

SCHEMES OF ARRANGEMENT FOR SOLVENT INSURANCE COMPANIES

WHAT IS A SCHEME OF ARRANGEMENT?

A scheme of arrangement is a statutory procedure pursuant to Part 26 of the Companies Act 2006 (formerly section 425 of the Companies Act 1985), whereby a company may make a compromise or arrangement with its members or creditors (or any class of them). It is similar to a US plan of reorganisation.

Traditionally, schemes of arrangement have been used outside the insurance industry to reorganise and restructure a company or group of companies, for example, to reorganize a company's share capital, to merge companies or as part of a reconstruction or amalgamation. The procedure has been used by as diverse and widely publicised companies as Amstrad plc, Virgin Group and Reuters Holding plc.

The procedure has also been used by many solvent insurance and reinsurance companies to accelerate the run-off process and enable companies to achieve finality for the whole or part of their business.

SOLVENT SCHEMES OF ARRANGEMENT

Occurrence-based insurance policies can, theoretically, continue to produce claims indefinitely. It is, therefore, very difficult to finalise a solvent run-off of a company that has written long tail business. Solvent insurance companies have sought to crystallise their liabilities and achieve finality by using what are sometimes known as 'cut-off' or 'estimation' schemes of arrangement. In any run-off of long-tail liabilities there is likely to come a point at which the administrative costs are not justified by the diminishing level and value of claims activity. It may be difficult to identify when the last claim has been paid - unless every policy has been commuted, which is likely to be impractical. Capital may be trapped in a run-off company indefinitely, to the extent that it is not dissipated.

A scheme which is implemented for the whole of a company's run-off is an efficient and powerful means of dealing with its residual liability and enabling its capital to be unlocked and redeployed. Such schemes effectively achieve a global commutation which is binding

upon the company and all relevant policyholders, and extinguish any future liability of the company in relation to the business included in the scheme. It should be noted that a scheme can only be used to bind a company and its creditors, therefore it cannot bind reinsurers of a company in relation to amounts owed to the company.

Under a 'cut-off' or 'estimation' scheme, the liabilities of the insurance company in relation to the business included in the scheme will be crystallized and paid earlier than would happen in the normal course. The scheme will include a bar date after which claims may not be made against the company. However, provided the creditor submits details of its claims against the company (including estimates in relation to any outstanding and IBNR claims) prior to the bar date, these will be crystallised into current payment obligations by a process of agreement and (if necessary) adjudication and/or actuarial estimation. The company will then pay such claims in full in accordance with the terms set out in the scheme.

The implementation of a scheme of arrangement involves the following stages:

- An application to the court by the company seeking permission to convene a meeting(s) of the relevant class(es) of creditors to vote on the scheme proposal;
- A notice to creditors summoning the meeting(s). At the same time, the scheme documentation is sent to creditors;
- Approval of the scheme by a majority in number, representing not less than 75% by value, of the creditors (or class of creditors) present and voting at the meeting(s) of creditors convened pursuant to the court's order. In some cases, creditors will be divided into separate classes for voting purposes;
- Sanction of the scheme by the court;
- Where relevant, Chapter 15 relief;
- The scheme becomes effective (operational) on delivery of the order of the court sanctioning the scheme to the Registrar of Companies.

The Regulator of UK authorised insurance companies, the Financial Services Authority (the "FSA") maintains a close watch on solvent scheme proposals by UK authorised insurers and reinsurers and it is important to liaise with it regarding the proposal of a scheme by such

parties. As a matter of courtesy, the FSA is commonly also advised in relation to proposed UK solvent schemes of arrangement in respect of non-UK authorised insurers/reinsurers. The FSA has the ability to formally object to any scheme proposal which it believes does not adequately safeguard policyholders' interests.

WHY CAN A SOLVENT SCHEME BE BETTER THAN THE ALTERNATIVES? SOME EXAMPLES...

Certainty and finality: Doubts cedants or policyholders might have over the solvency of the company and whether its insurance protection will perform can be removed by a scheme.

Flexibility: Schemes are designed to deal with the specific circumstances of each case and the particular needs of the stakeholders.

Early payment: a scheme will provide a mechanism for estimating and agreeing all present and future claims against the company allowing creditors to receive payment earlier than would be likely if the business being schemed was run off in the normal course.

Run-off costs: Some of the costs of run-off, which may be incurred in the normal course for many years, can be avoided by a scheme.

Shareholder equity: Residual shareholder value, if any, can be realised at the earliest opportunity through a scheme.

OTHER POINTS TO CONSIDER

(a) *Estimation:* Cedants and policyholders may ultimately receive more or less than the amount they would have received had the company been run-off in the traditional manner. However, schemes are generally designed to ensure that the claims agreement/determination process is reasonable and fair.

(b) *Finality:* In order to provide finality, a scheme may have a final date by which scheme claims MUST be submitted- sometimes referred to as the bar date. The company will seek to ensure that the bar date is brought to the attention of the relevant creditors.

(c) *Excluded policies:* Schemes may not be suitable for all types of business; eg UK compulsory insurance (eg employers' liability).

SOLVENT SCHEMES OF ARRANGEMENT APPLICATIONS (IN THE UK)

Schemes are continuing to evolve to provide ever more innovative solutions for those using them.

Schemes can be used by, amongst others:

- (a) *UK Companies*: schemes have been used by UK companies for some time now.
- (b) *Overseas Companies*: provided there is a "*sufficient connection*" with England.
- (c) *Pools*: The ability to scheme portfolios, where desired rather than the whole of a company is particularly useful when dealing with involvements in underwriting pools. A scheme can bring finality to a pool and can also be designed in such a way as to allow the pool members and their policyholders formally to agree ways of simplifying existing complex arrangements and relationships.

SCHEME STATISTICS

According to the October 2007 KPMG/ARC Run-Off Survey - Non Life Insurance, by the end of 2006, there had been a total of 63 solvent schemes for individual entities and a total of 36 when considered on a pool or portfolio basis.

According to the same survey, total capital tied up in solvent UK non-life companies is approximately £4.9 billion (excluding Lloyd's vehicles and companies with run-off portfolios mixed with other business). KPMG opined that by the end of 2006, total liabilities of UK companies whose entire non-life insurance business was subject to a solvent scheme of arrangement were £418 million representing more than a threefold increase since 2005. These companies collectively increased reported net assets by approximately £38 million.

Since the survey, the WFUM Pools Scheme has been sanctioned for 14 solvent (and one insolvent) WFUM pool members. We believe that from the beginning of 2007 to 22 February 2008, some 24 solvent schemes have been sanctioned in the UK for individual entities or a total of 5 when considered on a pool or portfolio basis.

As at 17 March 2008, we were aware of 8 proposed solvent schemes pending for 95 individual entities.

The solvent schemes sanctioned by the UK Court to date have been implemented in respect of companies incorporated in the UK, the EU, Australia and Asia and have involved a wide range of direct and reinsurance business, pool business and various combinations of these types of business.