Steptoe
STEPTOE & JOHNSON LLP

Reinsurance Update

June 2015

This edition provides an update of recent developments of interest to the global reinsurance industry.

- The US Case Note highlights a recent decision out of New York addressing whether and when, under New York law, the timeliness of a demand for arbitration is a determination for a court or for an arbitrator.
- The US Regulatory Note addresses proposed regulations that would impact the tax liability of reinsurance companies owned by hedge funds.
- The London Case Note looks at a decision by the English Court which ruled that a portfolio transfer did not transfer the original insurer's liabilities for mis-selling policies.
- The EU Case Note discusses two recent decisions impacting insurers and reinsurers. In the first, the Constitutional Council in France analysed automatic transfers of portfolios of contracts of insurance in the context of the deteriorating solvency of a mutual insurer. The second discusses a European Court of Justice judgment that may lead to further challenges by consumers claiming that their insurance contracts are void.
- The London Regulatory Update discusses The Insurance Act 2015, which is expected to make the greatest change to English insurance law in over a century.

Steptoe's London office is also pleased to take this opportunity to announce our recent move to a new office space. The state-of-the-art facility will benefit us in our continuing commitment to deliver excellent client service. Our new address is:

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Our contact numbers and DX address will remain the same, to view a map of our new location please click here.

US Case Note

In *ROM Reinsurance Mgmt. Co., Inc. v. Continental Ins. Co., Inc.*, 8 N.Y.S.3d 569 (App. Div. 1st Dep't 2015), a New York appeals court affirmed the denial of a reinsurer's motion to stay the arbitration of a reinsurance dispute, holding that because the reinsurer participated in the arbitrator selection process, the reinsurer was precluded from seeking a stay on statute of limitations grounds under New York law. This case reinforces whether and when, under New York law, the timeliness of a demand for arbitration is a determination for a court or for an arbitrator.

In this case, the reinsurer sought reinsurance coverage for asbestos-related claims brought against its insured. The insurer demanded arbitration pursuant to an agreement that "the arbitration laws of New York State" shall govern the parties' arbitration. *ROM Reinsurance Mgmt. Co., Inc. v. Continental Ins.*

Co., Inc., 982 N.Y.S. 2d 73, 74 (App. Div. 1st Dep't 2014) (citations and internal quotations omitted). The reinsurer petitioned for a stay of arbitration, and the insurer cross-moved to dismiss the proceeding. Unlike the Federal Arbitration Act, New York law allows a threshold issue of timeliness of an arbitration demand to be asserted in court, even absent an agreement to do so. *See id.* (citations omitted). The court held that the arbitration clause contained sufficient language indicating that New York law governed both the agreement and its enforcement, making it proper for the court, not arbitrator, to decide the timeliness issue. Indeed, the court stated, "'[i]t is hard to imagine what the parties intended when they agreed that the "arbitration law of New York State shall govern such arbitration" if they did not intend to have the [New York Civil Practice Law and Rules] apply . . . .'" *Id.* at 74-75 (quotation omitted).

On appeal, the court affirmed, finding that "[p]etitioners participated in the arbitrator selection process, even though they were undoubtedly aware of their statute of limitations claim. Under these circumstances, the court correctly determined that petitioners participated in the arbitration and therefore are precluded from seeking a stay on statute of limitations grounds . . . ." *ROM Reinsurance Mgmt. Co., Inc.*, 8 N.Y.S.3d 569. The court further held that, "[a]lthough petitioners have waived their ability to have the courts determine the statute of limitations issue, the issue may be determined by the arbitrators." *Id.*

US Regulatory Note

On April 23, 2015, the Department of Treasury and Internal Revenue Service (IRS) issued proposed regulations intended to address arrangements in which a hedge fund or its owners invest in a foreign reinsurance company, which then reinvests its capital and premiums that it receives in the hedge fund. The owners of the foreign reinsurance company take the position that they are not taxed until the company's earnings are distributed or the investors sell their stock. The basis for this position is that certain US tax rules (the passive foreign investment company or PFIC rules) intended to prevent tax deferral through offshore corporations provide an exception for income earned in the active conduct of an insurance business.

The regulations propose to define the terms "active conduct" and "insurance business" to clarify the scope of activities qualifying for the PFIC insurance exception. The proposed regulations define "active conduct" as substantial managerial and operational activities carried out by the corporation's own officers and employees. The proposed regulations define "insurance business" as including the investment activities that are required to support or are substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation. Treasury and the IRS have requested comments on the proposed regulations by July 23, 2015.

The proposed regulations follow over a decade of government scrutiny of reinsurance companies owned by hedge funds. In February, Senator Ron Wyden challenged IRS Commissioner John Koskinen to issue guidance within 90 days. Treasury and the IRS have also cited a desire to increase reporting with respect to US owners of hedge fund reinsurance arrangements as a reason for subjecting property and casualty insurance premiums to potential withholding under the Foreign Account Tax Compliance Act (FATCA).

London Case Note

***PA(GI) Ltd v GICL 2013 Ltd and another*, [2015] EWHC 1556 (Ch), 5 June 2015**

The English court has decided that a portfolio transfer did not transfer the original insurer's liabilities for mis-selling policies.

In 2006, PA(GI) entered into an arrangement under Part VII of the Financial Services and Markets Act 2000 to transfer a book of PPI insurance policies to GICL. In subsequent years, numerous insureds complained to PA(GI) that they had been mis-sold cover.

The transfer encompassed "liabilities under and attaching to" the PPI policies. PA(GI) argued that this included its liability to pay redress for any mis-selling, and that the transferee was obliged to handle such complaints and to pay any redress.

Andrews, J. found that the Part VII transfer did not encompass liabilities for mis-selling. The words of the transfer were not apposite to describe mis-selling liabilities, the surrounding documents did not refer to such liabilities transferring, and it did not make commercial sense that such liabilities would have transferred without that intention being mentioned and for no consideration.

EU Case Note

Constitutional Council, France: Decision n° 2014-449, QPC, 6 February 2015 – Société Mutuelle des transports assurances (automatic transfer of a portfolio of contracts of insurance)

In this matter, the Constitutional Council, the body entrusted with review of conformity of legislation with the Constitution, analysed provisions of the Monetary and Financial Code on transfers of portfolios of insurance contracts. The question arose in the context of the deteriorating solvency of a mutual insurer, SMTA.

The Code's provisions authorise the supervisory authority, the ACPR, to order automatic transfer of all or part of a portfolio where the solvency or liquidity of an insurer is, or is likely to be, compromised. The Council held that these provisions are unconstitutional on the grounds that, in the absence of a right for the insurer itself to transfer all or part of a portfolio before the ACPR intervenes, the ACPR's automatic transfer is a deprivation of property. As such, it is contrary to the Constitution.

In other words, a portfolio of insurance contracts is property which is protected by the Constitution against unlawful expropriation. An authority may only expropriate such property in cases of obvious public necessity which are recognised in law and are subject to fair compensation in advance. This means that the ACPR's powers set out in the Code are unconstitutional for all future matters from the date of publication of the Decision (on 6 February 2015). The legislature will now have to amend the offending provisions of the Code.

Court of Justice of the European Union: *Jean-Claude Van Hove vs. CNP Assurances S.A*., case C-96/14, 23 April 2015

This judgment arose out of a reference from a first instance court in Nîmes, France to the European Court. Mr. Van Hove had taken out two mortgage loan contracts with a bank. At the same time, he took out insurance to cover various repayment risks including disability. He subsequently challenged a decision by the insurer to cease coverage. The referring court asked the European Court to interpret EU legislation on unfair terms in consumer contracts.

In principle, terms which clearly define or circumscribe the insured risk and the insurer's liability - the "main subject-matter" - are not subject to an assessment of their fair or unfair character. The European Court held, however, that terms that relate to the main subject-matter of an insurance contract may only be regarded as being drafted in plain, intelligible language if they are "...*grammatically intelligible to the consumer*..." and "…*set out transparently the specific functioning of the [insurance] arrangements*…", taking into account the contractual framework of which they form part. As a result, the consumer must be

"…*in a position to evaluate, on the basis of precise, intelligible criteria, the economic consequences for him which derive from it*."

It is now for the French court to assess the possible unfairness of the term at issue. The European Court's ruling may lead to further challenges by consumers claiming that their insurance contracts are not sufficiently intelligible, are unfair and, therefore, void.

Steptoe represented CNP Assurances S.A. in this matter.

London Regulatory Update

Introduction

The Insurance Act 2015 (the Insurance Act) received Royal Assent on February 12, 2015 and will come into force in August 2016.[1] It will make the greatest change to English insurance law in over a century.

The Insurance Act will impact on various aspects of both consumer and business insurance. Reinsurers should note that contracts of reinsurance and retrocession are within the Insurance Act, as they are treated as contracts of insurance at common law.

The most significant areas of reform relate to (1) disclosure and misrepresentation in business insurance contracts, (2) warranties and (3) insurers' remedies. In most instances the Insurance Act lays down default positions which will apply unless they are contracted out of, and below, we discuss the conditions which apply to contracting out.

It is possible that further reforms will be made before the Insurance Act is implemented, in relation to other matters which the Law Commission has considered during its review (particularly matters relating to the concept of insurable interest).

Disclosure and misrepresentation in business insurance contracts

Extent of disclosure required

Under the Marine Insurance Act 1906, insureds are subject to a duty of utmost good faith. This places on the insured the burden of identifying all circumstances which would be material to a prudent insurer, and giving disclosure of those facts.

In consumer insurance contracts, the Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA) has replaced that duty with a duty to answer the insurer's questions honestly and reasonably.

The Insurance Act will change the law regarding disclosure in business (*i.e.* non-consumer) insurance contracts. The insured will be required to "*make to the insurer a fair presentation of the risk.*" In order to make a fair presentation, the insured must disclose "*every material circumstance which the insured knows or ought to know*" or, failing that, provide "*disclosure which gives the insurer sufficient information to put a prudent insurer on notice that it needs to make further enquiries for the purpose of revealing those material circumstances.*" This formulation shifts some of the burden on to the insurer, by placing a greater emphasis on the insurer making enquiries.

[1] A copy of the Act is available at www.legislation.gov.uk/ukpga/2015/4/contents/enacted/data.htm. Explanatory Notes are at: www.publications.parliament.uk/pa/bills/cbill/2014-2015/0155/en/15155en.pdf.

To avoid the insured *"dumping"* overwhelming volumes of unstructured information on the insurer, the insured's presentation must be made *"in a manner which would be reasonably clear and accessible to a prudent insurer*."

Material circumstances

The Insurance Act explains that a *"material circumstance"* is (1) a special or unusual fact relating to the risk, (2) any particular concerns which led the insured to seek insurance cover for the risk, and (3) anything which those concerned with the class of insurance and field of activity in question would generally understand as being something that should be dealt with in a fair presentation of risks of the type in question.

Knowledge of insured

Where the insured is a company, the relevant knowledge of the insured will be that which is possessed by "*senior management*" (those individuals who play significant roles in decisions-making about how the insured's activities are to be managed or organized) and the persons who are responsible for the insured's insurance (likely to be the risk management department).

The insured will be deemed to know (and therefore be required to disclose) material circumstances which should have been revealed by a reasonable search of information available to the insured (whether such search is conducted by making enquiries or by other means). This largely codifies the extent of the search required under previous case law.

The insured's knowledge will not include information acquired by the insured's agent by means unconnected with the placement of the insurance.

Knowledge of insurer

Exceptions to the duty of disclosure will apply in relation to circumstances which diminish the risk, which are already known to the insurer, or where the insurer waives the requirement for information.

Warranties

The effect of breach of a warranty in a contract of insurance is that the insurer is discharged from liability with effect from the date when the warranty was breached, regardless of whether the breach of warranty was material to any claim which subsequently arose. Warranties were therefore particularly perilous provisions for insureds.

Some policies contain *"basis of contract"* clauses, which convert all answers in the proposal form into warranties, which compounds the risk to policyholders. The Insurance Act will prohibit "*basis of contract*" clauses. Contracting out of that prohibition will be prohibited.

The Insurance Act will seek to create greater balance between insureds' and insurers' interests, by providing that the insurer's liability is merely suspended, rather than discharged, in the event of breach of warranty – so the insurer will remain liable for any valid claims which arise after a breach has been remedied. Further, the Insurance Act will provide that non-compliance with a warranty or other term relating to a particular type of loss should not allow the insurer to escape liability for a different type of loss, on which the non-compliance could have had no effect.

Warranties will, however, include somewhat perilous provisions for insureds because the Insurance Act will not exclude liability for losses occurring while a warranty is breached (and unremedied).

Insurers' remedies

Failure to make a fair presentation

Currently, if the insured makes a material non-disclosure or misrepresentation which induces the insurer to enter into the contract, the insurer has available to it the extreme remedy of avoidance *ab initio*: in other words, the insurer can treat the policy as if it had never existed.

The Insurance Act will replace that remedy with various more proportionate remedies for breach of the duty to make a fair presentation.

If the insured's failure to make a fair presentation (whether that failure was a misrepresentation or a non-disclosure) was deliberate or reckless, then the insurer will still be entitled to avoid the policy.

In all other situations, the Insurance Act aims to put the parties in the position in which they would have been had the insured made a fair presentation. So:

- If the insurer can prove (subjectively, on balance of probabilities) that it would have declined the risk if a fair presentation had been made, then the insurer will be entitled to avoid the policy;

- If the insurer would have accepted the risk, but with additional terms imposed, then the contract should be treated as if it included such terms (regardless of whether the insured would in fact have accepted those additional terms); or

- If the insurer had demanded additional premium, then any claims should have been scaled down proportionately, to reflect the difference between the premium actually paid and the premium which ought to have been paid if a fair presentation of the risks was made.

Fraudulent claims

If the insured makes a fraudulent claim, the insurer is not liable to pay the claim (and may recover from the insured any sums already paid in respect of the claim).

The insurer may also give notice to terminate the contract with effect from the time of the fraudulent act. If the insurer treats the contract as having been terminated, it may refuse all liability to the insured under the contract in respect of a relevant event occurring after the time of the fraudulent act, and it need not return any of the premiums paid under the contract (but it remains liable for legitimate claims which predate the fraud).

In relation to the effect of fraudulent claims on group policies, the Insurance Act provides some mitigation. Where a fraudulent claim is made by a (non-party) beneficiary of the policy, the insurer will be entitled to treat cover as terminated (from the time of the fraudulent act) only in respect of the fraudulent beneficiary; any innocent beneficiaries remain covered.

Contracting out of the Insurance Act

Insofar as it will apply to consumer insurance contracts, the Insurance Act will prohibit insurers from using any contractual term which reduces the protections provided by that statute.

For business insurance, the Insurance Act will be merely a default regime which (apart from the prohibition on "*basis of contract*" clauses) the parties may contract out. However, to be effective transparency is required in relation to any term which would put the insured in a worse position as respects any of the Insurance Act's default provisions.

Specifically, the insurer will be required to take sufficient steps to draw the disadvantageous term to the insured's (or its agent's) attention before the contract (or variation) is entered into force. In addition, the disadvantageous term must be clear and unambiguous as to its effect. In determining whether these requirements have been met, the characteristics of insured persons of the kind in question, and the circumstances of the transaction, are to be taken into account. A short-form clause dis-applying the Insurance Act generally will not suffice as insurers will be required separately to identify and clearly explain each opt-out from the Insurance Act.

Conclusion

Historically, English insurance law has given insurers considerable protections for situations where insureds did not give satisfactory disclosure of the risks or breached warranties. The Insurance Act will substantially reduce these special protections afforded to the insurance industry.

The Insurance Act will not come into force for another year. In the interim, insurers should consider how the statute could affect them and whether their business processes should be modified. As an example, it may be appropriate for insurers to be more proactive in asking questions at the disclosure stage. Many insurers will wish to consider whether they should contract out of the Insurance Act default provisions, and if so, how any arrangements to contract out can be made effective.

The default protections of the Insurance Act may be doubly unfavourable to reinsurers, because they will have the effect of reducing defences available to insurers in respect of insurance claims by their insureds, as well as the defences available to reinsurers in respect of reinsurance claims by their cedants. Reinsurers may therefore have a particular interest in contracting out of the default provisions.