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Perspectives

Beware solvent scheme procedures

By Joseph J. Schiavone and Jeffrey S. Leonard

U.S. policyholders and ceding insurers have become increasingly aware that they are at risk of losing insurance and reinsurance placed with solvent insurers and reinsurers, especially placements in the London market. The mechanism by which solvent entities are able to shed liabilities is the solvent scheme of arrangement, a proceeding authorized by Section 425 of the U.K. Companies Act 1985. This statute, which originally had nothing specifically to do with insurance, has engendered controversy as creditors cry foul and demand fairness and transparency in scheme proceedings.

A solvent scheme allows a solvent debtor to terminate its insurance and reinsurance obligations with judicial sanction. The end result of a scheme is typically full payment to creditors with liquidated claims and an estimated payout to creditors with reserves and incurred but not reported—or IBNR—losses. The owners of the scheme company take what is left.

Until recently, scheme proponents operated in an environment relatively free of creditor resistance. Creditor inertia, lack of knowledge and limited resources enabled both legitimate and questionable schemes to proceed unimpeded, often leaving policyholders and cedents stripped of insurance and reinsurance protection in exchange for a compulsory lump-sum buyout based, in large part, on estimated reserves and IBNR.

Scheme approval is a three-stage process. First, a court hearing is held at which the proponent seeks permission to hold a creditors' meeting. Second, a creditors' meeting is held at which a vote of 50% of the creditors present in person or by proxy representing 75% or more in total value of each class of creditors must be obtained for the scheme to proceed. Third, if the requisite votes are obtained, the court conducts a hearing to decide whether to approve the scheme. If the scheme is approved, creditors must submit claims by a specific bar date.

Court involvement and the participation of creditors at the creditors' meeting may suggest that creditors have a fair opportunity to present objections and vote with other creditors on the scheme. Historically, though, the scheme process has been one sided and has not favored creditors. Creditors do not always receive reasonable notice of the scheme. The time taken by scheme proponents to prepare a scheme is disproportionately large compared with the short time given creditors to react to it. Scheme documents often are unwieldy and may present an incomplete picture of the transactions contemplated in the scheme. Because creditor lists are not provided with the scheme documents, creditors are unable to confer prior to the creditors' meeting. The voting at the creditors' meeting may not accurately reflect the creditors' differing interests. A creditor who disputes the valuation of its claim has no right of appeal from the decision of the scheme adjudicator, who is selected by and paid by the scheme administrators.

In addition to procedural unfairness, a solvent scheme presents the fundamental inequity of forcing a policyholder to assume risks that it transferred for a premium to a company that remains able to pay but is unwilling to do so. Undoubtedly, there are solvent schemes that aim to achieve a fair distribution of a failing company's diminishing assets. When a scheme company is solvent, though, the good faith of the scheme proponent may be suspect. Even where the goal of the scheme is just, the type of procedural issues outlined above may deprive creditors of a full and fair opportunity to consider and respond to the scheme.

Two recent decisions from the United Kingdom signal that the days of creditor passivity may be over and that the scheme process is becoming less one-sided. In the matter of British Aviation Insurance Co. Ltd., creditors successfully opposed a solvent insurance scheme for the first time when a London court held that it lacked the jurisdiction to sanction the scheme because creditors with IBNR claims had been lumped together into one class with other creditors for voting purposes. The court also concluded that it would be unfair to force policyholders to take back risk that they originally transferred to the insurer.

In a September 2005 unpublished decision involving a solvent scheme proposed by Scottish Lion Insurance Co. Ltd., a Scottish court ruled that a scheme proponent must provide a list of scheme creditors sufficiently in advance of the creditors' meeting to afford creditors an opportunity to consult with one another before voting on the scheme. The court adjourned the creditors' meeting and ordered the company to post the creditors' list on its Web site. Rather than comply, Scottish Lion petitioned to withdraw its scheme.

Both cases are a call for fairness and transparency in the conduct of solvent schemes of arrangement. The decisions should help policyholders and reinsureds recognize that they remain passive in the face of a pending scheme at their peril and that there may be grounds to challenge solvent schemes.

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