Schemes of arrangement and their ongoing currency

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Michelle Kierce, Helen Martin, Adriana Cotter and Nigel Montgomery
Sidley Austin LLP

UK schemes of arrangement are used for closing insurance and reinsurance business. The significant opinion of Lord Glennie was recently given in *Scottish Lion Insurance Company Limited, Re An Order Under Section 896 of The Companies Act 2006* [2009] Scots CS CSott_127 (*Scottish Lion*) on its proposed solvent scheme. Following the handing down of the opinion, Lord Glennie agreed to the objecting creditors' request to dismiss the petition to sanction the scheme. This ruling (which has been appealed), has divided many on the potential consequences for future schemes. Lord Glennie's opinion, while not binding on English courts, is persuasive and relevant as the issues it deals with are common to many schemes.

Against this backdrop, this article looks at:

- The background to schemes of arrangement.
- Preparation and procedural requirements.
- The sanctioning of a scheme.
- Case law developments.
- Overseas recognitions and enforcement of schemes.

BACKGROUND

A scheme of arrangement is an English statutory procedure regulated by Part 26 (Arrangements and Reconstructions) of the Companies Act 2006 (formerly sections 425 to 427 of the Companies Act 1985). Part 26 of the Companies Act 2006 came into force on 6 April 2008, although legislation permitting schemes of arrangement in various forms has existed for over a century. The statutory provisions allow a company to reach a binding compromise or arrangement with its members or creditors, or any class of them.

A wide variety of commercial arrangements have been achieved through court-sanctioned schemes in connection with M&A activity and shareholders' rights. In insurance, schemes have been widely used by solvent companies to bring finality to the whole, or certain lines of, their business and by insolvent companies, as an alternative to liquidation. Schemes offer a method of running-off the company's business and making distributions to creditors.

This article is primarily concerned with the use of schemes of arrangement by solvent insurance companies. These schemes, often called "estimation" or "cut-off" schemes, are used to exit run-off business, by achieving a commutation of the portfolio, comprising all the company's business or selected parts. Without a scheme, the run-off of books of discontinued insurance business can continue for many years.

Under these schemes, the assureds or cedants whose insurance contracts are included in the scheme must submit their claims to the scheme company (or the appointed scheme manager) by a specified date (bar date). Claims for uncrystallised future amounts, outstanding and incurred but not reported claims (IBNR), and incurred but not enough reported claims (IBNER) must be estimated, as they would in individual commutations.

Schemes incorporate a method and timescales for agreeing and valuing claims. More complex schemes include detailed actuarial techniques used to value uncrystallised claims. These schemes prohibit access to the courts or arbitration in most circumstances, but allow binding adjudication, the rules of which are prescribed by the scheme.

Once the scheme is complete, and all claims properly submitted by the bar date have been valued and paid, the scheme company is released from all future claims under, and obligations in relation to, the scheme's insurance contracts, and creditors under these contracts cannot assert any future claims.

In the London market, schemes are a familiar mechanism for closing legacy business. At the end of 2008, 177 solvent schemes of arrangement for non-life companies had become effective (*KPMG Run-Off Survey Non-life Insurance October 2009*).

PREPARATION AND PROCEDURAL REQUIREMENTS

A well-constructed scheme undergoes significant legal and commercial preparatory work before it reaches the public domain. The scheme business must be accurately identified and described so that creditors know whether they are affected by it.

Jurisdictional issues also must be considered to determine whether the company may propose a UK scheme. Policyholders who may have scheme claims must be identified and their contact details must be updated, which can be very time consuming and labour intensive. Potential scheme creditors should be contacted and consulted, if practical, and outwards reinsurers informed about proposals. Also, the scheme and related documentation (voting and claim forms, notices to creditors and evidence for a court application) must be drafted.

The key piece of documentation in a scheme of arrangement is the scheme document itself, which sets out the scope and terms of the scheme and, crucially, the business, assets and liabilities the scheme covers. Although all schemes contain certain boilerplate clauses, the key clauses of the scheme, concerning claims submission and agreement, conflict resolution and payment are often highly specific to the needs or preferences of the particular scheme company and its creditors. The drafting should be sensitive to considerations and technical problems which have arisen in previous schemes and to creditors' concerns, particularly in valuation and adjudication.

The statutory framework also requires an explanatory statement to be drafted and sent to creditors. The aim of the statement is to draw creditors' attention to particular aspects of the scheme that are likely to have a bearing on their voting, and to explain how the scheme works.

While documentation is drafted, the scheme company and its advisers undergo a consultation process with the relevant regulatory authorities, and where practicable, with the company's creditors. Any intended scheme must be notified to the Financial Services Authority (FSA), the regulator responsible for the regulation of the UK financial services industry. The FSA has no statutory role in relation to schemes. However, it is consulted in relation to any scheme proposed by an insurance company which it supervises. Although lacking official status, an FSA statement that it has no objection to a scheme is taken into account at the court hearing to sanction a proposed scheme.

The FSA published *The process guide to decision making on Schemes of Arrangement for insurance firms*, available at *www.fsa.gov.uk*, which provides guidance on the FSA's procedures and on the factors the FSA considers in relation to a proposed scheme, including the:

- Type of policyholder affected by the scheme (for example, less scrutiny is required where the policyholder is a reinsurer).
- Type of business to which it relates.
- Degree of solvency of the company proposing the scheme.

Once these preparatory stages are complete, the next step is the statutory three-stage process for obtaining creditor and court approval of the scheme. The first stage is an initial court hearing, known as the "leave to convene" hearing, where the company proposing the scheme asks the court for an order allowing it to convene the creditor meeting(s) to vote on the scheme proposals.

The second stage involves the creditor meeting(s) during which votes are cast for or against the proposed scheme. The scheme proposal must be approved by a majority in number representing 75% in value of the creditors voting at the meeting in person or by proxy (*section 899(1), Companies Act 2006*). For voting purposes, creditors must be grouped into classes according to the effect of the scheme on their rights against the scheme company. The proposed scheme can only move on to the next stage if the requisite number and value of votes have been obtained in each creditor meeting. An exception to this is in schemes which contain provisions that survive rejection in a particular class meeting, if other classes approve them.

The third and final stage is the sanction hearing at which the court, at its discretion, either approves or rejects the scheme. Following court sanction, the scheme becomes effective once the order granting sanction is delivered to the Registrar of Companies in England. However, either before or after this step is taken, and depending on whether the scheme company has a significant creditor base and/or assets in the US, it can make an application for a Permanent Injunction in the US under Chapter 15 of the US Bankruptcy Code, to make the scheme binding under US law.

SANCTIONING A SCHEME

The court can refuse to sanction a scheme for various reasons, one of which is lack of jurisdiction. In this context, jurisdiction refers to the court's power to sanction on the basis that the correct statutory procedure has been followed. If a scheme company has failed to group creditors into the correct classes for voting purposes, the court does not have jurisdiction to sanction the scheme, even if the requisite majority of creditors have voted in favour of the scheme.

In relation to jurisdiction, the court must therefore be satisfied that the:

- Creditors were placed in appropriate classes to convene the meeting or meetings.
- Meeting(s) of creditors was summoned and held in accordance with the order of the court convening the meeting(s).
- Proposed scheme was approved by the requisite majority of those who voted at the meeting(s), whether in person or by proxy.

If the court has jurisdiction to sanction a scheme, it must then consider whether it is fair to do so. In *Re, The British Aviation Co Ltd* [2006] 1 BCLC 665 (*BAIC*), the court refused to sanction the scheme because the judge considered he did not have jurisdiction following class meetings which had been held incorrectly. However, the judge, Lewison J, also had concerns regarding the scheme's overall fairness and expressed that the test for whether courts will sanction schemes is the Buckley test (that is, whether the arrangement is one that an intelligent and honest man would reasonably approve, being a member of the class concerned and acting in relation to his interests). However, the test is not whether the opposing creditors have reasonable objections to the scheme. In *BAIC*, Lewison J stated that even if he had jurisdiction to sanction the scheme, he would not have on grounds of fairness.

As David Richards J put it in *Re Telewest Communications plc (No. 2)* [2005] 1 BCLC 772, courts generally follow two sets of principles in deciding to sanction a scheme:

- The following must be true:
  - statutory provisions have been complied with;
  - the class was fairly represented by meeting attendees;
  - the statutory majority are acting bona fide and are not coercing the minority to promote interests adverse to the class they represent;
  - the Buckley test is fulfilled.
- The court does not merely review whether the majority are acting bona fide and register the meeting's decision. However, courts do not generally differ from the meeting, unless either of the following apply:
  - the class has not been properly consulted;
  - the meeting has considered the matter without considering the interests of the class it can consequently bind; or
  - an error is found in the scheme.

DEVELOPMENTS OF SCOTTISH LION

A succession of insurance companies have effectively employed schemes for a wide range of purposes and therefore any refusal to sanction is, by contrast, rare and provokes considerable industry interest.

Cross-border

In *Scottish Lion,* Lord Glennie dismissed the petition by Scottish Lion Insurance Company Limited to sanction its solvent scheme of arrangement. He stated that for creditor democracy principles to apply in relation to a scheme (that is, for it to be fair for the majority of creditors in a class to be able to coerce the minority), there must be a "problem requiring a solution". However, he considered a solvent scheme as an example of "where..., creditor democracy should not carry the day". He essentially required unanimous creditor approval for a solvent scheme. It appears that Lord Glennie had a similar view to that of Lewison J in *BAIC* concerning fairness in solvent schemes.

In *Scottish Lion*, the court was asked to consider two issues:

- Can the decision that the statutory majorities were achieved be challenged?
- Can it ever be fair to sanction a solvent scheme with continuing creditor opposition?

On the first point, Lord Glennie did not want to preclude creditors from challenging vote valuations. On the second point, Lord Glennie considered there was no reason, apart from shareholders' wishes, why the company should not continue with run-off.

The requirement for a "problem requiring a solution" to justify a creditors' scheme for a solvent company appears to be a new test which is not present in the statute and has not featured in previous case law, which has merely required a balance between the advantages and disadvantages of proposed schemes (that is, some element flexibility producing a fair result). In a creditors' scheme, it is the benefit to a class as a whole that forms the main consideration.

However, Lord Glennie appeared to envisage circumstances where "creditor democracy" legitimately prevails, indicating he considered solvent schemes would be sanctioned in certain circumstances (for example where the scheme company was in danger of insolvency). However, it is unclear what these circumstances would be. The fact that a majority of creditors, correctly grouped into classes, may reasonably consider the scheme to be in their interests and therefore approve it is insufficient (in Lord Glennie's view) to entitle them to force other creditors to participate against their will.

THE EFFECT OF BAIC ON SCOTTISH LION

In *BAIC*, Lewison J thought it unfair and unreasonable to compel dissenting creditors to accept payment of an estimate of their claims.

BAIC concerned a proposed solvent scheme of arrangement by British Aviation Insurance Company Ltd which wrote insurance and reinsurance business in the aviation sector until 1 January 2002, at which point it entered into run-off. Lewison J found that since the class of creditors had not been correctly constituted, he had no jurisdiction to sanction the scheme and it was dismissed on 21 July 2005. *BAIC* was the first scheme, in relation to a solvent insurer, that had been opposed.

Despite concluding that he lacked jurisdiction, Lewison J considered other grounds for objection to the scheme, which are summarised as follows:

- The votes to be cast did not fairly represent creditors with substantial claims under the IBNR category. Such claims would be inherently difficult to value due to their uncertain nature.
- The estimation methodology used to establish the value of the votes did not provide a clear basis for treating all creditors uniformly, resulting in uncertainty.
- The company had an unfettered power to revert to run-off. Essentially, this would have allowed the company to return to run-off in the same state as it was before sanctioning the scheme, because the scheme was no longer beneficial to the company.
- The supposed scheme benefits were largely company and shareholder benefits and therefore, did not benefit scheme creditors.

Both Lewison J in *BAIC* and Lord Glennie in *Scottish Lion* focused on the specific facts of the cases before them.

In *Scottish Lion*, Lord Glennie makes reference to the first, second and fourth bullets above, in response to submissions put forward by counsel for the opposing creditors, and he is clearly influenced by Lewison J's remarks on fairness.

However, Lord Glennie appears to go further than Lewison J in his analysis of the issue, particularly with his requirement that for creditor democracy to prevail in relation to a scheme there must be a "problem requiring a solution". This forms part of the ratio of the case and in this respect, the judicial status of Lord Glennie's opinion is stronger than Lewison's obiter remarks on fairness in solvent schemes in *BAIC*.

Lord Glennie's opinion presents challenges for some approaches to solvent schemes. Solvent schemes can offer substantial benefits not only for insurers but also for their creditors, and many would consider it unfortunate (and an unexpected legal interpretation) if a minority of dissenting creditors were able to overrule the wishes of the majority in every case. It is likely (as happened following the *BAIC* case) that proponents of solvent schemes will step back and reflect on the lessons of this judgment (and any appeal that follows it), but that solvent schemes will continue to be proposed, debated and ultimately, sanctioned.

However, there will probably be a re-evaluation of some scheme tactics, a renewed emphasis on dialogue with creditors and consideration of how the drafting of the scheme affects them. Although traditional schemes will continue to have their place, new approaches to the way in which schemes are structured, to avoid the pitfalls of *BAIC* and *Scottish Lion*, are expected.

OVERSEAS RECOGNITION AND ENFORCEMENT

A number of jurisdictions including Australia, Bermuda, the Cayman Islands, Jersey, and other countries with a similar legal system to that of the UK, have legislation which enables companies to finalise potentially long-term liabilities through a scheme of arrangement.

Recognition and enforcement of UK schemes of arrangement in the US is achieved under Chapter 15 of the US Bankruptcy Code, which provides effective mechanisms for dealing with insolvency cases from debtors, assets, claimants and other interested parties involving more than one country. To enforce an overseas insolvency-related decision, a foreign representative (a person or entity authorised to administer the debtor's affairs) files a petition for recognition of the foreign proceedings (a judicial or administrative proceeding in a foreign country). UK solvent schemes, which have involved US policyholders, have been successfully recognised in the US for many years under the Chapter 15 procedure and under its previous form of section 304 of the US Bankruptcy Code.

In Canada, recognition of a UK solvent scheme was upheld by the Ontario Court of Appeal in *Cavell Insurance Company Limited (Re)* 23 May 2006, Docket C43657. This decision confirmed that foreign solvent schemes of arrangement can be recognised and enforced in Canada. A number of policy considerations were taken into account, such as the familiarity of the Ontario courts with the UK court process, and the fact that similar provisions exist in Ontario legislation to those regulating UK schemes of arrangement, which, as Justice Farley explained, made English solvent schemes neither "foreign nor repugnant" to the Canadian legal system. The recognition order was made conditional on certain criteria to ensure the Canadian reinsureds would be treated fairly. The decision was important as it was the first time a solvent non-Canadian insurer attempted to enforce a scheme on the cedants of its Canadian branch.

In the EU, UK solvent schemes have the potential to be recognised and enforced through Regulation (EC) No. 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (Brussels Regulation), which regulates the implementation and enforcement of judgments in civil and commercial matters in all EU member states, except Denmark. Article 32 of the Brussels Regulation defines judgment as any judgment given by a member states' court or tribunal, whatever the judgment is called.

However, recently a German court held that an English scheme of arrangement was invalid and unenforceable in Germany. Among other reasons, including local law reasons, the German court held that the English High Court had not made a judgment within the meaning of the Brussels Regulation by sanctioning the scheme, but had merely approved an agreement between the company and its creditors. This decision is currently under appeal in the German Federal Civil Court, and the outcome of the appeal will be of interest to European scheme proponents.

However, the decision related specifically to a scheme involving German law governed contracts. Where an English law governed contract is to be enforced, this requires an application to the English courts which have jurisdiction, irrespective of the location of the scheme creditors. This position remains unchanged.

CONCLUSION

It would be premature to view *Scottish Lion* as signalling the end for schemes. *Scottish Lion*, like *BAIC*, highlighted areas of consideration for companies proposing solvent schemes that wish to either wind up their business or close a particular book of business.

An important point for scheme companies to consider is the effect on their creditors and the scheme's working procedure, both of which are paramount. Early and effective creditor consultation is vital to a scheme's success. *Scottish Lion* demonstrates that the proposed scheme must show that the scheme compensates creditors for loss of cover. In relation to "substantially solvent" insurance companies proposing a scheme, the FSA normally requires that a risk premium or other "uplift" benefit is paid to creditors.

The importance of fair treatment of creditors and clear communication cannot be underestimated. Preparation, communication and consultation are placed at the top of the scheme development agenda. Solvent schemes remain a practical solution for closing direct and reinsurance business in a much shorter time frame than would be possible in the ordinary course of run-off.

CONTRIBUTOR DETAILS

Michelle Kierce, Helen Martin, Adriana Cotter and Nigel Montgomery
Sidley Austin LLP
T +44 20 7360 2583
+44 20 7360 2582
+44 20 7360 2559
+44 20 7360 2580
F +44 20 7626 7937
E *mkierce@sidley.com*
hmartin@sidley.com
acotter@sidley.com
nmontgomery@sidley.com
W *www.sidley.com*