Insolvency Trends – 2010
An Annual Publication of the National Conference of Insurance Guaranty Funds

Welcome to the 2010 edition of Insolvency Trends. Authored by the legal and public policy staff of the National Conference of Insurance Guaranty Funds (NCIGF), this paper provides an update on recent events in insolvency law and practice and a look ahead at what is on the horizon in the coming year.

Property and Casualty Guaranty Funds: Built to work for 40 Years

Forty years ago the property and casualty guaranty fund system was built to work; it continues to work today.

In the late 1960s policymakers and the insurance industry created the property and casualty guaranty funds to address a public policy imperative: to provide a safety net that addresses the needs of personal insurance consumers if an insurance company fails.

To accomplish this, policymakers developed a nationwide system of insurance guaranty funds. The statutorily created guaranty funds draw on a combination of the insolvent company's remaining assets and industry assessments on healthy insurers in each state to seamlessly step into the shoes of a defunct company's claims department and pay the covered claims of policyholders and claimants, who otherwise would likely be adversely impacted by the insolvency of the insurance company.

Today, the guaranty fund system remains true to its original intent: to work to deliver protection to those least able to weather the impact of an insurance company insolvency.

On Capitol Hill

For the guaranty funds, 2009 was an active year in Washington D.C.

As 2009 dawned, questions and predictions about the future of financial services in the United States were in no shortage. As

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

the federal government acted to shore up an uncertain marketplace, consumer protection took on newfound significance. For this reason, attention was directed to the guaranty fund system.

Members of Congress and their staffs, officials at the Federal Reserve, Department of Treasury and the FDIC sought information from the NCIGF, a provider of assistance and support to the nation's property and casualty guaranty fund system. The NCIGF, along with the National Organization of Life & Health Insurance Guaranty Associations (NOLHGA), NCIGF's counterpart on the life and health side, met throughout the year with lawmakers and administration officials to answer questions about the system.

By year's end, the U.S. House of Representatives passed a bill that if enacted essentially recognizes the system as the preferred way to help resolve an insurance company failure.

In the Trenches – Report on Active Estates

According to a recent A.M. Best article 1 "Insurance company impairments for both life/health and property/casualty writers are up by at least 30% compared with 2008. At least 20 insurers became impaired this year, up from 15 in 2008 and 14 in 2007. It can be difficult to track impairments because sometimes regulators take a financially troubled company under confidential supervision in an effort to save it." Note that an "impairment" would not necessarily trigger a property and casualty guaranty fund to undertake claim payments. However, the property casualty guaranty funds did see their share of new activity in 2009.

In Florida, for example, as of November 2009, two Florida property and casualty insurance companies were found insolvent and are being liquidated. American Keystone Insurance Company was a residential property insurer. First Commercial Insurance Company and its subsidiary wrote various commercial coverages. Earlier, in October, a Georgia workers' compensation insurer, Southeastern U.S. Insurance, was placed into liquidation.

In November, several guaranty funds were preparing to undertake responsibility for a small workers' compensation insolvency involving large deductible coverage and Professional Employer Organization (PEO) insureds. In the case of Park Avenue Property & Casualty Insurance Company, the Oklahoma regulators had to act quickly and decisively due the conditions of the estate. The company was liquidated with no prior notice to the guaranty funds (or the freshly appointed deputy liquidator for that matter). The guaranty funds and the receiver are now hard at work to transition the files with minimal disruption of ongoing benefits to injured workers.

Any insolvency brings with it its unique complications. This one involved many issues related to data conversion and electronic files. The Park Avenue insolvency did much to identify the need for proven and tested electronic systems to ensure quick and secure transfer of insolvency-related claims information between guaranty funds and receivers. As the Park Avenue insolvency well illustrates, in modern insolvency practice, data is a key consideration. While small in number of claims, this situation is a case study in why it is important to keep the guaranty fund safety net in place and "ready to roll" literally at a moment's notice.

There is a growing trend to close some of the larger estates ordered liquidated in the early 2000s or before. Notably the Commonwealth Court of Pennsylvania has rendered a final bar date order in PHICO – a large medical malpractice insolvency which occurred in 2002. Remaining operations have been moved out of the

[1] A.M. Best Web site edition. "Impairments for Life/Health and P/C Up by at Least 30%" 12-21-09

old PHICO offices in Mechanicsburg, PA and into the Pennsylvania insurance department. To date the estate has distributed almost $300 million dollars to the guaranty funds in early access.

The California Conservation & Liquidation Office (CLO) has indicated it is undertaking similar efforts. The CLO has completed five final distributions in the last two years and anticipates completing two more in 2010. All seven of these estates are expected to be judicially closed by year-end 2010. In addition to these closure estates, the CLO has distributed in excess of $2.7 billion in early access payments and final distributions over the past five years as the organization works to position large insolvencies such as the Superior National estates, Fremont and the Mission estates for closure in the next couple of years.

In Illinois, the liquidator reports seven estates were closed in 2008, with distributions totaling $9,408,359, and another five in 2009, with final distributions totaling $96,338,423. Early access distributions to guaranty funds totaled $17.4 million in 2008 and more than $14 million in 2009. Illinois plans to close at least four more estates in 2010.

The American Mutual Companies (American Mutual Liability Insurance Company and American Mutual Insurance Company of Boston) will also wind down soon. In a recent status report the liquidator states that if a proposed commutation is approved by the court the only remaining reinsurance recoveries will total less than $2.5 million. Estate staff has completed the claim determination process and claims are being submitted to the court for allowance and disallowance. The plan is then to make a significant distribution to Policy Class 2a (workers' compensation policy claims). This would leave only claims of the federal government, if any, and collection of the relatively small reinsurance balance.

Ohio has also taken action in this regard. Recently the liquidation court judge approved an order to distribute an additional amount of almost $74 million dollars in final distributions to Class 2 (policyholder class claimants) in the PIE insolvency.

The liquidator of Transit Casualty Insurance Company (a Missouri domiciled company) is seeking to close the estate in 2010. Transit Casualty has been in liquidation since December 3, 1985. Transit was domiciled in Missouri and was licensed in all fifty states. The company wrote in multiple commercial lines of business including workers' compensation, commercial auto, and general liability. Transit had exposure for asbestos and environmental claims, among many others.

The Transit liquidation court issued a proof of claims bar date of December 31, 1987. Any claims filed after December 31, 1987 were deemed post-bar date or late-filed claims under Missouri Statute 375.1206 and Rule 75.06(b). This permitted the liquidator to consider and allow these late filed claims in his absolute discretion under certain conditions, provided that doing so would not prejudice the orderly administration of the estate. In an October 31, 2000 Order, as the estate was readying to close, the liquidation court also established March 15, 2001 as the final cut off date for the presentation of any additional claims and additional evidence in support of claims.

As of early 2010, Transit has only a handful of remaining claims, the majority of which are Post Bar Date claims. It is expected that in order to close the estate in 2010, the liquidator will seek yet a further court order to terminate any remaining and future Post Bar Date claims, to the extent they were not already terminated by the October 2000 order, on the grounds that having to address these claims while attempting to wrap up the estate's final affairs will prejudice the orderly administration of the liquidation. In the words of the Missouri

Supreme Court – which recently issued a ruling on the subject of Transit's October 2000 claims bar date – "the curtain has fallen."

Once there is a determination on the status of the remaining claims, it is expected the liquidator will make a final distribution to the guaranty funds and other policyholder level creditors early in 2010, and a smaller final distribution in late 2010 or early 2011.

Meanwhile at the NAIC….

While the guaranty funds, in partnership with the liquidators of insolvent estates, grapple with new activity and receivers the NAIC adopted new model acts for both the property casualty and life and health guaranty funds in 2009. While to date there have not been major overhauls of the property and casualty acts being proposed in the state legislatures based on this model, there is some interest in the increased covered claim cap level of $500,000 recommended by the NAIC. Recent hikes include Connecticut (to $400,000), Rhode Island (to $500,000) and Vermont (to $500,000). Amendments are being proposed to raise the cap to $500,000 in Illinois and Iowa. The NCOIL model property and casualty guaranty fund act is also in play with policymakers also considering the provisions of this model when amending their states' laws.

The NAIC also continues to vet its Insurer Receivership Model Act (IRMA). Most recently a task force has been formed to identify "critical elements" of IRMA that all jurisdictions should have on their books.

The NAIC is close to adopting a white paper written by the Restructuring Mechanisms for Troubled Companies Task Force. This task force, which reported to Financial Condition (E) Committee, was charged with evaluating the advantages and disadvantages of various alternatives to placing insolvent companies into liquidation. The paper was intended to provide regulators a tool to assist them in evaluating the advantages and disadvantages of various alternate mechanisms to liquidation, including runoffs and UK style schemes of arrangements. The NCIGF participated in the deliberations and offered written and oral comments that focused attention on the need for regulators to consider the public policy objectives behind the alternative mechanism and be certain that the interests of policyholders and consumers were placed above the interests of general creditors and investors.

The NCIGF's comments are reflected throughout the NAIC's white paper and are summed up in its concluding paragraph:

> *First and foremost, it is the responsibility of regulators to protect insurance consumers. Thus, proponents of alternative mechanisms for troubled insurers should be pressed to prove to the regulator's satisfaction that the claims of greater efficiency or flexibility will not be used to strip policyholders and claimants of their policy rights so that value can be returned to investors. And regulators should ensure all alternative mechanisms for troubled insurers place the interests of consumers ahead of other competing interests, coupled with a clear statement of goals and objectives and a meaningful oversight mechanism.*

The Task Force and the E Committee adopted the final paper at the December 2009 NAIC meeting in San Francisco. We expect it to be adopted without further substantive change by the Commissioners at an upcoming NAIC meeting. Once final, the white paper is expected to be made an appendix to the NAIC Troubled Company Handbook.

The NAIC is also working through accounting issues related to guaranty fund assessments. Adopted in 2001, SSAP No. 35 requires an insurer to record a liability for guaranty fund assessments for the ultimate loss expected from insolvent insurance estates as of the date the insolvency/liquidation occurs. The insurance companies have experienced great difficulty getting enough current information to calculate the ultimate expected assessment exposure. A survey performed by industry in 2006 indicated that property and casualty insurers did not appear to have any consistency in their estimates in applying the current SSAP 35 guidance.

The AICPA SOP 97-3 takes the approach that two events must occur to trigger liability for post-insolvency assessments: 1) the insolvency itself and 2) the writing of the premium in the base year for guaranty fund assessments. The liability to be recorded is what can be reasonably estimated and relates to premium writings for the year preceding the year of assessments. This estimate coincides with the way the majority of guaranty funds make assessments, which is also based on premiums for the year preceding the year of assessments.

NAIC's SSAP 35 Subgroup of the NAIC Statutory Accounting Principles Working Group has been considering revisions to SSAP 35. The NCIGF provided substantial input in the process. At this point an issue paper has been prepared and exposed for comment. The draft contemplates replacing SSAP 35 and adopting SOP 97-3 with certain limitations that would be carried over from SSAP 35 (requirement to report assessment in Taxes, Licenses and Fees and the Recognition criteria from SSAP No. 5 – Liabilities, Contingencies, and Impairments of Assets.)

It is expected that the NAIC Statutory Accounting Principles Working Group will adopt the change to SSAP 35 in summer 2010; the change will then become effective later that year.

Rehabs and Run Offs

Highlands Insurance Company, a Texas domiciled company, continues in runoff. Under the court's June 2008 order approving the Second Amended Plan of Rehabilitation, the special deputy receiver was directed to develop a Monitoring Plan to assist the Special Master in monitoring the progress of the Highlands runoff. Key to this determination is whether the critical assumptions that formed the basis of the special deputy receiver's Economic Cash Flow Model (ECFM) are proving accurate as the runoff progresses.

The special deputy receiver has undertaken a four phase monitoring plan. Phase 1 of the plan will review critical financial, asset recovery, reinsurance, and claim assumptions utilized in the ECFM. This will include review of investment rates of return, recovery of assets, actual versus projected claims payouts, and administrative expenses, among others. Phase 2 will conduct an updated analysis of the estate's claims liabilities. Phase 3 will include an actuarial review of the estate's receivership loss and loss adjustment expenses for all lines of business, including environmental and mass tort exposures. Phase 4 will take the updated financial and claims information and the findings from the actuarial analysis and run them through the ECFM. This phase is expected to be completed at the end of February 2010.

If the updated information supports the contention that there will be sufficient assets to pay all policyholder claims in full, it is expected the runoff will continue. If it appears that there will not be sufficient assets to pay these claims in full, it is expected that the special deputy receiver will petition the court to place the company into liquidation. The Monitoring Plan cautions, however, that "[I]t is appropriate to note that the ECFM projects development over a significant time horizon. Utilization of the ECFM to look at isolated points in time is not an appropriate use of the analysis." Until the results of the updated ECFM are known, and parties have an opportunity to evaluate long-term implications of the results, the ultimate fate of Highland's will remain unknown.

Frontier Insurance Company was placed into rehabilitation in October 2001. Since that time, the rehabilitator has been paying claims and has stated its desire to see Frontier eventually returned to financial health. According to Frontier's 2007 annual statement, as of year-end 2007, it had a negative surplus of $103 million. It is unclear how the rehabilitator's plan will be affected by the current financial downturn.

The Kemper insurance companies are operating under a runoff plan filed with the Illinois Division of insurance in 2004. The runoff continues to progress.

Two Courts; Two Decisions; Two Days

In June, the highest courts in two states, Louisiana and Nevada, ruled on the status of self-insurance and workers' compensation.

The Nevada Supreme Court ruled the MGM Mirage and Steel Engineers (SEI), two Las Vegas companies, had the right to recover for payments from the Nevada Insurance Guaranty Association for their covered workers' compensation claims payable by the companies' insolvent excess insurance carrier. In its June 25, 2009 MGM Mirage vs. Nevada Insurance Guaranty Association decision, the Nevada Supreme Court determined that "… self-insured employers under Nevada's workers' compensation law are not insurers for the purposes of the NIGA Act." The court therefore concluded that MGM's and SEI's claims are 'covered claims' as defined in [the NIGA act]."

MGM and SEI were self-insured to cover workers' compensation claims, but are required by law to buy additional insurance coverage for excess claims. The two companies both purchased policies for the excess coverage from Reliance National Insurance Company, which was declared insolvent in 2001. The two Nevada companies then had to cover the claims of the injured workers.

After Reliance was pronounced insolvent, the two Las Vegas companies asked the Nevada Insurance Guaranty Association to cover their excess losses. The association denied the claims on the basis that the two companies were insurers under the law and were not eligible to recover the money they paid in excess claims.

The court ruled the MGM and SEI were not insurers "because they are not in the business of insurance."

The following day, on June 26, 2009, the Louisiana Supreme Court reversed lower courts' rulings and held that a self-insured fund was an insurer for purposes of Louisiana Insurance Guaranty Association coverage. As a result, the court found the insolvent Reliance Indemnity Company was the fund's reinsurer, and not its excess insurer. (Louisiana Safety Association of Timbermen – Self Insurers Fund v. Louisiana Insurance Guaranty Association) To view the decision, visit: *http://www.lasc.org/opinions/2009/09C0023.pdf*

The Louisiana Safety Association of Timbermen (LSAT) formed the Louisiana Safety Association of Timbermen's Self Insurers Fund as a means of securing workers' compensation for association employees. The Fund obtained insurance coverage from Reliance for the 1998 policy year, and Reliance was placed in liquidation in October 2001. The Louisiana Insurance Guaranty Association (LIGA) in 2004 concluded that the policy between the Fund and Reliance was one of reinsurance and that it was not covered under LIGA.

The Fund sued LIGA, seeking coverage for all past and future losses. The Supreme Court ruled that Section 23:1195 (A) (1), when read together with the applicable revised statutes addressed self-insurers, thereby demonstrating that the state Legislature intended to exclude only workers' compensation self-insurers. Therefore, the Supreme Court held that "self-insurance is one of the means of securing workers' compensation to employees." Recognizing "it was good business practice for the Fund to buy reinsurance to cover part of its risk," the court determined it did not make LIGA liable for reimbursement of claims covered by the reinsurance, as it "would effectively make LIGA liable for claims that are exempt from LIGA's responsibility."

For More Information…

We hope that Trends 2010 provides a helpful summary for those interested in various insolvency related issues. We encourage those who wish to find out more on specific topics to review the following resources:

- Our Web site at *www.ncigf.org* – Our Web site contains a compilation and summary material on guaranty fund law, publications on various topics and a wealth of assessment, financial and other information about property casualty guaranty funds.

- *www.naic.org* – This is the official Web site of the National Association of Insurance Commissioners. Various insurance topics and NAIC committee activities are covered on this site.

- *www.ncoil.org* – NCOIL has adopted a property casualty guaranty fund model which is obtainable on this site.

- *www.iii.org* – The Web site of The Insurance Information Institute provides many informational resources on the insurance industry.

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.

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