Court of Appeal Reverses High Court's Rejection of Prudential/Rothesay Part VII Transfer

3 December 2020

On 2 December 2020, the Court of Appeal allowed the appeal of The Prudential Assurance Company Limited ("Prudential") and Rothesay Life plc ("Rothesay") in connection with the refusal of Snowden J of the English High Court to sanction their proposed transfer of around 400,000 policies under Part VII of the Financial Services and Markets Act 2000 ("FSMA") with a gross best estimate of liabilities for Prudential of about £12.9 billion.

The High Court has the discretion to refuse to sanction a Part VII transfer - a discretion that Snowden J exercised in his judgment in August 2019, which can be found here. This was the first time that the Court of Appeal had been asked to consider a judge's refusal to sanction a Part VII transfer that had been approved by the independent expert, the UK's Prudential Regulation Authority (the "PRA") and the Financial Conduct Authority (the "FCA"). The Court of Appeal identified two broad reasons why Snowden J refused to sanction the transfer:

- Rothesay did not have the same capital management policies or the backing of a large, well-resourced group which would be more likely to act to defend its reputation (in contrast with Prudential); and

- Prudential's policyholders had chosen to buy their annuities from Prudential on the assumption that it would not transfer their policies to another provider. This assumption was deemed reasonable on the basis of Prudential's sales materials, age and reputation.

The Court of Appeal noted in its judgment that it is "rare" for Part VII applications to be refused and, in this, its first judgment on the judicial discretion granted under Part VII of FSMA, also considered the approach that the High Court can and should adopt in dealing with Part VII transfers.

As part of the appeal, the Association of British Insurers (the "ABI") intervened to express the concerns of the industry that the principles of Part VII schemes ought to be

clear and predictable, given the significant time and costs required in connection with them.

Summary

The Court of Appeal found that Snowden J:

- gave inadequate weight to the independent expert's conclusions that the risk of either insurer needing support in the future was remote;
- was wrong to conclude that there was a material disparity between the future financial support available to each insurer and ought not, in any event, to have regarded that as a material factor;
- failed to give adequate weight to the regulator's non-objection and continuing future regulation of Rothesay; and
- ought not to have accorded any weight to the policyholders having chosen Prudential on the basis of age, venerability and established reputation or assumptions as to Prudential providing their annuity throughout its term.

Points of Appeal

Prudential and Rothesay raised three broad points of appeal before the Court of Appeal:

1. That inadequate weight was accorded to the following issues:
    - the conclusions of the independent expert that the risk of Prudential or Rothesay requiring external support in the future was remote;
    - the lack of objection from the PRA and FCA;
    - the commercial judgment of the board of directors of Prudential; and
    - the negative impact that a refusal to sanction the transfer would have on Prudential and Rothesay.[1]

[1] The latter two issues were classed as "subsidiary" issues by the Court of Appeal.

2. Too much weight was afforded to the objections of policyholders, particularly in relation to:
   - their choice of Prudential on the basis of its age and reputation;
   - the assumption that their annuity would never be transferred to a third party; and
   - their argument that an annuity should be distinguished from other types of insurance policy that may be transferred under a Part VII scheme.
3. That it should not have been determined that there was a material disparity between the external financial support potentially available to Prudential and Rothesay based on the evidence.

Determination of the Court of Appeal

In connection with the appeal on the external support available, the Court of Appeal determined that Snowden J was not justified in dismissing the independent expert's view that there was no disparity in the financial resilience between Prudential and Rothesay, now or in the future. The ABI noted that Solvency II requires that solvency capital is "calculated to ensure that the insurer could still pay out to policyholders after the occurrence of a 1-in-200 year stress event".[2] Snowden J had accepted that, measured by their Solvency Capital Requirement coverage ratios, the relative financial strengths of Prudential and Rothesay were comparable. However, he had challenged the independent expert and the PRA on looking at the metrics as at a specific date. The Court of Appeal determined that the date the metrics are judged is not the critical feature - the fact that Rothesay would continue to be regulated under the same rules into the foreseeable future meant that the independent expert's conclusion was valid in connection with Rothesay's future security. As such, the Court of Appeal held that Snowden J was mistaken in holding that, in contrast to the findings of the independent expert and the PRA, there was a material disparity between the potential need for external support for each of Prudential and Rothesay.

As part of the same analysis, the financial support being considered was of a non-binding, non-contractual kind - the availability of this kind of support was determined to be irrelevant for the judge to take into account by the Court of Appeal. Indeed, the Court of Appeal noted that parent companies cannot be required to support their subsidiaries' capital, whether for reputational reasons or otherwise, and such parents are

[2] See paragraph 76 of the PRA's approach to insurance supervision published in October 2018 and cited at [95] of the Court of Appeal's judgment.

always at liberty to sell their regulated subsidiaries to third parties. Snowden J's finding that there was a material disparity between such external support available to Prudential and Rothesay was therefore found to be unjustified.

The Court of Appeal determined that the subjective factors relied upon by the objecting policyholders in connection with the reputation of Rothesay (versus Prudential) were not relevant to be taken into account in the exercise of the court's discretion. The court must exercise its discretion on the basis of objective standards and factors.[3]

The Court of Appeal did find that Snowden J had not made an error in law in (i) his approach to the questions of any negative effect suffered by Prudential or Rothesay in connection with a refusal to sanction the transfer and (ii) the lack of weight given the commercial judgment of Prudential's board. These were deemed irrelevant in consideration of whether there was a material adverse effect on the policyholders (for further discussion see below).

Judicial Discretion

The Court of Appeal noted that Part VII of FSMA was deliberately drafted so broadly that different factors would need to be considered, depending on the business and the circumstances. On this basis, there can be no single test that would apply in all circumstances. The Court of Appeal did identify two important distinctions, whilst refusing to be drawn into producing definitive categorisations:

- general versus long-term insurance; and
- policies that vest a discretion in the insurer and those that do not (for example, policies with a with-profits element versus a book of annuities).

These distinctions, as well as the underlying circumstances giving rise to the application, should be kept firmly in mind when considering the court's sanction of insurance business transfer schemes. The Court of Appeal noted that whilst the court's discretion must not be "exercised by way of a rubber stamp", it must also "take into account and give proper weight to matters that ought to be considered, and ignore matters that ought not properly to be taken into account".[4] In particular, the Court of Appeal noted that statements of factors in the judgments of Hoffmann J in London Life[5] and Evans-

---

[3] Citing to [63], [114]-[116], Re Scottish Equitable plc and Rothesay Life plc [2017] EWHC 1439 (Ch).

[4] [78] of the Court of Appeal's judgment.

[5] *Re London Life Association Ltd* (21 February 1989, unreported).

Lombe J in Axa,[6] while containing factors likely to be applicable to the transfer of with-profits business, may not be relevant in their entirety to the individual case before the court.

In this case, the Court of Appeal determined that the "paramount" concern is to assess whether the proposed transfer will have any material adverse effect on the policyholders' receipt of the annuities or the ability of the insurer to make payments when due. The Court of Appeal determined that an adverse effect will only be material if it is:

> *(i) a possibility that **cannot sensibly be ignored** having regard to the nature and gravity of the feared harm in the particular case, (ii) a consequence of the scheme, and (iii) material in the sense that there is the **prospect of real or significant**, as opposed to fanciful or insignificant, **risk to the position of the stakeholder** concerned.*[7]

The Court of Appeal also noted that it may be relevant for the court to consider whether there would be a material adverse effect if the scheme was not sanctioned. In addition, even if the court finds that the there is a material adverse effect, it may still sanction the scheme in the exercise of its discretion, as it will need to consider the proposed scheme as a whole where there are different effects on the interests of different classes of persons.

Lastly, in the absence of defects or obvious error, the court must accord full weight to the opinions of the independent expert, the PRA and the FCA - the court should not depart from their recommendations without significant and appropriate reasons, particularly in relation to the financial and actuarial assessments.

Next Steps

The Court of Appeal has set aside Snowden J's judgment and has remitted the renewed application for the Part VII transfer to the High Court to be heard before a different judge. It is not clear at this time when this hearing will take place, but given the length of time that has elapsed since this transaction was originally agreed in March 2018, it is likely that the parties will push for this to be sooner rather than later.

The effect of the High Court's decision on the wider market has been considerably less influential than the industry originally feared might be the case. Despite the opportunity to take a more activist approach to the sanctioning of Part VII schemes,

[6] *Re Axa Equity & Law Life Assurance Society plc and Axa Sun Life plc* [2001] 1 All ER (Comm) 1010.

[7] [83] of the Court of Appeal's judgment.

judgments on Part VII applications before the High Court since August 2019 have tended to distinguish explicitly Snowden J's judgment - most notably in Re Equitable Life.[8] In addition, there has been a considerable reduction in the number of Part VII schemes being put before the High Court while this case has made its way through the appeals process. As such, it may be that previously halted Part VII transfers will be re-initiated following this positive result for the industry. Given the approach taken by the Court of Appeal, it is likely that the status quo - the refusal of the court to sanction Part VII transfers support by the independent expert and the regulators being "rare" - will remain the norm.

***

Please do not hesitate to contact us with any questions.

LONDON

James C. Scoville
jcscoville@debevoise.com

Clare Swirski
cswirski@debevoise.com

Benjamin Lyon
blyon@debevoise.com

Philip Orange
porange@debevoise.com

Sarah Hale
shale@debevoise.com

Katie Power
kpower@debevoise.com

[8] *Re Equitable Life Assurance Society and Utmost Life and Pensions Limited* [2019] EWHC 3336 (Ch).