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UK Insurance Insolvency – Achieving Finality

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The ultimate achievement in insurance insolvency is "finality". Over time the procedures for dealing with insurance insolvencies have evolved with solutions now being implemented which enable insolvencies to be concluded and final distributions made to creditors at a much earlier stage than had previously been possible.

Finality or closure can now be achieved through the use of the scheme of arrangement (scheme), now generally accepted as the primary tool for dealing with the resolution of an insurance company's insolvent run-off and increasingly used as a mechanism for achieving finality for solvent companies, either in respect of the whole of their business or for certain classes of discontinued business.

Dealing with insolvency

Schemes of arrangement have been used for some time for insolvent insurance companies as they generally represent a better alternative for creditors than liquidation. This is particularly due to the rigidity of the winding up rules for insurers and the delays that are likely to be experienced before dividends are declared. An insolvency process is however required to provide a stay on proceedings whilst the company's strategic options are being considered. The most commonly used insolvency proceedings for insurers are provisional liquidation or administration.

Provisional liquidation

This was generally the preferred process before a modification in UK Insolvency law in May 2002 resulted in administration for the first time becoming available for insolvent insurers. The usual process was that the directors would petition the Court for a winding up order which when coupled with the appointment of a provisional liquidator (an independent, licensed insolvency practitioner) would provide a stay against an action or proceeding in the United Kingdom, against the company or its property. The winding up petition is usually adjourned so that whilst the company is protected from creditor attack it is not in liquidation. The provisional liquidator takes over day-to-day control of the company and its assets in accordance with a Court order and will also investigate the circumstances surrounding the company's insolvency.

Provisional liquidation was in origin only intended to be used as a short term mechanism to protect the company against any action or proceeding that a creditor may seek to take to gain advantage over creditors as a whole, pending the hearing of the winding up petition.

The winding up of an insolvent insurance company is not something that can usually be concluded in a short period of time particularly where the insurer wrote long term business such as employers' liability cover. For such a company, claims could potentially continue to arise for thirty to forty years hence. Further, there are often disputes, particularly in respect of large losses, to be settled and reinsurance to collect. A mechanism is therefore required to ensure that there is an orderly run-off of the company's business and that the maximum possible distribution is made to creditors in the shortest practicable time without prejudicing the potential reinsurance recoveries. These insurance specific issues led to the development of the scheme, further discussed below.

Administration

This insolvency process also protects the company from creditor attack and has some similarity to the Chapter 11 process in the US. The administrator is an independent licensed insolvency practitioner and is required, shortly after appointment to call a meeting of the company's creditors in order to present his proposals for achieving the purpose of the administration order.

A significant difference between the administration rules for an insurer versus those for other companies is the extension of Rule 4.90 of the Insolvency Rules 1986, which deals with set off of the amounts due between an insolvent company and a creditor at the liquidation date. Article 5 of the Order permitting administrations for insurers requires set-off to be determined at the date of the presentation of the administration petition, thus preventing debt trading during the period of the administration. Debt trading could enable a creditor to achieve a better position

than they would have obtained had a winding up petition been presented against the insurer on that date. In the context of an insurer this is considered appropriate as the complexity of a company's reinsurance arrangements could result in it taking some years to establish a creditor's net position.

The administrator, in investigating the matters leading to the insolvency of the company has additional powers over a provisional liquidator to investigate and apply to the court to set aside antecedent transactions. An administrator does not however have the power to pursue the directors for fraudulent or wrongful trading therefore it is necessary to weigh up the relative disadvantages of liquidation when assessing the benefits of putting a company into liquidation to pursue for example a wrongful trading asset.

The administration process for insurers further differs from that for other companies as the administration order gives the administrator of an insurance company the power to make payments to creditors (subject to the approval of the creditors or the court). While in theory a court could grant a provisional liquidator the power to pay creditors, in practice it is likely to require a scheme to be put in place first, so that creditors and the court have an opportunity to review the proposals.

The recent changes to UK insolvency law introduced by the Enterprise Act 2003 recognise the potential complexity of an insurance insolvency in allowing administrators of insurers a thirty month period before they are required to return to court to seek permission to extend the administration, whilst for other businesses this is now only a period of one year.

It is now expected that most UK insurers will be placed into administration if they become insolvent.

Policyholder compensation

The Financial Services Compensation Scheme (FSCS) (created under the Financial Services and Markets Act 2000 to replace a number of compensation schemes, including the insurance industry compensation scheme operated previously by the Policyholders Protection Board (PPB)) exists to protect certain policyholders who may be prejudiced as a result of the insolvency of their insurer. The FSCS also has discretion to give financial assistance to insurance companies in financial difficulty, even though they are not formally insolvent, in order to allow them to continue to effect or carry out contracts of insurance.

The availability and level of compensation depends on the type of insurance policy and excludes reinsurance, marine, aviation, transport business, credit insurance and Lloyd's policies (although there are now proposals to bringing Lloyd's into the compensation framework). Risks outside of the EEA are also excluded.

For certain compulsory classes of insurance policy, (for example Employers' Liability and Third Party Motor), the FSCS will meet claims in full. For non-compulsory classes of insurance (and generally only in respect of private policyholders and small businesses) compensation is restricted to 100% of the first £2,000 of the agreed claim and then 90% of the balance. Additionally the FSCS will respond where claimants would have had a third party claim against the insolvent insurer by virtue of the fact that the policyholder is also insolvent. This is particularly relevant in the context of Employers' Liability business.

The involvement of the FSCS within insolvent run-offs is further discussed below.

Achieving an orderly run-off

In order to achieve an orderly run-off the solution needs to be acceptable to all the company's stakeholders, which could include policyholders, claimants, reinsurers, brokers, and the FSCS.

Schemes of arrangement, under section 425 of the Companies Act 1985 have emerged as the preferred tool for dealing with the insolvencies of insurers and reinsurers as they provide the flexibility that insolvency practitioners require to tailor a solution that addresses the specific circumstances of each case and is capable of being drafted in a way that balances the needs of the business's stakeholders. A scheme is a compromise or arrangement between the company and its creditors or any class of them, and becomes legally binding on all creditors or any class of creditors if the necessary majority or creditors or class of them vote in favour of the scheme and it is approved by the High Court.

Whilst not all stakeholders would be bound by the scheme it may benefit them if it provides them with certainty and / or finality in respect of their liabilities. The scheme can therefore be structured in a way in which they are able to participate. An example is the FSCS. In order to protect the interests of policyholders who would have been paid under the FSCS in the event of a liquidation or other insolvency procedure, the FSCS will generally be a party to a scheme and the scheme will formalise the relationship between the FSCS and the company. In such circumstances the FSCS would either pay the policyholder the applicable level of compensation, or top-up the payment from the company, and usually then have a subrogated claim against the company under the scheme.

There are a number of different types of scheme which broadly fall into the following categories:

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- Run-off schemes
- Cut-off schemes (also referred to as a valuation or crystallisation schemes)
- Hybrid schemes
- Contingent schemes

Run-off schemes

A run-off scheme will typically operate by enabling the company to continue to agree and process claims in the same way as within an ordinary solvent run-off although there may be special provisions for those claims subject to litigation.

As the company is insolvent it will however only pay a certain percentage of the amount owing to the creditor following the agreement of the claim. The payment percentage is set from time to time by the scheme administrator based on an actuarial assessment of the company's liabilities and is usually set initially at a very prudent level to ensure that there is not a risk to those creditors whose claims mature in the future, of there being insufficient funds to pay them at the same level. The balance due to the creditor is recorded as a debt owed by the company and as over time the company achieves greater certainty as to its available assets and ultimate liabilities, the scheme payment percentage is likely to be increased. Where claims have already been paid at the lower level creditors will be paid a further amount.

Cut-off schemes – achieving finality

Where insurance policies have been written on an occurrence basis, claims could potentially continue to arise indefinitely. It is therefore very difficult to finalise the run-off of a company that has written long tail business. In response, a type of scheme has been formulated, which is effectively a commutation with all policyholders, allowing the company's ultimate liability to be actuarially estimated, a payment percentage to be set based on this estimation and a final distribution to be made to creditors.

This is known as a cut-off scheme as a 'bar date' is set, enabling determination of the company's liabilities at this time. Under the terms of the scheme, policyholders will be required to submit claims by the bar date, following which the company will either agree the claims or submit them to independent adjudication. The process therefore facilitates a wholesale estimation of all present and future claims by a set date with a view to making a final payment to creditors much earlier than would have been achieved under a long-term run-off scheme.

The scheme can be formulated such that claims can either be submitted under a 'claims allocation' or 'claims submission' basis. Under the claims allocation basis the scheme will use an actuarially determined estimation methodology to provide policyholders with a value for the contingent element of their claims. Correspondingly under a claims submission basis creditors are invited to estimate the value of their future claims together with supporting evidence to be agreed by the company. Both methods have their advantages and disadvantages and the appropriate method will depend on the circumstances of that particular business.

An example of a case where the valuation scheme methodology has been used is Andrew Weir Insurance Company Limited. Andrew Weir became insolvent in November 1992 and a run-off scheme became effective in April 1994. This scheme provided for claims to be processed and agreed as they would in a normal solvent run-off, albeit creditors were only paid a percentage of their claims as and when they were agreed. Almost ten years later, a significant proportion of Andrew Weir's remaining reserves of $500m were in respect of asbestos, pollution and health hazard risks and it was considered likely to be many years before these liabilities fully matured. In addition, it was considered unlikely that the payment percentage could be increased for some time because of the company's low reinsurance cash flow. These issues meant that finality was not something the creditors could have expected in the short term. Following consultation with the creditors' committee, approval was achieved to trigger a valuation option contained in the original scheme. This option allowed for contingent liabilities to be valued as at a particular point in time. Andrew Weir is therefore currently in the process of crystallizing its liabilities, calculating and collecting its remaining reinsurance recoveries in order to pay a final dividend to scheme creditors and bring about finality for the estate. The scheme will therefore be closed and final payments made much sooner than would have been the case if the run-off were left to continue to natural expiry. This is one of the first such schemes, and the largest to crystallise a substantially direct book of business.

Achieving finality where there is FSCS involvement

The PPB, and latterly the FSCS have been involved in reserving schemes for a number of years, however prior to the development of the scheme for North Atlantic Insurance Company Limited, a company with liabilities estimated to be in excess of $800m there had not been a cut-off scheme for an insolvent run-off involving FSCS protected policyholders.

North Atlantic's protected claims were largely professional indemnity and Employers' Liability business, and the first difficulty in concluding the run-off was that the Financial Services Authority had indicated strongly its concern about the legality of any employer agreeing to commute an Employers' Liability policy,

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because of the potential impact on third parties which might benefit from claims under the policy. It was therefore necessary to find a way to achieve finality for North Atlantic's creditors whilst enabling the continued run-off of long-tail policies. The second issue was that even if commutation was possible, the IBNR (incurred but not reported) reserve for Employers' Liability business is generally calculated on a class basis as it is impossible to determine in advance which policyholder will actually incur the loss in the future. This results in a difficulty in putting a present value on future claims from protected policyholders other than as a class.

As compulsory Employers' Liability business is all protected by the FSCS, it was possible to devise a solution which separated the cut-off of the estate from the run-off of the Employers' Liability, and other protected policies. For protected policyholders, the scheme actuary therefore placed a present value on all outstanding and IBNR claims in respect of the protected policies as a class. Dividends in the scheme will be paid to the FSCS based on this class valuation and protected policyholders whose claims are finally agreed at a later date within the scheme period will be paid directly by the FSCS at the appropriate protected percentage. Protected policyholders' claims that are finally agreed after the scheme period in a subsequent liquidation will be paid directly by the FSCS whose obligations will be triggered by the liquidation in accordance with the FSCS rules.

This process ensures that even once the estate's liabilities are cut-off, protected policyholders will receive the protected percentage whenever their actual claims are agreed and the FSCS continues to make payment in accordance with its rules. The FSCS will continue to pay claims in this way as the policies remain valid until the company is dissolved. Following conclusion of the scheme, the company will pass into the hands of the Official Receiver, thereby avoiding further run-off costs.

Hybrid schemes

It is not always possible to implement a cut-off scheme early in the run-off and often insolvent estates will commence with a run-off, rather than cut-off scheme with it being necessary at some future date to put in place the estimation methodology to achieve closure. The timing of this will often be influenced by the significance of the reinsurance assets to be collected and uncertainty as to how reinsurers may react to the crystallisation of inwards losses. Commutation of the reinsurance may be risky until it is known how the inwards losses will settle. For an insolvent insurer, its reinsurance will often represent a significant asset for the estate. Commonly the wording of the reinsurance contract is such that once the insurer has been found liable to pay the underlying claim, the reinsurer is required to pay irrespective of whether the insurer has actually paid.

A solution to this issue has been the development of the hybrid or "double dip" scheme, referred to as such because creditors have two opportunities to vote on the features of the scheme. Whilst it is not possible to bind reinsurers in a traditional scheme, this type of scheme provides a mechanism whereby they can more actively participate in the scheme process. Following creditor and court approval of the scheme, there will generally be a period of time during which the company will progress commutation discussions with its major reinsurers and the reinsurers will be asked to indicate the sums that they would be prepared to pay in settlement of their obligations. Creditors will then have a second opportunity to vote, this time on whether to accept the reinsurers' offers. Reinsurers will be aware that if their offers are not considered satisfactory, creditors will chose to revert to a long-term run-off which also has the effect of removing the early prospect of certainty and finality not only for the creditors but also for the reinsurers.

This scheme recognises the fact that reinsurance assets are often significant for insolvent insurers by enabling their participation in the scheme process but protecting creditors by giving them the ability to vote to revert back to a run-off scheme if they consider this to be preferable based on the outcome of the discussions with reinsurers.

Contingent schemes

Insolvencies inevitably result in considerable disruption to business, and insurers are no exception. A contingent scheme may be an effective way of dealing with a company that has concerns about its ultimate solvency without the need for insolvency proceedings.

Such a scheme was formulated for Chester Street Insurance Holdings Limited, one of the UK's largest Employers' Liability insurers, whose solvency was at the time, marginal. The aim of the scheme was to ensure that significant disruption and costs would be avoided if Chester Street became insolvent.

This involved a two part scheme. The first part operated such that it allowed the business to continue its normal run-off for as long as the company's assets exceeded its current and expected future liabilities. It however provided that if Chester Street became insolvent, the second part of the scheme would be triggered and the company would enter into what was referred to in the scheme as the 'reserving period'.

The reserving period was effectively a run-off scheme however it had provisions enabling Chester Street to continue to pay its non-insurance creditors in full, thereby ensuring minimal disruption to the claims handling process. In addition, the scheme allowed Chester Street to continue to make payments to its insurance creditors, albeit at less than 100%,

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with a mechanism to ensure that the FSCS 'topped up' these payments in the same way as they would have done had the company been in liquidation.

In the event Chester Street did subsequently become insolvent and the reserving period was triggered upon sanction of the scheme. Had this scheme not been in place, the company would have been placed into provisional liquidation and in all likelihood payments by the company would not have commenced for at least a year and Chester Street's tens of thousands of policyholders and claimants would have faced a far worse position.

Conclusion

The scheme of arrangement has facilitated the development of innovative solutions for a large number of insolvent insurers (as shown in Table 1) bringing real benefits to both creditors and other stakeholders.

In addition, this methodology has recently been successfully applied to solvent companies with books of discontinued business. As Table 2 demonstrates this has provided an exit route for a wide range of insurers including those with involvements in underwriting pools, and certain overseas companies deemed to have sufficient connection to the UK. This has allowed excess capital to be released to shareholders or more effectively redeployed elsewhere in the business.

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Table 1: Insolvencies

Insolvency Procedure		*Organisation*
Administration	*Date of Administration*	*Administrators*
Folksam International (UK)	19 July 2002	PricewaterhouseCoopers
Provisional Liquidation	*Date of Provisional Liquidation*	*Provisional Liquidators*
Återförsäkring AB LUAP - UK Branch	1 July 2002	PricewaterhouseCoopers
Black Sea & Baltic	24 August 1998	PricewaterhouseCoopers
Compagnie Europeenne de Reassurances [1]	7 December 1998	PricewaterhouseCoopers
HIH [2]	16 March 2001	KPMG
Home UK Branch	8 May 2003	Ernst & Young
Independent	17 June 2001	PricewaterhouseCoopers
Municipal General [3]	9 March 1994	Mazars
UIC	12 August 1996	Grant Thornton
Run-off Scheme of Arrangement	*Current Dividend*	*Scheme Administrators*
Anglo American	80%	KPMG
BAI (Run-off)	5%	PricewaterhouseCoopers
Bermuda Fire & Marine	33%	Ernst & Young
Chester Street	5%	PricewaterhouseCoopers
Drake	Undeclared Deloitte	
English & American	30%	KPMG
ICS (UK)	100%	PricewaterhouseCoopers
KWELM [4]	K-51%, W-43%, E-56%, L-55%, M-38%	PricewaterhouseCoopers
Monument	36.9% (final)	PricewaterhouseCoopers
OIC Run-Off (formerly Orion), London & Overseas [5]	42%	PricewaterhouseCoopers
Paramount	47% (final)	PricewaterhouseCoopers
Sovereign	35%	KPMG
Trinity	65%	PricewaterhouseCoopers
Valuation Scheme of Arrangement	*Current Dividend*	*Scheme Administrators*
Andrew Weir (converted from run-off)	36%	PricewaterhouseCoopers
Aneco	70%	PricewaterhouseCoopers
Bristol Re	49%	PricewaterhouseCoopers
Bryanston (converted from run-off)	34%	PricewaterhouseCoopers
Chancellor (converted from run-off)	25%	Deloitte
Charter Re	25%	PricewaterhouseCoopers
Fremont (UK)	38.3% (final)	PricewaterhouseCoopers
Hawk	23% (final)	PricewaterhouseCoopers
ICS Re	88.8% (final)	PricewaterhouseCoopers
North Atlantic	Undeclared	PricewaterhouseCoopers
Pan Atlantic	Undeclared	Grant Thornton
Pine Top	24.9% (final)	Ernst & Young
RMCA Re	75%	PricewaterhouseCoopers
Scan Re (converted from run-off)	80.5% (final)	Ernst & Young
Stockholm Re (Bermuda)	25%	Deloitte
United Standard	Undeclared	PricewaterhouseCoopers
Liquidation	*Current Dividend*	*Liquidators*
Continental Assurance [6]	Undeclared	PricewaterhouseCoopers
Dai Ichi Kyoto	Surplus funds remitted to Belgian liquidator	PricewaterhouseCoopers
Kobe	Surplus funds remitted to Belgian liquidator	PricewaterhouseCoopers
National Employers Mutual General ("NEMGIA")	35%	KPMG

[1] There is also a concurrent liquidation in France. The French liquidator is M. Jean Claude Pierrel.
[2] The following companies in the HIH group entered into provisional liquidation on the dates shown: FAI General – 23 March 2001, FAI Insurances 10 April 2001, FAI Underwriting 12 Feb 2002, HIH Casualty & General 16 March 2001 and World Marine & General Insurances Pty 10 April 2001.
[3] Jackie Stephenson and Graeme Gadsby are the provisional liquidators to Municipal General and are assisted by Mazars.
[4] Chris Hughes and Ian Bond are the scheme administrators to the KWELM companies and are assisted by PricewaterhouseCoopers.
[5] Certain claims are presently being paid in full by OIC Run-Off and London & Overseas.
[6] Joint appointment with David Buchler.

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Table 2: Solvent Schemes

Solvent Scheme of Arrangement	*Scope*	*Home Jurisdiction*	*Organisation*
Arig (UK)	Company	UK	PricewaterhouseCoopers
City General	Company	UK	PricewaterhouseCoopers
Crombie (UK)	Company	UK	KPMG
Dunedin pool (4 companies):			
– Continental Management Services	Book of Business	UK	PricewaterhouseCoopers
– Cornhill	Book of Business	UK	PricewaterhouseCoopers
– Dowa (Europe)	Book of Business	UK	PricewaterhouseCoopers
– Tower	Book of Business	UK	PricewaterhouseCoopers
Hassneh (UK)	Company	UK	PricewaterhouseCoopers
HIR (UK)	Company	UK	Grant Thornton
Hopewell International	Company	Bermuda	None
ING (5 companies):			
– Assurantiemaatschappij "De Zeven Provinciën" (also known as "The Seven Provinces")	Company	Netherlands	PricewaterhouseCoopers
– "Transatlantica" Herverzekering Maatschappij	Company	Netherlands	PricewaterhouseCoopers
– Nationale-Nederlanden Schadeverzekering	Book of Business	Netherlands	PricewaterhouseCoopers
– Nationale-Nederlanden Internationale Schadeverzekering (also known as "NV The Netherlands Insurance Company Est. 1845")	Book of Business	Netherlands	PricewaterhouseCoopers
– Mercantile Mutual (Australia)	Book of Business	Australia	PricewaterhouseCoopers
La Metropole	Book of Business UK Branch	Belgium	PricewaterhouseCoopers
Marlon	Book of Business	UK	PricewaterhouseCoopers
Mutual of Omaha (UK)	Company	UK	PricewaterhouseCoopers
National Insurance & Guarantee Corporation	Book of Business UK		PricewaterhouseCoopers
Nichido Fire & Marine of Japan	UK Branch	Japan	None
Osiris	Company	UK	KPMG
Ramus	Company	Bermuda	PricewaterhouseCoopers
Scottish & Commonwealth	Company	Bermuda	PricewaterhouseCoopers
Transcon	Company	Bermuda	PricewaterhouseCoopers
Trent	Company	Bermuda	PricewaterhouseCoopers

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