

Commentary

British Insurance & Schemes Of Arrangement What The Hell Are They?

By
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Over the last decade, more than 30 insolvent schemes of arrangement have been approved in England — and more recently, a similar number of proposed solvent schemes of arrangement have been announced — all of which directly impact the rights of U.S. policyholders.

American policyholders are effected because America is the largest insurance market in the world and many Americans bought insurance policies from companies that are now in British Schemes of Arrangement.

What are they? What is an “insolvent scheme” versus a “solvent scheme?” How do they help or hurt U.S. policyholders?

Technically speaking, a scheme of arrangement is a compromise or “arrangement” under English law (Section 425 of the 1985 Companies Act) between the company and its creditors to run-off the company's liabilities under an agreed format. In the case of

insolvent schemes, the run-off will pay at less than 100¢ on the dollar.¹ It is the functional equivalent of a Chapter 11 Reorganization Plan in this country. It is also vastly preferable to liquidation in the U.K. which can be very expensive.

For a solvent scheme of arrangement, the major difference is that the run-off of the company's liabilities will be at 100¢ on the dollar. For management, the purpose of using a solvent scheme of arrangement is to terminate the insurance business and recapture any remaining capital for the shareholders. See generally Tom Riddell, Solvent Schemes in the London Market — Will the Bubble Burst?, Excess, Surplus Lines and Reinsurance Committee Newsletter (ABA, Tort Trial & Insurance Practice Section, Chicago, Ill.) Spring 2005 (“Solvent Schemes”).

For a proposed Scheme (solvent or insolvent) to become final and binding it must first be approved by a majority in number and 75% in value of those voting at the Scheme meeting — and sanctioned by order of the English court.

How Does An Insolvent Scheme Of Arrangement Work?

Without getting into mind-numbing detail, once a policyholder's claim has been filed with the Scheme and “approved” (or what the British call “crystallized”), it is set for payment — on an installment basis. In order to protect against preferential treatment of creditors whose claims become approved in the early years of the run-off to the detriment of

those policyholders that have contingent long-term claims (such as environmental or asbestos claims) — approved claims are paid on an annual installment basis. For example, in the first year after approval of the insolvent Scheme, an interim payment percentage of 10% may be established. If a policyholder has an approved claim of \$1,500,000, the policyholder's payment in that first year will be \$150,000. The second year installment will be made in the ensuing year as further assets (e.g. reinsurance) are collected and more of the liabilities are fixed. In the second year, the installment percentage may be increased to 15% in which case the first year policyholder will get an additional 5% (in this example, \$75,000) plus interest. This procedure of incremental increases in payment percentages will continue throughout the life of the run-off. At the end of the run-off, the policyholder may obtain total percentage of payment which is significantly higher.

The insolvent schemes of arrangement have met with a favorable response from U.S. policyholders because of (1) the transparency of the company's financial condition — which is the subject of annual reports to the public, (2) the installment payments, and (3) the efficient process for approving claims. In comparison with the normal insurance insolvency process that occurs in this country, the British system is seen as more transparent and efficient. In the U.S., insurer insolvencies are run by the various states and there is almost no transparency regarding the financial condition of the company, at least on a timely basis. In addition, policyholders can wait for years and even decades for payment.

In any event, there comes a point in time in the life of any insurer insolvency when it becomes more economical to close the run-off rather than continuing to pay all the expenses required in administering the remaining unresolved claims. In England, when this occurs, the run-off is closed by an amending Scheme with a published bar date for filing claims. At that point all claims are determined or agreed (even long-tail contingent claims) and subsequently, final dividends are issued.

Solvent Schemes Of Arrangement

After schemes of arrangement were successfully utilized for insurance company insolvencies, schemes were adapted for solvent run-offs. The primary motivation for solvent schemes of arrangement are to

benefit the insurance companies' management and shareholders by quickly terminating an unsuccessful insurance business or line of business, unlocking any surplus for the shareholders — and avoiding the possibility of insolvency in the longer term. *See* Ridell, Solvent Schemes at 1, 4.

The solvent scheme establishes a bar date and hopes to cut-off all liabilities for the terminated insurance business — after paying all their policyholders.

This all sounds well and good. But is it? While an insolvent scheme has many benefits to U.S. policyholders, the same may not be true for solvent schemes.

With insolvent schemes, the policyholders are concerned with getting as much money as they can — as soon as they can. Most policyholders and other creditors realize they will sacrifice some of their rights (such as receiving 100¢ on the dollar) so that the estate is handled efficiently, payments are made promptly and all creditors treated equally.

These policyholder concerns are not necessarily the same with solvent schemes.

In the case of a solvent insurance company, the primary interest of policyholders is to receive what they paid for — insurance protection for a future loss. That is particularly true with policyholders who have potential long term liabilities involving claims that have not even been filed against the policyholder yet (e.g. future asbestos or environmental claims).

A 'Bad' Court Ruling

These issues and a number of others came before the London High Court in the proposed solvent scheme of arrangement for British Aviation Insurance Company Limited ("British Aviation").

British Aviation is an old insurance company whose main liability involved U.S. claims for products liability and general liability arising out of asbestos, pollution or other health hazards which were underwritten on an "occurrence" basis and therefore subject to triggering British Aviation policies for years and perhaps decades into the future.

British Aviation said its proposed Scheme would finalize all liabilities and set a final bar date after which

no further claims could be filed. The period that was the subject of the scheme included all the business British Aviation wrote between 1930 and 1990.

The relevant regulatory authority in Britain, the Financial Services Authority, did not raise any objection to the proposed scheme.

However, a number of policyholder creditors did object to the Scheme. The most material objections were (1) two separate voting classes should have been required for scheme voting and (2) the scheme was unfair to long-tail policyholders and claimants.

In a decision rendered earlier this year, Justice Lewison agreed and refused to sanction the proposed scheme.

- (1) IBNR Creditors as a Separate Voting Class: While schemes to date generally have lumped all creditors into one class, Justice Lewison thought the interests of policyholders with accrued or pre-agreed claims substantially differ from the interests of policyholders with long-tail claims.

“[T]hose with accrued claims and those with IBNR claims have interests which are sufficiently different as not to make it possible for them sensibly to consult together ‘in their common interest.’ In truth, they do not have a common interest at all.” In re British Aviation Insurance Co. Ltd., [2005] EWHC 1621 (Ch) 165, [92] (Eng.).

As a result, the Court rejected the Scheme stating that British Aviation should have held two separate voting classes and the scheme would only proceed by obtaining the approval of a majority of both.

- (2) The Fairness Issue: On a more significant issue, many policyholders objected on the ground that it was unfair to have their cover for contingent claims removed by fiat.

The English court held:

“[T]he effect of the proposed solvent Scheme on . . . long tail policyholders is that their valuable and irreplaceable insurance cover would be extinguished at a time when asbestos and other latent injury claims under the

policies are beginning to materialize.” In re British Aviation Insurance Co. Ltd., [2005] EWHC 1621 (Ch) 165, [51(iii)] (Eng.).

The judge went on to say:

“In the end, though, the most powerful consideration is that it seems to me to be unfair to require the manufacturers who have bought insurance policies designed to cast the risk of exposure to asbestos claims on insurers to have that risk compulsorily retransferred to them. The Company is in the risk business; and they are not. This is not a case of an insolvent company to which quite different considerations apply. On the evidence presented to me the Company is able to meet its liabilities under such policies as and when they fall due. The purpose of the scheme is to allow surplus of funds to be returned to shareholders in preference to satisfying the legitimate claims of creditors. No matter how usable and reasonable an estimate may be, the very fact that it is an estimate is likely to make in an inaccurate forecast of the actual liabilities of policyholders. If the individual policyholders wish to compound the Company’s contingent liabilities to them, and to accept payment in full of an estimate of their claims, there is nothing to stop them from doing so. But to compel dissentients to do so would, in the words of Bowen LJ, require them to do that which it is unreasonable to require them to do.” Id. at [143].

In sum, the Court ruled the Scheme was unfair — that British Aviation is solvent and would obviously benefit from the proposal by permanently extinguishing its policyholders’ long tail liabilities — and retransferring the risk to policyholders at a time when asbestos, environmental and health risks are only increasing.

What Will Happen?

To say the least, the British insurance industry is not happy with the decision. Several solvent schemes in the “pipeline” have the jitters. In fact, the recently proposed Scheme for 18 Dutch Aviation insurance companies known as the Dutch Aviation Pool carved out from the scheme all direct policyholder claims

including those with potential long-term claims so that the issues raised in the British Aviation decision would be avoided:

In the proposed Scheme for Lion City Run-Off Private Limited, the directors recently announced:

“The Directors of the Company have decided to postpone the Creditors’ Meeting originally scheduled for 1 September 2005 in order to evaluate any potential implications for the Company and the Scheme arising from the recent judgment concerning The British Aviation Insurance Company Limited.”

The proposed run-off of Scottish Lion Insurance Company Limited was withdrawn.

At the same time, the Scottish Court of Session on September 1, 2005 approved the solvent scheme of Mercantile & General Reinsurance Company Limited (“M&G”) — despite similar (although tardy) objections from creditors (who also failed to appear at the court hearing). The Scottish court ruled that only one class of policyholders and creditors was required and that the proposed scheme was fair as to long-tail claimants. While this decision may provide some comfort to supporters of solvent schemes in the U.K., it should also be noted that the case was influenced by the fact that the creditors of M&G were for the most part insurance companies with sophisticated knowledge of the industry and insurance policy rights.

Recently, the appeal of the British Aviation decision was withdrawn.

Which side will prevail?

While American policyholders emphasize the British Aviation holding on the issue of fairness, U.K. lawyers and insolvency practitioners focus upon the two voting classes issue. Knowing the British, and as a U.S. attorney who has been involved with British Schemes of Arrangement (for both insolvent and solvent), let me suggest that I would be fully confident in the influence of the many business interests in the U.K. that favor solvent schemes of arrangement. As a result, I would predict: with a tweak here and a tweak there, solvent schemes will prevail.

By that I mean that solvent schemes of arrangement will be approved if (among other things):

- (1) The voting process is fair;
- (2) There are two (and possibly more) voting classes, one with IBNR claims;
- (3) A fair basis is established (perhaps even replacement insurance) for resolving IBNR and pure IBNR claims; and
- (4) The scheme promoters make a major effort to pre-sell the scheme to creditors and amicably resolve through settlement a majority of the IBNR claims.

In addition, there are many reasons why U.S. policyholders may favor (in certain circumstances) a solvent scheme:

- (1) Business reasons: The U.S. policyholder may favor a quick estimation and payment on their old policies. There may also be cash flow reasons prompting the decision to obtain payment now rather than later.
- (2) Coverage Problems: The U.S. policyholder may decide to accept an estimation rather than fight potential future coverage issues.
- (3) Insolvency: Concerns regarding the eventual insolvency of the scheme company may be an incentive for many policyholders.
- (4) Satisfaction with the estimation process and the “pre-sell” of the solvent scheme.

In sum, there will undoubtedly be more developments but this author predicts there will also be more solvent (and insolvent) schemes.

If your insurance company is part of the London Market and has entered into a solvent (or insolvent) scheme, here are a few things you can do to protect your rights:

- (1) Review your policies and determine what coverage was or could be effected.

- (2) If you haven't already, obtain replacement coverage.
 - (3) Communicate with scheme personnel — a claim will not be paid unless they know who you are.
 - (4) Ascertain if you are protected by the British Financial Services Compensation Scheme if it is an insolvent scheme.
 - (5) When the Scheme of Arrangement is proposed, review and analyze it.
 - (6) If you hear a scheme is being proposed, attempt to negotiate your IBNR claims early rather than after the scheme is issued.
 - (7) Cast your vote for (or against) the Scheme. Your vote is one way to put the liquidators on notice that you are a claimant in the liquidation.
 - (8) Team up with other policyholders in the same situation to increase your clout. If you are a substantial creditor, you may even want to join the creditors committee.
 - (9) Monitor the liquidation proceedings in the U.K. (and the U.S.) to protect your rights.
 - (10) Act.
- There is money to be had in British Schemes of Arrangement but you cannot rely on Scheme Administrators to hand it to you. You must grab it.

Endnote

1. Although a few have actually paid 100¢ on the dollar. ■