The INSURANCE RECEIVER

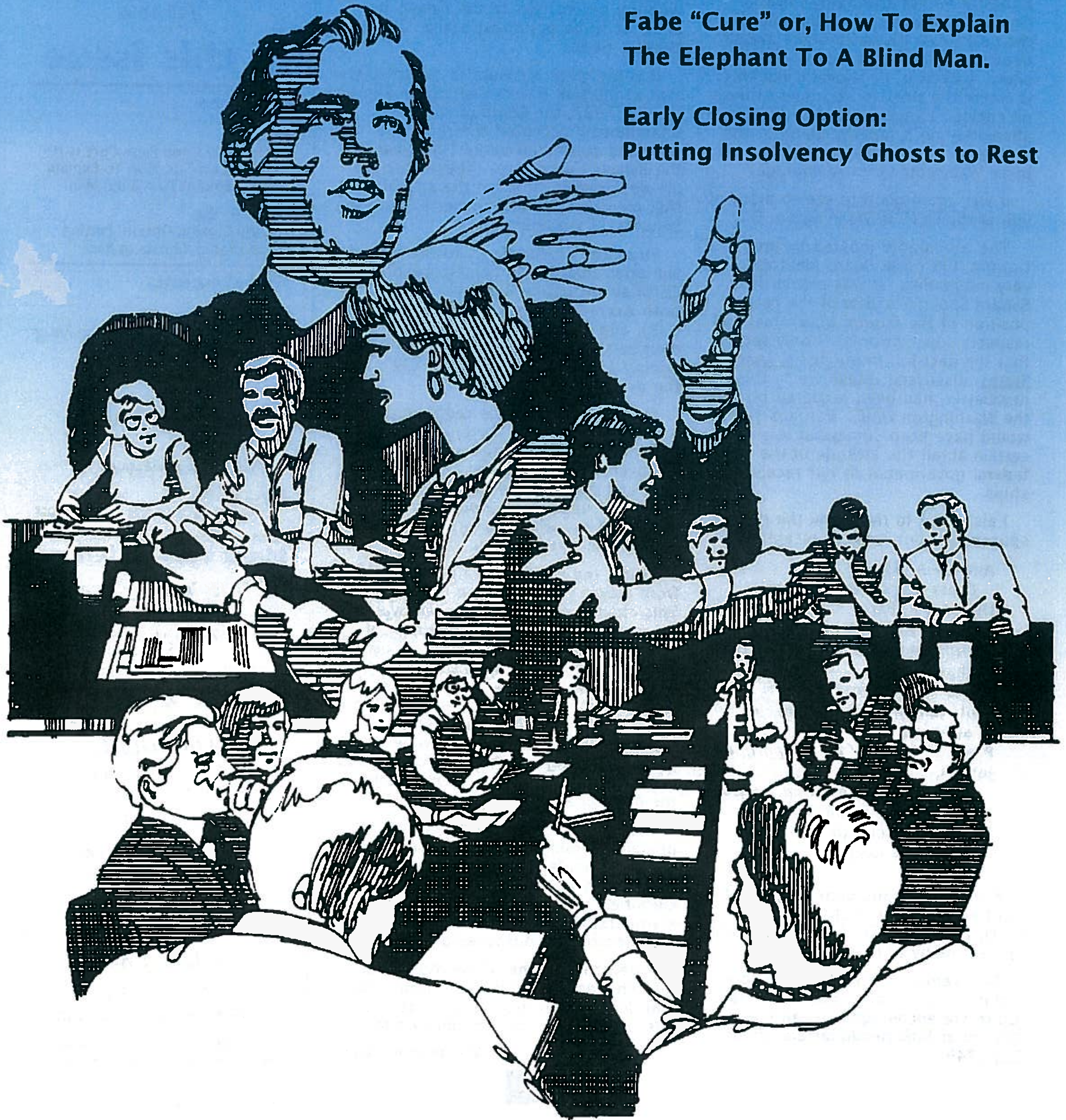
Promoting high ethical standards in the administration of insurance receiverships.

Volume 6, Number 3

FALL 1997

The Only Good Fabe Cure Is No Fabe "Cure" or, How To Explain The Elephant To A Blind Man.

Early Closing Option: Putting Insolvency Ghosts to Rest



President's Message

By Dick Darling, CIR
Chief Operating Officer, Illinois Department of Insurance

Fall! The tomatoes and cucumbers are in and the leaves are piling up on my patio faster than I can rake them. Its cooling off and sometimes you can actually smell snow in the air. I honestly do not know why I live in Chicago. In fact, this is the time of the year when I have to brace myself because I still do not like to look at snow, walk in it, or shovel it but this is where the work is, so I guess I have no choice. I know some of you have absolutely no sympathy being in the Northeast or even former Director Joyce Wainscott up in Anchorage.

It was again good to see so many of you at the NAIC in Washington, D.C.

The roundtable (hosted by Jim Gordon, CIR - IAIR Board Member) was very interesting. It was nice to hear Sandra Spooner's view of the current position of the federal government as respects super priority. I only wish that the decision in Boozell v. United States, discussed elsewhere in this newsletter, had been rendered prior to the Washington NAIC. Perhaps she would have been somewhat less certain about the attitude of the federal government in our receiverships.

I also want to the thank the patron sponsors of our cocktail reception:

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Without the continued support of involved members such as our patrons, IAIR would be financially unable to meet many of its goals.

Any members interested in sponsoring the cocktail reception in the future are encouraged to call Frank Bistrom at IAIR Headquarters, (913) 262-2749.

The roundtable for Seattle appears to be shaping up and will be co-chaired by Charles Glass and Stephen Schwab.

As I indicated to you in my last President's Message, the Board has been working on changes to the bylaws to allow us to be more responsive to membership needs.

It is my great pleasure to report to you that at the IAIR Board meeting on September 20, 1997, the Board of Directors unanimously accepted the proposed revisions submitted earlier this year by the Bylaws Committee. These changes are designed to broaden the appeal of IAIR membership and further expand the benefits of membership.

First, the amendments to the bylaws will open board membership beyond Certified Insurance Receivers (CIR) to both Accredited Insurance Receivers (AIR), and nonaccredited dues paying members in good standing, while maintaining a minimum number of CIR's on the association's board.

Second, the previous requirement that a director had to be currently employed, appointed, or contracted would be removed. This will allow retired members and experienced, but not presently employed, receivers to work for the benefit of the whole association, irrespective of their membership status.

Third, the Board would be expanded from eleven (11) to fifteen (15) members. This change along with the removal of the current employment requirement will, a) relieve the burden on some of our most involved board members and, b) allow IAIR to continue to promote the high standards of excellence expected by those members acting as receivers of insolvent insurance entities while simultaneously using the vast knowledge and experience of our entire membership for the good of all.

Fourth, based on the association's present membership, voting privileges will be extended to over two-thirds of the association members, those previously classified as sustaining or associate members, who have not previously been included for the purposes of voting.

I view this as one of the most important changes along with the proposed addition of such members to the board as one of openness, responsibility and full

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Mark Your Calendar

IAIR Reinsurance Roundtable
Hosts: Charles Glass & Steven Schwab
December 6 1-5 p.m.
Seattle, Washington

IAIR/NOLHGA Joint Session
November 19-20, 1997
Brown Hotel $124/night
Louisville, Kentucky
Seminar Cost $150

IAIR/NAIC Insolvency Workshop
January 29 - 30, 1998
Hyatt Regency La Jolla
San Diego, California

Washington, D.C. Meetings Recap

By Mary Cannon Veed

We've all been saying it would, and now it's really happened: an NAIC where even the liquidators thought the interesting stuff was in the other committees. The insolvency meetings were, for the most part, constructive, productive, and, well, tame. The folks who are running our next set of customers, however, were on a roll. The topics of the hour were deregulation, de-mutualization, the codification of accounting standards, banks and insurance, domestic violence and, of all things, the Holocaust. With all those new ideas buzzing around, who wants to talk about failures? This isn't just bull market euphoria, however there are lots of interesting and creative ideas in quiet circulation, and a fair level of intelligent thought going into them. They will certainly shape the insurance market for the immediate future, and sooner or later they will affect liquidations as well.

Reaganomics has finally found its way into the world of insurance regulation, if only tentatively. The much-anticipated White Paper on Regulatory Re-Engineering is finally on the NAIC web page and in easy circulation. It's really an impressive piece of thinking, which includes some nuggets of sense you might want to save for a rainy day. Some of the best comments, oddly enough, are on the reasons why regulation is needed. How about this for giving an old subject some new shape?

"Regulation plays an exceedingly important function in making insurance markets work, not simply by imposing controls, but by representing the interests of policyholders...Given that insurance tends to be a contract between parties that are not equal, there is an obvious demand for representation - a demand for insurance regulation.

While some may argue that regulation dampens competition or promotes the interests of one particular group over another, insurance regulation represents a series of compromises between competing interest groups. Some insurance regulation is decidedly pro-consumer, while other facets of insurance regulation may {be} characterized as pro-insurer or pro-third party. The business of insurance regulation must involve a continuous rebalancing of benefits to competing interest groups. To the extent that regulators are successful in their balancing efforts, a vigorously competitive marketplace can coexist with reasonable controls designed to protect consumers and other parties to insurance transactions."

The same group has packaged a very presentable proposal on coordinated licensing activities across state lines. It sounds more radical than it is, but it's subversive enough. The idea is to have a single application form and a set of consistent procedural timetables for an application for license in each of 7 states (more confidently expected?). The states will continue to make their own judgements about the applications. But they are held up to comparison to identical procedures in other states. In some states, that would be considered a dangerous invasion of the absolute state prerogative to mishandle licensing.

The re-engineering proposal itself contains lots of other sensible ideas designed to make anyone who ignores them look silly. It suggests that rate and form regulation for "large commercial insureds" is no help to anyone, and that rate regulation for lesser, but still substantial businesses is also of questionable value. A less practical, albeit well-intended suggestion is the expansion of export lists. Somehow everybody likes export lists in theory, but they can rarely put them to use for significant lines of business. The scheme would be a success, I suspect, if it did nothing but accomplish the initiative for which, to quote Bob Lange, "we couldn't find any 'con's" - abolition of countersignature requirements. No state can honestly deny protectionist instincts if it still maintains countersignature requirements!

One idea the group considered and has apparently rejected, is the creation of separate "industrial" insurers limited to the writing of large risk. Separately incorporated and licensed insurers would insulate the conventional market from the financial bageries and potential cutthroat competition of a substantially unregulated market, but they would also siphon large amounts of capital out of it.

Conventional wisdom maintains that these proposals will fizzle because the larger states won't adopt them and the big insurers will prefer to protect their investment in the regulatory infrastructure. I'm not so sure. As the White Paper pointed out, 2/10th of a percent of the businesses in this country employ 37% of the employees, and, presumably, generate equally disproportionate shares of income tax revenue and economic multiplier effects. In the smaller states, which make a big effort at attracting new industry, regulatory moves which allow the promoters to call their state "business-friendly" are the sort of things that get governors reelected and turn insurance commissioners into household words at the Chamber of Commerce - and should. Underwriters are not immune to that kind of incentive, either. If the big states won't play along, so much the better.

Another bubbling pot was labeled "Mutual Holding Companies". Staying competitive in today's market demands increasing amounts of capital cushion. Prime customers expect prime financial security when they invest in insurance, meaning size and depth. Although they may have other advantages, mutual insurers lack the ability to obtain share capital, or to recover surplus of some misfortune drains it. Operating on the assumption that if something is economically essential, sooner or later it will also be legal, companies have undertaken any number of demututalization schemes. The flavor of the month at the moment is the mutual holding company, which was the subject both of a half day seminar, reportedly an excellent one, a meeting of a study group, and a seminar on the fiduciary duties of Blue Cross directors considering demutualization.

The insolvency side had only one marquee event, the IAIR roundtable featuring a visit from the always inflammatory Sandra Spooner. She must have felt like Daniel entering the lions' den, but that did not stop her from declaring war on Fabe "cure" statutes. According to her understanding, Fabe established that state priority statutes were "unconstitutional". I know the Priority Act has been around a long time, but I don't think they've put it in the Constitution yet.

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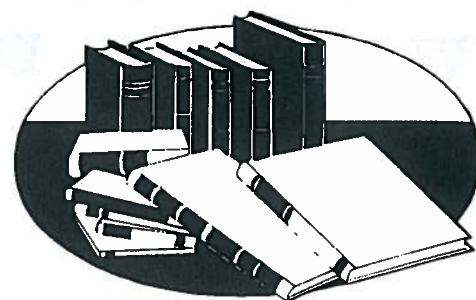
Other News & Notes

***by Douglas Hartz, Missouri Receivership Supervisor*[1]**



[1] The views expressed here are solely those of the author and are not intended to represent statements, opinions or positions of the Missouri Department of Insurance or any particular receivership or the International Association of Insurance Receivers, and to the extent that some views may be expressed merely to generate discussion those views may not even be those of the author.

This Fall issue of the Insurance Receiver newsletter should be in orange and black. Along with a) the "Grave to Grave" theme for this coming January's NAIC/IAIR Insolvency Workshop in [bless Mike Surguine for this site selection] La Jolla, California (see page 17) and b) the ghost next to the Early Closing Option article (page 18) with its discussions of zombies, graves and the living dead, and c) this newsletter's delivery on about October 31, it sure fits Halloween.

In contrast to the above grave discussion, on the topic of growth, IAIR is once again changing to be better prepared for such as is explained in Dick Darling's President's Message (page 2) about the proposed changes to IAIR's bylaws. The deadline of November 15 for the vote on these changes was set so that if these changes are adopted then everyone will have time to make nominations for the four new positions on the board. Consideration also should be given to nominations for the four board positions that will be opening this year. This should prove to be another interesting annual meeting for IAIR. Nominations should be directed to Mike Surguine, Chair of the Nominations, Elections and Meetings Committee c/o IAIR Headquarters in Mission, Kansas. This committee will have the tall order of ensuring, if the proposed bylaws changes take effect, that the proper mix of board members results from the nominations and the elections to occur at the annual meeting.

The last issue of the Insurance Receiver also contained a note by IAIR Director Philip J. Singer on the issue of increasing benefits to members by increasing membership. It is hoped that if the proposed changes to IAIR's Bylaws are adopted, then the recruiting of 'one, or even better, two or more new' members will become a more appealing and easier task to be undertaken.

The last couple of installments of Other News & Notes have presented an explanation of why interest ought to be added to the claims against an insolvent insurer from the date that the claims mature. Well, I can't help but provide another "mind-bending illustration" of how failing to take into account the time value of money on the claims against an estate decreases the real value of the distributions from an estate. But that can wait. However, I would like to note here one probable conclusion that was not made in connection with the last "mind-bending illustration" That conclusion is if interest is added to the advances, then it must be added to the claims. Otherwise, the state guaranty funds (SGFs) take it in the teeth. Which is hardly the idea. The idea of kicking the SGFs in the teeth brings us to our next topic, the comments of Sandra Spooner at the last IAIR Roundtable in Washington D.C.

What can I say? It took some courage to come and speak to us, a group of rabid regulators that obviously believe in the states administering estates. To her credit, interpreting meaning in statutes is difficult. The meaning of the federal insolvency statute is, however, pretty simple. "The King or sovereign gets paid first." This antique concept is much older than its U.S. adoption in 1797. Isn't it a bit out of sync with modern times? There are many laws of that time that are still on paper but are essentially without effect. For example, take a provision that is even more inviolable than an Act of Congress — Article IV, Section 2, Clause 3 of the Constitution. It provides that an indentured servant must be delivered up, by any state to which the servant has escaped, to the person owed the service. Now assume that John Elway decides this week he is just going to go fishing for the rest of his life in, as justice would have it, Missouri. The owner of the Broncos writes to the Governor in Missouri and citing this Constitutional Article asks that the great horse-toothed wonder be delivered up for next Sunday's game. Well, there is Amendment XIII, adopted in 1865, that says no slavery or involuntary servitude shall exist and some other and some later Acts of Congress that could keep this from happening. Like involuntary servitude, the federal insolvency statute has been superseded by the U.S. Bankruptcy laws and by the states, through McCarran Ferguson reverse peremption, having adopted comprehensive insurer insolvency laws with priorities of distribution. Many of our model laws are meant to abrogate old anachronistic laws. A point that is too often missed.

The meaning of policyholder priority also seems to be causing Sandra Spooner some problems. One problem is that our priority statutes create classes using incongruent criteria. Distinctions are made on both the type of claim and the type of claimant. But her view of those distinctions is really frightening. In short the argument that she made at our roundtable (and in their brief in the Reserve case) is that the Fabe case means we can only give *policyholders* priority over the federal government. Meaning, no "claims under policies" as many of our priority statutes read. And, thus, "policyholders" means no third party claimants (she did not appear to have given too much thought to this) and no SGF claims.

She may have been thinking that some SDRs would support moving the SGFs down to a lower priority. A few years back some SDRs wanted to do this in the Model Act. Some of us are still suffering from war wounds inflicted upon us for arguing against this misguided idea, which could have destroyed the SGF system. At the risk of further wounding, and speaking from a consumer protection standpoint, our SGFs today are the best policyholder protection system in the world. Like our system of government, the SGF system is not perfect and can improve, but it is the best. The SGFs also help the receiver. They handle the short-tail consumer claims, getting these politically charged claims paid in full much

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Washington, D. C. Meetings Recap

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Short takes:

The UDS group wondered plaintively why, now that the new data formats are in place and of obvious value, liquidators aren't using them? Do the folks who key in data over and over again have some sort of special interest group? Do we dislike reinsurance collections? What gives?

The Model Act group tackled Section 20, which does not, it turns out, say what most of us thought it said. It seems to limit the jurisdiction of a US court over alien insurers to those "domiciled" here, and further to assets and business "in the United States". This assumes, somewhat optimistically, that the alien will have a properly motivated liquidator in its home country, that only companies domiciled" (a term of art) here will be capable of incurring significant insurance liabilities here, and that it is reasonable to expect that American policyholders of such a company be paid only out of assets which can be found in the U.S. (an old-fashioned idea from the days before electronic funds transfer and book entry securities). It is one thing to say that a U.S. liquidation can be ancillary to a properly organized foreign one, it is another to tie the hands of the U.S. regulator when the foreign jurisdiction is not holding up its end of the comity bargain or does not act at all.

The Guaranty Fund Model Act group had another one of those meetings where the pros and cons of covering retirement fund products (a.k.a. unallocated annuities) were rehashed, and the stalemate continued. It is interesting to watch the development of sentiment on this one over the years. Certainly when the unallocated annuities language was introduced, there was broad feeling that coverage could be limited without actually hurting human beings. That has proven optimistic; moreover the language adopted has, because of ill-defined premises, proven unequal to the task. Two entirely contradictory concerns have converged on the Working Group: the trades say they want language that keeps products marketed to "sophisticated buyers" out of the guaranty system, but the human beings who lurk in the backs of the minds of the group members point out that, even when a product is marketed to "sophisticated plan organizers, the reality is that human beings who thought they owned a "safe" retirement program are left holding the bag. The option of suing the organizers for bad judgement is a long shot legally even when there are deep pockets to tap, and all too often there aren't. Running under both currents of thought is a cross-current: why should the industry go to such a lot of trouble to be compelled to sell a product which is indistinguishable from what your neighborhood stockbroker could find on the securities market, and why should regulators let them? The industry used to be concerned about the high cost of the guaranty system. Now it seems to see a glimmer of competitive edge, which may be taking the urgency out of their pleas for reform?

More productively, the group tackled the ever-mutating subject of coverage for health insurance, and seemed to be making headway. The proposed way out of the labyrinth of coverage forms is a functional definition: if it involves a transfer of risk from a patient to an entity for a fee, it's health insurance, and it goes in the guaranty fund. The ticklish question seems to be, which guaranty fund? And how? The suggestion is to include it as a subdivision of the life and health guaranty fund, but neither the life insurers or the health insurers seem keen on that sort of shotgun marriage. Another sticky question is whether the operation ought to be pre-funded, given that health insurers don't carry large reserves of cash and long-term liabilities, and do tend to come and go a lot, the idea is to pre-fund the program. But that's expensive and intrusive, especially when, at the time the money is being demanded, there is no rash of insolvencies hanging over everyone's heads. With any luck, having made the initial assessment, the fund could sit back and waive further demands for a while. To which the health insurers say, if it's all quiet on the insolvency front, who needs a fund? This particular debate is a long way from finished.

I want to thank my "reporters", including, among others, Ed Greer, Tom Clark, and John Gavin for their help in keeping track of everything. Any errors, of course, are mine.

Next stop, Seattle!

IAIR Roundtable Schedule

NAIC Meeting - December 7-10, 1997
Seattle, Washington
IAIR Roundtable - December 6, 1-5:00 p.m.

NAIC Meeting - March 14-18, 1998
Salt Lake City, Utah
IAIR Roundtable - March 14, 1-5:00 p.m.

NAIC Meeting - June 20-24, 1998
Boston, Massachusetts
IAIR Roundtable - June 20, 1-5:00 p.m.

NAIC Meeting - September 12-16, 1998
New York, New York
IAIR Roundtable - September 14, 1-5:00 p.m.

NAIC Meeting - December 5-9, 1998
Orlando, Florida
IAIR Roundtable - December 5, 1-5:00 p.m.

The Insurance Receiver

The IAIR newsletter is intended to provide readers with information on and provide a forum for opinion and discussion on insurance insolvency topics. The views expressed by the authors in the IAIR newsletter are their own and not necessarily those of the IAIR Board, Publications Committee or IAIR Executive Director. No article or other feature should be considered as legal advice.

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IAIR Officers: Richard Darling, CIR - President; Doug Hartz, Vice President; Mike Marchman, CIR - Treasurer; Robert Deck, CIR - Secretary.

Directors: Betty Cordial; James Gordon, CIR; Michael Surguine; Robert Craig; Elizabeth Lovette; Lennard Stillman, CIR & Philip Singer.

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The Only Good Fabe Cure Is No Fabe "Cure" Or, How to Explain The Elephant To A Blind Man

By Mary Cannon Veed of Peterson & Ross

Most of the liquidation bar thought that the decision in Department of the Treasury v. Fabe, 508 U.S. 491 (1993) was a victory for the principles of state regulation of insurance. The Supreme Court rejected the sophistic distinctions which had been recurrently cropping up in the federal circuit courts: that insolvent companies were no longer in the business of insurance simply because they were insolvent, that laws increasing the chances of performance of an insurance obligation did not regulate the "business of insurance" because they did not implicate what one decision has pegged as the "core" component of insurance, namely the underwriting of risk. The Supreme Court was, apparently, not misled by semantics. "Mere matters of form need not detain us," it said, citing National Securities, 393 U.S., at 460, 89 S.Ct., at 568. "The broad category of laws enacted 'for the purpose of regulating the business of insurance' consists of laws that possess the 'end, intention, or aim' of adjusting, managing, or controlling the business of insurance." "'The relationship between insurer and insured, the type of policy which could be issued, its reliability, interpretation, and enforcement—these were the core of the 'business of insurance.' Undoubtedly, other activities of insurance companies relate so closely to their status as reliable insurers that they too must be placed in the same class.'", *citing* SEC v. National Securities, Inc., 393 U.S. 453, 460 (1969). Although the court referred to the "three prong test" of Union Labor Life Ins. Co. v. Pireno, 458 U.S. 119 (1982), it refused to buy the idea that the focus on the underwriting end of the insurance business in Pireno meant that statutes regulating the performance of the insurance promise were outside the McCarran Ferguson umbrella. In other words, it declined to hold that the language of any one of its cases superseded the plain language of the McCarran Ferguson law.

This is a reassuring approach; the alternative is a reduction to absurdity. Although the trilogy of former McCarran Ferguson cases (National Securities, Royal Drug and Pireno) adequately define the term for the purposes of the cases then before the court, they suffer from the problem of the blind men and the elephant: each one tends to describe the animal in terms of the part it has hold of. National Securities involved the application of securities law to insurance ownership; its text focuses on the distinction between the protection of the interests of policyholders (including their interest in having insurance companies controlled by reputable owners) and the protection of the interests of shareholders as such. Royal Drug involved the conditions under which insurers would pay for certain goods and services. In arranging to pay for prescriptions, the insurer had gone into the business of health care, not the business of insurance, and state regulation had no exclusive scope. The court, in identifying what it was about the relationship at issue which was not the "business of insurance" focused on risk transfer and the "policy relationship", because those were characteristics typical of an insurance transaction and not of the transaction presented to it. Similarly, in Union Labor Life Ins. Co. v. Pireno, where the subject was a peer review process for payment of chiropractic services, the court focused on whether the transaction had anything to do with risk transfer or the policy relationship. These were, of course, perfectly appropriate questions for the court to ask, given the issue it was considering. The court accurately observed, in effect, that in these transactions the insurer was behaving like a consumer of services, not a risk bearer. But it would be a mistake to assume that the Pireno definition was exhaustive. If, instead, the court had confronted a challenge to a solvency regulation, a completely different definition would have been called for. A court which applied the Pireno tests would find that statutory accounting rules flunked every one. So would producer licensing rules. Under the circumstances, it is not surprising that the Fabe district court, which felt constrained to apply Pireno, drew the ludicrous conclusion that insolvency rules which put policyholders first did not regulate the business of insurance. Nor is it odd that the Court of Appeals, trying to extract the right result from the wrong definition, had to stretch the words a little bit to reach the opposite result. Judge Edgar, who concurred specially in the Court of Appeals, probably got closer to the nub of the problem when he asked what Congress had meant to accomplish when it enacted McCarran Ferguson. While it is undoubtedly true that its purpose was not exactly the simple return to *status quo ante* Southeastern Underwriters, Congress clearly had in mind a general endorsement of the existing system of state regulation, and a license, in advance, for its future development. Therefore, the proper inquiry was not whether a test invented for prescription plans could be stretched to fit insolvency, but whether the regulation now before the Court was the sort of thing that Congress had in mind when it referred to the "business of insurance." The existing tests for the "business of insurance" before Fabe were directed principally to the underwriting end of the business. But that did not mean that legislation intended to regulate the performance end of the relationship between insurer and insured (in this case, what to do when full performance was likely to be financially impossible) was not part of the regulation protected by McCarran Ferguson. The important language of the Supreme Court's ruling in Fabe is not its affirmation of Royal Drug and Pireno, but its confirmation of Judge Edgar's approach, the adoption and application of a much broader definition which catches laws with the "'end, intention, or aim' of adjusting, managing, or controlling the business of insurance."

Having got this far, near the end of its opinion the Supreme Court stepped in a hole. When it addressed the effect of the Ohio statute's preference of employee wage and general creditor claims to those of the federal government, it limited its

discussion to a single sentence: laws whose purpose was not the protection of policyholders but the protection of "other creditors" did not qualify for McCarran Ferguson protection. The court does not explain why the multifactorial analysis it had just described was suddenly reduced to a single criterion: "protection of policyholders." In leaping to this conclusion, the Court did not discuss the validity of its assumption that "protecting other creditors" was what the suspect provisions were for, or that was not a legitimate aim of insurance regulation. It failed to take into account rather obvious policy reasons, in addition to tradition and fundamental fairness, why a liquidation scheme might offer preference to employees, who are usually in a position to quickly destabilize a struggling company by departing, causing its premature or unnecessary insolvency and adding cost and complexity to the takeover process. Not having asked, the Court was presumably unaware that the vast majority of "general creditor" claims derive from reinsurance. Nor does it seem to have wasted much thought on the fate of federal claims against a non-insurance company in bankruptcy (where they would be relegated to payment after wage claims, child support, and refunds on deposits, the Federal Priority Act having been repealed where bankruptcy is concerned) or considered the potential impact of low priority on a potential creditor's willingness to extend credit to a troubled insurer.

The basic problem with the holdings on wage and general creditor priority is that, in practical effect, they contradict the rest of the opinion. The Court's initial definition of terms borrowed from Black's Dictionary left room for a great many motives and objectives besides "protection" of "policyholders". Moreover, it focused on the intent of the state legislation, not its effectiveness or wisdom. The "end, intention or aim" approach of the body of the opinion wisely leaves the federal courts out of the business of second-guessing legislatures who act to regulate insurance. Under that definition, once the intention of a state legislature to "adjust, manage or control" the business of insurance was found, the court need not, indeed could not, concern itself with whether the provisions were effective, wise, or even fair. The states are entirely free to "adjust" the balances among the participants in an insurance relationship to serve whatever interest they deem important. Unfortunately, the only way to reconcile the Fabe rationale with the Fabe result is to assume that the Court misunderstood the impact of its conclusions about priority.

Coincidentally, a study group at the NAIC recently issued a white paper which analyzed the purposes and strategies of insurance regulation in terms which would make a much better guideline for McCarran Ferguson determinations than the fragmentary ones in common use:

"While some may argue that regulation dampens competition or promotes the interests of one particular interest group over another, insurance regulation represents a series of compromises between competing interest groups. Some insurance regulation is decidedly pro-consumer, while other facets of insurance regulation may [be] characterized as pro-insurer or pro-third party. The business of insurance regulation must involve a continuous rebalancing of benefits to competing interest groups. To the extent that regulators are successful in their balancing efforts, a vigorously competitive marketplace can coexist with reasonable controls designed to protect consumers and other parties to insurance transactions."

Draft White Paper, Regulatory Re-Engineering White Paper Working Group, Special Committee on Regulatory Re-Engineering, 9/16/97 at 3-4.

I would submit that the Supreme Court was led into error by the failure of state insurance liquidation law to clearly express its intent, and the failure of the defenders of the law to fill the gap. The factual predicate on which the Fabe Court relied is simply false. A completely different case, and a completely different outcome, would very likely result if the legislative history and drafting record reflected something like the philosophy of the Re-engineering White Paper.

Under the auspices of the NAIC, the insurance regulatory community has been busy drafting Fabe "cure" legislation. The treatment generally raises the priority of federal claims (other than claims as a policyholder) to a level just below that of policyholders, and includes express severability language intended to prevent the sort of disaster which resulted when the Ohio court declared that state's priority scheme incapable of surviving the loss of its wage provision. The Department of Justice, however, is not impressed. It has recently asserted, both in discussions with liquidators and in a counterclaim filed in Illinois litiga-

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1/6 page	*2-1/4" x 4-7/8*	*$ 95*	*$ 85*	*$ 80*
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The Only Good Fabe Cure . . .

(Continued from Page 7)

tion over a supposedly "cured" statute, that a) it is not bound by any liquidation court's bar date orders, and b) that a priority scheme which allows guaranty funds, subrogated to the claims of policyholders they have paid, to recover ahead of the government and at the same level as policyholders is subject to the same objection the Ohio statute was.[1]

DOJ's position amounts to a declaration of war on the system of state control of the liquidation of insurers, but its contention is not without precedent. In International Insurance Co. v. Duryee, 96 F.3d 837 (6th Cir. 1996), the same court which decided Fabe concluded that an Ohio statute which made it a condition to continued licensing as a foreign insurer in Ohio that the insurer not haul Ohio policyholders into federal court if they did not choose to go did not regulate the "business of insurance" because the choice of forum was not " an integral part of the policy relationship". The court has wandered far away, it would seem, from the language of the law.[2] In the 8th Circuit, as well, McCarran Ferguson has been dying by inches, with the declaration of that court that, "the adjudication of an ADEA claim [against the estate] in federal court would not so substantially impair the deputy receiver's ability to effect ProMed's liquidation under the Insolvency Act as to run afoul of the proscriptions of the McCarran-Ferguson Act." Murff v. Professional Medical Insurance Company, 97 F.3d 289 (8th Cir., 1996). One has to wonder how the same federal court would view a state court's conclusion that compelling a bankruptcy trustee to litigate claims against the estate in state court would not "substantially" interfere with the bankruptcy proceeding, so that the bankruptcy stay could be safely ignored.

The bankruptcy stay, it would tell us, does not say "substantially". Moreover, the ability of the bankruptcy court to bring all creditors into one forum, and to dispose of them in suitable order and according to a consistent set of rules, is critical to getting the bankruptcy disposed of at all.

There is, of course, no "substantially" in McCarran Ferguson, either, nor is it limited to regulation that is "integral to the policy relationship". The "regulation of the business of insurance" shrank even further in the hands of then Chief Judge Breyer in the First Circuit, who held that the protection to the policyholder created by a claims bar date was merely an "indirect, speculative benefit of the kind the *Fabe* court found far too tenuous to prevent peremption", since the Liquidator could protect himself from unfiled federal claims simply by conducting a diligent search for them.[3] Garcia v. Island Program Designer, Inc., 4 F.3d 57 at 62 (1st Cir. 1993).

Each of these cases took the "protection of policyholders" criterion applied by the Supreme Court at the end of its Fabe opinion and treated it as if it superseded the broader test set out in the rest of the case, and the plain language of McCarran Ferguson as well.

Taking its cue from Murff, Garcia and Duryee, DOJ attacks, not only the character of guaranty fund protection as part of the regulation of insurance, but, most significantly, the liquidator's ability to force the government to present its claim, in the liquidation court, or be barred. As a logical extension of Duryee, that makes sense. This is, after all, merely a question of forum and procedure; the relationship to the protection of policyholders is an indirect one, and some might call it "tenuous". But the provision of guaranty fund priority in exchange for guaranty fund protection to policyholders, and the application of a bar date for the liquidation of contingent claims are certainly law with the "end, intention or aim of adjusting, managing or controlling" the business of insurance.

As an interpretation of McCarran Ferguson, however, DOJ's approach, and that of the First, Sixth, and Eighth Circuits, is pure fantasy.

The District Court just handed down its ruling on cross motions for summary judgment in the Illinois case, and it is fairly encouraging.

For one thing, DOJ backed down from its most disturbing positions, waiving its right to assert that with respect to its as-yet-unliquidated claims, it could safely ignore the bar date set in the estate. That left it with total claims of $580. It also left the court with some qualms of conscience about whether it had a genuine case or controversy. In spite of them, it turned to parsing Fabe. It largely followed the approach of Stephens v. American International Ins. Co., 66 F.3d 41 (2nd Cir. 1995), which emphasized the breadth of the

Supreme Court's holding rather than its narrow application. "Fabe states that 'statutes aimed at protection or regulating [the relationship between policyholder and insurer], directly or indirectly, are laws regulating the "business of insurance" and that any law with the 'end, intention or aim of adjusting, managing or controlling the business of insurance' is a law 'enacted for the purpose of regulating the business of insurance", Boozell v. United States, N.D. Ill. 96 CV 06270 (Sept. 26, 1997), slip up at 14, *quoting* Stephens at 45. Judge Castillo concluded that Fabe did not, after all, merely ossify the standards of National Securities, but was an attempt "to give meaning to the plain wording of the McCarran-Ferguson Act by exempting any state law which directly or indirectly assists policyholders from federal preemption." Boozell at 17. He reviewed the terms of the guaranty fund law to ascertain that the guaranty fund's entitlement to policyholder priority was "in exchange" for its obligation to pay claims and a mitigation of the spread of insolvency losses to member insurers, before concluding that the priority scheme in general exists to protect policyholders and is therefore not preempted. He "expressly rejected" the Garcia reading of Fabe, and went to some trouble to make clear that, had the government not waived its right to assert contingent claims in derogation of the bar date, he would have held the bar date controlled. *Id.* at FN 3. In sum, Judge Castillo took a systemic approach to McCarran Ferguson.

]He concentrated on the "plain wording" of McCarran Ferguson rather than the wording of cases which applied it, and he considered the issues of the bar date and the guaranty fund priority in their proper context as part of an interlinked program that both protected and constrained policyholder rights. His analysis is correct, but just now, he is in the minority, and, by comparison to the Courts of Appeals, a little short of precedential authority.

It has to be said that some of our problems are self-inflicted. The arguments in Fabe made little or no attempt to explain to the Supreme Court how the priority rights of employees and general creditors fit into the business of insurance (*see* the transcript of the arguments at 1992 WL 687894).

The Ohio Department apparently was very nearly decided by default. The liquidator in Garcia seems to have left the court uninformed about the problem of contingent claims, and the Murff court does not seem to have been reminded that the expenditure of time and money defending the plaintiff's tort claim was pointless unless policyholder claims were going to be paid in full.

If, like those blind men, the federal courts continue to view insurance regulation in terms of tree trunks, walls, and snakes, McCarran Ferguson is a dead letter. Only if they can be persuaded to inspect the whole animal can we hope to maintain a regulatory system which lives harmoniously with the other beasts in the jungle.

The way to "cure" Fabe is not to write a statute so limited it is acceptable to the Department of Justice. It can't be done. The cure for Fabe is to make the courts aware of the whole picture of insurance regulation, to demonstrate the "continuous rebalancing of benefits to competing interest groups" which is central to insurance regulation in the hands of the states, so that they are in a position to hold that when the states are consciously exercising the discretion guaranteed to them by McCarran Ferguson, it is not the place of the federal courts to second-guess their choice of methods.

[1] And that, moreover, no amount of severability language in the statute can allow it to survive a declaration that half of the largest priority class is misclassified. This latter point is very likely correct, at least as current severability clauses are drafted.

[2] It does not appear that the Ohio Insurance Department even filed a brief, or argued in the Circuit Court.

[3] Justice Breyer's eyesight is reportedly fine, but his vision is poor. The claims he was considering were tax liens, which could, indeed, be located by search. Like the proverbial blind man, he did not consider the validity of his observation that "liquidation would still prove manageable" without a bar date enforceable against the federal government where the federal government's claims were the sort of contingent liability claims that are in issue in most of today's liquidations.

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Avoiding Insolvency:

Fundamental Internal Controls for Insurance Companies

By Scott Fargason, Professor of Accounting at Louisiana University, and a Certified Internal Auditor and attorney who practices at Crawford & Lewis.

In placing an insurance company into receivership, the receiver is often met with a plethora of problems, many of which have directly or indirectly resulted from the absence of internal controls. Whether this was intentional or a negligent oversight, the fact remains that sound internal controls often will provide a means of resolving minor problems before they develop into monumental defects that can bring about the demise of the company. What follows is a road map to the internal controls that should be used in every company.

All insurance companies should promote a strong internal control structure in order to ensure that the business runs efficiently and effectively and to enhance the probability that organizational goals and objectives are obtained.

For most insurance companies, fundamental internal controls that should be in place include the following: a board of directors; a code of ethics; an audit charter; an audit committee; an internal audit department; a litigation committee; a risk management team; and current policies and procedures. Many companies end up in receivership because of deficiencies in one or more of these areas.

The Board of Directors

One way to prevent gross mismanagement is to start with a strong board of directors. The board of directors should be made up of members who possess a strong degree of integrity and have the necessary knowledge and skills to run an insurance company.

Unfortunately, this is often overlooked and contributes greatly to the demise of many organizations.

Members of the board should collectively possess the competence necessary to ensure operations are running as designed and that the reliability of financial information is not compromised.

Several disciplines should be represented on the board, including finance, law, accounting, and insurance management. Many companies fail because of board members are lacking in education and experience. Additionally, many insurance companies hire board members with questionable pasts, including criminal histories.

Such undesirable characteristics are often overlooked in favor of fostering personal relationships. While seemingly obvious, such practices should be avoided.

The Code of Ethics

Most companies placed in liquidation lack an audit charter, an audit committee and an internal audit department. A code of ethics is an effective tool for committing the board to ethical behavior and communicating that commitment to the employees of the organization.

While considered by some as trite, the code is a means for setting the overall tone of the organization and laying the foundation for terminating employees for cause.

Employees should be given a copy of the code. Prior to employment, each employee should be required to sign a statement that they have read, understand, and will abide by the terms of the code.

The statement should provide that violation of the code constitutes grounds for immediate termination. In this regard, the code acts as a preventive control against deviant and unethical behavior.

The Audit Charter, The Audit Committee, and The Internal Audit Department

The audit charter is arguably the most critical document of the organization. The charter lays the foundation for the formation of the audit committee of the board and the internal audit department, both of which are critical to the success of the company.

The audit charter should articulate the organizational aspects of powers of the audit committee. The committee should be made up of members external to the organization. In other words, executive managers should not sit on the audit committee as this impairs the independence.

The charter should establish the internal audit department and state that the audit committee shall be the sole body for regulating the internal audit department, including hiring the internal audit director, approving the internal audit budget, and approving the annual internal audit plan.

The charter should also include a provision that the audit committee as well as the internal auditors shall have access to all information in the organization, without scope limitation, unless agreed to and approved by the audit committee or the board. This is extremely important.

All too often internal audit departments are restricted in scope where such restrictions are unwarranted.

For example, many organizations refuse to let the internal audit department audit the legal function. However, in the opinion of the author, this restriction is unjustified with respect to most legal work.

The internal audit department should be comprised of individuals who collectively have the knowledge, skills and discipline to audit an insurance company. The director is the individual responsible for seeing that this objective is realized.

Accordingly, the company should exercise extreme care when selecting an audit director.

The author suggests working with the Institute of Internal Auditors (IIA), the international organization that represents internal auditors throughout the world.

The IIA provides a wealth of information with respect to internal audit candidates, and publishes a journal read by nearly 100,000 internal auditors throughout the world.

The IIA is also an excellent source for information regarding the Internal Auditor Code of Ethics, Statement of Responsibilities, Standards, and Statement on Internal Auditing Standards, all of which have been promulgated by the IIA. The IIA is located in Altamonte Springs, Florida. The Director should be a Certified Internal Auditor. Other qualifications of course include related work experience, sufficient education, and related certifications such as Certified Public Accountant, Certified Fraud Examiner, and Certified Information Systems Auditor.

The director of internal audit should meet with the audit committee at least quarterly on a formal basis. During the course of these meetings the results of audit conducted should be discussed.

These meetings are also the forum for approval of internal audit budgets and plans.

It is necessary that the director have free access to the audit committee, without the presence of executive management, if the situation calls for such confidentiality.

Such access to the audit committee helps promote the independence of the internal audit department and encourage the audit director to present openly and candidly with the audit committee.

The Litigation Committee and Risk Management Team

Many companies placed in receivership meet their demise because of litigation mismanagement. One of the biggest functions of an insurance company is processing litigation claims.

In order to enhance the efficiency and effectiveness of processing claims, the organization should have a litigation committee that evaluates claims and applies a cost-benefit analysis to material claims in order to determine the prudence of continuing litigation or settling the dispute.

It is important that material claims are decided in a committee environment to mitigate the risk of claims processors making imprudent settlements or, even worse, favoring various plaintiff's attorneys during the settlement process.

The litigation committee should be comprised of members with various backgrounds.

While it may be prudent to have some attorneys on the committee, they should be in the minority.

The committee should also include financial analysts, accountants, and general managers.

It is important to have a cross section of disciplines to provide an objective overview of the litigation process.

In conjunction with the litigation committee, the organization should have a risk management team that evaluates each claim and ascertains the following:

1) the magnitude of the claim,

2) the probability of loss, and

3) anticipated costs of continuing litigation.

The risk management team is often organized as an extension of the litigation committee, reporting to the committee on a regular basis.

The risk management team should work in conjunction with attorneys assigned to the case.

Additionally, their analysis should be integrated with the actuarial analysis with respect to setting reserves for the insurance company.

Unfortunately, such detailed analysis is often lacking in the insurance industry, resulting in insufficient reserves and insolvent organizations.

Often, once actuarial reserves are set, there is inadequate follow-up to determine the reasonableness of the reserves set by the actuaries.

Accordingly, budgeted reserves should be frequently compared with the ongoing work conducted by the risk management team and the litigation committee.

Current Policies and Procedures and Control Self-Assessment

While seemingly obvious, many insurance companies are lacking in updated policies and procedures. Managers should be compelled to frequently review and update policies and procedures to ensure that the documented process reflects the reality of what transpires in that area of the business.

This should be done no less than on an annual basis. Additionally, managers should be required to conduct self-audits.

Mirroring the audit process, managers should employ audit techniques, evaluating performance and discerning where the area is in compliance with established policies and procedures.

Managers should also attempt to conduct self-operational audits, in order to improve the efficiency and effectiveness of operations.

Control self-assessment should be done on a monthly, quarterly, or semiannual basis.

While control self-assessment does not eliminate the need for internal auditors, it greatly enhances control awareness and departmental performance.

Summary

Insurance companies should have in place a basic control framework. At a minimum, these controls should include a board of directors; a code of ethics; an audit charter; an audit committee; an internal audit department; a litigation committee; a risk management team; and current policies and procedures.

While such controls do not guarantee that the organization will be successful, they greatly enhance the probability.

It is prudent for insurance companies to employ such controls in order to enhance organizational performance and mitigate the risk of loss, while improving overall profitability.

Such controls provide structure, give general guidance to employees, and greatly facilitate the management of the organization.

Meet Your Colleagues

Jo Ann Howard

Jo Ann Howard, like many women who graduated from college in the 1960's, majored in education, taught school, had a family, and became an active volunteer.

Then, with two of her four children still at home, she entered the University of Texas School of Law from which she graduated in 1987.

Following graduation, Jo Ann began practicing law in the east Texas town of Texarkana, where she, her husband and children lived.

Upon moving to Austin in 1989, Jo Ann was appointed by the governor to serve as one of the three State Board of Insurance members.

Texas law changed in 1992 by "privatizing" the function of liquidating insurance companies and Jo Ann was one of the first special deputy receivers appointed by the Commissioner of Insurance.

Since 1992, Jo Ann Howard & Associates has worked on closing over twenty-five Texas receiverships.

Jo Ann and Ed Howard live in Austin where he is a legislative consultant. While East Texas will always be "home", the Howards enjoy the hill country around Austin, the great Texas outdoors, Austin music and the arts, and, of course, politics.

"With the blessings of good health, we all have many options for lifetime learning and career options," Jo Ann says.

The computer chip has changed our lives, and will continue to do so as a view of the computer industry in Austin confirms. "To work smarter, that is our challenge," according to Jo Ann Howard.

Stephen Phillips

Stephen Phillips has served as accountant for IAIR since its inception. Steve was born and raised in Philadelphia and attended Temple University. He is a Certified Public Accountant in both the District of Columbia and Pennsylvania.

In April, 1983, Steve was appointed by the Court of Chancery of the State of Delaware to be the auditor in the matter of Tara Life Insurance Company of America, in rehabilitation and (now in liquidation).

He retained that appointment through three insurance commissioners and five deputy receivers.

In June, 1984, Mr. Phillips was appointed Auditor and Special Assistant to the Deputy Receiver for Commonwealth Marine and General Assurance in Liquidation.

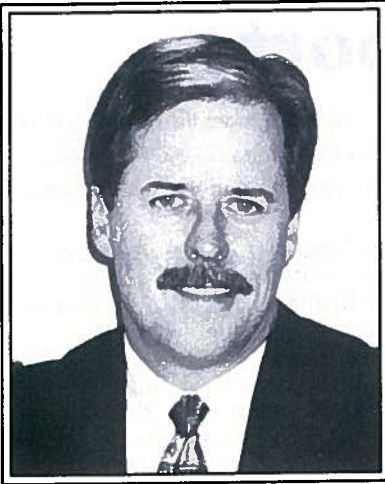
In September, 1984, Steve was appointed Special Deputy Insurance Commissioner and Deputy Receiver of Pacific American Insurance Company (a Delaware domiciled company) located in Utah. At the same time, he functioned as the acting chief executive officer of Fidelity American Life Insurance Company (an Arizona domiciled company)

Steve currently serves as auditor and consultant for life and health guaranty associations, liquidation bureaus and insurance departments in several domiciles. He provides similar services to several active insurance companies in the life, property & casualty and accident & health lines of business as well as two fraternal insurance organizations.

Steve is active in the NAIC's Insolvency Subcommittee (author of the Tax Section of the *Receivers Handbook*) and the NAIC Codification of Statutory Accounting Practices Working Group.

He has also obtained the designation of Fellow Life Management Institute (FLMI with Distinction)

When not assisting IAIR on both the Finance and Education Committees, Steve's personal interests include bicycling and travel.



Stephen S. Durish

Is the Special Projects Director for the Texas Property & Casualty Insurance Guaranty Association (TPCIGA). He has worked for the organization since 1992. Steve began his career in insurance insolvency in May of 1983.

He was informed late one night of the "good news" that he had secured the job of Liquidator for the Arkansas Insurance Department, accompanied by the bad news that he was to arise at 5:00 am the following morning to join in a takeover of a small life insurer in the northern part of the state.

Steve received a bachelor's degree from Colgate University and continued his education in the MBA program at the University of Arkansas-Little Rock. He is a Fellow of the Life Management Institute (FLMI).

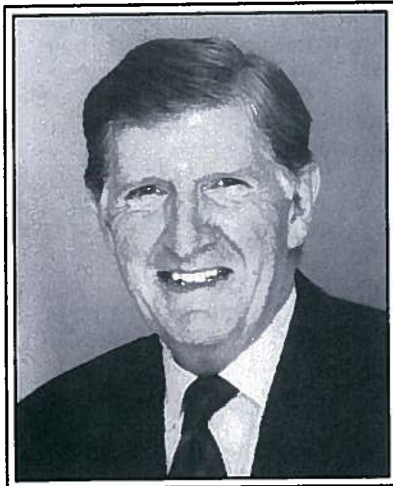
After five and a half years as Deputy Receiver for the Arkansas Department, he was appointed Liquidator-Receiver for the Texas Department of Insurance in January, 1989 and inherited 145 existing receiverships followed by nearly 70 more in the next year and a half.

The assortment included domiciliaries and ancillaries, P&C, L&H, HMO's, title underwriters and agencies, MGA's, unauthorized insurers, and some "none of the above".

Steve currently chairs or cochairs a number of National Conference of Insurance Guaranty Funds (NCIGF) committees including the Education Committee and coordinating committees for Employers Casualty and Breast Implant Claims.

He has been involved in insolvency/guaranty fund educational programs since 1990 including the inaugural SIR-NCIGF Joint Workshop, the 1996 IAIR-NCIGF program and several of the annual NAIC Insolvency Workshops.

Steve and his wife Cile have two sons, Nevin, 15 and Drew, 12. When not enjoying vacation travel on a "Clark Griswold" schedule, they enjoy watching their boys' sporting endeavors, two of which (soccer and baseball) Steve has attempted to coach over the last decade.



Burleigh Arnold

Burleigh Arnold, a long time Missouri resident, is an attorney and graduate of the University of Missouri, School of Law. He received his undergraduate degree from Northeast Missouri University and pursued advance study in banking at Northwestern University, Evanston, Illinois.

Following Mr. Arnold's military service during the Korean War, he served as an Assistant Attorney General in the state of Missouri and was executive assistant to John M. Dalton, Governor of Missouri.

Earlier in his career, he also served as an associate circuit judge and taught on the faculty of Northeast Missouri University.

Mr. Arnold has been the court appointed liquidator for Transit Casualty Company in Receivership since 1987. Chartered by Missouri and located in Los Angeles, the Transit receivership is approximately $4 billion in size and generally recognized as the largest property and casualty insolvency in United States history.

Since Transit has significant reinsurance claims against the KWELM companies in London, Mr. Arnold serves as Chairman of the KWELM creditors committee.

The KWELM companies (Kingscroft, Walbrook, El Paso, Lime Street and Mutual Re) are considered to be the world's largest insurance insolvency.

Mr. Arnold's extensive business career includes service as CEO and Chairman of a Missouri life insurance company, Senior Vice President and Corporate Counsel to Central Bank in Jefferson City, Missouri, as well as a board member of Easton Publishing Company in the communications industry.

Mr. Arnold is married to Rebecca Sommers Arnold. The Arnold's have four children including two daughters, Ashley Theresa and Sharis Leigh, a lawyer in Washington, D.C.

Their two sons are Charles Andrew with Arnold & Associates in St. Louis and Victor John Arnold, Director Research Systems at Stanford University.

Receivers' Achievement Report

Ellen Fickinger, Chair **Reporters:** **Northeastern Zone - William Taylor (PA); Midwestern Zone - Ellen Fickinger (IL), Brian Shuff (IN); Southeastern Zone - Roger Hahn (FL), James Guillot (LA); Western Zone - Mark Tharp (AZ), Jo Ann Howard (TX); International - Phillip Singer (England), John Milligan-Whyte (Bermuda)**

Our IAIR achievement news received from reporters covering the first quarter of 1997 is as follows:

RECEIVER'S ACHIEVEMENTS BY STATE

Arizona (Mark Tharp, State Contact Person)

Disbursements made under early access for first quarter of 1997

Receivership	Amount
Farm and Home Life Insurance Company	$7,000,000.00 AZ LDIGF

Illinois (Mike Rauwolf, State Contact Person)

Receivership	Year Action Commenced	Insurance Category	Dividend Percentage
Trans-Pacific Insurance Company	1994	P & C	0%
			Dismissed 2/22/97

Disbursements for first quarter 1997

Receivership	Amount
AMRECO	$26,690,573.00
Centaur	$ 30,039.00
Merit	$ 800,953.00
Millers	$ 45,401.00
Sub-total	$27,566,966.00
Plus six (6) additional estates where disbursements for each estate were below $10,000	$ 19,471.00
Total	$27,586,383.00

Kansas (Don Gaskill, State Contact Person)

Disbursements to policy/contract creditors for first quarter of 1997

Receivership	Amount
Farm & Ranch Life Insurance Company	$ 2,269.58(Class 3)

Maryland (Lisa Forry, State Contact Person)

Disbursements to policy/contract creditors for first quarter of 1997

Receivership	Amount
Trans-Pacific Insurance Company	$ 11,645.51
	$ 188,625.64 (Total)

New Jersey (John Kerr, State Contact Person)

Disbursements made to policy/contract creditors for first quarter of 1997

Receivership	Amount
Integrity Insurance Company	$ 58,996.00

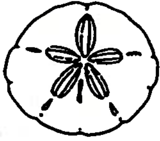
Mark Tharp (AZ) reported that litigation settlements of claims against former officers, directors and professionals resulted in cash payments to the Receiver of $10.77 million during the first quarter of 1997 in connection with the **Farm and Home Life Insurance Company**. Additionally, the Rehabilitation Plan for **American Bonding Company**, approved by the Court on February 27, 1997, has been implemented and the Special Master provision of the Plan is pending submission to the Court. Further, the claims moratorium for **ABC**, imposed in November, 1996 was lifted in July of 1997 allowing for the payment of senior creditor obligations.

Mike Rauwolf (IL) advised that the Illinois Receiver continues to manage the run-off of two insurance companies under supervision. **American Mutual Reinsurance Company, in Rehabilitation**, is under supervision for the reinsurance run-off of their business. Total claims paid inception to date for loss and loss adjustment expense is $30,448.74, Reinsurance payments of $113,064,792.59 and LOC drawdown disbursements of $9,613,385.54. **Centaur Insurance Company, in Rehabilitation** total claims paid to date for Loss and LAE is $50,182,667.73, Reinsurance payments of $4,945,492.57 and LOC drawdown disbursements of $13,876,555.31. A third company, **Merit Casualty Company,** now in liquidation, made payments while under supervision during the first quarter of 1997. Total claims paid to date for Loss and LAE was $5,426,764.64 with Reinsurance payments totaling $276,714.27.

It was reported by **Lisa Forry (MD)** that collections during the first quarter of 1997 against former officers, directors, employees and professionals of **Trans-Pacific Insurance Company, et al.,** totaled $84,459.92.

Bill Taylor (PA) reports that the Policyholder death benefits and

(Continued on Page 16)



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Receivers' Achievement Report *(Continued from Page 14)*

Pennsylvania (William S. Taylor, State Contact Person)

Receivership	Year Action Commenced	Insurance Category	Dividend Percentage
Keystone Medical Services, Inc.	1990	MEWA	100% Class B 17% Class C

Disbursements under early access for first quarter of 1997

Receivership	Amount
Rockwood Insurance Company	$ 3,587,718.00
Westmoreland Casualty Company	89,452.00
Total	**$ 3,677,177.00**

Other News & Notes

(Continued from Page 4)

closer to the dates on which they mature than could ever be done in the absence of the SGFs. Since they have been around for over 25 years, some of us do not appreciate how politicized an insolvency would become if there were no SGFs. We do not want to go back where the Feds want to take us.

More than 25 years ago the deal was, the SGFs will pay claims in full as they mature in exchange for 1) "claims under policies" or "policyholder" priority, 2) early distributions from the assets of the estate and 3) being allowed to recoup the cost by premium tax offset or otherwise. In relation to this note see Ms. Veed's quote (page 7) about compromises between competing interest groups. The Fed's arguments that our priority ranking of SGFs is illegal would destroy, not just the first, but rather the first two parts of the deal. A liquidator can not make early distributions other than to priority classes that will be paid in full or the priority just below those.

The destruction of these parts of the deal would have a strong potential for destroying the SGF system. At the very least, the burden would be unfairly shifted to taxpayers and policyholders. *(Continued on Page 17)*

annuity payments continue to be paid at 100% for **Fidelity Mutual Life Insurance Company (FML), in Rehabilitation.** Crediting rates are at or above policy guarantees. As of 3-31-97, **FML** showed a statutory surplus of $20,339,032. Another petition has been filed with the Commonwealth Court to relax the moratorium restrictions.

If approved, hardship exemptions will be expanded and policyholders will have access to an additional 10% of their cash values.

A settlement has been reached with the agents who had begun litigation over the amount of commissions owed to them.

A petition was recently filed with the Commonwealth Court to approve this settlement.

The Rehabilitator continues to meet with the Policyholder Committee to resolve their objections to the Second Amended Plan which was filed in June of 1996.

It is expected that a court approved bid process will be initiated in 1997 to select an outside minority investor to assist in recapitalizing the company through a stock subsidiary.

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President's Message

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participation by the membership.

The proposed amendments to the IAIR Bylaws were mailed to the entire voting membership (i.e., principal members as of 12/31/95) on October 14, 1997 and hopefully by the December meeting we will be able to report acceptance by the voting membership. For those members who have not yet submitted their Bylaws ballot, are encouraged to fax it back as expeditiously as possible.

When I first became your president, one of my primary goals after discussing the association with many of the membership, was to create an open responsive association capable of growing and meeting the challenges of accreditation, as well as education, that we face in our day-to-day professional careers. I am particularly happy that the Board was able to resolve these issues during my tenure as president.

With the annual meeting in December, new members will be added to the Board to fill both exiting vacancies and, if the bylaws are approved, the new positions as well as the election of new officers for IAIR.

As a result, this in all probability will be my final message to you as President of the International Association of Insurance Receivers.

I would like to thank all existing and former Board members for their assistance and encouragement over the last two years as well as specifically thank Vice President Doug Hartz, Secretary Bob Deck, CIR and Treasurer Mike Marchman, CIR.

Your contributions and assistance have been invaluable in meeting the goals of the association.

While I may no longer be an officer after the annual meeting, the membership did make the mistake of electing me to a three year term on the board, so while you will not have to listen to my ramblings anymore, I will still be around doing whatever I can do to assist the new officers.

In closing, I would like to wish all of you and your families a very happy and productive holiday season, and hope to see as many of you as possible at the Seattle NAIC.

Other News & Notes

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The good news is the Fed's arguments in the Reserve case were rejected by the Court. Please see Ms. Veed's discussion starting at page 8. While it seems likely that this will be appealed, the holding and the arguments made by the Illinois OSD and the SGFs are very persuasive. In fact, they are so persuasive that using the potential of federal superpriority claims to avoid making early distributions to SGFs, or to simply avoid making any liquidation dividends at all, should be reconsidered by a large number of liquidators. Which brings us to the topic of early distribution.

Well, you have all lucked out. I have run out of time and space. I will have to send off to Mealey's the mind-bending illustration that I was about to get into showing how failing to make early distributions prejudices the SGFs and how the U.K. concept of making an annuity out of the liquidation dividends has the same effect on the SGFs and other short-tail claimants.

Anatomy of a Liquidation From Grave To Grave

When that next insolvency comes your way, are you ready to handle the problems it will present?

How will you resolve issues such as:

- Commuting participants rehabilitation (should all participants be offered the same deal?)
- Domicile state not a signatory of any of the Uniform Insurance Receivership Acts
- Preference issues including excessive severance packages to company executives
- Impact of availability of insurance in the market due to the timing of rehabilitation and/or insolvency?

Get ready for your next estate!

Mark your calendar to attend the NAIC/IAIR Insolvency Workshop January 29th and 30th, 1998 at the Hyatt Regency La Jolla in La Jolla, California.

This is Super Bowl Weekend so, make your Air Line Reservations NOW!

For registration information call NAIC Education Department 816-374-7192

WANTED

Your Articles for *the Newsletter*

If you have an article you would like to submit for publication in the *Insurance Receiver*, please submit it in MS Word 6.0, or Wordperfect 5.0 or 5.1 on an IBM-formatted 3.5" floppy disk. Mail it to IAIR Headquarters, attention Lisa.

Article(s) must be received by the first of the month, one month prior to publication date. All submissions become property of IAIR and may or may not be chosen for publication.

If you wish to have your diskette returned, please enclose a 6"x9" SASE.

Early Closing Option: Putting Insolvency Ghosts to Rest

By Steven C. Elliott, J.D., CPCU, CLU
Vice President, NAMIC Regulatory Affairs

Some of the largest property/casualty insolvencies were Mission, Transit and integrity. Mission Insurance Co., after sustaining huge losses in 1984 and 1985, was placed in conservatorship by California regulators in 1986 and ordered liquidated in 1987. Transit Casualty Co. was insolvent by the end of 1984, and was placed in liquidation in 1985 by Missouri authorities. Its receiver called Transit "the Titanic of insurance company insolvencies," with potential losses variously estimated at from $2 billion to $4 billion. The Integrity Insurance Co. was taken over by New Jersey authorities in 1987, and the receiver found that it was probably insolvent from at least 1981.

The Living Dead

All this sounds like old news, until one realizes that many estates such as these are still open, and still costing insurers through guaranty fund assessments. These guaranty fund assessments are likely to require more management attention if proposed accounting standards regarding them are adopted in current form. There are two such proposals, one found in a draft Statement of Principle (SOP) prepared by the American Institute of Certified Public Accountants, the other in Issue Paper 35 of the National Association of Insurance Commissioner's (NAIC) project codifying statutory accounting principles. Both, if implemented in their current form, would require insurance companies to book their estimated ultimate liabilities for guaranty fund assessments at the time any insolvent company goes under, with guaranty fund assessment exposure to other companies.

This almost touching faith in the capabilities of actuarial science is not shared by many company CFOs. This issue and the continued assessments bloodletting have prompted calls for some way to put these undead companies to rest. How best to plant and keep these zombies in their graves so they no longer trouble successful company executives? Having been dogged by these often low-priced companies while alive, must they continue to pay additional tribute after the incantation "early closing" has frequently been on their lips. Would early closing succeed?

First Attempts at Exorcism

The first legislative attempt at early closing was in Missouri, state of domicile of the ill-fated Transit Casualty Co. In legislation enacted in 1991, Missouri provided for a claims estimation process with a view toward early closing of insolvent estates. All claims were to be estimated, both reported and "incurred but not reported" (IBNR), and final closing of the estate made on that basis. This statue was followed in 1993 by a very similar Illinois statue. Significantly, neither of these early closing statues specifically addressed the issue of whether or not reinsurers must accelerate their payments to the estate in virtue of estimated IBNR. Reinsurance recoverables are generally the most significant assets of insolvent estates, so that unanswered question is of major importance. In the *Holland America* case, the Missouri courts have filled in this missing piece. In 1995 it was ruled that the Missouri statute would indeed permit acceleration of reinsurer's payment to the estate to cover estimated IBNR, regardless of the language of the reinsurance treaty.

What was thus a judicial construction of earlier early closing statutes then became an explicit provision of the next generation of statutes, at this writing represented only by Utah. Utah's early closing statute, enacted in 1995, provides that after an insolvent estate has been open five years, early closings can be accomplished by the receiver, with a feature for binding arbitration of disputes over mandatory commutation of reinsurance contracts. A bill modeled on the Utah statute has been before the California legislature, but has not been enacted as of this writing.

How the Haunting Affects Reinsurers

Early closing, with estimation of IBNR and acceleration of reinsurance recoverables, is attractive to many primary companies. They expect this to lower their guaranty fund assessments. There is no authoritative source for the actual impact, but some observers have estimated that widespread enactment of early closing legislation could cut up to half the national cost of guaranty fund assessments. That forms one end of the spectrum, representing the perspective of some primary companies. But observers from within the reinsurance community, which would admittedly be directly impacted by this type of statue, say that no overall savings would occur. In fact, some suggest that the overall burden on the guaranty funds might actually increase. That could happen if guaranty funds were to be required to assess primary companies on the basis of IBNR, thus mirroring the treatment of reinsurers under the proposal. Clearly, there is little hard data readily accessible to validate conflicting assertions.

One thing is clear: reinsurers would indeed have some economic incentive to litigate a legislative solution to early closing that included acceleration of their contractual obligations. For example, consider the Integrity insolvency. Some estimate its IBNR as $1.4 billion, certainly a significant enough number to spawn some aggressive court action. Reinsurers would likely attack acceleration of their payout as an unconstitutional retroactive

abridgment of their contractual rights. But suppose this treatment does pass constitutional muster. There is still liable to be intensive litigation. With an insolvency the size of Integrity, determination and application of IBNR liabilities to the right year, the right layer, and hence the right reinsurer presents formidable methodological problems that could result in a luxuriant crop of arbitrations and litigations.

Obviously this can represent a tremendous expenditure of time and legal costs to the estate, leading to greater guaranty fund assessments.

Proponents of this kind of legislation point out that the *Holland America* decision found that mandatory commutation of reinsurance contracts was a valid exercise of police power in the insolvency situation, and that the reinsurance markets will prospectively learn to adjust their treaty wordings and pricing to reflect this changed situation. Of course, this adjustment can be a double-edged sword.

Proposals for Putting the Dead to Eternal Rest

In spite of the legal and conceptual difficulties to reform, and regardless of the mare's-nest of methodological valuation and allocation problems just mentioned, the fact remains that something must be done about the undead haunting the ongoing operations of viable companies.

Primary companies are reinforced in this conviction by observing the British example. U.K. insurer insolvencies appear, from the distant vantage point of the American side of the pond, to have achieved a balance between equitable treatment of all interests and the need to economically and expeditiously bury these corpses. While some of the U.K.'s greener grass may not look quite as paradisiacal on closer inspection, enough of it remains to convince most that "there must be a better way" than the current system. Right now there are at least five early closing alternatives actively being considered. They are claims estimation (with acceleration of reinsurance recoverables); a trust fund arrangement; a so-called "bifurcated" approach; asset/liability transfers; and an absolute cutoff.

The first of these early closing proposals, claims estimation, would follow the approach of the Utah and Missouri (as judicially construed) statutes. Any time after five years (or some other appropriate time) of the liquidation order, the commissioner could commence the claims estimation process. This process would include estimation by the receiver of all contingent, unliquidated, immature and IBNR claims. This process would be open for input from all interested parties, including the reinsurers. The claims estimation process would yield definitively allowed claims and their final values for all purposes, including reinsurance recoverables. Should disputes arise, there would be provision for application to the court for statutory commutation procedures, culminating in arbitration.

This approach probably yields the largest amounts to the guaranty funds earlier than any other alternative, and this is its greatest attractiveness.

There is some significant support for claims estimation from some receivers.

Proponents of the approach acknowledge that the estimation procedures may take several years, but maintain that there would still be a final distribution decades earlier than in a conventional long-tail liquidation.

How best to plant and keep these zombies in their graves so they no longer trouble successful company executives? Having been dogged by these often low-priced companies while alive, must successful insurers continue to pay additional tribute after their death?

Despite these clear benefits, there are genuine difficulties to the claims estimation approach. First, there is the constitutional and legal issue of the retroactive statutory rewriting of existing contracts. If these legal hurdles are successfully surmounted, there remains the issue of equitable distribution of reinsurance proceeds representing allowed IBNR claims. It is reasonable to assume large policyholders would fare better than small ones. Large policyholders would presumably have a larger internal claim database from which actuarially supportable IBNR numbers can be developed. Small businesses, sole proprietorships and independent professionals would most likely not be able to lay claim to IBNR proceeds the way Fortune 500 companies would. This could ultimately create huge political problems.

The second approach, the trust fund alternative, calls for claims estimation process just like the previous approach. But the reinsurance recoverables would not be paid up front. Instead, they would be paid in installments to a trust, say every five to seven years, depending on loss development. Reinsurers would earn the interest on payments thus held by the trust.

The liquidation estate would close after it had established the trust, thus ending liquidation expenses. This approach is modeled after a successful trust fund plan used in Executive Life and some other life receiverships.

Although this approach may be moderately more palatable to reinsurers, it still involves some rewriting of their contractual obligations, something which they have traditionally steadfastly opposed.

The third alternative, bifurcation, lacks actual examples to which its proponents can point. It is a discussion concept. When the marshaling of assets and adjustment of reported claims have been completed and all that remains to be done is adjustment of contingent liabilities, collection of reinsurance and distribution, a claims estimation procedure would be initiated. But the

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Early Closing Option: Putting Insolvency Ghosts to Rest

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estimate would only affect determination of an early dividend. Although statutory incentives for voluntary reinsurer commutations are mentioned in passing, there would be no mandatory acceleration of reinsurers' payments.

Thus, there would be no early closing of the estate, but it is hoped that the early dividend on the basis of claims estimation would result in a larger than otherwise expected payment to guaranty funds because it would be based on ultimate exposure. And the incentives to commutation may result in earlier than expected closings.

This idea of separating claims estimation from acceleration and estate closing is innovative but needs further elaboration by its proponents before it will start to generate support.

Turning to the fourth possibility, U.K. liquidations are used as the prototype. Asset/liability transfer might be thought of as a "free market" approach. Once again, the procedure would be triggered when marshaling of assets and adjustment of reported claims have been accomplished and the only remaining tasks are adjustment of contingent liabilities, collection of reinsurance, distribution and closing.

A claims estimation process would ensue, on the basis of which a final dividend rate would be fixed and distribution made to all claimants, including guaranty funds. The estate would then be closed, with a transfer of contingent liabilities and reinsurance recoverables to the guaranty funds, who would then run off the contingent claims. There would be a final cutoff date in 10-15 years.

This suggested solution may well require some legislative modification of guaranty fund status, powers and immunities. It raises questions about the proper role of guaranty funds.

For these reasons, some observers have turned to a subspecies of asset/liability transfer. This variation involves selling the contingent claims and reinsurance recoverables to a private run-off company.

This "free market" solution most closely resembles what happens in some English "schemes of arrangement." The risk of reinsurance recoverables falling short of future claims would be assumed by the runoff entity.

Finally, a fifth approach to the problem is to simply impose an absolute cutoff of long-tail liabilities, say 10 years after the date of the liquidation order.

This of course has the disadvantage of prejudicing the claims of contingent claimants and policyholders, making enabling legislation hard to pass.

And enabling legislation would be needed, not only to implement the plan but also to protect the guaranty funds by guaranty fund legislation providing for either an independent claims bar date or else a bar date that automatically tracks the liquidation claims bar date.

It can be readily seen from this survey of available alternatives that none of them affords opportunity for early closing of undead companies without some sacrifice from one interested quarter or another.

It looks like the "free market" asset/liability approach is least intrusive on existing contractual rights while still offering realistic hope of early closing. Absent some solution, the undead will haunt the industry for years to come.

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