Final Report of the Special Task Force on Insurance Company Run-Off and Reorganization

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Over the last decade insurance regulators have focused increasingly on early detection of financial trouble at insurance companies. Rating agents, brokers and insureds have also focused increasingly on early detection. This increased attention has worked. While in the past, many companies continued underwriting long after they became insolvent, now many companies cease underwriting long before they reach financial crisis. The result has been a multitude of so-called "run-off" companies. These companies span the spectrum of financial impairment from marginally solvent to substantially solvent.

Regulators have a well-developed set of receivership laws with which to handle the problem of the insolvent companies. However, there is not a coherent and clear set of laws and regulations that deal with run-off companies which are not clearly insolvent. Numerous substantially solvent and marginally solvent companies are already in run-off. Many more are expected. Industry estimates of global reserves in run-off are at about $300 billion. United States companies account for approximately half of that amount. Approximately five hundred United States companies are insolvent and in run-off while approximately four hundred solvent companies are in run-off. The law and regulation of insurance has not kept pace with the emerging phenomenon of solvent companies in run-off. In light of this reality, Susan F. Cogswell, Insurance Commissioner of the State of Connecticut, established a task force to study the need for laws regulating run-off companies, and the feasibility of establishing such laws.

Formation of the Task Force

The Commissioner sought participation by representatives from the principal constituencies interested in insurance company run-off. These included insurance and reinsurance companies in run-off, policyholders, guaranty funds, reinsurers, the insurance companies as represented by the Insurance Association of Connecticut, professionals, interested associations and regulators. The guaranty funds, reinsurers and the Insurance Association of Connecticut declined to participate. The following parties did participate in the work of the Task Force. Harold Horwich, Bingham McCutchen, Chairman; Jon Arsenault, Connecticut Insurance Department; Yadu Karimbil, Connecticut Insurance Department; Marialuisa Gallozzi, Covington & Burling; Timothy Graham, LaSalle Re Ltd.; Douglas Hartz, Bingham McCutchen; Andrew Rothseid, PricewaterhouseCoopers; and James Schacht, Navigant Consulting. The views expressed in the report are those of its individual members and do not necessarily represent the views of their respective organizations. While various entities chose not to participate, the Task Force considered the stated and anticipated views of those entities in reaching its consensus.

Objectives and Concerns of Constituents

The task force attempted to develop a list of the various constituencies and their objectives and concerns regarding the run-off process.

Run-off Companies

Companies may have very different objectives depending on whether they are marginally solvent or substantially solvent. Marginally solvent companies typically wish either to attract capital to stay in business by "ring-fencing" their prior liabilities, or engineering a cost effective run-off in a manner that would satisfy their claimant base and minimize the need for regulatory intervention. Also, successful run-offs have the potential to avoid litigation (which some times raises spurious claims) for officers and directors from third parties. In addition, successful run-offs maintain a viable employment vehicle for at least some employees and remaining personnel with knowledge of the company's pre-run-off operations, a factor that is generally recognized as critical to achieving success by all constituents. Finally, successful run-offs may enable an eventual repatriation of excess capital to shareholders and their debt holders. Solvent companies are typically interested primarily in eliminating the expense and uncertainty of a lengthy run-off, while ensuring that their business reputation is maintained. All constituents engaged in the process of run-off or reorganization are interested in having a regime that will provide some form of certainty for planning and liability purposes.

Policyholders

Policyholders' interests in run-off are paramount. They deserve the full benefit of their bargain to the extent that a company has the financial resources to meet the insurance obligations undertaken. In the event that a company does not have the resources to meet its obligations, policyholders want a fair share of the company's assets and a recovery that is at least what it would be in liquidation. Policyholders also want a prompt resolution to their claims and, where feasible, a fair opportunity to evaluate the uncertainties arising from the company's financial situation. If the policyholders are to have their rights impaired, they want to vote on the plan that creates the impairment. Prior to voting, they want to have full disclosure of the company's financial condition including the costs of alternatives, such as liquidation, and the attendant risks to such alternatives. It was recognized that small policyholders and large policyholders have differing abilities to participate meaningfully in run-off transactions and proceedings, and that smaller policyholders may require additional protection in some situations. Importantly, it was immediately identified that legislation might be best limited to insurers and reinsurers who wrote policies covering either assumed reinsurance or, in the case of direct coverage, policies to commercial insureds. It was agreed that legislation not be used to impair rights under personal lines policies such as life, health, auto and homeowners.

Guaranty Funds

Guaranty funds are legitimately concerned that run-offs will be unsuccessful and that an unsuccessful run-off will result in an inequitable distribution of funds among claimants and make a subsequent liquidation case more expensive for guaranty funds and policyholders. This can happen if claims are paid during the run-off that would be junior in priority to guaranty fund claims. To a lesser extent, guaranty funds may be prejudiced if non-guaranteed claims in the same class as guaranty fund claims are paid. Guaranty funds have also expressed the concern that policyholders will be shortchanged in run-off plans conducted by management because such plans may promote the interests of other interested parties at the expense of claimants. On the other hand, it is recognized that successful plans could avoid insolvencies and resulting liquidations, which would actually decrease the burden on guaranty funds and preserve or enhance their capacity. They would also take some of the strain off of guaranty fund infrastructure. However, distinguishing successful and unsuccessful plans at the outset is not always possible. As such, it may be appropriate to provide for potentially affected guaranty funds to participate in proceedings if they desire.

Reinsurers

Reinsurers have repeatedly expressed antipathy to any system that could result in the accelerated and involuntary payment of their obligations based on any estimation of policyholder claims. Reinsurers object to both the uncertainty of estimates and the acceleration of their payment obligations. To a lesser extent, reinsurers have expressed opposition to the estimation of underlying claims even if such estimation is not the basis for accelerated recovery from reinsurers. Liquidation proceedings often give reinsurers a multi-year hiatus on the payment of their obligations. They may also give the reinsurers a weaker party to negotiate against, thereby enhancing their opportunity to reduce or limit their ultimate liability. However, run-off may also provide reinsurers with opportunities to terminate their obligations with cost savings and finality.

Other Insurance Companies

Other insurers have an important interest in the run-off of insurer liabilities. They have interests that coincide with those of the guaranty funds to the extent that insurers either pay or pass on the costs of guaranty fund assessments. Other companies may also be burdened with liabilities of failed or failing companies as a result of insureds electing to seek coverage from them rather than the company in run-off. In this regard, other companies want to make sure that policyholders get paid their fair share of the assets of the company in run-off. On the other hand, other insurers have incidentally benefited from the lack of a rescue system for troubled companies. As competitors withdraw from the market, voluntarily or because of financial weakness, remaining insurers may have opportunities to purchase renewal rights at very favorable prices or charge more for coverage.

Domiciliary Insurance Regulators

Regulators want to ensure that policyholders receive the full benefit of their contracts to the greatest extent possible. They also want to avoid receiverships when that is consistent with the interests of policyholders and with the NAIC standards for solvency surveillance and regulation. In addition, regulators wish to maintain competitive and robust insurance markets for the benefit of insurance consumers in their states and to avoid disruptions in the marketplace which can be costly to many of their constituencies. Aside from these insurance regulatory concerns, government bodies may wish to preserve employment opportunities in a particular region where the company is a major employer. Concern has been expressed that in the past, regulators have authorized imprudent run-offs to delay inevitable insolvencies for political reasons. However, even if the possibility of an insolvency cannot be eliminated by a run-off plan, such a plan may substantially simplify the subsequent insolvency proceeding and reduce its ultimate cost.

Other Parties

The interests of other parties were considered (such as employees, brokers, reinsurance intermediaries and third-party claimants), but it was determined that their interests did not differ materially from the foregoing. Further, the interests of these parties as well as the groups discussed above are within the purview of the insurance regulators in all of the states.

Overview

The views expressed in this report are the unanimous view of its members. While certain members would favor additional provisions that would give companies broader discretion, all members endorse the conclusions and recommendations of this report.

The Task Force determined that the regulation of run-offs varies widely, based in large part on the views, experiences and practices of the principal domiciliary regulators. The source and scope of regulation is not well codified and this leads to uncertainty in planning and dealing by all parties with companies in run-off. The Task Force further determined that there are aspects of run-off that should be regulated, but currently are not. Therefore, the Task Force recommends that laws be implemented to regulate the conduct of all run-offs. These laws should ensure that the process is conducted with transparency and fairness, and with appropriate levels of regulator oversight. They should also provide insurers that have commercial policyholders an opportunity to use court proceedings to expeditiously wind up their business with the consent of their policyholders. It was believed that all parties should benefit from the efficient and expeditious treatment of these activities.

There is a wide disparity in the circumstances of companies that enter run-off. There are some companies that are a part of large financially sound insurance organizations that have many lines of ongoing business to support the run-off effort. These companies do not pose any material risk of insolvency or operational neglect. Others are running off their entire business and have no ongoing support from shareholders and affiliates. Often these companies are under financial pressure and may be only marginally solvent or are in danger of insolvency in the future. The regulatory obligations of companies that are substantially solvent should differ from those that are only marginally solvent.

Each company's situation when entering into run-off is different depending on its history, its mix of business, its ongoing operational and staff characteristics and the existence of third party support. As a result, run-off strategies may differ significantly from company to company. Some companies may decide to commute substantially all of their commercial business in a series of transactions addressing all policyholders. Others may decide to deal with claims as they arise with only occasional commutation activity. These strategies involve different risks and should entail different levels of regulatory oversight.

Basic Run-off Regulation

As noted, the Task Force believes that the level of regulatory involvement should differ depending on such factors as the financial strength and tactic employed in bringing finality to the run-off.

Substantially Solvent Companies

All companies should be required to notify the financial divisions of the Connecticut Insurance Department and other insurance departments that have an interest in the company's financial condition when they cease substantially all underwriting of a line of business (as defined in the NAIC statutory financial statements) in all states.[1] (Withdrawing from a line of business in a single state, or even several states, would not trigger run-off regulation unless substantially all of the company's ongoing underwriting of a line of business was to be terminated.) The notice should include a plan for winding up the business that is going into run-off. Companies would be required to report to the Insurance Department and other affected states at least annually as to their progress on the run-off plan. The Insurance Department would have the right to indicate the content of such plans and reports, and require them more frequently than annually in its discretion.

The level of regulation beyond basic reporting should vary according to the financial condition of the company. A company that is substantially solvent and stable for the foreseeable future should require significantly less regulation than a company that is marginally solvent. In this context, "substantially solvent" could mean 2.5 times the Authorized Control Level under applicable Risk Based Capital statutes and regulations. There would also need to be a liquidity test in order to fully assess a company's financial strength. Further study of this issue may be necessary. Companies with different exposure profiles may require higher solvency margins in order to be considered to be "substantially solvent." The level of regulatory involvement in a run-off could depend on whether the

[1] Although Conn.Gen.Stats. §38a-44 requires advance notice by an insurer to the Insurance Department when it intends to cease underwriting a line or sub-line of business, the purpose of such notice is to permit the Commissioner to evaluate the impact of such withdrawal on insurance markets, not on the company's financial condition.

company was engaged in adjusting and paying claims in the ordinary course with occasional opportunistic commutations, or planning to implement a larger, more global commutation plan in which a substantial majority of its obligations could be extinguished in a short period of time.

Existing regulatory tools should be adequate to regulate substantially solvent companies pursuing run-off by paying claims in the ordinary course. However, when substantially solvent companies undertake strategies to commute a substantial portion of their liabilities over a short period, the law should provide for uniform financial disclosure that is approved by the regulator. This disclosure would then be distributed to policyholders and creditors being solicited for commutation and posted on a company's website. Such disclosure would provide information about the company's financial condition as well as its plans for commutation, ongoing operations with respect to its remaining policy obligations and other information designated by the Insurance Department. The Task Force concluded that the disclosure requirements should be imposed when a company plans to undertake commutation of a substantial portion of its outstanding liabilities.

The Task Force believes that substantially solvent companies should specifically be barred from making statements that suggest to policyholders and creditors that their financial condition is in doubt. While this seems obvious, the Task Force believes it should be included in a run-off statute for the avoidance of doubt. The use of disclosure documents approved by the Department should eliminate much of the dialogue concerning financial condition that often provides the opportunity for misleading statements.

Marginally Solvent Companies

For marginally solvent companies, the Task Force believes that greater regulatory oversight is appropriate as there presumably is a much higher potential for insolvency if a run-off is not successful. The Insurance Department should require the filing of a plan that addresses issues specified by the Insurance Department. The Insurance Department would review such companies' plans carefully to determine their financial and operational feasibility. If a plan to run-off a book of business in the ordinary course and pay claims as they mature is feasible, it is likely that the Insurance Department will closely monitor the progress of the plan.

A plan to run-off a book of business on an accelerated basis through a series of commutations (not involving court proceedings) would require substantially greater regulatory scrutiny. The company's run-off plan would likely need to address a broader array of issues. Any plan should require the company to provide reasonably consistent treatment to similarly situated policyholders and creditors unless there is a principled basis for doing otherwise. Moreover, such a plan should give recognition to the potential for future insolvency proceedings if that is a plausible possibility.

The run-off company would also need to prepare a disclosure document that would be filed with the regulator and would accompany commutation solicitations that describes the company's financial condition and plans for run-off. This document would go to all policyholders and creditors who are being solicited to compromise their claims, and would need the approval of the Insurance Department prior to distribution. The Insurance Department should also be involved in the ultimate approval of commutation agreements above a de minimis amount (e.g., the greater of $200,000 or ¼% of admitted assets). Such approval may be given for each transaction or may be given by specifying guidelines for all transactions. Naturally, these approval amounts would differ based upon the solvency of the entity in run-off or its exposure profile.

The law should provide protection to commuting creditors against preference avoidance in a subsequent liquidation proceeding. Such protection would be part of the Insurance Department's approval of individual or bulk commutation proposals. If such proposals were on terms unacceptable to the Insurance Department the transactions would not be approved. Similar provisions have been enacted in Illinois.[2]

It was suggested that marginally solvent companies seeking to commute their liabilities in substantial part should be required to make an identical offer to each creditor similarly situated. This proposal was rejected by a majority of the group on the reasoning that creditors and policyholders that have adequate information should be able to negotiate fair and equitable resolutions for themselves based on their unique situation. However, it was agreed that the Insurance Department should have the right to insist on at least a threshold minimum treatment for policyholders and creditors with small claims to ensure that they are treated fairly.

Run-off Proceedings

The Task Force believes that substantially solvent and marginally solvent companies in run-off should have the opportunity to wind up their affairs through a court proceeding. Such proceedings should not be commenced without the approval of the Insurance Department after extensive financial and operational review. The object of such proceedings would be the winding up of the company's business with consistent, fair and equitable treatment of creditors. The Task Force does not envision that such legislation would be available to a troubled company that intends to continue underwriting business or to recapitalize companies and restore them to underwriting status.

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2 The preference provisions of Illinois receivership law provide:

(m) The Director as rehabilitator, liquidator, or conservator may not avoid a transfer under this Section to the extent that the transfer was: . . .

> (C) In the case of a transfer by a company where the Director has determined that an event described in Section 35A-25 or 35A-30 has occurred, specifically approved by the Director in writing pursuant to this subsection, whether or not the company is in receivership under this Article. Upon approval by the Director, such a transfer cannot later be found to constitute a prohibited or voidable transfer based solely upon a deviation from the statutory payment priorities established by law for any subsequent receivership. 215 ILCS 5/204 (m)(C).

In considering the contours of laws for run-off proceedings, the interests of policyholders are paramount. All policyholders are inherently reluctant to have the fundamental insurance bargain changed. However, they should be willing to accept a realistic commercial disposition of insurance assets in a process that is characterized by fairness and transparency.[3] The experience of insolvency practitioners in England confirms this view.

Fairness

The basic process considered by the Task Force consists of a plan that establishes classes of creditors and allows classes to vote on a plan. A class would be deemed to accept if a majority in number and super-majority in amount voted to accept the plan. In the event of such a vote, dissenting creditors in the class would be bound. In all events, a plan would need to provide recoveries at least equal to what creditors would receive in a hypothetical liquidation proceeding with respect to the company. That determination should give recognition to the benefit which policyholders would receive from a guaranty fund. (Thus, a plan would need to provide that the guaranty fund covered portion of any claim would be paid in full. This should not be a substantial commercial impediment as the majority of policyholders or cedents that would participate in such a plan would be excluded from guaranty fund participation.) The plan would require Insurance Department review and support and be subject to court approval. It was recognized that such a plan would not be suitable for personal lines policies.

The proceedings would provide for the estimation and payment of claims to policyholders. Claims would be heard by a magistrate or special master appointed by the Superior Court with a right of appeal to the Superior Court judge hearing the case. The appeal would follow normal appellate standards and would not be a de novo review.

The fairness of having the minority dissenting commercial policyholder creditors bound to a plan accepted by the vote of the majority was discussed at length. For marginally solvent companies where there is a substantial possibility that original policyholder expectations cannot be met, commercial policyholders should be bound to the plan approved by the voting majority if the plan provides for payment of the claim in full under the methodology established by the plan. A dissenting creditor could only defeat such a plan if it could prove that the plan did not provide a better recovery than would be achieved in a liquidation of the company.

For substantially solvent companies, the dynamics are different. In a typical plan, it is expected that policyholders will have their claims estimated and paid in cash. However, because the alternative to estimation and early payment would be payment in the ordinary course (and such payment is not in doubt), the Task Force concluded that policyholders should have an alternative to compulsory estimation of their claims where the company is substantially solvent.

[3] Public companies may face reporting issues in connection with insurers in run-off depending upon their level of impairment (which may not be readily ascertainable).

Several alternatives were acceptable to the Task Force. At least one of them would need to be offered in a plan for a substantially solvent company. One alternative would be to leave objecting policyholders with the right to present and collect claims in the ordinary course. However, this alternative does not provide companies with a mechanism to make an orderly and prompt exit from a line of business in a way that assures finality. A second alternative would be to permit the run-off entity to require novation of policies to another company of substantially equal or greater financial strength to that of the company. This alternative would be modeled upon the NAIC Assumption Reinsurance Model Act which has been adopted by some states. The court would need to determine that the new company had the requisite financial standing. A third alternative would be to require the run-off entity to make a cash payment of an amount that would be required to replace the policy. A creditor would be entitled to file and prove a claim based on the cost of a reasonably equivalent coverage.

The final alternative would provide for the establishment of a liquidating trust that would pay claims by policyholders in the ordinary course as they were presented or permit consensual commutation as the claims matured. This would eliminate the need for non-consensual estimation of claims by creditors that chose this alternative. An injunction would be entered requiring all policyholder claims to be brought against the trust instead of the company. This would, in substance, release the company from further obligations with respect to such claims. The trust would be funded at a fixed percentage over reserves allocated by the company or at a reasonable level of actuarial certainty according to appropriate actuarial methodology. The group will seek input from actuaries to develop an appropriate test.[4] Companies establishing such a trust would be able to recapture excess funding over a reasonable period based on the actuarial determination of ultimate liability. It would be necessary to transfer the applicable reinsurance (together with any supporting security) to the trust or permit commutation as the claims matured.

The Task Force considered mechanisms by which policyholder interests would be represented in the determination of the appropriate level of trust funding. A creditors committee of the type employed in bankruptcy reorganizations was rejected as commercially infeasible. The Task Force endorses a procedure under which the court would appoint an independent policyholder representative to review the mechanics and adequacy of trust funding with the company. The policyholder representative would be empowered to employ actuaries and other experts or professionals at company expense to review the work performed by the company or its representatives and to negotiate changes if desirable. The representative could either approve or disapprove the level of funding. The representative could, in appropriate circumstances, confer and negotiate with the company if he or she deems it appropriate. He

[4] Preliminary indications are that a seventy five percent level of certainty would be appropriate. The reserving issues may vary widely depending on the business involved. For example, claims in dispute may need to be reserved to their worst-case levels. However, upon resolution, the trust may be able to distribute any surplus reserve. Casualty business with latent claim potential will require loading for unknown claims. Professional liability and errors and omission business written on a claims-made basis also has substantial uncertainty, but the number of claims is typically known in a short period. Also, reserves would need to be established for loss adjustment expenses.

or she could meet with creditors and solicit their views. The representative would have immunity from suit except for intentional misconduct. The evaluation and report to the court and the creditors would be undertaken within a short period. Opt out creditors would still have the right to challenge the findings of the policyholder representative in court if they disagreed with the representative's conclusion.

The company could abandon a plan in whole or in part any time prior to consummation. This would prevent the company from being put into a position where its obligations under a plan exceeded its financial resources, or it appeared that policyholders were seeking to obtain unrealistic or unjustifiable benefits.

Transparency

In considering any plan for a global commutation with policyholders and creditors, transparency is essential. The group concurred in the view that the disclosure standards established by the Bankruptcy Code provided an excellent template. These standards require the description of the plan as well as a description of alternatives to the plan. Such disclosure should include a liquidation analysis and financial statements for the company using appropriate methodology.

The Task Force concluded that a company in run-off should prepare financial statements on a basis that is appropriate to its condition. In some instances this might involve discounting of reserves or accruing expenses for the run-off period. For purposes of uniformity of reporting, NAIC guidelines should be observed. These guidelines are expected to evolve over time.

Other Aspects of Court Proceedings

Court proceedings in connection with a run-off plan would need to ensure due process for policyholders. This would require accurate notice and sufficient time for policyholders to determine the amount of their claims and respond to a plan. Procedures should be well defined to enable parties to adequately plan and adequately respond.[5]

At the commencement of proceedings, the court could, if requested by the company and the Insurance Department, impose a stay of proceedings and creditor action against the insurer where the court was persuaded that such a stay was necessary and appropriate. Such a stay might be appropriate if there was a possibility that creditors would seek to attach assets while the plan approval process proceeded. The stay would not be automatic as it is in liquidation proceedings. Since the proceedings are anticipated to be short-lived, such a stay would be unlikely to substantially interfere with the rights of creditors or policyholders.

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[5] Rhode Island has adopted regulations to address the confirmation process that should prove instructive in addressing the notice, voting and confirmation process. 42 R.I. Code R. §68.

In connection with the confirmation of a plan, policyholders, creditors and even guaranty associations with a significant interest would have the right to appear in court and object, much as creditors have in federal bankruptcy reorganization cases. The company would have the burden of proving that it met each requirement for confirming a plan and would also need to prove that the plan was fair and equitable to all claimants as a whole. This contrasts with liquidation proceedings in some states where the liquidation court merely considers whether a proposed action was an abuse of discretion by the receiver. By changing the standard to be followed by the court, the interests of creditors should receive greater deference than they would in liquidation proceedings in some states.

Reinsurance

The Task Force concluded that it would not be feasible to propose legislation that required reinsurers to make payments based upon estimated claim payouts. However, the law should specifically enable companies to transfer their reinsurance and proceeds to a trust or to sell reinsurance recoverables to third parties. Similar provisions are contained in the Insurance Receivership Model Act recently adopted by the NAIC.[6] A plan might require policyholders to continue reporting claims experience even after commutation of their policies in order to provide data to submit to reinsurers for claim payment.

Extraterritorial Enforcement

While the Task Force would like to design a statute that has indisputable extraterritorial reach, this may not be possible. However, the Task Force believes that the level of certainty is entirely consistent with commercial necessity.

For marginally solvent companies, the statute would include provisions that tie plans under the run-off law to rehabilitation provisions of the insurance company insolvency statutes. A company that sought confirmation of a plan would simultaneously enter rehabilitation proceedings and simultaneously confirm a rehabilitation plan. This would capture the reciprocal state provisions of the uniform and model insolvency laws. Reciprocal states would be required to give deference to plan provisions.[7] This would ensure a very high level

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[6] Existing law in all likelihood already enables companies to make such transfers.

[7] In order to deal with the problem of extraterritorial assets, the Uniform Insurers Liquidation Act and the later Insurers Rehabilitation and Liquidation Model Act creates a regime of reciprocal states which recognize the authority of the domiciliary receiver and sending claimants to press their claims in the receivership proceeding in the domiciliary state or an ancillary proceeding in their own state. <u>See</u> IRLMA § 56. *See Vlasaty v. Avco Rent-A-Car System, Inc.*, 60 Misc.2d 928, 304 N.Y.S.2d 118 (N.Y. Supr. Kings Co. Sp. Term pt. 1 1969); *Lawrence v. Illinois Life and Health Guaranty Ass'n,* 293 Ill.App.3d 489, 495, 688 N.E.2d 675, 680 (Ill. App. 1997); *Reliance Ins. Co. v. Hernandez,* No. F040704, 2003 Cal. App. Unpub. LEXIS 8473 (Cal. App. Sept. 5, 2003). Lastly, Illinois has adopted the Uniform Insurers Liquidation Act (the Act), (215 ILCS 5/221.1 *et seq.* (West 1996)). Section 221.4 of the Act provides that when a liquidation proceeding is commenced in a "reciprocal state" involving an insurer domiciled in the reciprocal state, claims against the insurer by Illinois claimants must be decided in the domiciliary state as provided by the law of that state. 215 ILCS 5/221.4 (West 1996). Accordingly, plaintiff's argument that the California court's approval of the enhancement agreement is not entitled to full faith and credit is without merit. *Clark v. Standard Life & Accident Insurance Co.,* 68 Ill.App.3d

of confidence in enforceability. Using the rehabilitation statutes may not be feasible for companies attempting to commute only a portion of their business.

For substantially solvent companies, the problem is more complicated. For such companies, entering receivership is an unacceptable alternative. As such, the enforceability of a run-off statute would need to stand on its own. A claimant outside the jurisdiction of the domiciliary state court could attempt to secure a judgment and obtain a lien on assets in other states.[8] However, it is expected that states will give full faith and credit to the judgment of a court in the domiciliary state where that judgment was entered in a proceeding where the claimant had an opportunity to fully participate and even vote.

With far less policyholder participation and far less procedural protection, courts have been enforcing demutualization plans for over a century.[9] These plans change the rights of their policyholders pursuant to state statute or regulatory process. While these proceedings are often challenged in the domiciliary state, no one would seriously question the effect of the completed transaction in other states once approved by the company's domiciliary state courts. It might be argued that the demutualization cases are inapplicable because they deal with the rights of policyholders as equity owners rather than as creditors. However, there is a long line of authority that mutual policyholders are more like creditors than shareholders.[10] There are many cases indicating that the court of the company's domicile can decide questions of allocating policyholder's entitlement to the surplus of a mutual insurance

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977, 25 Ill.Dec. 416, 386 N.E.2d 890 (1979). *Lawrence v. Illinois Life and Health Guaranty Ass'n,* 293 Ill.App.3d 489, 495, 688 N.E.2d 675, 680 (Ill. App. 1997).

8 *Clark v. Williard*, 294 U.S. 211, 214 (1935).

9 *Grobe v. Erie County Mutual Ins. Co.*, 39 A.D. 183, 57 N.Y.S. 290 (N.Y.A.D. 4th Dep't 1899).

10 *See Andrews v. Equitable Life Assurance Society of United States*, 124 F.2d 788, 790 (7th Cir. 1942); *Everson v. Equitable Life Assurance Society of the United States,* 68 F.258, 258 (W.D.Pa. 1895) aff'd 71 F. 570 (3d Cir. 1896); *Peters v. Equitable Life Assur. Society of the United States*, 200 Mass. 579, 584, 86 N.W. 885, 886 (Mass 1909); *Cohen v. N. Y. Mut. Life Ins. Co.*, 50 N. Y., 610, 624 (N.Y. 1871); *People v. Security Life Ins. and Annuity Co.*, 78 N.Y. 114, 122, 124 (N.Y. 1879); *Uhlman v. New York Life Ins. Co.*, 109 N.Y. 421, 428-29 (N.Y. 1888); *Mygatt v. New York Protection Insurance Co.*, 21 N.Y. 52 (N.Y. 1860)*Fidelity and Casualty Co. of New York v. Metropolitan Life Ins. Co.*, 42 Misc.2d 616, 623, 248 N.Y.S.2d 559, 565 (N.Y. Supr. N.Y. Co. Special and Trial Term Part XV 1963); *Chatlos v. MONY Life Ins. Co.*, 298 A.D.2d 316, 749 N.Y.S.2d 230 (N.Y.A.D. 1st Dep't 2002); *See also Equitable Life Assurance Society of the United States. v. Brown*, 213 U.S. 25, 29 S.Ct. 404, 53 L.Ed. 682 (1909); but see *Dornberger v. Metropolitan Life Insurance Company*, 961 F.Supp. 506, 545 (S.D.N.Y. 1997), *Reiff v. Evans*, 630 N.W.2d 278 (Iowa 2001); *Heritage Healthcare Svcs., Inc. v. The Beacon Mutual Ins. Co.*, No. C.A. 02-7016, 2004 WL 253547, *5 (R.I. Super. Jan. 21, 2004); *Silverman v. Liberty Mutual Insurance Co.*, No. 01-2767-F, 13 Mass.L.Rptr. 303, 2001 WL 810157 (Mass. Super. July 11, 2001).

company[11] and have broad authority to recognize many changes to the company's structure.[12] The Supreme Court has recognized great powers for an insurance company's corporate governance to make changes permitted by statute with minimal interference from the courts.[13]

It remains important, however, that the fundamental contractual rights of the policyholder under the policy, such as the policy limit, not be altered.[14] In Massachusetts, the Supreme Judicial Court endorsed a reorganization that allowed policyholders to opt into a new structure or stay behind in an old structure made much less desirable by the transaction, although the right to be paid the face value of the policy remained in any event.[15] If a domiciliary state can change the economics of a policy contract by demutualization or reorganization and have that change enforced in other states, there is a good case to be made that the channeling to a trust pursuant to a court approved run-off plan would also be enforced. The combination of comity and courts' tendency to defer to the domiciliary state in matters of insurer corporate organization lead to the conclusion that it is unlikely that a claimant could successfully challenge the types of reorganizations contemplated by the Task Force.

In addition, it is expected that the number of opt out creditors that would seek to collaterally attack a plan is small and the identity of those creditors is probably predictable. However, companies utilizing the run-off statute would need to evaluate the risks involved and plan accordingly.

It has been suggested that a plan of the type envisioned by the Task Force would be unconstitutional[16] because it violated the Contracts Clause[17] or the Takings Clause of the Fourteenth Amendment.[18] A constitutional challenge based on any one of these clauses would require action under color of state law.[19] Reorganizations initiated by a company's board of directors pursuant to procedures legislated by statute would not likely be considered

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11 *See Ashurst v. Preferred Life Assurance Society of Montgomery*, 282 Ala. 119, 209 So.2d 403 (Ala. 1968).

12 *See Royal Highlanders v. Wiseman*, 140 Neb. 28, 299 N.W. 459, 465 (Neb. 1941); *Wall v. Bankers Life Co. of Des Moines*, 208 Iowa 1053, 223 N.W. 257, 263-64 (Iowa 1929).

13 *See Hartford Life Ins. Co. v. Ibs*, 237 U.S. 662, 671, 35 S.Ct. 692, 695 (1915); *Polk v. Mutual Reserve Fund Life Ass'n of New York*, 207 U.S. 310, 28 S.Ct. 65 (1907); *Wright v. Minnesota Mutual Life Ins. Co.*, 193 U.S. 657, 24 S.Ct. 549, 48 L.Ed. 832 (1904).

14 *See Ohio State Life Ins. Co. v. Clark*, 274 F.2d 771, 778 (6th Cir. 1960); *Partridge v. Mich. Mut. Windstorm Ins. Co.*, 256 Mich. 76, 239 N.W. 309 (Mich 1931). *Opdyke v. Security Savings & loan*, 157 Ohio St. 121, 147, 105 N.E.2d 9, 23 (Ohio 1952); *Royal Highlanders v. Wiseman*, 140 Neb. 28, 299 N.W. 459, 465 (Neb. 1941).

15 *Delaney v. Grand Lodge of the Ancient Order of United Workmen of Mass.*, 244 Mass. 556, 562, 138 N.E. 918, 922 (Mass 1923).

16 It is debatable whether the Takings Clause of the Fifth Amendment ("nor shall private property be taken for public use, without just compensation" U.S.Const. amend. V), as applied to the states under the Fourteenth Amendment also applies, but even if it did, state action would be required.

17 "No state shall . . . pass any . . . law impairing the obligation of contracts. . ." U.S.Const. art. I § 10 cl. 1.

18 "nor shall any state deprive any person of life, liberty, or property, without due process of law." U.S.Const. amend. XIV § 1.

19 *Tancredi v. Metropolitan Life Ins. Co.*, 316 F.3d 308, 312 (2d Cir. 2003) ("A plaintiff pressing a claim of violation of his constitutional rights under § 1983 is thus required to show state action.").

state action.[20] There is strong authority for this proposition from the demutualization cases where disappointed policyholders launched Constitutional challenges to the proposed transactions. Even if state action were found, a challenge under the Contracts Clause can be defeated by showing a "significant and legitimate public purpose" enforced with measures that are reasonable and appropriate under the circumstances.[21] In this situation, the public purpose is ensuring the stability and capitalization of the insurance industry. This purpose, taken together with full payment of policyholder claims under procedures designed to protect fairness, should be recognized by the courts. Similar findings would probably be included in an order approving a run-off plan. Even if state action were found, a challenge based on the takings clause could be turned away because the statute provides for due process of law and, in the case of a solvent insurer, involves no taking of property because the claimant would retain its policy or receive its indubitable equivalent.[22]

Conclusion

As one commentator put it, "The insurance business is hard to get into but harder to get out of."[23] The Task Force believes that the number of companies in run-off will increase dramatically during the coming years and there is a need for regulation of companies destined to "get out of" the insurance business. There are a number of states which have realized that this is an area which requires attention, including New York, Rhode Island and Illinois; and a number of foreign jurisdictions, led by England, that have tried to address the issues of run-off.

In pursuing its charge, the Task Force has attempted to keep in mind the varied needs of the constituencies involved. The proposals in this report represent a balance of views and a compromise of positions.

All run-off efforts require full and fair disclosure. As solvency decreases, the level of regulatory involvement needs to increase. Similarly, large-scale commutation programs require greater regulatory diligence to ensure that solvency is not threatened and unfair practices are not being utilized.

Court proceedings should be available to aid companies in accomplishing run-off. In such proceedings, there should be creditor participation in the form of voting and an opportunity to contest in court whether a plan is fair and equitable. Where a company is substantially

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[20] *Tancredi*, 316 F.3d at 313-14; *Cranley v. National Life Ins. Co. of Vermont*, 318 F.3d 105, 111-12 (2d Cir. 2003); *Gayman v. Principal Financial Services, Inc.*, 311 F.3d 851, 852-53 (7th Cir. 2002).

[21] *Vesta v. State of Florida*, 141 F.3d 1427, 1433 (11th Cir. 1998) citing *Energy Reserves Group, Inc. v. Kansas Power and Light Co.*, 459 U.S. 400, 410-13, 103 S.Ct. 697, 704-05 (1983).

[22] *See Wright v. Minnesota Mutual Life Ins. Co.*, 193 U.S. 657, 24 S.Ct. 549, 48 L.Ed. 832 (1904); *Delaney v. Grand Lodge of the Ancient Order of United Workmen of Mass.*, 244 Mass. 556, 562, 138 N.E. 918, 922 (Mass 1923).

[23] This sentiment was recently captured in a thought provoking speech entitled "Regulating Firms in Run-Off" delivered by Julian Adams, Head of Wholesale Insurance Department, FSA on March 7, 2006 to the Association of Run-Off Companies.

solvent, greater protections should be available to ensure that policyholders are receiving the full benefit of their bargain.

The members of the Task Force would like to thank Commissioner Cogswell for the opportunity to participate in the work of the Task Force. We hope that the product we have produced will be useful and that it will provide the basis for meaningful legislation.