LLOYD'S

MARKET BULLETIN

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Title	Lloyd's Sanctions Guidance – Sanctions Clauses
Purpose	To set out Lloyd's general position regarding the use and function of sanctions clauses on insurance and reinsurance contracts
Type	Event
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Introduction

Sanctions exclusion clauses and warranties[1] are commonly used across the insurance[2] industry as a useful tool for insurers to mitigate risk arising from the international sanctions regimes to which they may become exposed.

As sanctions clauses are being deployed in policy wordings across the Lloyd's Market with greater frequency, the guidance below has been drafted to assist the market. However, it should be kept in mind that the principles discussed in this document are general in nature and the precise effect of a sanctions clause will depend on its terms.

The scope of this guidance relates primarily to the EU and UK sanctions regimes but many of the principles may apply to US sanctions. Where appropriate legal advice should be sought both on the drafting of appropriate clauses and their interpretation.

Given the absolute effect of sanctions, breach of which can create criminal and civil liability, Lloyd's considers the appropriate and risk based use of sanctions clauses to be a matter of good underwriting practice and a means of achieving contract certainty in highlighting to insureds the sanctions obligations with which the insurer must comply.

The sanctions clause most widely used across the Lloyd's Market is the LMA 3100[3]. The most commonly used clause across the aviation market is the AVN111 clause.

[1] Referred herein collectively as "sanctions clauses".
[2] References to "insurance" or "insurers" should be interpreted to refer also to "reinsurance" or "reinsurers" as appropriate.
[3] The wording of which is: '*No (re)insurer shall be deemed to provide cover and no (re)insurer shall be liable to pay any claim or provide any benefit hereunder to the extent that the provision of such cover, payment of such claim or provision of such*

This guidance focuses on sanctions clauses only. The use of such clauses does not remove the requirement to maintain appropriate systems and controls, including appropriate and proportionate due diligence, to mitigate the risk of a breach of sanctions.

This guidance should be read in conjunction with the Sanctions Due Diligence Guidance for the Lloyd's Market (see Market Bulletins on www.lloyds.com).

In addition to this guidance, Lloyd's has issued an abridged version which is attached at Appendix 1. The purpose of this abridged version is for brokers and managing agents to inform clients and counterparties of Lloyd's general position regarding the use and function of sanctions clauses on insurance contracts, should their clients seek this assurance.

Purpose of a sanctions exclusion clause

Sanctions can affect the scope of coverage an insurer can provide under an insurance contract, as well as activities they may carry on pursuant to a contract. Where sanctions apply, one or more of the parties to an insurance contract may be prohibited from performing certain contractual obligations. The obligations that the affected party will be prohibited from performing will depend on the sanctions that apply. Certain sanctions only have a "suspensory" effect, in that they suspend an underwriter's liability to perform a contract for the period that they are in force. Others may have a more fundamental effect on an underwriter's ability to perform the (re)insurance in question at all.

Broadly speaking:

(a) Where asset freezing restrictions apply, the insurer (and/or the broker) may not be able, directly or indirectly, to make payments to or for the benefit of, or receive payments from, the individual or entity designated under sanctions. So, for example, where the insured becomes subject to an asset freeze, the insurer may not be able to pay claims, return premium or other sums.

(b) Under certain sanctions regimes[4], the provision of coverage itself is prohibited. In these situations, the existence of insurance coverage and the performance of activities under it are prohibited.

Sanctions clauses protect an insurer by ensuring that it is not contractually required to perform activities which will expose it (or related persons or entities) to sanctions. Lloyd's views on how sanctions clauses should operate in the following situations are set out below.

Asset freezes[5]

Where an insured is the subject of European and UK asset freezing restrictions, standard sanctions clauses do not automatically exclude cover. In cases involving financial

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benefit would expose that (re)insurer to any sanctions, prohibition or restriction under United Nations resolutions or the trade or economic sanctions, laws or regulations of the European Union, United Kingdom or United States of America.'

[4] Including trade sanctions, those EU sanctions applicable to Iranian and Syrian persons (as defined in EU Council Regulations 267/2012 and 36/2012) and under certain US sanctions programmes.

[5] Managing agents should note that very different freezing/blocking obligations arise under US sanctions and certain activities listed as permissible in this section in relation to EU/UK sanctions may not be permissible where US sanctions apply. US legal advice should be sought as to the relevant compliance obligations.

sanctions, cover will remain valid in most instances, however transactions must not be carried out under the contract that would result in funds being made available to any designated insured or beneficiary (for the period it remains designated under the sanctions).

In such circumstances, under European and UK sanctions it is normally (but not always[6]) the case that whilst claims cannot be paid, they can still can be adjusted provided any funds payable pursuant to a claim are kept in a frozen bank account (or an escrow account), until such time that the asset freezes are lifted. When they are, it may be possible to make a payment to that party in accordance with any remaining applicable sanctions[7]. Even where claims are not adjusted and no funds are required to be frozen, managing agents should consider whether to post reserves (now or in the future) for the payment of the claim once the financial sanctions are lifted (subject always to complying with the requirements of the asset freezes).

Where asset freeze restrictions apply to an insured, it may be possible to obtain a licence from the appropriate authorities to perform activities otherwise prohibited. Lloyd's would generally expect underwriters to take reasonable steps to request the necessary authorisation or licence to pay or to provide coverage, even though a sanctions clause may not oblige them to do so.

Trade sanctions[8]

Where trade sanctions (including arms embargoes) apply, the provision of insurance coverage itself may be prohibited unless an appropriate licence is available or is obtained prior to underwriting the cover in question.

Where a contract is underwritten which, despite appropriate due diligence having been undertaken, would otherwise provide coverage prohibited under trade sanctions, a sanctions clause should have the effect of excluding coverage in relation to the activities, transactions or persons/entities which are the subject of trade sanctions. Its effect is such that it deems that no coverage is provided in respect of those activities, transactions or persons/entities under the insurance contract in question.

A sanctions clause may not have this effect if the insurer has knowledge of the activities, transactions or persons/entities subject to trade sanctions at the time they underwrite the risk, or where they have accepted premium specifically allocated to those activities, transactions or persons/entities. For this reason, such activities should be clearly and specifically excluded from cover to put this question beyond doubt and the insurer should not accept any premium in respect of them.

[6] Managing agents should also be aware of the wider restrictions on the provision of financial services to designated persons under the Terrorist Asset Freezing Act 2010 ("TAFA"). TAFA prohibits the provision of financial services to designated persons and this technically includes the provision of insurance cover. There is a currently a licence (AFU/2011/G1) issued by HM Treasury which allows for the provision of insurance as an exception to this prohibition. However, this licence is revocable. In addition, the definition of "financial services" in the TAFA may, dependent on the facts, include certain activities to be performed in relation to insurance claims. Where this is the case, managing agents may not be able to adjust or conduct other activities in relation to that claim.

[7] Managing agents should keep in mind that on occasion certain asset freezes are left in force in relation to funds arising during specified periods of time. A current example of this can be seen under certain remaining Libyan sanctions. This is sometimes the case where asset freezes are directed at assets that have been expropriated from a state by a government regime that is subject to sanctions.

[8] Including those EU sanctions applicable to Iranian and Syrian persons, trade sanctions under certain US sanctions programmes and the trade restrictions contained in the UK Export Control Order 2008.

It is also worth noting that HM Treasury's view is that that both the knowledge based defence and sanctions clauses can only be relied on if, having conducted due diligence, insurers have no reasonable cause to suspect there is a sanctions breach. Therefore, the protection offered by a sanctions clause will always depend on the particular facts of the case.

In addition, HM Treasury have said that if an insurer knows a breach will occur, providing cover (even if specific activities are carved out) would be contrary to the spirit of sanctions regimes and therefore contrary to the UK Government's policy.

Considerations when applying a sanctions clause

Managing agents are expected to consider the circumstances in which sanctions clauses are likely to be effective and should ensure that these clauses are deployed as part of their risk-based sanctions compliance procedures. The risk factors set out at paragraph 2.1 of the Sanctions Due Diligence Guidance for the Lloyd's Market (which are not exhaustive) may be relevant in this regard.

In doing so, managing agents should consider which terms are likely to be most effective to manage the risk to which they are exposed. Managing agents should be aware that inappropriate clauses can create additional and unnecessary risk. As a minimum, managing agents should ensure that sanctions clauses:

> (a) exclude from cover any risk or activity that would expose the managing agent to sanction or penalty under EU, UK or other applicable financial or trade sanctions (including UN Security Council Resolutions); and
>
> (b) exclude liability for managing agents to pay claims or other sums including return premiums (or provide any other benefit under the insurance contract concerned) which would put them in breach of such sanctions[9].

However, other considerations may be relevant to managing agents and may need to be reflected in the sanctions clause. Certain examples are set out below.

Separately, managing agents should note that certain jurisdictions may not allow for sanctions clauses to be deployed on certain insurance contracts covering risks in their jurisdiction, or will not permit certain wordings to be used (e.g. Germany).

Other Sanctions Regimes, including the US

Where a sanctions clause names certain countries' sanctions regimes, for example the US, it should not create an obligation for a contracting party to comply with those sanctions unless it is otherwise exposed to those sanctions[10]. So, whilst certain sanctions clauses specifically refer to US sanctions this does not mean that they will exclude coverage in respect of activities which would be prohibited under US sanctions unless those sanctions actually create exposure for persons performing activities under or pursuant to the insurance contract.

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[9] As noted above, this should not preclude managing agents from seeking a licence to make certain payments and/or freezing funds pertaining to otherwise valid claims where such activities are permissible under sanctions.
[10] Either because the sanctions apply to the entity directly, or apply to its employees or companies in its group, or to persons or entities with whom it must deal to perform its obligations under the insurance contract.

With the above in mind, managing agents will also want to consider whether the sanctions clause they use mitigates any exposure to their employees, group or related companies as a result of their activities, where appropriate. For example, if under their internal corporate procedures, business decisions must be referred to group companies in the US, the managing agent should consider whether its sanctions clause needs amending to refer to US primary sanctions and to reflect its referral procedure. Similarly, even if they are not part of a US group, managing agents need to consider the position of staff who are US nationals.

Amendments and Variations to Standard Wordings

Lloyd's is aware that there are many different sanctions clauses in use in the London Market. Managing agents should exercise caution in agreeing to sanctions exclusions or warranties which deviate from market model wordings (or their own internal standard wording). Managing agents' sanctions compliance procedures should always allow for full consideration of the effects of such deviations (which may include internal compliance and legal review of such terms) prior to underwriting such contracts.

Insurance subject to Foreign Law

Managing agents should take steps to understand how the chosen or applicable law and jurisdiction of the contract may affect the interpretation of the sanctions clause, so as to ensure that they have their intended effect. It may be necessary to seek local legal advice on the appropriate terms that will achieve the desired protection.

In the event of any doubt as to the treatment of such terms under the chosen law of the contract, managing agents may wish to alter the choice of law/jurisdiction of the insurance contract concerned (if this is permissible pursuant to applicable local insurance regulation).

Due Diligence and Sanctions Clauses

Whilst the insertion of a sanctions clause may give a measure of protection for insurers in specified circumstances in relation to relevant sanctions legislation, it does not remove a managing agent's obligation to carry out, or to have performed on their behalf, due diligence appropriate to the type of contract in question and to ensure that that it is evidenced accordingly.

Lloyd's has previously issued guidance to the effect that where sanctions clauses are likely to have the effect of excluding all risk under that contract, managing agents should not underwrite the contract concerned. This remains Lloyd's view. In situations where particular matters giving rise to risk are known by insurers prior to underwriting, managing agents should take additional measures (in addition to applying appropriate sanctions clauses) to ensure that such matters are fully and appropriately excluded from cover provided by the insurance contract. Such measures may include:

- Using specific geographical or territorial exclusions in the contractual wording,
- Excluding particular entities, individuals or activities from cover.

In addition, premium should not be accepted for these territories, activities or persons/entities.

Managing agents should not underwrite a contract without a sanctions clause in order to obtain a competitive advantage, where such a clause is clearly appropriate.

Classes of business for which Managing Agents should consider deploying sanctions clauses

Lloyd's does not mandate the use of sanctions clauses, however, managing agents should consider using a sanctions clause on a risk sensitive basis, in line with their own sanctions risk assessment. There are some types of business for which Lloyd's considers that it is best practice to deploy an appropriate sanctions clause on the policy, because these may increase risk by including coverage for mobile or complex risks which create exposure in territories where sanctions apply. These include, but are not limited to:

- Open covers, including marine open cargo covers and line slips,
- Treaty reinsurance,
- Global policies, e.g. product liability,
- Master policies, e.g. worldwide travel.

Additionally, managing agents should consider using an appropriate sanctions clause on any contract where there is potential for additional insureds, activities or locations to be declared to the policy without prior approval by the managing agent.

There are likely to be other circumstances in which it is appropriate to deploy an appropriate sanctions clause on the policy.

Subscription Market Issues

When subscribing (as a following market) to an insurance contract, managing agents will still have to confirm that any sanctions clause applied to that contract is suitable for their needs. If it is not, managing agents should consider requesting an amendment to the clause or applying additional wording to their line on the contract.

Appendix 1 – Client / broker sanctions clause fact sheet

This is a summary document, and is not a substitute for specialist legal advice on issues specific to individual contracts.

Sanctions can affect the scope of coverage an insurer can provide under an insurance contract, as well as activities they may carry on pursuant to a contract. Sanctions clauses are now used increasingly frequently across the Lloyd's and London markets to achieve contract certainty in respect of sanctions and to mitigate sanctions risk.

They are also recommended as good practice for underwriters by regulators such as US Treasury's Office of Foreign Asset Control ('OFAC') when providing global coverage to insureds that could potentially expose underwriters to sanctions risk.

Lloyd's general position regarding the use and function of sanctions clauses on (re)insurance contracts can be expressed, briefly, as follows:

- A sanctions clause should be used as part of an overall sanctions compliance programme, which should also include appropriate due diligence and screening.
- The clause is designed to recognise that in certain circumstances (determined by law, not the underwriter) the underwriter may not be able to pay a claim, provide another service to the (re)insured or provide the cover as originally anticipated.
- Certain sanctions only have a "suspensory" effect, in that they suspend an underwriter's liability to perform a contract for the period that they are in force. Others may have a more fundamental effect on an underwriter's ability to perform the (re)insurance in question at all.
- Sanctions clauses are designed to protect against matters which cannot reasonably be identified through pre-underwriting due diligence and uncertainties inherent in sanctions regimes, including changes to the law, post inception.
- Sanctions clauses do not affect the nature of cover given, nor do they affect the scope of cover the underwriter can or cannot provide without exposure to sanctions.
- Sanctions clauses are designed to promote contract certainty – and to alert the parties to the contract that different sanctions regimes to which the parties may be exposed.
- Lloyd's would generally expect underwriters to take reasonable steps to request the necessary authorisation or licence to pay claims or to continue to provide coverage, where sanctions prohibitions apply, even though a sanctions clause may not oblige them to do so.
- Regulators and enforcement agencies recognise that sanctions clauses should be used on a risk-sensitive basis in the (re)insurance market.
- It is good practice to use a sanctions clause as a risk mitigation tool on lines of business which represent a higher risk of sanctions exposure, such as marine, aviation or energy, but this does not mean that sanctions clause should not be used in other lines of business.
- A sanctions clause will be appropriate where:
    - o the underwriter does not know the identity or location of all possible (re)insureds or beneficiaries to a (re)insurance contract, for example global policies or treaty reinsurance, or,
    - o where the exact details of the (re)insured activities are not known at inception by the underwriter, for example marine open cargo covers.

  This is not an exhaustive list, but illustrative of some common examples.