

**TO ALL SCHEME CREDITORS, BROKERS, AGENTS AND INTERMEDIARIES OF HIGHLANDS INSURANCE COMPANY (U.K.) LIMITED (IN ADMINISTRATION) (THE "COMPANY")**

March 2009

Dear Sir/Madam

**PROPOSAL FOR A SCHEME OF ARRANGEMENT**

1. We are writing to inform you that the Company intends to propose a scheme of arrangement under Part 26 of the Companies Act 2006 (the "**Scheme**") in relation to certain of its creditors ("**Scheme Creditors**").
2. Scheme Creditors are creditors in respect of:
  - (a) any liability to which the Company was subject at 1 November 2007 (the date the Company went into administration); or
  - (b) any liability to which the Company become subject after that date, under any Insurance Contract. An "**Insurance Contract**" is a contract or policy of direct insurance (as opposed to a contract or policy of reinsurance) entered into by or on behalf of the Company (or in relation to which the Company has assumed liability), other than any contract of insurance written in accordance with section 1(1) of the UK Employers' Liability (Compulsory Insurance) Act 1969 ("**EL Policies**"). Claims arising out of contracts or policies of direct insurance rank in priority to certain other debts in the insolvency of the Company by virtue of the Insurers (Reorganisation and Winding Up) Regulations 2004 (SI 2004/353) (the "**2004 Regulations**").
3. **For the avoidance of doubt, the Scheme is not intended to apply to any liability arising directly or indirectly out of any contract of reinsurance or retrocession of any kind whatsoever.**
4. Where the Company wrote an Insurance Contract as a member of a pool the Scheme will only apply to a claim for an amount representing the Company's percentage participation in such Insurance Contract.
5. **We are writing to you as this Scheme might affect you, either as a Scheme Creditor or, alternatively, as a broker, agent or other intermediary who acted on behalf of such a Scheme Creditor in placing business with the Company. Brokers, agents and intermediaries are requested to forward a copy of this letter to the clients they believe may be affected by the Scheme. If this communication should have been directed to somebody else within your organisation, please would you pass it on accordingly and inform us of this using the contact information provided at the end of this letter. We would strongly encourage you to read this letter in its entirety and would in particular draw your attention to paragraphs 17 – 20 below, which set out details of the deadlines for submitting claims under the Scheme.**

## Background

6. The Company was incorporated in England and Wales on 18 November 1974 with registered number 01190948, although it did not write business until 1983.
7. The Company is a wholly owned subsidiary of Highlands Holdings (UK) Limited, which in turn is wholly owned by Highlands Insurance Group, Inc. ("**HIGI**"). HIGI is a corporation organised under the laws of the state of Delaware, United States of America ("**USA**") and is also the immediate parent of Highlands Insurance Company ("**HIC(US)**"), an insurance company organised under the laws of the State of Texas, USA.
8. Between 1972 and 1975, HIC(US), through its unincorporated London branch, wrote business as part of an underwriting pool (the "**Tower X Pool**") with London & Edinburgh Insurance Company Limited and American Home Assurance Company, through the underwriting agent Tower Underwriting Management Limited ("**TUM**"). The Tower X Pool wrote all classes of marine, aviation and non-marine business. During this period, HIC(US)'s London branch also wrote similar business through Highlands Underwriting Agents Limited ("**HUAL**"), a new underwriting agency organised by HIC(US). In 1975, the capacities of TUM and HUAL were combined with a new underwriting pool (the "**HUA Pool Account**" and together with the Tower X pool, the "**Pools**"), which continued writing business until the end of 1977.
9. From the beginning of 1978 until 1982, HUAL underwrote excess of loss business on behalf of HIC(US) only. This business became known as the "**HUA P A/C**".
10. The Company began writing business on its own account in 1983. Between 1983 and 1994 the Company predominantly wrote London and international market excess of loss business.
11. In the mid-late 1980's the business written by the London branch of HIC(US) was transferred to the Company, by virtue of two separate transactions, both pursuant to Section 51 of the English Insurance Companies Act 1982 (the "**Section 51 Transfers**"). The first Section 51 Transfer, on 9 October 1986, transferred the policies written between 1978 and 1982, as detailed in paragraph 9 above, and the second Section 51 Transfer on 29 December 1988 transferred the policies written between 1972 and 1977, as detailed in paragraph 8 above (together the "**Section 51 Policies**").
12. The Company ceased underwriting new and renewal business in January 1994.
13. On 25 October 2007, the directors of the Company applied to the English High Court of Justice (the "**English Court**") for the appointment of joint administrators to the Company pursuant to paragraph 12(1)(b) of Schedule B1 to the Insolvency Act 1986, declaring in such application that they believed that the Company was, or was likely to become, unable to pay its debts. At a hearing of the application on 1 November 2007, Dan Schwarzmann and Mark Batten, both partners of PricewaterhouseCoopers LLP, were appointed as joint administrators (the "**Administrators**").
14. The respective rights and obligations of the Company and HIC(US) in respect of the Section 51 Policies, particularly in relation to US domiciled policyholders, have been the subject of extensive litigation in the Texas Courts since August 2006. However, pursuant to the terms of a settlement agreement (the "**Settlement Agreement**"), approved by the Texas Court on 13 October 2008, the Company and HIC(US) agreed, amongst other things, that:
  - (a) HIC(US) would pay the Company the sum of US\$13,000,000 (the "**Settlement Amount**");
  - (b) the Company would administer all Section 51 Policies, including those Section 51 Policies which are Insurance Contracts ("**Section 51 Direct Policies**");

- (c) policyholders and other claimants under Section 51 Direct Policies (the “**Section 51 Direct Policyholders/Claimants**”) will be required to make any and all claims in respect of their Section 51 Direct Policies exclusively against the Company; and
- (d) the Company would take, and would cooperate in the taking of, certain steps, including the implementation of the Scheme, to ensure that holders of the Section 51 Direct Policies are paid their claims exclusively in accordance with the provisions of the Scheme and are prohibited from making other claims both in the UK and the USA.

### The Scheme

15. The primary purposes of the Scheme are to:
  - (a) implement and trigger the relevant terms of the Settlement Agreement; and
  - (b) determine the Company's liabilities to Scheme Creditors (including, but not limited to, those arising from Section 51 Direct Policies) and to settle such liabilities in full, in order to enable the Administrators to administer the Company's estate more quickly than would be the case if the Scheme does not become effective and an alternative insolvency proceeding is implemented in its place.
16. Once the Scheme becomes effective (the “**Effective Date**”) all Scheme Creditors' claims (including those arising from Section 51 Direct Policies) will be administered and, if agreed or otherwise determined to be payable, paid exclusively in accordance with the Scheme. Accordingly, all Section 51 Direct Policyholders/Claimants will be required to make any and all claims in respect of the Section 51 Direct Policies, and seek payment of such claims, exclusively against the Company in accordance with the provisions of the Scheme. Furthermore, no Scheme Creditor of the Company may set off any claim in the Scheme against any obligation owed by such creditor to HIC(US).
17. **Scheme Creditors with actual, contingent and future claims (including notified outstanding and incurred but not reported ("IBNR") claims) will be asked to:**
  - (a) **submit to the Company advance notice of their intention to claim in the Scheme (a "Claim Notification") within 90 calendar days after (but not including) the Effective Date; and**
  - (b) **providing that (a) above is complied with, submit to the Company a claim form setting out their claims in full (the "Final Claim Form") within 180 calendar days after (but not including) the Effective Date (the "Final Claims Submission Date").**
18. The requirement in the Scheme for Scheme Creditors to provide advance notice of their intention to claim against the Company is a result of limitations in policy information available to the Company. The filing of a Claim Notification is designed to enable the Company to identify earlier than would otherwise be the case the likely population of Scheme Creditors and, therefore, to confirm, as currently anticipated, that it will be able to meet the claims of Scheme Creditors in full. The procedure should also allow for the earlier consideration of the most appropriate strategy for dealing with the claims of reinsurance creditors.
19. Scheme Creditors who according to the Company's records have unpaid claims which have previously been agreed by or on behalf of the Company, either prior to or after the appointment of Administrators, will be exempted from the requirement to submit a Claim Notification or Final Claim Form in order to be eligible for payment in respect of such claims. Scheme Creditors with such agreed but unpaid claims will be notified accordingly in writing by the Company within seven days of the Effective Date. **If any Scheme Creditor believes it has an agreed unpaid claim and does not receive such notification from the**

Company, they must submit a Claim Notification and Final Claim Form as detailed in paragraph 17 above.

20. If a Scheme Creditor is required, but fails, to submit a Claim Notification to the Company within the appropriate timeframe or, having done so, does not subsequently submit a Final Claim Form to the Company within the appropriate timeframe, the Company will attribute a zero value to any claims such Scheme Creditor might have, if any. If a Scheme Creditor has any doubt as to whether or not it is required to submit a Claim Notification they are strongly encouraged to do so.
21. The Company will assess the claims filed by Scheme Creditors and will seek to reach an agreed valuation of each Scheme Creditor's claim for payment. Where the Scheme Creditor and the Company fail to reach an agreement there will be a procedure for the adjudication of these disputed claims by an independent adjudicator.
22. Any claim against the Company which is not covered by the Scheme will be dealt with separately by the Administrators in the Company's administration.
23. Payments to Scheme Creditors will only commence once the Administrators, acting in their capacity as the Scheme administrators (the "**Scheme Administrators**"), have determined that all Scheme Creditors can be paid in full, after taking into account any claims arising from EL Policies. In the event that the Scheme Administrators determine that it will not be possible to pay all Scheme Creditors in full, the Scheme will be terminated prior to any payments being made to Scheme Creditors.
24. It is a condition of the Settlement Agreement that the Scheme will also be made effective and enforceable in the USA. Accordingly, there will be an application by the Company under Chapter 15 of the US Bankruptcy Code for a permanent injunction recognising and giving effect to the Scheme in the USA.

#### Classes of Scheme Creditors

25. On 15 April 2002, the English Court issued a Practice Statement that requires any company proposing to implement a scheme of arrangement to notify those affected by it (i) that a scheme is being promoted; (ii) the purpose that the scheme is designed to achieve; (iii) the meetings of creditors the company believes are required for the purposes of voting on the scheme; and (iv) the constitution of those meetings. Points (i) and (ii) have been covered above.
26. More than 50% in number representing not less than 75% in value of those creditors who vote at a meeting of creditors convened for the purposes of considering the Scheme (the "**Scheme Meeting**") must vote in favour of the proposed Scheme in order for it to be approved. Where creditors have rights which are so different as to make it impossible for them to consult together with a view to their common interest they must be split into separate classes and a separate Scheme Meeting must be held for each class.
27. The Company has considered the position of Scheme Creditors generally, including those who:
  - (a) are Section 51 Direct Policyholders/Claimants;
  - (b) due to the insolvency of the Company, may have claims against the Financial Services Compensation Scheme (the "**FSCS**") (in the UK) or the National Association of Insurance Commissioners trust fund (in the US) (the "**NAIC Trust Fund**"); and
  - (c) may have predominantly notified outstanding or IBNR claims (as opposed to unpaid agreed claims).

28. Having taken into account the recent decisions of the High Court, the Company intends to convene a single Scheme Meeting of all Scheme Creditors. This is considered appropriate given that:
- (a) it is anticipated that all Scheme Creditors, regardless of whether they are Section 51 Direct Policyholders/Claimants or have potential claims against the FSCS or the NAIC Trust Fund or otherwise, will be paid in full under the Scheme (or the Scheme will otherwise terminate); and
  - (b) for Scheme Creditors with notified outstanding and/or IBNR claims, as opposed to unpaid agreed claims, the relevant comparator in circumstances where the Scheme is not implemented is likely to be an insolvent liquidation or other insolvency proceeding of the Company, where such claims will be subject to a similar valuation procedure in any event.

As such, Scheme Creditors' rights are not so different as to make it impossible for them to consult together with a view to their common interest.

### **The Court hearing**

29. The date of the Company's application to Court for leave to hold the Scheme Meeting has not been set, but it is anticipated that it will take place in May 2009. The exact date of this application will be notified to you on the following website [www.ukhighlands.co.uk](http://www.ukhighlands.co.uk)
30. If any potential Scheme Creditor has concerns, having considered appropriate professional advice, regarding the proposed constitution of classes, please would they inform us in writing (using the contact details below) as soon as possible. Any concerns that Scheme Creditors communicate in writing to us on this issue will be drawn to the attention of the English Court at the hearing.
31. Scheme Creditors are not required to attend this hearing but they do have a right to be present for the purpose of making representations. We ask that any Scheme Creditor who intends to attend the hearing informs us at least seven days prior to the date thereof.

### **Recommendation in respect of the Scheme**

32. The Company considers that the implementation of the Scheme will:
- (a) satisfy one of the conditions to the Settlement Agreement which, once fully effective, will mean an additional US\$13,000,000 becoming available to the Company for distribution to Scheme Creditors through the Scheme as well as other relevant creditors; and
  - (b) offer Scheme Creditors the most effective, economical and timely method for agreeing their claims in accordance with the 2004 Regulations.

For these reasons, all Scheme Creditors are encouraged to support the Scheme.

### **Next steps and further assistance**

33. If the application is approved by the English Court, a letter constituting a short-form explanatory statement, prepared in accordance with Section 897 of the Companies Act 2006, will be sent to Scheme Creditors, brokers, agents and intermediaries with details of where and when the Scheme Meeting will be held. A copy of the Scheme and accompanying explanatory statement will be available on the website detailed above.

34. Scheme Creditors are encouraged to make contact if they have any queries or concerns in relation to this letter or if they require further information regarding their insurance policies/contracts in relation to the Scheme, or wish to discuss the value of their claims for voting purposes. In any of these respects, please contact either the Administrators or PRO Insurance Solutions Limited, the run-off managers of the Company, as follows:

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	Natalie Pearce	Ian Leighton
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Address:	PricewaterhouseCoopers LLP	PRO Insurance Solutions Ltd
	Plumtree Court	Bruton Court
	London EC4A 4HT	Bruton Way
	United Kingdom	Gloucester GL1 1DA
		United Kingdom

Yours faithfully  
For and on behalf of  
Highlands Insurance Company (U.K.) Limited



Dan Schwarzmann  
**Joint Administrator**

*Dan Schwarzmann and Mark Batten have been appointed as joint administrators of Highlands Insurance Company (U.K.) Limited to manage its affairs, business and property as its agents. Dan Schwarzmann and Mark Batten are licensed to act as insolvency practitioners by the Institute of Chartered Accountants in England and Wales.*