National Conference of Insurance Guaranty Funds

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Why Large Deductible Reimbursements Belong To Insurance[1] Guaranty Funds

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Introduction. The recent wave of insurance insolvencies created stiff, new challenges for receivers and the insurance guaranty funds alike. Both groups have grappled with an unprecedented claims load and financial burden, and a diverse variety of alternative insurance products largely unseen in prior insolvencies. With the worst hopefully behind, it is agreed that both groups arose to the challenge in distributing funds to the individual insureds and claimants of the insolvent insurers. Lingering issues remain in the wake of the insolvencies however, none more prominent than the dispute between the receivers and the guaranty funds relating to large deducible insurance policies.

The dispute itself is simple: when a guaranty fund pays claims within a policyholder's large deductible, who is entitled to the benefit of the corresponding Reimbursements paid by the policyholders? The lines on this issue are distinctly drawn. The guaranty funds contend that the Reimbursements should be paid to the guaranty funds which triggered the Reimbursements by paying the claims in the first place. Receivers contend that the Reimbursements belong to the estate of the insolvent insurer.

This paper explains why – for practical, legal and public policy reasons – the Reimbursements should properly flow to the guaranty funds for purposes of paying the claims of individual policyholders, and not the estate of the insolvent insurance company.

Because Guaranty Funds Made the Corresponding Payments, They Should Receive Large Deductible Reimbursements on Behalf of Policyholders. A large deductible policy is an insurance contract where the financial risk of the insurance is allocated by agreement between the insurer and the policyholder. The allocation of risk is achieved by varying standard guaranteed-cost insurance policies through the use of deductible endorsements. A "large" deductible is typically in excess of $100,000, which 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. While large deducible policies are written primarily for workers compensation lines, they also include automobile and general liability lines.

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The Reimbursements arise as a direct result of post-liquidation claims that the guaranty funds pay in the insolvent insurer's stead. In any context, reimbursements are, by definition, amounts that are "repaid," "refunded" or "reimbursed" to the party who made the payment in the first instance. In the context of large deductibles, the party who makes the initial payments is the guaranty fund. Without the guaranty fund's payments, there would be no Reimbursement to fight over. It is illogical to "reimburse" receivers for payments that they never made. Moreover, as described below, it would be unfair to the policyholders and taxpayers, who ultimately bear the burden of any increase in the guaranty funds' net assessments.

Legislatures And Courts Agree: Reimbursements Should Be Made To The Guaranty Funds. In recognition of the above considerations, five states – Pennsylvania, Illinois, California, Texas and most recently Michigan – have passed legislation stating that Reimbursements are to be paid to the Guaranty Funds. No state legislature has enacted legislation stating that Reimbursements belong to the estate of an insolvent insurer.

Other states are sure to follow, because the large deductible statutes in place squares with existing guaranty fund statutes. While the large deductible policies may be relatively new, the role of the guaranty funds were long ago settled by state statutes. According to the legislatures of almost all states, as a matter of public policy, the guaranty funds cannot assume a greater risk than the insolvent insurer assumed under the policies. The guaranty fund statutes expressly or substantively provide that state guaranty funds shall:

> be deemed the insurer only to the extent of its obligations on the covered claims and to such extent, subject to the limitations provided in this article, **shall have all rights, duties and obligations of the insolvent insurer as if the insurer had not become insolvent**…. (emphasis added).

This "deemer" provision is a part of the NAIC Model Act, adopted by the legislatures of most states, with minor variations in a few states. Additionally, long before the Reimbursements dispute arose, the receivers effectively incorporated this "deemer" provision into its published handbook, which states:

> When a guaranty fund pays a claim on behalf of an insolvent insurer, the guaranty fund is generally considered to step into the shoes of the insurer. Then, through subrogation, a guaranty fund may seek indemnity from a third party as if it were the insolvent insurer.

Through the deemer provision therefore, the guaranty funds are entitled to "step into the shoes" of the insolvent insurer and recover the Reimbursements generated by the claims they paid post-liquidation.

Allowing the receivers to retain the Reimbursements, on the other hand, is contrary to existing state law. It would require the guaranty funds to assume a risk under the large deductible policies greater than the insolvent insurers ever agreed to assume as solvent companies. Thus, the receivers' position is essentially a rewrite of legislative public policymaking as reflected in state guaranty fund statutes.

In light of this well-established legislative framework, it is not surprising that the one court that has considered this issue found that Reimbursements belong to guaranty funds, and not receivers. In *Imperial*, the California Court of Appeals explained that a guaranty fund is entitled to recover large deductibles from the liquidator of an insolvent insurer's estate. *See In re Imperial Ins. Co.*, 157 Cal. App. 3d 290, 295 (Cal. Ct. App. 1984). *Imperial* involved a dispute between the liquidator of two California insurance companies and the California Insurance Guarantee Association ("CIGA") over the right to policyholder large deductibles held by the liquidator. Affirming the lower court, the Court of Appeals held that the liquidator was not entitled to the deductibles, because they were not property of the insolvent insurers' estates. The Court found that, because the insolvent insurers would not have been responsible for the deductible amount had they remained solvent, CIGA could not be responsible for paying the deductibles when paying those claims.

Reimbursements Are Not Premium. A repeated refrain of receivers is that Reimbursements are analogous to premium, which under state liquidation statutes is an estate asset. But the analogy does not fit because large deductibles do not have the key attributes of premium. Among other things, the Reimbursements are not called premium, taxed like premium, accounted for like premium, or calculated like premium.

Perhaps most significantly, the policyholders who purchase large deductible policies, and the insurers that sell the policies to them, do not treat the Reimbursements in the same manner as premium. Policyholders treat large deductible policies in their books and records in the same way that they would treat self insurance. For example, policyholders generally record amounts expended within large deductibles as loss payments, not premium. Insurers record large deductible reimbursements similarly in their books and records as a reduction of paid losses, not premium. Under this or any light, Reimbursements are not premium.

There Is No Need For A "Compromise." Leaders of the receivership community have suggested that the guaranty funds agree to so-called "compromise" legislation, which would treat Reimbursements as estate assets. As such, the guaranty funds would only receive partial reimbursement for amounts paid within policyholders' deductibles, with the estate pocketing the rest. There is no need to upend the well-established legal authority on this issue because, as discussed above, the current framework makes good sense. Moreover, the receivers' position would lead to adverse legal and practical results in insurance insolvencies, as demonstrated by the following three examples.

- First, as discussed above, the receivers' proposal squarely violates the principle that the guaranty funds should not assume any risk greater than that assumed by the insolvent insurer, who would have obtained 100% reimbursement from the policyholder.
- Second, the receivers' position would effectively require the guaranty funds to subsidize claimants that state legislatures throughout the country have already determined are not entitled to guaranty fund subsidization. For example, many states have net worth exclusions that prevent large net worth policyholders from bringing claims against the guaranty funds. The receivers' position would require the guaranty funds to subsidize such large net worth policyholders, who likely knowingly and voluntarily purchased insurance from the higher risk insurer in order to get a lower price.
- Third, requiring the guaranty funds to pick up the tab for the large deductibles would lead to an increase in the guaranty funds' net assessments, the burden of which will fall on policyholders and owners of solvent insurance companies, as well as taxpayers in states with offset provisions. In essence, the cost of the insured's large deductible policy would be shifted to the general public. Large policyholders excluded from guaranty fund coverage benefit most from the payments, receiving a larger dividend from the estate. This would be a perverse regulatory transfer of wealth and contrary to the public interest and principles underlying the guaranty fund system.

Conclusion. State legislatures long ago decided as a matter of public policy that guaranty funds cannot assume a greater risk than the insolvent insurer assumed under the policies. Five states have reaffirmed that position by enacting legislation that provides state funds, not the estate of insolvent insurers, with large deductible Reimbursement and at least one court has agreed. There is no need to "fix" anything at this point through the proposed "compromise" legislation because – for practical, legal and public policy reasons – the current approach is not broken.