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Schemes of Arrangement for Insurance Companies in Bermuda

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Preface

This publication has been prepared for the assistance of those who are considering schemes of arrangement for Bermuda insurance companies. It deals in broad terms with the requirements of Bermuda law. It is not intended to be exhaustive but merely to provide brief details and information which we hope will be of use to our clients. We recommend that our clients and prospective clients seek legal advice in Bermuda on their specific proposals before taking steps to implement them.

Copies of the Bermuda Companies Act 1981, as amended, and the Insurance Act 1978, as amended, have been prepared and are available on request.

Conyers Dill & Pearman

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1. INTRODUCTION

Under the provisions of section 99 of the Companies Act 1981 (the "Act") a company may compromise or enter into an arrangement (a "Scheme") with its creditors, or any class of them. As such, it is possible for an insurance company to achieve an early cut off of claims through the implementation of a Scheme.

Schemes can be implemented in respect of either solvent or insolvent companies, provided that it is a genuine and effective arrangement or compromise. A Scheme is particularly useful for insurance and reinsurance companies with mid to long-tail liabilities that may result in a long and expensive run off of business written, even though the company has long since ceased writing new business.

The advantage of such a course of action is that the company could achieve finality in respect of its long-tail business whilst avoiding the costs required to keep the company in run off, and without the necessity of obtaining the agreement of each and every one of its policyholders.

A scheme becomes binding on the company and its creditors if a majority in number representing 75% in value of those creditors attending and voting at the scheme meeting (in person or by proxy) vote in favour.

A Scheme is typically promoted by the company. Where a company is insolvent, a Liquidator may wish to bring the liquidation to an early closure and can introduce a scheme to creditors as an alternative to the statutory framework of liquidation set out in Part XIII of the Act.

2. FORMAL STEPS

2.1. Preliminary Steps

Bringing a Scheme into operation requires the following basic steps:

- An outline of a scheme should be prepared by the company, ideally through consultation with representatives of those policy holders to whom the Scheme will apply, to ensure that there is support for the proposal;
- A 'practice direction letter' should be sent to the policyholders, informing them of the intention to apply to Court for a "convening hearing", briefly explaining the terms and purpose of the Scheme, and how the class (or classes) of creditors have been formulated (discussed further below);
- An application is made to the Supreme Court of Bermuda (the "Court") seeking leave to convene a court meeting (the "Scheme Meeting") for the purpose of placing the scheme before the creditors. The Court will give directions as to the number of classes for voting purposes, how the meeting should be convened in terms of the length of notice, where it should be advertised, how the "scheme document" should be circulated and who should be Chairman of the meeting.
- Thereafter the company should serve on the creditors the "scheme document" which includes notice of the Scheme Meeting, along with (i) information on the steps which will be followed in order to implement the scheme, (ii) a statement (the "explanatory statement") explaining the purpose and effect of the scheme and in particular any material interests of the directors of the company (in their capacity as either directors, members or creditors or otherwise) and the effect of those interests on

the proposals in so far as they might be different from the interests, and (ii) the forms necessary for voting.

2.2. The Meeting

At the meeting itself, in order for the scheme to pass, the 'statutory majority must be achieved. This means that a majority in number representing three fourths in value *of the creditors present and voting* either in person or by proxy must agree to the scheme. If a creditor does not vote, that creditor will still be bound by any Scheme.

Whilst the minority within a class will be bound if the majority vote in favour, each class of creditors must vote in favour in order for the Scheme to proceed.

If the class or classes of creditors vote in favour, the company may then proceed to seek the Court's sanction of the Scheme.

2.3. The Sanction

The Court's sanction is not a "rubber stamp", and the Court must be satisfied that:

- The provisions of the Act have been complied with, this includes that the convening hearing took place in accordance with the Court's directions;
- The each class was fairly represented by those who attended the meeting and that those voting in favour were acting honestly (i.e. not trying to coerce the minority);
- The proposal is 'fair' such that it would be acceptable to an intelligent and honest creditor acting in his own best interest; and
- The proposals are commercially viable, i.e. there is no 'blot' in the proposal which would prevent the Scheme from being implemented.

In the absence of opposition the Court will be slow to differ from the views of the majority creditors who voted in favour. The Court recognises that the creditors are likely to be much better judges of what is to their commercial advantage that the Court can be[1].

Any creditor who has a grievance with respect to the scheme is entitled to appear at the hearing of the petition and make whatever submissions to the Court he so chooses and the Court will take these into consideration in reaching its decision.

Examples of when the Court may exercise its discretion to deny sanction might be (a) where the Court finds that the scheme is being used simply as a device to unfairly impose the views of the majority on the minority; (b) where the Court finds that the classes have not been properly determined (see below for a detailed discussion of class issues); or (c) if it can be shown that the information provided to creditors was materially defective.

Once the scheme has been sanctioned by the Court, in order for it to become operational, a copy of the Order with the scheme attached must be filed with the Registrar of Companies and is retained in the

[1] See *Re Osiris Insurance Ltd.* [1999]1BCLC 181

public file of the company. If all of these steps are followed and the scheme becomes operational then the company and all of those creditors being schemed are bound by the terms of the Scheme.

3. CLASSES

An important issue which needs to be addressed at an early stage is that of classes. The Act provides that the scheme should be between the company and its creditors, or any class of creditors. Each class must then vote at a separate meeting, and each class meeting must pass the scheme by the requisite majority in order the scheme to be approved.

Failure to identify the correct classes can be fatal to the scheme receiving court sanction. Pursuant to the *Guidelines Applicable to Schemes of Arrangement under s99 of the Companies Act 1981* (Supreme Court of Bermuda Commercial Court Circular No. 18 of 2007) the person promoting a scheme (normally the company) should, where the composition of classes is complex or potentially contentious, notify any person affected by the scheme of the purpose of the scheme along with the particulars of the meetings of creditors and their composition. The purpose is to enable creditors to raise any issues regarding the composition of the classes or meetings at the directions stage. The Court can then consider whether or not to give directions for the resolution of that issue prior to any Court directed meeting being held.

How are classes defined? A scheme is, in essence, a compromise or arrangement between the company and its creditors. If the company is offering what is, in effect, a different arrangement or compromise to one group of creditors than that which it is offering to another, then each of those groups of creditors would form different classes.

In practice, it is often difficult to determine when separate class meetings are required. There have been a number of decided cases in the English Courts which have gone some way to providing a formula but perhaps the best is that postulated in the Court of Appeal in Re Hawk Insurance Co. Ltd. where Lord Justice Chadwick stated:

> *...the relevant questions at the outset are: between whom is it proposed that a compromise or arrangement is to be made? Are the rights of those who are to be affected by the scheme proposed such that the scheme can be seen as a single arrangement; or ought the scheme to be regarded, on a true analysis, as a number of linked arrangements? The questions may be easy to state; but as the cases show, it is not always easy to answer*[2].

That case involved a scheme for an insolvent company which in its terms proposed that non insurance creditors and those insurance creditors with paid claims should receive 100% of their claims, those with outstanding claims should receive 75% and those with IBNR claims should receive 50%. All creditors were included in the same class and one meeting was held at which the scheme was approved. The judge of first instance (Arden J), in the absence of any opposition from creditors, refused to sanction the scheme and held that in light of the different treatment afforded the various groups of creditors, there should have been separate class meetings.

[2] [2002] 2 BCLC 480 at p. 514

The Court of Appeal held that in the context of that case, the scheme was between the company and its unsecured creditors who had a debt at a certain date (the ascertainment date). All debts were to be valued as at the ascertainment date and were to be submitted by a particular bar date. The only difference in treatment is the "weighting" with respect to dividends – which was described by the Court of Appeal as "crude or rough and ready" basis of valuing those elements of "contingency and futurity" of the outstanding losses and IBNR losses.

> *Seen in that light, it becomes clear not only that the provisions of the scheme do not reflect any difference in the rights which are to be released or varied, but also that the new rights given in place of the pre-existing rights do not fall into different classes*[3].

Following this analysis, the Court of Appeal restated the test which had first been laid in *Sovereign Life Assurance Co v Dodd*[4] namely that neither:

> *the rights released or varied, nor the new rights given under the scheme, are so dissimilar as to make it impossible for the persons entitled to those rights to consult together with a view to their common interest. The common interest, in the present case, is in achieving a relatively simple, inexpensive and expeditious winding up of the company's affairs outside a formal liquidation. It is a striking feature of this case that the creditors have, in fact, found it possible to consult together with a view to that common interest: there have been no dissentient voices.*

4. VALUING CLAIMS

In view of the fact that the purpose of the scheme is likely to be to allow the company to "commute" its long tail business, assess the value of same and pay out creditors immediately taking into account paid and outstanding claims together with IBNR, the scheme will need to provide a mechanism by which this can be assessed. This mechanism will require proposals on how claims should be filed, how they will be valued (i.e. by reference to some form scheme imposed actuarial assessment or some other method) and consideration given to issues relating to set off. In addition, much as one would in reaching agreement by way of commutation, consideration will need to be given to discounting IBNR claims to reflect early payment.

5. FOREIGN ASSISTANCE

The insurance/reinsurance industry is an international one, and this is particularly so in the case of Bermuda companies. As a result, companies who are considering schemes are likely to have written business with companies or individuals outside Bermuda, or to have purchased reinsurance cover from entities outside Bermuda. Indeed, oftentimes there may be assets in the US or the UK, securing a letter of credit or in a trust. While a scheme will bind all scheme creditors as a matter of Bermuda law, it may be that there are those who are outside the jurisdiction of Bermuda who will attempt to attach assets or commence actions elsewhere in an attempt to circumvent the provisions of the scheme. To prevent this occurring, it is not unusual for the company, or those administering a scheme to make an application in

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[3] *supra*, Chadwick LJ at p. 527

[4] [1892] 2 QB 573

the UK or the US to extend the effectiveness of the scheme to those jurisdictions. As indicated below, the scheme will generally include an adjudication process for claims which cannot be agreed. The purpose of this is to ensure a timely and consistent approach to the resolution of any disputes. By seeking assistance in foreign jurisdictions, the effectiveness of this scheme provision can be assured.

In the case of the UK, the most efficient manner to achieve this may be to have a parallel scheme run through the UK courts. While we do not advise on matters of English law, this is a well-trodden path and involves making an almost identical application in England as that which is made in Bermuda and obtaining an order for directions in both jurisdictions, together with a sanction order in both. There will be one scheme document, one circular and one meeting or one set of meetings.

Again, while we do not advise on matters of US law, it has been our experience that in the US an application may be made to the Bankruptcy Court for recognition pursuant to Chapter 15, or for parallel restructuring proceedings pursuant to Chapter 11 of the Bankruptcy Code.

Obviously, either of the two alternatives set out above would involve additional expense, but in certain circumstances it may well be that the exposure to the company in not seeking to extend the scheme's effectiveness in this way will result in a greater loss.

6. THE SCHEME IN OPERATION

Once a scheme is in place, with a scheme administrator appointed within the terms of the scheme itself, all dealings in respect of claims against the company caught by the scheme are dealt with within the terms of that scheme. The scheme administrator oversees the operation of the scheme. In respect of a solvent scheme, the work required to receive and value claims etc. will probably be carried out by the managers who will report to the scheme administrator. In the case of an insolvent scheme, this work may be carried out by the liquidator.

No creditor/policy holder bound by the scheme can be dealt with in a manner different from that set out in the scheme. In the event that there is disagreement in respect of any particular claim, the claim will be referred to an adjudication procedure which is built into the scheme. This is generally a method by which a scheme administrator and the policyholder can refer their dispute to an independent scheme adjudicator for a final decision. This avoids the expense and time delays involved in having disagreements referred either to court or arbitration. However, in the case of solvent schemes it is generally believed to be preferable to allow creditors, if they are unhappy with the decision of the adjudicator, to have a right of appeal to the court.

Once all claims have been valued, agreed and payments made, the company will be free to enter into a members' voluntary liquidation and thereafter dissolve, or in the case of an insolvent scheme, proceed with the formalities required to dissolve.

One of the key factors to the success of the scheme is to be able to actuarially assess the claims against the company. If this cannot be done then, certainly in the case of a solvent scheme, the process is not necessarily available. Another key factor is the recovery of reinsurance. It is essential that nothing done in connection with the scheme jeopardises the collection of any cover that might be available in respect of the claims made and allowed. Major reinsurers should be approached at the drafting stage with a view to obtaining their agreement to the methods proposed in the scheme for valuing creditors' claims.