

**HIH CASUALTY & GENERAL INSURANCE
LIMITED (IN LIQUIDATION)
ACN 008 482 291**

**FAI GENERAL INSURANCE COMPANY LIMITED
(IN LIQUIDATION) ACN 000 327 855;**

**CIC INSURANCE LIMITED (IN LIQUIDATION)
ACN 004 078 880;**

**WORLD MARINE & GENERAL INSURANCES PTY
LIMITED (IN LIQUIDATION) ACN 000 093 112**

**FAI TRADERS INSURANCE COMPANY PTY
LIMITED (IN LIQUIDATION) ACN 000 177 177;**

**FAI REINSURANCES PTY LIMITED
(IN LIQUIDATION) ACN 004 401 138;**

**FAI INSURANCES LIMITED (IN LIQUIDATION)
ACN 004 304 545; and**

**HIH UNDERWRITING & INSURANCE
(AUSTRALIA) PTY LIMITED (IN LIQUIDATION)
ACN 004 906 110**

Explanatory Statement to the Australian Schemes of
Arrangement

(pursuant to s412 of the Corporations Act 2001)

10 February 2006

McGrathNicol & Partners

This report contains 33 pages

10 February 2006

In the Explanatory Statement, reference is made to the HIH Royal Commission, and in Appendix 4 a chronology and company background have been sourced from it. The source of these documents is the HIH Royal Commission Website (<http://www.hihroyalcom.gov.au>) and the Royal Commission report titled "The HIH Royal Commission - The failure of HIH Insurance", Commonwealth of Australia 2003. Copyright Commonwealth of Australia reproduced by permission.

Contents

1	Introduction	1
2	History of HIH group companies	5
3	Background Financial Information	7
4	Operation of the Australian Scheme	8
5	Distribution Priorities	12
6	Agreement of Claims	18
7	Communication with Scheme Creditors	27
8	Information required by statute	28
9	Factors to be considered when voting on the Australian Scheme	29
10	Conclusion	32

Please note that if you have received payments from HIH Claims Support Limited (Australia) or the Financial Services Compensation Scheme (UK) in relation to all your actual and potential claims, and you have no possible further claims against any one of the Scheme Companies, you can ignore this document.

The terms used in this document, except as otherwise defined, are defined in the Australian Scheme, at pages 5 to 13, and the FSCS Schedule, at pages 1 to 3.

1 Introduction

HIH Insurance Limited (the holding company of the HIH group) was a publicly listed company in Australia. Prior to its failure the HIH group was the second largest general insurer in Australia, and had operations in many other countries.

On 15 March 2001 the HIH group failed. A G McGrath and A R M Macintosh (then of KPMG Sydney) were appointed as provisional liquidators of HIH Insurance Limited and many of its subsidiaries. A J McMahon, T A Riddell, and J M Wardrop of KPMG London were appointed as provisional liquidators of some of the same companies in the United Kingdom, and also of other group companies incorporated in the UK. Other insolvency practitioners were appointed to various group companies incorporated in other parts of the world.

On 27 August 2001 the major Australian companies in the HIH group to which provisional liquidators had been appointed, were placed into liquidation with the former provisional liquidators Messrs McGrath and Macintosh being appointed as Liquidators.

On 1 July 2005 ARM Macintosh retired as Liquidator of the Australian HIH Group companies and was replaced by CJ Honey. AG McGrath & CJ Honey (both now of McGrath Nicol+Partners) are the Liquidators

1.1 *Why have you been sent this document?*

- 1.1.1 You have been sent this document because one of the HIH companies listed below may have provided you with insurance cover, or because you might otherwise have a claim against one of these companies. In that case, you may be a creditor or potential creditor of one of these companies:

HIH C&G

CIC

FAI General

FAI Traders

FAI Reinsurances

FAI Insurances

WMG

HIH U&I

- 1.1.2 Each of these companies was a licensed or formerly licensed insurance company in Australia. Each is now insolvent and unable to pay its creditors in full. The Liquidators have concluded that implementation of a scheme of arrangement (**Australian Scheme**) between each company and its creditors is the best way of maximising the return and achieving the earliest practical distribution to creditors.
- 1.1.3 Details of the scheme recommended by the UK Provisional Liquidators (**English Scheme**) together with an explanatory statement (**English Explanatory Statement**) are being sent to Scheme Creditors at the same time as this document. The UK Provisional Liquidators have concluded that the best way of distributing the assets held in England is to propose a scheme of arrangement in England, designed to work in conjunction with and be complimentary to the Australian Scheme.
- 1.1.4 Such schemes can only be implemented with the approval of creditors and the court. The approval of creditors is through a vote at a creditors meeting, if the creditors vote by the required majorities in number and value of those of them voting at the meeting. Accordingly if you are a creditor or potential creditor of one of the HIH companies listed above, you may be entitled to vote on whether a scheme of arrangement should be implemented, as recommended by the Liquidators.
- 1.1.5 **The proposed Australian Schemes will only apply to each of the eight companies listed above.** For each company, the Australian Scheme covers the liabilities of the company worldwide, including liabilities arising from any former US and UK branches of the company. Enquiries in relation to any HIH company, including those shown above, should be directed to the relevant contact addresses provided in Appendix 1 to this document.
- 1.1.6 RECEIPT OF THIS DOCUMENT DOES NOT NECESSARILY MEAN THAT YOU ARE CURRENTLY OWED, OR WILL EVER BE OWED, MONEY BY ANY OF THE EIGHT SCHEME COMPANIES.
- 1.2 ***What is a scheme of arrangement?***
- 1.2.1 A scheme of arrangement of the kind recommended by the Liquidators is a compromise, or arrangement, between a company and its creditors (or any class of them), governed by section 411 of the Corporations Act in Australia. Such a scheme essentially sets out the rules by which certain aspects of the administration of the company will be governed, although the liquidations that are already underway in relation to the Scheme Companies will continue subject to the terms of the Australian Scheme. The Australian Scheme becomes legally binding on the Liquidators and on all creditors of the company, or any class of them if:
- a) a majority in number representing at least 75% in value of the creditors (or any class of them) present and voting in person or by proxy, vote in favour of the Australian Scheme at a meeting convened by Order of the Australian Court; and

- b) the Court subsequently approves the Australian Scheme; and
- c) a copy of the Court Order approving the Australian Scheme is lodged with ASIC.

1.3 ***What is the effect of the proposed Australian Scheme?***

1.3.1 The effect of the Australian Scheme is to introduce a structure to operate in conjunction with the liquidation of the companies to which the Australian Scheme will apply, covering the following:

- a) the filing and agreement of claims;
- b) priorities to apply to assets;
- c) payments to Scheme Creditors including interim distributions;
- d) management of the run-off; and
- e) final closure of the remaining insurance business by an estimation procedure.

1.3.2 Each of the eight Scheme companies will be subject to a scheme in Australia pursuant to sections 411 and 412 of the Corporations Act.

1.3.3 For each of HIH C&G, FAI General, WMG and FAI Insurance (**English Scheme Companies**), separate but complementary schemes of arrangement will be promoted. Under the English Schemes, the distribution priorities applying to the assets to be distributed under the English Schemes will reflect the English statutory distribution priority. However, the English Schemes also provide an alternative in the event that an appeal against the recent decision of the English Court is successful, in which case the Australian statutory distribution priorities would apply to the assets.

1.3.4 For each of HIH C&G, FAI General, WMG, FAI Insurances and CIC continuation of the current temporary injunction under section 304 of the US Bankruptcy Code will also be sought on the basis that the Australian Schemes in relation to these companies would also have effect in the United States of America.

1.3.5 The Australian Scheme will not have any impact on the investigatory or recovery powers of the Liquidators.

1.3.6 The Liquidators consider that the Australian Scheme will allow more efficient agreement of Scheme Creditor claims, earlier distribution of funds to Scheme Creditors, and earlier final closure of each insolvency.

1.4 ***What should you do?***

1.4.1 If you are a Scheme Creditor of any Scheme Company listed above, you will be entitled to attend and vote at the meeting of Scheme Creditors of that Scheme Company to consider, and if thought fit, approve the Australian Scheme for that Scheme Company.

- 1.4.2 Notice of the meeting, together with the necessary proxy and voting form are enclosed with the cover letter to this documentation, together with notes to assist in completion of the form.
- 1.4.3 Creditors who wish to vote at the meeting should comply with the instructions provided with the forms. The purpose of voting by creditors is purely to determine whether the Australian Scheme will be approved or not.
- 1.4.4 Failure to complete the necessary forms or to vote will have no impact on any creditor's right to participate later in either Australian Scheme distributions (if the Australian Scheme is approved) or liquidators' dividends (if the Australian Scheme is not approved).

1.5 ***Who will be bound by the Australian Scheme?***

If approved by the necessary majorities of Scheme Creditors, and by the Court, the Australian Scheme will bind all Scheme Creditors of the Scheme Company, whether they have received notice or not, and whether they have voted or not. However, under the terms of the Australian Scheme, the rights of Scheme Creditors with priority or preferential claims (e.g. employees) and secured Scheme Creditors will not be affected.

1.6 ***Valuation of Claims for Voting Purposes***

- 1.6.1 Claims against a Scheme Company (**Scheme Claims**) will be admitted for voting at the agreed amount (in the case of claims that have been agreed but not yet paid) or at an estimated amount (in the case of claims that have been reported but not yet agreed, or incurred but not reported (**IBNR**)).
- 1.6.2 It is the responsibility of the Scheme Creditor to provide sufficient information to enable the chairman of the Creditors' Meeting (who will be one of the proposed Scheme Administrators) to judge whether an estimate can be accepted for voting purposes.
- 1.6.3 A decision by the chairman to admit or reject a proof of debt or claim for the purposes of voting may be appealed against to the Court within 14 days.
- 1.6.4 The valuation or estimate of claims used for voting purposes will not affect any Scheme Creditor's rights to rank later for any payments made under the Australian Scheme (or any Liquidators' dividends if the Australian Scheme is not approved).
- 1.6.5 Scheme Creditors have a separate vote, but do not have to complete separate claim details for the Australian Scheme and the English Scheme. Any claim submitted by Scheme Creditors will be considered for voting purposes in relation to both the Australian Scheme and the English Scheme. Scheme Creditors will be entitled to vote to the full extent of their claim in the Australian Scheme and in the English Scheme, as determined by the chairman of the respective scheme meetings.

1.7 ***When will the Australian Scheme become effective?***

- 1.7.1 If the Australian Scheme for any Scheme Company is approved by the required majorities at the meeting of Scheme Creditors and then approved by order of the Court, the Australian Scheme will be effective from the date a copy of the Court Order is lodged with ASIC in Australia.

2 History of HIH group companies

- 2.1 Following the failure of the HIH group, the Australian Federal Government established the HIH Royal Commission to inquire into the causes of the failure.
- 2.2 The HIH Royal Commission completed its enquiries, and its report was made public¹, in April 2003. In addition to the final report, the HIH Royal Commission made extensive information available to the public via its website, which can still be accessed at <http://www.hihroyalcom.gov.au>
- 2.3 At the time of its failure, the HIH group consisted of more than 240 companies, only eight of which were licensed or formerly licensed insurance companies incorporated in Australia. The rest of the companies were holding and investment companies, and in some cases licensed insurance companies incorporated in other jurisdictions.
- 2.4 The proposed Australian Schemes are only in relation to the eight licensed or formerly licensed insurance companies incorporated in Australia, described as the Scheme Companies.
- 2.5 The following materials are attached as Appendix 2 to this Explanatory Statement:
- corporate chart - this is an abbreviated chart identifying the ownership structure of some of the significant companies in the HIH group, with the eight insurance companies licensed or formerly licensed in Australia identified on the chart;
 - chronology of key events – this is the Royal Commission’s summary of key events in the history of the HIH group between its commencement in 1968 and its failure in 2001; and
 - historical introductions – these brief summaries are the historical introductions published by the Royal Commission for each Scheme Company for which the Liquidators now propose a Scheme of Arrangement.
- 2.6 The Royal Commission website contains a great deal more information in relation to each of the companies, including details of any name changes in prior years, details of directors and office holders, and the last published financial information for each company prior to the failure.
- 2.7 One point which is not in the Royal Commission website so far as the history of the group is concerned relates to a transaction which took place in 1990. At that time FAI Insurances and FAI General entered a deed whereby FAI Insurances assigned to FAI General its interests under insurance contracts in respect of business carried on in New South Wales. The purpose of this transaction was to allow revocation of FAI Insurances’ license to carry on insurance business.
- 2.7.1 The Liquidators have concluded that FAI Insurances remains liable to insureds under the contracts referred to above. They have also concluded that section 116(3) of the

¹ "The HIH Royal Commission - The failure of HIH Insurance". Commonwealth of Australia 2003. Copyright Commonwealth of Australia reproduced by permission.

10 February 2006

Insurance Act (see section 5) will apply to FAI Insurances in the same way as it does to the other companies which are the subject of an Australian Scheme.

3 **Background Financial Information**

3.1 In August 2001 the Liquidators publicised an estimate for the total deficiency of the HIH group of companies, as being between AUD3.6 billion and AUD5.3 billion. The Liquidators consider that deficiency estimate remains reasonable.

3.2 The overall deficiency estimate is for all companies in the HIH group, including some significant overseas subsidiaries not under the control of the Liquidators. An example is HIH America Compensation and Liability Insurance Company, which is incorporated in California and which is now in liquidation under the control of the Californian Conservation and Liquidation Office. Of the licensed or formerly licensed insurance companies within the group incorporated in Australia (all of which are under the control of the Liquidators), HIH C&G, FAI General and CIC make up the dominant proportion of the overall deficiency.

3.3 Appendix 3 to this Explanatory Statement contains financial information about each of the Scheme Companies as follows:

- report as to affairs – this is a statement in the format required by Form 507 of the Corporations Act, giving summary details of assets and liabilities of each Scheme Company as at 30 September 2005;
- website details for the reference materials section of the HIH Royal Commission website – this contains the latest available financial statements for each Scheme Company prior to the failure of the group in March 2001; and
- Liquidators' statement of receipts and payments – this provides summary details of the Liquidators' receipts and payments for each Scheme Company since the failure of the group to 30 September 2005.

3.4 ***Liquidators' Dividend Estimates***

3.4.1 It is not yet possible to provide estimates of ultimate dividend rates with any degree of certainty. The outcome for individual Scheme Creditors will depend upon which Scheme Company their claim is against, the results for that Scheme Company, and the effect of the legislative priorities in relation to their particular Scheme Claim or Claims. The results for each Scheme Company will depend in particular on the actual level of Scheme Claims received and agreed in future, compared to current actuarial estimates of those claims.

3.4.2 A schedule of the Liquidators' current estimates of ultimate dividend rates for each of the companies for which an Australian Scheme is proposed is attached as Appendix 4 to this Explanatory Statement.

3.4.3 Subject to the Australian Scheme being implemented, the Liquidators expect that the Scheme Administrators will be able to pay a first Australian Scheme payment of at least five cents in the dollar on all agreed claims against HIH C&G, FAI General, and CIC during the second quarter of 2006. The likely timing of first Australian Scheme payments on the remaining Scheme Companies has not yet been determined.

4 **Operation of the Australian Scheme**

- 4.1 Under the proposed Australian Schemes, all assets of the Scheme Companies which can be realised by the Liquidators or Scheme Administrators will be progressively distributed to Scheme Creditors by the Scheme Administrators as claims are agreed.
- 4.2 The proposed Australian Schemes are what are commonly referred to as reserving schemes, converting to estimation schemes at a later date to enable closure of the insolvencies. A reserving scheme is one under which the scheme administrators continue to realise assets and agree claims as those claims are made during a run-off, and periodically pay interim distributions to scheme creditors with agreed claims at the scheme payment percentage, set after allowing (reserving) for future costs and claims expected and future asset realisations expected.
- 4.3 An estimation scheme is one under which scheme creditors submit claims to the scheme administrators by a certain deadline, covering all claims they have against the company, including present and future claims. The value of future claims is then estimated. The Australian Scheme provides for an automatic conversion to an estimation scheme seven years after commencement, unless on the recommendation of the Scheme Administrators and the Creditors' Committee, a special resolution of Scheme Creditors is passed approving an earlier or later Estimation Date. No Estimation Date in the proposed Australian Scheme may be less than five years, or more than nine years, after commencement. The Liquidators consider that the period as a reserving scheme is necessary to allow Scheme Creditor claims to develop and reinsurance assets to be collected prior to conversion to an estimation scheme.
- 4.4 All of the Australian Schemes will be governed by Australian Law. However the English Court will have exclusive jurisdiction in relation to the Schedule and provisions of the Australian Schemes which relate to the FSCS or the Policyholders Protection Act.
- 4.5 All of the Australian Schemes will be implemented in addition to, not in replacement of, the liquidations in Australia. The Australian liquidations will continue.
- 4.6 ***Separate but complimentary Schemes in England***

Following the insolvency of the HIH group in Australia, A J McMahon, T A Riddell, and J M Wardrop of KPMG London were appointed as provisional liquidators (**UK Provisional Liquidators**) of the English Scheme Companies.

The UK Provisional Liquidators currently control the assets of the English Scheme Companies in the UK.

The Liquidators, with the support of an Australian creditor, applied to the English Court for orders that the assets be remitted to Australia for distribution in accordance with the Australian statutory distribution priorities.

As a result of the different statutory distribution priorities which apply to liquidators' distributions in Australia and the United Kingdom, the UK Provisional Liquidators sought directions from the English Court as to whether the assets they control should be remitted for distribution in accordance with the Australian statutory distribution priorities.

Judgment was obtained in October 2005 to the effect that the assets the UK Provisional Liquidators control should not be released for distribution in accordance with the Australian statutory priorities, see *In the Matter of HIH Casualty and General Ltd* [2005] EWHC 2125 (the judgment can be located at <http://www.bailii.org> by searching the reference [2005] EWHC 2125 (Ch), described as *McMahon v McGrath*). The decision is being appealed by the Liquidators and several Australian creditors. Should the appeal be successful, the UK assets will be remitted to Australia for distribution under the Australian Scheme reflecting Australian statutory distribution priorities.

The UK Provisional Liquidators will promote the English Scheme as separate but complimentary schemes of arrangement for each of the English Scheme Companies to deal with the distribution of the assets under their control. The English Schemes will adopt most of the provisions of the Australian Scheme, with the particular exception of the distribution priorities. Under the English Scheme, the distribution priorities applying to the English assets will either reflect the English statutory distribution priorities (as detailed in the English Scheme) or the Australian statutory distribution priorities, depending on the outcome of the expected appeal against the judgment of the English Court.

All creditors worldwide will be entitled to claim in both the Australian and the English Scheme for the relevant company. The Liquidators and the UK Provisional Liquidators (and subsequently the relevant Scheme Administrators) will work in close co-operation, and creditors will not need to lodge separate claims in each jurisdiction. The scheme administrators in either jurisdiction can, subject to their right of review, determine to accept claims agreed in the other jurisdiction.

4.7 ***People Involved in the Australian Scheme***

4.7.1 ***The Scheme Administrators***

The Scheme Administrators must be individuals qualified to act under section 411 (7) of the Corporations Act. It is proposed that the initial Scheme Administrators will be Anthony Gregory McGrath and Christopher John Honey of McGrathNicol+Partners, Sydney. The Australian Scheme contains provisions regarding resignation, removal and filling of vacancies in respect of the Scheme Administrators. Attached as Appendix 5 are CVs for the proposed Scheme Administrators.

4.7.2 The Scheme Administrators will implement the terms of the Australian Scheme. They will manage the run-off of each Scheme Company's liabilities, realise its assets in co-operation with the Liquidators, and apply the assets for the benefit of Scheme Creditors.

4.7.3 The Scheme Administrators will have broad powers to enable effective conduct of the Australian Scheme. Details of the Scheme Administrators' powers are set out in clauses 42 and 43 of the Australian Scheme. In carrying out their functions and exercising their powers under each Australian Scheme, the Scheme Administrators must consult with, and take account of, the views expressed by the Creditors' Committee. Any person aggrieved by an act, omission or decision of the Scheme Administrators will be able to appeal to Court under section 1321 of the Corporations Act. The Australian Court also has a general supervisory role over the Scheme Administrators under section 536 of the Corporations Act.

4.7.4 The Scheme Administrators will not have any powers in relation to recoveries under the antecedent transaction provisions of the Corporations Act. These functions and powers will remain with the Liquidators, and will not be affected by the Australian Scheme.

4.8 *The Creditors' Committee*

4.8.1 The Australian Scheme provides for the establishment of a Creditors' Committee for each Scheme Company. HIH C&G, CIC and FAI General will have committees initially of between 10 and 16 Scheme Creditors. All other Scheme Companies will have committees of between 3 and 10 Scheme Creditors. In addition a representative of the English Scheme Administrators will be entitled to participate as a non-voting member.

4.8.2 The main functions of the Creditors' Committee are to monitor the carrying out of the Australian Scheme and to supervise the Scheme Administrators in the exercise of their functions and powers. A number of the powers of the Scheme Administrators (see clauses 42 and 43 of the Australian Scheme) may only be carried out with the agreement of the Creditors' Committee. In addition, the remuneration of the Scheme Administrators will be subject to Creditors' Committee approval.

4.8.3 The Creditors' Committee of each Scheme Company will have a duty to act in good faith for the benefit of that Scheme Company's Scheme Creditors as a whole. Creditors' Committee members will be indemnified out of the assets in each Scheme Company.

4.8.4 In order to be eligible for membership of the Creditors' Committee an individual or corporate entity must be a Scheme Creditor of the Scheme Company or be nominated by two creditors. Corporate Scheme Creditors, if appointed, must nominate an authorised representative. The Australian Scheme contains provisions covering resignation, removal, and filling of vacancies on the Creditors' Committee.

4.9 *Procedure for appointment of the Initial Creditors' Committee*

4.9.1 Each of the three largest licensed or formerly licensed insurers in the HIH group (HIH C&G, FAI General and CIC) currently has committees of inspection which were appointed by meetings of creditors of these companies.

4.9.2 The names of the members of the committees of inspection, and who they represent, are shown in Appendix 6 to this Explanatory Statement.

4.9.3 Each of the members of the committees of inspection has indicated that they are prepared to act as a member of the relevant Creditors' Committee in the Australian Scheme. In addition other Scheme Creditors may seek nomination. The meeting of Scheme Creditors held to consider implementation of the Australian Scheme will also vote on the membership of the Creditors' Committee (assuming the Australian Scheme is approved by the necessary majorities of Scheme Creditors). In addition it is proposed that the English Scheme Administrators be permanently entitled to representation on the Creditors' Committee as a non voting member.

4.9.4 The nomination form for membership of the Creditors' Committee is given in Appendix 7 to this Explanatory Statement. Any nomination for membership should be completed and forwarded to the Liquidators prior to the meeting of Scheme Creditors to consider implementation of the Australian Scheme, or be handed to the chairman at the meeting.

4.10 ***Scheme Adjudicators***

- 4.10.1 Under the terms of the Australian Scheme, the Scheme Adjudicators will be experienced independent actuaries. They will be appointed prior to the Estimation Date for each Australian Scheme, by the Scheme Administrators after consultation with the Creditors' Committee. All Scheme Creditors whose claims are subject to an estimate by the Scheme Administrators at the Estimation Date will have the right to appeal to a Scheme Adjudicator. The Scheme Adjudicator's decision will then be binding on the Scheme Creditor and the Scheme Company. Any person aggrieved by an act, omission or decision of a Scheme Adjudicator will be entitled to appeal to the Court under section 1321 of the Corporations Act. The Australian Court also has a general supervisory role over the Scheme Adjudicators under section 536 of the Corporations Act.

4.11 ***FSCS***

The FSCS provides protection to certain policyholders in relation to business that an insurer was authorised to carry on in the United Kingdom. The FSCS will be bound by the Australian Scheme and will make payments to Protected Policyholders under the terms of the Australian Scheme.

5 **Distribution Priorities**

- 5.1.1 Claims against companies in liquidation do not all receive the same priority. Most countries have legislation which provides the order of priority which must be followed by a liquidator when making distributions. For example, certain employee claims usually have a higher priority than ordinary unsecured creditor claims.
- 5.1.2 All liquidations in Australia (whether insurance companies or not) are subject to distribution priorities set out in the Corporations Act. These priorities are similar to the kind of priorities in other countries. However, two additional sections of Australian legislation apply when an insurance company is placed into liquidation in Australia. These sections are section 562A of the Corporations Act, and section 116(3) of the Insurance Act.
- 5.1.3 Section 562A contains special provisions which detail the priorities which apply to reinsurance recoveries made by a liquidator. Section 116(3) overlays a restriction on top of all of the other priority provisions. Section 116(3) provides that the liquidator of an Australian insurance company should not distribute any of the Assets in Australia other than in payment of the Liabilities in Australia, unless the Liabilities in Australia have been paid in full.
- 5.1.4 The effect of the Australian legislative priorities is that creditors whose claims are classified as Insurance Liabilities have a potential advantage over creditors whose claims are not classified as Insurance Liabilities, and creditors whose claims are classified as Liabilities in Australia have a potential advantage over creditors whose claims are not classified as Liabilities in Australia.
- 5.1.5 The Australian Scheme adopts the following approach:
- The Australian legislative priorities that would apply in an Australian liquidation will apply to all assets worldwide which can be realised by the Liquidators or the Scheme Administrators (other than US Trust Fund Assets) for distribution in accordance with those priorities;
 - Where the Liquidators or Scheme Administrators are prevented from realising assets located in foreign jurisdictions and distributing them in accordance with the Australian legislative priorities, it may be necessary to implement separate schemes of arrangement or other insolvency proceedings in those jurisdictions. This is no different to the situation that would apply if the Australian Scheme companies were to remain in liquidation; and
 - Any amounts released to the Scheme Administrators from the US Trust Fund Assets by the Superintendent of Insurance for the State of New York will be distributed, after payment of the Scheme Administrators' reasonable and necessary expenses in causing the distribution of the US Trust Fund Assets, pro rata to the specified beneficiaries of the US Trust Fund Assets (who are defined in the related trust agreements as "American Policyholders") after adjusting for any payments Scheme Creditors have received from all other sources.

- 5.1.6 The Australian Scheme does not alter any of the priorities which would apply in the distribution of any of the assets which would be available to the liquidators in an Australian liquidation. The Australian Scheme reflects what would happen to those assets in an Australian Liquidation.
- 5.1.7 In order to give effect to the Australian priority sections, the Liquidators would have to divide the assets available to them into four categories. A further category is required to distribute US Trust Fund Assets. The relevant Australian Scheme clauses, outlining the four categories of assets necessary to give effect to the Australian legislative priorities are listed below, together with the clause detailing the priorities to apply to the US Trust Funds.
- Clause 31 Reinsurance Assets that are Assets in Australia
 - Clause 32 Reinsurance Assets that are not Assets in Australia
 - Clause 33 Non-Reinsurance Assets in Australia
 - Clause 34 Non-Reinsurance Assets which are not in Australia
 - Clause 35 US Trust Fund Assets
- 5.1.8 The distribution of the Scheme Assets has been designed taking into account the guidance received in a recent judgment by the Court in *HIH Casualty & General Insurance Ltd* [2005] NSWSC 240; (2005) 53 ACSR 12. This comprises the following steps:
- Reinsurance Assets in Australia are to be applied in accordance with Section 562A towards Insurance Liabilities which are Liabilities in Australia. Any assets the subject of a Section 562A(4) Order will be distributed as the Court directs in its Order. From the balance of the Reinsurance Assets in Australia, there are first deducted the costs "of or incidental to the getting in those assets". The remainder is then paid on a prorata basis to all Scheme Creditors whose claims are Insurance Liabilities in Australia. Any Scheme Creditors who have received a payment to meet any Section 562A(4) Order will be eligible to participate in this prorata distribution at the residual value of their claim only, after deduction of the amounts received pursuant to the Section 562A(4) Order.;
 - Reinsurance Assets not in Australia are distributed on the same basis as Reinsurance Assets in Australia except that the operation of s116 (3) is not relevant. A Scheme Creditor who has received a payment out of Reinsurance Assets in Australia will not be entitled to receive any payment out of Reinsurance Assets not in Australia until all other Scheme Creditors entitled to a distribution out of those assets have received the same level of payments;
 - Non Reinsurance Assets in Australia are applied towards satisfaction of such Liabilities in Australia as have not been fully satisfied at the conclusion of the step set out in the second bullet point above, with those Liabilities being ranked according to the priorities given to them by the Corporations Act priority provisions. Claims are payable at residual amounts after taking into account all payments made under the first two bullet points above; and

- Non Reinsurance Assets not in Australia are applied towards satisfaction of such of the amount of Established Scheme Claims as have not been met in full at the conclusion of the third bullet point above, with those debts being ranked according to the priorities given to them in the Corporations Act. Creditors rank for "residual values" after payments made under the first two bullet points above. Scheme Creditors who have received payments toward a Liability in Australia shall not receive any payment until all other Scheme Creditors have received the same percentage payment. Thereafter, all creditors are paid pro rata.

5.2 ***Meaning of terms used in the Australian Legislative Priorities***

The Australian Scheme does not alter the meaning of any of the terms used in the priority provisions of the Australian legislation. Three terms used in the Australian legislation are particularly important in determining the outcome of the priorities when applied by a Liquidator. Those three terms are "Assets in Australia" and "Liabilities in Australia", used in section 116(3) of the Insurance Act; and the term "Reinsurance" used in section 562A of the Corporations Act.

5.3 ***The meaning of "Assets in Australia"***

Section 116(3) of the Insurance Act places restrictions on the way that "Assets in Australia" are distributed and accordingly it is necessary to determine the meaning of that term in order for the section to be applied in practice by a liquidator. Section 116(3) does not provide its own meaning.

The meaning of the term as used in section 116(3) has not been subject to any significant judicial interpretation in the past. The Liquidators consider that in order to give effect to the section, the meaning of "Assets in Australia" would need to be determined by applying the principles of private international law. In the event that there is future judicial determination of the meaning of the term as used in section 116(3) the newly determined meaning would have to be used by the Liquidators, or if the Australian Scheme is approved, by the Scheme Administrators.

5.4 ***The meaning of "Liabilities in Australia"***

The meaning of the term "liabilities in Australia" must also be determined.

5.4.1 During 2003 a case was run in the Supreme Court of NSW for another Australian insurance company insolvency – the NewCap Re liquidation. Judgment was given on 12 September 2003, see *New Cap Reinsurance Corporation (In Liq) v Faraday Underwriting Limited* [2003] NSWSC 842; (2003) 47 ACSR 306. An appeal was subsequently heard by the New South Wales Court of Appeal, with judgment given on 6 October 2004, see *AssetInsure Pty Ltd v New Cap Reinsurance Corporation Ltd (in liq)* (2004) 61 NSWLR 451; [2004] NSWCA 225.

5.4.2 The New Cap Re appeal judgment provided the following guidance as to what liabilities should be included within the meaning of "Liabilities in Australia". The Court of Appeal determined that those liabilities should include:

- liabilities to indemnify insured persons against losses occurring in Australia;

- liabilities which are to be satisfied in Australia;
- liabilities which are otherwise liabilities in Australia within the meaning of section 31(4) of the Insurance Act; and
- those determined pragmatically as liabilities in Australia, having regard to the purpose of the Insurance Act that liabilities in Australia are the liabilities for which there should be assets in Australia to meet them.

5.4.3 The Liquidators consider that in the case of the Scheme Companies, if this guidance continues to apply, the vast majority of Scheme Creditors worldwide will have liabilities in Australia, other than those who wrote business with the UK or US branches of HIH C&G, FAI Insurances, and FAI General. The High Court of Australia has given special leave for an appeal to it in respect of two issues determined by the *NewCap Re* appeal judgment. Those are whether section 562A applies to a retrocession and the proper construction of which creditors comprise "liabilities in Australia" for the purpose of section 116(3) of the Insurance Act. The High Court appeal is set down for hearing on 7 December 2005, although a judgment from the appeal would not be expected until some time in 2006.

5.4.4 In the event that there is further judicial determination of the meaning of the term as used in section 116(3) the newly determined meaning would have to be used by the Liquidators, or if the Australian Scheme is approved, by the Scheme Administrators.

5.5 *The meaning of "Reinsurance"*

5.5.1 The term "Reinsurance" is used in section 562A of the Corporations Act, which provides for the priorities which a Liquidator must apply to recoveries "under a contract of reinsurance".

5.5.2 The *NewCap Re* appeal judgment has provided a judicial determination of what "reinsurance" means in this context.

5.5.3 When an insurance company is being liquidated, it will typically have claims from directly insured policyholders, which it reinsures with other insurance companies. The Court of Appeal determined that this kind of reinsurance was what was meant by the term as used in section 562A.

5.5.4 An insurance company can also have claims from other insurance companies, which it in turn reinsures with further insurance companies. This reinsurance of reinsurance is called retrocession. The Court of Appeal determined that this kind of reinsurance (ie retrocession) was not included in the meaning of "reinsurance" as used in section 562A. This determination is the subject of an application for special leave to appeal to the High Court of Australia.

5.5.5 The practical effect of this meaning of "Reinsurance" is that any insurance companies which are creditors because they have reinsurance claims against the Scheme Company will not receive the advantage of priority under section 562A. Only directly insured policyholders will receive that advantage.

5.6 ***The meaning of section 562A(3)***

- 5.6.1 Section 562A of the Corporations Act provides three possible mechanisms for the distribution of reinsurance recoveries to insurance creditors. The first possibility is under section 562A(2), which only applies if the reinsurance recoveries are sufficient to pay all insurance creditors in full. That will clearly not be possible in the case of the Scheme Companies, and accordingly that section will not be applicable.
- 5.6.2 The second possibility for distribution is under section 562A(3). This section provides a mechanism for the distribution of reinsurance recoveries pro rata to insurance creditors where there are insufficient funds to pay them all in full. Two possible interpretations of the mechanism provided in section 562A(3) are as follows. The first interpretation is that the available reinsurance recoveries should be divided pro rata only amongst those creditors whose claims gave rise to the available reinsurance recoveries (referred to by some commentators as the “narrow pooling approach”). The second interpretation is that the available reinsurance recoveries should be distributed pro rata amongst all insurance creditors of the company (referred to by some commentators as the “broad pooling approach”). The *New Cap Re* judgment has provided a judicial determination that the broad pooling approach should be adopted to give effect to section 562A(3). This was endorsed by a subsequent judgment of the Supreme Court of New South Wales in *HIH Casualty & General Insurance Ltd* [2005] NSWSC 240; (2005) 53 ACSR 12. Accordingly unless there is further judicial interpretation of the section which applies to the Scheme Companies in the future, the Liquidators would adopt the broad pooling approach if the winding up of the Scheme Companies were to continue, absent the Australian Scheme. The Australian Scheme does not alter that position.
- 5.6.3 The third possibility for distributions under section 562A is for specific distribution of reinsurance recoveries in accordance with a Court order under section 562A(4). This section provides a right for any Insurance Creditor to apply to the Court for an Order that sections 562A(2) and 562A(3) should not apply to specified reinsurance recoveries, and instead that the Court should order the liquidator to distribute the specified reinsurance recoveries in any manner that the Court considers just and equitable in the circumstances. The Australian Scheme does not alter the right of creditors to apply under section 562A(4).
- 5.6.4 The Liquidators consider that there is no reasonable prospect of any successful section 562A(4) applications being made by Scheme Creditors in relation to treaty reinsurance. The reason for this is that treaty reinsurance typically covers extensive business involving the claims of many policyholders, and accordingly it is most unlikely that the Court would consider an order in favour of individual creditors to be just and equitable in the circumstances. The right to make such an application is however preserved in the Australian Scheme.
- 5.6.5 The position is not as clear in relation to facultative or fronting reinsurance. These types of reinsurance cover risks related to specific underlying policies. Accordingly the Liquidators expect that a number of Scheme Creditors will wish to make applications under section 562A(4). In order to enable such applications to occur, the Australian Scheme provides that prior to the distribution of any recoveries under facultative or fronting reinsurance, the Scheme Administrators must give notice to those creditors

whose underlying policies gave rise to the reinsurance recovery, so that those creditors can make an application to the Court for a Section 562A(4) Order should they wish.

5.7 *Future judicial determinations*

- 5.7.1 The provisions of the Corporations Act and the Insurance Act 1973, as at 27 August 2001, determine the distribution priorities which apply to the liquidation of each of the insurance companies in the HIH group in Australia. This was the date the liquidations commenced.
- 5.7.2 As with any legislation, the meaning of terms used in the legislation is subject to judicial interpretation by the Courts. When distributing funds to creditors, an Australian liquidator must apply the legislative provisions as at the commencement of the liquidation, as interpreted by any subsequent judicial determinations.
- 5.7.3 This means that for a liquidation which continues for a lengthy period, there is a possibility that initial distributions to creditors may be made under different judicial interpretations of the legislation than later distributions. In such cases, creditors are not required to refund any distributions already received, but the liquidator will adjust any further distribution entitlements to the extent possible, to achieve the same result as if the latest available judicial interpretation of the meaning of the legislation had been applied to all of the distributions made during the liquidation.
- 5.7.4 The Australian Scheme reflects the same approach as would apply in a liquidation. The Australian legislative priorities as at 27 August 2001 will be used and interpreted in accordance with any judicial determinations by the courts with appropriate jurisdiction. Payments which have already been made to Scheme Creditors before the time of a new judicial interpretation of the relevant sections is made will not be disturbed, but the Scheme Administrators will adjust further distributions to the extent possible to give effect to the latest available judicial determination.

6 **Agreement of Claims**

6.1 ***Liabilities to which the Australian Scheme will apply***

The Australian Scheme will apply to all liabilities worldwide (insurance and non-insurance) which would have been provable debts against the Scheme Company in the liquidation, adopting 27 August 2001 as the Record Date. (This is the date the Scheme Companies were placed into liquidation in Australia).

6.2 ***English Claims Agreement provisions adopted under the Australian Scheme***

Creditors whose claims are agreed in England will not be required to separately lodge claims for the purposes of the Australian Scheme. Any claim agreed by the English Provisional Liquidators or the English Scheme Administrators, will be accepted, subject to the Scheme Administrators' right of review, as agreed under the Australian Scheme.

6.3 ***Claims during the Run-Off Period***

Under the Australian Scheme, Scheme Creditors should continue to make their claims in accordance with the usual course of business to the Scheme Company at the contact addresses given in Appendix 1 to this Explanatory Statement. The liabilities of each Scheme Company will be run off in the usual course of business until the Estimation Date is reached (expected to be seven years after commencement, but not less than five years, and not more than nine years). Until that time there is no bar date or deadline for submitting claims. Once a relevant Payment Percentage has been set, Scheme Creditors will be paid a percentage of their claims as those claims are accepted as Established Scheme Claims.

6.4 ***Enforcement by Scheme Creditors during the Run-Off Period***

In a liquidation and a provisional liquidation, there is a stay of proceedings which prohibits creditors from taking any step or proceeding against the company or its property to enforce payment of a claim. It can only be lifted by application of a creditor to the court. The Australian Scheme follows a similar approach, with a stay prohibiting enforcement action by Scheme Creditors. However, under the Australian Scheme the Liquidators and the Scheme Administrators will not object to any application to the Court to lift the stay if, within six months of a Scheme Creditor lodging a Notice of Litigation with the Scheme Administrators, the Scheme Administrators and the Scheme Creditor have not reached agreement on the appropriate treatment of the claim. The Scheme Creditor will then be entitled to pursue its contractual rights, subject to obtaining a Court order lifting the stay. Provided the Australian Scheme requirements have been met the Scheme Administrators will not oppose any necessary application by a Scheme Creditor to the court under section 471B of the Corporations Act. Any costs order resulting from the Scheme Creditor pursuing proceedings will be a Liability under the Australian Scheme, but will not be a Priority Claim unless the relevant court or tribunal with power and jurisdiction to do so orders otherwise. Under the Australian Scheme there is no stay at any time preventing a Scheme Creditor making an appeal to court under section 1321 of the Corporations Act regarding any act or omission or decision of any person

administering the Australian Scheme, and there is no stay preventing any creditor from making an application to the court under section 562A(4) of the Corporations Act.

- 6.4.1 In instances where the Scheme Company is one of two or more Co-Insurers on the same policy, the Australian Scheme provides that a Scheme Creditor must first agree their claim with, or achieve judgment against, a majority by percentage participation in the policy by the other co-insurers, and then advise the Scheme Company of that settlement or judgment value. The stay against litigation or enforcement will then not be lifted until six months after the Scheme Creditor has notified the Scheme Company with a Notice of Determination of Common Liability and lodged its Notice of Litigation.

A diagram setting out the process for dealing with disputed Scheme Claims during the Run-Off Period is set out at Appendix 8 to this Explanatory Statement.

6.5 *Claims after the Estimation Date*

- 6.5.1 Most Scheme Creditors will have their claim agreed in the usual course of business during the Run-off Period of the Australian Schemes. Scheme Creditors who already have Established Scheme Claims at the Estimation Date, will then rank for final payments under the Australian Scheme (**Scheme Payments**).

- 6.5.2 However Scheme Creditors with potential long-tail claims may still have outstanding and potential IBNR claims at the Estimation Date (expected seven years after commencement, but not less than five years, and not more than nine years).

- 6.5.3 After the Estimation Date, Scheme Creditors with any claims which have not yet been accepted as Established Scheme Claims, and who wish to participate in the final Scheme Payments, will be required to submit a Final Claim Form for Estimation within three months following the Estimation Date. The Scheme Administrators will forward a Final Claims Form for Estimation to all Scheme Creditors with Notice of the Estimation Date. The Final Claim Form for Estimation must include a value for all agreed, outstanding and IBNR components which the Scheme Creditor wishes to claim against the relevant Scheme Company. Scheme Creditors will not have to submit a Final Claim Form for Estimation for Established Scheme Claims.

- 6.5.4 A diagram setting out the process for dealing with all Scheme Claims after the Estimation Date is set out as Appendix 9 of this Explanatory Statement.

- 6.5.5 Protected Policyholders will not be entitled to any payment under the Australian Scheme (**Scheme Payments**) as a result of the estimation procedures of the Australian Scheme, unless the FSCS agrees. The reason for this is that the FSCS will continue to make payments to Protected Policyholders on relevant claims, even after the Estimation Date.

6.6 *Resolution of disputed Scheme Claims after Estimation Date*

- 6.6.1 Within three months after the final date for submission of Estimation Notices, the Scheme Administrators must then notify each Scheme Creditor in writing of any element of their claim which is not accepted, and provide the Scheme Administrators' estimate for that element.

6.6.2 Scheme Creditors who are not satisfied with the estimation by the Scheme Administrators will have their claim referred to one of the independent Scheme Adjudicators, whose decision will be binding on the Scheme Creditor and the Scheme Administrators. The Scheme Adjudicator may also determine what proportions of the cost of any adjudication will be borne by the Scheme Creditor and the Scheme Company. Any person aggrieved by an act omission or decision of a Scheme Adjudicator will be entitled to appeal to the Court under section 1321 of the Corporations Act.

6.7 ***Rights in relation to Security Interests, Letters of Credit, escrows and trusts***

Scheme Creditors' rights in relation to Security Interests, Letters of Credit, escrows and trusts will remain the same under the terms of the Australian Scheme as they would under a liquidation in Australia.

6.8 ***Set-off***

6.8.1 The principles of set-off in the Australian Scheme are similar to those which would apply in a liquidation in Australia (reference section 553C of the Corporations Act). Set-off will be applied as at the Record Date. Specific reference is drawn to the treatment of Lloyd's syndicates below.

6.8.2 At the Estimation Date, the Australian Scheme provides for set-off to include an estimate of the value of any amounts which the Scheme Company may become entitled to from the Scheme Creditors which do not yet bear a certain value.

6.9 ***Lloyd's Names and syndicate Set-off***

6.9.1 Lloyd's syndicates are not incorporated entities. A contract with a Lloyd's syndicate is legally a series of contracts with the individual names or members of the particular Lloyd's syndicate in that underwriting year.

6.9.2 The Australian Scheme contains provisions dealing generally with set-off of claims owed by and to a Scheme Creditor and a Scheme Company. It is also necessary to address how set-off should apply in the context of Lloyd's syndicates, given that they are not legal entities. There would be significant practical problems in identifying any set-off at the level of individual Lloyd's Names. This would also entail substantial additional costs. Accordingly, the Australian Scheme adopts the practical solution normally used in London market insurance insolvencies, which is that set-off will be applied at syndicate level, not names level. Set-off at syndicate level will be permitted across different underwriting years, provided the syndicate managing agent establishes to the satisfaction of the Scheme Administrators that there has been no material change in syndicate membership between the different underwriting years.

6.10 ***Payments to Scheme Creditors***

6.10.1 Payments will be made at regular intervals (expected to be quarterly), at the then current Payment Percentage, to all Scheme Creditors whose claims have been accepted as Established Scheme Claims and who are then due to be paid sums in relation to their Established Scheme Claims (i.e. if it is a newly accepted Established Scheme Claim or if there has been an increase in the relevant Payment Percentage).

6.10.2 Scheme Creditors will receive a statement with each payment detailing the amount accepted as an Established Scheme Claim, which category of assets the Scheme Creditor's claim has been paid from, which clause of the Australian Scheme the payment is made under, and where relevant the Payment Percentages for that category of asset and priority of the Scheme Company.

6.11 ***Setting the Payment Percentages under the Australian Scheme***

6.11.1 The Scheme Administrators will review the Payment Percentages for each Scheme Company (and each category of assets of the Scheme Company) at least annually. The Scheme Administrators will consult with the Creditors' Committee before setting any Payment Percentage.

6.11.2 The Scheme Administrators and Creditors' Committee will be entitled to take into account the cash available at the time, cash expected to become available from further asset realisations, future cash expenditure expected, any Section 562A (4) Applications and actuarial projections of liabilities not yet agreed when setting the Payment Percentage. The Payment Percentages for each Scheme Company will be set at a level such that the Scheme Company can be expected (to a reasonable confidence level) to be able to pay that same Payment Percentage on all its liabilities expected to be admitted ultimately, including future liabilities not yet fixed in amount.

6.11.3 The Scheme Administrators will not be required to consult the English Scheme Administrators prior to setting any of the Payment Percentages under the Australian Scheme, but will receive full co-operation from the English Scheme Administrators in provision of information concerning the run-off of the Scheme Company's business in England.

6.12 ***Setting payment percentages for the English Schemes***

The Payment Percentages set under the English Scheme will be set by the English Scheme Administrators, after consultation with the Scheme Administrators.

Unless the English Court judgment referred to in Section 4.6 of this Explanatory Statement is overturned on appeal, all of the assets to be distributed under the English Schemes will be in one category for distribution purposes, because the English distribution priorities are pro rata to all Scheme Creditors without distinction for the different types of asset. Accordingly the English Schemes would only have one Payment Percentage per English Scheme Company.

In contrast, the Australian Scheme may have different Payment Percentages for the different categories of assets of any Scheme Company, and it is expected that some creditors will be entitled to receive higher distributions than others in the Australian Scheme.

The Payment Percentages set for the English Schemes are therefore likely to reflect supplementary payments to English Scheme Creditors, starting at the lowest dividend rate achieved by any English Scheme Creditors under the Australian Scheme.

To the extent made possible by the assets available, this will give effect to the English legislative priorities, which require pro rata distribution. For example, if creditor A had

received 10 cents in the dollar under the Australian Scheme, but creditor B had received 12 cents in the dollar under the Australian Scheme, then under the English Scheme, no distributions would be made to creditor B until creditor A had been paid a further 2 cents in the dollar. At that point both Creditor A and Creditor B would participate in any further distributions under the English Scheme.

This principle (of adjustment for funds received from other sources) is referred to as the equitable principle of “Hotchpot”, which is applied in any English liquidation.

The Scheme Administrators will ensure that, notwithstanding any application of “Hotchpot” by the English Administrators, any further payments under the Australian Scheme will take into account receipts by Scheme Creditors from all sources, so that to the extent possible the Australian Scheme distribution terms will be given effect.

6.13 ***Currency of Scheme payments***

6.13.1 Scheme Payments will be made to Scheme Creditors in the contract currency of their claim. Where individual Scheme Creditors have claims in more than one currency, payment will be made in the dominant currency of their claims.

6.13.2 Payment will be made to Scheme Creditors via cheque, telegraphic transfer or any other legal payment method nominated by the Scheme Administrators.

6.14 ***Allocation of costs***

Under the Australian Scheme, the direct costs of recovering any asset, including reinsurance assets, and distributing the proceeds of that asset will normally be paid in priority ahead of any payments to Scheme Creditors. However in the case of any reinsurance recoveries distributed in accordance with a Court Order under section 562A(4) of the Corporations Act, the Court Order may determine the order of priorities. All indirect costs of the External Administrators will be allocated to the different categories of asset by the Scheme Administrators on a fair basis, and will be paid in priority to pro-rata distributions to Scheme Creditors. This reflects the position which would apply in a Liquidation.

6.15 ***Damages recoveries as a result of the HIH group failure***

6.15.1 As a result of the findings of the Royal Commission, the Liquidators’ own further investigations, and potential prosecution activities by the regulatory authorities, it is possible that the Liquidators of the Scheme Companies and other HIH companies will make significant damages claims against various defendants.

6.15.2 Under the Australian Scheme the Scheme Administrators will indemnify the Liquidators for the costs of recovery actions, and will have power to enter into agreements with other HIH companies as to the allocation of costs and proceeds of the Liquidators’ damages recovery actions generally. This power is only to be exercised with the approval of the Creditors’ Committee.

6.16 ***Non payment of small cheques***

Under the Corporations Act, a Liquidator is entitled to withhold any dividend cheque (i.e. not make the payment) for any cheque which would be below AUD25. Under the Australian Scheme the statutory limit would be maintained for the final distribution to Scheme Creditors. However the Scheme Administrators, in consultation with the Creditors' Committee, would have discretion to increase the limit for interim Australian Scheme payments. The main Scheme Companies are likely to have a high volume of very low value Scheme Creditor claims (for instance caused by entitlement to premium return on cancellation of policies). Progressive increases in the interim Payment Percentage could result in a series of small cheques being paid to some Scheme Creditors, which would be uneconomic for both the Scheme Creditor and the Scheme Company when compared to receiving the same amount through fewer cheques of higher value. Under the Australian Scheme the Scheme Administrators intend to recommend to each Creditors Committee that the de minimis limit for payment of interim Scheme Payment cheques be set initially at AUD50.

6.17 ***Final offers to Scheme Creditors with low value claims***

6.17.1 In a liquidation creditors with low value claims, like all other Scheme Creditors, would need to wait for completion of the insolvencies to receive their final dividend. The Australian Scheme allows for the Scheme Administrators, in consultation with the Creditors' Committee, to make final offers to Scheme Creditors with low value claims (defined in the Australian Scheme as Threshold Amounts) at any stage during the conduct of the Australian Scheme. The upper limit for Threshold Amounts is AUD2000. Any final offers made must be in relation to entitlements to a specified distribution priority from a specified category of assets. The final offer must be made to all Scheme Creditors with potential claims below the limit set for the offer in relation to that specified priority. The offers can be of a specified amount, or a specified percentage.

6.17.2 Such offers will be made only in circumstances where both the Scheme Administrators and the Creditors' Committee consider that the offer is in the interests of Scheme Creditors generally.

6.18 ***Treatment of particular policyholders***

6.18.1 ***Policyholders eligible for Federal or State Government assistance***

Many policyholders in Australia are eligible for assistance from HCSL, the compensation body set up by the Australian Government after the HIH failure. In addition, claimants under compulsory classes of insurance such as workers' compensation and third party motor accident are eligible for assistance from similar State compensation programmes. These policyholders, when paid by the relevant compensation body, assign their right to claim against the HIH companies to the relevant compensation body. The compensation bodies will then be entitled to vote as a Scheme Creditor and to receive any Scheme Payments in respect of the assigned claims, instead of the original policyholder.

6.18.2 The statutory bodies in Australia which compensate policyholders for the compulsory classes of business when an insurance company fails, have specific rights under State legislation to receive reinsurance covering those statutory classes of business. As a result

reinsurance recoveries from reinsurers anywhere in the world, covering statutory classes of business, will be paid to the relevant statutory bodies after deduction of any recovery costs incurred by the Scheme Administrators or the Liquidators. To the extent that amounts have not been paid in full, the relevant statutory bodies may claim as a Scheme Creditor.

6.19 ***Policyholders eligible for assistance under Financial Services Compensation Scheme (FSCS) in the United Kingdom***

The following section relates to Scheme Claims in respect of which policyholders of the English Scheme Companies may be entitled to protection from the FSCS. Compensation from the FSCS under the Australian Scheme is, subject to its terms, only payable to policyholders of the English Scheme Companies whose policies were United Kingdom policies (within the meaning of the Policyholders Protection Act 1975 (PPA)) at the Record Date and who would otherwise qualify for protection under that Act if those companies had gone into liquidation at the Record Date.

- 6.19.1 In the event of the liquidation in the UK of HIH C&G, FAI General and FAI Insurances, certain Scheme Creditors with insurance claims would be entitled to claim payment in respect of their insurance claims on that English Scheme Company from the FSCS under the provisions of the PPA.
- 6.19.2 The FSCS has agreed to be bound by the Australian Scheme (if it becomes binding on Protected Policyholders) and to make payments, in accordance with the terms of the Australian Scheme, to Protected Policyholders.
- 6.19.3 Assuming that the Australian Scheme has not already terminated, the Australian Scheme will continue in operation even if the relevant Company goes into liquidation in the United Kingdom and the FSCS will continue to make payments under the Australian Scheme in such an eventuality. Thus, if the relevant Company goes into liquidation in the United Kingdom and given that the Australian Scheme continues in effect, Protected Policyholders shall not be entitled to claim against the FSCS outside the terms of the Australian Scheme (for example under sections 6 to 8 of the PPA).
- 6.19.4 Protected Policyholders should notify their claims to both the FSCS at the address appearing in Appendix 1 and the relevant Company (through Omni Whittington Insurance Services) at the address appearing in Appendix 1.
- 6.19.5 If the FSCS determines that a claim submitted to it is a Protected Liability, it will, subject to certain qualifications and the assignment of certain rights, pay either 90 per cent or (in some limited cases) 100 per cent of that claim (according to the duty it would have under sections 6 to 8 of the PPA), less payments under the Australian Scheme already received and certain other amounts paid or payable in respect of that claim. On payment of a Protected Liability to the Protected Percentage by the FSCS, the FSCS will take an assignment of the Protected Policyholder's rights and therefore will receive any further payments under the Australian Scheme.
- 6.19.6 The FSCS will continue to make payments to Protected Policyholders on relevant claims, even after the Estimation Date. For this reason, unless the FSCS agrees, Protected Policyholders will not be entitled to any payments under the Australian Scheme as a result of the estimation procedures of the Australian Scheme.

- 6.19.7 A brief explanation of the obligations of the FSCS under the Australian Scheme is contained in Appendix 10 and a summary of certain provisions of the PPA appears in Appendix 11. It is important that Scheme Creditors who consider that they may be Protected Policyholders read Appendix 10 and 11 and consult their own professional advisers.
- 6.19.8 If, in the course of processing a Scheme Claim, the Scheme Administrators consider that it may give rise to a Protected Liability, they will refer the Scheme Claim to the FSCS.
- 6.19.9 Details of the procedures and rules applicable to payment which may be made by the FSCS are set out in full in the FSCS Schedule which forms part of the Australian Scheme.

6.20 ***Trust Funds held in the United States***

- 6.20.1 The Superintendent of Insurance of the State of New York holds two trust funds of USD5.4 million each for the benefit of certain creditors of HIH C&G and FAI General respectively. The trust funds were established by the companies as a regulatory requirement in order to be permitted to do business in the United States. The trust funds protect policyholders (and their respective assignees, pledgees and mortgagees named on the related policy) who are residents or doing business in the US and who have claims on policies written by HIH C&G and FAI General that provide coverage for property or risks located in the US. The trust funds do not protect reinsurance creditors (ie other insurance companies). They accordingly do not contain any reinsurance proceeds or recoveries and there is therefore no question of s562A applying to them. The Superintendent of Insurance for the State of New York has taken control of the trust funds, and now holds all of the US Trust Fund Assets.
- 6.20.2 If the US Trust Fund Assets are separately distributed, the Scheme Payment entitlements of the relevant Scheme Creditors will be reduced accordingly to allow for the funds received. The Liquidators expect that the Scheme Administrators will make arrangements with the Superintendent of Insurance for the State of New York for the release of the US Trust Fund Assets to be distributed to the relevant Scheme Creditors as part of the Australian Scheme, as this would be more efficient.
- 6.20.3 The Liquidators expect that the priority adopted under clause 35 of the Australian Scheme will allow the Superintendent of Insurance for the State of New York to release the US Trust Fund Assets for distribution under the Australian Scheme.
- 6.20.4 The Australian Scheme (subject to the particular considerations applying to the US Trust Fund Assets) otherwise applies the distribution priorities in the Corporations Act (including where relevant s562A) to all assets in the United States which can be realised for distribution by the Liquidators or Scheme Administrators in accordance with those priorities.

6.21 ***Claims by Brokers for client funding***

In some instances before the HIH insolvency, brokers will have paid their clients in advance for claims expected to be paid by Scheme Companies. The policyholder will remain the Scheme Creditor and so be entitled to vote at the Scheme Creditors meetings and to receive Scheme Payments, unless the broker arranges an assignment of rights from the policyholder.

6.22 ***Lineslips, binders and agencies***

- 6.22.1 Lineslips, binders and agencies refer to arrangements under which policies covering multiple insureds are written through an agent, without the insurance company necessarily knowing the identity of all of the insureds.
- 6.22.2 The Scheme Administrators will use reasonable endeavours to split these covers down to their principal level, in conjunction with the holder of the lineslip, binder or agency. If this proves impractical, the Scheme Administrators shall be entitled to pay distributions to the holder of the lineslip, binder or agency as principal in discharge of the obligation to make Scheme Payments to the Scheme Creditors concerned.

7 Communication with Scheme Creditors

7.1 *Meetings of Creditors' Committee*

For meetings of the Creditors' Committee, the Australian Scheme provides that the frequency, notice, method of attendance, location, provision of reporting information, method of communication and any administrative details are to be as agreed between the Creditors' Committee and the Scheme Administrators.

7.2 *Meetings of Scheme Creditors*

7.2.1 The initial meeting of Scheme Creditors to vote on implementation of the Australian Scheme will be convened in compliance with the requirements of the Corporations Act and the Court.

7.2.2 Under the terms of the Australian Scheme, subsequent meetings of Scheme Creditors will be convened only if the Scheme Administrators or the Creditors' Committee for the relevant Scheme Company considers a meeting to be warranted, or in the case of HIH C&G, FAI General, or CIC, if more than 50 Scheme Creditors with a collective claims value in excess of AUD100 million request the Scheme Administrators to convene a meeting. Notice of any subsequent meetings of Scheme Creditors will be by such means as the Scheme Administrators, in consultation with the Creditors' Committee, consider to be reasonable, including by advertisement alone.

7.3 *Communication with Scheme Creditors*

Under the Australian Scheme, the Scheme Administrators are required to produce an annual report to Scheme Creditors, detailing progress made in the conduct of the Australian Scheme. The report will be provided to the English Scheme Administrators for inclusion with the corresponding report of the Scheme Administrators. Distribution of the report is to be by way of the HIH Website, with hard copies to be provided to any Scheme Creditor on request. The annual report will include a summary of the Scheme Administrators' receipts and payments, including the amounts of remuneration approved by the Creditors' Committee. Availability of the report is to be notified to Scheme Creditors by public advertisement in such newspapers as the Scheme Administrators consider appropriate, after consultation with the Creditors' Committee.

7.4 *Termination of the Australian Scheme*

The Australian Scheme provides for its termination 12 months after payment of the final Scheme payment, or earlier if all of the liabilities of the Scheme Company have been discharged in full.

After termination of the Australian Scheme any remaining assets will be paid to the Liquidators to be dealt with in accordance with the law applying to liquidations.

8 Information required by statute

8.1.1 In providing this Explanatory Statement to Scheme Creditors, the Liquidators are required to include the following information:

- a statement as follows: a Court order under subsection 411(1) of the Corporations Act directing that meetings of creditors be convened to vote upon the proposed Australian Scheme is not an endorsement of, or any other expression of opinion on, the Australian Scheme;
- a statement of any material interests of the directors of the Company. In the Liquidators' opinion, there are no interests of the directors, whether as directors, members or creditors of the Company or otherwise, which are material in relation to the proposed Australian Scheme, and the proposed Australian Scheme has no effect on the interests of directors which is different than the effect on the like interests of other persons;
- details of the expected dividends which would be available if the company were to be wound up. These companies are in fact already being wound up. The Liquidators' estimates of likely dividend ranges under each Australian Scheme are given in Appendix 4. In the Liquidators' opinion, the effect of each Australian Scheme will be to allow faster distribution of funds to creditors and earlier closure of the insolvency, with cost savings and no reduction in the level of dividends which would be available by liquidation alone; and
- the scale of charges which any person who would be appointed to manage the Australian Scheme proposes to charge for his or her services and for the services of his or her staff. The Scheme Administrators proposed are Messrs A G McGrath and C J Honey of McGrathNicol+Partners, Sydney. The scales of charges which currently apply to the Liquidation are attached as Appendix 12 to this Explanatory Statement. Under the terms of the proposed Australian Scheme, the actual remuneration of the Scheme Administrators, including any variation in scale rates, will be subject to approval by the Creditors Committee.
- As at the date of this Explanatory Statement, a listing of the names of all known Australian Scheme creditors and the debts owed to those creditors; the names of any known guarantee creditors and amounts owed; and the names of any known internal creditors and amounts owed. A register of these details will be provided to any Scheme Creditor on request and free of charge.

9 Factors to be considered when voting on the Australian Scheme

9.1 Each of the companies for which an Australian Scheme is proposed was a licensed insurer in Australia at one time, is clearly insolvent, and is currently in liquidation. The Royal Commission findings have resulted in further investigations and a number of prosecutions by the relevant authorities are expected. In addition, damages and antecedent transaction recovery actions are available to the Liquidators. A number of these actions require the continuation of the liquidations in order to utilise the Liquidators' recovery powers.

Accordingly the alternatives available are:

- continuation of the liquidation, in conjunction with the Australian Scheme; or
- continuation of the liquidation alone.

9.2 *Differences between the effects of the continuation of the liquidation alone, and the implementation of the Australian Scheme.*

9.2.1 The Australian Scheme will operate to alter or modify the relationship between the Scheme Company and its Scheme Creditors that would otherwise exist in the continuation of the liquidation alone.

9.2.2 A number of the aspects of the relationship which will be altered or modified are considered throughout this Explanatory Statement and, in that regard, the Explanatory Statement should be considered as a whole. For ease of reference, a schedule of the primary differences between the Australian Scheme and a liquidation is attached as Appendix 13.

9.3 *Reasons why Liquidators recommend the Australian Scheme*

9.3.1 The Liquidators recommend that the Australian Scheme of Arrangement be implemented in addition to the liquidation, rather than the liquidation continue alone, for the following reasons:

- more efficient claims agreement – insurance claims against the company will be agreed and recorded through normal market mechanisms, or may be notified direct by Scheme Creditors. The formal proof of debt procedure used under liquidation law will not be required under the Australian Scheme;
- use of contract currency - claims and Scheme Payments under the Australian Scheme will generally be agreed and paid in the currency of the original contract. In liquidation, creditors' claims would be converted into Australian Dollars using the exchange rate at the date of the winding-up order, regardless of the fact that many of those claims may not be established for some time. The Australian Scheme removes the exposure of Scheme Creditors to the effects of any significant exchange rate movements;
- complimentary provisions – the Australian Scheme provisions, in conjunction with complimentary provisions in the English Schemes, will allow unified claims

agreement, co-ordinated distributions, and unified closure mechanisms which will be more efficient than stand alone liquidations in the separate jurisdictions;

- savings in legal costs for resolving disputed claims – the Australian Scheme provides for a moratorium on legal action until six months after a Scheme Creditor lodges a Notice of Litigation. If the Scheme Administrators have not agreed the claim with the Scheme Creditor during that six months, the Scheme Creditor can then revert to legal remedies;
- earlier interim distributions – the liquidation of insurance companies normally continues for an extended period. The reason for this is that creditors may be entitled to make claims against the company many years after the company failed. The Australian Scheme allows interim distributions to be made to Scheme Creditors on a more streamlined and efficient basis than would be possible in a liquidation;
- restricted de minimis payments – the Liquidators consider that the flexibility to set a higher de minimis payment level for interim Scheme Payments than would be possible in liquidation, may allow cost savings to the benefit of all Scheme Creditors, including those Scheme Creditors whose cheques are deferred until a greater entitlement has accrued;
- final offers to Scheme Creditors with low value claims – it is anticipated that use of this provision would produce a better result for all Scheme Creditors, because the Scheme Creditors with low value claims would receive earlier payment, and cost efficiencies would be achieved for the benefit of remaining Scheme Creditors; and
- earlier final closure – the Liquidators estimate that if the insolvencies were to continue as liquidations alone, they would need to continue for approximately 20 years, to be fair to Scheme Creditors with potential long tail claims. Examples of potentially long tail business are public liability cover and professional indemnity cover. The Australian Scheme includes an estimation mechanism (expected after seven years, but not before five years and not after nine years). At this point Scheme Creditors with potential claims not yet agreed would receive a Scheme Payment based on an actuarial estimate of their claim. This estimation procedure would enable Scheme Creditors (including those receiving an actuarial estimate) to receive final Scheme Payments significantly sooner than would be possible under liquidation alone. This will result in a significant cost saving when compared with a longer liquidation.

9.4 ***Risk Factors***

9.4.1 The risks of implementing the proposed Australian Scheme are as follows:

- overpayment of interim distributions – the Australian Scheme provides for the Scheme Administrators (in consultation with the Creditors' Committee) to set Payment Percentages at least annually, taking into account the cash available at the time, cash expected to become available from further asset realisations, future cash expenditure expected, and actuarial projections of liabilities not yet agreed when setting the Payment Percentage. Scheme Creditors with claims not yet agreed at the

time of interim Scheme Payments would be disadvantaged if subsequent failure to realise assets or subsequent growth in liabilities beyond actuarial projections, resulted in the Payment Percentage later needing to be reduced. The Liquidators consider that this risk can be minimised by prudent estimation when setting the Payment Percentages;

- distribution of Reinsurance Assets the subject of a Section 562A(4) Order – the Australian Scheme provides for the Scheme Administrators to pay to the Liquidators any amounts the subject of a Section 562A(4) Order for distribution by the Liquidators in accordance with that order. There is a theoretical risk that the relevant Reinsurance Assets may be distributed prior to the making of any Section 562A(4) Order. However, the Australian Scheme provides for an adjustment mechanism with respect to the distribution of assets, which could be invoked so as to allow the Scheme Administrators to make any adjustments which might be required. This same risk, and mechanism, would exist in a liquidation, absent the Australian Scheme;
- estimation procedure – the feature of the Australian Scheme whereby an estimation procedure would be adopted to allow closure of the insolvency after the Run-Off Period means that Scheme Creditors with claims not yet agreed by that time will receive their final Scheme Payments based on an estimate of claim value rather than actual claim value. This means that some Scheme Creditors may receive more, and other Scheme Creditors less, than if their claims were allowed to finally mature. The Liquidators consider however that use of the estimation procedure is in all Scheme Creditors' interests on the grounds of cost savings and efficiency, to allow final payments to be made to Scheme Creditors sooner than would otherwise be possible.

10 **Conclusion**

- 10.1 The Liquidators consider that each Australian Scheme will produce a better result for all groups of Scheme Creditors of the relevant Scheme Company than would be achieved by liquidation alone.
- 10.2 The Liquidators recommend that Scheme Creditors vote in favour of the Australian Schemes.

Appendix	Content
1	Contact details for HIH parties
2	Background information <ul style="list-style-type: none"> • Abbreviated Corporate Chart • Chronology of Key Events (from HIH Royal Commission) • Historical Introductions for the 8 companies (from HIH Royal Commission)
3	For each company: <ul style="list-style-type: none"> • Report as to Affairs • Liquidators' statement of Receipts & Payments • Website Details from HIH Royal Commission for financial position pre-insolvency
4	Liquidators' current estimates of ultimate dividend
5	CVs of the proposed initial Scheme Administrators
6	List of the Committees of Inspection
7	Nomination form for membership of Creditors' Committee
8	Process for dealing with disputed Scheme Claims during the run-off period
9	Claims agreement procedure after Estimation Date
10	Summary of Australian Scheme provisions in relation to the FSCS and the English Authorised Scheme Companies
11	Summary of Policyholders Protection Act and the FSCS
12	Current scale of charges of McGrathNicol+Partners, Australia
13	Comparison of Liquidation with the Australian Scheme