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Scottish Lion – a flick of the tail by Tim Goodger and Ed Stanley

"We can see no basis...for the view that 'creditor democracy' operates only where 'failure to agree would ruin it for all'."

The Lord President

These are the words of the Inner House Court of Sessions when deciding in favour of The Scottish Lion Insurance Company Limited on the appeal of the first instance decision of Lord Glennie dismissing its petition for a solvent scheme of arrangement. The Inner House ruled on 29 January that The Scottish Lion Insurance Company's appeal has been successful.

The Inner House confirmed that the concept of creditor democracy that has been applied to insolvent schemes of arrangement under the Companies Act legislation applies to equally for solvent schemes, in circumstances in which the requisite majorities by value and by number of creditors voting at the relevant scheme creditor meetings, have been obtained. The court was reluctant to come to the view however that creditor democracy was conclusive and binding on all creditors in all circumstances.

The Court's ruling confirms that solvent schemes can in principle be a legitimate way of running off long-tail insurance business, provided the procedures are followed correctly and the requisite majorities obtained. The petition is now to be remitted back to the lower court for further consideration.

The Inner House concluded that Lord Glennie was wrong to make a distinction, and therefore require different considerations to be accounted for, between insolvent and solvent schemes of arrangement for insurance companies under Part 26 of the 2006 Companies Act.

The Court considered that the loss by the assured creditors of contractual rights could not be said to be something that would "*disable*" the Court from sanctioning the scheme. This notwithstanding that the Court readily accepted that the creditor assureds would prefer to retain their existing contractual rights. The relevant statutory provisions conferred on the Court a power to vary or extinguish contractual rights, notwithstanding opposition by those who possessed those rights.

Background

The Scottish Lion's appeal related to its application to the first instance Court for approval of a solvent scheme following scheme creditor meetings at which Scottish Lion had obtained the requisite majorities by value and by number of creditors voting. As is well known, Scottish Lion was in run-off and had not written new business since 1994, having previously written insurance business including business with long tail losses arising out of asbestos, pollution

and health hazard (APH) risks. Not being insolvent or close to insolvency, the company had promulgated a solvent scheme of arrangement to, in effect, enter into a statutory compromise whereby claims on insurance policies it had issued would be settled. Two classes of creditor had been identified, one being for IBNR creditors (for losses that had been incurred but not reported) and the other non-IBNR creditors. The scheme was opposed by certain American corporations (being IBNR creditors), which had taken out "occurrence" policies with Scottish Lion, and had exposures to APH losses. They had contended amongst other things that the methodology employed by the chairman of the scheme meetings to evaluate claims for voting purposes was not fair and reasonable.

The decision

The Inner House considered whether Lord Glennie was entitled to dismiss the petition of Scottish Lion on what was essentially a preliminary point, that a petitioner – in a solvent scheme – could not succeed in its application for sanction in the absence of "**a problem requiring a solution**". The Inner House concluded that this was not a knock-out point but rather a factor the court should take into account when considering points in favour of and against sanctioning the scheme.

Lord Glennie at first instance had posited the question whether it was sufficient for a company petitioning for a scheme - in the face of opposition from dissenting creditors – to rely on creditor democracy to carry the day. Or must the petitioning company go further? He distilled that question to the short point being:

"in a situation where the Company is sound financially, why should one group of creditors who might wish to enter into a commutation agreement with the Company be entitled to force other creditors to participate against their will?"

Lord Glennie had considered that, in a solvent scheme, petitioners applying for a scheme to be sanctioned should be able to place before the court averments and supporting material justifying the proposition that the minority should be bound by the decision of majority.

The Inner House Court of Sessions, having rehearsed the various legislation that had been enacted prior to the 2006 Act (under which this particular scheme had been proposed) noted - perhaps unsurprisingly - that there was nothing in that legislation to suggest that applications for sanction of a so-called solvent scheme are in principle to be dealt with differently from those where the company is insolvent or indeed where a company is on the verge of insolvency. This strengthens the view that a company's solvency does not have to be the only factor to be taken into account when considering a scheme. Although a scheme may be presented where there is a "problem", being when a company and its creditors (or a class of them) each face an adverse situation which requires to be resolved, the existence of a problem does not have to be a precondition of the sanctioning of a solvent scheme. It may be just one factor in favour of granting a scheme.

The Inner House observed that there could not be a pre-emptive dismissal of the case on the question of its fairness and reasonableness without consideration of evidence and factual circumstances. The Court observed: -

"The argument that the proposal in this scheme is unreasonable, or not "so far fair and reasonable as that an intelligent and honest man, who is a member of that class, and acting alone in respect of his interest as such member, might approve of it", is

one which should be addressed when the whole relevant factual circumstances are before the court and it is, in light of these, considering the exercise of its discretion. At this stage the argument based on the fact that insured with long tail policies are being required to accept current estimated values in lieu of their contingent claims may, possibly with other arguments, win the day."

Simply because there has been no voting process agreed or one that decides the valuation of votes prior to the meeting of scheme creditors, does not itself mean that the voting process is unfair. However, the Inner House stipulated that petitioners must be able to demonstrate "*the positive benefits of the scheme, as well as the soundness and robustness of the procedures it has put in place for valuing claims*". This suggests that clear evidence of due process may well be expected.

The Inner House noted that account should also be taken of any contention that some of the creditors who voted in favour of the scheme had a special interest by reason that compositions had been agreed privately with them in advance of the vote. That might, if established, be in the Inner House's own words a "*blot*" on the scheme.

The Court observed that the argument based on the fact that insureds with long tail policies are being required to accept current estimated values in lieu of their contingent claims may, possibly with other arguments, win the day. This qualification leaves something of a sting in the tail for those promulgating solvent schemes. Maybe the lion turns out to resemble that curious beast of antiquity, the Manticore, with its lion's body but the sting of a scorpion. It leaves the onus on those bringing schemes to Court to demonstrate that they have treated all policyholders equally or else face the possibility of a successful challenge from a disgruntled minority.

This decision therefore brings some clarity to what might have been an uncertain future for solvent schemes, and represents on its face a victory for creditor democracy. Had the decision gone the other way it would have made it virtually impossible to introduce a solvent scheme in the face of objections from even the slightest minority of creditors. The decision addresses areas that have required focus and the canvassing of these issues before the Court provides greater certainty and confidence in the scheme processes for policyholders.

As predicated in our analysis of the first instance decision, the further issues about voting valuations and adjudication have not been decided and these still remain to be where future battles will be fought.

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