

PART VII TRANSFERS: AN UPDATE

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INTRODUCTION

Since Part VII of Financial Service and Markets Act 2000 (FSMA 2000) took effect there has been great interest in the use of this restructuring tool within the run-off sector of the non-life insurance market in the United Kingdom. The majority of Part VII insurance business transfer schemes effected in the non-life sector have been in relation to run-off business. Part VII transfers are an extremely flexible tool which companies can use to restructure their businesses.

Under Part VII the policies and the underlying reinsurance protection transfers from the transferor to the transferee company without the time consuming and expensive task of separate novation of each individual policy and reinsurance contract. Hence it provides a neat solution to a company seeking to reorganise its affairs using this tool.

A recent high profile Part VII transfer case is the transfer of the 1992 and prior years non-life business of underwriters at Lloyd's (also known as "Names") to Equitas Insurance Limited (EIL). Mr Justice Blackburne handed down his judgment on this case on July 7, 2009.

The Part VII process has been used largely to simplify the internal structure of groups previously operating a number of separate run-off companies within one financial group. The successful Equitas transfer involved long tail liabilities and unique security, in the form of unlimited liability of Names.

Hence, it appears that the Part VII transfer provisions of FSMA 2000 continue to achieve their purpose: helping insurance companies to reorganise their affairs in an expedient manner and to achieve finality as far as the original underwriter is concerned. This is the case even with complex transfers such as that of Equitas.

AMENDMENTS AND UPDATES

In order that the plan for the proposed Equitas Part VII transfer could be implemented and achieve its objective of finality for all Lloyd's Names in respect of the 1992 and prior year non-life business, the Part VII legislation had to be amended.

First, an amendment needed specifically for the purposes of the Equitas transfer was that the definition of Lloyd's underwriting members be adjusted to include those who ceased to be underwriting members before December 24, 1996. This was duly achieved in the amendments to the legislation which took place in June 2008, after a consultation process which started in 2006.

Further, Part VII of FSMA 2000 in its original form did not make express provision as to whether the outwards reinsurance protection transferred with the liabilities being transferred, though the Wasa case in 2002 established that the rights under the outwards reinsurance did transfer once the Part VII transfer was sanctioned by the court. Nevertheless, the relevant provisions of FSMA 2000 were also amended in 2008 making it clear that the court does have the power to transfer outwards reinsurance

contracts even if the contract seeks to prohibit their transfer. However, notice must be given to the outwards reinsurers in respect of the proposed transfer to give them the opportunity to decide whether they wish to appear at any of the court hearings should they feel that they are adversely affected by the proposed transfer. The court can in fact waive the obligation to notify, depending on the specific circumstances, and allow a more general form of notification by way of advertisement, as was done in the Equitas Part VII transfer. The fact that ambiguity as to the transfer of the underlying reinsurance asset has been removed is very important in the case of Equitas, since there was over \$700 million of reinsurance from potentially thousands of outward reinsurers.

EQUITAS' SUCCESSFUL TRANSFER USING PART VII

In brief, as a matter of background, in 1996, as a result of significant and ongoing losses, including some major natural disasters, and continued liability to asbestos and pollution claims underwritten by Names, a reconstruction and renewal plan was promoted and put in place at Lloyd's. Equitas was formed and under this, the Equitas Reinsurance Contract was arranged to protect policyholders and underwriters with respect to 1992 and prior non-life Business and create an environment for the ongoing Lloyd's market. The effect of reconstruction and renewal is that the 1992 and prior business is reinsured by Equitas

Reinsurance Limited (ERL) which in turn is reinsured by Equitas Limited (EL).

On March 30, 2007 Equitas entered into a run-off reinsurance contract with National Indemnity Company (NICO), a member of the Berkshire Hathaway Group. NICO provided US\$5.7 billion worth of reinsurance protection to Equitas over and above the reserves at March 31, 2006. This was phase 1 of the Equitas transaction with NICO. This initial phase also involved the transfer of claims and reinsurance run-off operations to the Berkshire group and so Equitas Management Service Limited (EMSL) was moved from the Equitas group to the Berkshire group. EMSL was renamed Resolute Management Service Limited.

Even though the \$5.7 billion layer of reinsurance protection was available after phase 1, the problem of unlimited liability remained for Names who had underwritten the 1992 and prior years business at Lloyd's. In the event that Equitas ever became unable to cover the whole amount of the Names' liability, Names would continue to be exposed.

A successful Part VII transfer of the business would achieve legal finality for Names with respect to the laws in England and Wales and countries in the EEA. The plan was to transfer all the 1992 and prior non-life business to a new company. This would mean that legal liabilities of Names under the original policies would be transferred to the new company. Phase 2 of the NICO transaction involved NICO providing a further US\$1.3 billion worth of reinsurance protection for a premium of £40 million as long as the business was transferred under a Part VII transfer from Names by December 31, 2009. As mentioned previously the transferee is Equitas Insurance Ltd (EIL).

The Equitas Part VII business transfer was designed to keep in place as much of the existing structure as possible—including preserving trust fund structures and certain guarantees that had been provided by Lloyd's in the past. Insofar as the transferring policyholders are concerned, the only significant change is that instead of Names being liable under the policies, EIL

has become the insurer or reinsurer of the transferring policies.

THE ROLE OF THE INDEPENDENT EXPERT

When a Part VII business transfer is being proposed it is required that an Independent Expert be retained. An Independent Expert's report is required for the purposes of any Part VII transfer under Section 109 of FSMA. The Independent Expert is required to consider the proposed transaction and consider the impact of it on policyholders and other stakeholders. The Independent Expert must consider the structure as it currently stands and the proposed structure in the event of the transfer being sanctioned. The Independent Expert does not consider alternative transactions, only the transaction being proposed.

The Independent Expert sets out the results of his review of the likely effects on the various groups of policyholders and other stakeholders in the event of the proposed transfer being sanctioned. When completed the report is sent to the Financial Services Authority (FSA) for their consideration. The FSA consider it and set out in writing whether they agree with the form of the report or not. The Independent Expert's report is then filed with the application for the proposed transfer in court. It is usually made available on the transferor company's website set up to disseminate information about the transaction to policyholders. In the case of Equitas, Allan Kaufman from Navigant Consulting was appointed to act as the Independent Expert. The FSA will make a report to the court for both the directions hearing and the sanction hearing, hence there will typically be two FSA reports to court. Though, the FSA will make further reports to the court on proposed transfers as it sees fit.

The size and issues related to the Equitas proposed Part VII transfer were unprecedented and correspondingly the work required by the Independent Expert was also unprecedented. The Independent Expert had to consider the security offered by Names compared with the security

offered by NICO's extra US\$1.3 billion in the event of the proposed transfer being sanctioned. Extensive actuarial modeling had to be undertaken, reviewed and challenged. The probability of Equitas becoming insolvent also had to be addressed, together with the likely recovery rate of funds from Names in the unlikely event of an Equitas insolvency. Arriving at a recovery rate from Names is complicated as there are so many individuals involved (a fragmented population from which to seek recoveries)—some Names are already deceased, others bankrupt and others will be deceased at the time of any insolvency event. Given the modelling that was carried out the Independent Expert reported that the average policyholder could not reasonably expect a recovery rate from Names of more than 20 per cent of any shortfall in the event of an Equitas insolvency. Based on this and other work the Independent Expert concluded that given the extra security of \$1.3 billion protection, overall policyholders stood to gain from the proposed transfer and that no policyholder group would be materially disadvantaged in the event of the transfer being sanctioned.

Mr Justice Blackburne, in his Judgment of July 7, 2009, indicated emphatically the important role the Independent Expert. Blackburne J. commented that the report prepared by the Independent Expert, dated 8 April 2009, was "a model of clarity, both of exposition and analysis and of presentation and ease of comprehension. It is a lengthy, objective and extremely well prepared document."

The Independent Expert may, sometimes, be required to file one or more supplemental reports with the court. This is required should new information come to light which the expert feels that he needs to bring to the courts attention. In the case of the proposed Equitas Part VII transfer the initial report was dated April 8, 2009 and in the report the expert stated that he would be filing a further supplemental report in respect of certain issues listed. This was because there were various issues still being worked on which he knew would have

progressed prior to the sanction hearing scheduled for June 24, 2009. A supplemental report was duly prepared and issued on June 15, 2009. The supplemental report set out progress on the various matters as necessary and conclusions were as previously stated.

As well as relying on the Independent Expert's report the court also has the reports which the FSA file. There will typically be two reports filed by the FSA— one in advance of the directions hearing and a further report in advance of the sanction hearing. The purpose of the reports is to provide the court with information on the FSA's position in relation to the proposed transfer, in particular stating whether the FSA does or does not object to the proposed transfer. In relation to the Equitas Part VII transfer, Blackburne J. highlighted part of the final FSA report to the court on this transfer: "further reinsurance from NICO will benefit policyholders and thereby contribute to the FSA's consumer protection objective." It goes on to say that: "based on discussion with and challenge to the Independent Expert, the FSA accepts [the] conclusion" of the Independent Expert.

ADVISORY ROLES AND CONSIDERATIONS

Under the Part VII business transfer process advisors, other than the Independent Expert, are also critical as they help navigate through legal, strategic, administrative and process matters. Accordingly the team typically includes:

- Legal Advisors: the legal advisors will generally draft the Business Transfer Scheme. The extent of their involvement depends upon any in house counsel's experience. Should the transfer involve EEA and non EEA jurisdictions different sets of legal considerations will need to be addressed.
- Actuaries: they will be appointed to provide an updated actuarial valuation of the business to be transferred. There might be several actuaries involved since the majority of appointed

independent experts are in fact actuaries themselves.

- Outside consultants: they act as project management for the Part VII transfer process. They will assist in ensuring that the transferor's records are as complete as possible, necessary with regard to notice requirements and to report to the court steps taken to give adequate notice. These consultants are important in helping client companies to better discern the business being transferred and the strategic and business implications.

OVERSEAS RECOGNITION

The Equitas Part VII transfer was sanctioned in the High Court of England and Wales, it is also recognized in the European Economic Area (EEA). The EEA includes all 27 European Union countries plus Iceland, Norway and Liechtenstein. Even though the Part VII transfer process is recognized in the EEA and offers a flexible and efficient restructuring tool to insurance businesses not all of the international aspects are clear. In the US for example, to date, there has not been an application to seek recognition of the Equitas transfer. However, Mr Justice Blackburne commented in his judgment that "the underlying policyholders and cedents will not be disadvantaged" in the various jurisdictions where the transfer may not be recognized (these jurisdictions include the US, Canada, Australia, New Zealand and South Africa).

OPTING FOR PART VII: MAJOR CONSIDERATIONS

The Equitas transfer represented unique circumstances. Common situations which might trigger the decision to Part VII transfer Insurance/reinsurance business include the desire to reorganise certain insurance business within the group; to finalise the affairs of one or more insurance entities; to move certain defined books of business from one entity to the other and/or

to prepare a business or particular part of the business for disposal. Considerations about the most appropriate route for a company will take into account the strategic objectives of the company as well as the type of business at stake. As a result of these considerations, a Part VII transfer may not always be the right tool to meet the company's objectives. A business may also consider the complexity of the insurance arrangements which it is dealing with; whether a Part 26 Scheme of Arrangement is appropriate (formerly known as a s.425 Scheme of Arrangement); use of accelerated commutation programmes and/or the sale of the business in whole or in part.

CONCLUSION

The Equitas Part VII transfer was not opposed by any policyholder. Anyone who believes that they may be adversely affected in the event of a proposed transfer has the right to attend and be heard in court. Equitas held policyholder and Names road shows to explain the transfer. The fact that no policyholder felt the need to attend and oppose the transfer speaks volumes regarding the acceptability of the Part VII transfer process, the structure of the Equitas transfer and the explanations provided to policyholders. It also supports the conclusion drawn by the Independent Expert that no policyholder would be materially disadvantaged in the event of the transfer and that overall policyholders would gain.