Part VII Transfers and the Protection of Policyholders

by Paul Bugden

Since the first insurance business transfer scheme was approved in late 2001 they have grown enormously in popularity. This article reviews the background to such schemes in the UK and how they contrast with the procedures in other European states. It also reviews the purposes for which schemes are used and considers how policyholder protection is achieved and the issues which arise where policyholders consider they may be adversely affected by a proposed transfer.

As part of the drive towards harmonising the European insurance markets, the Third Non-life Directive required member states to put in place legislation allowing the transfer of insurance business from one EEA authorised insurer to another.

As usual, the Directive was not prescriptive of the form of the legislation and each member state was free to give effect to the objectives of the Directive as its legislature deemed appropriate. So, we now see a diversity of legislation throughout the EEA allowing the transfer of insurance business. The legislation in each state reflects its own political and social culture. So, for example, in France it is required that the workers' committee is consulted where a transfer affects jobs, whereas no such provision appears in the UK legislation.

Part VII of the Financial Services and Markets Act 2000

The legislation giving effect to the Directive in the UK appears in the Financial Services and Markets Act 2000 ("FSMA"), wherein Part VII deals with the transfers of both insurance and banking business.

It had previously been possible to transfer general insurance business in the UK: a process familiarly known as a Schedule 2 C transfer. However, there were weaknesses in the previous system, notably the absence of any mechanism for transferring the benefit of reinsurance protections in a manner that clearly bound reinsurers without the need to obtain their consent. FSMA presented the opportunity for a radical overhaul of the process in the UK including a cure for this problem.

There are various features of Part VII of FSMA, which distinguish the approach in the UK from other European states. I single out three of them for particular mention.

Firstly, it is a requirement that all transfer schemes are sanctioned by the court. In contrast, the norm throughout Europe is to allow the insurance regulator to sanction transfer schemes, as was the previous position in the UK in respect of general insurance. One of the benefits of having a court order sanctioning a transfer scheme is that it may assist with achieving recognition in countries which have agreed reciprocal recognition of judgments or in countries where the principles of comity between nations would be likely to lead to recognition of a UK court judgment.

Secondly, as the UK has traditionally drawn little or no distinction between insurance and reinsurance in legislation, this approach was followed in Part VII with the effect that it applies to both. Other European states have traditionally paid closer regulatory attention to insurance, mainly because it is seen as a product sold to consumers requiring protection, and have been relatively indifferent to the regulation of reinsurance. The result has been that, in the UK, it has been possible under Part VII to transfer both insurance and reinsurance or a mixture of the two. In other European states only direct insurance is transferable under their equivalent legislation.

This second distinction is now changing as a result of the Reinsurance Directive, which will harmonise the regulation of reinsurance throughout Europe and result in legislation in other European states permitting the transfer of pure reinsurance business. The Reinsurance Directive was supposed to be enacted in all European states by 10 December 2007, but many countries have not yet put legislation in place.

Thirdly, Part VII gives the court wide powers to transfer property including the benefit of outwards reinsurance protections. FSMA section 112(2)(a) provides that the court has power to:

> *"transfer property or liabilities whether or not the [transferor] otherwise has the capacity to effect the transfer in question"*

The first application for sanction of a transfer scheme under Part VII: Wasa International (UK) Insurance Co (2003)

Interpretation of this provision was considered in *WASA International (UK) Insurance Co v Wasa International Insurance Co (a Swedish company)* ((2003) 1 All E.R. (Comm) 696), which was the first application for sanction of a transfer scheme under Part VII (in which the author acted for the applicants). The question was whether this power extended to contracts of a personal nature such as contracts of employment, which are by their nature not transferable. It was postulated that contracts of reinsurance may be of a personal nature and thus would not be transferable. Park J decided that section 112 did give him jurisdiction to transfer the benefit of the outwards reinsurance contracts and he decided to exercise that jurisdiction. He said:

> *"Section 112(2) should be construed widely and gives the court power to sanction… the transfer of property or liabilities even in cases where those properties or liabilities might otherwise be non-transferable, for example by reason of express contractual provision."*

The *WASA* judgment has been followed on many occasions, even though there has been some academic debate as to whether it was properly decided. In order to put the matter beyond any doubt the Treasury issued a consultation paper in November 2006 on various aspects of Part VII, including a proposal for a statutory instrument providing that even where a reinsurance contract stipulates that it may not be transferred or that a transfer will bring it to an end or otherwise vary its terms, the court will nevertheless have power to transfer the benefit of such contracts. This statutory instrument is expected to be enacted shortly.

The ability in the UK to obtain an order transferring the benefit of outwards reinsurance protections considerably enhances the practical operation and value of transfer schemes and has played a significant part in their current attraction. Because transfers in other European states are not sanctioned by court order, there is no equivalent ability to obtain an order transferring the benefit of outwards reinsurance, which is a serious drawback in transfers elsewhere in Europe, where the transferring business is reinsured.

Part VII as a tool for insurers

Part VII has proved a versatile tool for insurers. It has been used to achieve numerous objectives including the following:

1. Reorganising an insurance group's corporate structure by transferring the business of one or more subsidiaries into a single subsidiary. This may be done to rationalise the business, for example, by reducing the administrative, fiscal and regulatory burden involved in running several subsidiaries with overlapping businesses and to achieve a more effective use of capital. It might also be done to achieve better management of certain business, for example, by moving all business in run-off into one subsidiary, where it can be more effectively resolved, perhaps through a scheme of arrangement, a sale or by outsourcing to professional run-off managers.
2. Sales of part of a company's business by transferring just the particular book or books of business, which the company no longer wishes to handle.

3. Collapsing pools by transferring the business of pool members to one pool member or third party thus bringing to an end all the complications involved in managing pools.
4. Achieving finality by transferring business which has previously been fully reinsured and managed by a reinsurer under a loss portfolio transfer arrangement or finality reinsurance. The transfer would usually be to the reinsurer in question so that the legal liability to policyholders moves to the party with the economic interest in the business, thus achieving true finality for the transferor.

One feature of the Part VII process is that it does not involve obtaining the consent of policyholders, nor does it give policyholders any right to vote on a proposed transfer scheme. Although this may seem striking at first, it is less objectionable when consideration is given to the various safeguards built into the process to protect policyholders.

Protections for policyholders

The protection of policyholders features strongly in Part VII and the statutory instruments and regulations providing the framework for effecting a transfer scheme. The following protections are in play:

1. The FSA closely monitors applications for transfer schemes and requires being informed as soon as it is proposed to embark on an application for approval of a scheme. Thereafter, the FSA is closely involved in the entire process. Its focus is on achieving its regulatory objective of protecting policyholders. Recently, the FSA has begun preparing its own reports for the court, which it is intended will be submitted both at the directions hearing and at the sanction hearing.
2. An independent expert who has to be approved by the FSA must review a proposed scheme and produce a Scheme Report, which will need to conclude that the scheme will not adversely affect policyholders, if the scheme is to be approved. The independent expert must consider the position of policyholders who will continue to be insured by the transferor, the position of transferring policyholders and the position of the existing policyholders of the transferee. A crucial consideration is whether the security of each group of policyholders is materially diminished by the transfer.
3. Policyholders must be notified of the proposed scheme both directly and through advertisements in the official gazettes and national press. Policyholders

must be given access to a summary of the Scheme Report and must be advised of their rights to raise objections in correspondence or at court.

4. Finally, a scheme is only effective if approved by court order, which will only be granted if, *"in all the circumstances of the case, it is appropriate to sanction the Scheme"*.

Provided proper care is taken in identifying and notifying policyholders, satisfying concerns raised by the FSA and in ensuring the independent expert is confident that policyholders and/or any reinsurers will not be adversely affected, there should usually be no difficulty in persuading the court to sanction a scheme. However, objections can and do arise.

One consideration, which is often apparent from the judgments, is that the court has no power to amend a proposed scheme and may only sanction the scheme as presented or decline to do so. A scheme will not be rejected because it could have been drafted more fairly to policyholders, provided that the proposed draft is sufficiently fair. (See, for example, Evans-Lombe J in *Equitable Life Assurance Society* (2007) EWHC 229 (Ch)).

The rights of parties to object to a transfer scheme: Re, Norwich Union Linked Life Assurance Ltd & Ors

There have been several decisions concerning the rights of parties to object to a transfer scheme. One of the most informative decisions was that of Mr Justice Lindsay in *Norwich Union Linked Life Assurance Ltd & Others* (2005) B.C.C. 586), (Ch), delivered on 1 December 2004. The scheme concerned the transfer of life business within the Aviva Group. There were 10 companies in the Aviva Group with long term insurance business and the proposed scheme was designed to reduce that number to four.

Policyholders' objections included the following:

1. **The scheme resulted in the reduction of the excess over the required minimum margin (RMM) of solvency of some of the companies whilst the excess over RMM of others was improved.**

   The complaint was twofold. Firstly, that there was unfairness between policyholders. Secondly, that the shareholders of the companies with reduced excess over RMM were benefiting at the expense of policyholders.

   The judge was not sympathetic to either complaint. He observed that the RMM is determined in accordance with EU rules, implemented in the UK through FSA regulations, and is intended to be a practical level of policyholder protection. He considered that insurers were free to reduce the excess over RMM as they saw fit and policyholders had no entitlement to security beyond RMM. He also relied on the opinion of the independent expert that any reduction in the excess over RMM would not cause any material suffering to policyholders.

As for shareholders gaining any advantage, the judge was not persuaded that there was any unfairness in the scheme. He felt that, whilst the simplified capital structure and improved capital raising ability undoubtedly benefited shareholders, this was no basis for considering the scheme unfair, especially considering that these features might ultimately have some benefit for policyholders.

2. **The independent expert was not independent because he was paid by the proposers of the scheme and had worked on other Aviva schemes.**

   This complaint was dismissed because the independent expert had stated in his report that he recognised that he owed his duty to the court and this overrode his duty to those paying his fees. His report also contained a statement of truth. As there was no evidence of actual bias or lack of independence there was no basis for declaring that any lack of independence existed.

3. **The independent expert had relied on information provided by the proposers.**

   The expert stated that he *"relied without independent verification upon the accuracy and completeness of the data and information provided to me".* Mr Justice Lindsay considered that such reliance was, in practice, *"inescapable"* as verification of all information could take years on a complex scheme. He was comforted by the consideration that much of the information relied upon had been audited or was the subject of returns to the FSA and so had been professionally scrutinised. Also, no specific criticism of reliance on any specific information had been made.

4. **The FSA did not positively approve the scheme.**

   It would be worrying if this complaint were to succeed, as the FSA does not usually positively approve a scheme, preferring instead to make no objection and to indicate that it will not attend the hearing. The judge recognised this protocol and determined that, as the FSA had been fully consulted throughout, had seen the evidence and had decided not to appear, and he assumed they had *"seen no shortcomings of any real significance in the proposals…"* (More recently the FSA has begun producing its own report and attending court hearings, so this basis for objection would now be hard to sustain in any event.)

5. **Information had been provided late and the scheme application should be rejected or adjourned.**

   It is not unusual that enquiries are raised late and information is provided close to a hearing date. The objector, having been provided with voluminous papers, suggested that he needed more time to study them and an adjournment should be granted. This application was rejected because the possibility of the objector being able to raise additional arguments based on the information provided was too remote to justify delaying the approval of an otherwise acceptable scheme.

6. **The scheme did not contain opt-out provisions or guarantees protecting policyholders.**

   The judge made it clear that the court had no power other than to approve or disapprove the scheme as drafted. It could not require amendments. It was for the proposers to construct the scheme as they saw fit, and provided it was fair, it would be approved even if objectors convincingly argued that it could be improved.

One concern which is sometimes raised is that a transfer scheme is a prelude to some other objective such as a sale or a scheme of arrangement. One such example arose in *Royal & Sun Alliance v British Engine* ((2006) EWHC 2947 (Ch)).

The scheme involved a series of intra-group transfers at RSA whereby the legacy business of several subsidiaries was placed into a single subsidiary. In that case, the independent expert commented in his report that the transferee company might be the subject of a subsequent sale, which would have the effect of ending a guarantee, by the main group operating company, that the obligations to transferring policyholders would be met by the transferee. The independent expert was satisfied, by information received from the FSA, that policyholders would be protected in the event of a subsequent sale. He believed the FSA's policies with regard to sanctioning a change of control would ensure policyholders were adequately protected. However, a reinsurer objected to the transfers on the grounds it was not satisfied that the FSA's powers on a subsequent sale of the transferee company were an adequate safeguard. Just before the sanction hearing the FSA consented to the disclosure of a letter it had sent to the independent expert explaining how it would protect policyholders on a subsequent change of control. The reinsurer sought and obtained an adjournment in order to consider the FSA's letter. Having done so, the objector then withdrew its objection.

Although there was no decision as such, the outcome suggests that a contemplated subsequent sale of a transferee company is unlikely to prevent a transfer scheme proceeding, because a change of control is subject to adequate safeguards should it subsequently occur. It is likely that similar arguments would arise in respect of any scheme of arrangement in contemplation at the time of transfer, where similar considerations would apply because policyholders would be protected through their voting rights and the requirement for court sanction.

The *RSA* case is also interesting on the subject of costs. The general rule is that, where objections have been properly made and have assisted the court in reaching its decision, objectors will be allowed to recover their costs from the applicant. In the *RSA* case, the objector sought an order that the applicants should pay its costs. However, the judge rejected this application on the basis that although there had been no contested hearing, the objector had wrongly challenged the independent expert's assertion that he had received FSA assurance that policyholders would be adequately protected on a subsequent sale and, in these circumstances, he ordered that the objector should bear its own costs. The *RSA* case demonstrates that objectors run the risk either of not recovering their costs or possibly even having an adverse costs order made against them if their objection proves to be an unfounded objection to grounds expressly relied upon by an independent expert.

The rights of parties to object to a transfer scheme: The Winterthur case

As the size and complexity of business subject to transfer schemes increases, so too is the likelihood of challenge increasing. A relatively recent example was the transfer from Winterthur of its Weavers business to Tenecom, a Berkshire Hathaway subsidiary. This transfer was heavily dependent upon two factors. Firstly, an undertaking by NICO, another Berkshire Hathaway subsidiary, to maintain the solvency of Tenecom until 2021 and secondly, an undertaking by NICO to increase its existing adverse development stop loss reinsurance cover by US$100m. A detailed series of questions were raised concerning the report produced by the independent expert, Mr Ipe Jacob. The general tenor of the questions was to challenge the conclusions reached by Mr Jacob, where the objectors suggested he had not sufficiently set out the basis for his opinions. The questions are too extensive to deal with in detail in this article but one feature deserves attention. Mr Jacob was challenged as to whether he had satisfied himself as to the legal enforceability of the solvency undertaking given by NICO, which was not contained in any agreement to which Tenecom was a party. He was similarly challenged with regard to the agreement to enhance the stop loss reinsurance. The result of the extensive enquiries was a delay whilst Mr Jacob prepared a further report to deal with the various issues that had been raised. It appears from the subsequent report that, during this time, Mr Jacob sought advice from leading counsel on both of the questions regarding legal enforceability and was able, in his second report, to confirm that he had been advised that both undertakings were enforceable.

It has subsequently become policy for the FSA to enquire as to the legal enforceability of guarantees and similar security to be provided in support of proposed transfers.

Hurdles faced by objections to a transfer scheme

Provided all procedural steps have been carefully implemented, objectors to a transfer scheme face a considerable burden in demonstrating valid objections. As the court relies heavily on the opinion of the independent expert, objectors will usually need to put his opinion in serious doubt. Challenging a professional's opinion is not easy as it involves establishing that the views he has expressed are open to serious doubt.

The decisions to date make it clear that challenges based on lack of independence would need to be established on evidence rather than inference drawn from the expert's source of remuneration or prior engagements. Actual evidence of a lack of independence is likely to prove difficult to establish, except in an extreme case.

Any attack on the opinion of the independent expert is only likely to succeed when a detailed criticism of his reliance on data or a deficiency in his reasoning can be illustrated. The practical difficulty is that policyholder's usually only see the report itself a little more than six weeks prior to the sanction hearing. Policyholders are not provided with all the evidence upon which the independent expert bases his opinion, unless they request it. So objectors first need to embark on requests for disclosure and then to undertake their own work to demonstrate that reliance on the data provided to the expert is open to question because it is inherently unsound or that his opinions are themselves unsound. This exercise will almost certainly involve external lawyers and consultant actuaries/accountants. As the disclosure process and subsequent analysis takes time, it is often only possible to formulate objections relatively close to the sanctions hearing.

Given the complexities often involved in a transfer scheme, it may be very difficult in practice for an objector, even when assisted by an expert of their own, to raise sufficiently cogent arguments to justify the court not proceeding with a sanction order. Even when the court is faced with weighing contrary opinions, unless the objector's views ought clearly to be preferred, a judge would understandably be inclined to prefer the opinion of the independent expert, who is approved by the FSA and who is bound by his duty, as an officer of the court, to express an objective view. Furthermore, the judge will appreciate that the independent expert has had the advantage of fully considering all the evidence at leisure and discussing it with the applicants and with the FSA, whereas the expert appointed by objectors will not have had such opportunities.

The Winterthur case demonstrates that raising valid criticisms can result in policyholders gaining further reassurance that their interests are not adversely affected, which may be of benefit even if the transfer proceeds, as was the case with the Winterthur scheme. Equally, valid criticism can result in the applicants making concessions for the benefit of policyholders in order to avoid a contested hearing.

Conclusion

The lessons to be learned are that objectors need to be well organised and to react promptly to determine whether a proposed transfer scheme is a real threat and, if so, to establish quickly what further information should be obtained and to get early assistance with formulating objections. It would be appropriate to raise objections with the FSA in the first instance and seek to invoke their help if there are concerns that policyholders will be adversely affected, as it is the FSA's role to protect policyholders.

Finally, the views of Mr Justice Lindsay in *Norwich Linked Life,* with regard to assessing whether a scheme is fair, need to be taken into account. He said: *"it does not follow that a scheme is unfair and hence to be rejected merely because one or more persons or classes of persons are adversely affected by it."* So the courts will regard the assessment of a transfer scheme as a balancing act and may approve a transfer scheme even where there may be some adverse consequences to some policyholders, provided they are outweighed by the overall benefits of the scheme. Any objector should look beyond its own interests and seek to establish that policyholders generally are adversely affected; otherwise the risk is that even establishing its own position is adversely affected may not suffice to defeat a proposed scheme.

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