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Pollyanna Deane's insurance column: January 2021

by Pollyanna Deane, Partner, Financial Services Regulatory Team, Fox Williams LLP

Status: **Published on 04-Jan-2021** | Jurisdiction: **United Kingdom**

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Pollyanna Deane is a Partner in Fox Williams LLP's Financial Services Regulatory Team, and is also a member of Practical Law Financial Services' Consultation Board.

In her column for January 2021, Pollyanna considers the Court of Appeal's judgment in *Re Prudential Assurance Company Ltd and Rothesay Life plc (Part VII of the Financial Services and Markets Act 2000) [2020] EWCA Civ 1626*.

Practical Law has been keen for me to produce a column on the *Prudential v Rothesay Life* decision handed down at the beginning of December 2020 and I have been promising to do one. It's just not been as quickly as I should have liked!

Snowden J's decision

The initial decision by Snowden J was a shock. We all say how much the Part VII process is not a rubber-stamping exercise, but the way in which it has developed over the years means that there is some routine to it. With all the extra loading and scrutiny that the regulators have afforded the process (with little real improvement, an increased timetable which the process doesn't really bear well, and a great deal more work to show for it), a grandstanding performance from the courts is not to be expected.

Snowden J's judgment was carefully produced, with a decision in favour of the policyholders who complained, but with little rooting in the reality of the Part VII process. Complaining about the process is about as useful as a chocolate fire-guard. It has developed to enable insurance companies to reorganise their business, when it would be nearly impossible to obtain consent from all their policyholders. Accordingly, the court acts in their stead and monitors the various viewpoints which are put to it – from the regulators, the independent expert, the companies and, of course, the policyholders.

When we received Snowden J's judgement and heard that it was to be appealed by Prudential (PAC) and Rothesay, the basis for the appeal was given, and had to be, on the basis of error of law. Yet, reading the first instance decision, it was hard to see how this might be argued. Snowden J had been careful to follow the decisions on Part VII, both reported and unreported, and structured his judgment accordingly. Indeed, that being the case, I heard enough people saying that they were not sure exactly what the legal errors were, and confess that I found that the careful writing of the judgment was perhaps designed to make it hard to appeal. Although, as the Court of Appeal commented, Snowden J has heard a number of these Part VII transfers and is an experienced judge in the area. The only legal error I thought clear was the failure to apply the requirements to have regard to the commercial decision of the directors, which appears pretty much at the top of the list Evans Lombe J put together in the *AXA Equity & Law transfer [2000]*, (drawn from Hoffmann J in *London Life*, an unreported decision), of the issues that the court must consider in a Part VII case.

The Court of Appeal produced its judgment on 2 December 2020 and referred to the key issues that Snowden J found most worrying. As taken from the summary of the judgment, there were two that the judge had stressed:

- Despite the fact that PAC and Rothesay had equivalent solvency capital requirement (SCR) metrics, Rothesay did not have the same capital management policies or the backing of a large well-resourced group with a reputational imperative to support it over the lifetime of the annuity policies.
- It had been reasonable, in the light of PAC's sales materials, age and reputation, for policyholders to have chosen PAC on the basis of an assumption that it would not seek to transfer their policies to a third-party provider.

Basis of appeal

Both PAC and Rothesay mounted an appeal on the following basis:

- First, PAC and Rothesay contended that the judge failed to accord adequate recognition or weight to:
  - (a) the commercial judgment of PAC's board;
  - (b) the conclusions of the independent expert that the risk of PAC or Rothesay needing external support in the future was remote;
  - (c) the regulators' lack of objection to the Scheme and the continuing future regulation of Rothesay; and
  - (d) the prejudice that a refusal to sanction would cause to PAC and Rothesay.
- Second, PAC and Rothesay submitted that the judge accorded too much weight to the objecting policyholders' contentions that:
  - (a) they chose PAC on the basis of its age and established reputation;
  - (b) they had reasonably assumed that their annuity would be provided throughout its term by the same provider; and
  - (c) there were distinguishing features of an annuity.
- Third, PAC and Rothesay argued that the judge ought not to have concluded on the evidence that there was a material disparity between the external financial support potentially available for each of them.

The Court of Appeal, which comprised Sir Geoffrey Vos, Sir Nicholas Patten and David Richards LJ, considered these and summarised the arguments put by Prudential and Rothesay as follows:

- i) Whether:
  - (a) the judge was wrong to conclude that there was a material disparity between the external support potentially available for each of PAC and Rothesay; and/or
  - (b) he failed to accord adequate weight to the conclusions of the independent expert that the risk of PAC or Rothesay needing external support in the future was remote.

  (The "security of benefits issue".)
- ii) Whether the judge failed to accord adequate weight to the regulators' lack of objection to the Scheme and to the continuing future regulation of Rothesay (the "regulatory issue").
- iii) Whether the judge accorded too much weight to the fact that the objecting policyholders chose PAC on the basis of its age, venerability and established reputation, and reasonably assumed that PAC would provide their annuity throughout its lengthy term (the "reputational issue").

Two subsidiary issues were also argued as follows:

- i) Whether the judge failed to accord adequate weight to the commercial judgment of PAC's board (the "commercial judgment issue").
- ii) Whether the judge failed to accord adequate weight to the prejudice that a refusal to sanction would cause to PAC and Rothesay (the "prejudice issue").

Factors courts should consider

What is really interesting is the way in which the Court of Appeal has determined to "add value", lamenting somewhat the tendency of applicants to treat the list of requirements set out in the cases of *London Life* and *AXA Equity & Law* transfers "as if they were a comprehensive statement of the factors that should be applied by the court in all insurance business transfers". Whereas Evans Lombe J in *AXA* set out the points made by Hoffmann J in *London Life*, not least because there was no reported judgment which included them, it is clear that the courts have, over the years, found those a helpful steer on what they should be looking for. Both *London Life* and *AXA* were a good deal more complex as transfers go, and were of course made under the old Schedule 2C regime (from the Insurance Companies Act 1982), which took into account the simpler transfers required for general insurance business. Instead, the Court of Appeal has suggested that, far from a comprehensive list, these principles might be more applicable to the transfer of with-profits business rather than anything else. If that is the case, then there is going to be a limited application from now on, given the reduction in with-profits business over the last 20 years. The Court of Appeal, clearly irritated by the cut and paste job of the Evans Lombe J judgment into decisions given on multiple transfers, stated:

> "We very much doubt whether anything is to be gained by setting out and seeking to apply the factors listed in those cases, for example by Evans-Lombe J in Axa at [6], to transfer schemes involving every type of insurance business."

Instead, you could see the *Prudential v Rothesay* decision as setting out a new list of requirements, which follow in order:

- 1. The courts' paramount concern is to assess whether the transfer will have any material adverse effect on a number of persons, including the policyholders, annuitants and creditors of both parties and, further, any material adverse effect on service standards as they affect transferring annuitants or policyholders.

  After all, the conclusion of any independent or other actuarial report has long been that no policyholder will be materially adversely affected by the transfer and this clearly remains the case. Entertainingly, some years ago, the PR department of a life insurer

put the proposed policyholder circular through the wringer and suggested that the conclusion reported there and reached by the actuaries, to the effect that no policyholder was going to be materially adversely affected, should be changed to "no policyholder will be badly affected by the transfer". To which the actuary responded, tersely, that the person who had suggested the change should take a drop in salary of £100 per month on the basis that they wouldn't be badly affected.

- 2. Where the transfer involves the transfer of annuities, the paramount concern (another one) of the court will be to assess whether the transfer will have any material adverse effect on the receipt by the annuitants of their annuities, and on whether the transfer may have any such effect on payments that are or may become due to the other annuitants, policyholders and creditors of the transferor and transferee companies.
- 3. The court will also be concerned to assess whether there may be any material adverse effect on the service standards provided to the transferring annuitants or policyholders.
- 4. Whether any other factors require consideration will depend on the circumstances of the case.

The court, having taken into account the above, will then decide whether or not to sanction the scheme, if appropriate to do so. As has long been the case, the Court of Appeal noted that it cannot require the applicants to vary or alter the scheme. The choice of whether to do the scheme, and its detailed terms, are for the directors of the parties concerned.

Court of Appeal's decision

Essentially, the Court of Appeal in analysing the case determined as follows: the judge made errors in his approach to the exercise of his discretion as to the sanction of the Scheme under section 111(3) of the Financial Services and Markets Act 2000 (FSMA). He ought not to have concluded that there was a material disparity between the non-contractual external support potentially available for each of PAC and Rothesay. In any event, such a disparity was not a material factor. Moreover, he failed to accord adequate weight to the expert's conclusion that the risk of PAC or Rothesay needing external support in the future was remote, to the regulators' lack of objection to the Scheme, and to the continuing future regulation of Rothesay. Finally, he ought not to have accorded any weight to the fact that the objecting policyholders chose PAC on the basis of its age, venerability and established reputation, and reasonably assumed that PAC would always provide their annuities. So, we should add to these to the list above and note that the Court of Appeal agreed with PAC and Rothesay as to their second and third points, and to sections (b) and (c) of their first point. They rejected the points at sections (a) and (d) of the first point.

Rejection of directors' commercial judgment

It is the rejection of the commercial judgment made by the directors which I find interesting. As the court said "The primary duty of those directors is, of course, to promote the success of their companies". The commercial judgment point reflects one of the items on the Evans Lombe J list from *AXA* and it, of course, remains fundamental to the start of the process – the directors embark on a Part VII transfer usually to reflect a commercial decision and their duties to the companies they direct remain in place from start to finish. If the proposed Part VII is refused or rejected for whatever reason and the trajectory of the procedure means that there are tests in place to be overcome throughout. The directors' performance of their duties is constantly under scrutiny, if the directors were unable to justify their reasoning at any stage before the hearing, the scheme to be put before the court would need to be changed or withdrawn. The Court of Appeal acknowledged that there was little likelihood that a scheme that breached the directors' duties would be accepted. It follows that the court, when faced with a determination by the directors that a scheme is for the success of their company, should recognise the reality of the determination and accept that it is a key driver for at least one of the parties.

That said, when the Court of Appeal identified the directors' duty, it then looked to the case of AXA, stating that:

> "Axa's proposal was the subject of intense scrutiny and discussion between Axa and the regulators and the independent actuary (as he was then known). The commercial judgment of the board of Axa was that the deal was fair, but that was, in truth, of limited value since their duty was to act in the best interests of Axa. It is to be noted that, although Evans-Lombe J referred in [6(i)] to the board's commercial judgment as one of the factors to emerge from Hoffmann J's judgment, he did not rely on it, or even again refer to it, in his reasons for sanctioning the scheme."

Essentially, the Court of Appeal found in *Prudential*, that the commercial judgements made by directors to start the process had little or no part to play once the case is before the courts and were not inclined to consider that the rejection of the commercial basis by Snowden J was wrong. And yet, without the boards of

companies determining what is likely to be the most successful course of action, and being encouraged to promote the success of their companies, we would face a listless, stagnant and undynamic insurance industry. It seems to me that consideration of the commercial realities in which a scheme is proposed and scrutinised by the courts is not something that the court can wash its hands of and, if unacknowledged, will return to haunt us in another scheme.

If the court's role is to scrutinise and enable all parties to have their positions considered and evaluated, then it needs to give some value to the commercial realities, while recognising that there are experts who have more experience than they do – why else have the independent expert giving a report, not to mention the regulatory oversight that any scheme will have already been subjected to.

Court's actuarial oversight

At paragraph 99 of the *Prudential* judgment, the Court of Appeal criticises Snowden J for adding his own actuarial oversight. As a lawyer who has worked with the insurance market for many years, I am always impressed by the breadth of the actuarial training and its need for understanding not just the maths behind the calculations but also the predictions drawn from them. Even in *AXA*, some of the objections raised were that the actuaries had not looked further than the immediate situation and certainly not to wider economic issues, which was strongly refuted by them. As one of the actuaries who was there remonstrated to me, actuaries by virtue of their job and training are obliged to be conversant with economics, law, regulation and wider social issues. All of these will have been taken into account in their report, and backed up by the PRA's assertion that it, in assessing the prudential risk and determining whether or not to allow the scheme to go ahead in its proposed format, has taken into account regulation, risk and consideration of the future. These protections reflecting the regulatory background to such schemes were surprisingly something that Snowden J appeared to ignore or dismiss, as the Court of Appeal found. We are well aware of the protections that Solvency II's prudential requirements are intended to offer and the Court of Appeal noted these, but the somewhat sentimental approach to the choice of Prudential and its brand to provide annuities, and the importance that the judge apportioned to these points, were found to be wrong.

Lessons from the judgment

So, other than the potential for grandstanding that the chance to derail a simple transfer offered, was there any advantage or advance in learning we can take away from the *Prudential* case? Well, the list of tests that the Court of Appeal has provided for transfers going forward is shorter, but somewhat vaguer and, in deferring to the circumstances at hand, makes it less clear-cut. The likelihood is, and we have seen schemes being presented in this way since, that Snowden J's legacy will be that:

- The policyholders' position must be set out even more clearly.
- The manner in which complaints are handled should be detailed and presented to the court for its consideration.

That said, it may only be important for retail customers. The commercial customers who form the bulk of policy transfers, and/or where the retail market is not key, will not necessarily be given the benefit of the detailed scrutiny afforded to retail. Given the other protections provided, this is unlikely to matter quite as much, but transfers will usually reflect the most recent decisions and it would seem odd not to account for this.

The problem with Snowden J determining that the Prudential transfer should not go ahead was not just the cost to the companies of appealing, leading to legal costs and, of course, further updating of the actuarial reports etc, it was more importantly the threat to their reputation and their own and the wider commercial costs of putting matters on hold. Indeed, having their commercial decisions subject to the court's whim and timetable and the inevitable market uncertainty, which everyone from the companies, to the courts and the regulators feared would be a potential cause of regret, was something the ABI took very seriously.

The Court of Appeal reached the correct decision, but whether this case in particular should have found its way there, is less clear – a simple transfer of annuities, following a time-worn path with full consideration accorded to the issues it raised should have been enough. I fear the implications for transfers of reducing the import of the commercial decision and am less enthused than the Court of Appeal by the revision of the *AXA* list.

Happy New Year – let us hope for many new and wonderful things!