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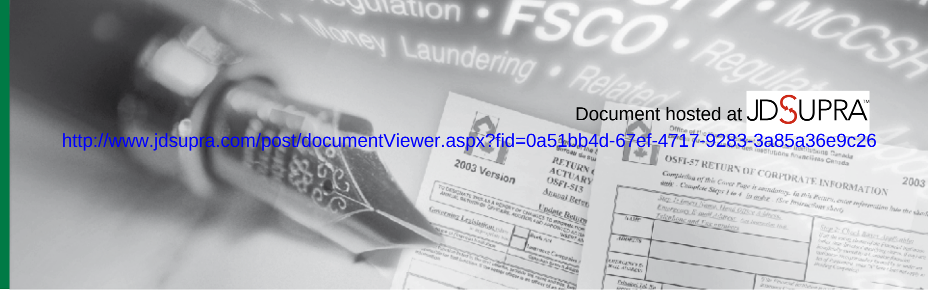


CorporateInsuranceBrief

Winter 2009

In This Issue

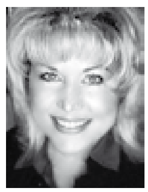
In this issue, Carol Lyons describes OSFI's new requirements for Canadian branches with respect to implementation of changes to Part XIII of the *Insurance Companies Act*. Carol also summarizes OSFI's new consultation paper on changes to the regulation of reinsurance.

Frank Palmay discusses risk-based regulation and insurer self-assessment, highlighting a change to Alberta's insurance legislation which he hopes will be followed by other provinces.

Hartley Lefton discusses a recent Supreme Court case that highlights the importance of selecting the correct insurance policy. Hartley also provides a summary of OSFI's new requirement for Canadian financial institutions to implement policies and procedures for assessing the suitability of "responsible persons".

Finally, George Waggott examines a decision regarding restrictive covenants in employment contracts entered into by employees, including those in the insurance industry.

OSFI Issues Implementation Instructions and Guidance Regarding Changes Affecting Foreign Companies



Carol Lyons

In December 2008, Canada's federal insurance regulator, the Office of the Superintendent of Financial Institutions ("OSFI"), issued documentation relating to the amendments to Part XIII of the *Insurance Companies Act* respecting foreign companies. The amendments will be effective January 1, 2010. These documents may be accessed on OSFI's website through the following link: http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=2729.

OSFI has stated that the amendments are necessary in order to align the *Insurance Companies Act* with the *Winding-up and Restructuring Act* as to the rights of policyholders and ceding companies in the event of a winding-up of a Canadian branch of a foreign insurer.

Prior to the amendments to Part XIII, OSFI's jurisdiction over the insuring activities of foreign insurers was based on a combination of the location of the insured risk and the location of the insuring activities. If the foreign insurer had a qualified branch in Canada, all Canadian risks were required to be reflected in the books of the branch. The amendments to Part XIII, together with OSFI's Advisory No. 2007-01 entitled *Insurance in Canada of Risks* (the "Advisory") make it clear that OSFI's jurisdiction over the activities of foreign insurers will be primarily determined based upon the location of the insuring activities (e.g. where the insurance transaction takes place, based on the location of marketing activities, policy issuance, premium payment, and other factors). If the risk was insured "in Canada", regardless of the location of the risk, then OSFI will have jurisdiction over that part of the foreign company's insurance business. If OSFI has jurisdiction over the business, the foreign company must be licensed in Canada and maintain a Canadian branch operation, including vesting assets in trust as collateral for its obligations insured in Canada, and be subject to Canadian reporting and other regulatory requirements. To the extent the risk was insured "outside Canada" then OSFI will not have jurisdiction over that insurance and there is no obligation to have a Canadian licence for that business or to vest assets in trust as collateral (except that collateralization is required in the case of reinsurance in order for the ceding company to receive capital/asset credit for the reinsurance).

Once these amendments are in force, it will be necessary for foreign companies that have insured, in Canada, risks located outside Canada to report that insurance business through the Canadian branch and vest assets in support of that business. On the other hand, it will be possible for foreign companies that have a Canadian branch operation to apply for release of assets currently vested in trust in Canada to the extent the assets relate to insurance business that was insured outside Canada. This also means that foreign companies may now carry on what is called "unregistered reinsurance" respecting risks located in Canada while at the same time maintaining a Canadian branch. In the case of unregistered reinsurance, the reinsurance would have to have been effected outside Canada and not be recorded on the branch's books.

As these changes are considered to be clarifications rather than amendments, OSFI requires adherence even before the amendments are proclaimed in force.

As these changes are considered to be clarifications rather than amendments, OSFI requires adherence even before the amendments are proclaimed in force. For example, in the case of an application for a portfolio transfer involving a Canadian branch, OSFI will take the opportunity to require the foreign company to perform due diligence to align the books of the branch with the "clarified regime". For branches that took Canadian risks onto their books that were written by the home office, this might mean shedding some business (with OSFI's consent). Conversely, for branches that wrote, in Canada, multi-national business for which the foreign risk was written by head office, this might require bringing those foreign risks onto the branch's books.

Implementation Instructions

Part XIII Progress Reviews

On December 19, 2008, OSFI issued a cover letter enclosing *Implementation Instructions* with respect to the amendments to Part XIII. All foreign companies that have a Canadian branch are required by OSFI to submit four quarterly progress reports for 2009-2010 relating to their identification of risks located outside Canada that were insured in Canada. The first report is due on May 31, 2009.

The progress review reports must describe the project structure, governance and timelines and key personnel involved, including accountabilities and an assessment of whether resources are sufficient to meet project deliverables. In addition, the reports must describe the internal controls that the foreign insurer will have in place to identify policies that have been insured in Canada prior to January 1, 2010 and set out a description of any significant impact that may result on the branch's vested asset account as a result of the amendments to Part XIII. Finally, the reports must also include the planned schedule for the project and a description of the foreign insurer's adherence to the schedule.

The cover letter describes OSFI's expectation that the foreign insurer must communicate with its auditors and actuaries with respect to its implementation review, as well as involve a senior officer from the home office. If the implementation will significantly impact the assets required to be vested in trust in Canada, OSFI expects the board of directors of the foreign insurer, or a committee of the board, to be involved. OSFI may take supervisory action in the case of any foreign insurers that do not take sufficient steps to identify their insured risks that will be subject to the new Part XIII regime.

Once the amendments are effective, Part XIII will also apply to foreign companies undertaking marine insurance in Canada.

Marine Insurance

Once the amendments are effective, Part XIII will apply to foreign companies undertaking marine insurance in Canada. In addition to the requirement to vest assets in trust, foreign insurers undertaking marine insurance in Canada that already have an established Canadian branch will be required to request to have their Order to Insure in Canada Risks amended to include marine as a class of insurance. Foreign marine insurers that do not have a branch (because marine was previously exempt) will be required to establish a Canadian branch in order to insure marine insurance in Canada.

Statement in Policy Documents

As set out in the *Implementation Instructions* dated December 2008, in order to comply with the statutory amendments, foreign companies that insure risks in Canada will be required to set out in legible characters in all premium notices, applications and policies a statement that the document was issued or made in the course of the foreign insurer's insurance business in Canada. This will identify risks insured in Canada as distinct from any business of the foreign company (including risks located in Canada) that is insured outside Canada.

Credit for Reinsurance

Federally-regulated institutions that are Canadian companies or Canadian-licensed foreign companies or societies ("FRIs") that obtain reinsurance for their Canadian business with foreign companies will only be allowed to receive a capital/asset credit for the reinsurance if (a) the foreign company reinsures the business in Canada (through a Canadian branch), or (b) the foreign company otherwise posts collateral as required by OSFI's capital/asset adequacy guidelines. FRIs will be able to rely on the identifying statement (described above) to determine whether their business was reinsured in Canada. Where reinsurance is being negotiated and the documentation has not yet been issued, FRI's will only be entitled to a capital/asset credit if the foreign reinsurer includes a similar statement in the cover note or quote.

> *[F]oreign companies that insure risks in Canada will be required to set out ... in all premium notices, applications and policies a statement that the document was issued or made in ... Canada.*

Procedure to Request Release of Assets for Business Insured Outside Canada

All business on the books of a Canadian branch as at January 1, 2010 will be presumed to have been insured in Canada, but foreign companies will be permitted to request to have assets released where the business was insured outside Canada. OSFI anticipates that it will take 6-8 weeks to process these requests.

The *Implementation Instructions* describe the procedure and steps required to be followed to make such requests, as follows:

1. The foreign company must provide OSFI with affidavit evidence attesting:

- as to the nature of the liabilities recorded on the books of its Canadian branch and reported in its regulatory filings (e.g. insured in Canada or outside Canada);
- that the foreign insurer has undertaken a due diligence review to identify all liabilities relating to risks located outside Canada that were insured in Canada prior to January 1, 2010; and
- as to the portion of liabilities that were insured outside Canada in accordance with the Advisory as well as the vested assets maintained in respect of those liabilities.

2. As part of the affidavit, the foreign company must provide OSFI with a detailed description of the process the foreign company followed to verify the information in item 1.

3. Also as part of the affidavit, the foreign company must provide OSFI with a statement itemizing:

- the amount of liabilities it added to its books (i.e. that were insured in Canada but not previously recorded on the branch's books);
- the amount of liabilities relating to risks located in Canada that were insured outside Canada prior to January 1, 2010;
- the liabilities relating to risks located in Canada that were insured in Canada at the time of the request; and
- in each case, the corresponding amount of vested assets held by the branch relating to such category of liabilities.

This statement must also confirm that the branch will meet OSFI's test for adequacy of assets (as applicable to life and property and casualty insurance, respectively) if the request were to be granted.

4. In the case of reinsurance, the foreign company must obtain permission to proceed to the following two steps.

5. Where the request relates to reinsurance business that was reinsured outside Canada, the foreign reinsurer must send written notification to the FRIs that are its ceding companies providing information with respect to the foreign reinsurer's request to OSFI and notifying them that, if the request is granted, assets previously vested in trust with respect to the reinsurer's liabilities will be removed from the trust account and the reinsurance will thereafter be "unregistered", such that the ceding company will not receive capital/asset credit for the reinsurance. The notification will also ask the ceding FRI to provide the foreign reinsurer and OSFI with notice of any objection it has within 30 days.

6. The foreign reinsurer must subsequently provide OSFI with confirmation that the steps in item 5 were completed and information regarding any objections received and, if received, how such objections were resolved (with a copy sent to the ceding FRI).

7. OSFI will then notify the foreign company and its auditors in writing (and the ceding FRI's if applicable) that it approves the request.

OSFI cautions that the Canadian provinces and territories may impose different requirements which may apply to the extent the foreign company is licensed in those jurisdictions.

In this document, OSFI cautions that the Canadian provinces and territories may impose different requirements which may apply to the extent the foreign company is licensed in those jurisdictions.

Questions and Answers

A *Questions and Answers* document accompanies the *Implementation Instructions* to provide guidance to insurers that will be affected by the amendments to Part XIII of the *Insurance Companies Act.*

Note to Cedants

Also on December 19, 2008, OSFI issued a *Note to Cedants* designed to assist ceding FRI's to determine whether they are entitled to capital/asset credit in connection with reinsurance they have placed with foreign companies in light of the changes to Part XIII. The note advises ceding FRI's that the foreign reinsurer may be entitled, on notice to the FRI and subject to OSFI's consent, to request release of assets vested in trust that relate to the reinsurance ceded by the FRI which, in turn, means that the FRI would no longer be entitled to capital/asset credit for the reinsurance. The note also cautions ceding FRI's that, even where no notice is given by a foreign reinsurer to release vested assets, the FRI may find itself without a valid claim against the Canadian branch's vested assets account in the event of a winding up of the Canadian branch (i.e. if the reinsurance activity took place outside Canada). In the case of uncertainty as to the location of the reinsurance activities for historical reinsurance, the note advises a ceding FRI not to take credit for the reinsurance unless assets are specifically vested by the reinsurer for the reinsurance arrangement. It also suggests that the FRI attempt to remove any uncertainty on renewal of the reinsurance by following the Advisory to ensure the reinsurance activities take place in Canada.

On a going-forward basis, the note states that ceding FRI's will be eligible for a capital/asset credit for reinsurance by a reinsurer falling within one of the following four categories:

- a Canadian insurance company or society;
- a foreign company that reinsured the risks in Canada;
- a provincially/territorially regulated insurer where criteria specified in OSFI's capital/asset adequacy guidelines are met; and
- another entity that makes collateral available in Canada as specified in OSFI's capital/asset adequacy guidelines.

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Ed.: *A version of this article appeared previously in* "International Law Office", *an e-subscription information service that delivers global analysis of legal developments to lawyers worldwide.*

Alberta Provides Privilege for Self-Assessment Programs

Frank Palmay

In November 2008, Alberta became the first Canadian jurisdiction to provide privilege for the self-assessment programs of insurance companies.

Risk based regulation involving self-assessments overseen by a company's governing structure are an effective and ever growing mode of regulation. In Canada, the federal insurance regulator which oversees the prudential (solvency) of the majority of Canadian insurers and all foreign insurers operating in Canada has adopted it. The provincial regulators are looking at it for market conduct regulation and, where they have responsibility, prudential (solvency) regulation. It is a regulatory model that can be applied to other areas of regulation and in the broader area of risk management.

Risk based regulation requires companies to implement a system which identifies risks (for example, regulatory compliance), and requires periodic reports on compliance to be provided to a compliance officer who is charged with overseeing the system and who reports to the appropriate corporate governance body, usually the board of directors or a committee of the board.

Risk based regulation is felt to be effective and desirable for a number of reasons, including:

- Systematic and proactive approach to identifying problems early and thereby enhancing the company's ability to rectify.

- Alignment with the company's corporate governance. Risk management is one of the important oversight functions of the board of directors. A robust and effective risk management system can also provide directors statutory due diligence protection.

- Increased regulatory efficiency. Regulators can focus on risk or problem areas rather than devoting limited human and financial resources examining areas of operations that pose little or no risk.

In addition to insurance company regulation, the risk based approach also applies to privacy and money laundering and anti-terrorism regulation. It will be interesting to see if this approach becomes part of the much expected revamping of the financial regulatory system.

Sophisticated web-based self-assessment systems are available in Canada. A properly operating self-assessment system provides a central and readily accessible location for problems identified and how they are dealt with by the company.

Insurers, understandably, are concerned that a robust and effective self assessment system, which is designed to identify and document problems and instances of non-compliance, does not provide a roadmap for plaintiffs and others wishing to attack the company. A number of U.S. states have introduced privilege provisions to address this concern.

Starting in 2005, a working group of the Canadian Council of Insurance Regulators (CCIR) looked at this issue. After consulting with a number of groups, the working group issued its final report in the summer of 2008, recommending that privilege be extended to self-assessments and proposed a form of wording that can be included in legislation to achieve this.

Alberta is the first Canadian jurisdiction to act on the CCIR recommendation. The privilege provisions are found in section 816.2 of the *Insurance Act* (Alberta). It defines what constitutes an "insurance compliance self-evaluation audit" and the resulting "document". With some very express and limited exceptions, it makes those documents privileged and non-discoverable or admissible in civil and administrative proceedings and prohibits being able to discover or require their production in such proceedings. The exceptions to privilege are: (i) proceedings commenced by the regulator; (ii) privilege asserted for fraudulent purposes; (iii) proceedings involving disputes with a person involved in the audit; and (iv) non-audit information referred to in the document. The section also addresses the issue of waiver. While the company may waive the privilege, disclosures to persons with "a need to know" including auditors, directors and regulators does not constitute waiver.

Alberta's approach is a reasonable balance of the equities and its lead will hopefully be followed by the other jurisdictions.

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Ed.: *A version of this article appeared previously in* "International Law Office," *and is frequently referenced in an article entitled* *Alberta First Out of the Gates to Adopt CCIR Privilege Model*, *featured on the* Canadian Underwriter *website.*

The Importance of Being Earnest in Insurance Matters

Hartley Lefton

How well do insurers and insureds understand their policies? Do the policies fit the business needs of the insured? Recent cases in Canada and in the United Kingdom demonstrate the importance of knowing and understanding insurance policies and ensuring that policies are appropriate to the insured's needs. In each case, a "claims-made" policy was in dispute and both courts' rulings turned on the precise details of the insurance policies. The implications of these judgments illustrate the importance of knowing and understanding your insurance policy – as with many insurance cases, millions of dollars may be at stake.

Types of Insurance Policies

Two general types of insurance policies are available that provide coverage to insureds, (e.g. guaranteeing a defence and providing partial or full indemnification).

"Claims-made" policies cover insureds according to when a claim is filed by a third party against the insured. If the claim is made during the policy period, the insurer is required to indemnify the insured, regardless of when the act giving rise to the claim occurred. Claims-made policies offer a degree of certainty to insurers and insureds: after the expiration of the policy, they know that no new claims may be made based on that policy, and insurers can calculate future premiums with extra certainty.

In contrast, "occurrence-based" policies cover insureds according to when the act giving rise to the claim occurred. If the act occurred during the policy period, the insurer is required to cover the insured. Occurrence-based policies offer insurers and insureds a different sort of predictability: each party knows the term during which the insurer is liable for coverage, providing them with time to work together to mitigate risk as much as possible.

Other policies – such as those which blend elements of claims-made and occurrence-based policies – also exist; however, "claims-made" and "occurrence-based" policies are the two principal types of insurance policies.

From 1913 to 1958, the Jesuit Fathers of Upper Canada operated and administered a school in Spanish, Ontario ... As early as 1988, rumours and news articles suggested that improper activities – including harsh discipline and sexual abuse – took place at the school.

Claims-Made Policies Interpreted in Canada

The Supreme Court of Canada's ("SCC") recent ruling in the case of *Jesuit Fathers of Upper Canada v. Guardian Insurance Company of Canada and ING Insurance Company of Canada* (the "Jesuit Case") adds new context to the treatment of claims-made policies.

From 1913 to 1958, the Jesuit Fathers of Upper Canada operated and administered a school in Spanish, Ontario (the "Spanish School"). The Spanish School was operating under a federal policy to educate and assimilate Aboriginal children in Canada. The Spanish School closed in 1958.

As early as 1988, rumours and news articles suggested that improper activities – including harsh discipline and sexual abuse – took place at the spanish school. In January 1994 a lawyer informed the Jesuits of a claim by her client who alleged physical and sexual abuse, and offered to settle the claim (the "1994 Letter"). By the end of January 1994, the Jesuits knew of other general claims of abuse at the Spanish School.

Counsel for the Jesuits wrote to the Jesuits' insurer on March 18, 1994 (the "March Letter"), advising the insurer of the possibility that the Jesuits may, in the near future, face claims other than those in the 1994 Letter. After the conclusion of the term of the insurance policy, approximately 100 additional claims were made, making allegations similar to those outlined in the March Letter, including claims of abuse resulting from the lack of proper supervision. Even though the claims themselves were made after the conclusion of the Jesuits' insurance policy, the Jesuits sought indemnification against these claims as the general facts underlying the claims were communicated to the insurer during the policy period.

The Jesuits had purchased from two insurers (the "Insurers") a general liability insurance policy (the "Policy") that expired on September 30, 1994 and that provided insurance with respect to professional services offered by the Jesuits, such as those at the Spanish School. The Policy was a claims-made policy that differentiated between a "claim" and a "circumstance or occurrence." This distinction was made in various sections of the policy.

Prior case law has established that a "claim" requires a clearly communicated intention by an alleged victim (the "Third Party") to hold the insured responsible for certain damages. The required communication, at minimum, is a clear intention by the Third Party to hold the insured responsible for the damages. This clear intention could include a demand for compensation or another form of reparation.

The SCC found that, with the exception of the 1994 Letter, the notification given to the Jesuits did not meet the standard of a claim as these notifications did not include an intent to hold the insured responsible for specific damages. The Jesuits' general knowledge of events that may have given rise to potential claims did not, of itself, constitute a claim. As a result, there was no duty for the Insurers to defend against any other claims against the Jesuits, as the duty to defend relates only to claims and complaints that fall within the coverage period of a policy. The SCC held that, while the general circumstances giving rise to the other claims were known to the Jesuits prior to the expiration of the Policy and were communicated to the Insurers, the specific claims were made only after the expiration of the Policy. Since the Policy covered "claims" and not "circumstances", there was no coverage under the Policy for these later claims.

The SCC held that, while the general circumstances giving rise to the other claims were known to the Jesuits prior to the expiration of the Policy and were communicated to the Insurers, the specific claims were made only after the expiration of the Policy. Since the Policy covered "claims" and not "circumstances", there was no coverage under the Policy for these later claims.

The SCC also noted that a provision known as a "Notice of Circumstance Clause" (the "NCC") is available in some commercial contexts. An NCC permits an insured to report, during the policy period, circumstances that may give rise to future claims. Any claims based on circumstances brought to the attention of the insurer, but made after the expiry of the policy period, are deemed to be made during the policy period. As the Policy did not include an NCC, even though it was commercially available upon the last renewal, the SCC inferred and determined that the Jesuits did not desire that this coverage be included in the Policy. In the SCC's view, a refusal to take on additional coverage (e.g. an NCC) is an implied rejection of the terms of this coverage and bars the insured from claiming these terms at a future date.

Claims-Made Policies Interpreted in the United Kingdom

The case of *HLB Kidsons v. Lloyds Underwriters* (the "UK Case") offers a useful international point of comparison against the treatment of claims-made policies in Canada.

A firm of accountants (the "Accountants") owned a company which designed and sold schemes to avoid tax. This firm received claims from its customers in respect of these tax avoidance schemes, on the basis that they did not achieve the purpose advertised. These claims were over a range of tax plans and alleged that the Accountants were negligent in their advice, in making false representations about the tax schemes, and in not providing sufficient warning of the possibility that the government may reject the schemes.

The Accountants' insurance policy (the "UK Policy") was a professional indemnity policy, which operated on a claims-made basis. General Condition 4 of the UK Policy required the insured to provide notice to the insurer "as soon as practicable of any circumstance… which may give rise to a loss or claim against them." Where notice was given prior to the expiration of the UK Policy, the insurer was required to indemnify and defend the insured, even if an actual claim was made after the conclusion of the UK Policy. This policy was different than that in the Jesuit Case, as the notification required in this case is that of a circumstance that may give rise to a claim, while the notification required in the Jesuit case was of a claim itself; however, the policies each required notification to the insurer and offered coverage based on when notification was received by the insured, as opposed to when the insured act took place.

The Accountants argued that proper notification was provided under the Policy. They relied on letters written to representatives of the insurer during the covered policy period, dated August 31, 2001 and March 28, 2002.

The U.K. Court found that notifications should leave a "reasonable recipient in no reasonable doubt" that the insured person was giving notice of a potential claim which would trigger the policy. This notification should be clear and unambiguous. The Court also found that any claim would have to be fairly said to have arisen out of the circumstance that was covered.

The letter of August 31, 2001 was addressed to a placing broker, rather than the claims broker who would normally be sent such notices. As well, the letter was vague about specific allegations made to the Accountants regarding the Accountants' work and failed to identify any specific victim of poor work, or any possible claimant against the Accountants. When this letter was received by the underwriters, it was treated as being for information purposes only and was not considered to be notification of a circumstance, but rather was referred to in the letter as "material information for insurers." In contrast, in prior notifications made by the Accountants in prior years, explicit references were made to "circumstances." As a result of these facts, the Court did not find the letter to be a valid notification of a circumstance.

The letter of March 28, 2002 provided more detail and clarity than did the letter of August 31, 2001. The March 28 letter observed that problems may arise with each scheme that would affect the proper implementation of the scheme, and may lead to future "criticism". The Court found that a reasonable recipient of this letter would appreciate that the Accountants were notifying the insurers of the possibility of claims arising in the future. However, the Court also found that this notification was limited to the problems identified in the letter, and that the notification could not be extended to all of the other tax avoidance plans the Accountants promoted.

The Court found that, for insurers to cover claims made against the Accountants, the circumstances giving rise to these claims would need to have been brought to the attention of the insurers and the loss or claim would have to have been sufficiently causally related to this circumstance such that a reasonable person can fairly say that the claim arose out of the circumstance.

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Final Remarks

In each of the cases above, the final decision of the relevant court turned on the precise details of the insurance policies. In the Canadian case, notification to insurers required knowledge and receipt of a formal intention by alleged victims to hold the insured responsible for damages. In the U.K. case, notification to insurers required only notification of a circumstance that may give rise to a formal claim. However, in each case, it was crucial for the insureds that the notification given to insurers was clear to a reasonable person, and that this notification related directly to the ultimate claim.

With this case law in mind, insurance companies and insureds are advised to:

- discuss the offerings of insurance companies and clients' business needs, to ensure that the most appropriate insurance is being used in each situation;
- ensure that all notifications are clear and appropriate and meet the standards set out in the insurance policy;
- keep track of timelines in the policy (including policy expiry and notification dates) to verify that claims and notices are made within the prescribed limits; and
- consult with a lawyer when negotiating insurance contracts, when making or reviewing notifications or claims, or if in doubt about their legal rights.

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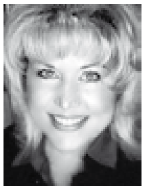
Ed.: *Different versions of this article, under different titles, appeared previously in* "International Law Office"*, as well as in Lang Michener's* In Brief.

OSFI Seeks Input on Proposed Changes to its Regulation of Reinsurance



Carol Lyons

On December 12, 2008, the Office of the Superintendent of Financial Institutions ("OSFI") (www.osfi-bsif.gc.ca), Canada's federal insurance regulator, released a consultation paper relating to its "Regulatory and Supervisory Approach to Reinsurance". The paper describes OSFI's overall philosophy with respect to reinsurance and outlines certain initiatives that are currently being considered.

OSFI has requested feedback from the industry and other stakeholders by March 6, 2009. The Insurance Bureau of Canada (www.ibc.ca) has announced that it is preparing a submission which it will in turn coordinate with the Reinsurance Research Council (www.rrccanada.org) and the Property and Casualty Insurance Compensation Corporation (www.pacicc.com).

To put the discussion paper in context, a number of regulatory initiatives relative to reinsurance have recently concluded or are underway in other jurisdictions. In 2007, the International Association of Insurance Supervisors (www.iaisweb.org) published a discussion paper on mutual recognition arrangements for the supervision of reinsurance. The National Association of Insurance Commissions in the United States (www.naic.org) is in the process of reviewing proposals for changes to its supervision of reinsurance. There have also been similar developments on insurance/reinsurance regulation and supervision in Australia and the European Union. These developments have prompted the discussion paper. OSFI is seeking consultation with respect to the topics set out below.

To put the discussion paper in context, a number of regulatory initiatives relative to reinsurance have recently concluded or are underway in other jurisdictions. ... These developments have prompted the discussion paper.

Unregistered Reinsurance

25% Rule For Unregistered Reinsurance

A current feature of OSFI's regulation of reinsurance is a 25% limitation on reinsurance that can be ceded by Canadian-licensed property and casualty insurers to reinsurers that are not licensed in Canada either as a subsidiary or a branch ("unregistered reinsurance"). This rule is to limit insurers' exposure to foreign reinsurers not regulated in Canada. OSFI is questioning the relevance and appropriateness of this rule in the current environment, noting that its application constrains diversification of risk by ceding companies.

OSFI is considering moving to a more principle-based approach and may consider replacing the 25% limit on unregistered reinsurance with an overall requirement for insurers to adopt sound reinsurance practices and procedures.

Limit on Letters of Credit as Collateral

Collateral is required to be vested in trust in Canada for unregistered reinsurance in order for ceding companies to receive credit for the reinsurance. There are rules regarding the types of assets that are acceptable for this purpose, one of which is to restrict the use of letters of credit to 15% of the risks ceded to the unregistered reinsurer. OSFI is considering changing the 15% limitation on letters of credit.

Mutual Recognition of Extra-Jurisdictional Reinsurance Regulation

Commentators have suggested that mutual recognition of reinsurance regulation could facilitate the cost effectiveness and availability of reinsurance. Basically, the concept of mutual recognition involves two or more reinsurance regulators that, by agreement, recognize the other jurisdictions' regulation of reinsurance as acceptable, such that collateralization and other restrictions relating to unregistered reinsurance could be reduced or eliminated.

OSFI recognizes that a number of steps would need to be taken before it could enter into mutual recognition agreements, including an analysis of the supervisory, legal and tax framework in the proposed jurisdictions to be recognized, development of risk-based capital requirements for Canadian companies ceding to unregistered reinsurers and coordination with the insurance regulators of the Canadian provinces.

OSFI may consider approaches similar to the current proposals in the United States and Australia, whereby collateralization requirements may be reduced or eliminated for certain reinsurers, for example, based on the reinsurer's risk ratings. OSFI notes that care would have to be taken to "avoid creating a competitive *advantage* for unregistered reinsurers".

Unregistered Reinsurance with Related Parties

Under the "self-dealing" provisions of the *Insurance Companies Act*, Canadian ceding companies must obtain OSFI's approval before they can cede risks to affiliates that are not licensed in Canada. Administering this approval process may be using up a disproportionate amount of OSFI's resources and OSFI is considering streamlining these approval requirements, for example, by the development of materiality criteria as a threshold.

Registered Reinsurance

Capital Requirements

Because the life and property and casualty sectors undertake different kinds of risks, OSFI has historically differentiated between the life and non-life sectors in the imposition of capital/asset charges for insurers ceding risks to Canadian-licensed reinsurers ("registered reinsurance"). Currently, OSFI imposes a "counterparty credit risk" capital charge on property and casualty insurers in respect of registered reinsurance that does not apply to life insurers. OSFI proposes to implement a capital charge on the life sector in the next round of changes to the credit risk component of the Minimum Continuing Capital and Surplus Ratio (MCCSR) test.

> *OSFI may consider approaches ... whereby collateralization requirements may be reduced or eliminated ...based on the reinsurer's risk ratings. [C]are would have to be taken to "avoid creating a competitive advantage for unregistered reinsurers".*

OSFI also proposes to implement a minimum capital charge of 25% of MCCSR gross capital requirements for life insurers to account for "operational risk" associated with registered reinsurance. Currently, life insurers have a 20% flat capital charge on business embedded in their MCCSR for this risk.

Limit on Risks Ceded

The regulations under the *Insurance Companies Act* impose a maximum limit on reinsurance by property and casualty insurers of 75% of gross written premiums. OSFI is questioning the effectiveness of this overall "fronting" limit and, because of existing regulatory risk controls, such as prudential requirements, actuarial reviews and required stress-testing of capital adequacy, will consider replacing the 75% limit with an operational risk capital charge similar to the proposal for the life sector. OSFI is also considering the formulation of new guidance for both life and property and casualty insurers which would require adequate due diligence with respect to reinsurance practices.

Approvals for Registered Reinsurance Transactions

In 2007, the *Insurance Companies Act* was amended to change the approval requirements for certain reinsurance transactions. These approvals relate to assumption reinsurance transactions where blocks of Canadian business are transferred from one licensed insurer to another. The amendments relating to Canadian insurers came into force in 2007 and the amendments relating to foreign companies licensed in Canada are scheduled to come into force on January 1, 2010.

The former approval requirements for assuming (purchasing) insurance policies from another licensed insurer were removed in the case of both domestic insurers and foreign Canadian-licensed insurers. For domestic insurers, the Minister of Finance's approval is only required for ceding, on an assumption basis, "all or substantially all" of the insurer's risks. For domestic insurers that cede, on an assumption basis, less than substantially all of the insurer's risks, only the Superintendent's approval is required. When the amendments respecting foreign companies come into force, only the Superintendent's approval will be required in connection with foreign companies that cede, on an assumption basis, all or any portion of its risks. So, OSFI will no longer regulate the assumption side of the transaction; only the cession.

Although the reinsurance approval regime is a key element of OSFI's regulation, OSFI is open to suggestions for improvement, particularly in light of the other proposed changes contained in the consultation paper.

Revised Guidance

OSFI is working on updating Guideline B-3 (currently entitled Unregistered Reinsurance). The update will apply to both registered and unregistered reinsurance and will require insurers to establish and implement sound reinsurance cession practices and procedures (including, for example, a reinsurance management strategy, criteria for reinsurer suitability, risk concentration limits, limits on authority to execute reinsurance agreements, internal systems for monitoring, and risk management and compliance mechanisms) as part of overall enterprise risk management. OSFI is considering whether this approach will pave the way to removing the 25% limit on cessions to unregistered reinsurers and the 75% aggregate limit on cessions of gross written premiums, both discussed above.

OSFI also plans to revise Draft Guideline B-13 (currently entitled Reinsurance Agreements) to address the issue of time lags between the date on which the reinsurance is agreed to in principle and the date on which final documentation evidencing the arrangement is actually executed by the parties. The revisions will also address specific clauses in reinsurance contracts, such as the need for an insolvency clause requiring the reinsurer to continue to provide reinsurance without diminution notwithstanding insolvency of the ceding company. OSFI points out that some jurisdictions in the United States require reinsurance agreements to have an insolvency clause in order for the insurer to receive credit for the reinsurance. The guidance will also address the use of types of clauses to be avoided; for example, those which could operate to allow the reinsurer to receive preferential treatment over creditors/claimants of the insolvent insurer.

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Government Enacts Changes to Reinsurer Oversight

Hartley Lefton

On March 29, 2007 the government passed Bill C-37 as part of its five-year review of the laws governing financial institutions. However, it reserved the implementation of a number of the bill's components. One such component was recently enacted and will reduce the regulatory cost for licensed reinsurers doing business in Canada.

New Section 489.3 of the *Insurance Companies Act* and Regulation SOR/2008-167 permit reinsurers to apply for exemption from the oversight of the Financial Consumer Agency of Canada (FCAC). Previously, as is the case with all Canadian federally regulated insurers, reinsurers were:

- required to file assessments with the FCAC;
- obliged to have and publish complaint-handling procedures; and
- required to be members of a third-party dispute settlement mechanism.

However, as the government is seeking to alleviate unnecessary compliance burdens placed on insurers that do not deal directly with individuals or small businesses, it was felt that these requirements, while necessary for insurers, were unnecessary for reinsurers. As a result, reinsurers are now eligible to apply for exemption from this FCAC oversight.

Insurers may apply for exemption from the FCAC oversight if:

- their order to insure risks in Canada is restricted to reinsurance;
- the company provides the FCAC commissioner with a declaration stating that it does not deal with the prescribed group of consumers; and
- the company does not deal with the prescribed group of consumers.

The prescribed consumers are individuals and enterprises, other than financial institutions, which have fewer than 500 employees and gross annual revenues of less than C$50 million. Insurance companies that deal with financial institutions or larger enterprises may apply for exemption from the FCAC oversight.

Many global financial regulators are likely to respond to the current credit crunch by increasing the attention that they pay to companies under their jurisdiction, which will serve only to increase the cost of compliance with these regulatory rules; however, Canadian regulators have focused their efforts thus far on protecting smaller, less sophisticated consumers.

If reinsurer exemption from the FCAC oversight is part of a continuing trend away from a 'one size fits all' approach to regulation and towards targeted regulation, this will have the effect of lowering costs for financial sector participants in Canada.

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New Assessments Required of the Corporate Leaders of Financial Institutions in Canada – The Thin Edge of the Wedge?

Hartley Lefton

In February 2008, Canada's Office of the Superintendent of Financial Institutions (OSFI) - the primary Canadian regulator of financial institutions - released a new guideline to be followed by federally regulated entities in the financial sector (including banks, trust and loan companies, cooperative credit associations, insurance companies, branches of foreign banks and branches of foreign insurance companies) operating in Canada. This new guideline became effective January 31, 2009. Guideline E-17, "Background Checks on Directors and Senior Management of FREs (Federally Regulated Entities)" is a result of the OSFI emphasis on risk management. Specifically, Guideline E-17 is aimed at mitigating risks impacting the stability, financial soundness and reputation of the organization that may be posed by the leadership of an organization, by requiring assessments of the suitability and integrity of these individuals.

This risk management effort has created ongoing assessment and examination requirements of the corporate leaders of these institutions. In light of the global economic turmoil and what is likely to be a flight to regulation, other jurisdictions are likely to impose similar and enhanced requirements on key market sectors. Corporate actors in the Canadian market are required to abide by Guideline E-17; corporate actors outside of Canada are advised to keep an eye on the Canadian example, as other countries in which they operate may be next to impose additional regulation. In the near future, and in response to the credit crunch, regulators will be likely to "err on the side of regulation". While other jurisdictions require assessments of responsible persons and a common benchmark has been set, in this instance OSFI's approach appears to be one which takes some of the highest standards from regulators around the world.

> *In light of the global economic turmoil and what is likely to be a flight to regulation, other jurisdictions are likely to impose similar and enhanced requirements on key market sectors… In the near future, and in response to the credit crunch, regulators will be likely to "err on the side of regulation".*

Effective January 31, 2009, the federally regulated entities described above were required to establish written policies and procedures to conduct assessments of the suitability and integrity of the corporate leaders referred to in Guideline E-17 as 'responsible persons'. This class of person includes directors, principal officers, chief agents and the senior management of the organization, which may include the chief executive officer, the chief financial officer and any other officer who has a functional reporting line directly to the board of directors or chief executive officer.

OSFI's approach to ensuring the suitability and integrity of responsible persons is part principles-based and part risk-based. Guideline E-17 sets out various principles in the establishment of policies and procedures in the conduct of assessments of responsible persons. However, OSFI has also indicated that it will, where warranted, assess an entity's processes based on risk factors. For example, OSFI will use a risk-based approach when reviewing how companies address situations where assessments of responsible persons reveal an enhanced risk to the company.

Requirements

Effective January 31, 2009, financial institutions and branches were required to:

- determine which individuals and job categories should be considered responsible persons;
- design a policy for assessing these responsible persons;
- abide by this policy; and
- at regular intervals, assess each responsible person (as well as potential new responsible persons) to determine whether they are suitable or have the correct integrity, and to ensure that unsuitable people do not have positions of responsibility.

Companies and branches will need to be aware of the importance of their assessment policies and their proper implementation. In particular, they should:

- ensure that an appropriate schedule and timeline of assessments is designed, including assessment frequency;
- select appropriate jurisdictions and determine how far back verifications should be conducted, based on the responsible person, the position held and the circumstances;
- assess when attestations from responsible persons (or individuals being considered for a position that would make them a responsible person) will be sufficient and when independent verification will be necessary; and
- determine effective key practices to follow with respect to, for example, disclosing the organization's assessment policy to responsible persons or potential new responsible persons, or deciding what to do if the assessment of a responsible person or a potential new responsible person reveals concerns with the person's background.

With respect to the assessment process itself, companies and branches will need to address certain questions, such as the following:

- Who will conduct the assessment? Will the assessment be done internally or outsourced? How will the assessors be selected?
- What information will be sought by the assessors?
- What type or quantity of adverse information is material and sufficient to disqualify a person from a position as a responsible person?
- What additional information (if any) should be sought to follow up on this adverse information? Examples of additional information may include mitigating factors or circumstances that influenced or led to the adverse circumstances and information.
- How will decisions be reached? Will the company appoint a committee or will there be an ultimate decision maker? Who will assess the assessor(s)?
- How will the process be documented? Proper documentation will be essential to protect the institution where responsible persons, or potential responsible persons, later allege that they were treated unfairly during or after the process and possibly seek damages from the company, its board of directors or the assessors.
- Where a responsible person is not removed, what risk minimization and mitigation techniques will the company use? These could include more frequent assessments, more thorough assessments, the purchase of additional insurance, requiring additional approval for certain transactions and the shifting of certain sensitive responsibilities to a different responsible person.

OSFI's approach to ensuring the suitability and integrity of responsible persons is part principles-based and part risk-based. Guideline E-17 sets out various principles in the establishment of policies and procedures in the conduct of assessments of responsible persons.

Finally, the company or branch should address legal concerns in the employment and privacy areas, along with other issues that may arise as a result of assessments being conducted, to ensure that the process and assessment policy protect the company, the board of directors and the assessors as much as possible. These concerns include:

- referring to OSFI or Guideline E-17 in employment policies and contracts and obtaining any requisite consent (either expressly or by implication) from responsible persons;
- ensuring that personal information, including information relating to the results of assessments, of responsible persons or potential responsible persons is kept confidential; and
- ensuring that confidentiality is emphasized in any outsourcing agreement whereby the assessment of responsible persons is undertaken by a third party.

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Insurance Employee Covenant Struck Down By Highest Court

George Waggott

In a decision released on January 23rd, 2009, the Supreme Court of Canada has confirmed the increasing scrutiny now brought to bear on restrictive covenants in employment contracts entered into by employees, including those in the insurance industry.

In *Shafron v. KRG Insurance Brokers (Western) Inc.* [2009] S.C.C. 6 (January 23, 2009, S.C.C. docket number 31981), the Court rejected efforts by KRG to use the courts to rewrite what was essentially a defective restrictive covenant.

Morley Shafron worked in the insurance business for a number of years, and in 1987 he sold his insurance agency to KRG. During the period from 1987 to 2001, Shafron was employed pursuant to a series of employment contracts entered into with the purchaser of his business and its successors. The apparent lack of care taken in drafting the post-employment restrictions came back to haunt the employer. Each employment contract which Shafron signed contained a similarly worded restrictive covenant provision which provided as follows:

> Shafron shall not, upon leaving the employment of the Corporation for any reason, save and except for termination by the Corporation or KRG management without cause, for a period of three years thereafter, directly or indirectly, carry on, be employed in, or be interested in or permit his name to be used in connection with the business of insurance brokerage which is carried on within the Metropolitan City of Vancouver.

In December 2000, as the last of his employment agreements was about to expire, Shafron left KRG's employment and began working as an insurance salesman for another agency, Shaw Insurance Agency Ltd., in Richmond, B.C.

Mindful of protecting its interests and purporting to have rights which precluded Shafron from moving because of the provisions in the employment agreement, KRG commenced an action to enforce the restrictive covenant. Claims were also asserted that Shafron had breached his fiduciary and equitable obligations.

At trial, Parrett, J. dismissed KRG's action, finding that, among other things, the term "Metropolitan City of Vancouver" was neither clear nor certain and, in any event, was unreasonable. The trial judge also found that Shafron owed no fiduciary duty to KRG, and did not breach any duty relating to confidential information.

The trial decision was reversed by the B. C. Court of Appeal. Although the Court found that Shafron had no fiduciary duty to his former employer, the Court held that the restrictive covenant was enforceable. In the opinion of the B. C. Court of Appeal, although the term "Metropolitan City of Vancouver" was ambiguous, it was possible to apply the doctrine of notional severance. Under this concept, it is possible to construe a provision like that contained in Shafron's contract as applying to the City of Vancouver and municipalities contiguous to it. As a result, the B. C. Court of Appeal held the covenant would cover the City of Vancouver, the University of British Columbia endowment lands, Richmond and Burnaby. Having regard to this geographic area and the non-competition term of three years, the Court of Appeal found the covenant reasonable and therefore enforceable.

In overturning the decision of the B. C. Court of Appeal, the Supreme Court took the opportunity to summarize the legal principles applicable to restrictive covenants, and the importance of demonstrating mutual agreement between the parties about the nature of the restrictions being sought by the employer and agreed to by the employee. The term "Metropolitan City of Vancouver" was uncertain and ambiguous, and the SCC held it was inappropriate for an appeal court to rewrite such a covenant. Though commenting on a specific case from B.C., a number of the principles outlined in the case would clearly be applicable to employers throughout the country.

Restrictive covenants are, as a general proposition, restraints of trade and thus contrary to public policy. While the legal system provides that freedom of contract will allow exceptions for reasonable restrictive covenants, the onus is on the party seeking to enforce the restrictive covenant to show that it is reasonable. The key, therefore, is for the employer seeking to enforce an ambiguous covenant to demonstrate that there was a clear intention of the parties to be bound by the specific wording. Restrictive covenants in employment contracts will be scrutinized more rigorously than those negotiated in the context of a sale of a business. This is obviously sensible because there is often an imbalance of power between employees and employers. There is also typically some payment on account of goodwill made in the context of a sale transaction.

The KRG provision fell down for a number of reasons, including the fact that the higher standard of scrutiny applicable to Shafron's employment contract could not be satisfied. The concept of notional severance was expressly rejected by the SCC as an approach which should not be adopted for defective restrictive covenants. Under the notional severance doctrine, documents may be construed in some instances as though certain portions of the document do not exist. In other words, the document is interpreted or read as though one portion which offends legal principles has been deleted.

The SCC provided two significant reasons why notional severance will have no place in the construction of restrictive covenants in employment contracts. First, covenants must be interpreted using a test of reasonableness. An example where notional severance might apply is a contract which provides for an illegal interest rate, with notional severance being used to bring the rate down to the legal rate of 60 percent. In the case of an unreasonable restrictive covenant, there is no so-called "objective bright-line" rule that can be applied to render the covenant reasonable. As a result, the Court expressed its concern that using notional severance in this type of situation "simply amounts to the court re-writing the covenant in a manner that it subjectively considers reasonable in each individual case." As the Court acknowledged, this type of approach really only creates uncertainty for employers and employees, since there is no obvious direction about what might be found reasonable in any specific case.

A second concern which the Court cited with notional severance involves what employers will do as a practical matter. If notional severance is allowed, employers would be invited to impose unreasonable restrictive covenants on employees in every contract. Then, the only potential sanction would be that if the covenant is found to be unreasonable, the Court would still enforce the provision to the extent of what might otherwise have been validly agreed to. This involves a substantial change to the risks assumed by the parties. Having regard to the generally accepted imbalance of power between employees and employers, the Court focused on the importance on ensuring that employers not be provided what would essentially be a further incentive to force employees to abide by unreasonable covenants.

The Court also further clarified its approach to so-called "blue-pencil severance". The "blue-pencil" notion involves having a contract read as though an editor took a blue pencil and removed part of a contractual provision. While many commentators have noted the limited application of blue-pencil severance, the SCC's decision in KRG confirms explicitly that blue-pencil severance payment will be resorted to sparingly, and only in cases with the part being removed is clearly severable, trivial and not part of the main purported restrictive covenant. Blue-pencil severance could not be applied to remove the word "Metropolitan" from the restrictive covenant in the Shafron contract because it was neither a trivial nor severable part of the provisions agreed by the parties. In reviewing the trial record, the Court found no evidence that the parties unquestionably would have agreed to remove the wording "Metropolitan" from the non-competition clause without varying any other terms of the contract or otherwise changing the bargain.

The term "Metropolitan City of Vancouver" was uncertain and ambiguous, and the SCC held it was inappropriate for an appeal court to rewrite such a covenant.

The SCC also rejected the argument that rectification might be relied upon to resolve the ambiguity in this case. Rectification is used in contractual cases to restore what the agreement of the parties actually was, but for an error in the written agreement. Here, a series of contracts had been entered into which contained the same provisions. There was no indication that the parties had actually put their minds to what their bargain was and then mistakenly included something different in their contract. Instead, the ambiguous and improper contract provision had been included in the successive contracts and KRG could not point to any prior agreement, written or oral, that explained the term "Metropolitan City of Vancouver".

The KRG case resoundingly emphasizes the challenges which employers face in seeking to enforce restrictive covenants. Any clauses which seek to prohibit post-employment conduct will only be enforceable if they are carefully prepared, having regard to the specific industry. The fact that Shafron had obtained $700,000 when he sold his business to KRG was essentially irrelevant, since the parties failed to pay particular attention to relevant issues, including what the insurance brokerage industry might consider to be a reasonable covenant, what amounted to an appropriate restraint of trade, and what was reasonable in this specific case. Since these disputes invariably involve employers looking to enforce covenants, it is essential that appropriate care and attention be paid to crafting clear clauses with appropriate restrictions on prohibited activity, together with reasonable geographic and temporal restrictions.

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Events

2009 National Spring Conference of the CCCA

Presented by the Canadian Corporate Counsel Association
April 5 - 7, 2009 - Montreal, QC

Martin Masse, Partner, will be on the "Achieving Optimal Results at Regulatory Hearings" panel at the 2009 National Spring Conference of the CCCA. The theme of the conference this year is "Corporate Counsel: Regulatory Advisor, Compliance Officer, Governance Gatekeeper."

Independent Financial Brokers: 2009 Toronto Spring Summit

Presented by The Independent Financial Brokers
May 26 & 27, 2009 - Toronto, ON

Frank Palmay, Chair, Corporate & Insurance Group, will be discussing "Money Laundering and Anti-Terrorism" at the Independent Financial Brokers: 2009 Toronto Spring Summit. The Independent Financial Brokers has been exclusively devoted to the independent financial services advisors for more than 20 years.

Advanced Forum on Commercial Insurance and Reinsurance

Managing Risk and Enhancing Profitability in a Dynamic Market

Presented by Insight Information
June 15-16, 2009 - Toronto, ON

Frank Palmay, Chair, Corporate & Insurance Group, is a Conference Co-Chair with Jordan Solway, General Counsel and Vice-President, Claims with Munich Reinsurance Company of Canada for the upcoming Advanced Forum on Commercial Insurance and Reinsurance presented by Insight Information. Frank will be moderating a panel titled "Insurance and Reinsurance Coverage Issues Arising out of the Financial Crisis". **James Musgrove**, Chair, Competition & Marketing Law Group and **Peter Wells**, Partner, Intellectual Property Group, will also be lending their expertise on panels at this forum. James is speaking on a panel titled "What Insurers Need to Know about Changes to Canada's Competition Act", and Peter is on a panel titled "New Insurance Products for IP and Technology Risk".

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