UK Part VII Transfer
as a Guide to US Insurance Business Transfers

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1. Insurance business transfer plans of one form or another are well recognized in multiple jurisdictions outside the United States. In the European Union, a series of European Directives require EU members to have in place mechanisms for such transfers. Directive 2002/83/EC provides for the transfer of all or part of the part of the portfolio of life assurance business from one life assurer to another (see article 14), Directive 92/49/EC addresses the transfer of all or part of the portfolio of non-life insurance business (see article 12), and Directive 2005/68/EC addresses portfolios of reinsurance business (see article 18).

2. British law establishes a procedure to transfer insurance portfolios under Part VII, sections 103A to 117 of the Financial Services and Markets Act 2000 ("FSMA").[2] This legislation covers both insurance business transfers and banking business transfers and is fundamentally a restructuring statute. Although it satisfies the requirements of the various European Directives just identified, it predates those Directives and is itself an update of previous British legislation allowing for such transfers, specifically Schedule 2C to the Insurance Companies Act 1982 (now repealed).

3. As U.S. jurisdictions implement or consider implementing similar legislation allowing for corporate restructuring of insurance companies, many of the issues already addressed under the British legislation will undoubtedly arise again, making it useful to review British practices.

4. As with the US transfer mechanisms that have been implemented or are being considered, an insurance business transfer plan may be implemented with court approval after all interested parties (including regulators) are given an opportunity to object. No consent of interested parties is required,[3] with the court approval process

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[2] In particular, see FSMA section 105(1) which defines the relevant transfer as being one that "results in the business transferred being carried on from an establishment of the transferee in an EEA State", comprises business by a UK insurer or carried on in the UK, and is not excluded by statute.
[3] In contrast, a majority of creditors needs to approve a scheme of arrangement, which is a voluntary restructuring of a UK company. The process involved is analogous to a Chapter 11 reorganization under the U.S. bankruptcy code, including requirements of approval by separate classes of creditors where interests among the creditors sufficiently diverge. UK Companies Act 2006, §§ 895-901. Although the scheme process is analogous to a U.S. bankruptcy reorganization, it is also used with solvent companies for other purposes such as mergers and demergers of companies and to effect the transfer of minority shareholders' interests where 75% of shareholders agree to sell a company. Because majority creditor approval is required, a scheme may prejudice creditors in ways that would not be deemed fair for the purpose of a Part VII transfer. The statute governing schemes actually allows for a "compromise or arrangement", *id.* § 895(1), and many insurance schemes involve compromises of liabilities in the form of commutations, which go well beyond what can be accomplished through a transfer of policies.

(including regulatory review and comment) serving to protect the interests of affected persons. Applicants for a transfer must take appropriate steps to give policyholders and other affected persons notice of the proposed transfer and an opportunity to object.

5. The core regulatory concern for insurers is solvency, and unsurprisingly the core issue addressed in court cases on business transfers is the degree of solvency required for a transferee insurer. The statute itself expresses little guidance on the point (or indeed on the requirements for transfers in general), indicating simply that the "court must consider that, in all the circumstances of the case, it is appropriate to sanction the" transfer.[4] The British courts have elaborated further on that test, determining:

> "Ultimately what the court is concerned with is whether the scheme is fair as between different classes of affected persons, and in arriving at a conclusion as to whether or not it is, among the most important material before the court is material which the Act requires to be before it, namely the report of an independent actuary as to his opinion on the scheme."[5]

6. This was elaborated further by the court in *Re Axa Equity & Law Life Assur. Soc. plc & Axa Sun Life plc* (applying the predecessor statute, the Insurance Companies Act 1982):

> "(1) The 1982 Act confers an absolute discretion on the court whether or not to sanction a scheme but this is a discretion which must be exercised by giving due recognition to the commercial judgment entrusted by the company's constitution to its directors.
>
> "(2) *The court is concerned whether a policyholder, employee or other interested person or any group of them will be adversely affected by the scheme*.
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> "(3) *This is primarily a matter of actuarial judgment involving a comparison of the security and reasonable expectations of policyholders without the scheme with what would be the result if the scheme were implemented*. For the purpose of this comparison the 1982 Act assigns an important role to the independent actuary to whose report the court will give close attention.
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> "(4) The FSA[6] by reason of its regulatory powers can also be expected to have the necessary material and expertise to express an informed opinion on

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[4] FSMA § 111(3).

[5] *Re: Hill Samuel Life Assurance Limited* [1998] 3 All ER 176, at 177 (as quoted in *Re Pearl Assurance (Unit Linked Pensions) Ltd and others* - [2006] All ER (D) 72 (Sep), ¶ 6).

[6] The FSA, or Financial Services Authority, no longer exists. Its functions have been split between the Prudential Regulation Authority and the Financial Conduct Authority.

whether policyholders are likely to be adversely affected. Again the court will pay close attention to any views expressed by the FSA.

"(5) *That individual policyholders or groups of policyholders may be adversely affected does not mean that the scheme has to be rejected by the court. The fundamental question is whether the scheme as a whole is fair as between the interests of the different classes of persons affected.*

"(6) It is not the function of the court to produce what, in its view, is the best possible scheme. As between different schemes, all of which the court may deem fair, it is the company's directors' choice which to pursue.

"(7) Under the same principle the details of the scheme are not a matter for the court provided that the scheme as a whole is found to be fair. Thus the court will not amend the scheme because it thinks that individual provisions could be improved upon.

"(8) It seems to me to follow from the above and in particular paras (2), (3) and (5) that the court, in arriving at its conclusion, *should first determine what the contractual rights and reasonable expectations of policyholders were before the scheme was promulgated and then compare those with the likely result on the rights and expectations of policyholders if the scheme is put into effect*." [7]

7. If policies are transferred from one company to another, what level of security in the new company is sufficient such that the transfer is considered fair? Put differently, what exactly must the independent actuary opine on? The British courts have determined that as long as the transferee company has sufficient assets to meet its *regulatory capital requirements*, the transaction is fair. A mere reduction in capital coverage does not give reason to refuse sanction to a transfer.[8] The court discussed this point in *Re Norwich Union and other companies*:[9]

> "**[14]** With that in mind I shall deal first with the objections raised by Mr Butcher. Chief amongst them was a complaint as to changes effected by the Scheme as to the excess over the "required minimum margin" of solvency or "RMM" available to several classes of policyholders. It is a fact that by reason of different funds having, for example, different origins, different investment records, different administrative costs and by reason of their being open or closed, they have ended up with different amounts by which their assets exceed their liabilities and, in turn, different extents to which their RMM is

[7] [2001] 1 All ER (Comm) 1010, ¶ 6 (emphasis added). The principles quoted in the text are derived from a previous unpublished judgment under the Insurance Companies Act 1982, *Re London Life Association Ltd* (21 February 1989) (Hoffman J.). The principles have subsequently been applied under the FSMA. *See, e.g., Re Norwich Union*, [2004] EWHC 2802 (Ch), ¶¶ 13-14; *Re The Copenhagen Reins. Co. (UK) Ltd*, [2016] EWHC 944 (Ch), ¶ 17.
[8] *Re The Copenhagen Reins. Co. (UK) Ltd*, [2016] EWHC 944 (Ch), ¶ 21.
[9] [2004] EWHC 2802 (Ch).

covered. Under the Scheme in some cases the RMM is improved, in some diminished. Accordingly there is a double complaint; one part is that the Scheme is unfair as between policyholders, some having their position improved, some having it weakened, and, as to the other part of the complaint, it is that the Claimant companies and the shareholders standing behind them gain from the Scheme whereas, policyholders or at any rate those with diminished RMMs, only suffer from it.

"**[15]** As to the first part of that double complaint, firstly *as an insurance company is in general free in the course of its business to annihilate or diminish the excess over the RMM, to that extent there is no entitlement of a policyholder to cover beyond the RMM itself or to the maintenance of an existing RMM*. Secondly, the RMM, determined according to EU rules and based on calculations of assets and liabilities following FSA Regulations, is intended to represent a practical level of policyholder safety. One can thus reduce the excess over the RMM without materially endangering security. Thirdly, whether any particular reduction in an excess over RMM represents a material disadvantage to any policyholder is a matter for expert actuarial and accounting assessment. Here the Independent Expert whilst, as one might expect, using slightly different language as to different funds and as to guaranteed benefits or benefit expectations, has concluded that no-one sufferers by the Scheme to a material extent; there would be no discernible impact, he says, on security; there was no reason to believe that there would be any adverse affect." (Emphasis added.)

8. Notably, the requirements of regulatory capital for British companies have shifted over time. The current requirement is that companies meet the requirements of Solvency II. That requirement applies to any Part VII transfers that happen under current law, as indicated both in court precedent[10] and in the EU Directives cited above.[11]

9. Solvency margins for EU companies are calculated on a different basis than those of American companies. Under Solvency II, companies can either use a standard model or a customized model approved by the regulator better reflecting the risk profile of the company than the standard model. The standard model is deterministic, meaning that it determines capital requirements based upon a presumed risk profile without regard to the actual actuarial profile of the company involved. The model, however, is based upon certain actuarial assumptions. Specifically, the model determines, on

[10] *See*, *e.g.*, *Re Sompo Japan Ins. Inc*, [2011] EWHC 260 (Ch), ¶ 36.
[11] *E.g.*, Directive 2002/82/EC, art. 14 ("Under the conditions laid down by national law, each Member State shall authorise assurance undertakings with head offices within its territory to transfer all or part of their portfolios of contracts, concluded under either the right of establishment or the freedom to provide services, to an accepting office established within the Community, if the competent authorities of the home Member State of the accepting office certify that after taking the transfer into account, *the latter possesses the necessary solvency margin*." (Emphasis added.))

its assumptions, the amount of capital required for an insurance company to run off solvent in 99.5% of outcomes over a one-year time horizon. In other words, if the loss reserves of the company deteriorate, at the end of one year the company will still have sufficient capital to meet 99.5% of the modelling outcomes for the run off of that company.

10. Before implementation of Solvency II, the UK used a similar but different solvency determination known as an Individual Capital Assessment or ICA.[12] Under that test, the company had to have sufficient capital such that it could meet 97.5% of modelled outcomes at the end of five years.[13] For most long-tail books of business those two tests – 99.5% on a one-year time horizon and 97.5% on a five year time horizon – are effectively equivalent. For shorter tail books they may generate different outcomes.

11. The discussion thus far has focused on the standards applied by the court sanctioning the Part VII transfer. Some transfers falling within the definition of a "ring-fencing transfer scheme" require approval of the UK regulator.[14] Most schemes do not expressly require approval, but the UK's two insurance regulators, the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA"), have a statutory right to be heard in any proceeding to approve a transfer, and in practice the courts are unlikely to approve a transfer that the PRA or FCA determines is unfair to policyholders. In addition, the regulator has to approve the choice of independent expert to advise the court on the transfer and has to approve the form of the independent expert's report.[15] Both the PRA[16] and the FCA[17] have issued guidance papers on Part VII transfers.

12. The practice in the UK is for the independent experts – in practice always an actuary[18] – to evaluate the transfer from the perspective of three different groups: (i) the policyholders being transferred, (ii) the policyholders of the transferor not being transferred, and (iii) the pre-transfer policyholders of the transferee company.[19] In each case, the expert advises the court whether any of the three groups is being materially prejudiced by the transfer.

[12] A related acronym is "ICAS" referring to individual capital adequacy standards, which was the framework under which a firm prepared its ICA before Solvency II became effective. *See* https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2013/pension-obligation-risk-treatment-under-the-individual-capital-adequacy-standards-for-insurers-5-13. Of course, the same letters can also refer to the plural of ICA, or "ICAs".
[13] *Re The Copenhagen Reins. Co. (UK) Ltd*, [2016] EWHC 944 (Ch), ¶ 20.
[14] FSMA § 106B, 107.
[15] FSMA § 109.
[16] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2015/ps715 (pdf p.199)
[17] https://www.fca.org.uk/publication/finalised-guidance/fg18-04.pdf
[18] PRA Statement of Policy, *supra* note 16, ¶ 2.18.
[19] The affected classes of persons to be considered also includes shareholders. For a full list see *Re Sompo Japan Ins. Inc*, [2011] EWHC 260 (Ch), ¶ 6. The three point identified in the text are specifically enumerated in the PRA policy statement on the form of the expert opinion. PRA Statement of Policy, *supra* note 16, ¶ 2.30(11).

13. U.S. insurance companies also have a statutory calculation of regulatory capital, known as risk-based capital or RBC.[20] Similar to the standard model used for Solvency II, it is a deterministic model that does not rely upon an assessment of the individual actuarial profile of the specific book of business. However, the U.S. model is principally designed to identify when regulatory action is required, so how that translates to determining the capital adequacy of a transferee company is unknown.

14. Policyholders have also objected to business transfers on the ground that they did not offer an opt out to individual policyholders. That objection has been rejected, albeit with the qualification that if the "failure to provide an opt-out [went] to the basic question of fairness", then it would be appropriate for the court to consider.[21] However, courts have yet to find a transfer deficient for failure to provide an opt out.

15. Other issues of prejudice to policyholders have arisen as well. For example, reinsureds may have collateral from the reinsurer to ensure that they receive balance-sheet credit for the reinsurance asset. In most cases the reinsured will have a contractual right to the collateral, and thus will not be prejudiced since the transferee of the book will be legally obligated to provide replacement collateral.[22]

16. An additional objection sometimes raised is that a counterparty will lose set-off rights. For instance, assume Company A is both a cedant and a reinsurer of Company B. Company A will in some cases have the contractual right to set off amounts owed to Company B as a reinsurer against amounts by Company B. Even if there is no contractual right, as a practical matter there would be a commercial ability to assert set-off in the form of a counter-claim (although that can be complicated by different arbitration clauses and other matters) and there would also likely be a set-off right in the event Company B became insolvent. If the inwards or the outwards book is transferred, Company A loses its set off rights. It may of course gain set-off rights against the transferee company, but that will depend upon who is the transferee. In any case, in practice where someone raises concerns about set off, they are typically dealt with commercially to eliminate any objections.

17. A key aspect of Part VII transfers is the transfer of outwards reinsurance that attaches to the inwards book of business being transferred. Section 112(2)(a) of the FSMA permits the transfer order to "transfer property or liabilities whether or not the

[20] *See, e.g.,* R.I. Gen. Laws §§ 27-4.6-1 to -13; Okla. Stat. §§ 36-1521 to -1530; N.Y. Ins. Law § 1324.
[21] *Re Norwich Union & other cos.*, [2004] EWHC 2802 (Ch), ¶ 26 ("In any event, one can readily see the massive disadvantages which would arise were any given company to be required to continue with some of its business (where an opt-out had been exercised) as it had been before the Scheme and some of it (where there was no such exercise) as it should be after the Scheme had received sanction. So far from simplifying the structures in the companies, they would be made even worse.").
[22] *See Re Names at Lloyd's for the 1992 and Prior Years of Account, Represented by Equitas Ltd.*, [2009] EWHC 1595 (Ch) ¶¶ 26-28 (concluding that U.S. policyholders were not prejudiced by the transfer because substitute collateral was provided).

authorised person concerned otherwise has the capacity to effect the transfer in question". The UK courts have held that this provision authorizes the courts to order the transfer of reinsurance assets without reinsurer consent.[23] Indeed, the reinsurance can be transferred "even in cases where those properties or liabilities might otherwise be non-transferable, for example by reason of express contractual provision."[24] They have also permitted modification of guarantees of the business being transferred so that transferred policyholders continue to benefit from the guarantee.[25]

18. Other objections depend upon the details of the book of business being transferred and the treatment of the book by the transferee. For example, with respect to the transfer of a life insurance book, policyholders in *Re HSBC Life Ltd.* raised a number of concerns:

> "At present, HLUK policyholders can access information concerning their policy, make fund switches and make additional contributions online, at the same time as dealing with their HSBC bank accounts. Although it will be possible for ReAssure [the transferee] policyholders to access unit prices on the ReAssure website, so as to calculate the value of their fund, and ReAssure will continue to accept regular payments electronically, ReAssure is not intending to offer the same online facility in relation to switching and the making of additional contributions. As a matter of policy, such changes will have to be made in written correspondence or following a telephone call to a call centre, which is to be open during business hours on week days."[26]

19. These concerns were evaluated by the regulator (in this case the FCA rather than the PRA), the independent expert, and the court. The independent expert opined, and the court agreed:

> "Although policyholders may be less familiar with ReAssure as a brand compared to HSBC, I do not consider this, in itself, to be a reason for the Scheme not to proceed. In particular, holding a product with a well-known or familiar brand does not provide any guarantee about the standards to which the policies will be administered. Indeed, in this instance, I believe it is important to note that HLUK no longer sells pension business and that the Scheme represents a stage in HLUK's strategic decision to exit this market. In contrast, ReAssure has a substantial existing pension book and the Scheme represents an expansion of its presence in this market. While impossible to quantify, I consider that there is a benefit to policyholders in being in a

[23] *WASA Int'l (UK) Ins. Co Ltd v WASA Int'l Ins. Co Ltd*, [2003] 1 All ER (Comm) 696, ¶¶ 17-21.
[24] *Re Cater Allen Ltd* [2002] EWHC 3147 (Ch) (as quoted with approval in *WASA Int'l (UK) Ins. Co Ltd* at ¶ 20); *see also Co-operative Group (CWS) Ltd v Stansell Ltd* [2006] EWCA Civ 538 (applying the same principle to non-insurance transfers under the Industrial and Provident Societies Act).
[25] *Re The Copenhagen Reins. Co. (UK) Ltd*, [2016] EWHC 944 (Ch), ¶¶ 28-49 (the court relied upon § 112(1)(d) as authority to do so).
[26] [2015] EWHC 2664 (Ch), ¶ 21.

company with an ongoing commitment to a particular market, as it is more likely that they will invest to reflect emerging market developments in the future …

"I appreciate that HLUK may inspire confidence in policyholders as a result of being part of HSBC, an established and recognisable brand. However, this brand recognition comes primarily from its retail banking services rather than its presence in the UK life insurance industry - a sector in which it has limited presence, which would be reduced further by the approval of the Scheme. ReAssure is a part of Swiss Re, which is also a large global business with its own established brand, and one of the market leaders in the financial services industry. It already manages a large block of pensions business, and has an ongoing commitment to expanding its presence in the UK life insurance industry. As a result, I do not believe that objections on the basis of brand loyalty, in itself, is a reason for the Scheme not to proceed."[27]

20. In addition, the PRA Policy Statement on insurance business transfers highlights some issues that could raise potential issues of prejudice in its requirements as to the form of the expert opinion required for the transfer, indicating that the opinion should evaluate, *inter alia*:

"(a) the effect of the scheme on the security of policyholders' contractual rights, including the likelihood and potential effects of the insolvency of the insurer;

"(b) the likely effects of the scheme on matters such as investment management, new business strategy, administration, claims handling, expense levels and valuation bases in relation to how they may affect:

"(i) the security of policyholders' contractual rights;

"(ii) levels of service provided to policyholders; or

"(iii) for long-term insurance business, the reasonable expectations of policyholders; and

"(c) the cost and tax effects of the scheme, in relation to how they may affect the security of policyholders' contractual rights, or for long-term insurance business, their reasonable expectations."[28]

21. How the factors identified by the PRA will affect an individual transfer will of course depend upon the particular facts of a case. As the *Re HSBC Life Ltd.* decision quoted above indicates, the mere fact that a transfer will involve changes to how the policyholder interfaces with its insurer will not prevent British courts from sanctioning an insurance business transfer. To prevent the sanctioning of a transfer,

[27] Id. ¶ 55.
[28] PRA Policy Statement, supra note 16, ¶ 2.33.

the changes must be materially prejudicial such that sanctioning the scheme would not be deemed fair.

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