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The Orderly Resolution of Lumbermens

By John K. Conway, James W. Schacht and Kenneth R. Wylie⁺

Introduction

This article provides a brief overview of the resolution of Lumbermens Mutual Casualty Company (a U.S. property/casualty insurer) and its insurance subsidiaries and affiliates through a nearly 10-year commercial run-off. In the context of the current debate in the United States and internationally regarding the systemic risk caused by insurer failures, the Lumbermens Mutual Group (LMG) run-off provides an example of how the U.S. insurance regulatory system can handle an insurer wind-down in a way that avoids undue hardship on the insurer's claimants and policyholders. Also, it is an example of an insurer wind-down that does not present a systemic risk to the American insurance and financial services sectors and certainly not the broader American or global economies. The wind-down of Lumbermens did not require any governmental assistance.

Lumbermens was formed in 1912 to handle the risk exposures of the Chicago-area lumberyard industry under the then newly enacted workers compensation laws in the State of Illinois. By 2001, Lumbermens grew to become the sixth largest workers compensation carrier in the United States and one of the largest property/casualty carriers in the country.

Following a series of initiatives in the 1990s to strengthen Lumbermens' balance sheet and diversify its writings within the limitations inherent to a mutual insurance company structure, the company remained capital constrained in the eyes of rating agencies, who downgraded the company to below A- status in late 2002. The company was quickly forced to enter a run-off status, the largest property/casualty run-off in American history.

Under the close administrative supervision of the Illinois Department of Insurance (the Department), beginning in early 2003, Lumbermens was able to resolve 90 per cent of its direct and assumed liabilities by mid-2012, resulting in a company group with greatly reduced liabilities and a simplified corporate and contractual structure. At that time, the Department chose to place Lumbermens and certain of its remaining insurance subsidiaries and affiliates into receivership in preparation for the final stage of its wind-down and dissolution.

Run-off

The commercial run-off of LMG was an unprecedented and highly successful endeavour. Over nearly ten years, without any form of governmental intervention or financial assistance, Lumbermens was able to (i) pay over US\$10bn in current claim obligations in full as they became due (without any *involuntary* discount or other decrease in claim payments as a result of Lumbermens' financial condition or regulatory status), (ii) monetise over US\$9bn in reinsurance recoverables and direct premium receivables, (iii) implement the orderly simplification of its very large and complicated organisational and reinsurance structure, (iv) resolve over US\$1 billion in future liabilities to insureds and reinsureds on a purely *voluntary* basis, while (v) maintaining the confidence of the national regulatory community through frequent and in-depth communication, assisted by the leadership and cooperation of the Department.

⁺ Respectively, former General Counsel, Lumbermens Mutual Casualty Company; President, The Schacht Group; Senior Counsel, Sidley Austin LLP. The information provided in this article was obtained from public and/or other non-confidential sources. The opinions expressed are those of the authors only and not of any organisations with which they were or are affiliated.

The Lumbermens run-off is a prime example of how regulators and company personnel can implement the best features of the American insurance regulatory system for the benefit of all constituencies. It also confirms the benefit of early and decisive action by the board of directors of Lumbermens, who decided to accept the inevitability of a run-off solution and to take prudent and responsible steps for the benefit of the company's claimants and policyholders.

The flexibility of a commercial run-off permitted the gradual non-renewal of Lumbermens' in-force business over a 12-month period, placing a consistent, but limited, responsibility on the company's producers to obtain substitute coverage over that extended period. The availability of coverage in the U.S. insurance marketplace permitted most policyholders of Lumbermens to quickly find replacement coverage. While Lumbermens was a substantial player in the U.S. insurance industry, it was not a significant player in the financial services sector and was not interconnected with other insurers, banks or other entities measured by either the size or the nature of such interconnections so as to present a systemic risk to the U.S. (or global) economic system. Most importantly, the very nature of a commercial run-off is to permit the gradual unwinding of significant counter-party risk exposures with direct insureds and reinsureds, with cash payments occurring as would be expected of normal operating companies in the ordinary course. In that way, the actions mitigated the potential stress of unexpected liquidity pressures. This is in sharp contrast to failures that create a "run on the bank" concern voiced by banking and other non-insurance governmental officials in the U.S. and globally. Finally, no taxpayer moneys were used during the wind-down of LMG.

The decision to enter run-off. A rating downgrade at year-end 2002 was quickly met with the decision to enter a run-off. As Lumbermens rapidly changed from an operating company to a full-scale wind-down, its focus shifted from being a profitable *underwriting* company to strictly and solely a *claims-paying* company. 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 through mid-2012, was characterised by highly focused attention on liability reduction, through both the ordinary course of claim payments and voluntary disengagement agreements with large insureds, further aggressive expense savings and consistent treatment of counter-parties. The challenges facing LMG occurred in an environment that was not supportive of either a private market rescue solution or pursuit of a traditional state insurance receivership proceeding. A key challenge was the over 200,000 open claim files in early 2003 and the nationwide scope of the business that would have created unnecessary stress to a state insurance receivership proceeding and the 50-state guaranty fund system. The recent failures of almost 30 other writers of workers compensation were straining the operational resources of the U.S. guaranty fund system as then configured. Again, while those challenges in 2003 would not have had a significant adverse impact on the insurance industry (let alone the financial services sector or the U.S. economy), it was determined these challenges could be better addressed through the commercial run-off of LMG.

Advantages of run-off. Consideration of a commercial run-off of LMG under the supervision of the Department avoided an insurance receivership proceeding of LMG that could have had an adverse impact on claimants and policyholders (i) due to delays in the payment of claims, particularly in workers compensation and (ii) elimination of the obligations to provide a claim defence for the benefit of liability policyholders because of the immediate cancellation of ongoing policies. A commercial run-off was a better way to preserve the value of pre-paid claims handling agreements covering workers compensation, general liability and automobile liability, the bulk of the company's claim counts.

A commercial run-off under the supervision of the Department, as the domiciliary regulator for the LMG insurance companies, allowed for the introduction of "economic" financial statements through the use of permitted accounting practices in contrast to the use of statutory accounting principles more suitable for an ongoing company. This flexibility is inherent to 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.

The Department's financial regulators, in contrast to a statutory receiver, were familiar with company operations and financial results, and thus could enhance the transition to ultimate receivership through review and approval of LMG's implementation of transactions involving surplus and liquidity initiatives. Finally, the Department in its capacity as the guardian of the interests of policyholders and claimants—the key constituents in the context of a commercial run-off—was able to protect against the possibility of inconsistent treatment of those policyholders and claimants.

Guiding principles. To enhance the run-off plan, certain guiding principles and initiatives were followed:

- 1) All valid obligations that met insurance policy provisions and applicable law were timely paid or otherwise settled.
- 2) LMG's assets, including reinsurance recoverables on both paid and unpaid claims, were managed to maximise the value of those assets, consistent with continued solvency and liquidity.
- 3) Supervision by the Department included all filings normally required of an operating company with the preparation of financial statements on an "economic basis", while maintaining accounting-based solvency. Additional confidential filings were also specifically designed to assist the Department in its role.
- 4) Transparency and accountability to policyholders and other creditors were a primary feature of the run-off plan, including regularly scheduled meetings with state insurance regulators and guaranty funds. Disclosures on LMG's publicly available filings were drafted to be both wide and deep, while selective disclosures to private constituencies such as individual claimants were strictly avoided.
- 5) Retention arrangements were put in place to keep personnel in place to avoid the flight of institutional memory essential to the wind-down.
- 6) The distribution of assets to the extent appropriate with the run-off plan followed the priorities set forth in Section 205 of the Illinois Insurance Code.
- 7) A new Illinois Law was enacted to facilitate disengagement transactions (Section 204(m)(C)), which provided that transfers made during the run-off that have been approved by the Department would not be considered a prohibited or voidable transfer in the event the company was later placed into receivership.

Summary

The LMG commercial run-off was a success. In many respects, the run-off was an unprecedented exercise with a high degree of creativity and flexibility in regulatory oversight by the Department in conjunction with focused attention on continued reduction of expenses and policy liabilities by the company. This focus was 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 and the number of open claim files by 95 per cent, and greatly eased its eventual transition to the receivership begun by the Department in July 2012. Significantly, the LMG resolution illustrates the lack of systemic risk to the U.S. insurance or financial sectors of a large property and casualty wind-down and the avoidance of any governmental assistance.