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Rhode Island Jurisdiction and Impact on Insurance/Re-Insurance Restructuring

Andrew Rothseid and Andrew Ward, PriceWaterhouseCoopers Global Restructuring Services, Philadelphia, USA

The run-off market in the United States continued to expand in 2003. Established companies either stopped underwriting, sold renewal rights, exited major lines of business or undertook other modes of strategic restructuring.

'Traditional' risks that have plagued the insurance industry for close to a generation – notably asbestos, pollution and health hazards ('APH claims') – remain problematic and unresolved. The inability of industry, government, unions and claimants to agree a legislative solution for asbestos liability further delayed resolution of this troublesome exposure.

Like a computer virus, asbestos liability spreads, without abatement, from insured to insured, and, in turn, from insured to insurer, from insurer to re-insurer and, finally, from re-insurer to retrocessionaire. Initially it affected just the companies that mined and manufactured products containing asbestos fibers. It has progressed through the economic matrix of manufacturing – beyond insulators to the manufacturers of brake linings, cigarette filters and from there to the other entities in the process – even distributors of the products. As a result, companies that in the late 1980s most certainly never anticipated potential economic ruin simply from handling the product, find themselves now struggling to stop the flow of cash to impaired and, most significantly, allegedly unimpaired claimants.

Little has been accomplished to stem the tide. Traditional coverage defences have been ineffective. The insureds – in their own fight for survival – have appeased claimants' groups by paying bulk settlements for those who may now be unimpaired but perhaps will be impaired later. Insurers find the insured often asserting claims for coverage for the losses under theories once thought inapplicable. Worse yet, the consequential bankruptcy of numerous insureds has subjected the insurers to potentially faster payout patterns than were ever anticipated.

The problems facing the industry do not end with APH claims. Additional risks – construction defect claims, surety claims, finite re-insurance – have added significantly to the billions of dollars in run-off in the U.S.

Various non-traditional sources of capital entered the market after September 11, perhaps hoping to take advantage of a hardening market. While some hardening in price has occurred, and premiums have grown, it is too soon to tell whether these portfolios will experience loss development consistent with strict underwriting standards.

A notable development concurrent with the post-September 11 premium growth has been a troublesome growth in re-insurance balances both in paid claims and reserves. It is unclear, and perhaps unfair to conclude, that the expansion in unpaid re-insurance is the direct result of the drive to generate large premium volume. Regardless, the ceded re-insurance balances – particularly with recent entries into the run-off market – remain high.

Companies remain eager to explore methods and practices that will allow them to manage and bring finality to these long-tail and often volatile portfolios. Companies that are no longer actively writing new business are forced to come to grips with their ceded or outwards re-insurance exposures. Where a focus of the ongoing business may have been premium generation, the 'run-off' company – whether formally or informally in run-off – must now preserve capital, reduce volatility of inwards exposures, control expenses, maintain regulatory compliance and, most importantly, continue to honour valid policyholder claims.

Various factors complicate the process. Declining interest rates have lead to reduced yields on investment portfolios – particularly those that are not heavily invested in equities. More and more significant companies are also shutting down lines of business. This can lead to difficulties in collecting re-insurance cover – or even communicating effectively with the re-insurer regarding the cover.

For those US companies that no longer write new business, re-insurance assets and their collection are paramount to their ongoing financial health. There should be a greater willingness to explore settlement opportunities with re-insurers, which may lead ultimately to commutation.

Significantly capitalized companies with discontinued operations are challenged to find an exit strategy that allows them to honour their obligations, preserve capital and satisfy rating agency demands relating to their ongoing lives.

A struggling cedent will most likely be unwilling to commute with the run-off re-insurer that is owned by a large, well-capitalized, carrier. The run-off subsidiary of the well-capitalized entity has to ensure that its commutation or run-off program does not result in compromises that hinder its parent's ongoing lines of business. Hence the commutation strategy for the run-off subsidiary of the well-capitalized entity must be disciplined to deliver value through the settlement process.

Many US cedents will wonder why they should give away the value of their re-insurance by entering into discounted commutations. Many of these cedents, as well as the re-insurers, are struggling to find a transparent basis on which to simply communicate to advance the settlement process. Protocols and procedures established to address these communication issues have met with marginal success to date. They provide good frameworks for dialogue but only if the cedent and re-insurers have compatible business objectives.

Arbitration – once a streamlined method for resolution of the 'honorable engagements' – has begun to resemble the litigation process rather than a commercial form of alternative dispute resolution.

All of these dynamics require that the owners and managers of companies in run-off abandon business as usual, realize that run-off is itself a business and strive to find a transparent solution that – on a commercial basis – allows for finality in the face of assumed and ceded obligations simultaneous with the extraction of capital.

Run-off is a business. Businesses are not in business to lose money. Run-off is no different. Value can be extracted for the benefit of the shareholder while valid policyholders claims are honoured. The entities involved – the stakeholders of the discontinued operation – simply have to understand and be aware of the tools available to execute these strategies.

Risk carriers in run-off, their policyholders – even their regulators – have a new alternative in the quest for finality in respect of discontinued insurance operations.

In the United Kingdom – and certain other Commonwealth countries – solvent carriers in run-off may use the 'Scheme of Arrangement' as a transparent mechanism to extinguish their obligations to their policyholders. This process is now about to become possible for carriers in the United States through a Rhode Island statute modelled on the existing UK law.

'Voluntary Restructuring of Solvent Insurers' – otherwise known as the Rhode Island Plan of Administration (the term 'scheme' has a pejorative connotation in American English) or the Rhode Island Statute – was passed into law in 2002.[1]

Although untested to date, the Rhode Island Statute is the first piece of American legislation that – conceptually – should provide solvent companies with a transparent resolution of their insurance obligations.

Exit strategy alternatives

Before discussing how the Rhode Island Statute operates, and its merits – even its disadvantages – it is important to place this mechanism in context with other exit strategy alternatives.

An insurer or a re-insurer let's make it simpler and call them 'carriers' – go into run-off when they stop accepting new risks and manage their assumed obligations from their available assets – most commonly re-insurance recoverables and posted reserves. Often the decision to stop writing new business is the result of a change in company focus or direction. More often, the decision is the consequence of a poorly performing portfolio that can result in the carrier's financial impairment.

The business model for a run-off company is strikingly different from the business model of an ongoing organization. It is no longer focused on premium development but, rather, on the elimination of liability. To succeed, a run-off company must honour valid claims, control administrative expenses, maximize available assets, control – to the extent possible – the speed of claim payouts and, ultimately, eliminate all liabilities.

To accomplish these goals the company should explore speedy and effective exits from discrete lines of business, implement pro-active credit control procedures, tie investment assets to payout patterns and reduce the volatility of their business by removing liabilities on a discounted basis.

Insurance run-off is an industry in itself. Billions of dollars of reserves reside in these discontinued portfolios. The owners of these portfolios find themselves asking the same question: 'How do we end this?'

Various alternatives exist:

The business can be 'run-off' until its natural conclusion. (A utopian concept. It has never occurred.)

The owner can aggressively commute – or buy back its obligations – hoping that by doing so it will remove

Notes

1 R.I. Gen. Laws §§ 27 – 14.5-1 et. seq.

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the volatility from the business and allow it to run itself off indefinitely.

The owner can find another carrier to re-insure the run-off exposure, either by an indemnity agreement or loss portfolio transfer. These may provide the cedent with some balance sheet relief but at a cost – re-insurance for run-off portfolio can be costly – and at a risk – the cedent is gambling on the financial strength of the selected re-insurer.

The owner can sell its portfolio or company in run-off. However, the price a purchaser may be willing to pay may not give the owner the value it seeks for the business sold. Further, sellers of portfolio or companies in run-off with volatile liabilities may be exposed to residual claims over pre-sale liabilities.

The solvent scheme is the only mechanism that pays all policyholders – in full – for their claims, binds all policyholders subject to court order, extinguishes the carrier's obligations to its policyholders and allows for the sanctioned extraction of capital from the portfolio or company in run-off.

The solvent scheme

The solvent scheme is growing in popularity as larger and more complex portfolios and companies in run-off are using this exit route. The scheme of arrangement has been credited with providing a transparent and rapid resolution to the liabilities facing a carrier in run-off. Through a quick and efficient process – often lasting three years or less from conception to conclusion – a shareholder of a run-off portfolio can terminate its liabilities, pay its reserves to its creditors, extract the residual value from its business and terminate its liabilities. Moreover, rather than incurring run-off administration costs over a fifteen, twenty, twenty-five year, or longer, period, those costs are conserved and used to pay policyholders.

How does a scheme work?

A scheme is a deal – a commutation – between a carrier and its creditors.

Assuming the requisite number of creditors agree to the scheme – in the UK the scheme must be approved by fifty percent or more of creditors by class of creditor representing seventy-five percent or more of value present and voting in person or by proxy on the date of voting[2] – the scheme will become binding on all of the effected creditors.[3]

In very broad outline the process is as follows:

The scheme process begins with discussions among the carrier's board of directors to determine their view on terminating exposures through the scheme. Thereafter the scheme is designed, with the assistance of a scheme advisor; soundings of support are taken from the relevant stakeholders of the carrier. A scheme document is drafted and circulated to the creditors.

The scheme document will provide for the establishment of a bar date for the submission of claims. Once approved by the creditors at a meeting set for that purpose, the scheme becomes binding on all creditors and the carrier itself.

The creditors are asked to agree a methodology for the evaluation of liabilities. This may take the form of the carrier providing creditors with an actuarial assessment of its inwards exposures at policy level or inviting the policyholders to submit their own actuarial assessment.

Creditors' claims are agreed at present value. A scheme adjudicator resolves any disputes and payment arrangements are made.

Depending on the size and complexity of the portfolio involved a scheme may be completed within a time frame of between twelve and thirty-six months.

For the shareholder, the advantages of a scheme are clear. All valid policyholder claims are honoured. Shareholder value is preserved – even enhanced. Residual shareholder funds are released – quickly. Group re-insurances and guarantees – if they exist – are eliminated. The shareholder sees a significant cost savings compared to an extended run-off. Finally the shareholder receives the added benefit of a positive public image – 'We paid all our claims in full'. This image is conveyed to the market, the regulator and rating agencies.

Equally, there are advantages for the policyholder. It receives payment in full for its valid claims – quickly. The policyholder is treated fairly through a transparent process. Finally, there is certainty of payment from a carrier that the policyholder might have considered a credit risk.

The UK scheme process is flexible. It applies – in theory – to all forms of insurance except compulsory covers such as employer's liability. It applies to portfolios of business in addition to whole companies. It can work for pool exposures and has even been shown to work with portfolios of business written by carriers outside the UK that have a sufficient connection with the UK. Although flexible, the UK scheme does not bind a carrier's re-insurers. They must agree to support the scheme or the carrier may have to commute these exposures to control its re-insurance asset.

To date the UK scheme has been successful in more than twenty-five applications. Its success is due to

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2 Companies Act 1985, Pt XIII, s 425 (2).

3 'Effected creditors' is used because – in the UK – a carrier may put its entire business or segmented lines of business through the scheme process.

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many factors, not the least of which is that it has evolved from an established crystallization process used by provisional liquidators of insolvent companies to extinguish those entities' liabilities.

The Rhode Island Statute

The Rhode Island Statute – while similar in intent to §425 of the UK Companies Act is different in origination and application.

As noted, the solvent scheme process is an outgrowth of methodologies used in the UK to extinguish the liabilities of insolvent companies. The insurance regulatory models enacted in the individual states can allow for the potential for a crystallization process for insolvent companies, but that is not the norm.

The resources of many state liquidation bureaus are stretched beyond capacity. As a result, estates can remain open for years, often creditors do not receive payment – much less timely payment – and re-insurance inuring to the benefit of the estate is not collected. State guarantee funds – established to protect the policyholder – make the timely payment, receive some benefit from estate assets but often are not reimbursed in full due to the failure or inability of the liquidators to collect the re-insurance protection.[4]

Hence, in addressing the problems facing solvent companies in run-off – looking for a solution to keep the solvent run-off from becoming an insolvent run-off – regulators in the various states cannot draw on the experiences of the successful resolution of insolvent carriers' exposures to the same degree as can the Financial Services Authority.

Nonetheless, the Rhode Island Statute represents a necessary innovative effort by a US regulator to tackle the issue of run-off administration.

In most aspects, the Rhode Island Statute is similar in focus to Section 425 of the UK Companies Act. Certain of the similarities are that:

- It binds policyholders – not re-insurers[5] – subject to court order.[6]
- All creditors are given notice[7] and an opportunity to vote on the commutation plan.[8]
- Approval of the plan requires the consent of the majority of each class of creditors holding three quarters of the liabilities for each creditor class.[9]
- The creditors must submit their claims by the bar date established in the plan.[10]
- After the commutation plan is drafted and application made to the court, the carrier is allowed – subject to court approval – to continue to make payments to creditors other than as set forth in the plan such as payments in the ordinary course of its business.[11]

There are also some noted differences. For instance:

- The carrier applying to implement the commutation plan must be domiciled in Rhode Island.[12] Thus a 'foreign' entity – be it a carrier domiciled in a state other than Rhode Island, or in a country other than the United States – must move its domicile to Rhode Island and submit to the jurisdiction of the Rhode Island Department of Business Regulation.
- Where the UK statute permits the scheme process for whole companies in run-off or discreet portfolio of business, the Rhode Island Statute may be used only for whole companies in run-off.[13]
- Where the UK statute can be used for all lines of business except compulsory covers such as employer's liability, the Rhode Island Statute excludes life, workers' compensation and personal lines.[14]
- Finally, the Rhode Island Statute, in its present form, does not specify – unlike the UK statute – that the consent of the requisite number and value of creditors be obtained from those 'present and voting in person or by proxy at the meeting [of creditors]'[15] – though approval is required from 'voting' creditors. This clarification may be

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4 Through 2002 the various state guarantee associations have made claim and allocated loss adjustment expense payments in excess of US$ 13.2 billion but have received reimbursement from the estates of just over US$ 5 billion. *See* Bakke and Hartz, 'New Perspectives on Insurer Insolvency' (2003) 12(3) *The Insurance Receiver* 12–14.

5 R.I. Gen. Laws § 27 – 14.5.4 (e).

6 Id. at 27 – 14.5.4 (c) and (d).

7 Id. at 27 – 14.5.4 (b).

8 Id.

9 Id. at (b)(4).

10 Id. at (c)(2) (iii).

11 Id. at § 27 – 14.5.4 (c)(2) (iv).

12 Id. at § 27 – 14.5–1 (6).

13 Id. at § 27 – 14.5–7 (6) and (21).

14 Id. at § 27 – 14.5–1 (6).

15 Companies Act 1985, Pt XIII, s 425 (2).

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addressed in the regulations required to implement the Rhode Island Statute.[16]

Will this work?

What therefore is the anticipated impact of the Rhode Island Statute on insurance and re-insurance restructuring in the United States? In other words – will this work?

Yes, it should. The Rhode Island Statute should provide the relief intended if the following criteria and practicalities are met:

– The applicant must try to use the statute for the right business.
  What is the 'right type of business?' There is no one answer but given that personal lines, workers' compensation and life covers are excluded, the business must be commercial liability. Assumed re-insurance should prove to be the most susceptible to success. The policyholders are sophisticated entities. Many will be familiar with – and trusting of – the scheme process.
  General commercial liability covers should also be successful – especially those with large exposure to APH liabilities. The insureds of those businesses have dealt successfully with the scheme process in the UK for both solvent and insolvent carriers. They know that the process can work.

– The owner of the portfolio should be innovative and entrepreneurial.
  There will be a cost to absorb in moving the carrier's domicile to Rhode Island.

– Regulatory hurdles will have to be overcome.
  If we start with the presumption that many carriers in run-off are financially impaired, the decision to move to Rhode Island will be subject to much regulatory scrutiny.
  The regulator in the home state will want to be convinced that the commutation plan will succeed when the business moves to Rhode Island. He or she will want to avoid the potential criticism that may be leveled at the decision to let a company leave the jurisdiction only to become insolvent.
  Similarly, the Rhode Island Insurance Department will need to be convinced that insolvency is not a realistic option for the portfolio once it resides in the state.

Rhode Island would like to position itself as a 'centre of excellence' for run-off in the United States. Unless and until another state or states adopts a similar statute, Rhode Island will be able to maintain that 'bragging' right. The proof, however, will be in the execution. At present, Rhode Island is not an insurance centre, though its state government appears eager to attract the business necessary and support the process to put itself in that position.

Carriers in run-off are here to stay. Perhaps it is time for the industry to accept innovation rather than 'business as usual' to resolve these problems. Perhaps other state regulators may wish to evaluate how effective their processes are in resolving solvent run-off and insolvent exposures. Perhaps if both the industry and regulatory communities accept that there may be merit in innovation, the problems that plague the industry through run-off will become more manageable.

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16 R.I. Gen. Laws §27 – 14.5–6 requires that the commissioner promulgate rules and regulations 'necessary to effectuate the purposes of this chapter'. As of this writing these regulations have not been finalized. R.I. Gen. Laws §27 – 14.5–6 does not allow the Department of Business Regulation to accept applications for a commutation plan 'until the time that these regulations have been promulgated'.

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