Insurance Company Insolvencies

Order Out of Chaos

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Abstract

This article analyzes the problems with the current state receivership system, the proper objectives of a receivership system and the ability of the current state system to meet these objectives. A uniform, national receivership system is recommended and the various means of attaining such a system are reviewed.

Background

Focus Group On Insurer Receiverships

While the administration of insolvent insurance companies is a complex topic, there has been relatively little analysis of the process by which insurance companies are rehabilitated and liquidated (hereinafter the "receivership system"). This is due in part to a lack of available information about the system. In an attempt to fill this gap, a Focus Group was formed that represented a cross section of the industry, receivers, guaranty funds, and regulators. Its mission was to evaluate the current receivership system and, if appropriate, to recommend an alternative system.

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On May 1, 1992, the Focus Group issued an extensive report[1] that recommended a uniform, national receivership system (NAIC, 1993). Sections three through five (dealing with problems, objectives and recommended structure) of this paper are drawn in substantial part from that report. The remaining sections are solely the work of the authors of this paper. However, they are intended to reflect issues discussed by the Focus Group that are relevant to the conclusions reached in the Focus Group report.

Statistics On Receiverships And Studies Of Guaranty Fund Capacity

Property and Casualty Company Insolvencies

Number of Insolvencies In June 1991, A.M. Best Company issued a Special Report (Best, 1991) that contained the most comprehensive examination to date of the characteristics and causes of property and casualty company insolvencies. This P & C study noted that 372 such insolvencies had occurred during the period from 1969 to 1990. Of those insolvencies, 225 or 60 percent took place in the period from 1984 to 1990. The study predicted that insolvencies would peak at 45 in 1992 or 1993 but would remain at historically high levels thereafter.[2]

Cost of Insolvencies The total cost of an insolvency is difficult to determine,[3] but the most readily available measure is the guaranty fund

1. The Focus Group report reflects a majority viewpoint and, as such, does not reflect the opinion of any single member of the Focus Group or the organizations that those members represent. This paper represents the opinions of two people who participated in the Focus Group and not necessarily the opinions of the Group as a whole or any of its other members. Neither does this paper represent the opinions of the organizations with whom the authors are affiliated.

2. A subsequent study documented the continuing high levels of impaired companies. "Although the number of liquidations declined to 41 in 1992 from 46 in 1991, the number of companies that were restricted from writing business rose from an estimated 47 in 1991 to 59 last year." Presumably, the difference is made up of companies in rehabilitation or supervision. "Future environmental and asbestos claims also could pose a threat to many financially strained companies hammered by stricter regulations. And let's not forget the weather: They say the worst is yet to come." (Best, 1993).

3. An attempt to quantify these costs was made by James Barrese and Jack M. Nelson of the College of Insurance in a paper called "The Consequences of Insurer Insolvencies" presented to the American Risk and Insurance Association in August 1991.

assessments. The Alliance of American Insurers (AAI, 1992) reported that property and casualty guaranty fund assessments for the period from 1969 to 1990 equalled $3,770,222,988.[4] Approximately 91 percent of these funds were assessed from 1984 to 1990. At that time, over a billion dollars had been assessed for losses arising from the insolvencies of the Mission, Transit Casualty, Ideal Mutual and American Mutual insurance companies. Nonetheless, Best's P & C study noted that guaranty fund assessments were less than 0.5 percent of the industry's net written premium.

Life and Health Insolvencies

Number of Insolvencies One year after its P & C study, A.M. Best issued a similar report (Best, 1992 a) on impaired life and health companies. Two hundred ninety (290) impairments took place during the period from 1976 to 1991, with 141 or 49 percent occurring in the period from 1989 to 1991. The portion of impairments relative to total life and health insurers has surged in recent years to a record 2.3 percent for 1991. Best's L & H study predicted that impairments would decline to about 35 (1.3 percent of all life and health companies) by 1993 or 1994 but would remain at historically high levels thereafter.

Cost of Insolvencies Best's L & H study reported that between 1976 and 1991, $680 million was assessed by guaranty funds, with an additional $4.2 billion in estimated ultimate costs.[5]

Guaranty Fund Capacity

State laws have established guaranty fund mechanisms for the protection of policyholders and claimants in the event of an insurance com-

4. Guaranty fund assessments under represent claims and policyholder benefits payable by insolvent insurers, because of statutory restrictions on lines of business covered and limits available.

5. This $4.2 billion figure excludes First Capital Life, Fidelity Bankers Life, and Mutual Benefit Life insurance companies. Coverage is statutorily restricted. In addition, several jurisdictions (*e.g.*, California and New Jersey) did not have life and health guaranty funds during this period of time.

pany's insolvency. These funds are generally divided into property and casualty guaranty funds (P & C funds) and life and health guaranty funds (L & H funds).[6] A few states have established separate funds for health maintenance organizations or workers' compensation. New Jersey has a fund for surplus lines business.

Funding for state guaranty funds is accomplished by assessments upon the industry. Methods for recoupment of those costs vary among states but include tax offsets, policyholder surcharges, or incorporation of the costs into future rates. Sometimes assessments cannot be recouped fully, and the industry must absorb some of the costs of insurer insolvencies.

An important question is whether or not the guaranty funds will be able to meet their obligations if one or more major, or several minor, insolvencies occur. This topic was considered by an NAIC Guaranty Fund Task Force formed in 1984 (Duncan, 1987, p 286–287). In connection with the Task Force's efforts, three studies were performed. The first was an Insurance Service Office (ISO) study on State Guaranty Funds issued in April 1985. It analyzed available national guaranty fund capacity and the impact on capacity of the insolvency of any one of the 30 of the largest property and casualty companies. It concluded that no one insolvency would exhaust national capacity.

Later that year, the Alliance of American Insurers (Alliance) produced a study that focused on the impact on the various guaranty fund accounts in each state of the insolvency of one major company. The Alliance study concluded that the capacity of 38 accounts in 31 states would be exhausted in the first year, and 31 accounts in 29 states would be exhausted in the second year (Duncan, 1987, p 284).

The third study was issued by the Illinois Insurance Department (IDI, 1985). It was designed to correct several shortcomings of the ISO and Alliance efforts by using real data from the Reserve Insurance Company insolvency to model information on loss reserve inadequacy, availability of assets of the insolvent company and payout patterns. Use of such data resulted in a much more grim picture of the capacity of guaranty funds to meet the needs of claimants (Duncan, 1987).

In March 1992, the General Accounting Office (GAO) issued a paper in which it modeled the impact of a large insolvency on the state

6. Guaranty fund statutes are generally based on NAIC Model Acts, but the Model Acts have been significantly modified in many states.

guaranty fund system (GAO, 1992). It concluded that significantly more than half of the states would require one to two years to pay the first year of losses, and that a few would require two or more years.[7] Based on these findings, the GAO questioned whether the current guaranty fund structure would be capable of paying claims in a timely fashion if one or more large insurers became insolvent.

Because all of the models noted above contain a number of erroneous assumptions and other limitations, the best indicator of adequacy of capacity may be actual experience. This suggestion is supported by certain statistical evaluations performed by Robert Klein of the National Association of Insurance Commissioners (NAIC, 1992). Klein noted that P & C fund capacity for 1991 was $3.0 billion and that L & H fund capacity for 1990 was $3.2 billion. From 1986 to 1991, net P & C assessments averaged 21.8 percent of capacity with the highest P & C fund assessment ($902.2 million in 1987) representing only 36.3 percent of 1991 capacity. Over a similar period, L & H net assessments averaged 5.4 percent of capacity with the highest L & H fund assessment ($460.7 million in 1991) representing only 14.4 percent of 1990 capacity (NAIC, 1992, p 21).

Hurricane Andrew has precipitated 8 insolvencies and an estimated $500 million in guaranty fund payments. These payments have swamped the Florida fund, and a variety of measures are being considered to fund the shortfall (Best, 1992 b). Although 1992 may prove to be the highest year to date for payments by P & C funds, these payments need to be considered in light of overall fund capacity.

Prior to Hurricane Andrew, individual state funds and accounts within those funds had, with certain exceptions,[8] been adequate to meet the needs of claimants. This fact suggests that gross capacity is adequate, although shortfalls may occur in specific areas. Ideas for avoiding state or account shortfalls and for better use of gross capacity are discussed in the fifth section, which recommends an alternative structure for a receivership system.

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7. The GAO made a number of assumptions that skew the results of its study. For instance, it focused on insured rather than paid losses, thereby understating the guaranty funds' ability to fund liabilities. However, it also assumed that each state had only one account, thus overestimating the flexibility of guaranty fund assets.

8. Although guaranty funds have borrowed money on 25 occasions, only two instances involve situations in which the fund ran out of money (Stephenson, 1992).

Problems Of The Receivership Process[9]

States began to enact receivership laws in the early 1900s and have resisted efforts to make these laws consistent (NAIC, 1993). Given the non-uniform nature of these laws, the commercial nature of recent insolvencies and the inherent difficulty in the administration of a receivership (Stewart, 1990), inefficiencies and conflict are not difficult to predict. Available evidence supports this prediction (NAIC, 1993; Hiestand, 1986, p 590). The current problems result largely from regulatory delay, outdated laws, territorialism, lack of resources, and structures that are fragmented and not designed to cope with the nature and frequency of current liquidations. Despite these systemic difficulties, the individuals involved in the receivership process have tried very hard to make the system produce the desired results, with considerable success.

Regulatory Delay

Timely removal of insurance companies from the marketplace is one of the most important factors in ensuring a fast and efficient receivership system. Delay by regulatory officials can result in wasted assets and deterioration of records and, at worst, in unnecessary dissipation of assets and destruction or removal of vital records (Fogel, 1992a).

Certain industry representatives, while supporting a state based receivership system, have criticized state regulatory personnel for their failure to act in a timely manner. A National Association of Independent Insurers (NAII) Task Force examined structural issues related to insurer solvency regulation and concluded that the failure of regulators to remove troubled insurers from the marketplace in a timely fashion was the single most important factor contributing to the cost of insurer insolvency (NAII, 1992, p 21). The NAII noted that a significant period of time can elapse between payment of insurance premium and payment of property/casualty claims. As a result, an insurer can continue to conduct business for a substantial period before its past errors are reflected in operating results. The NAII noted:

> Recent insolvencies of insurers writing excess liability, umbrella liability and other long-term liability coverages highlight this problem;

9. For an extensive review of the receivership process, see the *Report of the Focus Group on Insurance Receiverships*, NAIC Proceedings, (forthcoming).

> these insurers represent the most costly insolvencies ever experienced in the history of the property/casualty insurance industry. A critical challenge to the present state system of insurer solvency regulation is to find a method for removing failing insurers from the market before their net worth is depleted beyond the point of being able to meet outstanding contract obligations (NAII, 1992, p 21).

The NAII Task Force described this problem of timeliness as reflecting a lack of "regulatory will":

> Like everyone, insurance commissioners do not like to admit failure, and many commissioners and their staffs view the insolvency of a domiciled insurer as a personal and institutional failure. This, despite the fact that however intense and expert the regulation, some insolvencies will occur. Many regulators lose sight of the distinction between an insolvency caught early and one permitted to grow through regulatory indulgence (NAII, 1992, p 10, n 39).

The NAII Task Force correctly noted the many competing factors that a regulator must consider before removing an insurance company from the marketplace. Nonetheless, it concluded in very certain terms that:

> The complexity of the decision to act does not diminish the need to stop an insurer from driving up the ultimate cost of insolvency, however. In the view of the NAII Task Force, the cost to the public of deferring action on a failing insurer outweighs other political and economic considerations in the regulatory equation. Until this cost/benefit conclusion is accepted by regulators and integrated into the central structure of the regulatory process, it is unlikely that significant reduction in the costs of insurer insolvencies can be achieved (NAII, 1992, p 22).

Lack of Expertise and Funding

The size and organization of the receiver's staff varies from state to state (NAIC, 1993). These differences include whether or not the receivership personnel are state employees, the source of funding for their salaries, the applicability of state laws governing state agencies, and the role of the attorney general in the insolvency proceedings.

Because of limitations frequently imposed on salaries and incentives, it is often difficult to attract qualified personnel to fill receivership

positions. It is even more difficult to retain qualified employees when opportunities in the industry provide better career potential, income, and job security (NYSID, 1990, p 19–21).[10] The specter of personal liability provides a further disincentive.

Some states do not have a sufficient number of insolvencies to require a full-time receivership staff, and many states have difficulty staffing large insolvencies. In either circumstance, individual receivers may be appointed to administer the activities of a single estate. This practice often results in inefficiencies and inconsistencies. Single-estate receivers may spend substantial time and funds "reinventing the wheel." As the result of their narrow focus, single-estate receivers may take policy positions that: (a) are inconsistent with those of other receivers within or outside the state; or (b) do not reflect sound regulatory policy. For this reason, disputes may arise between multi-estate and single-estate receivers. The former sometimes view the latter as having a limited perspective on the receivership process that does not fully take into consideration the ramifications that a policy may have upon other estates or the ongoing marketplace.

Often, insufficient resources and time are available to provide adequate training (other than on the job) to develop qualified receivership personnel.[11] By the time receivership proceedings are implemented, the insolvent insurer's estate may lack sufficient assets to fund necessary administrative functions relating to claims. Additionally, potential assets and causes of action may be unrecognized or abandoned

10. Some guaranty funds are similarly unable to attract and retain qualified personnel. In some states, the temporary nature of the individual's job may further exacerbate this problem.

11. Some receivers and their staffs are dependent upon state legislative funding. Other receivership staffs are funded through the assets of the insolvent insurer's estate. In either situation, resources are often inadequate.

An April 1988 study of insurance departments conducted by the Consumer Insurance Interest Group and the National Association of Professional Insurance Agents concluded that state insurance departments do not receive adequate funding. According to the study, state governments allocate only 0.063 percent of their total budgets to insurance regulation, whereas the average consumer spends nearly 20 percent of the consumer's disposable income on insurance premiums.

Although the study found that premium taxes on insurance companies were a substantial revenue source for the states, an average of 5.37 percent of those taxes were allocated to insurance department regulation in 1988, a decrease from a 7 percent allocation average in 1985.

The study recommended that at least 10 percent of premium taxes be devoted to effective insurance regulation and cited to inadequate staffing, low salaries, and deficient examinations as examples of the negative results of poor funding (Engel, 1992, p 11).

because the estate lacks sufficient funds to pay for investigation or litigation.

A lack of staff expertise may result in poor advance preparation for the receivership, defective takeover procedures and an inability to identify and transmit necessary information in a timely manner (Fogel, 1992 d, p 20–24). Receivers may find it difficult to retain key employees of the insolvent company to assist in claims and data processing efforts. Turnover in personnel and communication problems within the receivership system may slow information movement among the various component parts of that system. Delays in claims payment and ineffective marshalling of assets in the estate may result (NYSID, 1991). Some states overly rely on outside legal counsel and consultants, further exacerbating the inability to develop necessary talent and substantially increasing costs (NYSID, 1990, p 9–18).

Although some state receivership staffs are composed of experienced, knowledgeable, and dedicated individuals, the multi-state nature of today's insolvencies and the inconsistent level of expertise nationwide often impede the effective performance of these individuals.

Receiverships are supervised by local state courts that may lack the expertise necessary to address the problems of a multi-state or multi-national financial organization (NAIC, 1993). These courts often fail to understand the urgency associated with insurance insolvency matters. Some judges are reluctant to make difficult decisions regarding the estate and are sometimes unwilling to accept judicial responsibility for statutorily required actions. Those judges who lack expertise are, at times, unable to prevent over-reaching by a receiver or obstructionist tactics by the insolvent insurer's management.

Political Influences and Territorialism

Regulators are often politicians who view a liquidation during their tenure as a failure of the regulatory process. Local political influences and the reluctance to eliminate jobs can have an impact on regulators, the attorney general, and the courts.

Additionally, conflicts exist over jurisdiction and authority. In some jurisdictions, local courts struggle with receivers over retention and compensation of outside legal counsel and consultants. In other states, the attorney general may attempt to control these often lucrative appointments. Once viewed as a backwater, insurance company re-

ceiverships are attaining a much higher political profile, affecting the manner in which these proceedings are conducted.

The territorialism of states and other entities can result in conflicts, poor communications, inefficiencies, and inequities. It may cause receivers to consider what is best for the receiver's individual state rather than overall estate administration. Similar criticisms may apply to state insurance guaranty funds. Courts may fail to abide by the orders of sister-state courts, resulting in waste of estate assets, inconsistent decisions, and inefficient liquidations.

Disputes arise between the federal government and state governments concerning priority of claims, jurisdiction over certain entities, and the impact of various federal laws on state insolvency proceedings.

Additionally, disputes may arise between receivers. For example, a domiciliary receiver may object to the establishment of an ancillary receivership that is created for political reasons, i.e., to control local assets or provide work for a local law firm. Disputes may also occur if procedures implemented by an ancillary receiver are in violation of the uniform laws governing the relationships between domiciliary and ancillary receiverships.

Mechanisms such as statutory and special deposits are sometimes used inappropriately in an outdated attempt to protect an individual state's policyholders. The existence of these deposits may unnecessarily thwart the process of marshalling the assets of the insurer and may prevent a domiciliary receiver from using alternative runoff procedures that benefit the estate's creditors as a whole.[12] Statutory and special deposits may also be used by receivers to fund unjustified ancillary proceedings. Conflicts may also arise between domiciliary and ancillary receivers over the right to reinsurance or subrogation recoveries, and procedures may be implemented by an ancillary receiver in such a fashion as to undercut the rehabilitation efforts of the domiciliary receiver.[13]

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12. For example, the Michigan Insurance Commissioner required a sufficiently large deposit from Executive Life that 50 Michigan residents could be paid 100 percent of their claims. Claimants in California, the domicile of Executive Life, were not so lucky because of what most commentators and policyholders regarded at best as ineffective regulation by the prior California Insurance Commissioner. Although the Commissioner had the best and quickest access to critical information, the Commissioner did not act until the run on Executive Life's assets was too massive to stop (Engel 1992, p 23).

13. A few states have statutes that recognize "commercially domiciled" insurers and permit a state regulator to place such an entity in receivership as if it were domiciled in that state, thereby impeding the regulatory efforts of the domiciliary state.

Similarly, jurisdictional conflicts may arise between the regulator/receiver and the state's attorney general. Whereas receivers are often experienced in insurer liquidations, an attorney general may have minimal knowledge of insurance, reinsurance, or receivership law and may lack sufficient interest or resources to pursue civil remedies and criminal prosecutions. Territorial attitudes may result in a refusal to act quickly, resulting, as previously noted, in dissipation of limited estate assets.

Disputes also arise between receivers and guaranty funds. Varying reserving practices may distort the accuracy of outstanding loss calculations.[14] Lack of coordination between receivers and fund administrators may jeopardize potential salvage and reinsurance recoveries. Disputes may occur over the continued servicing of policies, extent of guaranty fund coverage, reporting formats,[15] and classification of guaranty fund claims in the priority of asset distribution.[16]

Finally, regulators in different states may fail to coordinate their activities and to cooperate in taking unified action with respect to troubled companies prior to liquidation. The territorial behavior engaged in by some regulators may result from their differing political, social and economic agendas.

Regulation of Alien Insurers

States sometimes encounter unauthorized alien insurers that conduct the business of insurance without a license, a surplus lines approval, or other authorization by any state or U.S. territory. Since these are completely illegal operations, standard regulatory efforts (e.g., a cease

14. Some funds reserve the entire value of a claim, whereas others reserve only to the fund's limit. If the reserve amount forwarded to the receiver reflects only the fund's limit instead of the true value of the claim, an understatement of the insurer's liabilities can result. This circumstance can lead to underreporting in statements to reinsurers, thereby jeopardizing potential reinsurance recoveries. Additionally, the reporting formats used by guaranty funds may be inadequate for use by the receiver in perfecting claims with reinsurers.

15. Although there have been efforts to develop standardized forms of reporting by receivers and guaranty funds, few such forms are actually used.

16. Although early access laws were developed to encourage the early flow of estate assets to guaranty funds, as previously noted, some receivers do not grant early access when sufficient funds exist or they fail to utilize this mechanism in a timely or adequate manner to avoid assessments upon the industry and increased costs to the public. In at least one state, a domiciliary liquidator has provided early access to its domiciliary guaranty fund but has not disbursed assets to other guaranty funds.

and desist order) to prevent or prohibit the violation of the state's insurance laws may be ineffective. Receivership is sometimes the only available means of stopping these entities and protecting policyholders and claimants. However, unauthorized alien insurers often shelter their funds in offshore bank accounts so there is little for the receiver to seize. In some cases, the recovered assets are insufficient to cover the expenses of the initial seizure activity. As a result, it is difficult to effectively stop the unauthorized business of insurance in some states.

Inconsistent Laws and Procedures

There are more than 50 state and territorial jurisdictions in the insurance insolvency system. These jurisdictions have varying laws and procedures to govern receiverships, P & C funds,[17] L & H funds,[18] health maintenance organizations, workers' compensation funds, and surplus lines. Many of these laws were adopted when liquidations were of regional personal lines companies. They were not designed to address the insolvency of large, multi-state or multi-national insurers that write commercial casualty business, issue sophisticated investment products, assume reinsurance, and handle long-term coverage (Stewart, 1990).

Even when state laws are similar or identical, the interpretation of those laws by receivership staffs and the courts can vary signifi-

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17.

> It is difficult for many observers to understand why the extent of coverage that a policyowner receives for a given claim should depend on which state he or she lives in. . . . Caps on property/casualty claims range from $50,000 to $4 million. (NAIC, 1992 a, p 30).

In 1991, the Risk and Insurance Management Society (RIMS) surveyed its membership concerning P & C funds. Lengthy delays were reported in certain situations, particularly when the claim is covered by more than one fund or where the state of residence of a multi-state operation is in question. The result is that the claim is filed in all possible states with the claimants and the funds then expending the time and effort necessary to determine which fund(s) are the proper payers (RIMS, 1993, p 4-5).

18.

> The most significant state differences are in the areas of maximum payments and coverage of unallocated annuities. . . . Limits on death benefits range from $100,000 to $500,000 and health benefits from $100,000 to unlimited. A number of state guaranty funds do not cover unallocated annuities. There also are concerns about gaps in life/health guaranty fund coverage between states with resident-only coverage and states with non-resident coverage (NAIC, 1992, p 30).

cantly. The result often is inconsistent application of laws, litigation between receivers and guaranty funds, and disputes among receivers (NAIC, 1993).

Structural Barriers, Delays and Inefficiencies

Some barriers and inefficiencies are inherent in a multi-state system. The number of parties involved in the receivership process and its highly fractionalized structure create substantial delays, unnecessary costs, and duplicative efforts by receivers and guaranty funds. Although some progress has been made on flow of data, lack of acceptance of common data elements and reporting format and differences in the capabilities and technology of the various state entities continue to create inefficiencies. Insufficient coordination among guaranty funds, receivers, and regulators makes it difficult, or impossible, to adopt innovative solutions and remedial action in a cohesive and timely manner.

Some receiverships suffer from a lack of oversight. Commissioners are oriented toward the ongoing marketplace and often wish to distance themselves from the failures of solvency regulation. Receivers sometimes resist public scrutiny of their activities.[19]

Given the number of problems in the receivership process and the lack of incentive to close estates, receiverships can drag on for extended periods. In some states, receiverships of 20 to 30 years are not uncommon (NYSID, 1990, p 29).

Various organizations have been created to enhance communication and coordination among the states. The National Conference of Insurance Guaranty Funds (NCIGF) and the National Organization of Life and Health Guaranty Associations (NOLGHA) are among those

19. Of the California receivership office it was noted in a newspaper article that "(t)here is little oversight of the conservation division beyond a simple review by the Department of Finance of financial statements of insolvent companies—statements prepared by conservation division employees." (Wagner, 1993). The article comments on the difficulties of getting information about the receivership office; however, the reporter did receive some records that suggested that nearly $90,000 in severance payments were paid to employees still employed. The only publicly known salary is that of the new division chief, Fred Buck, who is paid $250 *per* hour. This is a reduction from the $300 *per* hour he received as a California Insurance Department consultant. The article reported that Mr. Buck formerly was the chief executive of a First Capital Life Insurance Company before it was seized by the receivership office. According to the article Mr. Buck, when questioned about his fees, commented, "I'm worth it."

organizations that have done a commendable job, but whose efforts are frustrated by the limitations and inconsistencies inherent in the current system.

Public Policy Objectives For A Receivership System And Barriers To Achieving Objectives

Objectives For A Receivership System

The success of a receivership system must be measured by its ability to meet its objectives, and the structure of the system must be designed to achieve those objectives. In order to evaluate the current system, the Focus Group identified the following as appropriate objectives for a receivership system. However, it recognized that not all of those objectives are completely achievable.

- Fast and efficient treatment of insurers in hazardous condition
- Uniform guaranty fund coverages and procedures
- Uniform receivership laws and procedures
- Complete receiverships more quickly
- Fast and efficient information flow through the receivership system
- Development and retention of qualified personnel
- Minimization of political appointments and agendas
- Efficient marshalling and reinvestment of assets
- Elimination of state barriers to multi-state receiverships
- Development of a mechanism for handling unauthorized companies and no-asset companies
- Improved reinsurance collections
- Specialized liquidation courts
- Improved utilization of guaranty fund assessment mechanisms
- Higher public confidence in the insurer receivership system

Current Barriers To Achieving Public Policy Objectives

The Focus Group concluded that there are sufficient structural barriers to achieving desired objectives to suggest the need for wholesale revision of the laws governing receivership proceedings.

1. **What are the barriers to fast and efficient treatment of insurers in hazardous financial condition?**
   a. It is sometimes difficult for state departments of insurance to detect financial impairment and quickly ascertain its reason.
   b. Insufficient information may exist about a company for an adequate assessment by the regulator of the alternatives available and the appropriate type of receivership.
   c. Preference laws and inconsistent guaranty fund laws inhibit a receiver's ability to transfer blocks of business or implement creative solutions to remedy the impairment.
   d. Specialized receivership courts are rare, and the courts of equity or general jurisdiction that preside over receiverships on a part-time basis along with other matters often lack the time or experience to cope adequately with the problems raised by an insurer's insolvency in a timely and decisive manner.
   e. Most receivership proceedings must be initiated by the state's attorney general, whose staff is often inexperienced in receivership matters. Additionally, political differences between the attorney general and the receiver may also result in significant delays.
   f. Insufficient coordination exists among guaranty funds, receivers and regulators to permit a cohesive or timely response to financial impairment. Since most state laws prohibit the receiver from giving a guaranty fund advance warning of a potential liquidation, the guaranty fund cannot make necessary arrangements for matters such as staff, office space, and supplies.[20]
   g. The staffs of insurance departments, guaranty funds, and receivers, like judges, are often inexperienced and lack the

20. The delay caused by these statutory restrictions must be balanced against the need to maintain confidentiality and to prevent premature public disclosure that a company is financially troubled.

technical knowledge to create or respond quickly to alternative solutions.

h. Political considerations may also cause significant delay or failure to act. Among other matters, insurance commissioners may be under political pressure to maintain insurance company jobs. Company officials themselves may wield sufficient political influence at a state or local level to hinder effective action. Commissioners may feel politically pressured by economic conditions or timing of elections.

i. Finally, regulators themselves may be reluctant to trigger receiverships, since the need for a receivership may be regarded as a failure of the regulatory process.

2. What are the barriers to uniformity among receivership and guaranty fund laws and procedures?

a. While the NAIC has adopted a number of Model Laws, many states have adopted widely varying laws relating to receiverships, P & C funds, L & H funds, HMOs, and workers' compensation funds. The multiplicity of laws and the varying agenda, approaches, and levels of expertise in each state make statutory uniformity unlikely.

b. Even if laws were substantially similar, variations in construction, application, and procedure would result in significantly different outcomes.

c. Substantial variations in the procedures of various states make it difficult for the component parts of the system to work together in a coherent and efficient manner.

3. What are the barriers to prompt claims payment and estate closure?

a. The condition of the impaired company's records is often poor.

b. The receiver and guaranty funds often lack the time and the expertise necessary to adequately sort out and evaluate such records as do exist.

c. The estate may lack sufficient funds to allow the receiver to perform the necessary administrative functions relating to claims.

d. Asset distributions and claims payment are delayed and unnecessary costs are incurred as a result of duplicative efforts by the guaranty funds and the receiver.

e. A lack of coordination may exist between the efforts of the guaranty funds, the domiciliary receiver, and ancillary receivers.
f. It is difficult to retain key employees of the insolvent company to assist in claims and data processing efforts.
g. It is difficult to attract qualified personnel to serve in receivership offices that are often underfinanced.
h. Inconsistencies among governing statutes lead to delays when guaranty funds, domiciliary receivers and ancillary receivers must use different methods or formats for reporting on claims or when they require different proofs or information.
i. The lack of training and expertise of personnel connected with insurance company receiverships and the inability to attract and retain competent personnel remain serious impediments to efficient estate administration, prompt claims payment, and estate closure. Poor advance preparation for the receivership also is demonstrated.
j. Moreover, because of the nature of the business written by the insolvent company, claims have become increasingly complex and difficult to evaluate. The proliferation of suits against guaranty funds and solvent insurers seeking coverage for environmental liabilities illustrates this problem.
k. Delays may be caused by claimants who seek the most favorable venue in terms of court jurisdiction and guaranty fund responsible for their claims.

4. What are the barriers to the improved flow of information (and money) through the receivership system?

a. Preparation for the receivership may be poor.
b. It is difficult to obtain sufficient data from the company's records in a timely manner.
c. The data processing equipment and technical capabilities of guaranty funds and receivers varies.
d. Guaranty funds, receivers, and reinsurers lack common data elements and reporting formats.
e. The lack of coordination between guaranty funds and receivers often results in untimely notice to reinsurers and delay in marshalling reinsurance proceeds.
f. Guaranty funds sometimes reserve claims only to the limits of guaranty fund coverage, rather than to the true value of

the claim. This practice may result in delay in collecting or an inability to collect reinsurance proceeds.

g. The identification, location and collection of records from branch offices, MGAs and TPAs is difficult and time-consuming, and the process often results in jurisdictional disputes.

h. The analysis and liquidation of the company's assets is often a slow process.[21]

i. Guaranty fund and receivership staffs often lack the necessary expertise in data processing, reinsurance, finance, and other important areas.

j. There is minimal or no oversight of the receivership process and few incentives to achieve greater efficiency.

5. **What are the barriers to the development and retention of qualified receivership personnel?**

a. It is difficult to hire and/or retain qualified former employees of the estate, given other employment opportunities and questionable job security.

b. For financial and career development reasons, it is also difficult to hire qualified personnel from the industry, and it is difficult to keep qualified people from moving from jobs with the estate to industry.

c. Little training is available to develop qualified people, other than that received on the job.

d. The uneven distribution and inefficient use of expertise is an additional barrier to efficient implementation of the present receivership system.

e. The influence of politics on the system may also be detrimental. The hiring of unqualified or marginally qualified lawyers, consultants, and receivership personnel may result from such political considerations. Even when political appointees are qualified, their hiring may cause disruption to the receivership operation.

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21. Sometimes, state law places undue restrictions on the ability of a receiver to invest company assets in a fashion designed to achieve an adequate return. For instance, New York Insurance Code § 7472 limits investments to deposits in state or national banks, savings banks, or trust companies. The Superintendent of Insurance has obtained judicial waiver of § 7424 in connection with Constellation Re and Executive Life and is seeking to amend the statute (Veach, 1992, p 19-23).

f. There is sometimes an over-reliance on outside consultants who themselves may be marginally qualified.

6. **What are the barriers to minimization of the politics in the receivership system?**

a. Federal—State Relationships

(1) Disputes exist over the subject matter and geographical jurisdiction of the liquidation court, as well as disputes concerning the need for federal court abstention.

(2) Disputes over the relative priority of federal claims to the assets of an insurer's estate.

(3) When a corporate affiliate is in bankruptcy, conflicts may arise between the trustee in bankruptcy and the receiver over records, rights to assets and personnel matters.

(4) The impact is unclear on receiverships of various federal laws and regulations such as the Federal Arbitration Act, the Internal Revenue Code, Interstate Commerce Commission regulations, and Pension Benefit Guaranty Corporation regulations.

(5) Because of the complexity of insurance issues and a lack of understanding of those issues, insurance fraud is inadequately pursued.

b. Receiver—Receiver Relationships

(1) Ancillary receivership proceedings are sometimes undertaken as a political reward or to fund a receivership staff. This wastes estate assets.

(2) Statutory or special deposits in individual states unnecessarily ties up the assets of the estate and can prevent a receiver from using alternative and more beneficial runoff procedures. Additionally, such deposits are used to fund unneeded ancillary receiverships.

(3) Territorial considerations sometimes cause receivers to consider what is best for their state rather than what is the most efficient and fair way of administering an impaired company.

(4) Single-estate receivers may have a narrow perspective on the liquidation process and, as a result, their pro-

cedures may conflict with those of multi-estate receivers who must develop procedures that are attuned to estates with a variety of characteristics and problems.

(5) When affiliated companies that are domiciled in several states become insolvent, the various receivers can conflict over ownership of assets, shared employees, commingled records, control of business premises, joint assets and liabilities, and pooling arrangements.

(6) Inconsistent state laws can permit a nondomiciliary receiver to trigger receivership proceedings for political or other reasons while the domiciliary state is attempting to work with the company for the benefit of all creditors.

(7) In some states, consultants, receivers and lawyers who have insufficient expertise in insurance insolvencies are utilized. The use of personnel who lack business acumen and knowledge of insurance company operations creates additional problems.

(8) Inexperienced receivers or small, understaffed receivership offices may rely too heavily upon outside counsel for business decisions, with protracted, litigious receiverships as the result.

c. Receiver/Regulator—Attorney General Relationships

(1) Conflicts exist regarding the jurisdiction of the respective offices.

(2) Attorneys General often have little knowledge of insurance, reinsurance, or receivership law.

(3) Attorneys General often lack interest in pursuing civil remedies or criminal prosecutions.

(4) Attorneys General may not understand the need for prompt action when an insurer is impaired.

(5) Attorneys General may fail to fulfill their legal responsibilities for political reasons.

(6) Issues arise as to when the Attorney General should represent the receiver and what immunities apply to the receivership process.

d. Receiver—Guaranty Fund Relationships

(1) Guaranty funds may focus on the welfare of their own state, not the efficiency of the overall effort.

(2) Receivers are often reluctant to allow the guaranty funds early access to estate assets.
(3) Disagreements occur over the nature, content, systems and format of information to be exchanged between receivers and guaranty funds.
(4) The fact that guaranty funds often only reserve claims up to statutory limits gives receivers a distorted view of outstanding losses and makes accurate reporting to reinsurers difficult.
(5) Poor tracking of payments made under policies with aggregate limits makes coverage determinations difficult and allows for payments in excess of guaranty fund or receivership obligations.
(6) Guaranty funds and receivers may dispute subrogation, salvage, and reinsurance recoveries.
(7) Disagreements occur over the responsibility to service business that continues after a company is placed in liquidation.
(8) Conflicts arise between receivers and guaranty funds regarding what is covered by the policy and by the fund.
(9) Although administrative expenses of guaranty funds are accorded a high priority in the allocation of assets of an insurer's estate, differences exist regarding the definition of such expenses.
(10) Receivers may object to loading the cost of test litigation into a single receivership in instances in which guaranty funds bring test litigation in one matter to clarify the law for a variety of similar claims.
(11) Because receivers fund their activities out of the assets of the estate, when there are minimal or no assets, the receiver may be unable to provide necessary support to the guaranty funds.
(12) Single-estate receivers lacking substantive and procedural perspective may require idiosyncratic claims and other reporting formats. This practice often results in conflict and a high number of inefficient, manual reporting systems.
(13) Although guaranty funds are often the largest creditor of an estate, they have little input into the administration of the estate.

(14) The fact that estate assets may be depressed in value for a variety of reasons can create conflict between receivers and guaranty funds if one party wishes to hold the assets until their value appreciates and the other seeks their liquidation.

e. Guaranty Fund—Guaranty Fund Relationships

(1) The fact that guaranty funds are presently established on a state-by-state basis leads to conflicts between the funds. Some funds are very territorial in their dealings with other funds and fail to cooperate in resolving disputes over which fund is responsible for a claim.

(2) The present fund structure does not provide a ready mechanism for the tracking of policy aggregates.

(3) Disagreements occur over state jurisdiction when a particular matter is litigated.

(4) Similarly, disagreements occur over the funding for test cases.

(5) Finally, conflicts occur between L & H and P & C funds as the result of their differing priorities, responsibilities, and procedures for such matters as continuation of coverage and tax offsets.

f. Regulator—Regulator Relationships

(1) A nondomiciliary state may be able to exert little control or influence over the actions of a domestic regulator with respect to an impaired company.

(2) On the other hand, the nondomiciliary state may use its statutes and procedures in a fashion that undercuts the rehabilitation efforts of the domiciliary regulator.[22]

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22. Each insurer is regulated separately, and consolidated proceedings are not as common as in Chapter 11 cases. For example, the Executive Life case in California proceeded independently from the Executive Life affiliate in New York.

(Indeed, the two commissioners took very different approaches to each case, with the California Commissioner being accused by many critics of a 'fire sale' of junk bonds at a low cash price to avoid future market risk, while the New York Commissioner held what many critics saw as a largely comparable bond portfolio in order to avoid the policyholders losing money on the large cash discounts involved in a sale in an illiquid market abandoned by the regulated financial and insurance company investors to the speculators.) Administrative consolidation (in the Chapter 11 sense) does not appear to be universal even within one state, and substantive consolidation is largely unprecedented in insurance insolvency cases (Engel, 1992, p 23-34).

(3) A number of states have inconsistent grounds for triggering receiverships.
(4) In many instances, regulators fail to coordinate their actions or to cooperate in providing unified action on troubled companies.[23]
(5) Regulators have differing political, social, and economic agendas.
(6) The experience and abilities of regulatory staff can vary considerably from state to state.
(7) Similarly, some regulators rely on consultants with naive or novel but inappropriate approaches to insurer insolvency.

7. **What are the barriers to efficient judicial supervision of receiverships?**
   a. The judges in receivership courts usually lack expertise and the time to obtain expertise in liquidations and run-offs and lack an understanding of the urgency often associated with these matters.
   b. Presiding judges often have limited knowledge of insurance and reinsurance law.
   c. Conflicts occur between judges and receivers regarding the authority of each.
   d. Because of their lack of expertise, judges may fail to deter over-reaching by a receiver.
   e. Judges may be reluctant to make difficult decisions with respect to the dissolution of a corporate entity.
   f. Likewise, judges may be reluctant to accept judicial responsibility for the actions that are statutorily required of them.
   g. Courts in other states may fail to give full faith and credit to the orders of receivership courts and thereby waste assets, reach inconsistent decisions, and cause inefficient liquidations.

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23. For instance, Michigan's Insurance Commissioner David J. Dykhouse, who held a special deposit posted by Executive Life, stated:

> I have enough money in this special deposit to discharge . . . all of the obligations, potentially, of the Michigan claimants. [However] in the past year and a half, I have been engaged in what amounts to a virtual war with the California Commissioner to get the information to determine who these potential claimants might be (Otis, 1992, p 1).

h. Jurisdictional conflicts may occur between state and federal courts.
i. Inconsistent decisions may be rendered by the various courts supervising multiple estates administered by a single receiver.
j. If multiple courts have authority to approve internal administrative matters, inconsistent decisions, inequitable results, and excessive administrative costs may result.
k. Judges accustomed to adversarial proceedings may regard themselves as rubber-stamping routine decisions of a receiver that have been presented to the court for approval.

Some of the barriers to achieving objectives noted in this section may be intrinsic to receiverships. For instance, it is difficult to improve the quality of an impaired company's records by altering the receivership system. However, it might be possible to mitigate the impact of such a barrier through improved resources (manpower, expertise, technology) to overcome such a barrier. Then the issue becomes what system can best produce and focus such resources.

The Focus Group concluded that there are inherent and unsolvable problems in overcoming barriers to public policy objectives on a state by state basis. The significant variations inevitable to such an approach are mirrored in the current system. Although incremental changes to the current system through the NAIC have had a beneficial effect, the magnitude of the problems with that system and the number of barriers that exist to reform of the system make incremental change impractical.

Recommended Structure For A Receivership System

The Focus Group concluded that the development of a uniform, centralized, national receivership system funded by the industry through an assessment mechanism would achieve the majority of the objectives identified in the prior section (Stewart, 1990, p 48–49).[24]

24. A greater degree of uniformity in state receivership and guaranty fund laws

Basic Structure and Organization

In the system proposed by the Focus Group,[25] the functions currently undertaken by receivers and guaranty funds would be combined. Uniform procedures and a centralized administration would be established, but functions would be performed out of regional offices, thereby shortening lines of communication, lessening confusion, and reducing conflict among relevant parties.

The system would liquidate, when necessary, any insurer or HMO operating in the United States, plus the United States operations of an alien insurer. Its authority would apply regardless of whether the entity had been a member insurer for purposes of contributions to the guaranty function and regardless of whether the entity had been authorized or approved to assume United States risks.

The receivership system would be run by a not-for-profit corporation organized by "members" consisting of companies licensed to write insurance in at least one jurisdiction in the United States. A national board of directors would be established that would consist of three elected representatives of licensed property and casualty members, three elected representatives of licensed life and health members, one elected representative of licensed reinsurer members, three appointed regulatory officials, and the national administrator, who would be the chief executive officer of the corporation.

The board would establish regional offices, committees, standards, procedures, and internal controls appropriate to the sound functioning of the corporation. An audit committee would be established, con-

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was recommended by the report of a study group sponsored by the American Council of Life Insurance (ACLI, 1991). A later report recommended that greater uniformity be achieved through one or more interstate compacts (ACLI, 1992). The Risk and Insurance Management Society advocates a uniform national guaranty fund law (RIMS, 1993). Conning & Company believes that a uniform, national system for guaranty funds and liquidating insurers will result in better solvency regulation, increased financial stability of the marketplace, and clarification of the rights of interested parties (Conning, 1993, p 59).

25. The Focus Group identified three means of attaining the necessary structure: (a) the NAIC accreditation process; (b) interstate compact; and (c) federal legislation. The Focus Group was aware that the relative merits of these methodologies were being debated in a number of contexts, and the Group preferred to let that dispute run its course. Therefore, the Group recommended objectives and a structure for a receivership system, but left the methodology for attaining those objectives and structure for a separate inquiry. For further analysis of the three alternatives by the authors of this paper, *see* the next section.

sisting of board members and other member representatives, to promote technological innovation, procedural efficiencies, and internal oversight. The corporation would be subject to oversight/audit by an independent third party and/or regulatory officials, and periodic reports would be made to receivership courts on individual receiverships.

The employees of the corporation would not be civil servants. They would be selected based on industry-relevant skills and would be compensated in a competitive fashion. Staff would function in both receivership and guaranty fund capacities. For instance, the same people would adjust claims regardless of whether they were covered by a guaranty fund. Those claims falling within the scope of guaranty fund protection would be paid from such funds.[26] Those claims that were not covered by a guaranty fund would be paid from the estate in accordance with a priority system. This combined procedure would eliminate duplication of effort, accelerate information and money flow, and better service claimants.

The corporation would not engage in regulatory activity such as examinations for solvency or initiation of action against potentially impaired companies. Removing regulatory functions avoids potential conflicts of interest that could otherwise arise in connection with the implementation of regulatory decisions affecting insurance companies.

The Focus Group additionally discussed at length their concern that the corporation not develop into an inefficient and overbearing bureaucracy. This concern needs to be further addressed when a means is selected to implement the recommended receivership system.

The Guaranty Function

The Focus Group determined that some administrative efficiencies and economies of scale could be achieved by combining the operations of the P&C funds and L&H funds within the corporation, while main-

26. The guaranty function would apply only to business written by member insurers in jurisdictions in which they had been licensed. Eligibility would depend, as it now does, upon such matters as whether the insolvent insurer was a member insurer in the state in question and whether the implicated line of insurance had been accorded guaranty fund protection. Monetary limitations on claims payments would also be imposed.

taining separate assessment mechanisms.[27] A number of existing state guaranty funds are operated on this basis, and no significant problems have resulted.[28]

The Focus Group believed that a workable receivership system could not guaranty every claim of every party in unlimited amount, since a guaranty of full payment in all instances would act as a disincentive to placing impaired companies into receivership and to placing insurance with financially solid insurers. Instead, limited guaranties should be available for the protection of consumers who lack the sophistication or bargaining power to protect themselves. As a consequence, limitations on the lines of business covered, the limits of payment available and the types of claimants eligible to receive benefits must be addressed. Experience at the state level has indicated that these determinations involve difficult public policy issues that merit a separate inquiry. Nonetheless, the Focus Group proposed certain elements that it believed should be reflected in the guaranty aspect of a national system:

- The NAIC Model Guaranty Association Acts should be the starting point for a national act.
- Limit the guaranty function to companies licensed in the United States.
- Apply guaranties only to claims against member companies in jurisdictions in which they are licensed.
- Exclusion of captives, risk retention groups and similar self-insurance vehicles, and HMOs from the guaranty function.

Funding

The administrative cost (other than losses and allocated loss adjustment expense) of the receivership system would be paid by member

27. This procedure would reduce the difficulty of developing plans to protect the policyholders of impaired life and health companies. For example, the disagreement of one state nearly jeopardized the plan to protect policyholders of Mutual Benefit Life, thereby calling into question "the promise of a state-run system designed to protect consumers when life insurers fail." (N.Y. Times, 1992).

28. New York favors a federal requirement that a uniform guaranty fund law be enacted by the states. It does not favor establishing a single national fund or combining property and casualty and life and health funds. A basis for its position is that with a single national fund, "a politically motivated state [could] . . . sacrifice financial solidity in favor of low prices, knowing that policyholders of a failed insurer in that state would be covered by contributions from the 49 others" (Curiale, 1992, p 1).

companies. Assessments for such costs would consist of an annual fixed fee, with additional fees based on net direct written premium in the United States, whether policies were written on an admitted or nonadmitted basis.

The primary purpose of assessing companies for administrative costs is to assure funding for the liquidation of a no-asset estate and to end infighting between receivers and guaranty funds over control of monies from sources such as reinsurance recoverables, subrogation recoveries, salvage, and early access payments, necessary to fund their respective operations. To balance the additional burden on the industry, companies would receive a top priority for claims to recover administrative assessments from the estates.

Assessments for the cost of claims and allocated loss expense would be calculated by use of the present formula, i.e., by net direct written premium by line, broken out by state. Member companies would be able to pass on the cost of these assessments to the public through mechanisms such as premium tax offsets, policyholder surcharges, and rate adjustments. The Focus Group determined not to take a position on which methodology was most appropriate, so long as the method selected spread the costs of assessments fairly and effectively.

The Focus Group believed that the current system of multiple funds and accounts could be maintained, so long as the ability existed to borrow among the funds and accounts, thereby making better use of existing gross capacity.

The Focus Group determined that subrogation, salvage, and reinsurance recoverables should be credited to the estate. Because of the industry's position as a first-priority creditor with respect to administrative assessments, the industry's assessments would ultimately be reduced by these recoveries.

Rehabilitations

The Focus Group observed that rehabilitations are successful only when the impaired company has retained its economic viability. It is unfair to the industry and the public, the Group concluded, to maintain a company on "life support" while assets dwindle. Extended rehabilitations of economically viable companies deny the public the benefit of guaranty fund benefits and waste assets.[29] Often they are used merely as a decision avoidance mechanism.

29. In testimony before the House Energy and Commerce Subcommittee on

There are a few instances, however, in which involvement by the corporation might help to save a troubled, but viable company. One such instance occurs when sale of a book of business, particularly life business, is possible. Because life insureds, recognizing the build-up in value of their policies and the higher costs of new coverage, are reluctant to go elsewhere, a book of life business has a cohesiveness that can survive a sale. In such a situation, the corporation can play a role similar to the Federal Deposit Insurance Corporation. It can facilitate a sale of a viable book of business to generate additional surplus. Additionally, the Focus Group believed the corporation should be able to facilitate the transfer of a poor book of business, if the insurer is in receivership and if such a transfer would be more cost effective than canceling and running off the business. If the receivership and guaranty functions are combined in the corporation, that corporation would have access to liquid assets through the assessment process that would assist such a transfer.

The Role of the Receivership Court

The Focus Group concluded that in order to improve and expedite the receivership process, the detail submitted to the court should be reduced and the court's expertise should be increased. These goals can be achieved by adoption of a number of the procedural changes discussed below and by utilizing the Federal District Courts as receivership courts. The Focus Group further recommended that, as a means of promoting expertise and reducing expenses, one District Court in each of the receivership system's regions be designated to handle all insurer receiverships.

The Role of the Regulator

Insurance regulators should continue to monitor insurer solvency, including applying to the court to place a company in receivership.[30]

Oversight and Investigation, given on September 9, 1992, New York Superintendent of Insurance Salvatore Curiale stated that regulators are often torn between

> the desire to explore every reasonable avenue available to save the entity . . . and the knowledge that if the entity is beyond saving, then every day it remains alive ultimately means a greater burden to the insurance buying public (BNA, 1992, p A-9).

30. The Focus Group recognized the potential benefits of a "troubled companies" unit of the Corporation that could assist regulators in evaluating a company in difficulty, developing solutions, and understanding the procedures for and ramifications of putting a company into receivership.

That regulator should have flexible remedial tools available to handle financial impairment, including the ability to take control of a company temporarily. (See next section). The corporation should function to implement regulatory decisions.

Types of and Grounds for Receiverships

The Focus Group concluded that presently existing forms of receivership (conservation, supervision, rehabilitation, and liquidation) are cumbersome and subject to misuse. A faster, more flexible process is needed that can remedy the impairment quickly or liquidate the company while there are still assets to distribute. The Focus Group therefore devised a "Control" procedure as a substitute for conservation, supervision, and rehabilitation and as a prelude to liquidation. Such a procedure could be initiated either administratively or judicially.

The regulator could authorize the corporation to administratively (without court order) seize the insurer's assets if certain statutorily defined causes were present and (1) the action was necessary to prevent dissipation of assets or (2) the action was necessary to prevent removal or destruction of books, records, or other vital documents. Such a seizure by the corporation would be based on an administrative order, issued by the Commissioner, certifying that sufficient grounds existed and specifying: (1) whether claims were to be paid and (2) what other activity within statutory parameters could be undertaken by the corporation. Administrative control would be limited to a maximum of 60 days. After that period, the insurer should either be released from administrative control or placed in liquidation, or a judicial order of control could be entered.

Judicial control also would be initiated by the regulator on the same grounds applicable to administrative control. However, a showing of imminent dissipation of assets or destruction of records would not be required.

Both administrative and judicial control procedures would remain confidential or sequestered for a period of 30 days. During this time, the insurer's management would have the opportunity to petition the court for vacation or modification of its orders or to seek an end to administrative control. Confidentiality would cease automatically 30 days after entry of a control order, unless the parties otherwise agreed or the court so ordered following a hearing.

Once a company had been under control status for a total of six months, the corporation must either: (1) release the company, (2) place the company in liquidation, or (3) adopt a long-term runoff plan that could avoid triggering the guaranty function.

The current NAIC Model Act and some state statutes provide a broad range of grounds for conservation, supervision, rehabilitation and liquidation. Although most of those grounds are appropriate as the basis for initiation of control status, some are inappropriate for liquidation. For instance, failure to remove an officer objectionable to the regulator does not make a company an appropriate target for liquidation, but may warrant control status.

Among the appropriate grounds for liquidation are the following findings: (1) that the insurer's liabilities are greater than its assets; (2) that the insurer is unable to pay claims and other obligations as they become due; or (3) that the insurer has failed to maintain the minimum capital and surplus required by statute. Other deficiencies may not be sufficient to trigger immediate liquidation. However, the insurer's failure to correct those deficiencies while in control status would warrant liquidation. Such deficiencies include: (1) conduct of business in a manner that is hazardous to policyholders, creditors or the public or (2) inadequacy or concealment of records.

Liquidation Procedures

The Focus Group concluded that foreign and ancillary receiverships, as well as special deposits, should be eliminated, since they constitute barriers to the efficient management of insurer insolvency and a source of unnecessary expense. Moreover, such mechanisms would be redundant in a uniform, national receivership system. Under such a system, the administrative expenses of the receivership would be funded through the industry, thus obviating the need for statutory deposits. Ancillary receiverships can have no purpose in a uniform, national system.

The Focus Group determined that the corporation should follow the policy provided by current NAIC Model Acts governing the termination of business of a company in liquidation, and therefore recommended that:

- Property and casualty policies be terminated in 30 days or in accordance with the terms of the policy, whichever date is earlier.

- Life policies be continued by the guaranty function of the corporation under certain terms and conditions.
- Accident and health policies be terminated in accordance with their terms, except for guaranteed renewable and noncancellable policies, which would be covered by the guaranty function of the corporation under certain terms and conditions.

Continuing books of business would be transferred to solvent carriers. The receiver would not be permitted to offer tail coverage on claims-made business; instead, this business would be left to the marketplace to absorb.

Upon entry of the receivership order, an automatic stay of specific duration should be imposed upon lawsuits against the estate, receiver, and insureds. In addition, suits by claimants and insureds against the company's reinsurers should be statutorily prohibited, except in instances in which a cut-through or similar device ran to the benefit of the party making the claim.

Given the membership of the board of the corporation, creditors' committees should be unnecessary. Nonetheless, the enabling statute should empower the receiver to appoint such a committee when required, the expenses of which would not be paid by the corporation or the estate.

The corporation in its receivership function should succeed to all rights of action on the part of the estate against parents, affiliates, directors, officers, and others. The corporation would stand in the shoes of the companies that it liquidates for purposes of asserting contractual rights and complying with contractual obligations. However, it must retain the right to disaffirm or cancel appropriate contracts.

Compromise of debts and commutations would be in accordance with procedures adopted by the corporation and would be subject to review by the audit committee of the corporation. No court approval of individual settlements would be necessary. However, the activities of the corporation with respect to individual liquidations would be reported periodically to the relevant receivership court. In addition, the policies and procedures of the corporation would be reviewable by its board and by independent third parties and/or designated regulators.

Setoff of mutual debits and credits among one or more contracts would be allowed, except when: (1) the claim occurred after the cancellation or termination of the policy or agreement; (2) the claim was

purchased to be used as a setoff; (3) the claim was against an affiliate of the insolvent; (4) the insolvent owed the debt to an affiliate of the party claiming the setoff; (5) the setoff was asserted against an assessment against members or a subscription to capital stock; or (6) the setoff was asserted in a circular set of cessions.

Given the substantial differences in the times at which debits and credits become due and owing in a reinsurance relationship, a mechanism must be established to ensure equity among the parties. This mechanism could consist of a trust fund to protect the rights of the receiver with respect to setoffs against current balances. It could also take the form of an exception to the priority rules, which would assure that overpayments would later be repaid without regard to such rules.

An administrative procedure should be established for all claimants who contest the corporation's claims evaluation, regardless of whether the claim is covered by the guaranty function. Appeals could be made to the receivership court during a 30-day period following the administrative determination. Once the claimant had exhausted or failed to use these remedies, the corporation's valuation would become final and would constitute "payment" for purposes of triggering reinsurance. Although the liability of the receiver to pay guaranty fund covered claims is often determined by independent litigation under the proposed system (as well as the current system), both the issue of liability and the amount of the claim is determined by the receiver with respect to claims not covered by the guaranty fund. The evaluation of immature, unliquidated, and contingent claims would follow bankruptcy procedures, i.e., claims susceptible to estimation would be evaluated as if there were no contingency. Net present value techniques would be applied.

Priority of unsecured claims against the estate would be as follows:

Class 1. (a) Administrative expenses of the receivership paid by the corporation;
(b) Unpaid wages of non-officer and director employees for up to two months before the initiation of the receivership; and
(c) Unallocated claims handling expenses of the corporation;

Class 2. Claims on policies and allocated claims handling expenses of the corporation, including such claims and expenses guaranteed by the corporation;

Class 3. (a) Unearned premiums;

(b) General creditor claims;

Class 4. Claims for punitive damages, pre- and post-judgment interest, and bad faith or errors and omissions claims against the insolvent insurer;

Class 5. State, federal, and local taxes;

Class 6. Late filed claims;

Class 7. Surplus notes; and

Class 8. Shareholders.

Immunity

The corporation, its board of directors, members, and employees should be provided with immunity and indemnification with respect to their activities on behalf of the corporation.

Transitional Issues

The Focus Group recommended that the corporation handle all receiverships that occur after a certain date. That date should take into consideration the time needed to create the corporation and make it operational. Although it might be beneficial to transfer some existing estates to the corporation, the Focus Group believed that in many instances this transfer would be too costly and disruptive. It therefore recommended that the corporation be given the authority to contract with existing state receivers to take over existing estates where both parties determine that this is feasible.

Alternate Methodologies For Achieving A Better System

As previously mentioned, the Focus Group identified three means of achieving a better system: use of an interstate compact, the NAIC accreditation process and federal legislation. Although the Focus Group took no position with respect to these alternatives, the authors of this paper believe that some evaluation of the alternatives is appropriate, since each has characteristics that make it more or less attainable.

Interstate Compacts

The United States Constitution provides for the use of interstate compacts as a contractual mechanism between and among states (U.S. Const., art. I, section 10). In general, an interstate compact is subject to substantive principles of contract law and is protected by the constitutional provision prohibiting the impairment of contracts (U.S. Const., art. I, section 10, cl. 3; CSG, 1983, p vi; McCabe, 1991). Such compacts are passed as statutes by each state involved.

Although Article I, Section 10 of the U.S. Constitution appears to require Congressional approval of compacts, it has been established that only those compacts that affect a power delegated to the federal government or alter the political balance with the federal system require such consent (McCabe, 1991: citing *Virginia v. Tennessee*, 148 U.S. 503 (1893)). It is unclear whether an interstate compact dealing with a receivership system would require specific Congressional approval or whether such approval is implicit in the McCarran-Ferguson Act (Jackson, 1990, p 151).

In order to create a uniform system, a uniform law is required. This law could define the substantive aspects of the receivership system, or it could empower a central organization to make substantive rules that would be binding on each participant in the compact. Either alternative would require negotiation among interested parties, presumably on a multi-state basis, and then adoption of the same language by the legislatures of all participating states. One study has reported that after negotiation of the language of a particular compact, it has taken four years and nine months to eight years and nine months for an unspecified number of states to pass the compact in question (Jackson, 1990, p 161).

This is similar to the process by which the NAIC develops model laws and regulations for the states. Some model act provisions reflect years of debate and tinkering, followed by a low rate of passage by state legislatures. Quite a number of states have statutes that resemble a current or past NAIC receivership model law. However, very few states have adopted the NAIC model receivership laws in their recommended form.

Various explanations for this phenomenon exist. The needs and political atmosphere of each state vary considerably. As the debate continues over a number of years, interest groups bring their concerns

to bear in state legislatures.[31] The model acts themselves may change. Inevitably, significant variations result in the laws actually passed, even when all legislative debate commenced by reference to the same model.[32]

Likewise, political mechanisms contained in a compact can undercut its ability to provide uniformity. For instance, the National Conference of Insurance Legislators (NCOIL) has circulated a draft "Interstate Insurance Protection Compact." This exposure draft, dated August 7, 1992, establishes a Commission that acts as receiver of impaired or insolvent insurance companies and is composed of the insurance commissioner of each compacting state. However, the NCOIL draft allows individual states to reject the compact's statutes, rules, regulations, and operating procedures and adopt their own (NCOIL, 1992, section 8). Also, under the compact, administration of a receivership can be delegated to an individual state (NCOIL, 1992, section 9.4). The result will be nonuniform law, procedures, and administration.

The NCOIL draft provides a mechanism whereby states can withdraw from the compact by passage of a statutory repealer. The draft provides that the participation of only two states is necessary for a compact. As the NAIC has recognized:

> . . . there is no assurance that a large number of states would be willing to delegate authority in such an arrangement. Interstate compacts may tend to be more successful in more narrowly defined areas, where states have a clear common interest and cooperation is essential. Guaranty fund and receivership functions are arguably much more complex and while cooperation could be beneficial, states may not see a compelling need to work collectively in this area (NAIC, 1992, p 41).

The Chairman of the NAIC Guaranty Fund Task Force wrote to NCOIL listing a number of substantive and technical objections to the

31. To the extent that substantive receivership rulemaking is delegated by interstate compact to a nationwide group, the role of the state legislatures in defining and implementing individual state policy is undercut (ACLI, 1992, p 22).

32. The Focus Group has determined that the current system is weakened not only by the inconsistency of state laws but also by the inconsistent interpretation of similar or identical state laws. This being the case, implementation of a new system through the use of interstate compacts may not achieve the primary purpose of providing consistent receivership policy and procedures.

proposed NCOIL compact (Googins, 1992) but NCOIL adopted its proposal without major changes.

Current interstate compact proposals therefore do not appear well suited to achieve a uniform, national receivership system.[33] Additionally, the role of state legislatures in determining individual state policy is undercut if substantive receivership rule-making is delegated to an interstate compact.

The NAIC Accreditation Program

Another means by which a uniform, national receivership system might be achieved is through the Financial Regulation Standards and Accreditation Program of the NAIC (Accreditation Program). As described by the NAIC in a February 1991 pamphlet, this program requires that state regulators have: (1) adequate statutory and administrative authority to regulate an insurer's corporate and financial affairs; (2) the necessary resources to carry out that authority; and (3) organizational and personnel practices designed for effective regulation. The first requirement is most relevant to this paper and will be discussed below in a receivership context.

To achieve NAIC accreditation, a state must adopt a growing number of laws and regulation. In some cases, the requirements are expressed very generally. For instance, the NAIC asks for a law requiring a diversified investment portfolio. In other cases, the NAIC model law on point is cited as an example of an appropriate statute. In still other cases, the NAIC requires a law that is "substantially similar" to the NAIC model act. The NAIC is currently in the process of identifying sections in NAIC model laws that must be substantially replicated before accreditation can occur. A working group of the Rehabilitators and Liquidators Task Force has been assigned this task with respect to the Insurer, Rehabilitator and Liquidator Model Act. The Accreditation Program has become more controversial as the NAIC has added to the list of requirements for accreditation and has become more precise in its definition of "substantially similar."

The Accreditation Program has been criticized by the General Accounting Office, among others (Fogel, 1992b; Fogel, 1992c).

33. "There's no way in hell we're going to have a monolithic, 50 state compact, even if it relates solely to guaranty fund participation and rehabilitations and liquidations" (Googins, 1993).

> The Financial Regulation Standards are typically stated in general terms that give NAIC and its reviewers broad latitude to interpret the standards. Our evaluation of accreditation reviews of the seven state insurance departments accredited during 1991 suggests that NAIC and its review teams have interpreted the standards so permissively that accreditation has not established a meaningful minimum level of solvency regulation (Fogel, 1992b, p 4).

The NAIC has acknowledged that, under its Accreditation Program, the states would retain the ability to adopt their own statutes and procedures,[34] and yet it is precisely this flexibility that causes the current problems and inconsistencies.

At the same time, the NAIC recognizes that legislatures may object to the establishment by the NAIC of standards for adequate guaranty fund protection, because they may prefer the ability to decide such standards on a state-by-state basis, and the NAIC acknowledges that

> . . . the financial regulation standards may not be an adequate vehicle to establish more formal coordination mechanisms among state guaranty funds and other beneficial improvements to the current system (NAIC, 1992, p 41).

Notwithstanding such criticism, the Accreditation Program has been responsible for moving a great deal of beneficial legislation through state legislatures. The issue at hand, however, is whether the Accreditation Program can achieve a uniform, national receivership system. Unfortunately, it was not designed to yield such a result.[35]

As noted above with respect to interstate compacts, a uniform system requires a uniform law. A receivership system requires a large, complex regulatory structure equipped to deal with a number of controversial issues. Legislation governing such issues will be lobbied intensely by interested parties, and for that reason, it is highly unlikely

34. A primary advantage of the financial regulation standards is that it [sic] allows preservation of the existing state guaranty fund system but would establish minimum requirements where necessary that all states would have to meet. Presumably, states would still have some flexibility designing their system to meet local needs and preferences (NAIC, 1992, p 40).

35. In testimony before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce on June 9, 1993, the NAIC disclaimed such an intent stating, "[I]t is not a goal of the program to create a national, regulatory system."

that a uniform law on point could be passed in a significant number of states.

Moreover, a workable national system requires a high degree of similarity in interpretation of law and uniformity in procedure and administration. Although the Accreditation Program seeks to raise the quality of administration and procedure generally, it does not and probably cannot achieve any meaningful degree of uniformity in these areas. In fact, the NAIC's use of the "substantially similar" standard for acceptable legislation recognizes and preserves the ability of states to retain differences among their laws.

Like the interstate compact, the NAIC Accreditation Program tends to diminish or supplant the role of individual state legislatures. Those states that vary from the NAIC standards, or from the NAIC's interpretation of those standards, will be sanctioned by the NAIC through nonrecognition of those states' examinations or accreditation of reinsurers. As the General Accounting Office has noted, this has generated a backlash against the Program:

> In March of this year, New York—of the first states to be accredited—had its accreditation suspended by the NAIC for failing to adopt several model laws or regulations added to the original standards. Recently, a number of regulators, industry representatives and state legislators have expressed resistance to NAIC's efforts to clarify vague standards and add new ones. Opposition from these participants in the regulatory process raises further doubts about the long-term viability of the program (Fogel, 1993).

Federal Legislation

Given the apparent inability of the interstate compact or the Accreditation Program to achieve a uniform, national receivership system, it appears that federal legislation provides the only viable alternative. The enactment of a federal receivership code would provide uniformity nationwide. Federal courts would supply a reasonable degree of uniformity of legal interpretation. Federal law would vest in the corporation the ability to create and implement uniform procedures and systems of administration.

The NAIC has acknowledged the benefits of federal legislation in the context of a national guaranty fund (NAIC, 1992, p 42). Although the NAIC is critical of such a fund to the extent that it would be "inherently less responsive to the needs of individual states" (NAIC,

1992, p 42), it fails to elaborate on what those needs are and the reason that a uniform national system cannot accommodate those needs in a timely and efficient manner.

One state insurance commissioner has supported federal legislation as a means of achieving a uniform, national receivership system:

> A uniform guaranty fund law (with separate funds for life, health and property/casualty insurance) should be enacted, which should include a federal requirement that each state adopt it without modification. . . . The current (liquidation) system, with one primary receiver and up to 49 ancillary receivers, is expensive and unduly time consuming. A statute similar to the one proposed in H.R. 4900 (calling for a Federal system), coupled with a uniform guaranty fund law, would result in a more efficient and equitable process (Curiale, 1992, p 31).

The danger with a federal system is the possibility of a bloated, inflexible bureaucracy that is pervasive and not limited geographically. This possibility is a highly legitimate concern, and one that should be addressed in the legislation and the organization of the corporation. Nonetheless, it appears that federal legislation is the only realistic means of achieving a uniform, national receivership system.

Conclusion

The number and complexity of insurance company receiverships have increased significantly in recent years. The current state based system of laws and organizations is too fragmented and inconsistent to handle these receiverships in a fashion that is efficient and treats fairly interested parties.

It is unlikely that the current system can be amended to resolve current problems. A uniform, national system is required. The only effective means of achieving such a system is federal legislation.

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