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Insolvency regime for the Lloyd's market

Treasury publishes proposals to implement EU directive

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Introduction

The Treasury has published proposals for implementing the EU directive on the reorganisation and winding-up of insurance undertakings (the Directive) in the Lloyd's market. The Directive was brought into force in the UK in relation to the insurance company market in April 2003, but its application to the Lloyd's market presents certain unique problems, which need to be addressed in implementing legislation. This guide looks at the Treasury's proposals and, in particular, how they take account of issues raised by the structure of the Lloyd's market and how insurance business is conducted.

The Directive

The main purpose of the Directive is to establish co-ordinated rules throughout the EU for the reorganisation and winding-up of insurance undertakings. Its basic framework is that only the member state where an insurer is authorised, the ‘home’ member state, can take a decision on the reorganisation or winding-up of the insurer. This decision must be recognised and given effect to in all other member states. The laws of the home member state will also govern all major aspects of the relevant proceedings or measures.

Priority of claims

Perhaps the most important feature of the Directive from the UK’s perspective is that it has changed the rules on priority of claims in the winding-up of an insurer. Historically in the UK, policyholders have had equal priority to other unsecured creditors on the winding-up of an insolvent insurer; the general pari passu rule applied and insurance creditors were not afforded any special status. The Directive changes this by providing for direct insurance claims to have priority in a winding-up over the claims of other creditors. For these purposes, the term ‘insurance claims’ is defined as amounts owed by the insurance company to its policyholders under insurance contracts. Importantly, it does not include reinsurance.

Member states also have discretion under the Directive to exclude assets that are subject to proprietary rights (eg assets subject to security and assets held on trust) from the new rules on priority. The UK has adopted this approach to the insurance company market.

Application to Lloyd’s

In implementing the Directive for the insurance company market, the UK made the minimum changes necessary to insolvency law. Adopting the same approach to Lloyd’s, the Treasury needed to address a number of issues to ensure both compliance with the Directive and that its proposals are workable within the peculiarities of the Lloyd’s structure.

The Directive applies to winding-up proceedings or reorganisation measures for all ‘insurance undertakings’. In the case of Lloyd’s, this means ‘the association of underwriters known as Lloyd’s’, not the Society itself or the underwriting members taken individually. Current insolvency procedures apply on a member-by-member basis, however, and do not attach to the Lloyd’s market as a whole. The Treasury’s proposals therefore address how to apply the requirements of the Directive at the level of the ‘association’ of underwriters.

Because the Directive is directed at the 'association' of underwriters, the Treasury has chosen to distinguish between:

- the insolvency of an individual member, in which case existing procedures under the Insolvency Act 1986 will continue to apply, as well as the now customary processes used for insolvent Lloyd's corporate vehicles, without recourse to the requirements of the Directive; and
- a wider market insolvency, in which case the provisions of the Directive are triggered and the new regime described below will apply.

The decision to exclude individual insolvencies from the new regime has been made on the basis that financial safeguards operating in the Lloyd's market, including the ultimate availability of the Lloyd's Central Fund, already protect creditors in such cases and additional Directive safeguards are not needed.

Other issues considered by the Treasury include the application of Directive requirements on priority and how rules on set-off might be applied.

Treasury's proposals

The Treasury's proposals aim to ensure that if either the entire Lloyd's market, or a significant part of it, is in difficulty, it should have every opportunity to restore its financial position and, if appropriate, to continue carrying on insurance business. The insolvency of an individual underwriting member alone would not trigger the new regime.

Court-ordered procedure

A new court-ordered procedure (the Lloyd's market reorganisation order or LMRO) would be made available where regulatory solvency requirements applicable to the market are not, or may not, be met. The objective of the procedure would be to:

- preserve or restore the financial situation of, or market confidence in, Lloyd's, so that insurance business can continue to be carried on; or
- assist in reaching the best outcome for creditors of members (and insurance creditors in particular).

Moratorium

There would be a stay of all unilateral action by creditors and litigation against anyone covered by the LMRO (including members, managing agents, the Society and others) to enable a reorganisation to take place in an orderly manner.

Appointment of a Lloyd's market reorganisation controller

A Lloyd's market reorganisation controller would be appointed. His role would be to investigate the extent of any problems faced by the market and to find ways of meeting the objectives of the LMRO. Among other things, this would include agreeing a reorganisation plan with the Financial Services Authority (FSA) and the involvement of the court.

Notification of insolvency measures

Once a LMRO has been made, any insolvency measures affecting members would have to be notified to the reorganisation controller and to the FSA. In turn, the FSA would have to notify regulators of such measures.

Insolvent members to be treated in accordance with the Directive

While the LMRO is in force, members that are the subject of insolvency proceedings would be treated in accordance with the Directive unless the court is satisfied that insurance market debts of the member will be satisfied. In such cases, other EU insolvency legislation, in particular the Insolvency Regulation, would be disapplied.

Rights of the reorganisation controller

The reorganisation controller would have the right to be heard on any application to lift the moratorium, and the court must take his representations into account.

Timetable

The Treasury is keen to implement the Directive for Lloyd's as soon as possible. However, it also recognises that its proposals are complex and that interested parties will need some time to consider them in detail. The consultation period therefore runs until 11 March 2005. The Treasury aims to bring forward legislation by May 2005, which would be brought into force shortly afterwards.

Scope of the Directive

'The association of underwriters known as Lloyd's'

The Directive applies to reorganisation measures or winding-up proceedings affecting all 'insurance undertakings' as defined by the First Life and Non-Life Directives (the First Life Directive has since been incorporated into Directive 2002/83/EC). Applying this definition, it catches 'the association of underwriters known as Lloyd's', which does not have any independent legal personality. This makes it difficult to implement the requirements of the Directive.

Although only underwriting members of Lloyd's actually incur insurance liabilities, the Treasury argues that relevant participants for the purposes of implementing the Directive effectively must include:

- the Society of Lloyd's;
- members or former members of the Society;
- Lloyd's managing agents, members' agents and brokers;
- approved run-off companies;
- coverholders;
- subsidiaries of Lloyd's; and
- trustees of certain Lloyd's trust funds and overseas business regulatory deposits.

The close relationship between the various participants and, in particular, the role some of them play in managing the affairs of members, mean that all must be involved.

Insolvency in the Lloyd's market

Because the 'association of underwriters known as Lloyd's' has no separate legal personality, there are no clear events of insolvency for the market as a whole. Existing procedures already deal with the insolvency of individual members. Also, the Central Fund may provide additional financial support to an underwriting member who gets into difficulty. Usually, therefore, safeguards provided by the Directive are not needed when insolvency problems experienced by individual members do not leave valid insurance claims unpaid and have no further impact on the market.

Because of this, the Treasury argues that the Directive is aimed at the following two situations.

- The Lloyd's market has, or is likely to have, a problem meeting its market regulatory solvency requirements. In this case, the Treasury

notes that failure to meet regulatory solvency requirements at any time does not necessarily mean that insurance claims cannot be met. So, measures taken to implement the Directive should allow for the restoration of a sound financial position (in accordance with existing procedures under EU insurance directives) and the continuation of insurance business in the Lloyd's market. This is much the same as for the insurance company market.

- Insurance creditors of one or more members cannot be satisfied through the usual Lloyd's market methods. In these circumstances, the Treasury argues that any insolvency of a member of Lloyd's should be subject to the insolvency regime already applied to insurance companies.

Implementation of the Directive

Trigger for LMRO

Based on its assessment of the intended scope of the Directive, the Treasury is clear that an insolvency event at the level of individual Lloyd's members should not trigger the requirements of the Directive while Central Fund assets are enough to meet insurance liabilities. In this case, no threat is posed to market solvency.

The Directive only becomes relevant at the point where events within the market give rise to a material risk that market regulatory solvency requirements will not be met or that not all policyholders will be paid. However, it may be too difficult to assess when policyholders are at risk of not being paid. So, the Treasury proposes that the point at which steps may be taken to apply the provisions of the Directive should be when regulatory solvency requirements applying to the Lloyd's market are not or may not be met, even though that would not necessarily imply that policyholders' claims might not be paid.

Imposition of LMRO

The court will have power to make a LMRO, on application by the Society or the FSA, if it appears that:

- the regulatory solvency margin imposed by FSA rules is not or may not be met; and
- the order is likely to:
  - preserve or restore the financial situation of, or market confidence in, the Lloyd's market to facilitate the carrying on of insurance market activities by Lloyd's members; and/or
  - assist in achieving an outcome that is in the interests of creditors of members, and insurance creditors in particular.

An important aspect of the proposed new procedure is that there is no automatic imposition of a LMRO. This allows the FSA and the Society to look for ways of restoring the financial position of the market before approaching the court. The court also has discretion whether to make the LMRO.

In making a LMRO, the court will appoint a reorganisation controller and impose a moratorium on claims by creditors and litigation. The court decides who falls within the scope of the LMRO and so benefits from the moratorium. All relevant participants in the market for the purposes of the Directive, as described above, except coverholders are automatically caught unless excluded following an application to the court. Coverholders, on the other hand, need to be expressly named. At this stage, there is no intention that any

action taken in relation to the market should inevitably lead to a 'winding-up' procedure.

The LMRO will not:

- prevent payment of insureds, or of other liabilities, where appropriate – managing agents will be able to continue paying claims from assets that are available to them; or
- impede or unwind payments that at the time of suspension were either settled or in process.

Once a LMRO is made, insolvency proceedings in respect of UK members will have to be notified to the FSA and to the reorganisation controller. The reorganisation controller is entitled to be heard in any proceedings and the court is under an obligation to take account of his representations.

When insolvency proceedings are begun in relation to a member, the member will be treated as if it were a UK insurer for the purposes of those proceedings unless the court is satisfied that it is likely that insurance market debts of the member will be met. This means, therefore, that members will be treated in accordance with the Directive rather than the Insolvency Regulation. The significance of this relates to whether Directive rules on prioritisation in a winding-up need to apply. Provided that creditors are likely to be paid in full, the priority rules have no real relevance but once it seems that this will not be the case the winding-up needs to take place under the regime established by the Directive.

Prioritisation of claims in winding-up

Difficulties in applying the requirements of the Directive on prioritisation of claims in a winding-up to the Lloyd's market arise because of:

- the number of legal entities who might potentially be liable on a claim, ie many members often participate in underwriting the same claim;
- the forms in which assets are held; and
- the nature of the reinsurance to close mechanism.

Little can be done about the first of these, but the second and third are considered further.

Assets held on trust

As stated above, in applying the priority rules member states have discretion under the Directive to exclude assets over which a person can assert a proprietary right (ie rights in rem). This would catch most of the assets backing underwriting liabilities and capital

requirements of Lloyd's members, which are held on trust. For example, members must place all premiums and insurance receivables in a Premiums Trust Fund. Because these trust requirements are essentially measures aimed at protecting policyholders, the Treasury argues that it is consistent with the objectives of the Directive to exclude trust assets from any rules established on priority.

RITC

The Lloyd's market operates as a series of annual ventures. Each year of account usually stays open for a period of three years, at the end of which it is closed under a process known as 'reinsurance to close'. Essentially, this involves outstanding liabilities for the closing year being taken over by a succeeding year of account (usually of the same syndicate) in return for the payment of a premium. The reinsurance to close contract (RITC) giving effect to these arrangements is designed not to alter the position of the underlying policyholder.

The policy of the Directive that direct, not reinsurance, creditors of an insolvent insurer are given priority over other creditors needs to be implemented in a way that is compatible with the RITC process. Briefly, therefore, the Treasury proposes that any liability of a succeeding year of account under a RITC contract should be deemed to be a direct insurance liability in those cases where the original liability was one of direct insurance. The Treasury argues that any other approach would be incompatible with the Directive's objectives.

Central Fund assets

Because the Central Fund plays an important part in ensuring that insurance claims can be met in full, the Treasury proposes to introduce a control mechanism to address the use of Central Fund assets once a LMRO has been made. Unless otherwise agreed by the Society, the reorganisation controller and the FSA, the Society will be required to give five working days' notice to the reorganisation controller of any proposed payment from the Central Fund.

Personal assets of members

In principle, personal assets of individual Names are available to meet insurance claims even though they do not count towards regulatory solvency. The Treasury has therefore decided that all unencumbered assets and property of members should be caught by the new priority rules. This means, of course, that the claims of other creditors of an insolvent Name would be subordinated to policyholder claims in a winding-up or bankruptcy.

Set-off

Finally, the Treasury looks at how set-off might apply in the Lloyd's context. Taking a pragmatic line, it argues that to apply set-off across the market at the level of every member would be excessively costly and time-consuming, if not impossible. It therefore proposes that set-off should operate at a syndicate level to allow its arrangements to work.

This is not dissimilar to the process commonly adopted in schemes of arrangement by companies having dealings with members of Lloyd's.

Interaction of Directive with other insolvency legislation

Interaction with the Insolvency Regulation

The Insolvency Regulation, like the Directive, deals with the cross-border effects of insolvency proceedings in the EEA. While the regulation purports to exclude insurers from its scope, the exclusion does not appear to apply to Lloyd's corporate vehicles. However, where there is a failure of the Lloyd's market, the Treasury notes that the overriding concern must be that the requirements of the Directive are met. So, if:

- insolvency proceedings are begun in respect of a member;
- at a time when the Lloyd's market cannot meet its regulatory solvency test; and
- a LMRO is in force;
- if the court is not satisfied that it is likely that the insurance market debts of the member will be satisfied,

the insolvency of that member is to be treated as falling within the ambit of the Directive, not the Insolvency Regulation and Directive requirements on prioritisation of claims apply.

Conclusion

In implementing the Directive for the company market, the Treasury had to incorporate the unusual feature of giving priority, in a winding-up, to some ordinary creditors at the expense of others. This also required the creation of a distinction between insurance and reinsurance creditors.

In turning its attention to the Lloyd's market, the Treasury had once again to deal with this priority issue. It also had to apply provisions of the Directive that had been drawn up without any special regard to the particularities of the Lloyd's market.

The Treasury has come up with a proposal which creates a flexible structure at the level of the 'association of underwriters known as Lloyd's' but which leaves largely untouched the insolvency processes and procedures as they operate at the level of individual members.

The Treasury is therefore proposing to create a framework that would be available, if ever needed, in an extreme situation. These proposals adhere to the principles underlying the Directive.

In a sense, the structures adopted by the Lloyd's market, and, in particular, the placing of assets in trust, represent adherence long before the Directive, to the philosophy of policyholder protection and priority.

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