# THE INTERACTION OF THE POLICYHOLDERS PROTECTION ACTS 1975 AND 1997, EMPLOYERS' LIABILITY INSURANCE AND THE NEW COMPENSATION SCHEME

*By Beth Rees*

## Introduction

A new single Financial Services Compensation Scheme will replace the existing compensation schemes for investment business, deposits and insurance as part of the changes introduced by the Financial Services and Markets Act. Three conditions will have to be met before compensation will be paid:

- An eligible claimant must have applied for compensation;
- The claim must relate to business covered by the Scheme conducted by an authorised or passported firm in default; and
- Where required to do so, the claimant must assign his rights in respect of the claim to FSCS Limited, administrator of the Scheme.

Where FSCS Limited determines that an authorised insurer is in financial difficulties, it must try to arrange the transfer of the business to another authorised insurer or give financial assistance to the company to enable it to continue. Such action must only be taken if it is determined to be more cost effective than paying compensation. A company is defined as being in financial difficulties when:

- It is in provisional liquidation; or
- It has been proved to be unable to pay its debts under formal insolvency proceedings; or
- An application has been made to court to secure a creditors voluntary arrangement, but the firm is not yet in liquidation or being wound up.

Claims can be in respect of a protected deposit, a protected contract of insurance or protected investment business.

Contracts of insurance are protected only if the risk or commitment of the policy falls within the UK, another EEA State, the Channel Islands or the Isle of Man. This reflects the provisions of the Policyholders Protection Act 1997 ("PPA 1997") which has been only partially enacted. The PPA 1997 changes the geographical scope of the Policyholders Protection Act 1975 ("PPA 1975"), amending the definition of a UK policy, and excluding risks written outside specified geographical areas. Marine, aviation, transport, reinsurance and, (a new exclusion), credit insurance will not be

protected by the Scheme. In addition, Lloyd's polices are also excluded as they are protected by the separate Lloyd's Central Fund.

The level of compensation for general insurance is as follows:

- Compulsory claims: 100% of valid claim/unexpired premiums
- Non-compulsory claims: 100% x £2000 of valid claim/unexpired premiums 90% remainder of claim

There is no maximum.

**PPA 1997**

Sections 3, 16 and 21 of the 1997 Act came into force on 5 April 2000. Section 3 of the Act amends section 16 of the PPA 1975 by extending the category of persons qualifying for protection in the case of insurance companies in financial difficulties and section 16 extends the definition of "policyholder". Under the provisions of the PPA 1997 larger partnerships are excluded from the ability to claim compensation. Instead the focus is on protecting private individuals and small companies. The commencement of sections 3 and 16 of the 1997 Act does not apply to cases where companies were already in liquidation or financial difficulties before 5 April 2000.

**Policyholders Protection Board - claims on general business policies**

***Table 1: Accumulated net cost of assistance to protected policyholders since year ending 31 March 1993 to 28 February 1999.***

| Defaulting Insurers | Payments (£) | Less recoveries (£) | Total (£) | Number of payments | Average payment (£) |
|---|---|---|---|---|---|
| Kwelm | 208,769,789 | 27,266,518 | **181,503,271** | 1,086 | **167,130** |
| Continental | 595,568 | 0 | **595,568** | 647 | **921** |
| Trinity | 5,727,329 | 1,828,262 | **3,899,067** | 577 | **6,757** |
| Bryanston | 4,168,983 | 477,508 | **3,691,475** | 500 | **7,383** |
| MGI | 31,384,614 | 0 | **31,384,614** | 1,164 | **26,963** |
| Scan Re | 226,417 | 22,743 | **203,674** | 29 | **7,023** |
| Orion | 3,376,233 | 708,053 | **2,668,180** | 353 | **7,559** |
| Paramount | 9,417,998 | 0 | **9,417,998** | 4,379 | **2,151** |
| English & American | 2,116,086 | 231,083 | **1,885,003** | 12 | **157,084** |

| Defaulting Insurers | Payments (£) | Less recoveries (£) | Total (£) | Number of payments | Average payment (£) |
|---|---|---|---|---|---|
| **Kwelm** | 208,769,789 | 27,266,518 | **181,503,271** | 1,086 | **167,130** |
| **Bermuda Fire & Marine** | 1,386,301 | 26,523 | **1,359,778** | 55 | **24,723** |
| **Anglo American** | 24,341 | 0 | **24,341** | 3 | **8,114** |
| **North Atlantic** | 5,850 | 0 | **5,850** | 1 | **5,850** |
| **Sovereign Marine** | 138,127 | 0 | **138,127** | 9 | **15,347** |
| **UIC** | 28,189 | 0 | **28,189** | 2 | **14,095** |
| **Black Sea & Baltic** | 740,753 | 0 | **740,753** | 5 | **148,151** |
| **Builders Accident** | 1,674,476 | 0 | **1,674,476** | 118 | **14,190** |
| **Others** | 661,102 | 11,155 | **649,947** | 6 | **108,325** |
| **Total** | 270,441,156 | 30,570,845 | **239,870,311** | 8,946 | **26,813** |

*(Information reproduced from **FSA Consultative Paper 24 - Consumer Compensation : a further consultation**)*

The PPB is financed by a regular levy on UK authorised insurance companies. The total sum levied on the industry since the introduction of the PPB stands at £239.9m in the period to 1999. It is understood that the PPB has decided not to raise the levy for 2000.

In addition to the payment of compensation to protected policyholders of failed general insurers the PPB has also paid out compensation of more than £4m to the policyholders of two failed life companies.

**Commercial and Regulatory Environment**

Table 1 provides details of those companies where protected policyholders have received assistance from the PPB since 31 March 1993. It excludes Drake Insurance Company Limited, an UK authorised motor insurer. PPB claims manager Roger Clements said "The board estimates the demise of Drake could cost up to £50m and take between five and ten years before the last claim is settled." This company went into provisional liquidation in May of this year with little warning. The insurance industry is continuing to experience a noticeable withdrawal by insurance companies from the marketplace. This is due in part to the continued emergence of latent

liabilities, low investment returns and the high cost of settling claims compared with the premium income received at the time policies were written. Of the 630 or so UK authorised insurance companies supervised by the FSA approximately one third are in run-off.

Additionally, UK authorised insurance companies and other financial services entities will be effected by the regulatory overhaul currently taking place. The FSMA creates major changes to the way in which companies with a financial services bias carry on business. The FSMA relies on the concept of applying regulatory principles to the conduct of financial services business rather than adherence to tightly defined legislative guidelines. Arguably this approach could find more companies in breach of financial services regulations because of the increased scope to misinterpret them. A likely consequence is that a number of London Market insurance companies are, at the very least, likely to experience difficulties in the near future.

The introduction of FSCS Limited is intended to ensure that there will be sufficient resources in place to assist in the assessment of when compensation is payable should a financial services company fail and also in the administration of such payments. However the continued postponement of N2, the date by which the FSMA will be fully enacted, means that it is unlikely that FSCS Limited will be fully operational before next Autumn. In the interim, claims arising from insurance companies which are in financial difficulties or those in an insolvency process will continue to be dealt with by the PPB in accordance with the provisions of the PPA 1975 and the PPA 1997, where applicable. Furthermore the new FSCM Limited will be reliant on the way in which those Acts are interpreted in assessing what constitutes an eligible protected claim.

Table 1 sets out the accumulated net cost of assistance to protected policyholders since the year ending 31 March 1993 to 28 February 1999 at the statistical level. At a meeting held at the offices of Grant Thornton on 12 September 2000 a number of market professionals met to discuss the practical difficulties and uncertainties of dealing with protected claims focusing on those relating to compulsory insurance.

Contracts of compulsory insurance include any policy which satisfies the requirements of the Riding Establishments Act 1964, the Employers' Liability (Compulsory Insurance) Act 1969, Part VI of the Road Traffic Act 1988 and any policy evidencing a contract of insurance effected for the purposes of section 19 of the Nuclear Installations Act 1965 (or equivalent legislation for Northern Ireland).

Paul Taylor, Head of Run-Off, Insurance and Friendly Societies Division of the FSA facilitated the meeting. Those attending comprised insolvency practitioners and lawyers who have an involvement in a number of well-known London Market insolvencies. Paul Taylor announced that the FSA is currently in the process of looking at the issue of employers' liability. He said he was hopeful that the meeting of market professionals might provide some clarification of the issues with which they had found themselves involved when dealing with protected claims against an insolvent insurance company.

In the broader sense, he confirmed that the new compensation scheme proposed by the FSA is to replace the existing compensation schemes, including the PPB. Consequently the convening of the meeting was timely. Additionally the Association of British Insurers ("ABI") is constantly reviewing the issue of employers' liability and input from market professionals to the ABI's discussions might be helpful.

**Employers' Liability: qualifying protection under PPA 1975**

In the United Kingdom, a scheme of arrangement has become the preferred method of dealing with the liabilities of an insolvent insurance company. Since 1990 over 30 insurance companies in the London Market have become insolvent. All are either in a scheme of arrangement or provisional liquidation and awaiting the implementation of a scheme of arrangement. It is unusual for an insurance company to go into liquidation. Only two insolvent insurance companies in the London Market are in liquidation and it is understood that schemes of arrangement are in the process of being considered for each.

A scheme of arrangement is an arrangement or compromise entered into between the company and its creditors. It is a contractual relationship. Where that company is an insolvent insurance company implementing a scheme of arrangement has a number of key advantages. One is the acceleration of the ascertainment of liabilities. Cut-off schemes enable those liabilities to be crystallised either on an ascertained basis or by estimation. If the insurance company is insolvent the usual effect is that creditors will receive an amount less than the full value of their claim, actual or estimated, in discharge of the liability owed by the company to them. Once the company's liabilities have been discharged it could be argued that the company is no longer insolvent. In theory, following the conclusion of a scheme of arrangement, it may be possible for that insurance company to start writing new business again.

Pacific & General Insurance Company Limited ("Pacific & General") has been in compulsory liquidation for some 15 years. It is proposed that an application is made

for the liquidation to be stayed and instead, a cut-off scheme of arrangement in accordance with the provisions of section 425 of the Companies Act 1985 implemented. A draft of the scheme of arrangement has been available for over a year. The PPB is an ascertained creditor in the liquidation because it has had assigned to it the claims of protected creditors and a contingent creditor in the event that further protected claims might arise in the future. As Pacific & General is in liquidation, under the terms of the PPA 1975 the PPB has an absolute statutory duty to compensate protected policyholders in that estate.

In summary the position taken by the PPB in respect of Pacific & General gives rise to two issues. First the matter of how cut-off schemes provide for the claims of protected creditors and where that leaves the policyholder that does not become aware of the fact that he might have a claim until after the scheme of arrangement has terminated. The second point is how far the PPB or, looking forward, the FSCM Limited, should seek out potential protected claims and the amount of evidence that would be required to satisfy the PPB that a claim is valid.

There are two further elements that need to be considered: these are which policies comprise protected policies and where the policies were written.

**Which policies constitute protected policies?**

Those market professionals attending the meeting looked at the example of employers' liability contracts of insurance. If an insurance policy was issued in 1969 and the insurance company went into liquidation in 1972 is that policyholder protected? The relevant provision would appear to be section 6 of the PPA 1975 and its interaction with the Employers' Liability (Compulsory Insurance) Act 1969. There are no timing requirements set out in either Act. However section 6 of the PPA 1975 states "(1) This section applies to any policy which satisfies the requirements of any of the following...(the various types of compulsory contracts of insurance)". It was considered that the use of the word requirements would appear to suggest that only employers' liability policies incepted after 1972 are protected. The fact that the terminology used in section 6 of the PPA 1975 is inexact does not assist in determining the effective date when compulsory contracts of insurance achieve the status of protected policies. Compare this with section 8 of the PPA 1975. This deals with general policies other than compulsory policies and is clearly retrospective.

Both sections 6 and 8 of the PPA 1975 apply to any "private policyholder". Private policyholders for the purposes of the PPA 1975 are defined as individuals or a partnership or other unincorporated body of persons all of whom are individuals.

Ascertaining which compulsory contracts of insurance the provisions of the PPA 1975 protect is important. Under the PPA 1975 "it is the duty of the Board (PPB) to secure that a sum equal to the full amount of any liability of a company in liquidation towards any policyholder (of a contract of compulsory insurance)...paid to the policyholder as soon as reasonably practicable after the beginning of the liquidation". In other words the compulsory insurance private policyholder will be paid in full by the PPB, whereas private policyholders of general insurance will receive a sum equal to ninety per cent of the amount of any liability of an insurance company in liquidation.

The PPB itself is of the view that only compulsory contracts of insurance written after 1972 are protected by section 6 of the PPA 1975. It was the majority view of those market professionals attending the meeting that this was the correct approach. However it was suggested that in order to obtain a definitive position it would be necessary to look at this issue in conjunction with the way in which other statutes that deal with protected claims are interpreted.

**Location of the policy**

The PPA 1997 limits the geographical scope of the PPB. Under the provisions of the PPA 1975 protection was merely confined to United Kingdom policies. Consequently this meant that policyholders outside the United Kingdom but which held policies written by a United Kingdom authorised insurance company could qualify for protection. The introduction of the PPA 1997 means that compensation is now limited to those claims arising from policies in the EEA, the Channel Islands or the Isle of Man.

**Change in definition of "private policyholder"**

Larger partnerships are now excluded from the definition of "private policyholder" under the provisions of the PPA 1997. The insolvency of the KWELM group of companies occurred in 1992. It gave rise to potential protected claims of almost £180m. Larger partnerships have, in the past, been the biggest drain on PPB resources. Their exclusion means that if the KWELM group of companies had failed today, the number of eligible claims and the consequent cost of compensation would be significantly less due to the change in definition of private policyholder introduced by the PPA 1997.

**How should cut-off schemes provide for compulsory contracts of insurance?**

There was general agreement by those market professionals attending the meeting that the purpose of implementing a scheme of arrangement is to carry out a distribution of the estate, whereas the issue of compensation for protected policyholders is a separate matter. Nevertheless the existence of the PPB means that protected policyholders have an additional right of recourse in the event an insurance company fails.

When an insurance company goes into liquidation the PPB has an absolute statutory duty to pay protected claims. What right would the protected policyholder have to pursue a claim against the PPB where his claim arises after the liquidation is closed, and the company is subsequently dissolved and struck off the register at Companies House? Would the policyholder have to apply to have the company restored to the register before he could pursue a claim against the PPB? Indeed, would he be able to make a claim?

It was acknowledged that this issue presents no clear solutions and that ultimately it might fall to the PPB to determine.

In practical terms it may have little impact as most insolvent insurance companies now use the mechanism of a scheme of arrangement to deal with their liabilities and assets. In the London Market different types of schemes of arrangement have been employed to deal with insolvent insurance companies. These comprise reserving schemes, hybrid schemes and cut-off schemes. Most schemes of arrangement of the reserving type now provide for them to convert at the end of their life to cut-off schemes in order to deal with residual assets and liabilities.

Where a cut-off scheme has been implemented between an insolvent insurance company and its creditors and that company has written compulsory contracts of insurance the ability of a protected policyholder to pursue a claim after the scheme has terminated needs to be considered. Protected policyholders with general insurance policies are relatively easy to identify because general insurance policies tend to be written on a "losses occurring during" basis. Employers' liability claims do not manifest themselves so readily as they often materialise years later: take the example of industrial deafness or asbestosis claims.

Should the cut-off scheme of arrangement include provisions that provide an avenue whereby the unknown policyholder of a compulsory contract of insurance can, in the event that he has a claim that arises after the conclusion of the scheme of

arrangement, seek recourse to the PPB? It is important that any scheme of arrangement preserves a balance between the interests of all creditors. (The issue of classes is not considered here.)

It was suggested that it may be possible to draft the provisions of a cut-off scheme so that the position regarding the distribution of an insurance company's assets is settled while keeping open the liability position to enable protected policyholders to pursue any remedies they might have against the PPB.

The market professionals who attended the meeting also discussed other ways in which this could be effected. One suggestion was the prospect of transferring the protected policies to the PPB. Another was ensuring that the shell of the company is preserved in some way either by a sale of its shares or by merely retaining it on the register in some way, preferably as a dormant company.

To what extent should potential claims of protected policyholders be sought out and on whom does the obligation to do so rest?

There was general consensus by those market professionals attending the meeting that the role of a scheme administrator is to ensure the equitable and timely distribution of the assets of the insolvent insurance company. Should he dissipate the assets of the estate by seeking out potential protected claims? Indeed would such a course of conduct be welcomed? It may be argued that, where protected policyholders are concerned, ultimately the relationship is between the potential protected policyholder and the PPB. Consequently it might be that the obligation to seek out protected claims is a matter to be dealt with between the PPB and that policyholder.

**Employers' liability: commutations and their implications**

Paul Taylor asked those market professionals attending the meeting for their views on whether, if an employers' liability policy is commuted, this meant that any claims which arise subsequently in respect of the commuted policy are not eligible for protection.

It is evident that there is a penalty under the provisions of the Employers' Liability (Compulsory Insurance) Act 1969 if an employer does not maintain insurance. However those attending the meeting considered it was not certain from a perusal of the Act whether the requirement to maintain insurance is an annual commitment or a continual one. The example was given of a policy taken out in 1978 that is then

commuted in 1999. Does this constitute a breach of the Act? Alternatively if the policy is taken out in 1978 and the employee contracts a disease in that year but the employee doesn't become aware that he has the disease until 1999 but the policy was commuted in 1990 would he be a protected policyholder? Furthermore does it make a difference if the policy is voluntarily or involuntarily commuted?

It was suggested that the involuntary commutation of an employers' liability policy is only a mitigating argument in defence of any breach in the requirement to maintain employers' liability insurance. There was general consensus that any scheme of arrangement should provide for an appropriate treatment of employers' liability policies.

The ABI is constantly reviewing the issue of employers' liability. In January 1998 the ABI issued a response to the consultation document on the draft Employers' Liability (Compulsory Insurance) General Regulations issued by the Department of the Environment, Transport and the Regions in September 1997. In it the ABI commented that, according to statistics published by Financial Intelligence and Research Ltd, 35 companies regulated by the DTI (now FSA) presently write employers' liability insurance. The ABI response also set out various ways in which the issue of employers' liability could be managed. One suggestion was that, in order to afford better protection to employees whose employer has ceased to trade, the ABI would support the inclusion of employers' liability insurance details within the Annual Accounts and Records submitted to Companies House.

Since that consultation document was issued an industry Code of Practice for employers' liability has evolved. This recommends that arrangements be made for employers' liability policies to be retained for 40 years.

The ABI is currently undertaking a review of the way in which commutations are managed by the insurance industry. If the ABI has not already considered the position with regard to employers' liability it is suggested that this might provide an opportunity to do so.

**Compensation Scheme: the way ahead**

FSCS Limited will be funded on a national basis. This contrasts with the funding provided to the PPB by means of a levy on the insurance industry. Consequently the PPB has always had to balance the interests of the insurance industry against the interests of protected policyholders. This need to maintain equilibrium may, in part, explain the PPB's stance in connection with insolvent insurance companies and the

prolonged discussions that market professionals have had in securing the PPB's support for certain schemes of arrangement. Looking forward it is understood that FSCS Limited will be able to provide a more balanced consideration of the issues involved in its dealings with insolvent insurance companies.

Nevertheless, under the new regime, resolution of issues pertaining to potential protected policyholders will still have to have regard to the provisions of the PPAs 1975 and 1997 and the effect of other legislation such as the Employers' Liability (Compulsory Insurance) Act 1969. Any uncertainties arising from the way in which this legislation has been interpreted will need to be dealt with. If there is a legislative impasse guidance should be provided if the purpose for which these statutes was enacted is to be fulfilled in an equitable way without prejudice to the interests of other parties. The transitional period prior to the commencement of the new compensation scheme provides a potent opportunity for those involved to take the initiative and introduce real and much needed change.

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