Legal Backgrounder

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202.588.0302

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DELIBERATIVE PROCESS NEEDED TO REFORM INSURANCE GUARANTY FUNDS

by

Roger H. Schmelzer and Mark D. Steckbeck

The state property and casualty insurance guaranty associations are statutorily created entities designed to pay certain policy claims owed by insurance companies who are unable to meet their policy obligations due to insolvency.[1] In a sense, guaranty funds act as an insurer for those insurance companies that become insolvent and are placed into liquidation.

Guaranty funds work closely with insurance receivers. Receivers are appointed by state insurance commissioners, subject to court approval. Acting on behalf of their commissioners, receivers assume control over the operations of insolvent insurance companies. Receivers play a role similar to that of bankruptcy trustees; they are charged with the responsibility of gathering the company's assets, paying its debts, and winding up its affairs. Together, insurance receivers and the guaranty funds comprise the state-based insurance insolvency system.

In recent years, some insurance receivers, along with other stakeholders, have asserted positions that, if upheld, would have the effect of enlarging the statutory role of the guaranty funds for the benefit of persons or entities not covered by state guaranty fund statutes. These efforts have taken various forms and can be grouped into two categories: expansion of the statutory definition of "covered claims" eligible for guaranty fund payment and reduction or delay in statutorily mandated reimbursements by the receivers to the guaranty fund. The result of either shifts a greater percentage of the insolvent insurer's claims costs to the guaranty funds and makes an increased sum of assets available for distribution to the "non-covereds," those persons or entities not covered by state statutes governing guaranty funds. These efforts, which are contrary to the legislative scheme expressed in receivership and guaranty fund laws, have led to greater instances of litigation between guaranty funds and insurance receivers, resulting in higher administrative costs for both groups, the cost of which is ultimately borne by the public.

This LEGAL BACKGROUNDER will examine some of the problems and implications raised by efforts to shift additional claims costs to the guaranty funds through non-legislative mechanisms and the reaffirmation of guaranty fund public policy through the judicial system. It will also suggest alternative approaches for minimizing these frictions within the state insurance insolvency system.

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[1]Property and casualty guaranty associations provide for payments for most lines of property and casualty business, including commercial liability, homeowners, and automobile. There is a separate guaranty system that provides protection for policies written by life and health insurers.

Roger H. Schmelzer is President & CEO of the National Conference of Insurance Guaranty Funds. **Mark D. Steckbeck** serves as Assistant Vice President of Legal Affairs & Assistant Corporate Secretary.

Background. Insurance companies are excluded from the federal bankruptcy system.[2] When an insurance company fails, it is generally placed into a state receivership proceeding overseen by a state court. The court appoints a receiver, generally selected by the state insurance commissioner, who plays a role similar to that of a bankruptcy trustee. In those cases where it is determined the insurance company is insolvent and cannot be rehabilitated, the company will usually be placed into liquidation, at which point the receiver becomes the liquidator.

Once an insurance company is placed into liquidation, the role of the liquidator is to administer the affairs of the insolvent insurer, marshal and invest the company's assets, pay and discharge its obligations, adjust policy claims, and carry out the winding up of the insolvent company's business. Assets must be distributed to the company's policyholders, claimants, and other creditors in accordance with a statutorily mandated priority distribution scheme. The highest level of claims is the receiver's administrative expenses and certain guaranty fund administrative expenses. The next class includes insurance policyholder level claims. These include direct policyholder claims including those policy claims paid by the guaranty funds.

The state property and casualty insurance guaranty fund system came into existence in the early 1970s in response to calls for a federally mandated national guaranty association. Prior to that time, policyholders and claimants submitted their claims to the insurance receiver and then waited for payment, a process that could take up to several years or longer and would usually result in only a partial recovery.

The system of state guaranty funds was created to address three primary concerns: the loss of insurance protection, the insufficiency of funds, and the delay in payment due to the insurer's financial condition.[3] Since their inception, the property and casualty guaranty associations have paid out over $21 billion to affected policyholders.[4]

Where Guaranty Associations Get Their Funding. As a condition of holding a license to conduct the business of insurance in each state, insurance companies are required to pay assessments to the guaranty associations. In most states, these assessments are capped at 2% of the company's net premiums written in the year prior to the assessment. Historically, these assessments have provided approximately 2/3 of the money collected by the guaranty associations. The remaining 1/3 has come from reimbursements from the estates of insolvent insurers whose claims were paid by the guaranty associations. Insurance companies that pay these assessments are permitted to recoup these amounts through one of three methods, depending upon the state: through increased premiums, premium surcharges or an offset in the company's state premium taxes.[5]

Scope of the Guaranty Funds. Early in the development of the guaranty fund system, it was recognized that the cost of paying all claims of the insolvent insurance companies would be cost prohibitive and that it would be necessary to devise an allocation scheme to maximize the recovery available to those believed to be most in need, leaving others to seek recovery from the insurance receiver. Drafters created a system that allowed payment of most claims quickly by the guaranty association, while limiting or excluding coverage under the guaranty fund law for others. Thus, the guaranty funds were designed as a safety net for those most in need, and not as a complete back stop for all policy obligations of the insolvent insurer.

These policy choices were reflected in the National Association of Insurance Commissioner's (NAIC) Post-Assessment Property and Liability Insurance Guaranty Association Act, a version of which has been adopted by nearly all states. With some slight variation from state to state, the guaranty funds cover claims

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[2] 11 U.S.C. § 109(b).

[3] *See* The U.S. Guaranty Association Concept at 25, Christopher J. Wilcox, J. OF INS. REG., Spring 1996, Vol. 14, No. 3.

[4] Source: National Conference of Insurance Guaranty Funds.

[5] Through this recoupment process, although the insurance industry advances the initial funding to pay for the guaranty fund's claims and administrative expenses, it is ultimately the policyholders and taxpayers who pay these costs. Therefore, lower guaranty fund costs translate to smaller assessments and lower eventual costs to the public. Similarly, the greater the portion of funding that comes from reimbursements from these insolvent companies' estates, the smaller the amount that must come through assessments.

arising under most lines of insurance, paying the lesser of the policy limits or $300,000, or in the case of workers' compensation, the full amount of benefits as defined by the states' workers' compensation statutes.

Most state guaranty funds exclude coverage for punitive damages, amounts due to other insurers or reinsurers, insurance pools, or for persons whose net worth exceeds a certain level, typically $25 million. Guaranty funds do not apply to risk retention groups and certain other insurance lines where there are federal programs in place, for example, flood or crop insurance.

Challenging Times. Recent years have seen some stresses within the state insurance insolvency system. Innovative new products utilizing large deductibles[6] and the more frequent use of assumption transactions[7] not contemplated at the time the guaranty fund laws were written have led to a greater awareness that the current guaranty association statutes do not cover every person or business entity impacted by insurer failure.

The late 1990s and the early part of this decade saw a rash of very large commercial insurance insolvencies with widespread impact and intense guaranty fund activity. This has given rise to a legitimate question of public policy: who exactly *should* be covered by guaranty fund law?

Failure of state statutes to adequately address a dynamic property/casualty insurance marketplace has led to disputes between some insurance receivers and guaranty funds over the guaranty funds' and receivers' respective responsibilities toward these individuals. These disagreements have resulted in litigation over a number of issues regarding the scope of guaranty fund coverage and over the timing and conditions of reimbursements owed by insurance receivers. Until state legislatures address these issues, guaranty funds and receivers are bound by the original statutory language.

That said, a source of disagreement between insurance receivers and guaranty funds as to their respective roles and obligations is that their duties are derived from the statutes themselves; the receiver's s role is governed by the state's liquidation act, the guaranty association's role is defined by the state's guaranty association act – hence there are two different statutory models in play – one for the receiver of the insolvent estate, one for each state guaranty association which is triggered by the insolvency.

These statutes define their respective duties differently, although not necessarily in conflict. The fundamental difference is that receivers' duties are defined very broadly (to the extent they are defined at all) while guaranty fund duties are very narrow and specific.

Insurance receivers are charged by law with a broad fiduciary obligation to maximize the recovery for the benefit of *all* creditors. Due to the very nature of insurance company insolvencies, which typically involve a myriad of complex legal claims, and financial issues, insurance receivers must have, and are generally granted, substantial discretion as to how they manage the day-to-day operations of the receivership. This discretion allows a greater degree of flexibility as they manage the company's assets and liabilities.

In contrast, guaranty funds are charged with a very specific mission: to promptly pay "covered claims" as defined by their enabling statutes. They have no duties or obligations with respect to claimants who fall outside this statutory charge.

One set of statutory duties is not superior to the other. They are intended to work in a complimentary fashion to address the comprehensive public policy impact of insurance company failure. While these missions do not necessarily conflict, these different duties and perspectives can lead to disagreements if a receiver, in an effort to mitigate losses caused by insurer insolvency, fails to recognize the limited statutory role of the guaranty funds.

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[6] A large deductible policy is an insurance contract where the financial risk of the insurance is allocated by agreement between the insurer and the policyholder. A "large" deductible is typically in excess of $100,000.

[7] Assumption transactions includes policy obligations transferred from one entity to another through any of a variety of mechanisms including assumption reinsurance agreements or mergers.

Examples of such problems became evident in the liquidation proceedings of Reciprocal of America, a Virginia domiciled reciprocal insurer ordered into liquidation in 2003.[8] In these proceedings, the deputy receiver and the guaranty funds on several occassions have resorted to litigation to resolve questions over the rights of the guaranty funds relative to those of certain other claimants. These disputes reflect a fundamental difference in how the receiver and the guaranty funds interpreted the same set of statutes. The guaranty funds applied their enabling statutes as written in determining that certain claims were "covered claims" while others were not. The deputy receiver, on the other hand, in evaluating the plight of the non-covered claimants, sought to apply a more liberal interpretation that would have extended guaranty fund coverage to persons outside of the statute's provisions. Guaranty funds view this approach as irreconcilable with the existing statutory scheme and the clear, unambiguous definitions of what the guaranty funds cover that are included.

Lessons Learned. Regulatory efforts to reduce the severity of losses incurred by all claimants of the insolvent insurer serve a laudable objective. It reflects the desire to be responsive to citizens for the failure of a corporate entity. However, challenges to the multi-state insolvency system could have the effect of eroding property/casualty guaranty fund laws in all states. Fortunately, the courts have generally not given in to an expansive interpretation and have upheld the property/casualty insurance guaranty fund statutes as written.

When the guaranty fund system was created by statute more than 35 years ago, it was intended to serve as a limited backstop to protect consumers from insurance company failures that inevitably arise in competitive markets. Perhaps more importantly, it made a powerful public policy statement about the sanctity of the insurance contract. What was not intended however, was for the guaranty fund system to become a source of funds from which broader relief can be drawn.

The basic framework on which the current guaranty fund system is based reflects its authors' best judgment of how the system should work to provide the best protection for the most people in a sustainable manner and at a reasonable cost. Since its original enactment states have, as one would expect, made numerous changes to limit, expand, or clarify the scope of the state guaranty funds.

Shifting additional claims liabilities to the guaranty funds is contrary to the insolvency scheme envisioned by the NAIC Model Acts and the express will of the state legislatures that adopted versions of these acts. If the nationwide system of state-based insolvency laws is to operate in a cohesive and effective manner, participants must be able to rely upon the presumption that similar laws will be interpreted similarly in all states. Without this ability, neither insurance receivers nor guaranty fund managers will be able to effectively carry out their respective roles, and the efficacy of the state-based system will be compromised.

Conclusion. It is only logical that a system created in the late Twentieth Century should undergo change to remain current with the market and prevailing public policy priorities. The National Conference of Insurance Guaranty Funds' Board of Directors has suggested a number of public policy modifications to state laws that would strengthen the system in pursuit of its original mission. Sensible and well-reasoned policy choices will help limit disagreements within the system related to who is covered and who is not, and who will ultimately pay for the safety net the property/casualty insurance guaranty fund system provides.

However, as stakeholders identify the need for change, their proposals must undergo the same transparent, deliberative process that resulted in the original design of the system. Only individual state legislatures acting upon persuasive, balanced and well reasoned policy choices can make these judgments. Until they do, state regulators, insurance receivers and guaranty funds are obligated to execute the laws as intended and written.

[8]Virginia State Corporation Commission Case No. INS-2003-00239.

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