The HIH decision – Universalism reigns

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Executive Summary

What started as a request to the Court for directions in the summer of 2005 ended almost three years later when on Wednesday 9 April 2008, the House of Lords handed down its decision in relation to the HIH assets case. In their decision, which will have a direct financial impact on the creditors of the HIH group, the Lords held that the HIH assets in the UK should be subjected to Australian priorities when they are distributed.

Brief background

Various members of the HIH group of companies operated in Australia and other jurisdictions, including the United Kingdom. For the purposes of this article, we focus on the HIH company with the highest profile in the UK – HIH Casualty & General Insurance Limited ("HIH C&G").

HIH C&G is an Australian company which was registered in England as a foreign company. The UK branch operated from premises in London and underwrote both primary and reinsurance business in the UK. HIH C&G also purchased significant reinsurance from the London Market covering both Australian and UK branch underwriting. The majority of HIH C&G's assets and liabilities were in Australia. In their submissions to Court, the Australian Liquidators ("ALs") and English Provisional Liquidators ("PLs") estimated that of the AUD1.1 billion of assets of HIH C&G, 20% were held in the UK. On the creditor side, of the AUD4.5 billion, around 75% were located in Australia, with the rest being worldwide, mostly UK.

The HIH group failed in Australia on 15 March 2001 and many of the group companies were placed into Provisional Liquidation. HIH C&G was one of them. The Supreme Court of New South Wales requested under s426 of the Insolvency Act 1986, that PLs be appointed in England, and the High Court in England duly appointed Tony McMahon, Tom Riddell and John Wardrop, Partners of KPMG LLP, as PLs on 16 March 2001.

A number of other applications were made to Courts both in England and Australia, with the effect that HIH C&G was placed into liquidation in Australia on 27 August 2001 and the

Australian Provisional Liquidators became the ALs. On 10 September 2001, subject to another request from the Supreme Court of New South Wales, the PLs were appointed under the provisions on s135 of the Insolvency Act 1986, discharging the 16 March 2001 order.

Why was the application made?

The laws of distribution in insolvency differ between England and Australia. At the time of the failure of HIH C&G, English law provided for unsecured creditors to be treated pari passu, that is, to rank for distributions equally. The Australian legal structure afforded preferential treatment to claims based on their type (insurance or non insurance) as well as their location (liabilities in, or not in Australia). As a result, the ALs and PLs resolved to seek the Courts Directions. A Letter of Request under s426 of the Insolvency Act was therefore sought by the ALs and issued by the Supreme Court of New South Wales.

The legal context (1) - English statute

Section 426 of the Insolvency Act 1986 deals with co-operation with other Courts in relation to insolvency both within and outside the United Kingdom. It states:

4) *The courts having jurisdiction in relation to insolvency law in any part of the United Kingdom shall assist the courts having the corresponding jurisdiction in any other part of the United Kingdom or any relevant country or territory"*
5) *For the purposes of subsection (4) a request made…is authority for court to which the request is made to apply… the insolvency law which is applicable by either court in relation to comparable matters…*

Australia is a relevant country for the purposes of the Act. Accordingly, when confronted with the request, the English Courts had to consider both whether the matter was comparable and which law should be applied.

The legal context (2) - The Australian statutes

Distribution differences in the English and Australian statutes arise by virtue of two sections of Australian legislation. The first is section 562A of the Corporations Act 2001. The section grants a type of priority to insureds and reinsureds over other creditors where reinsurance is held by the insolvent entity.

There was, at the time, no such priority in the English statute for this type of claim, which clearly has the effect of preferring insurance and reinsurance claimants over non insurance claimants, by giving them an enhanced right to receive the proceeds of reinsurance recoveries.

In the context of HIH C&G, this statute would have the effect of applying the proceeds of all reinsurance recoveries to insurance and reinsurance claims. Interestingly, the EU led Insurers (Reorganisation and Winding Up) Regulations 2004 now enacts a similar preference, but only for direct insurance creditors, not reinsureds. The implementation of these Regulations had no retrospective effect however and therefore do not apply to this case.

The second major difference between Australian and English law is contained within Subsection 116(3) of the Insurance Act 1973, which states that:

> *(3) In the winding up of a general insurer, the insurer's assets in Australia must not be applied in the discharge of its liabilities other than its liabilities in Australia unless it has no liabilities in Australia.*

This quite clearly favours those creditors with liabilities in Australia over those who do not. In other words, those creditors without liabilities in Australia (mostly UK reinsurance creditors) will be adversely affected when compared to a worldwide pari passu distribution between all unsecured creditors. It is worth noting that this subsection deals with the *location* of the liability and the assets and does *not* relate to the domicile of the claimant, although in practice, creditors often deal in their own jurisdictions and the two concepts are often mistaken as analogous.

Possible effects on returns to creditors

By way of context, the current UK[1] distribution rate for HIH C&G is 9 pence in the pound and the ultimate distribution percentage for HIH C&G is estimated by the ALs and PLs at between 15% to 25%.

In the agreed facts of the application, the ALs and PLs estimated that the impact on those creditors adversely affected by the imposition of Australian priorities (typically those without insurance/reinsurance claims in Australia) could be a 24% reduction in their return, together with a 10% estimated increase in return to those with insurance/reinsurance claims in

[1] The application in Australia of the priorities outlined above currently result in a distribution rate of 12.64 cents in the dollar to (re)insurance creditors with liabilities in Australia

Australia. The difference in these estimates is due mainly to the relative size of claims and assets which are located in Australia compared with elsewhere in the world.

Schemes of Arrangement

Following legal advice and in parallel to the directions hearing, the ALs and PLs determined, in co-operation, that it was possible that two distribution mechanisms may be required within any proposed Schemes of Arrangement to reflect the differing distribution priorities. In effect, there would be an "English" fund to be distributed in accordance with English insolvency law and an "Australian" fund, applying Australian priorities.

The Schemes jointly formulated by them and approved by creditors therefore had the in-built flexibility to cater for the Court's ultimate determination. These were the first schemes of their kind to include such a device and allowed the commencement of distributions to creditors whilst the issue was being resolved.

English law is affirmed at first instance

On 14 June 2005, the ALs demanded payment of monies held by the PLs. Following the ALs demand, the PLs and ALs submitted their queries to the English Court on 25 June 2005 and 4 July 2005 respectively. Clarification of a number of matters was sought. For the purposes of this article, the two main points raised were as follows:

Firstly, whether the assets held in England should be:

a) Remitted to the ALs to be distributed by them in line with Australian priorities,
b) Distributed in England in line with Australian priorities, or
c) Distributed in England in accordance with English priorities.

In short Richards J found that "the English Court would not direct or authorise the [PLs] to remit the assets collected by them to the [ALs], having regard to section 562A of the Corporations Act 2001 and section 116 of the Insurance Act 1973, unless some means could be found of ensuring those assets could be distributed as if in an English liquidation"[2].

The second matter to be considered was, given the answers above, whether the PLs could propose a Scheme of Arrangement which:

[2] At paragraph 155 of the judgment

- Applied the principle of hotchpot [a form of equitable equalisation], or whether
- It should give effect to the operation of s562A and s116.

The ALs and PLs accepted that recoveries made under s116 would have to be subject to hotchpot prior to being eligible to participate in an English liquidation. Richards J held that distributions under s562A should *also* have hotchpot applied to them.

Richards J held that the English Laws of distribution were mandatory and the Court had no power to disapply them. He found that the PLs should not be directed to pay the monies to the ALs, nor should their powers be extended to allow them to do so. As such the concept of an English asset pool to which English law would apply was affirmed. He did, however find that if there was no prospect of a mechanism to deal with the assets in England, that he would allow the transfer.

The position is confirmed on appeal

Following Richards J's findings, the ALs appealed a number of his findings.

The Chancellor of the High Court gave the leading judgment, which was followed by his colleagues and concentrated on s426. He considered whether the request for the English Court to accede to the Australian Courts request in relation to distribution priorities was permissible.

He differed from the first instance judge by finding that "If s426, which is itself part of the statutory scheme, can authorise a transfer from the liquidators of an ancillary winding up to the liquidators of the principal winding up the only question can be whether such authority or jurisdiction should be exercised".[3]

The Chancellor concluded that accordingly, there *was* a discretion open to the Court to authorise such a transfer. He concluded that the Court would *not* exercise its discretion as to do so would prejudice the rights of all creditors, except those who had insurance liabilities in Australia.

The Lords decide otherwise

[3] At paragraph 49 of the judgment

The House of Lords took a different view from that of the Appeal Court. They were unanimous on the question of whether the assets should be subject to Australian priorities.

Lord Hoffman found that he agreed with the Court of Appeal in that the English Court did have jurisdiction to order the remission. On the question of whether he would apply the discretion to the current case, the outcome differed.

"It would in my opinion make no sense to confine the power to direct remittal cases in which the foreign law of distribution *coincided* [emphasis added] with English law" [4]and that "As for UK public policy, I cannot see how it could be prejudiced by the application of Australian law to the distribution of the English assets."[5] By way of final conclusion, he found that "In my opinion, therefore, this is a case in which it is appropriate to give the principle of universalism full rein. There are no grounds of justice or policy which require this country to insist upon distributing an Australian company's assets according to its own system of priorities only because they happen to have been situated in this country at the time of the appointment of the [PLs]. I would therefore allow the appeal and make the order requested by the Australian court."[6]

The Lords were divided on how they reached their conclusion. Lords Hoffman and Walker found that they would have ordered the application of Australian priorities irrespective of whether s426 existed. Lords Scott and Neuberger found that were it not for s426, they would *not* have ordered the imposition of Australian priorities.

Conclusion

The Lords decision brings to an end one of the significant uncertainties of the HIH estate. The assets held in the UK are to be distributed in accordance with Australian priorities. On a day to day basis, this will have little effect on the operation of the estate as the ALs and PLs had made allowance for both outcomes in the Schemes and the ultimate impact of the decision will likely only be fully felt at the conclusion of the HIH estates.

Whether this will have a wider reaching effect than this case, given the development in both UNCITRAL and EU led legislation since the failure of HIH C&G, will be borne out in future cases as and when they arise. What can be said is that in this case the assets held in a branch of a foreign company have been subjected to the law applicable in the company's home state, and in the circumstances of HIH C&G, is likely to reduce the assets available to UK creditors.

[4] At paragraph 21 of the judgment
[5] At paragraph 34 of the judgment
[6] At paragraph 36 of the judgment

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