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Alternative Approaches to Restructuring Troubled U.S. Insurers

by Wolcott B. Dunham Jr., Alexander R. Cochran and Michael G. Stern

The past 24 months have witnessed the worst financial crisis in recent memory. The crisis has had wide-ranging effects on financial institutions generally and insurance companies specifically, and with these events has come a heightened focus on the framework governing insurance company insolvencies. An insolvent U.S. insurer can be placed in receivership in the courts of its state of domicile, with the state insurance commissioner appointed by the court as receiver. Receivership proceedings can take years, or in some cases decades, until they are resolved. Regulators and market participants are interested in working to resolve potential impairments outside of a lengthy and expensive court proceeding because such a resolution will often be best for all constituencies, including the insurer's policyholders, stockholders and regulators.

Any out-of-court restructuring of a troubled company takes place against the backdrop of what would happen in a receivership. A workout is consensual, and a party deciding whether to consent compares the proposed workout with how the party would fare in a receivership proceeding. Many regulators view a receivership as a step to be avoided if policyholders can be protected in another way. In this article we begin by reviewing the mechanics of a traditional receivership proceeding and then describe some noteworthy recent instances in which insurers have avoided receivership through alternative regulator-approved arrangements. We conclude with a brief discussion of a white paper recently adopted by a committee of the National Association of Insurance Commissioners (the "NAIC") that evaluates several "alternative mechanisms" that may be available to distressed insurers in the U.S. and elsewhere.

Receivership: The Traditional Approach to Insurer Insolvency

Insurance companies and insurance company insolvency proceedings have long been regulated by the individual states and not the federal government. The principle is codified by the McCarran-Ferguson Act, enacted in 1945, pursuant to which the regulation of the "business of insurance" is reserved to the several states in the absence of federal law that specifically relates to the business of insurance. Additionally, under section 109(b)(2) of the Federal Bankruptcy Code, a domestic insurance company cannot be a debtor in a Federal bankruptcy proceeding, though insolvent insurance holding companies are subject to federal bankruptcy law.

A traditional receivership proceeding, whether it is a liquidation or a rehabilitation of an insurer, is generally initiated by petition of the insurance commissioner of the insurer's state of domicile upon a finding by the court that one or more statutory grounds for receivership is present. If the court grants the commissioner's application to place the insurer into receivership, then control of the insurer's property immediately vests by operation of law in the commissioner (in his capacity as receiver). The receivership order also generally has an injunctive effect, similar to that of the automatic stay under the federal Bankruptcy Code, barring creditors from seeking to enforce claims against the insurer. The receiver takes the position of and supersedes directors, officers and management, and has power to deal with the employees and property of the insurer.

New Alternatives to Conventional Receivership Proceedings

While state statutes delineate the receivership process in some detail, regulators generally have expansive discretion to work with insurers to formulate

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WHAT'S INSIDE

A Renewed Focus on Foreign Corruption and Access by Politically Exposed Persons to the U.S. Financial System

by Satish M. Kini

On February 4, 2010, the Senate Permanent Subcommittee on Investigations released a 325-page report detailing the access gained by politically exposed persons ("PEPs") to the U.S. financial system. The report concludes that U.S. based financial institutions and other intermediaries, including lawyers, realtors and escrow agents, need to strengthen their PEP controls to prevent U.S. financial institutions from being used to conceal, protect and use gains from foreign corruption. The Subcommittee then held hearings on the issue of detecting PEPs and the proceeds of foreign corruption and called for reforms to existing compliance approaches and laws to require closer scrutiny of PEP accounts and transactions.

The Subcommittee's report, of course, has no immediate legislative or regulatory effect, but it deserves attention from financial institutions. For more than a decade, the Subcommittee has investigated money laundering issues at U.S. financial services firms and has highlighted what the Subcommittee has viewed as deficiencies in U.S. efforts to combat money laundering and foreign corruption. These past reports have resulted in regulatory focus on the issues highlighted by the Subcommittee. In addition, the Subcommittee's Chair, Carl Levin (D-MI), was a principal author of many of the anti-money laundering ("AML") provisions that were included in the USA Patriot Act; the genesis of those provisions was the Subcommittee's work.

Key Findings and Recommendations of the Subcommittee's Report

Using four detailed case studies, the report examines the ways in which several PEPs

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from Equatorial Guinea, Gabon, Angola and Nigeria gained extensive access to the U.S. financial system and used that access to acquire significant U.S. real estate and other assets and to do business with U.S. and international firms. The report finds that, often, these PEPs relied on shell companies, law firms and other entities and relationships to mask transactions and to circumvent U.S. financial institutions' AML controls. Often times, according to the report, these means were highly effective, and the PEPs studied were able to engage in high-dollar volume transactions through U.S. banks for many years without detection.

According to the Subcommittee, the AML efforts of the U.S. banks involved in the four case studies were uneven. Examples of the issues cited by the Subcommittee include the following:

- several of the banks developed insufficient AML risk-rating systems, as a result of which they opened high-risk accounts for which they lacked the capability to monitor adequately;
- other banks obtained insufficient information and performed inadequate diligence on account signatories and beneficial owners, which led them to fail to understand the PEP exposure presented by the accounts they were opening;
- other banks closed specific PEP accounts when they spotted suspicious transactions but failed to ascertain that those PEPs had interests in other accounts, which remained open and continued to be used for large-dollar transactions from foreign sources; and
- other banks detected suspicious transactions, such as large foreign wire transfers, but were slow to investigate and take remedial actions, as a result of which significant funds continued to flow through the banks in the interim.

The Subcommittee's report also is critical of other entities – including insurers, lobbyists, real-estate and escrow agents and lawyers – that dealt with and represented PEPs. For example, in one case study, an attorney for a PEP used his friendship with an insurance agent to circumvent an insurer's policies and to obtain an extension of coverage for the PEP's fleet of 32 motorcycles and cars. In addition, insurance agents helped the PEPs to shop among insurance underwriters until they were able to find ones that were prepared to offer coverage to these high-risk individuals.

> **A significant issue ... is the lack of a standard list of known PEPs; institutions have complained in the past of the difficulty in creating and maintaining an accurate and comprehensive PEP list and have called for the federal government to promulgate such a list.**

The report is highly critical of a number of attorneys, whom the Subcommittee found were very deliberate and purposeful in attempting to circumvent banks' AML controls. The attorneys incorporated shell companies for the PEPs and, in some instances, used their own law firm accounts to engage in transactions for PEPs. In these cases, when a bank detected suspicious transactions and closed one or more PEP accounts, the lawyer for a PEP often helped the PEP move funds to other accounts at the same bank.

Based on the findings of the report, the Subcommittee makes a number of compliance and policy recommendations. The report suggests that banks should strengthen their PEP controls by, among other means, using reliable PEP databases to screen clients, obtaining complete beneficiary information at account opening and conducting annual reviews of PEP account activity. The report also suggests that the Treasury Department should extend AML program requirements to real estate and escrow agents and other entities currently exempted from such Patriot Act obligations. Further, the report recommends that the Treasury Department issue rules requiring U.S. financial institutions to obtain certifications from attorneys that they are not using their accounts to circumvent AML and PEP controls. In addition, the report calls for the enactment of federal legislation obligating persons forming U.S. corporations to disclose their beneficial owners.

To be sure, the Subcommittee's report is open to criticism on several fronts. For example, many U.S. financial institutions already devote substantial compliance resources to PEP detection and monitoring to meet their obligations under existing provisions of the Patriot Act and other international legal regimes. A significant issue for these firms, however, is the lack of a standard list of known PEPs; institutions have complained in the past of the difficulty in

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creating and maintaining an accurate and comprehensive PEP list and have called for the federal government to promulgate such a list. The Subcommittee report skirts this issue.

Notwithstanding these issues, the Subcommittee report does suggest some risk controls and approaches firms may consider adopting. Banks and other financial institutions may wish to review their account opening procedures to ensure that they receive adequate information about account signatories and beneficiaries. Further, institutions may wish to confirm that they have sufficient account monitoring and transaction detection procedures and resources to spot and, in a timely manner, follow up on suspicious foreign wires and other higher-risk transactions. Finally, firms that rely on third-party vendors for PEP detection may wish to confirm how reliable and comprehensive such software is in screening for PEPs. All such databases are likely to have some gaps, given the earlier mentioned difficulties in defining PEPs; firms should understand the limits of the databases they use and not rely on them exclusively for PEP detection. ■

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An Overview of the NAIC Solvency Modernization Initiative

by Elizabeth K. Brill and Michael K. McDonnell

In June of 2008, the National Association of Insurance Commissioners (the "NAIC") announced a new solvency modernization initiative. In the NAIC's words, the initiative is "a critical self-examination of the United States' insurance solvency regulation framework and includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. insurance regulation." The initiative draws upon, and brings under its umbrella, several longstanding NAIC projects for regulatory reform, including the NAIC's effort to introduce a system of principles-based reserves for life insurance and annuity products and its plan to overhaul the regulation of reinsurance in the United States. Ultimately, however, the initiative encompasses more than existing NAIC reform projects, and should be understood as an important component of the NAIC's response to the recent financial crisis. The initiative represents a broad-based attempt to articulate fundamental regulatory principles that will guide ongoing efforts to improve U.S. insurance regulation. According to the NAIC, these principles will "provide a foundation from which to establish goals, priorities and long-term modernization plans for a more robust U.S. solvency regulation framework."

The NAIC's commentary clearly suggests that the initiative may serve as a catalyst for future reform proposals, some of which may have profound effects on the insurance industry. For this reason, the development of the initiative bears close watching. Set forth below is a brief overview of several areas of focus for the initiative: (1) capital requirements; (2) corporate governance; and (3) group-wide regulatory supervision.

Regulatory Capital Requirements

As part of the solvency modernization initiative, the NAIC is undertaking a comprehensive review of regulatory capital requirements. The review includes an examination of "risk-based capital" requirements, which are used by U.S. insurance regulators to establish minimum capital levels for insurers. An insurer's risk-based capital level is calculated using complex formulas that are designed to capture accurately an array of different risks that a particular company faces in its business. If an insurer's risk-based capital level falls below minimum required levels, regulators are authorized to take action against the insurer to correct the problem.
If risk-based capital is low enough, regulators are authorized, or in severe cases required, to place an insurer into receivership.

In December of 2009, the NAIC released a consultation paper regarding regulatory capital. The consultation paper outlines a broad array of questions for regulators to consider in connection with their review of regulatory capital. The consultation paper indicates that U.S. regulators believe risk-based capital is "an effective solvency regulatory tool and, with some potential adjustments, is anticipated to remain a key component of the U.S. solvency system." With that said, the consultation paper raises a number of fundamental issues for regulators to consider in their review of capital requirements. These questions include proposals for adjustments to the formulas used to calculate risk-based capital, and also include questions that are more sweeping in scope, including:

- whether the U.S. regulatory regime should be modified to include an evaluation of "economic capital" or "target capital" (i.e., the amount of capital that is justified economically, or that a company should target as a matter of best practice, rather than the minimum amount of capital that is required to forestall regulatory action);
- whether current risk-based capital thresholds for regulatory action are established at appropriate levels;
- whether there should there be any role for internal models or company discretion in the establishment of risk-based capital and, if so, with what type and amount of regulatory oversight;
- whether and to what extent insurance regulators should require that insurers maintain a "buffer" of capital over minimum risk-based capital requirements;
- whether a "leverage ratio," or a similar simple, transparent measure drawn from the world of banking regulation, could have a useful role in the regulation of insurer capital levels;
- whether the regulatory regime should require periodic stress

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testing and, if so, whether the NAIC should perform the stress tests;

- whether risk-based capital calculations should be made publicly available;
- whether there should be convergence between generally accepted accounting principles and statutory accounting principles;
- whether adjustments are needed to the regulation of capital to make it counter-cyclical;
- whether the NAIC should develop an approach to group-wide capital requirements that span international jurisdictions; and
- whether the U.S. regulatory regime for insurers should contemplate special resolution mechanisms in the event of failure, or "living wills," for systemically important insurers.

Corporate Governance

At the same time that the NAIC released its consultation paper regarding regulatory capital, described above, it also released a companion paper regarding corporate governance. The consultation paper acknowledges that corporate governance requirements have historically been the province of state corporate law, but notes that because of "changes in the economic environment and a move toward principles-based regulation, a greater regulatory focus on corporate governance may be required." This added focus is in evidence in the NAIC's proposal for principles-based life insurance reserves. The system of principles-based reserves that is being developed by the NAIC confers significant discretion on company actuaries, giving additional flexibility in the establishment of the assumptions and methodologies used to calculate reserve liabilities. As a result, the principles-based reserving reform includes new, detailed governance procedures that will be required to ensure thorough oversight and controls in connection with the establishment of life insurer reserves. For additional discussion, see the article on principles-based reserves in the October 2009 issue of the Financial Institutions Report, available at www.debevoise.com.

The NAIC's consultation paper endorses the more robust regulatory approach to corporate governance that is embodied in the principles-based reserves reform project, suggesting several potential areas of focus for further review by regulators, including:

- executive selection and compensation;
- strategic planning and risk management;
- the audit function (including consideration of the potential for regulatory requirements that are more extensive than those that apply under the NAIC's recently revised model audit rule);
- the actuarial function (including consideration of whether governance requirements should be imported from the principles-based life insurance reserving project to other product types);
- insurance company codes of conduct and ethics;
- processes needed to ensure regulatory compliance;
- director education and evaluation; and
- director and senior executive succession planning.

In addition, the consultation paper proposes that information regarding corporate governance should be regularly shared with insurance regulators and "verified" during periodic insurance regulatory financial exams. The consultation paper also proposes that every insurer should be required to adopt an independent "formal risk management framework/function to ensure that the insurer is properly identifying, monitoring and managing the risks it faces." The risk management function would, among other things, be required to quantify risks for "a sufficiently wide range of outcomes" and accurately document significant risks. The risk management function would be responsible for performing an internal risk and solvency assessment under the supervision of senior management and the board of directors, and would be required to share information with insurance regulators on a regular basis.

Group-Wide Regulatory Supervision

Another focus of the solvency modernization initiative is the regulation of insurance conglomerates that consist of multiple legal entities spanning several jurisdictions. As part of the initiative, the NAIC has established the Group Solvency Issues (EX) Working Group, which is exploring a variety of ways to enhance the ability of state regulators to monitor insurance conglomerates at a group-wide level. The working group's efforts include consideration of a wide array of possible regulatory reforms, including:

- the participation of state regulators in supervisory colleges to facilitate the sharing of information and the coordination of regulatory action involving multi-jurisdiction insurance conglomerates;

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- enhanced reporting requirements for unregulated entities within insurance holding company systems;
- the potential imposition of group-wide capital requirements; and
- the development of a revised model law for insurance holding company systems.

The working group's efforts to develop a new model insurance holding company law are already well under way and could, if adopted in current form, have a significant impact on insurers and on transactions in the insurance industry. The proposed revisions include, for example, stricter regulatory filing requirements and standards for inter-affiliate agreements, a requirement that an insurer file consolidated financial statements of its holding company system on request, and a requirement that buyers of insurers, in connection with the regulatory filing needed to take control, commit to provide an annual report "identifying all material risks within the holding company system that could pose financial and/or reputation contagion to the insurer". For additional discussion, see our Client Update on the NAIC's 2009 Winter National Meeting, available at www.debevoise.com.

Conclusion

The solvency modernization initiative has the potential to significantly affect the regulatory regime applicable to U.S. insurers in the coming years. As a next step, the NAIC plans to add more detail to a draft solvency modernization roadmap that was first exposed for comment by the NAIC's International Solvency (EX) Working Group on September 20, 2009. The NAIC is also in the midst of developing a white paper that summarizes the "core principles" of the U.S. system of solvency regulation. In the meantime, detailed work on existing reform projects continues apace. These and other matters will be the topic of a special, interim meeting of regulators to discuss the solvency modernization initiative on March 11-12 in Phoenix, Arizona, in advance of the upcoming 2010 Spring National Meeting of the NAIC in Denver, Colorado from March 25-28. ■

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alternatives to formal receivership. During the recent financial crisis regulators, the companies they regulate and other interested parties have been increasingly willing to pursue alternative approaches to formal receivership proceedings. The most well-known example of course is the federal government's assistance to AIG, which was primarily focused on the holding company but not the insurance company subsidiaries. Below are some other examples of alternative approaches to formal insurer receivership proceedings.

Use of a Special Purpose Entity to Segregate Distressed Business

In 1996, Conseco acquired insurers that had written "legacy" guaranteed renewable long-term care ("LTC") policies. A series of internal mergers left these policies as obligations of Conseco's indirect subsidiary Conseco Senior Health Insurance Company ("CSHI"), but they quickly became a financial drain on the entire holding company. Between 1998 and 2008, Conseco made over $900 million in capital contributions to CSHI to offset the drains on CSHI's surplus of higher claims costs, driven by adverse morbidity and investment experience. The LTC policies were expected to remain a burden into the future.

Conseco sought the approval of the Pennsylvania Department of Insurance (the "PA" Department") to transfer CSHI to a specially-created independent trust for run-off of its business. Conseco proposed that it would capitalize the trust with $175 million in cash and unsecured notes, and pay the trust's operating expenses for the first four years of its existence. The "Form A" regulatory filing seeking approval for the transfer listed several advantages of the plan for the LTC policyholders, including appointment of well-qualified trustees and elimination of shareholders (thus making protection of policyholders the sole purpose of the trust). Upon completion of the run-off, CSHI would be liquidated or sold, with the proceeds to be donated to one or more charities focused on issues related to senior health. The Form A also indicated that Conseco would not be obligated, and would have no intention, to provide additional financial support to CSHI if approval of the transfer were denied.

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The PA Department approved the transfer on November 12, 2008. In response to various written comments filed with respect to Conseco's application, the PA Department's Order noted that the trust would be subject to the terms of a Regulatory Settlement Agreement among various regulators and CSHI, no rate increases would occur that would not otherwise occur under the company's existing structure and upon consummation of the transfer the company would meet minimum surplus requirements for a stock company authorized to write the company's lines of business.

... as of mid-year 2008 there were approximately 129 U.S.-domiciled insurers in voluntary run-off, with over $36 billion in claims in progress.

Now called the Senior Health Insurance Company of Pennsylvania, the company continues to be owned by the trust.

Restructurings of New York Monoline Insurers

In 2007, the New York Insurance Department (the "NY Department") announced a plan to stabilize New York-domiciled bond insurers through development of new regulations, attracting new capital to the market and the resolution of troubled companies. Recent approvals by the NY Department include:

- the January 2009 approval of the plan of CIFG Holding, Ltd. to avoid rehabilitation by commuting approximately $12 billion in collateralized-debt obligations backed by credit default swaps and obtaining reinsurance on guaranties of $13 billion in municipal bonds;
- the February 2009 split of MBIA Insurance Corporation into two companies, one of which would be responsible solely for MBIA's public finance policies (such as those on municipal bonds), with the other devoted to the international and structured finance market; and
- the July 2009 restructuring of Syncora Guarantee Inc., intended to eliminate the company's $4 billion deficit through (1) commutation of insurance policies on certain credit default swaps in exchange for a $1.2 billion payment to policyholders, (2) reinsurance for the company's municipal bond business by a newly formed well-capitalized subsidiary and (3) reduction in exposure to residential mortgage-backed securities ("RMBS") through cash tender offers to holders of insured RMBS in satisfaction of outstanding claims. These tenders, under which policyholders were also offered certificates representing the economic characteristics of uninsured RMBS, were accepted at a rate of nearly 70% and ultimately allowed the company to commute about $3.8 billion in liabilities and $1.2 billion in loss reserves.

In addition, Financial Guaranty Insurance Company ("FGIC") recently submitted a proposed surplus restoration plan to the NY Department intended to eliminate the $932 million surplus impairment that the company reported in November 2008 and prevent the initiation of receivership proceedings. Specific components of the plan were to include a tender offer for certain mortgage-backed securities guaranteed by the company and initiation of discussions with holders of insured collateralized debt obligations. This proposal follows FGIC's 2008 entry into a "cut-through" reinsurance agreement, brokered by the NY Department, under which the reinsurer agreed to make claims payments directly to the holders of $184 billion of municipal bonds insured by FGIC.

Proposed Sale of Insurer in Liquidation

Even where insurers have become subject to formal receivership proceedings, regulators have explored new strategies for protecting policyholders while limiting administrative burdens. In March 2009, the NY Department announced a plan it described as "the first time an American insurance company in liquidation has been sold to private investors." Under the plan, the New York Liquidation Bureau, which manages the estates of New York domiciled insurers in liquidation, issued a "Request for Proposal" seeking bids from investors to buy the Midland Insurance Company ("Midland"). Midland, which had been in liquidation since 1986, had assets of approximately $1 billion and liabilities of about $2.9 billion. The purchaser would agree to pay a percentage of Midland's liabilities in the form of a guaranteed distribution to policyholders with resolved claims plus a pro rata percentage of its profits over a set threshold. The purchaser could turn a profit through settlement of Midland's liabilities and successful collection from Midland's reinsurers. The Liquidation Bureau indicated that a purchaser would be expected to enter into reinsurance and parent support agreements with the liquidator.

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NAIC White Paper on Receivership Alternatives

The NAIC has also begun to explore methods for resolution of distressed insurers outside of receivership, as evidenced by the Financial Condition (E) Committee's adoption of a white paper entitled "Alternative Mechanisms for Troubled Companies" (the "White Paper") at its 2009 Winter National Meeting. According to the White Paper, the advantages of such methods include speedier resolution, uninterrupted claim payment, lower cost and enhanced financial flexibility for the troubled company. Disadvantages include the potential placement of excessive discretion in the hands of regulators, denial of procedural safeguards to policyholders, the risk of preferential payments to creditors of irreparably insolvent companies better suited to liquidation and conflicts of interest between policyholders and incumbent management. The mechanisms for troubled insurers discussed in the White Paper include the following.

Run-Off of a Troubled Insurer

The "alternative mechanism" most familiar to U.S. companies is entry into run-off. According to the White Paper, as of mid-year 2008 there were approximately 129 U.S.-domiciled insurers in voluntary run-off, with over $36 billion in claims in progress. In a troubled company run-off, an insurer seeks to wind up its business while remaining solvent and keeping management in place. While the insurer ceases writing new business, it continues to collect premiums and pay claims on existing business and it may seek relief from its obligations through such devices as negotiated settlements with policyholders, voluntary policy commutations, or purchases of reinsurance.

A run-off is typically subject to close supervision by state regulators, who will monitor the company's financial condition and its treatment of policyholders. The regulator's ultimate mission is to ensure that policyholders and other creditors fare no worse than they would in a receivership proceeding. Where a company fails to maintain solvency during a run-off, receivership proceedings may be commenced.

Commutation of Reinsurance Agreements under New York Regulation 141

Section 1321 of the New York Insurance Law authorizes the New York Superintendent of Insurance (the "Superintendent") to allow an "impaired or insolvent" insurer to eliminate the impairment or insolvency through commutation of reinsurance agreements under which it assumes business. Pursuant to Section 7425(d), such a commutation is exempt from treatment as a voidable preference.

Under Regulation 141, an insolvent insurer, other than a life insurer, is eligible to provide the New York Insurance Department a plan for relief from its reinsurance liabilities. The core of the plan is a draft commutation agreement, subject to the approval of the Superintendent, to be offered to every ceding insurer to which the insolvent insurer has obligations. No variation is permitted in the terms of the agreements offered to different cedents, except that the discount on the insolvent insurer's obligations may, under certain circumstances, vary with the type of business being commuted.

No negotiation is permitted; each ceding insurer considers the offer on a take-it-or-leave-it basis. If (and only if) enough ceding insurers accept the commutation order for the insurer to be restored to adequate surplus (as determined by the Superintendent), those agreements will become effective.

Other Approaches

In addition, the White Paper describes a Rhode Island statute permitting voluntary restructuring by a solvent, adequately reserved insurer. Under this framework, a Rhode Island-domiciled reinsurer or commercial property and casualty insurer in run-off might be permitted to extinguish liabilities outside of receivership after receiving various approvals from creditors and the court. This device, which has never been used in practice in the United States, has attracted significant criticism from corporate policyholders and others as well as doubts about its enforceability outside of Rhode Island.

Finally, the White Paper discusses options available under UK statutes: a "scheme of arrangement" between a solvent or insolvent company and its creditors and the transfer of reinsurance business from one insurer or reinsurer to another without policyholder consent. Both of these devices include procedural safeguards including court and regulatory approval.

Conclusion

Recent events have shown that regulators are increasingly willing to consider innovative approaches to working with distressed insurers. As insurance companies continue to confront the effects of the financial crisis and recession, those that see trouble on the horizon should open lines of communication with counsel and regulators and embrace flexibility in working toward long-term solutions. ■

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