

An update on Part VII transfers



The Part VII transfer mechanism has proved increasingly popular in the run up to Solvency II. **Nick Miles*** of Sedgwick, Detert, Moran & Arnold, a co-author of 'Part VII Transfers: a practical guide', reviews some recent developments in practice and procedure and additions to case law

The interval since the publication of 'Part VII Transfers: a practical guide' early in 2009 has witnessed some substantial transfers under the UK regime, including the transfer of 1992 and prior general business from Lloyd's names to Equitas Insurance Ltd (June 2009) and the very recent consolidation of general business of various Aviva entities into Aviva Insurance Ltd (November 2011).

The number of transfers advertised in the UK during 2010 was materially higher than those in 2009, and the trend has continued this year. Incidence of advertisements can belie the scale of the business affected. However, with Sompco, Aviva and Direct Line this year, 2011 must qualify as one of the higher years by volume since the Part VII process was

introduced in 2001. That the trend is driven in large part by Solvency II is hardly open to doubt. The pace seems likely to continue through to implementation of Solvency II and possibly beyond.

There are developments in practice and procedure to report, as well as additional case law:

- More light has been cast on the standard that objections must meet.
- The Financial Services Authority (FSA) is becoming increasingly attentive to objections.
- The courts and the FSA are making more stringent demands on applicants to comply with statutory notification requirements.
- We know a little more about the court's approach to 'transfers' of policies that may not be effective under law of the policy.

Objections

Fairness and security

This topic is discussed in Chapter 10 of the book. Recent decisions underscore the high standard objections must meet and clarify what is meant by the 'fairness' of a transfer.

Unless it uses the 'lite' regime, the transfer needs sanction of the court.

Among other things, the court must consider whether the scheme is fair as between different classes of 'affected persons'.

A detriment to one class of affected person will not of itself make the transfer unfair (in any event, if the detriment is really material, the FSA will have opposed and the transfer will not have reached the court – particularly where the detriment relates to security).

The court considered what unfair-



ness amounts to in *Re Sompo Japan Insurance Inc.* ([2011] EWHC 260 (Ch) (*Sompo 2*)). One objector invoked detriment to security as grounds for objection.

The Independent Expert (IE) had attributed a confidence level of the transferring policyholders' claims

ing policyholders. This, the objector argued, was 'at the expense' of the transferring class.

The court agreed that this would, 'be a consideration of significant weight if the existing policyholders' benefit was being obtained at the expense of the transferring

While the court in *Sompo 2* did not need to consider it (there was one such objection but it was withdrawn) the IE responded in detail in a supplemental report. The approach and discussion were representative.

Set-off between contracts in a solvent context is available in only a limited range of cases. But its potential is frequently factored into commercial negotiations and so removal of mutuality (by transfer) will be noticeable. But strictly speaking this is not a matter of security.

Set-off is more widely available in a winding-up or administration (at least under principles in the UK). So loss of mutuality in this event might have a detrimental effect on security. But provided the confidence level attributed to the applicants is satisfactory, the detriment involved in loss of this 'extra' security is unlikely to be considered material by the IE or the court.

'Set-off is often raised by objectors who are both policyholders under transferring business and reinsurers of the transferor under non-transferring business as a security issue'

being paid in full *without the transfer* of 99.88 per cent. For the same class post-transfer, the confidence level was 99.6 per cent.

Realising that its opposition was unlikely to gain traction unless it could show unfairness, the objector argued that the problem was not just the detriment in itself, but its conjunction with an advantage conferred on the transferee's policyholders.

As a result of fresh security, conditional upon the transfer taking place, the transferee received an increased reinsurance limit. This marginally improved the security of all exist-

policyholders.'

However, since the increased security was 'not in any sense taken from, or at the expense of, resources otherwise available to meet the claims of the transferring policyholders,' the objection failed.

Set-off and security

Set-off is often raised by objectors who are both policyholders under transferring business and reinsurers of the transferor under non-transferring business as a security issue.

Notification

Notification has assumed renewed significance and is likely to be a more costly aspect of the process than before. (Notification is discussed in Chapter 8 of the book.)

Statute requires applicants to send a notice, stating that an application for sanction of a transfer has been

made, to every policyholder. However, applicants often ask the court to waive the need for strict compliance where this would be disproportionate.

Provided the FSA does not object, the court has been prepared to allow notifications to intermediaries, industrial or professional bodies, and supplemented advertising, in lieu of compliance.

Lloyd's Names and Equitas Insurance Ltd sought such a waiver in 2009. The judge observed that where parties have undertaken that they 'will do their utmost to notify and publicise the Scheme as far as possible, it would be a rare case where sensible waivers, subject to conditions, would be refused.'

But by 2010 a different approach was emerging, and notification has now become a more onerous and closely scrutinised factor.

The FSA intimated plans to take a more rigorous approach to proposals to abridge notification requirements and now generally takes a closer interest in objections.

The judge who heard the waiver application in *Equitas* said, one year later, in respect of another transfer (*Ecclesiastical Life*; 2010), 'the importance of the notice provisions cannot be underestimated' and refused to waive the need for notification of a class of policyholders.

In another case (*Direct Line*; 2011), a directions hearing was adjourned to allow the applicants to adduce further evidence about how advertising would be enhanced to bring the transfer to the attention of policyholders, in lieu of individual notice.

Finally, in the Aviva transfer earlier this year, the court helpfully set out factors to which it will have

regard in a waiver application. These include: the possibility, practicability and utility of individual notification; proportionality – the burden / benefit of individual notification; and the commercial objective of the transfer and its impact on policyholders. These are largely reflective of the considerations the FSA already takes into account (in Chapter 18 of SUP in the FSA's Handbook).

In one heroic recent effort, parties to a transfer were required to notify 14 million policyholders.

Transfers which may be only partially effective

Security again

The significance of policies governed by a foreign law, which it cannot be assumed will recognise the transfer, has come up more than once since publication of our Part VII book. As Chapter 4 of the book discusses, such transfers are only 'partially effective' because mere sanction of a UK court does not of itself bring about transfer of liability, nor may liability ever be transferred (under the relevant system of law).

Sompo 2 was a sequel to an earlier transfer (2007; *Sompo 1*) between the same applicants. In *Sompo 1*, the court considered how a preponderance of transferring policies governed by foreign systems of law (most notably the law of Japan and the law of states of the United States of America) should affect the court's decision.

The court concluded that partial inefficacy was not a reason not to sanction, provided a 'substantial purpose' would nonetheless be achieved – in other words, provided a substantial number of policies could be expected to transfer effectively (just under 30 per cent in *Sompo 1*).

In *Sompo 2*, the court endorsed that view, with qualifications. In particular, partial inefficacy is tolerable provided that it does not undermine the IE's analysis by introducing 'some distinct element of unfairness or

unacceptable level of security.'

Objectors argued that partial efficacy may impair security. However, partial inefficacy proved to be advantageous to transferring policyholders and transferee's existing policyholders, and neutral to the policyholders who should but do not transfer.

For the former pair, it meant new security (which was not conditional on complete transfer) would be shared among fewer policies. For the latter, they kept the level of security of *Sompo*. The objection did not succeed.

Conclusion

The approach to the protection of policyholders has toughened substantially over the past five years, but objectors still face the same challenges.

By the time of publication of our book, the FSA had responded to the recommendation of the court to attend the sanction hearing and report on (among other things) objections, case law had confirmed that key documents referred to in the IE's report should be made available to affected persons, and that the IE should take legal advice on the validity, scope and enforceability of important components of applicants' security. Today, applicants face tougher expectations about notification and must engage much more closely with the FSA on objections.

The overwhelming majority of transfers receiving sanction testifies to two factors; the resilience of the procedure, and the rigorous approach of the FSA in the early stages. ●

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