

K&LNG Alert

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Insurance Coverage Highlands Proposes Rehabilitation Plan

INTRODUCTION

Insurer insolvency is an all-too-familiar challenge facing corporate policyholders, particularly those with long-tail liabilities.¹ The insurance failures of the past forced many policyholders to bear substantial liabilities, only to wait years – if not decades – to learn whether they were to receive any recovery on their claims for coverage. Insurer near-insolvency (or, to take a more jaded view, undeclared insolvency) is a variation on this theme. It is a variation that could perhaps be playing out in the Texas state courts with respect to Highlands Insurance Company (“Highlands”), a company placed in receivership in Texas on November 6, 2003. Recent activity in the Highlands proceeding warrants policyholder attention.

On Monday, July 24, 2006, the Special Deputy Receiver (“SDR”) for Highlands filed its Rehabilitation Plan (“the Plan”) in the receivership court in Texas.² Pursuant to the Plan, Highlands would continue in rehabilitation indefinitely, affording the SDR an opportunity to work to resolve claims by negotiation while working to preserve the assets of the Highlands estate.³ Interested policyholders may wish to move promptly in considering their options under the Highlands Plan – objections are due in the receivership court on **August 21, 2006**, with a hearing scheduled on the Plan for September 8, 2006. In addition to these deadlines, policyholders will want to take note of the **March 30, 2007** deadline for filing proofs of claims previously established by the receivership court.

OVERVIEW OF THE PROPOSED PLAN

The Plan purports to comply with Texas insurance insolvency law, which requires that a rehabilitation plan be “fair and equitable to all parties concerned.”⁴ Among the guiding principles in the rehabilitation process are that each claim or class of claims be treated in a manner that is “no less favorable” than in a liquidation scenario, and that claimants of a higher priority be paid before those with a lesser priority receive payment. The SDR proposed the Plan in lieu of an immediate liquidation of Highlands “because it believes that an orderly runoff of the obligations of Highlands is more likely than a liquidation to result in a higher return to creditors and claimants.”⁵

After an overview of pertinent background (including Highland’s history and coverages written, the receivership, significant claims resolved, significant assets collected and pending litigation),⁶ the Plan addresses the financial condition of the estate. In a prediction that some observers may question, the SDR predicts that the estate will have sufficient assets to pay claims as they come due in the next ten years, and that it will thereafter have \$179 million in cash and investment assets remaining to pay claims after 2015.⁷ These projections are based upon what the Plan calls the estate’s economic cash flow model (“ECFM”). The ECFM forecasts estimated inflows and outflows on an annual basis through December 31, 2032, based on known asset account balances as of December 31, 2005 and estimating an annual yield on investments of 5.00%, and based upon estimates of future liabilities and future assets such as reinsurance recoveries.⁸

¹ Relatively recent domestic insurer insolvencies, such as those of Reliance and The Home, join those of a long list of companies (including Midland, Integrity, Pine Top, and Transit) that failed in the wake of overwhelming claims, most particularly long-tail environmental and mass tort claims.

² See Application for Approval of Rehabilitation Plan, filed on July 24, 2006 in *State of Texas v. Highlands Insurance Company*, No. GV304537 (Travis City, Texas).

³ Plan, at 16, 22.

⁴ Plan, at 2 (citing Section 21A.103(a) of the Insurance Receivership Act).

⁵ Plan, at 3.

⁶ Plan, at 4-14.

⁷ Plan, at 18.

⁸ Plan, at 16-18.

Of course, the SDR's projections of the estate's financial viability contain admitted uncertainties, including the SDR's ability to negotiate settlements, future jury decisions, potential changes in the law, and general economic conditions. The most significant of those uncertainties, however, may well be the ultimate magnitude of long-tail environmental and mass tort claims to be faced by Highlands during the rehabilitation. As outlined in the Plan, "[t]he financial model set forth in this Plan assumes an estimated set of payments to claimants. Many claimants, including in particular claimants under commercial general liability policies who assert claims for coverage for toxic tort and environmental claims, have asserted or may assert claims which far exceed the claims estimates made by the SDR's claims staff in developing the financial model."⁹ With a projected equity margin of only \$179 million after ten years, claims assertions that "far exceed" the estimates used in developing the ECFM could potentially lead to a liquidation of Highlands in the future.¹⁰

That risk of a future liquidation may be used by the SDR into the future in an effort to leverage settlements with policyholders, for substantial discounts to limits, in order to benefit the estate's financial condition. In fact, the Plan reveals that the estate has been following such a strategy in the last few years. In reviewing the economic position of the estate since the establishment of the receivership, the Plan asserts a \$120 million financial improvement.¹¹ The Plan claims that the improvement "ultimately derives from the successful use by the Estate of its powers to negotiate beneficial policy buy-backs and to settle significant claims and lawsuits based on the facts and circumstances of particular cases. . . . This Plan is crafted to allow the Estate to continue to have the discretion and flexibility to deal with the remaining claims and assets in a cost-effective and beneficial fashion."¹² The Plan, however, offers no guidance on the range of discounts to limits or amounts due that the SDR may seek in negotiating its

settlements, nor what a final payment percentage may be in the event that Highlands is liquidated. Thus, policyholders face uncertainty regarding whether settlements they negotiate will compare favorably or unfavorably with what they may receive in a liquidation of Highlands.

Another important power that the Plan would give to the SDR is the power to regulate the estate's cash flow by deferring payment on claims. The Plan provides that "[t]he SDR may defer payment of Allowed Claims if it reasonably believes that the cash management needs of the Estate so warrant, but may not defer payment of specific claims or portions of such claims if the effect with respect to such claim (or portion) is to provide for less favorable treatment than such claim (or portion) would receive in a liquidation."¹³ Unless and until it is clear what those payments in a liquidation would be, however, it is difficult to see how this limitation on the SDR's authority to defer payment of claims will have any real force.

After outlining the projected financial condition of the estate, the Plan reviews the claim submission process. That process, with respect to Class 2 claims (the class that includes policyholder claims for insurance coverage)¹⁴ is reviewed briefly below.

CLAIM SUBMISSION PROCESS

Importantly, all claimants must file a proof of claim with the SDR by March 30, 2007.¹⁵ The proof of claim must include (1) a statement signed by the claimant that gives particulars of the claim; (2) the amount and any security for the claim; and (3) the name and address of the claimant or its counsel.¹⁶ The proof of claim amount must be net of all payments owed and must state that no setoff, counterclaim, or defense to the claim exists.¹⁷ Documentation supporting the claim must be described in detail in the proof of claim or attached.¹⁸ If not attached, documents supporting the claim must be provided to the SDR within 30 days of a request, or the claim may be disallowed.¹⁹ The Plan states

⁹ Plan, at 20.

¹⁰ Plan, at 20 ("if the allowed amount of such claims exceeds the estimates, including actuarial projections, then the Plan will not succeed and liquidation will follow").

¹¹ Plan, at 20.

¹² Plan, at 20.

¹³ Plan, at 30.

¹⁴ Plan, at 28.

¹⁵ Plan, at 35.

¹⁶ Plan, at 33.

¹⁷ Plan, at 33.

¹⁸ Plan, at 33.

¹⁹ Plan, at 37.

that notice to Highlands of the existence of a claim does not constitute the filing of a proof of claim.²⁰ The Plan also states that policyholders need not file a new proof of claim if a proof of claim has already been filed with the SDR prior to the filing of the Plan.²¹

Policyholders should be aware that by submitting a proof of claim, any information on the claim or in its attachments will be used to evaluate the claim and may become publicly available.²² According to the Plan, by submitting a proof of claim, the policyholder authorizes Highlands and the SDR to disclose, discuss, and/or release orally or in writing information contained in the proof of claim form and its attachments to the extent deemed necessary or desirable by the SDR.²³

Regardless of whether the Receivership Court adopts the Plan, all proofs of claim must be served on the SDR by March 30, 2007 pursuant to a prior order.²⁴ The Plan states that claims served after this deadline will be treated as late claims and receive lower priority of payment.²⁵ According to the Plan, policyholders must comply with this deadline or risk nonpayment of their claims.

POTENTIAL LIQUIDATION

If the Plan is not approved, the SDR states that the rehabilitation will be converted into a liquidation proceeding under Texas receivership law.²⁶ In the event of a liquidation, the distribution percentage to policyholders will be determined after a lengthy process that would require the SDR to work with guarantee associations in every state.²⁷ The Plan states that coordination with fifty guarantee associations would increase the estate's administrative costs, reducing the portion of the estate available for policyholder claims.

Additionally, according to the Plan, a liquidation could trigger "cut-through" provisions in certain policies and grant certain policyholders direct access to Highlands' reinsurance policies, further diminishing the size of the estate.²⁸

The SDR may apply to the receivership court for an order of liquidation during the course of the receivership if in the SDR's judgment the benefits to claimants of a liquidation outweigh the benefits of continuing under the Plan.²⁹ In the event of a conversion to liquidation, the SDR reportedly intends to keep the same March 30, 2007 claim filing deadline.³⁰

CONCLUSION

Highlands is the latest in a procession of insurer insolvencies or near-insolvencies that present challenges to policyholders seeking to maximize their historical insurance coverages. Depending upon their individual circumstances, policyholders may support or oppose the rehabilitation plan, objections to which must be filed by August 21, 2006. Regardless of their individual circumstances vis-à-vis the Plan, however, each policyholder with Highlands coverage may wish to give serious consideration to filing a claim before the March 30, 2007 deadline.

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²⁰ Plan, at 33.

²¹ Plan, at 35.

²² Plan, at 34.

²³ Plan, at 34.

²⁴ See Order Approving Program for Notifying Creditors of Rehabilitation Plan and Setting Claims Filing Deadline, filed on May 23, 2006 in State of Texas v. Highlands Insurance Company, No. GV3-04537 (Travis City, Texas).

²⁵ Plan, at 35.

²⁶ Plan, at 42.

²⁷ Plan, at 43.

²⁸ Plan, at 43.

²⁹ Plan, at 44.

³⁰ Plan, at 45.

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