

The applicability of solvent schemes of arrangement to German portfolios

The two articles by Dr Schnepf and Ms Janzen which appeared in the July 2007 editions of *Versicherungswirtschaft* on whether solvent schemes of arrangement are effective under German and EU law made a powerful case for casting doubt on the validity of such schemes under German law. This article will examine the arguments put forward by Dr Schnepf and Ms Janzen from both a commercial and legal standpoint.

Solvent schemes of arrangement have emerged in the last five or so years as a uniquely powerful procedure to achieve rapid and legally binding closure of insurance and reinsurance companies. What had previously been thought of as an impossible objective has been achieved at an ever-increasing rate in common law jurisdictions such as England, Scotland, Ireland, Bermuda, Australia and New Zealand. Although such schemes emanate from the UK they affect insurers, reinsurers and policyholders all around the world. It was estimated in February 2007 that of the 80 solvent schemes that had been implemented up to that date, 52% related to non-UK businesses with 33% of them specifically relating to Continental European insurance and reinsurance business.¹ This is especially significant for Germany as it is considered to have the largest volume of business in run-off in Continental Europe, almost double that of any other country in Continental Europe.²

Some of the promoters of solvent schemes of arrangement have been German companies who have successfully closed down their subsidiaries or portfolios in common law jurisdictions. An example is AXA Colonia which in 2005 closed down a number of reinsurance portfolios in its Irish subsidiary.

Under a solvent scheme creditors accept a lump sum payment which reflects the amount of their paid losses, notified outstanding claims and incurred but not reported claims (IBNR). They do so in return for surrendering their right to continued cover. Provided the strict procedures are adhered to and court sanction

is given, all creditors of the company implementing the scheme will be bound, whether they voted for or against or did not vote at all in support of the scheme.

A scheme of arrangement has been a feature of English company law for many years and is found in very similar terms in a number of earlier incarnations. It is currently found in Section 425 of the Companies Act 1985 (Section 425). It will shortly be found in Part 26 of the new Companies Act 2006.

In view of the fact that creditors' rights under their contracts will be varied by the scheme, the procedure laid down by Section 425 contains several checks and balances. It is a court driven process. There are two court hearings:

- 1) The convening hearing where the court gives directions for one or more meeting(s) of creditors to be convened to consider the scheme and if thought fit approve it. The number of meetings depends on the number of classes of creditors which there are.
- 2) The sanction hearing which is held after the meeting(s) convened in 1) has been held and the scheme has been approved by the necessary majorities. At this hearing the court will decide whether in all the circumstances the scheme is fair and ought to be sanctioned.

The necessary majorities are 75% in value and a simple majority of those present in person or by proxy and voting at each of the creditors' meetings convened.

1 Unlocking Value in Run-off – A survey of Discontinued Insurance Business in Europe, PricewaterhouseCoopers LLP, February 2007

2 Unlocking Value in Run-off – A survey of Discontinued Insurance Business in Europe, PricewaterhouseCoopers LLP, February 2007



It is not commercially realistic to characterise solvent schemes of arrangement as a threat to German primary insurance companies. The current and future reinsurance assets represented by companies in or likely to enter a Solvent Scheme of Arrangement constitute a very small percentage of the total asset base of all major German insurance companies. They may represent a minor irritation but are unlikely to have, in the future, a material impact on German insurance companies' solvency.

From a commercial perspective solvent schemes of arrangement, provide an early payment of current and future actuarially estimated liabilities, offering an alternate and definitive prospect for German cedants rather than the uncertainties associated with a run-off spanning several decades.

Some of the entities that are promoting solvent schemes of arrangement are in a precarious financial situation. If these entities were forced to run-off their business over a twenty or thirty year time span, there is a very good chance that they could become insolvent. Commercially, German primary insurers who are creditors of such companies could benefit by accepting cash now under a Solvent Scheme of Arrangement rather than receiving a slow drip feed of dividends from the liquidators of insurance companies over a long period of time at some future stage.

Managers of German insurance companies should also understand that solvent schemes of arrangement have not been developed merely as an escape clause for the benefit of reinsurers but are a commercial reality of the market place. They are effectively a consequence of the dramatic collapse of the international reinsurance market since the early 1990's.

Many of the small players who operated in this market were not professional reinsurance companies. They were often conventional medium sized property and liability insurers who often participated in underwriting agency pools in London or wrote business in their home territories. These entities along with a number of the larger market participants took the decision to exit the reinsurance market in the wake of such major losses as Hurricane Andrew in 1992 and the rapid increase in USA asbestos claims. Many of these companies have now been in run-off for over ten years.

Many German insurance companies have gradually become accustomed to managing the uncertainty surrounding this market situation by agreeing to individual contract commutations with reinsurers who are in run-off. Solvent Schemes of Arrangement could be said to be the second phase of the run-off market dynamic in that they are effectively the implementation of mass commutations in an economically efficient manner.

The question in point is namely whether schemes of arrangement implemented in the UK are enforceable in a creditor's home jurisdiction. The situation is still uncertain as there have been no legal decisions on this issue in any Continental European court. Nevertheless, for the reasons explained below, there are strong arguments in support of the view that such schemes – using EU legislation – ought to be enforceable across Continental Europe³.

The Enforcement issue

One of the many tasks undertaken by companies intending to propose a scheme of arrangement is a full-scale review of the jurisdiction and choice of law clauses in the contracts that are the intended subject of the scheme. This is because the scheme proponent will want to know how many of the contracts are not subject to English law and the jurisdiction of the English courts (or arbitration in London). This is because, irrespective of the location of the creditor, if his contract with the scheme proponent is subject to English law and the jurisdiction of the English courts, that creditor will have to apply to the English court to enforce the terms of his contract. If a scheme has been implemented in England, the English court will enforce the terms of the scheme against the creditor. If, however, the creditor has a contract with the scheme proponent that is subject to the law and jurisdiction of the creditor's home state, he can apply to his home court to enforce that contract. In those circumstances, the question arises whether the home court will enforce the terms of the scheme implemented in England.

Whilst insurers may receive advice to the effect that solvent schemes of arrangement implemented in the UK cannot, under German law, dissolve reinsurance policies established under German law, and that the rights of German insurers remain enforceable until the end of time under the original policies, the reality is very different. What benefit is there in having rights against a reinsurer who no longer exists (because the Scheme of Arrangement has extinguished its liabilities), and who may never have had any assets in Germany, even when it did exist?

The Enforcement Regulation⁴

The Enforcement Regulation replaced the Brussels and Lugano Conventions on jurisdiction and enforcement of judgments in civil and commercial matters.⁵ It came into force on 1 March 2002 and now regulates the recognition and enforcement of judgments for all EU Member States (except Denmark). The aim of the Enforcement Regulation is "the free movement of judgments in civil and commercial matters" including "the rapid and simple recognition and enforcement of judgments from Member States bound by [it]"⁶. In many respects the Enforcement Regulation is similar to the Conventions it replaced. Consequently, the Conventions are commonly used as a tool for the interpretation of the Enforcement Regulation.

To understand the scope of the Enforcement Regulation it is helpful to compare it to how insolvency proceedings are enforced across the EU. Article 2(b) of the Enforcement Regulation excludes insolvency proceedings from its ambit. The reason for that exclusion is that insolvency proceedings are intended to be enforced across the EU using the EC Insolvency Regulation.⁷ This view is supported by the Jenard Report⁸ which reported on the committee that prepared and drafted the Brussels Convention,

3 For a different view on this issue, please see the two-part article *Reinsurance: can solvent schemes be applied to German portfolios* in the July 2007 editions of *Versicherungswirtschaft*.

4 Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters

5 Brussels Convention on Jurisdiction and the Enforcement of Civil and Commercial Matters signed on 27 September 1968 (the **Brussels Convention**), the Lugano Convention on Jurisdiction and the Enforcement of Civil and Commercial Matters signed on 16 September 1988 (the **Lugano Convention**) and together the Conventions.

6 Recitals 6 and 2 of the Enforcement Regulation.

7 Council Regulation (EC) 1346/2000 on Insolvency Proceedings.

8 Report on the Convention on Jurisdiction and the Enforcement of judgments in Civil and Commercial Matters signed on 27 September 1968 (the **Jenard Report**)



the precursor to the Enforcement Regulation. It notes that ideally the Brussels Convention would have applied to all civil and commercial matters, without exception. However, such a solution was not possible. Bankruptcy and insolvency matters were excluded because a separate convention was being drafted to deal with that area of law (although, in the end, the project was not completed for another 30 years). When the EC Insolvency Regulation was eventually implemented throughout the EU it was intended to dovetail with the Brussels Convention and be mutually exclusive⁹. Thus, a judgment of the English court sanctioning a scheme of arrangement made by an insolvent company is thought to be enforceable across the EU under the auspices of the EC Insolvency Regulation.¹⁰ However, schemes implemented by solvent companies cannot be enforced using the EC Insolvency Regulation.

As schemes by solvent companies are specifically excluded from the ambit of the EC Insolvency Regulation, and the EC Insolvency Regulation and the Enforcement Regulation are intended to be mutually exclusive, it can be argued that schemes ought to be enforceable under the Enforcement Regulation.

Articles 32 to 37 of the Enforcement Regulation

Articles 32 to 37 of the Enforcement Regulation set out the circumstances in which a judgment given in one Member State must be recognised in another Member State. Article 32 of the Enforcement Regulation defines a judgment as “*any judgment given by a court or tribunal of a Member State, whatever the judgment may be called*”. The question then arises as to whether an order by the English Court sanctioning a scheme falls within this definition. There is considerable uncertainty about this issue as neither the European Court of Justice nor any Continental European court has yet considered it.

There are two main arguments in support of the view that an order sanctioning a scheme is not a judgment for the purposes of the Enforcement Regulation. First, there has been a number of European Court of Justice decisions confirming that a judgment as defined by the Enforcement Regulation must have been preceded by adversarial proceedings where the other party is heard or has the opportunity to be heard. Dr Schnepf and Ms Janzen suggest that the hearing preceding the order sanctioning a scheme is not adversarial in nature. We respectfully disagree with that proposition.

The English court’s role at that hearing is not a formality; it has a discretion whether to sanction a scheme. The starting point for the court, however, is that a majority of the company’s creditors want the scheme to be implemented. Nevertheless, it is clear that the court is not bound by the decision of the meeting. At the hearing the court will confirm that the legislation has been complied with, that the meeting or meetings were conducted in a fair manner (for instance, that there was no coercion of a minority) and that the scheme is fair to creditors. Provided the court is satisfied, it will then sanction the scheme. Although such hearings are often not adversarial, it would be wrong to conclude that they

are necessarily non-adversarial by nature. Any creditor (or other interested party) can appear at the hearing to object to the sanctioning of the scheme. Indeed, creditors have been making such objections with increasing frequency (see *British Aviation Insurance Company Limited* [2005] EWHC 1621 (Ch) and *Sovereign Marine & General Insurance Company* [2006] BCC 774 also known as WFUM). Hence, it can be argued that as creditors are entitled to appear at the sanction hearing to object to the scheme, such hearings are adversarial in nature.

Secondly, one must consider the role of the court when it sanctions a scheme. The European Court of Justice has ruled that for a judgment to be enforceable under the Enforcement Regulation it must “*emanate from a judicial body of a Contracting State deciding on its own authority on the issues between the parties*”.¹¹ As a result, settlements in court that bring legal proceedings to an end are not judgments as they depend on the intention of the parties and not the authority of the court. It can be argued that a scheme is akin to a settlement approved by the court and so not enforceable using the Enforcement Regulation. This argument, like the first argument, wrongly assumes that sanction hearings are all un-contested and that the role of the court at such hearings is minimal. It fails to recognise that the court has a very significant role in choosing whether or not to sanction the scheme. It refuses to do so if it considers that there have been irregularities in the way in which the creditors’ meetings have been convened and conducted or if it is deemed unfair to creditors. The court adopts a relatively “*light-touch*” at most sanction hearings precisely because they are un-contested not because it lacks authority. As contested hearings have shown recently, the court can take a far more active role if it deems it necessary. Further, the court itself has power to modify the terms of the scheme which strongly indicates that the court is deciding on its own authority despite the fact that creditors have approved a scheme in its unmodified form.

The fact that the scheme only becomes effective once it is filed with the registrar of companies is not an indication that the scheme does not arise from the sanction given by the court using the power given to it under Section 425. The need for filing is an administrative requirement ensuring that interested parties have access to the scheme.

The intention of the Enforcement Regulation is to facilitate the recognition and enforcement of judgments within the EU. Arguably, the provisions of the Enforcement Regulation ought to be interpreted with that intention in mind and thus the definition of “*judgment*” should include an order sanctioning a scheme. It would, in fact, appear to be in conflict with the spirit of the Enforcement Regulation if the enforcement of schemes did not fall within the scope of its application. This view is supported by the notion that the EC Insolvency Regulation and the Enforcement Regulation are intended to be mutually exclusive: one dealing with the enforcement and recognition of insolvency proceedings, the other dealing with the enforcement and recognition of other civil proceedings, such as schemes of arrangement by solvent companies.

As to the question of schemes conflicting with local German law ie Article 14 of the German Basic Law, it will be interesting to see which law would prevail. However, the expressed aim of the

⁹ For instance, the report by Professor P Schlosser prepared on the accession of Denmark, Ireland and the United Kingdom to the Brussels Convention and the Protocol signed on 9 October 1978 notes that the Brussels Convention and the proposed insolvency convention “*were intended to dovetail, almost completely with each other*” (paragraph 53).

¹⁰ Article 25 of the EC Insolvency Regulation.

¹¹ *Solo Kleinmotoren GmbH v Boh ECRI-2237* at para 17 to 18



Enforcement Regulation of furthering the free movement of judgments in civil and commercial matters by rapid and simple recognition and enforcement of judgments throughout Member States, we would argue would take priority over Article 14 as a matter of principle in the absence of an express exclusion.

There are strong arguments to support the view that schemes ought to be enforceable using the Enforcement Regulation. The arguments against such a position underplay and misunderstand the role of the English court in sanctioning schemes of arrangement. In addition they overlook the spirit and intention behind the Enforcement Regulation. The lack of court decisions on this issue means that there remains a risk that courts in Continental Europe will not enforce schemes implemented in the UK. However, in our view, the arguments in favour of enforcement are stronger and more persuasive than those against it.

From a practical, commercial perspective we would add that legal arguments cannot provide a permanent shield against recent market developments which have affected the German reinsurance market (eg the withdrawal of Gerling Globale Rueck and Gothaer Rueck) in the same way as the Anglo-Saxon common law jurisdictions have been affected. As the soft reinsurance market arrives in 2008 it would be difficult to exclude the possibility of further contractions in the international reinsurance markets, and thus the implementation of further Schemes of Arrangement.

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