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# Warm Reception

## NOLHGA's Legal Seminar visits Baltimore in August—the wit is dry, the heat is not

*By Sean M. McKenna*

When Charlie Richardson (Baker & Daniels) said that "the insurance reform cauldron continues to boil," it's safe to say the metaphor hit home with attendees of NOLHGA's 14th Annual Legal Seminar. As temperatures and "how hot is it?" jokes hit triple digits in Baltimore, the heat was a frequent topic of conversation. It's a testament to the dedication of the more than 140 people who attended the seminar that it wasn't the *only* topic of conversation.

Instead, the seminar's two days were filled with in-depth discussions of federal and state insurance regulation, alternatives to current solvency regulation, the life settlement industry, and a wide variety of other topics. And while it's always easy to make jokes at the expense of lawyers, it should be noted that most of the hot air in Baltimore was outside the seminar ballroom.

Photograph by Kenneth L. Bullock

### Eye on Washington—and the States

A number of presentations focused on the heightened interest Congress has shown in insurance regulation and on changes in state regulation. Richardson began the seminar by noting that after a lull in insurance-related activity in Congress, 2006 has seen a great deal of activity, including the Sununu-Johnson National Insurance Act, which would create an optional federal charter for insurers, and the July Senate hearings on insurance issues. He also predicted that Representatives Royce (R-Calif.) and Kanjorski (D-Pa.) might introduce optional federal charter legislation in the House by the end of the year.

While decision makers on Capitol Hill are much better informed on insurance issues and the state guaranty associations than they were just a few years ago, Richardson indicated that the tendency of many lawmakers might be to favor a federal safety net for insurance much like the FDIC. To offset this, he advised the associations to "stick to your insolvency knitting" by concentrating on protecting consumers and reaching out to key stakeholders, including receivers.

"We are now on a national stage," Richardson said, and any perceived shortcoming among the guaranty associations in what he called the three C's—coverage, caps, and capacity—"is one of our biggest challenges." It is not, he added, an insurmountable challenge. The key for guaranty associations is consistency, both in self-improvement and in telling their story of successful consumer protection. "We must make our case again and again," he said. "In Washington, consensus is built over years, not months."

Andrew Olmem, counsel to the Senate Committee on Banking, Housing and Urban Affairs, gave attendees his perspective on the Capitol Hill discussion of insurance regulation and modernization. He noted that the committee has taken a particular interest in insurance this year (two hearings were held in July) for a

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# Legal Seminar 2006: A Shared Enterprise

I am writing the first draft of this column on August 11, 2006, during the flight home from a NOLHGA Board meeting in San Francisco. The return trip has been anything but normal, because of the arrest yesterday in London of a group of more than 20 would-be terrorists alleged to have been plotting a bomb attack on a number of transatlantic flights.

Many of you will have flown since then; if you have done so (especially in the immediate wake of the arrests), you know firsthand how this plot affected air travel. The impact today is particularly evident, since the events are still so recent and the resulting security precautions are still so makeshift.

One impression, though, is quite clear, even this early in a developing story: Everyone I have encountered in the aftermath of the plot's unraveling—my fellow passengers on this flight, travelers passing through the airport, flight crews, security officers, and employees at the airport (to mention only some)—is treating everyone else with a degree of cordiality, even affection, that I have not seen generally extended to total strangers since the September 11, 2001, terrorist attacks of which this story is a frightful echo. As was true immediately after September 11, there seems to exist a public recognition that what unites us all is so very much more important than the comparatively insignificant issues that may divide us.

Even before today's journey home, I had quite recently been sensitized to that feeling of shared enterprise from experiences relating to the 14th Annual NOLHGA Legal Seminar, which was held on August 3 and 4 (a week ago as I write) in Baltimore. No, I do not mean that during the seminar breaks, participants all joined hands and sang "Kumbaya." Indeed, both at the seminar and at the MPC meeting that preceded it there were a number of spirited debates, some of which remain unresolved. Rather, I am referring to the process of producing the seminar, as conducted by the 2006 Legal Seminar Planning Committee under the very able guidance of its chair, Jan Funk, and Legal Committee Chair Chuck Gullickson.

The 2006 Seminar was the eighth opportunity I've had to work with a Legal Seminar Planning Committee. It would be dishonest to deny that working with these Planning Committees has been one of my very favorite NOLHGA "chores." This year's committee produced a seminar that not only was once again tremendously successful by all conventional measures—it was also genuinely newsworthy. (More on that below.) However, the joy to be derived from working on a project like this has at least as much to do with the preparation process as with the execution of the seminar itself.

For this year's seminar, the work began in December 2005, when Jan began leading a series of sessions during which the committee explored themes, settled on topics, and set about recruiting speakers. As in prior years, the gatherings of the committee developed within its membership a deep sense of shared enterprise and mutual commitment in some ways similar to what I observed today among the traveling public.

I hope that sense of shared mission was apparent to seminar participants during the various seminar panels. It would have been hard to miss, for example, the camaraderie displayed by Frank O'Loughlin, Cindy Oliver, and Tad Rhodes in the litigation developments panel. The same could be seen in a very different panel on solvency regulation featuring Betty Patterson of the Texas Department of Insurance and Mel Anderson of the Arkansas Department of Insurance. And though disagreements may have surfaced among the presenters in the panels on runoffs and life settlements, I suspect that seminar participants were able to sense the depth of care that went into planning those segments by moderators Jack Falkenbach and Doug Furlong (respectively).

The sense of esprit that I hope was evident across the different seminar panels was, to put it simply, a reflection of the esprit that pervaded the planning process from the very beginning.

But beyond being a great shared educational experience, the 2006 Legal Seminar produced some real news. In the context of several excellent presentations on the reform of insurance regulation (including insightful remarks by ACLI President Frank Keating; NAIC Washington office leaders Brett Palmer and Cheye Calvo; senior Senate staffers Andrew Olmem and Stacey Sachs; American Bankers Insurance Association spokesman Kevin McKechnie; and the "Sage of Bedford, Indiana," Charlie Richardson), one presentation drew particularly rapt attention from our audience.

David G. Nason, Deputy Assistant Secretary for Financial Institutions Policy of the United States Department of the Treasury, delivered on Thursday morning (August 3) some carefully prepared remarks that, for the first time in the seven-year-long public debate over insurance regulatory reform, put the Treasury Department "on record" regarding some views about the regulation of the insurance industry generally, and specifically regarding the state-based system of insurance guaranty association protection of consumers. Any doubts that Mr. Nason's views spoke for the Treasury Department were put to rest when the department issued a press release that day with the full text of his speech.

Mr. Nason addressed three broad areas: terrorism reinsurance, the modernization of insurance regulation, and the guaranty system.

***Mr. Nason and Treasury appear to view both the SMART Act and the NIA as essentially respecting the value of the current guaranty system, while believing that either approach would require some important improvements to guaranty associations and how they work with receivers and regulators.***

His comments on terrorism reinsurance highlighted the work that Treasury is now doing with the President's Working Group on Financial Markets to explore the extent to which a federal terrorism reinsurance program may be needed after the expiration on December 31, 2007, of the current Terrorism Risk Insurance Act (TRIA).

On the subject of regulatory modernization, Mr. Nason stated that, while Treasury currently does not support a specific proposal, the department is carefully studying the issue in light of several key considerations. In general, he noted that "the current insurance regulatory system needs to be modernized." Driving factors behind the need for modernization include, in Mr. Nason's view, "potential economic inefficiencies resulting from both the substance of regulation (such as price controls), but also from its structure (multiple non-uniform regulatory regimes)." He also noted that Treasury is exploring the extent to which regulatory impediments are hampering either the ability of foreign insurers to operate in the United States or the ability of U.S. insurers to compete abroad. Mr. Nason summarized by saying that "the question posed…is whether our current state-based system of insurance regulation is up to the task of meeting the challenges of today's evolving and increasingly global insurance market."

By contrast, Mr. Nason's conclusions about the current guaranty system were unequivocally positive. In the first minute of his speech, he observed that, within the broader debate over regulatory modernization, "one thing is clear—the state guaranty fund system has worked well as a mechanism to protect our nation's insurance consumers."

Mr. Nason went on to make a number of comments about insurer insolvencies and the guaranty system that made it obvious that the Treasury Department has given considerable thought to the insurance safety net. He noted that, in any competitive market like the market for insurance, the failure of some companies is inevitable. He also noted the development in the 1960s and 1970s of a national consensus that an insurance safety net was socially important—a consensus that led to the development of our current system.

He reviewed in particular the significant life insurer failures from Baldwin-United in 1983 through the tidal wave of 1991 insolvencies, observing that guaranty associations were "able to react under crisis conditions to events of insolvency and have constantly reinvented themselves to fulfill their mission" and that "the state guaranty system has continued to develop and mature."

Mr. Nason noted particularly that he was sharing his thoughts about the guaranty system with the seminar's informed audience in order to make it clear that, as Treasury continues to review the larger issue of regulatory modernization, "about which there are passionate views on virtually all aspects…the viability and merit of the state guaranty system is rarely, if ever, called into question."

He also observed that one critical issue in the broader regulatory reform debate is the future of the safety net system. In particular, he contrasted the approach of the SMART Act, which would leave in place the current system but likely would necessitate requiring more coordination and cooperation among regulators, receivers, and guaranty associations, with the Senate's pending optional federal chartering bill—the "National Insurance Act of 2006" (NIA) sponsored by Senators Sununu (R-N.H.) and Johnson (D-S.Dak.).

The NIA requires that a federally chartered company participate in the guaranty associations of those "qualified" states where the company writes business. However, Mr. Nason explained that a state would not be qualified unless it had a guaranty association based on NAIC models. In non-qualifying states, the federally chartered company would be required to participate in the National Insurance Guaranty Corporation (NIGC). He described the qualification and NIGC concepts as an effort to incent states to adopt the NAIC guaranty association model statutes.

To put it slightly differently, Mr. Nason and Treasury appear to view both the SMART Act and the NIA as essentially respecting the value of the current guaranty system, while believing that either approach would require some important improvements to guaranty associations and how they work with receivers and regulators.

On that score, Mr. Nason would be safe in believing that the state-based guaranty association system in fact will continue to improve, to "reinvent itself" to fulfill its mission, and to develop and mature.

This long-term trait of the system—continuous self-evalua-

["President's Column" continues on page 12]

# An Arrangement for Everyone?

## Will the U.K.'s schemes of arrangement work for U.S. insurers?

By Joni L. Forsythe

Much has been published of late on the subject of U.K. "schemes of arrangement" and the use of such schemes for expediting the run-off of solvent and insolvent insurance company liabilities. A scheme of arrangement is a statutory procedure authorized under U.K. law that allows a company to propose a plan or "scheme" for compromise and settlement of its obligations to creditors. It has become the tool of choice for both solvent and insolvent insurance companies seeking to expedite closure for select lines of business because it permits them to compromise claims and extinguish liabilities by imposing a binding plan for commutation of policy obligations. Proponents view the scheme mechanism as a tool for maximizing efficiencies and achieving finality with respect to the disposition of run-off business. Others are concerned that it can be used to restructure, compromise, and compel commutation of select policy obligations without affording policyholders the basic rights and protections to which they would be entitled in receivership.

Advocates of the U.K. scheme approach have suggested enactment of similar scheme mechanisms for U.S. insurers and have questioned the reluctance of state regulators to embrace this approach.[1] Any proposal for incorporating this type of scheme mechanism into the framework of U.S. insurance regulation raises important public policy issues. Recognition of the differing legal structures that have emerged in the U.K. and the United States for winding up the business of solvent and insolvent insurers, and the goals and public policies served by each, provides a useful foundation and context for consideration of those issues.

### The U.K. Approach

Historically, insurance companies in the U.K. have been subject to the same reorganization, liquidation, and wind-up laws as every other U.K. commercial enterprise. Unlike the U.S. approach to insurer receivership and liquidation proceedings, the U.K. does not have receivership statutes tailored specifically for the insurance industry. Instead, insurer reorganizations and insolvencies are governed by general corporate and insolvency laws that provide the framework for a broad spectrum of remedies ranging from voluntary creditor workouts, court-sanctioned restructuring plans (including schemes of arrangement), supervisory and administrative

intervention, and voluntary and compulsory liquidation schemes for the wind-up of both solvent and insolvent companies. One significant feature common to each of these statutory remedies has been the absence of any distribution priority scheme for the protection of insurance policyholders. In fact, until very recently, U.K. law has treated policyholder claims against an insurer as general creditor claims. This is in stark contrast to the insurance regulatory and receivership system in the United States, which maintains as its primary goal the protection of policyholders.

In the U.K. today, policyholder claims against an insolvent insurer are afforded priority over other creditor claims. This is the direct result of a mandate imposed upon the U.K. and other members of the European Community by the European Parliament and Council.[2] The directive provides for mutual recognition of the reorganization and wind-up laws of member states and requires, among other things, the implementation of regulations affording direct insured claims priority in connection with any reorganization or wind-up of an insurance company, regardless of whether the company is solvent or the proceedings are voluntary or compulsory. The concept of direct insured priority over reinsurance and other general creditor claims was very controversial in the U.K. and resulted in much debate over the types of proceedings that would be included within the scope of this new rule.

The directive was eventually implemented in the U.K. through adoption of the Insurer's Reorganisation and Winding-up Regulations, effective as of April 20, 2003.[3] However, the scheme lobby prevailed, and schemes of arrangement were carved out of the regulations. It is unclear whether this exclusion would hold up to scrutiny in the European Court.[4] Nevertheless, as discussed further below, the regulations still have an impact on schemes.

**Scheme Components**

The skeletal framework for schemes of arrangement is found in section 425 of the Companies Act.[5] It provides the mechanism for disposing of selected lines of business through commutation or transfer, without requiring individual policyholder consent. It contains no limitations concerning solvency and no restrictions on lines of business, though as a practical matter, certain compulsory lines may be disposed of through transfer rather than commutation. Companies have broad discretion to determine what business and assets to include or exclude from the scheme, as well as the treatment afforded each creditor under the plan.

The scheme provision outlines a three-step process, which begins with the filing of the company's application for an order convening the requisite creditor meetings. The number of meetings required depends on the number of creditor classes established. Similar claims may be grouped in the same class. Step two consists of the creditor meetings. If a majority of creditors representing 75% of the value of the claims in each class present and voting at the meetings approves the scheme, the scheme is deemed approved. Otherwise, the scheme fails, and other alternatives must be considered. If the

**In the U.K. today, policyholder claims against an insolvent insurer are afforded priority over other creditor claims.**

# Compulsory commutation or restructuring of insurance

## mechanism for avoiding liquidation or as a strategy for getting

## undermine essential policyholder and consumer protections and would,

scheme is approved by vote, the company will then file an application with the court seeking a confirmation order. Upon entry of the order, the scheme becomes binding on all creditors, including those who rejected the scheme.

As a practical matter, the fewer classes established under the scheme, the easier it is to secure the requisite majorities. Accordingly, there is a built-in incentive to compress claims into a single creditor class. Not surprisingly, class compression has been the subject of contentious litigation and successful scheme challenges in recent years and continues to be a focal point for fairness challenges.[6]

**The Allure of Schemes**

It is important to understand that the section 425 scheme mechanism evolved as part of U.K. corporate law—not insurance or insolvency law. It serves first and foremost the goals of the company, including rescue of a troubled company, or in the context of solvent schemes, achieving a financial accommodation for the benefit of the company and its shareholders. It is not a consumer or policyholder protection statute.

Arguably, the scheme mechanism offers some distinct advantages to companies seeking to wind up business quickly. First and foremost, it provides finality; i.e., a binding and complete resolution of the liability so that the company has no further exposure on the business. It can be much faster than traditional reorganization or liquidation proceedings, particularly given the short notice periods and limited court involvement. As a result, it can provide a shortcut for freeing up targeted reserve capital. It may also be significantly less expensive than formal reorganization or liquidation, with potential savings resulting from conservative claim estimation and "insolvency risk discounts" used to reduce claim values, as well as the avoidance of regulatory and/or receivership expenses and the costs of ongoing administration of the business.

Moreover, successful schemes can rescue a company from liquidation, leaving open the possibility of business continuation and returns for investors. Solvency margins can grow as a result of favorable claim settlements. The company gets the benefit of the best deals it can negotiate with the majority needed to approve the plan and can then impose reduced values on remaining insureds. Moreover, management can often keep control of the company and its assets throughout the entire process. Unfortunately, these advantages for the company come at the expense of policyholders.

*Insolvent Schemes:* Schemes became popular in the U.K. initially as a mechanism for bringing closure to insurance company insolvencies. Although not required by the scheme statute, schemes for insolvent companies are typically preceded by the entry of an order for administration. Administration orders are considered a practical necessity in most cases because they provide the means for staying collection and enforcement actions, as well as the commencement or continuation of other proceedings (including liquidation proceedings) against the company or its assets for as long as the order is in effect.[7]

Under the U.K. Insolvency Act, administration is available as a tool for a company that "is, or is likely to become, unable to pay its debts," provided the administration order is reasonably likely to achieve the purpose of the administration. Upon entry of the order, an administrator is appointed to pursue specific goals authorized in the act, including: 1) the rescue of the company as a going concern; 2) achieving a better price for the company's assets, or otherwise realizing greater value for creditors as a whole than would be likely if the company were liquidated without first being in administration; or 3) realizing property to make a distribution to one or more secured or preferential creditors.[8] The statute also confirms the ranking of these permissible objectives, placing *rescue of the company* as the very highest priority. Rescue of the company as a going concern has been construed specifically to include facilitating a reorganization of its capital structure through a scheme of arrangement.[9]

As noted above, schemes of arrangement are carved out of the U.K. regulations imposing policyholder claim priority. The validity of that carve-out may become somewhat moot in this context because administration is within the scope of the rules. Accordingly, entry of the administration order to facilitate implementation of a scheme triggers the priority regulations such that policy claims must be paid before other classes of claims. If the scheme provides priority treatment for policy claims, policyholders may have less incentive to reject a plan in favor of liquidation or remaining in run-off.

Once the purpose of the administration is achieved (or is rendered unachievable, because a scheme was rejected or otherwise), the order for administration may be terminated and the administrator discharged. To the extent the scheme has returned the company to solvency, control of the company may revert to the directors and management, and the company can continue as a going concern.[10] The problem, from a U.S. perspective, is that unless policyholders have received full

obligations pursuant to a company-devised scheme, whether as a target lines of business off the books of a solvent company, would therefore, conflict with the overriding goal of U.S. insurance regulation.

value for their claims and have retained full coverage and benefits under their policies—which is extraordinarily unlikely if the company was not solvent—the company has been bailed out and recapitalized at the expense of policyholders.

*Solvent Schemes:* Section 425 schemes have become increasingly popular in the U.K. for solvent companies as well because they provide a mechanism for cutting off long-term policy liabilities to relieve the company of the burden and expense of long-term administration and to free up reserves and other assets for the company and its shareholders. Presumably, a solvent scheme would provide full compensation for creditors. However, this expectation is subject to several qualifications.

As a starting point, these commutation schemes forcibly cash out policy obligations and, in so doing, deprive insureds of bargained-for coverage, which may in some cases be irreplaceable. That aside, full compensation is difficult to achieve. Even if no "insolvency risk discount" is imposed, claim amounts are based on allowed claim values. Moreover, long-term liabilities necessarily require estimation, and estimates under a scheme may tend to be conservative. In addition, companies actively solicit voluntary commutations from select creditors. Accordingly, claim values will reflect adjustments for those commutation deals.

Solvent schemes are deemed to be outside the scope of the U.K. priority regulations. If policyholders and creditors were, in fact, receiving full compensation for their claims, it would not really matter. However, even where full compensation is intended and no discounts are imposed, estimation of values for long-tail claims is a tricky matter, as the case law bears out; and the values are, in the end, just estimates.

This aside, it seems that the priority rules have the potential for significant impact, albeit indirect, on the success of solvent schemes. One consequence may be that direct policy claims become a separate class of claims for purposes of voting on scheme proposals. Because a majority vote is needed from each class to approve a scheme, this could provide pressure for scheme proponents to ensure fair and reasonable treatment for policy claims. Buy-in from the direct policyholder class would be essential, and policyholders would have incentives to reject any plan that appears to provide less than they might recover in liquidation, where the priority rules would apply. Moreover, the threat of insolvency, previously used to encourage scheme approval, may not carry much weight any longer and may, in some cases, be preferred or even initiated by policyholders.

## Closing Thoughts

As reflected in the recent and ongoing solvency and insolvency initiatives undertaken by the European Commission, the legal and regulatory environment within the European Community is changing, with greater emphasis being focused on the protection of insurance policyholders. Recent case law developments within the U.K. in connection with scheme litigation have echoed that shift, and new standards and limitations have been imposed on scheme structures and implementation to address fairness and policyholder protection concerns. Given the reality of this shifting environment, the future viability of schemes of arrangement in the U.K. has been the subject of much debate and contention among U.K. practitioners.

Regardless of how that debate unfolds in the U.K., consideration of this type of compulsory commutation scheme for U.S. insurers raises a multitude of fundamental questions and concerns, far more than can be detailed within the scope of this article. Compulsory commutation or restructuring of insurance obligations pursuant to a company-devised scheme, whether as a mechanism for avoiding liquidation or as a strategy for getting target lines of business off the books of a solvent company, would undermine essential policyholder and consumer protections and would, therefore, conflict with the overriding goal of U.S. insurance regulation. Accordingly, reluctance on the part of state regulators and legislators to consider such scheme proposals is understandable.

As one source has acknowledged, "it is still a radical idea to curtail the contractual rights of a substantial minority that may be opposed to the plan. U.S. regulators and consumers would need time to be comfortable with it. For most legislatures and consumers, the concept of solvent run-off continues to be met with skepticism."[11] ✪

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## End Notes

1. One U.S. state (Rhode Island) has enacted a substantially modified version of a scheme statute that permits voluntary restructuring and dissolution of solvent commercial lines property and casualty carriers, subject to certain limitations and restrictions. This statute is far more limited in scope than the U.K. scheme statute and incorporates some safeguards for policyholders, such as the requirement that any commutation plan not materially adversely affect the interests of objecting creditors or assumption

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["Seminar" continues from page 1]

number of reasons: the global competitive environment, its oversight of the Gramm-Leach-Bliley Act, and the topic of insurance reform.

"For the most part, members are sincerely interested in this issue and haven't come to a lot of conclusions," Olmem said. "It's an honest debate right now." The committee is currently focusing on the problems with insurance regulation and their possible solutions. He noted that this is a unique issue for Congress because "from a federal perspective, it's a clean slate." It's also unique, or nearly so, because the discussion hasn't been prompted by emergencies or huge insolvencies. "It's a good time to have a debate," Olmem said.

While Olmem wasn't certain if the committee would hold more hearings, he predicted that solvency will be a key factor in the committee's analysis: "That issue will always be out there." Competitiveness will also play a major role in the committee's work.

*ACLI President and CEO Frank Keating talked about the "affectionate disagreement" the ACLI has with the NAIC on the need for an optional federal charter.*

J. Kevin McKechnie (American Bankers Insurance Association) traced the optional federal charter issue back to the passage of the Gramm-Leach-Bliley Act in 1999, which first allowed banks to affiliate with insurers and facilitated banks selling insurance. He said that the associations that make up the Optional Federal Charter Coalition, which he chairs, originally supported a federal guaranty safety net but now support the current state-based system. He added, however, that several property and casualty companies do not like having to "foot the bill" for badly managed companies that fail.

The push for a federal charter is in some ways due to simple math, according to McKechnie. The number of state regulators and legislators far exceeds the number of members in Congress, so it should be easier to build consensus on a federal level. With matters such as the Terrorism Risk Insurance Act and flood insurance, Congress has also turned its attention to insurance-related matters with increasing frequency, he said: "There have never been more votes on insurance in Congress than there are now." In his opinion, this and other factors make an optional federal charter far more likely than it was in the past.

McKechnie's views on a federal charter were not shared by the NAIC's Brett T. Palmer and Cheye M. Calvo. The NAIC opposes federal regulation of insurance, Palmer said: "Frankly, we think we do it better." He pointed to the success of the Interstate Compact (which has been adopted by 28 states) and the popularity of the System for Electronic Rate and Form Filing as examples of the state regulatory system adapting to the changing needs of the insurance marketplace.

Photograph by Kenneth L. Bullock

With the passage of an optional federal charter, Palmer added, "state insurance commissioners will effectively be eviscerated." The proposed Sununu-Johnson National Insurance Act removes federally chartered companies from state regulation, he said, but when a company is declared insolvent, "the states get stuck with the bill." The act also fails to address a number of con-

## Catastrophes, Morons & More

### *Overheard at the Legal Seminar...*

"The analysis and examination functions are coming closer and closer together."

*— Mel A. Anderson, Arkansas Insurance Department*

"Receiverships *are* litigation."

*— Franklin D. O'Loughlin, Rothgerber, Johnson & Lyons LLP*

"Our country is in a react and respond mode [to catastrophes]."

*— Edward T. Collins, ProtectingAmerica.org*

"We do believe that catastrophe risk is an insurable risk."

*— Franklin W. Nutter, Reinsurance Association of America*

"The market is only as realistic as its biggest moron."

*— Max J. Rudolph, Mutual of Omaha*

"There's more of a focus on the linkage between risk and value."

*— Jack L. Gibson, Towers Perrin*

sumer protection issues overseen by state regulators, such as prompt payment, clear contracts, and discrimination.

Palmer also warned against a rush to achieve uniformity. "You'll hear about uniformity and how it's the greatest thing since sliced bread," he said. "Let's not pretend that uniformity is the be-all, end-all." He pointed out that in many areas of property and casualty insurance, uniformity is impossible due to state laws. State insurance regulators will continue to pursue uniformity as they work to improve the system, he added, but only where it's warranted. "I'm not saying there aren't problems in the state system—there clearly are," Palmer said. "But we're fixing them."

Calvo said that "the proponents of the federal approach are mischaracterizing insurance" by likening it to the banking industry even though the commitments made in the two industries differ significantly. Citing the Interstate Compact, he pointed out that state regulation is capable of achieving uniformity when necessary, but he also said that "we can't pretend this one tool—uniformity—is the answer to everything. There is no 'one size fits all,' so [federal charter supporters] just want the one size that fits them."

Calvo also said that the National Insurance Act treats consumer protections as "an afterthought" and criticized some of the bill's "ridiculous and quite frankly embarrassing provisions," pointing out that its product review provisions call for self-certification of companies. He warned that a federal charter would do major, and irreparable, damage to insurance regulation. "If the federal government goes down the road to a federal charter, there's no going back," he said. "You can't put Humpty Dumpty back together again."

Frank Keating, president and CEO of the American Council of Life Insurers (ACLI), took a more optimistic view of dual regulation, explaining that the organization supports both modernization of state regulation and the creation of an optional federal charter. He said that "most of our members will remain state chartered" while perhaps 100 companies would take advantage of a federal charter.

That charter is needed for a variety of reasons, Keating said. First, his experience has been that insurance, despite being a multi-trillion-dollar industry, is virtually ignored in Congress. He pointed to a proposal to eliminate capital gains taxes on investment income that did not offer similar benefits to income from annuities. When he asked lawmakers why the insurance industry had not been considered in the bill's drafting, he discovered that "they don't think of us because they don't regulate us."

Keating added that the state regulation system makes it difficult to do business with insurers from other countries. These companies view United States insurance regulation as "a provincial regulatory system," he said. That's bad for business, and Keating made it clear that business is the driving force behind the ACLI's support for an optional federal charter: "The board of the ACLI is neither federalist nor anti-federalist. We're businesspeople. We want to sell products."

Selling products is difficult, he explained, when it can take years to get them approved. Insurance regulations serve as a disincentive to brokers, who can sell other investment products more easily than insurance products. That's bad for the industry and the consumer, Keating said, because these other products don't have the state guaranty associations standing behind them. While praising the associations, Keating also said there's room for

improvement. "We happen to think this system works, but it can work better," he said, calling for increased uniformity in state guaranty laws.

### Run-offs & Settlements

A possible alternative to traditional U.S. solvency regulation was discussed in a presentation on voluntary run-offs and solvency schemes. Vivien Tyrell (Kendall Freeman) explained the U.K.'s policy of allowing a solvent company to stop writing new business and pay off its existing liabilities to exit the insurance industry or a particular line of business. The company must have an operational plan approved by the Financial Services Authority, but run-offs are not limited to insolvent companies. "It is not the case that when a company is in run-off, insolvency is inevitable," Tyrell said.

The U.K. and other European Union countries also allow solvent companies to develop "schemes of arrangement," which are plans to expedite the run-off process by estimating potential future liabilities and submitting a plan outlining payment to creditors (including policyholders). The creditors are divided into classes with similar claims, and each class votes on the plan. If each class approves, the plan is accepted.

These schemes of arrangement have been described as "beneficent and draconian," Tyrell said, because while the schemes should be beneficial to both shareholders and creditors, this isn't always the case. The terms of these schemes "effectively change [the creditors'] relationship with the company" and eventually transfer the risk assumed by the insurance company back to the policyholders. Tyrell also noted that many schemes rely on what she called "creditor inertia"—the companies hope that creditors will miss the deadline for filing claims with the company, and that money instead will flow to the shareholders.

Peter A. Ivanick (LeBoeuf, Lamb, Greene & MacRae LLP) explained how the concepts of solvent run-offs and solvency schemes have made their way to the United States. Rhode Island has passed a "voluntary restructuring act" designed to facilitate run-offs through involuntary commutations and assumption agreements, and the Connecticut and New Mexico legislatures both considered proposals for "voluntary reorganization acts" that were even more flexible than Rhode Island's act.

The main question, Ivanick said, is whether a solvent company has the right to impair the contract rights of its policyholders. Since the Rhode Island act allows companies to estimate future liabilities (as in the U.K.), policyholders also need to be concerned about whether the methodology used will favor the company at their expense.

The Rhode Island act allows companies to redomesticate to Rhode Island to take advantage of the voluntary restructuring act (for which Rhode Island collects a fee), and it applies only to commercial property and casualty insurers. The requirement for court approval of the run-off plan—that it not "materially adversely affect" the interests of the creditors—is "not much of a standard," according to Ivanick. "That's not too tough to hit."

Unlike the U.K. practice, reorganization plans under the proposals previously made (but not adopted) in Connecticut and New Mexico could be approved even if one or more classes of creditors opposed them—what Ivanick called "cram down," since the plans would be forced on creditors who voted against them: "In these plans, we have cram down with a vengeance."

The Connecticut and New Mexico proposals were modeled on Chapter 11 bankruptcy laws here in the United States, Ivanick said, and "there is no insolvency requirement for being an applicant." However, he believes that the courts would impose a "good faith requirement" so that companies would have to explain why they're seeking to reorganize.

The seminar tackled another controversial topic with a panel presentation on life settlements—the sale to a third party of a policy for more than its cash settlement value but less than its death benefit. Michael D. Freedman (Coventry First) explained the parameters of this growing market

> "If the federal government goes down the road to a federal charter, there's no going back," the NAIC's Calvo said. "You can't put Humpty Dumpty back together again."

(known as the secondary market), which has seen an influx of capital as well as an increasing number of interested policyholders who are being directed to the market by their financial advisors.

"Lenders have come to realize there's a value in the policy itself other than the surrender value," Freedman said, and they are taking the policy as collateral on loans. This creates a possible incentive for people to acquire insurance they don't truly need to satisfy a third-party investor. There must be an insurable interest at the time a policy is issued, and the possibility of a preexisting contract to sell the policy at a later date brings into question the legitimacy of the insurable interest.

George T. Coleman (Prudential Financial) called the secondary market and the changes it has brought to the insurance industry "revolutionary, antithetical to the bedrock principles of life insurance, and dangerous to our customers." Policies are priced and sold using actuarial predictions of early deaths, lapse rates, etc., and the secondary market makes these predictions invalid. Some companies in the market use factors such as lapse rates to criticize the industry, he said, but "factoring lapses into the premium is not encouraging them. An insurer that didn't do the math wouldn't last long in this business."

Both Freedman and Coleman agreed that the NAIC and the ACLI have advanced proposals to constrain or even eliminate the secondary market. James R. Mumford (Iowa Insurance Division) doesn't think these efforts will succeed. "It's my opinion that this market is here to stay," he said, "and I see a real need for strong regulation." This need stems, he said, from the nature of the secondary market. It targets seniors, who are often the victims of fraud. It changes the concept of insurable interest and also creates "a financial risk to companies," he said, thanks to its effects on lapse rates and other principles underlying pricing and sales. The practice of premium financing by lenders brings with it a potential for fraud, and the entire market raises questions about guaranty coverage.

Mumford also said that life settlements change the very nature of the product. "When a policy hits the secondary market, is it an investment rather than an insurance product?" he asked. "To me, that's a security, and the security people should regulate it." ✭

*Sean M. McKenna is NOLHGA's director of communications.*

# 2007 MPC Meetings

**January 15–17**
Hyatt Regency Grand Cypress
Orlando, Florida
407.239.1234
http://grandcypress.hyatt.com/hyatt/hotels/index.jsp.

**April 18–20**
Hyatt Regency Philadelphia at Penn's Landing
Philadelphia, Pennsylvania
215.928.1234
http://pennslanding.hyatt.com/hyatt/hotels/index.jsp

For more information, contact Sean McKenna at smckenna@nolhga.com.

["U.K. Schemes" continues from page 7]

policyholders. However, like the U.K. scheme, it provides a cram-down mechanism for commutation plans. Significant questions have been raised with respect to the Rhode Island statute, including whether such a scheme would be recognized and enforced in other states. The Rhode Island statute was adopted in June 2002 but has never been implemented. In the past few years, scheme legislation has been introduced in Connecticut and New Mexico. However, it has not been adopted in either state.

2. Directive 2001/17/EC of the European Parliament and Council on the Reorganisation and Winding-up of Insurance Undertakings.
3. Insurer's Reorganisation and Winding-up Regulations (2003), revised by statutory instrument 2004 No. 353.
4. In January 2004, the European Commission referred the U.K. and seven other member states to the European Court of Justice for having failed to fully implement the directive. At that time, the U.K. did not have regulations implementing the directive with respect to the Lloyds insureds. Regulations governing Lloyds were adopted shortly afterward.
5. Companies Act 1985, §425.
6. See, British Aviation Insurance Company Ltd. [2005] EWHC 1621 ("BAIC") and its progeny.
7. Amendments to the Insolvency Act in 2002 and 2003 removed a prior prohibition against the use of Administration Orders for insurers.
8. Insolvency Act 1986, Sch B(1), ¶3.
9. See, John Armour and Rizwaan Jameel Mokal, "Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002," Working Paper No. 289 published by the ESRC Center for Business Research, University of Cambridge, June 2004.
10. Janie Anderson Castle, Peter Castle, "Through the Looking Glass—English Insolvency Law," Bankruptcy Litigation, Newsletter of the Bankruptcy and Insolvency Committee published by the American Bar Association, Vol. 12, No. 02, Summer 2005.
11. Kim Moore, "Breaking Down the Barriers," U.S. Insurer, June/July 2005 at p. 3 (Quoting Nick Pearson, partner at the law firm Edwards & Angell).

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The views expressed herein are those of the authors and do not necessarily reflect those of NOLHGA or its members.

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["President's Column" continues from page 3]

tion and reinvention—that is obvious even to an outsider like Mr. Nason is no accident. Rather, it stems from fundamental characteristics and perspectives of all the constituencies of our system today: the shared sense of our system's mission in protecting consumers; an indefinable esprit based on mutual commitment to fulfill the purposes for which guaranty associations were created; and a recognition that, within the guaranty system family, the goals that unite us all are much more important than any comparatively insignificant disagreements. ✭

*Peter G. Gallanis is president of NOLHGA.*

## NOLHGA Calendar of Events

### 2006

| Date | Event |
|---|---|
| **October 9** | **MPC Meeting**<br>**Dana Point, Calif.** |
| **October 10–11** | **NOLHGA's 23rd Annual Meeting**<br>**Dana Point, Calif.** |
| October 22–24 | ACLI Annual Conference<br>Orlando, Fla. |
| November 2–3 | Joint NCIGF/IAIR Seminar<br>Salt Lake City, Utah |
| December 9–10 | IAIR Winter Quarterly Meetings<br>San Antonio, Tex. |
| December 9–12 | NAIC Winter National Meeting<br>San Antonio, Tex. |

### 2007

| Date | Event |
|---|---|
| **January 15–17** | **MPC Meeting**<br>**Orlando, Fla.** |
| March 10–13 | NAIC Spring National Meeting<br>New York, N.Y. |
| **April 18–20** | **MPC Meeting**<br>**Philadelphia, Pa.** |
| May 3–4 | NCIGF Annual Meeting<br>Baltimore, Md. |
| June 2–5 | NAIC Summer National Meeting<br>San Francisco, Calif. |
| September 29–October 2 | NAIC Fall National Meeting<br>Washington, D.C. |