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Response of the Insolvency Law Committee of the City of London Law Society to the Consultation Document dated March 2010 entitled "Strengthening the Administration Regime for Insurers" (the "Consultation Paper")

1. INTRODUCTION AND EXECUTIVE SUMMARY

The City of London Law Society ("**CLLS**") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients ranging from multi-national companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the Consultation Paper has been prepared by the CLLS insolvency law committee. This committee is made up of a number of solicitors from the City of London firms who specialise in insolvency law. The committee's purpose is to represent the interests of those members of the CLLS involved in insolvency law and practice.

In summary, we think it is a sensible approach to review the current rules and legislation as they apply to the administration of an insolvent insurance company so as to ensure that liquidation offers no significant perceived advantages over administration. In principle, extending the Insurers (Winding Up) Rules 2001 the ("**Winding Up Rules**") to an administration is likely to be of more practical use in the case of a life insurance company. There is a long established practice of schemes of arrangement being used by insolvent non-life insurance companies as an alternative to liquidation/winding up.

Administrators of non life insurance companies are likely to continue using such schemes even if the Winding Up Rules are applied to a company in administration. A scheme of arrangement under the Companies Acts allows claims to be admitted and dividends paid to policyholders, whilst facilitating the payment of compensation by the Financial Services Compensation Scheme ("**FSCS**") and the continuance of that compensation for unknown latent claims in a way which the Winding Up Rules appear not to allow.

However, we think that the terms of the proposed amendments to the objectives of the administration fail to recognise the issues and priorities with which an administrator has to deal and more fundamentally, the rationale for the administration

process itself. If such amendments are to be fair and/or acceptable, they require further thought and refinement. There are, for example, obvious issues to be considered before imposing a duty to assist the FSCS, in terms of the extent of that duty; how the duty would be discharged in practice and what effect compliance with that duty may have on the overall cost and conduct of the administration and upon different stakeholder interests. The question of who would bear the cost of providing the resource and assistance needs to be considered.

Some potential advantages and disadvantages of applying the Winding Up Rules are considered below. It should be noted that these comments may apply equally to the case of administration or liquidation.

2. RESPONSES TO INDIVIDUAL QUESTIONS

Question 1: Do you agree that the valuation rules set out in the Insurers (Winding Up) Rules 2001 should be applied to insurance companies in administration?

General Insurance

The basis for applying the Winding Up Rules to an administration appears to be that administration currently offers less protection for policyholders than liquidation because there are no rules as to how liabilities under a policy should be valued in an administration and thus a lack of clarity on how to deal with such a contract upon an insurer's default.

There are however existing provisions under the Insolvency Act 1986 and the Insolvency Rules 1986 which would appear to allow an administrator to estimate and admit insurance claims outside of the provisions of the Winding Up Rules, though as is discussed below, the way in which the Insolvency Rules would operate in this context has not been tested.

Once appointed, the administrator would continue to agree, but would cease paying, claims. The company would be prohibited from underwriting new business. Where possible the administrator would seek to transfer the whole (or part) of the business to a solvent company in order to obtain continuity of insurance, for the benefit of policyholders. If the administrator was unable to secure continuity of insurance, then in due course he would want to distribute the assets to creditors. The practice in prior insurance insolvencies has been to agree claims and pay dividends to creditors through a scheme of arrangement rather than a liquidation.

The use of a scheme of arrangement in this context dates back to the early 1990s, and has been (almost without exception) the procedure by which all non-life insolvent insurance companies in the last twenty years have made payments to policyholders/creditors. Those insolvencies have largely taken place under the control of a provisional liquidator and the Winding Up Rules have rarely if ever been applied.

An administrator has power (with the court's permission) under para 65 Sch B1 Insolvency Act 1986 to pay a dividend to creditors. In doing so, an administrator would act, in effect, as a liquidator for that purpose. Where there was considerable uncertainty as to the value of the total liabilities of the insolvent insurance company, the administrator would be unlikely to pay a dividend for some time - perhaps years, even under a scheme of arrangement. The Winding Up Rules would not speed up this process unless (possibly) the law was changed so as to compel the company's

reinsurers to make payments under reinsurance contracts to the insolvent company on the basis of a valuation of claims and policies carried out under the Winding Up Rules.

The Winding Up Rules have not always been easy to interpret. The court has commented on the complexity of their application (see for example, Transit Casualty Co. and another v. The Policyholder Protection Board and others [1992] 2 Lloyd's Rep. 358, where the court considered the 1985 version of the Winding Up Rules. The 1985 rules have subsequently been repealed and substantially re-enacted as the Winding Up Rules which contain a revised rule 6 and schedule 1 (valuation of general business policies) which confirms that contingent claims must be valued by a court approved estimation process and which seek to clarify some of the interpretational problems before the court in the Transit Casualty case.

In the case of liability claims arising under non-life policies, rule 6 of the Winding Up Rules provides that the holder of a general business policy shall be admitted as a creditor without proof for an amount equal to the value of his policy as determined by schedule 1 of the Winding Up Rules. Schedule 1 requires the valuation of the policy to be determined on such actuarial principles and assumptions in regard to all relevant factors as the court shall direct. In practice, this would involve the administrators applying to court for an order approving an actuarially based estimation methodology. Depending on the complexity of the business, one or more methodologies may need to be developed, explained to and approved by the court before being applied to policy valuation. It is unlikely that a "one size fits all" approach to valuation of general insurance policies would be appropriate.

Each individual policyholder's policies would then need to be identified and reviewed by the administrators and a value allocated to each policy, based on the court approved methodologies, which would then become that creditor's claim in the administration, subject to amendment if further evidence as to the actual value of a claim became available during the course of the administration (the so called "hindsight" principle).

The provisions of Rule 2.72 of the Insolvency Rules which would apply absent the introduction of the Winding Up Rules would place the onus on the policyholder to submit his claim in writing to the administrator along with particulars as to how and when the debt was incurred. Contingent debts (i.e. latent claims for which the policyholder's liability to its claimants has not been established or is unknown) would be required to be estimated by the administrator under Rule 2.81. The process for estimation is not specified. In practice, an administrator would seek directions and approval from the court for an actuarially based estimation methodology.

Insolvency Rule 2.105 provides that in relation to a claim for a debt payable at a future time, for the purposes of paying a dividend, the amount of the admitted claim shall be reduced by the application of a specified formula. That formula may be difficult to apply to some types of contingent/latent insurance claims which could take many years to emerge, since it assumes that the date upon which the latent claim would crystallise into an actual claim for damages is known or can be established.

One advantage which the Winding Up Rules have over the Insolvency Rules is that a policyholder is not required to submit its claims under the proof of debt process. Under the proof of debt process, a policyholder may have missing or incomplete records and may have great difficulty and incur considerable expense in producing an estimate of the value of its policies or the contingent claims which may exist thereunder. The Winding Up Rules require the insolvent company rather than the

policyholder to carry out much of the necessary work in order to come up with a policy valuation.

Application of the Winding Up Rules could create problems for the ability of the FSCS to provide continuous compensation. This is because when the value of a policy is established under the Winding Up Rules, it is assumed that the policy itself is cancelled and the insurance cover is terminated. The policyholder is entitled to a dividend based on the value of the policy (subject to any later revision to the claim before all assets are distributed). The effect is as if the policy no longer exists.

Thus where liability policies (including Employers' liability) are valued and paid out in this way, the risk is that any employee or third party who has a latent claim against the policyholder which matured after the payment of the dividend would be reliant on the policyholder having sufficient funds to pay that claim from its own assets at the relevant time, since cover would have terminated upon administration/liquidation.

Compensation from the FSCS to the employee/third party (whom as a matter of policy are also intended to be compensated by the FSCS) would not be available at that date, since the FSCS would have been required to pay compensation to the policyholder based on the value of the policy under the Winding Up Rules. An employee/third party could therefore be left without any compensation in the future if the policyholder became insolvent after receipt of the FSCS compensation and was unable to pay the claim in full.

A scheme of arrangement can be used to remove this potential (but significant) disadvantage and provide continuity of FSCS compensation. This can be achieved by the FSCS participating in the scheme of arrangement, acting in effect as an insurer of last resort to provide continuing compensation to any third parties who might become eligible for protection at some time in the future.

It will be appreciated that neither the allocation method of valuation of the policy under the Winding Up Rules or the submission method required in the ordinary proof of debt procedure under the Insolvency Act and Rules provides a complete solution to how to value claims or policies, whilst maintaining the right to FSCS compensation.

A Companies Act scheme of arrangement provides flexibility to the claims valuation and dividend payment process. Claims are usually submitted in the ordinary course of the run off and established by agreement or judgment under a "reserving scheme" which pays out a prudent rate of dividend calculated to ensure that all policyholders with actual, contingent or prospective claims receive fair and equal treatment. This allows reinsurance recoveries to be made and allows the FSCS to participate in the scheme and make streamlined compensation payments to creditors through the scheme as and when protected claims become established.

Where the assets and liabilities of the insolvent company can be more confidently predicted, a scheme can be used to estimate on a once and for all basis all prospective and contingent claims and/or the value of all outstanding policies. Again, the FSCS can participate in such a scheme in a flexible way by offering continued protection to eligible claimants which would not be possible under the Winding Up or Insolvency Rules. Valuation of claims is achieved by a flexible estimation methodology which has to be approved by creditors as part of the scheme, and sanctioned by the court.

In practice, an administrator (or a liquidator) would be unlikely to want to pay a dividend based on a claim for the value of a policy valued under the Winding Up Rules until he was reasonably confident that all available reinsurance assets had been collected. Reinsurance contracts typically provide a reinsurance indemnity for actual liabilities covered by the insurance policy, as opposed to an indemnity for an actuarial estimation of the value of the policy, as would be produced under the Winding Up Rules. A reinsurer might seek to use such an argument as a defence to payment under the policy.

In our view, this is one area of insurance insolvency law which could be reviewed and improved upon. If an insolvent insurer was able to make claims and collect in full under its reinsurance policies on the basis of estimated inwards claims (whether under the Winding Up Rules or a scheme of arrangement) rather than having to wait until its liabilities were established in the ordinary course of the run off before being able to collect its reinsurances, the insolvency of an insurance company could be made less costly and payments to policyholders made sooner than is currently possible.

Long-Term Insurance

Rule 7 and Schedules 1-4 of the Winding Up Rules deal with the valuation of long-term policies where no stop order has been made. We understand that the Winding Up Rules have only been applied in one life company liquidation; that of Oaklife insurance in the mid 1990s.

In practice, the application of the Winding Up Rules could raise certain difficulties whether to an administration or liquidation. Further consideration should be given to whether, in light of points raised below, these valuation provisions should also be applied to insurance companies in administration.

Schedule 2 of the Winding Up Rules deals with the valuation of non-linked long-term policies. Paragraph 2(2) states that the present value of ordinary benefits under such policies is the value, at the liquidation date, of the reversion in the ordinary benefits according to the event upon which those benefits are payable calculated on the basis of the interest, mortality and disability rates referred to in paragraph 1 of the schedule. This provision could produce valuation difficulties in certain circumstances, for example, if the relevant mortality and disability tables are applied the present value of a policy (such as a critical illness policy) is likely to be higher than zero, but substantially less than the ultimate payout. This may not match the circumstances of the policyholder who is likely to be either over-compensated (because he has not suffered any change in his health and can take his premiums elsewhere and obtain equivalent cover) or under-compensated (because he has had a change in his health and the present value will not begin to compensate him for the premiums that he would have to pay for equivalent cover elsewhere). However, this may be a reasonable match for the level of assets that the insolvent company is likely to be holding against a policy.

Accumulating with-profits policies are subject to different rules. Paragraph 2(4) of Schedule 2 provides for the value of ordinary benefits to be adjusted by the future income made by the company (which is calculated in the same way as for linked policies (see paragraph 3 of Schedule 3)). This adjustment therefore suffers from the same defect as is referred to below in relation to linked policies, in that no provision is made for the lapse of policies.

Accumulating with-profits policies are to be further adjusted by reference to the value of the assets underlying the unit price (i.e. to bring unit value back to the value of the underlying assets) or the value of the fund, if the liquidator considers it necessary. This adjustment could prejudice holders of such policies as the value of their claims would be reduced, and the proportion of their entitlement would fall as compared to other types of policyholder. It is unclear why this mechanism applies to accumulating with-profits policies and not other types of policy.

Paragraph 3 provides that the expectation of additional benefits (such as future bonuses) is also to be valued. Paragraph 3(1) suggests that the existence and extent of expectation to receiving additional benefits should be assessed at the date of liquidation. However, at that time the expectation of receiving additional benefits, certainly non-guaranteed benefits, is likely to be very low in most cases (except, for example, where the policy is held in a well-capitalised ring-fenced fund).

Schedule 3 of the Winding Up Rules deals with the valuation of unit linked long-term policies and other policies linked to liabilities that are not expressed in terms of units. Paragraph 3 of that schedule describes how rights of the company to make charges to the fund, or units of a fund, are to be valued. The value of unit linked policies is to be reduced by the amount of the company's charges. This appears slightly odd as prior to the insolvency a policyholder would usually be able to take money out of his policy and avoid a reduction for future income.

The amount of the reduction to the value of the policy is to be determined on the basis of interest, at such rate as the court may direct, and the rates of mortality and the rates of disability that the court considers appropriate, after taking into account both the published rates of mortality and disability and the rates of mortality and disability experienced by the company (paragraph 3(5)). No provision is made for the lapse of policies – i.e. cases in which a policyholder takes his policy elsewhere prior to insolvency and thereby deprives the company of income. It may be appropriate to make this provision in order to take account of the lapse experience of the company or provide for lapse assumptions so as to not overstate the future value of such income (and, therefore, the amount of the reductions to be applied to the policy).

Question 2: Do you agree that the administrator should have a duty to provide assistance to the FSCS to enable it to administer the compensation scheme?

Question 3: Do you consider that the administrator should have a duty to provide assistance to the FSCS to enable it to secure continuity of long-term insurance contracts?

Taking both of these questions together, our experience is that in practice, a responsible administrator would, using his general powers, provide assistance to the FSCS in the form of access to information, personnel and claims data etc. so as to enable the FSCS to administer and make payments under the compensation scheme.

The principal concerns with imposing a duty on an administrator to assist the FSCS to enable the FSCS to administer the compensation scheme and making compliance with that duty an overriding priority above the duty to perform functions in the interests of creditors as a whole are obvious. Imposing that duty on an administrator would in effect oblige the administrator to act in accordance with the directions of the FSCS and its priorities at (presumably) no cost or liability to the FSCS or its levy payers.

In practice the administrators and the FSCS would have a common interest in avoiding policyholder hardship/payment delay. There would therefore be a high level of immediate and continued cooperation between the Insolvency Practitioner and the FSCS in terms of mobilising the administrative resources of the company to assist the FSCS in performing its compensation function, provided that to do so was consistent with achieving the purposes of the administration (which we would expect to be the case in almost every insolvency). In some cases it may be appropriate for the FSCS to pay for this assistance.

The question is whether the company and its creditors (not all of whom may be insurance policyholders or policyholders eligible for FSCS compensation and who might therefore not expect the insolvency to be run solely for the benefit of the FSCS and at their expense) should bear the burden for providing the assistance and resource or whether the administrators and the FSCS should be free to negotiate appropriate commercial terms as may be appropriate.

In our view, the administrator is best placed to determine, acting in the best interests of creditors overall and in carrying out his statutory functions, which matters should be given priority in the administration, as opposed to being required to defer to the views and interests of the FSCS. An administrator should be free to seek a contribution from the FSCS towards the cost of providing assistance.

In our view the general powers given to any administrator to carry on the business are sufficient, without the need for s376 FSMA to be extended to administrations. Schedule 376 FSMA is required in the case of a liquidation in order to create an exception to the basic rule that a liquidator can only carry on the business of the company in liquidation where to do so is for the benefit of the winding up.

See further our comments under question 5 below.

Question 4: Do you consider that the duty to assist the FSCS in securing continuity of insurance contracts should also apply in relation to general insurance contracts?

No.

An administrator has the power to assist the FSCS under existing law. We do not consider that the imposition of a duty would be helpful or is required, particularly if that duty included an obligation to use the company's cash or other assets to facilitate the issuance of new insurance cover by a solvent insurance company. In previous non-life insolvencies, where cash has been required to ensure continuity of insurance cover (e.g. as a payment to a new insurer offering new cover), the FSCS (and the Policyholders Protection Board before it) have exercised their powers and provided funding to the new insurer of amounts equivalent to compensation which would otherwise have been paid direct to each transferred policyholder as compensation for return of premium due ("**ROP**").

The opening of administration proceedings would not of itself result in automatic cancellation of current policies. Where policies contained contractual cancellation rights, policyholders could be expected to consider cancelling their policies in accordance with policy terms and to seek alternative cover depending on their view of the ongoing value of the policy given the insolvency of the insurance company.

The administrator would also want to take the company off risk by exercising any available contractual cancellation rights where possible (including in relation to FSCS

protected policies), which would ordinarily give rise to claims for ROP. In some cases, those ROP claims may be eligible for compensation from the FSCS.

An administrator already has the power, where he considers it desirable and where the FSCS exercises its powers to provide funding for that purpose (see above), to transfer individual books of business/blocks of policies or to otherwise facilitate the issuance of new continuous cover by a replacement solvent insurer. This has been done in previous cases such as in the motor insurance books of Independent Insurance and Drake Insurance plc where such arrangements were put in place as an alternative to policy cancellation which would have left many motorists uninsured.

Question 5: Do you agree that the administrator should be required to maintain contracts of long-term insurance?

A requirement to maintain life policies with a view to transfer or rescuing the company should generally be beneficial to policyholders as it might help secure full recovery for policyholders, rather than 90% by way of compensation from the FSCS.

However, an administrator is in any event required to perform his functions under the Insolvency Act 1986 with the primary objective of rescuing the company as a going concern. Administration would not result in the automatic termination of policies of insurance and therefore contracts of long-term insurance would ordinarily continue in existence whilst the administrator sought to rescue the company or transfer the business.

An administrator has power under para 66 Schedule B1 to make a payment other than by way of a dividend on a claim if he thinks it would assist achievement of the purpose of the administration. Para 66 therefore appears sufficient to allow an administrator power to make payments due under the company's policies as and when they fall due for payment. However, such a power would no doubt be exercised cautiously and with prior court sanction. An administrator is unlikely to be prepared to continue paying claims in full given that the company's insolvency would mean that its liabilities exceeded the value of its assets. Instead, we think that an administrator would expect the FSCS to agree to fund payments due to protected policyholders at the 90% level of compensation and/or indemnify/repay the company in respect of such payments made by it from its own assets. The indemnity would also extend to any over payments or mistaken payments made by an administrator from the company's assets.

If a requirement to maintain contracts is imposed, the proposed requirements referred to below should also be added (i.e. power to enter into new contracts and power of court to vary contracts) as these powers will help maintain the business and perhaps facilitate rescue of the company or the transfer of the business.

Question 6: Do you consider that an administrator should be permitted to enter into new contracts of long-term insurance where it relates to existing policyholders and arrangements in place?

There may be cases where such a specific power would prove useful. Regulatory issues would need to be addressed so as to allow such a power to be exercised by the Company (in administration) where the FSA had previously limited or withdrawn the Company's authorisation to write new business.

However, an administrator would want to ensure that any such new contract entered in to was not a contract "entered into" by an administrator for the purposes of

paragraph 99(4) of Schedule B1 to the Insolvency Act 1986, such that sums payable in respect of debts and liabilities arising out of the new contract would be payable in full as an administration expense, in priority to the claims of other policyholders. This concern could be addressed by appropriate drafting in the Winding Up Rules.

Question 7: Do you agree that the power to agree variation of contracts in force should be given to the administrator?

Yes, although we are not aware of any recent use of such a power by a liquidator in an insolvency context.

Question 8: Do you agree that the administrator should have the same power to apply to the courts for the appointment of a Special Manager, as currently held by the liquidator?

We think that such a provision would be of little value. Insurance insolvencies are by their nature extremely lengthy, costly and complex and require specialised skills and experience. We would not expect a suitably experienced administrator from a large and experienced accountancy firm to need the assistance or seek the appointment of a Special Manager or wish to incur the additional costs of doing so, unless there was a clear benefit to creditors in doing so.

Question 9: Do you agree that the courts should be given the power to reduce the value of contracts and to appoint an independent actuary, in the event of an insurer going into administration?

We agree in principle that the court ought to be given such powers. However, consideration has to be given to whether the power to appoint an actuary would encroach on the accountancy firms' actuarial responsibilities and whether the proposed powers are proportionate to the intended benefits.

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THE CITY OF LONDON LAW SOCIETY
INSOLVENCY COMMITTEE

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