

May 2020

Financial Interest Clauses – Recent Developments Affecting Multinational Insurance Programs

Q We understand that a recent tax decision in India addressed Financial Interest Clauses (FICs) in multinational insurance programs. Can you summarize what happened in that case?

The sportswear manufacturer Adidas suffered a fire at its warehouse in India in 2009, for which both its German parent (Adidas Germany) and Indian subsidiary (Adidas India) received insurance indemnification. Adidas India received ~USD 7M under a property policy issued to it in India (the Adidas India policy) covering loss caused by fire to stock-in-trade and fixed assets. Adidas Germany received ~USD 13M under a separate global policy covering loss of financial interest in subsidiaries (the Adidas Germany policy) provided in Germany by a different insurer. Adidas India was not an insured under the Adidas Germany policy.

In 2011, the Indian tax authority levied income tax on Adidas India for the claim payment paid to Adidas Germany under the Adidas Germany policy, arguing that such payment was for the benefit of and taxable to Adidas India, and was paid to Adidas Germany to evade taxes in India.

Adidas India appealed the 2011 decision, and in July 2019, India's Income Tax Appellate Tribunal (the Tribunal) reversed the original tax authority decision, on the basis that:

1. There was no privity of contract between the Adidas Germany policy insurer and Adidas India:
 - (a) Adidas India separately contracted with, and paid premium to an independent local insurer in India;
 - (b) no part of the premium for the Adidas Germany policy premium was allocated to India or reimbursed by or charged to Adidas India; and
 - (c) the Adidas Germany policy specifically excluded coverage for affiliates located in countries that prohibit unlicensed insurance (such as India).
2. The risks insured by each policy were distinguishable from each other: the Tribunal observed that the Adidas India policy was a property policy, covering damage to Adidas India's tangible assets in India, while it characterized the Adidas Germany policy as covering Adidas Germany for erosion of economic value of its investment in its global subsidiaries (intangible assets held in Germany).
3. While Adidas Germany did consider contributing funds to Adidas India after receiving the loss payment under the Adidas Germany policy, the Tribunal held that the contribution would have been on account of Adidas Germany restoring its loss of financial interest in its Indian subsidiary, not a claim payment accruing to the benefit of its Indian subsidiary and thus was not relevant to determining income tax liability in India.

Q The Adidas Germany policy included a Financial Interest Clause (FIC). What is an FIC?

An FIC is a provision within a global or master policy that covers the parent company's diminution of financial interest when losses are suffered by its worldwide subsidiaries¹. A loss suffered by a subsidiary causes a reduction in the value of the parent's financial interest in the subsidiary, for which the parent is indemnified under the FIC in its home country. An FIC is typically included as an endorsement to a global² policy in place of one or more separate local policies. Notably, the parent is the only insured under an FIC; the subsidiaries themselves are not insureds.

¹ While the FIC is typically used in a parent/subsidiary context, it can also apply to other instances where one party has a financial interest in another.

² This can be a standalone global policy or a global policy functioning as the master policy in a controlled master program.

An FIC is typically requested by brokers and clients in an effort to obtain coverage for local exposures without purchasing a local policy and to mitigate compliance concerns in jurisdictions where unlicensed insurance is not permitted (so DIC/DIL may carry regulatory risks). By removing the local subsidiaries as insureds such that the parent is the only insured, an FIC avoids the local subsidiaries being covered by an insurer not licensed in the local jurisdiction.

Q What are some of the limitations of an FIC?

First, because the parent is the only insured under the FIC and the subsidiaries are not actually insureds, claim payments must be made to the parent - - payments cannot be made locally to the subsidiaries and local claims handling activities may likewise be constrained.

This can be a significant limitation for some clients who want local claim payment for local losses. Second, since the local subsidiaries are not insureds on the global policy, they cannot provide evidence of local coverage to their counterparties or government authorities. Third, any recovery under the FIC is limited to the parent's interest, while the subsidiary's actual loss could be greater than the parent's financial interest loss. Fourth, as underscored by the Tribunal's rationale, no premium should be allocated to, or paid by local subsidiaries.

It is critical for brokers and clients to understand these aspects upfront as they will impact the coverage offered, potential policy response and tax treatment.

1. While the FIC is typically used in a parent/subsidiary context, it can also apply to other instances where one party has a financial interest in another.
2. This can be a standalone global policy or a global policy functioning as the master policy in a controlled master program.

Q What does the Adidas case mean for FICs going forward?

While the Adidas case lends some support to the viability of FICs in India, it is important to recognize that the Tribunal relied on facts unique to the Adidas case in reversing the underlying tax authority decision. These facts may not be present in other situations:

1. Adidas India held a separate local policy in India that responded directly to the fire damage. This bolstered the argument that Adidas Germany's policy was not simply arranged as an attempt to avoid taxes in India;
2. the policies in question here were procured separately from different insurers, with each insured – Adidas Germany and Adidas India – paying its own premium (and premium tax) for its own policy in its own country, and neither entity had a right to claim proceeds from the other's policy; and
3. the risks insured by the global and local policies were different from each other: the Adidas India policy covered property damage to tangible assets in India, while the Tribunal spoke of the Adidas Germany policy not as a property policy, but rather as a policy that only covered the parent company's financial interest in its global subsidiaries (not just those in India).

It is important to keep in mind that the Tribunal's decision is not binding on any court outside of India and therefore has only limited precedential value. We understand that the Tribunal's decision is further appealable by the tax authority, meaning that the final outcome of the case cannot be certain at this time.

Q What does the case mean for exposures in India going forward? Are there any general recommendations for multinational companies and their insurance programs in light of the Tribunal’s decision?

A salient aspect of the decision is the way the Tribunal called out the separateness and substantive coverage differences between the Adidas Germany and Adidas India policies. The Tribunal in effect characterized the Adidas Germany policy as a ‘financial Interest’ policy that insured Adidas Germany for loss in economic value of its financial interest in subsidiaries, with no mention as to whether other coverages were included or not.

Above all, the case underscores the heightened scrutiny India’s regulators apply to cross- border transactions – even between affiliates. India remains a high-risk market for non- admitted insurance. Local (rather than solely global) policies remain the recommended option for insureds when seeking to cover risks in India, or other similar markets.

We continue to recommend that each company participating in a multinational program should: (i) review with its professional advisors the potential legal and tax obligations that may arise from not purchasing local insurance to covering its local exposures; and (ii) consider the potential implications of not having local insurance available to respond to a loss in any jurisdiction included in its multinational program.

We would also caution insurance buyers from placing too much reliance on the outcome of the case ... the Indian regulator is one of many insurance regulators around the world and there is no guarantee that a non-Indian regulator will reach exactly the same conclusion.

Q What is AIG’s position on FIC?

We are unequivocal in our view that local policies remain the most effective option to facilitate compliance, local servicing and payment in most jurisdictions, including highly regulated markets like India. While the insurer on a global policy may be able to cover local exposures under an FIC or other provisions, the global insurer may not be able to provide local insurance services such as local claims payment and handling, and the client will not be able to show evidence of local coverage without a local policy. These limitations could have a negative impact on the client’s needs or objectives if/when local losses occur.

That being said, we are glad to accommodate requests by clients for an FIC. We just want to make sure our business partners and clients understand the risk and limitations so they can make informed decisions.

More information about Financial Interest Clauses can be found by clicking the following link to AIG Multinational’s Briefing Paper:
<https://www.aig.com/content/dam/aig/america- canada/us/documents/brochure/1065a-fic-briefing-paper-formatting8-7-14-brochure.pdf>

