It is only slight exaggeration to say that the Commission has powers as extensive as those once enjoyed by the Spanish Inquisition. They are effectively entitled to search premises, take copies of documents and to insist on answers to questions, including (to a limited extent) during the course of an investigation. The practice here is that the Commission will turn up a little before the start of the business day, often at a number of offices simultaneously, armed with its equivalent of a search warrant. If their overtures are refused, there is a simple procedure by which the Commission can, usually within about an hour, obtain a mandatory injunction from the Commercial Court requiring their admission. Leaving aside potential fines for contempt of court, the Commission has its own regime of fines which can be levied specifically for obstructing their enquiries.

Once on the premises, they can ask for all manner of documents relevant to their investigation. In this context, the concept of "legal privilege" is severely restricted, and almost non-existent as regards in-house lawyers and non-EEC lawyers. They can and do ask questions on the spot. The rules regarding what questions have to be answered on the spot are not straightforward; nor are the rules governing what documents must be produced and how documents may legitimately be withheld during the course of an investigation. "Dawn Raids", as they are sometimes known, have not yet afflicted the insurance sector, but it is only a matter of time before this happens. It is essential be to prepared!

EEC Anti-Trust Law has not traditionally been thought of as applying to the insurance sector. In fact, it does apply with full force to all those trading in and with the sector. It is important that everyone involved in cooperation within the insurance sector should be aware of the rules and of the potentially serious consequence of ignoring them.

BILA ANNUAL CONFERENCE
September 1993
"RECENT DEVELOPMENTS IN INSURANCE INSOLVENCY LAW & PRACTICE"
by Philip Singer, Cork Gully

At first sight the choice of "Recent developments in the Law and Practice of Insurance Insolvency" as the subject of a talk might seem to be a very narrow one. After all in any given year there will be a number of decisions dealing either with insolvency or insurance but the number of occasions when there is a conjunction of the two is likely to be limited.

Ordinarily this might well be the case but these are not ordinary times; rather they are extraordinary times and as a consequence the developments in the field of insurance insolvency both as regards law and practice in the last year or so have been considerable.

Why should I say these are extraordinary times? It cannot have escaped the notice of most observers, let alone those involved in one way or another with the industry that the insurance industry has suffered the most appalling losses in recent times. The consequence being that many insurers have withdrawn from the market either voluntarily or involuntarily in varying states of disarray.

In a career handling insurance insolvencies which now stretches back a quarter of a century with my firm I have been involved in the affairs of about 60 insolvent insurance and reinsurance companies or an average of about 2 per year. Between 1966 and 1971 there were a rash of collapses of secondary motor insurers and during that time my firm handled about 20 such cases, say nearly 4 per annum or double the average.

In 1992 we were instructed in no less than 12 cases involving insurance and reinsurance companies with combined liabilities in excess of $7 billion and on some estimates quite a long way in excess of that figure.

To my knowledge other firms of insolvency practitioners were instructed in at least 4 more cases.

The level of insolvency for insurance companies is unprecedented in modern times. Many of those insolvent insurers first took the step of going into run-off in the happy anticipation of being able to meet their liabilities in full. Regrettably as a result of adverse loss development a number of those companies were forced to become involved in some form or other of insolvency proceedings.

The following 14 companies exhibit three common features:

Andrew Weir	Bryanston
Chancellor	English & American
El Paso	Fremont (UK)
ICS Re	Kingscroft

Lime Street	Mutual Re
RMCA Re	Scan Re
Trinity	Walbrook

Firstly they each sought to run-off their liabilities on a solvent basis.

Secondly they each failed to achieve that and became insolvent.

Thirdly they each now seek to deal with the problems of their insolvency not by going into liquidation but by way of schemes or arrangement and in addition 12 of the 14 listed exhibit a further feature never before seen prior to March 1992.

In circumstances where there is a justifiable concern for the safety of a company's assets and where winding-up proceedings have been commenced it is open to the court to appoint a provisional liquidator who is ordinarily appointed to get in and preserve a company's assets pending the hearing of a winding-up petition and the appointment of a substantive liquidator.

In 1992 the directors of 4 insurance companies, Kingscroft, El Paso, Lime Street and Mutual Re (collectively "KELM") applied to the court for the appointment of joint provisional liquidators not only for the usual purposes outlined above but additionally to investigate and if thought practicable to promote a scheme of arrangement as an alternative to liquidation. Somewhat remarkably the court was persuaded of the merits of the proposition and joint provisional liquidators were indeed appointed under those terms. Since then a further 8 similar orders have been made and to date schemes have appeared not only for KELM but also for Walbrook and Trinity.

The scheme of arrangement is hardly a new procedure, and in one form or another its history goes back to at least the Companies Act 1862 and possibly before that. Thus an archaic procedure principally designed to enable a company under Companies Act provisions to reorganise its affairs has become the most modern tool in the armoury of the insolvency practitioner dealing with the problems of insurance company insolvency.

Why should this be? The reasons are many and not always obvious at first sight and beg the question why, if a scheme is preferable to liquidation, should not some of the other alternative procedures available under the Insolvency Act 1986 such as administration or corporate voluntary arrangements be even more preferable.

The answer to the latter part of this question would require a separate paper and indeed I have dealt with it as a separate paper annexed at Appendix A.

So why a scheme and why a provisional liquidator?

There are various reasons for appointing a provisional liquidator not the least is that it enables an independent licensed insolvency practitioner to take over the reins of the company restoring on occasions credibility which might otherwise have been lost by the directors. A number of things happen on the presentation of a winding-up petition and on the appointment of a provisional liquidator. After the presentation of a petition application can be made to the court to stay the continuation or commencement of any proceedings against the company without leave of the court (S. 126 IA 1986); to prevent the disposition of any assets of the company without leave of the court (S. 27 IA 1986); to prevent the attachment of the company's assets (S. 28 IA 1986) and to provide a "commencement date" for any subsequent winding-up proceedings. In addition the provisional liquidator has (subject to the order of the court) all the powers of a substantive liquidator including powers to get in the company's property (S. 234 IA 1986); enforce co-operation from those having information (S. 235 IA 1986) and to compel the attendance before the court of persons known or suspected to have possession of any property of the company or information concerning its affairs (S. 236 IA 1986).

In addition where the company in question has assets in the United States, such as reinsurance, the provisional liquidator constitutes a "foreign representative" in a "foreign proceeding" (as defined in S. 101 US Federal Bankruptcy Code) and thus a party of interest capable of seeking ancillary relief from the Federal Bankruptcy Court (S. 304 Federal Bankruptcy Code) but without submitting to the jurisdiction of the US court (S. 306 Federal Bankruptcy Code). I believe I am correct in saying that all 12 provisional liquidators appointed in relation to the cases mentioned above have each sought S. 304 relief. A fuller note on S. 304 is annexed at Appendix B.

The specific powers of the provisional liquidator are laid down in the order appointing him and may be as narrow or as wide as the court directs and of course the provisional liquidator may at any time go back to the court for additional directions.

So what is a scheme of arrangement and what advantages does it hold over alternative courses of action? These are more fully dealt with in Appendix A and will

of course vary from specific case to specific case but typically the advantages and disadvantages are as follows.

Advantages:

(i) **Flexibility.** A scheme can be tailored to deal with the specific problems and needs of any particular case.

(ii) **Cost.** The costs of a liquidation can be reduced or avoided in a scheme especially in relation to ISA fees.

(iii) **Speed.** A scheme can provide for the earlier realisation and distribution of assets to creditors.

(iv) **Currency.** Creditors' claims can be paid in their original currencies thus avoiding the exchange risk which would be unavoidable in a liquidation where claims in a foreign currency crystallise into sterling at the date of liquidation (Rule 4.91, The Insolvency Rules 1986).

(v) **Binding.** The scheme can be binding on all creditors including those who object to its provisions provided the statutory majorities are achieved and the sanction of the court obtained.

(vi) **Control.** The scheme may be drafted in order to effect appropriate checks and balances to ensure the proper administration of the scheme for the benefit of the creditors.

(vii) **Tax.** The scheme can be structured to ensure that tax losses are pre served which might otherwise be lost on a liquidation.

(viii) **Policyholders Protection Board.** The PPB have power (S. 16, PPA 1975) to provide financial assistance to companies in "provisional liquidation" or the subject of a scheme of arrangement. This means that creditors can obtain from the PPB the equivalent benefits of a liquidation but without incurring the disadvantages which might otherwise come with a liquidation.

A fuller description of the position of the PPB under both schemes and liquidation together with a review of the Court of Appeal decisions in Re Ackman and Scher v. PPB and the House of Lords decision in

Re Royal v. Ackman and Scher is found annexed to this paper at Appendix C.

(ix) **Investment.** Subject to the terms of the scheme, the scheme administrator can make investments on a commercial basis unlike a liquidator who has a limited range of investments which he is permitted to make.

(x) **Certainty.** Under the scheme creditors will know exactly the basis upon which the run-off of the company will be conducted. With a liquidation there is no certainty as to how a liquidator will conduct the affairs of the company until after he has been appointed.

There are however some disadvantages with a scheme.

(i) **Inflexibility.** Whilst a scheme can be extremely flexible nevertheless once the scheme is sanctioned there is in effect a written constitution under which its affairs will be conducted which can be difficult to amend should this prove to be necessary to meet the changing needs of the run-off.

(ii) **Reinsurance.** There is a small question mark over the ability of a scheme administrator to make reinsurance collections on unpaid claims. The position is (arguably) clearer with a liquidation.

(iii) **Liquidator's Remedies.** With a scheme outside of a liquidation there is the loss to creditors of the potential remedies which are available to a liquidator in respect of wrongful or fraudulent trading, voidable preferences and transactions at an undervalue.

Having dealt with the advantages of a scheme over liquidation I should add of course that a scheme is also available to a liquidator in order to enable him to achieve a specific purpose. In the case of Halvanon Insurance Company Limited which was an Israeli company writing domestic risks in Israel and reinsurance risks in London, a scheme was approved which effectively divorced the two sides of the business in order to enable the English liquidators to deal with the reinsurance business and the Israeli liquidator to deal with the Israeli business. It is also planned in the Halvanon case to lay a further scheme before creditors in the near future to deal with what I have called in the past "the liquidator's dilemma".

The liquidator's dilemma comes about in this way. In the ordinary course of events the liquidator of a trading company will in the first instance realise the assets of that company before they deteriorate, depreciate or otherwise disappear and then turn his attention to establishing creditors' claims and thereafter he will make distributions. With a reinsurance company in particular there is a particular problem because the liquidation of a reinsurance company is back to front since of course the assets of the company, in the form of its reinsurance recoveries, are a function of its liabilities so therefore in order to realise the company's assets it is first necessary to establish creditors' claims.

There is a further problem caused by the incestuous nature of reinsurance business where companies who may be cedants on some contracts are retrocessionaires on others. A retrocessionaire on receipt of a demand for payment from a liquidator may very well turn round and point out that he is in fact a creditor or a potential creditor and that until all his claims in the liquidation have finally been established and set-off against any claims against him he will pay nothing because on analysis it may turn out that he is in fact a net creditor.

This creates the next problem in as much as the tail of liabilities could well stretch 20 or more years into the future so that it may be many years before the company's liabilities are established and even longer before realisations are made.

Until a liquidator can be reasonably certain of the size of ultimate liabilities it is highly unlikely that he will be willing to pay interim dividends and if he does he will only do so having firstly made enormous retentions against the possibility of adverse loss development.
This is particularly bad news for creditors who are thus kept waiting for their money, the value of which reduces by the day as a result of the inflationary impact of the effluxion of time. This delay also has an adverse effect on the creditor companies' need to reserve for bad debts and will also affect their cashflow.

Creditors want and need their money now while it still has a value and can still be useful.

Many insolvent companies have identified the insolvency of one or more of their reinsurers as a cause of their own insolvency. This has been termed the "domino effect". However it seems to me that if the insolvency of one reinsurer can make another insolvent then the insolvency of two reinsurers increases the likelihood of a third becoming insolvent. Three insolvent reinsurers further increases the risk and so on. This is what I call the "snowball effect" where you have a situation akin

to a small snowball starting at the top of the hillside and rolling down, it getting bigger and bigger and going faster and faster all the time. The insolvency practitioner can probably do nothing about the fact of an insolvency but what he should strive to do is take every possible step to ensure that an insolvent company's money goes back into the market place as quickly as possible.

How can this be achieved? The answer is to be found in the Insolvency Rules 1986 and the Insurance Companies (Winding-Up) Rules 1985. The Act of 1986 at Rule 4.86 says "The liquidator *shall* estimate the value of any debt which by reason of its being subject to any contingency or for any other reason, does not bear a certain value; ....". Of course the Insolvency Rules do not tell a liquidator how he should carry out that estimation and so he has to turn to the Insurance Companies (Winding-Up) Rules 1985 where Rule 6 provides for the valuation of general business policies. These in turn refer to the First Schedule of the Rules where to cut a long story short at s. 2(2)(i)(b) he finds "in any other case, ... a just estimate of that value", which isn't particularly illuminating.

What is the benefit of estimation, recognising that there appears to be a compulsion upon a liquidator to estimate? The point is this; if a liquidator can establish a just estimate of a creditor's claims he can then apply the results of that estimate to the company's reinsurance programme and establish the liabilities of the company's debtors. To the extent that debtors and creditors are one and the same party their mutual claims can be set-off and the liquidator can very rapidly establish the net balance due to or from the company's creditors and debtors. Thereafter all being well the length of time that it takes for him to conclude his liquidation will be a function of the time taken to make collections from debtors.

Of course a liquidator when estimating a creditor's claim needs to ensure that that estimate is made final and binding and the simplest and most straight forward way of doing this is by way of a scheme which if approved will bind all creditors including dissentient creditors.

The mechanism by which the estimates are established is relatively straight forward although it does require tremendous actuarial input in order to ensure that the estimates are "just". A description of the methodology required would take another full paper.

Estimation seems almost too good to be true and one might question whether in fact there are any drawbacks. The most obvious one is of course that the estimates

could be wrong and that is indeed a possibility. However the likelihood is that any individual creditor will be a creditor of a number of contracts and so to the extent that any individual estimate is wrong then there should be a smoothing effect arising from the swings and roundabouts principle. On the whole the insurance market welcomes estimation as a means of returning funds to the market as quickly as possible and whilst one might expect reinsurers on occasions to question the procedure, there has to my knowledge only been one occasion when that has arisen. That was in 1992 (in Re A Company No. 0013734 [1993] 2 Re LR) where the liquidator of C sought to wind-up the company which had failed to respond to the liquidator's demands for payment. In a judgment by Mr Roger Kaye QC sitting as a Deputy Judge of the High Court, dealing with a number of issues, he said, on the question of enforcing a claim based on a valuation or estimate "...... I have considerable sympathy with the liquidators. Their argument has the undoubted merit of good common sense ...... it may well be that the consequential effect is that [estimation] also serves to fix the underlying liability for the purposes of claims by the petitioners against reinsurers. It may well be that many reinsurers did not challenge the order. It may be that the company may not be able to or will not wish to challenge the actuarial methodology ...... that is not, however a matter for me. In my judgment, however, the hearing of an interlocutory application to strike out a winding-up petition and the hearing of the winding-up petition itself is not the appropriate forum for resolving what could be an important and serious [matter] of fact and law affecting the insurance and reinsurance market as a whole. That seems to me an important consideration when all I have to decide is whether the arguments of the company have no real prospects of success and whether or not to allow this petition to proceed." Having considered this and several other factors Mr Roger Kaye QC concluded "All these factors, together with the other two issues, show to my mind that there is indeed a serious issue to be tried between the parties ......". He therefore rejected the petition. The matter remains undecided since the petitioner and defendant in the matter subsequently settled the claim.

The other question is of course whether the liquidator, or indeed a scheme administrator under a scheme, can recover from reinsurers where the company has merely admitted cedants' claims to proof but has not paid them. Until recently I would have said that the matter had been decided beyond doubt but that sadly is no longer the case.

The position as regards claims on quota share treaties was established as long ago as 1892 (Eddystone Marine Insurance Co [1892] 2 Ch 423; also Law Guarantee & Accident Society Ltd, Liverpool Mortgate Co's claim [1914] 2 Ch 617). Quota

share contracts being contracts of liability can be differentiated from excess of loss contracts which are contracts of indemnity. In the latter regard it had been felt that the matter had finally been decided in Home & Overseas Insurance Co Ltd v. Mentor Insurance Co (UK) Ltd [1981] 1 Lloyd's Rep 473. In that case the liquidator of Mentor (UK) had commenced arbitration proceedings. The arbitration clause contained an "honourable engagement clause" providing that the arbitrators should "interpret this reinsurance as an honourable engagement and they shall make their award with a view to effecting the general purpose of this reinsurance in a reasonable manner rather than in accordance with a literal interpretation of the language". The reinsurer sought a declaration under Order 14 to the effect that the arbitrators were bound to apply the strict wording of the contract which contained the usual "ultimate net loss clause" in which the cedants' ultimate net loss is decribed as the sum "actually paid" by him. The judge at first instance was fairly rude about the reinsurer's application and threw it out as being wholly inappropriate and they suffered the same treatment in the Court of Appeal. I believe, but do not know because of confidentiality, that in the subsequent arbitration the liquidator was successful.

That did not prevent the point being raised again in Re A Company above and until a court of law finally decides the point it will still be open to reinsurers to arbitrate.

There is a high order of probability that if a reinsurer ever succeeded on the point then the DTI would amend the regulations to require inclusion of insolvency clauses into contracts failing which cedants would be unable to take credit for reinsurance in their accounts. This was precisely the route followed by Superintendent Pink, the Superintendent of Insurance of New York, when he as liquidator of Southern Surety Company failed in an action against reinsurers (Fidelity & Deposit Company of Maryland v. Pink [1937] 585 US 162). Having amended the New York State law the amendment was subsequently adopted thoughout the United States and all contracts of reinsurance made in the United States now require that in the event of liquidation a reinsurer must pay the insolvent reinsured in full.

I shall conclude this paper with a brief review of the latest position of illegality which although not a problem limited to liquidators or scheme administrators seems to affect them more often than most, possibly because of the quality of business written by the insolvent companies which they handle. There is now a fairly lengthy chronology of cases dealing with illegality, the principal ones of which

are: Bedford Insurance Co Ltd v. Instituto de Reaseguros do Brasil [1984] 1 Lloyd's Reps 210; [1985] QB 966; Stewart v. Oriental Fire & Marine Insurance Co Ltd [1984] 2 Lloyd's Rep 109; [1985] QB 988; Phoenix General Insurance Co of Greece v. Halvanon Insurance Co Ltd [1986] 2 Lloyd's Rep 552; [1988] QB 216; [1985] 2 Lloyd's Rep 559; and Cavalier Insurance Co Ltd, re [1989] 2 Lloyd's Rep 430.

Having moved from the position that an illegal contract is unenforceable by any party the Cavalier case established that the cedant on an illegal contract could at least recover his premiums if no claims had been paid.

The line of cases are all very unfortunate and make thoroughly unsatisfactory law. A succession of judges have optimistically opined that no reinsurer would ever use his own illegality as a defence but regrettably that optimism has been ill-founded as a succession of them have.

Section 132 Financial Services Act 1986 was brought in to deal with the problem and made provision for either an illegal contract to be enforced or premium refunded.

In D R Insurance Co v. Seguros American Banamex [1993] 1 Lloyd's Rep 120 the plaintiff sought to argue that even if the contract was illegal he should nevertheless be capable of recovering from the reinsurer on the basis that the provisions found in Section 132 FSA 1986 are retrospective. The court, in a judgment which I have heard some commentators suggest is highly appealable, declined to find that the application of the Act was retrospective.
The position on illegality continues to remain thoroughly unsatisfactory and I am daily faced with reinsurers who are arguing their own illegality as grounds for refusal to meet claims raised by me.

To conclude I would observe that in the last 18 months or so insolvency practitioners have been faced with an enormous increase in the number of companies which have sought to withdraw from the market in an insolvent condition. In days gone by they would simply have been permitted to go into liquidation leaving a liquidator to sort out the problem. These days the rescue culture is much more in evidence and the courts are co-operating with those innovative practitioners who are seeking to find a better solution to a sometimes seemingly intractable problem.