Insolvency Trends – 2008

An Annual Publication of the National Conference of Insurance Guaranty Funds

Welcome to the 2008 edition of *Insolvency Trends.* This publication, which is authored by the legal and public policy staff of the National Conference of Insurance Guaranty Funds (NCIGF), provides an update on recent events in insolvency law and practice and a look ahead at what is on the horizon in 2009.

Overview: Low Ebb, Significant Developments

Liquidation activity throughout the property and casualty industry is at low ebb. That notwithstanding, there continue to be significant developments in the insolvency community. The Insurer Receivership Model Act (IRMA) remains a matter of interest in some state legislatures. Insolvency issues also have captured the attention of members of the National Conference of Insurance Legislators (NCOIL). In addition, the perennially-discussed and debated $300,000 claim cap is receiving examination nationwide. Specific reports on these and other issues follow.

Developments at the National Association of Insurance Commissioners (NAIC) And How Issues Played Out in the States

The Insurer Receivership Model Act (IRMA)

IRMA continues to be a matter of discussion and occasional debate in the state legislatures. In Utah early in 2007, legislation repealing the state's liquidation statutory scheme in favor of a bill based on the NAIC-adopted IRMA framework was enacted. While some tout Utah as the second state to enact IRMA, the Utah law, like that of Texas – the first state to adopt legislation influenced by, but not wholly based on, IRMA – has significant differences from the IRMA model.

Although Delaware expressed interest in an "IRMA-based" bill early in 2007, legislators introduced no IRMA-related bills in the 2007 session. There are several possible reasons: disagreements over the large deductible language that would have been appended to the bill may have caused some reluctance to introduce a measure. Another possible reason perhaps may have been developments on California deposit law, which will be discussed later in this paper.

Pennsylvania continues a dialog on an IRMA proposal floated by the state's insurance department. Industry and other interested parties have expressed many concerns about the proposal. To date, no bill has been introduced.

Of keen interest last year was what the National Association of Insurance Commissioners' (NAIC) Financial Regulation Standards and Accreditation (F) Committee (FRSAC) would do with suggested specific provisions of IRMA that were proposed for consideration as accreditation standards. Many groups weighed in, including the NCIGF and the National Organization of Life and Health Insurance Guaranty Association (NOLHGA).

State legislators openly expressed opposition to an accreditation process that ties state certification to adoption of NAIC model laws and standards. This is because they say it requires legislators to approve model laws that may not be suitable for their states.

Previously NCOIL had adopted a resolution opposed to specific accreditation standards for IRMA. [1]

Ultimately, the FRSAC voted to retain the insolvency standard in place now and substitute IRMA nomenclature. [2] The new standard was exposed for a one year comment period in January of 2008. When asked, the FRSAC chair opined that those with "old" NAIC liquidation act language would ***not*** have to adopt IRMA format to maintain accredited status.

Large Deductibles

A large deductible policy is an insurance contract where the financial risk of the insurance is shared by agreement between the insurer and the policyholder through the use of deductible endorsements on insurance policies. Normally, large deductibles are employed in certain workers' compensation policies; however, large deductibles may also show up in automobile and general liability policies.

The deductible amount on these programs typically exceeds $100,000. Under terms of such a policy the policyholder agrees to reimburse the insurer, per claim, dollar for dollar up to the deductible amount. A standard large deductible policy and endorsement provide that the insurer will initially pay claims, and the policyholder will thereafter reimburse the insurer for amounts within the large deductible.

The character of the large deductible asset in the context of an insurance liquidation has been a matter of considerable controversy over the last several years. In 2006, debate at the NAIC centered on the appropriate large deductible language to be added to the IRMA model.

Ultimately, the NAIC adopted an approach in which the guaranty funds would receive prompt early access for claim payments within deductible amounts to the extent reimbursements were forthcoming or collateral was available. However, at the end of the day the deductible asset would be treated as a general asset of the estate.

[1] NCOIL Resolution Regarding Efforts to Make Insurer Receivership Model Act ("IRMA") Provisions Part of the NAIC Accreditation Standards adopted. July 22, 2006. This resolution reads in part "…BE IT RESOLVED that NCOIL opposes including post-solvency receivership standards in the solvency-based accreditation system…"

[2] The current standard, as set out in Financial Regulation Standards and Accreditation Program, p 12 (NAIC 2006) reads as follows: "State law should set forth a receivership scheme for the administration, by the insurance commissioner, of insurance companies found to be insolvent as set forth in the NAIC's Insurers Rehabilitation and Liquidation Model Act." We understand that the new standard would merely substitute Insurer Receivership Model Act (IRMA) for Insurers Rehabilitation and Liquidation Model Act. (IRLMA).

The actions of the states, of course, are key to how the issue will be dealt with in insolvent estates. In the end, state legislatures, the entities that originally created the guaranty fund system, will have the final say on how large deductible reimbursements are treated. While some version of the NAIC model has been discussed for adoption in modified form in one jurisdiction, so far no state has introduced a bill based on this model.

To date, six states have adopted large deductible language and woven it in to their liquidation acts. These include California, Illinois, Michigan, Pennsylvania, Texas and Utah. In addition, related legislation, which addresses the rights of the New Jersey Workers' Compensation Fund, is also in place. So far, no state has adopted NAIC model language. Significantly, all states that have addressed the issue call for the deductible asset to flow at 100 percent to the guaranty associations to the extent of their claim payments.

California Deposits and Deductibles

On July 20, 2007 California Assembly Bill No. 1364 was signed into law; the bill dealt with special deposits for workers' compensation liabilities. In essence, the new law simply states: insurance companies domiciled in a state that calls for deductible reimbursements, or collateral draw downs, related to payments made by the guaranty associations to be general assets of the insolvent estate, will pay deposits based on that within deductible amount.

Insolvency veterans are aware that California law calls for substantial deposits to be collected from companies doing workers' compensation business in the state. These deposits are significant and designed to secure the insureds workers' compensation writings in California.

This new law may have a profound impact on what states do prospectively in addressing the large deductible issue. California is by any measure a significant workers' compensation market; this being the case almost certainly the insurance industry will view carefully any statutory development that might increase the cost of doing business in this jurisdiction.

Reinsurance Collateral

A high-profile issue with the mainline insurance industry in 2007 was related to the terms under which non-US reinsurers would be permitted to do business in the United States. Obviously, non-US reinsurers have an interest in this issue's final outcome. The property casualty trades are speaking up as well. Not surprisingly, the Reinsurance Association of America (RAA) has joined many other groups to weigh in on the issue. Heavily debated is whether alien reinsurers will be required to post collateral – and if so, how much?

In November, the National Association of Insurance Commissioners (NAIC) released its Reinsurance Regulatory Modernization Proposal. The proposal is intended to respond to change in the global insurance marketplace. The proposal is meant to facilitate cross-border transactions and enhance competition within the U.S. market. It also is intended to ensure that U.S. insurers and policyholders are adequately protected from insolvency.

The interest of the guaranty funds is centered on one question: how will any new proposal impact the ability of the receivers of the insolvent estates to marshal reinsurance? In many cases the asset of most significance for liquidating insurance companies is reinsurance – and consequently the amount of guaranty funds' ultimate distribution is heavily impacted by the success of the receivers' reinsurance marshalling efforts.

On October 22 the NCIGF weighed in on the debate about reinsurance collateral proposals in a letter to John Oxendine, chair of the NAIC Reinsurance Task Force.

"The success of reinsurance collections has a direct bearing on how much insolvencies ultimately cost the public," wrote Barbara Cox, the NCIGF's vice president Legal & Regulatory Affairs. "For this reason, we are watching with interest the continuing debate over Reinsurance Collateral Proposals."

Cox also wrote, "It stands to reason, based on the significant impact collateral appears to have on estate recoveries, that any reduction in current collateral requirements will directly and considerably add to the cost of guaranty association protection that is, by statute, ultimately passed on to the public."

Cox's sentiments were echoed by James Corcoran, Principal of James P. Corcoran Co., EVP of American General Corp. and former New York Superintendent of Insurance.

"Receivers appear to be unanimously opposed to collateral reduction because they believe that reinsurance collections will be slower," said Corcoran.[3]

Model Acts

This year the NAIC looked at its process for determining whether various legislative proposals prepared by the NAIC should have the status of "NAIC Models." Two criteria were established for a body of language to merit such a classification:

> 1. The issue that is the subject of the Model Law necessitates a *national standard* and requires *uniformity* amongst all states; and
> 2. Where NAIC Members are *committed* to devoting *significant regulator and association resources* to educate, communicate and support a model that has been adopted by the membership.[4]

[3] AIRROC Matters, Winter 2006/2007, pp. 7
[4] From recent material prepared by the NAIC "Procedures for Model Law Development" – available upon request from NCIGF.

The Model Act Revision Group (MARG) and the Receivership and Insolvency Task Force (RITF) struggled with what the impact of the new process would be on their ongoing efforts to amend the longstanding NAIC Life and Health Insurance Guaranty Association Model Act and Post-Assessment Property and Liability Insurance Guaranty Association Model Act.

Ultimately, the Working Group and Task Force opted to recommend that the contemplated amendments to the two Acts be considered NAIC models. Extensive work had already begun on revisions to the Acts. The regulators felt it was important to be able to complete their work. We understand that the NAIC Executive Committee voted to adopt this recommendation at the NAIC's fall meeting. Work is now resuming on the Life and Health Model and we anticipate the RITF will complete its work on the Property and Casualty Model soon.

Regarding the substance of the Property and Liability Act – the regulators have, in their most recent draft, stricken language calling for the receiver to be bound by the guaranty association claims determinations. New language has been inserted calling for coverage of certain business assumed from another entity even if the product did not have guaranty association coverage before the transaction. Net worth is currently in the draft, although as an optional provision. There are also revisions being proposed to the Immunity provision along with other sections of the current model.

NCOIL Adopts Its Own Model Guaranty Association Act

NCOIL has adopted a Model Guaranty Association Act based substantially on NCIGF model language. A $300,000 claim cap is included in the NCOIL model but is footnoted to suggest states may want to consider a higher cap based on local conditions. Two states have already taken some initial steps to enact law based on this model – see specific reports below.

NCIGF's President and CEO Roger Schmelzer underscored the significance of the move.

"NCOIL has given state legislators the tools they need to ensure that the guaranty fund safety net remains strong," said Schmelzer. "This is great news for policyholders and claimants who for nearly 40 years have enjoyed the consumer protection accorded by the guaranty fund system. NCOIL is to be commended for digging into the details over the past year and adopting this new model law."

Schemes – Solvent and Otherwise

There continues to be interest on many fronts in "solvent run-offs." Proposals appear to be loosely based on the British "schemes of arrangement" – a device utilized in the United Kingdom to manage bankrupt insurance companies. Rhode Island law, originally enacted in 2002, was amended in 2007, despite objections of many groups to provisions being added that would permit a company being formed or reactivated solely for the purpose of transferring certain lines of business to it. [5]So far, it is believed, that no one has "field tested" the Rhode Island law even though the amendments might make it a more attractive device.

The Association of Insurance & Reinsurance Run-Off Companies (AIRROC) is also working on a proposal for run offs.

In October 2007 the International Association of Insurance Receivers (IAIR) sponsored "Emerging Investment Opportunities: Bridging the Gap between the Capital Markets and Troubled Companies," a conference that offered in-depth series of panel discussions on capital markets investment opportunities. The one-day program, which included insurance commissioners, reinsurers, attorneys and investment experts from the U.S. and abroad, explored the potential use of funding from the capital markets to address some of the issues and potential solutions to the serious financial challenges facing troubled insurance companies.

The discussion began by establishing several propositions: There is growing interest among regulators in finding market driven solutions to address the problems of troubled companies. Regulators are showing less interest in placing troubled insurers into liquidation. And troubled insurance companies present investment opportunities for the capital markets.

Overall, the discussion found that while troubled insurers may offer some strategic investment opportunities for the capital markets, given the long-tailed nature of many of the current insurance liabilities in the market place, and the strong public policy that favors policyholder and claimants' interests above the economic interests of investors, a rush of investment capital to fund insurance company runoffs is not anticipated.

The NAIC will also be weighing in on run-offs. A Task Force has been formed to study restructuring mechanisms for troubled companies. The charge of this task force is as follows:

[5] See 2007 Rhode Island Laws Ch. 07-269 (07-S 367A)

> Undertake a study of solvent schemes of arrangement (solvent run-offs) and Part VII portfolio transfers (a transfer leaving no recourse to original contractual obligor/insurer) and any other similar restructuring mechanisms to gain an understanding of (i) how these mechanisms are utilized and implemented; (ii) the potential affect on claims of domestic companies, including the consideration of preferential treatment within current laws; (iii) how alien insurers (including off-shore reinsurers) who have utilized these mechanisms might affect the solvency of domestic companies; and (iv) best practices for state insurance departments to consider if utilizing similar mechanisms in the United States and/or interacting with aliens who have implemented these mechanisms.

Note: Information on some companies currently in a runoff status appears later in this paper.

Optional Federal Chartering

On May 24, 2007 U.S. Senators Tim Johnson (D-SD) and John Sununu (R-NH) introduced S.B. 40, The National Insurer Act of 2007. The bill would authorize an Optional Federal Charter for insurance companies and agents. The legislation is similar to a bill both Senators - and Rep. Ed Royce (R-CA) in the House - introduced in the last session of Congress.

Later in the year, Congressman Ed Royce (R-CA) introduced an identical piece of legislation in the U.S. House of Representatives.

In the months leading up to the drafting of these bills, key congressional staff sought the expert advice of NCIGF and NOLHGA for advice on the intricacies of guaranty fund law and operations.

NCIGF has no position on the optional federal charter itself. Our sole focus is the guaranty fund system and keeping it delivering on its mission of paying claims. However, regulatory structure has a potentially profound impact on insurance policyholders; for this reason the NCIGF will continue to monitor developments on this front.

As it is currently framed, OFC legislation calls for the National Insurance Guaranty Corporation to step in when a state guaranty fund has not met the standards established by the federal legislation.

NCIGF takes the position that consumer protection related to insolvency of a property and casualty insurer, whether it be a national or state insurer or under state or national regulation, is best provided at the state level. The organization also maintains that OFC-related qualification requirements for state guaranty associations should be established so that all state guaranty associations are qualified under an OFC law. For this reason there would be no need to create a National Insurance Guaranty Association. In addition, the NCIGF maintains the assessment capacity of the guaranty fund mechanism should not be divided between a state and a federal guaranty fund mechanism; in order to avoid such a split, only one mechanism to protect both types of insurers should be in place.

Regardless of whether OFC legislation ultimately is passed, the guaranty fund system stands ready to continue to deliver on its mission of protecting policyholders and claimants.

Modifications to the Guaranty Association Acts

In 2007 Arizona amended its definition of an insolvent insurer to include an insurer "licensed to transact insurance either at the time the policy was issued or when the insured event occurred and against whom an order of liquidation with a finding of insolvency has been entered." A similar definition amendment was made in California.

A net worth limitation of $25 million was enacted in Massachusetts.

Connecticut enacted legislation raising the per-claim amount to $400,000 for claims arising under policies of insurers determined to be insolvent on or after October 1, 2007. In Rhode Island, the per-claim amount has been raised to $500,000 per claimant for all other covered claims for insolvencies occurring on or after January 1, 2008. In both states, provision paying the full amount of a covered claim for benefits under a workers' compensation insurance policy remains intact.

Currently a bill is pending in Alabama to increase the workers compensation account assessment cap from 1 to 2 percent. Another proposal may also be afoot to modify the state's net worth limitation and deal with other coverage issues.

In Mississippi, legislation has been introduced (SB 2990) to amend the Property Casualty Guaranty Association Act to add a net worth limitation of $25 million, a claims bar date, and an automatic stay.

A couple of states have already expressed some interest in the new NCOIL Post-Assessment Property and Liability Insurance Guaranty Association Model Act. In Hawaii, HB 2252 has been introduced which closely tracks the NCOIL Model. A similar measure is being discussed in Rhode Island.

Terrorism Risk Insurance Act (TRIA)

President Bush approved HR 2761, the Terrorism Risk Insurance Program Reauthorization Act, on December 26, 2007. The new law extends the federal terrorism insurance backstop for seven years and ends the existing Terrorism Risk Insurance Act (TRIA) distinction between foreign and domestic acts of terrorism. It does so without increasing the level of loss necessary to trigger the program ($100 million) or adding an onerous mandatory “make-available” requirement for attacks involving nuclear, biological, chemical or radiological (NBCR) weapons of mass destruction.

Recent Insolvency Case Law

Court Rules New York Liquidation Bureau Is Not a State Agency

In a unanimous decision, New York’s highest court ruled that the New York Liquidation Bureau is a private entity and not a state agency, and as such, is not subject to audit by the state comptroller. [6]

The decision ended a dispute between the Liquidation Bureau and the comptroller who had filed subpoenas seeking to compel testimony and the production of documents to allow it to review the Bureau’s financial management and operating practices.

The court noted that the Superintendent of Insurance serves in two distinctive capacities: one, as supervisor and regulator of the state’s insurance industry as a whole and two, as a court appointed receiver on behalf of distressed insurers. The court found that as a court appointed receiver, the superintendent is charged with managing assets of the estate on behalf of creditors of the troubled insurer. The court further found that the comptroller did not have authority to oversee the Liquidation Bureau because a liquidation does not involve state funds and has no fiscal impact on the state.

Virginia Court Rules Against Risk Retention Groups

The Virginia State Corporation Commission issued an order granting summary judgment in favor of the Reciprocal of America (ROA) Special Deputy Receiver and against the Tennessee Risk Retention Groups (RRGs) that were asking the court to classify their claims as policyholder level claims. The court affirmed the hearing examiner’s ruling that had reached the same conclusion. [7]

The court rejected the RRG’s theory that the RRGs and ROA’s course of conduct gave rise to a “single business enterprise” that should allow policyholders of the RRGs to be treated as if they were policyholders of ROA. Citing previous case law from Virginia and other states, the court also ruled that the priority distribution scheme provided in the Virginia Code cannot be altered by the exercise of the court’s equitable powers. The court also rejected the RRG’s claims to certain trust funds.

Based on information contained in ROA’s 2006 Annual Statement, if upheld on appeal, the Commission’s order should result in additional distributions to policyholder level

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[6] Eric R. Dinallo, Superintendent, The New York State Insurance Department Liquidation Bureau, et al., Appellants v Thomas P. DiNapoli, Comptroller of the State of New York, Respondent. 2007 NY Slip Op 07497. (October 11, 2007.) Available from the NCIGF.

[7] Doctors Insurance Reciprocal Risk Retention Group et al. and Reciprocal Alliance Risk Retention Group (Joint Petitioners) No. INS-2003-00092 (Virginia State Corporation Commission February 14, 2008.) Available from the NCIGF.

claimants of approximately $135 million, of which approximately $68 million would be payable to the guaranty associations.

It is expected the RRGs will appeal to the Virginia Supreme Court.

Runoffs and Rehabilitations

Highlands Runoff Plan

Highlands Insurance Company was placed into receivership in November 2003. In July 2006, the special deputy receiver filed a petition seeking approval of a Plan of Rehabilitation utilizing authority conferred by the newly enacted Texas Insurer Receivership Act, based upon an early version of the IRMA. The purpose of the plan was to wind up the affairs and obligations of the company under an orderly runoff process. The Plan did not contemplate any attempt to restore the company to financial health.

The proposed plan projected that there would be sufficient assets to pay one hundred percent of all approved Class 1 and Class 2 claims over the next ten years. Success of the plan was based on a number of critical assumptions, including the assumption that substantial savings would be achieved through discounted settlements with asbestos and other EMT claimants. Other critical assumptions were based on actuarial projections of anticipated cash flows of the estate. The Plan included the objective of providing creditors a greater return than what would be expected were the company to be placed into liquidation.

After the application for approval of the Plan was filed, the Special Master received numerous objections to the Plan. Following a number of procedural delays, a hearing was held before the Texas Special Master, Tom Collins, who issued a 37-page memorandum recommending that the Plan not be approved.

The recommendation focused on elements of two key issues: whether the statutory elements needed for approval of the plan were shown to be present and whether the deputy receiver, as proponent of the plan, had the burden of proof. Citing the extreme difficulty in accurately valuating Highland's claims liabilities, the Special Master concluded the Plan provided no assurance the liabilities would not exceed the deputy receiver's estimates and that there would be adequate funds to provide the same level of payments to all policyholder level claimants. The Special Master found the Deputy Receiver did not meet his burden of proof that the plan was fair and equitable to all policyholders.

Following entry of the Special Master's recommendation to disapprove the Plan, the Texas Department of Insurance, as statutory receiver, filed a petition for a *de novo* review. That hearing is currently scheduled for May 12, 2008. In the meantime, the special deputy receiver has been in negotiations with some of objecting parties, and several parties have withdrawn their objections to the plan. Of continuing interest will be how the Texas court will address the legal issues raised by the objectors. Foremost among these questions are: what evidence must the proponent of a runoff plan show under the Texas Insurance Receivership Act; which party has the burden of proof that the statutory standards have been met; and does the statute allow a different answer to the preceding questions simply because no one objects to the plan?

Frontier Insurance Company

The New York Liquidation Bureau is continuing in its efforts to rehabilitate Frontier Insurance Company. Since being placed into rehabilitation in 2001, Frontier has continued to pay claims. In 2007 the company made claim payments of approximately $30.8 million.

According to the company's 2006 annual statement, Frontier had $147.7 million in admitted assets and $252.5 million in liabilities. The company's 2007 annual statement is not yet available. According to a company representative, the overall numbers are not expected to change dramatically from 2006. Although no timetable has been set for completion of the rehabilitation, the Bureau reports that progress continues to be made.

Kemper Insurance Companies

The Kemper Insurance Companies are operating under a run-off plan filed with the Illinois Division of Insurance in 2004. The Kemper Companies' flagship, Lumbermans' Mutual Casualty Company is operating under a confidential RBC plan to address its RBC level. The run-off plan is designed to help the Company meet its goal of resolving, to the maximum extent possible, all valid policyholder claims.

According to the recently filed 2007 Annual Statement for Lumberman's "Achieving the surplus and liquidity projections in the run-off plan requires the consummation of agreements with insureds for policy buybacks and novations; the timely performance of payment and other contractual obligations owed to the Company by various third parties, including reinsurers as well as insureds and agents; agreements with regulators in various jurisdictions; and the absence of significant additional disputes not only with reinsurers but also with creditors, including insureds and certain states, which could involve judicial or other actions to seek either to force the Company to collateralize its unsecured obligations or to not timely release collateral back to the Company."

While the Annual Statement indicates no assurance can be given that the run-off plan will continue to be successfully implemented, the plan continues to chug along.

Guaranty Fund Strategic Planning Initiative Readies System to Meet Future Challenges

A significant development in guaranty fund system was ongoing work on the NCIGF's Strategic Planning Committee initiative.

Through this effort the property-casualty guaranty funds undertook a thoughtful, candid and broad-based self-examination of the culture and process of the state system through a strategic planning initiative created by the NCIGF board of directors.

The initiative, begun in January 2006, has evolved into the most ambitious self-examination of the state guaranty fund system in its history. As part of the effort, we have sought out and received the participation of the guaranty funds' insolvency partners. The goal: to assess how we perform on key fronts, and how the guaranty fund side of the insolvency equation can improve.

The final product of this effort is the NCIGF's strategic plan, *Putting Consumers First: The State Guaranty Funds Moving Forward Together.* The plan, which received an enthusiastic approval by the NCIGF board in November 2007, voices a strategic and tactical vision for the guaranty fund system and the NCIGF, the system's support organization.

In 2008 and beyond, the plan will inform an ongoing assessment and evolution of the guaranty fund system and the role of the NCIGF. It will also drive many of the changes that will continually improve the system's ability to deliver on the mandate that was given to it by policymakers nearly 40 years ago – to protect policyholders and claimants.

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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