

Appendix 25 B

Legal issues arising in respect of Rights and Interests in and Uses of the inherited estates.

A report by the legal advisers of the policyholder advocate in connection with the reattribution of the inherited estates of CGNU Life and CULAC with-profits funds.

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1.00 Introduction

The negotiation of the policyholder incentive payment (PIP) requires the policyholder advocate and Aviva to consider the value of the changes in both the rights and interests of the policyholders and the rights and interests of the shareholders that are brought about by the reattribution of the inherited estates. The nature and extent of those rights and interests and their valuation is central to whether the reattribution will be attractive to policyholders and shareholders. Both the policyholder advocate and Aviva have taken legal advice as to the respective rights and interests of policyholders and of CULAC and CGNU Life in respect of the inherited estates of the two companies, and as to the nature and extent of any legal constraints on the uses to which those inherited estates may be put by the companies.

It is important to recognise that in common with the approach of the industry generally, the terms of CULAC and CGNU Life policies do not include detailed provisions regarding the calculation and declaration of bonuses or the impact of the existence of an inherited estate on the rights and interest of the policyholders. There is also very little case law that relates specifically to the legal analysis of a with-profits contract and the rights and interests of policyholders and the insurer under such contracts, although there are two recent cases, AXA and Equitable Life, where the courts have needed to analyse the application of their discretion by the directors of the insurer in the context of with-profits contracts and in the former case have examined rights and interests of policyholders in the context of a reattribution.

The legal position as regards (i) the scope of the rights and interests of with-profits policyholders and (ii) the resulting impact of these rights and interests on the way in which the inherited estate within a with-profits fund can be used is not clear cut and, on the basis of existing case law, the policyholder advocate's legal advisers consider that it is possible to argue for a different approach from the conventional one proposed by Aviva's advisers.

So far as the substance of the advice is concerned, there are some areas of agreement as between the legal advice provided to the policyholder advocate and that provided to Aviva, but there are also material respects in which the legal advice provided to the policyholder advocate has differed significantly from that provided to Aviva. This appendix summarises

the main elements of the policyholder advocate's legal advice, comments briefly on the approach suggested by Aviva's advisers and concludes with an explanation of how the differences of legal approach (and the potential differences in approach to the valuation of policyholder and shareholder rights and interests they gave rise to) were addressed in the reattribution negotiations.

Aviva has prepared its own appendix (appendix 25A) in which it sets out the points it wishes to make regarding the legal analysis. That appendix includes a comment regarding the policyholder advocate's legal advice. It should be made clear that the two appendices have been independently prepared and that the policyholder advocate does not necessarily agree with all aspects of the presentation of her legal advice in the appendix prepared by Aviva.

2.00 The policyholder advocate's legal advice

2.01. Introduction

The policyholder advocate asked her legal advisers to address the following matters:

- (1) What rights do policyholders of CGNU Life and CULAC have at common law or in equity in relation to the inherited estates of their respective with profits funds?
- (2) Is the analysis of such rights consistent with the regulatory regime applicable to with-profits funds?
- (3) What are the implications of the foregoing for the terms on which policyholders should be prepared to agree to a reattribution of the inherited estate of a with-profits fund?

These questions raise a number of difficult issues that have been debated by lawyers, actuaries and regulators for many years. The policyholder advocate's legal advisers sought to provide a useful answer to the questions on a principled basis, and their full Opinion (including supplemental material) is available as a separate appendix.

What follows is a summary of their views as expressed in this Opinion

- (1) Given that with-profits policies themselves are notoriously unspecific as to the rights of policyholders beyond their guaranteed benefits, in analysing policyholders' contractual rights, one should start by considering what are the essential elements of such a policy. These are a right to receive a certain sum at a certain time in the future or upon the happening of a certain contingency (i.e. the guaranteed benefits) and a right to share in profits (i.e. the surplus of assets in a specified fund over the liabilities of that fund) .
- (2) The calculation of profits, and the decision whether and how much to distribute are matters left to the discretion of the insurer. The purpose of this is to give the insurer flexibility to distribute profits in a fair and sensible manner. A central aspect of such flexibility is the ability to “smooth” the amounts distributed to policyholders.
- (3) Having regard to the characteristics of a with-profits policy described above, the essential purpose of a with-profits fund, whether mutual or proprietary, is to act as the vehicle for the company to offer financial services to policyholders, comprising both guaranteed benefits and a “smoothed” share in the profits of the fund.
- (4) While it is accepted that the insurer has a very large measure of discretion, neither policyholder nor insurer can be taken to regard this discretion as absolute. At the very minimum policyholders expect their premiums to be paid into the fund and for it to be managed for the purpose referred to above. This expectation lies at the heart of with-profits business and if an insurer were to act inconsistently with this expectation, it would in the legal advisers' view nullify the whole concept of a with-profits policy.
- (5) It follows from this that policyholders do not expect that the insurer will use the assets in the with-profits fund for other, collateral, purposes, and they do expect that the insurer will distribute and not retain assets insofar as they exceed what is required for the purpose referred to above.

- (6) The parties must also expect that the wide discretion that the insurer still has within these limits must be exercised reasonably and fairly, which would include an obligation to treat policyholders in a non-discriminatory way, both as between policyholders and classes of policyholder, and in relation to the company, and to avoid actual or potential conflicts of interest .

The five principles

- (7) The policyholder advocate’s legal advisers consider that these matters can be expressed in five fundamental principles. They consider that these must be regarded not just as part of the basic expectations and understanding of policyholders and insurers but also as matters which must be followed in order to carry with-profits business into effect. They do not think that the insurer could derogate from these principles without the informed consent of policyholders, either in the policy document itself or on a case by case basis:

- (a) **The insurer will establish and maintain a with-profits fund into which premiums will be paid.**

This follows from the nature of the contractual relationship. Such a fund may comprise the whole of the insurer’s long term business, but more commonly is a separate fund.

- (b) **The purposes of this fund will be to meet guaranteed benefits and, subject to this, to generate profits for distribution to policyholders.**

This principle reflects the fact that with-profits business is based on the provision of financial services to policyholders as against any other form of economic activity that might have been undertaken by the insurer, and it is difficult to conceive of any other legitimate purpose for the with-profits fund, although there will clearly be many uses to which the assets can properly be put in furthering that purpose. The reference to “policyholders” does not ignore the fact that shareholders are also

entitled to a 10 per cent share of distributable profits, but reflects the essential role of the fund as a vehicle for the provision of financial services to policyholders and also the predominance of the policyholder interest.

- (c) **The with-profits fund will be managed for those and not for other purposes.**

This principle follows from the second principle. If the insurer was free to manage the with-profits fund for purposes other than the generation of profits for distribution to policyholders, or to extract assets to be used for other purposes, this would undermine the rationale for with-profits policies as a vehicle whereby policyholders are entitled to share in the profits of the fund.

- (d) **Any profits made by the fund will be distributed insofar as their retention is not justified for the purposes of the with-profits fund.**

This principle again reflects the essence of the bargain between policyholders and the insurer. Without it, the policyholder advocate's legal advisers consider the entitlement of policyholders to a 90 per cent share in profits would become meaningless, in that the insurer would be free as a matter of contract to provide no financial benefits beyond the guaranteed benefits. This principle does not say that policyholders can reasonably expect all profits to be paid out to them; the point is simply that retention of profits in the fund needs to be justified for the purposes of the fund. Examples of such purposes would include the provision of security for guarantees or other liabilities, to facilitate smoothing, or to allow greater investment flexibility.

- (e) **The insurer will exercise its powers and discretions reasonably and fairly.**

This principle reflects the general attitude of the law to the exercise of discretionary power. In particular, the insurer must not exercise its discretion in ways that unduly discriminate against, or between, policyholders.

- (8) The policyholder advocate’s legal advisers further note the following points:
- This analytical model applies to the entire with-profits fund. There is no reason to adopt a different approach to a surplus in the fund, and strong policy reasons not to do so, in order to avoid any incentive for the company to engage in under distribution .
 - The same principles should therefore apply irrespective of whether there is an “inherited estate”. Any inherited estate should be treated in the same way as the rest of the with-profits fund. There is no warrant for treating the inherited estate differently. Policyholders may not have been led to expect the inherited estate to be distributed (in whole or in part) but they would not expect that any part of the fund (including any inherited estate) could be used by the insurer for its own purposes and otherwise than in ways which will support the fund and help it to achieve its objectives. In principle, no use of fund assets should be acceptable from the estate unless it would be equally acceptable from the part of the fund comprising asset shares.
 - The principles are entirely consistent with the concepts of asset share and smoothing. But although the concept of smoothed asset share has achieved increased prominence both in the actuarial calculations of with-profits firms and in the regulatory approach adopted in the past few years, and forms an important element of the equitable treatment of policyholders, the underlying contract between the company and its with-profits policyholders is not to be determined solely by reference to that concept; these are simply features of the profit-sharing process; they do

not represent the limits of policyholders' expectations regarding the management of a with-profits fund.

- This approach eliminates (or at least reduces to a minimum) any conflict of interest between the company, shareholders and policyholders, all of whom benefit from a successful pursuit of the essential purpose of the with-profits fund in accordance with the terms of the policy and, in the case of the company and its shareholders, of the articles of association. The contrary approach, of suggesting that the fund is to be managed in the interests of the company or its shareholders, subject only to the explicit contractual rights of policyholders leads inevitably to acute conflicts of interest for the company in the operation of the fund and is contrary to the essential purpose of the fund as a vehicle for the provision of financial services to policyholders

The legal effect of the five principles

- (9) The policyholder advocate's legal advisers consider that these principles can have legal effect in two ways.
 - as implied terms of the contract between the insurer and its with-profits policyholders. The basis for the implication is two-fold, namely (i) as being necessary to give effect to the presumed intention of the parties – the judgment of Lord Steyn in the *Equitable Life* case provides support for this approach, in that he justified the implication of the term in that case as being “essential to give effect to the reasonable expectations of the parties” - and (ii) as being necessary to complete the contract embodied in the policy documents – the judgment of Lord Wilberforce in the well-known case of *Liverpool CC v Irwin* provides authority for this approach, in that he considered that the court may imply terms where the parties have not fully spelled out their relationship in the contract and the terms in question are necessary having regard to the “inherent nature of the contract and the relationship thereby established”.

- in equity and/or at common law in the following way. The courts have shown themselves willing to intervene in the exercise of powers or discretions conferred for the benefit of others (sometimes referred to as fiduciary powers or discretions) where they feel that the power or discretion is being exercised improperly. Lord Woolf MR referred to this in the Court of Appeal in the Equitable Life case and compared it to the courts' role in judicially reviewing the exercise of public law discretionary powers. It is clear that Lord Woolf regarded the discretions conferred on with-profits insurers as being just such discretions and therefore subject to the supervisory jurisdiction of the court. A similar approach was adopted by Lord Cooke in the House of Lords by reference to legal restrictions on the exercise of a contractual discretion. The effect of this analysis is that the discretions must be exercised reasonably and fairly and in a manner which is consistent with the underlying purpose of the policies.

The policyholder advocate's legal advisers consider that any exercise of the discretions of a with-profits insurer must therefore, as a matter of law, conform to the five principles.

Implications for management of a with-profits fund

(10) The policyholder advocate's legal advisers therefore consider that:-

- The insurer must manage the entire with-profits fund, including any inherited estate, in accordance with the purposes of the fund i.e. to meet guaranteed benefits and to generate profits for distribution.
- It is not open to the insurer to apply any part of the inherited estate for other purposes.
- If the inherited estate is in excess of what the insurer (acting reasonably and fairly) regards as necessary for furthering the purposes of the fund, it should be distributed in a fair and rational manner.

- The insurer is not entitled to manage a with-profits fund for its own benefit where this diverges from the purposes of the fund or to favour shareholders' interests over those purposes.
- The insurer must avoid practices which unduly discriminate against policyholders, or between policyholders or classes of policyholder.
- It is inherent in this approach that business decisions involving the relationship between the fund and the company or its shareholders must be conducted on an arms' length basis and may require close regulatory supervision where the risk of conflict of interest is acute.

Implications for current uses of the CGNU Life and CULAC inherited estates

- (11) The Principles and Practices of Financial Management (PPFM) refer to the inherited estates in CGNU Life and CULAC being used for a number of purposes which the policyholder advocate's legal advisers find difficult to reconcile with their identified five principles.

In particular:-

- Strategic investments. The companies reserve the right to make investments in the equity or debt of companies in which Aviva group companies have a strategic interest or connection. Under the current PPFM there is a requirement that such investments are considered to be for the long term benefit of shareholders and policyholders. Previously the PPFM permitted such investments if made for strategic reasons considered to be to the long term benefit of shareholders and not to the detriment of policyholders. In either event, the policyholder advocate's legal advisers consider that strategic investments should only be made if justified by reference to their identified purposes of a with-profits fund.
- New with-profits business. While there can be no valid objection to the with-profits fund investing in and supporting properly priced new business, a practice of subsidising new with-profits business out of the

estate, on a basis that is not commercially justified in the interests of the fund, would not be an appropriate application of with-profit fund assets.

- Shareholder tax. The inherited estate is being used to pay additional tax which is triggered for the company when distributions are made of the shareholders' 10% interest in profits. This practice is hard to justify as it appears to result in policyholders bearing part of the cost of tax which is referable to the shareholders' interest (changing the profit sharing ratio to around 87:13).
- Mis-selling expenses. It is not possible to generalise as to the acceptability or otherwise of charging mis-selling expenses to the fund in terms of consistency with the five principles outlined above. However, policyholders would prima facie expect that mis-selling costs should be met by the person responsible for the mis-selling (i.e. the insurer or its third-party agents) and not the fund, unless it can be demonstrated that the costs have been incurred in good faith and are merely incidental to the ordinary running of the with-profits business.

(12) The policyholder advocate's legal advisers do not consider that the fact that these uses are expressly set out in the PPFM affects the validity of such uses under the terms of the policy contract. In their view any substantial divergence from the five principles that was materially prejudicial to the interests of policyholders would require clear notification to and acceptance by policyholders if they were to take effect as contractual variations to the with-profits contract. It is therefore doubtful that the PPFM (which have not been seen by most policyholders when they contract, and which are subject to unilateral change by the insurer) are sufficient to constitute a contractually binding acceptance by policyholders of the relevant uses. The consumer-friendly version of the PPFM that is now sent to policyholders does not refer to those uses.

The regulation of with-profits business

- (13) The policyholder advocate’s legal advisers recognise that the with-profits business has been regulated for many years and have taken this into account in their analysis. In particular, they have considered the Conduct of Business Rules section 6.12 and their recent replacement, the New Conduct of Business Sourcebook, section 20.2, headed “Treating with-profits policyholders fairly”.
- (14) The policyholder advocate’s legal advisers do not consider that the existence of such regulation casts doubt on their formulation of the underlying understanding and expectations of the parties to with-profits arrangements by reference to the five principles they have identified, nor on the appropriateness of incorporating these five principles into the with-profits contract.
- (15) The current regulatory rules are set out in COBS 20 and are, the policyholder advocate's legal advisers consider, broadly consistent with their five principles, particularly in so far as they recognise:
- the potential conflicts of interest that might give rise to the unfair treatment of policyholders
 - the need for limits on the wide discretion vested in the insurer under a with-profits policy
 - the fact that such a discretion requires careful regulatory supervision “to ensure that it does not lead to an undisclosed, or unfair, benefit to shareholders”¹
 - the fact that the contractual entitlements of policyholders are independent of the current regulatory regime.²
- (16) COBS 20.2.22 is particularly important in that it imposes an obligation on insurers to distribute (or reattribute) amounts that are surplus to the fund’s requirements (i.e. excess surplus) if retention would be a breach of Principle 6

¹ COBS 20.2.1.
² COBS 20.2.2.

(Customers' interests). The reference to "customers' interests" appears to the policyholder advocate's legal advisers to be consistent with and to allow the application of their five principles.

(17) In relation to the four uses of the estate that appear questionable under the policyholder advocate's legal advisers' five principles:-

- Strategic investments. COBS 20.2.36 requires the insurer to consider whether use of the assets of the with-profits fund would be "fair" to existing policyholders. The policyholder advocate's legal advisers consider that their five principles offer an appropriate set of criteria for the company to apply in assessing this question, that investments that (as under the previous PPFM) were stated to be made in the shareholders interests (even if made on terms that do not harm the policyholders' interests) will be unlikely to be fair on this basis, and that even the new criterion of long term benefit of both shareholders and policyholders is unlikely to be enough to ensure a fair result given that such investments will not be primarily motivated by normal investment criteria.
- New with-profits business. COBS 20.2.28 prohibits the effecting of new contracts of insurance in a with-profits fund in so far as it would cause a "material adverse effect on the interests of its existing with-profits policyholders". The policyholder advocate's legal advisers consider that this is consistent with the five principles provided that this expression is not construed to refer exclusively to the "asset shares" of existing policyholders. On the assumption that the interests of policyholders relate to all the assets of the fund, then they believe that this rule can be construed compatibly with the five principles, although it does not in practice appear to be applied in this way by the FSA.
- Shareholder tax. COBS 20.2.20 prohibits the payment of shareholder tax on a distribution out of the assets of a with-profits fund unless it is an

“established practice” explained in the PPFM and on condition that it is not paid out of asset shares. The concept of “established practice” is not defined but it appears to the policyholder advocate’s legal advisers that it should be interpreted as a practice that is clearly explained to policyholders if it is to be consistent with the reasonable expectations of the parties. If COBS 20.2.20 is intended to mean that it is sufficient explanation to policyholders that the “established practice” is contained in the PPFM, then the policyholder advocate’s legal advisers do not agree, for the reasons set out above. As in other respects, it is difficult to justify drawing a distinction between the inherited estate and other fund assets in this connection. Either a proposed use of fund assets is a proper expense of the fund (in which case it could in principle be charged to asset shares) or it is not, in which case it should not be charged to any part of the fund, including the inherited estate.

- Mis-selling expenses. COBS 20.2.25 provides for payment of compensation to policyholders out of shareholder funds or the inherited estate in preference to asset shares. The policyholder advocate’s legal advisers consider this to be difficult to reconcile with the five principles of with-profits business: either the compensation is properly payable as an expense of the business, in which case it could properly be charged to asset shares, or it is not, and should therefore be met out of shareholder funds. However, they note that the FSA is currently reviewing this aspect of its rules.

(18) Overall, therefore, the policyholder advocate’s legal advisers consider that COBS 20.2 can in the main be interpreted as being in accordance with their five principles. However, to the extent that this is not the case, the policyholder advocate’s legal advisers do not consider that this casts doubt on their analysis. It is not to be expected that regulatory rules will precisely mirror private law rights and interests, although it is a legitimate ground of criticism if such rules fall short of the private law entitlements of policyholders.

The AXA case

- (19) The policyholder advocate's legal advisers recognise that in the AXA case the judge endorsed an approach which attributed little or no value to the rights of policyholders in respect of an inherited estate. Nevertheless, they do not consider that this precludes the principled analysis summarised above. No attempt was made on policyholders' behalf to argue on the basis of a detailed or principled analysis of their rights and interests such as above, and it is not clear that the judge would have felt himself able to entertain such arguments, given the limited role he considered the court to have in relation to the examination and approval of such schemes. Furthermore, since the time of that case there has been a significant change in the regulatory regime applicable to with-profits and to reattributions and, in the policyholder advocate's legal advisers' view, it would be wrong to assume that a court examining the issues today would reach the same conclusions as were reached in respect of the AXA reattribution.

The reattribution negotiations

- (20) It is wrong to analyse the bargain between policyholders and the company in respect of the reattribution of an inherited estate by reference to the narrow question of the policyholders' reasonable expectations of a distribution of the estate. In assessing that bargain, it is necessary to take account both of the 90% interest in special distributions given up by policyholders resulting from the reattribution and of the gains to shareholders in obtaining a 100 % interest in distribution of the reattributed fund, as against their current 10% interest in distributions from the inherited estate of a with-profits fund.
- (21) It would follow from the five principles that any negotiation as to the value of these benefits given up and gains to the shareholders should be conducted on the basis that the with-profits business is to be conducted in accordance with those principles whether or not a reattribution occurs, so that the value forgone by policyholders and achieved by shareholders should be calculated on that

basis, and not on the basis that practices that are inconsistent with those principles continue in the absence of a reattribution.

(22) Furthermore, the bargain between policyholders and the company must also take account of the fact that the existence of a substantial inherited estate is not a contingent feature of the with-profits fund but is marketed by the company as an integral part of the fund and an important indicator of financial strength. Policyholders choosing to take out a with-profits policy with the company in question rightly and reasonably rely on this.

(23) It follows from the above that the reattribution negotiations should involve consideration of two matters in particular:

A. The “value” of the rights and interests of policyholders in respect of the inherited estate. This value has three aspects.

First, in the policyholder advocate’s legal advisers’ view, the fourth of the five principles means that the policyholders’ expectation (at least in a collective sense) of a distribution from the inherited estate is not wholly contingent (in the sense of being wholly dependent on the exercise of an unfettered discretion by Aviva) and this can therefore also be attributed quantifiable value.

◦ Second, shareholders can only obtain a release from policyholders’ entitlement to a 90 per cent share of future distributions out of the inherited estate and from the restrictions on the use of the estate which the five principles and/or FSA regulation impose, if current policyholders agree by voting to accept Aviva’s Policyholder Incentive Payment (PIP) offer.

- Third, the Aviva funds, in common with many others, are run on the basis that new policyholders are not charged anything extra for the right to possible future distributions of excess surplus, but nor do current policyholders receive any payment as they give up that right when their policy matures. There is, in other words, a transfer of the right to share in possible distributions from the estate between generations of policyholders without any compensation.

It is not possible as a legal matter to say that this intergenerational transfer is in breach of the five principles as long as the estate is properly compensated for the risks inherent in writing new business, and policyholders' expectations are consistent with it. A direct conflict with the principles could however arise where new business was written on a scale or on terms that had a materially adverse effect on the rights and interests of current policyholders in light of those expectations, and in particular where the expanding interests of new policyholders significantly diluted the "strength" of the fund in which the existing policyholders had invested their premiums.

This intergenerational transfer gives rise to very particular and difficult issues in the context of a reattribution. After a reattribution the transfer will cease. No future policyholder will have any interest in future distributions from the estate, and any such distribution will go 100% to shareholders. Even if the company can demonstrate that its policyholders' rights and expectations of special distributions of inherited estate in the ordinary course are indeed limited by virtue of this compensation-free transfer, that of itself could never justify anyone making the argument that current policyholders should therefore be content with a reattribution offer that delivers to the shareholders, without payment, all of what would otherwise have been retained within the fund for the benefit of future policyholders.

The reattribution offer should therefore recognise that the policyholders' acceptance unlocks not just the part of the estate that current policyholders might expect to see distributed within the lifetime of their own policy, but also that part of the fund which would otherwise be retained for future policyholders. This is a particular challenge for the FSA in ensuring that policyholders are treated fairly, because current policyholders' primary concern will be with their personal bargain, i.e. with what they (as opposed to future policyholders) are giving up, and the price they are being offered for this.

- B. The "value" which the shareholder will derive from reattribution. Shareholders will acquire the right to the ninety percent of future special distributions that would otherwise be paid to policyholders. They will also have greater freedom of action in respect of the investment and use of the inherited estate after the reattribution than before. However, to the extent that the estate acquired by shareholders will continue to be subject to restrictions under FSA regulations and the terms of the reattribution scheme, the continuing impact of these restrictions should of course also be reflected in the calculation of shareholders' added value.

(24) The reattribution of the inherited estate of a with-profits fund raises conflicts of interest in an acute form. In particular:

- the possibility of a future reattribution gives the company an incentive, even in the ordinary course of business, to minimise the level of excess surplus in a fund available for distribution so as to avoid the need to distribute 90% of that surplus to policyholders, in accordance with the terms of their policies and the regulatory expectations of the FSA and the government;
- during the reattribution process, the valuation of policyholder and shareholder rights and interests will depend on forecasts and projections

of a large number of key business and financial variables. There is therefore an inevitable and material risk that the company's own plans for the future management of the business, and particularly its projections of new business levels (and the intergenerational transfer associated with this) will unduly depress the value which the current generation of policyholders place on their interest in future special distributions, and therefore the amount that the company needs to offer in the reattribution; and

- after the reattribution, by contrast, the company has a strong incentive to minimise the capital requirements of the fund, so as to maximise distributions of 100% of the reattributed estate to shareholders.

(25) It is therefore essential that the conduct of any reattribution is subject to tight regulatory supervision both before and after the reattribution, to ensure that the fairness of the underlying bargain between policyholders and the company, as to the distribution of the profits of the fund, is respected in any negotiation of the terms of such a reattribution.

3.00 The policyholder advocate's advisers' views on the AVIVA analysis

The policyholder advocate's advisers have given careful consideration to the analysis of Aviva's advisers which has been summarised in appendix 25A but are not persuaded that it seriously undermines their analysis and conclusions.

It is the view of the policyholder advocate's advisers that, despite the appearance on the surface of wide differences of view between the two teams, at bottom, the differences are far less substantial than they appear.

In particular, there is agreement between the two teams that

- The with-profits fund belongs to the company

- The policyholders do not have proprietary interests in the with-profits fund
- The relationship between the policyholders and the company is fundamentally a contractual one as embodied in the policy
- Notwithstanding that the policy contains few, if any, express restrictions on the manner in which the company may operate the with-profits fund and in particular as to the uses it may make of the inherited estate, the company is in fact subject to extensive restrictions.

It is at this point that the analysis of the two teams diverges. Whilst they both accept the existence of extensive restrictions, they differ as to the legal basis for such restrictions and as to their precise nature and extent.

The Aviva team's view is (at the risk of oversimplification) that such restrictions arise principally as a matter of regulation and there are few if any non-regulatory restrictions. In particular, they argue that because the manner in which with profits funds are to be managed is the subject of extensive regulation, there is no room to imply further sweeping contractual terms or private law restrictions, such as the five principles.

The policyholder advocate's advisers, on the other hand, suggest (again, at the risk of oversimplification) that:

- Significant restrictions arise as a matter of implied contract and/or as equitable limitations on the exercise of express discretions. These restrictions are derived ultimately from consideration of the presumed understanding and expectations of the parties to Aviva's with-profits policies. It being self-evident, in the light of such understanding and expectations, that the company would not be free to deal with the with-profits fund as it sees fit, the law implies appropriate and principled limitations to give effect to this.
- A further source of restrictions is also to be found in regulatory rules. However, these are over-laid on and are not necessarily coincidental with the above restrictions. They reflect the regulator's perception of what is necessary

having regard to the regulator's powers and duties and, as a result, may not go as far as or may go further than the above restrictions.

- The two sources of restrictions inevitably interact with one another. One aspect of such interaction is that application of the regulatory restrictions sometimes requires consideration of the non-regulatory restrictions because the former work by reference to general concepts such as “treating customers fairly”. In order to determine what is and is not fair treatment of customers, consideration has to be given to the customers’ non-regulatory rights.
- Furthermore, even if there are no relevant explicit non-regulatory rights, it may be necessary when applying regulatory restrictions to look much wider than the strict terms of the relevant provision. To take again as an example the regulatory obligation to “treat customers fairly”, it may be necessary to ascertain the reasonable expectations of the parties to the relevant arrangement which will in turn require consideration of the wider relationship between the parties and the history of communications between them.
- Seen in this light, regulation is not the end of the matter. Regulatory and non-regulatory restrictions are in principle mutually independent, even if they in practice overlap and interact with one another. Furthermore, the regulatory rules which are in place should be applied in such a way as to give effect to such non-regulatory restrictions or at the very least to recognise and respect the reasonable understanding and expectations of the parties upon which such non-regulatory restrictions are based.
- Ultimately, the fundamental question is as to what view should be taken of the understanding and expectations of the parties to Aviva’s with profits contracts. If they are as suggested by the policyholder advocate’s advisers, then they should be given effect, either as non-regulatory rights or as a guide to the proper interpretation and application of regulatory rules.

The policyholder advocate’s advisers consider their analysis of the understanding and expectations of parties to Aviva’s with-profits contracts to be a realistic and robust one. At

the same time, however, they accept that this is an issue which is not susceptible of a clear and definite answer. The with-profits policies are silent about many important aspects of the arrangements. The same goes for a large part of the other communications between Aviva and policyholders (the policyholder advocate's advisers accept that in recent years such communications (eg PPFMs) have become more detailed but they do not consider that such communications have been sufficient to introduce material alterations in the fundamental understanding and expectations of the parties). There is therefore scope for argument on many aspects of their analysis.

The policyholder advocate's advisers also accept that their principled analysis has not been the subject of judicial consideration and that it differs markedly from the approach taken by the judge in the AXA case. It would, however, be fair to say that there has been very little case law in this field and that there has not been any in which a full and principled analysis along the lines favoured by them has been put before a judge, let alone ruled on. They also note that the Court of Appeal and the House of Lords were prepared, in the Equitable Life litigation, to give detailed consideration to the principles underlying with profits contracts.

They would also accept that their analysis cannot be described as a "conventional" analysis in the sense of reflecting the accepted wisdom in the with-profits industry. However, this is perhaps unsurprising in circumstances where, at least until very recently, the views of the industry have been largely if not exclusively based on the views and interests of with-profits insurers themselves, rather than seeking to reflect a balance between the interests of both insurers and customers. This reattribution is the first occasion upon which an independent and well-resourced professional has been appointed with the specific task of considering the rights and interests of with-profits policyholders in an inherited estate from their point of view. It is not a fatal objection to that professional's position that it raises some questions and challenges for the "established wisdom" of the industry.

Finally, the policyholder advocate's advisers accept that there are aspects of their analysis which are not endorsed or fully endorsed by the FSA. However, again, this should not be unsurprising or a basis for rejecting a principled legal analysis. It is not necessarily to be expected that the evolving views of the regulator, which are based on its interpretation of its

legal powers and duties in changing economic, commercial and social conditions, should necessarily or precisely reflect the legal analysis of the contracts between policyholders and insurers that are subject to its regulatory powers.

4.00 Significance of legal advice in the context of the reattribution negotiations

There have been extensive discussions between the policyholder advocate and Aviva and their respective advisers around their respective legal analyses, and the advice of their respective legal teams has developed as a result. Nevertheless there are significant continuing differences.

If the policyholder advocate's advisers' analysis were accepted to be the correct one, it should in principle have a significant impact on the reattribution. Some of the uses of the estate that Aviva currently enjoys would not be permitted and the added value from owning the estate would be larger as a result. There would also be the question whether the effect on the estate of past uses should be corrected.

However, the legal principles suggested by the policyholder advocate's legal advisers remain (by any legal precedent applicable to the management of the inherited estate of a with-profits fund) untested. Testing the legal principles in Court, even if practicable, would be very time consuming, very expensive (including for policyholders) and the outcome would not necessarily benefit those policyholders who are receiving the reattribution offer. In particular, even if the legal advice received by the policyholder advocate was ultimately supported in its totality by the courts, it does not provide clear answers to all of the important issues that affect the valuation of policyholders' and shareholders' collective interests in the estate. In addition, the impact on current policyholders' rights and interests is not at all easy to judge, as the firm might well have to recognise claims from those who have ceased to hold with-profits policies in recent years.

The policyholder advocate and her advisory team had, before their advisers' legal opinion was completed, early and fundamental objections to FSA rules and guidance which allow inherited

estates to be used in ways which favoured shareholders over policyholders, and which in particular allow new business to be subsidised from the inherited estate to the detriment of current policyholders. On this basis, they were not impressed by the emphasis that conventional industry and regulatory views of “fairness” placed on the ownership of with-profit fund assets by the company, on the terms of complex and apparently rarely read PPFM or with-profits guides, and on the fact that policyholders had never been led to expect distributions from the inherited estate.

The policyholder advocate’s legal advisers’ advice has reinforced her objections to the conventional analysis, and its impact on industry and FSA views on fairness in relation to the management of with-profits business. Her legal advisers’ analysis does not go as far as the policyholder advocate’s own analysis, however. The policyholder advocate sees the investment of policyholders as an investment in the whole fund, not as an investment in asset shares. Any investment from that fund, including that of new business, should be profitable to the fund. The policyholder advocate considers that if new business is written such that it does not pay for the intergenerational transfer of capital, then that makes new business loss-making to the fund and to the current participants in the fund. Similarly, the policyholder advocate does not see how the value of policyholders’ rights to 90 per cent distributions can be eroded by shareholder uses of the estate if those uses are not permitted to be charged to asset shares as a proper expense of the fund, even if clearly signalled to policyholders when they acquired their policies. The policyholder advocate sees no justification for the estate being permitted to be used in any different way from any other money in the fund. She considers that all the capital in the fund should be treated as equally valuable to the participants in a 90:10 fund, and therefore there should be no distinction in use of that capital between asset shares and the inherited estate.

Nevertheless, the legal opinion has lent force to the arguments that the policyholder advocate deployed both with Aviva during the negotiations and with the FSA, when seeking guidance as to how various important provisions of its current rule book as regards the use of inherited estate are to be interpreted.

Crucially, the FSA's regulatory approach has clearly been based on a legal analysis similar to that of Aviva's advisers. The choice facing policyholders is to accept the PIP or to retain their right to receive such future special distributions as are made while they remain invested in with-profits. The FSA has a crucial role in the day to day support and protection of policyholder's rights; the policyholder advocate has always recognised that its rules and the way in which it interprets them in practice are likely to be the most influential factors in determining how inherited estates are used, and the extent to which policyholders can expect such surpluses as do arise to be distributed. The FSA also has a particularly important role in the reattribution process established under its rules. She has therefore shared her legal advice with the FSA and has sought guidance, as explained in Appendix 26 (FSA guidance letters and responses), on certain key issues relevant to these negotiations. The FSA was also supplied with a copy of the Aviva legal advice. The outcome has been that the FSA has provided guidance on a number of issues which has been taken into account in the policyholder advocate's analysis of Aviva's reattribution offer and in her guidance to policyholders.

One of the most important factors affecting the assessment of current policyholders' rights and interests in the estate is the free intergenerational transfer of estate referred to above. The policyholder advocate explains her viewpoint at the end of Chapter 13 of her report. She nevertheless accepts that it must be recognised that it is FSA regulation which will dictate the way in which these funds are run in the future, and it is unlikely that the current FSA rules will change in the near future. Given the FSA's guidance on the interpretation of their COBS rules (covered in Appendix 26) the policyholder advocate's advice to policyholders has reflected the fact that the amount of future distributions that they might receive in the absence of a reattribution will be heavily affected by the volume of future new business that is actually written in the funds.

The policyholder advocate has therefore analysed the value of the offer to policyholders under a reasonably wide range of potential outcomes, as to the level of possible future distributions which policyholders could expect to receive in the absence of a reattribution. This analysis could be seen as making the results of the policyholder advocate's analysis of the PIP offer

more robust against the possible effect of the FSA's subsequently amending its rules in ways that bring the prevailing regulatory approach closer to that envisaged in her legal advisers' advice and, if intergenerational transfers were no longer permitted by the FSA, closer to her own position.