CLIFFORD CHANCE

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2011 - The Year of the Insurance Business Transfer

2011 saw a significant increase in the number of insurance business transfers under Part VII of the Financial Services and Markets Act 2000 ("**FSMA**").

Valuable guidance as to the factors the court should take into account when deciding whether or not to waive strict compliance with the advertising and notification requirements on a Part VII transfer was also set out in two judgements. This was a welcome development, particularly as the volume of transfers looks set to remain high as insurers continue to reorganise their businesses in preparation for the implementation of Solvency II.

Introduction

A significant number of insurance business transfers under Part VII of FSMA were sanctioned in 2011, at least double the number coming to Court in 2010. Many of these transfers involved policyholders in the millions; the intra-group transfers of the general insurance businesses of RBS and Aviva alone involved well over 10 million policyholders so it is likely that at least half the households in the UK received some form of notification last year, if not more than one.

2011 was not just about volume of Part VII transfers as a number of judgments were also reported. Reported judgments of sanctions hearings, affirming the Court's approach to the exercise of its discretion to approve the transfer, are not new. However, of particular significance in 2011 were the judgments by Floyd J and Norris J which, unusually, were at the directions stage, setting out for the first time the factors the Court should consider when exercising its discretion to waive the notification and advertising requirements set out in the Financial Services and Markets Act 2000 (Control of Business Transfers) (Requirements on Applicants) Regulations 2001 ("**COBTRA**").

The increasing numbers of such transfers also means that third parties are becoming more aware of the potential effects on their interests of a Court order under Part VII. In particular, we are seeing more interest from third parties affected by the transfer in relation, for example, to leases of real property and in relation to guarantee and security arrangements.

Key issues

- A significant increase in the number of Part VII transfers
- Guidance by Courts on factors for advertising and notification waivers
- Increasing interest from third parties affected by the transfers
- Volume of transfers set to remain high as a result of Solvency II

Insurance Business Transfers under Part VII of FSMA

The procedure for the sanction by a UK Court of transfers of insurance business carried on in the EEA from one authorised insurer to another is a useful tool for those wishing to sell or reorganise insurance businesses. Provided the conditions for Part VII to apply are fulfilled, then insurers can

transfer their businesses without the need for individual policyholder consent, indeed without the need either for consent of third parties such as reinsurers and service providers whose contracts are also part of the transferring business.

To protect the policyholders, a report by an independent expert (the "**IE**") is required (covering the effect of the transfer on policyholders), and the FSA is heavily involved in the process and has the right to appear in Court. Under COBTRA, notices are required to be published in the Gazettes and various other national newspapers in relevant EEA member states and also sent to every policyholder of the insurance companies involved. Where the state of commitment or state of the risk at the time of entering into the policy was an EEA state other than the UK the FSA is required to notify the regulator of that state and wait three months for its consent or non-objection.

Analysis of Insurance Business Transfers in 2011

Anecdotal reports of the actual number of insurance business transfers being proposed in 2011 suggested well over 100 which would have been a considerable burden for the FSA were all these to have proceeded. In the event, we believe that over 30 transfer schemes involving almost 100 companies were sanctioned by the Courts - still a significant increase over previous years. Almost all business transfers were intra-group, an indicator perhaps that, as predicted, insurance companies are busy carrying out internal reorganisations to increase capital efficiency and prepare for the implementation of Solvency II.

Notifications

A considerable concern for applicants considering a Part VII transfer is the notification requirements and the potential availability of waivers. These concerns can be due to difficulties in obtaining policyholder addresses, a particular issue for non-life transfers in the London market and for both life and non-life business where the business has been sold through third parties, or for other reasons, including sheer numbers of policyholders and the potential costs and time involved compared to the perceived benefit to policyholders of individual notification.

One of the first steps in considering waiver applications, after careful due diligence, is usually discussing proposals with the FSA. The significant increase in the number of Part VII transfers has obviously put pressure on the FSA, at a time when it is facing other challenges such as the reform of the UK system of financial regulation and the implementation of a plethora of new financial regulation from Europe. Unsurprisingly, this has led to an increase in the time taken by the FSA to review and sign-off on Part VII timetables and documentation, but there has been no sign of any softening of the attitude of the regulator towards waiver applications. Indeed in recent years the FSA has been even more keen to ensure widespread notification of policyholders, even for intra-group transfers and policyholders whose policies are not transferring. Guidance on waivers in the FSA handbook refers to practicality and costs of notifying policyholders as well as to the likely benefits to policyholders of such notification and alternative arrangements being made to notify them. This implies that some proportionality is involved and that waivers can be granted for reasons other than impossibility of notification, but it can be difficult to assess where the line should be drawn.

Applicants are understandably reluctant to apply to the Court for waivers in the absence of FSA support, not only for relationship reasons but also since the Court will obviously have regard to the views of the regulator so there would need to be a particularly good reason to believe a waiver would be granted in the absence of FSA support.

Recent Judgments

As mentioned above, some of the transfers in 2011 involved numbers of policyholders in the millions and therefore some of the applicants were incentivised to seek further clarity on waivers. Indeed in one case, *Direct Line Insurance plc & Ors v the Financial Services Authority* [1] (the "**Direct Line Case**"), the applicants followed the approach first taken in November 2008 [2] in the Part VII transfer of liabilities from Names at Lloyd's of approaching the Court on the question of waivers at an unusually early stage in the proceedings even before the independent expert report was available. The Direct Line Case was also unusual since the applicants were applying for a waiver which was not supported by the FSA but which, in the event, the judge was minded to grant, subject to further information being made available.

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[1] *[2011] EWHC 1482 (Ch).*
[2] *Re the Names at Lloyd's for the 1992 and Prior Years' of Account, represented by Equitas Limited and Speyford Limited [2008] EWHC 2960 (Ch).*

Following on from the above hearing, one of the most significant developments in 2011 was the Courts giving guidance as to the factors which are relevant to the exercise of the Court's power to waive specific compliance with the advertising and notification requirements under the COBTRA. The previous lack of judgments and therefore clarity in this area was partly due to the fact that most directions hearings (at which applicants ask the Court to grant them waivers from the various COBTRA requirements) are held before a registrar. More complex applications are sometimes held before a High Court judge rather than a registrar in order to achieve greater certainty. This was the case with the two Direct Line directions hearings (the first of which is mentioned above) and the directions hearing in *Re Aviva International Insurance Limited [2011] EWJC 1901 (Ch)*. Judgments were handed down by Floyd J (the "**Direct Line Judgment**"[3]) and Norris J (the "**Aviva Judgment**") respectively providing useful precedents in relation to the exercise of the Court's powers to waive the COBTRA requirements.

Relevant Factors in the Court's discretion to waive COBTRA requirements

The Aviva Judgment summarised the factors relevant to the exercise of the Court's power to waive COBTRA requirements (given the need to balance the underlying purpose of COBTRA to allow each affected policyholder to participate, if they chose, in the transfer process by making written representations or by objecting at the sanctions hearing) as:

1. the impossibility of contacting policyholders;
2. the practicality of contacting policyholders;
3. the utility of contacting policyholders;
4. the availability of other information channels through which notice of the application can be made available;
5. the proportionality of strict compliance and the impact of collateral commercial concerns; and
6. the object of the transfer itself and its likely impact on policyholders,

(the "**Relevant Factors**").

Both Floyd J and Norris J were careful to say that the Relevant Factors should not be treated as formal requirements, nor as an exhaustive list, and that equal weight should not be attached to each factor since each case will necessarily depend on its own facts and circumstances. Nevertheless, setting out the factors which most applicants and practitioners have, in practice, considered to be relevant is welcome and will, we expect, give applicants greater guidance and comfort as to the Court's likely approach when planning their advertising and notification strategies.

White Labelled Products

A key area in which the Relevant Factors are relevant is the notification of policyholders of white labelled business. Insurers frequently underwrite white labelled business (business which is marketed and branded under different names e.g. an insurer may underwrite credit card insurance which is sold and marketed by a third party corporate partner). The COBTRA notification requirements raise significant commercial and practical issues for insurers in relation to white labelled products since insurers often do not hold the relationship with such policyholders (some may not even hold the contact details for policyholders in order to notify them of the Part VII transfer application) and indeed most policyholders may not be aware of the identity of their insurer since such products are often very heavily branded by the third party. The Court in the Direct Line application agreed to waive the COBTRA requirement to notify each individual policyholder of the transferee, despite the FSA pointing out that there would be a change in the nature of that company since the transferee would triple in size after the transfer, on the bases that:

1. the applicants would instead publish targeted advertisements;
2. the business was short term so could easily move elsewhere;
3. notification would incur significant costs; and
4. the identity of the underwriter was unlikely to have played a large part for the policyholder in his decision to take out the policy.

A move towards more targeted advertising?

It seems to be generally accepted that the wider the degree of advertisement that can be given to a scheme, the less important it is that the individual policyholders are notified. The advertisement should however be targeted such that the Court can be satisfied that a substantial proportion of the relevant policyholders will see the advertisement. This means a move away from the legal notices

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[3] *Re Direct Line Insurance Plc; Re Churchill Insurance Company Limited [2011] EWHC 1667 (Ch)*

section and potentially towards a larger and more prominent notice that, for example, includes the name of the relevant corporate partner where policyholders are unlikely to be aware of the identity of the insurer and placed in appropriate publications e.g. in the Nursing Times if the relevant policyholders are nurses. Therefore, we expect that insurers will increasingly consider and propose targeted advertising in place of individual notifications to policyholders where other Relevant Factors can justify this.

Effects of Part VII transfers on Third Parties

The statutory notification requirements are aimed only at notifying the policyholders of all the insurance companies concerned and, since 2008 (when FSMA was amended to make it clear that the Court had the power to order the transfer of reinsurance contracts covering the transferring business), reinsurers of the transferring business whose contracts would transfer. The regulations do not specify that other third parties whose contracts may also be transferring should be notified.

FSA guidance suggests notification to others affected may be appropriate, referring in particular to reinsurers and anyone with an interest in the policies being transferred who has notified the transferee of their interest. However, by analogy, if reinsurers whose contracts may transfer under the Court order whether or not such contracts contain explicit provisions prohibiting transfer should be notified so they have a chance to come to Court to object, it seems logical that other third parties whose contracts are intended to transfer should also be notified. Indeed it has increasingly been the practice that counterparties to material contracts are also often notified despite no statutory obligation to do so. Third parties are in turn responding to the applicants to question the effect the Part VII transfer would have on their contracts, for example the effect on the rights of landlords and original tenant liability under a lease, and the rights of beneficiaries under guarantees.

It should be noted that the right to participate in proceedings under s110(b) of FSMA is not limited to policyholders, but covers any person who alleges he would be adversely affected by the carrying out of the scheme. Whilst the independent expert report required by s107 of FSMA covers the effect of the transfer on policyholders (although its content is not specified by statute but rather by the FSA rules and guidance), very few reports go beyond the effect on policyholders, and indeed are not required to do so under the FSA rules.

EEA Consultations

The Treasury is currently consulting on changes to FSMA needed to accommodate the new EEA Solvency II regime for insurers, including changes to the portfolio transfer provisions regarding EEA notifications. We comment in greater detail on the Treasury consultation in our briefing note Solvency II Update of January 2012. The Solvency II directive appears to have switched to a concept of where the contracts were concluded (i.e. where the business was originally written) for EEA regulator consultation/notification purposes rather than the current "state of the risk" and "state of commitment" concepts. The Solvency II directive has however retained the "state of risk" and "state of commitment" concepts in relation to publishing notices in the relevant Member States. In the UK, regulation currently requires notification of the regulators of the states of risk and commitment at the time the transferring policies were taken out and yet insurers do not routinely have this information. It also catches all policies taken out in the UK by UK policyholders but which may also insure property abroad. Therefore a cautious approach is often taken of notifying the regulators in all member states, who then ask questions about the business in their state, only to be told that the parties do not believe there actually is any. This can be unnecessarily time consuming and expensive, particularly if the relevant EEA regulator then requires further notices or communication under local law.

The Treasury's proposed changes to FSMA have not, however, removed the requirement to notify regulators in the state of risk and state of commitment. In responding to this consultation, there may be an opportunity for the industry to persuade the Treasury to remove these references and switch to the more straightforward approach of notifying only the regulators in the states where the business was written.

Insurance Business Transfers in 2012 and beyond

The Part VII procedure is a powerful tool for the transfers of insurance business, particularly since, in contrast to the equivalent procedure in many European jurisdictions which usually only transfer the insurance policies and assets backing them, it can be used to transfer all of an insurer's business and override both statutory and contractual provisions in doing so. Nor is it a static procedure; the FSA is involved in every transfer and uses the experience to refine its approach to the next one, new issues are arising as more businesses make use of the procedure, and we are

seeing increasing case-law in the area. There have, however, been relatively few new challenges in Court in 2011, perhaps because so many transfers last year were intra-group and therefore relatively uncontroversial.

We expect to see more Part VII transfers being initiated and completed during 2012 as insurers continue to integrate their businesses and prepare themselves for the implementation of Solvency II and potentially to separate unwanted lines of business for future sale. We have also seen more interest in transfers of insurance portfolios under the relevant law in other European jurisdictions and expect to see more of these transfers, perhaps in conjunction with provisions implemented under the EC Mergers Directive, to enable wider transfers than just the policies comprised in the business.

Financial Services Bill

Changes have been proposed to Part VII of FSMA in the Financial Services Bill presented to Parliament on 26 January 2011 to reflect the coalition's proposal to split the regulation of insurance (and other prudentially important firms) between a new prudential regulator (the Prudential Regulation Authority "**PRA**") and a new conduct regulator (the Financial Conduct Authority "**FCA**"). The proposed changes currently mean that approval of the independent expert and independent expert's report will be made by the PRA which will consult with the FCA beforehand. Both the FCA and PRA will, for PRA authorised persons, have the right to (a) participate at the court hearing and (b) make an application to court, for an independent actuary to be appointed to review any reduction in benefits of policyholders. It is currently unclear how the new regulators will interact in Part VII transfer applications upon implementation of these provisions, with some debate over whether the PRA will take precedence in practice or the FCA will fully exercise its rights to be heard and demand equal say in the process. It is also possible that the proposed provisions in the bill may change or the memorandum of understanding which will be finalised between the new regulators will contain more detailed provisions governing the process. The Financial Services Bill is currently passing through Parliament and it is currently expected that the bill will obtain royal assent by the end of 2012 and be implemented during 2013. Insurers who intend to initiate Part VII transfers in 2012 to be sanctioned in 2013 should be aware of the uncertainty of how the regime will work between the FCA and PRA in practice (although the FSA's twin peaks model to be adopted from April 2012 may ease the transition) and engage with the FSA early to establish how the Part VII application will be processed by the regulators.

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