NORTON ROSE

strategies for discontinued insurance business

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strategies for discontinued insurance business

A NORTON ROSE GROUP GUIDE

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Introduction

The reasons why an insurer may decide to discontinue a particular line of business (or its entire business) are numerous and growing. Capital management is now at the forefront of most chief executives' minds, and the pressure to use capital to support core and profitable business lines, return excess capital to shareholders and maximise the return on capital deployed is intense. There are also strategic decisions to withdraw from particular classes of business, or to redeploy capital to hardening markets. In addition, there may be strategic and capital efficiency benefits in closing subsidiaries to new business, relying on passporting rights (including under the Reinsurance Directive) for the ongoing book. Each of these inevitably impacts on the ratings afforded by companies such as Standard & Poors, Fitch, AM Best and Moody's. Whatever the reason, there now exist more choices than ever for an insurer when it comes to exiting, managing the business it has already written, and ultimately achieving finality on its liabilities.

There are six principal strategies for dealing with discontinued business:

- retention of the book and run-off to expiry
- outsourcing the run-off to a third party service provider
- reinsurance by way of loss portfolio transfer or similar arrangement
- sale
- portfolio transfer to or merger with another carrier
- scheme of arrangement.

In many cases, these techniques may be combined, or one taken as a preparatory step to another. In this paper, we examine the above strategies and their relative merits, starting with the least pro-active and moving through to some of the more sophisticated methods used to achieve finality. As well as strategies for insurance companies, we also consider how these apply to Lloyd's syndicates. Ultimately, the aim may be to liquidate surplus companies, but as this is not possible on a solvent basis until the company has settled all its liabilities and as a liquidation will only be possible for a company that has completely ceased writing new business, this paper concentrates on balance sheet management, rather than liquidation as an exit strategy.

This paper is of general application as the concepts discussed are for the most part not particular to English law. However, specific comments relating to France, Germany, Italy, The Netherlands and Spain have been included where appropriate. All comments relating to Spanish law and regulation have been kindly provided by Garrigues.

Run-off to expiry

Whilst traditionally the preferred route for a business line (or syndicate) that has been discontinued, the in-house management of run-off to expiry is still undertaken by a surprisingly high number of insurers and reinsurers, particularly in continental Europe. The larger companies will often have dedicated teams to manage specific business lines that have been placed into run-off, but this is often not practicable for smaller companies. Placing a book of business into run-off will generally constitute a significant change to the insurer's business plan, and so notifications to the relevant regulators are normally required.

One perceived disadvantage of managing a run-off to expiry is that, despite the efforts of organisations such as ARC and AIRROC, there are still connotations of failure attached to a run-off book, especially in mainland Europe. This is almost entirely an issue of appearances rather than fact, as there are numerous reasons why a particular business line might be discontinued, but it does contribute to a difficulty in retaining staff once the decision has been taken. Underwriters in particular will prefer to be writing new business, often leaving claims teams without effective underwriting support. This, together with the different skill set required in the run-off arena, means that the advantages in managing a run-off with an existing team are often more than off-set by the difficulties.

Advantages	Disadvantages
Not dependent on external service provider	Possible connotations of failure
No external fees	Many employees do not want to work in run-off, leading to loss of important knowledge
Can utilise experience and knowledge of current team	Different skill set required in run-off
Any eventual profit retained	Retain exposure to adverse loss development
	Longest time frame

A run-off to expiry does not usually achieve the timely and efficient exit that many insurers and reinsurers are seeking, meaning that liabilities remain on the balance sheet and capital is tied up rather than being redeployed to core areas or returned to shareholders. Significant management time is also taken up, and the company remains fully exposed to any volatility.

In the UK, the Financial Services Authority (the FSA) and Lloyd's have dedicated units for run-off, resulting in teams that are well-informed about the issues faced by run-off companies and syndicates. For example, the level of detail required in the Individual Capital Assessment is often less, reflecting the removal of the complications of writing ongoing business. Additionally, the FSA may accept that a run-off business need only maintain solvency to a lower confidence level than the confidence level required for live business. This contrasts with the recently published draft Solvency II, which stipulates a 99.5 per cent confidence. It remains to be seen whether the FSA can maintain its more relaxed approach in the face of this inconsistency.

Germany

Run-off to expiry is not limited or restricted by German law. If the decision of the (re)insurer to run-off to expiry leads to a change in its business plan, notification requirements may be triggered under the German Insurance Supervision Act (*Versicherungsaufsichtsgesetz* – VAG). Unlike the FSA, the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungen* – BaFin) has no units dedicated for run-off. German insurers opting for active run-off in respect of discontinued business will have to develop a run-off supervisory practice together with BaFin.

France

In France, putting a company in run-off often involves terminating certain contractual relationships with third party contractors (for example brokers, other intermediaries, IT providers, etc.). Under the French Code of Commerce (article L.442-6) a person is liable and obliged to compensate for losses caused by "suddenly terminating, even partially, an established commercial relationship". French courts usually consider that in an established commercial relationship there is an implied

termination notice period of between six and twelve months. Therefore, it is advisable that termination should be communicated in writing at least six months before effective termination date.

Spain

In Spain, there is no specific legal regime for run-off to expiry, nor any specific regulatory rules. The Spanish Supervisory Body (*Dirección General de Seguros y Fondos de Pensiones* – DGSFP) does not have any direct role, although it is advisable for an insurer to notify the DGSFP of its intention to place the company into run-off.

However, the insurer might face the withdrawal of its licence to operate in the relevant discontinued classes of business if its turnover related to such classes falls below certain levels in two consecutive years.

Commutation

A key tool in any run-off, whether managed in-house or externally, is a commutation.

A commutation eliminates areas of uncertainty on long-tail insurance and reinsurance business and removes the potential for further deterioration in the underlying business. It may also achieve certain costs savings, as it usually resolves outstanding disputes between the parties which will be wrapped up in the commutation price agreed. Obviously, the actuarial process of estimating potential exposure and agreeing the price is critical to any commutation.

Companies are best advised to seek the consent of their reinsurers or retrocessionaires before commuting any of their inwards business. This is because, even where the reinsurance or retrocession contains a “follow the settlements” clause, arguably there is no loss settlement in a commutation as the payment covers an actuarial valuation of future losses rather than the loss itself. This leaves the commuting company open to dispute with its reinsurers (or retrocessionaires) as they seek to avoid cover for what they see as a payment outside the terms of their contract.

Third party run-off

If a company or Lloyd’s managing agency decides that it does not want to spend the management time involved in actively managing its run-off, there are now many specialist run-off managers who will take on the administration on their behalf. This is essentially a form of outsourcing, and so needs to comply with the relevant regulatory rules on material outsourcings.

In the UK a firm must notify the FSA before entering into or significantly altering a material outsourcing arrangement and sufficient control must be exercised by the firm, including providing for access to the run-off manager (including relevant books and records) by the FSA. Lloyd’s managing agents will need to consider the Underwriting Byelaw (particularly Part L of that Byelaw) and relevant codes of conduct. Franchise Board approval is required before a managing agent may delegate any of its functions in relation to the run-off of a Lloyd’s syndicate.

Advantages	Disadvantages
Frees up management time	Eventual profits reduced by management fee
Allows for redeployment of staff	May require redundancies if redeployment not possible
Firm may distance itself from run-off business	Reputation is in control of third party
Run-off manager may take firmer approach to claims handling, and pursuit of reinsurance recoverables	Potential for conflicts of interest with other books managed by service provider
	Does not remove liabilities or exposure to volatility

Traditionally, a more developed market in run-off service providers has existed in the UK than in many other jurisdictions. This is partly due to the cultural perception of run-off referred to above, and partly due to the nature of the London market, where more firms have needed to focus on run-off as an issue due to legacy issues and capital redeployment. Other contributing factors include the higher influence of the employee bodies in Continental Europe and the application of VAT. The dominance of London as a centre for run-off is undoubtedly weakening as more and more Continental European insurers look to third parties for innovative solutions for managing their legacy business, and it is expected that others may soon challenge London's position.

Amendments to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 introduced following the adoption of the Insurance Mediation Directive provide certain exclusions to the general prohibition on assisting in the administration and performance of a contract of insurance. A company will not be carrying on a regulated activity to the extent it is managing claims or loss adjusting on behalf of a relevant insurer. Guidance issued by the FSA to the ARC states that the FSA's view is that this includes claims recovery, commutations, reinsurance recoveries and back office administration. Effectively, this means that a third party run-off manager can frequently operate without the requirement to be authorised, and so can avoid the burden of regulation. In the Lloyd's market however, a managing agent may only delegate functions in relation to a syndicate in run-off to an approved "run-off company" or another Lloyd's managing agent.

Germany

In Germany third-party run-off, whereby a specialist run-off manager administers the run-off, would be regarded as outsourcing. Outsourcing agreements must be submitted to BaFin and, in order to be valid, must be approved by BaFin. Third party run-off managers providing administrative services qualified as outsourcing are not required to be authorised (re)insurers, and depending on the scope of each envisaged outsourcing, various regulations have to be complied with, including, for example, the German Data Protection Act.

France

Although third-party run-off has not historically been a major feature of the French market, this is changing. The trend towards a more sophisticated and comprehensive market for run-off is best illustrated by the recent formation of the *Syndicat Européen de Gestion de Sinistres* in 2006, to represent the run-off industry. The implementation of the Reinsurance Directive into French law has also resulted in an anomaly whereby companies that are entirely in run-off are not subject to regulation, potentially making this an attractive jurisdiction in which to conduct run-off activities.

Italy

Third-party run-offs are less common in Italy, although a proposed new regulation (n. 11/2007) will govern the outsourcing involved. One feature is that insurers will not be permitted to outsource their entire business, and this may prove to be a significant obstacle if an insurer wishes to place the entire portfolio into run-off.

Spain

Under Spanish law, third party run-off would also be regarded as outsourcing. Although there are no legal provisions, nor regulatory rules on outsourcing, DGSFP is reluctant to accept the outsourcing of core insurance activities.

Reinsurance

Reinsurance is another frequently used tool in a run-off. Although this does not achieve finality, in the sense that the liabilities remain on the cedant's balance sheet, reinsurance offers a degree of protection from future adverse development, and may assist in freeing up some capital. The amount of capital relief depends on the extent to which the insurer's regulatory regime will allow the insurer to take credit for the expected reinsurance recoverables in its solvency calculation. Additionally, if recoveries from a reinsurer are susceptible to counterparty risk, a risk-based capital approach might require additional capital to cover that contingency. Under the newly published draft Solvency II, there is no automatic limitation of the credit that can be claimed, but insurers will need to consider the risks (including counterparty risk) of recovery and limit the amount of credit claimed accordingly.

Various forms of reinsurance exist for these purposes. An unlimited stop loss caps the liability of the cedant, and effectively transfers the underlying risk above the agreed attachment point to the reinsurer. In the Lloyd's market, a reinsurance to close has a similar effect (but with no attachment point) and, although these are traditionally deployed within a single syndicate (albeit differently constituted from year of account to year of account), they are also available between syndicates. There are a number of specialist syndicates concentrating on offering reinsurance to close solutions to discontinued syndicates. A loss portfolio transfer, like an RITC, is essentially an unlimited stop loss, usually combined with complete delegation of claims handling so that to all intents and purposes, the reinsurer deals with the insured as if it were the primary insurer. What all of these have in common is that, when not an intra-group arrangement, they are often expensive as the reinsurer inevitably requires a risk margin to protect itself in the event of future deterioration as well as an element of profit.

Advantages	Disadvantages
Limits cedant's liability for future claims	Not complete recognition for solvency purposes
When coupled with delegation of claims handling, frees up management time	Cedant remains exposed in the event of insolvency of reinsurer
Some capital relief	Often expensive
Relatively straightforward from a documentation perspective	Does not remove liabilities from balance sheet and a proportion of capital remains tied into the business
	Reinsurer's due diligence gives access to books and records

Loss portfolio transfers and stop losses

A third party stop loss is likely to be more costly than managing the exposure in house. However, some insurers do buy third party stop loss, as the transaction brings a measure of finality to a discontinued book of business, as well as balance sheet security. In addition, and perhaps most importantly, a loss portfolio transfer with the associated delegation of claims handling means that management no longer need to spend time on the discontinued business, allowing them to focus more effectively on their ongoing business.

RITC

A reinsurance to close (or RITC) is the mechanism by which a Lloyd's syndicate closes out its exposure at the end of a year of account. Under Lloyd's three-year accounting system, after the 36th month of the year of account, the managing agent of a syndicate will generally seek to close out the liabilities by buying a reinsurance to close. This has the effect of releasing the assets in the syndicate's members' premiums trust funds and, if they have no other open participations on any syndicate, their funds at Lloyd's. It is therefore a direct trigger to the release of capital.

Occasionally, notably where a syndicate is ceasing to trade, the RITC will be provided by a third party syndicate. When this happens, the premium is generally calculated on a commercial basis, i.e. the current reserves of the ceding syndicate for that year of account, plus a margin to cover future deterioration and an element of profit.

For an ongoing syndicate, the RITC is generally provided by the next succeeding year of account of the same syndicate. As membership may vary from year to year, the syndicate may not be constituted in exactly the same way. This means that the managing agent, who has fiduciary duties to each member of the syndicate for the two years of account, must set the premium in a way which is equitable for all participants. In practice, this means that the commercial profit referred to above is not included – the premium is calculated on a no profit no loss basis. This approach was also used recently in a different context – the transfer of the liabilities of the Admiral syndicate to its companies market insurer (on which Norton Rose LLP advised) pursuant to Part VII of the Financial Services and Markets Act 2000 (FSMA), of which more below.

Run-off acquisitions

In many cases, a group will simply want to sell the insurance carrier in run-off. This might be the first step, or it might follow a reorganisation through portfolio transfers, commutations and reinsurances in order to create a single legal entity containing all the business the group wishes to sell. Generally, the sale of such a company follows the normal M&A processes. Increasingly, the sale is likely to be subject to an auction process and, given the increased volume of capital providers seeking run-off acquisitions in the UK (and the decrease in the number of available targets), pricing margins are falling. Some sellers, who have developed run-off capability in house, now seek to retain either the claims management or the asset management processes for themselves, as a useful income stream once the business has been sold. The overwhelming tendency is for sellers to seek finality, meaning that little or no contractual protection (by way of warranties and indemnities) is offered over the level of reserves, the reinsurance assets or the accuracy of actuarial information.

Advantages	Disadvantages
Achieves finality, subject to warranty and indemnity claims	Extensively negotiated documentation
Competitive auction sale process	Potential residual liability from warranty and indemnity claims
Quicker than a portfolio transfer or a scheme	

Any such sale will be subject to the relevant jurisdiction's rules on changes of control. In the UK, this means an application to the FSA for approval of the new controllers (broadly, anyone with a direct or indirect 10 per cent interest in the company) and of the new approved persons. The FSA has a statutory period of three months in which to respond, and a failure to respond constitutes a deemed approval. Similar consents are required in other jurisdictions although a change of control of a reinsurer often only requires notification rather than consent.

In the Lloyd's market, transactions may be structured such that in addition to taking on the management of the run-off of a syndicate, the purchaser also acquires one or more of the underlying capital providers (corporate members) to the syndicate in order to realise any anticipated or created surplus. Lloyd's consent to the change of control of the capital provider would be required. Reinsurance techniques may be used to protect a minimum level of surplus or assets for the purchaser.

Portfolio transfers

There will be times when a simple sale of a company is not desirable. This might be because a single carrier writes the discontinued business lines alongside the ongoing business that it wishes to retain. Alternatively, a prospective purchaser might want to cherry pick business lines, perhaps avoiding exposures such as asbestosis or jurisdictions where it does not have a direct licence. There may also be tax advantages in structuring a sale as a disposal of assets, rather than of shares.

Portfolio transfers have also been used to restructure a group's business with a view to facilitating the sale of a single run-off company, to consolidate portfolios into a single entity to enable a focussed approach to run-off (perhaps including a solvent scheme of arrangement) and to achieve operational efficiencies and benefits in terms of the number of regulators to which the group is subject, administration and accounting and potentially capital requirements.

The Third Non-Life Directive, the Consolidated Life Directive and the Reinsurance Directive contain provisions requiring member states to adopt a procedure allowing for the transfer of insurance and reinsurance business (although all of these will be replaced on the adoption of Solvency II). However, Member States were given flexibility as to the form of the procedure, and consequently there is now significant inconsistency across the EEA on procedural issues. For example, in the UK and Ireland the procedure requires Court approval whilst in Germany and other Continental European jurisdictions only the approval of BaFin or the equivalent regulatory body is required. One common requirement set out in the Directives is a three month period for direct insurance business transfers in which to consult with other relevant EEA regulators.

Advantages	Disadvantages
Achieves finality (subject to enforceability overseas)	May be question marks over enforceability outside the EEA
Preserves value of reinsurance assets	Relatively long process
Does not require policyholder consent	Procedural inconsistencies across EEA member states
Allows cross-border transfers (potentially allowing subsequent scheme of arrangement)	

Germany

Under German law portfolio transfers of insurers and reinsurers are regulated by the VAG.

Portfolio transfers (i) must be based on a written agreement, (ii) require BaFin approval, (iii) require evidence that the acquiring (re)insurer meets solvency requirements (certificate of the EEA home state regulator of transferee), (iv) require preservation of interests of policyholders (direct insurance, life insurance, reinsurance) and (vi) must be published in the electronic Federal Gazette (*elektronischer Bundesanzeiger*).

Portfolio transfers do not require the consent of the policyholders and normally do not require the approval of the shareholders.

France

Before it approves a transfer, the *Comité des Entreprises d'Assurance* must be satisfied that the transferee insurer will have an appropriate solvency margin to support the transferring business and that the transfer does not adversely affect the interests of policyholders. In practice, it is important for insurance companies contemplating a portfolio transfer to present and explain their project to their controller (*commissaire contrôleur*) in advance. The controller will help and assist the insurance company with the various regulatory stages of the transaction.

Court approval is not required, nor is there any requirement to appoint an independent expert or actuary.

It is questionable whether a portfolio of reinsurance business in run-off is capable of transfer under the regulations implementing the Reinsurance Directive, as the regulations define reinsurance as "accepting risks", arguably thereby excluding discontinued business.

The Netherlands

If an insurer in the Netherlands wishes to transfer a portfolio of insurance to another insurer, it must first obtain the consent of DNB, the Dutch Central Bank. The request for the transfer must be submitted in writing to DNB and must include certain information about the financial position of both the transferring and the transferee insurer. DNB will not give its consent if the acquiring insurer will not meet the solvency margin required to enable it to support the transferring portfolio of business.

If DNB does not object to it, then notice of the proposed transfer must be published, so that the policyholders concerned are made aware of it. The policyholders of a non-life insurer will be given three months to terminate their policies, in which case premiums paid in advance will be refunded.

Policyholders of a life insurer may object within the period specified by DNB. If policyholders who account for a quarter or more of the total insured amount object to the transfer, then the transfer will not be approved. However, if less than 25 per cent of the policy holders object, and all other requirements have been met, then DNB will consent and the insurer is required the publish notice of the consent in the Government gazette, the *Staatscourant*.

There is no court involvement and no automatic transfer of reinsurances or other assets supporting the portfolio. The usual 90-day consent and notification applies where risks are located in other EEA Member States.

Italy

Portfolio transfers are governed in Italy by the Code of Insurance and a proposed new regulation (n. 22/2007). The procedure is similar to other Continental European countries, with the consent of the Italian regulator, ISVAP,

being required rather than a Court approval. ISVAP has 90 to 120 days from the date of application to decide whether to approve the transfer. The new regulation also sets out the documents that must accompany the application, being a declaration of solvency, financial statements and documents relating to the licences and authorisations of the relevant companies.

The transfer must be advertised within 30 days of ISVAP publishing its approval, and policyholders then have a 60 day period in which to terminate their policies if they have their domicile or registered office in Italy and the transferee is a foreign undertaking or a foreign branch of an Italian insurer.

It is however questionable whether a portfolio of reinsurance business in run-off is capable of transfer under the regulations implementing the Reinsurance Directive.

Spain

Under Spanish law, portfolio transfers are regulated and subject to authorization by the DGSFP. Court approval is not required, nor is there any requirement to appoint an independent expert or an actuary.

Two types of portfolio transfers are regulated in Spain: (i) "total transfer", under which all the policies of one class of risk are transferred, and (ii) “partial transfers”, under which only some of the policies of one class of business are transferred.

Partial transfers are only permitted for policies that can be grouped according to an objective criterion, for example the policies cover the same risks or relate to the same geographical area. To check if a partial transfer meets the requirements to be authorized, a specific analysis of the intended transfer should be made.

In total transfers, policyholders cannot cancel the policies as long as the transferee assumes all of the rights and obligations of the transferor in relation to every policy transferred (except for international portfolio transfers). In partial transfers, policyholders are, however, allowed to cancel their policies and policyholders must be individually notified of the transfer and of their rights to cancel the policies within one month after the public announcement of the transfer. Policyholders are entitled to a refund of the unearned policy premium.

The transfer of all the policies of a company would result in the insurer’s licence to operate being lost and constitutes grounds for the dissolution of the company.

Outwards Reinsurance

Although the UK and Ireland arguably have the most onerous portfolio transfer procedures (in that they require an opinion from an independent expert and Court approval), they also have one key advantage in that section 112(1)(d) of the Financial Services and Markets Act 2000 (in the case of the UK) gives the Court power to make ancillary orders in relation to the business being transferred. Case law has suggested that this includes the ability to transfer the benefit of any reinsurances or retrocessions protecting the book being transferred.

This ability to preserve reinsurance recoverables in a transfer is invaluable in that it allows the wholesale transfer of a book of business with its associated reinsurance protections. The transferee effectively steps into the shoes of the transferor, and, as a matter of English law, is entitled to enforce the reinsurance programme taken out by the transferor. In other jurisdictions, the same effect is only achievable through a merger of companies or individually negotiated endorsements.

Following a consultation conducted by HM Treasury in 2006/7 (the response to which was published on 9 April 2008), draft statutory instruments are to be laid before Parliament during May 2008 to implement the following proposals as soon as possible:

- to make it clear that section 112(1)(d) gives the Court power to transfer the benefit of associated contracts (including reinsurance)
- to allow the Court to override contractual provisions in associated contracts purporting to modify or annul those contracts on a transfer or on steps preparatory to a transfer
- to require parties to notify reinsurers of a proposed transfer.

A slight note of caution should however be sounded as there has not as yet been an aggressive challenge by a reinsurer to any order made by the Court under section 112 and a number of practitioners are not convinced that such orders will necessarily override a provision in a reinsurance contract that expressly prohibits the transfer or assignment of the reinsurance contract without the reinsurer's consent. The proposed legislation should, however, strengthen transferee's arguments in relation to the enforceability of orders made under section 112.

Overseas jurisdictions

Portfolio transfers, although they have existed for some time in certain jurisdictions including the UK and Germany, are now subject to European directives. As regards policyholders, the Third Non-Life, the Consolidated Life and the Reinsurance Directives provide that portfolio transfers will be binding without further action being taken and even where transfers go beyond the scope of the Directive-mandated procedures, the Enforcement Regulation (Council Regulation No 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters) should ensure that portfolio transfers are enforceable throughout the EEA. However, there is no guarantee that they will be recognised in other jurisdictions, which may be of some significance where the transferor has significant assets located in those jurisdictions. Outside of Europe, the most important jurisdictions are arguably the US, Bermuda and Switzerland. The US notoriously has few bilateral treaties pursuant to which court decisions or other regulatory processes outside the US are recognised. The result may be that an insured or cedant is entitled to claim in the US courts that its policy remains with the transferor, which accordingly will be liable to pay its valid claims. While the transfer documentation should contain indemnities to ensure that the transferee meets the economic burden of any such decisions, the insolvency of the transferee is likely to encourage insureds to pursue their original insurer. In practical terms, this position may require the transferor to exclude certain portfolios from the transfer.

Previously, certain companies involved in portfolio transfers applied for permanent injunctive relief in the US, effectively endorsing the process. This took place under the auspices of the former section 304 of the UK Bankruptcy Code, which provided for the recognition of "foreign non-main proceedings". Even then, there was significant uncertainty as to the availability of this process, and the decision of the Bankruptcy Court for the Southern District of New York in respect of RiverStone Insurance (UK) Limited (granting relief under section 304) was greeted with some surprise as every other application had failed. More recently, section 304 has been replaced by the new Chapter 15 of the US Bankruptcy Code. This is framed in a different manner, and commentators have suggested that the possibility of achieving recognition is now significantly reduced. At the time of writing, we are not aware of any insurance company having applied for relief under the new Chapter 15 in relation to a portfolio transfer, although certain US commentators have suggested that the availability of relief might not be as problematic as has been thought previously.

There is a form of indirect enforceability in relation to US reinsurance business. Alien reinsurers in the US are required to post collateral as security for their obligations. These trust funds are maintained by the state regulators, and if it is possible to obtain their consent to the merger of the transferor's and transferee's trust funds, the practical effect of the unwillingness to recognise foreign processes may be mitigated.

Bermuda does have a treaty with the UK for the recognition of monetary awards. However, this is thought unlikely to apply to a declaratory judgment such as a Part VII order. As many reinsurers are incorporated in Bermuda, it is suggested that individual novation or endorsement of Bermudan reinsurance treaties would be a prudent approach.

Switzerland is a party to the Lugano Convention, which provides for the mutual recognition and enforcement of judgments between the EU Member States and, amongst others, Switzerland. Accordingly, provided that the original court had jurisdiction over the claim and that the order to be enforced is not contrary to public policy or a previous decision, it is likely that an order would be enforceable in Switzerland.

Lloyd's (Equitas)

By virtue of the Financial Services and Markets Act 2000 (Transfers of Business Done at Lloyd's) Order 2001, most members of Lloyd's can avail themselves of the process in Part VII of FSMA. Effectively this means that a portfolio transfer into an authorised insurance company is now a realistic alternative to a reinsurance to close, and is the only means of achieving finality for members of Lloyd's. To date, there has been one life and one motor syndicate that have availed themselves of the process. Although on the face of it Part VII provides a handy solution to the increasing problem of redundant corporate members (which cannot be liquidated without breaking the chain of reinsurances between the original insured and the most recent reinsuring syndicate), there have been very few successful applications. This is largely due to the problems with overseas jurisdictions highlighted above, notably the US. The two successful schemes have comprised solely UK risks.

There is now considerable political will to find a way round this issue. This is because the recent deal between Equitas and Berkshire Hathaway includes a second stage whereby all the liabilities previously ceded to Equitas will be transferred to a Berkshire Hathaway company. Under the current position, this would create an unacceptable risk for Lloyd's of overseas policyholders continuing to have their right to pursue their claims against Lloyd's members. In order to facilitate the transaction, and thereby completely remove the legacy issues that led to Reconstruction and Renewal, a realistic solution needs to be found.

As noted above, the Part VII process is not currently available to all members of Lloyd's. The reason is an anomaly in the FSMA, resulting from the use of the defined term "former underwriting member". The intention was to exempt persons who ceased to be members of Lloyd's before 24 December 1996 from regulation, but the inadvertent consequence was that such members are not permitted to use the Part VII process. This has had practical consequences for both the transfer of the business written by the Highway syndicate and the Equitas deal referred to above as both included former underwriting members as well as current members. As a result, the statutory instruments amending the FSMA referred to above also include drafting to rectify this position.

It is also possible for an insurance company to transfer a portfolio of discontinued business into a Lloyd's syndicate under Part VII of FSMA, although no such transactions have been completed to date. With the more flexible capital requirements of Lloyd's, this may be an attractive avenue. The Franchise Board will, of course, scrutinise in detail the business plan, structure and underlying capital of any proposal.

Reinsurance Directive

The deadline for implementation of the Reinsurance Directive was 10 December 2007. For many Member States, this will be the first time they have sought to regulate reinsurance. As a result, very few jurisdictions have had a process by which a reinsurance business may be transferred. One of the articles of the Reinsurance Directive provides that Member States must introduce a mechanism for the transfer of a reinsurance portfolio, and it is expected that many Member States will replicate the mechanism used for insurance.

The UK has always treated reinsurance in broadly the same way as insurance, and so the procedure under Part VII of FSMA has always been available to insurers and reinsurers alike. The implementation of the Reinsurance Directive did require some changes to the FSMA, although they were of limited scope.

As noted above, one consequence of the way in which France and Italy have implemented the Reinsurance Directive is that wholly-discontinued reinsurers may be prevented from using the portfolio transfer procedure. Interestingly though, provided there is some live business in the company (and the reinsurer is therefore subject to regulation), the portfolio transfer mechanism can be used for both the live and the discontinued business lines.

FSA consultation

Since the middle of last year, the FSA has been considering how to improve its involvement in the Court process for portfolio transfers under Part VII of the FSMA and has held discussions with the Lord Chancellor's office, members of the judiciary, HM Treasury and other interested parties. The FSA now provides the Court with a report on each proposed transfer at both the directions hearing and the final sanction hearing, setting out its views and reasons for deciding whether or not to object and including commentary on any objections that have been received. It is expected that this will mean that the FSA will not need to be represented routinely at such hearings, although it is still likely that the FSA will consider instructing Counsel where a transfer is particularly complex or likely to give rise to objections. Partly as a result of these reports, the FSA is also introducing a fee for portfolio transfers, currently £10,000 for non-life transfers and £18,500 for life transfers.

Mergers

Many European jurisdictions allow for the merger of two corporate entities, so that one or both of the original companies ceases to exist and the business of both the original companies is carried on either by the survivor or by a new entity. Such provisions are often referred to as "universal succession" provisions. The key principle is that the survivor succeeds to the assets and liabilities of the merging company or companies, and therefore for insurers, takes on the risks of policies written by the original companies.

As there is an automatic transfer of all rights and liabilities, a merger may assist with the perceived shortcomings of Continental European portfolio transfer legislation, namely the lack of the automatic transfer of reinsurance contracts. Set against that is the inability to be in any way selective about the portfolios – a merger is an all-or-nothing process. There are also some question marks over the automatic transfer of a contract that, it may be argued, is personal to the original contracting party in the absence of an express right to do so in the contract.

Although mergers are essentially a matter of company law, there are often complicated tax consequences. Such issues are beyond the scope of this brochure, although detailed advice can be provided on request.

Germany

The German Reorganisation of Companies Act (*Umwandlungsgesetz* – UmwG) provides for the complementary tool of a spin-off, which may be used instead of a portfolio transfer. A spin-off is the separation of a defined part of a business (including the respective assets and liabilities) from the remainder of that business, followed by a transfer, by operation of law to the transferee. One advantage in comparison with a portfolio transfer is that a spin-off leads to the automatic transfer of the underlying assets.

Restructuring of insurers under the UmwG requires prior BaFin approval. Restructuring of reinsurers under the UmwG must be notified to BaFin.

France

An insurance company wishing to effect a merger will have three options available to it under French law: standard merger, simplified merger and dissolution-fusion, the latter being also capable of achieving cross-border mergers.

Dissolution-fusion: cross-border merger fast track

The dissolution-fusion is the simplest and fastest technique (2–3 months) for obtaining a cross-border merger. By comparison, a normal or simplified merger would be completed in 3–4 months. The technique is called a dissolution-fusion (*dissolution par confusion de patrimoine sans liquidation*) and is also referred to as *transmission universelle de patrimoine* (TUP). Even though this procedure, as with a merger, results in the transfer of the assets and liabilities of the company, slight technical differences exist.

Like a simplified merger, the dissolution-fusion requires the absorbing company to hold 100 per cent of the absorbed company. As a general rule, it should be noted that changes of control of insurance undertakings (provided certain thresholds are crossed) are subject to the notification to or the approval of the *Comité des Enterprises d'Assurances* (CEA) an independent committee under the aegis of the Ministry of Economy.

Change of control procedures result in additional delays that should be added to the completion timetable. The decision to effect a dissolution-fusion must be taken by the board of directors of the absorbing company.

The dissolution-fusion effects a global transfer of the assets of the absorbed entity to the consolidating entity, like in a standard or a simplified merger. However, portfolio transfers resulting from the dissolution-fusion are subject to approval by the CEA, like stand-alone portfolio transfers.

Unlike a merger, the decision to use the dissolution-fusion procedure is irrevocable and cannot be retroactive. The dissolution and the subsequent transmission of the assets and liabilities to the absorbing company is completed at the end of a 30-day period. During the 30-day period company creditors can oppose the dissolution if it is detrimental to their rights. This period is mandatory, and as such cannot be changed or made subject to conditions.

Italy

Mergers are governed in Italy by the Code of Insurance and the new proposed regulation (n. 22/2007) referred to above. The same termination rights apply following a merger as they do following a portfolio transfer.

Portfolio transfer?

As indicated, mergers are permitted by company law, rather than insurance law or regulation. Accordingly, the process is generally relatively simple, only requiring advertising and notification to the body responsible for registering companies. However, increasingly European regulators are considering whether mergers of insurance companies constitute a portfolio transfer, hence falling within the provisions of the Consolidated Life, Third Non-Life and Reinsurance Directives as implemented into local law (or, in some cases, where implemented). As a result, insurance or reinsurance companies proposing to merge may find that they are now required to follow parallel processes: one governed by companies legislation and the other by insurance business transfer legislation.

In practice, this means that it is may be necessary to include the three month consultation period required by the Directives so that regulators of the jurisdictions in which the risks are situated (for non-life) or which are the states of the commitment (for life) can consider whether to object. If the UK is one of the relevant jurisdictions, the FSA has indicated that it would expect UK policyholders to be given the same information and rights as if a UK portfolio transfer was taking place. This would include advertising in national newspapers and notifying policyholders directly. It is not clear on what legal basis the FSA is basing these requirements, but the wide-ranging powers it can exercise on its own initiative effectively mean that most firms will need to cooperate.

Cross-border mergers

Member states were required to implement Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies (the Merger Directive) by 15 December 2007. The Merger Directive aims to facilitate the carrying-out of cross-border mergers with a view to the completion and functioning of the single market. Its provisions are not specific to insurance companies, but it is expected that they will be used by insurance companies seeking to effect a portfolio transfer whilst preserving their associated reinsurances. The Merger Directive allows for (a) one or more companies to transfer all their assets and liabilities to another company on being dissolved without liquidation, (b) two or more companies to transfer all their assets and liabilities to a new company incorporated for the purpose on being dissolved without liquidation and (c) a company to transfer all its assets and liabilities to its parent company on being dissolved without liquidation. The basic process is that each merging company must obtain a certificate in its own jurisdiction conclusively attesting to the proper compliance with all pre-merger formalities in that jurisdiction. The company that is to survive the merger then applies to the competent authority in its jurisdiction to confirm the merger. There are also detailed provisions requiring the surviving company to implement employee participation procedures in certain circumstances.

Since the effect of a cross-border merger, in the case of an insurer, is to transfer the transferring company's book of business (and associated assets and liabilities) to the surviving company, we would expect the FSA to regard the transaction as a portfolio transfer.

The Merger Directive was implemented by the UK on 15 December 2007, by The Companies (Cross-Border Mergers) Regulations 2007 (the Merger Regulations), allowing a genuine merger of companies for the first time under English law. The process described above has been transposed without significant alteration into UK law, save that (i) the High Court (or the Court of Session in Scotland) has been designated the competent authority for the purposes of issuing a pre-merger certificate and for sanctioning a merger and (ii) to ensure consistency with the existing procedure in Part XIII of the Companies Act 1985 (to be replaced by Parts 26 and 27 of the Companies Act 2006), it may be necessary for the merger to be approved by a court-convened meeting of its creditors.

On the face of it, the possibility of having to convene creditors' meetings might be expected to represent a significant impediment for English companies as the approval thresholds (a majority in number representing 75 per cent by value of each class of creditors) will be difficult to reach in the absence of any incentive for creditors to vote in favour. However, as market practice develops it is expected that the Court will exercise its discretion not to convene meetings where sufficient steps have been taken to protect creditors' interests. Given that the FSA will treat any merger as a portfolio transfer anyway, we anticipate that the Court will take comfort from the independent expert's report, the notification of policyholders and reinsurers and the rights of any creditor to make representations to the Court and so, absent specific issues, is unlikely to feel it necessary to convene creditors' meetings.

Although arguably cross-border mergers will be more attractive in jurisdictions where the portfolio transfer mechanism does not allow for the automatic transfer of reinsurance assets, mergers have one additional significant advantage even in the UK in that they are much more likely to be recognised in the US.

Germany

Cross-border mergers are now possible under German law as a result of the implementation of the Merger Directive in April 2007. However unlike the other provisions of the UmwG, the provisions referring to cross-border mergers are not applicable to mutual insurance companies.

Schemes of arrangement

A scheme of arrangement is a statutory process in the UK whereby a company can enter into a mass compromise with its creditors. The scheme is binding on all creditors once the requisite formalities have been completed, including a vote in favour at a meeting of all creditors (or each meeting of separate classes of creditors) and the sanction of the Court. The vote must be approved by 50 per cent in number and 75 per cent in value of all creditors entitled to vote (or each class of creditors). Since April 2008 the Companies Act 1985 provisions have been replaced by the Companies Act 2006, without significant alteration.

Advantages	Disadvantages
Achieves finality	May be perceived negatively, especially in the US
Very flexible	Not available for all books due to mandatory covers, e.g. employer's liability, or jurisidictional issues
English court prepared to accept jurisdiction over transferred portfolios	Can require lengthy negotiations with customers

Ever since the landmark judgment in July 2005 on the British Aviation scheme, commentary has focused on class issues, and the position of the IBNR creditors. However, despite some dire predictions, subsequent schemes have been successfully implemented, and it seems that the case now merely provides a useful reminder that each scheme is different and the composition of any classes should be considered carefully.

A more interesting and potentially useful question is jurisdiction. The English court will accept jurisdiction over a scheme if the company in question has "sufficient connection" with England. Although there is no judicial determination or statutory provisions setting out what constitutes a sufficient connection, the test might be met if the business was written through the London market, policyholders are English and/or the underlying policies are governed by English law.

Furthermore, the English Court will naturally have jurisdiction in relation to an English company. It is therefore possible to take an appropriate book of business, transfer it into a UK company (either through a portfolio transfer or, following implementation of the Merger Directive, a merger) and then undertake a scheme. Although not frequently used to date, this could prove a valuable solution to the issue of Continental European run-off books, where no similar domestic procedure is available.

One area where schemes are not currently available is where the business includes mandatory covers. This is because employer's liability policies, for example, cannot be terminated on payment of an agreed sum in respect of all claims as to do so would leave the policyholder without insurance cover that it is legally obliged to maintain.

As with a commutation, a reinsurer may seek to argue that any payments made under a scheme are not loss payments and so not covered by their reinsurance. It is therefore always prudent to discuss the proposed scheme at an early stage with reinsurers.

The FSA recognises that schemes can be very useful, but in a guide published in July 2007, it notes that they do raise regulatory issues. In particular, the FSA has indicated that it would normally object to a scheme if the company is substantially solvent, as such a scheme would not normally be in the best interests of the policyholders. There is also a strong indication in the guide that the FSA might require that a policyholder advocate be appointed where the scheme affects private retail or small commercial customers.

It is generally accepted that schemes can benefit from the relief under Chapter 15 of the US Bankruptcy Code, meaning that they can be enforced in the United States. Several schemes have successfully obtained this relief and it is notable that, notwithstanding a general disapproval of schemes amongst US persons, no significant objections have been raised to date in Chapter 15 proceedings.

Germany

German law does not provide for a statutory procedure with respect to global commutation by a solvent company. However, UK solvent schemes of arrangement may be used by UK branches of German companies or by German companies with sufficient connection to the UK. The subject of whether schemes of arrangement will be acknowledged under German law has been heavily debated in German legal literature and there have been many arguments in support of its acceptance. The first practical case may be the run-off of Global Re with respect to a part of its UK related business where it has chosen to use a scheme of arrangement.

The Netherlands

In The Netherlands, although schemes of arrangement are not a recognised concept, a number of Dutch insurance companies have finalised the run-off of insurance business by using an English law scheme of arrangement. Using an English law scheme of arrangement is possible when the insurer wrote business through a business presence in England (such as a branch), the insurer operated in the London Market via London Market brokers, some or all of the policy holders are based in the UK or some or all of the insurers assets are based in the UK.

If an English law scheme cannot be used, then a Dutch insurer will consider a portfolio transfer or, possibly, a merger as an exit strategy.

Summary

There are now more options than ever for an insurer or reinsurer looking to exit a particular line of business, or even its whole business. Some require a significant investment in time and resources, but achieve a finality within a timeframe that is not possible through a simple run-off. The most appropriate course of action will vary from insurer to insurer and from jurisdiction to jurisdiction, but almost all companies should be considering the most efficient deployment of their capital, the management time involved in running discontinued businesses and the effects of the discontinued business on its rating as a high priority.

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