Commentary

BAIC And Scottish Lion Decisions:

A Wake-Up Call For U.S. Creditors To Challenge Fairness Of U.K. Solvent Schemes

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Foreign insurers and reinsurers with asbestos, environmental and other long-tail risks in the United States have increasingly used solvent schemes of arrangement as an alternative to liquidation or protracted run-off. These schemes, implemented under §425 of the United Kingdom's Companies Act 1985, have been an efficient and reliable means of finalizing all or part of a company's portfolio of business and returning capital to shareholders. If the necessary majority creditor approval is obtained and the scheme is sanctioned by the U.K. court, it becomes binding on all creditors. Claims submitted by a date certain, including estimates of currently unknown future liabilities (known as incurred-but-not-reported losses or "IBNR"), if allowed, are paid at present value. All other claims are forever extinguished.

Some solvent schemes seek to fairly adjust debts and distribute the assets of a company that is in questionable financial condition. Other solvent schemes, however, are proposed by companies whose financial strength is undoubted. There may be good cause to question the reasonableness of such schemes where the scheme company is fully able to pay its obligations as they mature, but does not want to do so. While the benefits of a solvent scheme to the scheme company and its shareholders are clear, serious questions may be raised in many cases as to whether a solvent scheme is beneficial and fair to creditors.

Solvent schemes should be of particular concern to U.S. policyholders and reinsureds, who lose the bargained-for protection of coverage for future claims in exchange for payment based on an estimate of what those claims may be, assuming that they have the loss history and resources to submit a sufficiently documented IBNR claim to be allowed any payment at all.

Until recently, with the decision of the High Court of Justice in Matter of British Aviation Insurance Company Limited ("BAIC") [2005] EWHC 1621 (Ch), and the unpublished decision of the Scottish Court of Sessions involving the solvent scheme proposed by Scottish Lion Insurance Company Ltd. ("Scottish

Lion"), the proponents of solvent schemes of arrangement have enjoyed uninterrupted success in obtaining court approval. Such success may be attributed in no small part to the low level of creditor participation in the scheme approval process. In BAIC, the High Court refused to sanction BAIC's solvent scheme, and the decision is not being appealed. In Scottish Lion, the Court of Session required that the scheme proponent provide additional financial information and a creditors list in advance of the creditors' meeting. Rather than comply, Scottish Lion withdrew its scheme.

These decisions should serve as a wake-up call for U.S. creditors to challenge the fairness of U.K. solvent schemes in appropriate circumstances.

Statutory Framework

Section 425 of the Companies Act provides a method by which an insurer or reinsurer may enter into a legally binding compromise or arrangement with its creditors. Scheme approval is essentially a three-stage process. The initial stage involves an application to the court for an order summoning a meeting or meetings of creditors. (§425(1)). The court's function at this stage is to decide whether or not to convene a creditors' meeting and, if so, to determine the manner in which the meeting should be summoned and conducted. The merits or fairness of the proposed scheme itself are not considered at this stage.

The second stage consists of the creditors' meeting(s), at which point the scheme is put to a vote. In order for the scheme to be binding on creditors or a class of creditors, a majority in number representing three-fourths in value of those present (in person or by proxy) must accept the scheme. (§425(2)).

The third stage involves an application to the court to approve (sanction) the scheme. At the third-stage hearing, the court focuses on whether the creditors' meeting(s) have been summoned and conducted in accordance with its previous order; whether the requisite statutory majority (in number and value of creditors) have accepted the scheme; and whether the views and interest of those who have not accepted the scheme received impartial consideration. If the Court sanctions the scheme, it is binding on all creditors, whether or not they voted in favor of it. (§425(2)).

Disincentives To Creditor Participation

There are a number of explanations for the lack of strong creditor opposition to solvent schemes in the years leading up to the BAIC and Scottish Lion decisions. A U.S. creditor may learn of a pending solvent scheme, if at all, through notice received by mail from the scheme proponent or printed in an industry publication. Because these notices do not identify specific contracts or claims, and the accompanying scheme documents are lengthy, confusing, and filled with jargon and unfamiliar terms, the reaction of many U.S. creditors understandably is one of bewilderment. The potential impact, if any, of the scheme on a particular creditor may be difficult to discern, and there is very little time in which to consider whether and how to respond to the scheme in a foreign jurisdiction.

Under the circumstances, the expense of engaging U.S. and U.K. lawyers to do battle against a well-organized and well-financed scheme proponent may be daunting. Secrecy concerning the identity of creditors has made it difficult for creditors to exchange information, pool litigation resources, and maximize their leverage in negotiations with the scheme proponent.

BAIC: Fairness Comes To The Fore

The BAIC decision marked the first time that creditors successfully opposed a solvent scheme proposed by an insurance company. The court concluded that it lacked jurisdiction to sanction the scheme because it was not satisfied that the votes cast adequately represented the views of creditors. Specifically, the court held that creditors with IBNR (incurred-but-not-reported) claims constitute a separate class of creditors and that it was improper for the scheme proponent to convene a single meeting of all creditors. BAIC [2005] EWHC 1621 at ¶97 (Ch).

The BAIC court also considered a variety of other arguments relating to its jurisdiction to sanction the scheme, as well as the merits of the scheme itself. The court noted that it would "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." BAIC [2005] EWHC 1621 at ¶143 (Ch). BAIC is not proceeding with its appeal to the Court of Appeal and has advised creditors that the Scheme will not be implemented.

In the wake of BAIC, U.S. creditors should recognize that some solvent schemes may not be in their best interest and that there may be grounds to successfully challenge them. Many of these grounds concern issues of basic fairness, both of the process for obtaining scheme approval and of the scheme itself. There also may be arguments based on U.S. law that creditors can use to oppose scheme proponents' efforts to enforce sanctioned schemes in the United States.

Procedural Fairness

Scheme proponents rely on the ill-defined concept of "creditor democracy" to obtain approval of schemes. But a process that allows the will of a majority of creditors to control the fate of the minority is sustainable only if the system of creditor voting is fair.

Inadequate notice may lead to inequitable results. The scheme proponent's efforts to identify and locate creditors, as well as the sufficiency of publication notice, should be scrutinized. Low voter turnout may result in a scheme being approved by a small minority of creditors (who nevertheless comprise a majority of voting creditors) or by an unrepresentative sample of creditors.

The timing of schemes gives their proponents an unfair advantage over creditors. A solvent scheme typically is the result of many months of planning, drafting and negotiation. In comparison, creditors have scant time in which to evaluate the scheme, identify their contracts with the scheme company (some of which contracts may have been in effect years if not decades ago), analyze the scheme's potential impact, determine whether the scheme proponent's decision as to the number and nature of creditor classes is proper, attempt to organize themselves, and raise any objection. Scheme proponents have been known to be less than accommodating in granting adjournments of creditors' meetings and hearings and in allowing extensions of time to submit papers in opposition to the scheme.

BAIC underscores the importance of proper classification of creditors in achieving fair results. In a solvent scheme, the holders of accrued claims are paid no more and no less than what they otherwise would receive: full payment of their claims in accordance with the terms of the pertinent insurance policies or reinsurance contracts. IBNR creditors, however, are treated differently. In a solvent scheme, they are not paid the contractual indemnity to which they otherwise would be entitled. Instead, IBNR creditors are paid based on an estimate of what their claims against the scheme company may be in the future, assuming they are in a position to provide and substantiate such an estimate. IBNR creditors confronted with the compulsory commutation of their contracts should not be at the mercy of other creditors with divergent interests.

Adequacy of information about the proposed scheme and the scheme process also raises fairness concerns. The flow of information relating to a proposed scheme is largely controlled by the scheme proponent. However, the proposed scheme and its explanatory statement, prepared by the scheme proponent, may include misleading or incomplete information regarding matters such as the company's financial condition, its relationship with parent and affiliate companies, its history, the purpose of the scheme, and the business that would fall within the scheme's scope. Schemes usually contain a confusing labyrinth of definitions and cross-references. Creditors may be unable to determine the effect of the proposed scheme on their claims or, for that matter, whether their claims would even be subject to the scheme in the first place.

Negotiations between scheme proponent and creditors who support the scheme are kept secret. The ability of the scheme proponent to essentially "buy" votes by striking undisclosed side deals with certain creditors may skew the voting process. At the same time, the scheme proponent usually does not disclose creditors lists or, following the creditors' meeting, the voting records. Such secrecy makes it virtually impossible for creditors to exchange information, consult one another, pool resources, consider whether the scheme proponent's classification of creditors is fair, prepare for the creditors' meeting, and determine whether the creditors' vote at that meeting was equitable and should bind all creditors.

The September 2005 Scottish Lion decision scored a victory for creditors concerned about procedural fairness in the scheme process. In its unpublished decision, the Scottish Court of Session granted a creditor's application to require disclosure of the creditors list and additional financial information and ordered that such information be provided to all scheme creditors. Noting that creditors have the right to consult with one another to consider the extent of their common interests in respect of the scheme, the court ruled that knowledge of the identity of other creditors is essential to allow such consultation to take place. The court adjourned the creditors' meeting and ordered the company to post both the creditors list and the additional financial information on its website. Scottish Lion responded by petitioning to withdraw its scheme, rather than providing the additional information. The Court allowed Scottish Lion to withdraw the scheme, but awarded costs to the creditors who had made the application to require the additional disclosures.

In addition to notice and class issues and the inadequate disclosure of information, there are other ways in which the scheme process may unfairly favor the scheme proponent. The process by which claims are allowed and valued for voting purposes may be designed or manipulated to favor the scheme proponent, producing results that do not accurately reflect the views of creditors. The scheme proponent may attempt to reduce or disallow for voting purposes claims of creditors who oppose the scheme, while allowing the claims of friendly creditors in their entirety.

Under the voting procedures in BAIC, for example, although scheme creditors with disputed claims were eligible to vote at the creditors' meeting, it was left to the chairman of the creditors' meeting (one of the scheme company's directors) to decide whether or not a creditor's estimate of its claim was reasonable before admitting the claim for voting purposes. Some IBNR creditors who opposed the scheme had their claims rejected or arbitrarily reduced to one dollar for voting purposes without any genuine effort by the chairman to ascribe a value to the claim. BAIC [2005] EWHC 1621 at ¶107 (Ch).

The process by which claims are allowed and paid in the event the scheme is sanctioned also may be designed to favor the scheme proponent at the creditors' expense. The scheme proponent sets the bar date for claims, which may not allow creditors sufficient time to perform the research and actuarial work necessary to calculate the amount of their claims. Obviously, IBNR creditors are especially prejudiced by unreasonably short claims deadlines. Creditors who are unaware that the scheme has been sanctioned may find that their otherwise valid claims have been extinguished. The methodology for estimating claims may lead to inequitable results and unequal treatment of creditors. The scheme also may attempt to limit judicial review of the claims adjudication process and to place disputed claims in the hands of a scheme adjudicator who, while nominally impartial, is friendly with the scheme company.

Substantive Fairness

Although a solvent scheme obviously benefits the scheme company and its shareholders, the same cannot be said in all instances for its creditors, especially with respect to IBNR losses. The liabilities of a scheme company's creditors are unaffected by the scheme. Policyholders will continue to incur losses and will remain obliged to pay damages to injured third-parties. Reinsureds will continue to be liable to their policyholders and to ceding insurers. But deprived by the solvent scheme of the protection that they purchased from the scheme company, both policyholders and reinsureds will have to bear those future liabilities entirely on their own. Under a solvent scheme, the risks that the scheme company was paid to assume are involuntarily transferred back to its policyholders and reinsureds. In exchange, the scheme company pays its creditors an estimate of what those future liabilities may be.

IBNR creditors can argue that this compulsory abrogation of their contractual rights is unfair. One need look no further than to the extremely volatile fluctuations in projections of the insurance industry's ultimate exposure to asbestos and pollution losses to recognize that IBNR cannot be accurately projected. IBNR projections at an individual creditor or contract level can be expected to be far less accurate because there is less data from which to project future claims. Solvent schemes are especially unfair to smaller IBNR creditors, who may lack the financial resources or loss data to adequately support an IBNR claim. Creditors can argue that there simply is no reason why a solvent company that is able to pay its debts as they become due should be relieved of its contractual obligations simply in order to release capital for the pursuit of other business ventures or return to shareholders.

Some solvent schemes may be unfair to creditors for other reasons, as well. Schemes usually deprive creditors of access to the court system, including their right to a jury trial and appeal. They also abrogate all contractual rights to arbitrate disputes. Contractual arbitration clauses generally provide for claims to be decided before a neutral arbitrator or a panel comprised of a neutral arbitrator and an arbitrator appointed by each of the parties. Under a solvent scheme, creditors lose all of these rights. Instead, claim disputes typically are resolved by a scheme adjudicator selected by the scheme proponent.

U.S. Proceedings

The opportunity for U.S. creditor involvement in the scheme process may extend beyond the shores of the United Kingdom. Often, a representative of a scheme company will file a petition for ancillary relief with the United States Bankruptcy Court to enjoin litigation and avoid piecemeal liquidation of the company's assets in the United States. Bankruptcy Courts have routinely granted ancillary relief in connection with § 425 solvent schemes, usually without creditor opposition. Until recently, with the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, such applications were governed by § 304 of the Bankruptcy Code. Effective October 17, 2005, § 304 was repealed and replaced with a new chapter of the Bankruptcy Code, Chapter 15, which governs recognition of foreign proceedings.

The scheme proponent's need to petition the U.S. Bankruptcy Courts for ancillary relief does not necessarily give U.S. creditors another "bite at the apple" when it comes to raising objections to the scheme based on considerations of procedural and substantive fairness. Considerations of comity may weigh in favor of recognition, even if the scheme and the scheme approval process do not precisely comport with American notions of fairness.

Comity is "the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws." Hilton v. Guyot, 159 U.S. 113 (1895). U.S. Courts will afford comity to foreign proceedings only if they do not violate the laws or public policy of the United States and if the foreign court abides by fundamental standards of procedural fairness. Finanz AG Zurich v. Banco Economico S.A., 192 F.3d 240, 246 (2d Cir. 1999). At the same time, however, "where the foreign proceeding is in a sister common law jurisdiction with procedures akin to our own, exceptions to the doctrine of comity are narrowly construed." In re Gee, 53 B.R. 891, 901 (Bankr. S.D.N.Y. 1985).

A bankruptcy court may refuse to enforce a foreign order irrespective of considerations of comity where the relief sought is beyond the scope of the Bankruptcy Code. For example, in In re Rose ex rel. London & Scottish Assurance Corp., 318 B.R. 771 (Bankr. S.D.N.Y. 2004), a bankruptcy judge refused to grant ancillary relief in connection with an insurance business transfer scheme under Part VII of the United Kingdom Financial Services and Markets Act ("FSMA"). In that case, twelve solvent British insurance and reinsurance companies proposed to transfer the majority of their assets and liabilities into a thirteenth company under Part VII of FSMA. The petitioner in Rose argued that because the Part VII business transfer scheme was a corporate restructuring, or "reorganization," it fell within the Bankruptcy Code's definition of a "foreign proceeding," which, at that time, included "a proceeding, whether judicial or administrative and whether or not under bankruptcy law . . . for the purpose of liquidating an estate, adjusting debts by composition, extension or discharge, or effecting a reorganization."

While the Rose court did not disagree with the petitioner's assertion that solvent entities were eligible for ancillary relief under § 304, the court rejected the petitioner's attempt to isolate the term "reorganization" from its statutory framework and to apply it generally to business reorganizations. Id. at 775. The court held that because the Part VII business transfer scheme lacked the characteristics of a bankruptcy reorganization, as distinguished from a corporate consolidation or merger, the scheme fell outside of the Code's definition of "foreign proceeding" and was not entitled to § 304 relief. Id.

In conjunction with the enactment of Chapter 15, the definition of "foreign proceeding" has been amended and is expressly limited to certain types of proceedings "under a law relating to insolvency or adjustment of debt." 11 U.S.C. § 101(23). Therefore, it may be assumed that Rose would have been decided no differently had the petition been filed under Chapter 15.

U.S. creditors also may be able to challenge enforcement in the U.S. of §425 solvent schemes and Part VII business transfers by invoking the "reverse pre-emption" rule of the McCarran–Ferguson Act, 15 U.S.C. §1012; Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25 (1996) (Bankruptcy Code subject to McCarran-Ferguson). Reverse pre-emption may preclude the granting of ancillary relief under Chapter 15 in a manner that would invalidate, supersede or impair state regulation of the business of insurance. For example, a U.K. insurance business transfer scheme (such as the scheme at issue in Rose) that purports to effect a mass novation of insurance contracts outside of the applicable state regulatory framework may trigger reverse pre-emption. In that regard, Chapter 15 contains a provision (§ 1501(d)) that specifically prohibits the bankruptcy court from granting relief under the new chapter with respect to any deposit, escrow, trust fund or other security required or permitted under any state insurance law or regulation for the benefit of U.S. claimholders.

Conclusion

For years, proponents of solvent schemes operated in an environment free of significant creditor resistance. BAIC and Scottish Lion serve as a wake-up call for scheme creditors to challenge U.K. solvent schemes in appropriate cases. Scheme proponents may attempt to blunt such challenges by addressing fairness considerations upfront in the scheme documents themselves, as well as in their dealings with creditors before and during the scheme process. In so doing, scheme proponents will have little choice but to eliminate or lessen some of the disincentives that historically have suppressed creditor participation in the scheme process. In any event, it is unlikely that U.S. creditors will pull the bedclothes back over their eyes anytime soon. The sleeping giant rises. ■