Reinsurance in Switzerland – The legal framework

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In accordance with article 98 para. 3 of the Swiss Federal Constitution, the Confederation has an obligation to enact regulations on private insurance. This legislative mandate relates to: (i) the supervision of private insurance institutions; and (ii) the legal framework pertaining to insurance contracts. The latter also results from article 122 para. 1 of the Federal Constitution, according to which legislation in the field of private law is the responsibility of the Confederation. The most important statutes enacted in the fulfilment of this mandate are, firstly, in relation to the supervision of insurance companies in the field of private insurance, the Federal Act on the Supervision of Private Insurance Institutions of June 23, 1978 (Insurance Supervisory Act) and, secondly, in relation to the law on insurance contracts, the Federal Act on the Insurance Contract of April 2, 1908 (Insurance Contract Act), whereby the latter, as explained below, does not apply to reinsurance contracts. Both acts are undergoing revision. The Insurance Supervisory Act is being completely revised and the revised act may come into force as early as January 1, 2005. It is possible that at such time a partial revision of the Insurance Contract Act will also come into effect. However, it will still require a number of years before the undertaken total revision of the Federal Act on the Insurance Contract is completed.

The following overview is based on the legislation and the guidelines of the Federal Office of Private Insurance in force to date. However, at this time, it appears that the reinsurance business will hardly be affected by the pending legal revisions. Therefore, the following should continue to apply after January 1, 2005.

Law on supervision

Licence to operate

In principle, businesses in the field of private insurance are subject to the supervision and legislation of the Confederation. This applies in the first place – with very few exceptions – to all direct insurers. For reinsurers, on the other hand, this requirement applies only to those that have their headquarters in Switzerland (also to reinsurance captives with their headquarters in Switzerland). Subsidiaries of foreign insurance groups are also subject to government supervision, but not mere branch offices of insurance institutions with headquarters abroad which transact only reinsurance business in Switzerland.

Reinsurers with their headquarters in Switzerland require a licence from the Federal Department of Finance. The licensing requirements relate firstly to the legal organisation of the reinsurance entity, and secondly to financial aspects. It should be noted that the licence to operate as a direct insurer in a specific branch of the insurance industry also includes authorisation to conduct active reinsurance business in the same branch.

Only joint-stock companies and co-operatives are permitted to operate as reinsurers. Once set up, these companies have to submit an application for a licence to operate to the Federal Office of Private Insurance, which will pass it on to the Federal Department of Finance. Along with the application, other documents have to be submitted including the documents pertaining to the incorporation of the company, a confirmation regarding the amount of the capital paid-in, a list of the shareholders, details on the organisation of the management, the opening balance sheet, the intended business and investment policy, as well as a budget showing the profit and loss account for the first three years of operation. The minimum capital must amount to CHF10m (reinsurance captives: CHF1m, at least 20% of the premium income on their own accounts) and must be fully paid-in. Some 20%-50% of the capital has to be paid irrevocably and without possibility of repayment into the so-called organisational fund.

These monies serve to cover the costs of incorporation and development, the expenses associated with any extraordinary expansion of business, and, if necessary, may also be used to cover losses. Any further use without the consent of the supervisory authority is not permitted. A minimum of 20% of the annual profits must be allocated to the so-called reserve fund until the balance in this fund has reached 50% of the nominal capital of the company.

In addition, the company must disclose to the supervisory authority the risks that have been

retroceded and the level of the retention. The company must provide proof that the reinsurers are prepared to cover the risk.

Supervision of business operations

After the licence has been granted, the Federal Office of Private Insurance will subject the entire business operations of the reinsurer to constant supervision. The organisational structure of the company and its senior management must at all times guarantee its sound management. The conduct of business not related to insurance is not permitted. In comparison with the supervision of direct insurers, the supervision of reinsurers tends to be less rigorous. This can be justified on the grounds that there is less need for protection of reinsurance clients than of direct insurers' clients. The supervision of reinsurance business is accordingly to a large extent limited to the monitoring of solvency.

Every year, a written report on business operations must be submitted to the supervisory authority, the Federal Office of Private Insurance. Reinsurance captives must in addition inform the supervisory authority without delay of any changes in the identity of their shareholders, or of the shareholders of their parent company.

To cover the costs of the supervision, an annual fee has to be paid; the minimum fee currently amounts to CHF3,000.

Reinsurers with headquarters abroad

The situation is different, as already mentioned, for insurance institutions that have their headquarters abroad and which are only involved in reinsurance operations in Switzerland, either directly from abroad or via a Swiss branch office. These entities are permitted to operate without a licence and are not subject to Swiss insurance supervision. They are governed by the law of their country of domicile. Through this regulation, Switzerland guarantees the international freedom of establishment and the freedom to provide services.

Revision of the Insurance Supervisory Act

As already mentioned, the Insurance Supervisory Act is currently undergoing revision. The draft bill, however, does not provide for substantial changes to the principles detailed above. In particular, there will be no amendment of the provision according to which a foreign company that carries out only reinsurance operations in Switzerland is exempted

from Swiss supervision. The supervision of the business operations of reinsurers in comparison with direct insurers will continue to be less rigorous.

The new article 35 of the Insurance Supervisory Act contains a list of those provisions of the Act which are not applicable to insurance entities that exclusively conduct reinsurance business.

Law of contract

Applicable law

Very often reinsurance contracts involve international contractual relations. As a result, an issue which often arises in connection with reinsurance disputes pertains to the applicable law. Under Swiss international private law, i.e. the Federal Act on International Private Law of December 18, 1987 (International Private Law Act) the permissibility of a choice of law in reinsurance contracts – in contrast to the situation with direct insurance contracts – appears to be entirely undisputed. In principle, therefore, parties are free to decide on the applicable law. As a matter of fact, this is general practice in international reinsurance contracts (where the choice of law is often combined with an arbitration clause). It appears that Swiss law is often chosen by the parties, even when none of them is domiciled in Switzerland.

Pursuant to article 116 of the International Private Law Act there is no requirement to make an express choice of law but the choice of law can result "from the provisions of the contract or from the circumstances", i.e. it can be agreed upon tacitly. There are a number of court decisions which deal with the issue of an implicit choice of law (however, not with regard to reinsurance contracts). Pursuant to these precedents, a manifestation of the parties' mutual consent that a specific law should govern their contractual relationship is required.

With regard to a reinsurance contract, indications of such a mutual consent could be, for example: the agreement of a place of jurisdiction or arbitration, the reference to contractual wording which is typical for a specific market, or the reference to specific legal provisions under a specific law or the contractual currency. A close connection with another contract can also be an indication for an implied choice of law. However, it is worth noting that pursuant to legal literature in Switzerland (there is no published case law on this issue), the clause "reinsurance at original terms" should not be understood as an agreement that the reinsurance contract is to be governed by the law of the original policy.

In the absence of any choice of law, pursuant to article 117 of the International Private Law Act, contracts are governed by the law of the state with which they have the closest connection. Such a connection is deemed to exist with the state of the ordinary residence of the party having to perform the characteristic obligation, or, if the contract is entered into in the course of a professional or business activity, with the state of such party's place of business. It is not clear which party to a reinsurance contract must be deemed to perform the characteristic obligation. Both the risk assumption by the reinsurer and the claims handling obligation of the ceding company are typical for a reinsurance contract.

According to the prevailing academic opinion, it must however be assumed that, as a matter of principle, reinsurance contracts should be governed by the law of the domicile of the cedent. There are, however, dissenting opinions, and even the predominant opinion appears to accept a number of exceptions where the law of the domicile of the reinsurer should apply (e.g. in the event of a run-off, where the cedent is no longer active in the handling of a claim) or even the law of a third country (e.g. English law as a "neutral" law in a situation where a reinsurance contract is placed on the London market, neither of the parties is domiciled in England and the cedent's domicile is in a country which has no established system of private law).

Article 101 of the Insurance Contract Act: applicability of the Code of Obligations

The law on contracts of insurance in Switzerland is contained in the Insurance Contract Act of 1908. However, reinsurance contracts are expressly excluded from the application of this Act (article 101 para. 1 sec. 1 of the Insurance Contract Act). Instead, reinsurance contracts are, pursuant to article 101 para. 2 of the Insurance Contract Act, governed by general contract law, i.e. the Swiss Code of Obligations of 1911. The legal justification for this is the limited need for protection of the reinsured party. The Insurance Contract Act contains numerous provisions that cannot be modified by contractual agreement under any circumstances (absolutely mandatory provisions) or that cannot be modified to the detriment of the insured (relatively mandatory provisions). These provisions are intended to protect the theoretically weaker contractual party, and typically protect consumers from general or special conditions of insurance that would be disadvantageous to them. In the reinsurance business, in contrast, the parties are both insurance companies, and they therefore require no special protection, whether from a legal or from an economic point of view.

Reinsurance contracts are therefore governed by

the Swiss Code of Obligations which is based on the principle of personal autonomy (contractual freedom). This implies that the parties to an agreement are free to determine the contents of their contractual relationship. "The content of the agreement may be freely determined within the limits of the law" (article 19 para. 1 of the Code of Obligations). Most provisions of the Swiss contract law are thus optional in their nature, i.e. they apply only when the parties have not agreed otherwise, provided this agreement does not contravene other mandatory legal provisions or is immoral or impossible in its contents. For example, the Swiss Code of Obligations in article 97 ff. regulates the consequences of the non-fulfilment of an agreement. The parties are however free, within the aforementioned limits to agree on different consequences in the event of non-fulfilment. In principle, the Swiss Code of Obligations therefore applies only where it either imposes mandatory standards (that prevail over the freedom of contract of the parties) or where the parties have not agreed to an alternative approach.

Customary practices in reinsurance

Due to the lack of specific statutory law which governs the reinsurance contract (and also due to the lack of case law), the terms and conditions of the individual reinsurance contract and the customary practices in reinsurance are the most important sources of reinsurance law.

Quite often, the reinsurance principles are agreed upon by the parties along with a choice of law or arbitration clause. However, pursuant to the legal literature, it has to be assumed that the general reinsurance principles such as the follow-the-fortunes principle, the cedent's right to manage the direct insurance contract (including claims handling) and the reinsurer's obligation to follow the cedent (follow-the-actions or follow-the-settlements principle) also apply when there is no explicit agreement by the parties. Most of the authors who have addressed this issue, either take the position that certain reinsurance principles must be regarded as customary law which is an independent source of law pursuant to article 1 para. 2 of the Swiss Civil Code, or at least as customary practice which the judge has to take into account pursuant to article 2 para. 2 of the Code of Obligations. The latter position suggests that the parties to a reinsurance contract who have not contractually diverged from customary principles, have implicitly agreed that they should apply. In legal literature, the customary practices in reinsurance are also characterised as "unwritten reinsurance contract law". Again, there is no case law regarding this issue. However, in its only published decision on reinsurance, the Federal Supreme Court also appears to take the position (in accordance with legal literature) that the general principles of reinsurance are to be considered as an integral part of reinsurance contracts and, accordingly, must be taken into account by the judge.

As far as the contents of the reinsurance principles is concerned, it appears questionable whether it can be said that a specific Swiss customary practice exists. Therefore, failing a contractual agreement, a Swiss judge will, *inter alia*, refer to foreign legal literature and case law and to the internationally recognised contents of such principles.

Analogous application of the Insurance Contract Act?

A controversial issue is whether the Federal Act on the Insurance Contract – regardless of its article 101 – should apply *by analogy* to reinsurance contracts as an additional source of law. Basically, the only consensus on this question is that the Insurance Contract Act cannot apply by analogy as a whole, but only through the analogous application of particular principles of insurance law. These may for example include the pre-contractual duty to inform the insurer of material facts relevant for the assessment of the risks to be insured. This is regulated in detail in article 4 ff. of the Insurance Contract Act.

It appears undisputed that there is a similar pre-contractual duty for the direct insurer towards the reinsurer. It is however unclear whether the form of such notification duty and its legal consequences as provided for in the Insurance Contract Act should also apply to reinsurance contracts. For example, article 6 of the Insurance Contract Act provides that the insurer is not bound by the contract of insurance if the insurer rescinds the contract within four weeks of becoming aware of a violation of such a notification duty. Should the reinsurer also have this right of rescission in relation to the direct insurer? And should the reinsurer also have a period of only four weeks within which to exercise the right to rescind? Furthermore, should a violation of the notification duty of the ceding company – as is the case for the direct contract of insurance (article 4 of the Insurance Contract Act) – only arise if the cedent has not responded correctly or completely to a written enquiry from the reinsurer? Or is there a duty for the cedent to draw the attention of the reinsurer to matters that could be relevant for the assessment of the risk, even though there has been no specific enquiry on the part of the reinsurer? – The lack of legal certainty in this area is, in particular, due to the fact that in

Switzerland there is practically no legal precedent on reinsurance contracts, as disputes in the field of reinsurance are normally resolved out of court (by amicable settlement) or are dealt with by arbitration tribunals. As a result, as already mentioned, there is only one published judgment of the Swiss Federal Supreme Court which deals substantively with reinsurance.

Revision of the Insurance Contract Act

As mentioned previously, not only the Insurance Supervisory Act but also the Insurance Contract Act is currently undergoing revision. A first bill which includes a partial revision of the Act may come into force on January 1, 2005. However, article 101 para. 1 sec. 1 of the Insurance Contract Act which excludes reinsurance contracts from its scope of application remains unchanged. Furthermore, it appears unlikely that this approach will be questioned by the forthcoming total revision of the Act.

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