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Solvent Schemes - WFUM: the story so far...

The handing down of the English High Court's judgment in the convening application for the Wills Faber (Underwriting) Management Limited ("WFUM") schemes on 9 June 2006 ([2006] EWHC 1335 Ch) marked the latest stage in the judicial examination of solvent schemes of arrangement. The detailed judgment provided clarity on the current view the English courts are taking in resolving certain issues arising between insurance companies and their policyholders and cedants (i.e. re-insureds) (together referred to as "policyholders" herein) in the context of solvent schemes of arrangement. While the judicial arguments are still in their mid-game and the results of the contested sanction applications in the WFUM schemes and the Reliance National Insurance Company scheme are expected in the coming months, the judgments handed down so far are helping to set parameters for schemes in this developing field.

Solvent Schemes: a brief history

Schemes of arrangement have been the procedure of choice for dealing with insolvent insurers for some time. Since the late 1990s, solvent insurance companies have begun to use schemes to accelerate the closure of the run-off of their business. Since 2004 a large number of solvent schemes have been implemented for this purpose. Schemes are attractive for insurers because they replace the long-continuing, uncertain and slow run-off process of paying policyholder claims as they individually fall due with a "once and for all" evaluation and payment of claims. After scheme payouts, all policyholders party to the scheme are barred from raising further claims against the insurer. Insurers thus emerge from a scheme unburdened with many of their past liabilities and surplus capital can be released to the insurer's parent.

In 2005 the fairness of schemes began to be challenged in the court by some policyholders. Because schemes make an up-front payment to all policyholders, those policyholders who have contingent claims receive an amount equal to an actuarially derived estimate of the value of their likely claim. The estimation means that policyholders could receive less (or more) than the full value of their future claim, and the finality of the scheme means that policyholders who did not submit their claims in time to be included in the scheme lose their chance to claim.

The forthcoming sanction hearings in relation to the WFUM and the Reliance schemes will further clarify issues of fairness surrounding solvent schemes, but insurers can take some comfort from recent judgments (including the convening application judgment in WFUM itself). In light of the increased court scrutiny, insurance companies are advised to review carefully the nature and rights of their policyholders and to consult with policyholders before proposing solvent schemes. Those schemes which are carefully constructed and are substantially unopposed by policyholders stand a better chance of court sanction.

Key Issues

Increased scrutiny of schemes by courts and policyholders

BAIC - a policy driven decision?

WFUM - no invariable rule, but outstanding and IBNR claims required separate classes

Are One Class schemes still possible?

Fairness yet to be considered in sanction applications for WFUM and Reliance National Insurance Company (Europe)

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Scheme Fundamentals

A solvent scheme is a statutory compromise of the rights between an insurer and its creditors (or any class of them) under s.425 of the Companies Act 1985. The requirements for a scheme are as follows:

- the preparation of the scheme document (which contains an explanatory statement explaining the operation of the scheme, as well as the formal scheme rules themselves and a notice convening a meeting or meetings of policyholders to approve the scheme). Policyholders with different rights should generally be separated into different classes for the purpose of voting on the scheme (this is a key issue for insurance schemes, discussed below).
- The application to court for an order to convene the scheme meeting (or meetings if more than one class of policyholders). Here the court will consider the appropriateness of the class grouping of policyholders. The overall fairness of the scheme is not considered at this stage.
- The publication of the scheme document and its distribution to all relevant policyholders.
- The meetings convened by the court in (2) are held and approved by a majority in number of policyholders representing not less than three-fourths in value of policyholders (or each class of them, if more than one class) present and voting at the meeting.
- The court sanctions the scheme. The court will consider whether the scheme is fair and reasonable, each class was fairly represented at the scheme meeting(s), the meeting followed proper procedure and the majority vote approving the scheme was bona fide.
- Finally, an office copy of the order sanctioning the scheme must be delivered to the Registrar of Companies.

If the required steps set out above are followed, the scheme will bind all policyholders whether notified of the scheme and/or voting for the scheme or not. The court will need to be satisfied that every effort has been made to contact all creditors. However, where considerable efforts to contact policyholders can be demonstrated, the court will not normally refuse to sanction a scheme on the grounds that all policyholders did not actually receive notices.

A scheme of arrangement provides a very flexible method of binding a company and its creditors to a proposed course of action. The contents of the scheme are not prescribed by statute and schemes can be "tailor made" to suit the particular requirements of a company and its creditors. In the case of a solvent insurance company, the scheme provides a mechanism to obtain the agreement of policyholders to the estimation of all present and future claims and thus to pay all the long-term liabilities of the insurer. It brings finality to an otherwise long run-off process, saves the operational expenditure of the run-off, expedites payment of policyholder claims and frees up the excess capital of the insurer.

BAIC - Key Objections Raised

Prior to the judgment in *Re British Aviation Insurance Company Limited* [2006] BCC 14 (BAIC) in July 2005, policyholders and cedants were generally grouped into one class for the purpose of voting on solvent schemes and the BAIC scheme was similarly approved by a single meeting. However, a number of US direct insureds voted against the BAIC scheme and certain of these policyholders objected to the *BAIC* scheme being sanctioned by the court on a number of grounds.

Mr Justice Lewison refused to sanction the BAIC scheme on the basis that a single class meeting to vote on the scheme proposal was not sufficient. A number of BAIC policyholders had no present claims against the insurer, however, the nature of their policies permitted them to bring claims in respect of contingent losses that may have occurred many years ago (e.g. liabilities to employees arising out of exposure to asbestos-related diseases) even though those claims may not yet have been notified even to the insureds themselves, much less to the insurers. These sorts of claims - which are necessarily subject to actuarial valuations - are called "incurred but not reported" claims ("IBNR") and will, typically, be made in respect of latent exposure to long-tail asbestos, pollution and health hazard liabilities. The Judge concluded that those scheme policyholders with IBNR claims were subject to such significant uncertainty in estimating their claims (because they did not yet know whether they actually had an exposure in relation to them) that they were in a different position to those policyholders with agreed and notified outstanding claims and that, therefore, there should have been two class meetings convened to vote on the scheme to reflect this.

The Judge considered previous case law, including the important Court of Appeal decision in *Re Hawk Insurance Company Limited* [2001] 2 BCLC 480 (*Hawk*) and noted that the existing rights of scheme creditors had to be compared to those rights gained or lost under the scheme. To this end, he determined that an appropriate comparator had to be identified in the case of any scheme in order to determine how, if at all, creditors' rights had changed under the scheme. In the case of insurers or reinsurers in run off, the Judge determined that the appropriate comparators could only be a solvent liquidation or solvent run-off. However, due to the fact that the BAIC scheme was a scheme covering only part of BAIC's business, as well that, in the Judge's view, BAIC's owners would not likely wish to place BAIC into a solvent liquidation process, the Judge found that solvent run-off was the only realistic comparator.

Having determined this, the Judge distinguished policyholders with accrued claims (being agreed and/or outstanding claims) from policyholders with IBNR claims. He determined that, whilst policyholders with accrued claims would not

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require their claims to be valued under the scheme (or if valuation was required - as with outstanding claims - the risk of the valuation being incorrect was small), policyholders with IBNR claims would certainly require valuation which was very likely to be incorrect. Therefore, since policyholders with accrued claims would receive a full indemnity for their claims whilst policyholders with IBNR claims most likely would not, when compared with what would have happened in a solvent run-off of these claims, the Judge found that two separate class meetings should have been convened. The Judge went on to find that the fact that policyholders may have a mix of both accrued claims and IBNR claims was not "of any great moment". However, it would seem from the comments made by the Judge that there was little in the way of evidence on this point.

Although not necessary for him to do so, the Judge also considered various aspects of the BAIC scheme to be unfair. The Judge did not approve of the way in which the claims of policyholders had been valued/adjusted for voting purposes and also did not approve of various provisions of the BAIC scheme - for instance, he felt that the estimation methodology set out in the scheme for valuing claims was insufficiently clear, BAIC's power to "revert to run-off" (i.e. a power to terminate the scheme unilaterally by the company) was advantageous only to the company and the bar date (i.e the date by which creditors must formally submit their claim under the scheme) gave creditors insufficient time to submit their claims and should have been 12 months and not 120 days. Finally and most significantly, the Judge felt that it was unfair to require dissenting direct insurance policyholders to submit to the scheme because this would require them to estimate their claims and, unlike insurers and reinsurers, such policyholders were "not in the risk business".

Class Issues - post BAIC

The fundamentals of the law relating to classes are long established and have not been disputed in those court cases dealing with insurance schemes. The description of a class originates from the decision of *Sovereign Life Assurance v Dodd* [1892] 2 QB 573 at 583 where a class was "confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest". This principle has been upheld in *Hawk* and in the Practice Statement regarding schemes [2002] 1 WLR 1345.

Such a definition works well where it is relatively straightforward to identify groups which are clearly able or clearly unable to consult together. However, the nature of insurance policy claims creates a broad spectrum of different types of claims with varied uncertainties. Subsequent case law has indicated that BAIC did not establish a golden rule and that "whether separate classes for [policyholders] are truly necessary will depend on a long list of variables such that what is right for one company and one scheme will not necessarily be right for another." (*NRG Victory Reinsurance* [2006] EWHC 679).

Such variables include the businesses covered by insurance policies, the proportions covered between classes of businesses, geographical location of policyholders, when the insurer stopped writing policies, how long the run-off period is expected to be, whether the policyholders are reinsureds or direct insureds and the types of claims being made by each policyholder.

In the unreported Scottish case of the Mercantile & General Re scheme (which followed only 6 weeks after BAIC), Lord Clarke approved a single class meeting after examining the evidence before him in relation to the creditor profile in terms of the nature of creditors voting as well as the types of claim held. Lord Clarke did not seek to distinguish the scheme (a "whole business" scheme) from the BAIC scheme (a part business scheme) and, as a result, deem the correct comparator to be a solvent liquidation (for which a single class may be appropriate). He tackled the BAIC ruling in relation to the distinction between IBNR claims and other claims head on. Lord Clarke believed that the English Judge had allowed policy, rather than legal, considerations to drive his analysis.

WFUM - Classes revisited

Although Mr Justice Warren in his judgment on the WUFM convening application stressed that BAIC did not lay down a general principle that it was never possible to combine outstanding claims and IBNR claims in a single class, he was less critical of BAIC than Lord Clarke had been. This could indicate that the English courts may give more weight to the reasoning of BAIC in terms of the fairness of schemes.

On classes, Warren J restated the main guiding principle, namely as to whether policyholders' rights are so different as to make consultation impossible. To measure this, Warren J relied on the judgment of Lord Justice Pill in *Hawk* in which the Judge had suggested that where there was a polarisation of creditors, with some creditors only having certain claims and others having very uncertain claims (particularly in the light of advancing scientific knowledge) then separate classes might be justified. After examining the expert evidence before him, he concluded that "the rights of a Scheme Creditor in respect of an Outstanding Claim…at the certain end of the range of uncertainty are so different from those of a Scheme Creditor in respect of an IBNR claim at the uncertain end of the range that it is impossible for them to consult together (in respect of those divergent rights) for the purposes of voting on the Scheme" (paragraph 173). Therefore two classes would be required: outstanding claims and IBNR claims. The judge also considered the levels of uncertainty between settled unpaid and outstanding claims to be sufficiently similar to place them in the same class.

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The Future of One-Class Schemes?

Notwithstanding the WFUM judgment, a number of one-class schemes have been permitted to proceed since BAIC. An analysis of these cases (as well as of certain caveats in the WFUM judgment itself) reveals the circumstances where the courts may find one-class schemes appropriate.

- Where the relevant scheme comparator is solvent liquidation, the claims of all policyholders will be valued in a liquidation in a similar fashion to the valuation under a scheme because there will be no run-off period during which policyholders with IBNR claims can wait for their claims to arise. (*DAP Holding NV and others* [2005] EWHC 2092).
- If only a very small minority of IBNR policyholders is dissenting, or if there are very few or no IBNR claims on the insurer's book, the courts have indicated that the class test should not be applied in such a way that it becomes an instrument of oppression by a minority. Here, one class may be justified. (*NRG Victory, WFUM*).
- Where all or a strong majority of policyholders are reinsureds, the courts may be more likely to sanction a one-class scheme notwithstanding the fact that some reinsured policyholders may have considerable IBNR claims. Reinsureds have historically supported one-class schemes and the courts appear to reason that reinsureds are in the risk business and, as a result, the caps on their own liability render it fairer to give them an estimated pay-out under a scheme than it would to a direct insured whose liability is uncapped. This reasoning was put forward in BAIC. The WFUM judgment similarly indicated that one-class schemes may be appropriate for insurers without direct insured policyholders, however, it was not an issue in WFUM and the judge did not expand upon his reasoning. Whether the courts will agree with this reasoning if the issue arises in a particular case so remains an open question. (*BAIC, WFUM*).
- Where all policyholders have similar policies and have an almost identical mix of claim types across the spectrum of uncertainty, one class may be justified, albeit the chances of this ever being the case are slim. (*WFUM*).

Fairness

While the position of class may now be clearer post the WFUM judgment, issues still remain regarding the fairness of schemes. Lord Clarke in Mercantile & General Re showed no interest in the BAIC type objections to the scheme which had been made in writing by certain direct insured creditors. However, in light of the WFUM judgment's more favourable treatment of BAIC, the run-off industry will likely have to wait for the judgments in the upcoming sanction applications of the WFUM schemes and the Reliance National Insurance Company (Europe) scheme for more clarity on the court's view of the fairness of a solvent insurance scheme.

In the current market, insurers must consider a broader range of variables when designing schemes and consultation with policyholders is key. The fact that, at least, eleven schemes have been sanctioned since BAIC is cause for cautious optimism that schemes will survive as viable products in the run-off market, although a negative result in the WFUM and/or Reliance sanction hearings could have a serious impact on the use of schemes. But, the increased court scrutiny can perhaps be seen as a positive indication of solvent schemes maturing into a better understood means of dealing with insurance liabilities and insurers and policyholders alike can, it is hoped, look forward to the post-BAIC/WFUM future with some comfort.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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