NATIONAL CONFERENCE OF INSURANCE GUARANTY FUNDS

MEMORANDUM

Via E Mail

To: Trade associations, independent companies

From: Kevin Harris

Date: October 9, 2003

Re: NCIGF Board Legislative Proposals in Final Form

I provide the following to you on behalf of the Board of Directors of the National Conference of Insurance Guaranty Funds.

The NCIGF Board organized a Task Force in November of last year, the charge of which was to: (i) identify and analyze problems and issues raised by recent large insolvencies, and (ii) develop potential solutions. The Task Force members are as follows: Sonja Larkin-Thorne (chair), Steve Bennett, Paul Gulko, John Hartman, Mike Koziol, Lenore Marema, Mike Marchman, Larry Mulryan, Randy Seiner and Deb Wozniak. Prior to his retirement, Phil Schwartz also served on the Task Force. Kevin Harris and Dale Stephenson provided staff support.

In less than a year's time, the Task Force analyzed the myriad issues raised by recent insolvencies, identified those most in need of immediate attention, developed legislative recommendations and secured NCIGF Board approval for such. Special thanks for a job well done goes to Task Force Chair Sonja Larkin-Thorne, to each of the members of the Task Force, and also to Rowe Snider of Lord, Bissell & Brook who was retained to assist the task force. Rowe played a key role in developing the Task Force's recommendations.

The Task Force decided to initially address what were considered the most pressing issues. Attached you will find five different legislative proposals, with related explanatory memos. Broadly speaking, the enclosed addresses four areas: (i) guaranty funds' rights and obligations on large deductible policies (Exhibits 2-4), (ii) claims of large commercial insureds (Exhibits 5-8), (iii) access to records of insolvent insurers held by TPA's (Exhibits 9-10) and (iv) coordination with and cooperation of regulators and receivers (Exhibits 11-12). It is contemplated that the enclosed will be presented as a package, so an overall explanatory memo is also included (Exhibit 1). The materials are further described below.

The NCIGF Board of Directors, having now exposed these materials for comment, hereby recommends the enclosed package of legislative proposals to trade associations and independent companies, and asks that the package be treated as a legislative priority for 2004.

It is important to note that while the NCIGF Board endorses and recommends the enclosed as “model” legislative solutions for some of the more significant problems caused by the recent insolvencies of commercial insurers, a separate analysis on your part will be required to determine which specific states should be considered for action. We strongly recommend that, as with our past proposals, your analysis include consulting with representatives of the local guaranty fund and others involved locally. Finally, we also ask that you hold off for now targeting Mississippi on any of the proposals because the Mississippi Guaranty Association has asked for additional time to study and consider the package. We believe that you should have the benefit of any communication subsequently received from the Mississippi Association prior to considering action in Mississippi.

The Task Force is now beginning its work on a second round of topics that will likely generate additional proposals that the NCIGF Board may ask you to consider. We will keep you informed.

Thank you for your consideration of this matter. Please contact me if you have questions.

A detailed description of the proposals follows.

cc: Guaranty Fund Managers
NCIGF Board of Directors

Description of NCIGF Legislative Proposals

The charge of the NCIGF Board Task Force was to identify and analyze problems and issues raised by recent large insolvencies, and develop a comprehensive package of potential solutions. The Task Force focused on what it viewed as the most pressing issues to recommend liquidation and guaranty fund act legislation that:

- ***Clarifies law to ensure that guaranty funds' rights and exposure on large deductible policies mirror those of the insolvent insurer (Exhibits 2-4.),***
- ***Calls for a renewed effort to place reasonable limits on guaranty fund coverage of claims of large commercial policyholders (Exhibits 5-8),***
- ***Facilitates guaranty funds' obtaining records from and cooperation of TPA's of an insolvent insurer (Exhibits 9-10), and***
- ***Enables better cooperation and information sharing from regulators and receivers prior to liquidation (Exhibits 11-12).***

<u>**The specific proposals that are attached are as follows (the attachments have file names that closely correspond to the below)**</u>:

Overall memo explaining need for legislative proposals - Exhibit 1

Large Deductible cover and recover model legislation:
- Legislative proposal - Exhibit 2
- Explanatory memo - Exhibit 3
- Section by section analysis - Exhibit 4

Revised net worth provision legislation:
- Legislative proposal - Exhibit 5
- Explanatory memo - Exhibit 6

Independent bar date legislation:
- Legislative proposal - Exhibit 7
- Explanatory memo - Exhibit 8

Liquidation act provision that authorizes guaranty funds to secure records from TPA's:
- Legislative proposal - Exhibit 9
- Explanatory memo Exhibit 10

Information sharing provision/Coordination provision:
- Legislative proposal - Exhibit 11
- Explanatory memo - Exhibit 12

TO: Interested Property & Casualty Insurers, Insurance Trade Associations, and other interested Insurance Industry Organizations

FROM: Board of Directors of the National Conference of Insurance Guaranty Funds ("NCIGF")

RE: Proposals to address Insolvency Problems caused by Commercial Lines Insurers

Date: October 9, 2003

Introduction

Dynamic changes in the commercial insurance marketplace, combined with the severe financial stress currently being experienced by many commercial lines insurers, have created a climate in which insurer insolvency poses a major financial and regulatory problem for the industry. The insolvency of Reliance Insurance Company, Legion Insurance Companies, Superior National, Fremont Indemnity, and a variety of smaller insurers, have created a "shock wave" that is working its way through the insurance insolvency system, wreaking substantial havoc and costing the industry substantial amounts of money, with more to come. The industry's somewhat unique obligation to financially "bail out" victims of its failed competitors is a sensible idea when applied to personal lines insurance in a relatively stable pricing environment, but this commercial lines "shock wave" has stressed the system and has revealed to even the casual observer that the existing insolvency laws and administrative mechanisms were not designed to address the current "overload." Like a building being stressed beyond its design levels, the current system is moving in unexpected ways merely to survive and has an uncertain margin of safety remaining before potentially catastrophic collapse, at least in some states.

With this "shock wave" we have seen a dramatic increase in recent property/casualty guaranty fund assessments. In fact, assessment levels are at long term highs, and are at statutory caps in many states. As the problem was aptly described by the author of the Alliance report:

> The rapidly rising assessments are a major concern of insurers," said Roger Kenney, associate vice president of research for the Alliance and author of the study. "Unfortunately, I expect them to rise even further in the next couple of years as the result of recent major insolvencies that include those of Reliance, Superior National, California Compensation, PIE Mutual and others." Kenney further noted that these assessments "are particularly insidious because they represent overhead that a company cannot avoid and has absolutely no control over."

Alliance Study Says P/C Guaranty Fund Assessments Hit 15-Year High, Insurance Journal: The Property Casualty Magazine, *at* http://www.insurancejournal.com/news/newswire/national/2003/04/17/28055.htm (last visited September 4, 2003). Importantly, the Alliance Study was based primarily upon 2001 and earlier assessment data, *which did not include any substantial assessments that have been necessary to fund almost $1 Billion of guaranty fund claims payments for Reliance Insurance Company since its* *liquidation in the late fall of 2000.* We are seeing Mr. Kenney's prediction of even higher assessment in 2002 and 2003 unquestionably come to pass.

The NCIGF Board has commissioned a special task force to address the specific financial and operational problems that have arisen in this rash of recent commercial insolvencies. The Task Force concluded that many of the major problems clustered around two specific types of difficulties:

- First, certain kinds of complex, loss sensitive commercial insurance products threatened to burden the guaranty associations with a greater insurance risk, and thus a greater financial burden than the exposure the insolvent insurer itself faced. This anomalous result was the unintended consequence of newer, loss sensitive products interacting with older laws (both liquidation acts and guaranty association acts) that were not designed with such products in mind.

- Second, the complexity of modern commercial insurance programs, especially with the "unbundling" of various services and the extensive involvement of Third Party Administrators ("TPA's"), imposed extraordinary administrative burdens on guaranty associations in carrying out their core duty of adjusting and paying claims, followed by reporting to the liquidator.

The Task Force set out to identify specific solutions that offered the greatest potential to ameliorate these problems. It has completed its first phase of its work, and found that law reforms are needed. The proposals are described below.

I. "Cover & Recover" Legislation for Large Deductible Policies

The use of Large Deductible policies in the workers compensation line became wide-spread in the 1990's. Substantial parts of Reliance's and Legion's workers compensation book has been written on this basis, with per-claim deductibles ranging into the millions of dollars. The policies, which on their face if viewed alone, provide first dollar coverage. But the financially reality was very different -- the policies were most often issued as part of multi-state, and frequently multi-line, insurance "programs" with many loss sensitive policies tied together with side contractual agreements addressing funding and security. Almost all of these programs were heavily collateralized, most often with letters of credit to secure the policyholders obligations. Many, if not most, of these programs were structured with policyholder funding mechanisms in place, so that policyholder funds were provided up front rather than as post-payment reimbursements. These arrangements thus resulted in little if any of the insolvent insurer's funds being used (pre-liquidation) in funding claims within the deductible amount.

The Reliance liquidator wants to upend the original intention and structure of such large deductible insurance programs. In their view, the dollar one coverage of the formal policy is the responsibility of the guaranty associations. But to reach this conclusion, they must disconnect the claims payment obligation from the policyholder funding obligation, hoping to channel the cash from the policyholder obligation (either through collection of "reimbursements" or through drawing down the collateral) away from its intended use to pay that policyholder's claims and into the general assets of the estate, to be distributed to all claimants. *If this were the proper result, the guaranty associations would* *shoulder the full insurance risk on large deductible claims, without the right of reimbursement that the insolvent insurer had pre-insolvency. Such a result causes, in effect, guaranty associations' assessments to be used to subsidize the ultimate recovery of non-covered claimants against the insolvent insurers' estate. This outcome thus unquestionably contravenes the legislative intent of the guaranty fund acts.* The large deductible issue is so difficult however, and the points of view so diametrically opposed, that it has spawned large scale litigation between the Reliance Liquidator and approximately 40 guaranty associations.

To solve this serious problem most effectively, a clarifying amendment to the insurance liquidation act is required. The accompanying package includes proposed legislation to resolve the issue. It provides that the guaranty associations will "cover" the formal first dollar coverage of large deductible policies where such coverage exists, but the guaranty associations will receive the direct benefit of the financial funding or reimbursement obligations of the policyholder (including the benefits of the collateral) for such payments. In this fashion, the guaranty associations assume the financial risk that the insolvent company had pre-insolvency, but do not take on any more. Third party claimants are fully protected from the financial risk of the policyholder not being able to pay, thus satisfying the key elements of the workers compensation regulatory system -- that there is a reliable source ready to pay the worker's statutory benefits where a claim otherwise meets the appropriate qualifications.

While ultimately this legislation should be enacted everywhere, it should be targeted initially for states where major commercial lines insurers are domiciled. Because of the immediacy of the problem, the legislation has been drafted to apply to all open liquidation estates.

II. Renewed Initiative for Universal Net Worth Provisions

Approximately 34 guaranty associations have provisions which shift financial risk of insurance insolvency from the guaranty funds back to high-net-worth insureds, primarily through exclusion of first party claims and subrogation reimbursement on third party claims. The remaining guaranty associations, including some in very large jurisdictions, do not have such provisions. The lack of such provisions in all states and all guaranty association statutes is bad public policy and produces some anomalous results of "exporting claims costs" to other states when multi-state policies come into play. Overall system cost can be reduced and these anomalous results avoided if these high net worth provisions were enacted everywhere with relative uniformity.

These net worth provisions have the greatest impact in commercial lines insolvencies, where the policyholders often have far more financial resources than the insolvent insurer ever had. Given that the guaranty associations are intended to be a safety net designed to protect the "little guy" when their insurer, who was supposed to be the "big guy," becomes insolvent, logically the high net worth insured is simply not at the core of the group whom the guaranty association system is intended to protect. Without such a high net worth provision, you create a "reverse Robin Hood effect," where money is taken from the (relatively) poor average consumer (or state taxpayer) and is in effect given to the rich (i.e., sophisticated corporate insureds) who have lost their insurance. This is not a good result. A more complete statement of the public policy argument can be found in the enclosed explanatory materials.

The "cost exporting" effect occurs when more than one state guaranty association covers a claim, but the primarily responsible one has a net worth provision (such as the state of a workers compensation claimant's residence) and the secondary state (such as the employer's principal place of business) does not have such an exemption. Not only is this bad policy, it places political and administrative stresses on the guaranty association system itself.

In view of all these considerations, the Task Force concluded that a new push to get net worth provisions added to the remaining guaranty associations' statutes was an appropriate solution. Options are provided in the treatment and funding of third party claims, including workers compensation claims. Where third party claims are not excluded from coverage, a subrogation-like "right of recovery" is provided to compel the high net worth policyholder to reimburse the guaranty associations for payments made on the policyholder's behalf. Universal adoption of high net worth provisions would be most desirable. Because this proposal directly affects the coverage of guaranty associations, it is recommended that the legislation be drafted to apply only to future liquidation estates.

III. Independent Guaranty Association Claims Bar Dates

Commercial lines insurance is by its nature "long tailed." The policyholders' liabilities develop over a very long time. The insurance insolvency process has evolved to recognize the length of this tail, and as a result has fallen into a pattern of extending the times for filing of claims and has increasingly allowed policyholders to file sweeping proofs of claims covering unknown claims (essentially IBNR claims) through a very general and vague concept of a "policyholder protection claim." Such filings are not true "claims" in their own right at all, but are devices to keep the right of recovery under the insolvent policy (and thus the right of recovery from many guaranty associations) alive as long as possible.

When initially adopted, guaranty association statutes generally tended to borrow the receiver's claims bar date as a means of determining a limit to guaranty association exposure. This approach worked reasonably well for personal lines insurance, with its short tails and modest administrative costs. But with complex commercial lines coverages, the failure of the insurance company receiver to set firm deadlines can produce severe problems for a guaranty association in terms of both financial exposure and administrative and planning burdens. The issue is more fully explained in the accompanying explanatory materials.

Because the guaranty association is a safety net that is created by statute, the appropriate scope of the net should be defined in that same statute. Accordingly, a guaranty association can have its own bar date in its own statute to limit its "tail" liability, even if later claims can be asserted against the insolvent insurer. The attached proposal contains suggested language that creates a bar date and has been construed to cut off policyholder protection claims. <u>See</u>, <u>e.g.</u>, *See, e.g., Midwest Steel Erection Co. v. Illinois Ins. Guar. Fund*, (*In re Ideal Mut. Ins. Co.*), 578 N.E.2d 1235 (Ill. App. Ct. 1991); *Monical Mach. Co. v. Michigan Property & Cas. Guar. Ass'n*, 473 N.W.2d 808 (Mich. Ct. App. 1991); *Union Gesellschaft Fur Metal Industrie Co. v. Illinois Ins. Guar. Fund*, 546 N.E.2d 1076 (Ill. App. Ct. 1989).

All states should have independent bar dates. Because this proposal directly affects the coverage of guaranty associations, it is recommended that the legislation be drafted to apply only to future liquidation estates.

IV. Records Access Provision

Recent insolvencies have revealed that liquidators are not particularly well equipped to require independent representatives of the insolvent company, especially TPA's, to transfer claims files and related data (collectively referred to as "claims information") to the appropriate guaranty association. The liquidator, who generally would concede it is his job to deliver the claims files to the appropriate guaranty association, has often struggled to implement that transfer. In Reliance, for example, there were several hundred TPA's who had claims files at over 1000 different locations. Many of these TPA's had been paid "cradle to grave," thus had little incentive to be cooperative with guaranty associations or to effect an orderly transition. Many TPA's were outside the domiciliary state and not regulated by the domiciliary state insurance department, and thus were effectively beyond the reach of the process of the liquidation court and beyond effective regulatory influence. Most TPA locations had possession of claims files that would have been needed by their local guaranty association.

Out of this experience, we have created a "back up" basis for guaranty associations to obtain access to claims information by giving the association the absolute statutory power to sue for possession, subject to no defenses. Costs of litigation are shifted to the losing party, so TPA's have reason to pause before resisting a reasonable request to turn over claims information. (In addition to TPA's, we have also covered other representatives, such as attorneys, who often have common law liens.) The power is to be used only as a back up to the liquidator. It is contemplated that where litigation is required go obtain claims information that the liquidator should have provided, the unreimbursed expenses and fees should be afforded administrative priority against the insolvent insurer's estate. Due to its nature, it is recommended that this provision be drafted to apply only to future liquidation estates.

V. Information Sharing/Pre-insolvency Coordination Provision

As the business of the insolvent insurers becomes more complex, the need for pre-liquidation planning necessary for a smooth transition to guaranty association/liquidation grows proportionately. While some strides have unquestionably been made to foster the necessary cooperation on a voluntary basis, the guaranty association community views such progress as too little, too late. If the added costs of a disorderly transition are to be avoided, the basic elements of an orderly transition must be mandated.

Orderly transition requires several critical elements. One is an early warning provided on a confidential basis to allow the guaranty associations to commence their own planning. The proposed legislation provides for a confidential channel of early communication. Additionally, the transition from earlier stages of delinquency proceedings to liquidation must be timed and coordinated so that sufficient assets remain to fund all critical claims payments (such as workers compensation wage and medical payments) until claims payment responsibility can effectively be transferred to the guaranty associations. The proposed legislation requires that these necessary administrative steps be taken into account in timing the liquidation, and will facilitate a smooth and efficient transition.

All states need to adopt this legislation. By its nature, it only applies to future liquidation estates.

Conclusion

The Task Force has provided these materials as the result of the first phase of its deliberations. These reform proposals, even if universally enacted, would help substantially but of course do not represent a complete panacea to the complex problems facing the insolvency system. Many challenges remain and will grow substantially larger if more commercial insurers of significant size are liquidated in the near future.

Facing these prospects, the Task Force will be addressing some additional issues that it believes contribute significantly to the insolvency burden of the industry. Some of these are: unreasonable delay of payments by reinsurers; guaranty association capacity issues; Professional Employee Organizations, or "PEO's"; problems with insolvent insurer's data; matching policies used for fronting; and Supervised run-offs. The NCIGF will continue to address these difficult challenges and will continue to offer constructive solutions. Your assistance and support are needed to make these proposals realities.

H:\...\COMMITTE\Board Task Force\final-proposals-10-8-03\Ex 1 - Overall Memo Expl Need for Legislative Proposals.DOC

PROPOSED AMENDMENT TO INSURANCE LIQUIDATION STATUTES TO ADDRESS COMMERCIAL LINES LARGE DEDUCTIBLE POLICIES

By adding new Section [insert] which reads as follows:

[§ Number] Policyholder Collateral, Deductible Reimbursements, and other Policyholder Obligations

(a) Any collateral held by, for the benefit of or assigned to the insurer or subsequently the receiver in order to secure the obligations of a policyholder under a deductible agreement shall not be considered an asset of the estate and shall be maintained and administered by the receiver as provided in this section and notwithstanding in any other provision of law or contract to the contrary.

(b) If the collateral is being held by, for the benefit of or assigned to the insurer or subsequently the receiver to secure obligations under a deductible agreement with a policyholder, subject to the provisions of this section, the collateral shall be used to secure the policyholder's obligation to fund or reimburse claims payment within the agreed deductible amount.

(c) If a claim that is subject to a deductible agreement and secured by collateral is not covered by any guaranty association and the policyholder is unwilling or unable to take over the handling and payment of the non-covered claims, the receiver shall adjust and pay the non-covered claims utilizing the collateral but only to the extent the available collateral after allocation under subsection (d), is sufficient to pay all outstanding and anticipated claims. [*Option 1:* A claim against the collateral by a third-party claimant is not a claim against the insolvent insurer's estate for purposes of releasing the policyholder to the extent of applicable policy coverage.] If the collateral is exhausted and the insured is not able to provide funds to pay the remaining claims within the deductible after all reasonable means of collection against the insured have been exhausted, the receiver's obligation to pay such claims from the collateral terminates and the remaining claims shall be claims against the insurer's estate subject to complying with other provisions in this article for the filing and allowance of such claims. [*Option 2:* When the Liquidator's determines that the collateral is insufficient to pay all additional and anticipated claims, the Liquidator may file a plan for equitably allocating the collateral among claimants, subject to court approval.]

(d) To the extent that the receiver is holding collateral provided by a policyholder that was obtained to secure a deductible agreement and to secure other obligations of the policyholder to pay the insurer directly or indirectly amounts that become assets of the estate, such as reinsurance obligations under a captive reinsurance program or adjustable premium obligations under a retrospectively rated insurance policy where the premium due is subject to adjustment based upon actual loss experience, the receiver shall equitably allocate the collateral among such obligations and administer the collateral allocated to the deductible agreement pursuant to this section. With respect to the collateral allocated to obligations under the deductible agreement, if the collateral secured reimbursement obligation under more than one line of insurance, then the collateral shall be equitably allocated among the various lines based upon the estimated ultimate exposure within the deductible amount for each line. The receiver shall inform the guaranty associations of the method and details of all the foregoing allocations.

(e) Regardless of whether there is collateral, if the insurer has contractually agreed to allow the policyholder to fund its own claims within the deductible amount pursuant to a deductible agreement, either through the policyholder's own administration of its claims or through the policyholder providing funds directly to a third party administrator who administers the claims, the receiver shall allow such funding arrangement to continue and, where applicable, will enforce such arrangements to the fullest extent possible. The funding of such claims by the policyholder within the deductible amount will act as a bar to any claim for such amount in the liquidation proceeding, including but not limited to any such claim by the policyholder or the third party claimant. The funding will extinguish both the obligation, if any, of any guaranty association to pay such claims within the deductible amount, as well as the obligations, if any, of the policyholder or third party administrator to reimburse the guaranty association. No charge of any kind shall be made against any guaranty association on the basis of the policyholder funding of claims payment made pursuant to the mechanism set forth in this subsection.

(f) If the insurer has not contractually agreed to allow the policyholder to fund its own claims within the deductible amount, to the extent a guaranty association is required by applicable state law to pay any claims for which the insurer would have been entitled to reimbursement from the policyholder under the terms of the deductible agreement and to the extent the claims have not been paid by a policyholder or third party, the receiver shall promptly bill the policyholder for such reimbursement and the policyholder will be obligated to pay such amount to the receiver for the benefit of the guaranty associations who paid such claims. Neither the insolvency of the insurer, nor its inability to perform any of its obligations under the deductible agreement, shall be a defense to the policyholder's reimbursement obligation under the deductible agreement. When the policyholder reimbursements are collected, the receiver shall promptly reimburse such guaranty association for claims paid that were subject to the deductible. If the policyholder fails to pay the amounts due within sixty days after such bill for such reimbursements is due, the receiver shall use the collateral to the extent necessary to reimburse the guaranty association, and, at the same time, may pursue other collections efforts against the policyholder. If more than one guaranty association has a claim against the same collateral and the available collateral (after allocation under subsection (d)), along with billing and collection efforts, are together insufficient to pay each guaranty association in full, then the receiver will pro-rate payments to each guaranty association based upon the relationship the amount of claims each guaranty association has paid bears to the total of all claims paid by such guaranty associations.

(g) Receiver's duties and powers

(1) The receiver is entitled to deduct from reimbursements owed to guaranty associations or collateral to be returned to a policyholder reasonable actual expenses incurred in fulfilling the responsibilities under this provision, not to exceed three per centum of the collateral or the total deductible reimbursements actually collected by the receiver.

(2) With respect to claim payments made by any guaranty association, the receiver shall promptly provide the guaranty associations with a complete accounting of the receiver's deductible billing and collection activities, including copies of the policyholder billings when rendered, the reimbursements collected, the available amounts and use of collateral for each account, and any proration of payments when it occurs. If the receiver fails to make a good faith effort within one

hundred twenty days of receipt of claims payment reports to collect reimbursements due from a policyholder under a deductible agreement based on claim payments made by one or more guaranty associations, then after such one hundred twenty day period such guaranty associations may pursue collection from the policyholders directly on the same basis as the receiver, and with the same rights and remedies, and will report any amounts so collected from each policyholder to the receiver. To the extent that guaranty associations pay claims within the deductible amount, but are not reimbursed by either the receiver under this section or by policyholder payments from the guaranty associations own collection efforts, the guaranty association shall have a claim in the insolvent insurer's estate for such un-reimbursed claims payments. [*Option:* The priority of such claim shall depend upon the nature of the payment that should have been reimbursed.]

(3) The receiver shall periodically adjust the collateral being held as the claims subject to the deductible agreement are run-off, provided that adequate collateral is maintained to secure the entire estimated ultimate obligation of the policyholder plus a reasonable safety factor, and the receiver shall not be required to adjust the collateral more than once a year. The guaranty associations shall be informed of all such collateral reviews, including but not limited to the basis for the adjustment. Once all claims covered by the collateral have been paid and the receiver is satisfied that no new claims can be presented, the receiver will release any remaining collateral to the policyholder.

(h) The *[insert name of court]* which has jurisdiction over the liquidation proceedings shall have jurisdiction to resolve disputes arising under this provision.

(i) Nothing in this Section is intended to limit or adversely affect any right the guaranty associations may have under applicable state law to obtain reimbursement from certain classes of policyholders for claims payments made by such guaranty associations under policies of the insolvent insurer, or for related expenses the guaranty associations incur.

(j) This provision will apply to all delinquency proceedings which are open and pending as of the effective date of this section, which is intended to take effect immediately.

(k) For purposes of this section, a "deductible agreement" is any combination of one or more policies, endorsements, contracts, or security agreements, which provide for the policyholder to bear the risk of loss within a specified amount per claim or occurrence covered under a policy of insurance, and may be subject to aggregate limit of policyholder reimbursement obligations. This section shall not apply to first party claims, or to claims funded by a guaranty association net of the deductible unless subsection (e) above applies. The term "non-covered claim" shall mean a claim that is subject to a deductible agreement, may be secured by collateral, and is not covered by a guaranty association.

12/12/2011

Proposed Large Deductible Liquidation Act Legislation

This legislation clarifies rights and obligations of policyholders, the receiver and the guaranty associations with respect to commercial lines insurance "large deductible" insurance policies and related agreements written for large commercial insureds (often Fortune 500 companies or similar large companies) by insurers that become insolvent. The legislation will resolve a dispute, to the extent one exists or will exist, between the property and casualty guaranty associations and the receivers of insolvent large commercial insurers such as Reliance Insurance Company, in Liquidation and Legion Insurance Company, in Rehabilitation. Both of these insurers wrote substantial amounts of large deductible business, as is true of most commercial lines writers during the last ten to fifteen years. Both Reliance and Legion are discussed in some detail below as illustrative of the commercial lines practices that the proposed legislation is intended to address. Clarifying legislation is needed because insurance receivers have taken inconsistent positions concerning the guaranty associations' entitlement to deductible reimbursements on claims paid by them.

Large deductible insurance typically covers worker's compensation, commercial auto and general liability exposures of a large commercial insured, and is written subject to deductibles that are large in amount, typically $250,000 or more per claim, for which the insured using different approaches agreed to be financially responsible. Under these arrangements, although overall the insured has most of the claims exposure, the insurer under the policies is legally responsible to pay all claims within the deductible if the insured does not do so. The insurer therefore usually requires the insured to post collateral in favor of the insurer to secure the insured's payment and other obligations under these arrangements. Collateral may be either: (i) held by the insurer, or (ii) held by a third party for the benefit of the insurer and remaining with the third party, or (iii) held by a third party and later transferred to the receiver.

As in the Guaranty Associations Model Act, the legislation gives guaranty associations the same right and benefits that the insolvent insurer would have received under the large deductible arrangements, whether in the form of access to collateral or reimbursements from or payments by insureds, with the result that the guaranty associations' end up in the same place that the insurer would have, had it not become insolvent. That is to say, the guaranty associations' obligations would be no greater than that those of the insurer, but for the insolvency. The legislation would leave in place the arrangements through which insureds agreed to fund claims within the deductible, which is what the insureds had bargained for.

Reliance Insurance Company, In Liquidation

Reliance Insurance Company ("Reliance") was placed in liquidation by the Commonwealth Court of Pennsylvania on October 3, 2001. The Insurance Commissioner of Pennsylvania was appointed liquidator. Reliance is the largest property/casualty insolvency in history, and the bulk of Reliance's policy claims will be paid by the property and casualty guaranty associations of the various states, which are funded by assessments passed on to policyholders or taxpayers in the states. The guaranty funds will in the end pay billions of dollars to Reliance insureds and claimants.

Reliance, at one time a top 25 writer of property and casualty insurance business, wrote a substantial number of "large deductible" insurance policies. The insurance policies and related "side" agreements (together referred to as the "large deductible agreements") that were executed when this business was written allocated the risk between Reliance and the insured through the use of these large deductible policies, with most of the risk being borne by the insured. The actual amount of the deductible varied, from $100,000 to $1,000,000 per claim, but most commonly was $250,000. We believe most claims for this business did not exceed the deductible amount. We also believe that, as is generally true for large deductible policies, the insurance was priced so that Reliance as the insurer received premium only for that portion of the risk that for which it agreed to insure – that which exceeded the deductible. We believe Reliance accounted for the large deductible business as self-insurance. Statutory accounting principles would not require Reliance to record a liability for the deductible, only the excess.

The insured used different methods to actually assume responsibility for the deductibles, the most common being that the insured agreed to provide monies to a third party administrator ("TPA") that the insured retained to pay claims (these arrangements referred to as "insured-funded accounts."). Since Reliance remained obligated under many of these insurance policies to first pay the losses and then seek reimbursement from the insured, Reliance had an obligation to pay the claims if the insured did not. This, together with the fact that the business was priced so that Reliance through insurance premiums was compensated only for the risk it insured – that above the deductible, required Reliance to protect itself from being exposed on the deductible portion of the risk. Therefore, Reliance required insureds to post collateral, usually in the form of a letter of credit. The collateral secured the performance of the insureds under the large deductible agreements.

From Reliance's standpoint, insureds had three important types of claims obligations: (1) an insured agreed to directly fund claims (insured-funded accounts), (2) an insured agreed to reimburse Reliance for any deductibles Reliance paid, and (3) the insured posted collateral with Reliance to secure its performance under (1) and (2).

The liquidation of Reliance has been extremely challenging for both the Liquidator and the guaranty funds. Reliance's large deductible business has been especially challenging because the Liquidator and the guaranty associations cannot agree on who gets the benefit of these insured claim obligations for large deductible business. While an interim agreement between the guaranty funds and the Liquidator was reached and is in place, the parties have been unable to finally settle the matter, even after a year's worth of negotiations.

The guaranty funds believe that, to the extent that they pay claims, they should end up in the same place that Reliance would have, meaning that the guaranty funds receive the benefits of insured's claim reimbursement obligations. Importantly, the guaranty funds believe that insured-funded accounts should not be disturbed, and insureds should be allowed to continue to pay claims – that which was agreed to in the first place.

The Liquidator believes that the benefits of the insureds' responsibilities should flow into the Reliance estate, ultimately to the benefit of other creditors. We believe that neither applicable law nor equity would allow this result. It does not make sense for the guaranty funds to have substantially more exposure than Reliance would have had if it remained solvent. It also does not make sense to disturb the insured claim funding arrangements that have been in place and working well for many years.

The exposure on just the deductible portion is significant – the Liquidator estimated in the court petition to approve the interim agreement filed last year that at one time it held approximately $1.4 billion in large deductible collateral. That amount approximates the additional amount the guaranty funds would have to be responsible for, if the Liquidator's position were to prevail. While guaranty funds as creditors will receive distributions as creditors from the Reliance estate for claims they pay, it will likely be years before any are received, and the amount of those distributions is uncertain. At a minimum, guaranty associations will be required to front substantial sums to cover claims falling within the large deductible amounts (in addition to paying billions of dollars of claims under other Reliance policies), and will be required to wait for years for what will likely be a diluted distribution.

Legion Insurance Company, in Rehabilitation

Legion Insurance Company and its affiliate Villanova Insurance Company (together referred to as "Legion") have been in rehabilitation since April 2002. Both companies have had order of liquidation entered against them in July of 2003, although appeals are pending. Legion also wrote a substantial amount of large deductible business, although using an entirely different approach. Insureds handled deductible reimbursement obligations by buying "deductible reimbursement" policies issued by an offshore insurer affiliated with Legion. Under the deductible reimbursement policy, the Legion-affiliated insurer was obligated to pay Legion for deductible reimbursements that the insured became obligated to pay under its large deductible agreements with Legion, and the insured was obligated to reimburse the insurer for such amounts paid to Legion.

The insured posted collateral for the benefit of Legion to secure the performance of the insured's obligations under the deductible reimbursement policy, which collateral was actually held by one of the offshore Legion affiliated insurers. We have been informed that as a part of the commutation agreement being enforced in the Legion Rehabilitation proceedings, collateral now held by the offshore affiliate insurers to secure the insured's performance under the large deductible reimbursement policies will be transferred to the control of Legion Insurance Company.

Legion's total gross loss reserves as of the most recent date available were $2.9 billion. It is not known at this point how much of this total exposure relates to the large deductible business described above, or further how much is secured by collateral or insured deductible reimbursement obligations, or the amount of the collateral, although it appears the exposure and the potential recoveries are substantial.

While Legion is in rehabilitation and it is not known if or when Legion will be in liquidation, we believe that the legislation is important to resolve any potential dispute in the event Legion is liquidated. The legislation would give guaranty associations the benefit of the collateral and insured deductible reimbursement obligations to the extent that the guaranty associations pay claims.

Legislation Fairly Treats Affected Parties

We believe that legislation clarifying that the guaranty funds should receive the benefits of insured reimbursement obligations is the proper resolution of the matter, especially when one considers that the guaranty funds are simply a "pass-through" mechanism for allocating costs of insurance insolvencies. Guaranty associations are funded by assessments to insurers writing insurance in the various states. The economic burden of these assessments are passed along to ordinary insurance consumers (including personal lines auto and homeowner insureds) in most states in the form of higher premium costs. In some other states, through tax credits, the state taxpayers bear the cost of funding the guaranty associations. Regardless of the mechanism, it is an irrefutable fact that the general public, or insurance consumers or taxpayers, bear most of the ultimate economic burden of the "guaranty fund safety net" in insurance insolvencies.

The Reliance and Legion Liquidators' position would result in larger distributions to other policyholder level insureds ("non-covered insureds"), and smaller distributions to the benefit of the group absorbing the cost of the guaranty funds, which includes personal lines insureds and state taxpayers. While we do not know yet exactly who the non-covered insureds are because it is early in the insolvency and many claims have not yet been identified or finalized, at least in the case of Reliance we believe that, considering the nature of the business written by Reliance for which there would be non-covered insureds, in particular Reliance's surplus lines book of business, there would likely be two principal categories of non-covered insureds: (1) Commercial insureds who purchased Reliance "surplus lines" policies written on an unlicensed basis (this kind of insurance business is conducted between sophisticated parties and is largely unregulated, and is not covered by any guaranty fund except for one – New Jersey), and (2) Insureds whose net worth exceeded guaranty fund maximum limits ($50 million in roughly half the states) and whose claims are therefore not covered by a guaranty association. In the case of Legion, again should Legion be liquidated, we believe that Legion's non-covered claims would for the most part consist of category (2) above.

We submit that, in balancing the interests affected by an insurance insolvency, in the case of either Reliance or Legion or any other commercial lines insurers that may become insolvent in the future, shifting the economic burden away from a group that likely will be made up of mostly commercial insureds to a group that includes typical holders of homeowners and auto policies and state taxpayers is an undesirable result. It cannot be good public policy to shifts the cost from sophisticated parties in a much better position to absorb insolvency losses to ordinary consumers who are much less able to absorb such costs.

The benefits of insureds' reimbursement obligations and insured collateral on large deductible business should stay connected to related claims that are being paid, just as it was before the insolvency of a commercial lines insurer. To the extent that the guaranty association of the domiciliary state or another state pays large deductible claims, that guaranty association should receive the same benefits from insured claim obligations that insolvent insurer would have received but for the insolvency.

Please refer to the section-by-section analysis for a detailed explanation of the proposed legislation.

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12/12/2011

Proposed Large Deductible Liquidation Act Legislation
Section by Section Analysis

This legislation clarifies rights and obligations of policyholders, the receiver and the guaranty associations with respect to commercial lines insurance "large deductible" insurance policies and related agreements written for large commercial insureds (often Fortune 500 companies or similar large companies) by insurers that become insolvent. The legislation will resolve a dispute, to the extent one exists or will exist, between the guaranty associations and the Liquidators of large commercial insurers who become insolvent, such as Reliance Insurance Company, in Liquidation and Legion Insurance Company, in Rehabilitation. Both of these insurers wrote substantial amounts of large deductible business.

Large deductible insurance typically covers worker's compensation, commercial auto and general liability exposures of a large commercial insured, and is written subject to deductibles that are large in amount, typically $250,000, for which the insured using different approaches agreed to be financially responsible. Under these arrangements, although overall the insured has most of the claims exposure, the insurer under the policies is ultimately responsible to pay all claims. The insurer therefore usually requires the insured to post collateral in favor of the insurer to secure the insured's payment and other obligations under these arrangements. Collateral may be either: (i) held by the insurer, or (ii) held by a third party and remaining with the third party, or (iii) held by a third party and later transferred to the receiver. The legislation gives guaranty associations the same benefits that the insolvent insurer would have received under the large deductible arrangements, whether in the form of access to collateral or reimbursements from or payments by insureds, with the result that the guaranty associations' end up in the same place that the insurer would have, had it not become insolvent. That is to say, the guaranty associations' obligations would be no greater than that those of the insurer, but for the insolvency.

A section by section analysis of the bill follows.

Sections (a) – (d) deal with collateral

Section (a)
Makes it clear that collateral posted by policyholders for the benefit of the insurer that secures the policyholder's obligations under a large deductible agreement ("deductible collateral") is not an asset of the insolvent insurer's estate, and is to be administered by the receiver as provided by this legislation. Also makes the same clear for any collateral that may be transferred to the receiver. The statute expressly governs in place of any contract to the contrary.

Section (b)
Makes it clear that available collateral is to be used for the payment or reimbursement of claims within the deductible for the specific policyholder who posted or provided it.

Section (c)
Requires that deductible collateral that secures both claims covered by a guaranty association and claims not covered be equitably allocated, and that once the allocated deductible collateral is exhausted on non-covered claims, that those claims if unpaid are claims against the estate. It also provides an optional provision that may be added to resolve an issue arising in those states where the insurance liquidation act provides that filing a proof of claim by a third party claimant against the insolvent insurers releases the policyholder to the extent of policy coverage. Asserting a claim against the collateral only, which is not an asset of the insolvent company's estate, should not release the policyholder. The section also provides a second optional provision, expressly authorizing the Liquidator to prepare and file for approval a plan to equitably allocate collateral among all claimants where it is determined to be insufficient to pay all present and anticipated claimants. While not without some administrative burden, this provision makes substantial additional quantities of collateral available and expressly requires the use of the Liquidator's power to equitably allocate collateral held.

Section (d)
Requires deductible collateral that secures different lines of business or that also secures other obligations of the policyholder outside of a deductible agreement be equitably allocated among all the obligations. Modest reporting requirements to interested guaranty associations are reasonable in light of the claims payment the associations make.

Section (e) deals with claims policyholder pays
Where the policyholder has agreed to pay its own claims within the deductible, that arrangement continues and to the extent claims are paid there is no further obligation on anyone's part for such claims. The claims to the extent they are paid are (logically) treated as paid claims, and neither the estate nor a guaranty association has any further obligations.

Section (f) deals with claims that the insurer was paying that a guaranty association is now paying
Receiver shall collect from the policyholder deductibles the policyholder owes on claims under a deductible agreement and pay the guaranty association deductible reimbursements for claims that a guaranty association pays. Receiver shall use collateral to reimburse guaranty associations if policyholder does not promptly pay. Receiver shall pro-rate reimbursements among guaranty associations if more than one guaranty association is paying claims.

Section (g) provides for certain Liquidator responsibilities
(1) Provides for a limited amount of collection expenses to be deducted from deductible reimbursements paid to a guaranty association, so that the guaranty associations, the estate creditors benefiting from the activity, bear the cost, rather than all creditors of the estate.
(2) Requires receiver to account for collection activities and permits a guaranty association to attempt to collect deductibles if the receiver is unsuccessful. Provides the guaranty associations with a claim against the insolvent insurer's estate as a matter of last resort, and has an optional provision concerning the priority of such claim that may be appropriate in state where claims defense costs ("ALAE") is reimbursed as an administrative expense.
(3) Requires receiver to maintain collateral adequate to secure the policyholder's obligation and periodically such adjust as necessary, appropriately informing the guaranty associations. Allows collateral to be returned to the policyholder after all claims are paid.

Section (h) deals with jurisdiction
Provides that courts of the domiciliary Liquidator have jurisdiction over disputes under this provision.

Section (i) makes it clear that legislation does not affect other guaranty association rights against policyholders
Makes it clear that the legislation does not affect any other rights a guaranty association may have to pursue a policyholder for reimbursement. For example, a majority of the states' guaranty association acts contain a provision that permits the recovery of covered claim payments from insureds whose net worth exceeds a certain amount, typically $50 million. This section makes it clear that these "high net worth" provisions are not affected by the legislation.

Section (j) makes it clear that legislation applies to open insolvencies
Legislation applies to pending insolvencies, which would include Reliance, as well as future insolvencies, which may include Legion.

Section (k) defines certain terms and limitations
This section defines "deductible agreement." It also provides that the section does not apply to first party claims and to claims under various commercial coverages where guaranty associations have funded claims net of the deductible amounts because of the terms of coverage or customary claims practices in assembling funds, such as for lump sum settlements. The provision further makes clear that this "carve out" for net funding does not apply where the guaranty association may step in over an insured funded deductible claim and pay "net of deductible" for that reason alone. It also defers "non-covered claim" for purposes of this section.

Proposal for Large Net Worth Provision

Add to the section defining what is not a covered claim one of the following provisions:

Option A - Exclude only first party claims

(d) any first party claim by an insured whose net worth exceeds $10 million on December 31 of the year next preceding the date the insurer becomes an insolvent insurer; provided that an insured's net worth on such date shall be deemed to include the aggregate net worth of the insured and all of its subsidiaries and affiliates as calculated on a consolidated basis;

Option B - Exclude both first and third party claims

(d) any first party claim by an insured whose net worth exceeds $10 million on December 31 of the year next preceding the date the insurer becomes an insolvent insurer; provided that an insured's net worth on such date shall be deemed to include the aggregate net worth of the insured and all of its subsidiaries and affiliates as calculated on a consolidated basis;

(e) any third party claim relating to a policy of an insured whose net worth exceeds $25 million on December 31 of the year next preceding the date the insurer becomes an insolvent insurer; provided that an insured's net worth on such date shall be deemed to include the aggregate net worth of the insured and all of its subsidiaries and affiliates as calculated on a consolidated basis; and further provided, however, that this exclusion shall not apply to third party claims against the insured where the insured has applied for or consented to the appointment of a receiver, trustee, or liquidator for all or a substantial part of its assets, filed a voluntary petition in bankruptcy, filed a petition or an answer seeking a reorganization or arrangement with creditors or to take advantage of any insolvency law, or if an order, judgment, or decree is entered by a court of competent jurisdiction, on the application of a creditor, adjudicating the insured bankrupt or insolvent or approving a petition seeking reorganization of the insured or of all or substantial part of its assets;

DRAFTING NOTE: Jurisdictional circumstances may warrant consideration whether a carve out from subparagraph (e) for workers' compensation claims, PIP claims, no-fault claims and any other claims for ongoing medical payments to third parties is appropriate. If administrative consideration suggest that an unacceptable interruption in claims payments would occur, such a carve out may be warranted.

(f) any claim that would otherwise be a covered claim, but is an obligation to or on behalf of a person who has a net worth greater than that allowed by the insurance guaranty association law of the state of residence of the claimant at the time specified by such law, and which association has denied coverage to that claimant on that basis.

Add to the section addressing the Effect of Paid Claims the following subsection, numbered appropriately:

(2) The Association shall have the right to recover from the following persons all amounts paid by the Association on behalf of such person, whether for indemnity or defense or otherwise

(a) any insured whose net worth on December 31 of the year immediately preceding the date the insurer becomes an insolvent insurer exceeds $25 million; provided that an insured's net worth on such date shall be deemed to include the aggregate net worth of the insured and all of its subsidiaries and affiliates as calculated on a consolidated basis; and

(b) any person who is an affiliate of the insolvent insurer.

New Administrative Provisions Concerning Net Worth

Add to the section of the Act concerning the Power and Duties of that association the following new subsection:

Establish procedures for requesting financial information from insureds and claimants on a confidential basis for purposes of applying sections concerning the net worth of first and third party claimants, subject to such information being shared with any other Association similar to the Association and the Liquidator for the insolvent company on the same confidential basis. If the insured or claimant refuses to provide the requested financial information and an auditor's certification of the same where requested and available, the Association may deem the net worth of the insured or claimant to be in excess of [insert proper amount] at the relevant time.

Proposal for New Provision Concerning Litigation About Net Worth

In the section of the Act concerning the Powers and Duties of the Association, specifically the subsection addressed to "Suits involving the Association," add the following provision:

In any lawsuit contesting the applicability of sections [the first party claims exclusion] or [the third party exclusion and/or reimbursement provision] where the insured or claimant has declined to provide financial information under the procedure provided in the plan of operation pursuant to section [insert] of this Act, the insured or claimant shall bear the burden of proof concerning its net worth at the relevant time. If the insured or claimant fails to prove that its net worth at the relevant time was less than the applicable amount, the court shall award the Association its full costs, expenses and reasonable attorneys fees in contesting in claim.

DRAFTING NOTE: Because of the potential impact on guaranty association coverage, it is recommended that the legislation include an appropriate provision clearly stating that the any newly-enacted net worth provision applies only to legislation estates commencing after its effective date. If only the new administrative provisions are being added to a pre-existing net worth exemption, it would be possible to apply them to all outstanding claims.

<u>Explanation of Proposed Net Worth Provisions</u>

Almost all of the fifty six property casualty insurance guaranty associations in the United States and its possessions are funded through indirect contributors from the insurance buying public or from state taxpayers. While the guaranty associations mechanism spreads the cost of insurance insolvencies widely over a large number of people, the total cost is not insignificant. As a matter of good public policy, this aggregate cost needs to be limited in some rational fashion and the limited financial resources of the guaranty associations channeled to the most needy claimants.

Accordingly, guaranty associations are designed to be a safety net for those least able to absorb loss, and not as an absolute guarantor of <u>all</u> the obligations of the insolvent company. One important limitation on guaranty association coverage that is consistent with the safety net design is the exclusion of high net worth policyholders from the protections afforded by the system. This limitation of coverage is consistent with good public policy that has been the basis of the guaranty association system since its inception around 1970. The exemption achieves a substantial reduction in cost to those who support the guaranty associations, thereby making more funding available to protect the average insurance consumer.

High net worth insureds are almost always sophisticated commercial enterprises having both substantial risk management resources on their own and access to the best national and international insurance brokers. They are thus able to select their insurers carefully in the first place and accept the consequences of such choices. More critically, high net worth insureds are in a much better position than the average consumer to absorb the loss themselves if their carefully chosen insurer becomes insolvent. Certainly, it makes no sense to have average policyholders or typical state taxpayers, who do not have these kinds of resources and advantages, absorbing insurance insolvency losses for the high net worth policyholders.

Net worth provisions are presently enacted in approximately 34 states. These provisions should be universal, for at least two reasons. First and most important is the public policy justification discussed above. It should be the law in all states. Second, however, is the need to eliminate the anomalies that can arise from multi-state commercial lines policies. These anomalies can be created by the provisions in guaranty association statutes designed to coordinate their respective benefits when more than one state's guaranty association may apply to a particular claim. Without congruity of net worth provisions, the policyholders in state A may wind up funding the guaranty fund benefits of claimants residing in state B, when state B's public policy decisions intended to have the high net worth policyholders absorb the financial loss themselves. Any such interstate "exporting" of financial burden for high net worth policyholders needs to be minimized, if not eliminated altogether. As a transitional matter to protect individual states while this proposal is being enacted in more jurisdictions, the proposed legislation includes a provision to prevent this "importing" of claims costs into the enacting state.

The proposed legislation provides the following elements:

(1) A choice of total exclusion of all claims under policies issued high net worth insureds (see Option B), or a "cover and recover" approach (see Option A) where third party claimants are initially paid by the association and later reimbursed by the high net worth policyholder.

(2) A provision that excludes from "covered claims" any claim that has been excluded by another state by virtue of its net worth provision, thus prevention the "importing" of claims described above.

(3) A new provision concerning the administration of the net worth provision, clarifying what happens when the policyholder refuses to cooperate and authorizing the confidential sharing of financial information among guaranty associations.

(4) A new provision addressing net worth litigation, specifically addressing burden of proof and allowing attorneys fees when the guaranty association provides.

Finally, it is recommended that the legislation enacting a new net worth exemption be drafted so that it is applicable to all liquidation estates commencing after the bill's effective date. If only the administrative provisions are being added to an existing net worth exemption statute, such provisions could be made applicable to all claims.

Proposal for an Independent Guaranty Association Bar Date

Add to the section of the Guaranty Association Act defining the powers and duties of the Association the following language:

(b) In no event shall the Association be obligated to pay a claimant an amount in excess of the obligation of the insolvent insurer under the policy or coverage from which the claim arises. ***Notwithstanding any other provisions of this Act, a covered claim shall not include a claim filed with the Association after the earlier of: (i) eighteen months after the date of the order of liquidation, or (ii) the final date set by the court for the filing of claims against the liquidator or receiver of an insolvent insurer. [Optional: The requirement of filing within eighteen months after the date of the order of liquidation shall not apply to claims by injured employees for workers compensation benefits where the basis for the claim is an occupational illness that does not manifest itself within the 18 month period.] A "covered claim" shall not include any claim filed with the Association or a liquidator for protection afforded under the insured's policy for incurred-but-not-reported losses.*** The Association shall pay only that amount of each unearned premium which is in excess of $______.

Comment: *The optional language concerning workers compensation benefits is included for consideration in jurisdictions where the use of an 18 month bar date may be inappropriate in view of the latent nature of some occupational diseases which do not manifest themselves within this shortened period. The language in this provision referring to claims for incurred-but-not-reported losses has been inserted to expressly include the existing intent of this provision and make it clear that "policyholder protection" proofs of claim, while valid to preserve rights against the estate of the Insolvent insurer under the Insurers Rehabilitation and Liquidation Act, are* ***not*** *valid to preserve rights against the Association.*

DRAFTING NOTE: Because of its potential impact on guaranty association coverage, it is recommended that the legislation include an appropriate provision stating that the bar date only applies to claims in liquidation estates commencing after its effective date.

<u>Explanation for an Independent Guaranty Association Bar Date</u>

When property and casualty insurance guaranty associations were originally enacted by the state legislatures in the late 1960's and early 1970's, the legislative initiative was primarily focused upon solving the problem of failures of relatively small personal lines writers. The "claims tail" for the policies of such insurers was relatively short. In the interests of simplicity, it made sense to incorporate for the guaranty associations the claims bar date being used by receivers in the liquidation process itself. With the 1980's bring a rash of insolvencies of commercial lines writers, suddenly policies with much longer "claims tails" came onto the insolvency process and under guaranty association protection. Some liquidators and liquidation courts, with equality of treatment of all claimants being their primary consideration, provided longer and longer periods for the filing of claims. Some liquidators and liquidation courts also permitted the filing and allowance of contingent and unliquidated claims, and even incurred but not reported claims which became known as "policyholder protection claims." Many of these claims are asserted by commercial lines insured who have complex regulatory, environmental, or mass tort liability, but who are not in the core group intended to be the beneficiaries of the guaranty association safety net. Thus, through this evolution of the insolvency process, the continued use of liquidation bar dates as the limit of guaranty association protections introduced new complexities and uncertainties into the administration of the guaranty association safety net. With these uncertainties came the increased financial and administrative burden and difficulties of planning for these uncertain situations, without clear limits on guaranty association financial responsibilities.

Some states resolved these problems through enacting independent bar dates in their guaranty associations statutes. These have proven to be effective solutions that we now recommend be adopted everywhere as an alternative to the use of the liquidation claims bar date. The proposed model solution provides an independent bar date for claims against the guaranty association of 18 months following liquidation -- a fair balance between the need for coverage and the need to administer guaranty association's liability and financial obligations fairly, efficiently, and effectively, especially during this period of high insolvency activity that is taxing limited financial resources of the guaranty associations. Of course, claimants who cannot recover from the guaranty association are likely to still have an allowable claim against the insolvent insurer. We have included an option to carve out a limited class of workers compensation claims from this independent bar date, recognizing that the latent nature of certain occupational diseases may make it inappropriate to subject claims based on such diseases to a shortened bar date. It is recommended that the legislation enacting this new bar date be drafted to apply to all liquidations commencing after the legislation's effective date.

<u>Proposal for New Provision Granting Guaranty Associations' access to Claim Information in the Hands of Third Party Administrators and other Representatives</u>

Add to the section of the Act defining the Powers and Duties of the Association the following, specifically the section concerning what the Association "may" do:

(e) bring an action against any third party administrator, agent, attorney or other representative of the insolvent insurer to obtain custody and control of all files, records, and electronic data ("claims information") related to an insolvent company that are appropriate or necessary for the Association, or a similar association in other states, to carry out its duties under this Act. In such a suit, the Association shall have the absolute right through emergency equitable relief to obtain custody and control of all such claims information in the custody or control of such third party administrator, agent, attorney or other representative of the insolvent insurer, regardless of where such claims information may be physically located. In bringing such an action, the Association shall not be subject to any defense, lien (possessory or otherwise) or other legal or equitable ground whatsoever for refusal to surrender such claims information that might be asserted against the Liquidator of the insolvent insurers. To the extent that litigation is required for the Association to obtain custody of the claims information requested and it results in the relinquishment of claims information to the Association after refusal to provide the same in response to a written demand, the court shall award the Association its costs, expenses and reasonable attorneys fees incurred in bringing the action. The provisions of this section shall have no affect on the rights and remedies that the custodian of such claims information may have against the insolvent insurers, so long as such rights and remedies do not conflict with the rights of the Association to custody and control of the claims information under this Act.

<u>DRAFTING NOTE</u>: It is recommended that the legislation enacting this provision be drafted so that it clearly states that it is applicable to liquidation estates commencing after its effective date.

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Explanation of Provision Granting Guaranty Associations Access to Claims Information in Hands of Third Party Administrators and Other Representatives

As is still the case with personal lines coverage, commercial lines coverage used to be sold as one integrated package by large commercial lines insurers. Each company maintained and required policyholders to use its own capacity to provide the full array of services related to insurance -- policy issuance and other operations, claim reporting and adjusting, loss control and engineering, etc. With this business model, when the receiver took over an integrated company upon its insolvency, the receiver gained possession of all the claims files and information necessary to administer the estate and, most importantly for our purposes, to promptly transfer the necessary information to the appropriate guaranty associations to allow them to do their job.

This business model of an integrated company providing all services itself no longer holds true for many if not most commercial lines insurers -- the "unbundling" of services has become the norm and is demanded by many if not most commercial lines policyholders. One important manifestation of this "unbundling" trend is the wide-spread use of third party administrators ("TPAs") in the handling of claims. Some recent commercial lines insolvencies have involved hundreds of TPAs with claims files scattered in thousands of locations. In some instances, the TPA claims records and information systems were more important than, or had fully supplanted, the insolvent company's own systems and records, especially with respect to claims and related information.

The proposed legislation is designed to get guaranty associations back to where they were before "unbundling" --having an absolute right to obtain quickly and efficiently the claims information they absolutely need to do their important job. Liquidators often cannot cause TPAs, either because of practical reasons (lack of cooperation and sheer numbers) or legal considerations (due to a variety of defenses or remote venues), to transfer claims files and data to guaranty associations quickly, or perhaps at all. The proposed statute thus gives guaranty associations themselves the absolute right, through emergency court action if necessary, to obtain custody and control of necessary and appropriate claims information to do their job, regardless of what kind of representative of the insurance company has possession of the records. (Please note confidentiality considerations are not an impediment here -- guaranty associations are subject to the same confidentiality obligations as insurance companies.) It further provides that representatives shall pay guaranty associations' attorneys fees if, after a written demand for records, litigation is required to obtain the turn over of claims information. On the other hand, in order to strike a fair balance, the statute expressly preserves whatever rights and remedies the representative may have against the insolvent insurer, short of continued possession and control of claim information. The provision is not intended to affect ownership of the claims information. It is contemplated that "custody and control" provision would be a "back up" or "reserve" power that the guaranty associations have to exercise when they see fit, and is not intended to supplant or supercede the Liquidator's responsibility to have claims information transferred to the appropriate guaranty association. It is recommended that the legislation enacting these provisions be made applicable to all new liquidation estates commenced after its effective date.

Proposed Revisions Regarding Information Sharing with Guaranty Funds

Section 15. Confidentiality

A. In all proceedings and judicial reviews under Section 10, all records of the insurer, other documents, and all Insurance Department files and court records and papers, so far as they pertain to or are a part of the record of the proceedings, shall be and remain confidential, and all papers filed with the clerk of the [insert proper court] Court shall be held by the clerk in a confidential file, except as is necessary to obtain compliance with any order entered in connection with the proceedings, unless and until:

(1) The [insert proper court] Court, after hearing argument in chambers, shall order otherwise;

(2) The insurer requests that the matter be made public; or

(3) The commissioner applies for an order under Section 16.

B. The commissioner may share documents, materials or other information in the possession or control of the Department of Insurance pertaining to an insurer that is the subject of a proceeding under this Act with other state, federal and international regulatory agencies, with the National Association of Insurance Commissioners and its affiliates and subsidiaries, and with state, federal and international law enforcement authorities, and, pursuant to Section __, with representatives of the guaranty associations that may become obligated as a result of the insolvency of the insurer, provided that the recipient agrees to maintain the confidentiality of the documents, material or other information. In the case of guaranty associations, such confidentiality obligations of the guaranty associations to the conservator/rehabilitator shall end upon the entry of an order of liquidation with a finding of insolvency against the insurer. No waiver of any applicable privilege or claim of confidentiality shall occur as a result of disclosure to the commissioner under this section or as a result of sharing documents, materials or other information pursuant to this subsection.

New Section Concerning Obligation to Share Information and Execute an Orderly Transition to Liquidation

A. No later than 30 days after the entry of an order of conservation or rehabilitation, the conservator or rehabilitator shall begin appropriately planning and organizing so that an orderly transition to liquidation occurs, if liquidation is necessary. An orderly transition to liquidation requires, among other things, that: (i) the conservator or liquidator to the fullest extent possible reserve sufficient assets to continue to meet obligations under insurance policies of the insolvent insurer until the guaranty associations are triggered, and (ii) the conservator or rehabilitator shall conduct affairs in such a way and cooperate as necessary with the guaranty associations that may become liable as a result of the insolvency of the insurer to ensure that the guaranty associations are provided with appropriate information, along with complete updates at reasonable intervals, and a reasonable period of time to plan and organize so that the guaranty associations are able to properly discharge statutory responsibilities upon being triggered.

B. Appropriate information shall at a minimum include, for lines of business written by the insurer (whether covered or not covered by guaranty funds): a general description of the different types of business written by the insurer; loss reserves and claims count by state by line of business; sample policies and endorsements; listing of different locations of claim files; if third party administrators were used, copies of executed contracts and a description of the contractual arrangements; and information concerning claims in litigation, including a listing of claims with assigned defense counsel for those claims going to trial in the near future after a possible liquidation date. The conservator or rehabilitator shall make all reasonable efforts to prepare the insurer's electronic policy and claims data so that, upon the entry of an order of liquidation, the data will be ready for transmission using the Uniform Data Standard as promulgated by the National Association of Insurance Commissioners. The conservator or rehabilitator shall also provide information concerning states where the insurer is or was licensed and time periods for which the insurer is or was licensed and other information reasonably requested by a guaranty association.

Drafting Note: The Commissioner and the guaranty associations share a common goal of protecting the interests of insureds and claimants, and in the case of a liquidation this includes minimizing any disruption in the flow of benefits under insurance policies that occurs as a result of a delinquency proceeding, in particular, a liquidation. An orderly transition to liquidation requires that the receiver be able to promptly meet all policy obligations until guaranty associations are triggered, and also that the receiver do everything reasonably possible to cooperate and assist the guaranty associations prior to liquidation so that the guaranty associations are in the best position possible to begin the proper discharge of statutory responsibilities once triggered.

Proposed Provision that Permits Information Sharing with Guaranty Associations and Requires Cooperation Prior to Liquidation

The Commissioner and the guaranty associations share a common goal of protecting the interests of insureds and claimants, and in the case of a liquidation this includes minimizing any disruption in the flow of benefits under insurance policies that occurs as a result of a delinquency proceeding, in particular, a liquidation.

In order for the guaranty associations to be able to carry out their critically important role of protecting insureds and claimants by paying covered claims: (i) information, (ii) cooperation and (iii) a coordination of efforts are needed from the regulator and receiver (if different). The purpose of this proposed legislation is to ensure that regulators and receivers have the same priority of protecting these insureds and claimants by requiring an orderly transition to liquidation. An orderly transition must include cooperating with guaranty associations and providing needed information so that guaranty associations are in a good position to discharge statutory obligations upon being triggered. Also, since guaranty associations cannot pay claims prior to being triggered by a liquidation order, it is critical that an orderly transition include the obligation on the part of the receiver to meet policy obligations up till that point in time.