MIDYEAR REPORT: July 15, 2011

A PUBLICATION OF THE NATIONAL CONFERENCE OF INSURANCE GUARANTY FUNDS

Welcome to the midyear update of the National Conference of Insurance Guaranty Funds' (NCIGF) Insolvency Trends. Authored by the legal and public policy staff of the NCIGF, this paper provides an update on recent events in insolvency law and practice and a look ahead at what is on the horizon for the remainder of 2011 and beyond.

Property and Casualty Guaranty Funds: Built to Work – and delivering for 40 Years

The guaranty fund system was established in 1968 by the property and casualty insurance industry, insurance regulators and states to fulfill a public policy imperative: to provide a safety net that protects insurance consumers if an insurance company fails.

The guaranty fund system is an innovative and common-sense mechanism. The system draws first on the assets of the failed insurance company before turning to assessments on healthy insurers in each state. Since inception the system has paid out more than 26.4 billion to policyholders, beneficiaries and claimants related to more than 550 insolvencies.

Following liquidation, the statutorily created guaranty funds step into the shoes of a defunct company and pay the covered claims of policyholders and claimants whose claims otherwise likely would go unpaid by an insolvent insurance company.

Today, the guaranty fund system remains true to its original intent: delivering protection to those least able to weather the impact of insurance company insolvencies.

On Capitol Hill

The insurance industry has always operated in a dynamic political environment at the state and federal levels. Last July the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. It "carves in" the current system, including the property and casualty guaranty fund system. However, the law leaves open the option for future federally-mandated changes. Here are the highlights of the act that relate to insurance company insolvencies:

- The guaranty system's existing role in protecting policyholders will remain intact; however a newly created

GUARANTY FUNDS WORK

in partnership with insurance regulators to protect policyholders.

A state court finds an insurance company insolvent and orders it liquidated.

Policyholder claims files are transferred to the guaranty funds for servicing.

Covered claims are paid from a pool of money drawn from three sources made available at the time of the insolvency: a) the insolvent insurance company's remaining assets, b) cash already on deposit with state regulators and c) assessments on insurers licensed to write business in a state.

Payments are made promptly.

HOW THE GUARANTY FUND SYSTEM IS FUNDED

Recoveries

To the extent possible to fulfill guaranty fund statutory duties, monies are obtained from remaining estate assets.

- The insurance company's remaining assets (including reinsurance)
- Funds deposited with state regulators in certain states while the company is still writing business

Assessments from Insurers

Charged to insurance companies licensed to write business in a state

- Typical cap is 2% of "net direct written premium"
- Assessment is determined by the amount of money needed by the guaranty fund to supplement the funding pool described above
- Some guaranty funds have separate "assessment accounts" allowing them to segregate assessment billing and payments into various lines of business—a typical structure would be workers compensation, auto, and all other property & casualty lines covered by the funds

Federal Insurance Office (FIO) will study the possibility of subjecting insolvent insurance companies to a federal resolution authority and the potential impact of such an authority on the guaranty system. Recently former Illinois Insurance Director, Michael McRaith was appointed to head the FIO. His past experience in a key insurance industry state and hands-on involvement with some significant troubled insurance companies well-qualified McRaith for the job.

Dodd-Frank calls for large, interconnected financial companies that are systemically significant to be subject to oversight by the Federal Stability Oversight Council (FSOC). This could include insurance companies and insurance holding companies, although most observers contend that few (if any) insurers are systemically significant. A new term has been coined to describe this concept: Significantly Important Financial Institutions are now termed "SIFIs" – (pronounced sif-ees.)

- The FDIC will resolve systemically significant financial companies other than insurance companies.
- All insurance companies (including any that are systemically significant) will remain subject to state insurance insolvency laws.

Since the enactment of Dodd-Frank those in the insolvency community have been closely monitoring the federal rulemaking process and other developments related to the law. Developments include promulgation of new rules relating to federal resolution authority for insolvent SIFIs, FDIC receiver procedures, and "Living Will" requirements for SIFIs.

The National Association of Insurance Commissioners (NAIC) has been proactively addressing how state insurance insolvency procedures might be adjusted to address the unlikely event of a SIFIinsurance insolvency. The NAIC is working to bring state liquidation procedures into alignment with the accelerated timetable mandated by Dodd-Frank. Additionally, the NAIC is stressing the importance of pre-liquidation planning between regulators and the guaranty associations.

Players throughout the insurance and insolvency communities are preparing to respond to requests for information from the newly formed FIO. The agency, which is charged with completing the study, likely will examine the role of insurance companies and the guaranty fund system in the context of overall systemic financial risk.

In the States…

The NCIGF continued to see interest in guaranty association law amendments during the 2011 sessions. New NAIC model language was up for debate, with a bill floated in Connecticut based on this model. Guaranty funds also pursued changes from the National Conference of Insurance Legislators (NCOIL) and NCIGF model laws with Colorado increasing its claim cap to $300,000, among other adjustments. The NCIGF expects a comprehensive law change bill to be floated in 2012 in Utah.

Local state guaranty fund managers often play a key role in educating legislators and others on how any proposed changes to guaranty fund laws might impact guaranty fund coverage parameters, efficiency and cost. We encourage those with interest in such legislation to consult with the guaranty fund managers in the jurisdictions.

In Texas legislation was enacted this session to change the law regarding the state receivership process to make it consistent with the mandates of the Dodd-Frank law.

While it's been several years since a state has attempted to propose a comprehensive liquidation act bill based on the Insurer Receivership Model Act (IRMA) model, the NCIGF has seen IRMA (or similar) language regarding treatment of swaps and derivatives (investment vehicles used by insurance companies) being proposed in several states. At this time there is no apparent opposition to this technical measure in the various state legislatures considering it. Such provisions are now in place in Arizona, Connecticut, Delaware, Illinois, Iowa, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Texas and Utah. Proposals have been introduced in Virginia (HB 1504), Tennessee (SB 465) Missouri (SB 978) and New York (SB 2713).

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More New Insolvency Activity – Titanic Insurer Sinks

Atlantic Mutual Insurance Company was incorporated under the laws of the State of New York on April 11, 1842. Among its insureds was the RMS *Titanic* a passenger liner that sank April 15, 1912, killing 1,517 passengers.

The company was placed into liquidation April 27, 2011 by order of the Supreme Court of the State of New York. The New York Superintendent of Insurance was appointed liquidator. The company was licensed in all 50 states, Washington, D.C. and Puerto Rico. Many guaranty funds were activated, or “triggered,” by this insolvency. The predominant claims activity resided in New York and New Jersey.

In 2011 another three companies were placed into liquidation – Aequicap Insurance Company, Seminole Casualty Insurance Company (both domiciled in Florida) and Constitutional Casualty Company (domiciled in Illinois.)

Aequicap was a property and casualty insurance company which was originally licensed in Florida in 1985. The company was authorized to do business in four states – Florida, Georgia, Oklahoma, and South Carolina – and wrote commercial automobile, workers’ compensation and surety bonds. Guaranty funds in Florida, Georgia, Oklahoma and South Carolina were triggered by the insolvency.

Seminole Casualty was a property and casualty insurance company, which was licensed in Florida in 1988. The company was licensed in eight states – Florida, Alabama, Georgia, Maryland, Nevada, New York, Pennsylvania, and Tennessee – but wrote primarily personal and commercial auto only in Florida and Maryland. The Florida and Maryland guaranty funds were triggered in this sizeable insolvency. As of February 28, 2011, the company had 36,671 Florida personal auto policies, 1,764 commercial auto policies and 2,644 artisan contractors’ general liability policies. In addition, the company had approximately 1,160 Maryland personal auto policies in force as of that date.

Constitutional Casualty specialized in writing automobile insurance for private passenger and commercial vehicles. It also provided homeowners and personal liability coverage. The company was licensed and wrote business in Illinois, resulting in the triggering of the Illinois guaranty fund.

Closing Efforts – Estate Distributions

Estate distribution and closing efforts continue in several jurisdictions.

On April 14 the court approved a distribution of approximately $110 million dollars from the American Mutual Liability Company. This estate is in the process of resolving remaining open claims with the guaranty funds on long-tail workers’ compensation liabilities with a view towards closing in the near future.

The liquidator of Credit General Insurance Company and Credit General Indemnity Company obtained Court approval in mid December to distribute $19 million to be paid from the estate to guaranty associations for their administrative expense payments. The Credit General Companies, Ohio-domiciled insurance carriers, were liquidated in December of 2000 and January of 2001.

Missouri domestic Casualty Reciprocal Exchange (CRE) and sister company Equity Mutual Insurance Company (EMIC) obtained approval from the Court to distribute $16 million to the guaranty associations in June 2011.

On July 1, the California Insurance Commissioner filed papers seeking approval of a distribution totaling $114,477,048 from five California insolvencies, namely California Compensation Insurance Company, Combined Benefits Insurance Company, Superior National Insurance Company, Superior Pacific Insurance Company and Commercial Compensation Casualty Company. Funds will be distributed both to guaranty associations and to certain other claimants. These companies were placed in liquidation in 2000.

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Medicare Reporting and the "MARC" Coalition

The Medicare Secondary Payer provisions in Section 111 of the Medicare, Medicaid, and State Children's Health Insurance Program (SCHIP) Extension Act of 2007 impose information reporting requirements on insurance companies and other entities that provide payments pursuant to non-group health insurance plans, including liability insurance, self insurance, no fault insurance, and workers' compensation insurance plans.

The Medicare Advocacy Recovery Coalition (MARC) is a group formed to advocate for improvements in Medicare Secondary payer system. MARC is made up of a group of entities affected by the Medicare reporting requirements, including attorneys, brokers, insureds, insurers, insurance and trade associations, self insureds, and third party administrators. (Additional information is available on MARC's Web site at www.marccoalition.com.) The group also acts as a clearinghouse for letters of support submitted by other interested entities including the U.S. Chamber of Commerce and the American Association for Justice.

MARC is seeking support for HR 1063, federal legislation introduced in March 2011.

The key provisions of HR 1063 are:

- Improve the coordination of benefits process
- Bring finality to MSP claims
- Establish an appeal process for disputed MSP claim amounts
- Mandate an efficient and reasonable threshold amount for MSP claims
- Add a three year statute of limitations for MSP claims
- Create safe harbors for companies that attempt to comply with MSP laws
- Amend the reporting fine provision and establish a reasonable fine for "willful" reporting violations
- Reduce reliance upon social security numbers

Rehabilitations and Run-Offs

In some cases a state regulator will attempt to resolve a troubled company's claims by means other than a statutory liquidation. In these cases the guaranty funds are not activated. Proponents for alternative approaches cite orderly claims processing, low cost, and greater flexibility to achieve commercially acceptable results. However, the efficiency and cost-effectiveness of an alternative – versus a statutory liquidation – to our knowledge has never been established.

Probably the most well-known company in which this approach has been taken is the Lumbermens (formerly Kemper Insurance Companies) run-off.[1] Lumbermens Web site indicates "Lumbermens Mutual Group filed its first quarter 2011 financial statements (LMC financial statement - AMM financial statement) on Thursday, May 12, 2011. Lumbermens Mutual Casualty Company (LMC) posted a statutory surplus of $36.8 million as of March 31, 2011. American Manufacturers Mutual Insurance Company (AMM), a mutual company under common management with LMC, posted statutory surplus of $10.3 million for the same period." The company has reduced its liabilities from annual statement reported amount for 2003 of about $5 billion to about $825 million at the end of first quarter 2011.

Rhode Island has had a run-off law in place for several years. For the first time a proposal has been approved by the court for a commutation pursuant to the Rhode Island Statute. This matter involves assumed reinsurance business written by GTE Reinsurance Company Limited. GTE novated remaining non-related business and

[1] Per a press release dated June 29, 2010 Lumbermens Mutual Casualty Company and its affiliates have ceased the use of the name "Kemper Insurance Companies" and will continue winding up their operations under the trade name Lumbermens Mutual Group. Historically, Kemper has been the marketing and trade name for Lumbermens and its affiliates, including American Motorists Insurance Company and American Manufacturers Mutual Insurance Company. In connection with this change, Lumbermens Mutual Group today concluded the sale of its rights in the Kemper name to Unitrin, Inc.

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redomesticated its assumed reinsurance block to Rhode Island. A commutation plan was approved on June 25, 2010 that would “settle” the remaining liabilities of GTE. There is no direct insurance business involved.

On December 14, 2010, two creditors filed an objection to the implementation of the Commutation Plan, alleging that implementation of the Commutation violated the Contracts Clause of the United States Constitution.

By decision dated April 25, 2011, the court granted the Motion to Implement and overruled the filed objections.

On May 2, 2011, the objecting cedents filed a Notice of Appeal from the Court's April 27, 2011 Implementation Order.

Highlands Insurance Company, a Texas-domiciled stock, fire and casualty insurance company, was placed into receivership in November, 2003. In July 2008, the 250th Judicial District, Travis County, Texas, approved the Second Amended Plan of Rehabilitation. The rehabilitation plan calls for the special deputy receiver to manage Highland’s assets and liabilities and pay its claims without placing the company into liquidation. The plan also calls for the special deputy receiver to monitor the progress of the plan and to advise the court if at any time it appears there will not be sufficient assets to pay all claimants in full during the course of the run-off.

According to the special deputy receiver’s February 28, 2011 financial statement filed with the court, Highlands has assets of $220.6 million and liabilities of $401 million. The special deputy receiver continues to pay Highland’s policyholder claims.

It is expected that Highlands will remain in run-off under its Second Amended Plan of Rehabilitation Plan indefinitely, or until such time as it appears that the plan does not have sufficient cash to meet its claims obligations to all policyholders and claimants.

Frontier Insurance Company was placed into rehabilitation in October 2001. Since that time, the rehabilitator has been paying claims and has sought to see Frontier eventually returned to financial health. According to Frontier’s 2007 annual statement – the most recent financial statement available on the receiver’s Web site – Frontier had a negative surplus of $103 million.

In early 2010, Steven Poizner, the California Insurance Commissioner, filed a petition in the New York County Supreme Court seeking an order compelling James Wrynn, the New York Superintendent and rehabilitator of Frontier, to file a petition for the immediate liquidation of Frontier. In his petition, citing the company’s $90 million negative surplus, Poizner alleged that the eight-year effort to rehabilitate Frontier had failed, and that further attempts at rehabilitation were futile.

Following a hearing, the court declined the petition on the grounds the action must be brought against Wrynn in his official capacity as superintendent rather than as Frontier’s rehabilitator. However, the court issued an order compelling Superintendent Wrynn to develop and submit to the court for approval a plan of rehabilitation for restoring Frontier to solvency, including an assessment of how long continued rehabilitation efforts are expected to continue. The order also provided for interested parties to have an opportunity to comment on the proposed rehabilitation plan. Under the order, the plan of rehabilitation was to be filed by April 11, 2011. Counsel for the Superintendant requested and received an extension of time to file the rehabilitation plan by July 11, 2011. The Superintendant requested and was granted an additional extension until October 10, 2011.

Litigation in New Hampshire – Feds Seek High Priority Claim in Liquidation

Solis v. Home. On December 9, 2010, the United States Department of Labor (DOL) filed a complaint for declaratory relief in the United States District Court for New Hampshire against Roger Sevigny as liquidator of the Home Insurance Company. The complaint challenges a decision by the liquidator to assign Class 3 status to the DOL’s $2.7 million claim against the Home estate for unpaid assessments levied against Home under the Federal Longshore and Harbor Workers’ Compensation Act (“LHWCA”). Under the New Hampshire liquidation statute, Class 3 claims are defined as “claims of the federal government.” The liquidator does not expect to have sufficient

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assets to pay Class 3 claims – hence if the DOL prevails it will receive a distribution from the Home estate – if it does not it will likely receive nothing.

The DOL contends that its claims are entitled to treatment as Class 1 (costs and expenses of administration), or alternatively, as Class 2 (policy-related claims of the New Hampshire Insurance Guaranty Association, and any similar organization in another state.)

In its action before the federal district court, the DOL requested a judgment declaring that the New Hampshire priority statute is preempted by the LHWCA and that its claim is entitled to "absolute priority and must be paid in full before any other claims are paid." This would appear to place the DOL's position at odds with the U. S. Supreme Court's 1993 decision in *U.S. Department of Treasury v. Fabe* in which the court held that the government's claims against the Ohio liquidator were not entitled to priority over claims for the costs and expenses of administration, or claims of policyholders due to the reverse preemption granted by McCarran-Ferguson.

The DOL further contends that to the extent its claim against the Home estate seeks payment of assessments that were presented after the entry of the Home liquidation order, the DOL's claim is a claim for "costs and expenses of administration" of Home's estate and therefore should be treated as Class I. The DOL alternately contends that its claim against Home is the claim of an organization "similar" to a guaranty association, and therefore should be assigned to priority Class II. The case has been fully briefed and we await the court's decision.

To learn more…

More information about the property and casualty guaranty fund system is available on the NCIGF Web site at *www.ncigf.org*.

Look for an update of NCIGF's Insolvency Trends in January 2012.

The NCIGF is a nonprofit association incorporated in December 1989 and designed to provide national assistance and support to the property and casualty guaranty funds located in each of the fifty states and the District of Columbia.

National Conference of Insurance Guaranty Funds (NCIGF)
300 N. Meridian St.
Suite 1020
Indianapolis, IN 46204
www.ncigf.org

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