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## COVINGTON CLIENTS' OPPOSITION TO SCOTTISH LION SCHEME

### Introduction

We represent a number of policyholders of Scottish Lion in connection with its proposed solvent scheme of arrangement (“the Scheme”) under the Companies Act 2006.<sup>1</sup> The objective of the Scheme is to terminate the run-off of Scottish Lion’s business by placing a present value on Scheme Creditors’ claims, including future and highly contingent claims (known as “IBNR claims”) that have yet to emerge, and that defy accurate estimation. Our clients oppose the Scheme on the grounds outlined below.

You may, by now, have received a number of documents from Scottish Lion in connection with the Scheme, including notice of the meetings of Scheme Creditors which Scottish Lion proposes to hold on March 2, 2009. If the Scheme is approved at the meetings by a majority in number representing 75% in value of the Scheme Creditors present and voting, in person or by proxy, Scottish Lion may then apply to the Court for an order sanctioning the Scheme. If sanctioned, the Scheme will become binding on all Scheme Creditors, including those who object. What this means is that your rights under policies subscribed by Scottish Lion will be forever extinguished, whether or not you consented to the Scheme.

### Reasons Why Our Clients Oppose the Scheme

The Proposed Scheme is fundamentally unfair to policyholders because it:

- Seeks to extinguish decades of valuable occurrence coverage under valid and binding contracts in the absence of extraordinary circumstances (e.g., insolvency or other severe financial stress). Our clients regard this as a confiscation of a valuable corporate asset that would otherwise remain available to pay for “long-tail” liabilities such as asbestos, pollution and similar exposures.

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<sup>1</sup> We represent the following American policyholders in opposing the Scheme: ExxonMobil Corp., Goodrich Corp., ITT Corp., Textron, Inc., and Zapata Corp. (collectively, “Objecting Creditors”). This document provides a high-level overview of the Objecting Creditors’ principal concerns with the Scheme.

- Is fundamentally incapable of providing creditors with just compensation because, while IBNR claims pose real risks, they resist precise valuation using standard actuarial techniques, leading schemes to devalue or assign no value to such claims.
- For example, when an insurer sells a class of business to another insurer, the buyer typically requires the seller to value its potential future claims at the 98th percentile of confidence. In contrast, Scottish Lion intends to value IBNR claims based at “the mean of the distribution of possible outcomes.” The difference between the value placed on IBNR claims using the 98th percentile and the reduced value resulting from a mean (50%) confidence level can be substantial, and often results in little or no recovery from the Scheme for IBNR claims.
- To cite another important example of the devaluations forecast by the Scheme’s estimation methodology, many courts, including those in US states like California, Illinois, Ohio and Pennsylvania, have held that each policy triggered by an asbestos or pollution claim must respond with full indemnity for that claim, and that the burden is on the insurer to seek contribution from other co-insurers under separately triggered policies in effect during other triggered years. Scottish Lion proposes to abandon this principle -- known as the “all sums” rule -- by spreading the amount of the insured’s estimated indemnity into other policies subscribed by other insurers and even to periods where no insurance is available. This is fundamentally inconsistent with the “all sums” rule, as it greatly devalues the policyholder’s rights against policies subscribed by Scottish Lion.
- Unfairly requires creditors to expend considerable time and money in documenting and estimating contingent future claim that are by definition unknowable, when they would prefer to retain their coverage to pay claims as they emerge over time. Further, it is simply unconscionable that Scottish Lion, after forcing Creditors to incur such costs, would reserve to itself the purported right to unilaterally terminate the Scheme at any time if it determines that the Scheme is no longer financially attractive to Scottish Lion and its shareholders. *See* Scheme at 81, cl. 37, 38. A parallel creditor opt-out provision should be part of any solvent scheme of arrangement, as the right to opt out should belong equally to Creditors and Scottish Lion.

Vote valuation:

- It is fundamentally unfair that the Scheme Adviser is given unfettered discretion to assign whatever value he deems appropriate to IBNR claims, including the rejection of a claim in whole or in part “if he considers that it does not represent a reasonable assessment of the sum due from the Company.” Expl. Stmt. at 21-22, cl. 11.2, 11.3.
- There is an inescapable conflict of interest for the Scheme Adviser, whose decision as to vote valuation is final and binding, to be compensated by a contingency fee tied to “any return to shareholders of the Company.” Expl. Stmt. at 28, cl. 15.8 and 21, cl. 11.3. In effect, the Scheme Adviser is compensated on the basis of the amount of

funds remaining for shareholders when the Scheme is concluded, which creates an inherent incentive to devalue policyholder claims.

Compressed Timetables and Deadlines:

- The key Scheme deadlines (e.g. requirement to submit claims information within 180 days after the Effective Date, *see* Scheme at 45 (defining “Bar Date”)) are unreasonable given the complexities involved with amassing historical claims data and performing the difficult modeling necessary to estimate IBNR liabilities.
- The Scheme also would prohibit Creditors from submitting any additional supporting information after the Bar Date unless in response to a specific request by the Scheme Adjudicator. Scheme at 62-63, cl. 16.5, 16.6, 16.8. This is unfair to policyholders: if Scottish Lion fails to agree with certain claims, Creditors should have the right to respond with such additional information that they deem appropriate.

Adjudication - Choice of Law and Forum:

- Objecting Creditors disagree that Scottish law governs their insurance contracts. The contracts of insurance entered into between the U.S. Policyholders and Scottish Lion are, for the most part, governed by the law of various states of the United States.
- Scottish Lion’s attempt to impose Scottish law on policies governed by US state law seeks to deprive American policyholders of more favorable insurance coverage precedent governing allocation of “long-tail” liabilities. It is an abridgment of policyholders’ contract rights to impose Scottish law retroactively on policies that have been in effect for many years, especially when Scottish Lion did not include a Scottish choice-of-law clause in those policies.
- Objecting Creditors object to Scottish Lion’s purported unilateral authority to select the Scheme Adjudicator. *See* Scheme at 76, cl. 31.5, 31.6; 79, cl. 34.4. Given his critical role in dispute resolution, the Scheme Adjudicator should be appointed by, and mutually acceptable to, both Scottish Lion and the Creditors. Decisions of the Scheme Adjudicator affecting the rights of US policyholders should be subject to judicial review in US courts, and the Scheme Adjudicator should have legal training and a working familiarity with legal issues of policy interpretation that underlie most claim disputes submitted to adjudication under the Scheme. The Scheme Adjudicator should not be a financial consultant with no legal or judicial background, as that encourages arbitrary claim determinations and lack of procedural due process.

Verifying policy information: Scottish Lion should not be allowed to place “sole responsibility” on Creditors to verify the “accuracy and completeness of any information provided by the Company with respect to Insurance Contracts.” *See* Expl. Stmt. at 25, cl. 13.14. The onus should be on Scottish Lion to identify which policies fall within the scope of the Scheme.

Cost Shifting: Objecting Creditors object to any and all provisions that permit costs of resolving disputed matters to be shifted to Creditors, especially those that permit costs to be shifted to Creditors at the “absolute discretion” of the Scheme Adjudicator. *See, e.g.*, Scheme at 69-70, cl. 20.15, 20.16.

### **Contact Information**

If you are concerned, as our clients are, that the Scheme will deprive you of valuable insurance cover for inadequate consideration, we invite you to contact us without delay so that we can consult with you in advance of the Scottish Lion creditor meetings and vote (currently scheduled for March 2, 2009) and ensure that creditor opposition to the Scheme is clearly and fairly communicated to Scottish Lion through the creditor voting process.

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### **Our Experience in Opposing Solvent Schemes**

We successfully represented opposing creditors in both the BAIC and WFUM solvent schemes in the English courts. To date, these are the only schemes that have been challenged in court by objecting policyholders. In both cases the objecting policyholders prevailed. In BAIC, the court ruled that the scheme was invalid (*see* below) and in WFUM the court ruled in our favor on the key class issue, and then all of our clients reached very favorable settlements, the last coming just weeks before the WFUM sanction hearing.

### **A Final Note: The Wisdom of the BAIC Ruling**

In striking down the solvent scheme proposed by the British Aviation Insurance Company (“BAIC”), Justice Lewison eloquently described the problems inherent in any solvent scheme of arrangement.

“[It] seems to me to be unfair to require the manufacturers who have bought insurance policies designed to cast the risk of exposure to asbestos claims on insurers to have that risk compulsorily retransferred to them. The company is in the risk business; and they are not. This is not a case of an insolvent company to which quite different considerations apply. On the evidence presented to me the company is able to meet its liabilities under such policies as and when they fall due. The purpose of the scheme is to allow surplus funds to be returned to shareholders in preference to satisfying the legitimate claims of creditors. No matter how usable and reasonable an estimate may be, the very fact that it is an estimate is likely to make in an inaccurate forecast of the actual liabilities of policyholders. If individual policyholders wish to compound the company’s contingent liabilities to them, and to accept payment in full of an estimate of their claims, there is nothing to stop them doing so. But to compel dissentients to do so would ... require them to do that which it is unreasonable to require them to do.”

*In Re British Aviation Insurance Company* [2006] BCC 14.