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ARTICLE

Solvent Schemes of Arrangement in the Australian Reinsurance Industry

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Solvent schemes – also known as 'cut off' or 'valuation' schemes – involve a court approved process by which insurers which have written contracts with reinsurers approve the company settling all of their outstanding or future claims by one payment. They have become prevalent amongst UK insurance and reinsurance companies as a way to accelerate the payment of long-tail liabilities.

For reinsurers, solvent schemes can bring an early end to run-off and the repatriation of capital much sooner than if claims are allowed to mature in the ordinary course. This typically occurs where there is both a mature book of business and a clear surplus of assets over liabilities after payment of all liabilities. For cedants, solvent schemes allow them to have their future potential claims valued and paid in full sooner than in the ordinary course.

There have only been a few instances of solvent schemes implemented in Australia. This is explicable by the relatively small amount of mature long tail reinsurance business written by Australian reinsurance companies. However, their support in Australia suggests they are considered advantageous by both cedants and reinsurers. This article considers the nature and processes involved in solvent schemes for reinsurance companies, and the advantages and disadvantages of these schemes for reinsurers and their cedants.

The purpose of a solvent scheme of arrangement

Run-off exists where a reinsurance company has ceased to accept new insurance or reinsurance risks for the entire business or a division of the business, but claims remain unresolved and there are prospects of future claims being made. In the ordinary course of events, these claims are discharged as and when they arise, potentially over an extended period of time.

For a reinsurer that is no longer seeking new business, it is clearly undesirable to prolong the existence of such claims. Solvent schemes can accelerate the payment of these current and future claims and facilitate the winding up of inoperative businesses or bring an end to inoperative books of business in discrete divisions.

There have been only three instances of approved solvent schemes in Australia to date – those implemented on behalf of Mercantile Mutual Insurance (Aust) Ltd ('MMIA'), NRG London Reinsurance Co Ltd ('NRG London') and NRG Victory Aust Ltd ('NRG Victory').[1] In each instance, the reinsurers used a solvent scheme as a way of accelerating the payment of claims under existing reinsurance policies that had been made but not yet finalised, or were expected to be made in the future.

Mercantile Mutual Insurance (Aust) Ltd (MMIA)

The first solvent scheme approved in Australia was the MMIA scheme, which was approved by the Federal Court of Australia in *Re Mercantile Mutual Insurance (Aust) Ltd* (2002) 43 ACSR 676.

MMIA was an insurance company that as at 2002 had discontinued writing new reinsurance business. At that time MMIA was an Australian based division of the international financial services group ING, and prior to 2002 operated in both the general insurance and reinsurance markets.

MMIA and a number of other entities in the ING group decided to streamline their business, by removing books of business that were no longer active and were in run-off. For MMIA, the scheme was designed to apply only to claimants who stemmed from the discontinued non-Australian international reinsurance business emanating mainly from the London market, and discontinued inward reinsurance business. This allowed MMIA to bring an end to the inoperative segments of their business, and redirect funds and management into existing areas of business.

Notes

1 The writers acted for the companies in each of these schemes.

A feature of the scheme was that it was part of a number of different schemes which received concurrent Australian and UK court approval. The Federal Court of Australia granted permission for MMIA to convene the meeting of the scheme creditors in London, and for the parties to elect to have the arrangements governed by English law once approval had been gained.

As the only liabilities of the scheme companies to be subject to the scheme were reinsurance liabilities, the Federal Court accepted that the scheme creditors were all insurance companies (or similar entities) and could be expected to be sophisticated and knowledgeable in their consideration of whether to approve or reject the scheme. The court accepted that the proposed scheme provided a fair mechanism for dispute resolution where a creditor disagreed as to the nominated value of their claim, and that both ASIC and APRA had no objection to the scheme.

NRG London and NRG Victory

As with MMIA, NRG London and NRG Victory were both reinsurers seeking to bring an end to their unresolved insurance claims. NRG London was a reinsurance company incorporated in the UK. It was an active reinsurer until 1991, when it ceased underwriting new risks and was placed into run-off. The Australian branch of NRG London was a foreign corporation, licensed as a general insurer under the Corporations Act 2001. In 1991, the Australian branch of NRG London was also placed into run-off.

NRG Victory was incorporated in Victoria and was an active reinsurer in the Australian market until 1993. The company wrote both life and general reinsurance until 1993, when both activities ceased. At this time, the life insurance business of NRG Victory was transferred to another insurance entity, and the general insurance business was placed into run-off.

With the reinsurance business of both entities proceeding through the lengthy run-off process, the prospect of a solvent scheme that would bring an early end to this was appealing. Both entities proposed schemes that were nearly identical and were able to be dealt with in the one court approval process.

In granting approval, in *NRG London Reinsurance Co Ltd (ABN 77 001 160 792), Re NRG Victory Aust Ltd and the Corporations Act 2001* (2006) 58 ACSR 674, the Federal Court of Australia paid particular regard to three general features of the scheme – that the insurers could be expected to be commercially sophisticated by virtue of being insurance companies or similar entities, the business of both companies had been in run-off for a substantial period of time and there was a clear surplus of assets over liabilities.[2]

The process of implementation

The implementation of a solvent scheme in Australia is governed by Part 5.1 of the Corporations Act 2001 (Cth).

Identifying relevant creditors or classes of creditors

The first step in implementing a solvent scheme is to identify the relevant scheme creditors. Typically this will be defined in the scheme as a person who has a claim against the scheme company, being a liability under a reinsurance contract with the company.

The company must make all reasonable endeavours to identify the relevant creditors. In NRG, the Federal Court of Australia held that the scheme companies were required to establish that all reasonable steps had been taken or would be taken to identify the scheme creditors and to bring the proposed schemes to their attention, and that it seemed likely that the companies' efforts in these respects would be successful.[3]

Applying to the court for approval to convene meeting

Once all prospective creditors have been identified, the scheme company must apply to the court for approval to convene a meeting of the creditors, and for approval of the draft explanatory statement. The scheme company must also notify ASIC of the proposed scheme.[4]

Under section 411(1) and 1(A) of the Corporations Act 2001, the court has the power, upon application, to make orders that the company convene a meeting of creditors or a class of creditors be convened.

The court will also approve the explanatory statement that is required to accompany any notice of meeting that is sent to a scheme creditor.[5] Both the draft explanatory statement and the final statement are governed as to their contents by sections 411(3) and 412(1) of the Corporations Act 2001.

Section 411(3) provides that the draft explanatory statement must:

Notes

2 *NRG London Reinsurance Co Ltd (ABN 77 001 160 792), Re NRG Victory Aust Ltd and the Corporations Act 2001* (2006) 58 ACSR 674 at 676.
3 *Ibid.*
4 See section 411(2) of the Corporations Act 2001 (Cth).
5 The final version of this statement and its contents is required and governed by s412(1)(a).

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(a) explain the effect of the proposed arrangement, noting in particular any material interests of the directors of the scheme company; and

(b) set out such information as is prescribed and any other information that is material to the making of a decision by a creditor whether or not to agree to the scheme.

At the initial hearing, the court will determine whether the manner in which the proposed scheme will operate is so clearly unfair and unreasonable that it should not be allowed to go ahead for consideration.[6] The court will also determine whether there should be only one or multiple classes of scheme creditors, whether the explanatory statement provides adequate disclosure and complies with its statutory requirements and whether the way in which the value of scheme creditors' claims will be determined for the purposes of voting at the meeting is fair and reasonable.[7]

The scheme company will need to demonstrate to the court that the following requirements have been met:

– all reasonable steps have been or will be taken to identify potential scheme creditors and to bring notice of the proposed scheme to their attention;

– the explanatory statement for the proposed schemes provides an adequate description of the nature and purpose of the scheme, as well as its principal advantages and disadvantages;

– the manner in which the proposed scheme will operate is fair and reasonable and that the method by which the value of scheme creditors' claims will be determined is fair and reasonable;

– it is appropriate that there be only one meeting of creditors of each scheme company;

– the way in which the value of scheme creditors' claims will be determined for the purposes of voting at the scheme meeting is fair and reasonable;

– the proposed schemes comply generally with the requirements of the Corporations Act 2001 including adequate notification to ASIC;

– the scheme companies have provided full disclosure about the proposed schemes, and their future intentions, not only to scheme creditors and to the court, but also to APRA and ASIC, and that APRA and ASIC have had full opportunity to peruse the material and give the court a considered assessment of their positions.[8]

Approval by the majority

Once the court has approved the convening of the creditors' meeting and the explanatory statement, notice of the meeting must be given to the scheme creditors.

Typical examples of methods to notify creditors are:

– making enquiries of managers or agents of various underwriting pools;

– sending copies of the scheme booklet to all authorised insurers in relevant geographic areas, and all brokers who may have conducted business relevant to the scheme; and

– advertising the scheme in newspapers in relevant geographic areas.[9]

The scheme becomes binding upon approval at the meeting provided that the following requirements are met:

– the scheme is agreed to by a majority in number of the creditors (or class of creditors) present and voting;

– the relevant majority consists of creditors whose debts or claims against the company amount in the aggregate to at least 75% of the total amount of the debts and claims of the creditors present and voting.[10]

The process by which the value of the creditors' claims will be determined for the purposes of voting at the scheme meeting is generally set out in the explanatory statement.[11]

Final court approval

Once the scheme is approved by the requisite majority, a final application is made to the court for approval of the scheme. Where a creditor is unsatisfied with the result of a valuation at the creditors' meeting, they may raise this concern with the court at the final hearing for approval.

Once a scheme has been approved by the court, a suspension will be placed on all claims against the company. Claims cannot thereafter be commenced or continued against the company unless the scheme is utilised, as the scheme represents the only acceptable procedure by which to resolve such claims.

The claim forms are then sent to all known scheme creditors for them to lodge their claims. There also a

Notes

6 *NRG London Reinsurance Co Ltd*, supra note 1, 676.
7 *Ibid.*
8 *Ibid.*
9 *NRG London Reinsurance Co Ltd*, supra note 1, 680.
10 Section 411(4) of the Corporations Act 2001.
11 *NRG London Reinsurance Co Ltd*, supra note 1, 686.

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cut-off date imposed on claims once a scheme has been approved. This means that in order to recover a claim amount, creditors must submit their claims by the nominated cut off date. Claims will not be paid where they do not comply with this time period. Under section 1321 of the Corporations Act 2001, however, where a person is aggrieved by any act, omission or decision of a person administering the scheme, they have a right of appeal to the court. This is a final safeguard for a creditor to ensure that there is equitable treatment, and an opportunity to remedy this if it is not the case.

Advantages and disadvantages of solvent schemes of arrangement

Solvent schemes provide a number of advantages for scheme companies and scheme creditors, largely relating to the early resolution of claims and certainty for both parties. In terms of disadvantages, these chiefly concern the limitations in estimating an insurance claim that has not fully crystallised.

Certainty and finality

The principal benefits of a solvent scheme are:

– scheme companies are able to terminate their relevant businesses, avoiding the need for a costly and protracted run-off. This will involve saving a substantial amount of money in administrative, legal, accounting, regulatory and other costs; and

– scheme creditors will be paid in full for the value of their claims, and generally no discount will be applied for the time-value of money.

Limitations in valuation

A potential difficulty with a solvent scheme is the possibility of an inaccurate valuation of a creditor's claim. This is an issue for both the creditor and the company. Where the creditor is granted an amount in excess of the true value of the claim, the company is worse off and the financial benefits of an early resolution of their business may be diminished. As for the creditor, the estimate may be an amount less than that to which they would have been entitled if run-off had continued to its natural end.

With respect to this issue, however, Lindgren J remarked in NRG that '[n]o doubt scheme creditors will take into account this disadvantage, and, on the other hand, the extent of the advantage to them of having money in hand, in determining whether to support the scheme'.[12] The parties will need to have careful regard to whether the advantages of entering the scheme outweigh the limitations on the estimation of a claim.

Protection of scheme creditors

While there are advantages for both the scheme company and scheme creditors in implementing a solvent scheme, the inherent characteristics of such a scheme require a number of protections to be afforded to scheme creditors.

The protection of creditor interests is particularly important when one considers the binding nature of a solvent scheme and the cut off of all claims that are not made within the relevant time period. As such, the courts will typically consider whether the scheme provides adequate protection against these issues prior to granting approval to the convening of the meeting or approving the scheme itself.

The interests of creditors are protected by the key features of the scheme itself. These include:

Sufficient notification of creditors

The company must provide sufficient notification of the scheme meeting and cut off date to the scheme creditors to ensure that all the creditors are aware of the essence of the scheme's provisions and effects, and to provide the creditors with sufficient opportunity to submit their forms for voting and claim purposes.[13] Such notification is essential due to the fact that in order to receive satisfaction of a claim, the claim must be submitted prior to the cut off date imposed by the scheme.

Majority approval and classes of creditors

The scheme must be approved by a required majority of scheme creditors. Where it is regarded by the court that there are a number of groups with different interests, the court will require that numerous meetings are held, with each meeting comprised of the different classes of creditor.[14]

Both the requirement for majority vote and the division of claims into suitable classes increases the protection afforded to the creditor.

Notes

12 *NRG London Reinsurance Co Ltd*, supra note 1, 680.

13 *Re Mercantile Mutual Insurance (Australia) Ltd* (2002) 196 ALR 362 at 370.

14 For a discussion of this see *Re Mercantile Mutual Insurance*, supra note 12 and *NRG London Reinsurance Co Ltd*, supra note 1, 682-686.

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Adjudication of claims

If the scheme is to be approved, it will generally require provision for adjudication in circumstances where the company and the scheme creditor cannot agree on the value of a claim.[15] It is usually the case that the scheme company will instruct an actuary to assist scheme companies with the evaluation of their claims. The actuary will prepare an estimation methodology that is considered to be a sound actuarial approach to the valuation of the majority of claims expected to be made. Most claims will be estimated in line with this methodology, unless it is clearly inappropriate in the particular circumstances.

Generally, upon receipt of a claim form from a scheme creditor, the company will review the amount that the claimant has submitted. If the scheme company agrees with the creditor's valuation, then this amount will be accepted as the relevant claims amount. If the scheme company and creditor cannot agree, the matter will be referred to a nominated scheme adjudicator. The usual process is that the scheme adjudicator will consider all relevant information, may consult with actuaries and lawyers, and then determine the value of the claim.

Reversion to run-off

Most schemes will feature the option of reverting to run-off to guard against any danger that the company will become insolvent due to a high volume or value of claims made by creditors. Solvent schemes will generally provide that if the total amount of all claims exceeds a certain amount, the scheme company will have the option of terminating the scheme and reverting to run-off. This reassures both the creditors and the approving court that the scheme companies will not be rendered insolvent as a result of an unexpectedly high value of claims.[16]

The creditor can thus support the scheme knowing that their support will not result in the company entering insolvency, or if there is any danger of this, that the scheme will be suspended in order to secure funds.

Participation by regulatory bodies

In NRG, the Federal Court of Australia noted that in order to approve the convening of a meeting and the final arrangement, the company would have to establish that the proposed scheme was brought to the attention of not only ASIC, but also APRA.[17]

The sophistication of the creditor

As demonstrated by NRG, the court in making its determination will also have regard to the commercial sophistication of the creditor. In NRG, the Federal Court of Australia considered it relevant that the creditors were all insurance companies and thus could be 'expected to be commercially sophisticated and knowledgeable and ... able to assess where their best interests [lay]'.[18]

Conclusion

Solvent schemes are a useful tool for reinsurance companies which are in run-off. They provide an advantageous mechanism to bring unresolved claims to an end, and to free up both the relevant company and its creditors.

While potential disadvantages exist with the limitations on estimating a claim and the finality of a scheme, these are readily overcome by the precautionary measures the courts require when deciding whether to approve a scheme.

Although to date solvent schemes in Australia have been limited to mature books of business in the reinsurance industry, it is important to note the potential for expansion of such schemes. As regulators become more comfortable with these processes, there is the possibility that they will also become more comfortable with approving schemes for less mature books of business, and, providing the relevant safeguards are implemented, direct insureds.

If the overriding purpose of a scheme is in fact the implementation of an exit strategy which is both fair and commercially acceptable to all the stakeholders involved, an intelligently devised and compliant solvent scheme will produce this result.

Notes

15 *Re Mercantile Mutual Insurance*, supra note 12, 370.
16 *NRG London Reinsurance Co Ltd,* supra note 1, 679-680.
17 *NRG London Reinsurance Co Ltd,* supra note 1, 676.
18 *NRG London Reinsurance Co Ltd,* supra note 1, 684.

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