Alternatives to Estimation of Claims and Acceleration of Reinsurance Recoverables: The Uniform Receivership Law

by
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Introduction

Insolvent insurers with pollution, asbestos and other long-tailed liability exposures may require twenty, thirty or even more years to run off all losses. The costs and effort involved in such extended estates have caused receivers to examine methods for an earlier closing. Receivers generally have the power to shorten this period by providing a cutoff date for making and proving claims. However, this is sometimes characterized as prejudicing claimants with latent injuries and creating a windfall for reinsurers which would indemnify the estate for a portion of such latent injuries.

Receivers in California, Missouri and New Jersey have attempted to resolve this dilemma by estimating long-tailed claims and accelerating reinsurance recoverables related to such claims. Several states have enacted or attempted to enact legislation intended to allow some form of estimation and acceleration. Reinsurers have opposed these efforts[1] with growing success. Litigation in New Jersey over the receiver's statutory authority to estimate and accelerate claims is ongoing with no end in sight. Absent compromise or alternatives, extended litigation seems to be the pattern for the future.

The merits of the arguments for and against claims estimation and acceleration are detailed elsewhere and need not be recounted here. However, the debate has generated efforts to find alternatives which may serve as acceptable compromises for both receivers and reinsurers.

The Interstate Receivership Compact

The concept of an interstate compact for insurance company receiverships originated in an effort to assure more consistency and quality to the receivership process without resorting to a federal system.[2] Three states (Illinois, Michigan and Nebraska) have formed the Interstate Receivership Compact (hereinafter "Compact") and others are considering joining. It remains to be seen how many states will ultimately joint the compact and what influence it will have generally over the administration of insurance company receiverships in the fifty states. Nonetheless, the first stage of the Compact's efforts, drafting a Uniform Liquidation Law (hereinafter "URL"), may have an impact far beyond the states which actually join the Compact.

The URL Effort

The URL was drafted over two years by receivers, regulators and representatives of guaranty funds, insurers and reinsurers. The drafting committee initially used existing state law as a model. However the effort evolved into what was probably the most comprehensive effort at drafting state receivership law since the Wisconsin liquidation code was drafted in the mid-1960's. This Wisconsin code become the basis for the original Liquidation and Rehabilitation Model Act of the National Association of Insurance Commissioners (hereinafter "NAIC").

The URL is receiving very favorable reviews from veteran observers of U.S. receiverships. On November 21, 1998 the National Conference of Insurance Legislators adopted a resolution endorsing the "URL as an effective mechanism for handling insurance receiverships by establishing a uniform, fair and more efficient means of administering insurance insolvencies within the State-based system." On November 17, 1998 the International Association of Insurance Receivers adopted a resolution noting that "a uniform set of laws to govern insurer insolvencies is necessary for the efficient administration of those insolvencies" and that the URL "provides such a set of laws." In an analysis issued on January 20, 1999, the National Conference of Insurance Guaranty Funds commented that "[o]verall, the URL is superior to the NAIC Model Act and the Uniform Insurers Liquidation Act from the perspective of guaranty associations."[3]

This year the Insolvency Subcommittee of the NAIC will study the URL with a final report to be submitted in December, 1999. Some trade associations and states are considering the URL as a complete substitute for current state receivership law.

Chapter 8 of the URL

Some of the more innovative features of the URL are contained in Chapter Eight which, among other things, deals with the termination of estates. While this chapter prohibits mandatory acceleration of reinsurance based on estimated values,[4] it proves a variety of options, other than cut off or run off, by which a receiver may wind up the estate. The receiver may sell some or all of the business to another entity.[5] The receiver may sell the reinsurance recoverables to a third party[6] and/or transfer responsibility for claims handling to one or more guaranty funds or another qualified entity.[7] Some of the assets and liabilities of the estate may be transferred to a liquidating trust for long-tailed claims.[8]

The right of the receiver to enter into voluntary commutations is specifically recognized[9]. However, the URL also recognizes commutation provisions built into reinsurance contracts to the extent they were not entered into with reasonable cause to believe that the cedent was insolvent or about to become insolvent.[10]

One of the more creative aspects of Chapter 8 is its mandatory negotiation and arbitration provisions[11] which allows the receiver to force an arbitration of the value of outstanding and incurred but not reported (hereafter "IBNR") losses. Once the arbitration is complete, the reinsurer must pay or provide collateral for the value of their reinsurance payables as found by the arbitration panel.

The mandatory arbitration procedure may be invoked by the receiver via court order when: (1) reserves for outstanding claims and IBNR on casualty business is 25% or less of total estate liability; or (2) the reinsurer's total adjusted capital is at or below 200% of its authorized control level for risk-based capital purposes.[12] The first point is meant to assure a mature book of business which can be subject to relatively accurate actuarial estimation.[13] The second point allows an exception to such maturity requirement when the reinsurer is approaching unsound financial status.

Within 90 days of a court order authorizing arbitration, the receiver and the reinsurer will exchange their estimates of liability along with relevant documents and underlying data such as premiums, losses, projected payout patterns, discount factor and net present value of outstanding losses and IBNR.[14] If the parties cannot reach agreement 90 days thereafter, either party may demand arbitration of the proper commutation amount.[15]

Should arbitration ensue, the receiver and the reinsurer each select an arbitrator who shall be a "disinterested active or inactive officer, executive or other professional with no less than ten years experience in or serving the insurance industry."[16] In arbitration circles, "disinterested" generally is interpreted to mean not financially interested in the outcome of the dispute but not necessarily impartial. This is in keeping with the school of thought that party arbitrators have some advocacy role in typical reinsurance arbitrations. In addition, the quoted language differs from the qualifications commonly required for reinsurance arbitrators in that professionals other than officers or executives of insurers or reinsurers qualify. Given the nature of the financial deliberations involved, this language certainly allows the selection of those who have spent their careers in accounting or actuarial firms. However, the language might also allow the selection of members of law firms, regulators and receivers.

The umpire for the panel is selected by the party arbitrators. In contrast to the qualifications for arbitrators, the umpire must be "independent, impartial, disinterested" and be "an active or inactive officer or executive of an insurance or reinsurance company."[17] The "independent" and "disinterested" language suggests that the umpire must not be under the control of any relevant party and have no financial interest in the result of the arbitration. The "impartial" language suggests that the umpire must have no pre-disposition on the issue involved in the arbitration. The requirement of insurance or reinsurance company background suggests a desire for experience grounded in the manner in which insurers and reinsurers project, estimate and discount their loss reserves.

Should the party arbitrators be unable to agree on an umpire, they will each name three qualified individuals and strike two from the other's list. The umpire is chosen by drawing of lots.[18] In the reinsurance arbitration context, this often takes the form of guessing whether the Dow Jones Industrial Average for a future date will be odd or even.

Once the arbitration panel is in place, the URL does not provide structure or procedures for the arbitration. The panel develops its own procedures, which dictates an umpire, if not an entire panel, with significant arbitration experience. An award issued by the panel shall be approved by the court absent the limited statutory grounds for vacating an arbitration award under the Federal Arbitration Act.[19]

The URL allows a receiver or reinsurer who is dissatisfied with the result of the arbitration to hedge its bet. A reinsurer can either agree to pay the arbitrated value or disagree and place assets equal to such value into a trust patterned after a credit for reinsurance trust.[20] Should the losses run off in a lesser amount than that calculated by the arbitration panel, the excess is returned to the reinsurer.[21]

Should the reinsurer agree to pay the sum decided upon by the arbitration panel, the receiver may accept this tender and deliver a complete release to the reinsurer. The receiver may also decline to provide a release and require that the value of the arbitration panel's award be placed in trust to pay the reinsurer's claims. In this fashion both the reinsurer and receiver are protected against a rogue decision of an arbitration panel. In addition, the receiver has security against the future insolvency of the reinsurer.

Conclusion

The estimation of claims and acceleration of reinsurance recoverables has generated a great deal of controversy and litigation in receivership proceedings. The effort to find a procedural middle ground offers the opportunity to wind up estates with long-tailed casualty business at earlier dates while respecting the contractual and legal rights of reinsurers.

The Compact's URL is a ground breaking effort which allows receivers a menu of options to close estates. One such option is a mandatory arbitration procedure by which the value of reinsurance recoverables is determined and paid or secured. This procedure has the potential to act as the middle ground which can avoid the current litigation and bitterness associated with the acceleration of reinsurance recoverables.

Endnotes

1. Reinsurers oppose acceleration of reinsurance recoverables on the basis that they are theoretical claims with theoretical values allocated in a theoretical fashion. Reinsurers assert that because reinsurance is a contract of indemnity, they cannot be required to pay losses, such as incurred by not reported losses, which are unidentified or unknown and which, as a result, have not been asserted or allowed in the receivership proceeding.

2. *Compare* James W. Schacht, Peter G. Gallanis, *The Interstate Compact as an Effective Mechanism for Insurance Receivership Reform*, J. of Ins. Reg. 188 (1993) *with* Debra J. Hall, Robert M. Hall, *Insurance Company Insolvencies: Order Out of Chaos, id*. at 145.

3. In the executive summary of its report the Conference stated:

With provisions dealing with such matters as an automatic stay, standing and appeal rights of affected parties, a document depository maintained by the receiver and the requirement of the filing of a plan for the handling of the insolvency, the URL embodies a modernized, more businesslike approach to the handling of insolvencies. While it would be preferable for certain revisions to be made to sections that are important to guaranty associations, we believe that overall the URL gives proper consideration to guaranty association interests. The URL deals fairly and favorably with such topics as early access, distribution priority and intervention provisions. In considering the URL as replacement legislation, it is critically important to account for and preserve unique provisions in a state's existing liquidation act so that these provisions would not be lost by enactment of the URL.

4. § 805 D.

5. § 802 B. (2).

6. *Id*.

7. § 802 B. (4). Such a transfer would be an arm's length transaction, wholly voluntary to a guaranty fund.

8. § 806.

9. § 808 A.

10. § 808 B.

11. § 809.

12. § 809 A. (1).

13. Some unlucky estates have a wide variety of manuscript, high excess liability coverages written on a surplus lines or other unregulated basis with significantly varying retentions and severe exposure to asbestosis, pollution, tobacco and other latent injuries. Even for highly qualified actuaries, ultimate liabilities for such estates are extremely hard to predict early in the proceeding since losses may be impacted by a wide variety of economic, legislative and judicial factors.

14. § 809 B. (1).

15. § 809 B. (2).

16. § 809 B. (3) (a).

17. *Id*.

18. *Id*.

19. § 809 B. (3) (c). The Federal Arbitration Act, 9 U.S.C.A. § 10 allows an award to be vacated for a variety of reasons including fraud, corruption, partiality or misconduct of the arbitrators. For a discussion of certain bases for overturning awards under the Federal Arbitration Act, *see* Robert M. Hall, Paige D. Waters, *Partiality Among Arbitration Panelists*, VII Mealey's Reins. Rep. 3 at 18 (1997).

20. The trust is placed with a qualified U.S. financial institution and the assets may not be withdrawn without the approval of the receiver. The assets will be placed in specified categories of investments and shall be maintained at a value of 102% of the required amount. *See generally* § 810.

21. § 810 F.