THE GENEVA ASSOCIATION

Observations on the U.S. Resolution System for Property/Casualty Insolvent Insurers: The Lumbermens Mutual Group Case Study

A GENEVA ASSOCIATION RESEARCH REPORT

April 2016

The Geneva Association

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* The authors John K. Conway, James W. Schacht and Kenneth R. Wylie each served as legal counsel or consultant to the Lumbermens Mutual Group (LMG) before and during the run-off. They were closely involved in the operations of LMG and the issues facing LMG in the course of its run-off. The factual information provided in this case study was obtained from public and/or non-confidential sources. The opinions expressed and conclusions reached are those of the authors only and are based on their close experience with LMG and with the general subject matter of this research report, and not of any organisations with which they were or are affiliated. The authors wish to thank Lynne Prescott Hepler, Senior Managing Director of The Schacht Group, Inc., for her insights and contributions to the preparation of this research report.

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FOREWORD

The Geneva Association, a think tank for the global insurance industry, has produced numerous studies providing research insights on issues of insurance and financial stability. One such issue was the resolution of troubled insurers, which was examined in detail in The Geneva Association's *Insurance and Resolution in Light of the Systemic Risk Debate* (February 2012) on the basis of specific insurer insolvency case studies.

In this research report, we examine the process of resolution of property/casualty (P/C) insolvencies in the United States through its state receivership system and present a detailed case study of the decade-long wind-down of Lumbermens Mutual Group (LMG).

This research report builds upon our January 2015 report *U.S. and Japan Life Insurers Insolvencies Case Studies: Lessons Learned from Resolution*.

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The editor thanks the group that has worked diligently on the Lumbermens Mutual Group (LMG) story. Using only public and non-confidential information, John Conway, Jim Schacht and Ken Wylie have provided a new perspective on insurance resolution. A summary of their work originally appeared in The Geneva Association's *Insurance and Finance Newsletter,* August 2014.

Finally, we appreciate the in-depth reviews and assistance we received from our Members' companies during the production of this report.

EXECUTIVE SUMMARY

This research report concerns the resolution of insolvent property/casualty (P/C) insurers in the United States (U.S.). Part 1 provides a brief overview of the U.S. resolution system, a state-based (not federal) system backed by a state guaranty fund system safety net.

Part 2 is devoted to the case study of Lumbermens Mutual Group (LMG). A. M. Best & Co. lowered LMG's rating in December 2002 because of its capital position, and the company went into run-off in 2003. The failure occurred when LMG was unable to raise capital through an initiative to demutualise after steps towards rapid growth met with mixed results in the late 1990s. Although LMG was one of the largest American P/C insolvencies to date, it did not enter formal receivership until 2012, after 90 per cent of its liabilities had been resolved. With the expertise of in-house employees, under the supervision of the Illinois Department of Insurance and in cooperation with other insurance regulators, the LMG resolution involved a decade-long run-off. The policyholders, who were mainly commercial insureds, were able to find replacement coverage with other suitable insurers and often to negotiate solutions for pending and future claims with LMG through voluntary policy buy-backs and novations.

Part 3 of this research report offers some further insights and lessons learned from the LMG case study, in particular:

- **There are alternative methods to resolve insurance insolvency cases in the U.S. within the window between the detection of a troubled insurer and instituting receivership.**
  Formal systems provide an important measure of stability and confidence for policyholders. In the U.S., the primary method for resolution is a process grounded in state statutes governing formal judicial receivership proceedings including liquidation, triggering the 50-state guaranty fund system.
- **Less formal processes such as voluntary run-off may be an alternative to resolution of an insurer in financial hardship.**
  There are no studies showing more or less favourable results for policyholders under the run-off scenario as opposed to immediate liquidation with the triggering of guaranty funds. Voluntary run-off is less formal and requires strong cooperation between the insurer and the insurance regulators to protect policyholders to the best possible extent, as in the LMG case. As discussed in the case study, LMG was ultimately placed into receivership, but as a much smaller and less complex entity.
- **The U.S. early warning system has improved regulation for solvency.**
  In the U.S., a risk-based capital regime was introduced in the 1990s to provide

capital adequacy standards and legal requirements for insurance regulators and insurers to act to resolve the problems facing a troubled insurer. This early warning system continues to evolve in response to insolvencies and events (such as the financial crisis of 2007–2008).

- **U.S. P/C insolvencies did not disrupt either the U.S. financial sector or the U.S. economy.**
  The LMB insolvency, one of the largest P/C insolvencies, showed there was no interconnectedness and there were ample substitute insurers available to write the coverages for displaced policyholders. The resolution system in the U.S. appears to protect the policyholders in an orderly manner.

A summary of the LMG insolvency is shown in the following table.

Overall findings for LMG run-off (2003–2012)

Product characteristics	Main causes of insolvency	Regulation and industry actions	Lessons learned for resolution
• Most major P/C commercial lines. • Large market share in the U.S. of mandatory workers' compensation line. • Limited operations in the U.K., Canada, Australia, Singapore, Bermuda and Europe.	• Insufficient reserves on old claims such as asbestos. • Mutual insurer status caused difficulties in raising capital. • A mutual insurer that attempted to diversify into new markets in order to stabilise its overall operations and capital base. • The U.S. risk-based capital measure was breached and the insurer went under regulatory supervision. • LMG was downgraded by A. M. Best & Co. from an A- to a B+, which forced LMG to withdraw from ratings sensitive businesses and ultimately enter run-off.	• Illinois regulators agreed to and supervised a voluntary wind-down for 10 years, with 10% of insurance liabilities remaining when it went into liquidation and triggered the guaranty funds. • Certain large commercial policyholders agreed to negotiate with the insurer regarding claims, reducing LMG's claims reserves. • Replacement coverage was found during a rolling one-year period (versus immediate cancellation of coverage when reaching liquidation proceedings).	• Troubled insurers can be resolved in alternative ways. The resolution process has a window from the identification of a troubled insurer and formal receivership. • Voluntary run-off is one alternative to explore before receivership. There is no proof it is more or less effective in protecting policyholders than liquidation or the use of guaranty funds. • The expertise of the employees of the insolvent insurer may be helpful. • Under the run-off policyholders were served by payment in the ordinary course or disengagement transactions with regulatory approval. Replacement coverage was readily obtained as policies expired. • While insurers are part of the wider financial sector, their connections may not extend so far as to cause systemic risk.

PART 1

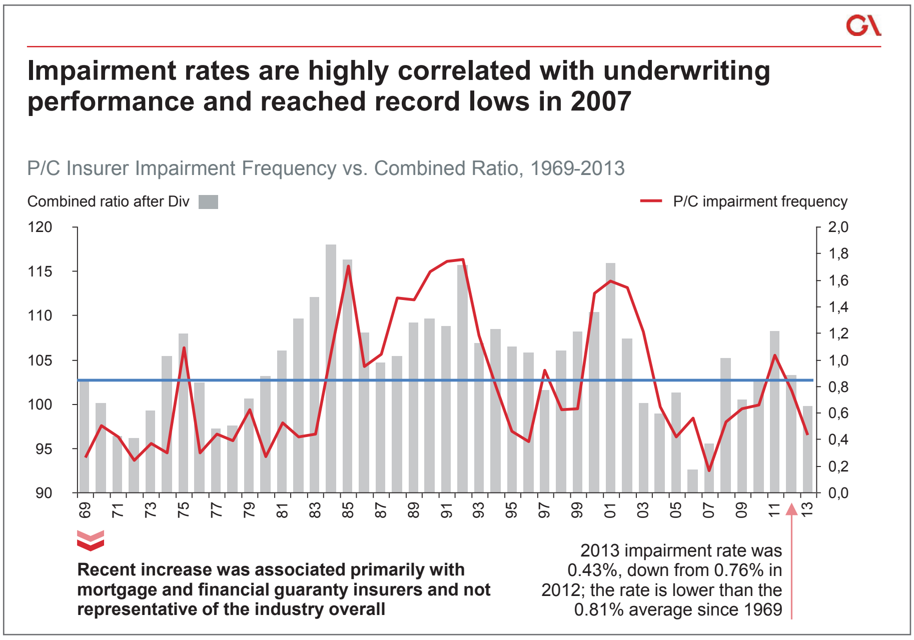
U.S. PROPERTY/CASUALTY INSOLVENCIES AND RESOLUTION SYSTEM

U.S. P/C INSURANCE MARKETS AND INSOLVENCIES

This part provides a background review of the market conditions and applicable causes of insolvencies of property and casualty (P/C) insurers in the U.S. over the past 45 years. It then explains the nature of formal receiverships in the resolution of insolvent insurers and suggests that the time between the identification of a troubled insurer and the inception of a formal receivership, including liquidation with the triggering of the guaranty funds for 'covered claims,' might be considered as a 'window' for possible alternative approaches. One such option might be the use of the window as a period of informal 'run-off', when an insurer operates under heightened regulatory oversight and not under a formal receivership subject to the review of a court.

P/C MARKET MECHANISM—UNDERWRITING CYCLES

Figure 1



Source: Hartwig (2014), p.37, from *http://www.iii.org/sites/default/files/docs/pdf/geneva-110414.pdf*

P/C insurance markets have tended to fluctuate in a cycle called the 'underwriting cycle,' which is illustrated in Figure 1 using a comparison of impairment frequency versus the combined ratio for the period 1969–2013. The 'combined ratio' is defined as the sum of incurred losses and operating expenses measured as a percent of earned premium. Fluctuations of the combined ratio characterise the so-called 'soft' and 'hard' markets. Insurers usually achieve underwriting profitability by balancing their underwriting results with investment income. When the combined ratio is very high, losses are high relative to premiums, but insurers can sustain more losses when investment income is high. Insurers often compensate for underwriting losses by relying on investment income, which is known as 'cash flow underwriting'. As losses continue to increase and investment income becomes inadequate to fully offset those losses, the cycle turns hard and insurers increase premiums and tighten their underwriting standards. It also can occur that when the markets harden, some insureds can no longer afford the increased premiums for coverage or become uninsurable.

It is notable that the correlation between the underwriting cycle and insolvencies was somewhat more pronounced in the older years in the chart (Figure 1) and less pronounced in later years for U.S. P/C insurers. This decrease in the correlation between underwriting cycles and current insolvencies suggests that the incidence of troubled insurers today is less the product of external financial conditions facing the industry as a whole and more the result of pricing and strategic decisions made by individual insurers. Similarly, the sporadic incidence of troubled insurers in the current insurance market suggests that U.S. P/C insolvencies do not pose a systemic risk to the financial system.

U.S. P/C RESOLUTION PROCESS: THE NATURE OF U.S. INSURANCE RECEIVERSHIPS

U.S. insurers are not subject to the U.S. Federal Bankruptcy Code.[1] Instead, the insolvency of a U.S. insurer and its wind-up are subject to the laws of the state in which the insurer is incorporated and domiciled. Each state has a statutory process to deal with a troubled insurer that typically involves one or more of the three stages of receivership: conservation, rehabilitation and liquidation. Each stage is subject to a state-supervised process where the domiciliary insurance regulator is appointed 'conservator', 'rehabilitator' or 'liquidator,' as appropriate.

1 11 USC §109 (b) (2).

These state receivership statutes were first introduced in the early 20th century. While these state statutes have been amended from time to time, their fundamental structure, including the three stages of receivership, has remained unchanged. The National Association of Insurance Commissioners' (NAIC) Insurer Receivership Model Act (#555), first introduced in 1977, has also been periodically updated. These statutes apply to both P/C insurers and life and health insurers, even though the type of business written and the types of claims that arise are significantly different. Insolvency for a P/C insurer almost always leads to a formal receivership process involving liquidation under these statutes.

In the late 1960s, in response to the failures of automobile, fire and workers' compensation insurers and the resulting demands for consumer protection of insureds and claimants against insureds, the NAIC and state legislatures began to introduce state P/C casualty insurance guaranty funds.[2] The guaranty funds satisfy certain claims of insureds in the event of the liquidation of a P/C insurer, i.e. a safety net for consumers. Guaranty funds receive funding through the assessment of their members (P/C insurers licensed to do business in the applicable state). In some cases, these members' assessments are later reimbursed through tax credits and premium surcharges or rate increases for amounts that cannot be collected from the insolvent insurer's estate. To some extent, the U.S. insurance-consuming public is ultimately paying for some of the shortfall of failed P/C insurers.

Guaranty funds, however, only pay certain types of claims for relatively low statutory limits (typically USD 300,000 per claim, but there is no such limit on workers' compensation claims). For personal lines business, i.e. payment of claims related to automobile accidents, fires and injuries to workers, the guaranty funds have performed very well. A number of guaranty funds have a limitation on payment of claims involving high 'net worth' insureds and claimants.[3] (Notably, neither California nor New York, both large states, has such a limitation.) This results in some commercial claims not being paid by some guaranty funds. Further, commercial insureds often purchase sophisticated insurance products with complex reinsurance programmes involving large self-insured retentions (or captive insurance programmes) from insurers operating on a national, if not international, basis. Inserting multiple guaranty funds (which exist in 53 states and U.S. territories) to handle claims of large commercial insureds results in potential inefficiency, duplication of effort and additional expense.

2 NAIC Property and Casualty Insurance Guaranty Fund Model Act (#540).
3 NAIC Model Act (#540), §13.

A similar, but separate, set of state guaranty associations provide a safety net to consumers for the insolvency of U.S. life and health insurance companies.[4] Because of the nature of life and health insurance business, the guaranty associations operate in a coordinated fashion (and not claim by claim as is the case for the P/C guaranty funds) in dealing with 'troubled' life and health insurers. They are also typically activated prior to liquidation (e.g. during the rehabilitation stage of a U.S. receivership). For a full discussion of these state guaranty associations and their involvement with state receivership proceedings, see The Geneva Association report entitled *U.S. and Japan Life Insurers Insolvencies Case Studies* (2015).[5]

During the period 2000–2003, an unprecedented number of large U.S. P/C insurers became financially troubled and ceased writing business.

These insurers ceased writing in the same year they were placed into state liquidation proceedings, triggering the obligations of multiple guaranty funds to pay claims. The exception was Lumbermens Mutual Group (LMG), one of the largest P/C insurers in the U.S. LMG was placed into a supervised run-off in Illinois in 2003 when it ceased writing business. It was then placed into rehabilitation in 2012 followed by liquidation in 2013. LMG is discussed in detail in Part 2 of this research report.

The process of dealing with U.S. commercial P/C insolvencies is subject to state receivership statutes supported by guaranty funds introduced decades ago. Because of the evolution of the industry, resolution of sophisticated commercial P/C insolvencies requires a correspondingly flexible and responsive system. There could be ways to update and improve the existing U.S. receivership system, including the vital role of guaranty funds, to provide a more effective system for insureds, creditors, reinsurers and other stakeholders involved with troubled commercial P/C insurers. Such a discussion, however, is beyond the scope of this research report. Nonetheless, there are steps that can be taken within the existing state insurance regulatory and receivership framework that can enhance the current U.S. receivership system.

Possible Enhancement to the Current U.S. Receivership System

Because of the development of improved financial surveillance laws and tools over the past few decades in the U.S. and other changes, insurance regulators are

4 NAIC Life and Health Insurance Guaranty Association Model Act (#520).
5 Available at *https://www.genevaassociation.org/media/913756/ga2015-insurance-resolution.pdf*

alerted earlier to the possibility that a P/C insurer is having financial problems.[6] In particular, the risk-based capital (RBC) law has been effective in providing 'early warnings' to both the insurance regulators and the troubled insurer.[7] The RBC law requires the P/C insurer and/or the regulator to act when the risk-based capital ratios are breached. In addition, the analytical tools used by insurance regulators (and auditors) during financial examinations assist the early detection of troubled insurers. Finally, the ability to recognise solvency related-problems at an early stage when the cessation of further underwriting is inevitable also suggests an ability to manage troubled insurers through an extended pre-receivership stage and avoid an abrupt transition to receivership as might have been necessary in the past.

Once a P/C insurer is identified as financially troubled, a relatively simple step that could be implemented is to create a 'window' of time to evaluate alternatives to traditional receivership, including liquidation and triggering of the guaranty funds for covered claims. Specifically, this window would allow insurance regulators, working with the major creditors and potential creditors (e.g. guaranty funds) and interested counterparties (e.g. reinsurers), to develop a plan of resolution to possibly avoid (or at least defer) insolvency and the formal step to receivership, including liquidation. Such a plan would identify the problems and propose a solution or process to address the problems. For example, the plan could speed resolution through voluntary agreements to address such things as long-tail and complex claims and the related reinsurance collections.

The stages of conservation and rehabilitation under the existing U.S. receivership system are designed to provide this window to explore and evaluate options to resolution. Another existing regulatory mechanism that would provide for this window of time is the use of corrective or supervisory orders issued by the domiciliary regulator to 'order' the troubled insurer to undertake certain steps to minimise, correct or remove the items causing the financial difficulty. Such orders would be tailored to the circumstances of each troubled insurer and are often issued on a confidential basis.

6 The expanded role of rating agencies over the past two decades has also enhanced the lead time for identifying financial problems than may have existed in the past.

7 The Risk-Based Capital Model Act (#312), which was developed by the NAIC in the mid-1990s and has since been substantially adopted by all U.S. states. Effective 1 January 2015, a new NAIC model act requiring insurance companies to prepare 'ORSA reports' was adopted—NAIC Risk Management and Own Risk and Solvency Assessment Model Act (#505). As the individual states pass legislation requiring ORSA reports, the ability of insurance regulators to identify financial problems with U.S. insurers will be further enhanced.

One alternative to 'formal' receivership, including liquidation, to be considered during this window is a supervised run-off. Run-offs could be an attractive alternative when a large commercial P/C insurer writing nationally (or internationally) is in financial trouble. Because of the existence of complex claims and reinsurance programmes, it is suggested that the retention of existing claims and ceded reinsurance personnel (and even senior management) would maintain continuity of claims handling and collections (e.g. reinsurance, additional premiums and deductibles). This avoids the introduction of 'new' personnel by the receiver (as rehabilitator or liquidator). The retention of institutional memory maximise in the short term the value of the troubled insurer in other ways as well, e.g. asset disposition, including the sale of operations. Stated differently, by exploring ways to 'defer' the receivership in order to slim down the troubled insurer, the insurer could more easily be handled under the existing U.S. receivership system.

PART 2

A CASE STUDY: THE RESOLUTION OF LUMBERMENS

LUMBERMENS FROM 1990 TO 2012[8]

This Lumbermens Mutual Group (LMG)[9] case study provides a summary of the background, history, implementation and results of the Lumbermens Mutual Casualty Company (Lumbermens) wind-down, as follows:

- During the 1990s, LMG was challenged to meet competitive pressures and responded with a wide variety of changes in management, underwriting initiatives, capital enhancements and other organisational improvements.
- During 2001–2002, LMG was pushed by rating agencies to further enhance its capital position, a particularly difficult task for a mutual insurance company. Demutualisation proved to be an unavailable solution during this period preceding run-off due to the lack of willing third-party capital. After the run-off began, demutualisation was not only impractical, but unnecessary.
- The rating downgrade at year-end 2002 was quickly met with the responsible decision to enter run-off. As Lumbermens expeditiously changed from an operating company to a full-scale wind-down, its focus shifted from an attempt to maintain its status as an underwriting enterprise to one centred on the sole objective of paying claims. As a result of this shift in focus, 2003 became a transition year characterised by a wide variety of transactional initiatives to aggressively shed business lines and expenses.
- The execution of the formal run-off plan, beginning in 2004 and continuing through mid-2012, was characterised by highly focused attention on liability reduction, through both ordinary course claim payments and voluntary disengagement agreements with large insureds, further aggressive expense savings, and consistent treatment of counterparties. It set the stage for the eventual transition to receivership in July 2012.

8 Details of the LMG strategic and transactional history and financial results, both before and during the run-off period, are extensively described in public disclosures made by LMG in its various regulatory filings and other statements, including those available at *http://www.lmcco.com/financial_information.html*. This information is referred to as the 'Lumbermens Primary Source Material.' See reference list on p. 39.

9 LMG did business under the trade name 'Kemper', the surname of the company's founder, James S. Kemper. As part of the LMG's wind-down, the trade name was sold in 2010 to Unitrin, Inc., an unrelated company which now does business under the Kemper name. In this case study, the Kemper name may be used to describe the legal name of various LMG companies.

LMG'S GROWTH AND RISK PROFILE

1994–1996: Setting the stage. As LMG's flagship company in 1996 and for decades earlier, Lumbermens (formed in 1912) had been the lead company in an intercompany pooling arrangement,[10] the employer of essentially all LMG employees, the provider of virtually all services to its affiliates, including American Manufacturing Mutual Insurance Company (AMM) (a mutual company, which came under Lumbermens control in the 1930s), and the reinsurer of most of the business written by those affiliates. These attributes remained relatively constant until LMG moved to run-off status in early 2003.

1996–1997: Management changes and capital growth through the sale of subordinated debt. In mid-1996, LMG began to actively recruit management from outside the organisation. One of the goals of this new management was to diversify LMG's product offerings in order to be a broader market for most of the business insurance needs of brokers, agents and customers. LMG went on a fast-growth path, adding numerous profit centres through acquisitions of both insurance companies and 'intellectual capital' (individuals hired to bring particular insurance product expertise to LMG), as new 'profit centres'. Another significant challenge to LMG in 1996 was its limited capital. Rating agencies threatened at that time to drop the group to below an A level. Asbestos and environmental exposures, an industry-wide issue, hit LMG particularly hard due to its long history of writing casualty coverages (both in connection with its core workers' compensation primary business and its assumed reinsurance operations). LMG had experienced a prolonged period of inadequate operating profitability and was subject to both investment and underwriting risk (having a total investment in equities which nearly equalled its total policyholders' surplus and property catastrophe windstorm risk (due to its coastal concentrations). LMG reduced these two risks in the late 1990s through reinvestment and reinsurance, respectively. Moreover, it addressed immediate capital needs through the sale of USD 700 million of surplus notes issued in late 1996 and 1997.[11] About half of the proceeds from the surplus notes issuances were contributed to the capital of LMGs assumed reinsurance operation. Much of the remaining proceeds were added to

10 A term commonly used to refer to a set of reinsurance and cost-sharing agreements among affiliates that are frequently used to spread net underwriting risk and expenses among an insurance group, to handle personnel and other common expenses among affiliates, and to efficiently allocate capital.

11 Surplus notes are a form of highly subordinated debt for which the payment of interest and repayment of principal at maturity are subject to the approval of the domiciliary regulator of the issuing insurance company. As highly subordinated debt, the proceeds of the issuance are included in policyholder surplus and not as a liability.

the pooled companies' surplus to support significant reserve increases. With the increased capital and new management who focused on growth strategies, the LMG's A.M. Best rating stabilised at A (until 7 May 2002).

1997–2000: Rapid growth of underwriting entities and premiums. During this portion of LMG's history, the corporate structure was completed through a series of acquisitions and new company formations. The resulting corporate structure raised significant challenges for both LMG and its domiciliary regulator, the Illinois Department of Insurance (henceforth 'the Department'), in designing and implementing the orderly wind-down of a very large and very complicated organisation. In all, from 1997 through 2000, LMG added almost 20 insurance subsidiaries as well as various related non-insurance companies.

By 2001 and through most of 2002, LMG offered most types of personal and commercial P/C insurance in all 50 states, the District of Columbia, U.S. territories and possessions, and major foreign markets (including Canada, Mexico, Australia and Europe). LMG marketed its insurance products primarily through independent insurance agents and brokers. In addition, it offered risk management and claim services (including medical bill audit, utilisation review, disability case management, loss control engineering, and corporate claims) through the National Loss Control Service Corporation (NATLSCO), a wholly owned subsidiary. LMG's most significant product lines included workers' compensation, automobile, commercial multiple peril, inland marine, directors and officers liability, professional liability, excess casualty, surety, warranty and homeowners insurance.

DISTRESS LEADS TO DEMAND FOR CAPITAL (AND DELEVERAGING)—A DEFINITIVE SOLUTION IS NEEDED

2001: Strategic initiatives. Leading up to the ratings downgrade in late 2002, LMG attempted to streamline its operations, reduce operating expenses and sell or discontinue unprofitable operations or operations deemed not to be core to LMG's future business plans. Subsequent to the terrorist attacks of 11 September 2001, LMG accelerated its efforts to raise capital and enter into reinsurance arrangements to support its future business plans. These efforts included the Kemper Commercial transaction with members of the Berkshire Hathaway Insurance Group (Berkshire) and the sale of Kemper's U.S. personal lines operations to Unitrin, Inc.

2002: Ratings pressures and resulting downgrades. By the beginning of 2002, LMG was capital constrained, having added significantly to reserves in 2001 and having implemented accounting changes (to reflect then recent accounting codifications providing for more stringent standards relating to expenses and other items). At 31 December 2001, LMG reported approximately USD 1.3 billion of policyholders' surplus (on a combined basis), with AMM reporting approximately USD 1.5 billion of policyholders' surplus. These amounts were 25 per cent less than a year earlier. By early 2002, LMG had engaged investment bankers to explore capital-raising alternatives, including a sponsored demutualisation or the formation of a new Lumbermens subsidiary in which outside capital could invest ('Newco').

In March, both Moody's and Standard & Poor's placed all LMG on credit watch. In mid-April, Fitch Ratings lowered its financial strength rating of LMG to BBB, the first time any rating agency dropped LMG to below an A- level. The market insecurity caused by ratings concerns led LMG to exit the capital-intensive specialty excess property business by moving it to run-off in April.

This heightened the need to complete two transactions then being negotiated. In April 2002, LMG announced an agreement to sell the renewal rights for its U.S. personal lines to Unitrin, Inc. At the same time, LMG and Berkshire announced the planned formation of a strategic arrangement, which included an equity investment by Berkshire Affiliates in LMG's new Kemper Commercial subsidiary. Berkshire would thereby obtain a 15 per cent ownership in the subsidiary, as well as various reinsurance relationships with substantial economic surplus benefits to LMG. In May 2002, A.M. Best downgraded LMG to A-, but privately warned that failure to close the two pending transactions with Unitrin and Berkshire by July would cause further downgrades. The two transactions closed at the end of the second quarter.

In August 2002, Moody's downgraded LMG's financial strength rating from A2 to Baa1, changing its commentary from 'credit watch with negative implications' to 'developing'. By the end of September 2002, the continuing effort to find a sponsor for a demutualisation failed, despite approaches by investment bankers to both potential strategic (insurance company) and potential financial (venture capitalist) buyers. In October 2002, LMG sold approximately 500 acres of land adjacent to its home office complex and subsequently sold the surrounding Kemper Lakes Golf Course.

In late December 2002, the three major ratings agencies downgraded LMG to the 'B' level. In what proved a final, but unsuccessful attempt to head off a company-wide run-off, or at least to delay it in an effort to preserve the value of renewal rights or businesses to be sold, LMG announced an agreement with a key Berkshire subsidiary, National Indemnity Company (NICO), to provide a cut-through endorsement on select LMG policies. The cut-through provided for a direct claim liability by NICO in the event LMG was unable to pay certain claims due to formal insolvency. These arrangements ultimately failed to preserve an ongoing market for those lines of business subject to the cut-through, with the resultant over-collateralisation inherent in these encumbrances placing substantial strain on LMG liquidity.

Results of operations and surplus for the years ending 31 December 2000 through 31 December 2002. LMG was unable to generate internal capital to sustain its surplus base, which deteriorated by USD 1.1 billion or 61.6 per cent from 31 December 2000 to 31 December 2002, including the effects of USD 1.13 billion in direct reserve strengthening. In addition to the weak operating results and significant net realised capital losses, surplus was negatively impacted by USD 419.4 million related to the adoption of certain provisions in the National Association of Insurance Commissioners' (NAIC) Statutory Accounting Manual, which became effective on 1 January 2001, USD 173.8 million related to LMG's minimum pension liability, USD 168.2 million related to a change in accounting for policyholder dividends, and the remainder to various other factors. As a result of the significant deterioration in surplus, LMG's risk-based capital ratios and financial strength ratings were under significant pressure.

Risk-based capital rules impose new capital restrictions. Under risk-based capital rules enacted in the 1990s in Illinois and elsewhere, state regulators were empowered to mandate remedial action for inadequately capitalised companies. In Illinois, the risk-based capital rules provide for four different levels of regulatory action depending on the ratio of a company's total adjusted capital to its risk-based capital.[12] The law required increasing degrees of regulatory oversight and intervention as a company's risk-based capital declines. The level of regulatory oversight ranges from requiring the company to inform and obtain approval from the Department of a risk-based capital plan to mandatory placing of a company under regulatory control in rehabilitation or liquidation proceedings.

As of 31 December 2002, LMG's risk-based capital was at the authorised control level. At this level, the Department may take any action it deems necessary, such as placing the company under regulatory control, including supervision by the Department.[13]

12 See 215 ILCS 5/35A *et seq.*
13 See 215 ILCS 5/35A-20.

THE DOWNGRADE NECESSITATED A RAPID MOVE INTO RUN-OFF

Decision to enter into run-off status. In response to the December 2002 downgrades, LMG substantially ceased underwriting activities other than as required by policy provisions or law and except for the business covered by the Berkshire cut-through.

Managing into run-off: initial liquidity initiatives and renewal rights deals. In early 2003, in the face of still more ratings downgrades and market resistance to acceptance of a Berkshire cut-through, LMG entered into seven renewal rights deals for various profit centres/lines of business. From February to late April 2003, LMG unsuccessfully negotiated with Securitas Capital, LLC a potentially larger renewal rights and licensed insurance company transaction, involving 1,100 employees, most of whom ultimately were terminated by mid-year. From April to July, LMG successfully negotiated the sale of its claim and loss control operations, including NATLSCO and Kemper National Services, Inc., to Platinum Equity, LLC. The transaction resulted in jobs for 3,300 employees, but necessitated a USD 32.5 million capital contribution to NATLSCO, a USD 95.3 million prepayment for future claim services, and a USD 180.8 million realised loss.

Run-off becomes more formalised through regulatory action. In February 2003, exercising its supervisory authority based on the risk-based capital levels of LMG (LMG being currently at mandatory control level), the Department issued the first of several corrective orders. As required, LMG in early 2003 proposed a risk-based capital (RBC) plan to address its RBC level, but the plan was not accepted by the Department.

Regulatory denial of payment of interest on surplus notes. In March 2003, the Department denied LMG's request to pay future interest payments on its surplus notes. From late March to late May, LMG extended a tender offer at 10 cents per dollar, or USD 70 million in total, for its USD 700 million of outstanding surplus notes. The offer was withdrawn following the collapse of the Securitas transaction. In May, renewal rights to the lines of existing U.S. commercial insurance business that were to have been part of the Securitas transaction were sold to the St. Paul Companies.

Liquidity initiative: centralisation of liquidity at Lumbermens. In April 2003, but effective 1 January 2003, the cession of 15 per cent of the intercompany pooled business to American Motorist Insurance Company (AMICO) was terminated, with the transfer of assets from AMICO to Lumbermens to satisfy the same amount of liabilities transferred. In addition, AMICO paid dividends to Lumbermens representing most of AMICO's remaining surplus. This transaction increased LMC liquidity at a time when substantial assets were otherwise encumbered, including in Berkshire-related transactions.

In June 2003, Lumbermens liquidity position was enhanced by restructuring LMG's reinsurance and other relationships with Berkshire. The restructuring allowed Lumbermens to regain direct access to liquidity of about USD 1.6 billion, but the commutations of the ceded reinsurance resulted in substantial adverse impacts to surplus and other economics. Lumbermens also began a programme executed over the last half of the year to commute most of the whole account stop loss and other finite reinsurance contracts that LMG had entered into in prior years. These initiatives generated liquidity of approximately USD 775 million, while resulting in a decrease of surplus of USD 365 million.

Regulatory order to enter run-off. Effective 1 July 2003, LMG became subject to a non-confidential corrective order by the Department not to write any new or renewal business, except as necessary to comply with contractual commitments or as expressly permitted by the Department.

Initial regulatory approval of reserve discounting as a permitted accounting practice. Associated with the Berkshire commutations in June was the grant by the Department of a permitted accounting practice to discount all loss and loss adjustment expense (LAE) reserves (not previously discounted) by 3.5 per cent. This permitted accounting practice offset the surplus reductions that would otherwise have been associated with the commutations of the ceded finite reinsurance agreements. The discount rate was based on a reasonable expectation of investment returns on the cash received in the ceded commutations.

Finally, in June 2003, KPMG issued its audit of the financial statements of LMG. The audit resulted in a further USD 284 million of negative adjustments to Kemper's previously reported year-end surplus for 2002.

Engagement of professional run-off management. By October 2003, LMG had engaged a professional run-off management firm to continue its run-off under supervision by the Department. The run-off management firm, subject to the direction of LMG's board of directors, acted as the company's financial and management consultant to develop, modify and implement the run-off plan. By August 2004, LMG and the management firm had terminated their agreement, and certain of the firm's personnel directly joined LMG as employees.

Regulatory approvals of further permitted accounting practices. On 23 December 2003, the Department granted LMG's requests for five additional permitted accounting allowances producing a USD 1 billion benefit to the combined surplus of LMG. Concurrently approved by the Department and effective 31 December 2003, Lumbermens and AMM entered into a reinsurance transaction, the results of which included an approximate USD 229.2 million strengthening of Lumbermens' statutory surplus, an amendment of the intercompany pooling agreement to eliminate the 8 per cent retrocession to AMM, and the issuance by Lumbermens of a new insurance policy to each and every AMM policyholder (other than those AMM personal lines policyholders already fully reinsured and supported by a cut-through from a subsidiary of Unitrin). This feature permitted AMM policyholders to participate in a potential receivership of Lumbermens on a *pari passu* basis with Lumbermens' policyholders and eliminated the potential run-off risk of disparate treatment of LMC and AMM policyholders. Absent this reinsurance transaction and the granting by the Department of accounting allowances, the statutory surplus of LMG at 31 December 2003 would have been negative.

Gross, ceded and net reserves at 31 December 2003. As of 31 December 2003, LMG established gross and net reserves of USD 9.2 billion and USD 4.2 billion, respectively, including the effects of USD 1.4 billion in gross direct reserve strengthening for the years 2001–2003. After considering the 3.5 per cent discount, LMG recorded net loss and loss adjustment reserves of USD 3.9 billion. The difference between gross and net reserves indicated the significant ceded reinsurance programme utilised by the company, especially in its growth years beginning in the 1990s. Despite the size of the reinsurance leverage, the reinsurance was purchased from major reinsurance companies with strong ratings. This mitigated LMG's credit exposure and facilitated reinsurance collections as the company entered run-off.

Gross, ceded and net loss and LAE reserve summary—2003 (in USD millions)

	Case reserves	IBNR reserves	Total reserves
Gross	5,115.2	4,059.9	4,059.9
Ceded	(1,962.3)	(2,244.7)	(4,207.0)
Discount	(407.6)	(688.8)	(1,096.4)
Net	2,745.3	1,126.4	3,871.7

Need for an amended run-off plan. As the 2003 results made clear, LMG needed to operate under a more formalised run-off plan which would have the support of the national regulatory community. There were a number of factors which impacted the regulatory perspective at that time.

External considerations impacting LMG and regulatory decisions to enter into run-off. The challenges facing LMG occurred in an environment that was not supportive of either a private market solution or the pursuit of a traditional state insurance receivership proceeding. Some of these factors were:

1. LMG was unable to raise capital as a mutual through demutualisation or the issuance of additional surplus notes. Furthermore, LMG had already explored a downstream investment with Berkshire and other third parties.
2. LMG was the sixth largest writer of workers' compensation in the U.S. The number of open claim files (>100,000) involving commercial insureds with complicated risk management programmes, loss sensitive premium arrangements with extensive collateral, and multi-state claim situations would have been disruptive if receivership had been pursued. Receivership involving liquidation would also have terminated the defence of liability claims. Large commercial insureds were frequently interested in negotiating voluntary disengagement transactions (typically involving the assumption of LMG policies by another insurer), which would benefit not only the disengaging policyholder but also the remaining policyholders. Such disengagements could not be negotiated in a receivership proceeding.
3. The addition of LMG to the recent failures of almost 30 other writers of workers' compensation, including large insurers like Reliance, Legion, Superior National and Fremont, would have been the largest challenge ever to the financial and operational resources of the U.S. guaranty fund system. While these challenges were most certainly manageable, they could be deferred and ultimately mitigated through the commercial run-off of LMG.
4. Alternative wind-up solutions were being discussed in the U.S. by the NAIC for troubled P/C insurers to avoid the typical delays and costs presented by the existing state insurance receivership system. There was a benefit to postponing receivership until those alternatives could be studied and possibly implemented.

Internal considerations impacting LMG and regulatory decisions to enter into run-off. Consideration of a commercial run-off of LMG under the supervision of the Department was enhanced by the following internal factors:

1. LMG's reserves were viewed as fairly stated and its reinsurance programme, though extensive, was placed with strong and reputable reinsurers. Similarly, the company's investment portfolio was appropriately conservative.
2. An insurance receivership proceeding of LMG would have had an adverse impact on claimants and policyholders due to the delay in the payment of claims, particularly for workers' compensation. Defence of claims of liability coverage policyholders may also have been eliminated.
3. An orderly transition to receivership, if required, of a much smaller LMG was preferable.
4. Resolution of policyholder claims, marshalling of assets and other activities to 'shrink' LMG was best performed by existing staff and management with run-off experience.
5. State insurance receivership proceedings can result in the immediate cancellation of ongoing policies, which would result in hardships for policyholders due to the premature cessation of underwriting activities by LMG.
6. A commercial run-off under the supervision of the Department as the domiciliary regulator for the LMG insurance companies would allow for the introduction of 'economic' financial statements through the use of permitted accounting practices in contrast to the use of statutory accounting principles for an ongoing company. This flexibility is inherent in the state insurance regulatory mechanism in the U.S. and provides for the ability to tailor a run-off solution to the specific situation presented.

Further, the Department's financial regulators, in contrast to a statutory receiver, would be familiar with company operations and thus could enhance the transition to ultimate receivership through careful implementation of transactions involving surplus and liquidity initiatives. Finally, the Department would be expected to look after the interests of policyholders and claimants who are the key constituents in the context of a commercial run-off, while protecting against the possibility of inconsistent treatment of policyholders and claimants.

FORMAL 2004 RUN-OFF PLAN FOR ORDERLY RESOLUTION

Objectives and rationale for the plan. In March 2004, LMG filed its second and more comprehensive run-off plan, as required under Illinois law applicable to companies at the risk-based capital mandatory control level, as described above.

As stated in the filing, the overarching objective of LMG's run-off plan was to settle fully and in a timely manner all valid policyholder claims and optimise the recovery by all persons to whom LMG was liable, through maximising the value of LMG's assets and minimising the costs incurred, with due recognition given to the liquidation priorities set forth in the Illinois Insurance Code.

Guiding principles. LMG committed to conduct the run-off plan in accordance with the following six guiding principles:

1. All valid obligations which meet insurance policy provisions and applicable law shall be timely paid without reduction, or otherwise settled to the mutual satisfaction of LMG and the policyholder or claimant, as applicable.
2. LMG's assets, including reinsurance recoverables, shall be managed to maximise the value of those assets, and any asset-related transactions shall be based on economic considerations consistent with continued solvency and liquidity.
3. Management shall provide all necessary and appropriate information to the Department, and to such others as the Department shall direct, to allow full supervision and oversight of LMG's affairs, including by filing monthly financial results measuring performance against the financial projections as provided in the approved run-off plan.
4. To maintain sufficient liquidity such that, if a receivership is ultimately unavoidable, adequate funds shall be available at all times to administer the estate and the requirements of the state guaranty funds.
5. The distribution of assets shall follow the priorities set forth in Section 205 of the Illinois Insurance Code to the extent not inconsistent with the run-off plan as the same may be amended from time to time.
6. Transparency and accountability to policyholders and other creditors shall be a feature of the run-off plan.

At any time, if LMG's actual results threaten its continued viability, LMG would solicit input from, and cooperate with, selected representatives of the regulatory community, the state guaranty fund system and the insurance industry in implementing potential alternatives subject to regulatory direction and approval to minimise any deficiencies to policyholders, claimants and other constituents.

Surplus-enhancing initiatives: transactional and other tools. Following extensive discussions with the Department, and the Department's own extensive discussions with other key state insurance departments, the run-off plan was approved in June 2004.

LMG thereupon began a series of surplus-enhancing transactions designed to implement its orderly wind-down, including:

1. commutation of the company's participation in various reinsurance pools;
2. a settlement agreement with the Pension Benefit Guaranty Corporation relative to the company's liabilities to its sponsored defined benefit retirement plan;
3. a series of policy disengagement transactions, primarily with larger commercial insureds;
4. a series of assumed reinsurance commutations affecting the company's relatively small book of assumed business.

All of these transactions settled LMG's obligations to its counterparties through payments considerably below balance sheet values, thereby creating a balance sheet surplus. These transactions (i) were voluntary, without any forced discount or other decreases in claim payables and (ii) used settlement prices derived through formulas which took recognition of the relative subordination of the counterparty's creditor status and which were then consistently applied to similarly situated counterparties throughout the duration of the run-off.

Liquidity-enhancing initiatives: transactional and other tools. At the same time, LMG began to implement a series of transactions designed to enhance liquidity, including:

1. a major undertaking to identify and collect in full all applicable reinsurance on paid claims, on a timely basis;
2. as to unpaid losses, a series of ceded reinsurance commutations limited to circumstances where the counterparty was in a weakened financial condition, or in settlement of disputes balances, or otherwise on an opportunistic basis;
3. a major undertaking to identify and collect in full all applicable balances on insurance policies, including loss-sensitive programmes; LMG ceased payment of policyholder dividends after the inception of run-off, pursuant to the discretionary authority given LMG under those programmes;

4. mergers of subsidiaries to eliminate the need to maintain excess liquidity in what were essentially shell companies;
5. the payment of shareholder dividends to Lumbermens, the ultimate shareholder and the payer of all claims within the affiliated group of companies;
6. the restructuring of the investment portfolio to maximise investment yield, consistent with a conservative style and with the actuarially determined cash flow needs of LMG.

Retention and compensation: an essential element for orderly wind-down. Recognising that the retention of institutional memory and competency was critical to the tasks of disassembling LMG's complicated corporate structure and negotiating terminations of third party arrangements (both insurance and non-insurance based), LMG sought and received approval from the Department to implement a retention and compensation plan to include the following:

1. a short-term retention programme—a salary enhancement paid at the end of each calendar quarter;
2. a long-term retention programme—a trust set up to secure LMG's liabilities under its severance programme in the event of a receivership and the expected cessation of payments under the long-standing corporate severance plan;
3. a short-term bonus programme—an annual payment based on LMG's achievement of certain specified surplus and liquidity objectives and the individual's contribution to those achievements;
4. a long-term bonus programme—an annual payment offered to senior management based on LMG's achievement of certain specified surplus and liquidity objectives.

As a result of these programmes, employee retention was solidified and LMG was able to retain the expertise and knowledge essential to the successful execution of various disengagement transactions and other steps necessary to wind down LMG's complex insurance and reinsurance programmes, while maintaining the ability to prepare (and file) accurate financial reports to enable policyholders, claimants, creditors, and the national regulatory community to review the financial position of LMG.

No disclosure of information on a selective basis. LMG made extensive public disclosures of its financial condition, the nature and scope of regulatory oversight, and the risk factors that might impair its ability to continue in voluntary run-off. These disclosures were included in the footnotes to its quarterly and annual financial statements, as well as in the Management Discussion and Analysis, the public actuarial reports and the annual CPA audit report. As noted below, LMG was required to continue filing all reports generally required of ongoing companies. LMG decided to use those reports to make its current condition known to a wide audience. Importantly, none of these public disclosures included any forward-looking statements, leaving the decisions of any of LMG's counterparties relative to a disengagement transaction entirely up to the counterparty's own analysis.

New Illinois law to facilitate disengagement transactions. To facilitate the run-off plan, and provide assurances to policyholders, claimants and other third parties entering into transactions with LMG, the Department arranged to have a provision added to the Illinois Insurance Code. Section 204m(C) provides that transfers made during a run-off that have been approved by the Department will not be considered a prohibited or voidable transfer when company is placed into a subsequent receivership.

CONTINUED REGULATORY OVERSIGHT, IN ILLINOIS AND NATIONWIDE

Regulatory supervision, nature and scope of administrative oversight. As noted above, the Department became authorised to take significant regulatory action as a result of LMG's risk-based capital ratio at year-end 2002. The Department exercised its discretion to permit LMG to wind down its liabilities under the provisions of the Illinois Insurance Code, which authorised the Department to issue confidential 'Corrective Orders'.

Required filings and meetings with regulators. While the contents of the Corrective Orders remained confidential, LMG was permitted to disclose that the scope of the orders required a variety of operational and financial reporting requirements, including monthly and quarterly reports on the progress of the run-off plan, as well as prior approval requirements for certain transactions. In general, LMG was required to file all financial and tax reports expected of ongoing companies.

'Economic basis' for financial statements. Also included in the orders were directives for prescribed or permitted accounting practices, including the discounting of loss reserves discussed earlier, all of which were permitted to be disclosed in the footnotes to LMG's financial statements. The intent of the accounting directives was to require LMG to file its public financial statements on an economic basis, using present values or readily realisable values for both assets and liabilities. Such a presentation proved to be instructive for both policyholders and claimants as well as for other interested parties.

Required maintenance of accounting-based solvency. It should be noted that LMG's continuing status in voluntary commercial run-off depended in part on maintaining statutory solvency, which most observers understand to be a positive statutory surplus. LMG received regulatory directions to implement various accounting allowances which generally had a positive effect on statutory surplus while at the same time being grounded in economic reality.

Continued meetings with other state regulators and guaranty funds. LMG, as part of its ongoing run-off efforts, made periodic presentations to regulators and guaranty funds from key states, both at NAIC meetings and on a one-to-one basis.

Successful wind-up of non-U.S. operations. In the course of the run-off, LMG achieved its goals to sell or otherwise close its operations and/or subsidiaries in Canada, Europe and Singapore, and its Australian subsidiary was positioned to be liquidated once the formula IBNR ('incurred but not reported') was eliminated as scheduled in 2014. Of particular note, the Canadian operations were conducted as a branch of Lumbermens; under the close oversight of the Office of the Superintendent of Financial Institutions (OSFI), the branch liabilities were reduced to a point where a reinsurance to close transactions (RITC) was approved by OSFI and the remaining liabilities were transferred to a Canadian reinsurer.

RESULTS OF WIND-DOWN

Direct nominal loss and LAE liabilities—reduced from USD 11 billion to USD 1.3 billion (88 per cent). This measurement included claim payments occurring in the ordinary course of business and did not include any reserve reductions resulting from policy buy-backs or novations. The latter class of reserve reductions were generally negotiated directly with the insureds and commonly were priced at a significant discount from LMG's held reserves.

Assumed nominal loss and LAE liabilities—reduced from USD 1.3 billion to USD 117 million (91 per cent). In recognition of the lesser priority given assumed reinsurance creditors in the event the company entered liquidation, settlements were aggressively pursued at a discount greater than that normally accorded direct insureds.

Claim counts, including deductible business—reduced from 213,000 to 11,000 (95 per cent). It should be noted that this metric does not measure the number of claims opened after year-end 2002. As a result, the percentage of claims resolved during the course of the run-off is understated.

Liquidity from reinsurance collections—USD 6.0 billion. In light of LMG's significant reinsurance programme, especially in the latter years before run-off, LMG placed very high emphasis on its reinsurance collection programme in order to fund its claim liabilities occurring in the normal course of business. Without the process improvements and organisational energy put into this effort, the run-off would have encountered liquidity problems early on.

Liquidity from premium and deductible collections—USD 3.0 billion. As was the case with reinsurance collections, the liquidity from collections activity provided support for claim payments throughout the run-off. Additionally, LMG had extensive policyholder dividend programmes in its workers' compensation book that required a deep understanding of its underwriting files and other collection issues, which were fortunately supported by the retention programme that kept key personnel available to handle these issues.

ASSESSMENT OF SIZE, INTER-CONNECTEDNESS AND SUBSTITUTION

An assessment of the LMG wind-down must focus on the following obstacles to a non-disruptive resolution, any of which could lead to further distress within the national or global financial system through financial losses or liquidity strain. By virtue of (i) the make-up of LMG's organisation and operation, (ii) the flexibility of the state regulatory system in the U.S., in particular, the role of the Department and (iii) the gradual cessation of operations and reduction of liabilities available under a commercial run-off, these issues were successfully managed.

Size. As noted above, LMG had become the sixth largest workers' compensation insurance company in the United States in 2001 and one of the largest P/C insurance companies in the country, writing USD 4.8 billion in gross direct premiums in 2001 (USD 2.5 billion in net direct premiums). As further described above, size alone did not prove to be an impediment to a non-disruptive wind-down.

Interconnectedness. Similarly, the seemingly intricate nature of LMG's relationships with its customers and financial partners did not lead to significant problems in the run-off, due in large part to management's detailed understanding of those relationships. Specifically, on the direct side, LMG's biggest counterparties were non-insurance companies (i.e. commercial policyholders), and the gradual nature of the run-off format itself mitigated outward liquidity issues. Similarly, on the reinsurance side, LMG was not a major assuming reinsurer, and its ceded reinsurance programme was diversified among a list of very major reinsurers who benefitted from the liquidity mitigation of the run-off format.

Substitution. LMG's customers were faced with the challenge of moving their coverage to other actively writing insurance companies. This situation did not prove especially problematic to either insureds or to the market itself. The run-off format permitted LMG to phase-in the cessation of new business over a 12-month period. This allowed producers to find substitute coverage for their insureds over an extended period and allowed the market to absorb those insureds slowly. Since LMG's in-force business was already adequately priced, insureds were generally able to find substitute coverage without any significant increase in rate.

SUMMARY OF RUN-OFF

The LMG commercial run-off was, in many respects, an unprecedented exercise combining a high degree of creativity and flexibility in regulatory oversight and company operations. Through focused attention on the continued reduction of expenses and policy liabilities, achieved with the benefit of institutional memory and without the loss of asset and liability opportunities which may have resulted from a premature receivership, the run-off reduced the size of the LMG liabilities by 90 per cent. It also greatly eased its eventual transition to receivership under the Illinois Insurance Department begun in July 2012, at which time the company's gross reserves were roughly 10 per cent of that existing at the inception of the run-off.

RECEIVERSHIP

By mid-2012, LMG had resolved roughly 90 per cent of the direct and assumed liabilities existing at the beginning of the run-off. On 2 July 2012, an Agreed Order of Rehabilitation was entered by the Circuit Court of Cook County, Illinois, following the filing of a petition for rehabilitation by the Illinois Director of Insurance, which ended the commercial run-off of Lumbermens and its affiliated company AMM, and began the wind-up of the companies under direct government control. (A stock subsidiary of Lumbermens, American Motorist Insurance Company—AMICO—was placed into rehabilitation on 16 August 2012.) The Illinois Director of Insurance, through his Office of Special Deputy Receiver, managed the business, property and affairs of LMG for the next 10 months as rehabilitator under Article XIII of the Illinois Insurance Code (215 ILCS 5/187 *et seq*.). On 10 May 2013, at the request of the Illinois Director of Insurance, an Order of Liquidation was entered by the Circuit Court of Cook County, Illinois, ending the rehabilitation and beginning the final wind-up of Lumbermens, AMICO and AMM, while also triggering the 50-state guaranty fund system (explained in Part 1) to assume responsibility for direct policy obligations up to the coverage limits of these state guaranty funds.[14]

When to convert a supervised run-off to a formal statutory receivership under the supervision of a court rather than an insurance regulator is difficult to define in absolute terms. Circumstances and conditions unique to the troubled insurer will determine when this so called 'tipping point' has been reached. Importantly, this determination must consider all relevant facts, consequences and alternatives. This study should be done by experts. It is not sufficient that a mere statutory ground for a receivership proceeding exists. The frictional costs of transferring administration from the insurer's management to a receiver creates unique costs that must be considered as well as the additional expense that will be incurred by the state guaranty funds in the administration of unfamiliar claims. Unfortunately, data from past situations is not readily available to estimate these and other costs.

The usual reason for placing a troubled insurer into receivership is the belief that it is insolvent. Insolvency exists as a general rule when statutory assets are less than required reserves. A P/C insurer's reserves represent liabilities for ultimate loss costs for insured events that have already occurred. Such reserve estimates may be imprecise; particularly for an insurer that has written large complex commercial risks. In such cases, determining whether an insurer is insolvent or not is a subjective process. Since the consequences of an insolvency determination are seldom propitious to insureds, in the case of a close call as to the adequacy or redundancy of reserves, it might be preferable to avoid statutorily mandated formal receivership. Unfortunately, insurance regulators are risk averse. Thus fear of criticism or failure (or both) often leads to the safe decision of receivership.

In the case of Lumbermens, AMICO and AMM, whether it was the appropriate time in 2012 to institute receivership proceedings is open to debate. Whether loss reserves were adequate or not, was not apparent. More needed to be done was to monetise assets, collect reinsurance cessions and conclude commercial policyholder disengagements. To our knowledge, at that time, potential

14 The Orders of Liquidation were preceded by an 8 May 2013 order of substantive consolidation among Lumbermens, AMICO and AMM to ensure policyholders were treated *pari passu*.

alternatives to receivership were not explored, even though management and its advisors had been in discussions with major insurers to achieve an industry solution. Due to a significant contractual benefit that existed at LMG, an industry alternative was potentially attractive. Specifically, at the commencement of the run-off, as a part of the sale of the LMG claims operation, LMG prepaid all loss adjustment expenses for all known claims. Unfortunately, once the state guaranty funds assumed responsibility for claims administration due to the liquidation of LMG, the benefit of this prepayment of loss adjustment expense was lost.

CONCLUDING THOUGHTS

LMG and other troubled insurer situations suggest there are ways to update and improve the existing U.S. receivership system, including the vital role of guaranty funds, to provide a more effective system for insureds, creditors, reinsurers and other stakeholders involved with troubled commercial P/C insurers. Some specific suggestions to facilitate this review are the following:

- **A new statutory framework should be created for supervised non-judicial run-offs such as described in the LMG case study.** Insurance regulators dealing with troubled insurers (or even possibly insolvent insurers) that have ceased underwriting new and renewal risks need an alternative available to create a plan that would be superior to the U.S. state receivership process. All stakeholders would participate in consideration and conduct of an alternative plan. Such an alternative, if appropriate for the circumstances, would likely avoid the delays, dislocation and costs of a lengthy receivership proceeding.[15]
- **The NAIC or a similar organisation needs to collect cost and other data and conduct post mortems of the resolution of troubled insurers placed into receivership.** As previously noted, run-off management lack the data needed on which to base a reasoned analysis of the cost of receivership vs continuation of the run-off if the run-off were halted and receivership sought. Data from other resolutions would allow insurance regulators and insurer management to develop more creditable alternative plans to immediate receivership.
- **Like the conduct of an insurance receivership, the administration of the voluntary run-off of a troubled insurer requires specialised expertise.** Yet, currently, there is no way for such expertise to be formally obtained or verified

15 This notion is further detailed and explained in an article prepared by James W. Schacht (2009) 'Enhancing the insurer resolution toolbox', *AIRROC Matters* (5)2: 11–13.

through a written examination or certification programme. Interestingly, the International Association of Insurance Receivers (IAIR) recently has been developing such a programme with the assistance of the law school of a major U.S. university. IAIR has made a proposal to the NAIC to fund the creation of such a programme including a written examination to obtain a professional designation for receivership/run-off expertise.

PART 3

INSIGHTS AND LESSONS LEARNED

In this report, we focused on the P/C insurance insolvency resolution process in the U.S. Despite the existence of a formal judicial receivership set-up for insurance resolution as described in Part 1, in the case of LMG (Part 2), the resolution process followed an alternative path within the window between detection of financial troubles and formal liquidation with the triggering of the guaranty funds. LMG was initially not declared insolvent, but went into a voluntary run-off that lasted nearly a decade until it was finally placed into formal receivership, followed by liquidation, which triggered claims administration by the guaranty funds.

One lesson of the LMG case is that resolution can be done with the expertise of the employees of the troubled insurer. By the time the LMG insolvency entered the formal insolvency process in 2012, only 10 per cent of the original liabilities remained. (Policyholders found substitute coverage during the initial year of the run-off in 2003, as existing policies were non-renewed.) For LMG, the insurance regulators were aware of, and approved, the agreements in the voluntary run-off negotiated with policyholders, primarily commercial insureds. Whether policyholders fare better with a pre-receivership settlement may depend on how reserves applicable to an individual policyholder's policies ultimately develop and on the timing of future regulatory action, all of which is beyond the control of both the insurer and the policyholder.[16]

Finally, large U.S P/C insolvencies and LMG's run-off can provide the following insights and lessons to be learned:

- The U.S. regulatory system has been designed to handle an insurer's insolvency in an organised manner, through formal judicial receivership, which has a seamless process that may end up triggering the guaranty funds or not, depending on the situation of the troubled insurer. This resolution system creates a sense of stability for policyholders and other stakeholders, but hardships do result.
- When the guaranty funds are triggered, the member insurers are assessed for guaranty fund costs (covered claims payments and expenses). In some cases, these member insurers are later reimbursed with tax credits and premiums surcharges (or rate increases) for amounts that cannot be collected from the insolvent insurer's estate. Thus, to some extent, the U.S. insurance-consuming public is ultimately paying for some of the shortfall when failed insurers are liquidated and claims are moved into the guaranty funds.

16 For example, the California guaranty fund does not have a net worth limitation for policyholders. Thus, commercial policyholders with California claims may have been less motivated to enter into a pre-receivership settlement. If correct, the member insurers of the California guaranty and in turn, the public, will pay more.

- As the LMG case showed, it is possible to wind down a large P/C insurer in an orderly manner through cooperation between regulators and the troubled insurer as a method to lower the guaranty funds obligations and attendant costs.
- Whether run-off or liquidation and the handling of claims by guaranty funds is the better option for policyholders (and other stakeholders) is still an open question.
- In the context of the preparation of 'living wills' that are required for insurance holding companies identified as systemically important financial institutions (SIFIs), it should be recognised that a non-judicial resolution/wind-down (not formal receivership proceedings) may be possible under the appropriate circumstances.

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NOTES ON THE AUTHORS

John K. Conway

John K. Conway is former General Counsel and Corporate Secretary of the Lumbermens Mutual Group, comprised of Lumbermens Mutual Casualty Company and its affiliates. John joined Lumbermens in 1982 in its legal department and became General Counsel in 1991. During the time of the company's active operations he supervised the delivery of legal services in a wide variety of areas, including financial reporting, reinsurance, regulatory relations, underwriting, claim, licensing, employment, corporate, acquisitions and divestitures. During the company's run-off phase beginning in 2003 he also became involved in company-wide strategy and external communications. He left the company shortly after its transition from run-off to receivership in 2012 and currently works as an independent insurance consultant.

James W. Schacht

As President of the Schacht Group, Jim advises national and international clients on regulation, restructuring and insolvency, litigation and public policy issues. Prior to forming his own firm, Jim led Navigant Consulting's Restructuring, Run-off and Insolvency practice. He served both Coopers & Lybrand and PricewaterhouseCoopers as leader of the insurance regulatory practice. During his 31 years with the Illinois Department of Insurance, Jim served as Illinois Director of Insurance on three occasions at the request of two governors, as well as Special Deputy Receiver for 15 years.

For more than 25 years, Jim took an active leadership role in the National Association of Insurance Commissioners (NAIC), serving in a leadership capacity on numerous task forces and committees. Several of Jim's reform initiatives garnered national attention, particularly the development of the NAIC's Insurance Regulatory Information System, the development of the first NAIC Handbook on Statutory Accounting Practices and Procedures , Risk Based Capital, the Financial Regulation Standards and Accreditation Program and numerous model laws and regulations. He organised and conducted the first meetings of international insurance regulators which led to the formation of the IAIS.

Jim is a recognised authority on insurance receiverships and guaranty funds. He served as a strategic advisor for the largest solvent run-off in the U.S. and has a particular expertise in assisting troubled companies develop innovative alternatives to receivership. He developed workout plans for two troubled mortgage insurers. He has given deposition and court testimony on numerous occasions in civil, criminal, and tax litigation involving insurance and regulatory issues. In addition, he has testified before congressional and state legislative committees. Jim serves on the board of directors for several insurers.

Jim frequently writes on emerging issues and is an oft-requested speaker. He and his colleagues have prepared numerous groundbreaking public policy studies on insurance regulation for the National Conference of Insurance Legislators and other industry trade associations.

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Kenneth R. Wylie is senior counsel in the Chicago office of Sidley Austin LLP. Ken concentrates his practice in insurance law with emphasis on insurance regulatory matters that affect insurance companies and other insurance entities. He has extensive experience representing insurance guaranty funds, insureds, reinsurers, reinsureds, claimants and other parties involved in insurance company insolvencies.

Ken is a frequent speaker on various insurance-related issues, including restructuring, runoff, insolvency, reinsurance and captives, and has served on drafting committees of the Illinois insurance-related legislation and industry advisory groups for the National Association of Insurance Commissioners.

He has been recognised by clients and fellow lawyers as a Leading Lawyer in the insurance field by Chambers & Partners' *America's Leading Business Lawyers* (since 2003); I*nternational Who's Who of Insurance & Reinsurance* (since 2007); and *U.S. News–Best Lawyers* (since 2010).

This report provides an analysis of the process of resolution of property/casualty (P/C) insolvencies in the United States through its state receivership system and presents a detailed case study of the decade-long wind-down of Lumbermens Mutual Group.

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