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Financial Interest Insurance: The Innovative Companion for Global Business

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Changing trends, court challenges and top questions to ask.

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**If you want to go fast, go alone.
If you want to go far, go together.
– African proverb**

Anyone who has traveled the globe – or even a modest distance from home – knows the truth in that adage. For companies transacting business outside of their home-country's borders, the same maxim applies.

Whether your enterprise manufactures circuit boards, distributes commodities, sends workers across the globe or provides any array of professional services, you're already keenly aware of the myriad laws, regulations, risks and rewards associated with multinational business. Some of those risks and rewards are static across borders, while others require navigating the unique systems, cultures and codes of the countries where your transactions and commerce take place. Obtaining insurance for that blend of global business risks and opportunities presents both worldwide and country-specific pitfalls as well.

This paper paints a brief picture of the global insurance landscape as it applies to multinational business, and it identifies the questions to ask when insuring your company's affiliated worldwide interests with financial interest coverage – an innovative companion to global business and a potential tool for successfully moving your franchise both fast and far.

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Global Business, Local Regulation

Before explaining the scope and potential benefits of financial interest coverage, there should be an understanding of the business need that led to its creation.

There is an accepted legal conundrum in the international business community: While international commerce has become increasingly *globalized* over the past few decades, insuring the risks arising from such dealings points in the opposite direction – toward *nationalization*.

Even though contracts, currencies and goods travel across borders, your insurance may not. Insuring all of your global operations through a policy issued in London or New York will carry your business as far as a stone skipped across a pond – a good one will take you to several stops, but eventually that stone and your insurance may sink when it skips too far from home.

To be clear, for the home-country parent operation, worldwide coverage in its liability policies should mean just that: The parent company is protected for its own covered exposures no matter where in the world it faces risk or gets sued. However, an oft-overlooked challenge relates to protecting subsidiaries, affiliates, joint ventures, employees or directors, and the parent company's other peripheral business interests in foreign jurisdictions. Most countries have strict laws and regulations governing who may provide insurance to the people, entities and property residing, operating or situated in their nation, and the vast majority require locally admitted insurance to legally provide coverage for those exposures in order to be compensated locally for such losses.[1]

This is the point where the reach of a parent company's home-country insurance may fall like a fading skipped stone into the sea. Even for multinational carriers, insurance is regulated and licensed country by country, and a carrier must consider specific licensing requirements in each jurisdiction. Being licensed to insure risks in one country generally does not permit that carrier to provide local insurance in another. Notable exceptions to this rigid requirement include specific insurance trade zones such as the European Union (freedom of services permits the licensed carrier to insure risks throughout the European Union[2]) and obtaining coverage via Lloyd's of London (whose licensing rights extend to scores of countries[3]).

Moreover, unlike in the United States, where a national carrier usually licenses its companies in multiple or all states, carriers on the international stage generally license separate companies in separate jurisdictions. As a result, while ABC Insurance Company-London may issue XYZ parent company a policy in the UK, ABC Insurance Company-Brasil must issue a separate policy for XYZ's Brasilian subsidiary.

But doesn't my policy grant automatic coverage for subsidiaries? And isn't the coverage territory worldwide? The answer to both questions will most likely be yes. But the country-specific prohibitions against providing non-admitted insurance apply as a matter of law. Regardless of whether the policy expressly addresses that reality, the conclusion is certain: Unless a recognized exception applies, risks situated within most foreign countries can only be insured with a policy issued by a carrier specifically licensed in that foreign country.

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Truth and Consequences

Should there be any question about the importance of complying with local insurance laws and regulations, take note:

Virtually every country has steep fines and penalties, sometimes including imprisonment, for violations.[4]

There is also a notable track record of countries investigating unlicensed insurance arrangements and enforcing the relevant consequences. Those consequences are sometimes meted out to all involved: the insurer, the policyholder and the broker who arranged the transaction.[5] Given that the non-admitted insurer is oftentimes outside the reach of the local jurisdiction, however, the penalties are most often assessed against the policyholder and its local broker.

Examples exist worldwide (see Examples 1 and 2 on page 6).

The pitfalls of contravening laws and regulations governing unlicensed insurance are truly global. Beginning in 2007, the International Association of Insurance Supervisors began promoting a Multilateral Memorandum of Understanding among its members, formally establishing cooperation protocols leading toward more effective cross-border enforcement of local insurance laws. Updated in 2014 and now including 76 signatory jurisdictions, the Multilateral Memorandum of Understanding specifically includes the exchange of information concerning unauthorized business by unlicensed or non-admitted insurance companies.[6]

Relying on insurance issued by the home country to directly protect a foreign subsidiary can have other unexpected consequences for a policyholder as well. An example of those consequences is in Example 3 on page 6.

Consequently, a multinational business may think it has to choose between obtaining a locally admitted policy in each country where it has insurable exposures or self-insuring those exposures. While procuring multiple local insurance policies can be a solution for obtaining the most complete portfolio of country-specific insurance, such an approach places a heavy burden upon the home-country risk manager to assemble and compare coverages across multiple foreign countries on a cost-effective basis. That solution also carries the potential for a significantly higher price tag. In cases where the home-country parent has numerous foreign insurance interests, the premiums for multiple local insurance policies can quickly add up unless coverages are carefully coordinated.

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Truth and Consequences (continued)

Example 1: In Argentina, regulators fined a local policyholder eight times the amount of its insurance premium, and the broker 15 times that same premium, for placing business with carriers from the United States and the Isle of Man that were not licensed in Argentina.[7]

Example 2: Brasilian regulator SUSEP levied a staggering R11 billion fine against U.S. life insurer National Western for selling insurance in Brasil without a license – an amount that was reduced, after appeals that lasted several years, to 3 million Brasilian Reals.[8]

Example 3: The Brasilian subsidiary of Eli Lilly was fined US$450 million and its plants ordered closed after an environmental incident in that country. When Eli Lilly tendered the claim to its liability carriers in the United States, under policies that expressly provided global coverage for the enterprise, coverage was denied on the grounds that their policies could not, as a matter of law, provide coverage to the Brasilian subsidiary because none of the U.S. carriers were licensed to insure risks in Brasil. Protracted coverage litigation in the United States ensued.[9]

Example 4: Adidas Marketing Ltd. (AM), an Indian company primarily owned by a German parent company, Adidas AG (Adidas Germany), sustained a fire at its premises. AM tendered the claim under its local Indian insurance policy with Bajaj Allianz to cover its stock-in-trade and fixed-asset loss. AM recovered approximately US$6.7 million. In addition, Adidas Germany tendered the excess loss under its global insurance policy with Zurich Insurance, which provided coverage for "loss of financial interest due to erosion of economic value of subsidiaries." Adidas Germany received approximately US$12.6 million from Zurich Insurance.

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What Is Financial Interest?

Thankfully, there is another option. Financial interest coverage is first-party insurance that indemnifies the parent company for its financial loss arising from an uninsured loss incurred by a subsidiary. To trigger financial interest coverage, the subsidiary's loss must be one that otherwise would be covered under the parent company's policy but isn't, due to the fact that the parent company's policy was issued by an insurer that is unlicensed in the subsidiary's jurisdiction. As a result, while the subsidiary may not get direct coverage, the parent company can recover its own loss under its own home-country policy.

Financial interest coverage is a relatively new but legally viable and recognized tool offered by many carriers in the marketplace to provide virtually worldwide coverage for liability exposures in a much more economical fashion.

Numerous expert legal opinions have weighed in on the efficacy of this coverage.[10] Depending on the type of coverage and local market conditions, financial interest coverage may be included in the home-country parent company's policy with no additional premium. At present, carriers take vastly different approaches to financial interest coverage, and knowing how to navigate and negotiate around those differences is vital to optimally protecting your company's insurable risks.

Here's how it works: Insurance operates under the principle of insurable interests. For the most part, a party can procure insurance to protect its interests that are insurable under the applicable law. Universally, an entity has a recognized economic, strategic and operational interest in its assets; those assets include the viability and well-being of any subsidiary, affiliate or other entity in which the parent entity has some ownership or other legal interest, such as contractual liability. If a foreign subsidiary sustains a loss (e.g., a lawsuit arising from its products or operations), such loss usually accrues to the parent company as well, even if only on the parent's balance sheet. For the parent company, that is an insurable loss.

At least one appellate court has ruled on the efficacy of financial interest coverage as well, but only after a tax court initially levied a hefty penalty against the insureds for receiving impermissible insurance coverage from an alleged unlicensed insurance arrangement.[11]

In the Adidas example (Example 4 on page 6), the Indian Assessing Officer initially scrutinized the claim and determined that the financial interest reimbursement received by the parent company, Adidas Germany, should be treated as the income of AM and taxed in India accordingly. The Assessing Officer argued that the income was connected to the company's business in India and thus was accrued to AM. On appeal, the Delhi Bench of the Income Tax Appellate Tribunal (ITAT) held that the insurance compensation received by the foreign parent due to loss of financial interest in its Indian subsidiary was *not* the subsidiary's income as alleged by the Assessing Officer, and therefore was not taxable in India.

Ultimately, the ITAT found that the Zurich Insurance policy did not provide coverage to AM. As a result, the financial interest payment was income of the parent company and not AM. Therefore, the claim was not taxable in India and the financial interest loss payment to Adidas Germany was made consistent with the parties' expectations and intent.

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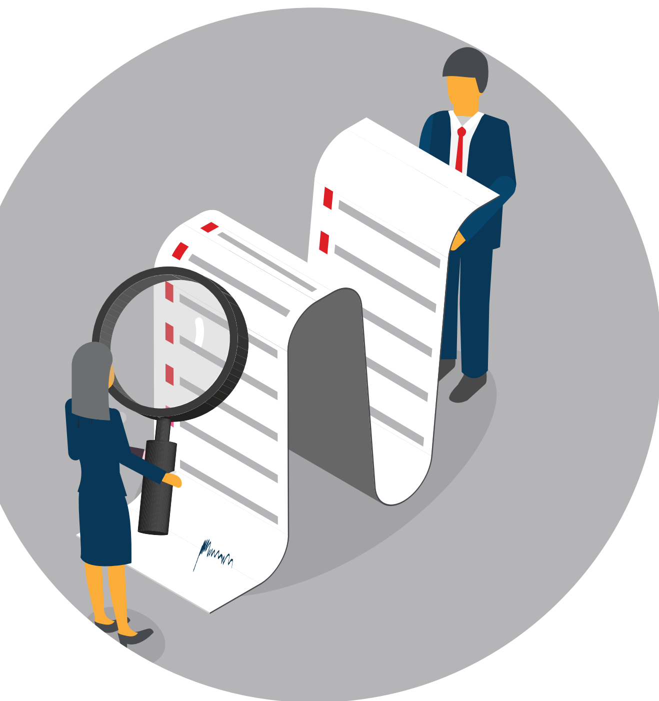
What Do I Need to Know?

If the parent company's policy contains this type of coverage, is that enough? Is all financial interest coverage the same? Simply put, no. To the extent that an insurance policy addresses this aspect of foreign coverage, typically the basics will be in fine print, leaving several outstanding issues to be debated between the parties at the time of a claim.

Who gets this coverage under the policy – is it only the first named insured or also any entity that qualifies as an insured? Does the coverage only indemnify actual losses, or are the foreign subsidiary's defense expenses, medical payments and crisis management expenses also covered as financial interest loss as well? What is the scope of the subsidiary's coverage? Do the conditions of the policy apply to the subsidiary even though the subsidiary is not covered for the claim? How and when does the loss become indemnifiable? Although this coverage protects the subsidiary losses flowing to the parent company's balance sheet, do all of these worldwide exposures share the same limit?



As with any coverage or determination, it is critical to read your policy and discuss these matters with your broker. Many standard insurance policies contain some mention of financial interest coverage, possibly in the conditions or extensions to the grant. Some contain more detailed provisions, addressing many if not all of the questions raised on this page. Some products, such as Travelers' Global Companion[SM] *Plus+*, even provide financial interest coverage as a stand-alone grant subject to a dedicated limit that does not erode the limits of insurance for the traditional P&C exposures of the parent company insured.

Among the more salient points to consider when reviewing terms and conditions applicable to financial interest is the definition and breadth of that important concept itself. Does it include only subsidiary or wholly owned entities? Would a loss by a joint venture be covered as well? Do sister companies or indirect-ownership situations qualify? What about situations where the parent company is contractually obligated to indemnify or insure a foreign operating entity even though there is no direct ownership interest? What happens if the subsidiary is less than wholly owned by the entity claiming a financial interest loss? And how will the claim be handled – locally or from outside the jurisdiction?

Again, reading your policy is paramount.

A promise of financial interest coverage is only as effective as the wording of the policy form and the strength of the carrier behind it.

Ultimately, with robust financial interest coverage, most multinational companies could conceivably secure adequate insurance coverage for many of their far-flung global concerns.

Use your mobile device to take a picture of the following page and text this list to your risk managers.

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5 Useful Questions for Risk Managers

The following questions and notes can help risk managers make smarter choices when evaluating coverage:

Which of your foreign entities can generate a financial interest loss?
Note: Some carriers only cover subsidiaries.

Does your financial interest cover defense costs?
Note: Some carriers are silent on this subject, which can lead to ambiguity.

Does your financial interest coverage have its own dedicated limit?
Note: Most policies do not, causing financial interest losses to erode the general liability limit.

Does your international policy cover foreign taxes on claim payments?
Note: Some policies either do not provide coverage or provide it on a limited endorsement-only basis.

Is your carrier able to refer you to in-country legal experts?
Note: Most carriers do not offer this service.

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An Enhancement to Local Coverage

So, is financial interest coverage a replacement for locally admitted policies in foreign jurisdictions? Is the choice to either purchase one or the other? The answer to both questions is the ultimate legal cliché: It depends. The unique insurance needs, risk appetite and location of its operations and exposures should be evaluated to best answer such questions for any multinational firm. It is wise to consult with a global insurance broker, tax and legal advisers, and current or prospective carriers during this process.

Generally, an insured might consider a combination of both local policies and a financial interest cover in the parent company's policy, rather than rely on just one of these solutions alone.

Procuring locally admitted insurance is often wise where either the scope of your ultimate risk is significant or the applicable local laws deem it optimal to have a policy issued by a carrier with in-country operations that can respond more directly to the needs of that foreign subsidiary or operation (e.g., coverage tailored to local market conditions, local claims handling). In addition, locally licensed insurance is a must for compulsory coverages such as auto, workers compensation or employer's liability, as well as any cover for which proof of local insurance is required. Locally issued policies are also critical for covering non-indemnifiable claims against foreign directors or officers (D&O Side A), an exposure that cannot be addressed via financial interest coverage.

Nevertheless, a strategy of only purchasing local insurance for your foreign subsidiary and affiliate interests is not a solution for all potential risks. Having financial interest coverage in the parent company's home-country's master policy provides potential safeguards against unexpected gaps in coverage that may arise.

The following two examples highlight how financial interest coverage potentially affords a global risk manager better confidence that the company's insurance program has addressed potential gaps in coverage:

In certain jurisdictions, including India and Japan, insurance coverage only becomes effective for the policyholder once the premium payment has been received by the carrier.

In those "cash before cover" countries, a claim arising in between the policy's binding and remittance of payment must technically be declined, leaving the policyholder uninsured for that claim. In that situation, financial interest coverage in the parent company's policy could be triggered, provided it's a covered claim, because the subsidiary's uninsured local loss creates a financial interest loss in the parent's policy.

Another situation where financial interest coverage provides an unexpected benefit is when a locally admitted foreign policy's terms and conditions either aren't broad enough to insure the specific claim or the policy has insufficient limits.

Again, if the details of the claim trigger coverage under the parent company's policy, the subsidiary's uninsured or underinsured loss could negatively affect the parent company's balance sheet and thus be covered via financial interest.

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Taxes: The Hidden Issues and Benefits

As American statesman Benjamin Franklin famously opined, the only certainties in life are death and taxes. The latter is certainly an important consideration in this area of insurance, too. Again, financial interest coverage, by design, provides indemnity in the home country to the home-country parent enterprise, even though the original loss stems from a foreign loss by a foreign operation. Once the financial interest loss is paid, the parent company may keep the insurance proceeds in-country to offset the parent's balance sheet loss, or it may desire to ultimately recapitalize the foreign subsidiary from which the loss emanated.

If the financial interest claim proceeds stay in-country with the parent, such claim payment might be considered a claim payment that is not subject to corporate income tax. However, the home country's taxing authority might alternatively deem the parent company's balance sheet reduction arising from the subsidiary's original loss to be an unrealized loss, thereby generating an income tax liability for the parent.

If the parent instead chooses to send a portion or all of those funds to its foreign subsidiary to make that subsidiary whole against its loss, the foreign subsidiary may well incur additional, unexpected income or other taxes, as well as foreign exchange losses, resulting in that subsidiary being made less than 100% whole. As a result, a loss paid to a home-country parent could potentially generate a net, after-tax payment to its foreign subsidiary that is less than the gross amount of that subsidiary's original loss, if in fact the amount of the financial interest claim payment were to be sent to the subsidiary and taxed, which is not exactly the insurance outcome an insured might otherwise expect.

Under either of the above scenarios, consideration of potential taxes is important.

The policyholder's tax adviser should always be consulted for guidance in this vital area. In addition, the parent company's policy should be read carefully to determine whether potential tax consequences are adequately addressed.

While many policies are silent on this important item, others, including Travelers' Global Companion℠ *Plus+*, contain an express tax benefit provision to mitigate taxation issues. Having tax liability coverage can provide the parent company with significant freedom and flexibility to make decisions, in consultation with their professional tax advisers, on how best to utilize financial interest coverage claim payments – flexibility and freedom that do not exist in the absence of such a critical coverage promise.

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Evaluating Your Opportunities, Insuring Your Risks

The world has grown far too small to avoid or retreat from engaging in global business. The specific location of foreign opportunities may change with the emergence, maturity and decline of particular markets, but the promise of international commerce, and the opportunity cost of avoiding it, is far too great.

Having decided to expand operations and investments beyond its home borders, every company must consider the optimal method for insuring its foreign-based risks.

As noted, options exist – self-insurance, procuring locally admitted policies in critical jurisdictions, securing financial interest coverage (ideally with tax liability reimbursement coverage) in your domestic liability insurance, or some combination of these solutions. The only other choice – non-compliance – is not wise.

The array of product offerings in this space is vast, and the variety and breadth of coverage can be staggeringly varied. Every multinational enterprise must carefully weigh its exposures in light of its own risk management appetite and strategy, and then make the choice that best suits it – a choice ideally made in consultation with its global broker or other insurance professional, in-house or outside counsel, and tax advisers. Even among competing choices, the ideal solution should be one that is tailored to meet the unique needs of the individual company considering its global footprint, financial strategies, insurance budget and tolerance for risk.

Financial interest coverage may well be the solution that carries your company both fast and far, or it may be but one aspect of your more complete portfolio of risk management tools. Regardless, it is a solution worth exploring as you navigate our rapidly changing world of risk.

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SOURCES

[1] See, e.g., Code des assurances [C. ass.] [Insurance Code] art. L.310-10 (Fr.).

[2] See, e.g., Zákon o pojišťovnictví [Insurance Act], Zákon č 277/2009 Sb. (Czech).

[3] Lloyd's Update: *Redefining the Future* (2019), http://thoughtleadership.aon.com/Documents/20190904-lloyds-update.pdf

[4] See, e.g., Criminal Law (promulgated by the Standing Comm. Nat'l People's Cong., July 1, 1979, rev'd Mar. 14, 1997), arts. 225, 231 (China).

[5] See, e.g., Hoken gyōhō [Insurance Business Act], Law No. 105 of 1995, arts. 3(1), 317-2(iv), 321(1)(iv), 337(i) (Japan).

[6] See *Multilateral Memorandum of Understanding* (*MMoU*), IAIS, https://www.iaisweb.org/page/supervisory-material/mmou (last visited Jan. 28, 2021).

[7] Decree No. 560/2009, May 15, 2009, Argentine Ministry of the Economy and Public Finance.

[8] See Ben Tavener, *Brazil Targets Unregistered Financial Services*, RIO TIMES (Nov. 15, 2011), https://riotimesonline.com/brazil-news/rio-business/brazil-targets-unregistered-financial-services; TozziniFreire Advogados, *Rs3 million limit on fines for unauthorised insurance operations*, LEXOLOGY, https://www.lexology.com/library/detail.aspx?g=e5e02459-59ba-4139-9f6a-02e914aa4566 (last visited Jan. 28, 2021).

[9] *Eli Lilly & Co. v. Arch Ins. Co.*, No. 1:13-CV-1770 (S.D. Ind. Filed Nov. 6, 2013).

[10] See, e.g., David Halperin, *Financial Interest Clauses – recent developments affecting multinational insurance programmes* Commercial Risk (Apr. 2020) https://www.commercialriskonline.com/financial-interest-clauses-recent-developments-affecting-multinational-insurance-programmes; Larry Schiffer, *What Is a Financial Interest Clause in a Reinsurance Contract?* IRMI: Expert Commentary (Aug. 2016) https://www.irmi.com/articles/expert-commentary/reinsurance-financial-interest-clause; Martin Strnad, *Neue Ausgestaltung Internationaler Versicherungsprogramme,* 2007 (Ger.).

[11] Adidas India Marketing (P.) Ltd. v. ITO, ITA No.1431/Del/2015 (India).

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