British Aviation Insurance Company: an End to Solvent Schemes of Arrangement, or a Useful Guide to the Perfect Scheme?

by Chris Finney

Introduction

Under section 425 of the Companies Act 1985, ('section 425'), when a scheme of compromise or arrangement, (a 'scheme'), is proposed between a company and its creditors, or any class of them, the court may, on the application of the company or any creditor, order a meeting of the creditors, or classes of creditors, to be summoned. If it does, and if a majority in number representing 75% by value of those voting at each creditors' meeting vote in favour of the scheme, that scheme will be binding on the company and the relevant class(es) of creditors, provided it is sanctioned by the court and a copy of the court's order is delivered to the registrar of companies.

In early 2005, the British Aviation Insurance Company Limited ("BAIC") proposed a scheme that would bind BAIC and some of its policyholders. That scheme was the first of its kind to be opposed and the first of its kind to be refused court sanction. This article considers why the court declined to sanction BAIC's scheme. It also sets out some practical steps, which a scheme promoter could take to improve his prospects of securing court sanction notwithstanding the BAIC decision.

The Section 425 Scheme Process

To secure the court's sanction, a scheme promoter must follow a three-stage process:

1. Stage 1: the company, or a creditor, applies to the court for an order convening a creditors' meeting. It is the applicant's responsibility to ensure that the creditors' meeting(s) are properly constituted by class of creditor so that each meeting consists only of those creditors whose rights against the company are not so dissimilar as to make it impossible for them to consult together with a view to their common interest. The applicant must draw the court's attention to any meeting constitution issues (if it reasonably can). At this stage, the court will consider whether a meeting of creditors should be ordered and whether more than one meeting is necessary, but it won't consider the merits or fairness of the scheme.
2. Stage 2: the scheme proposals are put to the meeting(s) held in accordance with the court's order and they are approved (or not) by the requisite majority (in number and value) of those voting at the meeting.

3. Stage 3: if the scheme is approved by the creditors' meeting(s), an application must be made for the court's sanction. At that stage, the court is concerned to ensure that the creditors' meetings have been held in accordance with its previous order and that they have approved the scheme by the requisite majorities. If the court is satisfied that that is the case, it will have jurisdiction to sanction the scheme; but it may still decline to do so if, for example, it is satisfied that the majority approving the scheme failed to act in good faith in the interests of the class it purported to represent; or the arrangement is not one that an intelligent and honest man, who was a member of the relevant class and acting in accordance with his interests, would have approved.

The BAIC Scheme

BAIC provided personal accident and product liability insurance and reinsurance products for the aviation sector. In particular, its policies offered protection against claims made in the United States arising out of exposure to asbestos and pollution.

BAIC closed to new business on 1 January 2002. It was, and was expected to remain, solvent. Expert evidence suggested that BAIC would continue to receive new asbestosis claims on its occurrence-based policies until at least 2049. To reduce the length of its run-off, and to allow it to release capital to its shareholders, BAIC proposed a scheme that would crystallise and settle the liabilities on every policy effected before, and some policies effected during, 1991. The scheme divided BAIC's liabilities into 3 groups:

1. 'unsettled paid claims' where the amount of the claimant's claim had been ascertained and the policyholder's liability to the claimant, and BAIC's liability to the policyholder, had been established;
2. 'outstanding losses' where a claimant had made a relevant claim against a policyholder, the policyholder might be liable to the claimant and BAIC might be liable to the policyholder, but liability had not been accepted and quantum had not been agreed; and
3. 'incurred but not yet reported' ('IBNR') claims where the act or omission that might give rise to a claim had occurred, but the cause of action was not yet apparent or the claimant had not yet made a claim against a policyholder.

The scheme required policyholders to notify their actual and potential claims within 120 days (the 'bar date'). Claims not submitted before the bar date would be valued at nil and treated as paid. A designated scheme manager was to value each claim, in accordance with the scheme's rules. If his valuation was accepted, the policyholder's

claim would be paid and his legal rights would be surrendered; if his valuation was rejected, the policyholder's claim would be referred to a scheme adjudicator who would make a final decision.

Lastly, BAIC had an 'absolute discretion' to terminate the scheme if it 'no longer [regarded it as] beneficial'. If BAIC gave notice, the scheme would bind paid creditors, but unpaid creditors would revert to run-off as if the scheme had never existed.

BAIC Stage 1: the Order Convening a Policyholder Meeting

BAIC used a team of people to identify relevant policyholders and find their addresses. After 18 weeks, BAIC had addresses for 17,500 policyholders, but some were out of date. 35,000 other policyholders were thought to exist, but the team had been unable to identify and/or locate them. On 20 December 2004, BAIC gave written notice of its proposed scheme to the 17,500 policyholders. It also placed advertisements in national and international newspapers and asked 30 insurance brokers who had placed scheme business for the names and addresses of other potential policyholders. On 18 January 2005, BAIC asked the court to convene a single meeting of its relevant policyholders. No scheme policyholder was present or represented at the hearing. The court ordered the meeting and gave directions.

BAIC Stage 2: the Policyholders' Meeting

The policyholders' meeting took place on 15 March 2005, as ordered. The scheme was approved by 61% in number, and 85% by value, of the policyholders admitted to vote at that meeting.

BAIC Stage 3: court Sanction

18 directly insured US corporations with large potential IBNR claims opposed the scheme at the sanction hearing. They argued that the court could not (as a matter of jurisdiction) and should not (as a matter of discretion) sanction the scheme, for the reasons set out below:

1. **The notice of BAIC's stage 1 application was inadequate**

   It was said that BAIC did not notify enough policyholders, did not do enough to ensure that its policyholder addresses were up-to-date and that it failed to advertise in all of the countries where its policyholders were known to be established. The court rejected those arguments: '*The first stage application is purely procedural...whatever deficiencies there may be in notification of the first-stage hearing, they go neither to the jurisdiction of the court to sanction the*

scheme; nor, save in exceptional circumstances, will they be critical to the exercise of the court's discretion at the third stage' (Re British Aviation Insurance Company Limited [2005] EWHC 1621 (Ch) at paragraph 77). These particular complaints were '*counsels of perfection*'. The court was '*not prepared to say that, in the absence of taking these steps,* [BAIC] *had failed to take reasonable steps, without good reason, to notify those who might be affected by the scheme*' (*Re BAIC* at paragraph 78).

2. **Policyholders with, and policyholders without, IBNR claims had different rights. BAIC should therefore have asked the court to order two creditors' meetings, one for each class**

   The court agreed. Having done so, it necessarily found that stage 2 had not been completed and the scheme could not be sanctioned.

3. **Policyholders with actual or potential IBNR claims were treated unfairly at stage 2**

   For example, it was said that BAIC had reached an agreement with two creditors, by which: (a) BAIC would accept their IBNR claims at a substantial value (for voting purposes) without requiring them to provide the detailed information required from its other policyholders; and (b) those creditors would vote in favour of the scheme. That arrangement was compared to the position of 7 of the 8 insureds who had valued their IBNR claims at more than $1 and voted against the scheme. The chairman of the policyholders' meeting materially reduced the value of their IBNR claims and BAIC declined to meet them before the policyholders' meeting to discuss the value of their claims. The court was sympathetic: '*I have a very uneasy feeling that these IBNR claims were simply brushed aside' (Re BAIC at paragraph 109).* '[BAIC] *stressed ...the importance of creditor democracy...but the corollary of a fully functioning democracy is a fair and free election, where all creditors are treated equally...the real problem is that the votes of the policyholders with IBNR claims have to be estimated using sophisticated and controversial actuarial techniques. In such a case ...the court must be especially wary of simply waiving through a vote in which so many of the dissentients have had a nominal value placed on their claims*' (*Re BAIC* at paragraph 110).

4. **Two of the companies admitted to vote were subsidiaries of BAIC's majority shareholder**

   If the scheme was sanctioned, their parent would receive a substantial return on capital. In the circumstances, their votes should be discounted. The court agreed.

5. **Sixteen of BAIC's insureds reinsured BAIC's business. They therefore had an interest in the scheme because it would cap BAIC's liabilities, and that would cap their liabilities**

   It was argued that in the circumstances, they were not representative of the class of affected policyholders as a whole and their votes should be discounted. The court agreed.

6. **The bar date was too short**

   The court agreed, indicating that if it had been willing and able to sanction the scheme, it would have extended the bar date to a year and ordered extensive advertising to reduce the risk that affected policyholders would miss the deadline and lose their claims without knowing the scheme existed.

The court also criticised the scheme on other grounds, including that only BAIC and its shareholders would benefit from an accelerated run-off. The court also said:

> *'...it seems ... unfair to require the manufacturers who ... bought insurance policies designed to cast the risk of exposure to asbestos claims on to insurers to have that risk compulsorily retransferred to them.* [BAIC] *is in the risk business; and they are not...*[BAIC] *is able to meet its liabilities ... The purpose of the scheme is to allow surplus funds to be returned to shareholders in preference to satisfying the legitimate claims of creditors...To compel dissentients to* [accept a payment in full settlement of an estimate of their claims] *would ...require them to do that which it is unreasonable to require them to do'.* (*Re BAIC* at paragraph 143).

Following the BAIC Scheme, What Can a Scheme Promoter do, to Improve the Prospects of His Scheme Being Sanctioned?

There are a number of possibilities:

1. If there is time, the scheme promoter should consider waiting until the relevant book of business is 'old': the older the business, the easier it will be to: (a) fairly value the outstanding claims; and (b) show that there are few, if any, IBNR claims. The clearer and fairer the valuation methodology, and the less likely it is

that a material number of significant IBNR claims exist, the more likely it is that the court will sanction the scheme.

2. The scheme promoter should consider arranging his scheme so that it is factually different to BAIC's; and factually similar to one or more of the many other schemes that have already been sanctioned by the court. For example, the scheme promoter may wish to:

   - engage as many potential policyholders as possible in a pre-scheme consultation exercise. The aim is to allow policyholders to express their views on the potential scheme and the make up of the creditor class(es). A full consultation makes it more likely that the class(es) will be correctly drawn, and reduces the risk of a successful challenge on the class issue at the third stage. (A similar approach was taken in *Re Equitable Life Assurance Society* ([2002] 2 BCLC 510). It is also consistent with Practice Statement (Companies: Schemes of Arrangement) [2002] 1 WLR 1345, para 7: *while creditors who consider that they have been unfairly treated* [vis a vis the constitution of the creditors' meetings and/or the conduct of those meetings] *will still be able to appear and raise objections* [at the third stage], *the court will expect them to show good reason why they did not raise* [that] *issue ...earlier ...'*);

   - seek to reach a reasonable agreement with as many (large) creditors as possible so that the value of their claims (at least for voting purposes) has been agreed, and they are bound to vote in favour of the scheme. (*'There is nothing inherently objectionable about a company promoting a scheme ... reaching an agreement with some of its creditors under which they undertake to vote in favour of the scheme'* (*Re BAIC* at paragraph 103). Compare *R -v- Potter*, ([1953] 1 All ER 296): *'Persons who enter into a secret bargain with a creditor by which, in return for a guarantee of payment of his claim, he agrees to support a scheme, are guilty of conspiracy'*);

   - try to accommodate as many other potential creditors as possible, if they wish to discuss the value of their claims ahead of the stage 2 meeting;

   - set the bar date (if any) at a year (or more), before taking (or making it clear that he will take) all reasonable steps to publicise his scheme, so that the risk of a policyholder losing an indemnity against a valid IBNR claim without knowing about the scheme will be as low as reasonably possible;

- ensure that any discretion which allows the company to revert to run-off at its choice is tightly drawn so that it is clear when and how the company can revert, and when it will be prohibited from doing so;
- whenever possible, seek to ensure that genuine benefits will accrue to each class of creditor, as well as to the firm;
- if the scheme is solvent, offer a reasonable compensatory payment in return for every IBNR claim to be given up ; and
- try to secure the highest stage 2 meeting turn-out possible. Low turn-outs are common and there is nothing inherently wrong with this. However, the lower the turn-out, the greater the risk that the court will discount or disregard the votes of any creditors with a special interest and/or find the creditors' meeting(s) unrepresentative before declining to sanction the scheme.
- If the relevant company is an 'authorised person' for the purposes of section 31 of the Financial Services and Markets Act 2000, the scheme promoter should also ensure that:
- notice of the proposed scheme is given to the Financial Services Authority ("FSA") (see (a) rule 15.3.21R(4) in the Supervision manual of the FSA's Handbook; and (b) Principle 11 of the FSA's Principles for Businesses); and
- the company meets it other regulatory obligations. For example, see the FSA's "Principles for Businesses". Principle 6 says: 'A *firm* must pay due regard to the interests of its *customers* and treat them fairly' and Principle 7 states: 'A *firm* must pay due regard to the information needs of its *clients*, and communicate information to them in a way which is clear, fair and not misleading'). The Principles for Businesses will usually require the company to ensure that its customers are: (a) treated consistently and fairly for valuation, voting and all other purposes; and (b) are given enough information (which is clear, fair and not misleading) to be able to work out how the proposed scheme will affect them.

3. At the stage 3 hearing, it may also be appropriate for the scheme promoter to argue that:
   - the BAIC decision was made on its own facts (for example, that it only relates to solvent schemes of arrangement where some of the firm's business will continue in run-off and/or the firm has an unrestricted option to revert to run-off at a time of its choosing); and

- the court's finding that it had no jurisdiction to sanction BAIC's scheme was wrong as a matter of law and should be disregarded.

It might be possible to do that by arguing that, when the court considered whether the IBNR policyholders would have different rights in a scheme, it ought to have considered the *nature* of the IBNR policyholders' rights, rather than whether the *economic value* of those rights might change. If it had, the court would probably have found that the scheme did not change the IBNR policyholders' rights and that it did, therefore, have jurisdiction to sanction the scheme. In *Re Hawk Insurance Company Limited* ([2001] 2 BCLC 480), the Court of Appeal found that the IBNR policyholders' rights were materially the same as other creditors' rights and that, whilst their *economic value* might change if the scheme was implemented, the *nature* of those rights would not. See, also, *Re Equitable Life Assurance Society* ([2002] BCC 1319), where the court found that the *strength* of a particular right was irrelevant. The key was whether the *nature* of that right would change if the scheme was implemented.

A court could be directed to: (1) the evidence in BAIC (that every scheme policyholder had, or could have, an IBNR claim, and that many policyholders would have an IBNR *and* a non-IBNR claim); and (2) the nature of IBNR claims (that it is difficult or impossible to show, to a high degree of certainty, that a particular policyholder has, or does not have, an IBNR claim), before arguing that, on the facts of BAIC, the court ought to have reached the conclusion that there was only a single class of policyholders, because: (3) the scheme would affect all, or almost all, of BAIC's policyholders in the same way; and/or (4) it would be impossible, from a practical perspective, to satisfactorily separate out policyholders with an actual or potential IBNR claim from those without.

It is also worth remembering that BAIC was a High Court decision. It might therefore be taken into account in other High Court cases, but it won't be binding on them.

Since this article was prepared, BAIC has decided not to appeal the High Court's decision and the case has been followed and applied in *Re Home Insurance Company* ([2005] EWHC 2485 (Ch)).

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