Trends in Insolvency – 2006

An Annual Publication of the National Conference of Insurance Guaranty Funds

Welcome to the first annual *Trends in Insolvency.* This publication is designed to provide an update on recent events in insolvency law and practice and a look ahead at what is on the horizon.

IRMA takes many forms

The Insurer Receivership Model Act (IRMA) was adopted by the NAIC as its new model liquidation act in December 2005, a move that came in the face of much controversy with concerns expressed by various parties regarding certain provisions of the model.

In 2006 the first IRMA bill was introduced in Delaware late in the 2006 legislative session.[1] While the bill was at first characterized as a "technical change," some industry lobbyists were having none of it. Heavy debate ensued, most notably between the local regulator and the American Insurance Association, who were not able to agree to appropriate large deductible language to be added to the IRMA bill.

Even though the department had made a number of changes correcting many of the flaws embodied in the IRMA model, disagreement over large deductible eventually squelched the 2006 effort. A draft has been floated for 2007; as of this writing nothing has been introduced.

The next state to put a bill into play was Utah. This draft revision to the Utah liquidation act was first presented to the Business and Labor Interim Committee, a group that meets off-session in Utah. Bills winning a "thumbs up" from the Interim Committee typically sail through the general session with little friction.

However, the Interim Committee soon became aware the presented draft was provoking controversy; it declined to cast a vote in its favor.

Rep. Jim Dunnigan led a task force that met several times to "fix" the bill. This task force made a number of positive revisions. The biggest struggle was centered on whether the bill would have a large deductible provision at all, and what that provision would look like.

Ultimately, Utah adopted a deductible provision that more closely resembled the "Arkansas version" deductible approach (Note: more about this appears in the NAIC update section below). A new liquidation act was adopted early in 2007. While touted by some to be the second IRMA bill enacted in the states, the Utah legislation too had so many variances from the IRMA model that it could only be considered to be a distant cousin.

In Pennsylvania, a draft was floated in 2006 giving rise to anticipation that a bill would be dropped sometime in 2007.

[1] Some will say the pre – IRMA adoption of the new liquidation act in Texas was the first IRMA to become law in the states. However, the Texas law was passed long before IRMA was finalized. There were many changes to IRMA after the Texas enactment, and much was different in the Texas law.

It is important to understand the pivotal role Pennsylvania has played at the NAIC deliberations on IRMA and on the large deductible issue.

Pennsylvania regulator Frank Martin chaired the NAIC Working Group that drafted the IRMA. After more than four years of painstaking drafting, redrafting and even "undrafting," as he called it in times of extreme frustration, Frank rightfully considers IRMA his daughter. Moreover, Pennsylvania was the original home of the large deductible debate, with significant money at stake in the Reliance and Legion insolvencies. For both these reasons, the local regulator was especially eager to get an IRMA bill through in the Keystone state.

Interestingly, the Pennsylvania drafts we have seen contain large deductible language – conspicuously absent from legislation first floated in Delaware and Utah. Industry is looking at the Pennsylvania language now. If past history is any indication of what may happen, the Pennsylvania bill will undergo serious extensive revision before it will gain any viability in the state legislature.

Currently, these are the only states where IRMA bills are being considered. It's difficult to say whether the three 2006/2007 states are an indication that wholesale revision to liquidation acts is going to catch on countrywide, or, conversely, whether these states are the only ones where the regulator is really so enamored with IRMA that he or she wants it in his or her state.

Large Deductible at the NAIC and in the states

High-spirited debate continued at the NAIC throughout 2006 on the appropriate large deductible language to be added to the IRMA model. Two approaches were in play – the "Arkansas approach" which called for the deductible recoveries and collateral draw-downs to be remitted to the guaranty associations at 100 percent to the extent of their claim payments, and the "Delaware approach," which made the deductible recoveries and draw-downs general assets of the insolvent estate.

The last round of substantive discussion took place at the Insolvency Task Force meeting at the December 2006 NAIC. There several interested parties, including trade associations and guaranty association representatives, spoke in favor of the Arkansas approach. Others advocated the Delaware approach. The Delaware approach was voted up by the Task Force, and adopted by E Committee the following day. Final adoption by the NAIC took place at the March 2007 meeting. The five minute presentation by Al Gross, followed by a vote to adopt, was almost anti-climatic after such a contentious action-packed history.

So far, the welcome accorded to large deductible in the states has been much different. In 2006 Michigan became the fifth state to adopt large deductible language modeled after that in the NCIGF Board Task Force package. Substantively, the Task Force language calls for the same result as the "Arkansas approach" – that is: the assets flow to the guaranty associations at 100 cent dollars.

Michigan joined Pennsylvania (effective 2004), Illinois (effective 2004), Texas (effective 2005) and California (effective 2006), and was soon followed by Utah in early 2007.[2]

IRMA and Accreditation

The IRMA topic cannot be closed entirely without some discussion of the effort to make certain provisions of the IRMA accreditation standards. This effort began in the Model Act Revision Working Group – perhaps as a reaction to the non-adoption of the 1995 Model Liquidation Act by the vast majority of states. Shortly after IRMA was adopted by the NAIC, discussions commenced in the Receivership Law and Intergovernmental Working Group on what particular provisions of IRMA should be made accreditation standards.

While some considered the original goal of the accreditation effort an attempt to force undesirable liquidation act provisions on the states, the discussion soon evolved in a very different and surprising direction. Some rumblings were heard among the regulator group members themselves with concerns about various provisions of IRMA and how, while the provisions may be all well and good for the NAIC model, they were perhaps not the best thing for their states.

Eventually, the Working Group provided a list of suggestions to the Financial Regulation Standards and Accreditation (F) Committee (FRSAC), stating, in effect, "If you are going to do this, here are some good sections of IRMA to make accreditation standards." The Working Group did not opine on whether a "substantially similar" test should be in play.

Enter the legislators

Before the close of Insolvency Task Force deliberations, the National Conference of Insurance Legislators (NCOIL) got wind of the accreditation effort and weighed in – strongly. First, NCOIL adopted a resolution soundly opposing any effort to make specific IRMA language accreditation standards. The debate reached FRSAC in March of 2007 where the NCOIL Vice President, Rhode Island Rep. Brian Kennedy addressed the group, scolding the NAIC for its efforts to usurp the authority of the state legislatures.

Any NAIC process is fraught with unpredictability. However, the use of the word "hot potato" during the FRSAC deliberations at the March NAIC may be an indication that regulators have lost any appetite they ever had to force IRMA on legislators.

For those with keen interest in this issue, comments are invited by FRSAC on whether specific IRMA language should be made accreditation standards. Comments are due on May 7.

The Guaranty Fund Acts – NAIC and Elsewhere

Soon after completing the IRMA, the Model Act Revision Working Group turned its attention to the Model Property and Casualty Guaranty Association Act.

[2] Related law is in place in New Jersey where the workers compensation guaranty fund has the right to pursue the deductible recoveries.

Heavy debate ensued over covered claim limits, bar dates, scope of coverage and net worth. Most disturbing was the elimination of long standing provisions in the Act calling for the liquidator to be bound by the settlements of the guaranty funds. The regulators struck this provision; their feeling was it was appropriately addressed in the IRMA. That would have been all well and good if the IRMA preserves the concept. It does not. The lack of language addressing this issue in the guaranty fund model along with bad language in IRMA could permit some to assert that guaranty fund claims determinations could be revisited by the liquidator.

Net worth is still in the draft, but teetering on the brink of extinction, a fact that's interesting given 36 states now have a net worth of one form or another in their guaranty association acts.

The Covered Claim Cap

At the behest of the Working Group Chair (Frank Martin-PA), a covered claim cap of $500,000 was drafted into the model. Frank was not alone in his sentiment that the longstanding cap of $300,000 was insufficient considering the changes in the economic environment since it was first put in to place.

A New Jersey court, while upholding the current $300,000 claim cap in its decision, opined in dicta that perhaps that cap should be altered. [3] This was quickly followed by legislation proposing an increase in the claim cap. While the bill has not been enacted, it still appears to be viable in the 2007 session.

Probably more as a result of hurricane season than the rumblings in New Jersey or at the NAIC the cap in the FIGA act for homeowners claims was increased to $500,000 during the 2006 session.

Whether this idea will catch on in a big way remains to be seen. Certainly there have been some discussions in other states. Whether those discussions will prompt introduction of bills is anyone's guess.

State Law Amendments

Michigan Act

Amendments to the Michigan guaranty fund act and liquidation act were signed in to law on September 15. This package of amendments is a very positive development for Michigan and other states that may have claims in a Michigan insolvency proceeding:

Notably the liquidation act amendments include the following:

- Revisions to permit the guaranty association to receive confidential information regarding a supervision proceeding
- A large deductible provision patterned very closely to the NCIGF model
- A strengthened early access provision

[3] See Johnson v. Braddy, 890 A. 2d 944 (N.J. 2006)

Guaranty fund act amendments include the following:

- A provision giving the guaranty association the right to obtain claim records in the custody of a TPA
- A provision giving the guaranty association the two-part trigger language embodied in the NCIGF model – that is an order of liquidation with a finding of insolvency.
- New net worth language excluding first and third party claims of insureds with net worth of 25 million or more.

Massachusetts Net Worth

Massachusetts recently adopted a net worth provision. This provision was modeled after language drafted in the NAIC model property casualty guaranty association act that is still on the table at the NAIC.

While the language may not survive at the NAIC, net worth statutes are part and parcel to most state guaranty fund acts – at last count 36. We would not be surprised to see more states adopt a net worth provision in 2007 and beyond.

Insolvencies, [In]Solvent Run-offs and Rehabilitations

Highlands

Highlands Insurance Company has been in receivership since 2003. Since then, the special deputy receiver has continued to pay claims. In July 2006, the special deputy receiver petitioned the court for approval of a Plan of Rehabilitation under the recently enacted Texas receivership statute modeled on IRMA. The proposed plan, which was in fact a runoff plan in so far as there was no intention to restore the company to financial health, was opposed by numerous large insureds who believed their interests would be better served if Highlands were placed into liquidation.

On April 18, 2007, the special master issued his recommendation denying approval of the Plan of Rehabilitation. The deadline for parties to file objections to the special master's recommendation is April 30, 2007.

Vesta

Vesta and its Texas subsidiaries were placed into liquidation in June 2006 following an unsuccessful attempt to arrange a sale of the companies to outside investors. When the sale of the company did not go through, the Texas Department of Insurance immediately placed Vesta and its subsidiaries into liquidation, leaving NCIGF and the guaranty associations with little time to prepare for UDS records and to arrange for the orderly transfer of claims files.

The process was further complicated by the fact most of the company's claim files were imaged and only a handful of the guaranty associations were set up to accept imaged files.

Although the special deputy receiver and guaranty associations were able to develop alternative methods to allow access to the claim files, most associations did not receive their files for three to four weeks after they were triggered.

Vesta is also proving a challenge for the special deputy receiver who is attempting to unwind numerous internal financial transactions among the Vesta subsidiaries. According to the SDR, difficulties in unwinding these transactions and properly allocating assets and liabilities among the Vesta subsidiaries has resulted in delays in his initial early access calculation.

Frontier

Frontier has been in rehabilitation since 2001; it continues to pay claims.

Kemper

Kemper continues on an even keel. Helping its continued successful operation in run-off status was the release of funds on deposit from California and other state totaling $436 million in the 2005-2006 timeframe. While we continue to monitor the situation, things appear to be running smoothly for now.

Run-Off Statutes

Proposals have been floated in a handful of states to enact run-off statutes. Typically, these proposals will statutorily permit the truncation of various creditor rights without their express consent. Creditors are segregated into various classes and permitted to vote their approval or disapproval of a plan to deal with their claims against the insurer.

In April of 2006 the "Final Report of the Special Task Force on Insurance Company Run-Off and Reorganization" was issued. The reporter for the Task Force was Hal Horwich, an attorney at the law firm Bingham McCutchen. This report observes that companies in run-off "span the spectrum of financial impairment from marginally solvent to substantially solvent. Regulators have a well-developed set of receivership laws with which to handle the problem of the insolvent companies. However there is not a coherent and clear set of laws and regulations that deal with run-off companies which are not clearly insolvent." The report goes on to opine that policyholders of such companies, if they are to have their rights impaired, would like to vote on the plan that creates the impairment. [4]

Mr. Horwich was also a proponent of "solvent run-off" legislation floated in Connecticut during the 2005 legislative session. Little momentum was garnered for another bill in 2006 or 2007 in this state.

However, there still may be some interest in solvent run-off schemes. Recently in Rhode Island, amendments were proposed to the "voluntary restructuring" law on the books. The law has been in place for several years, but to our knowledge was never used.

We speculate that there now may be some interest given the fact a proposal is being floated to, among other things, suggest that guaranty association coverage survives if a company is

[4] Harold S. Horwich, *Final Report of the Special Task Force on Insurance Company Run-Off and Reorganization.*

formed or reactivated solely for the purpose of restructuring under this statute. In reality, the law change can't do much beyond impact the local Rhode Island guaranty fund, if that, but it is interesting that the restructuring statute is now getting any attention.

Early Access becomes a popular concept

We are now winding down from a time of rather intense insolvency activity. Essential to the continuing ability of the guaranty funds' ability to fulfill their statutory duties during the busiest times were some sizeable distributions that were forwarded from some of the larger estates. To date, Reliance has pushed out about $1.3 billion to the guaranty funds in early access and other distributions. Fremont has reimbursed loss payments in full quite regularly. We've also received some sizeable distributions from Home, Superior National, PHICO and others.

Receiver support during these busy times has been appreciated by the guaranty fund community.

Early Access in Reciprocal of America

Although the use of the work "early" might be questionable, it appears that more than three years of wrangling between the deputy receiver and the guaranty associations has finally brought something resembling an early access distribution in ROA.

Competing versions of early access plans were submitted to the court after attempts at negotiation were unsuccessful. On March 15, 2007, the court issued a Final Order in which it ruled upon the various issues keeping the parties apart.

Among the issues decided in favor of the guaranty funds were: liquidating distributions (as distinguished from early access distributions) were *not* subject to clawback; initial early access distributions would be based on UDS records rather than a detailed review of all claim files; reimbursement of guaranty fund administrative expenses would be treated separately from early access distributions; and guaranty funds could not be forced to waive any appeal rights as a condition of obtaining early access.

The court decided in favor of the deputy receiver on two significant issues: allocated loss adjustment expenses including attorney defense costs would be treated as policyholder level claims rather than as administrative expenses. The court also ruled that it has the authority to determine whether a claim settled by a guaranty association is, in fact, "covered." It remains unclear whether this latter ruling means the court believes it has the right to determine what constitutes a "covered claim" under the various states' guaranty fund statutes, or whether the court is saying it has the power to make coverage determinations under policies issued by the insolvent insurer. Barring an appeal by one or more of the parties, it is anticipated the deputy receiver will proceed with the early access distribution.

New York Case on Right to Audit: New York Liquidation Bureau audit

The Supreme Court of New York, Appellate division, in the matter of Serio v. Hevesi, recently ruled that the state comptroller had the authority to perform an audit of the official

accounts and monies of the Liquidation Bureau of the New York State Insurance Department.

The comptroller had previously issued subpoenas seeking information regarding insurance companies under the bureau's supervision, and to determine whether the financial management and operating practices of the bureau were effective. The bureau objected to the subpoenas and moved to quash them. The New York Supreme Court ruled in favor of the bureau. The comptroller appealed and the Appellate court reversed, holding that the comptroller had statutory authority to conduct audits of the superintendent's handling of the dissolution of rehabilitation of distressed insurance companies, and to review the bureau's internal financial controls and management procedures. The Appellate Court rejected the bureau's argument that is not a state agency, reasoning that the bureau performs a governmental or proprietary function for the state, and is therefore a state agency under New York's State Finance Law.

A dissenting opinion argued that the superintendent *as liquidator* is not a state officer and the liquidation bureau is not a state agency, and not subject to audit by the comptroller.

Some maintain the decision would undermine the Supreme Court's authority to supervise liquidating proceedings and the Bureau could be subject to various spending restrictions applicable to state agencies, including pre-approval of contracts in excess of $50,000 and pre-auditing of any expenses before payment. The bureau is considering whether to appeal the decision.

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, Puerto Rico and the District of Columbia.

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