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## The Great Instrument of Chicanery: An Appeal for Greater Judicial Scrutiny of Solvent Insurers' Schemes of Arrangement

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## Notes & Comments

### The Great Instrument of Chicanery:

### An Appeal for Greater Judicial Scrutiny of Solvent Insurers' Schemes of Arrangement

J.H. Oliverio\*

#### INTRODUCTION

In 2002 the Rhode Island General Assembly became the first state legislature to enact a solvent scheme of arrangement law for solvent insurers and reinsurers by passing the Voluntary Restructuring of Solvent Insurers Act (the Restructuring Act).<sup>1</sup>

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\* J.D. Candidate, Roger Williams University School of Law, 2013; B.A. Providence College, 2010. I would like to dedicate this note to my father, Matthew T. Oliverio, Esq. You are living proof that one father is more than a hundred schoolmasters; all that I am, and all that I wish to be, is the result of your tireless love and devotion. I would also like to thank my editors and John Chung for their invaluable assistance throughout this process.

1. The Voluntary Restructuring of Solvent Insurers Act is contained in R.I. GEN. LAWS §§ 27-14.5-1 to -6 (2008). A scheme of arrangement is a method by which companies may reach binding agreements with creditors or shareholders to restructure their financial obligations. See Susan Power Johnston, *Why U.S. Courts Should Deny or Severely Condition Recognition to Schemes of Arrangement For Solvent Insurance Companies*, 16 NORTON J. BANKR. L. & PRAC. 953, 953 (2007). A solvent scheme of arrangement is one that may be utilized by a solvent company. *Id.* See also discussion *infra* pp.

The Restructuring Act gives flexibility to a solvent restructuring insurer or reinsurer to commute future liabilities in exchange for a lump-sum payment to creditors.<sup>2</sup> In 2010 GTE Reinsurance (GTE RE) became the first solvent reinsurer to test the constitutional viability of the Act when it sought to enforce a commutation plan in the Superior Court of Rhode Island.<sup>3</sup> Despite the objections of multiple reinsureds who found themselves in danger of receiving insufficient funds to cover future liabilities, the Superior Court sanctioned the commutation plan and determined that the scheme of arrangement posed no constitutional problem.<sup>4</sup> Yet, in doing so, the court failed to appreciate a key feature of insurance: the allocation of risk from the insured to insurer.<sup>5</sup> This essential feature of insurance distinguishes it from other contracts in which risk is a mere ancillary characteristic.<sup>6</sup> While the decision is a victory for solvent scheme proponents, it also reveals the potential dangers these schemes pose to the contractual expectations of insureds as well as the reliability of insurance products moving forward—dangers that call into question whether such legislation is truly in the best economic interests of a state.

The application of schemes of arrangement to insolvent insurers wishing to restructure their debt obligations has been recognized for decades, while some solvent insurers and reinsurers have more recently sought to utilize these schemes as well.<sup>7</sup> However, a solvent insurer's or reinsurer's use of this debt-

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2. R.I. Gen. Laws § 27-14.5-4.

3. *In re GTE Reinsurance Co. Ltd.*, C.A. No. PB 10-3777, slip op. at 9 (R.I. Super. Ct. Apr. 25, 2011). While this case involved a reinsurer and reinsured-policyholders, for brevity, when not directly discussing *GTE RE*, this note will discuss solvent schemes of arrangement by referring to all policyholders (both reinsured and insured) by the general term “insured.”

4. *Id.* at 40.

5. See ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 21 (3d ed. 2002) (noting that a key feature of insurance is “the transfer of risk from one party to another”).

6. See generally Steven J. Williams, Note, *Distinguishing “Insurance” From Investment Products Under the McCarran-Ferguson Act: Crafting a Rule of Decision*, 98 COLUM. L. REV. 1996 (1998) (discussing how courts have distinguished insurance products from other investment products by the role that “risk” occupies in the contract); see also discussion *infra* Part III.

7. Howard Seife & Francisco Vazquez, *U.S. Courts Should Continue to Grant Recognition to Schemes of Arrangement of Solvent Insurance Companies*, 17 NORTON J. BANKR. L. & PRAC. 571, 572 (2008).

restructuring tactic has not been without protest. English insurers and reinsurers have met considerable opposition from U.S. creditors who oppose U.S. Bankruptcy law's recognition of U.K. or Bermudian court-sanctioned commutation plans as foreign proceedings.<sup>8</sup> Insureds are concerned about a solvent insurer's ability to defeat their contractual expectations through a court-sanctioned commutation plan that is approved by only a majority of the company's creditors and abrogates a dissenting insured's right of rejection.<sup>9</sup> As such, there is a serious question as to whether the Contract Clause of the United States Constitution bans a state legislature from effectuating an ex post facto law that extinguishes the contractual expectations of dissentient-insureds. Rhode Island's Restructuring Act and the *GTE Reinsurance* litigation have provided a United States jurisdiction the first opportunity to address this question.

Unfortunately, the recent *GTE Reinsurance* analysis prematurely dismissed the reallocation of risk from the insured to its insurer as a non-essential characteristic of insurance.<sup>10</sup> As such, the court did not adequately address whether a solvent scheme of arrangement substantially impairs insureds' contractual rights under the Contract Clause.<sup>11</sup> The court also wrongly concluded that even if the reinsurance treaty at issue was substantially impaired, economic growth was a sufficient public purpose to justify the impairment.

This note will contextualize insureds' contractual expectations within a modern economic system in which insurance contracts act as vehicles for economic growth and security, and illustrate

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8. Johnston, *supra* note 1, at 963 (discussing whether U.S. courts should recognize solvent schemes of arrangement approved under section 425 of the Companies Act, 1985 as foreign proceedings under Chapter 15 of the U.S. Bankruptcy Code to ensure the enforceability of a scheme against U.S. policyholders).

9. *Id.* at 969 (stating that solvent schemes violate the policy of sanctity of contract).

10. See *In re GTE Reinsurance Co. Ltd.*, C.A. No. PB 10-3777, slip op. at 15 (R.I. Super. Ct. Apr. 25, 2011) (citation omitted) ("While the Court acknowledges that the 'essence' of insurance is the transfer of risk, the Court is of the opinion that at its most basic level, the risk involved is essentially about the right to receive, and the obligation to make, a monetary payment when a claim arises."); see also discussion *infra* Part II (discussing the Rhode Island Superior Court's analysis).

11. See U.S. CONST. art. I, § 10, cl. 1.

how solvent schemes of arrangement can frustrate these expectations. It will also explain how insureds' contractual expectations are intimately related to the allocation of risk from the insured to its insurer, and why the subsequent reallocation of that risk back to the insured can substantially impair its contractual expectations. To remedy this problem, this note will present a new framework that balances the interests of the commuting insurer with the contractual expectations of the insured so as to prevent abuse of the statute at the hands of substantially solvent companies. Such a framework will allow courts more discretion than that currently allowed under Rhode Island's Restructuring Act to ensure a company's debt-restructuring practice adheres to the history and tradition of the Contract Clause by maintaining insureds' contractual expectations.<sup>12</sup>

Part I of this note is intended to give the reader the necessary background with respect to the operation of solvent schemes of arrangement, the utilization of commutation plans as debt restructuring devices, and the corresponding indemnification conundrum the plans can create for a company's insureds. Part II discusses the Rhode Island Superior Court's decision in *GTE Reinsurance*. Part III addresses the particular problems with the court's reasoning and why it is important to recognize risk-transfer as the principal object of insurance for a Contract Clause analysis. Part IV examines how solvent schemes of arrangement substantially impair the insured's contractual expectations by

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12. "There is a wide disparity in the circumstances of companies that enter run-off," which mandates close scrutiny of the company's situation and how it relates to an insured's contractual expectations. See SPECIAL TASK FORCE ON INSURANCE COMPANY RUN-OFF AND REORGANIZATION, OFFICE OF INSURANCE COMMISSIONER OF THE STATE OF CONNECTICUT, FINAL REPORT OF THE SPECIAL TASK FORCE ON INSURANCE COMPANY RUN-OFF AND REORGANIZATION, 4-5 (2006) [hereinafter FINAL REPORT]. Some, like GTE RE, do not pose a of risk of becoming insolvent, thus negating many of the benefits associated with solvent schemes of arrangement—certainty of payment to creditors, avoiding deteriorating reinsurance collections, and preventing unfairness amongst creditor collections—and creating the contractual issues discussed in this piece. See Odyssey Insureds' Supplemental Memorandum in Support of Their Objections to GTE RE's Petition to Approve the Commutation Plan Pursuant to R.I. Gen. Laws § 27-14.5 and Insurance Regulation 68 at 9, *In re GTE Reinsurance*, C.A. No. PB 10-3777 (R.I. Super. Ct. Feb. 25, 2011) [hereinafter Odyssey Insureds' Supplemental Memorandum].

abrogating the ostensible finality with which the contract has transferred risk. Part V proposes an alternative analysis that courts should utilize to condition solvent schemes of arrangement, which protects the contractual expectations of the insured. Part VI will address and dismiss the counterargument that the Rhode Island General Assembly's intent to boost Rhode Island's economy is sufficient to justify an impairment of an insurer or reinsurer's contractual obligations.

## I. BACKGROUND

### A. The Operation of Schemes of Arrangement

Corporation law in Bermuda and the United Kingdom has long provided companies the opportunity to discharge their debt obligations through schemes of arrangement.<sup>13</sup> Schemes of arrangement are court-sanctioned compromises between a company and one or more classes of creditors, or cedents.<sup>14</sup> Under English law, a company that proposes a scheme of arrangement must petition the court for a meeting of its creditors and then present a commutation plan.<sup>15</sup> If seventy-five percent of the creditors approve the plan, and the court sanctions the plan, the debtor-company's obligations will be discharged with a lump-sum payment made to its creditors.<sup>16</sup>

Schemes have become popular within the past decade because of the flexibility they provide to highly-leveraged corporations in

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13. See Companies Act, 2006, c. 46, §§ 895-901 (Eng.).

14. Adam Gallagher, *The Growth of Schemes of Arrangement as the Tool of Choice in Complex Restructurings*, AM. BANKR. INST. J., Oct. 2010, at 36, 36. A "cedent" is defined as an organization that transfers risk to another insurer, otherwise termed a "reinsured" or "ceding insurer." JOHN S. DIACONIS & DOUGLAS W. HAMMOND, REINSURANCE LAW § 1:1.2 (3d ed. 2008).

15. Gallagher, *supra* note 14, at 86; see also Companies Act, 2006, c. 46, § 899 (Eng.) (explaining the process under U.K. law by which a court sanctions a scheme of arrangement). See generally R.I. GEN. LAWS § 27-14.5-1(8) (2008) (defining "commutation plan" under Rhode Island's Voluntary Restructuring of Solvent Insurers Act as "a plan for extinguishing the outstanding liabilities of a commercial run-off insurer"); *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 3, n.5 (defining "Commutation" as the "valuation, settlement, and discharge of all obligations between parties to a reinsurance contract. In return for cash, the primary insurer withdraws the liability for outstanding losses and loss adjustment expenses related to the commuted reinsurance contract.") (citation omitted).

16. Companies Act, 2006, c. 46, § 899 (Eng.).

complex debt restructurings where creditors represent a variety of interests.<sup>17</sup> These schemes allow for multiple restructuring options from simple covenant term amendments to full debt releases.<sup>18</sup> Additionally, a company is saved from the “reputational stigma” of an insolvency proceeding.<sup>19</sup> More recently, insurance and reinsurance companies with large, outstanding liabilities have utilized schemes of arrangement to commute obligations under insurance and reinsurance treaties.<sup>20</sup> These companies are most notably run-off insurers and reinsurers who have written large lines of business on occurrence-based policies throughout the 1980s-90s.<sup>21</sup>

#### B. How Solvent Insurers and Reinsurers in Run-off Benefit from Schemes of Arrangement

An insurance or reinsurance company enters into “run-off” when it “ceases writing new business, but remains bound by its preexisting contractual commitments under the policies and/or reinsurance contracts into which it previously entered.”<sup>22</sup> So long as the insurer or reinsurer remains solvent, it is obligated to pay claims under its existing insurance or reinsurance contracts.<sup>23</sup>

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17. Gallagher, *supra* note 14, at 85-86 (explaining that a highly-leveraged corporation is one with multiple tiers of debt and that a scheme of arrangement is one option for a company forced to turn to debt-restructuring options to deal with downturns in business performance).

18. *Id.* at 86.

19. *Id.*

20. Seife & Vazquez, *supra* note 7, at 572.

21. Occurrence-based policies provide coverage for “all sums which the insured shall become legally obligated to pay as damages . . . caused by an occurrence” that takes place during the policy period. BARRY R. OSTRAGER & THOMAS R. NEWMAN, 1 HANDBOOK ON INSURANCE COVERAGE DISPUTES § 8.03[a], at 489 (12th ed. 2004); *In re Brit. Aviation Ins. Co.*, [2005] EWHC (Ch), 1621, [2-3] (Eng.) (insurance company sought court approval of commutation plan under U.K. Companies Act because it had written insurance for American insureds on occurrence-based policies); *In re Scottish Lion Insurance Co.*, [2009] CSIH 6 ¶ 1 (Scot.). For a definition of “run-off” see discussion *infra* Part I.B.

22. *In re GTE Reinsurance Co. Ltd.*, C.A. No. PB 10-3777, slip op. at 3, n.4 (R.I. Super. Ct. Apr. 25, 2011). “Reinsurance is a contractual arrangement whereby a reinsurer, for consideration, agrees to indemnify a reinsured for all or part of a loss that the reinsured may sustain under a policy or policies of insurance issued by the reinsured to an original insured.” DIACONIS & HAMMOND, *supra* note 14, §1:1.1.

23. Thomas F. Bush, *Solvent Schemes Come to America*, WILDMAN

This means that an insurer or reinsurer may remain bound under an occurrence-based policy for decades because coverage is triggered when an insured risk *occurs* during the policy period, even if the claim does not manifest itself until decades later.<sup>24</sup> This risk results in long-tail liability because such a claim is separated by multiple years from the circumstances that caused it during the policy period.<sup>25</sup> Occurrence-based policies most commonly insure against long-tail liability such as products liability, asbestos-related injuries, chemical exposure, and environmental pollution.<sup>26</sup> Where this type of liability exists, there may not be a final settlement of a claim until many years after the policy period has lapsed.<sup>27</sup>

As a result, occurrence-based policies may take a run-off insurer decades to administer, and tie up significant amounts of capital.<sup>28</sup> A marginally solvent run-off insurer may later become insolvent should it continue in run-off.<sup>29</sup> Alternatively, an insurer can expedite the exhaustive run-off process by providing early payouts to creditors—based on actuarial estimates—in exchange for the cancellation of future obligations under a solvent scheme of arrangement, which is more attractive than continuing in run-off.<sup>30</sup>

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HARROLD, ALLEN & DIXON LLP (June 2011), [http://64.78.35.30/article/Solvent\\_Schemes\\_Come\\_to\\_America\\_June2011\\_header.pdf](http://64.78.35.30/article/Solvent_Schemes_Come_to_America_June2011_header.pdf).

24. Johnston, *supra* note 1, at 954. See also OSTRAGER & NEWMAN, *supra* note 21, at 489 (“The distinguishing feature of an occurrence policy is that it results in so-called ‘tail’ coverage, which refers to the lapse of time between the occurrence and the date a claim is made.”).

25. The term “long-tail” refers to “tail” coverage over multiple years. See OSTRAGER & NEWMAN, *supra* note 21, at 489.

26. Johnston, *supra* note 1, at 954. Nowadays, most commercial general liability policies include an asbestos exclusion. Kevin M. Madigan & Claus S. Metzner, *Reserving for Asbestos Liabilities*, 188-91 <http://www.casact.org/pubs/forum/03fforum/03ff173.pdf> (last visited Mar. 13, 2012).

27. See Johnston, *supra* note 1, at 954.

28. Stephen M. Prignano & Matthew Murphy, *Rhode Island Court Approves Nation’s First Solvent Scheme Program*, EDWARDS WILDMAN NEWSSTAND (Sept. 2011), <http://www.edwardswildman.com/newsstand/detail.aspx?news=2503>.

29. See FINAL REPORT, *supra* note 12, at 6 (discussing the greater need for regulatory oversight of marginally solvent companies who have a higher potential for insolvency if a run-off proceeding is not successful).

30. See Johnston, *supra* note 1, at 955.



### C. Rhode Island's Voluntary Restructuring of Solvent Insurers and Reinsurers Act

In 1995, then Rhode Island Governor Lincoln Almond recognized the insurance industry's potential for stimulating the state's economic growth and created the Governor's Insurance Development Task Force to "develop a legislative and regulatory agenda to establish Rhode Island as a highly competitive state in which to domicile companies in one or more segments of the insurance industry."<sup>31</sup> The Task Force was first assigned to identify legal and regulatory barriers in Rhode Island that affected the insurance industry.<sup>32</sup> The Task Force was instructed to "[d]evelop specific legislation, in consultation with industry experts, regulators, leadership in the General Assembly and economic developers" so as to "position Rhode Island as the most competitive United States location for one or more target segments of the insurance industry."<sup>33</sup>

In 2002, the Rhode Island State Legislature, upon the recommendations of the Governor's Task Force, enacted the Restructuring Act.<sup>34</sup> The Restructuring Act entitles a commercial run-off insurer, or reinsurer, that is domiciled in Rhode Island, or that has re-domiciled for purposes of the Restructuring Act, to petition the Superior Court to implement a commutation plan that has been approved by the Department of Business Regulation (DBR).<sup>35</sup>

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31. R.I. Exec. Order No. 95-21, § I (Aug. 22, 1995), *available at* <http://www.library.state.ri.us/publications/governor/executiveorders/1995/95exec21.pdf>.

32. *Id.* § III(C).

33. *Id.* § III(D).

34. *In re GTE Reinsurance Co. Ltd.*, C.A. No. PB 10-3777, slip op. at 2 (R.I. Super. Ct. Apr. 25, 2011). The Restructuring Act is contained in R.I. Gen. Laws § 27-14.5-1 to -6.

35. A "Commercial run-off insurer" is defined as

(i) A run-off insurer domiciled in Rhode Island whose business, excluding all business subject to an assumption reinsurance agreement, includes only the reinsuring of any line(s) of business other than life and/or the insuring of any line(s) of business other than life, workers' compensation, and personal lines insurance; or

(ii) A Rhode Island domestic insurance company meeting the requirements of subsection (i) hereof and formed or re-activated for the sole purpose of entering into a voluntary restructuring under this chapter and whose liabilities consist of commercial liabilities

DBR regulation 68 dictates the process by which a solvent insurer or reinsurer can present a commutation plan.<sup>36</sup> An applicant must first submit a plan to the DBR for review.<sup>37</sup> The DBR has sixty days to review the plan, make comments, and send it back to the applicant.<sup>38</sup> After the DBR is satisfied with the make-up of the proposed class of creditors and approves the commutation plan, the applicant must apply to the Superior Court of Rhode Island for a court order calling a "Meeting of Creditors."<sup>39</sup> At the "Meeting of Creditors," the applicant submits the commutation plan to a vote.<sup>40</sup> If the applicant receives the

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transferred to said company with the approval of the [DBR] and pursuant to the regulations issued by the [DBR] under this chapter. R.I. GEN. LAWS § 27-14.5-1(6) (2008). A "Run-off insurer" is "an insurer that: (i) Is domiciled in Rhode Island; (ii) Has liabilities under policies for property and casualty lines of business; (iii) Has ceased underwriting new business; and (iv) Is only renewing ongoing business to the extent required by law or by contract." *Id.* § 27-14.5-1(21). The Rhode Island Department of Business Regulation describes its primary function as "the implementation of state laws mandating the regulation and licensing of designated businesses, professions, occupations and other specified activities." *About The Department of Business Regulation*, R.I. DEP'T OF BUS. REG., <http://www.dbr.state.ri.us/about/> (last visited Jan. 27, 2011).

36. See *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 3, n.6; see also R.I. GEN. LAWS § 42-14-17 (2007) (giving the director of the DBR the power to promulgate rules and regulations necessary to carry out its duties assigned by law); *id.* § 42-14-1 to -19 (enumerating the various powers of the DBR including that over the Rhode Island insurance industry). "Reg. 68 was issued in accordance with [sections 27-14.5-6 and 42-14-17] which empower DBR's commissioner to 'promulgate rules and regulations that may be necessary to effectuate [the Restructuring Act's purpose].'" *In re GTE Reinsurance*, No. PB 10-3777, slip op. at 3, n.6.

37. See 11-5 R.I. CODE R. § 68:4(a)(i) (LexisNexis 2010).

38. *Id.* § 4(a)(ii).

39. *Id.* § 4(iii). Rhode Island General Laws section 27-14.5-2 grants jurisdiction over the sanctioning of commutation plans to the Rhode Island Superior Court. The notion that, in some instances, creditors must be divided into separate classes for purposes of a scheme of arrangement is borrowed from the U.K. Companies Act. Companies Act, 1985, c. 41, § 425 (Eng.). A properly composed "creditor class" consists of individual creditors who have a sufficient commonality of rights so that they may collectively determine what is in their best interest. See Johnston, *supra* note 1, at 958. Under Rhode Island law, a "Class of creditors" is defined to mean "(i) All voting policyholders, including those without known claims; (ii) Voting creditors, other than policyholders; or (iii) Any separate class of creditors as the court may in its discretion determine should approve the commutation plan." R.I. GEN. LAWS § 27-14.5-1(5).

40. 11-5 R.I. CODE R. § 4(c).

consent of fifty percent of each class of creditors, and seventy-five percent of the value of liabilities owed to each class of creditors, the applicant can petition the court to implement the commutation plan.<sup>41</sup> “[V]otes [are] calculated according to the aggregate amount of claims specified against the Applicant in respect of insurance or reinsurance contracts detailed in the voting form” to determine whether the requisite statutory majority has been obtained.<sup>42</sup> If the requisite majority of votes is obtained and the court determines the plan does not “materially adversely affect either the interests of objecting creditors or the interests of assumption policyholders” it will enter an implementation order.<sup>43</sup>

The court’s implementation order has several effects. It effectuates the commutation plan by enjoining all litigation in all jurisdictions between the applicant and creditors and requires the creditors to submit all claims information by the date specified in the order (the “bar date”), after which no further liabilities will be paid.<sup>44</sup> Additionally, it releases the applicant from all obligations to its creditors and policyholders upon payment of the amount specified in the plan, and requires the applicant to provide a quarterly report to both the commissioner and the court that details the progress of the plan’s implementation.<sup>45</sup> It further binds the applicant and all creditors and policyholders, including dissentients.<sup>46</sup> The dissenting insured’s inability to present claims after the bar date—particularly if it has large outstanding long-tail liabilities—raises questions as to whether an insurer should be permitted, under the Restructuring Act, to abrogate a dissenting insured’s contract.

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41. R.I. GEN. LAWS § 27-14.5-4.

42. 11-5 R.I. CODE R. § 4(c).

43. R.I. GEN. LAWS § 27-14.5-4. An “assumption reinsurance” agreement is one in which the ceding insurer cedes, and the assuming insurer assumes all of the policyholder liabilities. The assuming insurer therefore becomes directly liable to the policyholder, now called the assumption policyholder. See Cindy Chang, *A 50-State Look at Assumption Reinsurance: The Road to Novation*, MORRIS, MANNING & MARTIN, LLP (June 1, 2009), <http://www.mmmlaw.com/media-room/publications/newsletter/a-50-state-look-at-assumption-reinsurance-the-road-to-novation>.

44. R.I. GEN. LAWS § 27-14.5-4.

45. *Id.*

46. *Id.*

#### D. The Notion of Substantial Impairment and the Contract Clause

The Contract Clause of the United States Constitution reads, “no State shall . . . pass any . . . Law impairing the Obligation of Contracts . . . .”<sup>47</sup> Though not the subject of heavy debate, the Clause’s pre-ratification history demonstrates that its primary purpose was to protect private parties’ interests and expectations, particularly given that fluctuating public policies often drive legislation.<sup>48</sup> James Madison’s Federalist Paper 44 perhaps best illuminates the intention of the Framers:

Very properly, therefore, have the convention added this constitutional bulwark in favor of personal security and private rights; and I am much deceived if they have not, in so doing as faithfully consulted the genuine sentiments as the undoubted interests of their constituents. The sober people of America are weary of the fluctuating policy which has directed the public councils. They have seen with regret and indignation, that sudden changes and legislative inferences, in cases affecting personal rights, become jobs in the hands of enterprising and influential speculators, and snares to the more industrious and less informed part of the community. They have seen, too, that one legislative interference, is but the first link of a long chain of repetitions, every subsequent interference being naturally produced by the effects of the preceding. They very rightly infer, therefore, that some thorough reform is wanting which will banish speculations on public measures, inspire a general prudence and industry, and give a regular course to the business of society.<sup>49</sup>

Early Supreme Court decisions echo Madison’s sentiments.

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47. U.S. CONST. art. I, § 10, cl. 1. *see also* R.I. CONST. art. I, § 12. (“No ex post facto law, or law impairing the obligation of contracts, shall be passed.”).

48. *See* Robert A. Graham, Note, *The Constitution, the Legislature, and Unfair Surprise: Toward a Reliance-Based Approach to the Contract Clause*, 92 MICH. L. REV. 398, 399 (discussing how the Supreme Court’s early Contract Clause decisions highlight the clause’s original purpose).

49. THE FEDERALIST NO. 44 (James Madison), *available at* [http://thomas.loc.gov/home/histdox/fed\\_44.html](http://thomas.loc.gov/home/histdox/fed_44.html).

Chief Justice Marshall recognized that state legislative enactments that impair contracts have the effect of "break[ing] in upon the ordinary intercourse of society, and destroy[ing] all confidence between man and man."<sup>50</sup> In *Dartmouth College v. Woodward*, the Court held the Contract Clause stands for "the necessity and policy of giving permanence and security to contracts, [and] of withdrawing them from the influence of legislative bodies, whose fluctuating policy, and repeated interferences, produced the most perplexing and injurious embarrassments . . . ."<sup>51</sup>

Yet, the strictures imposed by the language of the Clause have never been strictly interpreted, and the Court has carved out a narrow exception for matters affecting the public welfare, particularly where exigent circumstances exist that compel the legislation.<sup>52</sup> In *Stone v. Mississippi*, the Court recognized a state legislature's right to exercise its police power notwithstanding the Contract Clause.<sup>53</sup> There, Mississippi had granted a twenty-five-year charter for the operation of a lottery, but later revoked the charter after the state legislature passed a new constitution forbidding the lottery.<sup>54</sup> Although the *Stone* Court limited the legislature's imposition on the Contract Clause to matters affecting "the preservation of the public health and the public morals,"<sup>55</sup> years later it defined the scope of this abrogation power in terms of emergency circumstances in *Blaisdell*.<sup>56</sup> There, the Court upheld a Minnesota mortgage moratorium law that was passed to relieve certain effects of the depression.<sup>57</sup> While slightly liberalizing Contract Clause jurisprudence, the Court's decisions were not intended to give state legislatures *carte blanche* to

50. Graham, *supra* note 48, at 404 (citation omitted) (internal quotation marks omitted).

51. 17 U.S. (4 Wheat.) 518, 648 (1819); *see also* Graham, *supra* note 48, at 404-405.

52. *See, e.g.,* Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934); *Stone v. Mississippi*, 101 U.S. 814 (1879).

53. *Stone*, 101 U.S. at 820 (citing *Trustees of Dartmouth College*, 17 U.S. at 629) ("[T]he framers of the Constitution did not intend [the Contract Clause] to restrain States in the regulation of their civil institutions, adopted for internal government . . . .").

54. *Id.* at 817.

55. *Id.* at 820.

56. 290 U.S. at 423.

57. *Blaisdell*, 290 U.S. at 423.

impair contractual obligations.<sup>58</sup> In fact, the decision required that any ex post facto law impairing contractual obligations be narrowly tailored; it could remedy only the emergency and could not outlast the exigency.<sup>59</sup>

Contract Clause analysis since *Blaisdell* asks whether a law substantially impairs a party's obligations, and if so, whether the law is reasonable and necessary to serve an important public purpose.<sup>60</sup> However, what constitutes an important public purpose is ill defined, and the Court's earlier decisions remain relevant.<sup>61</sup> Contractual expectations, and the nature of the exigency that requires the impairment, should be considered as the guideposts of modern Contract Clause jurisprudence.

## II. *IN RE GTE REINSURANCE COMPANY LIMITED*

GTE RE was incorporated in Bermuda in 1976 "as a captive insurer and reinsurer of GTE Corporation."<sup>62</sup> On June 24, 2010, GTE RE redomiciled in Rhode Island and later filed a commutation plan with the DBR.<sup>63</sup> Under the plan, GTE RE proposed to make lump-sum payments to each of its creditors and policyholders with whom it had entered into reinsurance treaties between 1980 and 1986.<sup>64</sup> In exchange, these lump-sum

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58. See *Blaisdell*, 290 U.S. at 423-448.

59. *Id.* at 441-443 ("[A] law depending upon the existence of an emergency or other certain state of facts to uphold it may cease to operate if the emergency ceases or the facts change even though valid when passed.") (citation omitted) (internal quotation marks omitted).

60. See *General Motors Corp. v. Romein*, 503 U.S. 181, 186 (1992) (noting that the question as to whether there is a substantial impairment of a contract has three components: "whether there is a contractual relationship, whether a change in the law impairs that contractual relationship, and whether the impairment is substantial").

61. See *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 242 (1978) (warning that "[i]f the Contract Clause is to retain any meaning at all . . . it must be understood to impose *some* limits upon the power of a State to abridge existing contractual relationships, even in the exercise of its otherwise legitimate police power").

62. *In re GTE Reinsurance Co. Ltd.*, C.A. No. PB 10-3777, slip op. at 7 (R.I. Super. Ct. Apr. 25, 2011). A captive insurance company is one established with the specific purpose of financing the risks of its parent corporation. A secondary purpose is to insure the risks of the parent corporation's customers.

63. *Id.* at 7-8.

64. *Id.* Reinsurance contracts are known as "treaties." The reinsurance treaty at issue involved one executed by a predecessor of GTE RE that was

payments would relieve GTE RE of all future liabilities remaining under the treaties, including any incurred-but unreported losses (IBNR liability).<sup>65</sup> The DBR reviewed the commutation plan and submitted a series of questions and comments to GTE RE that were subsequently incorporated into a final Commutation Plan.<sup>66</sup> The final Plan provided that “[a]s a result of the Commutation Plan, the Company’s liability to . . . Creditors in respect of Claims will cease and subsequent losses, which otherwise might have resulted in a claim against the Company in the ordinary course, will not be covered.”<sup>67</sup>

The DBR approved the Commutation Plan on June 25, 2010.<sup>68</sup> GTE RE then filed a petition with the Superior Court of Rhode Island to implement the Commutation Plan.<sup>69</sup>

On July 21, 2010, the Superior Court determined that a single class of creditors was appropriate and granted GTE RE’s motion to convene a Meeting of the Creditors.<sup>70</sup> At the meeting, GTE RE received consent from thirty-four of thirty-nine cedents, representing roughly ninety-seven percent of the value of the liabilities owed to the voting members of the creditor class.<sup>71</sup> Five cedents objected. One—Hudson—objected on the grounds that GTE RE had undervalued its claims by \$300,000.<sup>72</sup> Despite

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eventually ceded to GTE RE. Odyssey Insureds’ Supplemental Memorandum, *supra* note 12, at 3-4. The treaty was a continuous quota share reinsurance contract. *Id.* “Quota share reinsurance is ‘[a] form of pro rata reinsurance (proportional) in which the reinsurer assumes an agreed percentage of each insurance being insured and shares all premiums and losses accordingly with the reinsured.’” *Id.* at 3 (citation omitted). The reinsurance treaty at issue here was executed with the Hudson Insurance Company on September 15, 1981 and was effective through December 31, 1985. *Id.* The treaty states that GTE RE was liable for all losses occurring prior to the termination date. *Id.*

65. Odyssey Insureds’ Supplemental Memorandum, *supra* note 12, at 5-6. “IBNR” is short-form in insurance for “incurred-but unreported losses.” See Bush, *supra* note 23, at 1. This phrase refers to liability that remains on the policy at issue (even after the termination date has lapsed) for claims that are either unsettled or not reported for the policy period at issue. See *id.*

66. *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 9.

67. Odyssey Insureds’ Supplemental Memorandum, *supra* note 12, at 7.

68. *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 9.

69. *Id.*

70. *Id.*; see also *supra* note 39 and accompanying text (discussing creditor classes).

71. *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 10.

72. *Id.* Hudson alleged the value of its total claims was in excess of

Hudson's objections, GTE RE filed its motion to implement the Commutation Plan on December 2, 2010.<sup>73</sup> On December 14th, 2010, Hudson filed its objections in the Superior Court of Rhode Island, challenging the constitutionality of the Restructuring Act.<sup>74</sup>

Hudson alleged that Rhode Island's Restructuring Act, as applied, violated the Contract and Due Process Clauses of the Rhode Island and U.S. Constitutions because its future indemnification rights, under its reinsurance treaty, were substantially impaired.<sup>75</sup> Hudson asserted that the lump-sum payout might provide it with less in indemnification payments than if GTE RE remained in run-off.<sup>76</sup> Hudson believed the actuarial estimate utilized by GTE RE was tenuous because much of its business—reinsured by the GTE RE treaty—had been written on occurrence-based policies still subject to long-tail IBNR

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\$1,300,000. *Id.* See also *supra* note 64 and accompanying text (discussing the Hudson policy). Hudson is an affiliate of Odyssey America Reinsurance Corporation. In earlier memoranda filed by the parties with the court, Hudson is referred to as the "Odyssey Insureds" because Hudson, along with Clearwater—another Odyssey affiliate—were both parties to the lawsuit. The Superior Court's amended decision filed in February 2012, however, lists Hudson as the only objecting party.

73. *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 10.

74. *Id.* at 10. During the period that Hudson was covered by the GTE RE reinsurance treaty, Hudson had, itself, issued policies covering IBNR claims that often take decades to fully emerge or develop as is the case with toxic-torts, asbestos exposure, and environmental torts. Odyssey Insureds' Supplemental Memorandum, *supra* note 12, at 4-5.

75. *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 11-15. While this article is limited to addressing the Contract Clause of the United States Constitution, the Rhode Island Constitution contains a nearly identical provision, which states that "[n]o ex post facto law, or law impairing the obligation of contracts, shall be passed." See U.S. CONST. art. I, § 10, cl. 1; R.I. CONST. art. I, § 12.

76. *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 16. Hudson's objection was premised upon the language found in the Hudson contract stating that "[t]he Reinsurer's liability for risks ceded shall continue until the final settlement of *all losses* which have occurred during the Underwriting Year." Odyssey Insureds' Supplemental Memorandum, *supra* note 12, at 7 (emphasis added). Because there was the potential that Hudson would receive an insufficient sum under the Commutation Plan to cover its own liabilities for the risks it insured on occurrence-based policies that covered IBNR claims, Hudson argued that the GTE RE Commutation Plan negated the very essence of its reinsurance treaty and that such an impairment constituted a substantial impairment under the Contract Clause. *Id.* at 6-7.



liability.<sup>77</sup>

Despite the inherent problem associated with the valuation of the Commutation Plan, the Rhode Island Superior Court upheld the validity of the Restructuring Act.<sup>78</sup> The judge held there was no substantial impairment, noting:

While the Court acknowledges that the “essence” of insurance is the transfer of risk, the Court is of the opinion that at its most basic level, the risk involved is essentially *about the right to receive, and the obligation to make, a monetary payment when a claim arises. . . . Put simply, Hudson contracted for the payment of money, and under the Commutation Plan, that is exactly the benefit it will receive.*<sup>79</sup>

The court also noted that even if there was a substantial impairment, Rhode Island’s economic interests would have justified the Restructuring Act because it allowed the General Assembly to “address economic issues endemic to the insurance industry and Rhode Island as a whole.”<sup>80</sup> Yet, the court’s

77. Odyssey Insureds’ Supplemental Memorandum, *supra* note 12, at 12. Addressing the nature of its IBNR claims, Hudson wrote:

IBNR is an imprecise estimate of the unknown—a snapshot of a moment in time that must be adjusted on an ongoing basis based upon developing information. No matter how skillfully estimated, IBNR cannot, to quote Former Secretary of Defense Donald Rumsfeld, accurately estimate the ‘unknown unknowns.’ If some new ‘unknown’ appears—a new wave of environmental or mass tort claims, for example—the exposure could be enormous. History teaches that they do arise, with catastrophic consequences. Asbestos, environmental claims, mold, lead, latex, terrorism, and cyber liability are all recent examples. It is indisputable that whatever estimate either party makes now will, once all of the current and future claims have been paid, be wrong. Accordingly, to compare the proposed commutation payment against another actuarial estimate cannot adequately measure the impairment of the Odyssey Insureds’ contractual rights to indemnification.

*Id.*

78. *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 40. Judge Silverstein also dismissed Hudson’s Due Process claim. *Id.*

79. *Id.* at 15-16 (emphasis added).

80. *Id.* at 34. The court’s reference to “economic issues endemic to the insurance industry” most likely pertains to issues associated with solvent companies in run-off such as the expense to the company, inequitable distribution of funds among claimants, and increased burdens on other companies that insureds elect to seek coverage from rather than the run-off

simplistic reasoning failed to consider insurance's function as a means of economic security—independent of the actual payment of money—that is achieved by the allocation of risk from the insured to the insurer.<sup>81</sup>

This note has discussed the operation of solvent schemes of arrangement and the factual circumstances giving rise to *GTE Reinsurance*. The next section will explain why the Rhode Island Superior Court's analysis sets a dangerous precedent insofar as its decision fails to recognize that the transfer of risk—from the insured to the insurer—is the essential element of an insurance contract.

### III. RISK-TRANSFER IS THE ESSENTIAL ELEMENT OF AN INSURANCE CONTRACT.

The *GTE Reinsurance* court's definition of insurance is inaccurate insofar as it misclassifies the risk-element of insurance contracts. Judge Silverstein classified the risk element of the GTE RE reinsurance treaty as that involved with Hudson's right to receive, and GTE RE's obligation to make, a monetary payment, rather than the risk that Hudson transferred to GTE RE under the treaty.<sup>82</sup> But the court cited no case law and proffered only two secondary sources to support its theory.<sup>83</sup> Moreover, it is believed that

The articulation of a generally applicable definition of insurance has proven to be a very difficult task. The crafting of a definition of insurance that is both precise enough to be of use in distinguishing among various transactions and broad enough to be viewed as generally

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company. See FINAL REPORT, *supra* note 12, at 3-4. This note, however, presents the argument that due to the disparity of circumstances of companies that enter into run-off, solvent schemes can be more harmful to some creditors. See discussion *infra* Part V.

81. See discussion *infra* Part III.

82. See *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 15.

83. The court cited to *Couch on Insurance*, which defines insurance as

[A] contract by which one party (the insurer), for consideration that usually is paid in money, either in a lump sum or at different times during the continuance of the risk, promises to make a certain payment, usually of money, upon the destruction or injury of "something" in which the other party (the insured) has an interest.

1 STEVEN PLITT, ET AL., *COUCH ON INSURANCE* 3d § 1:6 (2009).

applicable has been an elusive goal . . . .<sup>84</sup>

Even the treatise cited by the court provides six alternative definitions of insurance, none of which the court expressly acknowledged.<sup>85</sup> In fact, "[i]nsurance has been defined in numerous ways" and a number of its definitions recognize the essential characteristics of risk transfer and distribution.<sup>86</sup>

#### A. Defining Insurance By Risk

Definitions recognizing insurance's risk-transfer function describe insurance as "a contractual security against anticipated loss where the risk of loss is occasioned by some future or contingent event and is shifted to or assumed by the insurer, with a distribution of the risk of loss by the payment of a premium or other assessment into a general fund[,] "<sup>87</sup> or as "a contract whereby one party promises for a consideration to indemnify the other against certain risks."<sup>88</sup> It is also believed that "[t]he primary requisite essential to a contract of insurance is the assumption of a risk of loss and the undertaking to indemnify the insured against such loss . . . ."<sup>89</sup> In fact, "[t]he element of risk is a prominent part of the definition of insurance given by many courts . . . ."<sup>90</sup>

Other treatises adopt definitions similar to those that highlight insurance's risk-transfer function.<sup>91</sup> For example, *Appleman* states, "[a]t its core essence, risk is the Mother Mold of Insurance . . . . In a superficial way, insurance is generally understood as risk sharing through consensual arrangements which transfer and distribute risks among the consenting

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84. Williams, *supra* note 6, at 2013 (citation omitted) (internal quotation marks omitted).

85. See PLITT, *supra* note 83, § 1:6 (footnote omitted).

86. *Id.*

87. *Id.*

88. *Id.*

89. PLITT, *supra* note 83, at § 1:9.

90. *Id.*

91. See 1 ERIC MILLS HOLMES & MARK S. RHODES, *HOLMES'S APPLEMAN ON INSURANCE* § 1.2 (2d ed. 1996). See also ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW* §§ 1.2, 1.3 (1988) (observing that insurance is an arrangement for transferring and distributing risk: at the very heart of insurance is this transfer and distribution of risk).

parties.”<sup>92</sup> While one can argue that the *GTE Reinsurance* court did discuss risk as an element of insurance contracts, the risk the court discussed in its opinion differs from that referred to in the above-mentioned definitions.

The Rhode Island Superior Court actually defined the risk element of the GTE RE reinsurance treaty as the risk that the insured or reinsured may not actually receive the indemnification amount.<sup>93</sup> However, “[t]o some extent, every contract involves the manipulation of risk . . . . [A] contract to sell property transfers from the seller to buyer the risk that a catastrophe will render the property worthless.”<sup>94</sup> The difference between the risk involved with a property-sale contract and the risk that is the object of an insurance contract is that the risk associated with the former is not the purpose of the contract—it is only a function of it.<sup>95</sup> Insurance’s principal object, on the other hand, is the transfer of risk for the benefits that the freedom of risk entails.<sup>96</sup> Therefore, because the purpose of insurance is not to transfer a monetary sum, but instead to transfer risk, it cannot be true that the risk involved in an insurance contract *is solely* about the obligation to make, and right to receive, a monetary sum. Rather, the *GTE Reinsurance* court misclassified the risk element of the GTE RE reinsurance treaty.<sup>97</sup> *Jordan v. Group Health Association*<sup>98</sup> and *Union Labor Life Insurance Co. v. Pireno*,<sup>99</sup> discussed in the next section, further illuminate this point.

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92. HOLMES & RHODES, *supra* note 91, § 1.2.

93. *In re GTE Reinsurance Co. Ltd.*, C.A. No. PB 10-3777, slip op. at 17-18 (R.I. Super. Ct. Apr. 25, 2011) (defining the risk as “the right to receive, and the obligation to make, a monetary payment when a claim arises”).

94. Williams, *supra* note 6, at 2018.

95. See JERRY, *supra* note 5, at 19 (distinguishing insurance from other contracts that similarly allocate risk).

96. See *Jordan v. Grp. Health Ass’n*, 107 F.2d 239, 248 (D.C. Cir. 1939) (establishing the “principal object” test for determining insurance); see also JERRY, *supra* note 5, at 17-19 (discussing the economic effects associated with the transfer and distribution of risk); discussion *infra* Part III.B.

97. See *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 15-16.

98. 107 F.2d 239 (D.C. Cir. 1939).

99. 458 U.S. 119 (1982).

B. The *GTE Reinsurance* Court Missed the Essential Purpose of Insurance.

*Jordan* established the "principal object" test for distinguishing insurance contracts from other contracts having characteristics of insurance that are ancillary to their principal purpose.<sup>100</sup> *Jordan* addressed whether a state insurance statute applied to group health plans that provided medical services on an "as needed" basis in exchange for the payment of a monthly fee.<sup>101</sup> The D.C. Circuit Court noted:

That an incidental element of risk distribution or assumption may be present should not outweigh all other factors. If attention is focused only on that feature, the line between insurance or indemnity and other types of legal arrangement and economic function becomes faint, if not extinct. This is especially true when the contract is for the sale of goods or services on contingency. But obviously it was not the purpose of the insurance statutes to regulate all arrangements for assumption or distribution of risk. That view would cause them to engulf practically all contracts, particularly conditional sales and contingent service agreements. The fallacy is in looking only at the risk element, to the exclusion of all others present or their subordination to it. The question turns, not on whether risk is involved or assumed, but on whether that or something else to which it is related in the particular plan is its principal object and purpose.<sup>102</sup>

The "principal object" test points out that a warranty accompanying the purchase of a good has features of insurance but is ancillary to the principal purpose of the contract: the purchased good.<sup>103</sup> So too, the risk element that the *GTE Reinsurance* court addressed—the risk that an insured or reinsured may or may not receive an indemnification payment under an insurance contract—is not the principal purpose of the GTE RE reinsurance treaty; it is a function of the actual risk that

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100. 107 F.2d at 248. Because *Jordan* is a D.C. Circuit court opinion it is not binding precedent on Rhode Island.

101. See *id.* at 240-44.

102. *Id.* at 247-48.

103. See JERRY, *supra* note 5, at 27.

Hudson transferred which is, itself, the principal object of the reinsurance treaty.<sup>104</sup>

The United States Supreme Court also focused on risk-transfer in *Pireno* when it established a three-part test to distinguish “the business of insurance” from other business for purposes of the McCarran-Ferguson Act.<sup>105</sup> Under this approach a court must look at whether the practice (1) “has the effect of transferring and spreading the policyholder’s risk;” (2) “is an integral part of the policy relationship between the insurer and the insured;” and (3) “is limited to entities within the insurance industry.”<sup>106</sup>

The *Pireno* test is enlightening because it further illustrates that Hudson’s principal purpose for obtaining the reinsurance treaty was to transfer its risk to GTE RE.<sup>107</sup> The Supreme Court defined the “business of insurance” in *Pireno* as involving a practice that transfers and distributes risk.<sup>108</sup> The Court noted, “one indispensable characteristic of insurance is the spreading and underwriting of a policyholder’s risk . . . . Congress understood the business of insurance to be the underwriting and spreading of risk.”<sup>109</sup> GTE RE’s ability to spread Hudson’s risk among other similarly situated parties in exchange for a premium is exactly what gave the reinsurance treaty its distinctive character, and it explains why Hudson entered into the treaty in the first place.<sup>110</sup>

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104. *In re GTE Reinsurance Co. Ltd.*, C.A. No. PB 10-3777, slip op. at 17-18 (R.I. Super. Ct. Apr. 25, 2011).

105. 458 U.S. 49, 129 (1982) (internal quotation marks omitted). There, the New York State Chiropractic Association (“NYSCA”) aided an insurance company in evaluating claims for chiropractic treatments. *Id.* at 123. *Pireno* alleged the collaborative effort violated the Sherman Anti-Trust Act. *Id.* at 124. The District Court dismissed the claim on the grounds that the insurance company’s use of the NYSCA peer review committee was exempted from antitrust scrutiny by the McCarran Ferguson Act that applies to the “business of insurance.” *Id.* On certiorari, the Supreme Court set forth a three-part test to determine whether a particular practice is part of the “business of insurance.” *Id.* at 129.

106. *Id.* at 129.

107. See JERRY, *supra* note 5, at 27.

108. *Pireno*, 458 U.S. at 130.

109. *Id.* at 127 (citations omitted) (internal quotation marks omitted).

110. See GAF Corp. v. Cnty. Sch. Bd., 629 F.2d 981, 984 (4th Cir. 1980) (noting the elements of risk transfer and distribution give insurance transactions their “distinctive character”); Odyssey Insureds’ Supplemental

*Pireno* and the “principal object” test of *Jordan* point out that the insured’s ability to transfer risk is the defining characteristic of an insurance contract.<sup>111</sup> The Rhode Island Superior Court, however, dismissed this precedent and conflated a function of Hudson’s risk allocation with the actual risk transferred.<sup>112</sup> By defining the risk element of the reinsurance treaty as it did, however, the court was able to dismiss the Contract Clause question without addressing the problematic issue of the contingent IBNR liabilities that were transferred to GTE RE under the Hudson Treaty. Recall that the court noted that “the risk involved is essentially *about the right to receive, and the obligation to make, a monetary payment when a claim arises. . . . Put simply, Hudson contracted for the payment of money, and under the Commutation Plan, that is exactly the benefit it will receive.*”<sup>113</sup> The risk associated with Hudson’s IBNR liabilities has been cursorily dismissed without explanation.

Insurance has been defined as “a contractual security against anticipated loss where the risk of loss is occasioned by some future or contingent event and is shifted to or assumed by the insurer . . . .”<sup>114</sup> The next section of this note will address why, had the court followed *Pireno* and *Jordan*, it would have found that there was a substantial impairment of the GTE RE reinsurance treaty in light of the risk-transfer function of insurance.<sup>115</sup>

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Memorandum, *supra* note 12, at 6-7 (arguing that when Hudson specifically contracted to shift its risk of loss to GTE, “[t]he Reinsurer’s liability for risks ceded shall continue until the final settlement of all losses which have occurred during the Underwriting Year”).

111. See *Pireno*, 458 U.S. at 127; *Jordan v. Grp. Health Ass’n*, 107 F.2d 239, 248 (D.C. Cir. 1939); see also discussion *supra* Part III.A.

112. See *In re GTE Reinsurance Co. Ltd.*, C.A. No. PB 10-3777, slip op at 15-16 (R.I. Super. Ct. Apr. 25, 2011) (“While the Court acknowledges that the ‘essence’ of insurance is the transfer of risk, the Court is of the opinion that at its most basic level, the risk involved is essentially about the right to receive, and the obligation to make, a monetary payment when a claim arises. . . . Indeed, the risk assumed by GTE RE under the Hudson Treaty is the responsibility to reimburse Hudson for, or indemnify it against, covered claims and legal fees incurred in defending those claims, up to the Treaty’s monetary cap.”).

113. *Id.* (emphasis added).

114. PLITT, *supra* note 83, at § 1:9.

115. See also *infra* Part IV (discussing how solvent schemes of arrangement substantially impair an insured’s expectations by abrogating its

### C. The Benefits Associated with the Transfer of Risk

Insurance affects every individual on a daily basis because life involves risk that, if not handled properly, can result in unexpected losses. In fact, "[t]he creation and enforcement of insurance contracts . . . vitally affect the social and economic welfare of individuals."<sup>116</sup> The United States Supreme Court has even declared that insurance is a business in the public interest.<sup>117</sup> This is because most human activities involve risk that can have different effects: economic, social, political, psychological, physical or legal.<sup>118</sup> "An individual's attitude toward" a particular activity is influenced by factors such as the "probability of loss, the potential magnitude of the loss, and the person's ability to absorb the loss."<sup>119</sup> As the potential magnitude or probability of loss increases, an entity becomes more risk averse.<sup>120</sup> Accordingly, society has developed methods of risk-management that distribute risk among multiple parties, a practice dating back as early as 2250 B.C.E.<sup>121</sup> One such method of risk-management is insurance.

Insurance is particularly important in an economically advanced society because pure risk breeds uncertainty.<sup>122</sup> Williams and Heins argue that uncertainty has two costs associated with it. First, it tends to reduce the total satisfaction associated with a given economic status.<sup>123</sup> Second, it has the

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ability to transfer risk).

116. JERRY, *supra* note 5, at 1 (citation omitted) (internal quotation marks omitted).

117. See *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389, 406-07 (1914).

118. WILLIAMS & HEINS, *supra* note 94, at 11.

119. JERRY, *supra* note 5, at 15.

120. *Id.* at 16. See also WILLIAMS & HEINS, *supra* note 94, at 11.

121. The earliest occurrences of risk-distribution mechanisms likely formed as a result of the maritime practices of the ancient traders of the Mediterranean. See JERRY, *supra* note 5, at 20-21. Perhaps the most famous iteration of the insurance industry began around 1688 when "Lloyd's Coffee House," a small public house for private English merchants, began indemnifying other merchants for losses suffered at sea and developed modern insurance. *Id.* at 22-23. "Lloyd's Coffee House" is now better known as Lloyd's of London. *Id.* at 23.

122. See WILLIAMS & HEINS, *supra* note 94, at 13 (defining pure risk as risk in which loss is the only possible outcome and that insurance is the product purchased to mitigate pure risk).

123. *Id.* at 17.



proclivity "to cause inefficiencies in the utilization of existing capital" that, in turn, inhibit "the development of new capital."<sup>124</sup> As such, the uncertainty that originates from the abrogation of an insurer or reinsurer's indemnification obligation can inhibit the development of new capital.<sup>125</sup> As a result, investors would be hesitant to invest capital in new businesses.<sup>126</sup> This slows investment of capital into a business, retarding the production of a new business, and translates into the loss of potentially beneficial endeavors to society.<sup>127</sup> Insurance, however, allows a party to manage "pure" risk by shifting it to an insurer who has the ability to distribute the risk amongst similarly situated parties for the payment of a premium.<sup>128</sup> The insurer's obligation to accept and spread the insured's risk provides the insured with security against unexpected losses. In turn, an insured can assume speculative risks that it might otherwise avoid.<sup>129</sup>

The economic benefits insurance provides are many. For example, a business may increase profits through the innovation of new products without the fear of exposure to consumer suits.<sup>130</sup> Profits from new products flow into the marketplace, encouraging the accumulation of new capital.<sup>131</sup> Furthermore, other businesses, creditors, and consumers are more likely to do business with a company protected by insurance than one that is not.<sup>132</sup> These benefits exist, regardless of an actual

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124. *Id.* at 17-19. Williams and Heins also note that while uncertainty can be costly, it also provides opportunities for improvement of economic positions. *Id.* at 19. This is not the case, however, with pure risk, which "is universally agreed to be costly." *Id.* at 19.

125. *See id.* at 18-19.

126. *Id.* at 19.

127. *Id.* 18-19. *See also* Williams, *supra* note 6, at 2014-15.

128. *See* WILLIAMS & HEINS, *supra* note 94, at 196.

129. WILLIAMS & HEINS, *supra* note 94, at 27. *See also* Williams, *supra* note 6, at 2014 (explaining how the insurer reduces uncertainty by combining similar risks together in numbers large enough that the actual losses of the entire group fall within statistical norms and replacing a large unknown risk with a small certain cost—the premium).

130. WILLIAMS & HEINS, *supra* note 94, at 27.

131. Williams, *supra* note 6, at 2014-15 (discussing that insurance, as a form of security, provides efficiency gains by reducing the amount of reserves of capital that a company must hold in the absence of insurance and that this allows that capital to be more profitably invested in other areas encouraging new investments and the accumulation of new capital).

132. WILLIAMS & HEINS, *supra* note 94, at 27.

indemnification payment, because the insured's expectation of economic security exists at the moment the insurer agrees to accept the insured's risk.<sup>133</sup> Similarly, at the moment Hudson entered into its reinsurance treaty with GTE RE, it had these same expectations.

#### D. The Difference Between Economic Security and the Indemnification Payment

One may argue that Hudson's expectation of economic security was adequately protected by the lump-sum payment provided by the Commutation Plan, even if the risk originally transferred to GTE RE was reallocated back to Hudson. True, the actual payment of money upon a contingent event (the "indemnification payment" represented by the lump-sum Commutation Plan payment) is the most recognizable benefit of insurance, but the indemnification obligation of the insurer is part and parcel of the essential purpose of insurance: security.<sup>134</sup> Security is the benefit that exists immediately upon the procurement of the contract, and independent of an actual indemnification payment.<sup>135</sup> This is because the indemnification obligation can be broader than the indemnification payment.

Recall that Hudson transferred its liability for contingent IBNR claims to GTE RE under a reinsurance treaty that provided coverage for "all losses" that occurred during the coverage period.<sup>136</sup> Had GTE RE chosen to remain in run-off, it would have remained obligated to indemnify Hudson for all claims that occurred during the coverage period.<sup>137</sup> As a result of the

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133. See Williams, *supra* note 6, at 2014 ("Even if no loss occurs, the insured enjoys the benefits of security. Thus, if one considers only the individual policyholder, risk shifting is the central element of insurance.").

134. See PLITT, *supra* note 83, § 1:6 (defining insurance as contractual security against the risk of loss); discussion *supra* Part III.C (discussing the economic benefits attributed to the risk-transfer provided by insurance).

135. This is evidenced by the insured's ability to assume speculative risks it may not otherwise assume, even before an insurer makes an indemnification payment. This is because the insured is not forced to set aside large reserves of capital for its own economic security. See *supra* notes 130, 132 and accompanying text.

136. Odyssey Insureds' Supplemental Memorandum, *supra* note 12, at 7.

137. See *In re GTE Reinsurance Co. Ltd.*, C.A. No. PB 10-3777, slip op. at 3, n.4 (R.I. Super. Ct. Apr. 25, 2011) (explaining that a run-off insurer or reinsurer remains bound by its pre-existing contractual obligations).

Commutation Plan, however, "[Hudson's] subsequent losses which otherwise might have resulted in a claim against [GTE RE] in the ordinary course, will not be covered" resulting in a risk that Hudson may ultimately receive less than it would have received if the reinsurance treaty had not been commuted.<sup>138</sup> Hudson's expectation of economic security was therefore greater under the reinsurance treaty than under the Commutation Plan given the greater breadth of coverage provided by GTE RE's original indemnification obligation.<sup>139</sup>

The breadth of the indemnification obligation compared with that of the indemnification payment is illustrated in *In re Texas Association of School Boards, Inc.*<sup>140</sup> There, the Texas Supreme Court explicitly rejected the notion that an insurer's contractual obligation stops at the payment of a monetary sum: "[T]he insurer is not promising to compensate the insured for an actual . . . loss in exchange for the relatively small, individual premium paid by the insured. Rather, the insurer is *assuming the risk* that death or property loss may occur . . ."<sup>141</sup> The court went on to state that the "foundation of insurance is therefore risk distribution."<sup>142</sup>

*Texas Association of Schools* also illustrates the proposition that insurance contracts are contracts of "indemnity."<sup>143</sup> The term "indemnity" encompasses two general ideas: "(1) providing security, such as through the execution and delivery of a bond; and (2) providing compensation for actual damage that has occurred."<sup>144</sup> It is economic security arising from the indemnification obligation, but existing independent of the actual indemnification payment, that *Texas Association of Schools* referred to when it rejected the notion that the insurer's contractual obligation stops at the payment of a sum.<sup>145</sup> The Rhode Island Superior Court, on the other hand, took the opposite

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138. Odyssey Insureds' Supplemental Memorandum, *supra* note 12, at 6.

139. GTE RE conceded that as a solvent company it would be able to meet its liability in full if it remained in run-off. Odyssey Insureds' Supplemental Memorandum, *supra* note 12, at 9.

140. 169 S.W.3d 653, 658 (Tex. 2005).

141. *Id.* at 658 (citation omitted) (internal quotation marks omitted).

142. *Id.* at 659.

143. See 169 S.W.3d at 655. See also PLITT, *supra* note 83, at § 1:7 (explaining the concept of "indemnity").

144. PLITT, *supra* note 83, at § 1:7.

145. See 169 S.W.3d at 658.

approach, and conflated the indemnification payment with GTE RE's indemnification obligation.<sup>146</sup>

The security provided by an insurer or reinsurer's indemnification obligation, however, is only a benefit insofar as the insured can rely on the insurance product's capacity to protect it from the uncertainty of pure risk. The existence of solvent schemes of arrangement frustrates the insured's expectations of security by undermining insurance products' reliability.<sup>147</sup> Now that insurance's risk-transfer function has been examined as an essential element of an insurance contract, this article will explore how solvent schemes of arrangement substantially impair this by infringing upon the insured's expectations of economic security.

#### IV. HOW AN INSURED'S CONTRACTUAL EXPECTATIONS ARE FRUSTRATED BY SOLVENT SCHEMES OF ARRANGEMENT

A commutation plan reallocates the risk from the insurer or reinsurer, who had agreed to bear the risk, back to the policyholder. As such, dissenting policyholders lose the economic security afforded by the risk-transfer of the original insurance or reinsurance contract.<sup>148</sup> For parties like Hudson that face large contingent IBNR liabilities, this is a particularly precarious situation.

##### A. *In Re British Aviation Insurance Company Ltd.*

In *In re British Aviation Insurance Co. Ltd.*, the United Kingdom's High Court addressed a situation similar to that faced by Hudson.<sup>149</sup> Although the petition was ultimately thrown out on procedural grounds, Justice Lewison's remarks illustrate why courts should examine the totality of the circumstances

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146. See *In re GTE Reinsurance Co. Ltd.*, C.A. No. PB 10-3777, slip op. at 15-16 (R.I. Super. Ct. Apr. 25, 2011) (implying that GTE RE's contractual obligations stopped upon the payment of a monetary sum to Hudson). Cf. *Tex. Ass'n of Sch.*, 169 S.W.3d at 658 (rejecting the notion that an insurer's contractual obligations necessarily end upon the payment of a monetary sum).

147. This concept, as well as the importance of maintaining reliable insurance products will be explained more completely in Part IV.

148. See generally discussion *infra* Part IV.A.

149. [2005] EWHC 1621 (Ch.) (Eng.). See also *Scottish Lion Ins. Co. Ltd. v. Goodrich Corp.*, [2009] S.C. 349 (Scot.) (holding that a solvent scheme "is an instance of where . . . creditor democracy should not carry the day").

surrounding each insured to best determine whether a commutation plan will frustrate its contractual expectations.<sup>150</sup>

### 1. *The Strikingly Similar Facts of British Aviation*

The British Aviation Insurance Company provided insurance and reinsurance to companies in the aviation sector until it went into run-off in 2002.<sup>151</sup> Aircraft manufacturers had used asbestos in aircraft manufacturing until the 1980s and, as a result, British Aviation's potential liabilities arose from claims brought by U.S. policyholders who faced liability under product liability, toxic tort, pollution and asbestos claims.<sup>152</sup> These liabilities were written on occurrence-based policies.<sup>153</sup> As a result, the policies had substantial value to the objecting insureds because of the broad coverage and security they provided against contingent IBNR losses.<sup>154</sup>

The objecting insureds' attorney argued that "[t]he proposed [s]cheme involve[d] the re-writing of contracts freely entered into by the Company and the withdrawal of the cover the policyholders bargained for."<sup>155</sup> The actuary, who was the "principal architect" of the estimation utilized by British Aviation's commutation plan, even noted that "[e]stimation of asbestos related IBNR claims involves a valuation of future contingent liabilities and is, therefore inherently uncertain. . . . I accept that wide variations might be experienced."<sup>156</sup> The fact that the occurrence-based policies covered long-tail liabilities created this inherent uncertainty in the valuation.<sup>157</sup> Dr. Rabinovitz, an expert for the

150. See *In re British Aviation Ins. Co. Ltd.*, [2005] EWHC 1621 (Ch) (Eng.).

151. *Id.* ¶ 1.

152. *Id.* ¶ 3.

153. *Id.* ¶ 8. See also *supra* note 21 and accompanying text (explaining the nature and distinguishing feature of occurrence-based policies).

154. One of the reasons the reinsurance treaties in *British Aviation* were valuable to the objecting creditors was the security they provided against contingent IBNR claims, similar to the certainty provided to Hudson by the GTE RE reinsurance treaty. Odyssey Insureds' Supplemental Memorandum, *supra* note 12, at 4 (explaining that GTE RE was liable under the reinsurance treaty for "all losses occurring prior to January 1, 1987").

155. *In re British Aviation Ins. Co. Ltd.*, [2005] EWHC 1621 (Ch.) [51] (Eng.).

156. *Id.* ¶ 18.

157. *Id.* ¶ 14.

objecting insureds noted that “[n]ew asbestos claims, caused by exposures from the 1940s to the 1970s, are expected to continue to arise until about 2049; and [some] claims are expected to extend yet further into the future” as a result of the aviation industry’s use of asbestos well into the 1980s.<sup>158</sup>

## 2. British Aviation *Insureds’ Contractual Expectations*

As a result of the actuarial valuation’s uncertainty, Justice Lewison proposed to evaluate the commutation plan by comparing the insureds’ contractual rights and reasonable expectations should a scheme be put in place with their expectations if British Aviation remained in run-off.<sup>159</sup> Within this evaluation, an insured, facing substantial IBNR liability, has much higher expectations of meeting its liabilities through a solvent insurer that remains in run-off than one that pays a lump-sum to the insured based upon inherently unreliable actuarial estimates.<sup>160</sup>

The Justice noted that the insurer’s promise to bear the risk of the “contingency materializing[]” is related to the insured’s expectations.<sup>161</sup> “The insurer is in the risk business; and the policyholder is not. . . . The essence of the scheme is that it retransfers the risk from the insurer (who had contracted to bear it) to the policyholder (who did not).”<sup>162</sup>

The Justice then concluded:

In the end . . . it seems to me to be unfair to require the manufacturers who have bought insurance policies designed to cast the risk of exposure to asbestos claims on insurers to have that risk compulsorily retransferred to them. The Company is in the risk business; and they are not . . . . The purpose of the scheme is to allow surplus funds to be returned to shareholders in preference to satisfying the legitimate claims of creditors. No matter how usable and reasonable an estimate may be, the very

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158. *Id.* ¶ 15.

159. *Id.* ¶ 71.

160. *See Id.* ¶ 83 (speaking of an insured’s expectations in terms of its contractual rights and noting that the rights of a policyholder with IBNR claims are different under a scheme from the rights it would have in the absence of a scheme).

161. *Id.*

162. *Id.*

fact that it is an estimate is likely to make i[t] an inaccurate forecast of the actual liabilities of policyholders. If individual policyholders wish to compound the Company's contingent liabilities to them, and to accept payment in full of an estimate of their claims, there is nothing to stop them doing so. But to compel dissentients to do so would . . . require them to do that which is unreasonable . . . .<sup>163</sup>

### 3. *British Aviation Applied to Hudson*

Justice Lewison focused on the detriment to the British Aviation insureds' contractual expectations when their risk was compulsorily shifted back to them in concluding that British Aviation's commutation plan was unfair.<sup>164</sup> The dissentients in *British Aviation* faced the prospect of large contingent IBNR claims.<sup>165</sup> As a result, the lump-sum payment provided by British Aviation would potentially be insufficient to cover the dissentients' total liabilities.<sup>166</sup> Justice Lewison believed that this arrangement deprived the dissentients of the economic security, originally provided by the insurance contracts, against potential IBNR liability.<sup>167</sup>

Hudson faced uncertainty similar to that confronted by the *British Aviation* insureds.<sup>168</sup> The lump-sum payment under the GTE RE commutation plan retransferred the risk of a "contingency materializing" back to Hudson.<sup>169</sup> The payment deprived Hudson of the economic security, originally provided by the GTE RE reinsurance treaty, against IBNR liability that could materialize.<sup>170</sup>

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163. *Id.* ¶ 143.

164. *Id.*

165. *Id.*, ¶ 3.

166. *See id.* ¶ 18.

167. *See id.* ¶ 143.

168. Odyssey Insureds' Supplemental Memorandum, *supra* note 12, at 4-6 (describing Hudson's significant liability that remained for claims that were either unsettled or unreported, how the GTE RE reinsurance treaty covered these liabilities, and why the commutation payment may be insufficient to replicate the Hudson's coverage that it originally contracted for).

169. *In re British Aviation Ins. Co. Ltd.*, [2005] EWHC 1621 (Ch.) [83] (Eng.); Odyssey Insureds' Supplemental Memorandum, *supra* note 12, at 4-6..

170. *See* Odyssey Insureds' Supplemental Memorandum, *supra* note 12, at 5 ("If the Plan is approved, the indemnity obligations contained in the

B. *Pireno* Revisted: Solvent Schemes of Arrangement and the Reliability of Insurance Products

Additionally, the availability of solvent schemes of arrangement undermines the reliability of insurance products. Recall that the second-prong of *Pireno* identified the importance of the contractual agreement to the insured-insurer relationship.<sup>171</sup> The sanctity of the contract ensures reliable insurance products and insurer/insured relations. In *Pireno*, the Supreme Court noted that Congress, by enacting the McCarran-Ferguson Act, was concerned with the “relationship between the insurer and insured, the type of policy that could be issued, *its reliability*, interpretation, and enforcement.”<sup>172</sup> The availability of solvent schemes of arrangement threaten the relationship between the insured and insurer by undermining the reliability of the insurance contract for an insured who knows its contractual expectations can be abrogated without its consent.

*British Aviation* also hinted at the importance of reliable insurance products.<sup>173</sup> A commutation plan that shifts the risk back to the insured who does not have the opportunity to redistribute the risk (recall that the court stated that “[t]he Company is in the risk business; and [the insured is] not”) injects the devastating uncertainty described by Williams and Heins into the insured-insurer relationship.<sup>174</sup> As Hudson discovered, expectations of economic security become mere figments should

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Hudson . . . contracts will be terminated in exchange for an estimate based on estimates—loss reserve estimates—despite (1) the Odyssey Insureds’ objection to such a substitution and (2) GTE RE’s admission that the estimates may ultimately not be sufficient to cover the risks being forcibly shifted back to the Odyssey Insureds.”). *Cf In re British Aviation Ins. Co. Ltd.*, [2005] EWHC 1621 (Ch.) [143] (Eng.).

171. See *Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119, 129 (1982) (discussing that an insurance practice must constitute an integral part of the relationship between the insurer and the insured).

172. *Id.* at 128 (emphasis added) (citation omitted) (internal quotation marks omitted).

173. See *In re British Aviation Ins. Co. Ltd.*, [2005] EWHC 1621 (Ch.) [143] (Eng.) (discussing how, in some situations, it would be unfair to allow an insurer to reallocate the risk it had agreed to assume back to the insured).

174. *Id.* ¶ 143. See WILLIAMS & HEINS, *supra* note 94, at 16-19 (discussing that uncertainty reduces the total satisfaction associated with a given economic status and has the proclivity to cause inefficiencies in the utilization of existing capital).



the insurer or reinsurer choose to enter a solvent scheme of arrangement.<sup>175</sup> As such, the availability of solvent schemes of arrangement to solvent insurers may cause a potential insured to question whether a policy is a sound investment and could lead to a more risk-averse society.<sup>176</sup>

The issues that solvent schemes of arrangement present for insureds' contractual expectations, as well as the reliability of insurance products, mandates a more thorough analysis than that provided by the *GTE Reinsurance* court. The next section will articulate a new framework within which courts can condition solvent schemes of arrangement to comply with insureds' contractual expectations.

#### V. CONDITIONING SCHEMES OF ARRANGEMENT: A NEW FRAMEWORK FOR EXAMINING AN INSURED'S CONSTITUTIONAL RIGHTS AND WHETHER THEY HAVE BEEN SUBSTANTIALLY IMPAIRED

Contract Clause jurisprudence has consistently emphasized that a party's contractual expectations are important, and that an ex post facto law that substantially impairs these expectations will violate the Contract Clause.<sup>177</sup> *GTE Reinsurance* creates a dangerous precedent insofar as it stands for the proposition that a court-sanctioned solvent scheme of arrangement need not be conditioned upon an insured's contractual expectations as they relate to considerations of risk-transfer and the economic security that arises therefrom.<sup>178</sup> As such, a court should examine the totality of the circumstances surrounding a dissenting insured's contractual expectations before sanctioning a solvent scheme of arrangement. Should a court determine that a dissenting insured's contractual expectations have been impaired, the dissenting insured should be allowed to opt out of the commutation plan.

A proper consideration of an insured's expectations must go beyond whether a sum of money is paid. It must also examine (1)

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175. A solvent scheme may operate to withdraw the cover insureds had contracted for. See *In re British Aviation Ins. Co. Ltd.*, [2005] EWHC 1621(Ch.) [51] (Eng.).

176. See discussion *supra* Part III.C (discussing the economic importance of insurance in light of the attitude of risk-aversion created by uncertainty).

177. See generally *supra* Part I.D.

178. See generally *supra* Part III.

the insured's ability to transfer and re-distribute its risk and obtain substantially similar coverage from another insurer or reinsurer should a commutation plan be enforced; (2) the solvency of the commuting party; and (3) the solvency of the insured, and its potential for IBNR liability.<sup>179</sup> These considerations are compatible with *Jordan*, *Pireno*, and *British Aviation*, as they consider the reliability of the insurance product and the relationship between the insurer and insured.<sup>180</sup> Most importantly, as per *British Aviation*, this analysis compels a court to comply with insureds' expectations before sanctioning a solvent scheme of arrangement because it requires the court to compare insureds' expectations under a commutation plan with their expectations should the insurer remain in run-off.<sup>181</sup>

The aforementioned considerations are important because they are intimately related to the insured's contractual expectations. An insured's ability to seek substantially similar coverage will provide it the same economic security it had under the original policies, while still allowing the insurer to enter a solvent scheme of arrangement.<sup>182</sup> The solvency of the insurer or reinsurer is also important because a commuting party's level of solvency—i.e., if a company is moderately solvent—may determine whether an insured's expectations are better served by a commuting insurer, who is protected against insolvency, than an

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179. "There is a wide disparity in the circumstances of companies that enter run-off," and this disparity mandates a close scrutiny of a company's situation and how it relates to an insured's contractual expectations. See FINAL REPORT, *supra* note 12, at 4. Some companies, like GTE RE, do not pose the risk of becoming insolvent. The situation in which a substantially solvent insurer or reinsurer seeks to commute its liabilities negates many of the benefits associated with solvent schemes of arrangement such as certainty of payment to creditors, deteriorating reinsurance collections avoidance, and prevention of unfairness amongst creditor collections. These benefits often exist only where the insurer or reinsurer is only marginally solvent. At the same time, however, the commutation of a substantially solvent insurer or reinsurer can create the contractual issues discussed in this piece. See Odyssey Insureds' Supplemental Memorandum, *supra* note 12, at 9.

180. See *supra* Part IV.B.

181. *Id.*

182. See FINAL REPORT, *supra* note 12, at 9 (proposing that a substantially solvent run-off entity be allowed to enter into a scheme so long as it substitutes the insureds' current contract with one from a company of equal or greater financial strength).

insurer that remains in run-off and later becomes insolvent or marginally solvent.<sup>183</sup> Furthermore, the solvency of the insured, and its potential IBNR liability, substantially raises the insured's expectations for economic security because of the breadth of the insurer's indemnification obligation compared to the potentially insufficient commutation payment.<sup>184</sup> Should an insured face a position similar to Hudson's, it should be exempt from further commutation proceedings and have the option to elect to collect from the insurer or reinsurer in the ordinary fashion.

Because the insureds' contractual expectations are of paramount importance, it is imperative that courts consider alternative solutions that comply with those expectations before sanctioning a solvent scheme of arrangement. The aforementioned framework would require more judicial discretion for conditioning a solvent scheme of arrangement than that currently necessitated by Rhode Island's Restructuring Act, but it is possible, and such a solution has been discussed by at least one state.<sup>185</sup> A Connecticut task force addressed alternative theories of debt restructuring that comply with a dissenting insured's contractual expectations.

The Task Force discussed at length the concerns associated with the traditional majority-rule feature of solvent schemes of arrangement, and stated that objecting creditors "should have an alternative to compulsory estimation of their claims" if a commuting company is substantially solvent.<sup>186</sup> One such alternative would allow objecting policyholders to present and

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183. See *In re GTE Reinsurance Co. Ltd.*, C.A. No. PB 10-3777, slip op. at 30 (R.I. Super. Ct. Apr. 25, 2011) (noting that the benefit of the Restructuring Act is that it provides some certainty of payment to creditors); see also *supra* note 29 and accompanying text (discussing the greater regulatory oversight needed for marginally-solvent companies in run-off).

184. No court has recognized a method of valuation that completely eliminates conjecture in the calculation of IBNR liabilities. See Odyssey Insureds' Supplemental Memorandum, *supra* note 12, at 11. Furthermore, GTE RE had total liabilities of \$56,466,962, total assets of \$92,412,487 and a total surplus of \$35,945,525 and acknowledged there was no danger it would be unable to meet its contractual obligations. *Id.* at 9-10.

185. In 2006 Susan F. Cogswell, Insurance Commissioner of the State of Connecticut, established a task force to study the need for laws regulating run-off companies. See FINAL REPORT, *supra* note 12, at 1.

186. *Id.* at 8.

collect their claims in the ordinary course.<sup>187</sup> A second possibility would require the run-off company to transfer the policies to another company of equal or greater financial strength as the run-off company.<sup>188</sup> Both of these options would give the insured the choice as to how best to protect its financial assets—either by retransferring the risk back onto itself, or maintaining the insurance agreement—without an unwarranted, compulsory reallocation of its risk as determined by a majority of creditors.<sup>189</sup>

Yet, it is true that solvent schemes of arrangement do provide important public benefits to Rhode Island such as fostering its economic growth by attracting large insurance companies.<sup>190</sup> Recall that under the Contract Clause, a state legislature's motivation to carry out an important public purpose can withstand Contract Clause scrutiny.<sup>191</sup> The public purpose exception, some might agree, would nullify any need to modify the Restructuring Act to allow for judicial contemplation of insureds' contractual expectations. However, the next section will explain that the Rhode Island General Assembly's intention to make Rhode Island an attractive state for insurance companies is insufficient to justify a substantial impairment of insureds' contractual expectations.

#### VI. THE INSUFFICIENCY OF ECONOMIC GROWTH AS A CONTRACT CLAUSE EXCEPTION

In 1995, Rhode Island Governor Lincoln Almond developed the Governors Insurance Task Force because he believed the insurance industry could promote the economic growth of the state.<sup>192</sup> The *GTE Reinsurance* court assumed economic growth was a public purpose sufficient to warrant the impairment of the contract held by Hudson.<sup>193</sup> The court noted, "a statute will be

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187. *Id.* at 9.

188. *Id.*

189. See R.I. GEN. LAWS § 27-14.5-1 to -6 (2008).

190. See *In re GTE Reinsurance Co. Ltd.*, C.A. No. PB 10-3777, slip op. at 30 (R.I. Super. Ct. Apr. 25, 2011).

191. See *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 441-43 (1934).

192. See R.I. Exec. Order No. 95-21 (Aug. 22, 1995) available at <http://www.library.state.ri.us/publications/governor/executiveorders/1995/95exec21.pdf>.

193. *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 30.

deemed constitutional, despite any substantial impairment, where a state establishes that the regulation is justified by a significant and legitimate public purpose."<sup>194</sup> However, the court's decision ignores the deference that the Supreme Court has given to insurance and insurance-like agreements where impairment will result in increased financial liability.<sup>195</sup> Furthermore, because insurance contracts are important vehicles for economic growth, the economic environment of Rhode Island is better preserved by efforts that maintain the reliability of insurance products.<sup>196</sup>

*Allied Structural Steel* demonstrates the Supreme Court's hesitancy to allow a state legislature to enact legislation that abrogates private contracts where the abrogation of said contracts could result in liability in "potentially disabling amounts."<sup>197</sup> *Allied Steel* had established a pension trust fund for employees to which the company was the sole contributor.<sup>198</sup> The contributions to the fund were based on actuarial predictions of eventual payout needs and, once those payments were made, they were irrevocable.<sup>199</sup> *Allied Steel*, however, had no obligation to make specific contributions.<sup>200</sup> In fact, the plan stated that "[n]o employee shall have any right to, or interest in, any part of the Trust's assets upon termination of his employment or otherwise, except as provided from time to time under this Plan."<sup>201</sup>

Subsequent to this arrangement, Minnesota enacted the Private Pension Benefits Protection Act to address the problem of plant closure and pension plan termination.<sup>202</sup> That Act mandated that a private employer of 100 or more employees, who already provided pension benefits under a plan meeting § 401 of the Internal Revenue Code, was subject to a "pension funding

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194. *Id.* at 28. (citing *Energy Reserves Grp., Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 411-12 (1983)).

195. *Id.*; see, e.g., *Allied Structural Steel Co. v. Spannus*, 438 U.S. 234 (1978); *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1 (1977).

196. See discussion *supra* Parts III.C, IV.B. (discussing the economic benefits of insurance and the detrimental impact solvent schemes of arrangement can have on the reliability of insurance products).

197. 438 U.S. at 247; see also *U.S. Trust Co. of N.Y.*, 431 U.S. at 19 (discussing the importance of security provisions in contracts).

198. *Allied Steel*, 438 U.S. at 236-39.

199. *Id.* at 237.

200. *Id.*

201. *Id.* at 238 (internal quotation marks omitted).

202. *Id.* at 238, 247-48.

charge" if the company either terminated the plan or closed its Minnesota office.<sup>203</sup> In 1974, Allied Steel closed its Minnesota office and discharged eleven of its thirty Minnesota employees.<sup>204</sup> Nine of the employees did not have vested pension rights.<sup>205</sup> On August 18, 1974, Minnesota notified Allied Steel that it owed \$185,000 under the Private Pension Benefits Protection Act.<sup>206</sup> After that, Allied Steel filed suit and claimed the Act was an unconstitutional impairment of its contractual obligations with its employees under the private pension agreement.<sup>207</sup>

The Supreme Court struck down the Pension Benefits Protection Act as unconstitutional and emphasized the importance of Allied Steel's contractual expectations under its private pension fund.<sup>208</sup> The Court noted that "[t]he company's maximum obligation was to set aside each year an amount based on the plan's requirements for vesting. . . . It relied heavily, and reasonably, on this legitimate contractual expectation in calculating its annual contributions to the pension fund."<sup>209</sup> The Court also acknowledged Allied Steel's heavy reliance on the contractual terms of the private pension agreement: "a basic term of the pension contract—one on which the company had relied for 10 years—was substantially modified."<sup>210</sup> The Court further stated:

These [pension] plans, like other forms of insurance, depend on the accumulation of large sums to cover contingencies. The amounts set aside are determined by a painstaking assessment of the insurer's likely liability. Risks that the insurer foresees will be included in the calculation of liability, and the rates or contributions charged will reflect that calculation. The occurrence of major unforeseen contingencies, however, jeopardizes the insurer's solvency and, ultimately, the insureds' benefits. Drastic changes in the legal rules governing pension and

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203. *Id.*

204. *Id.* at 239.

205. *Id.*

206. *Id.*

207. *Id.* at 239-40.

208. *See id.* at 246.

209. *Id.* at 245-46.

210. *Id.* at 246.

insurance funds, like other unforeseen events, can have this effect.<sup>211</sup>

The Court then concluded that the Private Pension Benefits Protection Act would have the effect of imposing unexpected liability in “potentially disabling amounts” on Allied Steel, and the Minnesota state legislature’s intention to boost the state’s economy, by fixing the problem of plant closure and pension plan termination, was not an economic or social problem sufficient to survive Contract Clause scrutiny.<sup>212</sup>

#### A. The Importance of Economic Security Under the Contract Clause

It is important to note the analogy that the *Allied Steel* Court drew between pension funds and insurance.<sup>213</sup> Just like Allied Steel, Hudson’s economic security hinges upon the accumulation of large sums to cover contingencies should the coverage it contracted for be commuted, and the amount of coverage Hudson bargained for was accomplished through an assessment of its likely liability.<sup>214</sup> The imposition of the GTE RE commutation plan, combined with Hudson’s estimate of its IBNR liability, could have the effect of imposing unexpected liability in “potentially disabling amounts.”<sup>215</sup> Furthermore, just as Allied Steel’s solvency would be jeopardized by the occurrence of major unforeseen liabilities in the absence of its private pension fund, so too would Hudson’s solvency be jeopardized by the occurrence of major unforeseen IBNR liability should the reinsurance it bargained for be abrogated.<sup>216</sup>

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211. *Id.* at 246-47 (citation omitted) (internal quotation marks omitted).

212. *Id.* at 247-48.

213. *See id.* at 246-47.

214. *See* Odyssey Insureds’ Supplemental Memorandum, *supra* note 12, at 8 (“Although both parties to a reinsurance transaction utilize actuarial assessments of risk, the decision to purchase reinsurance and the decision to provide reinsurance are also based on numerous other factors such as each party’s tolerance for risk and its desire to diversify the risk it holds.”).

215. *See Allied Steel*, 438 U.S. at 247; Odyssey Insureds’ Supplemental Memorandum, *supra* note 12, at 12.

216. *See Allied Steel*, 438 U.S. at 246-47; Odyssey Insureds’ Supplemental Memorandum, *supra* note 12, at 12 (discussing the potential for unforeseen liabilities that could impact Hudson’s solvency: “If some new ‘unknown’ appears—a new wave of environmental or mass tort claims, for example—the exposure could be enormous. History teaches that they do arise, with

B. A State's Economic Well-Being Cannot Come at the Detriment of a Private Company's Economic Security

The Supreme Court in *Allied Steel* also dismissed the Minnesota legislature's intended purpose of boosting its economy. The Court stated that "[i]f the Contract Clause is to retain any meaning at all . . . it must be understood to impose *some* limits upon the power of a State to abridge existing contractual relationships, even in the exercise of its otherwise legitimate police power."<sup>217</sup> It then noted that Minnesota's intent to boost its economy by fixing plant closure was not sufficient to withstand Contract Clause scrutiny.<sup>218</sup> In *GTE Reinsurance*, the Rhode Island Superior Court noted:

[T]he underlying goal of the Task Force was to stimulate Rhode Island's economy by attracting segments of the insurance industry to the State. . . . [T]he Restructuring Act . . . achieves Governor Almond's original objective of making Rhode Island an attractive location for insurance companies—whether or not they are in run-off—and encouraging economic growth . . . .<sup>219</sup>

Yet there is no significant difference between the Rhode Island General Assembly's purpose of attracting new jobs to Rhode Island and Minnesota's attempt to stop plant closures. Further, the Restructuring Act does not seek to remedy an economic depression, like the mortgage moratorium law in *Blaisdell*.<sup>220</sup> Rather, its purpose is to make "Rhode Island an attractive location for insurance companies" in order to stimulate its economic growth.<sup>221</sup> In doing so, the state is also able to collect a handsome

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catastrophic consequences. Asbestos, environmental claims, mold, lead, latex, terrorism, and cyber liability are all recent examples. It is indisputable that whatever estimate either party makes now will, once all of the current and future claims have been paid, be wrong.").

217. 438 U.S. at 242.

218. *Id.* at 249.

219. *In re GTE Reinsurance Co. Ltd.*, No. C.A. No. PB 10-3777, slip op. at 29-30 (R.I. Super. Ct. Apr. 25, 2011).

220. See *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 423 (1934).

221. The Rhode Island Superior Court also noted that the Restructuring Act allowed Rhode Island to address issues endemic to the insurance industry but protecting creditors from the harms of insurance companies in run-off. *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 34. However, as this



fee from the commuting company.<sup>222</sup> *Allied Steel*, however, discloses that a state legislature's attempt to boost its state's economy, absent an exigent circumstance, is insufficient to withstand Contract Clause scrutiny.<sup>223</sup>

## VII. CONCLUSION

A solvent scheme of arrangement is a beneficial tool to insurers and reinsurers who wish to restructure debt obligations with policyholders. These schemes allow an insurer or reinsurer to avoid a lengthy run-off process and limit administrative costs.<sup>224</sup> They further allow an insurer to efficiently deploy capital, once tied-up in run-off, to non-run-off operations.<sup>225</sup> For marginally solvent companies, solvent schemes of arrangement offer the best opportunity to remain solvent.<sup>226</sup>

However, *GTE Reinsurance* illustrates how a substantially solvent company can manipulate a law, like Rhode Island's Restructuring Act, to abrogate dissenting insureds' contractual expectations for its own convenience. Such state-sanctioned abrogation can create a substantial impairment of the insured's contractual expectations under the Contract Clause.<sup>227</sup> The economic benefits associated with the transfer of risk allowed by an insurance contract, like the insureds ability to assume speculative risks and accumulate new capital, are lost as the insured is forced to set aside large accumulations of wealth to handle its own pure risk.<sup>228</sup> In the aggregate, this affects the

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note has disclosed, in situations involving a substantially solvent insurer, a creditor may be better protected by allowing a court to consider an objecting creditors right of rejection in light of its contractual expectations.

222. R.I. GEN. LAWS § 27-14.5-5 (2008); *see also* U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 26 (1977) (noting that complete deference to a legislative assessment of reasonableness and necessity with respect to determining whether a law is passed for an important public purpose is not appropriate where the State's self-interest is at stake: "A governmental entity can always find a use for extra money.").

223. *See Allied Structural Steel Co. v. Spannus*, 438 U.S. 234, 242 (1978). *See also Blaisdell*, 290 U.S. at 441-43.

224. *In re GTE Reinsurance*, C.A. No. PB 10-3777, slip op. at 33.

225. *Id.*

226. *See* FINAL REPORT, *supra* note 12, at 6 (stating that greater regulatory oversight is appropriate for marginally solvent companies who have a much higher potential for insolvency if a run-off is not successful).

227. *See* discussion *supra* Parts I.D, V.

228. *See* discussion *supra* Part III.

reliability of insurance products by causing companies to question the soundness of their insurance investment and can lead to a more risk-averse society.<sup>229</sup>

To combat the potential dangers associated with traditional solvent scheme laws, this note has presented an analysis by which courts should condition solvent schemes of arrangement to comply with dissenting insureds' contractual expectations of economic security. Such an analysis would eliminate the majority-rule feature of Rhode Island's Restructuring Act through an examination of the totality of the circumstances surrounding each insured's policy and financial situation.<sup>230</sup>

Through this analysis a court can ensure that an insured's contractual expectations are best maintained by conditioning the solvent scheme of arrangement on the dissenting-insured's ability to "opt-out" of the commutation plan. This, in turn, will promote certainty in the execution of insurance contracts and extinguish the negative impact schemes pose to the reliability of insurance products. Under this newly proposed framework, the judiciary's increased scrutiny of insurers, which are seeking to enter a solvent scheme of arrangement, will continue to ensure that insurance contracts act as reliable vehicles for economic growth.

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229. See discussion *supra* Part III.B.

230. See R.I. GEN. LAWS § 27-14.5-1 to -6 (2008).