

# Captives and run-off – characteristics under German and Swiss law

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**This article scrutinises the question to what extent German and Swiss primary insurance and reinsurance portfolios can be shifted to a UK-based captive by means of a portfolio transfer. In the following, the article will outline the reasons for a practical need for such a portfolio transfer by presenting the instrument of the Solvent Scheme of Arrangement (in the following: "Solvent Scheme") in run-off scenarios. An attempt will thus be made to give a short overview of the relevant German and Swiss regulations concerning portfolio transfers in order to extrapolate the characteristics in law.**



## Need for run-off by means of a captive

An insurer that discontinues the underwriting of new business is said to be in run-off. Irrespective of the reasons for discontinuing the underwriting activity, the run-off of a business gives rise to obligations with regard to the administration of the existing portfolio. In theory, the run-off business continues until all insurance contracts are terminated.

The run-off might be related to the whole insurance company or only concern a branch/line of insurance or merely one insurance tariff. In many cases, run-off scenarios are chosen solely on grounds of missing profitability of an insurance line/tariff.

A 'passive' run-off (i.e., the insurer ceases its underwriting, while letting its remaining contracts expire by reaching their term) might last decades. What is more, during this entire period the insurer is obliged to bear the administrative costs and liabilities arising from the run-off business. In many cases, the loss ratio of such run-off portfolios is very high. This is due to the fact that the ongoing downsizing of the risks on grounds of expiry, cancellation or settlement brings a decreasing spread of risks.

On the other hand, the premium net income of run-off portfolios is very low which gives a strong incentive to the insurer to foreclose these inactive portfolios and to attend to its active business instead.

To sum up, the problems arising from a long-lasting passive run-off are well-known to insurers and give rise to their eagerness to considerably shorten the run-off period.

## Instruments to shorten the run-off

The closing of the portfolio can be achieved by different means such as commutation, portfolio transfer, debt collection or retrospective reinsurance, which are mostly not highlighted in this article.

These instruments – notwithstanding portfolio

transfer<sup>1</sup> – suffer from the flaw that they can be applied only if accepted by the insured. If but one insured person fails to agree another solution has to be found at least for the person in question.

Only by implementing a solvent scheme is it possible to achieve the shutting-down of the portfolio in its entirety with binding effect on all insured parties notwithstanding their individual disapproval.

## Solvent scheme under British law

Pursuant to the British Company Act 2006 Part 26, a solvent scheme is used for a so-called 'solvent liquidation' by way of a mandatory arrangement.

To summarise briefly: for the scheme to be approved, a majority of creditors (50% in number and 75% by value of those voting) must vote in favour of the scheme. In addition, the arrangement has to be approved by a competent British High Court. If the scheme is sanctioned by that court, the order of the court must be registered at the Office of the Registrar of Companies.

As a result, the solvent scheme brings about a commutation with all policyholders and allows a final distribution to be made to creditors. In addition, it compels policyholders to accept a one-time payment in return for excluding all future claims that might still arise from past policies.

For a solvent scheme to be implemented the British Company Act 2006 further requires that either the portfolio or a subsidiary company be located in the UK or that there be a substantial link to the UK.<sup>2</sup>

For the insurer, this procedure has the advantage that the entirety of active insurance contracts or rather the whole line of business in question is terminated. But even for creditors this might have a positive effect as they obtain direct payments. Furthermore, they are released from the risk that the insurer might become insolvent in the future.

However, the applicability of solvent schemes for

German and Swiss portfolios is highly disputed. In the following, an attempt will be made to give a succinct answer to the question of whether the mere formation of a captive company or the utilisation of an already existing captive might constitute a substantial link to the UK which would allow an active run-off by implementing a solvent scheme.

Further, clarification is needed whether the termination of insurance contracts resulting from the implementation of a British solvent scheme would be recognised under German or Swiss law. In this context, attention must be given to the judgment of the Higher Court of Appeals of Celle, which denied such recognition under German law at least for primary insurance.<sup>1</sup>

### Substantial link to the UK by the formation of a captive

The formation of a captive in the UK could create a substantial link which would allow the transfer of the portfolio to said captive in order to run it off by a solvent scheme.

#### Requirements for the portfolio transfer

In Germany as well as in Switzerland, the transfer of portfolios is subject to the authority of the Insurance Supervisory Authority and is regulated specifically by the Insurance Supervisory Act (*Versicherungsaufsichtsgesetz – VAG*). In Germany, there are different regulations for primary insurance and reinsurance portfolio transfers whereas in Switzerland there is a common regulation for both of them.

These regulations will be presented in the following with regard to the question of a portfolio transfer to a captive based in the UK.

#### Portfolio transfer in the German primary insurance

Pursuant to Article 14 VAG, any contract for the purpose of transferring to another enterprise the entire insurance business or a part of the insurance business requires approval by the supervisory agencies having jurisdiction over the undertakings involved. Such approval may be given only if the interests of the insured are sufficiently safeguarded, i.e., if it has been proven that the obligations to the insured arising from the insurance contracts can be continuously met and that a certification has been issued by the supervisory authority confirming that the acquiring company has shown that it will be funded after the transfer with uncommitted assets in the amount of the solvency margin (solvency certification – *Solvabilitätsbescheinigung*).

As far as mutual insurance associations (*Versicherungsverein auf Gegenseitigkeit*) as well as portfolios benefiting from surplus sharing (*Überschussbeteiligung*) are concerned, there are

special regulations which are not further highlighted in this contribution.

#### Portfolio transfer in the German reinsurance

According to Article 121f VAG, the supervisory authority must also give its approval for the transfer of reinsurance portfolios. In contrast to the transfer of primary insurance portfolios, there is but one requirement for such approval, which is the issuing of a solvency certification by the supervisory authority. However, there is no assessment of the question of whether the interests of the insured are safeguarded.

The sole requirement of Article 121f VAG, which is the issuing of a solvency certification, is subject to an ongoing discussion if this provision is still good law having regard to German constitutional law.<sup>4</sup> It is argued that the insured of such a reinsurance portfolio, which are basically primary insurers, could suffer losses if the insurance portfolio is transferred to a different reinsurer which is not rated equally. In addition, it could become more difficult for the insured to enforce claims against the reinsurer if the portfolio is transferred to some other reinsurer based somewhere else in the European Economic Area. However, so far Article 121f VAG has not been reviewed by the Federal Constitutional Court.

#### Portfolio transfer in Switzerland

The Swiss regulation – covering primary and reinsurance – is quite similar to the German equivalent concerning portfolio transfer in the primary insurance (cf. Article 14 VAG). Pursuant to Article 62 para. 1 VAG-Switzerland, the supervisory authority only gives approval to portfolio transfers insofar as the interests of the insured are safeguarded collectively. Furthermore, the Swiss regulation exceeds the scope of the German regulation by strengthening the influence of the supervisory authority, which is entitled to specify the conditions of the transfer by specifying volume and content via its approval (Article 62 para. 2 VAG-Switzerland).

#### Portfolio transfer to UK based captives

As far as portfolio transfers to a UK-based captive are concerned, two questions seem particularly worthy of being highlighted:

- Are the interests of the insured with regard to such a transfer still being adequately safeguarded?
- Is a captive formed for the sole purpose of allowing for a run-off by way of a solvent scheme still an insurance company within the meaning of the Insurance Supervisory Act (VAG)?

#### Safeguarding the interests of the insured

The interests of the insured according to Article 14 VAG and Article 62 VAG-Switzerland could be at risk if the portfolio transfer to a UK based captive is not made on grounds of continuing the insurance

business, but exclusively in order to terminate the whole portfolio by way of a solvent scheme. In this case, it seems questionable whether the interests of the insured are still sufficiently safeguarded, as the solvent scheme could even be executed against or without the will of the minority.

In contrast to that, it should be noted that the German and Swiss legislators both enacted the regulation on portfolio transfer not only with substantial insolvency scenarios in mind but also to facilitate the restructuring and the closing of special lines of business for all insurance undertakings. As a consequence, the legislator did not (explicitly) prohibit a portfolio transfer by way of a solvent scheme.

In addition, the supervisory authority has discretionary power with regard to the volume and content of the approval and to impose conditions for its approval; this is regulated explicitly for Switzerland (cf. Art. 62 VAG-Switzerland).

To sum up, the interests of the insured do not per se give rise to the assumption that a portfolio transfer to a UK based captive in order to implement a solvent scheme is not permissible.

#### **Captive as insurance company**

Article 14 VAG as well as Article 62 VAG-Switzerland require the undertaking to which the portfolio is to be transferred to be an insurance company.

In general, even a captive could be such an insurance company. However, this could be in dispute if the captive is formed for the sole purpose of liquidating the portfolio, but not to conduct any active business. In the case at hand, the transfer of a German or Swiss run-off portfolio to a UK based captive is only made for reasons of liquidation by way of a solvent scheme.

The German supervisory authority (BaFin) decided in this context that this was not sufficient to constitute an insurance company in the sense of Article 14 VAG. For a company to be regarded as an insurer in the sense of said regulation, it needs at the very least to be involved in the handling of active policies and not deal only with the immediate termination of remaining policies.<sup>5</sup>

For Switzerland, according to Article 11 para. 1 VAG-Switzerland, it is crucial that there be a causal link (*unmittelbarer Zusammenhang*) between the normal insurance business and the intended run-off business. That is the case only if 'running-off' portfolios are considered to be directly linked with normal insurance business. A captive whose sole purpose is such could be considered an insurer. So far it has not been decided if this link is still given in a sufficient way when the portfolio transfer goes to a UK based captive.

## **Legal acceptance of solvent schemes under German law**

It is highly disputed whether such a solvent scheme which is governed by British law must be recognised by the German courts.<sup>6</sup> Recently, the Higher Court of Appeals of Celle denied such recognition under German law at least for the primary insurance.<sup>7</sup> However, this judgment will be reviewed by the Federal Court of Justice (*Bundesgerichtshof*), however the Federal Court's decision is not expected before the end of this year.

If the judgment of the Higher Court of Appeals of Celle were to be upheld by the Federal Court, the case could be brought before the European Court of Justice.

## **Summary**

Although criticism has been expressed by some, a solvent scheme can be an appropriate instrument for a rapid and comprehensive liquidation of a German or Swiss insurance portfolio or rather an insurance business line.

However, the founding of a captive in the UK just for that purpose might not do the trick – at least not for German portfolios – as such a captive would run the risk of not being regarded as an insurance company. The German (and to a degree the Swiss) supervisory authority will in all likelihood distinguish between such case and cases where the portfolio transfer is made to an already existing captive, which serves different purposes (with the latter more likely being regarded as an insurer and thus as an admissible assignee for the transferred portfolio).

For German primary insurers and Swiss primary and reinsurers, as far as the question of portfolio transfers is concerned, it remains doubtful if the competent supervisory authority will agree that the interests of the insured are sufficiently safeguarded when confronted with a solvent scheme scenario. Even if the supervisory authority were to accept such a portfolio transfer, it would hold additional discretionary power with regard to the volume and content of the approval and it might impose conditions before granting its approval.

With regard to German reinsurance, a portfolio transfer in the meaning of Article 121f VAG appears to be possible (provided the transfer is made to a captive which may be regarded as an insurer). This follows from the fact that Article 121f VAG does not require the supervisory authority to pay heed to the interests of the insured. While this rule might pose different problems under constitutional law, it quite openly allows for the portfolio to be transferred for whatever reason, thus not disallowing a transfer for the purpose of implementing a solvent scheme.

While the Federal Court of Justice has not yet decided whether solvent schemes can be recognised under German law, this run-off method remains uncertain for German (and Swiss) insurers. It remains to be seen what position the German and Swiss courts will take concerning solvent schemes and whether the European Court of Justice will examine this situation in the coming years to determine whether the prohibition of a transfer might constitute an inadmissible restriction of one of the Four Freedoms of the European Union.

**Notes:**

- <sup>1</sup> See *infra* Chapter IV. 1. in detail.
- <sup>2</sup> Cf. Labes (2008) ZfV 698 (699).
- <sup>3</sup> Cf. OLG Celle (8 U 46/09) of September 8, 2009, (2010) VersR 612.
- <sup>4</sup> Cf. *inter alia* Bürkle (2008) VersR 1590 *et. seq.*
- <sup>5</sup> Cf. Decision of BaFin dated August 2, 2006 (European Speciality Rückversicherung AG).

- <sup>6</sup> Cf. *inter alia* Tyrell/Heitlinger/Stern (2007) VW 1695 *et. seq.*; Schnepf/Janzen (2007) VW 1057 *et. seq.*
- <sup>7</sup> Cf. OLG Celle (8 U 46/09) of September 8, 2009.

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