

## Part VII transfers

the recently proposed amendments to the law and their effect on reinsurers

Part VII transfers – moving insurance and reinsurance business from one insurer to another by way of statutory novation – have become a key tool for insurers and reinsurers within the London market. They are used both within the run-off sector and the live market. Group reorganisations, the sale of portfolios of business and the transfer of insurance business from the UK into an insurer within the EEA can all be achieved using the procedure under Part VII of the Financial Services and Markets Act 2000. In November this year, the UK government began a consultation into certain proposed changes to that procedure. The aim of the changes, which focus primarily on the ability to transfer outwards reinsurance at the same time as the transfer of the business it is protecting, is to try to reduce objections by reinsurers to transfers.

Such objections, which until now have been made mostly in private, but which are starting to appear in the courts, can greatly increase the cost of a transfer for proponents. The Treasury estimates that on average 10% of the legal costs of preparing a transfer are spent on addressing such objections. As a result, the proposals are being welcomed by many proponents of such transfers in London. However, for reinsurers, irrespective of their location, the proposals may raise issues of serious concern.

### Insurance business transfer schemes

Part VII transfers, which are referred to as “*insurance business transfer schemes*” in the legislation, allow an insurer to transfer insurance business to another insurer based in the UK or another EEA state without having to obtain the consent of the transferring policyholders. Particular care is taken in the legislation to protect the interests of policyholders affected by the transfer. However, unlike section 425 schemes of arrangement, policyholders do not get to vote on proposals. Instead, their interests are protected in largely indirect ways: first through the oversight of the English Court which must approve all transfers and which has wide powers of discretion when assessing a scheme; second through the role of the Financial Services Authority, which is consulted closely throughout the preparation and implementation of a transfer and third, through the appointment of an independent expert to report on the terms of the proposal, in particular, on how it will affect the

interests of policyholders. In addition, proponents are required to advertise their proposal and notify affected policyholders (although part of this requirement can be waived by the Court), who are then entitled to appear at the Court hearing to approve the transfer to object to it.

### The consultation

The consultation focuses on two main issues. First, it proposes removing the restriction on those Names at Lloyd’s who resigned before 23 December 1996 from transferring their insurance business using the Part VII procedure. This is largely uncontroversial as there was no good reason for excluding such Names from Part VII. In any event, the change is required to implement the second stage of the recently announced Equitas/Berkshire Hathaway deal as it will allow the transfer of insurance business of Equitas reinsured Names into Equitas or an EEA subsidiary of Berkshire Hathaway.

The second issue concerns the ability of the English Court to order the transfer of outwards reinsurance contracts when approving a transfer proposal. Three amendments to the legislation are proposed:

- removing any doubt that the Court has the power to transfer outwards reinsurance as part of a business transfer scheme
- conferring on the Court the express power to override contractual terms, such as anti-assignment or termination provisions, that would appear to prevent certain reinsurance contracts and other



types of contract, for example, those concerning intellectual property rights in computer software (discussion of these other types of contract is beyond the scope of this note) from being transferred by business transfer schemes

- ensuring that all affected reinsurers have the right to be notified of a proposed transfer.

## Transfer of outwards reinsurance

It is tempting to view the first of these amendments as largely unnecessary as it appears to be clarifying an issue that very few people (publicly at least) believed was in doubt. The ability to transfer outwards reinsurance as part of a transfer scheme for non-life business without the need for obtaining the reinsurer's consent has often been seen as the one key advantage of Part VII over the legislation it replaced. Moreover, the power to order such transfers has been expressly considered and confirmed by the Court (see the *WASA* case [2003]). Without it, Part VII transfers would lose much of their appeal. Why then has this proposal been made?

It appears that the main reason for the proposed amendment is that the current terms of the legislation leave open the possibility — which the consultation admits is narrow at best — for a reinsurer to argue that its reinsurance cannot be transferred without its consent. This argument has not, however, been raised in any reported Court decision so far, although it may have been raised by reinsurers in private. The proposed amendment would appear to remove any possible ambiguity. It is worth noting that the amendment merely empowers the Court to transfer the outwards reinsurance. Whether or not it chooses to exercise that power will remain a matter for its discretion.

## Overriding contractual provisions

The second proposed amendment is likely to be of more concern to reinsurers. It gives the Court the express power to override those terms of a reinsurance contract that would appear either to prevent or limit it from being transferred. The consultation states that without such power there is the risk that outwards reinsurance cannot be effectively transferred. It notes that this would seriously disadvantage the new insurer and would mean that the reinsurer would be freed of its responsibilities in respect of the transferred business for which it had received premium.

Aside from the relatively common anti-assignment provisions that reinsurers often insert into their contracts, the amendment would also allow the Court to override terms that are inserted specifically to protect a reinsurer against Part VII transfers. For instance, reinsurers have started to insert clauses into their reinsurance contracts which are triggered by Part VII transfers, or even by the preparatory steps for such transfers, that terminate or modify those contracts. The consultation notes that such clauses are not yet in widespread use, but the concern is that they could soon become a market practice. Once again, the consultation paper makes it clear that the decision whether or not to override such contractual provisions is within the complete discretion of the Court. It will have to consider all the merits of each particular case and decide whether the interests of the reinsurer out to outweigh those of the scheme proponents.

## Notifying reinsurers

The current legislation makes it clear that anyone adversely affected by a transfer has the right to be heard by the Court. However, to take advantage of that right, a reinsurer first has to be aware that a transfer is taking place. At present, although notice of the transfer must normally be advertised in two national newspapers and affected policyholders must be notified directly, there is no statutory obligation to notify affected reinsurers directly. In practice, however, it is common for proponents to notify their reinsurers as this in general helps to avoid objections by the surprised reinsurers. The consultation proposes that the proponents of a scheme should be obliged to notify those reinsurers whose contracts are being transferred. However, the Court will be empowered to waive such notification at the request of the proponents, but only if good reasons are given. The consultation notes that notifying reinsurers is likely to add to the overall cost of implementing a Part VII transfer.

## Points to consider

These proposals raise a number of serious issues for reinsurers. Set out below are some of the main potential concerns:

- If contracting parties agree to a contractual provision that prevents the reinsurance from being transferred, should the Court have the power — as these recommendations envisage — to override such provisions at the unilateral request of the cedant? The effect of a Court order may of course vary depending on the proper law of the affected reinsurance contract. This could in future lead to reinsurers seeking for English law not to be the proper law of their reinsurance contracts.
- Should any distinction be made in the proposed legislation between reinsurance contracts that are protecting business in run-off and those that are protecting live business? Reinsurers may have increased concerns about having a new cedant unilaterally forced upon them (as would be the effect of a transfer) if the contracts being transferred have not expired. This may be, for instance, because the new entity is a competitor or does not have the same underwriting philosophy as the transferor or is less well rated than the transferor and thus not able to write the same quality of business.
- Section 109 of FSMA requires that an application to the Court to sanction a business transfer must be accompanied by a report on the proposed transfer by an independent expert. The purpose of the report is to assess the impact of the transfer on affected policyholders. There is no obligation for the expert to consider the effect of the transfer on reinsurers. The only option currently available to reinsurers is to review the proposals, object and, if necessary, set out their objection before the Court.
- The transfer of reinsurance could mean that rights of set-off are lost or substantially altered, in particular in circumstances where only part of a company's business is being transferred to a new entity.

## Responding to the consultation

The deadline to respond to the consultation was 26 January 2007.

This note is for guidance only and is not intended to be a substitute for specific legal advice. If you would like any further information please contact:

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