

Solvent schemes of arrangement

the creditor's viewpoint

When an insurer or reinsurer implements a solvent scheme of arrangement its creditors lose their continued cover. They will receive compensation (the estimated amount of their current and future claims on the policy), but is that enough?

Many creditors have questioned the fairness of having their policies compulsorily commuted in circumstances where their insurer or reinsurer is still solvent. Such questioning – particularly by creditors in the US – resulted last year in the first legal challenge to a solvent scheme – *Re British Aviation Insurance Company*¹ in which, among other matters, the fairness of such a scheme was brought into question and the Court did not permit the scheme to go ahead². Consideration of schemes generally focuses on the company implementing the scheme, this note, however, will assess schemes from the creditors' perspective.

The legal framework

A scheme is an arrangement or compromise between a company and its creditors or any class of them governed by section 425 of the Companies Act 1985 (**the Act**). For a scheme to become effective it must be approved at a creditors' meeting (or meetings) by a majority in number representing not less than 75% in value of claims of those creditors who vote at each meeting. It then must be sanctioned by the Court. Once effective it is legally binding on both the company and all its creditors whether or not they voted (or indeed voted against) the scheme at the creditors' meeting.

Why are schemes used by solvent insurers and reinsurers?

Provided all the statutory requirements are complied with, a scheme of arrangement can bring about a global commutation

of a company's claims (whether of its whole book of business or of one or more portfolios of separate business). This aspect has led to their use by solvent companies with portfolios of discontinued business, including those containing long tail liabilities as a method of exiting such business. The most common form of scheme puts in place a binding procedure for the estimation of the creditors' ascertained and unascertained claims (including IBNR). The creditors will then receive a one-off lump sum payment and their right to receive future cover is brought to an end. The whole process can take as little as a year to complete, rather than the many years that is normal for a natural run-off.

It is this speed that is often the primary attraction to companies in run-off. Faced by the pressures of adverse claims development, increased operating costs and poor returns on investment capital an early exit can be an attractive prospect for companies in run-off. Such an early exit also allows capital, in the form of redundant reserves, to be released quickly to the company's shareholders.

The creditor's perspective

Unlike those of the scheme companies, the benefits to the creditor – which, after all, are losing their continued cover – may be less obvious. Schemes can be beneficial to creditors, but each must be carefully assessed on its own merits. The following central questions should be considered by creditors when reviewing a scheme:

1 [2005] EWHC 1621 – Kendall Freeman advised one of the US companies challenging the BAIC scheme.

2 See the *Kendall Freeman Insurance Review* - September 2005 Issue No 57 for a full summary of the BAIC decision.



– *What is the financial strength of the scheme company?*

Companies in run-off can often be financially insecure. As they have ceased to write new business their only source of income is their return on investments. In a strong economic environment such income might be substantial and reliable but, in combination with the need to strengthen reserves to cope with unexpected claims increases, even then the overall financial stability of the company can be subject to fluctuations. The less financially secure a company, the higher the risk of it becoming insolvent over time. In those circumstances, being given a one-off payment in respect of current and future claims may be attractive.

– *What type of cover is being lost?*

The real sting in the BAIC decision was the judge's view that it was unfair to the objecting creditors (mainly large US manufacturers) "*who had brought insurance policies designed to cast the risk of exposure to asbestos claims on insurers to have that risk compulsorily retransferred to them*". The judge noted (having already decided that he did not have jurisdiction to sanction the scheme) that even though the requisite majorities of creditors had voted in favour of the scheme it would be unfair to force the opposing minority to have its policies effectively cancelled. This was particularly the case because of the nature of the risks being covered by the insurance that was to be lost. The contracts were, in many cases, protecting the policyholders against claims arising from asbestos. The policyholders argued that, due to the unpredictability and volatility of such liabilities, they could not be estimated with any reliability. Moreover, they made the point that insurance for such exposure can no longer be purchased at any price.

– *Are the terms of the scheme fair to the creditor?*

The judge in BAIC was critical of a number of the standard terms – including the length of time creditors were given to claim in the scheme - that had appeared in many solvent schemes. The judge also noted that the list of "*benefits*" of the scheme to the scheme creditor that appeared in the explanatory statement accompanying the BAIC scheme (which had appeared in almost every scheme up to that point) are largely benefits to the scheme company and its shareholders and not to the creditors. Schemes since BAIC have been corrected in light of the judge's comments. Nevertheless, it is clear that unfair or unreasonable terms can be challenged.

Creditors must act quickly

The first formal notice of a scheme is likely to be when the scheme company writes to all its creditors in advance of the hearing to convene the creditors' meeting (or meetings). The main purpose of such a letter is to identify how many classes of creditors will be voting on the scheme³. This is required because under section 425 of the Act a separate meeting must be held for each class of creditor. The Court will not have jurisdiction to sanction a scheme if the classes are not correctly constituted⁴.

The relevance of this letter (aside from the technical issues over the correct constitution of creditor classes) is that it is early notice of the impending scheme. In some cases, creditors may be informally approached even earlier. Scheme companies, in order to avoid open confrontation with creditors, often quietly consult with their creditors well in advance of publicising their intention to implement a scheme. It is imperative that creditors begin their consideration of the scheme as early as possible in the scheme timetable (perhaps, even before receipt of the actual scheme document). This is particularly true in circumstances where there may be only six weeks between receiving the scheme document and the date of the meeting(s) to vote on the scheme. This provides very little time to assess the scheme and to calculate current and future liabilities for the purposes of voting at the creditors' meeting.

Creditor democracy

Prior to the creditors' meeting, creditors may also wish to discuss the scheme and coordinate their response with other affected creditors. Concerted action by a group of creditors will have significantly more leverage than acting alone. One difficulty is that it can, as a practical matter, often prove difficult to identify fellow creditors. A Scottish decision from last year in which Kendall Freeman acted, however, provides some useful assistance in these circumstances⁵. In that case, the scheme company, Scottish Lion Insurance Company, was asked by a creditor to provide a list of the names and addresses of all its creditors. The company refused and the creditor took proceedings in the Scottish Court.

Agreeing with our arguments, the judge ruled that the company must provide its creditors with the names and contact details of all its creditors. He noted that when deciding whether creditors fall into a single class the standard test is whether the creditors' rights "*are not so dissimilar as to make it impossible for them to consult together with a view to their common interest*"⁶. He noted that the basic assumption contained within this test is that creditors are in reality allowed to consult together. Without provision of a creditor list, creditors are effectively prevented from contacting each other and so virtually no discussion or consultation can take place.

The significance of this judgment is that in the past only the company proposing the scheme was able to contact the creditors affected. However, with the provision of the names and addresses of the other creditors, policyholders are able to discuss the proposal among themselves.

Scottish decisions are not formally binding on the English court, but can be persuasive. The decision supports the view that if a scheme company still chooses not to provide such a list (as has happened in connection with a number of recent schemes), creditors may wish to attempt to compel the company to do so.

3 This is recommended as best practice by the High Court in its procedural guidelines, namely *Practice Statement (Ch D: Schemes of Arrangements with Creditors)* [2002] 1 W.L.R. 1345).

4 It was for this reason in BAIC that the judge decided that he did not have jurisdiction to sanction the scheme - see the *Kendall Freeman Insurance Review* - September 2005.

5 *Scottish Lion Insurance Co, Re* (Unreported, September 5, 2005).

6 *Sovereign Life Assurance v Dodd* [1982] 2 QB 573.



Role of the FSA

During the preparation of a scheme of arrangement the proponent company will liaise very closely with the FSA. At an early stage, drafts of the scheme document will be provided to the FSA for it to review and comment upon. Such a review can often lead to a number of queries and suggested amendments. Customarily, however, the FSA will not approve the draft scheme, but will state that it has no objections to the scheme. This negative consent is generally brought to the Court's attention both at the hearing to convene the creditors' meeting(s) and the sanction hearing as evidence that the scheme is fair to creditors.

If elements of a scheme appear unfair or unreasonable, creditors can make representations to the FSA. Where such representations are made by a group of creditors they are likely to have a greater

impact. This is a further benefit of coordinating with fellow creditors in advance of the creditors' meeting(s).

Conclusion

Kendall Freeman acts both for companies implementing solvent schemes and creditors raising objections to them. Schemes of arrangement can offer benefits to creditors, but each scheme must be assessed on its own merits. A close and, equally importantly, early review of the terms of the proposed scheme, the types of cover being lost and the financial viability of the scheme proponent are vital. Equally significantly, discussing the scheme proposal with fellow creditors and possibly coordinating your response can also prove extremely beneficial.



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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