According to market estimations, technical provisions (versicherungstechnische Rückstellungen) for discontinued business amounts to about EUR 115 billion. Pro-active run-off is placed at about EUR 45 billion. The estimated size of both the discontinued business market and run-off portfolios show a sharp rise in comparison with the previous market estimations in the past and underscores the growing importance of these portfolios for business management.

The main drivers behind successful run-off cited by market participants are earlier closure (finality) and the freeing-up of capital. Solvency II is a likely trigger for future transactions. It is highly probable that markets participants will see a growing number of transactions driven by the requirements of Solvency II.

Moreover, there seems to be a trend towards cross-border consolidation and/or restructuring of insurance companies based in the European Union or in a treaty state of the Agreement on the European Economic Area.
EXPLANATION OF SOME KEY TERMS

**Discontinued business**
Denotes cases where underwriting for the entity as a whole or a portfolio has ceased.

**Run-off**
Generally means discontinued business which is being proactively managed. However, please note that run-off does not necessarily mean business that is no longer written. Today, run-off goes beyond the proactive management of discontinued business to include the management of all contracts which are problematic or where commutation is a wise solution for all parties involved. That does not necessarily mean that the underlying product has to be discontinued.

**Commutation**
Commutation is an individual agreement releasing the ceding insurer and reinsurer from all rights and obligations under the respective contract (proactive claims settlement with regard to individual insurance contracts). The creditor of the respective insurance contract has to agree to this kind of premature termination.

SOLVENCY CAPITAL REQUIREMENTS FOR THE RESERVE RISK OF RUN-OFF PORTFOLIOS
Typical for run-off portfolios is the so-called reserve risk which has to be covered under the solvency capital requirements.

A defining characteristic of run-off portfolios is that they contain payment obligations from former years of occurrence or policy years, the premiums for which have generally already been received. A key aspect of these portfolios is their reserve risk – the risk of losses – that reserves established for past losses will be insufficient to cover these claims. The reserves comprise separate reserves for reported claims and belated claim reserves for IBNER (Incurred But Not Enough Reserved) and IBNR (Incurred But Not Reported) claims. The reserve risk is particularly significant for lines with a longer run-off period.

Currently, the solvency capital requirement for reserve risks under Solvency I is calculated for property/casualty insurers using premium and claims indices. If limited to run-off portfolios, only the claims index applies. This calculation is based on the average claims incurred during the past three years.

The reserve risk under Solvency II (from 1 January 2013) will be calculated in proportion to the net technical provisions (versicherungstechnische Nettorückstellungen) while taking account of diversification effects arising from the writing of business in different lines or countries. According to estimates, the solvency capital requirement under Solvency II will tend to be higher than under Solvency I.

Please note that besides the reserve risk, run-off portfolios are naturally also exposed to market risk, operational risks and credit risks arising, in particular, from defaults from reinsurers.
Legal Background and Implications of the Transfer of Run-Off Portfolios under German Law

A number of insurance-specific German law legal and tax aspects must be taken into consideration when transferring run-off portfolios.

POSSIBILITIES FOR TRANSFERRING RUN-OFF PORTFOLIOS

There are different possibilities for transferring run-off portfolios.

Insurance contracts can be transferred in the form of a portfolio acquisition (Bestandskauf/Bestandsübertragung) under German law, as provided for in the Insurance Supervision Act (Versicherungsaufsichtsgesetz, VAG). In this case, one party transfers the rights and obligations from all or a number of its insurance contracts (Versicherungsbestand) to the other party. One of the parties is generally also required to make payment for this arrangement depending on whether the present value difference between the expected premium income and actuarial benefits payable for the maturity of the contracts is positive or negative. The insurance portfolio is transferred as a whole by way of legal succession (Gesamtrechtsnachfolge); a transfer of the individual insurance contracts and the consent of the respective policyholders is not necessary.

Besides such portfolio acquisitions pursuant to the VAG, there is also the possibility of transferring a portfolio through the mechanisms of law regulating company reorganizations (Umwandlungsrecht) (namely by a merger (Verschmelzung), a spin-off type I (Abspaltung) or type II (Ausgliederung) or a transfer of the company’s assets ([Vermögensübertragung]) or as a non-cash contribution in return for shares (Sacheinlage gegen Gewährung von Gesellschaftsrechten). Measures pursuant to the law regulating company reorganizations (Umwandlungsrecht) also allow the transfer of an insurance portfolio as a whole by way of legal succession (Gesamtrechtsnachfolge). Such measures, however, require a stricter observance of (formalistic) reorganization procedures (Formstrenge bei Umwandlungsmaßnahmen) and may possibly entail a subsequent statutory liability (gesetzliche Nachhaftung) (Section 133 Company Reorganization Act (Umwandlungsgesetz, UmwG). Another possibility is the transfer of a number of individual insurance contracts by way of singular succession (Einzelrechtsnachfolge). However, such transfer pursuant to the general rules of civil law is complicated and requires not only a clear designation of the individual contracts, but (inter alia) also the consent of the respective policyholders.

REGULATORY ASPECTS

Irrespective of the choice of transfer options, certain regulatory formalities apply to the transfer of insurance contracts (particularly Sections 14, 14a, 121f, but also Sections 44, 108, 111d, 121i VAG).

For pure reinsurers (Rückversicherer), certain reliefs are granted by the VAG, i.e. some of the regulatory requirements which have to be met by other insurance companies (direct insurers), pension schemes and pension funds do not apply to reinsurance companies (see for instance Section 121f VAG – as compared to Section 14 VAG).
Note that “mixed insurers” (providing direct insurance services as well as reinsurance services) have to fulfill the (generally stricter) requirements for direct insurers (especially Section 14 VAG), even if the transfer at hand relates to a pure reinsurance portfolio.

Portfolio acquisition (Bestandskauf/Bestandsübertragung)

Portfolio acquisition (Bestandsübertragung) according to the VAG

Portfolio acquisition (Bestandsübertragung) is allowed by regulatory law as a measure to facilitate – broadly speaking – the transfer of all or part of the insurance contracts (Versicherungsbestand) of an insurance company to another insurance company. Sections 14, 44, 108, 111d, 121f and 121i VAG stipulate the requirements for such portfolio acquisitions (Bestandsübertragungen) in different situations. Pursuant to those rules, portfolio acquisition (Bestandsübertragung) is available to direct insurers (Erstversicherer) as well as reinsurers (Rückversicherer). Moreover, the Insurance Supervision Act is also providing for special cases like mutual insurance societies (Versicherungsverein auf Gegenseitigkeit), German branch offices of insurance companies based in third countries outside of Germany or insurance undertaking having their head office in another member state of the European Union or in a treaty state of the Agreement on the European Economic Area etc. (for cross-border cases see page 6).

A partial transfer of the portfolio of an insurance company (Versicherungsbestand) in the form of a portfolio acquisition (Bestandsübertragung) is in principle also possible. However, when dealing with such a partial transfer, a case-by-case assessment is necessary to determine whether the insurance contracts to be transferred actually qualify as an insurance portfolio (Versicherungsbestand) in their own right (and can accordingly be transferred without the policyholders’ permission) – as opposed to simply a number of insurance contrast which do not qualify as a portfolio (Versicherungsbestand) in itself (and which can consequently only be transferred with consent of the insureds).

The portfolio acquisition contract (Bestandsübertragungsvertrag) has to be drawn up in writing (Schriftform). Notarial form (notarielle Form) is not required.

Contrary to general civil law principles, the permission of the insureds is not required if the regulatory requirements for portfolio acquisitions (Bestandsübertragungen) pursuant to the VAG are fulfilled (i.e. non-applicability of Section 415 German Civil Code (Bürgerliches Gesetzbuch, BGB) which is otherwise generally dealing with the assumption of debt (Schuldübernahme) between a third party and the obligor).
To compensate for the policyholder’s lack of participation rights in a portfolio acquisition (Bestandsübertragung) pursuant to the VAG, regulatory approval by the German Financial Supervisory Authority (Bundesanamt für Finanzdienstleistungsaufsicht, BaFin) is required. Approval is generally granted if the receiving company will still have sufficient own funds after the transfer (Eigenmittel in Höhe der geforderten Solvabilitätsspanne) and if the interests of the insureds are protected (see for instance Section 14 para. 1 and para. 2 VAG). Note, however, that there is one exception where protection of the policyholders’ interests is not required, namely when a pure reinsurer transfers its portfolios (see Section 121f VAG). Note, however, that this relief for the reinsurer can result in financial and legal risks for the previous insurer.

The conditions which have to be fulfilled to protect the interests of the insured persons generally have to be determined on a case-by-case basis. This poses the question whether the interests of the policyholders require not only a segregation of the technical provisions (versicherungstechnische Rückstellungen) plus the transferred premiums (Beitragsüberträge), but in addition also the transfer of the related asset cover (bedeckende Aktiva/Bedeckungswerte). Whether such related asset cover (bedeckende Aktiva/Bedeckungswerte) is also automatically transferred is discussed controversially; the majority opinion in German legal literature is against an automatic transfer with the transferred insurance portfolio pursuant to the rules for portfolio transfer (Bestandsübertragung) of the VAG. However, some voices in German legal literature argue that a separate transfer of the related asset cover (bedeckende Aktiva/Bedeckungswerte) pursuant to general civil law rules or by way of a transfer pursuant to the law regulating company reorganizations (Umwandlungsrecht) is required. If insurance contracts with bonuses (Über- schussbeteiligungen) are involved in the transfer, note that an additional requirement for approval is that the value of the bonuses accruing to the policyholders of the ceding and receiving insurance company must not be lower after the transfer (compared to the situation before such transfer) (Section 14 para. 4 VAG). Especially in transaction with particularities, it can be advisable to discuss the question whether the interests of the insureds are protected with the BaFin beforehand.

The legal consequence of a portfolio transfer pursuant to the VAG is a partial legal succession (partielle Gesamtrechtsnachfolge) concerning the rights and obligations of the respective insurance company. Automatic transfer includes any premiums owing, interest and cost claims as well as rights to establish or modify a legal relationship (Gestaltungsrechte) (e.g. right of rescission (Anfechtungsrecht) or right of termination [Kündigungsrecht]).

Note, however, that related reinsurance contracts are not automatically transferred. This is also the case concerning coverage assets (Sicherungsvermögen) allocated to the respective insurance portfolio (Versicherungsbestand). Generally speaking, other assets and liabilities have to be transferred in accordance with civil law (i.e. usually by way of singular succession [Einzelrechtsnachfolge]), in the form required by civil law (e.g. for the transfer of real estate property) (asset deal). Reinsurance contracts are usually renegotiated.
Portfolio acquisition (Bestandsübertragung) according to the VAG in an international context

The rules for portfolio acquisitions (Bestandsübertragungen) under the VAG generally follow the principle of home state supervision by the home regulator of the transferring insurer (Herkunftslandsprinzip, see for instance Section 14 para. 2, 111d, 121f VAG). Consequently, the right of final decision lies with the supervisory authority responsible for the respective country of residence of the transferor. This is in most cases which are provided for in the VAG the BaFin. However, please note that there are some exceptions (i.e. final decision and approval by the competent foreign authority), for instance concerning the transfer of a portfolio of insurance contracts concluded by a branch office or in the (cross-border) provision of services (Dienstleistungsverkehr) by insurance companies having their head office in another member state of the European Union or in a treaty state of the Agreement on the European Economic Area (Section 111d VAG). Note moreover that the sale of an insurance portfolio to an insurance not domiciled in a member state of the European Union or a treaty state of the Agreement on the European Economic Area, but instead domiciled in a third country, may lead to additional requirements.

Foreign regulatory authorities play an important role in international transfers. This is for instance the case for portfolio transfers (Bestandsübertragungen) pursuant to Section 121f para. 1 VAG from a German reinsurance company (Rückversicherungsunternehmen) to a insurance company having its seat in another member state of the European Union or in a treaty state of the Agreement on the European Economic Area: According to this provision, the BaFin will approve a portfolio acquisition (Bestandsübertragung) only if the competent authority of the home state of the acquiring insurance company certifies that the acquiring company has sufficient regulatory capital (Eigenmittel in Höhe der geforderten Solvabilitätsspanne) (so-called solvency certificate [Solvabilitätsbescheinigung]).

Under the Rome I Regulation (Regulation (EC) No 593/2008) (when applicable), the law which governs the portfolio transfer contract (Bestandsübertragungsvertrag) can generally be chosen by the parties involved (Article 3 para. 1 of the Rome I Regulation). In the absence of choice, a contract shall be governed by the law of the country where the party required to effect the characteristic performance of the contract has his habitual residence (Article 4 para. 2 of the Rome I Regulation). The party effecting the characteristic performance is the transferring insurance company.

Apart from the law governing the portfolio transfer contract (Bestandsübertragungsvertrag) between the parties, it has to be decided in international cases which law is applicable to the transfer of the insurance contracts (Versicherungsbestand). Note that the law governing the transfer is not necessarily the same as the law governing the contract. The law governing the transfer can generally not be chosen by the parties to the transfer (in contrast to the freedom of choice concerning contractual law). The relevant law applicable to the transfer is the law of the home state regulator (i.e. generally the law of the home state [Rechtsordnung des Herkunftslandes]).
Reorganization (Umwandlungen)

Note that the reorganization (Umwandlung) of insurance- and reinsurance companies according to the applicable company law also requires approval by the regulatory authorities (Section 14a and 121f para. 3 VAG). Note that in this case, the BaFin must also check whether company law requirements are fulfilled.

This means in particular that, under German company law, the requirements of the reorganization law (Umwandlungsrecht) for spin-offs (Section 123 et seq. Company Reorganization Act (Umwandlungs gesetz, UmwG), mergers (Section 2 et seq. Company Reorganization Act) and transfer of the company’s assets (Section 174 et seq. Company Reorganization Act) have to be met.

In the event of international transactions, it has to be determined which country’s company law is applicable and which law is applicable concerning regulatory questions (e.g. to the approval of the competent authority required by law).

TAX ISSUES

There are moreover tax issues which should be considered, especially in the areas of tax on profit (Ertragsteuern) and value added tax (Umsatzsteuern).

Run-Off Specific Aspects under English Law

The market for insurance run-off is probably best established and most active in the United Kingdom. Therefore, certain English law aspects are also of interest for continental Europe run-off business.

SOLVENT SCHEMES OF ARRANGEMENT UNDER ENGLISH LAW

A scheme of arrangement (SoA) is a statutory agreement between a company (solvent or insolvent) and its creditors pursuant to English law. Applied to insurance companies and reinsurance companies, this procedure enables mass commutation between an insurer (direct insurance/reinsurance or a retrocessionaire), proposing the scheme of arrangement, and its policyholders (including ceding insurers and retrocedents) under Part 26 of the Companies Act 2006. The main goal of using a solvent scheme of arrangement is the achievement of full finality in relation to all parties involved.

There is no similar instrument in Germany (even taking into account the statement of the Higher Regional Court of Celle that there are various opinions on conducting wind-up procedures within the meaning of Section 88 VAG, i.e. insolvency procedures, using the same approach as Section 88 of the VAG for solvent companies).

In cases where there is a “sufficient connection” to the United Kingdom (in the following text: “UK”), especially when insurance business is situated in the UK (e.g. is administered by an English branch), one might think of using a solvent schemes of arrangement under English law.
Given a sufficient connection to the UK, it is also under a German law perspective generally possible to use a using a solvent schemes of arrangement.

Another question in such circumstances is whether the solvent schemes of arrangement is binding and enforceable regarding German parties. If the place of jurisdiction (Gerichtsstand) is in the UK, the solvent scheme of arrangement is binding and enforceable vis-à-vis German insurance companies. However, in cases where the place of jurisdiction (Gerichtsstand) is in Germany, the answer is not so clear.

Note, however, that even if a solvent schemes of arrangement is recognized in Germany, the BaFin will generally supervise such scheme if it is used by a German insurance company.

TRANSFER INTO THE UNITED KINGDOM – PART VII TRANSFER AS AN ALTERNATIVE TO A TRANSFER UNDER GERMAN LAW

As far as transfers of (German) insurance portfolios to the UK are concerned or in other cases with a sufficient link to the UK, the German law portfolio transfer (Bestandsübertragung) according to the VAG and the English law so-called “Part VII Transfer” can be competing/alternative ways for transfer.

When compared to the English law Part VII Transfer, a German law portfolio transfer (Bestandsübertragung) according to the VAG is generally the simpler and cheaper solution for the transfer of an insurance portfolio.
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