2009 Insurance Economic Summit:
Navigating the New Business Landscape

FOLEY — FOLEY & LARDNER LLP · ADVISEN — Productivity & Insight for Insurance Professionals · RAYMOND JAMES · SMART

Insolvency and Bankruptcy 101 – A Refresher Course

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Run-off and Receivership Alternatives

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UIRRL

- Background and Overview of Proposed Uniform Insurer's Run-Off and Resolution Law ("UIRRL") created by AIRROC Subcommittee and Legislative Committee
- Advantages of the "UIRRL"
- Environmental Considerations and Factors

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Principles and Objectives that Guided the Subcommittee

- New statutory scheme to resolve an insurer's liabilities – efficiency and preservation of values
- Eligible insurers should have ceased writing and are "troubled"
- The insurer and/or its creditors given opportunity to have a resolution plan before government takes over
- Guaranty fund participation
- Promote innovation and creativity
- Transparency and accountability

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Overview of Proposed Statute

- Administrative Proceeding
  - Able to pay claims as due is presumed
  - Regulatory approval of plan
  - Uniform voluntary communications
  - Reporting requirements

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Overview of Proposed Statute

- Judicial Proceedings
  - Regulatory and court approved plan
  - Notice to ‘Partners in Interest’
  - Policyholders and creditor acceptance
  - Plan contents
  - Estimation of claims
  - Impact on reinsurers
  - Conversion to receivership

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Advantages of Proposed Statute

- Produces a quicker resolution than an indefinite run-off or long-term receivership
- Accelerates and maximizes payment of policy claims
- Preserves asset values and increases distribution
- Creditor control
- Process is transparent and demands accountability

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Environmental Considerations and Factors

- No statutory framework for run-offs today for insurers that are troubled
- New ‘regulators’ are rating agencies
- Impact of risk capital requirements
- NAIC study

Restructuring Options

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- Internal reorganizations
- “Good bank” versus “bad bank”
- Use of segregated accounts
- Disposition of assets
- Global commutations

Global Commutations

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- Global commutations involving individual companies of all assumed reinsurance are gaining popularity
- In many cases, used to address solvency concerns and avoid liquidation
- New York’s Insurance Law § 1321

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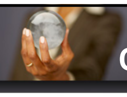
Nuts and Bolts of an Insurer Insolvency Proceeding



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Order of Distribution

- Priority of Claims
  - Each claim in a class must be paid in full (or have adequate funds set aside for their payment) before claims from the following class may be paid
  - Claims within the same class should receive roughly the same percentage of payment

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Insurer Receivership Model Act: Priority

- Priority of Claims(§ 801):
  1. Administrative costs.
  2. Reasonable expenses of guaranty association.
  3. Loss claims.
  4. Claims under policies of mortgage guaranty, financial guaranty, or other forms of insurance offering protection against investment risk, or warranties.
  5. Claims of the federal government not included in Classes 3 or 4 above.
  6. Debts due to employees for services/benefits.
  7. Claims of other unsecured creditors not included in Classes 1-6 (e.g. claims under reinsurance contracts, or claims of guaranty associations for assessments not paid by the insurer).
  8. Claims of state or local governments, except as specifically classified elsewhere in § 801.
  9. Claims for penalties, punitive damages, or forfeitures, unless covered under the terms of an insurance policy.
  10. Late claims under Classes 3-9, *see* exceptions in IRMA § 701(B), (C).
  11. Surplus notes, capital notes, or contribution notes, and premium refunds on assessable policies.
  12. Interest allowed on claims of Classes 1-11.
  13. Claims of shareholders or other owners arising out of their capacity as shareholders or owners.

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Reinsurer's Liability

- Reinsurance recoverables may not be reduced as a result of a delinquency proceeding with a finding of insolvency
- Contract provisions to the contrary are unenforceable

Determination of Liability

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- Amounts recoverable from reinsurers are determined on the basis of:
  - Proof of payment of the insured claim by a guaranty association, the insurer or the receiver *to the extent of the payment;* or
  - The allowance of the claim by the liquidator, an order of the receivership court, or a plan of rehabilitation
- Generally, reinsurers cannot be compelled to pay IBNR or case reserves

Alternate Payees

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- General rule is that third parties have no direct right to reinsurance proceeds
- Exceptions
  - Written agreement provides for another payee
  - Reinsurer agrees to step into the shoes of the ceding company
  - Life guaranty association assumes risk

Claim Estimation and Acceleration

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- Distinction Between Estimation and Acceleration
- Competing Interests of Receivers and Reinsurers
- Status of Statutory Law and Case Law

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IRMA Voidable Preference Provision

- A preference is a transfer of any interest in property of an insurer:
  - To or for the benefit of a creditor;
  - For or on account of an antecedent debt;
  - Made or suffered by the insurer within two (2) years preceding the filing of a successful petition commencing delinquency proceedings; and
  - That enables the creditor to receive more than the creditor would receive

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IRMA Voidable Preference Provision

- Any preference may be avoided by the receiver if:
  - The insurer was insolvent at the time of the transfer;
  - The transfer was made within 120 days before the filing of the petition commencing delinquency proceedings;
  - The creditor had reasonable cause to believe that the insurer was insolvent or was about to become insolvent; or
  - The creditor receiving it was:
    - An officer or director of the insurer;
    - An employee, attorney or other person with a level of control or influence; or
    - An affiliate.

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IRMA Fraudulent Transfer Provision

- Section 605. Fraudulent Transfers and Obligations
  - The receiver may avoid any transfer of property, any reinsurance transaction or any obligation incurred by an insurer that was made or incurred within two (2) years before the date of the initial filing of a petition if the insurer:
    - Made the transfer or incurred the obligation with actual intent to hinder, delay or defraud any person to which it was or became indebted on or after the date that the transfer was made or the obligation was incurred; or
    - Received less than a reasonably equivalent value in exchange for the transfer or obligation

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Role of Guaranty Funds

- Guaranty Funds as Creature of State Statute
  - Established by State law for the protection of policyholders and claimants
  - Generally divided into property/casualty funds and life/health funds
  - A few states have separate funds for HMOs or workers' compensation
  - New Jersey has a fund for surplus lines business

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Role of Guaranty Funds

- Industry Funding and Recoupment
  - Funding for state guaranty funds is accomplished by assessments on the industry
  - Methods of recoupment of those costs vary among states but include tax offsets, policyholder surcharges or incorporation of costs into future rates

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Role of Guaranty Funds

- Impact on Guaranty Funds in Face of Major Insolvencies

- Financial Implications of Change
  - Federal v. state funds and financial effect
  - Pre v. Post Assessment mechanism

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Unique Challenges Applicable to Mortgage Guaranty Insurers

- No Guaranty Fund Coverage
  - 7 Companies lost $18.9 B in 2008*
  - Traditional liquidation does not contemplate:
    - Future Premium
    - Future Reinsurance Recoveries on Future Losses
    - Is replacement coverage available?
    - Mitigation

*Includes unrealized losses

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Insurer Receivership Model Act: Setoffs

- General rule - mutual debts or credits may be set off
- Setoffs not allowed if:
  - The claim against the insurer is disallowed.
  - The claim was purchased by or transferred to the person within 120 days preceding the filing of the receivership petition.
  - The obligation is owed to an affiliate or entity other than the person/insurer, unless the obligation was assigned, in writing, more than 120 days prior to the filing of the petition.
  - The obligation of the person is in the nature of a capital contribution.
  - The obligations arises out of transactions by which either party has assumed risks/obligations from the other party and then ceded back substantially the same risks/obligations to it.
  - The obligation of the insured is for payment of earned premiums or retrospectively rated earned premiums.

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Setoffs and Mutuality

- Identity
  - The debts must exist between the same entities
- Capacity
  - Parties must have same legal capacity
- Timing:
  - Pre-insolvency debts may not be set off against debts arising after the issuance of the liquidation order

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Arbitrations in the Context of Insurance Insolvencies

- McCarran Ferguson v. Federal Arbitration Act
- State Statutes and Other Attempts to Limit Arbitration Rights
- Can a Receiver be Compelled to Arbitrate?

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Arbitrations in the Context of Insurance Insolvencies

- Majority and Minority View
  - A reinsurer attempting to compel arbitration in a New York receivership under New York law is not likely to prevail (until Knickerbocker is reversed);
- A reinsurer attempting to compel arbitration in most other jurisdictions, as a debtor, will usually prevail, except recent Ohio law is unclear;
- A reinsurer, or any other person or entity, pursuing arbitration in the capacity of a claimant against assets of the insolvent insurer, is not likely to prevail in any jurisdiction and runs the risk of contempt proceedings if such individual or entity initiates or pursues action in violation of an anti-suit injunction;
- Non-U.S. reinsurers may be at risk, in some jurisdictions, of forfeiting their removal and/or arbitration rights if their reinsurance contracts are old and contain both a service of suit clause and an arbitration clause. Contracting parties would be well-advised to amend these old contracts to harmonize the service of suit clause with the arbitration clause by adding a sentence stating that nothing contained herein is intended to waive the parties= right to arbitrate.

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Litigation and Damages Involving an Insolvent Company

- Claims Litigation –
  - Documentation is critical
    - Accounting, Policy and Claim records
    - Reinsurance (especially facultative certificates)
- Post-Acquisition Purchase Price Disputes
  - Earn-out agreements
    - Does the estate have documentation to collect on its earn-out?
    - Can the Estate defend collection efforts against it relating to the Earn-out?

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Interstate Relations

- Ancillary Receiverships
- Statutory and Special Deposits
- IRMA and Reciprocity

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State vs. Federal Jurisdiction

- Dual Proceedings
- Issues:
  - Can the policyholder terminate or liquidate in Bankruptcy or another federal court?
  - Does the Bankruptcy Code preempt state law?
  - Can a state injunction statute “reverse-preempt” the Bankruptcy Code under the McCarran-Ferguson Act?
  - Will the Bankruptcy Court or other Federal Court defer under the Abstention Doctrine?

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Impact of OFC on Insolvency Proceedings

- Uniform Receivership Law (URL)
- OFC Receivership Provisions
- Systemic Regulator and Treasury Proposal for Expanded Authority

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Non-U.S. Insolvencies

- EU Insolvency Framework
- EU Insolvency Regulation
- Current Insurance Guarantee Schemes
  - Of the 27 EU Member States, 13 operate one or more insurance guarantee schemes. Of those 13: five countries have general schemes which cover both life and non-life; three countries have a general scheme for life assurance; three other countries have a general scheme for non-life insurance; and six countries have special schemes that cover very specific classes of non-life insurance.
  - In some cases the schemes have never dealt with a single insurer failure while in others there have been sizeable losses that would have occurred had it not been for the existence of the scheme.
  - These existing schemes vary considerably in terms of business covered, operational procedures, funding arrangements and the corresponding capacity of the schemes.
  - Bulgaria, UK, Greece, Spain and Slovakia are reviewing or changing their status.
- EU Commission Consultation

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Non-U.S. Insolvencies (cont.)

- Solvent Schemes of Arrangement
  - Part VII Transfers
  - Impact in the U.S.
- Foreign Proceedings Under the U.S. Bankruptcy
  - Former U.S. Bankruptcy Code Sec. 304
  - 2005 Amendments to Bankruptcy Code, Chapter 15

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Minimizing Exposure in a Down Economy

Red Flags That a Company is Distressed

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- Risk Based Capital – TAC/RBC Ratio
- 12 IRIS Ratios
- Less common detecting distress
  - Hedge Fund at top
  - Product Susceptibility
    - Product Flaw
    - Systematic Correlation to a Down Market

Review Asset Side of the Balance Sheet

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- Investment portfolio review
  - Check Other Comprehensive Income (GAAP)
  - Liquidity of the Portfolio
    - Are investments thinly traded?
  - Credit Quality
  - Duration of the Bond Portfolio
  - Asset Mix
  - Lessons from Reliance on Balancing Portfolio
    - Have holdings in a single stock or asset class risen enough to cause an abnormal asset allocation?

Security/Collateral

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- Credit for Reinsurance Requirements
- Downgrade Triggers/ Ability to Perform/Liquidity Issues
- International Collateral Debate
- NAIC Efforts to Reduce Collateral

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Special Termination/Commutation Clauses In Reinsurance Agreements

- Allows cedent to terminate or commute agreement upon certain triggering events
- Common triggers include rating downgrade, placement under supervision, reduction in surplus, and change in control

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Appendices

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IV. Appendix – Voidable Preference Changes

Issue	**Prior Model Act (Model 555)**	**IRMA**
Preference period prior to receivership	One year	Two years
Person entitled to seek recovery	Liquidator	Conservator, rehabilitator or liquidator
Items recoverable	Property or value	Property or value, plus express reference to interest or income earned by property transferred, together with costs and attorneys' fees

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IV. Appendix – Voidable Preference Changes

Issue	Prior Model Act (Model 555)	IRMA
Persons liable	1. Any person who receives or converts the property (with an exception for those providing less than equivalent value) 2. Any person "who knowingly participates in giving any preference" and has reasonable cause to believe the insurer is or about to be insolvent. Any person receiving any property or the benefit thereof as a voidable preference	1. Initial transferee and specified subsequent transferees (other than those taking for value in good faith). 2. Deleted

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IV. Appendix – Voidable Preference Changes

Issue	Prior Model Act (Model 555)	IRMA
Types of transactions that are voidable	1. No express exclusion for Contemporaneous exchanges or ordinary course payments. 2. No express provision for setoffs	1. Exclusion for (a) transactions that were contemporaneous exchanges for new value, and (b) payments made in the ordinary course of business 2. Express addition of setoffs prior to receivership proceedings, when it would be disallowed under IRMA criteria.

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IV. Appendix – Fraudulent Transfer Changes

Issue	Prior Model Act (Model 555)	IRMA
Transfer period prior to receivership	One year	Two years
Amounts recoverable	Property transferred and any benefit thereof	Express reference to (a) property or value, (b) interest or income earned on property transferred, and (c) costs and attorneys' fees
Persons liable	1. Persons receiving property or "any benefit thereof" which is a fraudulent transfer	1. Deleted 2. Initial transferee and subsequent transferees are specifically included (with exceptions for those taking for value in good faith)

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IV. Appendix – Fraudulent Transfer Changes

Issue	Prior Model Act (Model 555)	IRMA
Criteria	1. Transfer without "Fair Consideration"	Transfer without "reasonably Equivalent Value"
Other		1. Receiver is a Creditor under Uniform Fraudulent Transfer Act and Uniform Fraudulent Conveyance Act 2. Receiver may avoid any transfer that the insurer (or any creditor) may have avoided, without regard to knowledge. 3. "Value" includes satisfaction of present or antecedent debt

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IV. Appendix

- **In spite of Healthy Net Income, Significant Unrealized Losses Can be Hidden in Other Comprehensive Income**

Torchmark Corporation	
For the Year Ending 12/31/2008	
Net (Loss) Income	$ 452,259,000
Other Comprehensive Income / (Loss)	(1,089,479,000)
Total Comprehensive Income / (Loss)	$ (637,220,000)
Source: Torchmark 2008 10-K	

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IV. Appendix

- **7 Mortgage Guaranty Companies Combined Lost $18.9 Billion in 2008**

For the Year Ending 12/31/2008	
	Total
Net (Loss) Income	(11,343,069,000)
Other Comprehensive Income (Loss)	(7,539,022,000)
Total Comprehensive Loss	(18,882,091,000)
Source: 2008 10-K's.	