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Structuring multinational insurance programmes: addressing the current challenges in Europe

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focus on:

Structuring multinational insurance programmes: addressing the current challenges in Europe

By Suresh Krishnan and Denis Whelan

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Overview

There is a continuing debate in the insurance and reinsurance industry about how to effectively provide seamless insurance to multinational clients across national borders. Outside of the European Union, insurance is generally regulated at the national and, in some jurisdictions, at the state or provincial level, which causes multinational enterprises, multinational insurers and producers to navigate a complex regulatory and tax landscape. Within the European Union, a series of Directives[1] have created the freedom of establishment and provision of services regimes (also known as "passporting" regimes), which allow insurers to carry on business and insure risks throughout the EU, subject to authorisation by the regulator of their domicile. Efforts are also underway to harmonise additional areas of insurance regulation, such as solvency margins and the regulation of control and management. These efforts should facilitate more expansive freedom of trade between and among European Union member countries.[2] "Insurers, insureds and brokers conducting business within the EU," stated Ashley Prebble, a partner in the London office of Norton Rose who advises on cross-border financial transactions, "have, generally speaking, a uniform set of regulations, which provide certainty and clarity with respect to structuring and implementing a cross-border multinational insurance programme where an insured has property or exposure in the EU. However, when it comes to providing insurance for risks outside the EU," Mr. Prebble adds, "insureds, insurers and brokers need to consider the insurance laws and tax rules of those countries outside the EU and how such countries would view an EU domiciled insurer assuming risks in such countries."

Multinational companies demand insurance programmes covering their foreign subsidiaries, affiliates, and joint ventures for several reasons, including: (i) the parent company's ability to assure consistent amounts and types of coverage and risk transfer terms worldwide; (ii) the parent company's ability to control the type and scope of coverage, rather than leaving these decisions to the discretion of managers of their local subsidiaries, and joint ventures, who may not be knowledgeable about commercial insurance, nor able to assure that the insurance purchased achieves corporate risk management objectives; (iii) the parent company's ability to use its buying power to obtain favourable risk transfer terms and pricing; and (iv) the parent company's ability to obtain consolidated loss information about each of its subsidiaries, affiliates, and joint ventures.

However, because of increased regulatory and tax scrutiny, the design and implementation of such a master policy may not be the best approach to a robust multinational programme in countries that prohibit non-admitted insurance covering risks in those jurisdictions. "In the past, insurance and tax regulators in many countries did not have a comprehensive understanding of how their citizens purchased insurance or transferred risk – nor, for that matter, did they actively enforce the existing laws governing such conduct" stated Mr. Prebble. "The *Kvaerner* case[3] and reported inquiries subsequently made by tax regulators in Europe and North America," he added "highlight the interest in revenue generated from premium taxes and other parafiscal charges. Routine audits of insureds in these countries and other countries and an understanding of how global multinational programmes are currently structured will make the availability of this revenue apparent."

A defensible solution under English law

Simplifying the master policy and its "broad-form" coverage is an important and prudent first step in designing a global programme that may withstand international regulatory and tax scrutiny. There are potential solutions that address the insurance demands of multinational enterprises while mitigating the emerging risks to insureds, producers, and insurers implicated by "broad-form" named insured master policies.

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These audits may reveal that, although a portion of the total master policy premium has been allocated to the subsidiary, neither the subsidiary nor the parent has remitted the appropriate taxes to the revenue authorities of the subsidiary's domicile. In *Kvaerner*, the audits uncovered no evidence of the master policy purchased by the parent on behalf of the subsidiaries in the subsidiaries' files[4]. However, the fact that the master policy may not have been delivered in the foreign jurisdiction did not affect the ultimate liability of the subsidiary. "Today," Mr. Prebble added, "based on cases such as *Kvaerner* and from cases adjudicated in continental Europe and the United Kingdom,[5] assumptions underlying this single "broad-form" master policy have come into question and may now be subject to challenge."

In light of these recent regulatory developments, the use of a master policy with a "broad-form" named insured clause should be carefully scrutinised. Although the "broad-form" master policy was historically designed to eliminate gaps in coverage provided under local policies insuring subsidiaries, affiliates, and joint ventures of multinational companies, this structure appears to no longer satisfy its original objective. Nevertheless, the "broad-form" master policy continues as the primary mechanism for providing insurance coverage to large multinational enterprises. Today, because of the increased regulatory scrutiny of non-admitted insurance, a closer analysis of the international regulatory landscape is necessary to ensure that regulatory and tax risks are not inadvertently assumed by insureds, producers and insurers and that the various participants understand their respective obligations to comply with local insurance and tax laws in the various jurisdictions implicated by the programme.

According to Mr. Prebble, "removing any of a parent company's subsidiaries, affiliates, and joint ventures located in jurisdictions that do not allow non-admitted insurance as additional insureds will significantly reduce the risk that a non-admitted insurer under a master policy will be deemed to be conducting business in those jurisdictions. In addition, under English law, the master policy could insure the parent company's financial interest in such excluded subsidiaries, affiliates, and joint ventures." Moreover, in the United Kingdom, the parent may obtain financial loss insurance, which is a form of liability insurance that could cover the parent's financial interest in such excluded subsidiaries, affiliates, and joint ventures.

This solution, based on how English law views "insurable interest," provides coverage and terms that are substantially similar to current "broad-form" master policies while mitigating the risk of being deemed to constitute transacting unauthorised insurance business. In particular, such a master policy covers the parent's financial or economic interest (through its shareholding or other type of ownership interest) in its subsidiaries, affiliates and joint ventures, rather than insuring such entities directly. Furthermore, under the master policy, the parent's financial loss may be measured by ference to the subsidiaries', affiliates' and joint ventures' actual losses - essentially, a form of "agreed value" policy.

In addition to directly insuring the parent company and its subsidiaries, affiliates, and joint ventures located in jurisdictions that permit non-admitted insurance under the master policy, local policies issued by locally-admitted insurers must be issued to any subsidiaries, affiliates, and joint ventures in jurisdictions that mandate particular coverages or where otherwise required by the local entity. A local insurer will underwrite and issue the local policy complying with the local insurance laws and calculate and remit the applicable taxes and fees in connection with such local polices. Claims arising out of such local policies will be adjusted and paid locally.

This solution provides structural protections for insurers, producers and multinational enterprises against issuing, soliciting and procuring insurance, as the case may be, in jurisdictions that prohibit non-admitted insurance and related premium tax liability in such jurisdictions. In particular, all premiums in respect of the master policy could be allocated to the parent in the United Kingdom and premiums on permitted local policies could be allocated to the appropriate subsidiaries, affiliates and joint ventures in jurisdictions that permit non-admitted insurance. In addition, because this solution clearly identifies the jurisdictions in which the insurance is being provided, the amount and allocation of premium taxes and other parafiscal charges among the insurer, the producer and the insureds is more easily identified. Moreover, any losses under the master policy could be paid to the parent in the United Kingdom. Thus, under such a master policy programme, unless a jurisdiction permits non-admitted insurance and unless all conditions to provide such non-admitted insurance are met, no premiums would be allocated to subsidiaries, affiliates and joint ventures, and no claims would be paid to subsidiaries, affiliates and joint ventures in countries that disallow non-admitted insurance.

The solution is perhaps best illustrated by an example.

Assume that a multinational group, which is headquartered in the UK, has subsidiaries, affiliates and joint ventures throughout the world. The parent company obtains a master property policy that is issued by a UK-authorised insurer, which provides Difference in Conditions and Difference in Limits (DIC/DIL) coverage and includes the parent, its subsidiaries, affiliates and joint ventures as named insureds. The DIC/DIL policy is in excess of and in addition to the UK insurer's affiliated insurance companies issuing local policies to the subsidiaries, affiliates and joint ventures in jurisdictions in which such insurance is either mandated or requested by the parent.

However, one of the subsidiaries, which is also insured under a local policy covering 50% of its losses, conducts its operations in a jurisdiction that prohibits non-admitted insurance. Consequently, depending on the applicable jurisdiction, the UK insurer, the producer in connection with the master policy and, in some cases, the subsidiary, could be subject to significant civil and criminal penalties in those jurisdictions that prohibits non-admitted insurance. Moreover, in jurisdictions like Russia and France, the coverage afforded to the subsidiary by the master policy could be deemed void and unenforceable and any claims paid could be confiscated.[6]

If the subsidiary suffers a loss (e.g., as a result of a fire at one of its factories), the local policy would cover 50% of the loss and the parent and the subsidiary would expect that the remainder of the loss would be covered under the master property policy. However, as a consequence of failing to structure the master policy compliantly, the insurance provided under the master policy to the subsidiary may be illegal and unenforceable, leaving the subsidiary without the benefit of coverage and subjecting the UK insurer, the producer of the master policy and the subsidiary to potential civil and criminal sanctions.

Because most countries prohibit or strictly limit non-admitted insurance, the example above does not merely illustrate an isolated risk.[7] "However, an alternative approach," according to Mr. Prebble, "is to name the UK parent under the master policy and cover the losses *incurred by the UK parent*, not the loss of its subsidiaries, affiliates or joint ventures, as a result of its investments in its subsidiaries, affiliates or joint ventures. Appropriate DIC/DIL wordings would still be used to address local policy coverage." Under this approach, it is necessary to determine whether the parent has the necessary insurable interest to support the coverage and the method in which the parent's losses will be calculated.

The insurable interest requirement

Under English law, the policyholder must have a sufficient interest in the subject matter of the insurance to support a valid and enforceable policy. Thus, in general, a policyholder must gain a benefit from the preservation of the subject matter of the insurance or suffer a disadvantage should it be lost. Because, under English law, a parent company does not have an insurable interest in the assets of its subsidiaries, affiliates and joint ventures, it cannot procure a policy that directly covers such property.[8] However, it is generally accepted that a parent company does have an insurable interest in its financial interest in its subsidiaries, affiliates and joint ventures. "Similarly, under German law," commented Susanne Ullrich, a partner in the Frankfurt office of Norton Rose, "the financial interest of a parent company in its subsidiaries constitutes a financial interest and can therefore be the subject matter of the insurance. The master policy can then be structured in the same way as under English law."

Calculating financial interest

Because the master policy indemnifies the parent for losses to its financial interest in its subsidiaries, affiliates and joint ventures caused by property damage and liabilities suffered by such entities, it is essential to clearly define the parent's financial interest and the mechanism by which its subsidiaries', affiliates' and joint ventures' property damage and liabilities will be determined. In general, under English law, the parent's ownership and financial interest in its subsidiaries, affiliates and joint ventures, as well as any legal or contractual obligations of the parent to procure insurance covering such entities' losses may dictate how such losses may be calculated and indemnified. In many jurisdictions, including the United Kingdom, an "agreed value" approach, in which the issuer of the master policy and the parent agree in advance on the value of the parent's financial interest in its subsidiaries', affiliates' and joint ventures' losses, to calculate losses should be legally enforceable.[9]

"It is critical that the parent company is effectively indemnified to the extent contemplated by the parties under the master policy for losses to its financial interest caused by covered losses suffered by its subsidiaries, affiliates and joint ventures in jurisdictions that prohibit non-admitted insurance."

It is critical that the parent company is effectively indemnified to the extent contemplated by the parties under the master policy for losses to its financial interest caused by covered losses suffered by its subsidiaries, affiliates and joint ventures in jurisdictions that prohibit non-admitted insurance. To the extent that non-admitted insurance is not permitted, the parent's losses may be measured as the product of the parent's financial interest in its subsidiaries, affiliates and joint ventures and such entities' losses, which may be pre-determined using the "agreed value" approach. Under this structure, the parent will be indemnified for its own losses, not the losses of its subsidiaries, affiliates and joint ventures and the parent may elect to reimburse its subsidiaries, affiliates and joint ventures for such amounts.

Similar to the United Kingdom, under the laws of other major European jurisdictions, including Denmark, France, Germany, Italy, Spain, Sweden and Switzerland, a parent may procure insurance covering its financial interest in its subsidiaries, affiliates and joint ventures. For example, "it is reasonable and defensible under French law ", according to Jerome da Ros, Of Counsel in the Paris office at Norton Rose, "for an Insurer to pay the parent company an agreed value for its loss to its financial interest in a subsidiary or joint venture. This loss can be determined by reference to, for example, damage to a property owned by one of its overseas subsidiaries." However, any assumptions attributing one hundred percent of all losses suffered by a subsidiary, affiliate or joint venture to the indemnity provided to the parent for such losses should be carefully evaluated on a country by country basis and based on the extent of the parent's ownership interest or legal or contractual obligations in connection with its subsidiaries, affiliates and joint ventures.

By insuring the parent company under the master policy and not its subsidiaries, affiliates and joint ventures in jurisdictions that prohibit non-admitted insurance, this structure significantly reduces the risks to insureds, producers and insurers associated with non-compliant, unlicensed insurance. Thus, this multinational solution lends itself to widespread application in the major European domiciles in which large multinational groups are concentrated.

Conclusions

Clearly, multinational policies are crucial for international groups - a way to ensure group-wide coverage where the group is operating in many jurisdictions. Yet for the insured, broker and insurer, the jurisdictional spread embedded in these programmes introduces increased regulatory and fiscal risk. The proposed solution keeps multinational policies straight-forward, transparent and marketable while ensuring that the parties are not inadvertently brought onshore in a country that disallows non-admitted insurance for tax and regulatory purposes.

"If designed and administered along the lines outlined in this paper," Mr. Prebble added, "this reformed master policy provides a reasonable and prudent approach to purchasing and selling multinational insurance and should withstand legal challenges under English law and under the laws of a number of European countries with respect to providing unauthorised insurance, allocation of premium, and payment of applicable taxes and fees."

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Notes:

1 See Council Directive 2005/68/EC, 2005 O.J. (L 323) 1 (concerning reinsurance); Council Directive 2002/13/EC, 2002 O.J. (L 77) 17 (concerning solvency margin requirements for non-life insurance undertakings); Council Directive 2002/83/EC, 2002 O.J. (L 345) 1 (concerning life assurance); Council Directive 2002/13/EC, 2002 O.J. (L 77) 17 (concerning solvency margin requirements for non-life insurance undertakings); Council Directive 2001/17/EC, 2001 O.J. (L 110) 17 (concerning the reorganization and winding-up of insurance undertakings); Council Directive 91/674, 1991 O.J. (L 374) 7 (concerning the annual accounts and consolidated accounts of insurance undertakings); Council Directive 73/239/EEC, 1973 O.J. (L 228) 3 (concerning the taking-up and pursuit of the business of direct insurance other than life assurance); Council Directive 73/240/EEC, 1973 O.J. (L 228) 20 (abolishing restrictions on freedom of establishment in the business of direct insurance other than life assurance).

2 Amended Commission Proposal for a Directive of the European Parliament and of the Council on the Taking-up and Pursuit of the Business of Insurance and Reinsurance, 2008 O.J. (COM) 119 available at http://ec.europa.eu/internal_market/insurance/docs/solvency/proposal_en.pdf (last visited 27 May 2010).

3 Case C-191/99, Kvaerner plc v Staatssecretaris van Financiën, 2001 E.C.R. I-4447, [2001] STC 1007. In this case, Kvaerner plc, a UK company, purchased professional indemnity insurance, worldwide umbrella insurance and worldwide catastrophe insurance from a UK insurer. The insurance policies provided that the named insured is "Kvaerner plc and/or its subsidiaries and/or associated companies as instructed by the policyholder" and Kvaerner plc included its Dutch subsidiary in the cover. The Netherlands tax authorities brought an action against Kvaerner plc to collect premium taxes in connection with the coverage. The European Court of Justice ruled that a European member state may charge insurance premium tax on a premium relating to the insurance of a subsidiary company established in that state. The court concluded that the tax is owed regardless of whether an intra-company payment of pro-rated premium is made.

4 One reason for the subsidiary not having the master policy in its files is because the policy was issued in the parent's domicile, with a "broad-form" named insured that included the subsidiary as an additional insured. It was, and is, customary for the foreign named insured not to receive copies of the master policy, because the insurer underwriting the master policy will typically not be licensed in the country of the foreign named insured.

5 DSG Int'l Ins. Services Ltd. v HMRC (2007) IPT 0013 (DSG). In this case, DSG International Insurance Services ("DSG"), an Isle of Man company, provided insurance to another Isle of Man company, ASL Serviceplan Limited ("ASL"), which in turn sold service contracts to a UK retailer's customers covering products that the customers purchased. The policy indemnified ASL against claims being made by the UK retailer's customers in the UK. HM Revenue and Customs attempted to collect premium taxes from DSG. The UK's VAT and Duties Tribunal applied the precedent established by Kvaerner regarding the location of the risk and held that it would be necessary to ascertain the location of the activities covered by the policy.

6 Under Article 14.1 of the Administrative Code of the Russian Federation, the conduct of an insurance business in the Russian Federation without the necessary license may expose the insurer to administrative sanctions in the form of monetary fines (up to RUB 50,000) or the "confiscation of the manufactured product, equipment and raw materials." Moreover, pursuant to Article 171 of the Criminal Code of the Russian Federation, the individuals involved in the conduct of such unlicensed activity may be subject to criminal sanctions. In addition, the policy may be invalidated by a court upon the claim of the insurer itself, a shareholder of the insurer or the Federal Service for Insurance Supervision, provided that it is proved that the insured knew or should have known that the insurer was conducting such business without a license. The effect of such voidance is that the insurer will be ordered to return to the insured any premiums paid in respect of the policy and the insured will be ordered to return to the insurer any claims payments made by the insurer.

The French Insurance Code does not specifically prohibit a non-admitted insurer from paying a claim on a French policy. However, the making of such payment (a principal element of an insurance policy) risks that French regulatory authorities and courts will label it the unauthorised practice of regulated insurance activities in France (Art. L. 310-2 III). Moreover, the violation of Art. L. 310-10 and L. 310-2 of the Code may constitute a criminal offense. However, insurance policies issued by non-admitted insurers are enforceable in France to the extent that the insured acquires the policy in good faith. Consequently, according to Art. L. 113-5 of the Code, the insurer may, nevertheless, be held responsible for performance under the policy. However, an insured that knowingly purchases a policy from a non-admitted insurer covering a French risk assumes the risk of not having enforceable coverage and the insurer assumes the risk of incurring criminal and civil penalties.

7 Major countries whose regulatory regimes take a dim view of non-admitted insurance include Argentina, Brazil, France (outside of the EU), India, Italy (outside of the EU), the People's Republic of China and Russia, along with many others. However, certain other jurisdictions, including Canada, the United Kingdom, Hong Kong and Singapore, broadly permit unauthorised insurers to assume local risks. Other jurisdictions have hybrid regulatory regimes that allow some local risks to be assumed by unauthorised insurers, while subjecting such transactions to regulatory oversight and imposing taxes. In the United States, for example, the insurance laws of every state and territory and the District of Columbia prohibit the conduct of an unauthorised insurance business and provide certain exceptions and exemptions to conducting non-admitted business. Similarly, Australia generally prohibits non-admitted insurance, but provides exceptions that include insurance sold to "high-valued insureds" and insurance covering certain "atypical risks."

8 See Macaura v Northern Assurance Company Limited, [1925] App. Cas. 619 (H.L. 1925). In contrast, in the United States, the generally-accepted principal is that a parent, as a shareholder in a company, has an insurable interest in the company's properties and liabilities to the extent that a parent would suffer a substantial pecuniary loss as a result of damage to such property or the company's incurrence of such liability, which, in most cases, is measured by a parent's equity interest. Jam Inc. v. Nautilus Ins. Co., 128 S.W.3d 879 (Mo. App. Ct. 2004); Riggs v. Comm. Mut. Ins. Co., 125 N.Y. 7 (N.Y. 1890); Miller v. Stuyvesant Ins. Co., 223 App. Div. 6 (N.Y. App. Div. 1st Dept. 1928); Thompson v. Trinity Universal Ins. Co., 708 S.W.2d 45 (Tex. App. 1986).

9 Spanish Insurance Agreement Act, Act 50/1980; Swedish Insurance Contract Act, 2006, Chapter 6, section 1; In Germany, Strnad HAVE/REAS 2007, 345 ssq, Armbruster, VerR 2008, 853 ssq, Lagheid/Grohe, VW 2008, 1510 ssq, Mazenauer, VW 2008, 19 ssq, Laupicher, VW 2008, 914 ssq, Lagheid/Grohe, 630 ssq; French Insurance Code Arts 121, 1964.

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