



# The insolvency of insurers

EU Directive on the reorganisation and winding-up of insurance undertakings



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## Introduction

In April 2003, the government introduced into UK law an EU directive which looks certain to have a big impact on how the London (and indeed, European) insurance market operates.

The Insurers (Reorganisation and Winding-up) Directive was adopted by the EU as long ago as February 2001. It was brought into force in the UK by the Insurers (Reorganisation and Winding-up) Regulations on 20 April 2003. This followed a lengthy consultation process during which interested parties provided the government with detailed comments as to how the Directive should be implemented.

The philosophy underlying the Directive is one of providing greater consumer protection and it is part of a wider drive to achieve consistency of approach to insolvency proceedings across Europe.

The Directive could lead to a major structural change in the London insurance market. It will affect all those who have any dealings with insurance companies which are in, or which might at some stage end up in, an insolvency or reorganisation process. In essence, the reason for this is that the Directive fundamentally alters the rules regarding payment priority on insolvency: direct insurance claimants now receive priority ahead of other unsecured creditors (including reinsureds).

This guide summarises the Directive, considering its effects on all those involved in the London market, and deals with:

- the traditional position in the UK and Europe;
- the scope of application of the Directive and its principal provisions;
- key issues concerning the Directive; and
- the expected impact of the Directive on some important aspects of financial and insurance transactions.

This guide does not consider the impact of the Directive on the Lloyd's insurance market. This is simply because the government is still considering how best to implement the Directive in relation to Lloyd's.

## **Traditional regime in the UK**

Over the past 15 years, UK procedures for dealing with the insolvency of insurance companies have become well established. Typically, provisional liquidators were appointed and a scheme of arrangement was then put forward pursuant to section 425 of the Companies Act 1985. Creditors with similar interests were divided into different classes for the purposes of the scheme. Creditor meetings voted on the scheme and each class had to vote in favour of the scheme by the requisite majority for it to be approved – that is, a majority in number and three-quarters in value of those attending. The final stage in the process consisted of obtaining the sanction of the court.

As far as distributions were concerned, the terms of the scheme would broadly reflect the position that would have applied if the company in question had gone into liquidation. In other words, all unsecured creditors (whether policyholders, reinsureds or otherwise) were treated similarly. In general terms, no group of unsecured creditors had any form of priority.

Although this has traditionally been the most widely used procedure, it must be noted that administration has recently been extended to cover insurance companies. The likelihood therefore is that, going forward, any new insolvencies of insurance companies will involve administrators (rather than provisional liquidators) being appointed.

From a European perspective, although the single insurance market has been in place for a number of years, there has been no co-ordination before now of member states' insurance insolvency laws. So, if an insurance company with operations throughout Europe was wound up, the authorities in each member state where the company is represented could begin separate proceedings. Each set of proceedings would be run according to local law, which could lead to conflicts of jurisdiction and unequal treatment of creditors. There could be recognition difficulties, together with an uneven availability of policyholder protection. The Directive aims to overcome these problems by establishing which member state has jurisdiction (at least so far as the majority of issues are concerned).

## **The Directive**

The Directive creates a new landscape for the winding-up and reorganisation of insurers in the UK and other member states. It provides for a single set of winding-up proceedings or reorganisation measures that will be started in the member state where the relevant undertaking is authorised, known as the ‘home’ member state. The home member state’s rules apply throughout the EU, subject to a number of exceptions.

### **Application**

The Directive applies to all ‘insurance undertakings’ – that is undertakings writing direct life and non-life business. The Directive has no direct application to ‘pure’ reinsurers. For insolvency proceedings relating to a reinsurer, the general rules under the EU Regulation on Insolvency Proceedings apply.

The Directive will assist principally in cases where an insurance undertaking has a branch or presence in more than one EU member state. In practice it may be that an insurance undertaking that is active in more than one member state has established subsidiaries rather than branches. Subsidiaries, being separate corporate entities, would each be subject to a different set of winding-up proceedings or reorganisation methods.

### **Implementation**

It is left to each national authority to choose the precise form and methods to implement the Directive. In the UK, this was secondary legislation in the form of the Regulations. The Regulations must be interpreted, as far as possible, to give effect to the Directive.

Article 31(1) specifies that the member states have to adopt the Directive by 20 April 2003.

### **Applicable law**

The Directive provides that, once implemented, winding-up proceedings or reorganisation measures should be carried out in accordance with the laws of the home member state and should be effective throughout Europe without further formality under a system of mutual recognition.

Article 9 of the Directive specifies that the law of the home member state shall determine in particular:

- the assets which form part of the estate;
- the respective powers of the insurance undertaking and the liquidator;

- the effects on current contracts to which the insurance undertaking is party;
- the treatment of claims;
- the rules governing the lodging, verification and admission of claims;
- the rules on distribution;
- costs and expenses; and
- voidability of transactions.

However, certain contracts and rights would continue to be dealt with under the law that governs them, rather than the law of the home member state. These include employment rights, rights of set-off, rights *in rem* and retention of title. As noted above, the Directive does not attempt to harmonise reorganisation and substantive insolvency law throughout the member states. So there will be some continuing scope for conflicts of law issues to arise following implementation of the Directive.

## **Key issues**

The scope of this guide does not permit a detailed analysis of all potential issues arising from the Directive's implementation. In this section, therefore, we focus on what we consider to be the key issues.

### **Types of proceedings**

The Directive applies both to 'winding-up proceedings' and to 'reorganisation measures'. These are defined in articles 2(c) and (d) of the Directive as follows.

Reorganisation measures 'include any measures involving the intervention by administrative or judicial authorities, intended to preserve or restore the financial position of the insurance undertaking and which affect pre-existing rights of parties ... including but not limited to ... suspension of payments, suspension of enforcement measures or the reduction of claims'.

Winding-up proceedings 'means collective proceedings involving realising the assets of an insurance undertaking and distributing the proceeds among the creditors, shareholders or members as appropriate'. This includes proceedings, regardless of whether they are founded on insolvency and if they are voluntary or compulsory.

The question arises as to which UK procedures fall into either (or both) of these categories. The Regulations make it explicit that the term 'winding-up proceedings' under the Directive will apply to compulsory winding-up proceedings, provisional liquidation and creditors' voluntary liquidation.

In relation to 'reorganisation measures', the Regulations make it clear that this will include administration proceedings, together with company voluntary arrangements under part I of the Insolvency Act 1986. The reduction of contracts under section 377 of the Financial Services and Markets Act 2000 is also a 'reorganisation measure' for the purposes of the Directive. This is because the intention behind such a procedure is that the insurer should continue its business as a going concern.

Receiverships clearly fall outside the scope of the Directive. This is consistent with the EU Regulation on Insolvency Proceedings and it acknowledges the use of receiverships to enforce the rights of a particular secured creditor, as opposed to the interests of the general body of creditors as a whole.

There was much debate, both at the time of the consultation process referred to above and subsequently, as to whether schemes of arrangement under section 425 of the Companies Act 1985 should fall within the ambit of the Directive. The Regulations now explicitly

exclude schemes. This is one of the most important aspects of the Regulations. Draftsmen of future schemes will have to bear firmly in mind the change in payment priorities discussed below.

There are transitional provisions in the Regulations which ensure that all existing insurance insolvencies will continue to be dealt with in accordance with traditional *pari passu* rules. Insurance companies which have already adopted schemes of arrangement will therefore be unaffected by the Directive.

### **Priority of payment of claims**

The most important feature of the Directive is that it provides for insurance claims to have priority in a winding-up over the claims of other unsecured creditors. For these purposes, 'insurance claims' means any claim owed by an insurance undertaking arising from an insurance contract to any injured person, policyholder, beneficiary or any injured party having a direct right of action against such insurance undertaking.

Previously, policyholders have had equal priority to other unsecured creditors of the insolvent insurer. In other words, the general *pari passu* rule under English insolvency law applied and there was no special status for insurance creditors (nor was there any distinction between insureds and reinsureds).

Article 10 of the Directive provides that member states must adopt one, or both, of the following methods.

- In relation to assets representing the technical provisions, insurance claims take absolute precedence over other claims. Where member states opt for this method, they must require insurance undertakings to keep a special register in line with the provisions set out in the annex to the Directive. This includes details of the assets used by an insurer to cover its technical provisions and the value of those assets must at no time fall below the value of the technical provisions. Further, separate registers have to be kept for non-life business and life business.
- In relation to all assets of the insurance undertaking, insurance claims take precedence over other claims, with the possible exception of claims by employees, claims for tax or social security and claims on assets subject to rights *in rem*.

In both cases, the expenses of the winding-up may take precedence over insurance claims. The claims of non-insurance creditors (including pure finance creditors) and insurance creditors that are not direct (such as reinsureds) are postponed to the claims of direct insurance creditors.

The UK has adopted the second method. Ireland, on the other hand, has opted for the first method and the Irish equivalent of the Regulations provides for insurance claims to have 'absolute precedence' over the relevant body of assets.

Member states also have the option of disapplying policyholder priority to the extent that a guarantee scheme (such as the Financial Services Compensation Scheme) meets an insurance claim and then assumes the policyholder's right to pursue that claim. The government in the UK chose not to exercise this option.

### **Notification and publicity**

One concern addressed by the Directive is the need to ensure that all interested parties throughout the EU, including policyholders, are made aware of any reorganisation measures or winding-up proceedings started in the home member state. In relation to this, the Regulations contain a number of detailed proposals for the notification of creditors' claims. These include a requirement for a liquidator or administrator to give notice of winding-up and reorganisation proceedings. There is also provision in the Regulations for notices to creditors to be translated into all official languages of the EU unless creditors have either requested or expressly agreed to receive communications in English. All these requirements reflect the consumer protection theme which underlies the Directive.

Once reorganisation measures or winding-up proceedings have commenced in a member state, or immediately before they commence, the competent authorities in that member state (usually the judiciary) must inform the relevant home state supervisory authority (in the UK, the Financial Services Authority). The supervisory authority must then inform the supervisory authorities in all other member states that proceedings have commenced, including the practical effects of such proceedings. A notice must be published in the Official Journal of the EU and known creditors in other member states must be notified.

### **Withdrawal of authorisation**

Once winding-up proceedings are open, the authorisation of the insurance undertaking will be withdrawn. However, the liquidator continues to have authorisation to carry on insurance business to the extent necessary or appropriate to the winding-up.

### **Non-EU insurers**

Article 30 of the Directive applies to insurers which are registered outside the EU. In other words, for a non-EU insurer which has branches in the EU, the Directive will apply to those branches.

Clearly, such a case raises more complex issues, notably if (as is likely to be the case) there are proceedings both in the insurer's non-EU home state and also within the EU. However, it is clear that:

- if the non-EU insurer has multiple EU branches, then (unlike the general rule) there may be separate procedures in each jurisdiction where there is a branch; and
- the rules on notification and priority of direct insurance claims will apply to any proceedings commenced in the EU in respect of a branch or branches in the EU. If the insurer in question is based in a jurisdiction which has a strict *pari passu* rule, the non-insurance creditors and reinsureds will have an interest in proving in the main insolvency rather than in the EU proceedings.

## **The impact of the Directive**

The impact of the Directive will not be limited to insolvency. Many aspects of financial and security transactions involving insurance companies will also be affected. This section of the guide focuses on the more general issues arising post-implementation of the Directive.

### **Reinsurance industry**

As noted above, the Directive applies to ‘insurance undertakings’ and pure reinsurers are excluded from its ambit. For reinsurers caught by the Directive, priority is afforded to direct insurance creditors only. In this respect, the Directive will have a big impact on buyers and sellers of reinsurance in the current market. Clearly, a major factor affecting the purchase of reinsurance is the security of the reinsurer.

It should be noted that the term ‘reinsurance’ is not used in the Directive (but it is used in the Regulations). There is scope for disputes as to whether a particular arrangement constitutes insurance and as to what constitutes direct insurance.

In light of the priority provisions, parties may attempt to implement strategies to mitigate the impact of those provisions. In particular, there will be an emphasis on reinsureds reviewing the risk profiles under their reinsurance programmes to establish definitively whether cover has been properly classified as insurance or reinsurance. If the latter, it will be necessary to find out whether the reinsurer also writes direct business.

The Directive may therefore result in many parties having an increased credit risk. The buyer of reinsurance is going to be exposed if the reinsurer goes into insolvency and, at worst, could receive nothing. This may lead to price adjustments or a shift towards alternative sources for reinsurance such as pure or overseas reinsurers. In the longer term, insurance companies may look to restructure, splitting out their reinsurance operations from their direct business. These options may be more attractive and less of a risk than under present reinsurance arrangements.

### **Counterparties and contractual arrangements**

The Directive will result in a radical change in risk profile for counterparties under reinsurance programmes, financial products with insurer participants and commercial/corporate transactions. For example, the classification of derivatives or derivatives involving insurance as ‘insurance’ or ‘non-insurance’ becomes important, as the holders of such instruments may find themselves ranking behind insurance creditors and ahead only of shareholders on an

insolvency. Further, a bondholder is likely to be an unsecured creditor of the insurer, subordinated to insurance creditors. Indeed, this issue will arise with any unsecured financial instrument, so that counterparties may become structurally subordinated to insurance creditors.

Counterparties are now likely to face increased credit exposure. In light of this, the prudent counterparty will reassess the risk profile of such arrangements and take appropriate action to protect itself. In particular, as rights *in rem* and rights of set-off fall outside the scope of the Directive, this may lead to parties building a form of actual security into the contractual arrangements, taking collateral and set-off rights or including a charge over future income streams. Alternatively, parties may seek additional comfort, for example in the form of parent company guarantees, or will attempt to create obligations as 'insurance claims'.

#### **Rating agencies**

Rating agencies have recognised the impact of the new rules on priority on all unsecured creditors of insurers (other than direct insurance creditors), including holders of debt. To take account of this, they have already announced a change in their rating criteria whereby senior and explicitly subordinated debt obligations of European insurance companies will now be rated lower than their counterparty credit and insurer financial strength ratings.

## Conclusion

It remains to be seen if the Directive will achieve the stated aim of mutual recognition of winding-up proceedings and reorganisation methods across the member states. This is obviously a desirable goal and with careful consideration and appropriate planning, insurers, counterparties and their advisers should be able to maximise the benefits of this co-ordinated approach to pan-European insolvencies.

The new regime will clearly have a big impact on the insurance industry. For insolvency professionals, the approach currently adopted towards preparing schemes of arrangement will have to change to reflect the fact that insurance claims and other unsecured claims will now need to be dealt with separately, and will therefore amount to different classes.

The implementation of the Directive may lead to a possible shift towards placing reinsurance cover with pure reinsurers over mixed direct/reinsurance writers. Alternatively, the Directive may lead to a reorganisation of existing underwriters to split out their reinsurance business, resulting in an increased number of pure reinsurers.

It is also clear that from April 2003 onwards parties will look for contractual solutions to the issues presented by the Directive and, in particular, the priority provisions contained in article 10. As already noted, this may lead to an increase in security and the use of set-off rights in contractual arrangements in the future.

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