YELDHAM PRICE O'BRIEN LUSK

A REINSURER'S DEBT

Introduction

In *New Cap Reinsurance Corporation Limited (in liq) v AE Grant & Ors* [2008] NSWSC 1015 (***New Cap Re***), Justice White of the Supreme Court of New South Wales considered the question of when, under Australian law, a 'debt' arises under a contract of reinsurance.

The decision (which is arguably a departure from the established authority) is relevant not only to categorising a claim under a contract of reinsurance, but also may impact upon determining the solvency of a reinsurer.

Is a claim under a contract of reinsurance a claim for unliquidated damages?

Until the decision in *New Cap Re*, the law in New South Wales on whether a debt existed under a contract of reinsurance where the reinsured had paid the underlying claim was enunciated by Windeyer J in *Odyssey Re (Bermuda) v Reinsurance Australia* [2001] NSWSC 266 (***Odyssey Re***)[1].

In summary, the principles in *Odyssey* Re are:

- the payment by a reinsured did not trigger an immediate obligation of the reinsurer to pay the reinsured under the reinsurance contract;
- the reinsurer's liability under the policy of reinsurance to pay the 'Ultimate Net Loss' was a liability for unliquidated damages for breach of contract and was not a debt that could support a statutory demand issued by the reinsured.

These principles drew support from and followed the position in the United Kingdom (for example, see *Edmunds v Lloyd Italico e L'Ancora Cia di Assicurazioni e Riassicurazioni SpA* [1986] 2 All ER 249, and *Hill v Mercantile & General Reinsurance Company Plc* [1996] 1 WLR 1239) in relation to contracts of reinsurance, and the position in New South Wales for contracts of insurance (see *Penrith City Council v GIO* [1991] 24 NSWLR 566).

In *Odyssey Re*, the reinsured issued a statutory demand pursuant to Section 459G of the *Corporations Law* in respect of losses that it had paid arising from an earthquake in Turkey in 1999, and which it said were applicable to the contract of reinsurance. The reinsurance contract was a reasonably standard excess of loss treaty.

The reinsurer sought to have the statutory demand[2] set aside, ultimately on two bases. First the claim was not for a debt but was a claim for unliquidated damages. Second there was a genuine dispute regarding the claim because the reinsurer had requested an inspection of the reinsured's records (pursuant to its right under the reinsurance contract to do so) and the reinsured had refused the inspection until the claim was paid.

The reinsurer successfully argued both grounds and the statutory demand was set aside.

Is a claim under a contract of reinsurance a debt?

In *New Cap Re* the question as to whether claims under a contact of reinsurance where the underlying claims had been paid was a debt arose for the purposes of determining whether at

---

[1] Timothy Price acted for the successful reinsurer in *Odyssey Re*.

[2] Section 459G of the former *Corporations Law* (now superseded by section 459G of the *Corporations Act* 2001) allows a company to apply to the court for an order setting aside a statutory demand served on the company in certain circumstances, including where there is a genuine dispute about the existence or amount of the debt to which the demand relates.

a particular point in time *New Cap Re* was unable to pay its debts, and was thus insolvent for purposes of Section 95A of the *Corporations Act* 2001 (Cth) (***Corporations Act***).

In *New Cap Re*, the court found:

- the reinsurer has an obligation to pay its reinsureds the amount, or a proportion of the amount, that the reinsureds had paid above the excess at which the relevant layer of cover was triggered;
- New Cap Re's liability to pay those sums was a primary obligation and constituted debts for which the count of money paid would lie;
- when the reinsurer paid its reinsureds, the payments were made in discharge or a reduction of its liabilities under its contracts of reinsurance. It was not paying damages because it had not refused or failed to provide indemnity.[3]

In reaching his conclusion, White J:

- followed *Box Valley Pty Ltd v Kidd* [2006] NSWCA 26; (2006) 24 ACLC 471 (an insolvency case in the NSW Court of Appeal which did not concern reinsurance or insurance).
- reviewed *Odyssey Re* and the line of authorities upon which it relied. However, he found that these authorities (and in particular *Odyssey Re*) could be distinguished from *New Cap Re* for the following reasons:
  - the subject of the contracts of reinsurance could be categorised as containing 'a promise to redress and compensate' [the reinsured] for losses sustained 'by the reinsured'. When a contract of reinsurance is characterised in this manner, then the reinsurer can be sued in debt for the recovery of what the reinsurance promised to pay.[4]
  - the Court in *Odyssey Re* was not asked to consider an argument that the claim to recover upon a promise of indemnity to compensate the reinsured for amounts which the reinsured had paid the reinsured was enforcing a 'primary obligation of performance' not a secondary obligation to pay damages in the absence of performance.

Analysis and implications

The decision in *New Cap Re* marks a departure from the previous authorities by determining that a claim under a reinsurance contract is a debt and not simply a claim for unliquidated damages, in circumstances where the underlying claims have been paid and there is no dispute regarding liability.[5]

This is a complex area of the law and the arguably inconsistent approach between *Odyssey Re* and *New Cap Re* leaves plenty of room for further debate. However, both cases illustrate that the principles to be adopted depend (at least in part) on the particular circumstances of the case including the terms of the subject reinsurance contract(s) and the purpose of the Court's inquiry. For these reasons some caution should be adopted when applying the principles to other circumstances.

Notwithstanding these observations, some of the implications of this decision are likely to include:

- The decision may lead to an increase in the use of statutory demands to recover claims under insurance or reinsurance contracts.

---

[3] Unlike the position in *Odyssey Re*, it does not appear that in *New Cap Re* the reinsurer argued that there was an issue about whether it was liable to pay the subject claims, in particular whether it had any liability at the relevant time.

[4] His Honour distinguished this from a contract of indemnity insurance which he said was usually a contract under which the insured is entitled to be protected from loss, and the insurer would be liable in damages if that did not occur. However, he observed that there was no warrant for assessing that all contracts of indemnity are to the same effect.

[5] At the time of publication, it is not known whether a notice of appeal has been filed in this matter.

- Directors of insurance companies should be aware that their liability for insolvent trading by the company could be affected by this decision, as the company's undisputed but as yet unquantified liabilities under their contracts of reinsurance can be considered debts for the purposes of the insolvent trading provisions of the *Corporations Act*. It should be noted that these liabilities would most likely already be taken into consideration by an insurer's actuary in preparing the company's insurance liability valuation report, and this information should be readily accessible to a Director.

Insurers who place their reinsurance with non-APRA authorised reinsurers should be aware that with effect from 1 January 2009, an Investment Capital Factor of 100 per cent applies to a reinsurance recoverable due from non-APRA-authorised reinsurers if the reinsurance recoverable has become a receivable, the receivable is overdue for more than six months since a request for payment has been made to the reinsurer, and there is no dispute between the insurer and reinsurer in respect to that receivable.[6] The effect of this provision on insurers in combination with the *New Cap Re* decision is that insurers must ensure that they have adequate capital reserves for reinsurance receivables, and that they have considered whether their undisputed but unquantified liabilities have been included in their reinsurance receivables.

It should also be remembered by reinsurers who provide reinsurance to Australian insurers, that for any reinsurance contract entered into by an insurer incepting on or after 31 December 2008, the insurer must ensure that the reinsurance contract provides that the governing law of the reinsurance contract is Australian law and that any disputes fall to be determined by a court are heard in an Australian court.[7]

December 2008

For further assistance with corporate and regulatory matters, please contact Isla Chisholm (t: 9231 7028, e: ichisholm@ypol.com.au), Timothy Price, Director (t: 9231 7022, e: tprice@ypol.com.au) or Kathryn Rigney, Director (t: 9231 7027, e: krigney@ypol.com.au)

LEVEL 7, 12 CASTLEREAGH STREET
SYDNEY NSW 2000

DX 162 SYDNEY

T: +61 2 9221 7774
F: +61 2 9221 7775
WWW.YPOL.COM.AU

YPOL PTY LTD TRADING AS
YELDHAM PRICE O'BRIEN LUSK
ACN 109 710 698

LIABILITY LIMITED BY A SCHEME APPROVED UNDER PROFESSIONAL STANDARDS LEGISLATION. LEGAL PRACTITIONERS EMPLOYED BY YPOL PTY LIMITED ARE MEMBERS OF THE SCHEME

[6] Prudential Standard GPS 114 Capital Adequacy: Investment Risk Charge

[7] Prudential Standard GPS 230 Reinsurance Management