Reshuffling the Deck: All Bets Are Off in High-Stakes Insurer Insolvencies

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The failure of insurance companies is nothing new and, until recently, did not present a serious threat to policyholders or the insurance industry. But recent insurer insolvencies now threaten both. There is concern that the current state insurance insolvency system, including the state guaranty fund system, cannot handle the volume and cost of both current and anticipated insurer failures.

The National Conference of Insurance Guaranty Funds reports that for property and casualty insurance failures, guaranty associations assessed solvent insurers $1.2 billion in 2002 and approximately $1.3 billion in 2003. From 2001 through 2003, property and casualty insurance guaranty associations handled in excess of $15 billion in new claims, compared to $9.3 billion paid for all claims handled through 2000. With the volume and value of claims increasing each year, one has to wonder who are the ultimate victims of failed insurers—policyholders and claimants, or the solvent insurers assessed for the claims against failed insurers?

The regulation of insurance, including insurer insolvency, is left primarily to the states. Unlike failures in other industries, insurer insolvencies are not subject to the federal Bankruptcy Code but are governed by state receivership laws, generally modeled after the National Association of Insurance Commissioners' Insurers Rehabilitation and Liquidation Model Act (Model Act). Most state laws provide that when an insurer is placed in receivership (conservation, rehabilitation, or liquidation) by a court of competent jurisdiction in the insurer's domiciliary state, that state's insurance commissioner is appointed statutory receiver.

Receivership Proceedings

Grounds to place an insurer into rehabilitation and liquidation parallel those found in the Model Act. The most common ground is insolvency. An order of rehabilitation, unlike an order of liquidation, may be issued without a finding of insolvency. The receiver acts on behalf of the creditors of the insolvent estate to secure and marshal the assets of the insurer and eventually rehabilitate the insurer or liquidate its assets.

There are significant differences between rehabilitation and liquidation proceedings, as well as between the duties and obligations of rehabilitators and liquidators. In both rehabilitation and liquidation proceedings, the receiver is vested with title to all of the insurer's assets, books, records, accounts, property, and premises. A rehabilitation proceeding is less structured, and a rehabilitator has considerably more discretionary authority than a liquidator to take whatever action is necessary to "save" the insurer.

Both types of proceedings generally include an injunction against pending and threatened litigation—against both the insurer and its policyholders. This delay provides the receiver the time to determine the true financial condition of the insurer. The receiver may bring causes of action on behalf of the estate, including actions to recover preferences and voidable and fraudulent transfers. The receiver also may pursue former directors, officers, management, and auditors of the insolvent insurer for claims of fraud and misrepresentation.

The primary goal of rehabilitation is to preserve the insurer's assets. The rehabilitator manages the insurer's affairs, under the supervision of the receivership court, until the insurer can be returned to management; acquired by a new owner; or, in the worst case, placed into liquidation.

A rehabilitator must formulate a rehabilitation plan, which should be in the best interests of policyholders, other creditors, and the insurer itself. The Plan must be approved by the receivership court and provide an opportunity for interested parties to be heard. If further attempts to save the insurer would substantially increase the risk of loss to policyholders, other creditors, or the public, the rehabilitator must petition the court for an order of liquidation.

Once an insurer is placed in liquidation with a finding of insolvency, the liquidator takes control of all aspects of the insurer's operations under the general supervision of the receivership court. The statutory liquidator is authorized to marshal assets; sue in the insurer's name; appoint special deputies; retain the services of professionals, including attorneys, actuaries, and accountants; obtain title to all of the insurer's assets; sell or borrow on the security of the insurer's assets; enter into contracts; and coordinate with state guaranty associations. (For more on state insurance guaranty associations, see the related article "Oh, No! My Insurer Has Gone Bust! Can an Insurance Guaranty Association Help Me?" beginning on page 1.)

Payment of Claims

In a rehabilitation, claim payments may be continued in the normal course of business or, at the discretion of the rehabilitator, only certain classes of claims may be paid. In a liquidation, the priority for payment of claims is statutory. All claims within a higher priority class must be paid in full before any payments are made to the next lower class. Most state priority of distribution statutes are modeled after the Model Act and prioritize payments as follows:

1. Administration costs and expense
2. Guaranty association administrative expenses

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3. Claims under policies (including third-party claims; claims of federal, state, and local government under policies; claims from guaranty associations; and claims for unearned premiums)
4. Non-policy claims of the federal government
5. Debts due employees
6. General creditor claims (including claims of cedants and reinsurers)
7. Claims of state and local governments
8. Surplus or contribution notes or similar obligations
9. Claims of shareholders or other owners

The Battle for Insolvent Insurers' Assets

With the failures of complex, multinational insurers, the battle for the assets of an insolvent insurer has increased significantly. Generally, the largest asset of a property/casualty insurer is its reinsurance receivables. When a ceding insurer is placed in receivership, the "insolvency clause" found in almost all reinsurance agreements provides that the reinsurance is payable to the insolvent estate "without diminution," because of the insurer's insolvency or because the receiver failed to pay all or a portion of a claim. The reinsurer must pay the full amount of the allowed claim to the receiver whether or not the claim was paid. Reinsurance recoveries become general assets of the estate. Reinsurance agreements are contracts of indemnity between the cedant and its reinsurer and do not exist for the benefit of the policyholder. Therefore, there is no direct liability from a reinsurer to the policyholder, unless there is specific cut-through language in the reinsurance agreement permitting direct payment from the reinsurer to or on behalf of the policyholder. Until recently, regulators and receivers did not favor, and fought strenuously against, cut-throughs to reinsurers.

In the *Koken v. Reliance Insurance Co.* receivership proceeding, No. 269 M.D. 2001 (Pa. Cmwlth Apr. 26, 2002), the receiver took an unprecedented step by seeking approval from the receivership court to apply certain guidelines for the direct payment of reinsurance proceeds to policyholders. A cut-through clause or endorsement, which only redirects the payment of reinsurance proceeds, permits a policyholder access to reinsurance proceeds for claim payments if its insurer should become insolvent. The Guidelines, however, require reinsurers to assume all of the insolvent insurer's obligations under the policies, not just the payment of claims.

What happens to policyholders that do not contractually provide for direct access to reinsurance proceeds in the event of insolvency of their insurers? Even before the direct access rulings in *Reliance* and *Legion*, No. 183 M.D. 2002 (Pa. Cmwlth June 26, 2003), courts found that, in certain instances, even though a policyholder generally does not have a direct right to reinsurance proceeds, if the relationship among the parties (the policyholder, the insurer, and the reinsurer) demonstrates that the reinsurer had direct dealings with the policyholder (through premium collections, underwriting, and direct claims responsibility), such course of conduct may dictate direct access to reinsurance proceeds.

In the *Legion* insolvency proceeding, for example, the court continued to find that policyholders are third-party beneficiaries under reinsurance agreements even where certain reinsurance agreements specifically exclude direct obligations to third parties. But because of the nature of Legion's commercial insurance programs—whereby Legion merely "fronted" for non-admitted insurers and reinsurers by issuing authorized paper—the *Legion* court found that certain insurance programs were designed and handled by policyholders and reinsurers and Legion was merely the conduit for a fee. Although the *Legion* cut-through cases are on appeal, the court continues to approve cut-through matters brought before it.

The lower court rulings in Pennsylvania have become the catalyst for policyholders to seek direct access to reinsurance proceeds in other pending receiverships.

In addition to the battle over reinsurance proceeds, competing claims to reimbursement payments for large deductibles and access to policyholder collateral held by receivers seem to have been resolved by the Pennsylvania legislature. On June 28, 2004, Pennsylvania Governor Edward G. Rendell signed into law Senate Bill 815, known as Act 46 (the Act). The Act clarifies and expands the rules for the handling of collateral held by an insurer subject to a delinquency proceeding in Pennsylvania. Highlights of the Act include the following:

- Collateral is not an asset of the insolvent insurer.
- Collateral will be used to reimburse guaranty associations for payments made by them under applicable insurance policies.
- Collateral will be allocated equitably according to lines of insurance.
- Receivers may now deduct a non-contractual, statutorily imposed "fee" from the collateral.
- Receivers are now subject to a statutory time frame for making adjustments to the collateral.

The Act went into effect immediately and applies to all "delinquency proceedings that are open and pending as of the effective date" of the Act. Accordingly, the provisions are applicable to ongoing receiverships, including *Reliance* and *Legion*.

Conclusion

The current insurer insolvency cycle has not yet peaked. It has become necessary to improve and refine the current state receivership system to meet the needs of policyholders and to provide relief from the growing financial burden on the insurance industry. We will continue to witness unique arguments for direct access to assets of insolvent estates, as sophisticated policyholders try to circumvent the Priority of Distribution laws. Although it is inevitable that some insurers will ultimately face financial failure, the majority of insurers will weather this storm and those to come; and the current state insolvency system, albeit with some lapses, will be there to protect noncommercial and small commercial policyholders.

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