CHAPTER 2

THE PARTICIPANTS AND COMMON REINSURANCE ARRANGEMENTS

REINSUREDS AND REINSURERS

2.1 An American court once stated the nature of the relationship between reinsurer and reinsured in this way: "A true reinsurer is merely an insurance company or underwriter which deals only with other insurance companies as its policyholders" (*Iowa Mutual Tornado Insurance Ass'n* v. *Timmons*[1]).

1. 105 N.W. 2d 209 (Iowa 1960).

2.2 A reinsurance contract is an agreement between two insurers, one who reinsures, self-evidently the "reinsurer", and one who is reinsured who may be known as the "reinsured" (a general term and one which is used throughout this chapter), the "reassured" (an expression more commonly encountered in the case of life, aviation and marine business) or the "cedant" (in the case of treaty business). These terms have become increasingly interchangeable in practice.

2.3 Where the reinsurer itself reinsures all or part of its liability it becomes a "retrocedant" and its reinsurer the "retrocessionaire". For the purpose of this chapter, we draw no distinction between a reinsured and retrocedant or between a reinsurer and retrocessionaire. A company or underwriting syndicate will, very often, be trading as both reinsurer and reinsured, as a buyer and seller of reinsurance. Many organisations act in both these capacities at one time or another.

2.4 "Cession" is a broad generic term used to describe the transfer of risk between reinsured and reinsurer in treaty business. (Strictly speaking, the term is apposite only in relation to proportional reinsurance, but one comes across the use of "cession", "cede" and "cedant" in the excess of loss context as well.)

2.5 A reinsurer is only indirectly interested in direct losses, that is, to the extent that they affect his liability to his reinsured under the contract of reinsurance. The reinsurance relationship is brought about by the reinsurance contract and is mutually exclusive from the relationship between the insurer and the original insured. The original insured has no legal interest in the reinsurance relationship. This important fact must be borne in mind. The liabilities and obligations of the reinsurer and reinsured are new ones which are created and governed by the reinsurance contract. They are not, despite what some reinsurance terminology might suggest, a simple "share" of an existing obligation, although there are circumstances where some elements of the underlying contract may be incorporated into the reinsurance contract.[1]

1. See Chapter 16 for further discussion of such circumstances.

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2.6 The separate character of direct insurance and reinsurance contracts is well illustrated by the Court of Appeal decision in *Meadows Indemnity Co. Ltd* v. *The Insurance Corporation of Ireland plc and International Commercial Bank plc.*[1] In that case, Meadows as reinsurer sought to obtain declarations as to the invalidity both of a reinsurance contract between itself and ICI and of an underlying policy of credit guarantee insurance. The Court of Appeal held that it was not possible for the reinsurer to obtain a declaration that the insurer was entitled to avoid the original contract of insurance. May LJ said this:

"These two parties [the reinsurer and the original insured] have no rights or obligations against or to each other; they are not in a contractual relationship. Although there is of course a connection between the contract of insurance on the one hand and of reinsurance on the other, [the reinsurer's] rights are in no way involved in the existing dispute between [the insurer] and [the original insured]. Whether [the insurer] has to pay [the original insured] depends upon the terms and circumstances of the insurance contract between them and, if relevant, any non-disclosure or misrepresentation that occurred between them. Insofar as [the reinsurer] is concerned, any liability on their part will depend upon the contract of reinsurance and the factual situation which existed between them when this was entered into. As I have said, the position of [the reinsurer] is in no way threatened because [the insurers] are vigorously defending [the original insured's] claim in the Irish proceedings . . . ."

1. [1989] 2 Lloyd's Rep 298.

2.7 Neill LJ did however say that it was with "some reluctance" that he reached this decision, as "one can . . . see the good sense of a person being able to establish by means of [a] declaration the legal rights of a third person if those rights will, in due course, directly affect him as an insurer or reinsurer . . . ".

2.8 Chapter 4 provides an overview of the main types of reinsurance contracts which reinsurance entities typically enter into.

BROKERS AND UNDERWRITING AGENTS

2.9 Brokers play a crucial role in the global reinsurance business. The leading brokers handling reinsurance business in the London market have also played a significant part in developing London as a major reinsurance centre. Much of the reinsurance business written in the London market is placed by brokers, and therefore an appreciation of their role, duties and obligations is crucial to an understanding of how the London market operates, as well as its legal framework.

2.10 A broker is the "man in the middle" between the insured and the underwriter/insurer. Reinsurance brokers perform distinct but important functions. First, on the instructions of the reinsured, they place reinsurance with reinsurers. Secondly, they act as agents through which the reinsurance premiums are paid and reinsurance claims collected. Thirdly, they may sometimes act as underwriting agents binding reinsurers to risks by a device known as a binding authority. It will be clear from this that brokers often act in more than one capacity, and often interchangeably as the agent of more than one party. For instance, when the broker places cover he normally acts as agent of the reinsured. However, the legal relationship between a broker and each of the other parties, namely the reinsured, the underwriting agent and the reinsurer is normally not explained in any written contract, but is generally implied by law. The rights and duties of the parties are frequently said to be governed by "market practice" which itself may not be clear or consistent. For example, the long-standing practice of Lloyd's brokers to

act as agents for the underwriter in appointing loss adjusters on behalf of the underwriter without the insured's knowledge or consent has received judicial disapproval in two decisions (*North and South Trust Co.* v. *Berkeley*[1] and *Anglo-African Merchants Ltd* v. *Bayley*[2]).

1. [1971] 1 WLR 470.
2. [1970] 1 QB 311.

2.11 In the reinsurance context where all parties to the transactions are professionals operating in the same market, cases of dual agency are not uncommon. In *IGI Insurance Co. Ltd* v. *Kirkland Timms Ltd*[1] Hirst J accepted Counsel's argument that a broker administering premiums and claims as between underwriters and brokers holding binders was an intermediary with agency obligations to both parties (a binder is a binding authority given by an insurer to an agent authorising the agent to bind the insurer to risks accepted by the agent). It is important to note that the overriding principle of fully informed consent by both principles in the case of a dual agency situation still applies. If a broker places business with an underwriter, the underwriter is the third party with whom the broker makes a contract for his principal; if the broker is then instructed by the underwriter to obtain reinsurance for him, the underwriter becomes his principal, the insured. It is doubtful that any disclosure is required to the original principal because there is no conflict in the two functions, but each should be fully informed as appropriate.

1. Unreported 5 December 1985.

2.12 The different capacities in which the broker may find himself acting when placing cover was analysed by Evans J in detail in *SAIL* v. *Farex*.[1] He stated:

"It is a commonplace situation in insurance and reinsurance business, and not just at Lloyd's for a broker who has undertaken to obtain insurance or reinsurance cover for an original client also to place reinsurance or retrocession cover on behalf of the insurer or reinsurer who accepts the original business. The legal analysis of this situation is not without its difficulties but the starting point for the analysis is clear. The broker acts as agent for the original insured or reinsured when placing the insurance or reinsurance and an agent for the insurer or reinsurer when placing the reinsurance or retrocession".

1. [1995] LRLR 116.

2.13 The role of brokers and their legal responsibilities and duties is considered further in Chapter 7.

2.14 As indicated above, many brokers also act as underwriting agents. Legally, this role is quite distinct from that of a traditional insurance broker. A broker, acting as a broker, will generally act on behalf of the insured (or reinsured). An underwriting agent will act on behalf of the insurer (or reinsurer) and will have legal authority to accept risks and bind the underwriters on whose behalf he acts. Put in its simplest terms, an underwriting agent is any person or body who writes insurance or reinsurance on behalf of another with that other's authority. Because the relationship is one of agency, this definition does not include employees.

2.15 The authority that an underwriting agent has been given by its principals will vary from case to case. Sometimes the agent will be given a binding authority which will allow it to underwrite certain classes of business on behalf of its principal without reference to the principal, provided that the business is written within the terms of the binding arrangement. On other occasions the authority may be limited to the grant of some form

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of temporary cover subject to the agreement of the principal, as would probably be the case with a line slip or open cover.

2.16 The relationship is governed by the law of agency and thus the underwriting agent, in writing the business on behalf of the principal, does not incur any liability in respect of that business itself. The liability, if any, is that of the principal. An agent owes duties to his principal and, in addition to a strict observance of the terms of his authority, he will be under a duty to exercise that authority with due care and in accordance with the standards generally applied and accepted in the market. Where an agent is alleged to have acted either without or beyond his express authority he may still bind his principal if the insured can establish either implied authority or, in default, apparent or ostensible authority. The former will derive from the terms of the agency agreement and the implied authority to do whatever is necessary in the ordinary conduct of the business in accordance with normal market practice. The latter (i.e. apparent or ostensible authority) may be established if the principal can be shown to have represented or held out the agent to have the authority necessary to perform the relevant transactions. If, however, the claimant actually knew the limits of the agent's authority then he will not be able to claim against the principal where that authority has been exceeded since he cannot show that he actually relied upon the holding out.

2.17 In cases where a principal is able to establish his agent's lack of authority the insured or reinsured may have a remedy against that agent for breach of the warranty of authority which an agent is treated in law as having given. Historically, the delegation of underwriting authority by underwriters to underwriting agents has led to a numerous disputes.

2.18 The role of underwriting agents is considered further in Chapter 6.

THE SUBSCRIPTION MARKET

2.19 Reinsurance placed in the London market invariably makes use of a document known as a slip. This is a document prepared by a broker which sets out the proposals to be made to the insurer. The slip contains the bare bones of the reinsurance contract using economic phraseology and the purpose of the slip is to offer the risk to each reinsurer in a form which is concise and which enables him to make a speedy decision as to whether or not he wants to participate. The slip typically identifies the reinsured, the nature of the risk, the duration of the reinsurance, the limits of the indemnity and the retention of the reinsured, and usually the premium payable.

2.20 In order to place a risk, a broker will typically approach an underwriter who is a recognised "lead" for that type of business with a view to persuading him to write a sizeable line in the hope that this will encourage other underwriters to follow his lead. The leading underwriter will be an individual, or group of individuals, whose acceptance and rating of the risk will be followed by the remaining underwriters who subscribe to that risk. The broker and the leading underwriter will discuss the slip and agree upon any amendments to the broker's draft and the appropriate premium. The following market will then accept (or not) the terms agreed by the leading underwriter and each reinsurer will identify his participation in percentage terms by stamping and signing the slip. Although there may only be one physical slip, the slip represents a series of individual contracts between the reinsured and the reinsurer and each is quite separate. If the

reinsured suffers a loss before 100% of the slip has been collected by the broker, then the reinsurers who have subscribed will of course be liable for their shares.

2.21 A market which permits the placing of insurance and reinsurance contracts in this manner, with a number of participating insurers, each subscribing individually to the terms of the contract, is known as a "subscription market". Historically, a great deal of reinsurance business written in the London market has been written on a subscription basis. Many view the subscription market as a key strength of the London market, allowing difficult or unusual risks to be placed in a cost-effective manner.

LINE SLIPS

2.22 A line slip is not a slip in the conventional sense as described above. It is not itself a document evidencing a contract of insurance or reinsurance. It is rather an agency agreement by means of which a number of underwriters grant authority to a leading underwriter or other agent to write business on their behalf. Such a facility will define the class of business to which it relates, the financial limits of the indemnity which may be granted and will often contain a specific wording setting out all the terms and conditions of the facility. The underwriter or other agent in whom such authority is vested thus binds the subscribers for each of their respective proportions. This is not a pool or a fronting arrangement but a delegation of authority. Authority under such a facility can also be delegated to a broker. The type of problems which can arise in relation to such agency relationships, such as the exceeding of authority and conflicts of interest, are discussed in Chapter 6.

2.23 The insurances or reinsurances which are concluded under such an authority are set out on separate slips known as "off-slips"; these are slips in the conventional sense in that they evidence the contracts between the reinsured and the respective reinsurers who have subscribed to the facility. Thus the off-slip is the binding contract of reinsurance and not the line slip. Losses arising under such cover can, as a matter of law, only arise under the off-slip although in the market they may be described as arising under the line slip. Reference will commonly be made in the off-slip to the terms and conditions of the line slip, particularly as to the scope of the cover. In these circumstances those terms will plainly be incorporated by reference.

2.24 The LMP developed a mandatory market line slip, the LMP lineslip [*sic*], in June 2005, which became compulsory on 1 October 2005. Off-slips attaching to the LMP lineslip have to be prepared in accordance with its guidelines. The LMP lineslip has been replaced by the Market Reform lineslip ("MR lineslip"), published by the MRG in October 2006, with effect from 1 February 2007. The MRG has published guidelines to accompany the MR lineslip, which are available on its website (www.marketreform.co.uk).

2.25 Notwithstanding that the relevant reinsurance contract will be contained in the off-slip and not the line slip, it is almost invariably the underwriter's original subscription to the line slip which will bind him to the contracts evidenced in the off-slip, because the off-slips may be issued as a result of "declarations" to the line slips (that is, proposals for reinsurance on terms conforming to those of the line slip) which are approved by the leading underwriter or underwriters alone, he or they having been invested with authority for this purpose by the following market. In *Denby* v. *Marchant*,[1] an issue arose as to when a Lloyd's underwriter had "written" a particular risk which was insured pursuant

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to a line slip: was it the date on which the underwriter had subscribed to the line slip, or the (later) date on which the disputed policy had been issued? Waller J held that the former date was correct because the underwriter, by signing the line slip, had granted irrevocable authority for the syndicate to be bound by its terms in relation to all policies issued under the line slip during the period of its validity. The Court of Appeal reversed this decision (*Denby* v. *English & Scottish Maritime Insurance Co. Ltd*[2]): the court reasoned that no risk was actually "written" until the relevant off-slip was signed by the leading underwriter. The line slip merely conferred an authority on the leading underwriter to write risks on behalf of all of the underwriters subscribing to the line slip.

1. [1996] LRLR 301 (QB Com Ct).
2. [1998] Lloyd's Rep IR 343.

2.26 Although the authority of the Court of Appeal's judgment has not been questioned in any subsequent case, its applicability may be limited to contracts written prior to 1 January 1995 (*Denby* was concerned with claims arising under contracts written in the early 1980s). As regards contracts written on or after 1 January 1995, Schedule 3 to the Syndicate Accounting Byelaw (No. 18 of 1994), which came into force on that date, provides that:

> "Premiums and claims in respect of insurance contracts underwritten by the members of the syndicate shall be allocated to the year of account corresponding to the calendar year in which the contract incepts, except as follows—
>
> (a) premiums and claims in respect of insurance contracts underwritten under a binding authority, line slip or consortium arrangement shall be allocated to the year of account corresponding to the calendar year of inception of the binding authority, line slip or consortium arrangement. . . . "

2.27 Although this byelaw was revoked by Syndicate Accounting Byelaw (No. 8 of 2005), which was made by the Council of Lloyd's on 7 December 2005, the new byelaw contains the same provision. No reference to the byelaw seems to have been made in argument in *Denby*, and certainly none appears in the judgment. Even if, prior to their introduction by the byelaw, there were no statutory or regulatory requirements to account for line slip business in a particular way, it might be asked whether the byelaw did anything more than clarify or ratify what had, up to then, been the relevant Lloyd's market practice. In any event, while *Denby* (unless and until it is overruled) remains good law in so far as contracts written prior to 1 January 1995 are concerned, the byelaw is likely to affect the position in relation to contracts written post 1 January 1995.

2.28 In *HIH Casualty and General Insurance Ltd* v. *Chase Manhattan Bank and Others*[1] Aikens J considered the nature of a line slip facility in the context of film finance insurance. The case involved a facility to which declarations in respect of individual film productions were made. Chase Manhattan Bank had lent money to fund the production of a number of films. Insurers subscribed to a policy of financial contingency insurance with Chase as the insured. Insurers sought to avoid or rescind the line slip facility itself in addition to the individual declarations made under it. One issue which was raised was whether there was a duty of disclosure and utmost good faith when the line slip was concluded. Aikens J held that as the line slip was not a contract *of* insurance but rather a contract *for* insurance (akin to a binding authority), it could not be a contract of utmost good faith. As there was no duty to disclose, there could be no question of avoiding the line slip on grounds of material non-disclosure, or of recovering damages from the insured or their agents. The court held, however, that there was a duty to disclose

"unusual features of the transaction" in relation to the line slip facility. Aikens J commented that this was really a duty not to misrepresent at common law and accepted that there was a duty not to misrepresent facts when the line slip was concluded. This aspect of the judgment of Aikens J was confirmed by the Court of Appeal[2] although other parts of the decision were reversed. On a further appeal to the House of Lords,[3] this aspect of the first instance judgment was not put in issue.

1. [2001] Lloyd's Rep IR 191 (QB Com Ct).
2. [2001] Lloyd's Rep IR 703.
3. [2003] Lloyd's Rep IR 230.

UNDERWRITING POOLS

2.29 Underwriting agents often write business on behalf of more than one, and often many, principals. The insurers or reinsurers for whom a particular underwriting agency writes may collectively be known as a "pool". Although they are now much less widespread than they were a decade or two ago, pool structures may be a convenient means of achieving a large underwriting capacity and are often seen as a method by which reinsurers may gain access to a foreign market or new classes of business to which they might not, as individual reinsurers, otherwise have access.

2.30 The contractual relationship in this situation will be the same principal and agent relationship described earlier; that is, the agency accepts business on behalf of each of the pool members individually so that each member is bound only to the extent of the line written on his behalf pursuant to the terms of the agency or pool agreement.

2.31 In certain circumstances and where permitted by the terms of the pool agreement, one company among the pool participants may be used to "front" the arrangement, accepting 100% of particular risks (or at any rate a larger proportion than would normally be the case) in its own name, which are then "automatically retroceded" to the other pool members. There are a variety of reasons for such an arrangement: for example, one company may be more acceptable as security to potential reinsurers, or such arrangements may facilitate the management and administration of the pool.

2.32 Under such an arrangement, the fronting reinsurer will, in the absence of specific agreement to the contrary, be liable to the reinsured for 100% (or other applicable proportion) of the risk ceded (*Wace* v. *Pan Atlantic Group Inc.*[1]).

1. [1981] 2 Lloyd's Rep 339.

2.33 Questions frequently arise as to the actual authority of the agent in appointing a fronting company under these circumstances, particularly where the result is that the fronting company is bound for a larger gross proportion of the risk than is provided for in the agency agreement, notwithstanding that its net share (i.e. after retrocession to the other pool members) is in accordance with that agreement. In such cases, it will be necessary to establish that there was implied or ostensible authority on the part of the agent to effect a fronting situation. A finding of implied or ostensible authority would, however, be unusual: see *Suncorp Insurance & Finance* v. *Milano Assicurazioni SpA*.[1]

1. [1993] 2 Lloyd's Rep 225, discussed at para 2.41.

2.34 It is common in the context of underwriting pools to encounter allegations of illegality, improper fronting and questions concerning the agent's authority. Illegality

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was and is a particular problem in respect of the pools set up in the late 1970s, where underwriting agents, by diverse, and usually ineffective, means, attempted to circumvent Department of Trade authorisation.

2.35 Some of the problems with pools are associated with the underwriting "chain" increasing in length, and Figure 2.1 provides an illustration of the various and numerous parties which can be involved in such transactions.

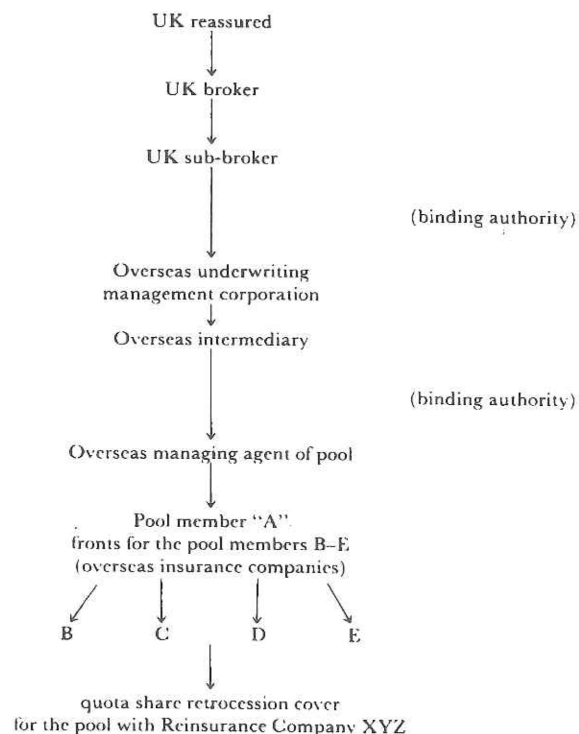

Figure 2.1 Possible parties in the underwriting chain

2.36 In Figure 2.1:

(i) The UK reassured places instructions with its broker to obtain reinsurance cover for a specific treaty.
(ii) The broker instructs a UK sub-broker.
(iii) The UK sub-broker places the business with an overseas underwriting management corporation (this company is part owned by the UK sub-broker and was formed specifically to handle business emanating from the UK sub-broker).
(iv) The overseas managing agent is reinsurance manager for a number of overseas companies who wish to reinsure UK risks. There are parallel managing agency agreements between each pool member and the pool manager.
(v) The pool manager enters into an agreement with the overseas underwriting management corporation whereby the pool manager delegates a binding authority to the corporation to accept on its behalf and cede to it business emanating from the UK sub-broker.
(vi) The pool manager also arranges retrocession cover for the pool.

2.37 The above, complex arrangements will maximise commission and minimise the premium reaching the ultimate risk carriers: a practice commonly known as "premium stripping". It is highly unlikely that the pool can ever make a profit after the various commissions and overriders have been paid.

2.38 The problems concerning the delegation of underwriting authority are further aggravated in the context of a pool. It is unusual for the pool members to know each other's identity, and therefore highly unlikely that they will combine sensibly to supervise properly the activities of the underwriting agent. In the example above the problem is further emphasised by the use of sub-agents and the delegation of the binding authority, perhaps without the authority of the pool members.

2.39 It has also been seen, for example, that fronting companies have been used to facilitate the underwriting process, perhaps where the front company is the only company licensed to write local risks. It is quite common for the underwriting agent to include in the agreement with each of the pool members a provision whereby it, the underwriting agent, can nominate any one of the pool members as the fronting company without that company's specific authority. The dangers are obvious, in that any one of the pool members reinsuring the front can become insolvent and yet the fronting company will remain fully liable to the cedant.

2.40 An example of the complications that may arise in connection with this type of arrangement can be seen in *North Atlantic Insurance Co. Ltd* v. *Nationwide General Insurance Co. Ltd*[1] which arose out of the Rutty pool's operation in the 1960s. Individual members of the pool were used as fronting companies, which would accept 100% of any inwards risk but would be reinsured by other members of the pool. The pool itself was then reinsured by external reinsurers. A dispute arose as to who within the pool could claim the external reinsurance recoveries when two of the pool members became insolvent. Even though the fronting company was named as the reinsured, the Court of Appeal held—on the particular wordings of the pool's underwriting agency agreements and reinsurance arrangements—that the reinsurances were based on pool liabilities and not on individual fronting companies' liabilities and therefore the outwards reinsurance proceeds belonged to each pool member in accordance with its agreed proportion, so that the fronting companies ranked alongside the insolvent pool members' other unsecured creditors for a share of the proceeds of the outwards reinsurances.

1. [2004] Lloyd's Rep IR 466 (CA).

2.41 The issue of whether or not the underwriting agent had authority to use one company as a front may in itself generate disputes. For example, does an express provision in the management agency agreement which gives discretion to the agent to reinsure or to retrocede in whole or in part any of the risks allow the agent to use one of the pool members as a front? Clearly much will depend on the precise terms of the agreement, but usually the answer should be in the negative. The agreement in *Suncorp Insurance & Finance* v. *Milano Assicurazioni SpA*[1] contained a clause permitting the agent "at his sole discretion [to] effect any reinsurance on behalf of the [pool member] as the [agent] considers desirable", but Waller J did not refer to this provision in reaching the conclusion that the contract did not permit the agent to use one pool member as a front for others.

1. [1993] 2 Lloyd's Rep 225.

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2.42 How does the pool deal with the run-off of the business? It is not uncommon for the underwriting agency to have disappeared after the first few years and left the pool members to run off the business. There are various ways in which a pool member can protect itself against such a possibility, by, for example, ensuring that the underwriting agent has provided for errors and omissions cover or that the underwriting agent is obliged to set aside funds in a separate interest-bearing account to provide for run-off facilities.

2.43 The market has probably learned a good deal from the mistakes made in the last thirty years, and pool membership is no longer as fashionable as it once was, although it has featured of late in the context of US workers compensation carve-out business. The problems remain obvious and probably insurmountable.

FRONTING ARRANGEMENTS

2.44 Whether the facultative reinsurance is arranged on a proportional or non-proportional basis, the amount of risk retained by the cedant will generally be a material consideration for the reinsurer when considering whether or not to accept the cession. Until the mid-1980s it was a common practice for the London market to receive risks from overseas, fronted by local insurers who retained varying amounts of risk for their own account. Such arrangements had become necessary for a variety of reasons, the commonest being due to local restrictions on overseas reinsurers' ability to write business on a direct basis, or local licensing or exchange control requirements. Alternatively, the local market may not have had sufficient expertise or capacity to assume the risk, in which case the local cedant would issue the direct policy and retain a ceding commission, while allowing the facultative or fronted reinsurer in all but name to underwrite the risk.

2.45 Fronting arrangements are likely to be subject to a claims control or co-operation clause, which enables the reinsurer to control the conduct of any direct claim presented to the cedant. These clauses are notorious for producing claims handling problems, as the local insurer will be unable to agree and adjust claims without reference to, or prior approval from its reinsurers. In addition, the local insurer may be subject to political and economic pressures from an interested financial institution or an industrial insured which is wholly or partly owned by its government. The fronted reinsurer may also encounter local regulations which require the ceding company to retain part of the reinsurance premium in that country for a specified time, and these will have the effect of allowing a virtually automatic set-off of claims against premiums, regardless of the applicability or otherwise of the original policy terms and conditions.

2.46 In the London market, fronting arrangements have been used by brokers on some UK and overseas risks where unlicensed or unacceptable security has had to be "concealed" for contractual purposes behind an acceptable fronting insurer. This has the legal effect of making the fronting insurer the only contracting party against which an insured can pursue its claim; the insurer is therefore solely liable to the insured for any fronted participations of other (re)insurers. In many cases the broker will have accounted for such arrangements on a net basis to both parties, "for convenience", but this will not alter the legal position reflected in the contract documentation, as in law the fronting insurer remains liable.

2.47 If one or more of the fronted reinsurers fails to perform, the previously "net" liabilities accepted by the fronting insurer then become gross liabilities. The prevalence of fronting arrangements has therefore declined in recent years, in line with an increased awareness of the need for sound reinsurance security.

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CHAPTER 3

GLOBAL REINSURANCE MARKETS

BACKGROUND

3.1 Reinsurance is, by its very nature, a global business. Reinsurance exists, on a macro-economic basis, in order to spread risk, not merely between companies but between countries and regions. Many of the earliest reinsurance agreements were made internationally and on a mutual basis whereby a company operating, for example, in Sweden, would share its risk with a company operating in Italy. By this means the accumulation of exposure to major natural disasters would be spread. Examples of mutual reinsurance can be found dating back to the early part of the nineteenth century.

3.2 In order for reinsurance to develop internationally, communication was required and it was therefore not until the latter half of the nineteenth century that reinsurance companies, designed with the sole purpose of accepting reinsurance business, were formed. In the years between 1850 and 1930 a total of 158 reinsurance companies came into being around the world. Twenty-seven of these were founded in Germany and 28 in the USA. Significant numbers also emerged in the UK, France, Sweden and Denmark. Others were established in Argentina, Austria, Belgium, Bulgaria, Canada, Czechoslovakia, Finland, Holland, Hungary, Italy, Japan, Norway, Poland, Portugal, Spain and Switzerland. The inclusion of Japan and Argentina in this list, where seven and three reinsurance companies were incorporated respectively, demonstrates the global spread of reinsurance, even in those times.[1]

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1. Golding, *A History of Reinsurance*, Second Edition, London 1932.

3.3 In the years that followed, major social, economic and political developments occurred and most of these impacted upon the reinsurance markets and their development. The end of imperialism and the birth of new nations led to the development of national reinsurance requirements aimed at balancing both the spreading of risk and exchange control. Regulation grew at both the insurance and reinsurance levels, altering the manner in which reinsurance could be bought or sold. All the time, the need to avoid risk accumulation on both a macro and micro economic basis drove the development of the market.

3.4 In 1906 the San Francisco Earthquake occurred, leading Cuthbert Heath, the founder of non-marine reinsurance in London, excess of loss reinsurance and the London company market, to telegraph the Lloyd's Agent in California: "Pay all our policy holders in full, irrespective of the terms of their policies." This iconic statement laid the basis of Lloyd's and the London market's involvement in US excess insurance and reinsurance. At various stages in the twentieth century, the US accounted for over

50% of the world's premium income. In higher catastrophe layers, considerably in excess of 50% of US liabilities were reinsured through London.

3.5 London, and in particular Lloyd's, had often written insurance business from the British Empire. As independence was won, countries regulated their own insurance, often requiring local insurers to bear the initial risk. London's role changed to one of reinsurer.

3.6 London was not alone. Many of the markets that had grown at the end of the nineteenth century grew and developed during the latter part of the twentieth century. The reinsurance capabilities of the US, Germany, Switzerland, Scandinavia, France, Italy and Japan grew and have continued to develop.

3.7 In some countries, reinsurance underwriting was seen as a means of obtaining hard currency quickly or as a means of expansion. Insurers in countries as diverse as those in the former Soviet Bloc, South America and Israel sought reinsurance business energetically in the late 1970s and early 1980s, often from underwriting agents, contact offices or brokers in London. Insurers from countries such as Finland sought to grow beyond their highly evolved local markets by underwriting non-accumulatory risk from London. In almost every instance, this "naïve capacity" found itself facing disastrous losses.

3.8 Even the sophisticated markets of London faced massive losses, primarily from their participation in the reinsurance of the US. Asbestos, pollution and health-hazard (APH) losses caused major upheavals and when coupled with major disasters such as Piper Alpha and Hurricane Andrew, caused the failure of many companies and the restructuring of Lloyd's.

3.9 Through all of these upheavals and disasters, the reinsurance market has continued to develop because it has been necessary. Regulatory and fiscal changes have shaped that development, as has the ability to attract capital.

3.10 Since the losses of the early 1990s, the interaction between the reinsurance and capital markets has been of great significance. Depending on the position of the cycle and the cost of reinsurance compared with capital costs, reinsurers have sought to participate in the capital markets. Capital markets have also provided capacity solutions to the reinsurance and insurance markets.

3.11 Today there are four principal regions which provide global reinsurance capacity. These areas are (1) London, (2) Bermuda, (3) Europe and (4) North America. In addition there are also markets in Japan and South East Asia and varying degrees of reinsurance activity in other areas such as Australia or Brazil where Lloyd's has recently been admitted as a reinsurer and has opened an office. While none of the markets is homogeneous, each market has notable characteristics, not simply in the nature of the entities that operate there but also in the manner in which participants write business. Finally, the fast growing economic power of the People's Republic of China ("PRC") means that it is a rapidly expanding market for insurers and reinsurers and will continue to be so for some years to come. Lloyd's was admitted as a reinsurer in the PRC in 2007 and has an office there. A number of companies have followed suit. We have discussed the Chinese market in detail in Chapter 51.

LONDON

3.12 London remains one of the principal centres of reinsurance capacity in the world and provides numerous products, both traditional and innovative. Although London's

capacity serves many of the businesses that are based in the City of London itself it also provides services to a large number of companies around the globe. All major classes of business are written by the London market. This chapter focuses principally on the companies market while Lloyd's is covered in Chapter 23.

The market

3.13 A notable feature of the London market, in contrast to other reinsurance centres, is the predominance of brokers. Traditionally around 90% of the business placed in London passes through brokers. As a result London market business involves more face-to-face negotiation and much less reliance on electronic trading than occurs in other markets. This situation is beginning to change somewhat as electronic trading becomes more established. It seems likely, however, that face-to-face broking of complex and major reinsurance risks will remain an established feature of the London market for some time to come.

3.14 Another notable feature of the London market is its willingness to write unusual risks.

3.15 The London market is, today, comprised of branch offices of major global reinsurers or their subsidiaries. Most of the entities participating in the market are internationally owned and are writing business from around the globe.

The International Underwriting Association of London

3.16 The International Underwriting Association of London (IUA) is the trade association for the London insurance and reinsurance market. It was formed from the merger of the Institute of London Underwriters (ILU) and the London International Insurance and Reinsurance Market Association (LIRMA) which took effect on 1 January 1999. The IUA now performs all of the functions which these two bodies used to share between them.

3.17 The ILU was the trade association of London market insurance companies and participated in marine and aviation insurance and reinsurance. It also maintained close working links with Lloyd's. The activities of the ILU went beyond those of a trade association, however, as it provided the facility of a single collective insurance policy for all its members subscribing to any particular risk. Each member retained its independence and was liable only for its own proportion of the policy, in much the same way as the members of a Lloyd's syndicate are liable only for their individual shares. The ILU also developed standard clauses for policy wordings and assisted underwriters by offering advice and information and providing a forum within which underwriters could meet. Perhaps the most important function of the ILU was that it operated a market settlement system, under which the net balances owed to one another by underwriting companies and participating brokers were calculated and paid centrally. Since 1 January 1994, the policy signing, central accounting and information technology operations of the ILU and LIRMA (see below) have been merged.

3.18 LIRMA came into being on 1 January 1991. It represented non-marine insurance companies operating in the London market. It was a trade association with functions and powers similar to those of the ILU. LIRMA was created through a merger of the Policy Signing and Accounting Centre (PSAC), which provided central policy signing and

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market settlement systems for non-marine insurance companies, with the Reinsurance Offices Association (ROA), whose members were reinsurance companies. The ROA developed policy wordings, disseminated information of interest to its members and provided advice where necessary.

3.19 From 1 March 1996, companies established in any of the states of the European Economic Area (EEA) were permitted to become members of LIRMA (and so of the IUA). The change in LIRMA's rules which occurred as a response to the Third Non-Life Insurance Directive means that EEA companies which are now IUA members are able to transact business in the London market from their home offices through computer networks and will not have to set up a subsidiary or branch office in London.

BERMUDA

3.20 Bermuda is an island located 774 miles from New York and 3,445 miles from London. Its total area is 53.3 km^2 with a population of around 66,000. Despite this small size it is one the most important reinsurance markets in the world, providing more capacity than any other region.

Captives

3.21 The growth in the captives market in Bermuda has been one of steady progress to a position of market leadership today. The number of captives has grown from the 1960s when there were approximately ten captives to today when Bermuda is believed to be the domicile of 3,000 captives, over half the global total. There have been two principal engines to this growth; first, the tax regime has been a powerful incentive for captives and reinsurers to become domiciled in Bermuda. Secondly, the quality of human resources that work in reinsurance is high. It is for this reason that Bermuda is more than simply a tax haven for captives; much of the management of captives is carried out from the island, with around forty active captive managers operating from Bermuda.

Reinsurance

3.22 In 1948 the American International Re-Insurance Company domiciled in Bermuda. Since that date the expansion of capacity has been one of stops and starts, with significant growth in the 1970s, 1980s, and 1990s and the twenty-first century. However, Bermuda has not always enjoyed its present stability. Following the changes to the American tax laws in the 1970s, various Bermudan companies were forced to diversify outside their captive client bases. In some instances this led to delegated underwriting in the London market which in turn had very poor results. This caused both the failure of various reinsurance companies and an increase in the run-off sector, with a number of companies remaining in run-off today.

3.23 The late 1980s led to a reinvigoration of the Bermuda market with a period of growth and the formation of several new companies. There was concern that although the capacity of these companies was considerable the capitalisation was such that they would be unable to withstand a major catastrophic loss. The events of 11 September 2001, however, proved otherwise: Bermuda's ability to withstand such losses led to a

further infusion of capital in recognition of the profits that could be made from operating from the island. This has led to a position where the island is believed to reinsure around 40% of all US risks.

3.24 In addition to establishing capital bases in Bermuda, many Bermudan companies have diversified their business by establishing subsidiaries or branches in other world centres including London and, in particular, at Lloyd's. Conversely, a number of Lloyd's and London entities have redomiciled their group headquarters to Bermuda for fiscal and regulatory reasons.

EUROPE

France

3.25 The French reinsurance market developed, to a large extent, from a base of nationalised companies which were subsequently privatised. For many years, this ensured that the French market was dominantly French-owned. In recent times, however, this has ceased to be the case. Much capacity now comes from foreign entities, with former major French companies ceasing to be French-owned. There has been a significant foreign infusion of capital. Notwithstanding these changes France remains a market of significant importance, offering risk not just on an national basis, but also providing capacity to other jurisdictions such as America.

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Ireland

3.26 Ireland has become an attractive location for reinsurers, with over a hundred reinsurance companies being authorised to carry on business there. The size of the market is said to rival London but the nature of the market is quite different from London. Ireland offers a broader spread of businesses, ranging from life and captive management to non-life reinsurance. Due to this the Irish reinsurance market is also home to a large number of captive insurance companies and SPVs.

3.27 This growth in the reinsurance sector reflects some of the benefits of an Irish domicile, with the relatively low tax regime being a significant influence. Ireland has also secured double tax treaties with many countries including all the major OECD countries. This allows companies to trade without substantial risk to any taxation plans. In addition Ireland has a highly educated and skilled base of re/insurers and brokers for reinsurance companies to tap into.

3.28 Until the Insurance Act 1989 ("1989 Act"), reinsurance business in Ireland was unregulated; Irish reinsurers did not need to submit accounts or maintain a solvency margin. Under the 1989 Act, however, requirements were laid down (and later extended by the Insurance Act 2000) for reinsurers wishing to carry on business in Ireland. The EU Reinsurance Directive established a new regulatory framework for the authorisation and regulation of reinsurers. Ireland was the first country to implement the Directive and many large reinsurers took up the opportunity that this presented. The Irish Financial Services Regulatory Authority has developed a reputation for being accessible and pro-business.

Germany

3.29 The German insurance market is one of the oldest and largest in Europe. Much of the market is life-based but non-life plays a important role, with motor being a significant

sector. Due to the size and longevity of many German entities business relations are long-term. In recent time there has emerged what may be a trend towards shorter-term relationships based upon a more global approach to reinsurance.

Switzerland

3.30 Switzerland is a well-established insurance centre, predominantly consisting of three large entities which have consistently maintained more than a 75% share of the market. However, there are a considerable number of smaller reinsurers that operate out of Switzerland; in August 2006, 69 reinsurers operated from Switzerland.

3.31 The Swiss reinsurance market is highly international; in 2005, 95% of reinsurance premiums came from foreign business. In 2007, 25% of the Swiss insurance market's total global premium came from reinsurance.

3.32 A major attraction of Switzerland for reinsurance companies is its taxation regime. Although tax rates differ between cantons, they are considerably lower than major European competitors such as the UK and Germany. The regulatory regime also appeals to international reinsurers and Switzerland has been described by one rating agency as leading the way in terms of regulation of insurance and reinsurance. Historically, regulation had been much lighter on the non-life side. However, this changed in 2006 with the Insurance Supervision Law and, in particular, Supervision Ordinance requiring reinsurers to fulfil new solvency requirements.

NORTH AMERICA

3.33 The predominance of the United States in the world economy has led to a substantial demand for insurance and reinsurance there. The convulsions of the credit crunch have had a significant effect on the US market, with AIG, once riding high on the Dow Jones, now only being maintained because of the support of the US Government. Many AIG entities are in the process of being sold and it is expected that this will lead to greater diversification of the US market.

3.34 Notwithstanding the strength of the US reinsurance market it does not by any means retain all US risks. Insurers are still placing business with foreign reinsurers to meet their capacity requirements, with Bermuda and London offering significant assistance in this regard. One example of this is that a significant proportion of the US property market is protected in London.

3.35 Reinsurance dispute resolution in the United States is discussed in detail in Chapter 50.

CHAPTER 4

TYPES OF REINSURANCE CONTRACTS

INTRODUCTION

4.1 This chapter is intended to provide an outline of the more conventional contract forms likely to be encountered in the London market, and to provide an insight into some of the technical and legal problems commonly associated with them. The variety of types of reinsurance is such that it is not possible to cover all the likely permutations in this chapter, nor is it practical to explore the intricacies of all the reinsurance arrangements which are used in the London and international insurance markets.

4.2 In deciding what reinsurance to purchase, an underwriter will have to consider how much and what type of risk contained in his inwards portfolio of business requires reinsuring. This decision is based on numerous different factors, not all of which relate to the risks accepted inwards. A Lloyd's underwriter once described his having purchased reinsurance "as wide and as deep" as he considered was necessary, at a price he believed was sensible. Although in theory it is possible to eliminate the risk of an underwriting loss to the net account, it would be difficult to do so without effectively ceding all of the reinsured's premium outwards or exposing the reinsurers (other than in a fronting situation) to an unacceptable degree of "moral hazard": a reinsurer will always be concerned to know that its reinsured is retaining enough of the risk to cause the reinsured to exercise care in his original underwriting. In *Société Anonyme d'Intermediaries Luxembourgeois & Another* v. *Farex Gie & Others*[1] ("*SAIL* v. *Farex*"), Gatehouse J in the Commercial Court concluded that the absence of a significant retention was a material matter, albeit one about which the reinsurer should make enquiry, or risk being taken to have waived disclosure by the reinsured. (This issue was not pursued in the Court of Appeal.) A reinsured's approach towards its outwards reinsurance requirements is therefore as much a question of individual underwriting judgement as the decision-making which precedes acceptance of the inwards business.

1. [1995] LRLR 116 (QB Com Ct and CA).

4.3 In *Kingscroft Insurance Co. Ltd and Others* v. *Nissan Fire & Marine Insurance Co. Ltd (No. 2)*,[1] Moore-Bick J held that the purchase of excess of loss reinsurance to protect a reinsured's retention enabled the reinsured to manage its underwriting account in a prudent manner, without undermining the reinsured's incentive for responsible underwriting.

1. [1999] Lloyd's Rep IR 603 (QB Com Ct).

4.4 The availability of reinsurance and its cost has been known to determine the type of business an underwriter is prepared to accept, and it will certainly affect the size of his

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gross line. The profitability of large risks or portfolios which are substantially reinsured may ultimately depend on the strength and performance of the security with which they are reinsured.

4.5 At one level, the decision to buy reinsurance will often be determined by such considerations as the capital base of a syndicate or company, by which the ability to retain risk for its net account is measured. Likewise, the cost of reinsurance must be balanced against its value to the reinsured, which must decide whether to protect itself against accumulations of multiple unrelated "attritional" losses, or "vertical" aggregations of similar losses arising out of the same reinsurance event or catastrophe, or both.

4.6 At another level, the underwriter's decision to purchase facultative reinsurance on an individual risk may depend largely on whether the line to be written on that risk is excluded from or limited (because of its size) in its protection under the outwards whole account or catastrophe programmes, or whether the underwriter wishes to avoid ceding that type or amount of risk to his treaty reinsurers. The broker may also offer him reinsurance at a competitive price to reduce his net exposure on a large risk while allowing him to maintain a controlling participation.

4.7 The types of cession used by syndicates and companies are therefore varied and often complex, as they are designed to reflect the different underwriting requirements relating to individual risks and portfolios. Nevertheless, the mechanisms for ceding risks fall into relatively few broad categories which are discussed below.

FACULTATIVE REINSURANCE

4.8 Facultative reinsurance is generally arranged in relation to a single risk. The individual risks to be ceded are declined or underwritten by the reinsurer in much the same way as if offered on a direct basis. The level of underwriting information is very often the same as that provided on the direct placement and a reinsurer in this area of the market will possess the specialist direct underwriting skills required, and may have at its disposal sufficient capacity to accept most, if not all, of the risk. Although the traditionally high administrative costs incurred by the reinsured in providing full details of each risk at inception and renewal may discourage facultative cessions, the opportunity for earning additional ceding commission has to some extent outweighed this, as may have the broker's enthusiasm for earning additional reinsurance brokerage when offering the original or reinsured risk. On the other hand, the added cost of maintaining facultative underwriting facilities may be justified for a reinsurer wishing to specialise in niche markets, such as London, into which the unusual and complex risks generally find their way.

4.9 In *SAIL* v. *Farex*,[1] it was suggested on behalf of the reinsured that there was a difference between the underwriting considerations applicable to a facultative reinsurance placement on the one hand, and to a declaration made under a lineslip on the other. The reinsured's argument was that a reinsurer who has accepted a lineslip has already indicated its willingness in principle to reinsure the cedant and would not expect (nor should be expected) to consider each risk with the same degree of attention as would be the case if it was offered to the reinsurer on a facultative basis. Gatehouse J disagreed. He saw no reason why Farex should have taken a less rigorous attitude towards

individual declarations made under a lineslip than it would towards a facultative reinsurance placement. The judge commented that the underwriter "had to exercise his expert judgment on every risk offered to him".

1. [1995] LRLR 116 (QB Com Ct and CA).

Ensuring reinsurance on the same terms as original

4.10 The primary objective of the underwriter is likely to be to lay off risk in a cost-effective manner and, if possible, on a "following form" basis. The intention is to ensure that reinsurance protection exists on the same terms (except as to premium, commissions, etc.) as the direct placement. Although this may appear to be a relatively simple task on an individual placement, the diversity of original policy forms requires close attention to detail on both the broker's and underwriter's part. This in itself presents a practical problem in that the reinsurance must not only track the original terms, but ideally should also be placed at the same time as the original risk. This effectively requires the underwriter to monitor the outwards placement simultaneously to ensure that his gross line is properly reinsured from the outset. This includes checking with the broker that the facultative placement has been completed, and on the same wording, and has been placed with acceptable security. In order to do this the underwriter should qualify his acceptance of the inwards risk as "subject to satisfactory reinsurance", or he faces the prospect of being inadequately reinsured without recourse against the broker and with no right to withdraw from the original.

4.11 The "*Superhulls*" case (*Youell & Others* v. *Bland Welch & Co. Ltd*[1]) clearly illustrated the need for an underwriter and his reinsurance broker to ensure that the facultative placement is on the same terms as the original. Although the placement in this case was not a single risk "facultative" cover in the strict sense, the protection purchased was an obligatory open cover on an excess of loss basis to which a relatively limited number of individual vessels would be declared on original terms as they were built. On the original, placement insurance for a primary period was to be declared, with the insured having the option to extend it at an additional premium, whereas the broker responsible for placing the outwards reinsurance facility on behalf of the original underwriters in fact arranged cover which (the court held) was limited to a 48-month period. In the events which followed, losses were paid under the primary insurance long after the reinsurance period had expired, and it was held that the reinsurance would not respond, thereby giving rise to a claim against the brokers for breach of their contractual duty in placing the reinsurance.

1. [1992] 2 Lloyd's Rep 127.

Timing of placements and claims processing

4.12 In an ideal world the broker would issue reinsurance cover and debit notes to the reinsured at the same time as processing documentation to the original insured. Frequently, however, this has not been done, particularly where different placing brokers are employed on the original risk and its facultative counterpart. Although one broker may act as agent for both the insured and reinsured on the same underlying risk, the placements, and therefore the broker's obligations to both parties, are quite separate.

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Likewise, when a claim occurs, the cedant can reasonably expect the reinsurance recovery to be processed at about the same time as the original claim, as delays in payment would expose the cedant's cash flow to a larger loss, being exactly the situation which the reinsurance was intended to prevent.

Premium and claims accounting systems

4.13 The administrative burden for a reinsured is not limited to monitoring the terms and placing of a facultative cover, but extends beyond this to the need for specific systems to handle the premium and claims accounting of each cession. These will, for example, ensure that declarations under less specific reinsurance (such as proportional whole account or catastrophe excess of loss programmes) have already taken the facultative placement into account. Since the facultative risk may have been ceded on a proportional or non-proportional basis, the reinsured and its reinsurers will be concerned to ensure proper accounting of any benefit which may inure (or not, as the case may be) for the benefit of reinsurers of less specific covers.

4.14 The contractual provisions which determine how such benefit is to be handled will generally appear in the less specific reinsurances within an outwards programme. In the absence of specific provisions, the parties' intentions may be gathered from the surrounding circumstances—in particular, the way in which the various reinsurance programmes fit together. For example, in order to determine whether a whole account quota share reinsurer is to receive the benefit of any underlying facultative cover, or of other more specific reinsurance purchased for common account, it may be necessary to consider whether that reinsurer has contributed part of the underlying reinsurance cost by way of a deduction in the subject premiums credited to that whole account reinsurer.

Double recovery

4.15 Under whole account and catastrophe excess of loss presentations, a failure to ensure that facultative recoveries do not form part of the ultimate net loss can result in a double recovery or "windfall" profit for the cedant. In the event that such a practice (and it need not be particularly widespread) is identified by a reinsurer during the course of an inspection of records, it exposes the reinsured to allegations that a material mis-cession, or non-disclosure or misrepresentation has occurred.

TREATY REINSURANCE

4.16 Broadly stated, a treaty is an agreement whereby the reinsurer agrees to accept part or all of the reinsured's business falling within the treaty terms and limits. The reinsured may be obliged to cede all business within the same terms and limits. In these circumstances the treaty is "obligatory" for both parties; but, as with any definition, variations do occur, such as the facultative obligatory treaty, which allows the cedant a discretion as to which risks to cede to that treaty, while the reinsurer is bound to accept all risks which the reinsured has decided to cede.

4.17 The use of reinsurance to manage underwriting capacity and reduce premiums (and therefore liabilities) accepted inwards has resulted in a variety of treaty mechanisms

being developed. In 1992, Lloyd's changed its regulations to allow syndicates to reinsure on a quota share basis a part of their whole account with other syndicates or companies, provided that in calculating the ceding syndicate's maximum premium allocation any such reinsurance does not exceed a predetermined percentage (increased in 1993 to 25%, or 50% for motor business) of gross written premium income (Lloyd's Byelaw No. 11 of 1992). This relaxation of the rules was designed to allow individual syndicates to maintain or increase their capacity by using reinsurance, which if placed with insurance companies could have the effect of increasing the capacity of the Lloyd's market as a whole. It also enabled individual syndicates to maximise the use of their capacity by taking on portfolios of risks not normally underwritten on a direct basis, and it redirected internally any premium surplus towards spare underwriting capacity within Lloyd's from 1992 onwards, at a time when it was unclear whether the capacity of certain syndicates would be sufficient to absorb the substantial premium increases anticipated in the current market. It is also a convenient route for "corporate capital" to find its way indirectly into the Lloyd's marketplace.

Facultative obligatory treaty

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4.18 As discussed above,[1] this form of treaty allows the reinsured an option whether or not to utilise the treaty. It is commonly found where the reinsurer already subscribes to the cedant's reinsurance programme but is willing to provide the cedant with additional capacity on selected risks. This is generally achieved by the treaty being written as a first or an additional surplus line contract, which gives automatic reinsurance facilities to the cedant when the capacity of any quota share or surplus contract taking priority has been exhausted. Although this form of treaty can be structured on an excess of loss basis, the discretionary nature of the contract lends itself more to a proportional sharing of risk between the parties.

1. See para 4.16.

4.19 The mechanism whereby original risks are ceded to a facultative obligatory treaty was considered by Potter J in *Colin Baker (Syndicate 947)* v. *Black Sea and Baltic General Insurance Co. Ltd.*[1] The judge held that an unequivocal act of cession takes place at the moment when the reinsured underwriter, by writing a line to which he attaches an appropriate reference, indicates his intention to cede a percentage of that line to the reinsurer. The cession becomes effective at the moment of contractual completion of the slip and neither any further formal act on the part of the cedant, nor (at any rate, in the context of the Lloyd's market) any specific notice of the cession, is required to perfect the cession and make it valid and binding. Potter J's decision on this issue was not challenged in subsequent appeals to the Court of Appeal and House of Lords.[2]

1. [1995] LRLR 261 (QB Com Ct).
2. [1996] LRLR 353 (CA); [1998] Lloyd's Rep IR 327 (HL).

4.20 An essential element of this relationship is trust, as the reinsured obtains automatic attachment on any risk it chooses to cede. Such treaties are (as already mentioned) more commonly written on a proportional basis, as it is the intention that reinsurers follow and share as far as possible in the fortunes of the reinsured on its selected risks. Since the reinsurers have no discretion whether or not to accept the risk within the treaty

terms, it is incumbent on the cedant to avoid selection against a reinsurer's interests, and to act in good faith when exercising any discretion conferred under the treaty.

4.21 In *Phoenix General Insurance Co. of Greece SA* v. *Halvanon Insurance Co. Ltd*[1] it was accepted by Counsel for both parties and by the judge that the reinsured under a facultative obligatory agreement was under an implied duty to exercise appropriate care and skill in the conduct of the business. This general obligation encompassed specific duties, *inter alia*, to keep full records of risks accepted and claims made; to investigate the risks offered prior to acceptance as well as any claims subsequently arising on those risks; to keep accurate accounts; to make collections and payments promptly and to retain all records and make them reasonably available to reinsurers for inspection. Although *Phoenix* v. *Halvanon* probably remains good law so far as facultative obligatory (or other proportional) contracts are concerned, it should be noted that the Court of Appeal has held that a reinsured owes no such implied duty of care to a reinsurer in excess of loss business: see *Bonner* v. *Cox Dedicated Corporate Member Ltd.*[2]

1. [1985] 2 Lloyd's Rep 599 (QB Com Ct).
2. [2006] Lloyd's Rep IR 385 (CA).

4.22 If a reinsurer chooses to participate in a facultative obligatory treaty in isolation, without the level of information and supervisory control provided by an underlying or associated obligatory treaty applicable to the cedant's entire portfolio of risks, the reinsurer may be at risk of "anti-selection" (i.e. the reinsured ceding only those risks to the treaty which it considers to be sub-standard), unless, for example, the cedant also retains a major share of the original risk for its own net account. In the hands of an unscrupulous cedant, this type of treaty is prone to bad underwriting results. If a dispute arises on such a treaty underwritten in isolation, the particular wording of a given inspection clause may, for example, be argued as limiting the reinsurer's access to records of the ceded risks in the cedant's inwards portfolio, whereupon the reinsurer may be unable to determine whether or not selection has occurred. The burden of proof of establishing that a breach has occurred will initially rest on the reinsurer, and in such circumstances the prospects for successfully establishing adverse selection, and thereby the right to avoid liability, may be severely limited.

4.23 The potentially disadvantageous aspects of a facultative obligatory contract were recognised in *Aneco Reinsurance Underwriting Ltd* v. *Johnson & Higgins Ltd*.[1] Cresswell J examined the nature of such a contract and held that, while it might fairly be described as a form of proportional reinsurance, it exhibited significant differences from a strictly proportional quota share treaty. Accordingly, a statement made by the defendant brokers on placement of an excess of loss reinsurance contract that the underlying business protected was a quota share treaty (when in fact it was a facultative obligatory contract) was a material misrepresentation. In an arbitration between the excess of loss reinsurers and the reinsured (Aneco), the reinsurers had been held to be entitled to avoid the reinsurances. Cresswell J found that the brokers had been responsible for the misrepresentation and were liable in damages to Aneco. His judgment was amended on appeal[2] but only in relation to the quantum of damages payable. The Court of Appeal's decision was subsequently upheld by the House of Lords.[3]

1. [1998] 1 Lloyd's Rep 565 (QB Com Ct).
2. [2000] Lloyd's Rep IR 12 (CA).
3. [2002] Lloyd's Rep IR 91.

4.24 Provided that a reinsured manages such a facility responsibly, the arrangement can have definite advantages for that reinsured in the form of a profit commission and ceding commissions higher than those normally available on individual facultative placements. The advantages to the reinsurer include the ability to identify its participations in, and therefore control, profitable risks selectively, while avoiding the production commissions paid to the reinsurance intermediaries, as well as reducing the reinsurer's own underwriting expenses.

Quota share treaty

4.25 A common form of proportional treaty used for both marine and non-marine business is the quota share contract, under which an agreed proportion of all original risks within the portfolio or class of business covered is ceded on "identical" terms and conditions to reinsurers. The principle behind the quota share interest is that a reinsurer participates in the reinsured's original business on almost the same terms as the reinsured, i.e. with the exception of profit commissions and reinsurance overriders deducted by the reinsured before cession.

4.26 In *Allianz Via Assurance & Others* v. *Marchant & Others*[1] a reinsurance underwriter was approached by brokers to accept reinsurance of jewellers' block business written under a binding authority operated by the brokers on the basis that some of the risks to be bound would be "fronted" by Lloyd's syndicates. The underwriter was not told that the syndicates in question, which had provided the security on similar facilities for the coverholder in the past, were refusing to continue to do so without reinsurance in place, and had decided to increase the premium rates substantially. The underwriter was subsequently told by the brokers that the syndicates would cede 80% of the business "on quota share reinsurance". Thereafter, declarations were accepted by the underwriter in the belief that the words "quota share" indicated that the syndicates and reinsurers would share premiums and risks in the same agreed proportions. In fact, however, the syndicates received premiums based on the new, higher rates which they had required, while the reinsurers received premiums based on the old rates. The reinsurers eventually discovered that the syndicates were receiving additional premium, with the effect that the risk borne by the reinsurers was vastly higher than the risk borne by the syndicates in proportion to their relative shares of the premium. The reinsurers thereupon sought to avoid the reinsurances, arguing (*inter alia*) that the brokers had materially misrepresented the nature of the reinsurance arrangements.

1. Commercial Court, 12 December 1996, unreported.

4.27 The judge held that the words "quota share" would be understood by an underwriter as indicating that a fixed proportion of all risks which fell within the scope of the reinsurance contract would be ceded by the reinsured to the reinsurer in return for the same proportion of the premium as paid by the original insured (adjusted as agreed to allow for brokerage or other commissions). When the brokers used the words "quota share", they had made a representation of material fact, i.e. that the rates indicated to the reinsurers were acceptable to the Lloyd's syndicates, who intended to insure at those rates any risks accepted by the reinsurers for their 80% share. This statement was untrue, and it had induced the reinsurance underwriter to accept the declarations, which the reinsurers were consequently entitled to avoid.

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4.28 As illustrated by this case, a quota share treaty is often obligatory in nature and the reinsured is bound to cede a fixed percentage of each risk within an agreed section of its business. Cessions are therefore automatic, and the treaty will generally contain (or so deem) a maximum limit for any one risk or cession, which acts as a safeguard to the reinsurer and prevents cession of unacceptably large amounts of risks. One disadvantage of quota share treaties is that the percentage of each cession is fixed in advance and allows the underwriter no flexibility to increase or reduce the amount of risk ceded. For this reason a surplus treaty[1] may be used as a substitute for, or in addition to, a quota share treaty, and may take the form of a facultative obligatory treaty.

1. Discussed at paras 4.39–4.44.

4.29 The advantages of the quota share contract lie in the administrative ease with which cessions can be processed; it is commonly perceived as an easy way of providing underwriting capacity for a large book of small premium business. Many of the reciprocal arrangements reached between European companies are effectively an exchange of quota share participations in each other's national business; these offer a simple *pro rata* share of the original premium, and reinsurers enjoy (or suffer) the same spread of risk and claims experience as the reinsured.

4.30 Since an obligatory cession and its acceptance are automatic, the amount of the original risk retained by the reinsured for its own account will be material to the reinsurer's decision whether, and on what terms, to underwrite the treaty. Where the contract wording stipulates a warranted net retention, a reinsured subsequently recovering all or part of that retention under other reinsurance arrangements risks avoidance of the contract by reinsurers for breach of warranty. Whether or not a warranted net retention exists will generally depend on the wording of the reinsurance contract, and in the absence of clear terms to the effect that the amount of risk to be retained is a "warranty" upon the contract, the existence of a warranty will be difficult to establish. In *Great Atlantic Insurance Co.* v. *Home Insurance Co. & Others*[1] the court found that a contractual provision as to the percentage net retention to be retained by the reinsured was not a warranty in favour of the reinsurer, because on the facts Great Atlantic (GAICO) had voluntarily retained 10% under the fronting arrangement in which its reinsurer had been willing to accept 100% of any inwards risk. It may be, however, that clear contractual wording and evidence of intention is not available to indicate whether a warranty can be said to exist; in these circumstances the materiality of a reinsured's decision to reinsure all or part of its retained amount could then depend on an expert's view of the relevant market custom and usage.

1. [1981] 2 Lloyd's Rep 219.

4.31 In the GAICO case it was alleged that GAICO had breached a warranted net retention by purchasing additional excess of loss reinsurance which might reduce GAICO's net retention below the relevant 10% to be retained in respect of each and every risk. The court found on the facts that the use of the word "net" retention was insufficient evidence of an undertaking on GAICO's part not to purchase excess of loss protection in respect of its ultimate retained loss. It is, for example, common practice in the London market to purchase whole account or catastrophe excess of loss protection to cover losses from multiple original risks arising from one reinsurance event or catastrophe, which is less specific than underlying "per risk" or individual cession reinsurances. In the GAICO case, Lloyd J took the view that even if the existence of excess of loss

cover constituted a breach at all, the breach was not of sufficient gravity to justify the reinsurer terminating the contract at a late stage.

4.32 It therefore appears that whereas it might be acceptable, for example, to purchase whole account excess of loss reinsurance to protect such aggregations of risk over multiple original insureds, the same may not be true if the reinsured's retention on a "per risk" or "per cession" basis is further protected by another proportional cover arranged on a similar per risk basis. In such circumstances the reinsurance of a reinsured's retention may be shown by expert evidence to be a material fact requiring disclosure; failure to do so would then entitle the reinsurer to avoid the contract from inception.

4.33 In *Kingscroft Insurance Co. Ltd and Others* v. *Nissan Fire & Marine Insurance Co. Ltd (No. 2)*[1] however, Moore-Bick J held that a provision in the quota share treaties in dispute that the reinsured would retain 50% "for [its] own account" did not mean that the reinsured could not purchase excess of loss protection in respect of its 50% retention. The undisputed expert evidence before the court was to the effect that as a matter of market practice, a prudent underwriter would purchase excess of loss reinsurance to protect his retention. On the other hand, the judge concluded that a reinsurer would regard the purchase of further quota share reinsurance as eroding the reinsured's incentive to underwrite responsibly and that non-disclosure of such reinsurance would be material.

1. [1999] Lloyd's Rep IR 603 (QB Com Ct).

4.34 Where the profit commission and overrider allowed to a cedant are substantial, and the cedant's retention is comparatively small, the financial equation may result in the cedant being less liable to sustain an overall loss than its reinsurers. This may tempt cedants to underwrite high premium volumes to generate commission, particularly through managing general agents, and in recent years this has become a common complaint, particularly from reinsurers. Where the brokerage and commissions allowed to the cedant on the original business are substantial, the reinsurer will have been aware of this possibility at the outset. On a large book of business, however, where the cedant may also have control over the production costs charged against the inwards business, a reinsurer could have difficulty in determining whether such acquisition costs have been correctly deducted, unless it commissions a detailed (and probably expensive) analysis of the reinsured's premium records.

4.35 The distinction between obligatory and non-obligatory treaties is, therefore, an important one which can often result in disputes between the parties. Generally the obligation of the reinsured is to cede all business classified (usually by the reinsured itself) as the covered class, but this does not necessarily entitle the reinsured to classify, for example, marine risks as non-marine. As to what is a correct classification for a given risk, this will, in the absence of a specific designation in the original policy wording, depend largely on market practice. Since there will always be grey areas between certain commonly recognised classes of business, the test of whether the reinsured has followed market practice will often depend on whether a substantial deviation has occurred. If, for example, the contract provides that the reinsured will cede a percentage of its casualty business to the quota share, but the reinsured omits to cede its professional indemnity and directors' and officers' liability business, the reinsured would be open to allegations of breach of contract and non-disclosure of a material fact.

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4.36 Likewise, if the treaty excludes professional indemnity business, and certain reinsurances assumed by the reinsured include treaties which contain (but are not classified as) professional liability exposures, it is questionable whether such liability would be covered under a treaty which did not expressly cover "incidental" risks, regardless of whether they were an incidental or substantial part of the original. With hindsight it is often clear that more precise contractual terms were necessary—and should have been used—to control the original business ceded.

4.37 If reinsurance assumed is not for net account, the reinsurer will itself need to ensure that adequate outwards reinsurance is in place. This in turn may generate problems for the reinsurer in later years, particularly as after risks have been class-coded (commonly done by way of the "underwriting reference" assigned to each risk) by the cedant for accounting to an assumed treaty, there may have been little or no analysis of their individual risk content by the reinsurer, until loss ratios on such portfolios reach an unacceptable level and the reinsurer's own outwards reinsurers are called upon to pay.

4.38 In order to determine whether an account has been properly ceded, the reinsurer undertaking an inspection will again need to analyse the whole inwards account, including the use of underwriting references and their effect on the allocation or omission of individual risks for presentation to the treaty. In practice this can present inspecting reinsurers with a heavy burden, as in any large underwriting operation the volume of risks is likely to be large and (in later years) substantially computerised. Unless the reinsurer has access to the computer data of the cedant, or is prepared to re-input large tranches of information into a parallel system, the chances of performing a thorough inspection of ceded premiums and claims may be greatly reduced.

Surplus treaty

4.39 Another form of proportional treaty is the surplus contract, whereby the reinsured is bound to cede, and the reinsurer is bound to accept, a surplus liability over the reinsured's retention. Similar restrictions may apply (concerning the reinsured's ability to reinsure that retention) to those discussed above in respect of quota share treaties. The surplus treaty is, however, more flexible for the reinsured, in that the reinsured is permitted to cede to the treaty any part of the risk not retained for its own account. The contract will be again subject to an overall limit, generally a multiple of the reinsured's retention, which is called the "line". If a surplus treaty is said to have "10 lines" the reinsured may allocate to its treaty up to 10 times its retention on a given risk.

4.40 Unlike the quota share contract, the surplus treaty does not generally stipulate the percentage of the original risk to be ceded. This percentage must, however, be fixed at the time of underwriting, and as the underwriter will use a variety of permutations when ceding the different risks in a book of business, the administrative requirement for ensuring that each risk is properly categorised, both as to the reinsured's own retention and the percentage to be ceded to the treaty, can be onerous.

4.41 The most common surplus treaty is known as a first surplus, meaning that the reinsured's surplus line must be allocated to that treaty first, in preference to any other surplus treaty. Whether the first surplus treaty is operated with a priority over other reinsurances will depend on the function which that treaty performs within the overall programme. This is a potential area for dispute between reinsured and reinsurer, particularly as on profitable business it is in a reinsurer's interest to ensure that its participation receives priority.

4.42 A second surplus treaty will receive a share of the reinsured surplus risk only after the first surplus has received its maximum amount. In these circumstances a cession would only be made to the second surplus where the original risk was too great to be accepted within the reinsured's retention and first surplus treaty. In more complex reinsurance programmes the allocation of lines between the retention, the first surplus and any subsequent surplus layers is the key to ensuring that all premium and claims cessions are correctly processed. Since the surplus contract is essentially a proportional mechanism, these percentages must remain fixed for a given original risk throughout the premium and claims development of that risk. It would not be correct, for example, to cede a claim to a first surplus treaty from an original risk for which the premium had been ceded to both the first and second surplus treaties, as to do so would almost certainly be in breach of the contract terms and could, in effect, retroactively superimpose a "layer" or non-proportional allocation of loss on this part of the reinsurance programme.

4.43 The importance of "layering" to the premium/risk equation was one of the issues examined in *SAIL* v. *Farex*.[1] Although in this case Gatehouse J did not find that the layering of risks by the reinsured required disclosure, his decision appears to have been based on the consideration that the reinsurer had been able to decide whether or not to accept each risk and at what premium. In other circumstances, where it might be possible for a reinsured to split an original risk into layers, select an allocation of premium between the different layers, and then cede those layers to reinsurers in different proportions, it might be argued that the practice of layering was a material fact which required to be disclosed by the reinsured.

1. [1995] LRLR 116 (QB Com Ct and CA). See paras 4.2 and 4.9.

4.44 In general, however, surplus treaties offer the reinsured greater flexibility to underwrite and retain small and profitable insurances, although at a greater administrative cost than that associated with quota share contracts. In a reinsurance programme which utilises a combination of quota share and surplus cessions, the opportunities for mis-allocating risks will be frequent. This can have severe consequences for the reinsured who needs to prepare accurate loss statistics for renewal of the programme. If errors have not been identified and corrected, their presence in a long-tail account subjected to a reinsurer's inspection will require explanation. Because the accounting of proportional treaties is generally done on a quarterly bordereau or statement basis, with premiums balanced against claims, several years can elapse before the effects of any widespread mis-allocation manifest themselves. Since many proportional treaty statements are now computer-generated, the level of information on the underlying policies, and the various cessions of risk which may have been made in respect of each of those policies, will not easily be ascertained. These difficulties will be compounded for the reinsurer by the volume of premium income ceded to the treaty, and the reinsured's need for cash flow from its outwards programme. The potential for a dispute in such circumstances is very real, particularly where developments giving reinsurers cause for concern may not become apparent for many years, when loss ratios have already reached unacceptable levels.

Non-proportional reinsurances

4.45 Under a non-proportional treaty the reinsurer agrees to pay the reinsured a specified amount of all losses in a portfolio which exceed an agreed excess point, in exchange

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CHAPTER 24

ALTERNATIVE RISK TRANSFER

INTRODUCTION

24.1 In addition to traditional reinsurance, there are several other ways in which risks can be transferred or financed. This chapter is intended to provide an outline of some of the available products and mechanisms, together with an overview of the principal associated legal issues. In Chapter 37, we shall look at a different aspect of the transfer of reinsurance risk, namely the regulatory safeguards established in connection with the replacement by one reinsurer of another in circumstances where the new reinsurer assumes liability to one or more reinsureds for certain risks (or an entire portfolio of business) for which the other reinsurer was formerly responsible.

24.2 In the last decade there has been a significant increase in the use of a variety of alternative risk transfer ("ART") products. Swiss Re (Sigma Report No. 1/2003—"The Picture of ART") reported that global commercial lines direct premium volume written by traditional carriers was about US$370 billion in 2001. This can be compared with the premium volume of various types of ART carriers which was about US$88 billion.

24.3 ART products are varied and include those which contain genuine risk transfer and others which are essentially risk financing vehicles. Some products (such as finite reinsurance) are not new, but others are—for example multi-line, multi-trigger and multi-year protections, securitisation products, structured finance solutions for new asset classes which include reinsurance elements and "insured" derivatives (credit default swaps and weather derivatives).

24.4 At the same time as new products have been developed, there has also been an expansion in "alternative" insurers and reinsurers. There is a growing trend, particularly in hard markets, towards self-insurance, risk retention groups, captives and protected cell companies. A specific innovation in recent years has been the transfer of risk from reinsurance markets to the capital markets through insurance-linked securities (such as catastrophe bonds) and through contingent capital arrangements. A new development in 2007 was the setting up of IFEX (the Insurance Futures Exchange) as a trading platform for insurance-based derivatives, including event linked futures (ELFs).

24.5 There has been a growth in products which seek to use the capital and reinsurance markets in one seamless product. This has been seen in some structured finance solutions for new asset classes with the reinsurance market providing a credit enhancement reinsurance product. The purpose of these credit enhancement products is to ensure that the notes or other financial instruments issued will receive an appropriate rating to enable them to be sold in the financial markets. These products have highlighted the tension between the different legal regimes that apply to the insurance and capital markets respectively. The legal principles of utmost good faith and the duty of

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disclosure do not apply to capital and financial market products. This clash of legal cultures has generated litigation, particularly in relation to film finance where a large number of high value disputes have come before the English courts. Some of these are considered in Chapter 10 and also at paragraphs 24.100–24.124.

PRINCIPAL TYPES OF ALTERNATIVE RISK TRANSFER PRODUCTS AND MECHANISMS

Financial reinsurance

Characteristics of financial reinsurance

24.6 There is no universally accepted definition in the market of what constitutes "financial" or "finite" reinsurance. It is, perhaps, more helpful rather to identify the main distinguishing features between conventional reinsurance contracts and financial reinsurance contracts. These are:

(a) The anticipated investment income from the transaction, such as investment earnings on premium or reserves, is usually an acknowledged complement of the underwriting and pricing of financial reinsurances.

(b) The financial outcome, or range of possible results, for the reinsured and reinsurers is determinable and generally an explicit term of the contract at its outset, because with financial reinsurance the parties will generally expect the reinsured to make a recovery from the reinsurer.

(c) The reinsurer's profit is not primarily dependent upon the level of claims made under the contract (although some element of risk transfer is probably required, as discussed at paragraph 24.44).

24.7 The Financial Services Authority ("FSA") in its consultation paper CP144 entitled "A New Regulatory Approach to Insurance Firms' Use of Financial Engineering" (July 2002) identified the following characteristics of financial reinsurance contracts:

— an element of direct or indirect profit sharing;
— multi-year and multi-risk contracts;
— establishment of an experience account maintained by the reinsurer according to a specific formula throughout the life of the contract; and
— despite the fact that a main purpose of the arrangement is financing, often a limited amount of insurance risk is transferred to the reinsurer but enough for the arrangement to be considered reinsurance for accounting purposes.

24.8 The FSA has subsequently offered a definition of financial reinsurance in its Quarterly Consultation (CP05/14) of October 2005 by describing the features of a contract of reinsurance which should be reported as financial reinsurance. This requirement applies to any contract of reinsurance under which general insurance business has been ceded by the insurer, where:

(a) the value placed on future payments in respect of the contract in the return for the financial year in question is not commensurate with the economic value provided by that contract, after taking account of the level of risk transferred; or

(b) there are terms or foreseeable contingencies (other than the insured event) that have the potential to affect materially the value placed on the contract in the insurer's balance sheet at, or any time after, the end of the financial year in question.

24.9 In considering whether a contract of reinsurance meets one or both of these conditions, the insurer must:

(c) treat as part of the contract any agreements, correspondence (including side letters) or understandings that amend or modify, or purport to amend or modify, the contract or its operation; and

(d) consider whether the contract meets the condition in (a) above when considered together with one of more contracts of reinsurance written between the insurer and the reinsurer under the first contract or between the insurer and a person connected with that reinsurer.

24.10 A further definition of finite reinsurance has been provided by the EU Reinsurance Directive passed on 16 November 2005 (2005/68/EC). Finite reinsurance is defined as:

> "... reinsurance under which the explicit maximum loss potential, expressed as the maximum economic risk transferred, arising both from a significant underwriting risk and timing risk transfer, exceeds the premium over the lifetime of the contract by a limited but significant amount together with at least one of the following features: (a) explicit and material consideration of the time value of money, (b) contractual provisions to moderate the balance of economic experience between the parties over time to achieve the target risk transfer."

The Directive has now been implemented in the UK.[1]

1. Implementation has been effected in part under the Reinsurance Directive Regulations 2005, in part through the Financial Services and Markets Act 2000, ("FSMA") as amended by the Financial Services and Markets Act 2000 (Reinsurance Directive) Order 2007 (SI 2007 No. 3254) and the Financial Services and Markets Act 2000 (Reinsurance Directive) Regulations 2007 (SI 2007 No. 3255) and through rules made by the Financial Services Authority under powers available to them under FSMA.

Prospective and retrospective covers

24.11 A further important distinction must be drawn between retrospective covers, which relate to the business of years past, and prospective covers, which deal with the business of current and future underwriting years.

24.12 Retrospective contracts are contracts where the reinsured will seek recoveries from the reinsurer in relation to future loss developments on existing contracts which remain in force. For instance, in the case of long-tail business, a reinsured may have to build up substantial reserves to cover future anticipated losses and may, under the financial and tax regime of the country of its residence, not be able to discount these reserves to allow for the time value of money. A retrospective financial reinsurance arrangement, such as that commonly known as a "time and distance" policy, may enable the reinsured to obtain the effective benefit of discounting reserves.

24.13 A prospective reinsurance contract is one where the reinsured is seeking protection and reinsurance recoveries in relation to future losses on existing and future business. Such contracts can be used to stabilise profits by permitting a reinsured to build up off-balance sheet reserves to smooth profits in the event of catastrophic events such as windstorms or hurricanes.

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Development of financial reinsurance

24.14 Various types of financial reinsurance contracts have been widely used in the London market (including Lloyd's syndicates) for many years.

TIME AND DISTANCE POLICIES

24.15 A time and distance policy is in essence a limited aggregate excess of loss policy which reinsures all or part of an insurer's run-off of a year of account. The types of time and distance policies are varied. They range from policies which have a structured settlement pattern, where the policy contains fixed limits and specified payment dates, to unstructured policies which incorporate the risk of accelerated claims. It would be necessary to examine the precise form of a particular time and distance arrangement to establish whether the contract is in fact a contract of reinsurance rather than a banking product such as a long-term deposit.

"ROLLOVERS"

24.16 Financial reinsurance contracts have posed a number of problems for the Lloyd's market. For instance, at the end of the 1960s many syndicates arranged policies of reinsurance which were commonly called "rollovers". The principal characteristic of such policies was that when a claim was made or the policy was cancelled, the Lloyd's syndicate received back from the reinsurer the whole of the premiums paid, together with interest at an agreed rate, or an agreed split of the interest actually earned by the reinsurer on the premiums. The essence of the "rollover" was that the premiums were "rolled over" from year to year with interest, thereby creating a fund in which the interest was compounded with the premiums. The fund was available for return to the syndicate when required by it to meet a catastrophic loss or for other reasons.

24.17 Following concerns expressed by the Inland Revenue in the early 1980s about "rollovers" and their derivatives, they are no longer used by Lloyd's syndicates because they do not comply with Lloyd's regulations. The experience of Lloyd's with rollover policies illustrates the importance of giving close consideration to the drafting and structuring of financial contracts to ensure that they achieve their legal, regulatory, tax and accounting objectives.

SPREAD LOSS CONTRACTS

24.18 In the early 1990s there was a contraction of capacity in the London excess of loss market which generated an increased interest in specialised forms of financial reinsurance contracts, commonly known as spread loss contracts. These contracts are intended to operate for a number of years, on the basis that the total indemnity available does not exceed what ultimately must be paid by way of premium and interest less expenses and claims paid. The great benefit from the reinsured's perspective is that he can immediately buy high levels of coverage, which may not be available in the conventional reinsurance market, and any additional premium which may be payable is spread over subsequent years, depending on the claims experience. Such arrangements can be structured so that there is a transfer of risk from the reinsured to the reinsurers, but considerable care must be taken in dealing with this issue.

Run-off solutions

24.19 Financial reinsurance has been used to address long-tail run-off exposures. An example of the type of product used in these circumstances is a retrospective financial reinsurance contract such as an aggregate stop loss cover.[1] Essentially, this is a contract which provides for the payment up to a limit in excess of the existing loss reserves in the event of a deterioration in the future losses. It may provide for an expanding limit and payment of an additional premium in the event that the deterioration is worse than anticipated. In the event that losses do not deteriorate or do not deteriorate as much as anticipated, the contract may provide for the payment back to the reinsured of a profit share out of the investment income earned on the premium. These types of products often take into account the effect of "discounting" which allows an insurer to discount the expected settlement figure by a rate of interest reflecting the investment earnings on the funds pending settlement of the claims. This mechanism is also used in many cases in connection with loss portfolio transfer covers. Before entering into such a transaction, the reinsured will be carrying undiscounted reserves. As an incentive to the reinsured to enter into the loss portfolio transfer covers the contract premium will normally be calculated by reference to the discounted value of the reserves, but the contract limits will be set by reference to the amount of undiscounted reserves.

1. See paras 36.50–36.56, for more on such policies.

24.20 The use of financial reinsurance to address run-off exposures may well increase in the lead up to the implementation of Solvency II.

Multi-line, multi-year and multi-trigger

24.21 Multi-line, multi-year and multi-trigger reinsurances are developing in response to demand from reinsureds exposed to a wide range of dissimilar operational risks. For example, a multi-national industrial corporation may be exposed worldwide to risks ranging from traditionally insurable risks such as product liability, material damage loss and goods in transit risks, through to traditionally uninsurable risks such as losses arising from exchange rate fluctuations, or pure financial loss by reason of abnormal weather conditions (for example, an energy supplier suffering a loss by reason of reduced demand for its products during an unseasonably mild winter). A single insurance or reinsurance cover at the right price would be extremely attractive to this type of corporation. Typically, the overall solution will combine capital markets products and traditional insurance products across a number of years sufficient to make best use of the time value of the premium. Various premium-reducing features can be built in, including multiple loss trigger clauses (so that no payment is triggered unless two or three insured events happen in conjunction) or additional premium clauses.

New asset solutions

24.22 Structured finance products are often used in connection with asset-backed securitisations of future flows of income such as credit card receivables. Insurers and reinsurers have become involved in these financial market transactions through providing credit enhancement by means of insurance guarantees also colloquially known as "insurance wraps". Insurance guarantees are particularly useful when the securitisation involves a new asset class such as income from films. There have also been innovative

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(re)insurance products for aircraft manufacturers such as BAe and Saab providing cover for aircraft leasing revenues.

Insurance risk securitisation

24.23 Essentially, securitisation is a mechanism by which income-generating assets can be turned into capital (or, in the case of insurance and reinsurance, risk-assuming capacity). In other words, it is a particular type of receivables financing. Underlying assets which are capable of providing income over a period of time represent an income stream. Securitisation is the label given to the process by which the right to receive the income stream is packaged and converted into securities to be sold to investors in return for the immediate payment of a capital sum. The first step is to create a homogeneous group of income stream assets. The underlying assets should be alike both in terms of their inherent risk and in terms of the timing of that risk. Next, the value of the income stream over a fixed period of time needs to be assessed. Once this is done, investors can be offered the right to receive a share of this income stream. The process is often channelled through a company incorporated specifically for this purpose and known as a special purpose vehicle (SPV). In the simplest form of securitisation the SPV buys the right to receive the income stream from the original party for a capital sum. Another way of structuring securitisation is by means of what is called a "synthetic securitisation". This is a transaction that involves the transfer of risk on a portfolio of assets through a credit default swap. Traditional securitisations have been structured on the basis that there is a transfer of assets to the SPV. This can be achieved in synthetic form by transferring the risk by using credit derivatives.

24.24 Securitisation is a mechanism which can be used to transfer risk from the reinsurance market to the capital market. Insurance-linked securities were first developed in the early 1990s following Hurricane Andrew and the Northridge earthquake. There has since been a steady stream of catastrophe bonds issued, so that at the end of 2002 there were US$2.77 billion of rated catastrophe-linked securities outstanding in the financial markets.

24.25 One of the earliest successful reinsurance securitisations was the St Paul Re securitisation, completed at the end of 1996. Investors were invited to purchase either three-year equity or ten-year debt in a reinsurance SPV, George Town Re. The equity comprised preference shares redeemable after three years, whereupon dividends and the capital (dependent upon the underwriting performance of George Town Re) were repayable. The debt consisted of principal amount notes on which interest was payable. Half of the proceeds of the issues were invested at inception in US treasury bonds for a ten-year period. The investment was designed to produce sufficient funds to repay the principal amounts of the notes at their maturity. A key part of the deal was that St Paul Re entered into a ten-year proportional treaty with George Town Re, enabling St Paul Re to underwrite inwards business for outwards cession to the cover on a fully secured (or fully collateralised) basis. Essentially, St Paul Re's comparatively illiquid asset, namely the right to receive reinsurance recoveries, had been securitised and made liquid, thereby providing St Paul Re with extra underwriting capacity.

24.26 In April 2002, Lloyd's Syndicate 33 became the first Lloyd's syndicate to arrange a catastrophe bond. St Agatha Re, named after the patron saint who is reputed to provide protection against earthquakes, protects the syndicate against the risk of earthquakes in California and other areas of the USA.

24.27 More recently, the first UK flood securitisation was placed by Swiss Re on behalf of Allianz in April 2007. This securitisation covers UK flood risk and US non-Californian earthquake risk which were non-correlated. The key to the securitisation of new perils is the development of properly constructed parametrics through the use of sophisticated risk modelling.

Insured derivatives

24.28 It has been estimated by the British Bankers' Association that, from a base of $180 billion in 1997, the total global credit derivatives market grew to over US$20 trillion by the end of 2006. Insurance companies have a significant interest as risk buyers. The insurance market has also been involved in insuring (or reinsuring) weather derivatives.

24.29 The most common form of credit derivative is the credit default swap ("CDS"). A CDS is a contract which enables one party (the "protection buyer") to buy protection from another party (the "protection seller") against the risk of default of an asset issued by a "reference entity". The protection buyer pays a fee for the cover until a credit event occurs or until maturity (if no credit event occurs). Following a credit event, the protection buyer will receive compensation for the loss on the reference asset. The basis of the typical CDS is that the protection buyer has no insurable interest in the reference asset, which is merely used as a convenient trigger for payment under the CDS. Insurers have become involved in the insurance of credit derivatives by means of various types of transformer structures whose purpose is to transform the CDS into an insurance contract. After the collapse of Lehman Bros in September 2008 (a large player in this market) and some significant losses to the reinsurance market during 2007/2008 there is some question as to how much insurance/reinsurance companies may participate in this market in the future.

Contingent capital

24.30 This is usually not structured as an insurance product but can provide similar protection for catastrophe losses. Contingent capital is based upon a commitment by a financial institution to provide capital in the event of the occurrence of a specific adverse event which will cause financial stress for the counterparty.

ALTERNATIVE REINSURERS

Self-insurance, captives and protected cell companies

Self-insurance

24.31 Self-insurance can be something of a misnomer: often it involves no insurance product at all. Essentially, self-insurance is simply a party bearing the risk of a particular loss itself. A certain level of self-insurance is built into almost every reinsurance contract, since the reinsured will bear the risk of losses falling below the retention or above the policy limits.

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Captives

24.32 Captives are fundamentally a refinement of the concept of self-insurance. In the context of insurance a captive is an insurer which is owned by its parent (insured) company. As a result of local legislation in many jurisdictions, captives cannot issue local insurance policies. This difficulty is overcome by the use of a fronting company which issues a local policy and in turn is wholly reinsured by the captive. For example, captives established in Guernsey, which is not a member of the EU, cannot directly issue local policies in the EU but need an EU-authorised fronting company. Captives are, in turn, important purchasers of reinsurance from the international reinsurance markets.

24.33 Captives can be formed at Lloyd's but to date there has been little interest in using the Lloyd's structures for captives.

Protected cell companies

24.34 A protected cell company (PCC) is a modern derivative of the captive concept. A PCC is a single legal entity comprising a number of separate "cells" with each cell intended to have full legal segregation and protection of its assets and liabilities from the other cells in the PCC. In its own formation and capitalisation, a PCC can create two types of share: core shares and cell shares. Correspondingly, two types of asset are provided for: core assets, which are attributable to the PCC itself; and cellular assets, attributable only to the cells. The basic principle of this corporate structure is to try to ensure that the creditors of one cell of the PCC will have no recourse to the assets of any other cell, but can have recourse to the core assets if necessary. The insolvency implications of the cell structure under English law are discussed at paragraphs 24.133–24.138.

24.35 Many offshore jurisdictions which are hospitable to captives now have legislation to allow for PCCs, the first such jurisdiction being Guernsey which introduced legislation in 1997. PCCs have many practical applications. The owner of a PCC can offer insureds as many traditional rent-a-captive facilities as there are cells. Also, PCCs can be used to facilitate the segregation of funds: for example, a life assurer may wish to segregate the assets of its life, pension and individual policyholder funds. In the context of ART, PCCs can be used to separate (say) finite reinsurance business from securitisation business whilst ensuring that capital can be allocated flexibly between the two.

Sidecars

24.36 A "sidecar" is essentially a reinsurer set up to increase a specific reinsured's underwriting capacity by assuming risk from that reinsured, typically through a quota share reinsurance. Usually, the sidecar will only write one short-term reinsurance contract per year, with renewals at the discretion of the sidecar. As a general rule, the sidecar will fully collateralise its obligations to the reinsured through equity or debt financing. Sidecars were initially used, typically, for property catastrophe risks, but new sidecars created since 2006 have covered more diverse businesses such as marine, energy and aviation.

24.37 The benefit of a sidecar, assuming it is fully collateralised, is that the reinsured can take full credit for cessions of those lines of business which have the greatest negative impact upon its adequacy ratios, thereby removing those risks from its balance sheets.

24.38 Sidecars, in common with SPVs, are vehicles that require regulatory approval to underwrite reinsurance. Due to tax benefits and the speed with which such vehicles can be set up in Bermuda, most sidecars created to date have been established in that jurisdiction.

LEGAL AND REGULATORY CONSIDERATIONS ARISING OUT OF ALTERNATIVE RISK TRANSFER

Financial reinsurance: legal considerations

Is the financial contract a contract of reinsurance?

24.39 One of the principal questions which is often asked about financial reinsurance contracts is whether they can properly be categorised in law as contracts of insurance. The importance of this issue has been emphasised by the investigations of finite reinsurance products led by the then New York Attorney-General Eliot Spitzer in the US and by the continued interest of the FSA in finite reinsurance in the UK.

24.40 English law has taken the practical approach of never exhaustively defining what is a contract of insurance. This approach is, perhaps, best illustrated by the following remarks of Sir Robert Megarry V-C in *Medical Defence Union* v. *Department of Trade*,[1] when he stated: "I do not know whether a satisfactory definition of a 'contract of insurance' will ever be evolved. Plainly it is a matter of considerable difficulty. It may be that it is a concept which is better to describe than to attempt to define . . . ."

1. [1979] 1 Lloyd's Rep 499.

24.41 It is important to bear in mind, when considering the question of whether a particular financial reinsurance is in law a contract of reinsurance, that it is the substance of what has been agreed which matters and not the form into which it may have been put. Therefore, the fact that a contract is structured and described as a reinsurance contract is not of crucial importance in determining whether in law it is in fact a contract of reinsurance.

24.42 The nearest the courts have come to defining a "contract of insurance" is the classic judgment of Channell J in *Prudential Insurance Co.* v. *Inland Revenue Commissioners*,[1] in which he said that a contract of insurance normally had three characteristics:

(a) There was entitlement to a benefit on the happening of an event.
(b) There must be some uncertainty as to whether that event would occur or when it would occur.
(c) The event must be adverse to the interests of the assured; this characteristic is generally satisfied if there is an insurable interest.

1. [1904] 2 KB 658.

24.43 This analysis has not been universally accepted, as it has given rise to a number of questions. For instance in *Gould* v. *Curtis*,[1] Buckley LJ pointed out that while the third characteristic is true for fire and marine insurance, it is not necessarily so in the case of life insurance, particularly as a life policy may also contain endowment provisions.

1. [1913] 3 KB 84.

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24.44 It is interesting that in the above definition there is no explicit reference to a requirement that there should be a transfer of risk. Although this issue has not been directly considered by the English courts, it is believed that they would be likely to decide that a transfer of risk is an essential characteristic of an insurance contract (there is authority to this effect in some US and Commonwealth jurisdictions), and it has certainly been highlighted by the accountancy profession and the FSA as one of the hallmarks of a reinsurance contract.

24.45 The FSA's guidance on the general principles and the specific factors that the FSA regards as relevant in deciding whether any arrangement is a contract of insurance is set out in the FSA's *Perimeter Guidance Manual*. In summary, these principles are as follows:

(a) The starting point for the identification of a contract of insurance will be the *Prudential* case mentioned above.
(b) The FSA will give more weight to the substance of the contract than to its form. The form of the contract is relevant but not determinative of the issue.
(c) In particular, the substance of the provider's obligation determines the substance of the contract. The FSA is unlikely to treat the provider's intention or purpose in entering into the contract as relevant to its classification.
(d) The contract must be read as a whole and not according to its dominant purpose or the relative weight of its insurance content.

24.46 It should be stressed that the question of whether any particular set of arrangements can be legally categorised as a contract of reinsurance is a matter for decision by the courts: the views of the regulator (or the accountancy profession) may carry some weight, but they cannot be conclusive. The courts are, however, unlikely to give an all-embracing definition of what amounts to an adequate level of risk transfer for the risk transfer requirement (assuming one to exist as a matter of law) to be satisfied in the context of financial reinsurance; each such reinsurance must be examined separately in its commercial context before a judgment can be made about this issue. The court will look at the substance of the transaction rather than its form. If in reality a transaction is a pure banking arrangement, such as a long-term deposit made by the "reinsured" with the "reinsurer" which has been dressed up to look like a reinsurance contract, then a court would be likely to cut through the often complex wording of the contract and hold that it is not one of reinsurance.

24.47 It is also possible that the courts would give weight to the manner in which such arrangements are evaluated from an accountancy perspective.[1]

1. This is discussed in more detail at paras 24.59–24.67.

24.48 In December 1992, the US Financial Accounting Standards Board issued Financial Accounting Standard 113 (FASB 113), which establishes rules regarding the reporting of financial reinsurance transactions. FASB 113 emphasises that there must be both underwriting and timing risks for the transaction in question to be regarded as a contract of reinsurance. This contrasts with the position in the UK where an underwriting risk may not be an essential requirement for a transaction to be categorised as a reinsurance contract.[1] It is likely, however, that there will be greater consistency of approach in the future. In late 2008, FASB decided to work with the International Accounting Standards Board ("IASB") "to develop a common, high quality standard that will address recognition, measurement, presentation and disclosure requirements for insurance contracts".

What this will mean for financial reinsurance remains to be seen. There is some concern that as a result of the joint approach the process of developing a comprehensive International Financial Reporting Standard ("IFRS") will slow. However, with the US and the EU working together, the result should be a more consistent international standard.

1. See para 24.44.

Financial reinsurance: regulation

24.49 Throughout the current decade, there has been a perceptibly heightened interest on the part of the FSA in the regulatory issues raised by certain financial reinsurance transactions. This was highlighted in a speech given by Sir Howard Davies, the outgoing chairman of the FSA, to the Association of Insurance and Risk Managers on 29 January 2002. He said the regulator had identified instances where it was unclear whether any risk had in fact been transferred and where the motivation seemed "purely presentational". He commented further that as a result, the FSA had required a number of companies to renegotiate their arrangements. Concerns about the use of financial reinsurances are not limited to the FSA. In the Royal Commission Report which examines the reasons for the collapse of the HIH Group in Australia, there is trenchant criticism of the use of financial reinsurance by HIH to obscure its precarious financial position.

24.50 The comments made by the Chairman of the FSA were followed in July 2002 by the publication of the FSA consultation paper (CP144) entitled "A New Regulatory Approach to Insurance Firms' Use of Financial Engineering". The FSA recognised that financial engineering (including the use of financial reinsurance) can be a valid method of:

(a) strengthening a firm's solvency position (for example, where there is a genuine and material transfer of risk to an unconnected counterparty in a financial reinsurance); and/or
(b) accessing overly prudent economic reserves within the technical provisions of life insurers.

24.51 The FSA observed, however, that regulators in several countries, including the UK, had become concerned about aspects of "financial engineering". These concerns included:

(a) whether all such arrangements have a legitimate commercial purpose and effect;
(b) whether the credit taken in regulatory returns is commensurate with the risk transferred and value added;
(c) whether systems and controls for this type of business are robust enough;
(d) whether compliance with current accounting and regulatory rules, especially for financial reinsurance, may sometimes be inadequate; and
(e) the adequacy of current regulatory requirements.

24.52 In addressing the above concerns the FSA proposed to give high-level guidance concerning the standards with which it expects insurers to comply. This approach would have the following key elements:

(a) Financial engineering should have a legitimate commercial purpose and effect in, for example, providing financing through risk transfer or in enabling access to economic reserves assessed on a prudent basis.

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CHAPTER 38

INSOLVENCY PROCEDURES AND TECHNIQUES IN REINSURANCE

INTRODUCTION TO CORPORATE INSOLVENCY

38.1 This chapter will focus on problems which are specific to insurance and reinsurance insolvencies. It is not a comprehensive guide to the legal regime governing individual and corporate insolvencies in the UK, the primary sources of which are the Insolvency Act 1986 ("IA 1986") and the Insolvency Rules 1986 ("IR 1986") made under it, both of which have been amended significantly over the years since they first came into force. These principles are almost all equally applicable to insurance and reinsurance undertakings, and guidance on their application should be sought in standard works dealing with insolvency law.

38.2 Specific legislation exists governing insurance and reinsurance insolvencies, which modifies the application of some of the principles of general insolvency law, but it cannot be said that there is anything like a comprehensive legislative regime for insolvency in the insurance and reinsurance context.

Individual insolvency

38.3 The law of individual insolvency is not considered in any detail in this work because the only practical relevance of this area to reinsurance business is the insolvency of non-corporate underwriting members of Lloyd's. Individual insolvency is governed by Parts VIII to XI of the IA 1986. By section 9 of the Lloyd's Act 1982, a Lloyd's Name ceases to be a member of Lloyd's on becoming bankrupt.

38.4 The remainder of this section looks at the various methods of dealing with corporate insolvencies.

Corporate insolvency

38.5 The IA 1986 provides a number of methods for dealing with corporate insolvencies. We shall highlight the main areas where there is specific legislation, case law, rules or market practice in place that may have a material effect in the context of an insurance or reinsurance company insolvency.

Receivership and administrative receivership

38.6 These remedies are highly unlikely to be used in the context of an insurance or reinsurance company.

38.7 Receivership is available to secured creditors who have a fixed charge over specific assets. The chargeholder is able to secure his claim against the proceeds of the

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assets charged to him in priority to all other creditors of the insurance or reinsurance company, including insurance creditors. It is improbable that the court would exercise its power to appoint a receiver to the property of an insurance company.

38.8 Only if an insurance or reinsurance company had given a qualifying floating charge prior to 15 September 2003, or in special limited circumstances, would there be the possibility of an administrative receiver being appointed over its assets. It would however be rare for an insurance or reinsurance company to have granted a floating charge over its assets, because that would be likely to cause it to struggle to meet regulatory solvency requirements. Receivership is outside the scope of the Insurers (Reorganisation and Winding Up) Regulations 2004.[1]

1. SI 2004 No. 353. Considered at paras 38.48–38.51.

Administration

38.9 The administration procedure allows for the management of the company for the benefit of creditors in order to secure its survival as a going concern, a better result for creditors or realising property for the benefit of secured or preferential creditors. The Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2002[1] made the administration procedure in Part II of IA 1986 available to insurance and reinsurance companies for the first time, with a number of modifications. While an administration order is continuing, the insurance or reinsurance company will be protected from winding-up proceedings as well as from any steps a creditor might take to seize the company's assets in satisfaction of a claim, unless the court orders otherwise or the administrator agrees.

1. SI 2002 No. 1242.

38.10 An administrator is able to pursue recoveries from the beneficiaries of preferential transactions or transactions at an undervalue, which is a power not available to provisional liquidators.

38.11 The IA 1986, as a result of amendments made by the Enterprise Act 2002 ("EA 2002"), provides that the administrator must perform his functions with the objectives of:

(a) rescuing the company as a going concern; or
(b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration) if rescuing the company as a going concern is not reasonably practical, and if achieving a better result for the company's creditors as a whole is not reasonably practical, he may proceed with the objective of realising assets to distribute to general or preferential creditors.

An administrator must act in the interests of all creditors, not simply those who appointed him.

38.12 Although the IA 1986, as amended, contains provisions allowing for out-of-court appointments of administrators by creditors or the company's directors, these provisions do not apply to insurance or reinsurance companies.[1]

1. See the Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2002 (SI 2002 No. 1242) as amended.

38.13 Whereas a creditor seeking a winding-up petition based on insolvency must show that the company is unable to pay its debts, the applicant for an administration order need only satisfy the court that the company is, or is likely to become, unable to pay its debts and that the making of an order is reasonably likely to achieve the purposes of the administration procedure outlined above.

38.14 An administration will automatically end after 12 months unless extended. Extensions usually require the court's approval. Administration may be used when a scheme of arrangement is determined to be the most effective solution for an insurance or reinsurance company's financial difficulties: for instance, the procedure was used to facilitate the preparation of a scheme of arrangement for AA Mutual Insurance Co. Ltd. An administrator also has power to make payments to certain creditors (usually with the informed consent of a creditors' meeting), which may enable resolution of the company's difficulties without a scheme of arrangement.

38.15 In *Freakley* v. *Centre Reinsurance International Co.*,[1] a company in administration (T&N) was insured in respect of asbestos liabilities by an insurer (Curzon) under a policy that provided (*inter alia*) that upon the occurrence of an "insolvency event" (including administration), Curzon should have the exclusive right to handle and defend claims brought against T&N. Curzon was in turn wholly reinsured by Centre Re and two other reinsurers under a policy that conferred claims control on the reinsurers—including the right to control relevant claims under the original policy. A number of issues arising out of the administration were referred to the court by the administrators. It was held by Blackburne J (*Centre Reinsurance International Co.* v. *Curzon Insurance Ltd*[2]) and the Court of Appeal (*Centre Reinsurance International Co.* v. *Freakley*[3]) that the claims control provisions in the reinsurance contracts were valid, that the reinsurers rather than the administrators were entitled to handle asbestos-related claims, and that the reinsurers' claims-handling costs were liable to be reimbursed by T&N.

1. [2007] Lloyd's Rep IR 32 (HL).
2. [2004] Lloyd's Rep IR 622 (Ch).
3. [2005] Lloyd's Rep IR 303.

38.16 A further appeal to the House of Lords followed on the question whether the reinsurers had any priority right to reimbursement for their claims-handling costs on the basis that those costs were expenses of the administration. The House of Lords ruled that while claims-handling expenses incurred and paid by the administrators were expenses of the administration within section 19(4) of the IA 1986, the reinsurers' claims-handling expenses were neither incurred in discharge of any contracts entered into by the administrators, nor were they expenses incurred by the administrators. Consequently, the reinsurers were not entitled to the priority conferred by section 19(5) of the IA 1986 on the reimbursement of costs incurred in the carrying out of an administrator's functions.

Provisional liquidation

38.17 Provisional liquidators may be appointed under section 135 of the IA 1986 at any time after the presentation of a winding-up petition. A provisional liquidator's powers are set out in the court order appointing him. Prior to the coming into force of the Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2002, insurers and reinsurers in financial difficulties had tended to adopt the practice of

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petitioning the court for the appointment of a provisional liquidator, because they did not have access to the moratorium provided by the administration procedure, in order to preserve the company's assets, especially to ensure that its property is protected for equal distribution so that no individual creditor "steals a march" on others once a winding-up petition has been presented. With this breathing space, the provisional liquidator would typically promote a scheme of arrangement under what has become Part 26 of the Companies Act 2006.[1] This process could involve postponing the hearing of the winding-up petition for several years.

1. See paras 38.53–38.63.

38.18 The administration procedure has one principal advantage over the appointment of provisional liquidators, which is that administrators have the power to investigate and challenge antecedent transactions, which may result in a recovery of assets. Previously, this was only possible once the insurance or reinsurance company had been put into liquidation. However, an administrator, unlike a liquidator, cannot disclaim onerous property and so cannot bring all of a company's commercial arrangements (particularly leases of property) to an end.

Company voluntary arrangements with creditors

38.19 Part I of the IA 1986 allows any company to enter into a voluntary arrangement with its creditors. Company voluntary arrangement ("CVA") schemes were in practice not an option for insurance and reinsurance companies before 1 January 2003 because an approved scheme only bound persons who had notice of and were entitled to vote at the creditors' meeting that was called to approve it. Because it is often impossible to ascertain the identity of all potential creditors of an insurance company (who will include policyholders with claims not yet notified to the company), it was generally impossible to be sure that notice had been given to every person who might have a valid claim against the company. As a consequence, it was always possible for contingent creditors who were unascertained at the time of the CVA to appear subsequently, thus upsetting the entire basis on which the scheme was concluded.

38.20 The Insolvency Act 2000 has, with effect from 1 January 2003, remedied some of the deficiencies of the former regime, making such arrangements a possible option for insurance companies. CVAs (which can be proposed by administrators and liquidators as well as by the company itself) bind not only creditors who have been identified and have received notice of the proposal, but also creditors who have not been put on notice. This could include creditors with IBNR claims under long-tail policies. In practice, however, CVAs are still rarely used because creditors cannot vote in separate classes in schemes under Part 26 of the Companies Act. This is not available under the CVA procedure.

38.21 The requisite majority for a voluntary arrangement to be approved by creditors is three-quarters in value of the creditors present and voting in person or by proxy at the meeting called to approve it. There are not the additional requirements which apply to schemes of arrangement under Part 26 of the Companies Act 2006,[1] such as a majority in number of the creditors voting in favour, or a need to go to court for approval.

1. See further paras 38.53–38.63.

38.22 The right (introduced by the Insolvency Act 2000) of a small company (defined by turnover, balance sheet total and number of employees) to apply for a moratorium

while it prepares a proposal for an arrangement will not normally be available to insurance or reinsurance companies because of their size, but if a scheme is proposed in the context of a liquidation or administration, a moratorium will in practice be in place in any event by virtue of provisions contained in section 130(2) of the IA 1986 as regards liquidation, or paragraphs 42 to 44 of Schedule B1 to the IA 1986[1] as regards administration.

1. Inserted by the EA 2002.

Liquidation

38.23 A company may be liquidated (or "wound up"—the terms are used interchangeably) either on a voluntary or compulsory basis. A voluntary winding-up may be either a members' voluntary winding-up or a creditors' voluntary winding-up. The distinction is that a members' voluntary winding-up requires a statutory declaration by the directors that the company is ultimately solvent. Any voluntary winding-up where the directors have not made such a declaration will be a creditors' voluntary winding-up. The practical distinction between the two forms is that the procedure which governs the liquidation is different in each case.

38.24 Either type of voluntary winding-up is commenced by a resolution passed by the shareholders themselves. A company carrying out long-term insurance cannot be wound up voluntarily without the consent of the Financial Services Authority ("FSA"). A compulsory winding-up, by contrast, is commenced by a winding-up petition presented to the court. Such a petition may be presented by the company, the directors, any creditor or group of creditors (which includes contingent creditors), any contributory (which includes shareholders) and certain official bodies, such as the FSA. For insurance companies, the FSA may exercise this power where it suspects that a company is effecting or carrying out insurance or reinsurance contracts without appropriate authorisation, or is otherwise prejudicing the interests of consumers.[1]

1. See, for example, *Re a Company No. 007816 and Others of 1994* [1997] 2 BCLC 685 (CA), decided under similar provisions in the Insurance Companies Act 1982, which was replaced by the Financial Services and Markets Act 2000 ("FSMA").

38.25 Section 122(1) of the IA 1986 lists seven separate grounds on which the court may make a winding-up order. The most important is that the company is unable to pay its debts.[1] For insurance and reinsurance companies, assessing this may prove difficult. The IA 1986 provides two main tests of insolvency—the "cash flow" and "balance sheet" tests. A petitioner may succeed under either. The cash flow test focuses on the company's cash flow position. A company is deemed unable to pay its debts under this test in any one of five circumstances set out in section 123(1) of the IA 1986, the most important of which are that it has failed within three weeks to satisfy a statutory demand properly made for a sum exceeding £750; that it has failed in whole or in part to satisfy execution on a judgment, decree or order of any court in favour of a creditor, or that the court is satisfied that the company is unable to pay its debts as they fall due. Debts in this context means liquidated, and not contingent or prospective, debts.[2]

1. S. 122(1)(f).
2. S. 123(1)(e), IA 1986.

38.26 It is not proper to petition for the winding-up of a company in order to enforce payment of a debt which is genuinely disputed. A statutory demand should therefore not

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be used where there is a dispute between debtor and creditor as to the very fact of the indebtedness itself. However, non-compliance with a statutory demand may be used as the basis for a winding-up petition, even though the company is apparently solvent, where it persistently fails to pay an undisputed debt. This will be the case even though the company's assets are far greater than its liabilities when looked at overall.

38.27 A similar approach is applied when determining whether the company can pay its debts as they fall due. In *Cornhill Insurance plc* v. *Improvement Service Ltd and Others*,[1] Harman J said that persistent non-payment of a debt (in this case of £1,154) suggested an inability on the part of the company to pay that debt and so justified the presentation of a winding-up petition. However, it will not be sufficient for a creditor merely to establish that a company has insufficient liquid assets to pay all its presently owing debts whether or not repayment of such debts has been demanded. In *Re Capital Annuities Ltd*,[2] the court held that the company could have other assets which could be realised to discharge the debts. The best evidence of inability to pay debts falling due under the cash flow test will therefore be a persistent failure to pay a debt due to the creditor who presents the petition where liability to that creditor is undisputed by the company.

1. [1986] 1 WLR 114 (Ch D).
2. [1979] 1 WLR 170 (Ch D).

38.28 The alternative test for insolvency is known as the "balance sheet" test. A company is judged in accordance with this test to be insolvent if the value of its assets is less than the amount of its liabilities. For purposes of this test, contingent and prospective liabilities may be taken into account. Thus it would be possible for a petitioner to establish that a company was insolvent under this test where its IBNR claims exceeded its assets, even though the liquidated claims against it were less.

Liquidator's powers

38.29 Once appointed,[1] a liquidator has the following powers:

(1) The power of sale or dealing with any of the company's property;
(2) The power to do all acts in the name of and on behalf of the company;
(3) The power to borrow on the security of the assets of the company;
(4) The power to appoint an agent to do any business which the liquidator is unable to do himself;
(5) The power to do all other things necessary for the winding-up of the company.

1. The IA 1986 and IR 1986 lay down the procedure for appointment of liquidators.

38.30 In addition, the liquidator may[1] pay any class of creditor in full and has the power to make any compromise or arrangement with creditors or persons claiming to be creditors. Other than in the case of a "pure" reinsurer, the liquidator will have to act in accordance with the Regulations.

1. Subject to the Insurers (Reorganisation and Winding Up) Regulations 2004, discussed at paras 38.48–38.51.

38.31 Liquidators will often look to see whether the assets available to creditors may be increased either by avoidance of certain transactions entered into by the company prior to the onset of liquidation or by actions against persons guilty of wrongful or

fraudulent trading. In addition, of course, liquidators will sometimes have actions available by virtue of the general law: for example, actions for negligence against advisers, actions for wrongful interference with contract or even for conspiracy or fraud. Specifically, transactions made by a company at an undervalue (meaning by way of gift, or where the company received substantially less value than the value which it gave) within two years prior to the commencement of the winding-up may be set aside by the court on the application of the liquidator under section 238 of the IA 1986. Transactions which were made by the company with intent to prefer a particular creditor (meaning to put that person into a position which, in the event of insolvent liquidation, is better than the position he would otherwise have been in) within two years of commencement of the winding-up can be set aside by the court on the application of the liquidator under section 239 of the IA 1986. IA 1986 provides a defence against the reversal of transactions at an undervalue in section 238(5) where the company acts in good faith, for the purposes of its business and at the time there were reasonable grounds for believing that the transaction would benefit the company.

38.32 An action for fraudulent trading may be brought by the liquidators under section 213 of the IA 1986 against any person who carried on the business of the company with intent to defraud creditors or for any fraudulent purposes. The court may order such a person to make a contribution to the company's assets, and any such person may also be guilty of a criminal offence under section 458 of the Companies Act 1985.

38.33 An action for wrongful trading may be brought by the liquidator under section 214 of the IA 1986 against any director or controller of the company where such a person carried on the company's business at a time when he knew, or ought to have known, that there was no reasonable prospect that the company would avoid becoming insolvent, and failed to take every step to minimise the loss to the company's creditors. A director found liable for wrongful trading may be ordered by the court to contribute to the company's assets and may be disqualified from acting as a director for up to 15 years under section 10 of the Company Directors' Disqualification Act 1986.

Effect of liquidation on policyholders

38.34 The making of a winding-up order in respect of an insurance or reinsurance company has a number of important effects on its relationship with its policyholders:

(1) On the making of the winding-up order the policy will be terminated and all cover under the policy will cease. Cover under policies or treaties issued by an insolvent insurance or reinsurance company terminates on the date a winding-up order is made against the company or on which the shareholders (or the company) resolve to put it into voluntary liquidation. Where a policyholder has paid premium in advance, it is entitled to a *pro rata* return of premium, which it can set off against any debts which it may owe to the insolvent insurer or reinsurer.[1] If the company does not go into liquidation, the policies do not terminate: this is one of the reasons why an alternative solution to liquidation may be sought.
(2) Time does not run under the Limitation Acts from the date of the winding-up order in respect of debts owed by the insolvent that are not statute-barred at that date.[2] This exception relates only to rights or remedies affected by the insolvency, and so would not apply to secured creditors' rights,[3] but it does

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extend to claims presented under the Third Parties (Rights Against Insurers) Act 1930, *Financial Services Compensation Scheme Ltd* v. *Larnell (Insurances) Ltd*[4] in which the Court of Appeal held further that creditors' claims were not affected by the fact that the primary limitation period had expired prior to the commencement of the winding-up if the creditors were entitled to rely upon section 14A of the Limitation Act 1980.[5] Time continues to run in respect of debts owed to the insolvent company and thus a liquidator must commence proceedings against debtors of the company within the relevant limitation period.

(3) Rule 4.91 of the IR 1986 provides that all sums due to and owed by the insolvent company must be converted into their sterling equivalent at the date of the winding-up order, or if the liquidation was immediately preceded by an administration, on the date that the company entered administration. The conversion rate will be the Bank of England middle market rate at that day. Any interest which is payable to the liquidator on any sums due must also be calculated in sterling and paid in sterling when the sums due are actually paid. This rule is one of many that encouraged the more flexible scheme of arrangement route to be used in the case of most insolvencies in the London market during the 1990s, because so much of the business of the insolvent companies was transacted in dollars.

1. *Transit Casualty Co.* v. *The Policyholders Protection Board* [1992] 2 Lloyd's Rep 358 (Ch).
2. *Re General Rolling Stock Co. Ltd* (1872) LR 7 Ch App 646.
3. *Cotterell* v. *Price and Others* [1960] 1 WLR 1097.
4. [2006] Lloyd's Rep IR 448.
5. Discussed at paras 42.40–42.46.

Proof of debt in liquidation

38.35 The EA 2002 has abolished the Crown's preferential status in relation to debts due to the Inland Revenue for unpaid taxes, Customs and Excise for unpaid VAT and also in relation to social security contributions.

38.36 The general position of the creditors of insolvent insurance and reinsurance companies is the same as those of any other insolvent companies. They must submit proofs of their debt to the liquidator in accordance with the IR 1986. One peculiarity of their position, however, is that the majority of creditors of an insolvent insurance company may well be contingent or unascertained creditors. It may be unclear whether any liability will arise on a particular policy for some time to come, or it will be clear that a liability is to arise but its quantum will be undetermined. In general:

(1) A claim under a policy may be proved in the usual manner where the liability of the insurer has been ascertained by agreement, judgment or arbitration award.
(2) The liquidator must estimate the value of the policy, and no proof of debt is necessary, where the creditor's claim is contingent or unascertained.
(3) Many policyholders' claims will be in respect of policies which straddle the period before and after the making of the winding-up order. In respect of the period after the winding-up order, when cover has automatically been terminated by the winding-up, the policyholder will be entitled to a *pro rata* return

of premium. In respect of the period before the winding-up order, the liquidator will need to value the expired portion of the policy.

38.37 Where a contingent or unascertained debt becomes ascertained during the period of the liquidation, the liquidator should admit the claim in the liquidation for the ascertained amount.[1]

1. *McFarlane's Claim* (1880) 17 Ch D 377.

Valuing policies in liquidation

38.38 Provision is made by the Insurers (Winding Up) Rules 2001[1] ("IWUR") for valuing both long-term and general policies after the making of a winding-up order. In the event of any conflict between the IA 1986 and the IWUR, the terms of the IWUR prevail. The great difficulty in the case of most insurance insolvencies is the valuation of contingent or unascertained claims. Liquidators are obliged to make a "just estimate" of the value of the claim, and cannot refuse to admit the claim to proof simply because it is contingent or unascertained.

1. SI 2001 No. 3635.

38.39 In *Transit Casualty Co.* v. *The Policyholders Protection Board*,[1] it was held that provisions that have been substantially re-enacted in Schedule 1 of the IWUR lay down principles for the valuation of all contingent and unascertained debts under policies classified as general business. In practice, however, the IWUR and the *Transit Casualty* case give little guidance as to how this is to be done. In some jurisdictions, specific provision is made for actuarial estimates or evaluations to be applied.[2]

1. [1992] 2 Lloyd's Rep 358 (Ch D).
2. For example S. 375.1220.2 of the Missouri Revised Statutes 1984, considered in *Angoff* v. *Holland-America Insurance Co. Trust* 937 S.W.2d 213 (Mo. Ct. App. 1996).

Reduction of insurers' liabilities

38.40 Section 377 of the FSMA permits the court to reduce the value of an insurer's contracts where it is unable to pay its debts. Effectively the court may, on such terms as it sees fit, reduce the insurer's liabilities. The consequences for reinsurance recoveries of seeking any such order should, however, be carefully considered.[1]

1. See further paras 38.67–38.71, and 38.97–38.122.

The Financial Services Compensation Scheme

38.41 The Financial Services Compensation Scheme ("FSCS"), established under Part XV of the FSMA, provides protection to policyholders who hold certain classes of policies issued by insurance companies in the UK or another European Economic Area state, if the insurance company in question became insolvent or was declared in default on or after 1 December 2001. For claims against insurance companies which became insolvent or were declared in default before this date, the rules and compensation limits of pre-existing compensation schemes will apply, although the FSCS will still handle the claims.

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38.42 While the FSCS was set up mainly to protect private individuals (subject to certain restrictions), small businesses (those with an annual turnover of less than £1 million) are also covered. In summary, the FSCS will compensate such policyholders in full for the first £2,000 of a protected claim and thereafter for 90% of the balance of the shortfall sustained by reason of the insolvency of the insurance company; the figure goes up to 100% in the case of compulsory insurances, such as third-party motor liability and employers' liability together with mesothelioma claims which are dealt with under COMP 4.4 of the COMP section of the FSA *Handbook of Rules and Guidance*. Reinsurance companies are excluded from the operation of the FSCS, but Lloyd's syndicates are not. The FSCS will, however, only step in to compensate a Lloyd's policyholder if Lloyd's has been unable to make good any shortfall from the Central Fund.

38.43 The rules of the FSCS can be found in the COMP section of the FSA's *Handbook*. The FSCS is financed by levies on financial services organisations. There is power for the FSCS to take action to safeguard policyholders of a specified class of insurance companies that are in financial difficulty, even if they have not formally gone into liquidation. If the FSCS pays a claim to a policyholder, it will usually take an assignment of that policyholder's rights against the company. As a result of the Insurers (Reorganisation and Winding Up) Regulations 2004[1] and of changes made from previous policyholder protection measures in order to reduce the number and categories of eligible claimants, there is perhaps less likelihood of the future cost of policyholder protection ultimately being as significant for the insurance industry as was the case with certain insolvencies in the 1990s.

1. See paras 38.48–38.51.

Role of the FSA

38.44 As the regulator of UK incorporated insurance and reinsurance companies, the FSA may wish to intervene in any procedure relating to the insolvency of a UK insurer. Two of its four regulatory objectives are the maintaining of market confidence and the protection of consumers. Part XXIV of the FSMA gives the FSA power to be heard at any hearing in relation to a voluntary arrangement, application for administration or winding-up. Insolvency practitioners have various duties imposed on them to report to the FSA.

38.45 The FSA also has powers to apply for administrators or liquidators to be appointed. In the case of long-term insurers, the FSA has power to intervene in applications to the court to reduce the value of one or more of the contracts of long-term insurance effected by the insurer. The court is given a discretion to reduce the value of one or more of any insurer's contracts instead of making a winding-up order, on such terms and subject to such conditions as the court thinks fit.

Accounting issues

38.46 There are various factors that may affect the choice of procedure for resolving any solvency difficulty that an insurance or reinsurance company might have. Usually the company will have no shortage of cash when its insolvency is identified (the problem almost always lies in inadequate reserves for future claims), so resources ought to be available to investigate the most appropriate solution, which may well be other than

liquidation. There may be significant disadvantages—for example from a taxation perspective, the returns available on investments, the ability to preserve part of the business as a going concern and some of the bureaucratic requirements of the IR 1986—if a business is put into liquidation rather than being made subject to some form of reorganisation.

Availability of insurance business transfer schemes

38.47 The procedure under Part VII FSMA pursuant to which the whole or part of an insurer's business can be transferred to certain other insurers, so that policyholders' rights are automatically novated (and possibly other assets transferred), may be a means of dealing with some solvency difficulties.[1]

1. The transfer procedure is considered in more detail at paras 37.5–37.36.

Insurance claims given priority over claims of other unsecured creditors

38.48 The order of priority given to creditors in the winding-up of a UK insurer is set out in the Insurers (Reorganisation and Winding Up) Regulations 2004 ("the Reorganisation Regulations"). They replace the original 2003 Regulations, which were passed in order to implement an EU Directive in the UK on the reorganisation and winding-up of insurance undertakings. The Reorganisation Regulations, which do not apply to pure reinsurers, provide that after the payment of preferential debts, "insurance debts" of a UK insurer that is being wound up must be paid before all other unsecured debts. An "insurance debt" is a debt for which a UK insurer is or may become liable, pursuant to a contract of insurance, to a policyholder or to any person who has a direct right of action against that insurer. It includes any premium paid in connection with the insurance contract which the insurer may be liable to refund. The insurance debt definition excludes reinsurance claims. Schemes of arrangement under Part 26 of the Companies Act 2006 do not fall within the scope of the Reorganisation Regulations, but will not in practice be a feasible option for non-UK EEA insurers because it is unlikely that a moratorium for claims against such companies will be achievable while a scheme is being designed. However, once the EU Reinsurance Directive[1] is implemented by all member states (which will require those states to enact provisions similar to those of the UK's insurance business transfer regime under Part VII of the FSMA),[2] the possibility of schemes for non-UK entities may well arise, by way of a two-step process: initially, the non-UK business would be transferred to a UK authorised entity under the other jurisdiction's provisions equivalent to the FSMA Part VII regime, and then a scheme could be implemented in respect of the business transferred to the UK. This has now happened in relation to Deutsche Rückversicherung AG, whose business has been transferred to England with a view to a scheme being proposed.

1. See paras 5.8–5.13.
2. See paras 37.5–37.36.

38.49 The exclusion of pure reinsurers and reinsurance claims from the ambit of the Reorganisation Regulations has certain commercial ramifications. Purchasers of reinsurance frequently take into account the security of prospective reinsurers when placing their business. If a buyer of reinsurance is placing business with a company that writes, or has been authorised to write, both insurance and reinsurance, then its security will be

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adversely affected if the reinsurer gets into financial difficulties. Potentially, it could receive nothing on an insolvency if the reinsurer's funds have been exhausted by payments to direct policyholders which will take precedence over debts owed under reinsurance arrangements. The purchaser of reinsurance may therefore try to negotiate a price readjustment or perhaps make a decision not to buy reinsurance from any company other than a pure reinsurer. Correspondingly, a seller of reinsurance that also writes insurance should consider splitting the business so that separate entities write either solely reinsurance or solely insurance.

38.50 The Reorganisation Regulations contain certain administrative requirements, including notification and reporting, detailed discussion of which is beyond the scope of this book, but which may encourage those associated with the company to pursue a scheme of arrangement under Part 26 of the Companies Act 2006, as such schemes fall outside the ambit of the Regulations.

Application of the Reorganisation Regulations to Lloyd's

38.51 Applying the EU Directive to Lloyd's proved difficult because "the association of underwriters known as Lloyd's" (which is the term used to refer to the regulated undertaking within the context of Community law) has no legal personality. Consequently, the Insurers (Reorganisation and Winding Up) (Lloyd's) Regulations 2005 (the "Lloyd's Reorganisation Regulations") were introduced on 10 August 2005 to impose on Lloyd's the same conditions with regard to reorganisation measures and winding-up procedures as had already been put in place for all other UK insurers by the Reorganisation Regulations. For action to be taken under the Lloyd's Reorganisation Regulations, it must appear at least likely to be the case that the Lloyd's insurance market as a whole does not, or will not, meet the solvency requirements set by the FSA. In this scenario, the principal objectives of the Lloyd's Reorganisation Regulations are (a) to preserve or restore the financial situation of, or market confidence in, Lloyd's; and (b) to assist in achieving an outcome that is in the interests of members' creditors and insurance creditors in particular.

38.52 Either the FSA or the Society of Lloyd's, or both, may apply to the court for a Lloyd's Market Reorganisation Order ("LMRO") and, once obtained, the LMRO will protect those to whom it applies through the imposition of a moratorium on all proceedings or other legal process against them. As soon as an LMRO is made, the FSA must inform every other EU regulator that the order has been made and communicate its probable effect on the carrying-out of contracts of insurance at Lloyd's and the rights of policyholders under those contracts. Once an LMRO is in force, the main body of the Reorganisation Regulations, with amendments to tailor them to the special nature of the Lloyd's market, will operate under the supervision of a court-appointed reorganisation controller.

SCHEMES OF ARRANGEMENT UNDER PART 26 OF THE COMPANIES ACT 2006

Introduction

38.53 Until the amendment to the IA 1986 in the early years of the present century, which made administration and voluntary arrangements possible solutions for insolvent insurance and reinsurance companies, schemes of arrangement under Part 26 of the

Companies Act 2006 which was formerly section 425 of the 1980 Companies Act were commonly used to deal with insurance insolvencies and, despite the availability of alternative procedures, such schemes still represent the procedure resorted to most frequently. The purpose of making an arrangement is to prevent the company from being wound up. One of the benefits of such a scheme is an avoidance of expenses otherwise payable in a liquidation, enabling creditors to recover a larger proportion of the debt. Another benefit is that when the liquidator takes over he will probably dispense with most of the staff and certainly existing management. In a scheme of arrangement the company may continue to be run by existing management.

38.54 As noted at paragraph 38.50, the Reorganisation Regulations do not apply to Part 26 schemes of arrangement. Draftsmen of schemes of arrangement will now have to bear in mind the new order of priorities outlined above, as unless policyholders are given the same priority over other unsecured creditors, or there is a good commercial rationale for not doing so, they can be expected to vote against a scheme. The administrative requirements of the Reorganisation Regulations (which are likely to prove costly) can be avoided by the use of a scheme of arrangement.

38.55 A scheme of arrangement, if approved by a majority in number, representing 75% in value, of each class of creditors voting at the creditors' meetings, and if sanctioned by the court, is binding on all creditors, including those who either did not attend a meeting, or who did attend but voted against the scheme.

38.56 Part 26 requires the appropriate majorities to be determined by reference to each relevant "class" of creditor. In *Re Hawk Insurance Co. Ltd,*[1] the provisional liquidators of Hawk Insurance Company proposed a scheme of arrangement under which payments would be calculated by reference to 100% of admitted claims, but only between 50% and 75% of losses which were outstanding or incurred but not reported. The scheme was approved without dissent at a creditors' meeting. The first instance judge refused to sanction it on the grounds that the provision for scaling down payments in relation to outstanding losses and IBNR claims meant that the creditors did not fall into a single class for the purpose of approving the scheme. The Court of Appeal, however, held that the provisions for weighting in relation to dividends did not reflect any difference in the rights of creditors, nor did the scheme create different classes of creditors. There was a single class of creditors with a common interest in achieving a relatively simple, inexpensive and expeditious winding-up of the company's affairs.

1. [2001] EWCA Civ 241.

38.57 In *Re Equitable Life Assurance Society (No. 1)*[1] Lloyd J approved the formulation put forward in *Re Hawk Insurance Co. Ltd*, that the purpose of classes of creditors in a Part 26 scheme of arrangement was to link creditors whose rights were sufficiently similar so as to allow them to consult together in their common interest. Lloyd J also held that the terms of Part 26 allowed the court to direct that the majority vote in each class could be ascertained by reference to the value of each creditor's claim and in calculating the majority by value, creditors could vote in different ways with respect to different parts of their claims.

1. [2002] BCC 319.

38.58 Until the scheme has been sanctioned, it is still open to any creditor who does not wish to participate to take some form of action to enforce his claim. In order to prevent this happening, the company may present a petition for its own winding-up and

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to obtain a provisional liquidation order or go into administration in order to obtain the advantage of a stay of proceedings.

38.59 The procedure requires the court's approval of the scheme in addition to the approval of the creditors. The legislative intention behind this provision is to protect the minority of creditors who would otherwise be bound by a scheme to which they may either have objected or of which they had no notice. Both reinsurers and the court will be concerned to ensure that the scheme takes into account the interests of all creditors. As a consequence the court will not approve the scheme unless it is satisfied that long-tail creditors will not be prejudiced. This issue arose in *Re British Aviation Insurance Co. Ltd*,[1] where an application was made to the court to sanction a solvent scheme in relation to the company ("BAIC"). BAIC had gone into run-off in 2002 and faced various long-tail products or environmental liabilities such as asbestos, pollution and related health hazards. The application was challenged by a class of creditors whose claims primarily involved IBNR. While the scheme proposed that IBNR creditors be allowed to submit claims, the IBNR creditors were unhappy with the manner in which these claims would be assessed and valued because the IBNR would be given a valuation that would not amount to the full indemnity that the IBNR creditors might expect to receive if the run-off were allowed to proceed to its natural conclusion.

1. [2005] EWHC 1621 (Ch).

38.60 Only one creditors' meeting was convened. At that meeting, the IBNR creditors' complaints were overruled by the majority of creditors and the scheme was approved. When the scheme subsequently came before the court for approval, Lewison J upheld the IBNR creditors' challenge and refused to sanction the scheme, ruling that the single scheme meeting was not properly constituted as creditors with accrued paid claims (who would have their claims paid in full) on the one hand, and creditors with IBNR claims on the other, effectively had no common interest and therefore could not be put together into one general body of creditors.

38.61 In the immediate aftermath of Lewison J's judgment, there was concern in the legacy market that the BAIC case could lead to problems with the sanctioning of future solvent schemes where there were creditors with significant unknown IBNR exposure (a feature common to many schemes). It does not appear, however, that these difficulties have materialised: a number of schemes have been approved subsequently (including one relating to the Mercantile and General Reinsurance Co. Ltd in which a single scheme meeting was allowed, although formal reasons were not given by the Scottish court which heard the application). In addition, Warren J, in *In the matter of Sovereign Marine & General Insurance Co. Ltd and Others*[1] provided guidance on how Lewison J's judgment in *BAIC* should be applied to future schemes. Warren J stated that the apparently general statement made by Lewison J—that creditors with IBNR claims and creditors with accrued paid claims had no common interest and therefore could not be put together into one general body of creditors: "must be read in the light of the facts before him and in particular in the light of his analysis of the rights of policyholders with different types of claim in a solvent run-off and the uncertainties to which they give rise . . . Each case will . . . be heavily fact-dependent."

1. [2006] EWHC 1335 (Ch).

38.62 On the facts of *Sovereign Marine*, Warren J found that creditors with IBNR claims and creditors with claims for outstanding losses had very different rights and, therefore,

could not take part in the same creditors' meeting for the purposes of voting on any scheme put forward.

38.63 Once a scheme has been approved, however, the court does not retain any residual discretion to vary the terms of that scheme on the application of creditors, for example, by extending the time limits for lodging claims: see *Kempe & Another (as Joint Liquidators of Mentor Insurance Ltd)* v. *Ambassador Insurance Co. (In Liquidation)*,[1] a case decided in accordance with Bermudian law. Schemes have nevertheless been varied on the application of the company, usually to bring about closure of the scheme by providing, once the run-off has progressed to a position where it is less difficult to estimate contingent claims, for a cut-off pursuant to which all outstanding claims are valued actuarially for the purpose of achieving a final distribution.

1. [1998] 1 WLR 271 (PC).

Voluntary creditors schemes

38.64 An alternative to the statutory procedures is a scheme of arrangement made by contract with the unanimous consent of the creditors. This method offers flexibility and avoids the expense and delay associated with the statutory procedures. Such an approach is, however, unlikely to be used in a reinsurance scheme, because generally the creditors upon whom it relies will not have been identified and will not be able to benefit from, or indeed be bound by, the contractual arrangement. Therefore, if assets are used in satisfying the contractual obligations at the expense of the unidentified creditors, the company and the directors may be open to a claim for damages at a later date.

38.65 In conclusion, such contractual arrangements can at best have only limited use within the ambit of the settlement of individual contracts and not as a form of overall arrangement with creditors.

Objectives of a scheme

38.66 The objectives of a scheme will depend upon its own particular circumstances, and flexibility is the key to any successful scheme. Two approaches are recognised by practitioners: first, a run-off scheme where claims are assessed in the normal way as they arise. Instead of the claims being paid in full a payment percentage of them is paid. This payment percentage is based upon a conservative estimate of the eventual level of liabilities and assets in the estate and additional amounts will often be paid as the claims are made and there is more certainty ("the run-off approach"). Secondly, the valuation approach is used where creditors are invited to submit their claims by a bar date. The claims are then agreed or adjudicated by an independent adjudicator based upon outstanding claims together with an estimation of IBNR claims which complies with estimation guidelines contained in the scheme which have been accepted by the creditors as a result of the scheme being approved by the requisite majority and sanctioned by the court.

38.67 Where advisers assess the terms of the scheme, consideration should be given to its effect on the terms of contracts of retrocession. Recoveries from this source usually account for a significant proportion of assets of reinsurance companies, and a failure to recover as a result of the effect of the scheme may ultimately make the scheme unattractive to creditors. As a consequence the terms of the two types of scheme endeavour to protect the company's ability to recover these assets.

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