

Lumbermens Enters Rehabilitation: What Are the Consequences for Its Policyholders?

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Lumbermens Mutual Casualty Company and American Manufacturers Mutual Insurance Company (part of the Lumbermens Mutual Group and formerly known as Kemper) (“Lumbermens”), after years of struggling financially under the supervision of the Illinois Department of Insurance, recently entered rehabilitation proceedings. Policyholders who purchased workers’ compensation and other types of insurance from Lumbermens should be aware that many opportunities for recovery remain.

The Chancery Division of the Circuit Court of Cook County, Illinois, entered an agreed Order of Rehabilitation, establishing separate estates for each of the companies. The Director of the Illinois Department of Insurance serves as the Rehabilitator to oversee the Lumbermens rehabilitation. The Illinois Insurance Code controls both the duties and powers of the Rehabilitator, and the rights and obligations of policyholders. The Rehabilitator, operating under court order, has taken possession and control of all of Lumbermens’ property, contracts, and rights of action. The Order of Rehabilitation restrains and enjoins anyone with knowledge of the Order from bringing or further prosecuting any claims against Lumbermens, except in the rehabilitation proceedings.

The proper purpose of a rehabilitation is to address issues of solvency with a goal toward returning the insurance companies to profitability. In recent years, however, rehabilitation has often been used, perhaps inappropriately, as a prelude to liquidation. The Order of Rehabilitation will likely lead to either a Rehabilitation Plan for addressing the liabilities of Lumbermens or an eventual Order of Liquidation. Because the basis of the Order of Rehabilitation was the consent of the companies being rehabilitated, rather than a finding of insolvency, no guaranty association will pay claims at the current time. If Lumbermens enters liquidation, insurance guaranty associations will pay many claims in full. In rehabilitation, however, the liabilities of Lumbermens remain with Lumbermens.

Lumbermens' Troubled Workers' Compensation Programs

Numerous corporate policyholders procured workers' compensation insurance through insurance policies issued by Lumbermens. Lumbermens' workers' compensation programs were often designed such that dividends were to be paid by Lumbermens to policyholders if loss-experience under the insurance program was positive, while additional premium or security might be due if loss-experience was negative. Policyholders often issued letters of credit to secure their potential obligations to Lumbermens under the terms of these program contracts. In many instances, policyholders' letters of credit provided Lumbermens with millions of dollars in security.

When selling the insurance, Lumbermens represented that it was financially sound and that, in its entire history, it had never failed to declare dividends on policies when due. Lumbermens promised that after the expiration of a policy, it would calculate the dividend and declare it from its available surplus. However, the financial turmoil that Lumbermens encountered starting in 2002 impaired Lumbermens' ability to continue to pay dividends under these programs, contrary to its assurances to policyholders. Many policyholders have resolved disputes with Lumbermens regarding these dividend obligations, as well as attempts by Lumbermens to draw down on policyholders' letters of credit collateralizing the premiums for such programs, through formal proceedings, policy novations, and settlements. For other policyholders, these issues will be resolved in the rehabilitation proceedings.

Dangers of Legal Actions by the Rehabilitator To Bring Assets Into the Estate

Policyholders who have recently resolved a claim or dispute with Lumbermens and received a payment should be aware that the Rehabilitator may seek to void such payments as constituting a "preference" payment. The "preference" period examined by the Rehabilitator runs two years before the filing of the complaint in the rehabilitation proceeding. Policyholders may be able to assert certain defenses to a "preference" claim made by the Rehabilitator. In particular, to the extent that the Insurance Department approved of a transaction, it is unlikely that the Rehabilitator will seek to set it aside.

Nevertheless, because of the unique workers' compensation programs issued by Lumbermens, we expect substantial litigation by and against policyholders relating to premium, collateral, and dividend issues. By Illinois statute, collateral such as letters of credit issued in favor of



Lumbermens to collateralize premium payments for workers' compensation programs should be segregated from the general assets of the estate. There are very specific statutory provisions about how that collateral is to be treated. Many policyholders will need to engage counsel to negotiate and litigate those issues with the Rehabilitator.

Reed Smith's Insurance Recovery Group attorneys have closely monitored Lumbermens' financial condition since the start of its decline, and have successfully represented numerous corporate policyholders in resolving disputes against Lumbermens regarding claims and liabilities involving Lumbermens' workers' compensation programs and other disputes related to its insolvency. We have also successfully represented corporate policyholders in other insurance company rehabilitations and liquidations throughout the country, including in disputes relating to collateral, deductibles, and retrospective premiums. Please contact one of the authors for further information regarding these important issues.

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