Highlands Insurance Company, *In Receivership*

Over the last 25 years, a few enterprising regulators have exercised their discretion to fashion rehabilitation plans that avoid the negative consequences typical of liquidation, including triggering guaranty associations, the insolvency clause in reinsurance agreements, and balance sheet adjustments, even though the company will never return to independent operation. The rehabilitation of Highlands Insurance Company ("Highlands") is the latest case in point.


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By Stephen W. Schwab and Carl H. Poedtke III

Introduction

In most cases, rehabilitation of an insurance company is undertaken either as a "pit stop on the road to liquidation"—an opportunity for the domiciliary regulator to "look under the insurer's hood" and determine if liquidation is necessary—or when there is a reasonable expectation that the insurer can be "put back on the street" and returned to independent operation. Over the last 25 years, however, a few enterprising regulators have exercised their discretion to fashion rehabilitation plans that avoid the negative consequences typical of liquidation, including triggering guaranty associations, the insolvency clause in reinsurance agreements, and balance sheet adjustments, even though the company will never return to independent operation. The rehabilitation of Highlands Insurance Company ("Highlands") is the latest case in point.

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Unsuccessful Runoff and Entry into Receivership

Highlands was incorporated in 1957 by Kellogg, Brown & Root to serve as its wholly- owned captive insurance company. Halliburton later acquired both Kellogg, Brown & Root and Highlands. Highlands is a Texas domiciled property and casualty insurance company. It held licenses to transact business in all 50 states, the District of Columbia, Guam, and Puerto Rico, but its principal place of business was in New Jersey. Highlands had various affiliates in and outside the United States, including a company that operated in England and later found itself in English administration proceedings, as well as a Delaware corporation that ended up in US bankruptcy court.

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Highlands underwrote primarily commercial (including worker's compensation, general liability, and commercial automobile), specialty, marine, and personal lines coverage. In the late 1960s, it began issuing excess and umbrella coverage to large corporations. The commercial lines, umbrella and excess covers were embodied in occurrence liability policies, exposing Highlands to environmental and mass tort ("EMT") liabilities, such as asbestos and pollution. The asbestos exposures included amounts billed to Highlands by its former parent, Kellogg, Brown and Root.

In the 1990s, Highlands was incurring significant loss development, particularly in its commercial, excess and umbrella lines. In 1996, Halliburton spun off Highlands and in 2001, the company began to request, and received, regulatory approval for non-renewals in

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all states. Highlands effectively moved into runoff, albeit operating under close regulatory scrutiny. In February 2002, it was placed in confidential supervision. In August 2002, the Texas Commissioner found Highlands to be in a "hazardous condition" and ordered it to rectify its condition. Circumstances deteriorated.

In November 2006, the State of Texas filed a court application for permanent injunction and an order appointing a receiver, citing:

- a $186 million decrease in statutory net worth from 1998 until June 30, 2003, when it landed at $7.6 million;
- negative net income, with a negative cash flow for operations of $158,624,622 as of December 31, 2002, and $99,598,209 as of June 30, 2003;
- under-reserving of estimated ultimate losses;
- insufficient risk based capital;
- negative unassigned surplus (which reflects historical earnings of the company) of $116,663,162; and
- entry of a $57.4 million final judgment against Highlands in California state court.[1]

The court entered the requested order on an agreed basis and appointed the Commissioner receiver "for the purpose of conserving the assets of [Highlands] and rehabilitating the business."[2] Although the State filed a petition to liquidate Highlands only weeks later due to a dispute with the $57.4 million judgment creditor, that dispute was resolved and the State elected not to pursue liquidation.

The Plan for Rehabilitation and Related Litigation

In June 2005, Texas became the first state to adopt a then unfinished version of the National Association of Insurance Commissioner's Insurer Receivership Model Act.[3] The new law went into effect September 1, 2005, substantially changing the law applicable to Highlands' rehabilitation. As required under the new law, the Receiver, through his Special Deputy (the "SDR"), developed a rehabilitation plan and in July 2006, the SDR applied for court approval. The proposed plan intended to effect a managed "runoff" of the company's liabilities; there was no intention to return the company to independent operation. The plan's lynchpin was an "Economic Cash Flow Model" ("ECFM") which the SDR proffered to demonstrate that the reasonable likelihood that Highlands' policyholders would have all of their claims paid in full—at least at a level greater than would be achieved in liquidation.

Opposition to the plan was fierce. At least 10 creditors — including major corporate policyholders — some in Chapter 11, "mom and pop" insureds, cedents, reinsurers and even some of Highlands' affiliates[4] — objected on multiple grounds, asserting, among other things, due process violations, that the plan was a *de facto* liquidation without guaranty fund protection and other liquidation "benefits" for policyholders, that the SDR had not demonstrated that policyholders would receive at least as much under the plan as they would receive in a liquidation—indeed that the plan discriminated in favor of workers compensation claimants as against all other policyholders, and that the plan did not demonstrate that there were adequate means to support it. An extensive hearing (spanning nine months, seven formal evidentiary hearings involving the testimony of numerous expert witnesses, closing argument, and thousands of pages of motions and briefing materials) followed before a Special Master in Austin, Texas, during which the SDR presented various financial and actuarial projections and analyses in support of the plan.

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In April 2007, the Special Master issued a 37-page memorandum opinion recommending denial of the proposed plan. The Special Master concluded, among other things, that the inherent risks in estimating EMT claims over many years called for a more conservative approach in developing projections, but even under such an approach, the SDR could not meet its burden to support the application. Among the Special Master's findings was the SDR's failure to demonstrate that the plan would pay all Allowed Class 2 (policyholder) Claims equally and in full over the life of the plan. The Special Master found in the SDR's favor on a few key points—notably the permissibility of implementing a managed runoff in the context of rehabilitation — but concluded that the proposed plan could not satisfy the new legal requirements. However, the Special Master gloomily commented that "the SDR has not established (and likely cannot establish) by a preponderance of the evidence in this Estate that all Allowed Class 2 claimants from now through closure of the Estate will receive 100% of their Allowed claim in rehabilitation."[5]

Despite the objectors' initial victory, the SDR petitioned the state court for a trial *de novo*. Among other things, they

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collectively contested the Special Master's allocation of the burden of proof and his interpretation of the Act, as well as his findings and conclusions. Meanwhile, the SDR was revising the plan to overcome the Special Master's damaging findings. Substantial briefing and discovery followed, as well as settlement with Highlands' UK affiliate (which had been the SDR's most vociferous opponent).

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The receivership court conducted a four day trial in May 2008. Unlike the Special Master hearing, very few interested persons participated or even observed. After considering evidence from the prior hearing, as well as new expert actuarial testimony establishing the reasonableness of the plan's financial projections, the court approved a Second Amended Plan of Rehabilitation ("Plan").

In reaching its decision, the court noted the size of the Estate's liabilities: $650 million of policy claim liability in all 50 states, of which approximately $110 million was for worker's compensation claims, $360 million for EMT claims, and $180 million of "other" claims. Upon its review of a new ECFM, the court concluded:

> The ECFM is based on assumptions concerning income and claim payments that are reasonable and reliable. Based on these estimates, the Estate should have sufficient funds to pay allowed administrative and policyholder claims as they become payable. As of the tenth anniversary of the ECFM, for example, the Estate reasonably anticipates having a cushion in excess of $140 million available to pay remaining policyholder claims and then non-policyholder claims. This cushion is more than 20% of the total estimated claim liability of $650 million. At the end of the anticipated payments to policyholders, the ECFM reasonably projects that significant funds will be available to pay lower priority non-policyholder claims.[6]

The court was further persuaded by the Estate's substantial reinsurance (approx. 90%), and general success in collecting reinsurance (approx. 82%). On balance, the court found that rehabilitation was likely to prove more effective than liquidation, particularly when considering the limited coverage of guaranty funds, and the impediments which liquidations cause (e.g., encumbrances in reporting data to reinsurers).

The Estate's Performance to Date

The SDR reports quarterly to the Special Master on the managed runoff of Highlands' liabilities. Per Special Master order, the SDR developed a four-phase monitoring plan to assess the Estate's performance, which includes:

- review of investment rates of return, recovery of assets, actual versus projected claims payouts, and administrative expenses;
- updated claims liability analyses;
- updated actuarial analyses; and
- processing of information through the ECFM.[7]

On July 19, 2010, the SDR orally reported to the Special Master that the updated ECFM and actuarial analysis confirm that the SDR's decision to support the rehabilitation continues to be reasonably and rationally based. The updated ECFM projects over time (through 2032) that all Class 1 and Class 2 claims will be paid in full as they become due. Per the analysis, the SDR reported there would be no impairment of cash and invested assets. The SDR also reported improvement in the Estate's gross claims liability. Prior reports indicated the Estate faced $650 million in claims liability; by July 2010, the number had reduced to approximately $399 million. The total claims paid out to date were slightly higher ($10 million) than prior projections, but reinsurance collections were $24 million higher, and cash and invested assets were $27 million ahead of ECFM projections.

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As of April 11, 2011, total assets equaled $220,638,733, while total liabilities inched up slightly to $401,043,427 (including multiple liability classifications). The SDR's quarterly financial reports may be viewed at the Highlands Docket Website.

Conclusion

Highlands confirms the flexibility of rehabilitation in the hands of a creative regulator. Time will reveal the Plan's relative success. Various disputes and issues involving interested parties continue, but the Estate is proceeding to address claims and operate under the platform set in place several years ago. Highlands teaches that, to the extent done within the bounds of the law: (i) a managed runoff

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group to keep the Mission failures under wraps for such an extensive period of time.

> *Today, it would be far harder to contain sensitive details and information within a small enough control group to keep the Mission failures under wraps for such an extensive period of time.*

Second, had a "Mission-like" company arisen during the past few years, it seems likely that the governmental and regulatory responses would have been stronger. The existence of the Dingell Report and the increased role of regulatory and prosecutorial oversight would inevitably allow for greater political pressure to proceed civilly and criminally against senior management. That reality, in turn, would make management less likely to be willing to take such risks. ■

Notes

1 Dingell Report at 2.

2 The Dingell Report observed that PRMC was able to convince approximately 75 reinsurance companies to join the pool and remain members over a period of several years. There was deliberate misrepresentation involved; however the Subcommittee's investigation has shown that anyone with a basic knowledge of insurance could have detected the wrongdoing. (Dingell Report at 21).

3 Cash flow underwriting in the soft market was made possible by double digit interest rates that prevailed during the late 1970s and early 1980s.

4 Mission had an executive compensation program that was geared to Mission's financial performance as compared to other companies in the industry. Key management personnel were awarded stock options and bonuses as rewards for superior results. The Mission Group chairman sold a large amount of his shares in early 1984, before the house of cards came tumbling down. PRMC senior management left in early 1983 and similarly sold stock before the full extent of Mission losses were made publicly available. (Dingell Report at 15-16).

5 Superior National was formed by former members of Mission Group senior management. Superior National ultimately collapsed as well. PRMC's senior management left to start their own reinsurance MGA, Continuity Re. Continuity Re had the pen for Integrity. Sadly, the only "continuity" was that Integrity also failed, just like Mission.

6 *See, Prudential Reinsurance Co. v. The Superior Court of Los Angeles County*, 3 Cal.4th 1118 (1992).

7 *See, Quackenbush v. Mission Ins. Co.*, 46 Cal.App.4th 458 (1996); *Quackenbush v. Mission Ins. Co.*, 62 Cal.App.4th 797 (1998).

8 (Dingell Report at 19.)

9 (Dingell Report at 19.)

10 PRMC wrote a number of contracts in favor of Integrity. Soon, Mission became the largest reinsurer of Integrity. When PRMC management left PRMC in 1983 to start up Continuity Re, Integrity not only gave them its pen, but also loaned them the money to finance the start up of Continuity Re's operations. PRMC pool members were laden with enormous losses on Integrity business.

11 Dingell Report at 17.

12 Dingell Report at 62.

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remains a viable option for receivers; and (ii) receivership modes and practice will continue to evolve as receivers seek innovative ways of balancing the best interests of policyholders, other creditors and the public. ■

Notes

1 *See* Plaintiff Original Petition and Application for Permanent Injunction and Order Appointing Receiver, Nov. 6, 2003, *available at* http://www.sdrtx.com/documents.asp?Company=Highlands (hereinafter "Highlands Docket Website".

2 *See Id.* Agreed Permanent Injunction and Order Appointing Receiver (Filed November 3, 2003).

3 *See* Tex. Ins. Code § 443.001 *et seq.*

4 Meanwhile, creditors of Highlands' UK affiliate initiated proceedings in England to place the company in receivership, thus embroiling the SDR in litigation on both sides of the Atlantic at the same time that included jurisdictional challenges as well as disputes over applicable law.

5 Highlands Docket Website, Memorandum Recommendations and Finding of Fact and Conclusions of Law, at 31 (April 18, 2007).

6 Highlands Docket Website, Findings of Fact and Conclusions of Law Regarding Application for Approval of Rehabilitation Plan, ¶ 25 (June 6, 2008).

7 See SDR's Monitoring Plan for the Second Amended Plan of Rehabilitation for Highlands Insurance Company (September 3, 2009) available at www.highlandsrehabilitationplan.com.