

# Clarifying rights or stifling dissent?

## reinsurers' and policyholders' rights to object to Part VII transfers

In the UK, insurance business transfer schemes (known as Part VII transfers) result in the novation of portfolios of insurance or reinsurance business from one insurer or reinsurer to another by way of a court sanctioned regulatory mechanism. They have become a key tool within the London market as group reorganisations, consolidations and the sale of insurance portfolios can all be achieved using the procedure governed by Part VII of the Financial Services and Markets Act 2000. Over 100 have taken place since the procedure came into force in 2001.

One reason for their popularity is that the court can order the transfer of reinsurance protections at the same time as sanctioning the transfer of the underlying portfolio. This power, which is not available in most EEA states, was confirmed by the Court in *Re WASA International Insurance Co Ltd* [2005] 1 BCLC 668.

In November 2006, the UK government launched a consultation into certain proposed changes to the legislation governing the Part VII procedure (the Consultation). 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 clarify the law and practice associated with the transfer of the reinsurance. It is intended that the changes will reduce the number of objections by reinsurers to such transfers. Addressing the objections of policyholders and reinsurers represents a significant proportion of the cost of any transfer. The Consultation paper estimates that reinsurers' objections alone account on average for 10% of the legal costs of preparing a transfer. Thus, the proposals which aim to reduce these costs have been broadly welcomed by proponents of transfers in London. For reinsurers, however, the proposals have raised a number of serious concerns, which are considered below.

### Insurance business transfer schemes

Part VII transfers allow an insurer or reinsurer to transfer insurance or reinsurance portfolios to another insurer or reinsurer 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 schemes of arrangement under section 425 of the Companies Act 1985, policyholders do not have a right to vote on the proposals.

Instead, policyholders' interests are protected in three ways:

- through the role of the insurance regulator in the UK, the Financial Services Authority (FSA), which is consulted closely throughout the preparation and implementation of a transfer – a transfer is unlikely to proceed if it is not supported by the FSA
- through the appointment of an independent expert who reports on the terms of the proposal, in particular, on how it will affect the interests of policyholders
- through the oversight of the English court, which must ultimately approve all transfers. The court has wide powers of discretion when assessing a scheme although it relies heavily on the views of the FSA and the independent expert.

Proponents of Part VII transfers are required to advertise their proposals 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 should they wish to object to sanctioning of the transfer.

### Policyholder objections to Part VII transfers

Broadly, objections by policyholders that have been made in court can be seen to fall into two categories: either that the proposed transfer prejudices the objector or that there is some irregularity relating to the independent expert or his or her report. Remarkably few of the objections made have been successful.



### Financial security of the transferee

The prejudice arguments have generally failed because the courts have not been convinced that the Part VII transfer prejudices the objector to a sufficient degree. The courts have decided that having your policy transferred to an entity that is less financially secure than your original insurer or reinsurer, does not by itself amount to prejudice.

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In both the *Re Norwich Union* [2005] BCC 586 and *Re Allied Dunbar* [2005] 2 BCLC 220 decisions, objectors complained that the transferee insurer was less solvent and thus financially less secure than the transferor. The objectors noted that in each case the transferee had a reduced surplus over (what was then called) its Required Minimum Margin of Solvency (RMM) compared to the transferor. In these cases, the courts ruled that it was a matter for the independent expert to determine whether the reduced excess over the RMM prejudiced policyholders. The courts concluded that such reduction on its own would not constitute prejudice. In both these cases, the independent experts concluded that the reduction in the surplus over the RMM had no adverse effect on policyholders. As a result, the objections failed.

This argument has recently been framed in a slightly different manner. In *Royal & Sun Alliance v British Engine* (Unreported 2006), one policyholder complained that transferring its policy from an A-rated reinsurer like RSA to the unrated British Engine would have a detrimental effect on the policyholder's own rating. The scheme proponents answered this by stating that RSA had provided a guarantee to British Engine of the performance of British Engine's policy obligations. As a result, the transfer should not affect the policyholder's rating. This point was not pursued by the policyholder at the sanction hearing so there is no ruling on this issue.

Similarly, a number of Lloyd's syndicates complained that as British Engine was less well rated than RSA there would be an impact on their reported results and on the level of the Funds at Lloyd's that the syndicates' members would have to deposit. As a result, they argued that the transfer was prejudicing them. Once again, the court was not called upon to rule on this issue as the proponents of the transfer agreed commutations with the objecting syndicates in advance of the sanction hearing. Until the court rules on this type of objection, it is likely to be raised with increasing frequency.

### Independent expert's report

The second category of complaint concerns the independent expert and his or her report. Like in the arguments based on prejudice, these have also all been unsuccessful. In the recent *Re Eagle Star Insurance Co Ltd* (Unreported 2006) decision, the objecting policyholders argued that they should be given a chance to test the conclusions made by the independent expert in her report, in particular those relating to the capital adequacy of the transferee. The judge said that to allow such an investigation, in the absence – as was the case in this dispute – of any substantive grounds for alleging that there was an error or mistake in the report, would be to overlook the importance of the independent character of the expert and the independence of her report. Thus, the objectors' request was rejected.

This decision is in line with the courts' general reluctance to allow policyholders to investigate behind a report without first providing some grounds for supposing that the independent expert had made an error. Clearly, this significantly limits the scope for objecting to a report. In any event, these type of objections can often be addressed by the expert in a supplemental report. Questions have also been raised about whether the expert is truly independent because he or she is paid by the proponents of the transfer or has undertaken work for them previously. However, in none of the cases where this issue has been raised have the objectors alleged that the experts were acting improperly or that there were irregularities in their reports caused by their lack of independence. The courts have ruled that without strong evidence that the experts were acting improperly, it would be completely wrong to impugn their independence. As a result, these objections have also failed.

### The court's approach to objections

Considering the increasing volume and complexity of Part VII transfers, relatively few objections have reached the courts when compared with section 425 schemes of arrangement. There are a number of reasons for this:

- First, the procedure is not nearly as controversial as section 425 schemes as often policyholders and other stakeholders do not believe that their interests are being harmed by the procedure. Under section 425 schemes, policyholders lose the benefit of their continued cover. The procedure under Part VII is not nearly as draconian as the transfer does not, in many cases, affect the policyholders' contractual rights, but simply changes the identity of its insurer.
- Secondly, the objections that are being made often relate only to the specific terms of the transfer and how they affect the objector. This makes them far easier to resolve without litigation than objections made by creditors to solvent schemes of arrangement (see for instance the objections made by the creditors in the *Re British Aviation Insurance Co Ltd* [2006] 1 BCLC 665 and *Re Sovereign Marine and General Insurance Co Ltd* [2006] BCC 774 (the WUFM Pools case)) which go to the heart of that procedure and leave little scope for compromise.
- Thirdly, the courts' approach to objections is to consider the interests of all the parties affected by the transfer. As a result, even if an objector is adversely affected by a transfer scheme, the court may still sanction it. It will consider whether *“the scheme as a whole is fair as between the interests of the different classes of persons affected”* (Hoffman J in *Re London Life Association* Unreported 1989).
- Fourthly, proponents of Part VII transfers have, in general, been keen to avoid contested sanction hearings. As a result,

the majority of objections are resolved through negotiation in private. This means that the number of objections being made in open court is not a good guide to the total number of objections that are actually raised. For instance, there appears to be only one example of an objection to a transfer by a reinsurer in open court. However, far more objections to Part VII transfers are raised in private, which explains to some extent why the proposals in the Consultation have been put forward.

### 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 these Names from Part VII of the legislation. In any event, the change is required to implement the second stage of the Equitas/Berkshire Hathaway deal as it will allow the transfer of the insurance business of Names reinsured by Equitas into a subsidiary of Berkshire Hathaway.

The second issue, and the one upon which this article focuses, 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 an insurance business transfer scheme
- conferring on the court the express power to override contractual terms, such as anti-assignment or termination provisions, that seek to prevent certain reinsurance contracts and other types of contract from being transferred by such schemes
- ensuring that all affected reinsurers are notified of a proposed transfer.

### Transfer of reinsurance protections

It is tempting to view the first of these proposed amendments as largely unnecessary as it appears to be clarifying an issue that most people believed had been resolved in *Re WASA International Insurance Co Ltd*. The ability to transfer outwards reinsurance contracts as part of a transfer scheme for non-life business without the need for obtaining the reinsurer's consent has often been seen as one key advantage of Part VII over the legislation it replaced.

Why then has this proposal been made? It appears that the main reason 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. The amendment would remove any possible ambiguity.

### Overriding contractual provisions

The second proposed amendment to the legislation is more controversial. It gives the court the express power to override those terms of a reinsurance contract that would prevent or limit it from being transferred. The Consultation states that without such power there is the risk that outwards reinsurance contracts could not be effectively transferred. It notes that this would seriously disadvantage the transferee insurer and would mean that the reinsurer would be freed of its responsibilities in respect of the transferred business.

Aside from the relatively common anti-assignment and change of control 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 in the

event of a Part VII transfer of the underlying business. For instance, reinsurers have started to insert clauses into their reinsurance contracts which are triggered by Part VII transfers, or even by the initiation of 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. It makes it clear that the decision whether or not to override such contractual provisions is within the complete discretion of the court. In general the court is reluctant to override commercially agreed contractual terms unless it is strictly necessary. It will have to consider all the merits of each particular case and decide whether the interests of the reinsurer outweigh those of the proponents of the transfer.

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### Notifying reinsurers

The current legislation states that anyone adversely affected by a transfer has the right to be heard by the court at the sanction hearing. However, to take advantage of that right, a reinsurer first has to be aware that a transfer is taking place. At present, there is no statutory obligation to notify affected reinsurers. In practice, however, it is usual for reinsurers and anyone with an interest in the transfer to be advised of it. Furthermore, proponents generally ensure that their key reinsurers are supportive of the transfer as this helps to avoid objections.

The Consultation proposes that the proponents of a scheme should be obliged under the legislation to notify those reinsurers whose contracts are being transferred. However, as with the notification of policyholders, the court will be empowered to waive such notification at the request of the proponents, but only if good reasons are given. Notifications could also be achieved, subject to the court's approval, by notifying the proponents' brokers and asking them to notify the relevant reinsurers. The Consultation notes that notifying reinsurers is likely to add to the overall cost of implementing a Part VII transfer.

### Reinsurers' concerns

The Consultation proposes to treat reinsurers in the same way as the individual policyholders whose contracts are being transferred, but without giving the reinsurers the equivalent formal



safeguards. The FSA's prime interest during a Part VII procedure is in ensuring that policyholders are not adversely affected by a transfer of their policies. As part of this, the issue of transferring reinsurance protections is likely to be considered mainly from a policyholders' perspective and not from that of the affected reinsurers.

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The same holds true for the role of the independent expert, who will consider the transfer of the reinsurance to the extent it affects the ability of the transferee to meet claims, but will not consider the effect on the reinsurer. Thus, the Consultation would appear to treat reinsurance protections as being akin to financial instruments assuming that affected reinsurers will have few legitimate concerns if their policies are transferred to new reinsureds.

This, however, fails to explain why reinsurers have for a long time negotiated anti-assignment provisions in their contracts or why they have started to seek the inclusion of clauses that terminate or modify their contracts in the event of a Part VII transfer. Such clauses are being inserted specifically because

reinsurers are often concerned about the identity of their cedants. Such concerns arise particularly in connection with unexpired policies in respect of business that has yet to be written.

Reinsurers may have been influenced in offering cover by the identity of the reinsured's underwriter and its underwriting team. Also, as part of their underwriting process, reinsurers may have evaluated the reinsured's management and claims systems. Their confidence in both the reinsured's underwriting team and management and claims procedures can often be a central factor when negotiating and pricing the reinsurance.

Further, reinsurers may object to having their contracts transferred if they are forced to reinsure a competitor or an organisation that is lower rated than the transferor and perhaps not able to write the same quality of business. The transfer may also affect reinsurers' rights of set-off as well as their ability to recover from their retrocessionaires.

#### Conclusion

The ability of an insurer to transfer its reinsurance asset at the same as the transfer of the underlying business it is protecting is a critical element of the Part VII process and a reason why this procedure is utilised so extensively in the UK. Without such ability, many Part VII schemes would not be viable.

The intention behind the proposals in the Consultation is to clarify and facilitate such transfers. For the reasons set out above, reinsurers may have serious concerns about the effect of those proposals, although many may have conflicting interests because they may also want to propose transfers. At the very least, reinsurers are likely to want a balance to be drawn between their rights as affected parties in the Part VII process and the rights of the companies proposing Part VII transfers.

The Consultation closed on 26 January 2007 and no timetable has yet been set for the UK government's response. The nature of that response and, in particular, how it will achieve fairness between the interests of reinsurers and the proponents of schemes will require a difficult balancing act.



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