

The Rise of Insurance Runoff:

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Insurance ideas, practices, and metaphors inform legal thought. From the loss spreading that powered the expansion of tort liability, to the moral hazard that haunts financial services regulation, to the adverse selection that lies behind a host of legal rules, and even to theories of distributive justice, an insurance idea or metaphor often lies at the core of the analysis.² Scholars in fields as diverse as civil procedure, torts, corporations, contracts, and employment law use insurance practices as a window on the law in action.³ Legal historians study private insurance to learn about the origins of the welfare state.⁴ And recent legal scholarship reveals insurers to be, among other things, soft-law makers extraordinaire, private regulators of public police, and enablers of securities fraud.⁵

Despite this widespread use of insurance ideas, metaphors, and practices, the dominant image of insurance that appears in legal writing is a caricature. Almost without exception, the insurance that appears in legal thought is an ideal type that involves the fixed-in-advance

¹ This is a preliminary draft based on qualitative research that is ongoing. Thank you to the runoff market participants who have generously spoken me. Notwithstanding their efforts, this draft surely contains significant factual and analytical errors. Those errors are mine. Please send any corrections or suggestions to tombaker@law.upenn.edu For helpful comments on earlier drafts, thank you to Sean Fitzpatrick, Kyle Logue, Travis Pantin, Natasha Sarin, and Peter Siegelman. Thank you to Taylor Hertzler, Kayla Katz, and Sam Tang for research assistance. Thank you for feedback from participants at workshops at Villanova and Penn Law Schools.

² On loss spreading and torts, *see, e.g.*, Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961); George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1525 (1987) (“This insurance rationale suffuses our modern civil law.”). On moral hazard and financial services regulation, *see, e.g.*, Kathryn Judge, *The First Year: The Role of a Modern Lender of Last Resort*, 116 COLUM. L. REV. 843 (2016). *See also* Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996) (explaining origins of the term “moral hazard” in the insurance trade). On legal rules designed to address adverse selection, *see*, Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat*, 113 YALE L.J. 1223 (2004); *cf.* Tom Baker, *Containing the Promise of Insurance: Adverse Selection and Risk Classification*, in RISK AND MORALITY (Richard Ericson and Aaron Doyle, eds., 2003) (explaining origins of the term “adverse selection” in the insurance trade). On insurance metaphors in distributive justice *see, e.g.*, RONALD DWORKIN, SOVEREIGN VIRTUE 73 et seq (developing a distributional theory using a hypothetical insurance market); Daniel Markovits, *How Much Redistribution Should There Be?*, 112 YALE L.J. 2291 (using Dworkin’s model to reveal some previously unappreciated limits to redistribution); [Placeholder for citable piece by Travis Pantin, whose draft dissertation and discussions have been helpful in my thinking about insurance in legal thought].

³ *See, e.g.*, Joanna Schwartz, *Police Indemnification*, 89 N.Y.U. L. Rev. 885 (2014); Nora Freeman Engstrom, *Sunlight and Settlement Mills*, 86 N.Y.U. L. Rev. 805 (2011), Steven Yeazell, *Refinancing Litigation*, 51 DePaul Law Review 183 (2001); Bernie Black on medical malpractice litigation [comment – not clear which paper]; Sean Griffith, *Representation and Warranty Insurance in Corporate Acquisitions* [comment – date, on file?]

⁴ *See* Michele Landis Dauber, *The Sympathetic State* (2013); John Fabian Witt, *The Accidental Republic* (2006).

⁵ *See* John Rappaport, “How Private Insurers Regulate Public Police,” 130 Harv. L. Rev. 1539 (2017); Shauhin Talesh, *Legal Intermediaries: How Insurance Companies Construct the Meaning of Compliance with Anti-Discrimination Laws*, 37 Law & Pol’y 209 (2015); Omri Ben-Shahar & Kyle Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 Mich. L. Rev. 197 (2012); Tom Baker & Sean J. Griffith, *Ensuring Corporate Misconduct* (2010).

distribution of determinable risks.⁶ Of course, legal scholars recognize that adverse selection and moral hazard complicate that picture, but those information problems typically are understood as (manageable) constraints on insurers' ability to price and select risks with precision, not as a challenge to this fundamental conception of insurance.⁷ So well-established is this fixed-in-advance conception as, not only a normative ideal, but also an adequate *positive* description of insurance practice that George Priest's Yale Law Journal article about the liability insurance crisis (which remains one of the boldest efforts to use insurance ideas to shape legal doctrine) could call for the restoration of pre-1960 product liability law on the grounds that strict liability had destabilized insurance markets by undermining insurers' ability to fix their risks in advance.⁸ His recent challenge to the Restatement of the Law Liability Insurance makes similar arguments about the potential impact of that project on insurance markets.⁹

Scholars have persuasively criticized both efforts on multiple grounds, but none took issue with the underlying understanding of insurance, which remains the implicit consensus in legal scholarship today.¹⁰ Even scholars who would recruit insurance markets to achieve

⁶ See, e.g., Dworkin, *supra* note 1, at 73 et seq (discussing the "value of insurance" in ways that imply a fixed in advance distribution of determinable risks); Priest, *supra* note 1, at 1539-40 ("Insurance . . . requires that the loss be probabilistic, either as to whether or not it occurs at all (for example, whether one's house burns down) or as to when the loss occurs (for example, whether one dies before or after full life expectancy)."); Calabresi, *supra* note 1, at 529-530 (unforeseeable risks that would be shifted by strict liability cannot be priced in market insurance and would among the "uninsurable risks" that entrepreneurs would assume under a strict liability regime); Kenneth Abraham, Environmental Liability and the Limits of Insurance, 88 COLUM. L. REV. 942, 946-47 (1988) ("Insurance operates most comfortably with stochastic events, in which the probability of the frequency and magnitude of insured losses that will be suffered by policyholders is highly predictable"). Cf. Henry Hansmann, *The Organization of Insurance Companies: Mutual versus Stock*, 1 J. L., ECON., & ORG. 125 (1985) (treating the fixed-in-advance, distribution of determinable risks as the ideal type for commercial insurance and explaining that the inability to satisfy this ideal type for certain risks helps to explain the presence of the mutual form of insurance organization); HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 277 (1996). [comment – is last citation needed?]

⁷ See, e.g., Siegelman, *supra* note --- (explaining that adverse selection is "an exaggerated threat"); Baker, *supra* note XX (describing tools that insurers can use to manage moral hazard). Put another way, the concern that moral hazard and adverse selection make insurance "reactive" and, thus, difficult to price typically operates under an assumption that there is some underlying determinable risk that could be fixed in advance if the problems of moral hazard and adverse selection can be addressed.

⁸ See Priest, *supra* note 1, at 1561-3, 1574-78 (asserting that the expansion of product liability had increased the variance in liability insurance pools, relative to manufacturers' ability to predict their risk, so that manufacturers now had greater private information about their risk than before, destabilizing the insurance market in the long term through an adverse selection unravelling of the liability insurance market). Following Hansmann, *supra* note 5, Priest used the mid-1980s expansion of mutual liability insurance organizations as evidence supporting his thesis. Cf., Abraham, *supra* note 6 at XX (suggesting changes in environmental liability law to reduce uncertainty and promote insurance markets).

⁹ George L. Priest, *A Principled Approach Toward Insurance Law: The Economics of Insurance and the Current Restatement Project*, 24 GEO. MASON L. REV. 635 (2017).

¹⁰ For critiques of the insurance crisis article and the larger project to use insurance ideas to reduce tort liability, see, e.g., Jane Stapleton, *Tort, Insurance and Ideology*, 58 MOD. L. REV. 820, 843 (1995); Steven P. Croley & Jon D. Hanson, *The Nonpecuniary Costs of Accidents: Pain and Suffering Damages in Tort Law*, 108 HARV. L. REV. 1785 (1995); Jon D. Hanson & Kyle D. Logue, *The First-Party Insurance Externality: An Economic Justification for*

redistributive or corrective justice ends in ways that the “Yale lawyers” would surely regard as misguided,¹¹ share their understanding of insurance as, fundamentally, a means for the fixed-in-advance distribution of determinable risks.¹²

There is just one field of research that seriously questions this conception of insurance. Researchers in a branch of sociology initiated in the 1980s by students of Michel Foucault, and invigorated in response to Ulrich Beck’s risk society thesis, have gone into the field and discovered insurance practices that are more varied and multi-faceted than simple loss distribution.¹³ Legal scholarship has incorporated, and even extended, one of the central findings of this research: insurers often serve as private regulators of the people and entities that they insure.¹⁴ This “insurance as governance” idea fits easily in legal scholarship because it gives shape to the moral hazard management function of liability insurance posited in Steven Shavell’s influential early work on tort law and economics, and it helps explain how tort law’s noisy deterrence signals translate into loss prevention efforts on the ground.¹⁵

Enterprise Liability, 76 CORNELL L. REV. 129 (1990). For a response to the restatement article, see Tom Baker & Kyle Logue, *In Defense of the Restatement of Liability Insurance Law*, 24 GEO. MASON L. REV. 767 (2017).

¹¹ Stapleton, *supra* note – at 837 (“Yale lawyers” is her term for George Priest, Alan Schwarz, and Richard Epstein). See also *id.* (“the “tort-as-insurance argument also generates a reform strategy which is radically redistributive whereby business is enriched and injured individuals are stripped of protection”).

¹² See, e.g., Tom Baker, *Health Insurance, Risk, and Responsibility after the Affordable Care Act*, 159 U. PA. L. REV. 1577 (2011); Allison Hoffman, *Three Models of Health Insurance: The Conceptual Pluralism of the Patient Protection and Affordable Care Act*, 159 U. PA. L. REV. 1873 (2011); Nan D. Hunter, *Risk Governance and Deliberative Democracy in Health Care*, 97 GEO. L.J. 1 (2008).

¹³ The first significant results from this research reported in English appeared in GRAHAM BURCHELL, COLIN GORDON, PETER MILLER, EDs., *THE FOUCAULT EFFECT* (1991). A sample of the subsequent research includes the essays collected in *RISK AND MORALITY* (Richard Ericson & Aaron Doyle, eds., 2003); RICHARD V. ERICSON, AARON DOYLE & DEAN BARRY, *INSURANCE AS GOVERNANCE* (2003); Richard Ericson & Aaron Doyle, *Catastrophe Risk, Insurance and Terrorism*, 33 J. ECON. AND SOC’Y 135 (2004); PAT O’MALLEY, *RISK, UNCERTAINTY AND GOVERNMENT* (2006); INE VAN HOYWEGHEN, *RISKS IN THE MAKING: TRAVELS IN LIFE INSURANCE AND GENETICS* (2007); LUIS LOBO-GUERRERO, *INSURING WAR: SOVEREIGNTY, SECURITY AND RISK* (2012); Turo-Kimmo Lehtonen, *Picturing How Life Insurance Matters*, 7 J. CULTURAL ECON. 308 (2014); Philip D. Bougen, *Catastrophe Risk*, 32 J. ECON. AND SOC’Y 253 (2003). Cf., Michael C. Behrent, *Accidents Happen: François Ewald, the “Antirevolutionary” Foucault, and the Intellectual Politics of the French Welfare State*, 82 J. OF MOD. HIST. 585 (2010); Jonathan Simon, *The Emergence of a Risk Society - Insurance, Law and the State*, SOCIALIST REV. 60, 60 n.* (1987) (“My interest in the social effects of risk management techniques was inspired by the work of Michel Foucault”). [comment – need to find this issue]

¹⁴ See Tom Baker and Jonathan Simon, *Introduction to EMBRACING RISK: THE CHANGING CULTURE OF INSURANCE AND RESPONSIBILITY*, 13 (Baker & Simon, eds. (2002) (describing insurance as “a crucial form of delegated state power” and summarizing research on insurance “as a form of regulation”). For research by legal scholars extending this idea see, e.g., the sources cited in note 5, *supra*. For a review of some of this research, see Tom Baker & Rick Swedloff, *Regulation by Liability Insurance: From Auto to Lawyers Professional Liability*, 60 UCLA L. REV. 1412 (2013).

¹⁵ See Steven Shavell, *On Liability and Insurance*, 13 Bell J. Econ. 120 (1982); Tom Baker & Peter Siegelman, *The Law and Economics of Liability Insurance: A Theoretical and Empirical Review*, in *HANDBOOK ON THE ECONOMICS OF TORTS* (Jennifer Arlen, ed., 2013). Cf. Kenneth Abraham, *Four Conceptions of Insurance*, 161 U. PA. L. REV. 653, 683-96 (2013) (describing “insurance as governance” as one of the four conceptions of insurance).

Legal scholarship has not yet adequately acknowledged, however, let alone incorporated, a second major finding from this branch of sociological research: the ideal type of a fixed-in-advance, distribution of determinable risks does not match the reality of insurance markets, even in a field like life insurance, which would be expected to be the paradigmatic example of this ideal type in action because of the availability of public and private mortality data going back hundreds of years.¹⁶ Everywhere they looked, the sociologists found insurance practices that deviated from this ideal type: insurance that went beyond the data, potential insured losses that could easily swamp the available assets of the industry, insured losses that defied prediction, and on-the-fly, after-the-sale adjustments to unforeseen circumstance.¹⁷ Insurers may well try to price based on their best assessment of the frequency and severity of severity of future losses,¹⁸ but this research provides so many reasons, beyond moral hazard and adverse selection, why insurers so rarely hit that pricing nail on the head that legal scholars should stop thinking and acting as if they did.¹⁹ Instead, we should start learning more about how insurers manage this uncertainty.

This Article brings this second finding and the challenge it poses into legal scholarship while also extending the underlying qualitative empirical research, by investigating, for the first time in the scholarly literature in any field, the rise of insurance runoff, a thriving sector of the insurance market whose first *raison d'être* was managing losses that proved to be indeterminable.²⁰

The qualitative research story begins with an etymology of the word “runoff” as used in the insurance context and then describes the most famous insurance runoff transaction in modern times: Lloyd’s Reconstruction and Renewal. This 1996 transaction reinsured all of Lloyd’s obligations under non-life policies issued before 1993 – most significantly asbestos, pollution and other toxic tort liabilities – into a newly formed entity, Equitas, designed to honor those

¹⁶ RICHARD V. ERICSON & AARON DOYLE, *UNCERTAIN BUSINESS: RISK, INSURANCE AND THE LIMITS OF KNOWLEDGE* XX (2004) (re: life insurance).

¹⁷ *Id.* See also Stapleton, *supra* note 11. For an insightful, insurance-industry-insider account of the uncertainty that permeates the insurance business, see Sean M. Fitzpatrick, *Fear is the Key: A Behavioral Guide to Underwriting Cycles*, 10 Conn. Ins. L. J. 255 (2004).

¹⁸ See, e.g. Luis Lobo Guerero, *supra* note --. Cf. Tom Baker and Sean Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors’ and Officers’ Liability Insurance Market*, 74 U. Chi. L. Rev. 487 (2007) (describing how Directors and Officers insurers attempt to price on the basis of risk).

¹⁹ For examples of legal scholarship that treat tort law rules that make hitting that nail on the head more difficult as a problem that suggests lawmakers should do something, see, e.g., Priest, *supra* note 1; Mark Geistfeld, *Legal Ambiguity, Liability Insurance, and Tort Reform*, 60 DePaul L. Rev. 539, 549 (2011) (describing the insurance underwriting cycle as the product of “forecasting errors” attributable to “legal ambiguity” and arguing that “the protection of individual tort rights in mass markets has led to a marked increase in legal ambiguity”); and, arguably, Tom Baker, *Insuring Liability Risks*, 29 Geneva Papers on Risk and Insurance - Issues and Practice 128 142-43 (2004) (describing how legal uncertainty poses a threat to the insurability of liability risks).

²⁰ For legal and actuarial practitioner articles about insurance runoff, see, e.g., Jason L. Russ & Thomas A. Ryan, *The Runoff Environment – Considerations for the Reserving Actuary*, Casualty Actuarial Society Forum, Fall 2002 at 287-304, available at <http://www.casact.org/pubs/forum/02fforum/02ff287.pdf>; David Whear and Bob Haken, *Closing books of business: the challenge of fairness and finality*, Research Handbook on International Insurance Law and Regulation 167; Stephen Carter, Bernadette Bailey & Tobey Butcher, *Exit Strategies in the Run-Off Market*, 56 Federation of Defense & Corporate Counsel Quarterly 219, 221.

obligations for the next fifty years, allowing Lloyd's to continue as a major force in insurance markets.²¹ Together with a set of similar transactions that took place at about the same time on this side of the Atlantic,²² the Reconstruction and Renewal set the stage for the consolidation of problematic, legacy insurance obligations in entities that do not sell the kinds of insurance policies that they are running off. More recently, this insurance runoff market has expanded beyond liability insurance to include other long-duration insurance products that have not worked out well for the insurance companies that sold them – workers compensation, savings-linked life insurance with guaranteed minimum returns, pension and annuity guarantees, financial guaranty insurance, and, most recently and tentatively, long-term-care insurance – none of which, with the possible exception of long term care insurance, are in trouble because of moral hazard or adverse selection.²³ Most recently, the runoff market has expanded into transactions involving blocks of policies that are only a few years old (what runoff market participants call “green runoff”), as some insurers seek to reduce uncertainty at an earlier stage.

The companies that assume and manage these legacy obligations serve as what we might call “uncertainty sinks,” extending a metaphor used by Richard Ericson and Aaron Doyle in The Uncertain Business.²⁴ Using Knight's distinction between risk and uncertainty,²⁵ Ericson and Doyle showed how the limits of knowledge and the competitive nature of the insurance business push insurers beyond the domain of risk (where uncertain individual losses become predictable in the aggregate) into the domain of uncertainty (where losses are not predictable even in the aggregate).²⁶ Insurance runoff transactions involve losses that, we now know, were *uncertain* in this sense at the time the original insurance policies were sold.

The insurance runoff market transforms those past uncertainties into today's tradeable risks. Understanding that market requires not only delving into some technical subjects – runoff

²¹ NAT'L ASS'N OF INS. COMM'RS EXAMINATION TEAM TO THE SURPLUS LINES (E) TASK FORCE, LLOYD'S: A REVIEW BY U.S. STATE INSURANCE REGULATORS 7 (1998), http://www.uniset.ca/lloyddata/Lloyds_Report_Final_091498.pdf [hereinafter NAIC REPORT ON LLOYD'S].

²² LIABILITY-BASED RESTRUCTURING WORKING GROUP OF THE NAIC FINANCIAL CONDITION (EX4) SUBCOMMITTEE, LIABILITY-BASED RESTRUCTURING WHITE PAPER, § VII.A, June 1997 1997 [hereinafter LBR WHITE PAPER].

²³ See, e.g., PRICE WATERHOUSE COOPERS, EUROPEAN LIFE INSURANCE BACK BOOK MANAGEMENT 2017 (2018), <https://www.pwc.co.uk/audit-assurance/assets/pdf/european-life-book-survey-2017.pdf> (describing growth of life and annuity runoff transactions); Ben Gonson, *Is Long-Term Health Care the Next Run-off?* AIRROC Matters Winter 2016-17 at 19; CNO Financial Group Form 8-K (September 27, 2018), <http://d18m0p25nwr6d.cloudfront.net/CIK-0001224608/19ca2a33-9ee2-4a9a-8844-2ecfd3b69506.pdf> (reporting a \$3.525 billion runoff transaction between Bankers Life and Casualty Company and Wilton Reassurance Company for legacy nursing home and comprehensive long-term care business). [Need a source for financial guaranty runoff].

²⁴ RICHARD V. ERICSON & AARON DOYLE, THE UNCERTAIN BUSINESS: RISK, INSURANCE, AND THE LIMITS OF KNOWLEDGE (2004). Cf., JOEL A. TARR, THE SEARCH FOR THE ULTIMATE SINK: URBAN POLLUTION IN HISTORICAL PERSPECTIVE (1996).

²⁵ Frank H. Knight, *Risk, Uncertainty and Profit* (1921). See also Geistfeld, *supra* note xx (explaining that legal ambiguity contributes to uncertainty in this sense).

²⁶ Ericson & Doyle, *supra* note xx at xx.

insurance underwriting, policy management, asset management, and finance – but also developing an appreciation for the role of rhetoric and organizational structure in this process. Prior research has documented that “[i]nsurance companies tell two different sets of stories about insurance at two distinct points in the insurance relationship”²⁷ and that insurance companies minimize the potential for these “sales” and “claims” stories to come into direct conflict by separating the organizational responsibility for their narration.²⁸ The sales stories stress the dependence of policyholders and the protection that insurance provides; the claims stories stress the contractual nature of the relationship and the limits of that insurance protection.²⁹

The traditional runoff market features another set of stories, told by people in another organizational location. These traditional runoff stories stress the burden that unforeseeable liabilities have placed on insurers, who were paid too little for accepting these obligations, and the need to relieve the insurance market from the drag on performance that otherwise would result.³⁰ These stories explain the benefits that runoff offers the insurance market and provide answers to countervailing concerns. The runoff stories valorize finality, compromise, and innovation over the protection, dependence, and contract of the sales and claims stories. If the sales stories help sell an important product that not enough people otherwise would buy, and the claims stories help people accept that insurance protection must have limits, then these runoff stories help people understand that insurance markets need room for after-the-fact accommodation and adjustment, and that there can be special circumstances in which the insurance industry’s ordinary approach to promise and contract can be suspended, precisely to permit that ordinary approach to be maintained more generally.

The new, “green runoff” market features yet another set of stories, one that focuses on insurance as a capital management business, the differences between public and private capital markets, and the ability to maintain the continuity of the insurance relationship even as the components of a traditional insurance business are distributed among organizations with more specialized functions. [Note to *JLFA* reviewers: the green runoff market is a new, not yet fully

²⁷ Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages*, 72 Tex. L. Rev. 1395 (1994)

²⁸ *Id.* at 1416-17.

²⁹ Compare *Id.* at 1404-05 (themes of dependency and trust) with *id.* at 1409 (themes of insurance as contract and the need to protect the insurance fund for the future and from fraudulent claims). Note that there is one other reason for separating claims and underwriting departments that cuts in the other direction: underwriting could pressure claims to delay or deny claims in order to improve the underwriting ratio on a book of business. Thank you to Sean Fitzpatrick for this operation.

³⁰ To be clear, I am simply reporting the runoff stories here. There is an obvious alternative framing. Namely, the insurance company made a bad bet, and the policyholder did get what it paid for. When the results work out the other way, and policyholders paid much more in premiums than the insurance company had to pay out, insurers do not offer to return the extra.

digested finding from the qualitative research that is not yet developed in this draft, but is a core focus of my summer research.]

The qualitative empirical research reported in this Article provides significant new insight into how insurers manage uncertainty, especially in the extreme cases that produced the traditional insurance runoff market. Nevertheless, it is important not to exoticize those insurance runoff transactions. The dynamic that produced the insurance runoff market is as old as the insurance business. Insurers have always extended protection against losses whose frequency and magnitude were unknown, whether by engaging in the obviously innovative act of creating a new insurance product to cover a new set of risks (happening with cyber risks and cyber insurance today³¹), by revising a standard-form insurance policy, or, even, by continuing to sell exactly the same insurance policies in the real-world insurance market. As Ericson and Doyle have shown, even selling a tried and true insurance policy into a well-established market can be a voyage into uncertainty, because of the dynamism of insurance markets and insured risks.³² Competition among insurers changes the shape of the insurance market, the creative destruction of the underlying insured activity changes the risks transferred in that market, and there is always the possibility of change in the governing legal rules.³³ In practice, there is no such thing as the fixed-in-advance distribution of determinable risks.³⁴ Insurance is an uncertain business.³⁵

It is time for legal thought to update its insurance ideas and metaphors, and its use of insurance practices, to this more realistic understanding of insurance. Perhaps ironically, this more realistic understanding of insurance markets may hold the greatest promise within legal thought more broadly for scholars whose ideas least take markets into account. If insurance markets always and everywhere trade in uncertainty, and if insurance organizations always and everywhere develop ways to transform that uncertainty into manageable risk, then legal thought can safely relax its concern about the impact of legal change on insurance markets, even when we regard those markets as essential. Indeed, the rise of runoff suggests that we may have

³¹ See, e.g., Shauhin Talesh, *Data Breach, Privacy, and Cyber Insurance: How Insurance Companies Act as "Compliance Managers" for Businesses*, 43 L. & Soc. Inquiry 417-440 (2018). Cf. Ericson & Doyle, *supra* note – at -- (describing how the insurance industry responded to the radically increased scale of potential terrorism losses revealed by 9/11); Dwight Jaffee and Thomas Russell, *Catastrophe Insurance, Capital Markets, and Uninsurable Risks*, 64 J. Risk & Ins. 205, 207 (1997) (describing how marine insurers historically addressed large, uncertain losses). Jaffee and Russell's accounts of how insurance markets manage uncertainty show that at least some members of the economics profession have a more nuanced understanding of insurance than might be suggested by the argument in the main text. See also Dwight Jaffee, *Monoline Restrictions, with Applications to Mortgage Insurance and Title Insurance*, 28 Rev. Indus. Org. 83 (2006) (explaining that monoline insurance manages cases of extreme loss through insolvency and that legal rules requiring certain kinds of insurance to be conducted through monoline insurance protect the larger insurance pool from that risk of extreme loss).

³² Ericson & Doyle, *supra* note xx at xx.

³³ *Id.*; Baker, *Insuring Liability Risks at –* (discussing “legal developments risk”). Cf. Karl Polanyi, *The Great Transformation* (Beacon Press 2001) (194\$).

³⁴ See Sean Fitzpatrick, *Fear is the Key: A Behavioral Guide to Underwriting Cycles*, 10 Conn. Ins. L. J. 255, 260 (2004) (“the bottom line is that pricing uncertainty [is] ... built into the very nature of insurance”).

³⁵ Ericson & Doyle, *supra* note xx at xx

learned exactly the wrong lesson from the property casualty insurance industry's harrowing asbestos and environmental liability experience.³⁶ The right lesson is not that insurance markets need legal certainty,³⁷ but rather that insurance markets can handle even extreme, once-in-history legal uncertainties. If the liability insurance market can absorb widespread, retroactive, and truly strict liability for asbestos injuries and the costs of cleaning up hazardous waste, then legal thought can safely focus more on identifying the just distribution of legal rights and obligations and less on the destabilizing impact that moving toward that distribution might have on insurance markets.

I. An Etymology of Insurance Runoff

The insurance usage of “runoff” can be traced back at least as far as the 17th century marine insurance market at Lloyd's coffee shop. At Lloyd's, individual merchants agreed to underwrite a share of the risks of a voyage, in return for a share of the insurance premium. They earned their share as soon as they “ran the risk,” meaning that the ship sailed.³⁸ Once the voyage was over and any claims paid, the risk was fully “run” and the potential liability came “off” the portion of the merchant's ledger book that listed liabilities, with the difference between the premium and any claim payments recorded as profit or loss.³⁹ This accounting process became known as “running off” the risk, a feature of insurance accounting that continues today.⁴⁰

Over time, the underwriters working at Lloyd's organized syndicates that underwrote risks for their members (including passive investors, known as Names) for a period of three years. At the end of the three years, a syndicate would close by reinsuring with a new syndicate all the risks that had not already run off and declaring and distributing the profit (or loss) to its members.⁴¹ This winding up process became known as “reinsurance to close,” and the new syndicate that offered the reinsurance to close often included some or all of the same underwriters and names as the closing syndicate.⁴²

³⁶ Cf. Jeffrey W. Stempel, *Assessing the Coverage Carnage: Asbestos Liability and Insurance Three Decades After Dispute*, 12 CONN. INS. L.J.349, 464-66 (2006).

³⁷ Cf. Baker, *supra* note --; Abraham, *supra* note XX at 946-47; Geistfeld *supra* note --.

³⁸ Cite to 17th century case about return premium due if risk not run. James A. Park, *A system of the law of marine insurances: with three chapters*, at 368 (“The principle upon which the whole of this doctrine depends, is simple and plain, admitting of no doubt or ambiguity. The risk or peril is the consideration for which the premium is to be paid: if the risk be not run, the consideration of the premium fails.”)

³⁹ Cite to manual of insurance ledgers. See also, William Barnes, *New York Insurance Reports*, vol 2 at 564 (1853-1863) (“It is clear that no profit or loss can be realized by the mere act of issuing a life policy, until time has run and certain events have been declared for or against the company.”)

⁴⁰ See, e.g., Jason L. Russ & Thomas A. Ryan, *The Runoff Environment – Considerations for the Reserving Actuary*, *Casualty Actuarial Society Forum*, 287 (2002), <http://www.casact.org/pubs/forum/02fforum/02ff287.pdf>.

⁴¹ NAIC REPORT ON LLOYD'S at 5.

⁴² *Id.* at 5, 18, 22-23 (describing the three-year accounting system, reinsurance-to-close, and the security of tenure of Names in their respective syndicate). To be clear, there would be no dollar limit on the reinsurance to close.

As required by contract law, the original syndicate retained a formal contractual relationship with the merchants it insured, but the reinsurance-to-close transaction assigned all the responsibilities for that relationship to the new syndicate.⁴³ As long as that new syndicate fulfilled those responsibilities, the merchants who purchased insurance from Lloyd's syndicates could safely remain oblivious to the opening and closing of the syndicates that issued the policies sold at Lloyd's.

Occasionally, a syndicate would be unable to reinsure to close, presumably because the underwriters and names were unable or unwilling to form a new syndicate that would reinsure the old syndicate to close, and they were unable or unwilling to pay the reinsurance-to-close premium demanded by other syndicates. Such syndicates remained "open," and they could not close until all the risks had run off or they found a syndicate willing to reinsure to close at a price that the members were willing to pay.⁴⁴ The only business of a syndicate that remained open after three years, then, was running off the risks and seeking reinsurance to close. The open syndicate was said to be "in runoff," a use of that term that continues through today.⁴⁵

By at least the 19th century, the concept of runoff and its association with reinsurance were accepted aspects of insurance market practice generally. Insurance companies closely tracked the rate at which their risks ran off, and actuaries within the companies estimated the likely losses from the risks that had not yet run off.⁴⁶ Like the open syndicates at Lloyd's, insurers that stopped underwriting entirely were said to be in runoff, and when an insurer stopped underwriting in a market, whether defined geographically or by type of insurance, that part of the insurer's business was said to be in runoff as well.⁴⁷ As at Lloyd's, one insurance company might agree to run off the business of another through a reinsurance transaction in which the acquiring insurer reinsured the risks in runoff and, typically, agreed to manage that business as part of its own active insurance business.⁴⁸

II. The Lloyd's Renewal and Reconstruction

Lloyd's continued to operate on this traditional basis into the mid-1990s.⁴⁹ As a formal matter, Lloyd's became a membership organization whose members – the names – participated

⁴³ *Id.*

⁴⁴ Carolyn Aldred, *Lloyd's to Make First Claim on Central Fund's Cover; Claim will Exhaust Reinsurance Program's Annual Limit*, BUS. INSIDER., Aug. 12, 2002, at 17 (describing a "surge" in open years at Lloyd's following the September 11 attacks).

⁴⁵ See, e.g., Charles Wright and C. Ernest Fayle, *A History of Lloyds* (1928); need very recent citation.

⁴⁶ See, e.g., City of London Marine Insurance Corporation, Limited, Reports of Meetings, 56 THE MONEY MARKET REVIEW, 266, 266 (1888) (reporting amounts underwritten, "run off or reinsured," and remaining liabilities).

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⁴⁸ Lee R. Steeneck, *Loss Portfolios: Financial Reinsurance*, 72 PROCEEDINGS OF THE CASUALTY ACTUARIAL SOCIETY, 154, 156 (1985) (providing history of loss portfolio transfers and describing a 16th century transaction).

⁴⁹ NAIC REPORT ON LLOYD'S at 7.

in syndicates that issued insurance policies.⁵⁰ Neither Lloyd's itself nor any other corporate entity was financially responsible for the payment of claims.⁵¹ Instead, Lloyd's was a central administrative apparatus that managed claims but had no formal financial obligation for those claims.⁵² In form, the Lloyd's administration simply connected policyholders with the syndicates, which were composed of individuals, that issued their policies. The names in the syndicates had unlimited liability, but only for their share of the obligations of their syndicates, not for the syndicate as a whole.⁵³

Traditionally, the Lloyd's administration managed that unlimited liability through the reinsurance-to-close transaction just described.⁵⁴ Because of mounting asbestos and environmental liability and catastrophic property losses on policies written in the 1980s and earlier, however, an increasing number of syndicates faltered in the 1980s and were unable to find a newer syndicate to reinsure their obligations, thus remaining open syndicates.⁵⁵ Names, many of whom only recently participated in Lloyd's for the first time as Lloyd's broadened its membership starting in the late 1970s, were hit with severe losses, in many cases several times their initial investment.⁵⁶ Names began to default en masse (*de facto* if not *de jure*), undermining confidence in the Lloyd's market.⁵⁷ Warren Buffett colorfully described this process as follows in his 2006 Letter to Shareholders:

Eventually, the names came to include many thousands of people from around the world, who joined expecting to pick up some extra change without effort or serious risk. True, prospective names were always solemnly told that they would have unlimited and everlasting liability for the consequences of their syndicate's underwriting – “down to the last cufflink,” as the quaint description

⁵⁰ *Id.*

⁵¹ *Id.* at 4 (“Lloyd's is a market, not an insurer.”).

⁵² *Id.* at 5, 19-22.

⁵³ *Id.* at 8.

⁵⁴ *Id.* at 5.

⁵⁵ Lawrence Ingrassia & Dana Milbank, *Market at Risk: Hit by Huge Losses, Lloyd's of London Struggles to Survive—Insurance Exchange Seeks to Raise Money and End Disputes with Investors*, WALL ST. J., May 15, 1995, at A1. Note that this description of Lloyd's problems came before the empirical research calling into question the “litigation explosion” narrative. For my contribution, see TOM BAKER, *THE MEDICAL MALPRACTICE MYTH* (2005). The litigation explosion narrative leaves out the contribution of the insurance underwriting cycle to Lloyd's financial problems. The “soft market” of the late 1970s and early 1980s encouraged Lloyd's and the property casualty insurance industry to forgo needed reserve strengthening until the “hard market” of the mid 1980s. While liability insurers in the 1970s and earlier cannot be faulted for failing to foresee the expansion of environmental liability that culminated in CERCLA (enacted in 1980) or the tort law changes in the 1960s that facilitated large scale asbestos claiming, they had increasingly good information about those expansions in liability rules when they were setting reserves in the late 1970s and 1980s. Many Lloyd's syndicates and some insurance companies with large asbestos and environmental exposures never fully recovered from the reserve strengthening that the mid-1980s hard market revealed to be necessary.

⁵⁶ Ingrassia & Milbank, *supra* note --.

⁵⁷ *Id.*

went. But that warning came to be viewed as perfunctory. Three hundred years of retained cfflinks acted as a powerful sedative to the names poised to sign up.

Then came asbestos. When its prospective costs were added to the tidal wave of environmental and product claims that surfaced in the 1980s, Lloyd's began to implode. Policies written decades earlier – and largely forgotten about – were developing huge losses. No one could intelligently estimate their total, but it was certain to be many tens of billions of dollars. The specter of unending and unlimited losses terrified existing names and scared away prospects. Many names opted for bankruptcy; some even chose suicide.

From these shambles, there came a desperate effort to resuscitate Lloyd's. In 1996, the powers that be at the institution allotted £11.1 billion to a new company, Equitas, and made it responsible for paying all claims on policies written before 1993. In effect, this plan pooled the misery of the many syndicates in trouble. Of course, the money allotted could prove to be insufficient – and if that happened, the names remained liable for the shortfall.⁵⁸

This “desperate effort” was known as Lloyd's Reconstruction and Renewal.⁵⁹ Through a series of transactions scrutinized and then approved by the UK Department of Trade and Industry and acquiesced in by U.S. regulators, names and underwriters paid a reinsurance premium (largely funded by monies that Lloyd's already held in trust for the names), and Equitas agreed to receive, process, and pay any claims on the reinsured legacy business, subject only to the terms and conditions of the original insurance policies and without regard to the total costs that Equitas might be obligated to pay.⁶⁰ In effect, Equitas issued a massive reinsurance-to-close policy covering obligations under all policies issued before 1993.

By reinsuring all old business into Equitas (except for life insurance, which could not be reinsured as Equitas did not qualify as a life insurer under English law), Lloyd's effectively created Equitas to function as an “old Lloyd's” comprised of all pre-1993 business. Equitas was separate from the “new Lloyd's,” which would house the on-going and active syndicates for years 1993 and beyond.⁶¹ The Lloyd's restructuring separated the legacy business from Lloyd's ongoing business, improving the syndicates' ability to continue selling insurance.

⁵⁸ Chairman's Letter to Shareholders, Berkshire Hathaway Inc. 2006 Annual Report at 9, <https://www.berkshirehathaway.com/2006ar/2006ar.pdf>.

⁵⁹ For a high-level, insider description of the R&R, see Mike Palmer, *The Deal of the Decade*, AIRROC Matters Summer 2007 at 30. See also Lloyd's Reconstruction and Renewal Byelaw https://www.lloyds.com/~/_media/files/the-market/operating-at-lloyds/regulation/acts-and-byelaws/byelaws/march07byelawreconstructionandrenewal_pdf.pdf

⁶⁰ NAIC REPORT ON LLOYD'S 10, 51-54; Lisa S. Howard, *Lutine Bell Tolls Relief for Lloyd's*, NAT'L UNDERWRITER, Sept. 9, 1996, at 1 (stating that the NYID had approved the transfer of \$5.5 billion from the LATF into Equitas).

⁶¹ *Equitas Receives Go-Ahead*, BUS. WIRE, Sept. 4, 1996. The contractual mechanism by which policies were reinsured into Equitas defined and separated every existing syndicate's policy liabilities into two groups based upon

To the extent that Equitas simply reinsured the old, open syndicates to close, Lloyd's Reconstruction and Renewal could be seen to differ from Lloyd's traditional runoff arrangements only in scale. Yet it also differed significantly in kind. First, by reinsuring to close all the open syndicates, Equitas facilitated a broader socialization of losses among the names than the individualized reinsurance to close process.⁶² Second, Equitas did not simply reinsure to close all the old open syndicates. Equitas also accepted the pre-1993 liabilities of the syndicates that had been able to reinsure to close, thereby taking those legacy liabilities off the books of the new, active syndicates.⁶³ This meant that the Equitas transaction split the liabilities of the 1993 and later syndicates, many of which carried liabilities for pre-1993 policies that had been reinsured-to-close into the more recent syndicates. Responsibility for managing the claims of policyholders insured under old policies that had already been reinsured-to-close into post-1992 syndicates were transferred to Equitas while policyholders insured under new policies covered by those same post-1992 syndicates remained under Lloyd's direct care.⁶⁴ Finally, unlike the prior entities that had offered reinsurance to close, Equitas went into runoff at inception, so there was never a possibility that the active business could provide support to the risks being run off.

As Buffett's letter described, the Lloyd's/Equitas transaction did not, as a formal matter, legally separate the legacy obligations from the ongoing business. Policyholders could still legally proceed against the original syndicates and, if the syndicates did not pay, assess the names individually for any deficiency not paid by Equitas.⁶⁵ Yet, because of the unique form of Lloyd's business – in which the contractual obligations of the syndicates that issued the insurance policies reduce to pro rata obligations of the individual members of the syndicates rather than an insurance company with a permanent life – it was understood that collecting from the syndicates at some uncertain point in the future would be unlikely.⁶⁶ Many Names in the older syndicates already were deceased with their estates already probated and, thus, no longer a potential source of funds, and many more would be deceased by the time that Equitas ran out of money (if it ever did). Moreover, the names that remained at that time would be living all over

whether the policy which could incur a liability was written during or before the 1992 year of account. *See* Reinsurance and Run-off Contract between Equitas Reinsurance, Ltd., Additional Underwriting Agencies (No. 9), Ltd., The Names, The Closed Year Names, The Society of Lloyd's, Equitas, Ltd., The Managing Agent's Trustees, and Equitas Policyholders Trustee, Ltd., at § 3.2, pp. 5-6, Schedule 2, p. 55 (Sept. 3, 1996), [comment – link?]

⁶² If a member of the syndicate has declared bankruptcy or is insolvent, that member would have no interest in paying additional premiums to close a syndicate. And since the other members are liable only for their shares, they wouldn't have the same incentive to reinsure to close that they would have if they had full liability.

⁶³ Disappointed policyholders that previously had been protected by reinsurance to close could not proceed against those active syndicates, because Lloyd's reinsurance to close transactions (like reinsurance generally) obligate the reinsuring syndicate to manage the liabilities for the benefit of the original syndicate; they do not give the policyholder of the original syndicate any rights directly against a syndicate that provided reinsurance to close.

⁶⁴ Reinsurance and Run-off Contract, *supra* note xx at xx.

⁶⁵ NAIC REPORT ON LLOYD'S at 53-54; David L. Foster, *Equitas and the New Lloyd's: Practical Implications for Policyholders, Brokers, and Reinsurers*, METRO. CORP. COUNSEL, May 1997, at 10.

⁶⁶ NAIC REPORT ON LLOYD'S 53-54; Stacy Shapiro, *Policyholders Called Key to Lloyd's Future*, BUS. INSIDER., June 5, 1995, at 42.

the world and, in many if not most cases, beyond the reach of policyholders without the cooperation of the Lloyd's administration, which appears to have decided that, with respect to the liabilities of the names who participated in Equitas, it has done everything necessary to protect policyholders by creating Equitas.⁶⁷ This *de facto* legal separation became *de jure* when subsequently enacted legislation pre-empted contract law in this case and permitted the transfer of liabilities from the issuing syndicates to Equitas without the acquiescence of policyholders, provided that the U.K. High Court of Justice approved the transaction.⁶⁸ The High Court did so in 2009, completing the legal separation of the obligations under the pre-1993 Lloyd's policies from the syndicates that issued or reinsured them.⁶⁹

Along with a set of similar insurance company restructuring transactions that took place in the U.S. at about the same time, Lloyd's Reconstruction and Renewal paved the way for runoff to become a distinct sector of the insurance market.⁷⁰ These U.S. transactions included: the restructuring of the property and casualty business of CIGNA through a series of transactions that culminated in the formation of a runoff entity known as Brandywine in 1995; the restructuring of the Crum & Forster Group in 1993 that facilitated the exit of Crum & Forster's then parent, Xerox, from the insurance business; the restructuring of ITT-Hartford in 1992 that placed several Hartford subsidiaries into runoff and facilitated the exit of ITT from the insurance business; and the 1994 restructuring and eventual winding down of The Home, pursuant to which Zurich Insurance Group acquired the valuable parts of The Home's business.⁷¹

These transactions became known as the asbestos, pollution, and health hazard ("APH") liability-based restructurings.⁷² They paved the way for a broader separation of legacy APH obligations from the active parts of the property and casualty insurance industry. Since the 1990s, an increasingly large percentage of legacy APH obligations have come to be managed by runoff specialists, most prominently by Berkshire Hathaway's National Indemnity Company (commonly known as NICO).⁷³ NICO reinsured all of Equitas's liabilities in 2006 in return for

⁶⁷ Cf. Stephanie Strom, *The Financial Safety Net Is Almost Spread Beneath Lloyd's; But Questions Persist on Risks of Reinsurance*, N.Y. TIMES, Aug. 22, 1996, at D1 ("If Equitas cannot ultimately fulfill a claim, a policyholder would have to sue each of the names who had underwritten the policy, some of which date back three decades. That would be a daunting, if not outright impossible, task, given Lloyd's reputation for spotty record-keeping.")

⁶⁸ Financial Services and Markets Act 2000, Title VII, §111

⁶⁹ In the matter of The Names at Lloyd's for the 1992 and Prior Years of Account, represented by Equitas Limited and In the matter of Equitas Insurance Limited (Formerly known as Speyford Limited) and In the matter of Part VII of The Financial Services and Markets Act 2000, [2009] EWHC 1595 (Ch).

⁷⁰ NAIC LPT White Paper, *supra* note xx.

⁷¹ *Id.* at Appendix 1. Further details of these transactions are included in the (on-line?) appendix to this article.

⁷² NAIC WHITE PAPER, Part I.

⁷³ See NEBRASKA DEPARTMENT OF INSURANCE, FINANCIAL EXAMINATION REPORT OF NATIONAL INDEMNITY COMPANY (May 23, 2018) at 17-19 (listing transactions); Tim Zawacki, *Berkshire Unit's Retroactive Reinsurance Biz Expands with Ironshore Cover*, S&P GLOBAL MARKET INTELLIGENCE (Dec. 5, 2007), https://www.spglobal.com/marketintelligence/en/news-insights/trending/1_vjh8pqbqn8dg8zhsegzw2

acquiring all of Equitas's assets (hence, Buffett's discussion of Lloyd's in his 2006 letter), and it reinsured APH obligations of, among other insurance groups, INA (now part of Chubb), CNA, AIG, Liberty Mutual, and The Hartford through conceptually similar transactions.⁷⁴ Other runoff specialists with significant stakes in APH obligations include Armour, Catalina, Darag, Enstar, Premia and Randall & Quilter.⁷⁵

III. Insurance Runoff: Mechanics and Stories

With the growth of the APH insurance runoff market came a cadre of experienced managers of runoff businesses, trade associations, and practice groups in accounting and law firms who specialize in the acquisition and solvent runoff of legacy obligations of insurers, initially focusing on property casualty lines of insurance but then expanding to life and health insurance lines.⁷⁶ There has long been a need for insurance transactions and procedures that facilitate the, relatively infrequent, runoff of *insolvent* insurance companies.⁷⁷ What was new was the extension and expansion of that transactional practice into the much larger field of *solvent* insurance runoff.

The description that follows is drawn from insurance trade literature and other public sources whenever possible, supplemented by interviews with participants in the runoff insurance market: actuaries, underwriters, consultants, claims professionals, lawyers, and industry analysts. Because of the tight network of participants in that market, I cannot provide detailed descriptions of the people I interviewed without revealing their identities.

Because insurance runoff is highly technical, and because the runoff market is operated by and for insurance professionals, any accurate explanation of the mechanics of insurance runoff will be tough going for anyone without a background in insurance finance or mergers and acquisitions practice. Most readers are unlikely to have that experience and, thus, they may want to skip ahead to the section on insurance runoff stories, which begins with a brief summary of what really matters about runoff mechanics.

⁷⁴ See, e.g., Chairman's Letter to Shareholders, *supra* note --. Berkshire Hathaway's insurance investments include a huge stake in insurance runoff. See Nebraska Department of Insurance Financial Examination Report, *supra* note -. Cf., Mark Roe, Foundations of Corporate Finance: The 1906 Pacification of the Insurance Industry, 93 Colum L. Rev. 684 (1993).

⁷⁵ See Survey of Discontinued Insurance Business in Europe, PricewaterhouseCoopers (2015) <https://www.pwc.com/gx/en/insurance/assets/pdf/survey-of-discontinued-insurance-ninth-edition-report.pdf> (listing runoff market highlights from the prior year) [comment – missing only Premia]. Leading life runoff specialists include Berkshire Hathaway Life, Swiss Re, and Wilton Re.

⁷⁶ See David Whear and Bob Haken, *Closing Books of Business: the Challenge of Fairness and Finality*, in RESEARCH HANDBOOK ON INTERNATIONAL INSURANCE LAW AND REGULATION 167, 168 (Julian Burling & Kevin Lazarus, eds., 2012).

⁷⁷ Cf. SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS, 101ST CONG., FAILED PROMISES: INSURANCE COMPANY INSOLVENCIES (Comm. Print 1990).

A. Insurance runoff mechanics

The starting point for understanding the structure of insurance runoff transactions is the legal rule that one insurer may not assign an insurance policy to another insurer (or anyone else) without the consent of the policyholder.⁷⁸ An insurer may hire a third party to fulfill the insurer's obligations under an insurance policy, but the obligation to perform remains that of the insurer, and, if the third party fails to perform, the policyholder sues the insurer, not the third party. This insurance law rule contrasts with the legal rule governing credit contracts, which are freely assignable.⁷⁹ As a result, there are deep secondary financial markets in which banks and other issuers of debt transfer debt contracts to third parties, and those transfers terminate the creditor's and debtor's contractual relationship with regard to that debt.⁸⁰ Not so with insurance.

[need a roadmap to this subsection]

Because policyholder consent to transfer is difficult to obtain, especially at scale,⁸¹ an insurer in the property casualty sector can terminate its obligations under a set of insurance policies as a practical matter only if (a) it sold the policies through a separately incorporated subsidiary that it now can sell, or (b) it can divide the entity that sold the policies into two or more parts and sell the part of that entity that holds the policies in question. The latter option is not available in most U.S. states, and, because of the regulatory scrutiny required, it is not widely used in those jurisdictions in which it is available (e.g. Pennsylvania).⁸² When there is a separate entity, the contractual relationship is between the policyholders and that entity, not the larger corporate group under whose brand the entity operated and, thus, the entity can be sold without violating the insurance law rule against assigning insurance policies. Once approved by the regulatory authority with jurisdiction over the entity, the sale gives the buyer complete control over that entity, subject only to compliance with legal requirements, and it gives the seller "a clean exit from liabilities."⁸³

Life and health insurers have greater opportunity to transfer a set of policies from one company to another, using a transaction known as "assumption reinsurance" (a confusing term

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⁸¹ Talegen exception.

⁸² For example, the holding company seller may have needed regulatory approval to remove the entity from an internal reinsurance pool that was made up of all or a portion of the insurance subsidiaries of the holding company. *See, e.g.*, ITT Hartford LPT. In addition, some jurisdictions permit an insurer to split a corporate entity into two parts, subject to regulatory approval. *See, e.g.* CIGNA/Brandywine. *See generally* NAIC LPT White Paper, *supra* note xx.

⁸³ CATALINA, <http://www.catalinare.com/runoff-industry.html> (last visited October 18, 2018) ("Selling to Catalina allows businesses to refocus on core activities, unlock capital, reduce costs and have a clean exit from liabilities."). Note that there may remain some uncertainty about whether all future courts will honor the legal distinction between the subsidiary that issued the insurance and the parent that later sold the subsidiary.

for the sale of a block of policies with the consent of each policyholder).⁸⁴ Typically, policyholders in the life insurance sector have an ongoing obligation to pay premiums and, thus, an ongoing relationship with their insurance company. After the “sale” of the assumption reinsurance to the insurer that issued the policies, the assuming “reinsurer” (in substance, the purchaser of the block of policies) obtains consent from the policyholders to the transfer of the policies to the reinsurer through the process of collecting premiums on renewal or, in some states, through a special notice procedure in which policyholders are deemed to consent if they do not object.⁸⁵

All other runoff market transactions must use a form of reinsurance that is similar to the reinsurance-to-close used to wind up syndicates at Lloyd’s. This *retroactive* reinsurance differs from the *prospective* reinsurance that most readers will have heard of (if they have heard of reinsurance at all) by providing protection against policies that the insurer sold in the past, rather than policies that the insurer will sell in the future. Like all forms of reinsurance, retroactive reinsurance can, at most, provide the insurer (called the “cedent” in reinsurance parlance) with financial insulation from the insurance policies in runoff. It does not terminate the cedent’s obligations under those policies.

The most common form of reinsurance-based runoff market transaction in the property casualty sector is a loss portfolio transfer, or LPT.⁸⁶ An LPT has two main parts: a (retroactive) reinsurance contract in which the original insurer pays a large premium in return for the runoff specialist’s agreement to pay claims under a designated set of legacy insurance policies, up to a total dollar amount known as the reinsurance limit;⁸⁷ and a management contract in which the runoff specialist agrees to manage these policies on the original insurer’s behalf, unless and until the losses incurred under the policies exceed the reinsurance limit. The responsibility for paying

See e.g., [sample order approving the acquisition]. Although the approval process is meaningful, and not just a rubber stamp, that process can safely be ignored for present purposes, because a company cannot stay in the runoff business if it cannot jump through the necessary hoops.

⁸⁴ JOHN E. TILLER AND DENISE FAGERBERG TILLER, *LIFE, HEALTH AND ANNUITY REINSURANCE* (4th ed.) 437 (2015).

⁸⁵ *Id.* Tiller & Tiller note that the legal rules regarding assumption reinsurance are sufficiently uncertain, and the prospect that at least some policyholders will object sufficiently likely, that assumption reinsurance transactions typically are structured in the alternative as indemnity coinsurance transactions. As a result, the practical differences between the runoff transaction structures that are possible in the life insurance sector and in the property casualty sector are less than would appear in theory.

⁸⁶ Neil Bruce et al, *Loss Portfolio Transfers: 2002 GIRO Working Party Paper* (analyzing LPT arrangements for the General Insurance Research Organization of the Institute and Faculty of Actuaries in the U.K.); Derek A. Jones, *An Introduction to Reserving and Financial Reporting Issues for Non-Traditional Reinsurance*, 2004 *Casualty Actuarial Society Forum*, Fall 2004 (available at <http://www.casact.org/pubs/forum/04forum/>) (discussing LPTs as one of the “most common retroactive reinsurance arrangements”); National Association of Insurance Commissioners, *Issue Paper no. 137 – Transfer of Property and Casualty Reinsurance Agreements in Run-Off* (Exposure Draft, June 13, 2009) (addressing the accounting treatment of “reinsurance run-off agreements,” which is another term for an LPT reinsurance agreement and noting that such agreements often “must be approved by the domiciliary regulators of the transferring entity”).

⁸⁷ A reinsurance to close transaction is a loss portfolio transfer without a reinsurance limit.

claims and otherwise managing the legacy policies reverts to the original insurer if incurred losses exceed the reinsurance limit.⁸⁸

Because an LPT does not legally separate the runoff book from the rest of the original insurer's assets and liabilities, this form of insurance runoff transaction leaves that insurer exposed to two kinds of risk that are not present when an insurance group sells a legally separate entity: counterparty credit risk (the risk that the reinsurer will go insolvent) and the risk that the total liabilities will exceed the limit of reinsurance. The original insurer can mitigate the latter risk by also purchasing another form of retroactive reinsurance known as "adverse development cover," which provides additional reinsurance in the event that the loss portfolio transfer reinsurance limit is exhausted.⁸⁹ Of course, that adverse development cover is subject to its own credit risk and the risk that the limit will be exhausted.

The equivalent transaction in the life sector is called "indemnity coinsurance."⁹⁰ Key differences between a typical indemnity coinsurance transaction and a typical LPT transaction include the following: indemnity coinsurance often leaves the ceding insurer with a quota share of the risk, twenty percent being typical; indemnity coinsurance rarely sets a limit on the reinsurance company's exposure for its share of the risk that is reinsured; and the ceding insurer more often retains the responsibility for administering the policies.⁹¹

In whatever way a runoff specialist acquires the runoff liabilities – by buying entities, through assumption reinsurance, through loss portfolio transfers or indemnity coinsurance, or some combination – the specialist's core business consists of four activities that are part of any insurance business but have special features in the runoff context: underwriting, policy management, asset management, and finance. The sections that follow provide a basic description of these activities and their role in making uncertainty tradeable.

⁸⁸ This has occurred in the case of the loss portfolio transfer between Berkshire Hathaway's NICO and Cigna's Century Indemnity Co., which has reverted to Century (currently part of the Chubb group).

⁸⁹ Eleni Iacovides, *The Legacy Market*, AIRROC MATTERS, Spring 2017, at 16. Note that property casualty insurers also can purchase adverse development cover instead of an LPT. In that case, the insurer retains day to day responsibility for the runoff, and the adverse development cover simply provides protection (up to the limit of the cover) from liabilities that exceed the insurer's reserves.

⁹⁰ For a description of indemnity coinsurance, see Jeremy Starr, *Use of Reinsurance in Mergers and Acquisitions*, 25 Record of Proceedings of the Society of Actuaries No. 1,

<https://www.soa.org/globalassets/assets/library/proceedings/record-of-the-society-of-actuaries/1990-99/1999/january/rsa99v25n171pd.pdf>. See Maryann Taylor, *The Life Deal Market*, AIRROC Matters, Winter 2018-19, at 29 (noting that indemnity coinsurance is the most common form of life runoff transaction). For a description of the various forms of reinsurance-based life runoff structures see TILLER AND TILLER, *supra* note XX at 175- 92

⁹¹ Interview (May 18, 2019). In my mind, indemnity coinsurance in which the ceding insurer retains the administrative responsibility is more similar to what is called adverse development cover in the property casualty context, with the key difference being the way that the risk is shared. Indemnity coinsurance is a quota share transaction, with the reinsurer taking 100% of the designated share; adverse development cover is an excess of loss transaction with a cap that leaves the extreme right tail risk with the ceding insurer.

1. Underwriting.

Underwriting is the process of deciding whether to offer (re)insurance and, if so, at what price. Underwriting the runoff of a book of insurance policies differs from underwriting the initial sale or prospective reinsurance of those policies in both the nature of the information on which the transaction is based and the scale of the transaction. A runoff transaction represents a wholesale repricing of an entire book of legacy business with the benefit of hindsight.

The runoff underwriting process consists of estimating inputs to a valuation formula:

- (1) a projection of cash outflows for the book of policies;
- (2) a projection of offsetting cash inflows from any reinsurance that the insurer previously purchased to support that book and, in the case of life and health products, cash inflows from any premiums and contributions that will be made for the policies while they are being run off;
- (3) an evaluation of the adequacy of the reserves that the insurer has posted for the book of policies and the value of the assets it holds to offset those reserves; and
- (4) a projection of investment returns from the assets that the runoff specialist plans to hold to offset the reserves that it will carry on its balance sheet for the reinsurance.⁹²

Because the original insurer has been managing the book for years, as have other insurers who sold similar policies covering similar losses in the past, the quality of the available information about the potential losses and offsetting cash flows is much greater than when the underlying policies were sold. In addition, the passage of time means that investment returns need to be projected less far into the future. This hindsight is a key part of what transforms the uncertainties of the past into the tradeable risks of today.

With these inputs, a runoff specialist can provide a quote for the runoff transaction. For the sale of a separately incorporated entity, the quote is simply a price for the purchase of that entity. If the entity is poorly reserved, the quote may be a negative number: the “dowry” of capital that the parent of the entity (typically a holding company in the insurance group) will have to put into the entity for the specialist to be willing to buy it.⁹³

⁹² See Frederick J. Pomerantz & Connie D. O’Mara, *Rx for Run Off: Four Experts Expound*, AIRROC MATTERS Summer 2015, at 6, 9 (describing important aspects of runoff underwriting and observing, “Basically when you look at value it’s just a time value of money equation. So there’s really two things that matter on the income side: premiums and investment income and on the liability side it’s payments and timing of those payments.”). Note that when underwriting a “buy to kill” transaction, the acquirer also needs to assess the value of any renewal rights that it plans to sell before putting the company into runoff.

⁹³ See, e.g., AIRROC Matters (describing additional capital put into a Lincoln Life subsidiary before runoff specialist Tata would buy it). Because of differences in the accounting rules that apply, life insurance transactions (a category that includes long term care and pension products) are more likely to require a dowry than property casualty insurance transactions. The key accounting difference concerns the ability to discount future payments to

For a reinsurance-based transaction, the quote will consist of two key numbers: (1) the reinsurance limit, which is the maximum amount that the runoff acquirer is obligated to pay out on the book over the course of the runoff, after which responsibility for managing the runoff reverts to the original insurer (this number can include policy management expenses or not, depending on the deal); and (2) the premium that the underwriter will charge, if any, on top of taking all the assets that presently support the liabilities that the insurer has set as the reserves for the book.⁹⁴ The higher the total limit of the reinsurance that the runoff underwriter offers, the higher the premium will be (all other things being equal), with the premium to be still higher if the underwriter agrees to provide reinsurance to close, meaning that the underwriter will assume the issuing insurer's liabilities for the book without limit. Similarly, the more adequately reserved the underwriter judges the book of policies to be, the lower the premium charged on top of those assets will be. A poorly reserved insurer might still be able to do a loss portfolio transfer without paying any premium beyond the transfer of the assets currently offsetting the reserves for the book, but the reinsurance limit would almost certainly be too low to provide the insurer with much confidence that the liabilities were gone for good.

2. *Policy management.*

The runoff underwriting process can be understood as a technical exercise that simply reflects the (newly) predictable and therefore tradeable nature of past uncertainties. This understanding would be too simplistic, among other reasons because no liabilities are tradeable until there is a buyer prepared to treat them as such, but it is not entirely wrong. By contrast, it would be entirely wrong to understand runoff policy management in similarly passive terms. Runoff policy management actively shapes the activities that produce the cashflows that determine whether the predictions underlying runoff transactions come to pass.

The day-to-day activity of running off insurance policies differs according to the type of insurance policies involved. For liability and property insurance runoffs, policy management means handling and paying claims, computing and collecting any retrospective premiums,⁹⁵ recovering any reinsurance that is owed, and, importantly, negotiating commutations.⁹⁶ A "commutation" is a modification of a (re)insurance contract in which the (re)insurer agrees to pay the policyholder/cedent a sum certain in return for the policyholder/cedent agreeing that this

present value. Unlike life insurance accounting, property casualty insurance accounting typically does not permit such discounting when setting reserves for future liabilities and, thus, property casualty companies are less likely to be under reserved, at least on a present value basis.

⁹⁴ Random question: what is the tax treatment of unrealized gains/losses on the assets transferred under a runoff deal?

⁹⁵ A retrospective premium is additional premium that is paid on an ex post basis, when claim payments exceed negotiated amounts.

⁹⁶ Michael T. Walsh & Maryann Taylor, *Commutations: A Road to Finality*, AIRROC MATTERS, Summer 2007, at 1 ("Commutations are indeed one of the most vital tools to the strategic plans of run-off operations.").

sum certain satisfies all of the (re)insurer's obligations under the policy.⁹⁷ A commutation is a “buy back” of the policy from the perspective of the reinsurer and a “sell back” of the policy from the perspective of the insurer-cedent.⁹⁸

Commutations are an important part of the runoff policy management story for two reasons. First, commutations provide the best evidence that runoff policy management differs from active policy management. While commutations sometimes take place in an active insurance business, for example to resolve a dispute over a large commercial insurance claim,⁹⁹ the aggressive pursuit of commutations is not part of the ordinary strategy of an active insurance business. By contrast, property casualty runoff specialists advertise their skill and experience with commutations, and their U.S. trade association actively facilitates commutations.¹⁰⁰

Second, commutations can play a key role in transforming uncertainty into tradeable risk. At the transaction level, a commutation transfers any remaining uncertainty regarding the losses that would have been covered by the (re)insurance contract back to the counterparty who accepted the flat payment in satisfaction of that contract. At the market level, the availability of commutations makes runoff specialists more willing to do runoff deals because they know that they can use commutations – “the chosen weapon of many in the legacy sector in their quest to find the Holy Grail of ‘finality’ to their liabilities” – to reduce the uncertainty involved in runoff transactions.¹⁰¹ Commuting insurance policies with policyholders or reinsurance contracts with cedents shifts uncertainty away from the book of policies in runoff. Commuting outward reinsurance contracts (which cover the policies or contracts being run off) shifts uncertainty back

⁹⁷ For a hypothetical example of a commutation, consider the following. Asbestos Manufacturer is insured by Trustworthy Insurance Company. Trustworthy agrees to pay the \$20 million limits of its policy to fund the defense costs and settlements of a group of asbestos claims against Manufacturer. Trustworthy demands that Great Reinsurance Company pay \$5 million of that amount, under a treaty that promised to pay 25% of Trustworthy's 1985 accident year general liability losses (above a \$10 million level that was long ago reached), subject to a reinsurance treaty limit of \$50 million (of which \$40 million has been paid). Great recently was sold to a runoff specialist. Great's new claims manager tells Trustworthy that it has conducted a thorough review of Great's pre-1990 treaties and determined that Great has been paying claims to Trustworthy and others that it was not legally obligated to pay. Great offers to pay \$5.5 million today to commute the treaty, meaning that Trustworthy would be unable to collect any money under the treaty in the future and that Great would be unable to reopen any prior payments.

⁹⁸ See David Whear and Bob Haken, Closing books of business: the challenge of fairness and finality, *Research Handbook on International Insurance Law and Regulation* 167, 168-69; Stephen Carter, Bernadette Bailey, Tobey Butcher, Exit Strategies in the Run-Off Market, 56 *FDCC Quarterly* 219, 221 (“A commutation is in effect, an underwriting exercise where the reinsured is paid to take back the risk that it had laid off”)

⁹⁹ For example, a senior policyholder coverage lawyer explained to me that a number of asbestos or environmental defendants have commuted some or all of their historical general liability insurance policies as a way to resolve coverage litigation with their insurers. [Find press stories to use]

¹⁰⁰ See, e.g. Enstar Annual Report (commutations), and AIRROC commutation event reported in their trade magazine.

¹⁰¹ See Julius Bannister, *Bygone Companies*, AIRROC Matters, Summer 2015 15-16 (providing a summary of “a major listing of commutations, the chosen weapon of many in the legacy sector in their quest to find the Holy Grail of ‘finality’ to their liabilities.”)

to the runoff book. Part of the craft of runoff is developing commutation strategies that reduce the net uncertainty of the book of business being run off. Because commutations are voluntary on both ends, negotiating commutations is a core expertise of a fast runoff specialist.¹⁰²

At a very high level, property casualty runoff specialists follow two approaches to managing the runoff after the acquisition: “slow” and “accelerated.” A slow runoff manages the policies in much the same way that an active insurance company manages its obligations under old policies that remain part of the insurer’s active business: paying claims as they come due and collecting on any reinsurance for those claims on the same timetable, perhaps with less urgency and greater attention to coverage defenses than would be the case if the insurer was interested in selling new policies to existing customers.¹⁰³ This kind of runoff is slow because it takes a long time for all the obligations under the policies to mature and be satisfied in the ordinary course. An accelerated runoff speeds up the process by reaching out to the original insurer’s counterparties and offering to commute their legacy insurance policies and reinsurance contracts.

Accelerated runoffs are most common when running off an inactive reinsurance company, because the counterparties – the cedents – are insurance companies. Reinsurance contracts tend to involve enough money to make the commutation process worth doing, and insurance companies have become increasingly comfortable with commuting their reinsurance. While the commutation indisputably shifts some risk back to the insurer-cedent, that risk is just more of the same risk that the insurer already faces, and, thus, already has on its balance sheet. Typically, the runoff specialist can offer reinsurance commutation terms that improve the balance sheets of the insurance company counterparties.¹⁰⁴ The exception is when the reinsurer being run off is in weak financial condition. In that circumstance, however, insurance company counterparties should be even more willing to commute their reinsurance contracts, because of the risk that they will later recover less if the reinsurer becomes even more financially impaired. As the latter point suggests, runoff specialists are adept at turning financial weakness into a negotiating strength.¹⁰⁵

¹⁰² See Terry Kelaher, *Claim Estimation*, AIRROC MATTERS, Fall 2005, at 16 (contrasting the voluntary nature of commutation from “forced, non-contractual estimation and payment acceleration”). For a time, as discussed *infra*, the UK permitted the involuntary, wholesale commutation of policies and reinsurance contracts through a process that was known as a “solvent scheme of arrangement.” See []. That process has for all practical purposes been shut down by the British courts and the Prudential Regulatory Authority [document in folder]. See *In re British Aviation Insurance Company* [2005] EWHC 1621 (Ch).

¹⁰³ I describe below the critique that slow runoffs are much slower than ordinary. *Cf.*, JAY M. FEINMAN, *DELAY, DENY, DEFEND: WHY INSURANCE COMPANIES DON’T PAY CLAIMS AND WHAT YOU CAN DO ABOUT IT* (2010) (suggesting that difficulties in the claims process are not unique to the runoff market).

¹⁰⁴ [need to confirm.]

¹⁰⁵ Susanne Sclafane, *Adverse Development Covers on the Rise*, National Underwriter, Property & Casualty/Risk & Benefits Management Edition, July 24, 2000 at S11:

“Not only does an insurer need a great deal of manpower and runoff expertise to take ownership, but ‘you need to be structured in a way that you don’t mind squeezing cedent clients,’ he [PSRE’s Mr. Mayer] said.

The greater importance of commutations in reinsurance runoff points to another important difference between the runoff of insurance and reinsurance liabilities. Because reinsurers' counterparties are insurance companies, any haircuts, delays, compromises or other variations from "normal" reinsurance market practice that are part of runoff have the effect of socializing losses among the insurance industry, similar in some ways to how Equitas socialized losses among the names of the open syndicates. Especially because runoff market transactions so frequently involve loss categories that the entire market underestimated,¹⁰⁶ reinsurance runoff can be understood as a process for sharing uncertainty across the broader insurance pool, based on the relative exposure of (re)insurers to the liabilities being run off. This process may not be as explicit or predictable as the market-share based assessments that fund the insurance guaranty funds that step in to pay claims when insurers become insolvent, but it is similar in kind. By contrast, any variations from the "normal" retail insurance market practice that are part of runoff have the effect of de-socializing losses, by leaving a greater share of those losses with the people or organizations that purchased the insurance. This difference helps explain the much greater regulatory scrutiny given to the runoff of retail insurance operations than to reinsurance.¹⁰⁷

The life insurance runoff market grew somewhat later and in response to different developments than property casualty runoff. In life insurance, the problems that lead to runoff are more likely to come from the asset side of the balance sheet: returns on investments that turn out to be much lower than expected.¹⁰⁸ Life insurance industry runoffs typically involve savings-linked insurance products that were priced based on overly optimistic assumptions about interest rates, which would of course affect what the company would be able to earn from the assets under investment: whole life insurance, annuities, pension guarantees, and long term care insurance. Among these, long term care insurance runoffs are unique in that they involve not only unrealistic assumptions about earnings from assets, but also problems on the liability side of the balance sheet: changes in the costs of, and demand for, long term care.¹⁰⁹

For all these life insurance product runoffs, policy management includes collecting premiums and contributions from policyholders whose policies remain in force, communicating with those policyholders, and related customer service activities, in addition to collecting reinsurance and handling and paying claims.¹¹⁰ Thus, life insurance runoff also differs from property casualty runoff in the nature of the ongoing relationship between the insurance

Profitably running off claims might mean offering 20 cents on the dollar he said, suggesting that for a reinsurer to make runoff operations successful it needs to separate its 'bad cop' runoff experts from the remaining 'good cops.'"

¹⁰⁶ For example, APH liabilities, construction defect litigation liabilities, workers compensation liabilities, and guaranteed minimum value life insurance policy liabilities.

¹⁰⁷ Interview (May 5, 2019).

¹⁰⁸ See, e.g. news story about Hartford Life runoff

¹⁰⁹ See, e.g. news story about insurance departments approving rate increases for long-term-care insurance.

¹¹⁰ Explain contributions – for pensions, annuities.

company and its policyholders.¹¹¹ In a property casualty insurance runoff, there are no premiums to be collected or policies to be renewed; the only ongoing relationship revolves around claims. The ongoing relationship in the life insurance segment makes it difficult to commute policies.¹¹² Thus, life insurance runoff investors tend to be companies that have a long-term asset management focus.¹¹³

As even this very general description makes plain, runoff policy management details differ greatly across insurance market segments, with each segment posing a unique set of problems. Asbestos liabilities are similar in many, but not all, ways to environmental liabilities; both kinds of toxic tort liabilities differ significantly from medical malpractice, workers compensation, and municipal liabilities; these liabilities differ from sexual abuse and molestation claims; and natural catastrophe and mega property insurance claims differ significantly from liability insurance claims. On the life insurance side, whole life insurance presents policy

¹¹¹ Swiss Re described its life runoff business in a 2018 prospectus as follows:

We acquire portfolios through acquisition of entire lines of business (and a subsequent transfer of the business to us in the United Kingdom under Part VII of FSMA or the entire share capital of (or a majority stake in) life insurance companies, or through reinsurance. We typically assume responsibility for administering the underlying policies in such portfolios until they reach maturity, are surrendered or an insured event occurs resulting in the termination of the policies. In addition, we write a nominal amount of new business on a passive basis normally for existing customers that request "top-ups" of current contracts or who need to move to an alternative product type to access certain product features. Our strategy is centered around gross cash generation (excess capital available compared with the target capital position) and we seek to maximize our future expected profits through a combination of efficient management of existing policies, disciplined asset management, the acquisition of additional books of business and consolidation of new business with existing operations to benefit from capital and asset management, operational and incidental tax synergies.

Swiss Re Global Share Participation Plan 2018, 67, https://www.swissre.com/dam/jcr:51c80e34-c8ab-46c2-b69c-6cd8c1ef9dcd/Swiss_Re_GSPP_Prospectus.pdf

¹¹² I learned of two life transactions that have a similar impact as a commutation: (1) companies managing an annuity runoff sometimes offer policyholders an “enhanced annuitization” option, that amounts to a buyout of the annuity (interview May 15, 2019) and (2) when companies managing a long term care runoff receive regulatory approval to increase rates for in force policies, they typically offer policyholders the option of selecting a shorter benefit period, which has the effect of reducing the right tail risk of the company (Interview May 5, 2019). An improper practice that would significantly limit the right tail risk of the runoff operation is inducing policyholders to lapse. See Jean Pinquet, Montserrat Guillen & Mercedes Ayuso, *Commitment and Lapse Behavior in Long-Term Insurance: A Case Study*, 78 J. RISK AND INS. 983, 986-7 (2011) (describing the benefit to the insurer from policyholder lapses when insurance pricing is front-loaded, as is the case in long term care and some forms of life insurance). Cf., Andrew Harley and Ian Farr, *How Can Life Insurers Improve the Performance of Their In-force Portfolios?* WILLIS TOWERS WATSTON INSIGHTS, September 2013, <https://www.towerswatson.com/en-US/Insights/Newsletters/Global/emphasis/2013/how-can-life-insurers-improve-the-performance-of-their-in-force-portfolios> (recommending that insurers “establish mechanisms to focus their retention management activities on higher-value customers” as an example of “smart customer handling — relates to treating customers differently depending on the underlying financial attractiveness of their policy to the insurer”)

¹¹³ See, e.g., RESOLUTION LIFE, OUR PURPOSE, <https://resolutionlife.com/our-purpose/> (last visited June 5, 2019) (“Returning capital over time to our institutional investors in the form of a steady dividend yield”); Oliver Ralph, *Europe’s Life Insurers Fall into the Hands of Private Equity*, FIN. TIMES (OCT. 22, 2018), [HTTPS://WWW.FT.COM/CONTENT/4E89FF8E-C8AF-11E8-BA8F-EE390057B8C9](https://www.ft.com/content/4E89FF8E-C8AF-11E8-BA8F-EE390057B8C9).

management challenges that are similar to, but significantly different from, annuities and pensions; and long-term care insurance presents its own distinct set of challenges.

Because of these differences among insurance market segments, the details of insurance runoff policy management resist easy generalization. Nevertheless, there are some commonalities. For example, across all lines of insurance, an insurer that stops writing active insurance business entirely, or that stops writing all active insurance in all the lines of insurance supported by its former reinsurers, is said to encounter greater difficulty in collecting on the reinsurance that it purchased, because the insurer no longer has any commercial leverage with those reinsurers.¹¹⁴ This difficulty presents an opportunity for runoff specialists, who explain that they can consolidate books of business to increase their leverage, create repeat-player relationships, and learn what it takes to open the wallets of reluctant reinsurers.¹¹⁵

The common thread that runs throughout runoff policy management is that intensive exposure to the legacy liabilities of each particular market segment leads to expertise and relationships that reduce the costs of running off those liabilities.¹¹⁶ Through this exposure, the runoff specialists identify market-segment-specific opportunities to contain and manage the legacy liabilities. Here are two more specialized examples.

Addressing the coverage litigation collective action problem and reducing legal spend in liability insurance runoff. For technical reasons that are not important to understand in this context, any single significant asbestos liability defendant or hazardous waste site defendant may

¹¹⁴ See AIRROC Matters. Cf., Kevin J. Walsh & William D. Foley, *Some Thoughts on the Pre-Hearing Security Freight Train in the Run-Off Context*, AIRROC MATTERS, Spring 2008, at 28 (“As many have noted, in the run-off context, where claims issues cannot be resolved by promises of new premiums on wonderful (loss free!) new business, run-off reinsurers find themselves with more disputes, many of which end up in arbitration.”)

¹¹⁵ That this difficulty might present a challenge to the legitimacy of runoff (by suggesting that runoff managers might engage in similar behavior with their counterparties on the other side) does not appear to have attracted notice in the runoff trade literature.

¹¹⁶ See, e.g., Pomerantz & O’Mara, *supra* note xx at 7 (noting that one important aspect of runoff management is making accurate assumptions about reinsurance collectibles, which requires detailed knowledge about the current state of the market and observing that “if the company is going into runoff, it could change the assuming reinsurers’ view on the way that they are paying out because they’ve no longer got an ongoing relationship with that client.”); Charles Ehrlich, *Found Money or Unobtainium: Security Deposits and the Run-off Company*, AIRROC MATTERS, Winter 2006/2007, at 21 (describing ways to recover security postings, which can be an important source of capital). “People in the runoff side now could go back into the ongoing side and I think it will help control costs because people in the runoff side are always focusing on keeping costs low.” AIRROC, *Thoughts on the Future*, Vimeo (2017), <https://vimeo.com/232113382>. Connie D. O’Mara & Bina Dagar, *Marcus Doran: Marcus Opens Up About the Biz, Likes and Dislikes, and AIRROC*, AIRROC MATTERS, Fall 2014, at 24 (“In respect to the run-off market, I’ve learned that it is a relationship business. The issues are complex, and there is a great deal of history between trading partners. Therefore, it is imperative to establish relationships based on respect, trust, and integrity.”); Pomerantz & O’Mara, *supra* note XX [Rx for Run Off] at 8 (observing that different (re)insurers have different “appetite for commutation”; knowing that appetite allows you to better assess a potential runoff). An early special issue of AIRROC Matters devoted to commutations reveals some of the nuances and relationships of communications. See generally, AIRROC MATTERS: SPECIAL EDITION – COMMUTATIONS, Summer 2007.

have hundreds of individual liability insurance policies that provide coverage for all or part of its potential liabilities, issued by multiple insurance companies, over multiple decades.¹¹⁷ In this circumstance, a well-counseled commercial policyholder can take advantage of what amounts to a collective action problem among its many insurance companies.¹¹⁸ The consolidation of most of the asbestos and environmental runoff liabilities of some of the largest insurers into the hands of a very small number of runoff specialists has changed this negotiating dynamic and, because the insurers for whom the specialists are managing the runoff no longer each need their own lawyer for all purposes, reduced insurers' insurance coverage litigation costs.¹¹⁹ That consolidation may also have the potential to address a similar collective action problem that results when the underlying plaintiffs sue many defendants.

Rationalizing legacy information technology in life insurance runoff. Insurance companies are intensive users of information technology. The earliest “computers” were humans, many of whom worked for insurance companies, and the insurance industry has long been an important customer of information technology manufacturers.¹²⁰ For the life insurance industry especially, the rapid change of information technology presents a challenge to the consistent, reliable maintenance of processes and customer relationships under contracts that can last decades.¹²¹ Each new life insurance product and each new feature in an existing life insurance product requires adjustments in information processing routines. Major updates in the core information technology of the life insurance company can require adjustments in hundreds, if not thousands, of policy management routines.¹²² In many cases it makes more sense, especially in the short run, to keep those routines running on older systems. Not surprisingly, life insurance companies are full of legacy information technologies running processes for legacy insurance products.¹²³ A key selling point of life insurance runoff specialists is relief from the cost and headache of maintaining legacy information technology systems for an unprofitable and declining book of legacy policies.¹²⁴ Life insurance runoff specialists have become expert in converting multiple legacy life insurance books running on multiple legacy information systems to a common, more state-of-the-art information system,¹²⁵ which is a concrete example of how the consolidation of insurance runoff reduces the marginal cost of managing the policies in runoff.

¹¹⁷ See Stempel, *supra* note XX

¹¹⁸ [policyholder source]

¹¹⁹ [policyholder source]

¹²⁰ JoAnn Yates, Structuring The Information Age

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¹²⁴ See, e.g. Wilton Re

¹²⁵ [Find news story about Swiss Re approach]

3. *Runoff finance and asset management.*

Like policy management, asset management and finance also differ in the runoff context in ways that reflect the narrower focus of runoff operations and support the claim that consolidation leads to more efficient runoff operations. Runoff finance is simpler than active insurance company finance because runoff companies have more focused operations and, hence, fewer expenses to project (and hold capital against): no salesforce, little to no marketing, few underwriters, and little brick and mortar.¹²⁶ A property casualty runoff company is, essentially, an insurance mergers and acquisition fund with a claims management department.¹²⁷ A life insurance runoff company needs to add a policyholder management function, but that function is highly automated, as explained in the policy management example above. Apart from these two management functions, a runoff company has more in common with acquisition vehicles, such as private equity funds, than an active insurance company. Perhaps for that reason, private equity funds hold substantial stakes in runoff companies.¹²⁸

Companies that specialize in runoff also invest their assets differently than active insurance companies. Among those companies for which it is possible to obtain asset information, the runoff companies invest in higher risk securities that, on average, yield a higher return than the investments of a comparison set of generalist property casualty companies, and a much larger share of the assets are invested in illiquid alternative assets.¹²⁹ My working hypothesis is that runoff specialists are able to take greater risk on the asset side of the balance sheet than most insurance companies for three main reasons (recognizing that not all of these reasons apply equally well to all the runoff specialists). First, as reinsurance companies, they are less heavily regulated than insurance companies. Second, because they are already so deeply into the business of compromising their liabilities, the downside of taking that risk does not threaten their business model. Running into trouble on the asset side of their balance sheet simply increases their “financial distress” leverage with counterparties. Third, the people who provide capital to the runoff specialists regard those specialists as high risk/high reward investments, and they are comfortable with the specialists taking risk on both sides of the balance sheets.

[eventual discussion of green runoff market will go here]

¹²⁶ Interview (January 31, 2019).

¹²⁷ *Id.*

¹²⁸ *See, e.g.,* Catalina, Wilton Re, Athene, others

¹²⁹ *See* Appendix A [Note Appendix A does not yet include NICO. NICO’s assets look more like the assets of an actively managed, value-oriented mutual fund, than an ordinary insurance company]. *But see,* Russ & Ryan, *supra* note xx at xx (noting that assets need to be managed differently for runoff because claims of companies in runoff are paid quicker and smaller as compared to before entered runoff). Talk to BG about whether there are regulatory reasons for this difference.

B. Runoff stories

“We aren’t the glamour kids.... We are the ghosts of mistakes past, of the failures that had fathers when they were shiny new ideas but are now orphaned in dismal disappointment. No one ever says, ‘this book/program is a great success, let’s put it in run-off.’ So, by definition, we deal in failure.”¹³⁰

As the preceding section described, runoff underwriting reprices legacy liabilities with the benefit of hindsight; runoff policy management consolidates those liabilities, develops relevant expertise, and identifies and executes operational efficiencies; runoff asset management takes calculated risks, with the goal of earning higher returns; and runoff finance facilitates lower cost planning for, and (for the owners and regulators) greater transparency into, the process of the runoff. Runoff specialists undoubtedly do not execute any of these activities with perfection, but they have a decent claim to better execution than is possible inside an active insurance company, for which the liabilities in runoff are a dwindling and unpleasant reminder of the underwriting mistakes of the past.

Insurance runoff also operates through a rhetorical and organizational process that begins long before the runoff market transaction takes place. This process reconceptualizes a large, diverse number of individual insurance relationships into segregable books of legacy insurance liabilities that can be managed distinctly from those of the insurer’s active business. This reconceptualization happens slowly. As the time when the insurer sold the policies recedes into the past, insurance company personnel increasingly understand and categorize the policies in terms of the claims presented and the liabilities carried on the company’s financial statements (as opposed to the identities, activities, or other distinguishing features of individual policyholders that company underwriters focused on during the sales process). Company actuaries track the financial results of the policies using statistics like the underwriting ratio (often called the claims ratio by people in the trade), which compares the premiums collected for the policies in the aggregate to the losses incurred under those policies in the aggregate.¹³¹ Gradually, the actuaries develop and propagate the understanding that a particular book of policies – once again understood as an aggregate – was a losing proposition for the company, and, therefore, that this group of policyholders got more than they paid for.¹³²

¹³⁰ Charles Ehrlich, *Why Are We Here?*, AIRROC MATTERS, Summer 2015 at 20

¹³¹ For an explanation of the underwriting ratio, *see* Chairman’s Letter, *supra* note xx (explaining why he prefers a measure that takes the investment income into account). I learned that people in the business call it the claims ratio from a specialty lines underwriter.

¹³² *See, e.g.*, John West, *Managing the Past in the Future*, AIRROC MATTERS, Fall 2013 at 12,13 (describing a typical runoff situation as follows: “There is no premium flow to offset the cost of those staff members. The loss ratio on the original business has long since exceeded 200%. Of the \$20 million in outstanding reserves, investment income is currently generating about 3.5% per year. That equates to \$700,000. Those 10 staff members and their associated costs could total \$1.4 million per year. Just on the face of it, there is a huge disparity between the income

At some point in this process, company underwriters decide not to sell new policies into this market (or not to cover these kinds of risks on an ongoing basis), confirming what the people involved in managing the claims and reserves already knew: this book of policies is non-core, unwanted business that does not represent the future of the company.¹³³ Indeed, this book of policies might even be a threat to the financial health of the company, making work on the book perilous to the careers of the people in the company who are responsible in the ordinary course for managing claims and setting reserves.¹³⁴ Identifying the book as being “in runoff,” and shifting the management of that book to runoff specialists mitigates that career risk.¹³⁵ The rhetoric and organizational logic of runoff normalizes that process:

Runoff is an organic, positive necessary part of a healthy (re)insurance industry. . . . Businesses need to test new markets and products; often, the outcome is “run-off.” Ultimately, most relationships end. What happens? Run-off. Customer requirements and demands change. Results? Run-off. Specialists and dedicated professionals are needed to deal with the most volatile – and therefore the most important – of the insurance industry’s protections against catastrophe.¹³⁶

This transition to runoff is an extension of the process that routinely occurs in the insurance business, as policyholders transition from the sales side of the insurance relationship to the claims side of that relationship. As prior work has shown, insurers tell different sets of stories about insurance when communicating with policyholders during the sales and claims processes:

In the first set of stories – the sales stories – insurance companies promise complete protection from the risks addressed by any line of insurance. In the second set of stories – the claims stories – insurance companies explain why it is that “complete

and the outgo on this aged business!”). See note xx, *supra* (on the alternative framing of the “more than they paid for” aspect of runoff stories).

¹³³ For a stylized parable of how this can happen, see Fitzpatrick, *supra* note xx at 270-73.

¹³⁴ Luann M. Petrellis, *Can U.S. Insurance Companies Afford Not to Restructure?*, AIRROC MATTERS, Winter 2016-17 at 6 (“The pressure is now on all insurance carriers to manage their capital more efficiently.” Eleni Iacovides, *The Legacy Market*, AIRROC MATTERS, Spring 2017 at 15:

Solvency II, the relatively new European regulatory framework, along with low investment returns, soft market and pressure on underwriting profit has forced insurers to focus, more than ever, on the cost of capital and consequently on capital efficiency, in addition to the need for optimization of internal resources and cost reduction. Reserves held for old, discontinued or non-core business have become more capital intensive, thereby restricting insurers’ ability to deploy capital elsewhere such as new products, digitalization or a strategy to increase one’s market share in core business or a new jurisdiction.

Eleni Iacovides, *The Legacy Market*, AIRROC MATTERS, Fall 2017 at 20:

The continued lack of investment returns, the need to ring-fence exposure, the more stringent regulatory obligations coupled with the additional capital required to simply operate and write the same level of business; each continues to drive the search for ways with which to limit an insurer’s exposure to the unknown or uncertain and to deliver value to shareholders.

¹³⁵ See Fitzpatrick, *supra* note –.

¹³⁶ Andrew Maneval, *Why We Work in “Run-Off,”* AIRROC MATTERS, Fall 2014 at 9, 10.

protection” sometimes amounts to a little less; why it is, in other words, that some risks are *not* shifted to the insurance company.¹³⁷

The sales stories highlight policyholders’ vulnerability and dependence, and they convey the message that insurers can be trusted to fulfill their promise to be there in time of need.¹³⁸ By contrast, the claims stories stress the limits of the insurance contract, the insurance company’s responsibility to future claimants, and the need to protect the insurance pool from policyholders who take advantage.¹³⁹ Insurers reduce the opportunity for these two sets of stories to come directly into conflict “by separating the organizational responsibility for the narration of the two sets of stories.”¹⁴⁰ The sales and marketing departments tell the sales stories; the claims department tells the claims stories. The sales stories help persuade people to buy insurance. The claims stories help people accept that there are limits on the protection that insurance provides.

The transition to runoff involves a third set of stories, told by people with yet another organizational responsibility: the runoff professionals. These runoff stories refer to “legacy liabilities” that represent a “drag” on insurance performance and that “trap capital” that could otherwise be put to better use.¹⁴¹ Unlike the “promises” of the sales stories and the “contractual obligations” of the claims stories, “legacy liabilities” are abstract representations of contingent future payments to an abstract collectivity. Unlike promises and even contractual obligations, liabilities can be accelerated and compromised, and, perhaps, even delayed and denied. Compromising and accelerating those liabilities is a fair thing to do for cedents and large commercial policyholders because, with the benefit of hindsight, it is clear that the policyholders/cedents as a whole got far more than they paid for.¹⁴² While each individual policyholder/cedent retains the contractual right to insist on the payment of its claims as they become due, the runoff administrators also have the right to revisit the insurer’s prior claims payment practices to search for ways to cut costs, encouraging policyholders/cedents to recognize that compromise is the normal, accepted practice in the runoff context for them as well.¹⁴³

[I will need address significance of green runoff for the runoff stories idea here.]

¹³⁷ See Baker, Insurance Stories, supra note xx at 1400 [comment – not sure this is previously cited?]

¹³⁸ *Id.* at 1403-07.

¹³⁹ *Id.* at 1407-13.

¹⁴⁰ *Id.* at 1415-16.

¹⁴¹ See, e.g., RESOLUTION LIFE, OUR PURPOSE, <https://resolutionlife.com/our-purpose/> (last visited 3/15/2019) (“We help global insurance groups to pursue growth and innovate new products by allowing them to release capital and remove cost stranded in their legacy insurance portfolios.”).

¹⁴² See note xx (on alternative framing). Note that the runoff trade literature and the runoff market participants that I interviewed exclusively employ this reasoning in relation to cedents and large commercial policyholders.

¹⁴³ E.g. Interview (May 7, 2019)

The following sections summarize the benefits of runoff that the stories promote and the responses that the stories provide to criticism of insurance runoff, using sources from the runoff insurance market, but presented in language that may be more familiar to an academic audience.

1. *Promoting the benefits of runoff*

[Runoff transactions] release capital, allow the [original insurer] to achieve higher ROE by investing released capital in more profitable and/or core business, reduce the insurer's exposure to potentially long-tail and volatile business and reduce operational overheads. Employing these solutions also often receives support from the [original insurer's] regulator as regulators are now more than ever, keen to support any steps taken by insurers which are likely to avoid failure.¹⁴⁴

The runoff stories posit three main benefits that runoff provides to the insurance market. First, by allowing insurers to expand their active insurance business, the runoff market increases the availability of insurance. Second, because runoff specialists administer legacy insurance policies more efficiently, the runoff market lowers the cost, and hence the price, of insurance. Finally, the runoff market allows unsuccessful insurers to unwind outside of the cumbersome and expensive insurance insolvency process, reducing the drain that insurance guarantees imposes on the active insurance market.

Increasing insurance availability. The argument here is that, by unlocking value and improving management focus, runoff transactions allow insurers to sell more insurance. Runoff transactions unlock value by transferring legacy books to companies that value those books more highly, providing the originating insurers access to capital that they can use to expand their core, active insurance business.¹⁴⁵ The transactions improve management focus by radically reducing the amount of time that senior managers need to give to the insurer's legacy business, "freeing them up to do the business that they want to do."¹⁴⁶

Although there has not been any systematic test of these claims, there is good anecdotal evidence that runoff transactions contribute positively to the credit rating of insurers that engage in them,¹⁴⁷ and there is good empirical evidence showing that an improvement in credit rating leads to a growth in the premiums that insurers write and, conversely, that a downgrade leads to

¹⁴⁴ Eleni Iacovides, *The Legacy Market*, AIRROC MATTERS, Spring 2017 at 17.

¹⁴⁵ *Id. Cf.*, finance literature on unlocking value.

¹⁴⁶ Interview with runoff market participant (May 6, 2019). *Cf.*, finance literature on management overhang.

¹⁴⁷ [look for news accounts of impact of NICO & Enstar deals on counterparty credit ratings]. See Randi Ellias, *Structuring U.S. Runoff Deals*, AIRROC MATTERS, Winter 2018-19 at 28 ("rating agencies typically consider those covers positively because the books of business reinsured are usually non-core – and therefore weaker – business"). Runoff market participants explained to me that insurers do runoff deals with Berkshire Hathaway because that is the best way to demonstrate to credit analysts that they have put their legacy problems in the past. *E.g.*, Interview (May 2, 2019).

a reduction in premiums.¹⁴⁸ Whether the change in sales that results from a stronger credit rating represents an expansion in insurance availability rather than taking market share from other insurance companies is more difficult to say, especially in a world in which the insurance industry does not appear to have difficulties raising capital.¹⁴⁹ Nevertheless, there is some evidence that internal capital is less costly than external capital in the insurance industry,¹⁵⁰ and it seems reasonable to consider the proceeds of a runoff transaction to be more like internal capital than external capital, because the counterparties of runoff transactions are members of the insurance industry. Thus, while hardly backed by the kind of evidence that would merit publication in the *American Economic Review*, the claim that the runoff market promotes insurance availability has to be regarded as plausible, which is all that is needed for it to be useful.¹⁵¹

Lower costs and lower prices. The argument here involves several steps. First, by consolidating the legacy liabilities of multiple insurers, runoff specialists manage legacy liabilities more efficiently than individual insurers would on their own as described in the preceding section.¹⁵² This is one reason why specialists value legacy books more highly than the originating insurers from whom they acquire those books. Second, the specialists share some of those savings with their insurer counterparties. This is part of how runoff transactions unlock value for the originating insurers.¹⁵³ Finally, insurers share some of those savings with policyholders in the form of lower prices, at least in theory.¹⁵⁴ This is the way that competitive markets are supposed to work, at least in theory, lowering costs and reducing prices. Whether they operate in that way in this circumstance is an empirical question. There is evidence that insurance markets are competitive,¹⁵⁵ and the runoff insurance market has a sufficient number of

¹⁴⁸ See Karen Epermanis & Scott Harrington, *Market Discipline in Property/Casualty Insurance: Evidence From Premium Growth Surrounding Changes in Financial Strength Ratings*, 6 *J. Money, Credit, and Banking* 1515 (2006) (documenting decline in premium volume following downgrades, especially in the commercial insurance sector). See, e.g., Steven W. Pottier & David W. Sommer, *Property-Liability Insurer Financial Strength Ratings: Differences Across Rating Agencies*, 77 *J. Risk & Ins.* 621, 623 (1999) (explaining importance of ratings). Cf. Sojung Carol Park & Xiaoying Xie, *Reinsurance and Systemic Risk: The Impact of Reinsurer Downgrading on Property-Casualty Insurers*, 81 *J. Risk & Ins.* 587, 616 (2014) (downgrade of a reinsurance leads to downgrade of primary insurer counterparties); Phillips, Cummins, Allen, *Financial Pricing in the Multiple Line Insurance Company*, 65 *J. Risk & Ins.* 597 (1998) (finding that insurance company premiums as a function of claims costs are lower for insurers with higher solvency risk, which correlates to lower financial strength ratings).

¹⁴⁹ See, e.g., *Former Catlin Executives Launch PE-Backed Insurer*, *BUSINESS INSURANCE* (April 30, 2019), <https://www.businessinsurance.com/article/20190430/NEWS06/912328178> (noting that “private equity firms have been attracted to the sector due to its strong returns compared with conventional assets such as bonds”).

¹⁵⁰ The leading evidence on this point comes from the literature studying the “capacity constraint” explanation for the insurance underwriting cycle. [pull citations from Med Mal Underwriting Cycle article]

¹⁵¹ Note that a critic would argue that providing more access to cheaper insurance is not necessarily a good thing if the lower price for that insurance reflects the more incomplete nature of the risk transfer that it provides. Evaluating this and other welfare economics questions is beyond the scope of this research.

¹⁵² See

¹⁵³ Trade literature citation

¹⁵⁴ [source in trade literature or interview]. Caveat about empirical question.

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participants and sufficiently low barriers to entry that it certainly could be competitive.¹⁵⁶ Thus, the claim that the runoff market promotes lower insurance prices also has to be regarded as plausible, though certainly far from proven.¹⁵⁷

Avoiding insolvency. While many runoff transactions involve insurers with strong balance sheets, enough transactions involve insurers in weak financial condition to make insolvency avoidance a notable theme in the runoff stories.¹⁵⁸ At times there has been a lively academic debate about whether regulators should allow more insurance companies to fail and whether regulators wait too long to declare that insurance companies are insolvent.¹⁵⁹ As that debate reflects, insurance insolvencies are often, if not always, seen as regulatory failures, not just business failures.¹⁶⁰ Insurance law and regulation texts describe solvency protection as the most important job of insurance regulators.¹⁶¹ Thus, it hardly surprising that runoff stories draw on this rich vein.¹⁶²

There are three main themes: first, runoff transactions can raise the credit rating of insurers with legacy liabilities, allowing them to solidify their financial condition by selling profitable new business;¹⁶³ second, even if the insurer cannot restart its active business (or even if the insurer eventually shuts down its active business), a runoff transaction can facilitate a solvent winding up of the insurance business that provides greater protection to policyholders than would a government supervised rehabilitation or liquidation proceeding;¹⁶⁴ third, even if the insurer eventually ends up in receivership, a good faith attempt at a solvent runoff will result in a smaller, simpler receivership and better outcomes for the policyholders who were able to resolve

¹⁵⁶ See, TAN (identifying XX companies active in the runoff market). Barriers to entry are relatively low because all that is required to enter the runoff business is capital and people with the necessary know-how and personal networks. This doesn't mean that starting a runoff company is easy, only that it is unlikely that runoff insurers as a whole can earn supra-competitive returns on a long-term basis. The recent entry of private equity into the runoff market is said to be based on the belief, not that the returns will be supra-competitive, but rather that they will not be correlated with other investments and, thus, an investment in runoff will reduce the overall riskiness of the PE portfolio. See Divya Kirti & Natasha Sarin, *Private Equity Investments in the Life Insurance Industry: Implications for Capital, Taxes and Risk* (Working Paper 2018).

¹⁵⁷ Cf., Kirti & Sarin *supra* note xx (increased yields earned by life insurance firms owned by a large private equity fund are shared with consumers in the form of lower prices for insurance). Note that this same PE fund – Apollo – is one of the largest investors in runoff in both the life and property casualty sectors, through Athene in the life sector and Catalina in the property casualty sector.

¹⁵⁸ See, e.g., Eleni Iacovides, *The Legacy Market*, AIRROC MATTERS, Spring 2017 at 17

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¹⁶⁰ See, e.g., Robert W. Klein, *Insurance Regulation in Transition*, 62 J. Risk & Ins. 363, 364 (1995) (“The increase in insurer failures and other market problems have raised serious concerns about whether state insurance regulation provides adequate consumer protection”); Failed Promises *supra* note xx.

¹⁶¹ Baker & Logue, Abraham & Schwarz, others

¹⁶² See, e.g., Mark D. Steckbeck and Roger H. Schmelzer, Capital Market Investment Opportunities in Insurance Insolvency and Their Impact on Consumers, National Conference of Insurance Guaranty Funds Backgrounder (July 16, 2008) (noting “[r]egulators are showing less interest in placing troubled insurers into liquidation, and troubled insurance companies seem to present investment opportunities for the capital markets”)

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their claims or commute their policies prior to the receivership.¹⁶⁵ Whether giving insurers more time works out well for policyholders/cedents sufficiently often is yet another unanswered empirical question, but there are enough cases in which that strategy worked – most prominently Lloyd’s Reconstruction and Renewal – to make this story plausible as well.¹⁶⁶

2. *Answering concerns about runoff*

There seems to be a belief that a portfolio transfer is somehow an exotic creature that interferes with a contractual arrangement with which one should never interfere. What about the robust approval process that must be followed before it actually concludes? What about the need for the transferor to ensure that its reputation remains intact following the sale and the safeguards that are put in place with this in mind? And what about the transferee, who must ensure that it does a good job in order for his business plan to be met and its shareholders to be kept happy and that their investment is well-managed? All these interests and considerations go a long way towards ensuring that policyholder rights (the other contracting party) are protected following the contractual change. We often hear that claims settlement is actually better in the hands of legacy acquirers. This is not surprising. The portfolio transferred would most likely be a non-core portfolio managed by a small team that perhaps had little involvement in the company’s core/ active business. When it lands on the transferee’s balance sheet, it becomes a core part of the acquirer’s value creation and receives top management attention.¹⁶⁷

Commentators have raised several significant concerns about the insurance runoff market. First, there is the potential for runoff transactions to place legacy obligations into entities without sufficient assets to support them.¹⁶⁸ In addition, even if the entities are sufficiently capitalized, they may not have the same incentive as the originating (re)insurers to

¹⁶⁵ Interview (May 7, 2019).

¹⁶⁶ Other examples in which the strategy is said to have worked include the CIGNA liability-based restructuring, which preserved the Insurance Company of North America (whose operations arguably today constitute the core of Chubb) (May 7, 2019 interview), the restructuring and subsequent sale of PMA Re (which preserved PMA’s active insurance companies and significantly reduced and simplified PMA Re before receivership) (Interview May 7, 2019), and the runoff of the Kemper companies. See John K. Conway, James W. Schacht and Kenneth R. Wylie, *Observations on the U.S. Resolution System for Property/Casualty Insolvent Insurers: The Lumbermens Mutual Group Case Study* (The Geneva Association 2016).

¹⁶⁷ Eleni Iacovides, *The Legacy Market*, AIRROC Matters Spring 2017 at 12. See also Eleni Iacovides, *The Legacy Market*, AIRROC Matters Winter 2018 at 11:

“Acquirers’ core business is insurers’ noncore or unwanted business. In order for them to be in a position to succeed, to continue to grow, to meet their business plans, to satisfy their shareholders’ expectations and to achieve the plethora of business goals that all businesses have, they have to build a reputation of reliability and credibility so that they can continue to acquire more portfolios and to grow their own balance sheet.”

¹⁶⁸ This is the insurance instantiation of the dynamic Lynn LoPucki described over twenty years ago. Lynn M. LoPucki, *The Death of Liability*, 106 *Yale L.J.* 54 (1996).

fulfill the underlying contractual obligations.¹⁶⁹ Moreover, even if runoff entities' have, or can be made to have, the same incentives and capacity as the originating (re)insurers, those incentives do not necessarily favor policyholders and cedents, and runoff specialists' expertise in commutations and other ways of "managing expenses" may mean that policyholders and cedents, on average, take larger haircuts from runoff specialists than they would from (re)insurers running off their own risks.¹⁷⁰ In addition, even if most runoff specialists would like to pay claims responsibly, the existence of a few that are willing to flout customary insurance market norms places pressure on the others to do likewise.¹⁷¹ Finally, dividing or unwinding troubled (re)insurers outside of the insolvency process shifts risks to policyholders/cedents from shareholders, who are supposed to be the first ones to come up short when assets are insufficient to cover liabilities.¹⁷²

The runoff stories have answers for these concerns that can be briefly summarized as follows: Regulators do not approve runoff transactions that put (re)insurance liabilities into entities without sufficient assets,¹⁷³ and (re)insurers choose well-funded counterparties for loss portfolio transfers because, otherwise, the loss portfolio transfer will not achieve the goal of providing economic finality for the insurers.¹⁷⁴ The incentives and capacity of the originating (re)insurers are not as wonderful as the runoff objectors presume,¹⁷⁵ and the focus and expertise of the runoff companies may even lead to a better claims experience.¹⁷⁶ Runoff specialists cannot get away forever with being bad actors, because they need new runoff transactions to succeed; and they cannot get those new transactions if they have a bad reputation, because regulators will not approve the transactions and insurers will not want to do business with them.¹⁷⁷ Whatever the incentives of runoff specialists might be on their own, the continuing

¹⁶⁹ See, e.g., John M. Sylvester and Max Louik, Policyholder Litigation Challenging the Claims-Handling Conduct of Resolute Management, 28 *Env. Claims J.* 97, 98 (2016) ("Once Resolute takes control of claims handling for the ceding insurer, Resolute has been known to pursue very aggressive strategies to reduce and delay the payout of coverage dollars to policyholders, the payment of attorneys fees to defense counsel, and the offering and payment of settlement amounts to underlying claimants") (note that Mr. Sylvester was at the time of this writing actively engaged in litigation against Resolute).

¹⁷⁰ According to market participants I interviewed, this is a widely shared belief among insurance company personnel responsible for collecting reinsurance. Whether this is a selection effect or a causal explanation is not knowable absent the kind of well designed empirical research that is highly unlikely ever to be done.

¹⁷¹ AIRROC article about violating norms. One industry insider described the claims payment strategy of a certain runoff specialist as "Don't answer the phone or, even better, don't have a phone." Interview (April 7, 2019).

¹⁷² See, e.g., Steven E. Sigalow and Richard E. Stewart, How Lloyd's Saved Itself, 37 *The Insurance Forum XX* (February 2010) (contrasting the situation of troubled banks, whose shareholders "have been severely penalized or wiped out entirely," with the treatment of Lloyd's names, who were insulated from pre-1993 losses by Equitas).

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¹⁷⁷ Eleni Iacovides, *The Legacy Market*, AIRROC Matters/Winter 2017-18 at 11 (observing that a runoff acquirer is "keen to preserve its own reputation in order to gain more business from the same client, new clients, to grow").

liability of the originating (re)insurers in the loss portfolio transfer context gives them sufficient incentive to choose counterparties that will do a good job and to monitor that the counter parties in fact do so.¹⁷⁸ Insurance insolvency is a long, drawn-out process that returns less to most policyholders than a private runoff, and policyholders who would receive more in receivership can hold out for that result.¹⁷⁹ Finally, and perhaps most importantly, even if there might be something to the claim that runoff specialists sometimes pay policyholders/cedents less than what their original (re)insurers promised, those promises were unrealistic and uninformed; what the policyholders/cedents do collect is much more than they paid; permitting a modest amount of after the fact adjustment is a fair way to preserve a healthy (re)insurance market; and policyholders/cedents who do not accept this adjustment have the right to go to court or arbitration and insist on full payment.¹⁸⁰

As with the benefits of insurance runoff, the empirical research needed to provide conclusive evidence in either direction has not been done and is unlikely to ever be done, at least to the satisfaction of the critics of the insurance runoff market. Certainly, there are counter-arguments and counter-examples.¹⁸¹ But, they are just that, not rigorous proof. Thus, the outcome of a careful weighing of the pros and cons of the insurance runoff market remains uncertain. What is certain, and what is all that qualitative research could aspire to prove in this context, is that the rise of runoff reveals that insurers are much more actively involved in managing uncertainty than the ideal type of the fixed-in-advance distribution of determinable risks would suggest.

[Will need to address green runoff.]

IV. Conclusion: Lessons from the Rise of Runoff

Within the insurance industry, the rise of runoff is a notable development that has expanded insurers' options for managing legacy liabilities. Whether that development has benefitted policyholders and insurance companies equally is an important question, but one that requires different research methods to answer than those employed in this Article. My judgment is that the benefits that the runoff stories describe are real, especially when it comes to the runoff of reinsurance treaty obligations, but I recognize that there are countervailing concerns, especially for consumer and small business policyholders.

One market participant described his company as follows: “[Company] is like a shark in the water. We have to get water over our gills via continually acquiring new portfolios.” Email (January 30, 2019).

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¹⁷⁹ Interview (May 7, 2019).

¹⁸⁰ Interview (May 6, 2019).

¹⁸¹ See, e.g., Sylvester and Louik, *supra* note XX.

My goal in this article was different: to use the rise of runoff as a window on the management of uncertainty in the insurance business and to introduce legal scholarship to the sociological research on that uncertain business. While no single qualitative study can prove that the fixed-in-advance-distribution-of-determinable-risks ideal type fails to capture the real life operation of the insurance business, even one such study can demonstrate that insurance operates outside this ideal type, and the accumulating weight of studies suggests that the insurance industry so regularly operates in the realm of uncertainty that this ideal type should be abandoned as a general model of how insurance works, even if it might continue to have some validity in some sectors of the insurance market.

In that regard, it is important not to exoticize the insurance runoff transactions explored in this Article. The rise of runoff did not create insurers' need or capacity to manage uncertainty. It simply helps bring that need and capacity into clearer view. As early insurance accountants understood, every insurance policy goes into a kind of runoff the moment it is sold. The promises made in all insurance policies get bundled and reconceptualized into sets of liabilities that are valued and revalued, further combined and recombined over time. Some sets of liabilities perform better than expected; others worse. Insurers use profits earned on the better performing sets to offset losses on the worse performing sets, and if too many sets perform too badly, insurers must raise prices on their new policies. Insurers use large, general accounts to back the promises and contractual obligations featured in their sales and claims stories precisely so that they can make these kinds of adjustments across sets of liabilities and assets over time. Cross subsidies abound.

These adjustments take place not only for "long tail" insurance obligations traded in the runoff insurance market. Even short tail obligations like private passenger auto and homeowners policies face significant uncertainties from factors such as changes in the underwriting and risk classification technologies, new entries into the insurance market (think insuretech today), changes in legal rules regarding residual markets, changes in the mix or risk appetite of reinsurers in a market, changes in auto and home construction technology, insuretech, and, of course, changes in the legal rules regarding liability or insurance.¹⁸² The runoff market targets long tail obligations not because they are uniquely uncertain but rather because their longer duration provides greater opportunities for specialists to earn above market returns through financial engineering or liability management.

¹⁸² See generally, Baker, *Insuring Liability Risks*, *supra* note --. On the impact of changes in underwriting and risk classification, see [article about impact on Progressive on non-standard auto market]. On the impact of residual market changes, see *State Farm Mut. Auto Ins. Co. v. New Jersey*, 590 A.2d 191 (N.J. 1991). On the impact of withdrawal of reinsurers, see. On the impact of changes in the technology of the underlying risks, see. On the potential impact of insuretech, see []. On the impact of changes in legal rules regarding liability, see. On the impact of changes in the legal rules regarding insurance, see [RAND study on Royal Globe].

Industry leaders understand that a precise match between the price charged for one set of insurance policies and the losses incurred in that set is rare.¹⁸³ A precise match is the goal and, thus, achieving it is not an accident. Nevertheless, there are too many moving parts to almost any insurance business and too much uncertainty for that goal to be achieved very often. There is no such thing in real world insurance markets as the fixed-in-advance distribution of determinable risks. There is always some uncertainty, and the accumulating weight of the sociological research suggests that the extent of that uncertainty is quite substantial.

Nevertheless, that ideal type can be useful for insurers: as an aspiration for underwriters and actuaries, as an explanation for why claims managers should not make exceptions in needy cases, and as a justification for resisting or promoting legal change. Because of this utility, industry leaders use the ideal type in public to describe how insurance markets work to an extent that diverges from their private understanding. This is not dishonest. The ideal type is a legitimate aspiration, and there is nothing wrong with advocating for a legitimate aspiration. The wrong, if there is one, is on the part of observers who conflate advocacy and reality.

That ideal type also can be useful in legal thought, for example to explore such important topics as the potential impact of liability insurance on deterrence,¹⁸⁴ the comparative advantages of public and private systems of compensation,¹⁸⁵ and the consequences for health insurance markets of outlawing preexisting condition exclusions and health-based pricing.¹⁸⁶ For those purposes, the ideal type can serve as useful, simple model of how insurance works.

Models, and theory more broadly, can help identify and perhaps even explain some of the problems and possibilities that exist in the world. But models also can misdiagnose problems and hide possibilities. When we act as if insurance markets require determinable risks whose distribution can be fixed in advance, we fail to see the many ways that insurance organizations manage uncertainty. We lose sight of the resilience in insurance markets and of the flexibility and innovation that produce that resilience. Keeping that resilience more firmly in mind, we should give little weight to arguments such as those of Stapleton's Yale lawyers that this or that liability reform will undermine insurance markets. Insurance already involves so much uncertainty, and insurers have so many ways to manage it, that the most likely result will always be that they will continue to muddle through.

¹⁸³ See Ericson et al, *supra* note – at 158 (quoting an actuary as follows: “while actuarial science has all the trappings of science ... it is best seen as the framework for a ‘guessing game’ You know you’re going to be wrong from the start.”); Fitzpatrick, *supra* note ---.

¹⁸⁴ See Shavell, *supra* note --

¹⁸⁵ See chapter in Schwarcz & Siegelmand on catastrophe insurance.

¹⁸⁶ See Hoffman, *supra* note --