ENMIRED INSURANCE AND REINSURANCE COMPANIES
- A Practitioner's View of Rescue

by Paul Evans

It is not often that we need to dust down a minor piece of legislation that has perhaps not been in great use in a particular field, and examine its workings in minute detail. This has happened in the past ten years where insurance and reinsurance law interact with insolvency law. The huge claims-related pressures that have mounted against companies in the London Market have led to an unprecedented number of failures and a list of companies in run-off that is longer than at any time ever. This threat to solvency has given rise to the need to examine innovative ways of finding solutions to business problems and to the search for "finality". So it is that "Schemes of Arrangement" have become much in vogue, not as solutions in themselves but as legal envelopes in which to wrap commercial deals. This article seeks to set out some of the legal and commercial issues surrounding troubled insurance and reinsurance companies. In this article, references to insurance companies include reinsurance companies.

Options for troubled companies

As solvency margins are eroded by the ever increasing level of reserves for known types of claim, and perhaps for the unknown, directors will have to consider what options are available to them if they are to avoid actual insolvency. Financial solutions might include a sale of the company or of the underlying business, or an increase in share capital from new or existing shareholders. A difficulty in selling the company or the underlying assets and liabilities (this would have to be done by way of a statutory transfer under schedule 2C to the Insurance Companies Act) is setting the price when faced by the inevitable and possibly huge uncertainty over the quantum of long-tail liabilities. Discounts to net assets are the usual result. A further difficulty may be the requirement of the Regulator, now the Insurance Directorate of HM Treasury as supervised by the Financial Services Authority, for there to be demonstrable benefit to the policyholders from any proposed change of control. Whether or not existing shareholders will decide to increase their investment in the face of worsening reserves is often the crucial test for companies in run-off. There does come a point when the commercial wisdom of supporting a dying subsidiary is properly questioned, especially where there is no legal exposure to the debts of that subsidiary. A number of prominent international groups have decided not to support subsidiaries in recent years and insolvencies have ensued.

Other alternatives for companies in trouble might include the provision of additional reinsurance protection (this might also comprise part of the financing of a sale). Whether or not such protection will provide effective finality will depend on whether the additional layers will be adequate to contain any future deterioration of inwards reserves. Companies can also set about a more aggressive claims handling strategy in particular seeking to commute significant parts of those inwards risks. This can bring about real termination of exposure to worsening claims but bilateral commutations can be time consuming and require significant data preparation which mean that it is usually difficult to conclude more than a handful of major deals a year. In the meantime things can still get worse on the remaining book. Nevertheless this approach is sparking new ideas toward the achievement of finality to which I will return later.

The need for commercial solutions

If none of these options lead to the avoidance of insolvency, then some form of statutory procedure is likely to be invoked. Historically, companies were placed in liquidation, a process for realising the assets and distributing them pari passu to the creditors. Unfortunately the most significant asset of any insurance company is its reinsurance recoverable from other companies, and this is not determinable until the creditors have been agreed. This led to a long drawn out process with little or no dividends being paid to creditors until liquidators could be reasonably certain of what all the liabilities would be. That often took many years. The process was also expensive for creditors due to the requirement for all liquidators to place all funds in the Insolvency Services Account where there are significant investment and handling charges. Creditors must also prove their claims in sterling giving rise to the possibility of currency mismatches between claims and dividends.

If it were not for the balance sheet deficiency, the company could continue to manage its run-off in the ordinary course agreeing claims and reinsurance recoveries like other companies, merely being unable to make payment in full. One commercial solution to the insolvency is to create a framework to allow the company to carry on its run-off as ordinarily as possible while making some payment to policyholders when claims are agreed. A further commercial solution is to create a mechanism to estimate all the future liabilities (and also the future assets as a consequence) in order to accelerate the collection of the assets and distribution to creditors. Both of these means of dealing with the insolvency need a legal envelope in which to set the plan, providing the outline rules for the plan without seeking to be proscriptive of every problem that may arise. In other words the desire is to create a framework that is characterised by a deal-making environment rather than a legalistic straitjacket.

Schemes of arrangement

The appropriate envelope that has been adopted in recent years is the Scheme of Arrangement, the basis for which is set out in Sections 425 and 426 of the Companies Act 1985. It should be noticed immediately that this is not an insolvency process and schemes have been used in other areas of business as tools for reorganisation for many years. Indeed the whole concept of a scheme has been known in several earlier versions of the Companies Act. In essence a scheme is a deal between a company and its creditors or a particular group of creditors, and if approved it represents a statutory contract between the parties. Two powerful benefits of a scheme if approved are, first, that it binds everyone in the creditor group whether they voted for or against the scheme, did not vote, or even did not know about the scheme although reasonable attempts to find creditors must be undertaken by the promoters, including advertising. Second there are few requirements as to what must go into a scheme and therefore a plan can be written to fit the circumstances of any particular company. The promoters may propose any deal with the creditors that will command adequate support.

Adequate support means a majority in number representing at least 75% by value of those creditors presenting and voting, whether in person or by proxy, at a meeting called for the purpose by the Court. The Court must also sanction the scheme after the vote of creditors. A scheme may be concluded between the company and its creditors or any class of them, so that where appropriate meetings of different classes of creditors must be convened and the scheme voted on separately by each class. All classes must vote in favour if the scheme is to be approved. Promoters of schemes and their advisers often spend inordinate amounts of time assessing whether there should be separate class meetings. Incorrect class meetings are matters that are capable of being raised as failures of procedure at the Court hearing to sanction the scheme. There are judicial precedents on this subject including *Sovereign Life v Dodd* and In *Re Osiris Insurance Company*. While there is some basis for suggesting that consideration of the financial interest of different groups of creditors in the scheme should determine whether those different groups could reasonably meet together and vote at the same time, there is a need for clarity and reform.

Provisional liquidation

When an insurance company is insolvent and contemplating a scheme it will be essential that the company can be protected from individual creditors that might seek to attach assets or otherwise gain advantage over the general body of creditors. The company also needs enough time to prepare a scheme, canvass the views of major creditors (and perhaps reinsurers) and circulate the required documents. The company needs a general stay against legal action by creditors. Usually creditors will also require a change of control from the Directors, if for no other reason than to ensure an independent review is carried out into the causes of failure. In any other industry these requirements would all be met by the application to the Court for the appointment of an Administrator under Part II of the Insolvency Act 1986. Currently the sole remaining exclusion from Administration covers authorised insurance companies, although there are signs that the Government is now willing to remedy this anomaly (see later). Accordingly a procedure has been developed with the support of the Court whereby the company (or on occasion a creditor) petitions the Court for a winding up order. Adjournment of the hearing of the petition is then sought while a scheme is prepared, the adjournments usually being for periods of six months at a time. At the same time application is made for the appointment of Provisional Liquidators with widespread powers of management not unlike those of an Administrator. The Provisional Liquidators will usually remain in office until the scheme is approved. This appointment also facilitates the request to the United States Bankruptcy Court for relief by way of an automatic stay against creditor action in the USA, imposed by way of injunction.

The Provisional Liquidators become in effect the chief executives of the insolvent company. Apart from preparing an appropriate scheme as a means of securing a deal with the creditors, they must also enable the company to carry out most of the functions that a company in run-off would expect to carry out. These include agreeing claims, preparing reinsurance collection notes and seeking to collect cash, managing cash flow and investments and dealing with ongoing litigation both inwards and outwards, although much inwards litigation will be stayed with consequent cost savings. They must also prepare an appropriate strategy for handling the run-off, which is likely to last for many years, and secure and incentivise the appropriate staff with the right mix of skills. The Provisional Liquidators' role is more akin to that of the long term project management of a run-off than a pure insolvency appointment, although there are always insolvency issues that demand attention such as the need to identify the rights of set-off of creditors and reinsurers.

In the early days, the Provisional Liquidators' tasks will focus on securing the staff and setting up the strategy for handling the run-off and reviewing the state of the records and the need for information. They will want to communicate with the market, especially with brokers, and explain the accounting position as well as seeking to collect cash in the brokers' hands. If the run-off has only recently started then there may be live policies in place where a strategy for those will be urgent. Unless they specifically say so, the Provisional Liquidators' appointment will not usually bring contracts to an end and therefore there will be a need to review the basis on which agreement to terminate policies or obtain an indemnity from another carrier may be achieved. This may be particularly relevant, for example, for marine and aviation policies where an insolvent carrier has written a line and where the inability to meet claims in full would almost certainly mean the grounding of aircraft pending replacement cover. Where insolvent companies are members of underwriting pools there is always a need for an early examination of the relationship with the other solvent pool members and the extent to which everyone could, or should, cooperate in the run-off.

Types of schemes

I referred earlier to two alternative commercial solutions for the run-off of an insolvency insurance company: these have become known as the "run-off" (or "reserving") scheme or the "cut-off" (or "valuation") scheme. The first of these enables the company to continue its run-off in the ordinary course, making some payment (the "payment percentage") on claims as they are agreed, with the expectation that this level of payment will increase over the lifetime of the scheme.

All previously agreed claims receive top-up payments whenever the percentage is increased. The advantages of this type of scheme include the avoidance of the investment and handling fees incurred in any liquidation, the ability to handle claims and dividends in currency, the expectation of earlier payments to creditors and the avoidance of any need for formal proofs of debt. Examples include the schemes for the KWELM companies, Orion and Trinity Insurance Companies.

The second alternative enables the company to estimate all its present and future claims, using actuarial estimation techniques if appropriate, and then to collect from reinsurers on the basis of those estimated claims with the result that final dividends can be paid fairly promptly. The advantages of this type of scheme include all those outlined for the run-off scheme, with the early payment to creditors being provided through the acceleration of the run-off. The estimation process inevitably means that creditors may have claims agreed at a level more, or less, than they might have if claims were to be agreed in the course of the natural run-off. This occurs because the techniques involve allocating that part of the company's reserves for claims incurred but not reported on a contract by contract basis. Experience has shown that, as long as creditors have the estimation process explained openly to them and can see that it has been applied fairly, then they will support this process as a means to early closure of the estate. Examples include the schemes for ICS and RMCA Reinsurance Companies, Fremont UK and Charter Reinsurance Company. Experience also shows that the company's reinsurers will also support the process provided they understand the fairness of the estimation technique. Reinsurers are asked to pay early at a discount to obtain finality and most will see benefit in that.

Most of the larger schemes have begun as run-off schemes while the large amounts of long-tail APH liability dominate their reserves. But even here there are signs of a willingness to negotiate settlement deals to cap liability and thus hasten the speed of the run-off toward closure. Eventually all these schemes will need to turn to estimation techniques in order to bring the run-offs to an end. There will be a need to avoid the costs of a long run-off where these begin to exceed the income arising on funds held, and also to make use of the ability to impose a bar date after which creditors not providing information to support their claims or valuations will be excluded from any dividends. Some schemes already have an option to convert to a cut-off process built in, others will need a second, closing scheme to effect the closure.

Solvent schemes

A further development in scheme technology is the spread of their use to solvent companies. One of the options for insurance companies in run-off is to set about a commutation programme with major insureds, with a view to eliminating risk. A difficulty is to get enough deals done quickly to make a difference before reserve deterioration, or reinsurer default, further eats into the surplus. A solution is to commute with all insureds, which is arguably fairer anyway, and again the scheme provides the legal envelope for a global commutation. This is based as for the insolvent companies on the use of actuarial estimation as the means of crystallising all liabilities, coupled with a bar date in order to produce finality. Whereas the need in the insolvent case is to balance the interests between the creditors with long and short tail claims and the reinsurers, in a solvent company the need is to balance the interests between the policyholders, the shareholders and the reinsurers.

The financial position of the company and the perceived strength of the shareholders will have a bearing on the nature of the deal between the company and the policyholders, bearing in mind that only the policyholders will have a say on whether the scheme is approved or not. The reinsurers will again need to be satisfied that what they are being asked to pay by way of accelerated claims provides them with sufficient financial incentive and does not contribute to any surplus available to the shareholders. There have been a small number of solvent schemes to date, for example Scottish and Commonwealth Insurance Company and Mutual of Omaha UK, where run-offs were far advanced and the remaining liabilities small. However the process should be equally viable for companies with more significant liabilities as it has been shown for insolvent companies. Time will tell.

Possibilities for reform

The scheme of arrangement process remains, from a legal point of view, somewhat cumbersome. The procedural requirements involve a number of Court hearings and I have already referred to the potential difficulties over class issues. The lack of extensive statutory requirements for schemes means that great flexibility in design is possible, but also means that every scheme document has to be self-contained in terms of its content. There are a great number of basic "housekeeping" types of clauses in schemes which deal with such matters as scope of the company's actions, the powers and duties of the directors, the scheme administrators, the members of the creditors' committee, the rules for the formation of the committee, for its meetings, for meetings of the creditors and so on. Many of these matters are common to all schemes and involve fairly standard drafting. Accordingly, consultations with the Department of Trade and Industry resulted in the publication in December 1994 of a Consultative document which proposed in effect the creation of a framework for a statutory run-off. This would incorporate many of the features of schemes as they exist today but with a number of proposed amendments to the process, including the ability to produce regulations to apply to all schemes which might, inter alia cover some equivalent to "Table A" on procedural matters. It was also proposed that creditors would comprise only one class unless circumstances demanded otherwise. Certain powers currently available only to liquidators or other insolvency office holders would be made available to scheme administrators.

At the time it was proposed to create a new entry process for the statutory scheme as the Administration process was not to be made available for insurance companies. Although the Consultation document has not led to any proposed legislation, the publication of The Financial Services and Markets Bill in July 1998 reopened the possibility of some change. The Bill includes the proposal to allow Administration for authorised insurance companies. This would immediately provide the appropriate entry route for insolvent companies to a process that would avoid the artificiality of provisional liquidation. However the exit from Administration would still be a scheme under the Companies Act, unless an alternative form of rescue could be achieved, and the need for reform to the scheme process remains.

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