INSURANCE INSOLVENCY

By Gabriel Moss Q.C. and Lloyd Tamlyn

This article discusses some of the issues which arise when an insurance company, or a broker, becomes insolvent. The first part of this article considers the insolvency of insurance companies, and the second briefly considers the insolvency of brokers.

Needless to say, an article of this length can only touch upon a few of the complex issues which arise out of insurance insolvencies.

Insolvency Processes for Insurance Companies

The appropriate insolvency processes for insurance companies differ to some degree from those which are appropriate for other companies. In part this is due to differences in the relevant legislation as it applies to insurance companies, in part because of the nature of insurance business.

Compulsory liquidation normally involves the termination of any ongoing business (other than run-off) and consists of the realisation and distribution of the assets of the company. No doubt because of a historic suspicion of voluntary liquidation, it is not available for insurance companies where the company writes long term business or where the company is registered abroad.

Legislation governing the liquidation of insurance companies is a mixture of the legislation governing all companies, normally found in the Insolvency Act 1986 , and specific provisions applicable to insurance companies only - mainly contained in the Insurance Companies Act 1982 and the Insurance Companies (Winding Up) Rules 1985. Some of the relevant statutory provisions, and recent developments in this area, are considered in an article in Insolvency Intelligence Volume 6 issue 6, *"Insurance law and insolvency: principles and recent developments"*, by Gabriel Moss QC. The recent spate of insurance insolvencies has evinced a clear preference for forms of insolvency process other than liquidation, for reasons discussed below.

Receivership is a secured creditor's remedy and not a true insolvency proceeding. It is rarely encountered in the context of insurance companies.

Although in principle the administration order process might appear to commend itself for insolvent insurance companies, in particular because it offers the company

the opportunity to protect its assets whilst putting forward a scheme of arrangement under section 425 of the Companies Act 1985, an administration order cannot be made in respect of an insurance company: section 8(4)(a) of the Insolvency Act 1986. This contrasts rather sharply with the attitude of the Irish government, which introduced a process akin to administration specifically for insurance companies before any such process was available for other Irish companies.

The 1986 Act originally excluded both banks and insurance companies from the scope of administration orders, probably on the basis that both are subject to special regulatory regimes. However, domestic banks have since been brought into the scope of administration orders and there is much to be said for insurance companies following suit. The DTI however appear to be in favour of a special new type of insurance insolvency procedure. This area is discussed in detail in *"DTI proposals for non-life insurance companies: a step in the wrong direction?"* by Gabriel Moss Q.C. in issue 6 of volume 8 of Insolvency Intelligence at p.43.

Provisional Liquidation and schemes

The restricted forms of insolvency process available in respect of insurance companies might suggest that liquidation is often the only possible option. However, the spate of insurance insolvencies over the last few years has seen a process known as provisional liquidation being used to achieve many of the advantages of the administration order process for insurance companies. The judicial willingness to adapt this form of process to modern needs has greatly aided this development. The adaptation of the process to modern conditions is discussed in an article by Gabriel Moss QC and Mark Phillips, *"Provisional Liquidators: new uses for an old remedy"* in Volume 6 issue 1 of Insolvency Intelligence.

The traditional form of provisional liquidation was and remains a form of interim procedure, lasting perhaps only a matter of weeks. The process was and still is used where an unpaid creditor feared that the assets of a company might be dissipated in the period between the presentation of a petition, and the making of a winding-up order. Hence, in cases where an unpaid creditor can justify its fear of dissipation to the court, a petition for winding-up can be presented, and an application made immediately for the appointment of a provisional liquidator, often the Official Receiver, to take control of the company's assets pending the making of a winding-up order. The provisional liquidator will typically be in office for a relatively short period, occupying a "holding role" pending liquidation proper by a liquidator.

This traditional use of the remedy has been adapted to rather different purposes in many cases of insolvent insurance companies over the last few years. The reason is that it will often not be in the interests of the creditors of an insurance company to enter liquidation. The nature of the business of an insurance company, and the complexity of the winding-up rules applicable to insurance companies, makes liquidation a slow, complex and expensive process. In particular, given that an insurance company's liabilities (and its reinsurance assets) may not become clear for many years after insolvency, a liquidator may not be able to make any significant dividend payments until the true financial position of the company is clarified, which can take many years. Unless a liquidator takes the step of making actuarial assessments of liabilities before they have crystallised, and thus makes payment on the basis of these estimates (a controversial step, unlikely to be done without a scheme), the liquidation of an insurance company may take 10 or 20 years.

In the case of compulsory liquidation where there are large assets there is also a huge price to pay as a result of the compulsory use of the Insolvency Services Account, which reduces the return on assets for creditors, and the imposition of fees.

Normally, it will be in the best interests of the creditors for the company to propose a scheme of arrangement under section 425 of the Companies Act 1985. The aim of a scheme is normally that the creditors of the company should agree to accept part payment in satisfaction in full of all their claims. For technical reasons they may simply agree to forego enforcement of the balance of the claim rather than release it. Meetings of various classes of creditors will be called to vote on the scheme, and if 75% by value of each class approves the scheme, and the Court gives its approval, then the creditors' rights are modified by statute in terms of the scheme The court will only approve a scheme if it is fair even to the dissenting minority.

A scheme of arrangement will provide the flexibility which is often lacking in the rules relating to the liquidation of insurance companies, as there are no hard and fast rules as to what a scheme may include. Crucially, a scheme can be framed so as to allow much speedier payments to creditors than would be the case in liquidation, through the actuarial assessment of contingent liabilities. Ancillary or simultaneous schemes can be proposed to creditors in different jurisdictions.

A scheme of arrangement may also be proposed in respect of a company incorporated abroad: section 425(6)(a) of the Companies Act 1985. The legislation is not clear as to whether a corporate voluntary arrangement under Part I of the 1986

Act can apply to a foreign company: the question is dicussed in *"Insolvency Administration for Foreign Companies in England"* by Gabriel Moss Q.C. in 15 Comparative Law Yearbook of International Business 3 at pp.9-11. Simultaneous schemes of arrangement were proposed in respect of two reinsurance companies incorporated in Singapore in *Re RMCA Reinsurance Ltd.* [1994] BCC 378. This enabled the creditors to agree to provisions which avoided the conflict between the different English and Singaporean insurance insolvency provisions as to preferential and priority creditors. The court decision confirmed that for convenience the meeting in the English scheme could be held in Singapore and that it was possible to hold a class meeting of only one creditor, the Singaporean Inland Revenue.

A scheme of arrangement also has a crucial advantage over a voluntary arrangement under the Insolvency Act 1986, in that a voluntary arrangement will only bind those creditors of a company who have had notice of the arrangement in accordance with the Insolvency Rules 1986: section 5(2)(b) of the 1986 Act. An insurance company will often not be certain of the names and addresses of all of its creditors, particularly in relation to contingent claims such as IBNR. Section 425 is more flexible in this respect, allowing the Court to direct, for example, that notice of a meeting of creditors can be given by advertisement.

The problem faced by an insolvent insurance company which wishes to propose a scheme is that a scheme will take a considerable period of time to put in place, usually a period of months and sometimes longer. An insurance company will usually become insolvent not in the sense that it will be unable to pay its debts as they fall due, but because its contingent liabilities exceed its present and future assets. If an insurance company is actuarially insolvent, the directors should cease to pay claims and should cease writing new business. Such action will in any event usually be forced upon it by the DTI, as the company will fail to satisfy the relevant solvency margin criteria necessary for continued authorisation. Unless the company's assets are protected pending the agreement of a scheme, then unpaid creditors, possibly in foreign jurisdictions, could execute over the assets of the company, obtaining payment in full for themselves to the detriment of the general body of creditors. Sometimes the mere cost of defending litigation, especially in the USA, can itself threaten a substantial diminution of assets for creditors.

Provisional liquidation provides a process whereby the assets of the company can be protected by a statutory stay on actions and executions pending the approval of a scheme. It is now clear that it is perfectly proper to present a winding-up petition

even though the purpose of the petitioner is not to wind-up the company immediately (or if possible, at all): *Re Esal Commodities Limited [1985] BCLC 450; Bowkett v Fullers United Electrical Works Limited* [1923] 1 KB 160,166.

The company, its directors, or a creditor, can present a winding-up petition. At the same time, application can be made for the appointment of provisional liquidators. The powers which the Court can grant to provisional liquidators under section 135 of the 1986 Act are theoretically unlimited. Often, the powers will include the power to take all necessary steps to seek the approval of a scheme of arrangement and also the power to take steps in foreign jurisdictions to protect any overseas assets of the company. Indeed, in the insolvency of Andrew Weir Insurance Co. Ltd., provisional liquidators were appointed by Mr Justice Harman simply to enable the company to apply in the United States courts to protect the American assets of the company: see 6 Insolvency Intelligence 30.

Under section 130(2) of the 1986 Act, after the appointment of provisional liquidators, no action or proceeding can be proceeded with or commenced against the company or its assets without the leave of the court. Individual creditors would not normally be given leave to execute over the assets of the company. The courts have held that this English statutory stay has no effect abroad: hence the need to apply to courts in foreign jurisdictions to extend the stay.

When the winding-up petition is heard, it is normally adjourned for periods of as long as six months at any one time, if a viable scheme can be shown to be in preparation.

Hence, the process of provisional liquidation has been used in recent times to enable insurance companies to benefit from a process in practice similar to administration orders. In the last few years, over a dozen insurance companies have been placed into provisional liquidation, primarily with a view to proposing a scheme of arrangement with their creditors. In several cases (such as the KWELM Companies, who wrote business on the Weavers' stamp) this process has been successful, resulting in the dismissal of the winding-up petitions following approval of the schemes. Others are in provisional liquidation with a view to proposing schemes at the time of writing this article. The provisional liquidations have also enabled the companies concerned to protect assets in foreign jurisdictions, such as in the United States, where section 304 of the United States Bankruptcy Code allows for relief to be granted to amongst others English provisional liquidators so as to prevent foreign creditors from executing over American assets. Section 304 also enables the provisional liquidators to apply for discovery of documentation, examinatons on oath and the handing over of assets in the US.

Thus, the most striking feature of insurance insolvencies in recent times has been the general absence of any significant liquidations proper. In large part, this is the result of the flexible use of provisional liquidation, aided by the commercial attitudes of the courts in this respect. There may, however, be exceptional cases where liquidation will be appropriate, where, for example, it is anticipated that significant claims may be made under remedies not available under a scheme but available in a winding up, such as the avoidance of preferences under section 239, and transactions at an undervalue under section 240. The likely recoveries would probably have to be very substantial to counteract the disadvantages of liquidation.

It is worth noting that sometimes assets can be sufficiently protected pending the putting together of a scheme without the aid of provisional liquidators. It is possible for a company which is actuarially insolvent simply to present a winding-up petition, using section 126 of the 1986 Act (the discretionary stay provision) to protect its own assets: see *Bowkett v Fullers United Electrical Works Limited* [1923] 1 KB 160.

The KELM and Charter Re insolvencies began in this way, with the directors retaining their management control of the companies' assets. In the case of *Kingscroft Insurance Company Limited,* initial and limited protection of the company's assets was achieved in the United States under section 304 of their bankruptcy code, even though no provisional liquidators had, at that time, been appointed: *Kingscroft Insurance Co. Ltd. 138 BR 121* (Bankruptcy SD Fla 1992). The reasoning in that decision is not wholly satisfactory and would not necessarily prevail in more important jurisdictions such as the Southern District of New York. Moreover, both the English Companies Court and creditors tend to be wary of substantial assets and the putting forward of scheme proposals remaining under the control of directors and tend to prefer to have one or more well-known authorised insolvency practitioners in charge. Any directors trying to make a go of it on their own will at the very least need thorough advice on the dangers of personal liability under the Insolvency Act 1986.

Corporate Broker Insolvency

Where a corporate broker has become insolvent, the normal forms of corporate insolvency procedure are applicable. Liquidation may be appropriate, if there is nothing to do but to collect assets and make distributions. Even then an administration order may have tax or other tactical advantages in the interests of creditors. Administration orders are available to try to save the company and its

business, or at least produce a better realisation The possibility of a scheme of arrangement or voluntary arrangement can be judged on its own merits without the special insurance company factors being involved..

One of the broker's main assets will often be its goodwill, thus the value of its ongoing business. The goodwill will often be valueless on liquidation. If so, then when a broker is insolvent, consideration should be given to attempting to sell the goodwill prior to the commencement of any formal insolvency process. If this is to be attempted, directors will need to take great care, and it will be appropriate to seek the advice of an insolvency practitioner and lawyers expert in insolvency law.

If a rescue or at least a better realisation than in a liquidation requires protection from creditors, an administration order would appear to be the appropriate form of insolvency procedure. Thought also needs to be given to moving the broker's accounts prior to formal insolvency proceedings, for the reasons explained below.

There are particular features of broker insolvency which invite attention. First, there is the question of the ownership of one of the major assets in a broker insolvency, being the monies which a broker will normally hold representing premiums paid by policyholders intended for onward payment to insurers. If the broker is a non-Lloyds broker, then these should be held in an IBA account. Brokers are obliged to set up such an account pursuant to the Insurance Brokers Registration Council (Accounts & Business Requirements) Rules Approval Order 1979 (SI 1979 No.489), which was effectively enacted by the Insurance Brokers Registration Council under the Insurance Brokers Registration Act 1977. Part III of the Rules, and in particular paragraph 6, deals with the setting up of IBAs, and the conditions which govern their use. For some time, there was a question as to whether monies held in an IBA account were held on trust for the payers of the premium, so that in a liquidation, the policyholders could trace into the account, and reclaim the premiums which they had paid in full. In *Re Multi Guarantee Company Limited* (Unreported) 31 July 1984, Mr Justice Harman decided that the monies in an IBA account were not held on trust, and so could be realised by a liquidator and distributed to creditors in the usual way.

It should be noted however that certain insurance companies have attempted to use contractual terms to impose a trust for themselves in respect of monies required to be paid into IBA accounts and there is litigation currently proceeding to determine the validity and effect of such provisions.

A further point must be considered prior to the initiation of any formal insolvency process. Where an IBA account is set up, it is provided by the regulations referred to above that the bankers will acknowledge that they have no right to set off other accounts (for example, overdrawn office accounts) against the IBA account. On liquidation, any such acknowledgement may cease to have effect, since it has been held in other contexts that in liquidation mandatory insolvency set-off rules apply notwithstanding any agreement to keep accounts separate. Hence, if no steps are taken prior to liquidation the broker's bankers may receive payment of any sum due to them in full, to the detriment of all other creditors. So, prior to liquidation, the broker should in the interests of the general body of creditors ensure that the IBA account is made safe, for example by moving it to another bank.

Set-off

Particular problems may also arise in applying the insolvency set-off rules in the context of insurance company insolvency where business is written through brokers. The matter is covered in detail in an article by the authors, "Net Accounting and set off in insurance insolvency", in Volume 6, issue 10 of Insolvency Intelligence. The insolvency set-off rules, which are found in rule 4.90 of the 1986 Insolvency Rules, in essence provide that where the insolvent company and its creditor have incurred mutual debts, credits and other dealings prior to liquidation, then there shall be a set-off, so that the mutual dealings are netted off, and either the creditor proves in the liquidation for the net amount owing, or if he turns out to be a debtor to the company, he pays the liquidator the net amount which he owes. The insolvency set-off rules have been held by the courts to be mandatory, so that the parties cannot contract out of them.

Although the insolvency set-off rules appear simple and have been in force in substantially similar form for over a century, they give rise to a number of difficulties.

The problem with the rules in terms of business done through brokers is that the insolvency rules are founded on a bilateral, principal to principal approach. Typically, the market does not operate on that basis. Brokers in practice may well operate their own form of contractual set-off, through net accounting or net net accounting. This can be a multi-lateral system of set-off, involving a number of

different principals. The broker may in practice be a one-man "clearing house" of debits and credits involving different principals. This contrasts with the compulsory bi-lateral system of insolvency set-off. As a result, whilst multi-lateral set-off may be proper whilst all the relevant principals are solvent, after liquidation of one of the principals, its debts can only be subject to bi-lateral set-off. A contractual term destroying by a purported set-off a debt which is otherwise an asset of the liquidation will probably be held to be void. This has already been held to be the case in litigation about the IATA clearing house: ***British Eagle v Air France*** [1975] 2 AER 390.

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