

Credit Derivatives

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INSTRUCTIONS TO COUNSEL

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## INSTRUCTIONS TO COUNSEL

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### 1. INTRODUCTION

Instructing Solicitors act for the International Swaps and Derivatives Association, Inc. ("ISDA").

ISDA is an international financial trade association, its membership comprising over 300 of the world's largest commercial, merchant and investment banks as well as other entities that participate in swaps and other privately-negotiated derivatives transactions. The market for credit derivatives is growing rapidly both in London and New York. ISDA would like Counsel to address certain questions regarding which there is currently some uncertainty in the market, particularly in relation to potential insurance law implications.

Accordingly Counsel is instructed to advise on whether entering into credit derivatives could be characterised as "insurance business" under the Insurance Companies Act 1982 ("ICA 1982"), whether a credit derivative could be characterised as an insurance contract for purposes of the ICA 1982 or otherwise as a matter of common law and on whether credit derivatives could be void under the wagering or gaming laws.

### 2. CREDIT DERIVATIVES

"Credit derivatives" is a general term used to describe various swap and option contracts designed to assume or lay off credit risk on loans, debt securities or other assets, or in relation to a particular reference entity or country, in return for either swap payments or payment of premium. The transfer of credit risk may be for the whole life of the asset or for a shorter period, and it may be a complete or a partial transfer of credit risk. There is a great deal of flexibility in the legal form that credit derivatives can take as a number of different structures can often be used to achieve the same economic effect. Often the credit derivative may be embedded into another instrument such as a note or warrant. For the purposes of these instructions, we are interested, primarily, in the credit default option although reference will be made to other types of credit derivatives.

#### (a) Credit default options

A credit default option gives one party to a transaction the right to dispose of an asset (or a group of assets), or the right to receive a payment from the other party, upon the occurrence of one of a number of specified credit events. (The expressions "credit default option" and "credit default swap" appear to be used as synonyms in the market and so for the purposes of these instructions we refer to credit default options throughout).

The credit event may be defined by reference to particular obligations (for example, a failure to pay under a particular loan or bond) or by reference to a particular entity (for example, on insolvency of a specified corporate). The definition of credit event is the most critical element in drafting the documentation.

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It is important to note that the credit event may be something short of an actual failure to pay on insolvency. For example, some credit events may be triggered by a credit downgrade, cross-default or rescheduling. Other points to note are that some market participants seek to regulate the occurrence of a credit event by applying some kind of "materiality" test and/or by stipulating that the occurrence of the credit event must be established by publicly available information.

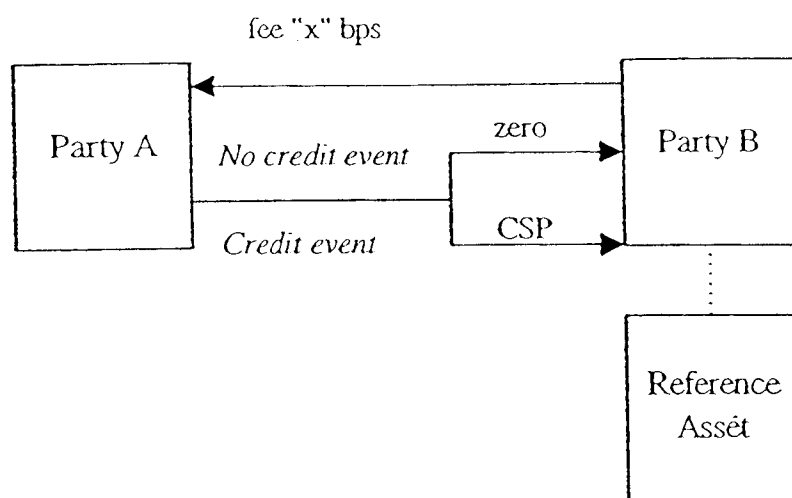
Credit default options are usually documented as transactions under an ISDA Master Agreement, consistently with (and often together with) other types of over-the-counter (OTC) derivatives. ISDA has set up a working group which is currently producing a standard form confirmation for credit default options. A copy of the latest draft (dated 14th March, 1997) of the ISDA confirmation is enclosed with these instructions.

Credit default options are usually settled in one of two ways, assuming the credit event is triggered and the option therefore becomes exercisable:

- (i) *Cash settlement.* This may be (A) on a "binary" basis, that is, if the credit event occurs Party A pays to Party B a sum fixed in advance; or (B) on a "market value" basis, that is, if the credit event occurs, Party A pays to Party B a sum fixed in advance less the residual value of the reference asset. Although we do not believe it is directly relevant to the question we have asked Counsel to consider, we note by way of background that residual value is typically determined by "dealer poll", namely, by asking various dealers for their estimates of the residual value of the reference asset, and averaging the resulting estimates.
- (ii) *Physical settlement.* If the credit event happens, Party B is entitled to put the reference asset to Party A at a strike price fixed in advance.

#### **Example of credit default option**

Party B transfers credit risk to Party A for 3 years on a \$50 million nominal amount of the reference asset. Party B pays Party A a fee of "x" basis points. Under the terms of the contract, if a defined credit event occurs in respect of the reference asset, Party A will pay Party B the cash settlement payment (CSP), being \$50 million less the recovery value of \$50 million nominal of the reference asset 90 days after the event; if no credit event occurs, the contract will expire after 3 years without any cash settlement payment. Party B may or may not own the reference asset.



(b) **Credit-linked notes**

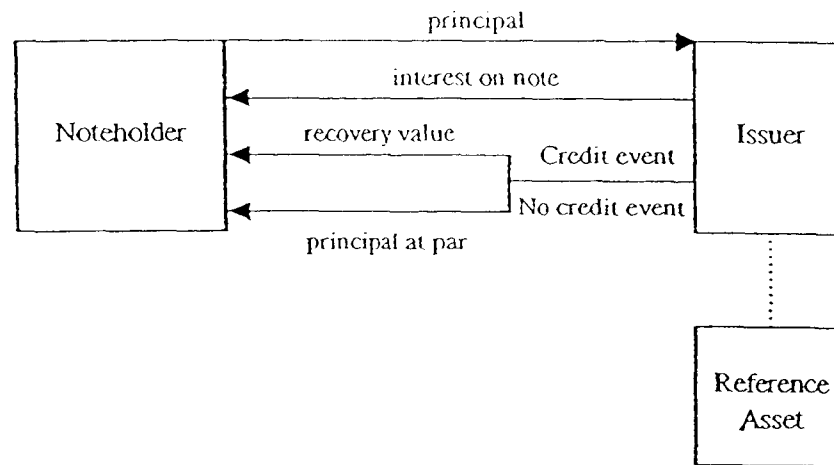
Under a credit-linked note the amount payable by one of the parties (normally the redemption amount payable by the issuer) is determined or varied by reference to the credit performance of one or more selected reference entities and/or debt obligations, or by reference to country or convertibility risk. Cashflows are contingent on specified credit-related events occurring (or not occurring). Although credit-linked notes can be distinguished from OTC credit default options, their effect is economically similar. They are sometimes characterised as "collateralised" credit default options.

**Example of a credit-linked note**

A typical example of a credit-linked note is a note that is redeemable on maturity at par unless a credit event occurs with respect to a reference entity or a reference obligation. Note that the same issues arise concerning the definition of credit event as in the case of a credit default option.

If a credit event occurs, the holder receives a redemption amount at less than par, being typically either an amount linked to a reduction in the value of the reference entity's debt obligations or zero.

For example, an issuer issues \$50 million in nominal amount of a 3 year note linked to the reference asset, and the note pays a fixed or floating interest rate. Noteholder buys the note at par. If no credit event occurs, the note will mature at par in 3 years. If a defined credit event occurs in relation to the reference asset, the note will be redeemed for the recovery value of \$50 million in nominal amount of the reference asset 90 days after the credit event. As noted in relation to credit default options, the recovery value would be determined by "dealer poll". The issuer of the note may or may not own the reference asset.



(c) **Credit spread swaps and total return swaps**

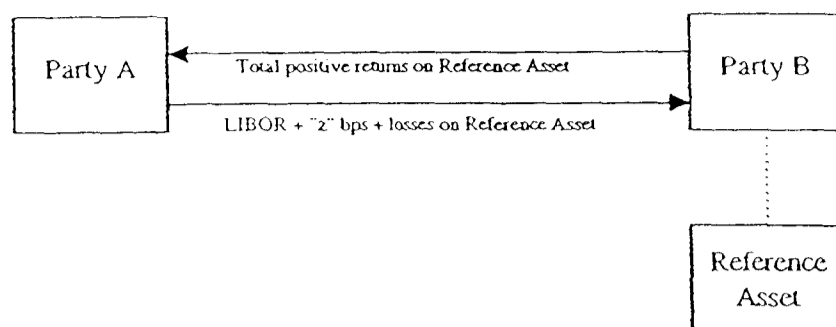
The term "credit derivative" also covers instruments with which Instructing Solicitors have less concern, such as the "credit spread swap" and the "total return swap".

A credit spread derivative is an instrument based on the relevant credit standings of two or more entities. The return is linked to the performance of the credit of one entity or group of entities when measured against another over a period of time. Under a credit spread derivative, payment is not directly linked to the occurrence of a credit-related event, but is based on the yield of an asset (in the case of a credit spread swap the movement of the value of one reference credit against the other). For example, the market's perception of the creditworthiness of the reference issuer will be reflected by the credit spread applicable to that issue, namely the yield on securities of that issuer, as compared with yield available on securities which have equivalent economic terms but zero credit risk (for example, gilts or US Treasuries). Fluctuations in the credit spread prevailing in respect of one or more reference issuers form the basis of a credit spread derivative.

Total return swaps transfer the entire economic benefit of the reference obligations (including the credit risk) to the counterparty. For example, a holder of securities or a lender under a syndicated loan may agree to pass on all the payments it receives in respect of the securities or loan in return for one or more fixed or floating rate payments from the counterparty.

**Example of total return swap**

Party A and Party B enter into a total return swap for 3 years referenced to a notional amount of \$50 million nominal of the reference asset. Party B makes quarterly payments to Party A of all cashflows arising from the reference asset plus positive mark-to-market movements in the value of the reference asset. Party A makes quarterly payments to Party B of LIBOR + "z" basis points plus negative mark-to-market movements in the value of the reference asset. The total performance of the reference asset has been transferred. Party B may or may not own the reference asset.



Instructing Solicitors consider that the risk that entering into credit spread swaps and total return swaps could be characterised as insurance business under the ICA 1982 should be even lower than for credit default options and credit-linked notes, even though these products are "economically" similar. This is due to the fact that neither a credit spread swap nor a total return swap specifies a credit event that in turn triggers a payment obligation. Instead, payments are determined by reference to market prices generally.

### 3. INSURANCE BUSINESS AND INSURANCE CONTRACTS

Counsel is asked to opine on whether, in his view, there is a significant risk that credit derivatives could constitute insurance business for the purposes of the ICA 1982 or otherwise as a matter of common law.

#### 3.1 Consequences of being "insurance business" under the ICA 1982

If credit derivatives constitute "insurance business" under the ICA 1982, then the party acting as "insurer" would need to be authorised pursuant to the ICA 1982.

If a party is not authorised under the ICA 1982 the contract may be unenforceable by that party (section 132 of the Financial Services Act 1986), and money paid under it may be recovered by the insured, together with compensation for loss. There are also possible criminal sanctions.

Section 2(4) of the ICA 1982 does provide a "banking business" exception to the need for authorisation. For the purposes of these instructions, please assume that this exception is not available.

#### 3.2 What is "carrying on insurance business"?

Case law establishes that "carrying on insurance business" means effecting and carrying out contracts of insurance (*Stewart v Oriental Fire and Marine* [1985] 1 QB 988). The description of classes of business in the ICA 1982 (Schedules 1 and 2) and the inclusive definition of insurance business contained in section 95 of the ICA 1985 support this interpretation.

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### 3.3 What is a "contract of insurance"?

Counsel is referred to Prudential Insurance v IRC [1904] 2 KB 658. A contract of insurance has been characterised by case law as a contract under which:

- (i) a person purchases the right to the payment of a sum of money upon the occurrence of some uncertain event; and
- (ii) that person has an "insurable interest" in the subject matter of the contract (in other words, the specified event must be prima-facie adverse to the interest of the assured).

Furthermore Fuji Finance Inc. v Aetna Life Insurance Co Limited [1994] 4 All ER 1025 is authority for the proposition that either the contract as a whole is a contract of insurance or none of it is and that the contract as a whole will only be a contract of insurance when the principal object of the contract is to insure.

In considering whether a contract is one for insurance, it is the terms agreed between the parties and the steps taken by the parties in accordance with those terms that will be the deciding factors and not the commercial effect of the contract. (Counsel is referred, in particular, to Lloyds & Scottish v Cyril Lord Carpets (1992) BCLC 60).

### 3.4 Characterisation of credit derivatives

Derivatives contracts are available on any number of underlying variables. In instructing Solicitors' opinion no distinction should be made in principle, or for any policy reason, between derivatives based on interest or currency rates or equity or commodity prices and derivatives where the underlying variable happens to be a credit-related event. Instructing Solicitors consider that credit derivatives are not the type of business which the ICA 1982 was intended to address, and there is no policy reason why it should be applied.

Although it could be argued that the economic effect of certain credit derivatives is similar to that of a contract of insurance, it is not correct to ignore the terms of those derivative transactions in favour of any such economic effect and conclude that the contract is an insurance contract. Rather it is necessary to address the legal terms and context of the contract to determine whether it contains sufficient legal similarity to a contract of insurance to require its characterisation as such. Instructing Solicitors consider that this will not be the case for credit derivatives, in the absence of exceptional circumstances. Counsel is asked to advise whether or not he agrees with this view.

### 3.5 Distinguishing credit derivatives from contracts of insurance

#### (a) Distinguishing characteristics

Instructing Solicitors consider that credit derivatives may be distinguished from insurance contracts in a number of important respects, including:

- (i) the nature of the contingency triggering a payment obligation;
- (ii) the lack of an insurable interest in the underlying risk;

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- (iii) the fact that the payment obligation under a credit derivative transaction is not conditional on a loss to the protection buyer (Party B in our examples);
  - (iv) the lack of a duty of utmost good faith (*uberrimae fidei*) requiring the protection buyer (analogous to the insured under an insurance contract) to disclose all material facts to the buyer;
  - (v) the form and structure of credit derivative transactions and the nature of the documentation; and
  - (vi) the intentions of the parties, there being a market consensus that credit derivatives are not intended to constitute contracts of insurance.

(b) **Protection against the risk of loss**

On the basis of our prior discussions with you, we believe that, while the cumulative effect of these various distinctions is to emphasise the difference in nature between a credit derivative and an insurance contract, the key reason why a credit derivative is not an insurance contract is that a credit derivative is not a contract against the risk of loss.

Although a protection buyer may suffer a loss if the relevant credit event occurs and, indeed, the protection buyer may have entered into the credit derivative precisely to hedge against that risk of loss, the protection seller is obliged to pay the protection buyer upon the occurrence of the credit event regardless of whether or not the protection buyer has actually suffered a loss.

For example, the protection buyer may have entered into a credit default option to hedge against the risk of loss in relation to its holding of debt securities issued by an emerging market sovereign counterparty. If the protection seller would be obliged to pay the protection buyer upon the occurrence of the related credit event (in this example, a default by the sovereign issuer or its declaration of a rescheduling of or moratorium in relation to its public debt generally) regardless of whether or not the protection buyer continued to hold the relevant debt securities at the time of the credit event, then the credit derivative is clearly not an insurance contract, even if the protection buyer is actually holding those debt securities at the time of the credit event.

Of course, in many cases, the protection buyer will not be holding the reference asset at the time of the event and, moreover, it will often be the case that a counterparty never actually held the reference asset but perhaps held something with comparable characteristics or with only an indirect link economically to the reference asset. Obviously, in such cases the reasoning above applies *a fortiori*.

(c) **Insurable interest**

It is a requirement of a contract of insurance that the insured must have an insurable interest in the risk insured against. In our prior discussions with Counsel, Counsel expressed the view, with which we agree, that this requirement is simply another way of expressing the fact that an insurance contract must be a contract against the risk of loss.

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There has been some concern expressed in the market that, because whether there exists an "insurable interest" has always been considered by the courts to be a question of fact, it might be possible for a court to decide that the same contract could in some circumstances be construed as a contract of insurance, while in other circumstances not.

In our prior discussions with Counsel, Counsel noted that a contract should be construed at the time it is entered into and that the rights, obligations and intentions of the parties at that time are important for the purposes of construction. If there is no "insurable interest" or obligation to pay on the occurrence of "loss" under a contract as it stands, then the fact that subsequently a party receives a payment that offsets a loss it has suffered will not alter that contract's characterisation. Illustrative of this is the approach adopted by the court in Fuji Finance Inc. v Aetna Life Insurance Co. Limited [1994] 4 ALL ER 1025 in order to reach the conclusion that a life assurance contract with an investment element was not a contract of insurance since payments were made irrespective of loss. The fact that loss occurred as a matter of fact did not persuade the court to think otherwise. A contract can have the same economic effect as an insurance contract without being characterised as such.

The only exceptions to this position in relation to a credit derivative would occur if:

- (i) the reference event is defined in such a way that it is conceptually impossible at the time of entry into the contract for the event to occur subsequently without a loss also occurring to the protection buyer. For this to be the case, the event would have to be defined, in effect, to be the loss to the counterparty. It is not enough that the reference event is defined to be a default in relation to the reference asset, since the protection buyer might not still own the reference asset (if it ever did own it directly) at the time of the reference event occurring.
- (ii) the contract could be construed as a "sham", that is, the parties really intended for payout under the contract to occur, notwithstanding the terms of the contract, only in the event of loss to the counterparty; or
- (iii) the contract is subsequently varied by the conduct or express agreement of the parties so that payout only occurs in the event of loss to the counterparty.

In relation to (i), Counsel previously agreed that careful drafting would help to avoid a contract falling into this category. In relation to (ii) and (iii), it was agreed that the parties' intentions are paramount in deciding whether a contract is a credit derivative in the sense described in paragraph 2 above or is, in fact, an insurance contract.

Counsel is asked to advise whether it would be helpful for documentation of credit derivatives to include wording along the following lines:

"The obligation of [protection seller] exists regardless of whether [protection buyer] suffers a loss upon the occurrence of the [Reference Event], and therefore this Transaction is not a contract of insurance."

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As with any such statement in a contract, it is only helpful, of course, if it is true. In other words, it is only helpful if none of (i), (ii) or (iii) above apply.

### 3.6 Insurance contracts at common law

Although the most important questions in relation to credit derivatives and insurance law arise in relation to the ICA 1982, because of (a) the possibility that a contract could, in a rare case, constitute a contract of insurance at common law without constituting an insurance contract for purposes of ICA 1982 and (b) because certain liabilities potentially attach to an insurance contract at common law that would not otherwise attach, Counsel is asked to consider for the sake of completeness the position of insurance contracts at common law.

Instructing Solicitors are of the view that the position is the same as it is in relation to the ICA 1982. Insurance contracts are contracts against risk of loss both at common law and under statute. If payment occurs regardless of loss, a contract will not be regarded as a contract of insurance, even at common law.

### 3.8 Section 95 of the ICA 1982

Counsel is referred to section 95(a) of the ICA 1982 which provides that for the purposes of the Act, insurance business includes "the effecting and carrying out, by a person not carrying on a banking business, of contracts for fidelity bonds, performance bonds, administration bonds, bail bonds or customs bonds or similar contracts of guarantee, being contracts effected by way of business (and not merely incidentally to some other business carried on by the person effecting them) in return for the payment of one or more premiums". Please note that this wording is similar to Class 15 of Schedule 2. Instructing Solicitors believe that, construing section 95(a) ejusdem generis, credit derivatives should not fall within this description particularly since credit derivatives are not strictly contracts of guarantee. Accordingly, Instructing Solicitors believe that the section 95(a)/Class 15 definition is not relevant. Does Counsel agree?

### 3.8 Conclusion

Counsel is asked to advise whether, in relation to views attributed to Counsel on the basis of prior discussions, Counsel confirms that those views are accurately represented and also whether in general Counsel agrees with the analysis set out above. Counsel is also asked to advise whether any additional considerations should be taken into account in analysing these questions in relation to the types of credit derivative described in paragraph 2.

## 4. WAGERING AND GAMING LAWS

Counsel is also requested to advise whether credit derivatives could be void under the wagering and gaming laws. Counsel is referred, in particular, to section 18 of the Gaming Act 1845.

Instructing solicitors consider, in the light of the decision relating to interest rate swap agreements in Morgan Grenfell v Welwyn Hatfield District Council (Islington London Borough Council, third party) [1995] 1 All ER 1, that credit derivatives entered into by parties involved

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in the capital markets are unlikely to be considered to be wagering and/or gaming contracts for the reasons set out below.

- (a) Case law provides that both parties to a contract must intend that the contract is to be a wager (Counsel is referred to Carlill v Carbolic Smoke Ball [1892] 2 QB 484). In Morgan Grenfell v Welwyn Hatfield District Council the proposition that a bank or similar institution would always have a commercial purpose in mind was approved by Hobhouse J. It is hard to bring to mind a situation where wagering or gaming would be the mutual intention of the parties to a credit derivative.
- (b) In Morgan Grenfell v Welwyn Hatfield District Council Hobhouse J stated that the normal inference, in the context of parties or institutions involved in the capital markets, will be that contracts such as interest rate swaps are not wagering or gaming but are commercial or financial transactions to which the law will, in the absence of some other consideration, give full effect.
- (c) Even if the views expressed in (a) and (b) above were incorrect and credit derivatives were to be considered wagering or gaming contracts, such instruments would generally fall within Paragraph 9 of Schedule 1 of the Financial Services Act 1986 (the "FSA") and, following the decisions in City Index v Leslie [1992] QB 98 and Morgan Grenfell v Welwyn District Council, would be excepted from the provisions of section 18 Gaming Act 1845 under section 63 of the FSA if either party could be said to be acting by way of business.

Counsel is asked to advise whether he agrees with Instructing Solicitors.

Counsel is asked to provide a written legal opinion concerning these issues. If Counsel has any questions or requires any further information, he should contact Edward Murray (direct line: 0171 330 2816) or David Benton (direct line: 0171 330 3118) of Instructing Solicitors.

Allen & Overy

19th May, 1997

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CREDIT DERIVATIVES

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OPINION

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1. I am asked to advise the International Swaps and Derivatives Association, Inc.

("ISDA"). I am asked three questions:-

(i) whether entering into credit derivatives can be characterised as "insurance business" under the Insurance Companies Act 1982 ("ICA 1982");

(ii) whether a credit derivative can be characterised as an insurance contract for the purposes of ICA 1982 or otherwise as a matter of common law;

(iii) and whether a credit derivative can be void under the wagering or gaming laws?

In my view the answer to each of the three questions is "no". I explain that conclusion or those conclusions in this Opinion.

2. My instructions describe the term or expression "credit derivatives" as a general term used to describe various swap and option contracts designed to assume or lay off credit risk on loans, debt securities or other assets or in relation to a particular reference entity or country in return for either swap payments or payment of premium. My instructions describe three types of credit derivatives. The first is a credit default option where one party to a transaction has the right to dispose of an asset or the right to receive a payment from the other party upon the occurrence of one of a number of specified credit events. The party may or may not own the reference asset and the cash settlement payment ("CSP") is payable whether or not the party has suffered any loss upon the occurrence of the defined credit event. The second is a credit linked note where the amount payable by one of the parties is determined by reference to the credit performance of one or more selected reference entities and/or debt obligations or by reference to country or convertibility risks. Again, the parties to be the transaction may or may not own the reference asset and payment is made whether or not loss has actually been sustained. The third comprises credit spread swaps and total return swaps. These do not specify a credit event which triggers a payment obligation. Instead, payments are determined by reference to market prices generally. As is evident from the conclusions and reasoning below addressing the first type of credit derivative, the conclusions and reasoning apply, a fortiori, to the second and third types of credit derivatives. Those types of credit derivative do not constitute insurance contracts or insurance business.

3. I begin with the question whether credit default options could constitute insurance business for the purposes of ICA 1982 or common law. Section 2(1) of ICA 1982 provides that no person "shall carry on any insurance business in the United Kingdom" unless

authorised to do so under Sections 3 or 4. The term "insurance business" is not as such defined but Section 1(1) provides that for the purposes of ICA 1982 insurance business is divided into long term business which means insurance business of any of the classes specified in Schedule 1 and general business which means insurance business of any of the classes specified in Part 1 of Schedule 2. It is thus clear that ICA 1982 does not apply to business which does not fall within Schedule 1 or Part 1 of Schedule 2. Credit default options plainly do not constitute long term business within Schedule 1. Credit default options only constitute insurance business if they fall within one of the classes set out in Part 1 of Schedule 2. Class 14 is "credit". This is defined as follows:-

"Effecting and carrying out contracts of insurance against risks of loss to the persons insured arising from the insolvency of debtors of theirs or from the failure (otherwise than through solvency) of debtors of theirs to pay their debts when due"  
[emphasis added]

I do not think credit default options fall within this class as the payment obligation arises whether or not the payee suffers loss and irrespective of whether the payee was subject to a risk of loss. Class 15 is "suretyship". This is limited to risks of loss arising from the person insured having to perform contracts of guarantee entered into by them and to contracts for various bonds "or similar contracts of guarantee". I do not regard credit default options as constituting contracts of guarantee. A contract of guarantee is a contract by which the promisor undertakes to be answerable for the debt, default or miscarriage of another person whose primary liability to the promisee must exist or be contemplated. Credit default options involve payment obligations irrespective of whether the defaulting person is under a liability to the promisee. He may be under such a liability or he may not be. It does not matter for the

operation of the option whether the counterpart actually does or does not suffer a loss upon the default or whether or not he has the ability to dispose of the reference asset. For the same reason I do not regard Section 95(a) of ICA 1982 as being in point. Class 16 is "miscellaneous financial loss". All the categories in this class are cases of insurance against the risk of loss. Since credit default options impose an obligation to make payment upon the occurrence of a triggering event irrespective of whether the payee has sustained loss, or was subject to the risk of loss, I do not consider that credit default options can fall within this class either. This is a matter of principle. I thus conclude that credit default options do not fall within any of the heads of insurance business falling within the ambit of ICA 1982.

4. In any event I do not think that a credit default option is a contract of insurance either at common law or for the purposes of ICA 1982. In Lucena v Crauford (1806) 2 B.&P. N.R. 269 at page 301 Laurence J stated:-

"Insurance is a contract by which the one party, in consideration of a price paid to him adequate to the risk becomes security to the other that he shall not suffer loss, damage or prejudice by the happening of the perils specified to certain things which may be exposed to them. If this be the general nature of the contract of insurance, it follows that it is applicable to protect men against uncertain events which may in any wise be of disadvantage to them; not only those persons to whom positive loss may arise by such events, occasioning the deprivation of that which they may possess, but those also, who, in consequence of such events, may have intercepted from them the advantage or profit which, but for such events, they would acquire, according to the ordinary and probable course of things"  
[emphasis added]

This formulation regards the risk of loss to the potential payee as being of the essence of a contract of insurance. In Wilson v Jones (1867) 2 Ex 150, Blackburn J stated:-

“a policy is, properly operating, a contract to indemnify the insured in respect of some interest which he has against the perils which he contemplates it will be liable to; and I know of no better definition of an interest in an event than that indicated by Lawrence J in Barclay v Cousins and more fully stated by him in Lucena v Crauford that if the event happens the party will gain an advantage. If it is frustrated he will suffer a loss”.

The above formulations emphasise both the necessity for the risk of loss and the necessity for an insurable “interest”. The necessity for an insurable “interest” is simply another way of expressing the requirement that an insurance contract must be a contract against the risk of loss. In Re London County Commercial Reinsurance Office Limited [1922] 2 Ch 67, P.O. Lawrence J considered what purported to be marine reinsurance policies in a sum of money in respect of total loss “in the event of peace not being declared between Great Britain and Germany on or before 31 March 1918”. The policies mentioned no marine losses nor any marine adventure and no ship. P.O. Lawrence J concluded that the policies were not contracts of marine insurance within the Marine Insurance Act 1906 and were illegal and void under the Life Assurance Act 1774. He referred to Wilson v Jones, supra, and stated that an insurance policy is:-

“a contract to indemnify the insured in respect of some interest which he has against the perils which he contemplates it will be liable to”

He concluded that the policies were in form (but not in reality) contracts of insurance because they purported to indemnify the assured against loss in the event of peace not being declared before the specified date. Likewise in Prudential Insurance v. IRC [1904] 2 KB 658 at page 663 Channel J stated that it was essential that the insurance (if it is to be an insurance) must

be against something. The uncertain event which is necessary to make the contract amount to an insurance must be an event which is prima facie adverse to the interest of the assured. He concluded:-

“The insurance is to provide for the payment of a sum of money to meet a loss or detriment which will or may be suffered upon the happening of the event”  
[emphasis added]

Accordingly, I conclude that a contract is only a contract of insurance if it provides for payment to meet a loss or detriment to which the payee is exposed. In the case of credit default options the payment falls to be made quite irrespective of whether the payee has suffered loss or ever been exposed to the actual risk of loss. In Fuji Finance v Aetna Life Insurance [1994] 4 AER 1025, Nicholls V-C referred to Prudential Insurance v IRC, supra, and reviewed subsequent authorities on the meaning of “insurance on the life of any person”. He accepted the proposition that only where the principal object is to insure can a contract as a whole be called a contract of insurance. In my view that must be the object of both parties as a matter of construction of the policy otherwise some non-disclosed desire on the part of one side to enter into the contract to cover the risk of loss would turn the contract into a contract of insurance. The decision of Nicholls V.C. was reversed on the construction and effect of the particular policy by the Court of Appeal at [1996] 3 WLR 871. The Court of Appeal held that the question is one of the characteristics of the contract as a whole. The Fuji case is also significant as emphasising that whether a particular contract is one of insurance is a matter of the constructions of the relevant contract. This is plainly correct. It is the terms of the particular contract and the rights and obligations thereby created which determines the

characterisation of the contract and not the commercial effect (see Yorkshire Railway Wagon Co. v Maclure (1881) 21 Ch D 309; Lloyds & Scottish v Cyril Lord Carpets (1992) BCLC Co. and Welsh Development Agency v Export Finance Co. Ltd [1992] BCC 270).

5. No doubt the economic effect of certain credit derivatives can be similar to the economic effect of a contract of insurance. Both may in particular instances be "investments". The authorities last referred to emphasise that economic effect is not the test to be applied to the characterisation of a transaction. It is necessary to address the rights and obligations specified in the relevant contract. If those rights and obligations are intended by the parties to operate genuinely according to their terms then it is those rights and obligations which determine the characterisation of the contract. Equally, if the parties do not intend the contract to operate in accordance with its expressed terms it is a sham and the court can characterise the transaction by reference to the true purpose of the parties. In the present case I assume that the credit derivatives are indeed intended to operate in accordance with their actual terms. I think that credit default options plainly differ from contracts of insurance in the following critical respects:-

- (a) the payment obligation is not conditional on the payee's sustaining a loss or having a risk of loss;
- (b) the contract is thus not one which seeks to protect an insurable interest on the part of the payee. His rights do not depend on the existence of any insurable interest.

6. I have emphasised above that a contract of insurance where the object of the contract, on its true construction, is not to safeguard the payee against the risk of loss. Nonetheless I think it is helpful for documentation in credit defaults options (but not in the other two types of credit derivatives) to include wording along the following lines:-

“The obligation of X exists regardless of whether Y suffers a loss or is exposed to the risk of loss upon the occurrence of [the Reference Event], and therefore this transaction is not a contract of insurance”.

The first part of the statement is true and accordingly the expressed conclusion is also, in my opinion, true.

7. I have considered both the provisions of ICA 1982 and the common law position above. I do not believe there is any difference between the meaning of “insurance contract” for the purpose of ICA 1982 and the meaning at common law. In both cases an insurance contract is a contract the object of which is to protect against the risk of loss. Where payment occurs whether or not loss occurs and irrespective of the risk of loss the contract is not a contract of insurance. It follows that the views attributed to me on the basis of prior discussions are accurately reflected in my instructions and that I agree with the analysis in those instructions. I do not believe that there are any additional considerations which should be taken into account in analysing the issues in relation to any of the types of credit derivative described in paragraph 2 of the instructions.

8. Finally I turn to the question whether credit derivatives could be void under the

wagering and gaming laws and, specifically, Section 18 of the Gaming Act 1845. I would answer this question in the negative. I have referred above to the decision of P.O. Lawrence J in Re London County Commercial Reinsurance Company Limited. He held the "peace policies" to be gaming or wagering policies. This was because they were not genuine marine policies at all but were in fact insurances by way of gaming or wagering within the meaning of the Life Assurance Act 1774. The policies were shams designed to conceal the true object of both parties. In Carlill v Carbolic Smoke Ball Company [1892] 2 QB 489 Hawkins J, a noted devotee of the turf, defined a wagering contract as one by which two persons, professing to hold opposite views touching the issue of a future uncertain event mutually agree that dependent upon the determination of that event one shall win from the other. The definition would not cover credit default options because the party coming under the obligation to pay on the occurrence of the relevant event does not profess to hold any view differing from that of the payee as to the likelihood or otherwise of the relevant event occurring. No doubt the risk of the event occurring is taken into account in determining the sums demanded for going on risk but that is a different matter. I add only in relation to Carlill that Hawkins J emphasised that both parties must intend their agreement to be in the nature of a wager and that he also rejected the contention that the agreement constituted a policy of insurance. He referred to the formulation of Blackburn J in Wilson v Jones, supra. He expressed the opinion that the agreement was not a contract of insurance and added "certain I am that neither of the parties so intended it". The question whether interest rate swaps were wagering or gaming contracts was considered by Hobhouse J in Morgan Grenfell v Welwyn Hatfield District Council [1995] 1 AER 1. It is of interest to note that the defendant did not even seek to contend that the transactions amounted to insurance contracts.

No doubt this was because in Hazell v Hammersmith L.B.C. [1992] 2 AC 1 at page 35, Lord Templeman described some transactions as more akin to gambling than insurance. Hobhouse emphasised that if the relevant contracts are bona fide commercial or financial transactions they will not be held to be wagering contracts. A contract is only a wagering contract where both parties to the transaction have the common purpose and interest to wager. In any event, credit derivatives will generally fall within paragraph 9 of Schedule 1 of the Financial Services Act 1986 as being contracts the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to a factor designated for that purpose in the contract. Following the decisions in the Morgan Grenfell case and in City Index v Leslie [1992] QB 98 such contracts are excepted from the provisions of Section 18 of the Gaming Act 1845 by Section 63 of the Financial Services Act, I agree with the analysis of those instructing me at page 10 of my instructions.

9. Accordingly, for the reasons set out above I repeat my conclusions as expressed in paragraph 1 of the Opinion that credit derivatives of all the three types described in my instructions are not entered into by way of "insurance business" under ICA 1982, are not contracts of insurance and are not void under the wagering or gaming laws.



Erskine Chambers  
Lincoln's Inn  
24th June 1997

CREDIT DERIVATIVES

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OPINION

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