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INSURANCE BULLETIN

The Prudential Regulation Authority's (PRA) approach to schemes of arrangement and capital extraction

The shockwaves created by the PRA's proposed policy on schemes of arrangement and extraction of capital in CP6/13 and 7/13 continue to ripple through the run off sector, with some commentators suggesting that the PRA has sounded the death knell for solvent schemes. While the approach of the PRA to extraction of capital from run off firms set out in CP 7/13 is largely a reflection of existing policy and therefore relatively uncontroversial, the same cannot be said for CP 6/13.

CP 6/13 – schemes of arrangement

CP 6/13 focuses on the PRA's approach to schemes of arrangement. It makes clear that when considering schemes, the PRA will focus on its statutory objective to *"contribute to the securing of an appropriate degree of protection for policyholders"*, a cornerstone of which, in the context of solvent schemes, is the continuity of cover. Yet the concept of continuity of cover seems fundamentally at odds with the finality a solvent scheme traditionally provides, for both insurer and insured.

Notwithstanding the absence of a statutory remit to approve schemes of arrangement, the FSA did (rightly) expect firms to engage with it in respect of their proposed schemes, again based on its statutory objectives to ensure an appropriate degree of protection for policyholders. Traditionally, the FSA provided firms with a letter of non objection, which could be submitted to the High Court. However, other than for certain policy types such as EL cover, the FSA never raised policy issues relating to the basic principle of finality offered by the scheme of arrangement, which is a Companies Act rather than regulatory procedure.

The PRA's starting point is that solvent schemes are unlikely to be compatible with its statutory objective of ensuring an appropriate degree of protection for policyholders, but without any meaningful discussion in CP 6/13 of the

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meaning, in this context, of what level of protection may or may not be "appropriate". The PRA's view, implicit in the CP, is that that the statutory procedure for schemes of arrangement set down in the Companies Act and policed by the High Court does not meet this threshold. Given the long history of application of the Companies Act procedure in the run off sector, one might have expected that, if the process was failing policyholders, the legislature would have taken the steps necessary to make changes to the process or indeed to give the PRA a statutory role to play in the decision making process. Certainly, the drafting of the extensive amendments to FSMA to implement the government's regulatory reform programme would have provided the ideal opportunity to do so. Instead, the statutory position remains the same but the PRA's policy is more robust and aggressive than that of its predecessor.

Avoiding the glide path to insolvency

Although the PRA attempts to draw a bright line between its approach to solvent schemes and insolvent schemes, there is, in reality, for many run off firms with long-tail exposure, a glide path from solvency to insolvency. Leaving aside any debate around the trigger point at which "insolvency" occurs, it seems unlikely that the PRA is suggesting that it is preferable for firms to wait until insolvency before commencing a scheme of arrangement. Invariably, it will be the case that the earlier solvent scheme will ensure a higher payment overall for policyholders than they would otherwise receive in an insolvent scheme, which must surely be consistent with the PRA's statutory objectives. Of course, for those fully solvent run off firms, there is always a significant focus on the methodologies and processes used to calculate the amounts due to policyholders and, in practice, payments are enhanced to take account of the loss of ongoing cover resulting from the scheme.

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Turning to the concept of continuity of cover, the PRA expects firms to provide an "acceptable" degree of continuity of cover for the minority of policyholders in a solvent scheme, who may be dissenting or simply not voting (and it is not clear whether the PRA expects both to benefit from continuity of cover or how they would be identified). However, the CP is silent as to the PRA's expectation of "acceptable", which may range from continuity of cover from the existing provider, which is unlikely to be workable for a firm wishing to exit the market, to an "equal in all respects" or simply a similar offering by a new provider. In this new era of judgement based supervision, the PRA's silence on this point is no doubt deliberate, thereby ensuring it retains the widest possible discretion.

Part VII by the bank door?

In any case, the acceptability of the continuity of cover is an issue traditionally encountered in the context of a Part VII transfer, where both the independent expert and the regulator will consider the status of the transferee assuming the book of business. If continuity of cover is to be provided by a third party, then it seems that run off firms cannot avoid the lengthy and expensive Part VII process as a means for ensuring continuity of cover by transferring the policies of the dissenting or non-voting minority. Continuity of cover achieved by a simple termination and replacement mechanism does not offer policyholders the level of protection of the Part VII process. The PRA does not appear to take account of the impact of this additional expense nor the cost of purchasing this alternative cover on the amounts available for distribution to policyholders under the solvent scheme.

The PRA states that it will raise objections with the High Court in respect of schemes which it believes are incompatible with its statutory objectives. The basis on which the High Court would consider an objection to a solvent scheme by the PRA on automatic grounds for a refusal to sanction a scheme is by no means clear. Moreover, where the PRA's objection is grounded in the need to protect the dissenting or non-voting minority of policyholders by ensuring they are granted some sort of continuity of cover appears to ride roughshod over the principle enshrined in the Companies Act that, provided the Court is satisfied that due process has been followed and the statutory voting thresholds met in each class of creditors, the majority decision can indeed bind the dissenting or non-voting minority.

Whilst ensuring that its approach to solvent schemes is compatible with its statutory objectives, the PRA must also consider whether its actions are

indeed appropriate and reasonable and whether the burdens it imposes on firms are proportionate to the resultant benefits. Schemes of arrangement are a useful tool in the UK's thriving run off sector and have been used with success for many years. Positive action by the regulator which inhibits the sector may not be in the interests of policyholders and the market in the long term. The PRA will, when applying the new policy proposal in CP 6/13, need to be mindful of the need to carry out this delicate balancing of interests.

CP 7/13 – extraction of capital

The policy espoused in CP 7/13 on the PRA's expectations of run off firms seeking to extract capital is clearly an attempt by the PRA to draw a line in the sand regarding its expectations of firms seeking to extract capital rather than a substantive change in policy. There is no suggestion in the CP that the PRA is purporting to prevent capital extractions.

The recurrent theme in CP 7/13 is that the PRA will be seeking comfort that the directors and senior management have reached their decisions by applying robust due diligence and governance processes and that the PRA will hold those individuals accountable for their decision making. This approach is in line with the regulatory focus on governance in financial services in the wider context.

CP 7/13 sets out a clear process which the PRA expects firms to follow when considering a capital extraction proposal, suggesting that before now firms have been approaching the PRA with proposals that were incomplete and which did not provide the PRA with sufficient evidence that the proposal had merit. The CP gives an added degree of clarity to the PRA's thinking, which should mean that firms can approach the PRA with a sound, robust proposal which ought, in turn, to reduce the timeframe required by the PRA to consider and give its views. Of course, as set out in the CP, the PRA retains the right to require further information or work, for example, the views of an independent expert. However, this power has always been present; in practice, complying with the expectations in the CP should minimise the risk to firms of the need to commission an independent expert's report in this area.

The PRA has given the industry a relatively short timeframe in which to respond to the CPs and firms are encouraged to make their views known on the impact of these policies on the run off markets. Of course, the extent to which the market's views impact on the policies of the PRA remains to be seen. To date, the FCA has remained silent on its approach to schemes of arrangement but given the overlap in the regulators' statutory objectives, we should expect its views to be made available in the not too distant future.

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Australian decision on Directors' defence costs

Chubb Insurance Company of Australia Limited v Moore[1] is the first Australian decision to consider the issues raised by the high profile New Zealand *Bridgecorp* decision.

The New South Wales Court of Appeal held that any charge freezing policy proceeds created by section 6 of the *Law Reform (Miscellaneous Provisions) Act* 1946 (NSW) cannot apply to defence costs that are paid by insurers in accordance with the relevant insurance policies before judgment is entered, or settlement is agreed, in respect of a claim for damages or compensation.

Chubb v Moore combined with the successful appeal of the original *Bridgecorp* decision will provide comfort to Australian Directors and Officers (and other professionals insured under defence costs-inclusive liability policies) that they should be able to access their cover for defence costs.

Insureds that have put in place arrangements in their D&O insurance structures to deal with the potentially adverse consequences of the original *Bridgecorp* judgment (such as defence costs only policy coverage) may now want to consider reverting to traditional "combined limit" policies, if insurance savings can be made.

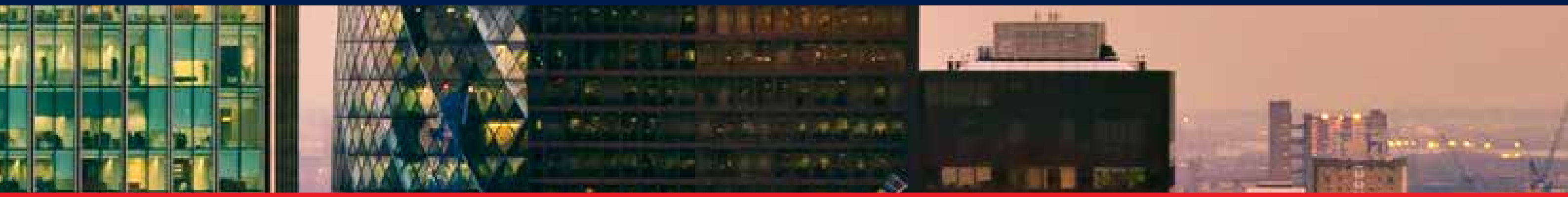
An alternative, if cautious approach was to be taken, may be to maintain those arrangements for the time being pending the result of the *Bridgecorp* appeal to the New Zealand Supreme Court, which is expected next year. An insured could consider negotiating some form of return of premium for their next renewal for those arrangements contingent upon this appeal being unsuccessful and there being no change to the current position in Australia.

Background

Certain Australian States & Territories (NSW, Northern Territory and Australian Capital Territory) and New Zealand have long-standing legislation[2] which creates a statutory "charge" over insurance moneys which are, or may become, payable in respect of an insured's liability to pay damages or compensation.

1 [2013] NSWCA 212.

2 Section 9 of the NZ Law Reform Act 1936, which is substantially mirrored in NSW by the Law Reform (Miscellaneous Provisions) Act 1946, Section 6, in ACT by the Civil Law (Wrongs) Act 2002 s.206 and in NT by section 26 of Law Reform (Miscellaneous Provisions) Act).



This legislation was intended to protect the position of third party claimants and it enables a claimant to recover directly from an insurer whose insurance moneys would otherwise be payable to the insured defendant in respect of the claim. For example, if a claimant could not recover from an insured defendant because it became insolvent, the claimant could recover the insurance moneys directly from the insurer.

The precise scope and effect of this legislation has, however, been difficult to determine and the language used has been described by the Courts as *"undoubtedly opaque and ambiguous"*. The Court in *Chubb v Moore* went so far as to say that *"section 6 should be repealed altogether or completely redrafted in an intelligible form, so as to achieve the objects for which it was enacted"*.

In September 2011, the New Zealand High Court held that a "charge" under the New Zealand *Law Reform* Act prevented D&O insurance policy funds being advanced to meet the Bridgecorp directors' criminal defence costs[3]. The Court held that once the insurer had been notified of the charge, its obligation to keep the insurance funds intact applied, regardless of the merits of the claims brought against the Directors.

As reported in our January 2013 briefing (http://www.hfw.com/Directors-defence-costs-Bridgecorp-Jan-2013) the original *Bridgecorp* decision has been overturned by the New Zealand Court of Appeal[4] but remains the subject of a further appeal to the New Zealand Supreme court. These decisions are not binding on the Australian courts and it has been unclear as to how the Australian courts would determine this issue.

Facts

The Full Bench of the New South Wales Court of Appeal was asked to determine a number of questions relating to the section 6 charges asserted in connection with proceedings brought against former Directors and Executives of the collapsed Great Southern Limited and its subsidiaries.

The Directors and Executives held D&O insurance policies (with cost inclusive limits) which responded to the claims brought against them in the Supreme Courts of Western Australia and Victoria (States which do not have equivalent legislation).

The D&O policies provided for the insurers to advance defence and legal representation costs incurred by the insured Directors and Executives in defending the claims.

Judgment

The Court held that section 6 does not apply to claims brought in courts outside New South Wales. Having made this determination, the Court was not required to determine the other questions. However, the Court noted the uncertainty surrounding section 6 and went on to make the following findings in respect of the scope and operation of section 6:

- Any charge created by section 6 cannot apply to defence costs, legal representation expenses and other costs and expenses that are paid by insurers in accordance with the relevant insurance policies before judgment is entered, or settlement is agreed, in respect of a claim for damages or compensation.

  This is because the insureds had a contractual right to payment of their defence costs and there is nothing on the face of section 6 to suggest that it was intended to alter the contractual rights of the parties in such a radical fashion by negating this contractual right. The Court said that, if the New South Wales Parliament intended section 6 to have such a drastic effect on the contractual rights of an insured, it could be expected to have provided so in express terms.

- Where section 6 imposes a charge on insurance monies, and the insured is faced with multiple claims, any payment made by the insurer under the policy by way of indemnity for the liability of the insured to pay damages or compensation to a third party claimant will constitute a valid discharge of the insurer, if the payment is made before judgment is entered, or a settlement is agreed, in respect of a claim for damages or compensation of any other third party claimant.
- Section 6 is not limited to "occurrence" based liability policies but also applies to "claims made" insurance.
- Section 6 does not create a charge where the event giving a rise to a claim for damages or compensation happened before the policy came into effect.

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3 Steigrad v BFSL 2007 Ltd & Ors, HC Auckland CIV-2011-404-611, 15 September 2011.

4 Steigrad v BFSL 2007 Ltd & Ors [2012] NZCA 604.

Supreme Court upholds decision on erosion of insurance layers

Teal Assurance v W R Berkley and others [2013] UKSC 57

In our April 2012 Bulletin we reported on the Court of Appeal's decision in *Teal Assurance v W R Berkley and others [2011] EWCA Civ 1570*, in which the Court refused to accept the argument of the reinsured (T) that it was entitled to determine the order in which losses eroded the insured's (B) tower of liability insurance, by choosing to settle them in a particular order, which would have the effect of maximising T's reinsurance recoveries. The Court of Appeal then held that the losses exhausted the layers in the order in which B's liability to the third parties in question was established (by admission, judgment or award) and that it was not open to T to alter this.

Following a further appeal by T, the Supreme Court has confirmed that the ascertainment by agreement, judgment or award of the insured's liability is what gives rise to the claim under the insurance, which exhausts the insurance either wholly or in part, depending on the limit of the insurance and the amount of the claim. The policy thus meets each ascertained loss when and in the order in which it occurs, and the insurer's decision to settle in a different order the insured's claims in respect of such losses cannot alter this.

The Supreme Court was not convinced that anything in the wording of the policies in question (and in particular wording relied upon by T to the effect that liability would only attach to each excess layer once underlying insurers had paid, admitted liability, or been held liable to pay the full amount of their indemnity) operated to displace this analysis. The Supreme Court's view was that, although the words relied upon by T determine when each layer's liability arises, they do not determine in respect of which claims such liability arises, which issue is determined according to the principles set out above.

The Supreme Court reasoned that, where an insurance has a limit, it makes no sense to speak of the insured having a number of causes of action or recoverable claims which together would exceed that limit. It is not therefore open to the insurer to argue that he has a choice as to which of a number of claims exhaust its policy. An insured may forbear from notifying, or withdraw or abandon, a claim under a policy. The insurance would not then be exhausted by that claim and the next claim would be recoverable in the ordinary course.

What T proposed, however, was not the withholding or withdrawal of a claim, but its continued pursuit, coupled with adjustment of its priority as against the programme of insurances. This, the Supreme Court held, could not be accepted.

As well as considering that this approach was correct in principle and supported by the wording of the policies in question, the Supreme Court was also satisfied that it made commercial common sense.

In the present case, it suited T, which was B's captive insurer, to claim that B or itself could adjust the order in which claims impacted the different programme layers. This produced what the Supreme Court described as the "unfamiliar phenomenon" of an insurer seeking to maximise its own insurance liabilities.

Had T been an independent rather than a captive insurer aiming to avoid as much liability to B as possible by choosing the order in which claims exhaust its layers, it was felt that B would no doubt have objected vigorously. The freedom of choice which T advocated could not readily be reconciled with the basic philosophy that insurance covered risks lying outside an insured's own deliberate control.

As explained in our previous Bulletin, the background to this appeal was that the top layer of B's insurance tower excluded claims from the US and Canada, whereas the other layers did not.

B had a number of claims against its programme, some of which emanated from the US/Canada, some of which did not. B and T wanted to be able to choose to meet the US claims from the primary and/or excess layers, so as to make sure that the remainder could be met from the top layer, in respect of which T had purchased reinsurance.

The Supreme Court has now confirmed that this choice is not available, meaning that it will be important to ensure that liability insurance towers of this kind are organised in such as a way as to ensure that the required cover (and reinsurance) is available, irrespective of the order in which the insured settles third party claims.

The inability of the insurer to determine which claims exhaust its layer(s) could have also have further consequences for reinsurance recoveries, such as for example where there are issues over aggregation at a reinsurance level; on standard contract wordings at least, it will not be open to a reinsured to argue that his layer has been exhausted by losses arising out of only one of a number of events or occurrences, where the order in which the original insured has settled its third party claims dictates otherwise.

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NEWS

We are delighted to announce the recruitment of Carol-Ann Burton, as a senior insurance regulatory Consultant, who joins the firm's London office.

Carol-Ann has over 10 years' experience of advising on insurance regulation and transactions, as a solicitor in private practice and at the FSA as a senior legal adviser. She advised the FSA's insurance supervisory and run off teams and has particular expertise in complex Part VII transfers, run off and also the FSA's policy in the life and with profits products area.

Carol-Ann's insurance regulatory practice covers all aspects of both the life and general markets, including authorisations, supervisory issues, conduct of business, governance and regulatory processes, as well as distribution, restructuring, run off and solvent schemes of arrangement. She has recently advised on a number of market leading transactions in the life sector, involving complex financial reinsurance, longevity insurance and VIF financing transactions.

Conferences & Events

London Market Claims Conference
Dexter House, London
24th October 2013
Presenting: Paul Wordley – (morning panel session) Defining and achieving the outcomes that will deliver client value. HFW will be the legal sponsors at this annual insurance event.

ILS Bermuda Convergence 2013
Hamilton, Bermuda
13–14 November 2013
Attending: Richard Spiller

For more information about any of these events, please contact events@hfw.com

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