



Report: The words “similar contracts of guarantee” in the definition of “a contract of insurance” in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001

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EXECUTIVE SUMMARY

The definition of a contract of insurance has been the subject of some debate amongst market participants. It is not, however, the purpose of this paper to tackle the thorny issue of whether (and if so, how) to define a contract of insurance. Instead, this paper is concerned with a related issue, created by the fact that Article 3(1) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the “**RAO**”) provides a definition of a contract of insurance, primarily for consumer protection reasons, that brings within the purview of insurance regulation under the Financial Services and Markets Act 2000 (“**FSMA**”) a range of other contracts, some of which are patently *not* contracts of insurance as a matter of common law. This paper is concerned with one such inclusion, which (subject to certain conditions) brings “fidelity bonds, performance bonds, administration bonds, bail bonds, customs bonds or *similar contracts of guarantee*” (subject to specified qualifications) within the scope of insurance regulation. In a nutshell, this paper asks the question exactly which contracts this description catches and, in particular, which (if any) contracts are “similar contracts of guarantee”.

There are a variety of potential consequences of a contract or transaction being found, contrary to the expectations or intentions of the parties, to be a contract of insurance and not falling within one of the RAO exceptions. For example, the person providing the protection may be in breach of the General Prohibition in FSMA. If that person is not authorised or exempt under FSMA, he will commit a criminal offence and the relevant contract will generally be unenforceable by him; if he is authorised under FSMA but is not permitted to carry on insurance activities, he will commit a regulatory breach. The Report goes on to consider the impact of the extended definition of contract of insurance in the context of transactions which commonly occur within the financial markets.

The Report makes three recommendations by which the uncertainty may be mitigated. The first suggests that the Financial Conduct Authority updates its own guidance, in PERG 6.7, to clarify the situations in which the definition might apply. The second is to consider amending the definition of a contract of insurance in the RAO so as to include a new activity-based exclusion from the scope of the regulation which would be made available to both (a) U.K. investment businesses and (b) investment businesses established outside the U.K., provided that in each case their investment business activity is sufficiently significant and central to their business that they are properly characterised as “investment firms” for U.K. regulatory purposes. The third is a legislative amendment to clarify the ways in which a contract of guarantee needs to be similar to the instruments listed in the

RAO definition, including by providing that the similarity be grounded in something more than just being a protection contract.

1. INTRODUCTION

- 1.1. The role of the Financial Markets Law Committee (the “**FMLC**”) is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.
- 1.2. Section 19 of FSMA establishes the general prohibition against the carrying on of a regulated activity unless the person in question is authorised or exempt. Breach of this prohibition is a criminal offence and a contract entered into by a person in the course carrying on a regulated activity in breach of the prohibition is unenforceable by (by not against) it unless the court exercises its discretion under Section 28(3) of FSMA to allow enforcement. Section 22 of FSMA stipulates that authorisation is required where a person proposes to: (a) carry on a regulated activity; (b) by way of business; (c) in the UK; (d) in relation to “specified investments.” Activities and investments which are subject to the requirement to be authorised are specified in the RAO. Article 10 of the RAO specifies as regulated activities the effecting or carrying out of contracts of insurance. Article 75 of the RAO specifies rights under a “contract of insurance” as a regulated investment.

It is not an offence for a person who is authorised under FSMA to effect or carry out contracts of insurance. However, unless that person is permitted by its regulator to carry on such activities (i.e. it is an insurance or reinsurance company), it will commit a regulatory breach if it does so.

- 1.3. Article 3 of the RAO ‘defines’ a “contract of insurance” in the following manner:

“contract of insurance” means any contract of insurance which is a contract of long-term insurance or a contract of general insurance, and includes—

- a) fidelity bonds, performance bonds, administration bonds, bail bonds, customs bonds or similar contracts of guarantee, where these are—
 - i. effected or carried out by a person not carrying on a banking business;

- ii. not effected merely incidentally to some other business carried on by the person effecting them; and
- iii. effected in return for the payment of one or more premiums;

[...]

The definition goes on to list five other types of contracts (sub-paragraphs (b) to (f)).²

- 1.4. It is apparent that, as regards contracts of insurance in general, this language is circular, insofar as it provides that “a contract of insurance ... means a contract of long-term insurance or a contract of general insurance”. Put another way, that part of Article 3(1) of the RAO, is not workable unless one imports a definition (or, failing that, a workable description) of a contract of insurance.
- 1.5. There is no further statutory definition of a contract of insurance, either in or under FSMA (or indeed in any other statute). Nor is there a definition of a contract of insurance at common law. There is only a well-established description of a contract of insurance, provided by the case of *Prudential v Commissioners of Inland Revenue*,³ as elaborated and applied by the English Court in the specific factual context of later cases. The description of a contract of insurance in *Prudential* and later cases is also reflected in Perimeter Guidance Manual (“**PERG**”) Handbook first published by the Financial Services

² Section 3(1) of the RAO provides:

“contract of insurance” means any contract of insurance which is a contract of long-term insurance or a contract of general insurance, and includes—

- a) [...]
- b) tontines;
- c) capital redemption contracts or pension fund management contracts, where these are effected or carried out by a person who—(i)does not carry on a banking business; and (ii)otherwise carries on a regulated activity of the kind specified by article 10(1) or (2);
- d) contracts to pay annuities on human life;
- e) contracts of a kind referred to in article 1(2)(e) of the first life insurance directive (collective insurance etc.); and
- f) contracts of a kind referred to in article 1(3) of the first life insurance directive (social insurance).

³ [1904] 2KB 658

Authority (the “FSA”) in 2006 and, from 1 April 2013, adopted by the Financial Conduct Authority (“FCA”).⁴

1.6. It is not, however, the purpose of this paper to tackle the interesting but thorny issue of whether (and if so, how) to define a contract of insurance. Instead, this paper is concerned with a related issue, created by the fact that, primarily for reasons of consumer protection, Article 3(1) of the RAO extends the meaning of the term “contract of insurance” for regulatory purposes, so as to bring within the purview of insurance regulation under FSMA a range of other contracts, some of which are patently *not* contracts of insurance as a matter of common law. This paper is concerned with one such inclusion, which (subject to certain qualifications) brings “fidelity bonds, performance bonds, administration bonds, bail bonds, customs bonds or *similar contracts of guarantee*” within the scope of insurance regulation. It is unclear exactly which contracts fall within this description.

1.7. As a preliminary note, it might be important to note that the drafting of the provision assumes that the five types of bonds which are deemed to be contracts of insurance do not constitute insurance at common law, otherwise:

the need for an express inclusion would be unnecessary; and

the exclusion from the express inclusion would not allow banks meeting the conditions in sub-clauses (a)(i) to (iii), set out in paragraph 1.3 above to enter into such arrangements.

This report does not analyse whether and why the five types of bonds named in the definition are not in fact contracts of insurance at common law.

1.8. In the context of these enduring issues of legal uncertainty, the FMLC established a Working Group to consider the uncertainties created by the phrase “similar contracts of guarantee” and the components associated with that phrase as set out in Article 3(1) of the RAO. Accordingly, experts were convened to analyse the issues involved and to draft a report making further recommendations.

⁴ FCA Handbook, PERG 6: Guidance on the Identification of Contracts of Insurance; available here: <https://www.handbook.fca.org.uk/handbook/PERG/6/1.html>

2. “SIMILAR CONTRACTS OF GUARANTEE”

2.1. The phrase, “similar contracts of guarantee”, prescribes two conditions which any contract would have to fulfil before it falls within the scope of the definition: (1) it would need to be a guarantee and (2) it would need to have similar characteristics to one of the instruments listed in the extended definition of contract of insurance.

“Guarantee”

2.2. The listed instruments (which are discussed in paragraph 2.5 below and in the Appendix to this report) are “bonds” which, as noted above, will generally not be “contracts of insurance” at common law. The question arises whether “similar contracts of guarantee” includes instruments which are not guarantees in the technical legal sense of the term. The drafting is unclear because the phrase “similar contracts of guarantee” is an oxymoron as the instruments to which the word “similar” relates are generally not guarantees. One possibility is that the word “guarantee” is not intended to have its technical legal meaning but encompasses any instrument with an economically equivalent function. However, such an approach would be extremely problematic as the definition could then be very broad indeed.

2.3. The better view is that “guarantee” should be given its normal legal meaning. As noted by Colinvaux & Merkin,⁵ although it is “not readily apparent which contracts are caught”, the phrase “similar contracts of guarantee” seems to be a “catch-all provision” included as a “safety-net to ensure that forms of suretyship having the same effects as those listed above are caught”.

2.4. The legal concept of a guarantee is elucidated by case law, although the practical application of the test is, not without its difficulties. The principles that can be derived from the case law—which have generally been in the context of distinguishing a “contract of insurance” at common law from a “guarantee” at common law—can be summarised as follows:

- a) **The relationship between the parties:** typically there is a pre-existing relationship between a guarantor and the principal debtor which provides the rationale for a the provision of a guarantee (for example, a guarantor will often deal with the principal debtor rather than the third party beneficiary of the guarantee and would often have a business reason for entering the guarantee rather than simply seeking

⁵ Colinvaux & Merkin, *Insurance Contract Law* (12th ed, 2019) (“Colinvaux & Merkin”),14-038.

consideration for doing so).⁶ By way of contrast, an insurer typically deals with the insured and does so in order to receive a premium. However, in a commercial context, even where companies are in a group, consideration would typically be paid for a variety of reasons (e.g. corporate benefit considerations, avoiding financial assistance concerns or addressing tax issues on transfer pricing) and so it is commonly problematic to rely on this criterion as a distinction.

- b) **Knowledge/disclosure:** given the relationship between the parties, it would typically be the case that the guarantor is acquainted in some way with the risk and the circumstances underlying the arrangement, whereas an insurer would rely upon the insured to disclose the facts and hence the transaction is of a more speculative nature.⁷
- c) **Primary v secondary liability:** a guarantor typically promises to see to it that the obligations of the principal debtor are discharged, which is a secondary obligation. In contrast, an insurer provides an indemnity against a loss (typically by promising to pay a sum of money on the occurrence of a certain event), which is an independent primary obligation to pay what is essentially a new debt.⁸ This appears to be the most significant distinction. However, it is worth noting that in commercial transactions a “guarantee” will typically be combined with a “back-up” indemnity, which has the effect of creating a primary liability *as well as* a secondary liability. Consequently, the result may be that this aspect of the analysis might result in a hybrid contractual arrangement, potentially making the process of categorisation difficult in practice.⁹

2.5. The need to include at least certain types of guarantee within the regulatory net is supported by an examination of New York law, a key jurisdiction governing insurance contracts. New York insurance law provides for similar (but distinct) insurance subtypes with guarantee features including: “fidelity and surety insurance”,¹⁰ “financial guaranty

⁶ *Seaton v Heath* [1899] 1QB 792-793

⁷ *Kreglinger and Fernau Ltd v Irish National Insurance Co Ltd* [1956] I.R. 116

⁸ *Dane v Mortgage Insurance Corporation* [1894] 1 QB 54

⁹ *Fuji Finance Inc. v. Aetna Life Insurance Co. Ltd. and another* [1996] LRLR 365 (the correct categorisation of a hybrid arrangement could be that it is a contract of insurance at common law).

¹⁰ This is defined in Ins Law 1113.

insurance";¹¹ "mortgage guaranty insurance";¹² and "contract of warranty, guaranty or suretyship".¹³ While New York law offers detailed, specific and mutually exclusive definitions for the first three categories, the last—a "contract of warranty, guaranty or suretyship"—is not defined and functions as a "catch-all" provision for situations excluded from the first three categories. Regulatory discretion is, however, frequently exercised and the Office of the General Counsel of New York takes up test cases and offers its opinion.¹⁴

“Similar”

2.6. As set out above, the extended definition of “contract of insurance” lists five types of instrument that (subject to the qualifications discussed below) fall within that definition:

- fidelity bonds, which involve a party (A) undertaking to pay for the loss suffered by an employer (C) due to the failure of an agent or employee (B) to perform their duties;
- performance bonds, which involves A undertaking to pay a party (C) for the failure by a party (B) to discharge its obligations (proof of C’s loss resulting from the failure is not necessarily needed);
- administration bonds, which involves A undertaking to pay for the loss suffered by those interested in a deceased person’s estate (C) due to the failure of an administrator (B) to properly administer an estate;
- bail bonds, which involve A undertaking to pay a certain sum to the court or another party in legal proceedings (C) if someone who has been arrested or whose property has been arrested (B) is found to have defaulted on their obligations; and
- customs bonds, which involve A undertaking to pay the customs duties owed to a governmental body (C) by another party (B).

¹¹ This is defined in Ins Law 6901.

¹² This is defined in Ins Law 6501.

¹³ This is set out (but not defined) in Ins Law 1101.

¹⁴ See, for example, OGC Opinion No. 93-40

The Appendix to this report sets out a more detailed examination of each type of instrument.

- 2.7. Each category describes a contract where A undertakes to pay C as some form of protection or guarantee against B defaulting on its obligations—i.e., all are examples of tri-partite arrangements.

There are, however, differing approaches as to whether it is necessary to prove the loss caused in order to claim under the relevant bond and how the value of the loss links to the amount that can be claimed.

- 2.8. By way of example, performance bonds are generally accepted as involving “unconditional undertakings to pay a specified amount to a named beneficiary”.¹⁵ Typically, these bonds are on-demand and do not require proof of loss.¹⁶ Whilst the commercial purpose of such a bond may be to secure the performance of an obligation, it is not the case that the performance bond is necessarily a “pre-estimate” of the loss suffered due to a failure of a party to fulfil their obligations.¹⁷ Commentators have noted, however, that “whether a particular contract is a performance bond or a true contract of suretyship conditioned on proof of actual breach or non-performance”.¹⁸ This is “determined on a case-by-case basis” with reference to “certain factors”.¹⁹ For instance,

¹⁵ Andrews and Millett, *Law of Guarantees* (7th ed, 2015) (“Andrews and Millett”), 16-001.

In *Vossloh Aktiengesellschaft v Alpha Trains (UK) Ltd* [2010] EWHC 2443 (Ch) at [34], Sir William Blackburne said the following: “... with the parties free to agree whatever terms they choose, there is in this field of law a spectrum of contractual possibilities ranging from the classic contract of guarantee, properly so called, at the one end, where liability of the guarantor is exclusively secondary and will be discharged if, for example, there is any material variation to the underlying contract between principal and creditor, to the performance or demand bond (or demand guarantee) at the other end, where liability in the giver of the bond may be triggered by mere demand and without proof of default by the principal (and indeed where it may be apparent that the principal is not in default).” In recent cases the courts have railed against the use of the term “guarantee” for demand guarantees as they are not in fact guarantees at all (see *Splithoff's Bevrachtungskantor BV v Bank of China* [2015] EWHC 999 (Comm) at 69/70: “Performance bonds create an independent obligation to pay on demand by way of primary obligation on the party giving the guarantee and not by way of surety. They are irrevocable undertakings to pay a specified sum to the beneficiary in the event of a breach of contract, rather than a promise to see to it that the contract will be performed. They are often called “performance guarantees” or “demand guarantees”, although they are not guarantees in the true sense but a strict form of contract of indemnity.” The last statement is, however, not always correct, e.g. if payment is on presentation of documents (even if those documents have to assert that a loss or event has occurred) without having to assert/prove a loss/event has occurred then that would not appear to meet the loss based requirement for an indemnity.)

¹⁶ Colinvaux & Merkin, A-0070; Andrews and Millett 16-001.

¹⁷ See *supra* fn 30.

¹⁸ *Andrew and Millett* 16-002.

¹⁹ *Ibid.* See also *Re Sentinel Securities Plc* [1996] 1 W.L.R 316 which considered whether certain contracts are “performance bonds” or “similar contracts of guarantee”, in the context of section 95(a) of the Insurance Companies Act 1982. That case concerned a guarantee protection scheme, whereby a company guaranteed—in return for a subscriber paying a monthly fee—to honour the “supplier’s original guarantee of the products supplied and installed by” the supplier. The company submitted that the scheme was not a performance bond or similar contract of guarantee, as an “essential feature of a performance bond is that it creates an original obligation to pay money and any ‘similar’ contract of guarantee” must have that. Rattée J ultimately did not need to consider whether the guarantee scheme was a similar contract of guarantee to a performance bond, as he found that the scheme fell under the general definition of a contract of insurance under *Prudential*. This shows

if the issuer is a bank or financial institution, the presumption is that the bond is paid out on demand rather than being a guarantee in the traditional sense.²⁰ The language of the bond is relevant too.²¹ A performance bond could be considered similar to an advance payment bond or retention bond.²²

- 2.9. Other than an assumption of risk of default, however, it is very difficult to identify clear commonalities between the listed instruments. As guarantees necessarily involve such an assumption of risk, it is therefore difficult to see what the use of the word “similar” was intended to add. It does, however, seem apparent that some form of limitation was intended.

3. QUALIFICATIONS

- 3.1. The provision that includes fidelity bonds, performance bonds, administration bonds, bail bonds, customs bonds and similar contracts of guarantee within the definition of contract of insurance is subject to three qualifications. The relevant instrument must:
- a) be effected or carried out by a person not carrying on a banking business;
 - b) not be effected merely incidentally to some other business carried on by the person effecting them; and
 - c) be effected in return for the payment of one or more premiums.

Carrying on a banking business

- 3.2. The RAO does not offer a definition of “carrying on a banking business”, nor was it defined under antecedent legislation in the U.K. and E.U.²³ In the absence of a statutory

willingness to look beyond guarantee terminology when analysing arrangements for the purposes of defining a contract of insurance, and thus suggests perhaps less scope for the “similar contracts of guarantee” expression to operate.

²⁰ *Ibid*

²¹ *Ibid*

²² Advance payment bonds provide that if a contractor fails to meet its obligations, then the issuer of the bond will refund advances (for instance, for materials or equipment) made by a party employing a contractor. These bonds are typically drafted in an on-demand form (for example, in the construction context). See: Practical Law, Bonds, guarantees and standby credits: overview, note, types of guarantee or bond. Retention bonds involve the employer and contractor agreeing that the employer will retain some of the interim payments made to the contractor: some funds are released upon completion of the works and the remainder after the rectification period for faults. These are typically also drafted in an on-demand form in the construction context. However, note that construction bonds are not tripartite. See: Practical Law, Construction bonds: quick guide.

²³ Relevant historical pieces of legislation include the Insurance Companies Act 1982 (the “**1982 Act**”), Insurance Act 1981 (the “**1981 Act**”), Insurance Companies (Classes of General Business) Regulations SI 1977/1552 (the “**1997 Regulations**”); First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct insurance other than life assurance (the “**First Non-Life Directive**”); and Insurance Companies Act 1974 (the “**1974 Act**”).

definition, one might consider the historical treatment of “banking business” in statutory provisions and judicial decisions. For example, under Section 2(4) of the Insurance Companies Act 1982, there was no prohibition against carrying out, without authorisation, insurance business of certain classes, if “carried on solely in the course of carrying on, and for the purposes of, banking business.” Under Section 2(3) of the Insurance Companies Act 1974, no prohibition was imposed against carrying on a pecuniary loss insurance business without authorisation if done so solely “in the course of carrying on, and for the purposes of banking business”. One interpretation of “banking business” has been provided by Simon James, in *The Law of Derivatives* (1999), who advises that a “safe approach” to interpreting Section 2(4) Insurance Companies Act 1982 is to limit its scope to “only an institution a significant part of whose business involves taking deposits”.²⁴

- 3.3. This approach would be consistent with the use of the term “banking business” in Section 106 of FSMA in relation to “banking business transfer schemes” where all or part of the transferring business must include the accepting of deposits. It would also be consistent with the approach to the term “banking” taken in *United Dominions Trust v Kirkwood*²⁵ (albeit in a different context), where deposit-taking was held to be a necessary condition to being a bank. The legislation does not, however, refer simply to a person authorised to accept deposits, which would have been the most straightforward way to indicate such a requirement, giving rise to a degree of uncertainty. Given the lack of clarity as to what might constitute “banking business”, it is arguable that it could also extend to certain types of business undertaken by investment firms and other types of market participants (for example, lending).

Incidental

- 3.4. The term “incidentally” as applied to the definition of “contract of insurance” has not been considered in case law or from a regulatory perspective in any great detail. The phrase “merely incidentally” suggests, as a matter of pure language, that the “incidental” exclusion should be interpreted narrowly. The exception only extends to a business carried on by the person effecting the guarantee (i.e. not by a subsidiary). This is another area where an eventual legislative modification might be proposed.

²⁴ Simon James, *The Law of Derivatives*; Published December 1, 1999 by Informa Law from Routledge

²⁵ [1966] 2 QB 431

- 3.5. The FCA has published guidance on its interpretation of the exceptions to Article 25 of the RAO (*Arranging deals in investments*) which provides a brief analysis of the FCA’s interpretation of the meaning of “incidental” in that context. Article 25 describes two types of regulated activities which relate to specified investments that may include contracts of insurance (as relevant investments).²⁶ Article 72C of the RAO provides an exclusion from Article 25(1) and (2) in relation to a transaction for the sale or purchase of a contract of insurance where specified conditions are met. In broad terms, Article 72C excludes activities that: (a) consist of the provision of information to the policyholder or potential policyholder; (b) are carried on by a person carrying on any profession or business which does not otherwise consist of regulated activities; and (c) amount to the provision of information that may reasonably be regarded as being incidental to that profession or business.
- 3.6. The FCA has considered the meaning of “incidental” as it applies to limb (c) of Article 72(C) and has determined that, in its view, “incidental” means that the activity must arise out of, be complementary to or otherwise be sufficiently closely connected with the profession or business.²⁷ In other words, there must be an inherent link between the activity and the firm's main business and the activity must not amount to the carrying on of a business in its own right. While this interpretation is not directly relevant in the present context, it does give an indication of the factors that the FCA might be expected to consider when determining whether permission under Part 4A of FSMA is required for Article 25 activities in the context of a transaction involving a contract of insurance.

The “merely incidental” exclusion may typically be available where, for example, a parent holding company gives a guarantee of the performance by one of its subsidiaries of the subsidiary’s obligations to a third party. The availability of the exclusion may be less clear in circumstances where, for whatever reason, the guarantee is proposed to be given by a group company which does not have a parent/subsidiary relationship with the company whose obligations are being guaranteed, where the giving of the guarantee may not self-evidently be *merely incidental* to the business of the particular company offering the guarantee.

²⁶ These are: (a) arranging (bringing about) deals in investments (Article 25(1) (*Arranging deals in investments*)); and (b) making arrangements with a view to transactions in investments (Article 25(2) (*Arranging deals in investments*)).

²⁷ FCA Handbook, PERG 5.6.7

Premium

- 3.7. Very few authorities have been identified which consider what constitutes a premium for the purpose of determining whether or not a contract of insurance exists at common law.²⁸ The cases therefore do not assist in reaching any definitive view as to the meaning of the word “premium” in the context of the RAO. It seems reasonable, however, to conclude that the draftsman of the RAO deliberately used the word “premium”—rather than, say, “consideration”—so as to include a term specifically associated with contracts of insurance rather than with any other types of agreement.
- 3.8. To the extent that any general principles can be derived from the case law, they might be summarised as follows:
- a) the payment of premium is an essential element for a contract of insurance;
 - b) premium might be a “periodic” payment but does not have to be so;
 - c) it would typically be in the form of a monetary payment, but need not be so;
 - d) it is sufficient for there to be consideration provided by the insured party in the usual contractual sense (although a purported contract of insurance executed by deed without consideration seems unlikely to fail for want of consideration/premium);²⁹
 - e) there is some support for the idea that a premium ought to be a payment in advance of the insured event occurring.³⁰ The more persuasive view, however, is that, if consideration is contractually due, this should be sufficient even if that consideration has not actually been paid at the time of the insured event occurring (specific interpretation of the wording of the relevant contract would, of course, be

²⁸ See *supra* ft 2, *Prudential*, Channel J in setting out his well-known description of the essential elements of a contract of insurance stated: “It must be a contract whereby for some consideration, usually but not necessarily for periodical payments called premiums, you secure to yourself some benefit, usually but not necessarily the payment of a sum of money, upon the happening of some event”. This has been much quoted in leading insurance textbooks and subsequent cases, but Channel J did not go further into defining “premium” other than to leave it open as not necessarily needing to be premium in the form of a sum of money or requiring payment on a periodical basis. In *Digital Satellite Warranty Cover Limited and another v Financial Services Authority* [2011] EWCA Civ 1413, Patten LJ provided a helpful overview of contracts of insurance. He quoted the Court of Justice in *Card Protection Plan v Custom & Excise Commissioners* (Case C-349/96: [1999] 2 AC 601). In that case the Court of Justice said that: “The essentials of an insurance transaction are, as generally understood, that the insurer undertakes, in return for prior payment of a premium, to provide the insured in the event of materialisation of the risk covered, with the service agreed when the contract was concluded”.

²⁹ Colinvaux’s *Law of Insurance*, 6th edition referenced the fact that a premium may be a consideration other than a money payment stating “a premium is in no respect a pre-requisite of a contract of insurance: all that is necessary is the undertaking by the insurer for good consideration. The policy may be made by deed, in which case no premium or other consideration flowing from the insured is necessary to render the insurer bound”.

³⁰ *Digital Satellite Warranty Cover Limited and another v Financial Services Authority* [2011] EWCA Civ 1413

an important factor and prior payment of premium in order for the insurer to go on risk might be a specific contractual requirement);³¹ and

- f) certain key insurance textbooks have suggested that, for a contract of insurance to be found, the “premium” should be proportionate to the assessment of the risk being undertaken by the insurer.³² There is judicial authority, however, that while this would typically be the case and may be a factor which helps to distinguish a contract of insurance from other forms of contract, the lack of a proportionate premium would not cause a contract not to be contract of insurance.³³

4. IMPACT

- 4.1. The definition of “contract of insurance” for the purposes of Article 3 of the RAO is somewhat open-ended, which may be by design, so as to capture ever-evolving types of financial contracts. This is not necessarily a concern as long as the applicable test is clear. However, for the reasons set out above, this is not the case.
- 4.2. Consequently, legal advice will frequently be needed to determine whether a particular contract falls within the definition provided in the RAO. This can delay and increase the cost of a transaction. In certain cases, formal legal opinions may be required. More significantly, the lack of clarity in the test means that the position may remain unclear, giving rise to the risk of a regulatory breach or (where the protection provider is unauthorised) a criminal offence. In the latter case, the result may be that the contract is unenforceable by the protection provider.
- 4.3. There are many financial products in relation to which it is not clear whether the RAO applies. In a trade finance context, for instance, a number of instruments are commonly

³¹ The reference to prior premium in *Digital Satellite* was part of citation of *Card Protection Plan v Custom & Excise Commissioners* [1999] 2 AC 601 but the prior basis for stating that the timing of payment needed to be prior was not analysed. The wording appeared in the First Non-Life Directive in one place but not in others and was not transposed into English law. Consequently, the basis for interpreting the generic concept of “premium” as inherently requiring consideration be provided as a “prior” event is arguable.

³² Black CJ preferred the position outlined in Colinvaux’s *Law of Insurance*, 6th edition (1990) which referenced the fact that a premium may be a consideration other than a money payment, as for example in mutual insurance. Colinvaux stated that “a premium is in no respect a pre-requisite of a contract of insurance: all that is necessary is the undertaking by the insurer for good consideration. The policy may be made by deed, in which case no premium or other consideration flowing from the insured is necessary to render the insurer bound. The premium more usually however takes the form of a money payment. It has been defined as a price paid adequate to the risk, but the adequacy of the premiums is purely the insurers concern. The amount of the premium may be of assistance, however, in showing the scope of the policy for it is measured by the insurers estimate of the risk formed upon an average of his previous experience of similar risks...”.

³³ In Clark, *the Law of Insurance Contracts* (1989), the author commented on the McGillivray definition as follows: “the calculation of the amount of premium on the basis of the chance that the contingency will occur, rather than the actual cost of the contingency after the event, is said to distinguish insurance contracts from repair contracts, but does not distinguish the latter from mutual insurance. Further the calculation of the premium according to the particular risk has been denied as an essential element of insurance – *Commissioner of Internal Revenue v Treganowan*”.

issued which could arguably fall within the RAO as currently drafted. These include demand guarantees and standby letters of credit. Firms often rely on the “banking business” exception but this depends on the nature of the business carried on by the protection provider and, as discussed above, the scope of the exception is unclear. Increasingly, new counterparties (for example, Fintech companies and investment banks) which would not satisfy a conventional deposit-taking test,³⁴ are entering the market.

- 4.4. Another example arises in the context of "residual value guarantees", in the context of the sale of machinery or aircraft which guarantee a minimum resale value within a specified period. Typically, the analysis of these types of guarantee needs to rely on the "incidental" exclusion (as they are not issued by banking businesses) and the absence of a separate payment which might be characterised as a premium, although an element of consideration for the overall transaction would likely be present. Such guarantees may also be issued by a different entity within the same corporate group which makes the "incidental" exclusion harder to apply, given that the guarantee needs to be incidental to some other business of the entity providing the guarantee (as opposed to being incidental to the overall group's principal business). Furthermore, there may be some separate consideration moving to the entity giving the guarantee, which might be capable of being regarded as a premium.
- 4.5. Difficulty may also arise in the context of corporate transactions, where businesses are sold which include projects undertaken by the target entity which require the provision of guarantees in favour of the project's client. In some cases, the guarantees may be given by the parent company. If the issue of such guarantees is provided by the selling parent company over a period of time, e.g. during a transitional period in relation to the corporate sale transaction, or in respect of multiple projects, this can give rise to concerns as to whether the guarantees are “similar contracts of guarantee” for the purposes of the RAO. Whilst a particular case may be able to rely on the “incidental” exclusion, or may not be issued in return for a premium, there remains legal uncertainty when performing this analysis.

5. SOLUTIONS AND MITIGANTS

- 5.1. In the preceding sections, this report has described the legal uncertainties which arise because Article 3(1) of the RAO brings within the purview of insurance regulation under FSMA a range of other contracts, captured by the phrase “other similar contracts of

³⁴ Post ring-fencing, investment banks which are not permitted to take deposits or offer chequing facilities are not within the *UDT v Kirkwood* meaning of banking business, and so would not be permitted to engage in performance bonds/guarantees.

guarantee”. The uncertainty may have a substantial impact on the firms which are parties to such contracts. The FMLC has therefore suggested below three possible mitigants by which the uncertainty might be resolved. These recommendations are not presented as alternatives; each could be considered independently on its merits and in the light of broader policy issues.

Recommendations to the FCA

- 5.2. Although a legislative solution is to be preferred, if this is not feasible, one way by which these enduring uncertainties could be mitigated is if the FCA updates its own guidance to set out its understanding of the position. As noted above, the FCA has helpfully provided, in PERG 6.7, some concrete examples which illustrate its understanding of the practical application of the RAO regime. It would be useful if the FCA were to review its guidance and amplify it to cover the issues raised by the extended definition of contract of insurance in the RAO.
- 5.3. As the FCA’s views will not be binding on the courts, this approach would not provide a complete solution for protection providers that are not authorised or exempt under FSMA. However, FCA guidance is likely to be persuasive and would help to clarify the market’s understanding of the position. Where the protection provider is authorised, FCA guidance would be of direct assistance because the issue that arises in such a case is whether a regulatory breach may occur.

Legislative amendment to impose a condition on the issuer

- 5.4. One approach would be explicitly to carve out financial guarantees which are guarantees similar to performance bonds from the definition. This may be achieved by including a condition relating to the identity of the protection provider. This would build on the existing banking business exception and might be achieved by amending the wording of “contract of insurance” definition in the RAO in the following manner by adding the emboldened words:

“contract of insurance” means any contract of insurance which is a contract of long-term insurance or a contract of general insurance, and includes—

- a) fidelity bonds, performance bonds, administration bonds, bail bonds, customs bonds or similar contracts of guarantee, where these are—
 - i. effected or carried out by a person that is **neither (A) an investment firm; nor (B) carrying on a banking business;**

- ii. not effected merely incidentally to some other business carried on by the person effecting them; and
- iii. effected in return for the payment of one or more premiums

[...]

5.5. Such an amendment would make it clear that the reference to banks includes not just deposit-taking institutions but also investment banks and certain other regulated firms, while enabling regulated insurance companies—i.e., “an authorised person who has permission to effect or carry out contracts falling within Part I of Schedule 1”—to continue to offer products covered by the express inclusion of the 5 types of bond (or similar types of guarantee) in line with their authorisations. As a result, it would be clear that the types of contract typically entered into by financial market participants for credit hedging purposes (either as protection buyer or seller) are not to be regarded as contracts of insurance for RAO purposes. Article 3(1) of the RAO defines an “investment firm” as

a person whose regular occupation or business is the provision or performance of investment services and activities on a professional basis, other than—

- 1) a person excluded by Schedule 3 ... ;
- 2) a person whose home State is not the United Kingdom and who would be excluded by Schedule 3 ... if the person's registered office (or head office, in the case of a person that is not a body corporate or a person that is a body corporate but has no registered office) was in the United Kingdom

5.6. Schedule 3 of the RAO, in turn, specifically excludes from the definition of an “investment firm” each of the following:

- a) the society incorporated by Lloyd's Act 1871 known by the name of Lloyd's;
- b) an authorised person with a Part 4A permission to carry on the regulated activity of—
 - i. effecting or carrying out contracts of insurance under article 10;
 - ii. insurance risk transformation under article 13A;

- iii. managing the underwriting capacity of a Lloyd's syndicate under article 57

when carrying on those activities (and any other activities permitted by rules made by the FCA or the PRA under the Act);

- c) a person which is a third country insurance or reinsurance undertaking... where the undertaking is transferring risk to a transformer vehicle, provided that the assumption of risk by that vehicle is a specified kind of activity within Article 13A of this Order’.

- 5.7. This amendment should mitigate those uncertainties which arise in relation to the interpretation of the phrase “carrying on banking business”. It makes the new activity-based exclusion available to both (a) U.K. investment businesses and (b) investment businesses established outside the U.K., provided that in each case their investment business activity is sufficiently significant and central to their business that they are properly characterised as “investment firms” for U.K. regulatory purposes.
- 5.8. As a corollary, any such change will need to be reflected in a corresponding change to the definition of “suretyship” in Schedule I, Part I, paragraph 15(2) of the RAO. In addition, not all firms that provide investment services or carry on investment activities will be “investment firms”, as defined. For example, a person providing investment services exclusively for its parent undertaking or subsidiaries is not an investment firm, as per Schedule 3(1)(c) of the RAO. In addition, some relatively niche enterprises may be found to be investment firms, for example some persons who deal on in investments on their own account (under Schedule 3(1)(e) of the RAO).
- 5.9. As a result, were HM Treasury to adopt this way forward, further work will be required to identify whether any of the provisions of Schedule 3 of the RAO inappropriately exclude or include a firm that in policy terms should or should not be able to access the new activity-based exclusion (which relates to the five types of bond or similar contracts of guarantee which are not insurance at common law). However, in drafting terms it would be simple to effect any necessary adjustments, by disapplying specific paragraphs of Schedule 3 of the RAO.

Legislative amendment to define “similarity”

- 5.10. A further solution would be either to clarify what is meant by the words “similar” and “guarantee” in the phrase “similar contracts of guarantee”. This would (i) confirm that it must be a “guarantee” as a technical legal matter (and not some wider type of contract) and (ii) make it clear that it must relate to substantially the same risks as those protected by the named types of bond or (in the case of performance bonds) have the same features as that type of bond (i.e. unconditional obligation to pay against presentation of documents which obligation is independent of the underlying relationship against which protection is sought) (and consequently does not treat other guarantees which are not so similar as “insurance” under the RAO).

APPENDIX

As explored above, it is not immediately clear what similarities exist among the five categories of bonds listed in the definition of a contract of insurance. One similarity among them is that they are all contracts where A undertakes to pay C as some form of protection or guarantee against B defaulting on its obligations. There are differing approaches as to whether proof of loss is required in order to claim under the bond and how the value of the loss links to what can be claimed under the bond:

- a) performance bonds and administration bonds generally do not require proof of loss and the amount paid out is not necessarily linked to the actual loss suffered;
- b) for a bail bond, whether proof of the loss suffered is required depends on the context in which the bond is given; and
- c) a fidelity bond and customs bond generally do require some proof of loss and the amount that can be claimed is linked to that loss.

The following paragraphs examine whether there are other bonds or guarantees that are similar to each of these five categories. This may aid in demonstrating the uncertainty with regard to determining which contracts fall within the catch-all provision “similar contracts of guarantee”.

Fidelity bonds

A fidelity bond is a “means by which an employer may seek to guard himself against the possibility of fraud by one of his employees”.³⁵ The fidelity bond is a “particular type of contract of surety”, “given to guarantee the due and proper performance” of an agent’s or employee’s duties. This obligation can be without limit or “more usually” is “up to a specified amount”.³⁶ Note that, confusingly, fidelity bonds may also be referred to as fidelity “guarantees”—see *New Hampshire Insurance Co v MGN Ltd.*³⁷

There are three other categories of bonds (advance payment bonds, retention bonds and performance bonds) that could be considered similar to fidelity bonds, as they are listed together in section 5(2)(e) of the Construction Contract (England and Wales) Exclusion Order 1998 (the “**Order**”), as certain finance agreements excluded from the statutory definition of a construction

³⁵ Colinvaux & Merkin, A-0070

³⁶ Andrews and Millett, *Law of Guarantees* (7th ed, 2015) (“Andrews and Millett”), 4-008.

³⁷ [1996] C.L.C. 1692, 1743.

contract. As discussed below, however, the advance payment bond and retention bond may be more similar to the performance bond than the fidelity bond, as these three categories of bonds are typically drafted in a form that is payable “on demand” rather than necessarily being linked to proof of the loss suffered.

Performance bonds

Performance bonds are sometimes known as “performance guarantees or demand guarantees”, involving “unconditional undertakings to pay a specified amount to a named beneficiary”.³⁸ Typically, these bonds are on-demand and do not require proof of loss.³⁹ Whilst the commercial purpose of a bond may be to secure the performance of an obligation, it is not the case that the performance bond is necessarily a “pre-estimate” of the loss suffered due to a failure of a party to fulfil their obligations.⁴⁰

However, “whether a particular contract is a performance bond or a true contract of suretyship conditioned on proof of actual breach or non-performance”.⁴¹ This is “determined on a case-by-case basis” with reference to “certain factors”.⁴² For instance, if the issuer is a bank or financial institution, the presumption is that the bond is paid out on demand rather than being a guarantee in the traditional sense.⁴³ The language of the bond is relevant too.⁴⁴ As mentioned above, a performance bond could be considered similar to an advance payment bond or retention bond.⁴⁵

Separately, *Re Sentinel Securities Plc*⁴⁶ considers whether certain contracts are “performance bonds” or “similar contracts of guarantee”, in the context of Section 95(a) of the Insurance Companies Act

³⁸ *Supra fn 30*, 16-001.

³⁹ Colinvaux & Merkin, A-0070; Andrews and Millett 16-001.

⁴⁰ *See Supra fn 30*, 16-001.

⁴¹ *Ibid*, 16-002.

⁴² *Ibid*

⁴³ *Ibid*

⁴⁴ *Ibid*

⁴⁵ Advance payment bonds provide that if a contractor fails to meet its obligations, then the issuer of the bond will refund advances made (for instance, for materials or equipment) made by a party employing a contractor. These bonds are typically drafted in an on-demand form (for example, in the construction context). See: Practical Law, Bonds, guarantees and standby credits: overview, note, types of guarantee or bond.

Retention bonds involve the employer and contractor agreeing that the employer will retain some of the interim payments made to the contractor: some funds are released upon completion of the works and the remainder after the rectification period for faults. These are typically also drafted in an on-demand form in the construction context. However, note that construction bonds are not tripartite. See: Practical Law, Construction bonds: quick guide.

⁴⁶ [1996] 1 W.L.R. 316. Note that the wording of s. 95(a) is near-identical to RAO Article 3.

1982. That case concerned a guarantee protection scheme, whereby a company guaranteed—in return for a subscriber paying a monthly fee—to honour the “supplier’s original guarantee of the products supplied and installed by” the supplier.⁴⁷ The company submitted that the scheme was not a performance bond or similar contract of guarantee, as an “essential feature of a performance bond is that it creates an original obligation to pay money and any ‘similar’ contract of guarantee” must have that.⁴⁸ However, Rattee J ultimately did not need to consider whether the guarantee scheme was a similar contract of guarantee to a performance bond, as he found that the scheme fell under the general definition of a contract of insurance under *Prudential*.⁴⁹ This shows judicial willingness to look beyond guarantee terminology when analysing arrangements for the purposes of characterising whether or not a contract of insurance.

Administration bonds

Administration bonds are bonds “used in connection with the administration of the estates of deceased persons”.⁵⁰ An administration bond does not require proof of a particularised loss due to the failure of an administrator properly to perform his duties; instead there is a “prescribed penalty” for breach of duties.⁵¹ Administration bonds are no longer required.⁵²

Instead, upon granting administration to a person over a deceased person’s estate, the Court may require as a “condition” that there are one or more sureties to guarantee... any loss which any person interested in the administration of the estate of the deceased may suffer in consequence of a breach by the administrator of his duties as such.⁵³

The benefit of the guarantee belongs to “every person interested in the administration of the estate”.⁵⁴

⁴⁷ *Re Sentinel Securities Plc*, 319.

⁴⁸ *Re Sentinel Securities Plc*, 326.

⁴⁹ See *Prudential*, *supra*, ft 2

⁵⁰ Colinvaux & Merkin, A-0070.

⁵¹ *Harvell v Foster*, [1954] 2 QB 367.

⁵² Halsbury’s, Vol 32, 300 (fn3).

⁵³ Senior Courts Act 1981, s. 120(1).

⁵⁴ Senior Courts Act 1981, s. 120(2).

Bail bonds

A bail bond is a bond entered into by a party “who agrees to guarantee that another person will comply with the conditions upon which bail has been granted”. In some contexts, a bail bond is a bond given to secure that a person will comply with the conditions of the bail granted to them and will attend court when called.⁵⁵ No proof of the actual loss suffered is required.

An alternative to a bail bond is to provide a “P&I Club guarantee”. The P&I Club provides an undertaking to “pay the amount of any judgment, arbitral award or settlement agreement in the event of default by the defendant”.⁵⁶

Customs bonds

A customs bond, also known as a duty deferment bond, facilitates the deferral of paying customs duties applied to goods imported to the UK, which normally must be paid immediately.⁵⁷ Instead, one party undertakes to pay the customs duty owed by another party to the relevant governmental body. A duty deferment bond is generally in “on demand” form, meaning that it can be called upon once a demand has been issued without proof of loss, as “the risk of unfair calling” (for example, unfairly calling for payment even when the customs duties have been paid on time) “may be considered to be minimal or non-existent”.⁵⁸ There is a clear link between the amount of anticipated loss and the amount that can be claimed under the bond, as that is quantified – the amount of the customs duty owed.

Alternatively, a party could seek a “customs guarantee”, which could take the form of an “individual guarantee” or a “customs comprehensive guarantee” to defer the payment of customs duties.⁵⁹

⁵⁵ Colinvaux & Merkin, A-0070.

⁵⁶ Andrews and Millett; 15-021.

⁵⁷ Henderson Insurance Brokers Ltd, Duty deferment/customs bonds, <https://www.hibl.co.uk/services/surety-services/services/duty-defermentcustoms-bonds/>.

⁵⁸ Practical Law, Bonds, guarantees and standby credits: overview, Why principals procure the issue of on demand bonds.

⁵⁹ Gov.UK, *Check if you need a customs guarantee*, <https://www.gov.uk/guidance/import-and-export-customs-comprehensive-guarantees-cggs>.

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