interpretation will automatically delimit a narrower Rome I Regulation and vice versa.

40. It is beyond the scope of this Paper to consider in detail how such an interpretation would interact with Member States' existing national implementation of the Insurance Directives. In theory a Member State's courts could find there to be a lacuna in their national conflicts rules between a narrowly interpreted, directly effective, Rome I Regulation and a narrow domestic implementation of the Insurance Directives. However, it seems more likely that, in these circumstances, the wide interpretation of the Insurance Directives hypothetically developed by the ECJ would be read back into, or would override, the domestic implementing measure.

41. Of course, it is also true to say that, in theory, a Member State's courts could find there to be inconsistency caused by an overlap between a widely interpreted, directly effective, Rome I Regulation and a wide domestic implementation of the Insurance Directives. In the UK, for example, the Directives are implemented by the Financial Services and Markets Act 2000 (Law Applicable to Contracts of Insurance) Regulations 2001 ("the 2001 Regulations") which assume a wide scope of application, covering risks carried by non-EU insurance providers. If, as a matter of European Law, it becomes clear in future that the Insurance Directives have a relatively narrow scope and that these risks should be covered by the directly-effective Regulation, a confusing conflict between two domestically-enforceable legal

measures will arise in the UK. In these circumstances, the Government would no doubt move swiftly to amend the 2001 Regulations.

42. This potential problem for the UK is thrown into even sharper relief by existence of the option, retained by the UK under Article 1(3) of the Final Proposal, which allows it to opt in, or out, of the Regulation. (The option also applies to Ireland; Denmark will not be covered by the Regulation.) As suggested above, if there is a clarification of the scope of the Insurance Directives, this will probably have the advantage of harmonising the treatment of both EU and non-EU risks covered by non-EU insurers across Member States subject to the Regulation. However, if the UK does not opt in to the Regulation, the Rome Convention (as enacted in the Contracts (Applicable Law) Act 1990) will continue to apply domestically in conjunction with the conflicts rules set out in the 2001 Regulations, which implement the Insurance Directives. In the UK the relative scope of these two instruments is delimited by the 2001 Regulations, which apply to contracts covering EU risks irrespective of whether the risks are carried by EU or non-EU insurance providers. This allows the 2001 Regulations a wider scope, relatively speaking, and the Convention a narrower one. If a different boundary line between the Regulation and the Insurance Directives is developed as a matter of European law, the UK will find itself taking a different approach to non-EU insurance carriers than that taken in the rest of Europe (although in these circumstances there would be no conflict between the respective domestic measures). Again, in these circumstances, the UK government might well consider that the appropriate response would be to amend the 2001 Regulations, so as to implement the narrower European interpretation of the scope of the Directives.

Possible approaches to resolving the issue with non-EU insurers at the European level

43. Clearly, the uncertainty over the scope of the Insurance Directives is unwelcome, particularly since it leads to a lack of a common approach in

relation to the rules for determining the law applicable to EU risks covered by non-EU insurers across the Community. It stands to reason that it would be of benefit to clarify the question on an EU-wide basis, so that a consistent approach is taken by Member States.

44. There are two possible resolutions to the question of the law applicable to EU risks covered by non-EU insurers. First, a narrow approach can be taken, whereby the provisions of the Insurance Directives do not apply to EU risks covered by non-EU insurers. Alternatively, a wider approach can be taken, such that the rules under the Directives do apply in such cases.

45. The first of these approaches is perhaps more in tune with the aim of the Insurance Directives, which is to promote freedom of services for EU insurers across the Community. The second approach, however, may have the advantage of conferring on policyholders the benefit of the rules under the Insurance Directives when insuring EU risks whether or not they are insuring with an EU or non-EU insurer.

46. Although there are arguments both for and against these two approaches, the FMLC favours the narrow approach, on the basis that this limits the use of special rules for ascertaining the law applicable to insurance contracts and instead maintains the choice made by the parties in their contract; at least as far as non-consumer contracts are concerned. The Committee considers that adopting rules of general application as far as possible, which uphold contractual terms agreed between the parties, is the best way forward in a wholesale or business-to-business context.[7]

47. Therefore, the FMLC recommends that the scope of the rules in the Insurance Directives is clarified; preferably confirming that the narrow approach is the correct one. This would then form the basis for eliminating the inconsistency observed by the Commission in the Green Paper, either as a matter of course

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[7] In a consumer context, there is probably little to choose between a narrow approach and a wider one. A narrow approach to the Directives gives the revised Article 5 of the Regulation greater scope. Under this provision, the law of the Member State in which the consumer has his habitual residence becomes the applicable law of a consumer contract. This objective of this provision, which is similar to the approach taken in the Directives for cases where the policyholder is a "natural person", is consumer protection.

in those Member States adopting the Regulation, or by other Member States adopting appropriate implementing legislation in relation to the Life and Non-Life Directives.

Conclusion

48. The Committee believes that the Commission's earlier suggestion of bringing all the conflicts rules on the law applicable to insurance contracts into the Rome I Regulation would have proved beneficial in terms of improving transparency, making the rules more accessible and contributing to certainty. Unfortunately, by leaving the conflicts rules on insurance contracts outside the Regulation, the Final Proposal largely fails to further promote these objectives (although the signposting of the Directives in the Annex is helpful in this regard).

49. By maintaining the status quo, the Final Proposal keeps in place a set of rules on conflict of laws that appear to have been operating satisfactorily in the market. The revised Article 5 in the Final Proposal removes the problem of hybrid or overlapping legal regimes for consumer contracts that were possible under the previous Article 5 of the Rome Convention.

50. Significantly, the Final Proposal does not address a problem identified in the Green Paper in relation to risks located in the EU but covered by non-EU resident insurers, where there is no harmonised solution for the Union. The Insurance Directives are unclear on this question. The UK has adopted a wide interpretation of the Insurance Directives for the purposes of implementation of the rules into UK law, but it is possible that at some stage the ECJ may apply a narrower interpretation.

51. The interaction of the Insurance Directives and the Final Proposal for the Rome I Regulation (since the Rome I Regulation applies without prejudice to the Insurance Directives and therefore the scope of the Insurance Directives reads through into the Rome I Regulation) means that the uncertainty over the scope of the Insurance Directives leads to uncertainty over the scope of the

Rome I Regulation. This uncertainty could have various implications for conflicts rules in Member States, depending on how the question of the conflict of laws for EU risks covered by non-EU insurers is addressed.

52. The FMLC considers that the best approach is to clarify that the narrow interpretation of the Insurance Directives should be adopted,[8] giving the widest possible scope to the Rome I Regulation.

88 This clarification could be given informally as guidance by the European Commission, or formally in the context of the general review of the Insurance Directives currently under way ("Solvency II").

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[9] Clive Maxwell abstained from discussions surrounding FMLC Issue 113 and involvement in the preparation of this paper in recognition of his prior official responsibilities