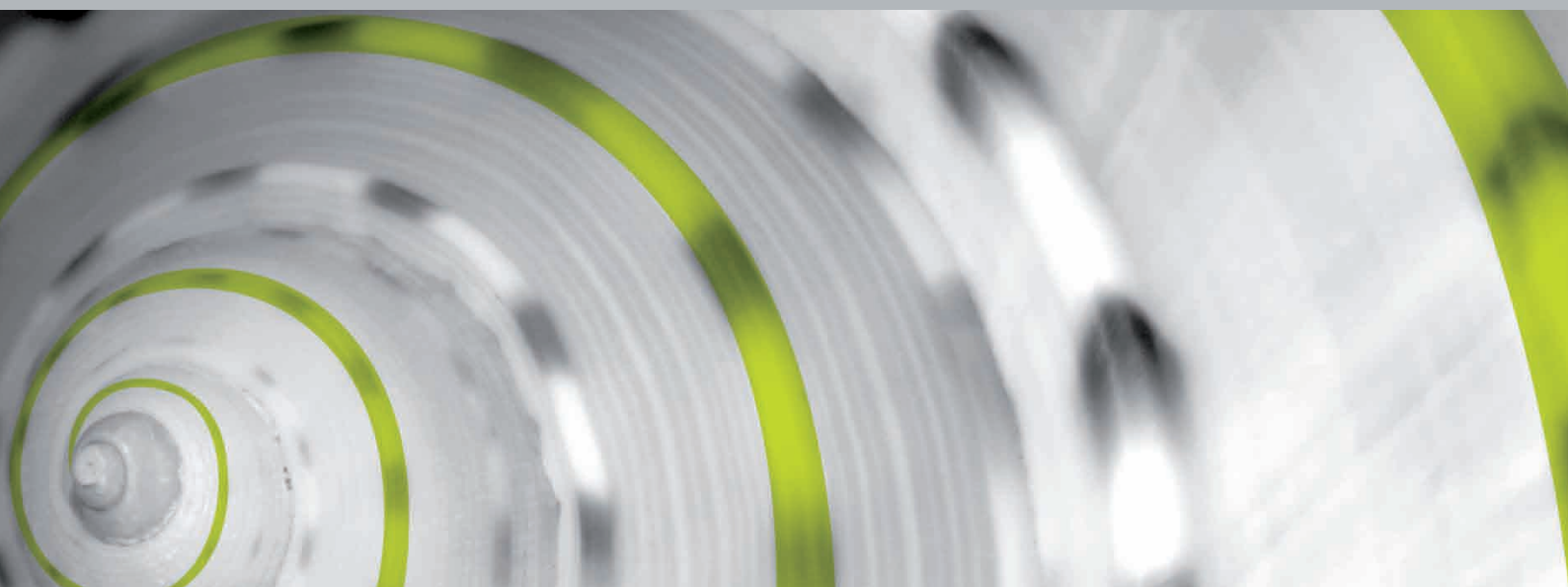


CLAYTON UTZ

Insurance and Reinsurance  
Review 2006



# Insurance and Reinsurance Review 2006

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Written by members of the Clayton Utz Insurance & Risk team.

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# Introduction

As we cast an eye back over 2006, what strikes us is not any dramatic change. Instead, we notice the gradual, the evolutionary, changes. Even where new prudential standards have been introduced, they're not radically different to those that came before.

This is not all that surprising. Australia's mature insurance industry and regulatory systems need no major overhaul, merely refinement and tweaking in response to industry developments. Our review of 2006 identifies the most important of these responses and their implications for your business.

That's not to say that there are no big changes ahead. The Government is still pushing through major amendments to the *Insurance Contracts Act*, and the regulation of direct offshore foreign insurers will also be reformed. Nonetheless, we're confident that Australia's insurance industry will adapt to them with its usual minimum of fuss.

# Solvent run-off scheme a first for Australia

Although widely used in the UK, solvent schemes for reinsurance run-off are only now being adopted in Australia.

NRG's solvent run-off scheme, approved by the Federal Court in August 2006, is an Australian first.

Under the scheme, which applies to reinsurance written by NRG's Australian wing, cedents will be able to achieve immediate settlement of both existing and future claims. Paying out the policies will allow NRG to close its Australian reinsurance run-off book.

This is the first time that Australian reinsurance liabilities have been subject to a solvent run-off scheme. This development clears the way for schemes by other solvent reinsurers whose Australian business is in run-off.

It is important to note that the NRG scheme related to reinsurance policies. There is probably still some work to be done before (if ever) a run-off scheme would be allowed for direct insurance policies.

Clayton Utz acted for NRG. We also acted for MMIA, in putting together Australia's first solvent run-off scheme (involving overseas liabilities) in 2002.

## Background

The *Corporations Act* 2001 allows a company to enter into a scheme of arrangement with its creditors. If the scheme is approved by 75 percent in value of the creditors and by a court, it will bind both the company and all creditors.

In the case of a run-off scheme, the cedents are the creditors of the reinsurer.

A scheme usually involves a compromise between the company and the creditors.

In the case of an insurance company run-off scheme, that compromise takes the form of a process under which all existing and future claims are settled by an estimation and adjudication process. The benefit for the insurer is that the scheme effectively terminates its future liabilities under the policies that are subject to the scheme. For their part, the policyholders get the benefit of an immediate payout of future claims under their policies.

There have been a considerable number of solvent run-off schemes (ie. where the insurer is solvent) in the UK in recent years. To date, this has not been reflected in Australia, in part because we do not have a run-off industry remotely comparable to that in the UK (where the size of non-life run-off liabilities is over £35 billion). Another issue is the attitude of APRA, which has concerns about the effect of a run-off scheme on direct insurance holders.

For that reason, the NRG scheme is a real breakthrough for the Australian insurance industry.

## The NRG scheme

NRG wrote reinsurance in Australia and overseas. That reinsurance business had been in run-off since 1993.

It proposed a scheme of arrangement under which cedents would be paid a sum in final settlement of current and future claims under their reinsurance policies. If the scheme were approved, cedents would be invited to submit their claims to NRG within 120 days of the scheme's becoming effective.

The scheme documentation set out a detailed procedure governing how claims would be evaluated by NRG; it included provision for adjudication if NRG and a cedent could not agree on the valuation of a claim.

The scheme would be governed by section 411 of the *Corporations Act*. As mentioned above, this allows a company to enter into a binding compromise with its creditors. If the scheme achieves the required majority vote from the creditors and the approval of the court, it binds all creditors whether or not they voted in favour of it.

The formal timetable for a run-off scheme is:

- submission of the scheme to APRA and ASIC, to allow them to determine whether to oppose the scheme
- an application to the court for an order for a meeting of the cedents
- the cedents meet and vote on the scheme – the required majority is 50.1 percent by number of the cedents who vote, representing 75 percent in value of the claims against the reinsurer
- an application to the court for an order approving the scheme
- lodgement of the court order with ASIC.

The NRG cedents met on 15 August and approved the scheme by the necessary majority. The Federal Court approved the scheme the following day. That court approval was immediately filed with ASIC, bringing the scheme to life and initiating the 15 day window for NRG to contact cedents and to invite them to lodge claims.

### Why a solvent run-off scheme?

A solvent run-off scheme can be advantageous for both cedents and their reinsurer.

For cedents, the benefits are both short- and long-term.

The short-term benefit is the immediate receipt of cash in respect of claims that may lie many years into the future (if at all). In the case of the NRG scheme, that benefit was compounded by the fact that there will be no discount for early payment in respect of claims that are projected to settle within the next five years. Longer term, cedents would be relieved of a solvency risk attaching to the reinsurer.

The benefit for the reinsurer is that the anticipated closure date of its run-off reinsurance book can be reduced from decades to months. This provides two benefits for the reinsurer (and its owners):

- administration costs can be dramatically reduced
- after settling all claims under the scheme, the reinsurer can return surplus capital to its investors, rather than having it tied up in a prudential reserve.

Although there are benefits all around, it must be remembered that a run-off scheme is still a compromise for both cedents and reinsurers. The industry regulator, APRA, will oversee schemes, and expects to be consulted at all stages of the process.

Based on our experience in talking with APRA about the NRG scheme, we would believe that the regulator would require that any run-off business proposed for a scheme should be quite mature (ie. the business should have been in run-off for at least 10 years). That sort of track record would provide a high degree of certainty about the expected liabilities of the business, thus improving the reliability of the settlement process proposed under the scheme.

Another factor which APRA will look at is the type of insurance covered by the scheme. Cedents can generally be expected to be experienced insurance industry players, who are capable of evaluating the pros and cons of a run-off scheme. However, at this stage, it is unlikely that general insurance policyholders would be considered suitable candidates for a scheme.

# Corporate governance for ADIs and insurers – Are you already complying?

From 1 October 2006, life insurers, general insurers, and authorised deposit-taking institutions (ADIs) had to comply with APRA's new prudential standards on corporate governance. While there has been some concern in the press about the new obligations, in essence they capture what most institutions already do.

In this article we sketch out the main features of the new prudential standards. It's important to remember, however, that these new rules must be read with other finalised prudential standards.

## What has been removed from the draft version?

- The Principles section
- the requirement that at least one independent director on the board must have financial expertise
- the provisions dealing with situations where the board of the insurer is not to act in the interests of another member of the corporate group; the oversight by the board of subsidiary entities; and situations where group policies are utilised by the insurer
- general requirements in relation to the board setting up committees and how these should be managed
- the requirement that a copy of the declarations obtained from the auditor, indicating that they are in fact independent, be provided to APRA has been removed
- the risk management section and provisions dealing with information on directors to be provided to APRA (these are covered by separate prudential standards).

## Who sits on a board?

Boards must contain a minimum of five directors, and a majority must at all times be independent directors (see below for an explanation). This includes directors present and eligible to vote at Board meetings. A majority of directors must also be ordinarily resident in Australia.

## The skills mix

The new prudential standard requires that collectively the board and senior management "have the full range of skills needed for the effective and prudent operation of the regulated institution, and that each director has skills that allow them to make an effective contribution to Board deliberations and processes." That includes directors' knowledge and understanding of legal and prudential obligations. The list of specific skills in the draft version has however been removed.

## Independent directors

An independent director is defined as:

- a non-executive director (ie. someone who is not a member of management)
- who is free from any business or other association that could materially interfere with the exercise of their independent judgment.

Furthermore, "in assessing whether a director is independent, the Board must apply the definition of independence set out in the ASX Corporate Governance Council's Principles of Good Corporate Governance and Best Practice Recommendations."

"Business or other" associations include, but are not limited to, those arising out of a substantial shareholding, involvement in past management or as a supplier, customer or adviser. As a result, many current boards may not have the right number of independent directors.

## Reviewing performance

The Board's performance as a whole, and also that of individual directors, must be assessed annually. This requires setting Board objectives (such as establishing the overall strategy for the regulated institution, assessing operating and financial conditions against forecasts, or making key decisions in a timely manner) against which performance can be assessed. For individual directors, APRA suggests objectives such as demonstrated expertise, or attendance and participation at Board meetings.

# The arbitration clause in my reinsurance treaty will work, won't it?

Arbitration clauses in reinsurance treaties don't bind non-life reinsureds in NSW, meaning that disputes between reinsureds and reinsurers are more likely to end up in the courts. The NSW Supreme Court's decision in *HIH Casualty & General Insurance Limited (in liquidation) v Wallace* [2006] NSWSC 1150 could also affect reinsureds in other States.

## Arbitration clauses and insureds and reinsureds in NSW

The liquidator of HIH wanted to sue Lloyd's Syndicate 683 to recover under policies of reinsurance. Syndicate 683 asked Justice Einstein in the NSW Supreme Court to stay the proceedings, arguing that the policies of reinsurance said that the parties had to go to arbitration instead of court.

Section 19 of the *Insurance Act 1902* (NSW) says that arbitration clauses (either in a contract of insurance or other contract or agreement) do not bind the insured unless the dispute has already arisen and they agree at that stage to go to arbitration.

HIH argued that it was an insured and thus was not bound by the arbitration clause. Syndicate 683 on the other hand said first that section 19 doesn't apply to reinsureds, only insureds, and anyway the Commonwealth's *International Arbitration Act 1974* overrode the State Act and made the arbitration clause binding.

Justice Einstein said that section 19 covers insureds and reinsureds alike. He then held the *International Arbitration Act* does not override the State Act; it applies only to arbitration agreements which are not "null and void, inoperative or incapable of being performed". Since section 19 of the State Act makes the arbitration clause non-binding on the insured, the arbitration clause is "inoperative" and the Commonwealth Act doesn't apply to it.

## Non-life reinsureds in other States

To fall under the *International Arbitration Act*, an arbitration agreement must be in writing. Very broadly, this means that the parties have signed the same piece of paper or there has been an exchange of letters or telegrams which contain assent to the terms.

Lloyd's syndicates have a process for negotiating slips and treaty wordings which involves "scratching" (completing information), stamping and processing the slips. Syndicate 683 could not locate signed policies for certain years, and asked Justice Einstein to infer from the usual Lloyd's process that they were signed. He said he could not infer this.

It is thus possible that other arbitration clauses for other reinsureds might not be in writing. This means that in States which do not have an equivalent of section 19, reinsureds might still be able to avoid arbitration because their clauses are not in writing. Of course, as of 1 January 2007, APRA required all reinsurance arrangements to be properly documented:

- two months after the arrangements have taken effect, the insurer must declare that the reinsurance has been fully placed and that it holds the final contract wording of the reinsurance arrangements as detailed in the Reinsurance Arrangements Statement previously lodged with APRA, or a detailed placing slip, a slip wording or cover note (conditions attach to the use of a placing slip or cover note)
- within six months of inception, the insurer would have to attest that it holds the final signed contracts relating to all its reinsurance arrangements.

## What does this mean for non-life reinsurers and reinsureds?

Although it's long been suspected that section 19 has this effect, this was the first decision which confirms it does.

The major result for non-life reinsurers is that they will have to review their dispute resolution processes as they can no longer automatically rely upon arbitration as an alternative to litigation. Reinsurance arbitration has frequently been very informal in this country and consequently fairly cheap; if litigation becomes the first option then dispute resolution costs will increase. Reinsurers should therefore look at their processes for handling disputes and see what incentives they can offer reinsureds to induce them to arbitration.

Reinsureds should first be aware that any arbitration clause is not necessarily effective in NSW. Outside of NSW, they should also be looking at their reinsurance treaties to see if there is in fact an arbitration clause that truly is an agreement in writing.

# Mediation – A rival to arbitration in reinsurance disputes?

Reinsurers must be fully informed about all aspects of the dispute resolution process before they choose to include clauses restricting a party to any particular means of dispute resolution.

It has been said that arbitration “antedates all the former legal systems”<sup>a</sup>. Originally used by merchants and traders in medieval times, arbitration’s growth in the last 15 years has hinged on the business community’s recognition that it provides a flexible and effective alternative to costly and time-consuming litigation. However, despite this, there is at times a perception that arbitration is increasingly imitating traditional court procedure, and recognition that the courts often recommend or require mediation prior to a court hearing<sup>b</sup>. As a result, business is increasingly opting for alternative means of dispute resolution such as mediation and expert determination.

## Insurance arbitration

An example of this is in the context of reinsurance. Arbitration is a common method of dispute resolution in the insurance industry, particularly in relation to reinsurance disputes. While the use of compulsory arbitration clauses in contracts of direct insurance is curtailed by section 43(1) of the *Insurance Contracts Act 1984* (Cth), this Act does not apply to reinsurance. As a result arbitration clauses, although rare in contracts of direct insurance, occur regularly in the context of reinsurance.

A compulsory arbitration clause in a reinsurance treaty generally stipulates at what stage of the dispute resolution process arbitration will become mandatory. For example, a clause may specify that if a dispute cannot be resolved by negotiation then it must be referred to arbitration. Compulsory arbitration clauses commonly stipulate

that arbitration must be conducted in accordance with, and subject to, the Institute of Arbitrators and Mediators’ Rules for the Conduct of Commercial Arbitrations or those rules set out by the United Nations Commission on International Trade Law (UNCITRAL). The arbitration clause also frequently sets out certain additional rules that must be followed such as what background and expertise arbitrators should have. An important aspect of many reinsurance treaty clauses is the rule that arbitrators may “dispense with judicial formality” and that arbitrators should have regard to customary practice in the insurance industry rather than strict legal interpretation of the terms of the agreement.

## Mediation and expert determination

Despite the popularity of arbitration clauses in reinsurance contracts, it is not uncommon in Australia for these to be replaced with clauses allowing for the resolution of disputes via other mechanisms of dispute resolution such as mediation or expert determination – or a clause allowing for resolution via arbitration only after other forms of alternative dispute resolution have failed. Which clause is used may depend on the cedent (ie. the insurer passing the risk to the reinsurer). Reinsurers will be more comfortable agreeing to a mediation clause with a sophisticated cedent, while preferring arbitration clauses with less sophisticated clients.

## Australian trends

In Australia, even in reinsurance arbitration clauses are not used as exclusively as in overseas jurisdictions. Approximately 70 percent of non-life reinsurance contracts contain arbitration clauses with a relatively high 30 percent containing mediation or expert determination clauses.

While this does not amount to a trend favouring mediation clauses over arbitration clauses, there is a definite, and peculiarly Australian, trend towards including both a mediation and arbitration clause in a contract of reinsurance. The reason for this, aside from the issue of arbitrations mirroring litigation, is that there is an apparent court preference for mediation and expert determination prior to a more formal arbitration or court hearing. This has led to reinsurers concluding that if a dispute is to end up in the court room and the court is to refer it to mediation or expert determination, such a clause should be included in the reinsurance contract from the outset so as to provide certainty as to the preferred process.

## Drawbacks associated with other forms of alternative dispute resolution

However, the move away from arbitration clauses should not occur without reinsurers being aware of the potential drawbacks associated with other forms of alternative dispute resolution. For example, in terms of mediation, George Golvan QC, from his experience, has outlined a number of pitfalls:

- the mediator must take control of the mediation process, including the time for mediation, location, what issues are raised in the dispute, and who will put the first offer on the table
- the failure of the mediator to listen to the issues raised by the parties to a dispute; and
- the refusal of parties to make further concessions in the negotiations<sup>c</sup>.

While an arbitrator has the ability to determine the dispute, a mediator's role is merely to encourage the parties to reach their own solution for the dispute.

In terms of expert determinations, an example of a drawback is with regard to procedural assistance. In respect of arbitrations, statutes typically provide for assistance by the courts where procedural difficulties arise. If the parties to an arbitration agreement cannot agree on the appointment of an arbitrator, or an arbitrator's impartiality is doubted, there are legislative procedures to help facilitate arbitration and ensure it stays on foot.

In contrast, if the expert determination process breaks down because, for example, the parties cannot decide upon the appointment of an expert, or if the agreement between the parties is incomplete as to a procedure necessary for the expert determination to be effective, then the agreement to use the expert determination may be unenforceable and therefore void. For this reason it is important that mechanisms are in place within the contract to enable a third party to decide upon a mediator or expert in the event that the parties cannot reach an agreement.

## Conclusion

Australian reinsurance contracts exhibit a proportionately higher use of mediation or expert determination clauses than their international counterparts. There is also a clear trend in this country, not seen elsewhere, towards including both mediation and arbitration clauses in the one reinsurance contract as the Australian courts have proven to be more likely to refer a dispute to mediation or expert determination.

In order to revert this trend back towards arbitration there may be a need for arbitration to be simplified through amendments to the Commercial Arbitration Acts. However, both mediation and expert determination possess their own issues. This highlights the need for reinsurers to be fully informed about all aspects of the dispute resolution process before they choose to include clauses restricting a party to any particular means of dispute resolution.

# What is an insurer's "liability in Australia"?

An insurer (or reinsurer) goes into liquidation in Australia. Do Australian insureds get priority in the distribution of the assets, or must they take their chances along with other creditors? This turns on what are an insurer's "liabilities in Australia". The High Court last year said that "liabilities in Australia" has a broad meaning, including all liabilities as defined under the *Insurance Act 1973* and those which the law would otherwise consider to have arisen, in the course of business, in Australia.

The decision in *AssetInsure Pty Limited v New Cap Reinsurance Corporation Limited (In Liq)* [2006] HCA 17 which was run as a test case not only clarifies what happens to creditors of collapsed insurers, but also potentially affects solvent insurers' capital adequacy requirements. It is a decision that APRA will be looking at very closely (Clayton Utz has been acting for the appellant).

## What is a "liability in Australia"?

When a general insurer goes into winding-up, section 116(3) of the Act says that its assets in Australia "shall not be applied in the discharge of its liabilities other than its liabilities in Australia unless it has no liabilities in Australia".

The key problem is the meaning of "liabilities in Australia" in section 116(3) of the Insurance Act. Before this case, everyone thought it included only those insurance liabilities described in the Act as having the requisite connection with Australia, but Justice Windeyer at first instance and then the NSW Court of Appeal surprised many by saying it went beyond that.

It gave "liabilities in Australia" a broad definition, meaning that

- insureds in Australia who satisfied the test set out in the Act would not get priority in the distribution of the assets, so more creditors would be fighting over the same pot of assets; and
- no-one knew what, if anything, this section actually does.

The High Court today held that the definition of "liabilities in Australia" under the Act is not an exhaustive definition of what might in fact be classified as a liability in Australia for the purposes of the Act.

Section 31(4) (now section 116A) says that if certain qualified conditions are satisfied, being various connectors with Australia, a liability under a contract of insurance is a liability in Australia, but, as the High Court pointed out, it does not mean that in no other circumstances will an insurance liability be a liability in Australia.

"Liabilities in Australia" in section 116(3) is not limited to liabilities under contracts of insurance, but covers all liabilities arising in the course of business in Australia. In this case, there was a liability undertaken by an Australian reinsurer which further reinsured (retroceded) certain risks overseas, which did not provide for satisfaction of any liability in any particular place and which did not meet any of the connecting factors with Australia set out in section 31(4) of the Act.

The High Court confirmed the decision of Justice Windeyer at first instance that, provided the liability satisfied the general law concerning the situs of the debt, then it did not matter that the liability did not satisfy section 31(4) of the Act.

### Reinsurance vs retrocession proceeds

Section 562A of the *Corporations Act* deals with the application of the proceeds of reinsurance contracts when a company is in liquidation.

The question is whether a “relevant contract of insurance” under section 562A includes a contract of reinsurance, such that the priority under that section then extends to the reinsurance of a contract of reinsurance (a retrocession contract), or is limited to reinsurance of direct insurance policies only. The High Court held that retrocession contracts are included, meaning that section 562A governs the redistribution of the proceeds of a retrocession contract as well.

### Implications for insurers

The High Court has clarified the meaning of “liabilities in Australia”. This decision might force a rethink of the drafting of the section and legislative reform if the Government considers that a more limited class of insureds in Australia, as defined in the Act, ought to have priority.

A more troubling issue is the status of insurers’ returns regarding capital adequacy requirements.

Insurers must tell APRA about their liabilities in Australia – this information is then used to determine the minimum capital requirements. For the last 30 years, insurers have complied with guidelines which have defined liabilities narrowly in line with section 116A of the *Insurance Act*, and before that section 31(4). The High Court noted that an insurer’s capital requirement is affected by the extent of all its liabilities, and this decision means that insurers may well need to seek advice regarding the manner in which their returns are being prepared. Likewise, APRA might now need to rethink its guidelines in the light of this decision, as insurers’ returns, made on one view of their “liabilities in Australia”, might now be in question.

### Footnotes

- a Pg 7: Wolaver, E. The Historical Background of Commercial Arbitration. 83 U. Pa. L. Rev. 133 1934-1935
- b Pg 7: Jones, D. Australian Domestic Commercial Arbitration. Paper presented at the Training in Arbitration Law and Practice Program University of Notre Dame 2005
- c Pg 8: Golvan, George H. QC. “Pitfalls in Mediation” (July 2001) The Arbitrator and Mediator 41

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