

# The Insurance Receiver

PROMOTING PROFESSIONALISM AND ETHICS IN THE  
ADMINISTRATION OF INSURANCE RECEIVERSHIPS

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## IAIR President's Message

By Joseph J. DeVito, AIR

Well, the holidays have come and gone and I hope that you all enjoyed the many pleasures that come along with the season. I know that one of my most cherished gifts this past year was being honored by my fellow members of IAIR. I want to extend my deepest thanks for your support in electing me as Chairman of the Board of Directors and President and for your confidence in my ability to lead IAIR into 2006. It is my hope and desire to continue to make strides for this organization by applying the same fine standards set by my predecessors.

You all know Trish Getty, IAIR's outgoing Chairman and President, and I am sure you agree that her strength and hard work during 2005 has added much benefit to our members and the insurance industry as a whole. For myself personally and on behalf of IAIR, I thank Trish for her past performance and look forward to her continued efforts as a member of the Board. There are others who have served the membership throughout the years and who have recently completed their service on the Board. In particular, our appreciation to George Gutfreund for his leadership as Chairman and President of the Board as well as Chairman of the A&E Committee; to Kristine Johnson for her outstanding contribution to the educational program of IAIR as Chairman of the Education Committee; to Vivian

Tyrell for her hard work and insight into the international arena through the educational programs conducted in the UK; to Lowell Miller for his assistance in maintaining a sound financial foundation for the continued growth in IAIR and the programs we offer to our members. As we thank our outgoing Board members, we welcome the newly elected....Jody Hall, Special Deputy Superintendent and CEO of the NY Liquidation Bureau; Dorothy Cory Wright, Partner at Kendall Freeman; Mary Cannon Veed, Partner of Arnstein & Lehr; and, returning for a second round, Doug Hartz, Bingham Consulting, who will also serve as Treasurer during this term. I am confident that the Members of the Board of Directors, Past...Present...Future, are dedicated to meet the goals and objectives of IAIR.

**The Past...** We were all saddened by the many disasters that plagued this nation and the world. Although only three meetings were held during 2005 due to the tragedy in New Orleans, everyone remained dedicated to the tasks at hand and I am pleased to highlight many of the accomplishments:

- An Accreditation Standards Committee was launched with George Gutfreund at the helm, Dan Watkins was appointed NAIC liaison, a MARG Committee was established and chaired by

Doug Hertlein, and Sue Kempler led the SMART Committee.

- Eleven designations were awarded: 9 AIR and 2 CIR bringing the total to 45.
- The first ever staff training was held in San Francisco in May 2005 and the evaluations were exceptional.
- The 2005 Workshop was held in Orlando with a successful participation.
- Our international members attended meetings held in London that were well-organized by Vivian Tyrell.
- The Nomination Committee, chaired by Hank Sively, established new Board balloting procedures.
- Our website is now the "new and (continuing to be) improved" website thanks to Alan Gamse and his team's efforts.
- IAIR members are now extended discounts by Mealey's (25%) and the American Conference Institute (15%).

**The Present...** Some of the goals are a continuation of our past efforts and others represent a new agenda. We will continue to review the accreditation process in the receivership/liquidation arena and begin efforts to develop a study

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course and testing program that will lead to awarding the AIR and CIR designations. We will continue the professional development programs through the quarterly roundtables and seminars sponsored solely by IAIR or in conjunction with NOLGHA, NCIGF, or the NAIC. In fact, our latest Insolvency Workshop held February 1-3 in San Diego, "The Hitchhikers Guide to Receiverships" had an attendance that exceeded 230. The Workshop covered receivership issues including legal updates, the "nuts and bolts" of receiverships, bankruptcy developments, international concerns, and practical tips. Our thanks to Chairman Phil Curley and Co-Chairman Patrick Cantillo, for making the Workshop informative, interesting, and successful.

We have decided to "get back to basics" by offering our entire membership a quarterly "Think Tank" session that is an open forum intended to draw on the vast experience of our general population so that members faced with insolvency issues in today's environment can learn, cultivate and possibly conquer their concerns. We are currently exploring avenues to further develop international membership participation in our activities and to help coordinate the ever-shrinking world. We also encourage our Commissioners to be more actively involved in our training programs...so far, our encouragement has been embraced and we are pleased at the response. We can thank Pam Woldow, our new Education Chairperson, for having Michael McRaith, Director of Illinois, and Julianne Bowler, Massachusetts

Commissioner of Insurance, speak at our Roundtable in Orlando.

**The Future...** A few years ago, then President, George Gutfreund, said that IAIR was becoming an international "Think Tank" of knowledge pertaining to insurance, restructuring, run-off and receiverships/liquidations. Our goal is to integrate the activities of our entire membership in a collective effort to strengthen IAIR as an organization and its members individually and as a whole.

This is your organization! I can assure you that you will get as much out of it as you put into it...but please lend us your support. I encourage all members to actively participate in the Board and Committee meetings to share in the experience and to grow as a team. Mine is an open door policy so I encourage each of you to contact me or any Board member with any questions, comments or suggestions that you may have. If you would like to become more involved, you are certainly welcomed by all...just contact someone and we will make sure you are heard.

The following is a list of current Committees and Chairs. Reach out!

Accreditation Standard Committee  
 Accreditation & Ethics Committee  
 Americus  
 By Laws  
 Editorial Review Board  
 Education  
 Finance  
 IAIR/NAIC Liaison  
 International  
 MARG  
 Marketing  
 Nominations, Elections & Meetings  
 Publications  
 SMART Act  
 Website

George Gutfreund  
 Dan Watkins  
 Paige Waters  
 Francesca ("Frankie") Bliss  
 Francine Semaya  
 Pam Woldow  
 Doug Hartz  
 Dan Watkins  
 Vivian Tyrell  
 Doug Hertlein  
 Mary Jo Lopez  
 Hank Sivley  
 Hal Horwich  
 Sue Kempler  
 Alan Gamse

Thank you all for your dedication and hard work...Also, our deep appreciation to Paula Keyes, Executive Director, who has and continues to represent us in the Past...Present...and Future.

## View from Washington

by Charlie Richardson



Washington is in the middle of the run-up to the 2006 midterm elections, with Democrats confident of recapturing at least the House, and Republicans petrified that President Bush's weakened political base could make that happen. Iraq, the ports deal, Katrina, and the lobbying scandal loom large, with the economy \_ always the biggest trump card in the electoral deck \_ the potential tipping point when voters make up their minds in late October and head to the voting booths on November 7.

Of course, for the insurance geeks reading this column, the action that matters most is on the insurance regulatory front where optional federal charter legislation was introduced on April 5. Therefore, I have first captured the thrust of thinking in Washington on those issues \_ as reflected in the new OFC bill and the NFI Summit \_ and then moved to other more general matters potentially impacting the insurance/financial services sector.

### Senators Sununu and Johnson Introduce Bill to Provide Optional Federal Regulation for Life and P&C Insurance

On April 5 Senators John Sununu (R-NH) and Tim Johnson (D-SD)

introduced the "National Insurance Act of 2006" (S. 2509), a bill that would permit life and property/casualty insurers to choose federal \_ instead of state \_ charters under an optional federal charter regulatory system. Both Senators are members of the Senate Banking Committee, which is where hearings on the bill are expected before summer. Senators Sununu and Johnson have supported the optional federal charter approach to insurance regulation because they argue it will provide efficiency, certainty, less regulatory competition, a streamlined approach and uniformity that otherwise has not been achieved under state regulation.

\* \* \*

### NFI Insurance Summit

The 3rd Annual Insurance Summit presented by Networks Financial Institute in Washington, D.C. was held in March. Liz Coit, Executive Director of NFI, made introductory remarks about NFI's education, outreach and research initiatives since the last Summit. Major federal and state policymakers as well as Dr. Scott Harrington of the Wharton School and industry representatives then discussed the future of insurance regulatory reform. Here are some of the things they said \_ this is as good a summary as any of where things now stand in Washington.

### Alessandro A. Iuppa, Maine Superintendent of Insurance and President, National Association of Insurance Commissioners

- State regulators welcome oversight of and discussion about insurance regulation and have generally risen to the task of improving the state-based system.
- The NAIC believes in coordinated processes and has shown this on its work on speed to market, producer and company licensing, and solvency monitoring.
- The industry should be concerned about the potential for consumer confusion under a dual system and about adequate treatment of consumer complaints by a federal regulator.

### Rep. Paul E. Kanjorski (D-PA), House Financial Services Committee

- While we are not ready to nationalize the insurance industry as a whole, some areas (e.g. life insurance) lend themselves to federal regulation.
- The SMART Act is not likely to put enough pressure on the states to get insurance regulation right. The solution is a "world-class non-partisan independent federal regulator," like the OCC, as a part of optional federal charter legislation.

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- Don't rely on Congress to understand the insurance industry. The industry should take the time to educate members of Congress to make sure they make an informed decision about regulation.
- It is unlikely that rate deregulation would ever pass Congress.

### Emil Henry, Jr., Assistant Secretary for Financial Institutions, U.S. Department of Treasury

- Secretary Henry gave a report on the U.S. economy.
- Treasury has not taken a formal position on insurance regulation and wants to continue to consult with those on all sides of the issue. It is now looking at the issue.
- The key principles of TRIA have not changed since its enactment. TRIA should be temporary and should encourage private action to address issues that will remain after the inevitable disappearance of TRIA.
- In February, Treasury issued a public notice seeking comment on TRIA and encourages interested parties to submit comments. A report will be issued by the September deadline.

### Jamie Burnett, Legislative Director to Sen. John Sununu (R-NH)

- Senator Sununu supports the optional federal charter because he sees it providing efficiency, certainty, less regulatory competition, a streamlined approach and uniformity that otherwise has not been and may not be achieved under state regulation.
- The federal regulator would be an independent agency housed within Treasury, funded by assessments on federally chartered insurers and licensed producers.
- An important part of the federal regulator's job would be to act as a spokesperson for the insurance industry with an international audience.

### Glenn E. Westrick, Counsel, House Financial Services Committee

- While the NAIC has had some successes at uniformity among states (interstate compact, financial reporting, uniform producer licensing), it is hard to get 50+ jurisdictions to work together in a uniform way without Congressional pressure.
- Chairman Oxley and Subcommittee Chairman Baker see the SMART Act as a compromise that leaves regulation with the states while promoting uniformity, standardization, cooperation and transparency.
- Chairman Baker is getting the SMART bill ready for introduction.

### Scott Harrington, Ph.D., Alan B. Miller Professor, Wharton School, University of Pennsylvania

- Delivered a research paper entitled *Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation*.
- There are some things that state regulation does well at present - good coordination of solvency standards and guaranty associations, good staff dedicated to regulation, and good opportunity for cooperation between insurance companies.
- While state regulation does some things well, it does a lot of things not so well. It is time for the federal government to help move insurance regulation into the 21st Century.
- The federal regulator would serve as a source of information about and advocate for the insurance industry to Congress. The federal regulator may prevent or deter questionable actions by state attorneys general with extra-territorial reach.

These speakers were followed by a panel of industry groups responding in a wide-ranging way to the perceived need (or lack thereof) for a federal role in insurance regulation and laying out their suggested approaches at the state and federal level for "reform".

\* \* \*

## View from Washington

by Charlie Richardson

### Second Bite at the Apple for Asbestos Bill Unlikely, Says Frist

Senate Judiciary Committee Chairman Arlen Specter's (R-PA) bill (S. 852) to establish a \$140 billion trust fund to end asbestos lawsuits was pulled from the Senate floor after it failed (58-41) in February on a procedural vote. Chairman Specter said he is "totally obsessed" with passing S. 852 and hopes for a second vote, but Senate Majority Leader Bill Frist (R-TN), who supports the bill, conceded that this latest vote is likely to be Specter's last for the remainder of 2006.

### House Lawmakers Moving Forward on Data Security Remedies

The House Energy and Commerce Committee voted unanimously (41-0) in March to approve the "DATA" bill (H.R. 4127). The bill seems to be more consumer-friendly than similar legislation (H.R. 3997), approved by the House Financial Services Committee. The DATA bill requires companies to implement data security programs and to notify consumers when their personal information has been compromised in a security breach. The bill also sets forth special requirements for data brokers. Prior to favorably reporting DATA, the Committee approved an amendment which made several changes to the bill. One such change lowers the

threshold for consumer notification from "significant" to "reasonable" risk of identity theft, fraud, or other unlawful conduct, making it more likely businesses will have to report. Fearing over-notification, industry groups and Republicans had supported a standard for breaches threatening "significant risk" of identity theft or other unlawful conduct. Democrats and consumer groups said the proposed notification standards were too weak compared to many states' rules. Senate Banking Committee Chairman Richard Shelby (R-AL) says his committee is drafting a bill.

### Enzi's SBHPs Bill Passes Senate HELP Committee

Following a two-day mark-up, the "Health Insurance Marketplace Modernization and Affordability Act of 2005" (S. 1955) passed the Senate Health, Education, Labor and Pensions (HELP) Committee in March along strict party lines (11-9). S. 1955, sponsored by HELP Committee Chairman Mike Enzi (R-WY) and Senator Ben Nelson (D-NE), would allow small businesses and trade associations to independently pool their members across state lines into Small Business Health Plans (SBHPs). Those SBHPs could offer coverage that does not comply with state mandates if they provide an alternative that mirrors the benefits included in the state government employee

health plans in one of the five most populous states - California, Texas, New York, Florida and Illinois. If Enzi's bill were to pass the Senate (President Bush has announced his support), it would need to be reconciled with House association health plan legislation (H.R. 525) that passed in July 2005. Many Democrats oppose allowing SBHPs to side-step coverage mandated by states and can be expected to offer several amendments on the Senate floor aimed at upholding state laws.

### Shelby Focuses on Portfolios of Fannie and Freddie

Among the legislative priorities of Senate Banking Committee Chairman Richard Shelby (R-AL) is government-sponsored enterprise reform. Shelby said the Banking Committee's agenda includes a bill to "beef up" regulation of Fannie Mae and Freddie Mac. The Banking Committee's GSE bill (S. 190) features a controversial provision to limit GSE portfolios, which is opposed by committee Democrats, but backed by the Bush Administration and the Federal Reserve. In his first appearance before the House Financial Services Committee, the new Chairman of the Federal Reserve, Ben Bernanke, said the current portfolios of GSEs "represent a risk to stability" and need to be more tightly controlled through legislation. Mr. Bernanke said the House bill (H.R. 1461) puts

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inadequate restrictions on the huge investment portfolios of Fannie Mae and Freddie Mac. GSEs are likely to come under even greater scrutiny now that Fannie Mae has released the accounting report by former Senator Warren Rudman (R-NH).

### **President Signs Deposit Insurance Legislation**

In February, President Bush signed into law the “Federal Deposit Insurance Reform Conforming Amendments Act” (H.R. 4636). In addition to other deposit insurance reform provisions contained in the “Deficit Reduction Act” (P.L. 109-171), the signing completes more than five years of work by Congress to revamp the deposit insurance system. Deposit insurance reforms include increasing the deposit insurance limit for certain retirement accounts to \$250,000, up from \$100,000, and requiring the FDIC and the NCUA boards (beginning in 2010) to consider raising the standard maximum deposit insurance every succeeding five years.

### **CRS Releases New Report on Medical Malpractice Liability Reform**

The nonpartisan Congressional Research Service published a report in January that sidesteps the policy question of whether medical tort

reform is a good idea, and instead explains specific tort reform proposals that have been included in past legislation. The report discusses the bills’ individual pros and cons from a legal perspective, such as capping punitive damages and creating a federal statute of limitations. The report also contains a state-by-state chart detailing caps on punitive and noneconomic damages. Passage of legislation to provide a \$250,000 federal cap on noneconomic damages in medical liability suits is high on the Bush Administration’s wish list from Congress.

### **Companies Weather Storms**

The P&C industry faces formidable challenges, including price competition, asbestos litigation and, not least, record natural disaster losses. But a recent report issued by Standard & Poor’s reflects a dramatic decrease in company failures measured in terms of total count and, most significantly, asset values. The fact that no P&C company domiciled in Louisiana or Mississippi, states hit hardest by hurricane Katrina, has been placed under regulatory supervision is testament to P&C company durability.

### **Treasury Working Group Seeks Comments on Long-Term Analysis of TRIA**

In February, the Treasury Department, as chair of the President’s Working

Group on Financial Markets, announced it was seeking public comments related to an analysis it is performing on the long-term availability and affordability of terrorism risk insurance, including coverage for group life and for chemical, nuclear, biological, and radiological events. The Working Group is to submit a report to Congress on its findings by September 30.

### **GAO Releases Insurance Study**

The Government Accountability Office released a study in February of insurance regulation and its many state variations. Specifically, the GAO provided information on the elements that are commonly part of definitions of insurance; how products not universally defined as insurance are regulated across the states by their insurance departments; and current developments in statutory and financial accounting practices as they relate to certain products, etc. The study was requested by House Financial Services Committee Chairman Mike Oxley (R-OH). You can see the report at <http://www.gao.gov/new.items/d06424r.pdf>.

# Ignoring Statutes, The Prime Directive And Debtor's Rights

by Douglas A. Hartz, CIR-ML

*[Mr. Hartz is a former NAIC senior counsel, receivership supervisor for Missouri and a contract deputy receiver and consultant for several states. The views expressed in this article are those of the author and do not reflect the views of any clients. Copyright 2006 by the author. Questions or comments may be addressed to the author at Bingham McCutchen LLP / One State Street, Hartford, CT 06103 / douglas.hartz@bingham.com]*

## I. Introduction

In the last issue of The Insurance Receiver, there was an article by Robert M. Hall entitled "When Can A Receiver Ignore Priority Of Distribution Statutes?" This question was asked in reference to the recent decisions by courts in relation to The Home Liquidation. In that matter the Liquidator is planning to pay administrative expenses to cedents, members of the American Foreign Insurance Association or AFIA, to cause them to file and pursue their claims against the liquidation estate.

The Hall Article covers several aspects of these matters. First, it recaps the decisions holdings (administrative expense needed to collect assets, cedents refusing to file or pursue claims, threats of side deals and cut-throughs to ultimate reinsurer, and the liquidator's broad powers re collecting assets) and concludes it is all about **ignoring**

**statutes.** Second, it asks, near the end, if the **prime directive** is simply "more assets for the estate" such that the receiver can just rewrite contracts to increase assets? Finally, it asks "If receivership codes are meant to create a balance between the **rights of debtors** and [creditors]...?" The original says "rights of ... creators," but this ecclesiastical issue is far beyond what we can cover here. This article, in turn, addresses a) ignoring statutes, b) the prime directive and c) debtor's rights. The Hall Article concludes that the receiver can ignore the priority of distribution when it would "benefit a favored group of creditors." This rather directly implies that the receiver is engaged in favoritism or something even more nefarious. Actually, the idea is to increase the assets of the estate for policyholders and others claiming benefits under policies, a group that is favored (rather foolishly one would gather from the Hall Article) by state legislatures as reflected in virtually all of our state insurer receivership statutes.

## II. Ignoring Statutes v. Ignoring Reality

The Hall Article is readily available at both the IAIR Site and Mr. Hall's Site. Respectively, these are "[http://www.iair.org/files/newsletters/2005/The\\_Insurance\\_Receiver\\_-\\_Vol\\_14\\_Num\\_04\\_Winter\\_2005.pdf](http://www.iair.org/files/newsletters/2005/The_Insurance_Receiver_-_Vol_14_Num_04_Winter_2005.pdf)," and "<http://www.robertmhall.com/articles/PriorityDistArt.htm>." Thus,

here it is only summarized very briefly, and I quote, as follows: "Reinsurance recoverables are not assets of an estate." In sum, that's it.

### a. Reinsurance Is Not An Asset

All right then, in the sixth paragraph he does add, "unless and until the estate becomes liable for matching liabilities...." But he then goes on to say, "Stated differently, the estate must incur substantial new liabilities before it can seek reinsurance recoverables." Since insurers in liquidation usually cannot write new business (the usual way to incur new liabilities) this would limit reinsurance recoveries to recognition of new liability in the form of increases in reserves. This implies that all of the policy benefit reserve liability and its related "contra-liability" (the reinsurance) are not carried from the insurer's balance sheet to the estate's statement of net assets. Maybe he means this: the liabilities of an estate can only be established by filed and approved claims, such that the liabilities of a liquidation are actually zero until claims are filed and approved. Looking at it this way, the reinsurance balances due an estate do drop to zero upon the entry of a liquidation order.

Now, here is an argument for the Liquidation Basis of Accounting that is used for the Global Receivership Database (GRID) reporting. GRID

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requires that these balances be carried forward into the statement of net assets. On the other hand, the modified cash basis of reporting used in some liquidation estates seems to reflect the above concept that the liabilities and reinsurance recoverables drop to zero upon the entry of an order of liquidation. Under the modified cash basis only invested assets and current liabilities are reflected. The claims and related reinsurance are subject to estimates and are thus not shown. The modified cash basis discloses the least about what is actually being done with the estate for its beneficiaries. In comparison, GRID is designed to show what is being done and the likely results for the beneficiaries.

### b. One Should Not Incur Expense To Recover Non-Assets

In the seventeenth paragraph it is again asserted, "reinsurance recoverables are not assets of the estate," and here more detail is added, "until the proofs of claim are filed by the AFIA cedents [the cedent claimants in The Home Liquidation case] and approved by the liquidation court." This time it is stated in support of the argument that it is not appropriate to incur administrative expenses to recover these reinsurance balances - because they are not an asset of the estate. The receiver should not incur expense to recover something that is not an asset of the estate.

If I were a reinsurer, then I would want all of my cedents to go into liquidation right before the monthly net accounting has ceded losses starting to exceed ceded premiums. That way I could collect the last drop of ceded premium and then, not only would my obligation to the estate be dropped to zero, but the liquidator would be prohibited from incurring any expense in trying to recover the written off balance. Free money. It's a good thing.

Does all of this seem to be 180 degrees out of sync with the idea of the insolvency clause required for credit to be taken (for an asset to be shown) in a cedent insurer's financial statements? The idea of the insolvency clause really is simply this: for a reinsurance asset to be shown by an ongoing insurer the reinsurer has to agree that the asset will be there in the event of the insolvency of that insurer. N.Y. Ins. Law § 1308(a)(2)(A)(i) provides: The reinsurance shall be payable by the assuming insurer on the basis of the liability of the ceding insurer under the contracts reinsured **without diminution because of the insolvency** of the ceding insurer. In stark contrast to this, the concept in the Hall Article is that there is a 100% "diminution" in the reinsurer's liability to a cedent upon the entry of a liquidation order. Under the Hall idea the reinsurers liability drops to zero and is only reestablished as claims are filed and approved by

the liquidation court. The idea is that filed and approved claims are the liquidation equivalent of the paid claim condition precedent to a reinsurers liability. This paid claim condition precedent was the idea in *Fidelity & Deposit Co. v. Pink*, 302 U.S. 224, at 227 (1937) that, ironically, gave rise to the idea of the insolvency clause. To keep these two ideas in one's head at the same time, one needs to assume that the reaction to the Pink case only meant that the reinsurer's liability cannot be based on the liquidation dividend (assuming it is cents-on-the-dollar) ultimately paid on a claim. Read that insolvency clause again. It says "liability of the ceding insurer," doesn't it? Does it say anything about filed and approved claims?

Is it unavoidable that in many cases some of the reinsurer's liability is going to evaporate due to claims that are not filed and approved in a liquidation? Probably, yes. The extent to which persons do not file claims may in some cases ("some" means "not all") produce a benefit to those that do file claims. Fewer claims means, in some cases, more for those with claims. When such a benefit is produced for claimants with active interests (a real possibility of being paid something on their claims) in the estate because the liability of the estate has decreased **more** than the related reinsurance assets have decreased, it **usually** is not a bad thing. But, **it is a bad**

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**thing** when the effect of claims not being filed and approved creates a net detriment (i.e. a decrease in the percentage paid on claims) to claimants with active interests in the estate. This is an especially bad thing when it is the policyholders and others claiming benefits under policies that are suffering decreased payments on their claims.

Again, if I were a reinsurer, then every time there was an estate with a sizable portion of my liability being based on assumed business, I would be making sure that those cedent claimants knew that they had no need to bother filing or proving their claims. If this happens enough maybe we can do away with the foolish preference given to policy benefit claimants.

## c. The Hypothetical

As is often the case, the way a question is asked may drive the answer. Rather than ask when the priority statutes can be ignored, a better question in this case may be, "Can a liquidator pay administrative costs to persons that also have claims against the estate?" A corollary query may be, "Can the liquidator do this even if it may not be the only way to recover assets of the estate?"

The facts in the Home Liquidation matter are very messy and complicated and include details like netting out costs and the AFIA

(remember no "M") claimants meeting to reach a "consensus that they would not file and prosecute claims, except to preserve offset, unless they could receive some additional benefit." The many pleadings in the case are all available at <http://www.hicilclerk.org/>. Given these messy facts, we will continue conforming to the maxim "If the facts do not support the theory, then they must be discarded," and will use a hypothetical case to explain the problems presented in situations like this and to address the questions above.

Assume an estate in liquidation (call it "X") after a long period in run off that currently has the following in its Statement of Net Assets.

Assets	
Invested Assets	\$ 800
Reinsurance Recoverables	140
Liabilities	
Admin. Expenses To Close	\$ 100
Policy Benefit Claims	1,000
Assumed Re Claims	200

Assume that the Reinsurance Recoverables of X all arise in relation to the Assumed Reinsurance (Assumed Re) Claims. From this Statement of Net Assets it appears that the Policy Benefit Claims will be paid about 84% (\$940 in total assets less \$100 in expenses on \$1,000 in claims). The Assumed Re Claims will not be paid anything. The absolute priority rule - claimants in

higher priority must be paid in full or sufficient assets reserved for full payment before next class gets any - will apply.

Now suppose the Assumed Re claimants tell you, as the liquidator of X, that since it does not look like they will get paid anything (they have no active interest) they are not going to file or prosecute their claims. This means that you will not be able to report final claims against the estate to the reinsurers of X. This would change your Statement of Net Assets so that it would appear as set out below.

Assets	
Invested Assets	\$800
Reinsurance Recoverables	0
Liabilities	
Admin. Expenses To Close	\$100
Policy Benefit Claims	1,000
Assumed Re Claims	0

If nothing is done to change this, the Policy Benefit Claims would be paid only about 70%. In this case, to borrow a phrase from *Ainsworth v. General Reinsurance Corp.*, 751 F. 2d 962 (8<sup>th</sup> Cir. 1985), at 965, "the obligation of the reinsurer has ceased to be an asset of the insolvent estate." Which, by the way, brings us back to the assertion that reinsurance recoverables are not assets of the estate. Does something have to be an asset of the estate before it can cease to be such? All the credit for reinsurance laws and regulations

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appear to assume that reinsurance recoverables are assets of ongoing insurers. Should this assumption change when the insurer goes into receivership? Isn't the idea behind the insolvency clause to prevent "the obligation of the reinsurer" from ceasing "to be an asset of the insolvent estate" or being diminished because of the insolvency?

Now suppose you determine that you better do something to cause the Assumed Re claimants to file their claims. Further suppose that they are all also in some form of receivership and have their own fiduciary duties. Among those duties are not wasting assets and trying to make recoveries for their beneficiaries. They tell you that the Legion cut-through case, *Koken v. Legion Ins. Co.*, 831 A.2d 1196 (Pa. Commw. 2003) aff'd, 878 A.2d 51 (Pa. 2005), makes them think they may be able to collect directly from X's reinsurers. They also note that since all of their Assumed Re contracts were done by X's Malta Branch Office, and Malta thinks that cut-throughs are just fantastic, they have convinced X's reinsurers not to worry about the *Ainsworth* idea that the reinsurer risks paying twice if they pay the Assumed Re Claims directly. They say the *Ainsworth* idea just won't hold water in Malta.

The Assumed Re claimants say they will not file their claims in X and thus help you collect its reinsurance, unless you agree to pay them half

of the reinsurance collected, as something of a contingency fee. You look at what this will do to X's Statement of Net Assets (netting the \$70 contingency fee against the \$140 reinsurance recoverable) as set out below.

Assets	
Invested Assets	\$ 800
Reinsurance Recoverables	70
Liabilities	
Admin. Expenses To Close	\$ 100
Policy Benefit Claims	1,000
Assumed Re Claims	200

From this Statement of Net Assets it appears that the Policy Benefit Claims will be paid about 77% (\$870 in total assets less \$100 in expenses on \$1,000 in claims). The Assumed Re claimants still will not be paid anything on their actual claims. Remember, they do not have an active interest in the estate. You enter into the proposed agreement with the Assumed Re claimants. You do this because 77% is better than the 70% that would be paid to the Policy Benefit claimants if you do not do it.

X's reinsurer looks at this and argues (I am not saying they argue with "substantial vigor" as this may imply agreement with their argument) that you should not be allowed to pay the Assumed Re claimants because that \$70 should go to the Policy Benefit claimants. Also, they argue that all you are really doing is subverting the

priority statute by paying 50% of the Assumed Re Claims. It is interesting that a debtor to the estate would be making the above arguments. They appear to be arguments on behalf of Policy Benefit claimants. But, are they really?

From the perspective of X's receiver this has nothing to do with getting any money to the Assumed Re claimants - that is their worry, not the receiver's. The receiver is worried about is being able to collect the reinsurance. The receiver is willing to pay anyone that can help do this. It happens that the Assumed Re claimants are in a position to help. In this case, as fellow receivership types, they may not be able to help without costs. If they had an active interest in the estate, then X's receiver could have to consider if some offset to their claims should be provided for in relation to the contingency fee.

In this hypothetical if X's reinsurer is successful in its argument, what happens? The Assumed Re Claims will not be filed and "the obligation of the reinsurer [will cease] to be an asset of the insolvent estate" because of the insolvency. Does that at least sound like it violates the idea behind the insolvency clause? The Policy Benefit claimants will get 70% instead of 77% on their claims. Did X's reinsurer's arguments on their behalf actually cost them 7%? The Assumed Re claimants will still

# Ignoring Statutes, The Prime Directive And Debtor's Rights

by Douglas A. Hartz, CIR-ML

likely try to recover directly from X's reinsurer. But, are they likely going to recover less than the 50% contingency fee they would get from the estate? No matter how much Malta likes cut-throughs, X's reinsurer is likely to raise some arguments. For example, how about not actually being in any contractual relationship with the Assumed Re claimants? Even if X's reinsurer ends up paying more than \$70 to the Assumed Re claimants, it is better off because it will likely not be paying more than the \$140 it would otherwise pay you as X's liquidator.

If X had been domiciled in a state that had adopted the modern, and I would argue with "substantial vigor" greatly improved, Insurer Receivership Model Act (IRMA) it could have pointed to the provision based on Section 701A allowing for deemed filed claims and applied this to the Assumed Re Claims. But, remember in our hypothetical these Assumed Re claimants were fellow receivership types. Suppose they argue it is just not fair to make their estates cover the cost of providing information regarding these claims. Something can be paid to them, even where their claims are deemed filed, because the priority statute does not prohibit paying the costs necessary to recover assets.

### III. The Prime Directive

The Hall Article conjecture about

the prime directive being "more assets for the estate" is interesting. It is not the case that we, as receivers, are only worried about pulling assets into the estate. We also have to worry about a) providing due process, b) enforcing - to the degree possible given the facts of insolvency - the rights and obligations of the parties, and c) paying benefits in relation to those rights and obligations: pushing money out of the estates.

In fact, if there has to be a "prime directive" then, perhaps, it should be focused on pushing money out of the estate in the form of advances to the guaranty associations and interim and final distributions to all claimants. The phrase "prime directive" also brings to mind the word "survival." If the state-based system for handling insurer insolvencies does not greatly improve on pushing money out of estates to those claiming policy benefits, at a lower overall cost, in an actually timely manner, and with transparency as to the timing and amount of potential distributions, then it is not going to survive. The competition - a federal system or an avoidance (never put an insurer in receivership, no matter how insolvent, if you can continue a run off) system - will win out.

There has not been enough thought, even in the recent drafting of IRMA and its related "accreditation standard identifying key provisions," addressing the ranking of insurer

receivership statutory provisions by relative importance. What is it that we are really trying to accomplish with a receivership statute?

There are several things that we and our state legislatures are trying to do with these statutes. The "apportionment of any unavoidable loss in accordance with the statutory priorities..." (IRMA Section 101E) leaps to mind in reference to the above hypothetical. However, not being able to collect reinsurance because a) claims cannot be filed, or b) information needed to collect the reinsurance cannot be obtained, should not be part of the unavoidable loss. Among the losses that can be avoided in regard to an insurer receivership is the loss of the insurer's reinsurance recoverables. That is what a) the insolvency clause, b) the credit for reinsurance laws and regulations and the related state accreditation requirements, and c) all of the related case law that has developed, are all about, avoiding the loss of the reinsurance recoverables. The liquidator must be able to pay the administrative expenses needed to ensure that the reinsurance can be collected.

### IV. Debtor's Rights

Some would argue that debtors to the estate have the right to pay their money, period. But, seriously, the receivership statutes should provide some consistency between states so

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that debtors to insurers that go into receivership at least know what to expect. The rights and liabilities that are fixed by the entry of a liquidation order, it must be understood, include the rights and liabilities of debtors to the estate.

Insolvency laws are supposed to provide a framework for the enforcement of these rights and obligations subject to the context of the emergency situation created by the troubled condition or insolvency of an entity. In insurance insolvency, everyone would like to be able to enforce their rights just as they would in the absence of the insolvency. Policy benefit claimants would like to enforce their right to have payment at the time and in the amount that their policies provide. The facts of insolvency, the fact that there is not enough cash to pay all of these at the time and in the amount that the policies provide, impairs this right. The rights of debtors to the estate may also be impaired given the facts of insolvency. The debtors would like to ignore these facts. But, if the creditors (especially those policy benefit claimants that insurer receivership statutes are ultimately meant to protect) cannot do so, why should the debtors be able to do so?

Further, does a debtor (reinsurer) have a right to use the fact that assumed claims cannot be paid to avoid liability to an estate? If so, then the credit for reinsurance laws

and regulations need to be updated to not allow credit on assumed business because "the obligation of the reinsurer [will cease] to be an asset of the insolvent estate" upon liquidation. Perhaps the NAIC's Financial Condition Committee should look into this.

### IV. Conclusions

Receivers, as noted above, "have to worry about ... enforcing - to the degree possible given the facts of insolvency - the rights and obligations of the parties..." as these are contained in the contracts entered into prior to receivership. There is a world of difference between rewriting contracts and having their enforceability affected by circumstances and the law. Receivership codes may aim for balanced enforceability, but they are NOT meant to create a balance between the rights of debtors and creditors, or creators, for that matter.

Several trade and guaranty organizations have recently made arguments that IRMA should prohibit administrative expense payments to persons that also have claims against an estate (other than guaranty associations, of course, which are special). They are arguing that they want less money out of estates. They are arguing that a reinsurer should be able to obtain a windfall by suppressing (or diverting) claims

in an estate - preventing the receiver from enforcing the estate's rights to bill under reinsurance contracts. It is hard to imagine a more strident example of a special interest perverting model provisions.

The larger problem is that these arguments have become an unfortunate distraction. The ultimate point here is that if the competing federal system or the avoidance (never put an insurer in receivership, no matter how insolvent) system even look like they may be cheaper, faster and more transparent than the state based system, then they will win out. Receivers need to be able to collect reinsurance. Arguments that the liquidation process itself causes the reinsurance recoverable to drop to zero are not likely to lead to a cheaper, faster and more transparent system.

# The NAIC Insurer Receivership Model Act History and Overview

by W. Franklin Martin, Jr., Project Director

Office of Liquidations, Rehabilitations and Special Funds, Pennsylvania Insurance Department

*[The opinions expressed in this article are strictly those of the writer; I am not representing the Pennsylvania Insurance Department or the NAIC. Of course, I do believe my opinions are shared by all right thinking real Americans].*

## **History**

The NAIC has had an insurer receivership model for many years; the first version was the Uniform Insurers Liquidation Act from the 1930's. The second version covered more than just liquidations and was based on the Wisconsin receivership statute. In 1995, the NAIC adopted a new version of its model. Many people in the insurance industry felt the 1995 model favored the receivers to the detriment of other interested parties, such as reinsurers and guaranty associations. As a result of industry opposition, the 1995 model was only adopted by Connecticut.

In the early 1990's, several commissioners, primarily in the Midwest, felt that there should be a more national approach to insurer receiverships and proposed creation of an interstate compact. The Interstate Insurance Receivership Compact Commission was established and the compact was enacted by the legislatures in several states. One provision of the compact required the Commission

to draft a receivership statute that would be adopted by each compact state. The Commission appointed a panel to draft such a statute. The Receivership Law Advisory Committee (RLAC) released its model called the Uniform Receivership Law (URL – not to be confused with URL which is short for the Uniform Resource Locator that you use to find things on the internet) in September 1998. The suggestion was made that the NAIC should adopt the URL in place of the 1995 model.

In 1999, the NAIC Insolvency Subcommittee EX5 established a working group to study the URL and make a recommendation on its adoption. The working group chaired by Douglas Hartz of Missouri met at each national meeting during 2000. At each meeting several provisions of the URL were studied. Members of the RLAC would explain the background and purpose of the provisions and respond to questions and comments from the working group and other interested parties. At the conclusion of its study in December 2000, the working group determined that there were worthwhile provisions in the URL that should be in the NAIC model, but that it should not be endorsed as the model. The working group recommended that the NAIC model should be revised to incorporate the best features of both the 1995

model and the URL. A new working group was established by the Insolvency Task Force of the Financial Condition (E) Committee and charged to do so.

Mr. Hartz was designated as the chair of the Receivership Model Act Revision Working Group (MARG - pronounced just like the name of your favorite diner waitress). During 2001, MARG determined what issues should be addressed by the new model act. Three subcommittees were appointed to study the issues in three areas, Harry Levine from California chaired the asset subgroup, Steve Uhrnowycz of Arkansas chaired the claims subgroup and I chaired the "everything else" subgroup. Drafting of the new provisions began in the subgroups in 2002. Diane Garber of Missouri became the MARG chair during 2002 and continued through the end of 2003 when I became the chair.

The process of adopting the new model began in March 2004 at the NAIC meeting in New York. At that meeting, the subgroup members advised that about one-third of the sections would not be changed and were ready to be voted on. Of the 27 "no-change" sections 10 were adopted, 6 were defeated and we ran out of time before we got to the last 11. This should have told me that we were in for a long process, but you've got to hit me

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with a brick to get my attention, so I went to the June meeting seriously thinking we would finish in the eight hours set aside for MARG deliberations. In four hours on Saturday morning we adopted Section 1 and 4 and started Section 5 (Section 2 was a “no-change” section adopted in New York and Section 3 was definitions, which we set aside until all substantive sections had been approved.) At that point I began to think this process would take longer than I anticipated. When we spent four hours on Sunday finishing Section 5, I was sure of it.

Since the charge to MARG was to report a new model at the December 2004 meeting, I knew more time would be needed (once I get hit with that brick, I start to figure things out.) MARG began with weekly teleconferences, and then switched to twice weekly teleconferences. We also held two-day interim meetings in August and November. MARG finally adopted IRMA in April 2005 and recommended it to the Insolvency Task Force. Better late than never. The Task Force adopted it with some changes in May 2005 and recommended it to the E Committee. E Committee’s consideration was interrupted by the cancellation of the September 2005 NAIC meeting. E Committee adopted IRMA with further changes in November 2005. IRMA was finally adopted by the NAIC Executive and Plenary session at

the December 2005 meeting in Chicago.

But IRMA’s story isn’t quite finished; in fact it may never be finished. As the insurance industry changes so must the receivership process. I anticipate that the Insolvency Task Force will review the model periodically to see that it still reflects the best practices. One of the criticisms directed at IRMA was the lack of a provision dealing with large deductible policies. Along with approval of IRMA, the E Committee directed MARG to draft a large deductible provision that would be amended to IRMA as soon as possible. To this end, a subgroup of MARG met with representatives of the guaranty associations and industry trades and drafted a new section for IRMA. Section 712 was approved and recommended to the Insolvency Task Force as a Valentine’s Day present to the guaranty associations on February 14, 2006.

Even IRMA’s harshest critics admit that the process was open and every interested party was given an opportunity to address every issue (and by and large they did, fully and completely, sometimes more than once.) The voting members of MARG were representatives of 18 states all of which are active in the receivership field. We were aided and advised by representatives of NOLHGA, the NCIGF, the RAA, the industry trade associations, experienced bankruptcy attorneys

and staff from several insurance companies and receivership estates.

## What’s New?

The easy answer to that question is “Almost everything”; but I assume you want a little more detail than that.

The most apparent change is the structure of the new model. The 1995 receivership model as well as most, if not all, NAIC models consist of sequentially numbered sections and if there are any subdivisions they are of limited importance. The 1995 model had 67 sections divided into three articles: General Provisions, Proceedings and Interstate Relations. IRMA has 11 articles and the first digit of a section number is the article number. With this system you can determine the subject of a section just by seeing its number. For example, Section 604 deals with assets of the estate and Section 402 deals with rehabilitations. The Articles are:

- I General Provisions
- II Proceedings
- III Conservation
- IV Rehabilitation
- V Liquidation
- VI Asset Recovery
- VII Claims
- VIII Distributions
- IX Discharge
- X Interstate Relations
- XI Separability and Effective Date

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In addition to the new structure, there are substantive differences between IRMA and any existing receivership law. One of the criticisms of the receivership process is that it frequently appears to be secretive; to combat this, transparency was one of MARG's key goals. Examples of this emphasis are in Section 107 – Notice and Hearing on Matters Submitted by the Receiver for Receivership Court Approval, Section 116 - Approval and Payment of Expenses and Section 118 – Financial Reporting.

There are new provisions to assist the receiver. Section 113 – Unrecorded Obligations and Defenses of Affiliates, provides that any defenses available to an affiliate of the insolvent insurer must be recorded in the books and records of the insurer to be valid. For example, if the insurer's parent company borrowed money from the insurer, the parent cannot use a side agreement relieving it of the obligation to repay the debt unless the side agreement had been entered in the books and records of the insurer contemporaneously with the creation of the debt. Section 112 – Actions by and Against the Receiver abolishes the defenses of regulatory negligence or prior management misconduct to suits by the receiver. Section 503 – Sale or Dissolution of the

Insurer's Corporate Entity allows the liquidator to remove the assets and liabilities from the insolvent company and then sell the shell corporation. Section 601 – Turnover of Assets requires anyone holding assets of the insolvent insurer to deliver them to the receiver or prove to the receivership court that they are entitled to retain possession of the disputed assets, pending a determination of ownership.

Reinsurers are given the right to enforce the arbitration clause in a reinsurance treaty against the receiver by Section 105 – Jurisdiction and Venue. Further, Section 611 – Reinsurer's Liability contains an express prohibition on using incurred but not reported estimates as the basis for reinsurance collections by the receiver. Section 614 – Commutation and Release Agreements allows the receiver, under certain circumstances, to compel the reinsurer to arbitrate a commutation of remaining liabilities. Section 615 – Reinsurance Recoverable Trust Provisions allows either the receiver or the reinsurer to require the establishment of a fully funded trust to hold the arbitration award and pay claims from the trust until all claims have been paid. At that time, any remaining unused funds are returned to the reinsurer.

IRMA recognizes that the guaranty associations are the primary agencies for the protection of the policyholders of insolvent insurers and that returning funds to the guaranty associations is one of the receiver's most important functions. Section 803 – Early Access Disbursements directs receivers to make early access payments as soon as possible, as often as possible and in as great an amount as possible. In cases where sufficient funds are available, IRMA allows early access distributions to fund future claim payments by the associations.

Frequently troubled insurers are placed into rehabilitation when all parties realize that there is no realistic prospect of rehabilitating the company. The owners or directors of a company are often willing to consent to rehabilitation, but refuse to consent to liquidation even though they know the rehabilitator will eventually petition to liquidate the company. (I guess rehabilitation looks better on the resume than liquidation.) Article III of IRMA has created a third judicial receivership to deal with this situation. An insurer can be placed into conservatorship. The conservator is given control of the company and can take up to one year to perform a thorough analysis to determine if the company can be rehabilitated or if it must be liquidated. At the end of the one

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year, the conservator must file a petition seeking release of the company from receivership, or a conversion to either rehabilitation or liquidation. Conservation will save rehabilitation for companies that can be rehabilitated.

If a company is placed into rehabilitation, Section 403 requires the filing of a rehabilitation plan within one year unless the receivership court grants an extension. This section also sets out very detailed requirements for a rehabilitation plan.

Sections 303 and 405 require a conservator or rehabilitator to meet and cooperate with the guaranty associations to plan for an orderly transition to liquidation if it becomes necessary. The coordination should begin as soon after the conservation or rehabilitation order as possible and should include providing claim and policy data to the guaranty associations, so that they can prepare to take over claim payments upon the entry of a liquidation order.

IRMA expands the grounds for placing a company into receivership with the goal of taking over insurers before their financial situation hits rock bottom. In this way, hopefully, receivers will be able to make distributions in much greater amounts, much sooner, to the guaranty associations and other claimants. Section 207 – Grounds for Conservation, Rehabilitation

or Liquidation adds impaired, about to become insolvent and the requirements of risk based capital laws to the grounds from prior statutes. Section 208 – Entry of Order prevents the receivership court from substituting its judgment for the commissioner's when deciding what type of receivership is appropriate. That section says that if the commissioner proves the grounds for receivership, the court must issue the order requested. The court cannot determine that it feels rehabilitation is better if the commissioner has asked for liquidation.

The provisions dealing with preferences, fraudulent conveyances and setoffs have been revised to reflect the current best practices in the Federal bankruptcy law. Several experienced bankruptcy practitioners were instrumental in the drafting of Sections 602-609. The new asset recovery sections will be the subject of a report in a future issue of the

## **Insurance Receiver.**

Section 612 – Life and Health Reinsurance was added to conform IRMA to the NAIC's life and health guaranty association model. Section 8N of the guaranty association model permits a guaranty association to assume any reinsurance supporting a policy which the association must keep in force. That section is mirrored by Section 612 of IRMA.

The area of the most significant change is probably in interstate relations. The 1995 model has 11 sections dealing with this subject; IRMA has two. IRMA gives due deference to the domiciliary receiver whereas all prior receivership laws have encouraged non-domiciliary states to second guess the receiver by establishing ancillary receiverships to administer assets and adjudicate claims. IRMA only allows the establishment of ancillary receiverships for very limited purposes and with the consent of the domiciliary receiver. IRMA provides that special deposits held by a state must be either given to that state's guaranty association or returned to the domiciliary receiver for distribution in accordance with the depository state's laws. Deposits actually received by a guaranty association are treated as early access to that association. States may no longer hold a special deposit while its residents or guaranty associations receive distributions from the estate. IRMA provides that the courts of an enacting state will give full faith and credit to receivership orders, including stays of litigation, issued by the courts of any state. The concept of reciprocal states has been abandoned. Hopefully most if not all states will adopt some form of IRMA before the next big multi-state insolvency occurs, so that the domiciliary receiver of that company will be able to expeditiously handle his or her function for the benefit of all the policyholders of and claimants against the estate.

# Presentation To Association Of Run-off Companies

## 7 March 2006 Regulating Firms In Run-off

by Julian Adams, Head of Wholesale Insurance Department, FSA

*[What follows is a presentation entitled Regulating Firms in Run-Off. It was delivered by the FSA in London to the Association of Run-Off Companies. We are pleased that we have been given permission to reprint this address because it is a thoughtful and insightful piece that applies equally to solvent and insolvent run-offs. In addition, it sets forth ground-breaking observations about the regulation of ongoing long term business that should influence regulators both here and abroad].*

### Introduction

Thank you very much indeed for giving me the opportunity to speak to you this afternoon on the subject of regulating run-off companies. It is a pleasure to be here with you and judging from the number of people in the audience and from those discussions going on in other parts of the livery hall, it is evident that run-off is very much alive and kicking.

I want to use my time here today to cover three subjects. First to describe where run-off sits within the FSA's regulatory framework. Secondly, to discuss with you what lessons can be drawn from our supervision of run-off firms plus our recent thematic study of the sector. And finally, I also want to make some remarks as to the extent to which the issue affecting run-off have broad similarities with many of the issues affecting the live market.

### Structure of Wholesale Insurance Firms Department

But before I go any further, I should give you all some explanation of my own role. I am the Head of the FSA's Wholesale Insurance Department, where we have responsibility for the supervision of all regulated firms within the London market. This includes Lloyd's; the various managing agents and members' agents; London market insurers; underwriting agencies; and reinsurance companies. As you will be aware, supervision of the London market insurance brokers was added to that list of responsibilities last year and last, but by no means least, we are responsible for the majority of general insurance companies in run-off in the UK and have a team dedicated to that purpose led by Paul Taylor, whom I know is well-known to most if not all of you.

### FSA Statutory Objectives

First I want to start by explaining the basis of our regulatory framework in general, and then to try and explain how run-off fits within this structure.

The FSA as a whole regulates almost twenty six thousand firms, over half of which conduct mortgage and general insurance business. We do this by way of regular risk assessments on larger or higher risk firms, our assessment priorities are driven by your view of the likely

impact of a risk to our statutory objectives, multiplied by the probability of this risk crystallizing. We also conduct a wide range of thematic work that cuts across firms – this is work that is carried out on particular topics that are relevant to a group of firms, within one or more sectors of the industry.

The FSA also aims to be risk based in its regulation – that is, we concentrate our attention and resources on issues which are directly linked to mitigating serious risks to our statutory objectives of maintaining market confidence, protecting consumers, reducing financial crime, and promoting public awareness of the financial system.

It is probably fair to say that market confidence and consumer protection are our principal concerns for an insurance firm in run-off, and it's a fact of life that, given its nature, this sector is always going to be considered one that presents us with some significant risks, especially where it is likely or possible that a run-off may be – or become – insolvent.

As such, it should be clear how supervision of run-off is an important consideration in meeting these objectives.

A healthy run-off sector with well managed run-offs obviously can facilitate an efficient and orderly insurance market. Equally, we want

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to try and ensure that consumers who may have policies with firms in run-off are treated fairly.

When we look at run-off in the context of the insurance market, it is clear that it is a large and growing sector in its own right. Given this, it is important to reinforce the fact that, in terms of our overall approach, the FSA regulates firms in run-off to the same standard and using the same regulatory framework and tools as for live firms proportionate to their size and complexity.

Indeed, in some cases, particularly where there is doubt as to the ability of a firm in run-off to pay claims as they fall due, we would consider a run-off to pose very significant risks indeed and devote to it a commensurate level of attention/

I now want to turn our recent thematic review of run-off and to cover in more detail how we have been addressing these issues.

### Thematic Review on UK Non-Life Run-Off Sector

Towards the end of 2005 we undertook a thematic review on the UK non-life run-off sector which focused on the management of a firm's run-off portfolios and the fair treatment of its customers, each in the context of the FSA's *Principles of Good Regulation*.

As part of that review we carried out a series of visits and structured interviews with run-off firms together

with representatives from the larger accountancy and legal practices. We also spent time with the ARC executive. I would like to take this opportunity to express my thanks to those who took part in the review for their time and their considered and helpful input. Their co-operation was an invaluable part of the process.

The objective of our review was to identify some of the wider issues facing the run-off sector, including the business practices and systems and controls operated by insurance firms and their service providers. It was also our intention to assess whether our approach to the way in which we regulate firms in run-off was correctly focused.

### Characteristics of Run-Off

Before I discuss with you the preliminary findings that emerged from our review, I thought that it would be useful to summarize some of what the participants in our review saw as the main characteristics of run-off in the London market. I am sure they will be familiar to you.

1. Run-off firms often have long-term and complex liabilities. By way of example, APH exposure comprise a significant proportion of run-off liabilities. Asbestos related diseases have a latency period of up to 40 years, and a firm's exposure to latent claim types is notoriously difficult to estimate.
2. Run-off knows no boundaries.

All insurance sectors are subject to run-off issues including retail, commercial and wholesale firms as well as brokers.

3. Reserve deterioration was described as "endemic". The position is exacerbated by late reporting of US business and/or coded reserves held by US cedants.
4. When a firm or portfolio goes into a run-off, influence is lost *immediately* with counterparties, particularly with brokers and reinsurers. The historic underwriter-led culture of the London Market means that emphasis is on a new business and premium income.
5. Live business today is tomorrow's run-off. There has been a failure by management to understand that every policy written is a policy in run-off until that policy is extinguished and/or underlying liability is discharged. This is especially important where policies are written on an occurrence basis – the premiums stops, while the coverage may continue *ad infinitum*.
6. Outsourcing plays a significant part in run-off, even where the run-off management itself is not outsourced. Outsourcing of core run-off functions is not the norm rather than the exception, but even where a run-off is carried out in-house, it is commonplace to outsource IT and some claims handling.

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7. A significant proportion of shareholders with run-off portfolios are actively exploring ways in which they can relieve themselves of their liabilities, either by way of sale, portfolio transfer or a solvent scheme of arrangement – this drive to exit raises significant issues, which we shall turn to later.

### Core Risks Identified by Thematic Review

As I have already mentioned, in undertaking our thematic study we were keen to establish the extent to which the issues facing the run-off sector affect our statutory objectives. What we found was that the core risk issues identified by our review are very similar to core risks facing other insurance firms we supervise.

It is perhaps helpful to think of the linkage between risk involving live and run-off firms in terms of cause and effect. Where risks emerge in the live market that are not adequately mitigated, such as poor data quality, loose wordings, and inadequate reserving then this is simply stores up problems further down the line should a firm cease to write new business. We'll turn to some of these areas in more detail in a moment but I want to say now that, whilst this might sound a very obvious point to make, it is a plain fact that many (if not most) run-offs today that are grappling with difficult issues because of a failure to acknowledge this fact when the business was first underwritten. The lesson is this: Run-

off, and the need to recognize the fact that risks written today will be run-off tomorrow, should be at the forefront of all insurers' minds.

Of those risks identified by our review, there are a number which I consider to be of critical significance to both the active and run-off market and which I want to spend some time discussing these with you now.

To summarize these in advance, I want to consider poor underwriting data, reserve deterioration, people risk, walk-away risk, and fairness to policyholders. All of these risks coalesce around run-off, but I think it is self-evident that they are also relevant to the live market.

### Poor Data

A concern repeatedly expressed to us during our review was the perceived failure by brokers to deal adequately with run-off data issues. I do not propose to spend too long dealing with the obvious aspect of this issue – that inadequate records and database management, particularly of underwriting and claims files by insurers, can lead to problems in managing the business of the run-off, whether it is handled in-house or by a third-party.

The concern I want to address specifically today reflects historic uncertainties about the extent of a broker's legal, fiduciary, and contractual responsibilities. In particular,

confusion about the extent to which a broker's duty extends to run-off claims handling issues has, in the past, failed to be adequately addressed by way of explicit contract terms. This failure to allocate contractual responsibility at the start of a trading relationship is, as was pointed out during our review, expensive and frustrating for all parties.

Some of you will no doubt have read the recent Court of Appeal judgement in the case of *Goshawk v Tyser*. While I do not propose to discuss the respective merits of the arguments put forward by either side or indeed the decision of the learned judges, it would appear that those matters which gave rise to the case being litigated (at first instance and then the Court of Appeal) illustrate a need for clearly defined policy documentation and terms of business agreements.

Further, in the past it seems that once a risk was written then, to all intents and purposes, it was written off – it was out of sight and out of mind as far as the underwriters were concerned. To have in place full policy documentation at or immediately after contract inception was the exception rather than the rule, with little thought being given by those, other than perhaps the actuaries, as to how long the risk might inure or its profitability over its lifetime.

Almost inevitably a lack of contract

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certainly and a failure to recognize what might be termed “contract duration” means that risk appetite was not being managed effectively. This, in turn, had cost implications for all parties in the underwriting chain.

The current initiative on contract certainty is an attempt to address some of these issues. And as an aside, I am pleased to say that the response from the market in improving contract certainty has been positive, although there remains still some considerable way to go.

Hopefully this initiative, combined with the Terms of Business Agreement (TOBA) which has been adopted across the Lloyd’s and Companies Market, will assist in improving clarity between brokers and underwriters, and the benefits will be felt by future run-offs. Indeed, this is an area where greater co-operation between parties in the underwriting chain could result in benefits to all in terms of pricing and processing efficiencies.

### **Reserve Deterioration**

Another priority risk area that was highlighted in our review was that of reserve deterioration. Reserve deterioration was described by one participant as “endemic”, and it is a risk which features highly on our radar given the risk it potentially

poses to the solvency of a firm.

To get a feel for the extent of reserve deterioration one has only to look at the cost to the insurance industry to date of asbestos claims where estimates of the ultimate cost of US asbestos claims rise to in excess of \$200bn of which \$120bn will be picked up by insurers.

As I noted earlier, reserve deterioration is exacerbated by the late reporting of US business and/or coded reserves held by US cedants. This is an important issue as to the use of coded reserves could result in reserves being understated on a market-wide basis. Furthermore, it is estimated that the London Market could pick up approximately 50% of the ultimate cost of insured US asbestos claims – this is a sobering thought.

The ability to manage complex reserving issues is central to our perception of the risk profile of a run-off over the medium to long term, and we expect senior management to have in place systems and controls to ensure that the monitoring and assessment of reserves and latent claim issues is at the top of their agenda. Whether or not significant crystallization of risk occurs when an account goes into run-off is something that varies on a case-by-case basis. We do, however, expect firms to

have adequate systems in place and to devote sufficient resources to enable a regular analysis of reserve movements, both in the area of specific case reserves and in general IBNR trends. Where it is possible that a solvent run-off may become an insolvent one, we would expect firms to demonstrate the highest levels of vigilance in reserve monitoring.

We also have the tool of individual capital guidance at our disposal in order to ensure that, in the event that owners wish to extract funds from solvent run-offs, sufficient capital is available to support liabilities.

### **People Risk**

Another risk highlighted in the review was what might be characterized as a ‘people risk’ – that is the risk of firms failing to recruit or (more likely) retain staff of sufficient quality. Now this risk obviously applies to all businesses, not just insurance companies. However, I think it is fair to say that there are often particular issues around certain individuals when a firm, or a book of business, goes into run-off. With the possible exception of claims, which has traditionally been perceived to have a higher status in a run-off business than in a live one, it is likely that where a run-off occurs the first instinct of many staff will be to look for the exit. This is understandable and, in many

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instances, unavoidable. However, it is often the case that in the early days and months of a new run-off the work on identifying and securing the staff that are essential for the first stages of management of the run-off could be more proactive. Once staff have left, it may be difficult or impossible to gain access to their specific knowledge of the account, and much damage may be caused by this.

There are also what might be characterized as 'environmental' factors that can increase the degree of people risk in the run off sector. As I've already said, historically at least, there has been a general cultural, commercial and behavioral bias towards the "live" side of the market which has led to a lack of senior management expertise and focus in insurers and brokers on the management of liabilities throughout their lifetime.

Many of these areas have been discussed before and there is a good deal of acknowledgement within the market of the need to enhance the positive profile of run-off, and I think there are signs that views are beginning to change in this area. There is, however, more work to do on contingency planning, and for firms to have in mind the potential for run-off issues to emerge within their firms, and to undertake sufficient planning

and key person identification at an early stage.

We will, therefore, be continuing to take an interest to ensure that these good intentions are followed through with good practice in the future. Indeed, we expect firms to give consideration to such issues as succession planning, identification and incentivization of key people, and adequate contingency planning for related people risk.

### **Walk-away risk**

Whilst people risk is something that affects all businesses, the issue of walk-away risk is something that has a particular resonance in the area of run-off. There is sometimes a perception that, once a firm goes into run-off, it does not need to deal with its liabilities in a proactive manner and, indeed, parent firms or capital providers may feel that they can simply cut ties and walk away.

The reality is that, apart from one or two well-publicised exceptions, this has tended not to be the case. We now use our principles and tools, such as senior management responsibility and ICAS, to influence the extent to which run-offs is managed proactively, especially where a run-off is part of a group which continues to undertake live business. Ensuring the on-going solvency of a solvent run-off is central to a firm's responsibilities, and their performance in meeting these

responsibilities will clearly colour our view of that firm's management of its on-going business. Indeed, we don't hesitate to step in and remind firms where necessary of the need to consider the worst case scenario for a run-off.

We also want firms to consider, where they outsource the management of a run-off, that just because it may be out of sight, the run-off should not be out of mind! Proper control over such outsourced arrangements should be clear and easily demonstrable if firms are to meet our requirements on senior management responsibility.

### **Threats to policyholders**

Regardless of whether or not a run-off is managed in-house or by third parties, there are obvious threats to policyholders – principally the risk that valid claims are not paid in full. There is sometimes a perception that when policyholders or their brokers deal with a firm in run-off they are more likely to experience vexatious claims handling, poor quality of service, and lack of flexibility. This is certainly an area that we are mindful of, and assessing whether this is happening in practice forms a part of our general supervisory work in this sector.

Beyond this, however, is a concern that when a run-off progresses in the direction of a solvent scheme there may be issues in respect of identifying all potential

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policyholders, estimating liabilities, and generally ensuring that the scheme proceeds in a manner that is seen to be fair.

Much of these matters are, of course, for the courts to determine. However, we do have a role to play – and one that we take very seriously – indeed many of you will be aware that my colleague Paul Taylor has spent a great deal of time thinking about these issues.

We expect to be consulted at an early stage about all details of any proposed scheme, and we will always consider each case on its own merits. We also keep under constant review the changing market and legal contexts within which schemes operate.

Beyond schemes, and in the realm of policyholder protection, I think it is worth raising briefly the issue of where a firm is considering a sale of its business or a disposal of all or part of its understating liabilities, perhaps by way of a Part VII transfer. In such circumstances we consider that a significant change to the business of a firm has been embarked upon, and we may call upon the firm to submit a scheme of operations, including the production of an internal capital assessment. In the event that the FSA disagrees with the firm's assessment of its capital requirements we will produce individual capital guidance which

sets the level of capital we would expect that firm to hold in order for the proposed transaction to proceed. In exercising these powers the FSA takes an approach proportionate to the size and complexity of the firm's underwriting liabilities.

### **Conclusion**

So in conclusion, during my presentation today I have attempted to focus on the significant risk issues involved in run-off. As I have said, most of these risks are not confined to the run-off sector but apply equally to the active market.

The message I wanted to send you today is that the FSA takes extremely seriously its regulation and oversight of firms in run-off and supervises them in a similar manner and using the same framework as firms in a live market.

We are looking for comfort from senior management of active firms that they are able to recognize and address run-off liabilities and the risks which attach without detriment to policyholders, and we are also looking for firms in run-off and their service providers to satisfy us that these risks are being adequately and proactively managed. I have also highlighted areas of risk as well as our expectations of how firms might handle these issues. Reassuringly, the review also confirmed that the thrust of our supervisory work was concentrated in the right areas.

Run-off issues do not as we know go away of their own volition. They have to be managed. As I have mentioned, failure to do so can impact adversely on the FSA's statutory objectives but also shareholder value, and policyholder security. In conclusion I would suggest that achieving these objectives is in the interest of all those who participate in the insurance market.

## Perspectives on Run-offs

by Barbara F. Cox

*[These views are my own and should not be considered those of the National Conference of Insurance Guaranty Funds.]*

Runoff of a statutory insurer or a discontinued line of business has been a method used for years by typically large insurance organizations when exiting a market or a line of business. This kind of runoff has been managed internally within the organization and is largely invisible to the outside world. The concept of run off is now being sometimes employed and often discussed in the context of financially troubled companies. Some believe that it's better to "run-off" a company of suspect solvency rather than place it in to a statutory liquidation. Others believe that states have a comprehensive and well tested procedure dealing with insolvent insurance companies. This procedure is embodied in the state insurance liquidation acts. This is the mechanism which should be employed when a company can't pay all creditors in full.

Before I get started, I need to say a few important words. The insolvency process was designed to protect insurance consumers. I believe we all, whether we agree on the particulars or not, (If you think we all do agree, please join us for a Tuesday afternoon MARG conference call.) consider that goal of paramount importance. Whatever system is used to deal with the policy liabilities of a

troubled insurance company needs to make policy claimant interest a top priority.

Let's take the proponent side first. An insurance liquidation just isn't a happy occasion. Anecdotal evidence suggests regulators have historically been loath to liquidate a company "during my watch" and a run-off can provide an alternative that could, perhaps, deal with the problem without the court's very public pronouncement of death. This attitude, I am told, is changing. In the future companies will be liquidated at an earlier time and with a larger pot of assets in the estate coffers. Necessary liquidations will lose their stigma and be viewed as a normal part of the free market process. However, to the extent this continues to be a concern a run-off may have a certain appeal.

Theoretically, one could avoid altogether the triggering of the guaranty associations (hereinafter "GAs"). The company's assets, and its assets alone, would be used to address the remaining claims against it. Hence, the member insurance companies of the GAs would not be assessed and those assessment costs would not be passed on to the public. If a liquidation does turn out to be necessary in the long run, at least part of the policy liabilities have been dealt with pre-liquidation. Hence, the GAs have a less expensive problem to deal with – or do they? Yes, there are fewer claims to pay but... and it's

a big but... there is a smaller pot of estate (we can now say "estate") assets with which to pay them. Whether the GAs, their member companies, and the public that ultimately pays come out better or worse is something I guess you could somewhat opine on through actuarial projections. You really won't know for sure till years later, if then.

Some say there are significant administrative savings to be realized by running a company off rather than placing it in to a liquidation proceeding. No one really has any numbers on this – at least no one I know. We are in the process of developing administrative cost data on guaranty fund claims handling – I don't know if anybody is doing this for run-offs or not. What is clear is that the variables for both types of operations are very different from those of an ongoing insurance concern. In a liquidation one might anticipate, for instance, inheriting a block of claims that are a result of slow payment by the company in the troubled days before liquidation. More of those claims may be in litigation. Poor claims management may also be evident – needed information is lacking and claims are under reserved. We might also expect to see poorly managed electronic data. Multiple data systems may be a result of the too quick growth that could have played a part in the company's downfall. This is only a partial list of the variables that make a liquidation

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in many ways a more expensive proposition than the administration of a solvent company. In a run-off of a financially troubled company it would seem that many of these same factors would apply.

Some assert that the cost of the transfer of the files to the GAs is significant and this cost could be avoided if the claims were not moved. I can't help but think there would be some moving about of files in a run-off process where one may be trying to consolidate the claims operation of a troubled company.

Run off operations can get assets out to the policy claimants who are not covered by the GAs much faster than any liquidator could make an estate distribution to this class. This is a laudable result. While the state legislatures have made the policy decision to exclude these folks from the benefit of guaranty association coverage, they still did, in fact, pay for insurance. If they can be taken care of in a way that more closely resembles the original promise in their insurance contracts, without detriment to the "covered" class this is a good thing. In a run off scenario, however, there is a concern that assets might be diverted from the covered class in order to make some sort of distribution to these claimants. This leads to the second part of this article, the "cons" of run-offs.

Here is a major issue that makes

the concept of run-off so complex. When there is not enough money to pay all creditors in full, and that is the context of this discussion whether we are dealing with a run-off or liquidation, a state liquidation act provides a comprehensive scheme for liquidating a company. It establishes a clear priority of payment out of the insufficient pot of assets. The state has had the opportunity to make some important policy decisions on the winners and losers in this context. The liquidation acts also deal with any number of other issues that come up – preference look back, rights and responsibilities in claims adjudication and the like. The GAs take over the lions share of the claims payment operation-there are real clear rules governing them too-who they pay, how much they pay, where they get the money to pay, etc. A body of case law has developed interpreting the statutory guidance for both the liquidation proceeding and the guaranty fund mechanism.

A run-off, on the other hand, is sort of self-styled. Presumably there would be some regulatory involvement in the context of the run-off of a troubled company. That suggests to me that someone in the mix would be concerned that the most sympathetic claimants, such as, for example, workers compensation claimants, are taken care of. Someone in the mix would make sure that claims are being adjusted and paid in a fair, prompt, and efficient manner. Someone

would make sure that when claims were compromised, and some would have to be in this circumstance, that the parties entering in to the deals were fully informed, treated fairly and entered in to the arrangement willingly. As you can see a lot is being left to "someone," possibly a cousin of the proverbial "they" who will simply have to fix Social Security and the health care crisis before all #\$\$%& breaks loose. Having to make judgments on those questions of fairness in this "not enough money to go around" environment is a hard position to be in. This isn't to say it can't be done, and that some folks aren't pulling it off with some success. It's just a difficult exercise.

Another problem. Since someone can make decisions that may not mirror the priorities in liquidation might someone think it would be a good thing, for example, to pay off claimants that might not have guaranty association coverage, leaving a big ole pot of covered claims and very little remaining assets for the GAs involved in the ultimate liquidation. Fairness is, after all, in the eyes of the beholder. This might make perfect sense to someone. The uncovereds get paid out of company (soon to be "estate") assets. The covereds get paid by the GAs. I grossly understate when I say that this outcome would be viewed as making less than perfect sense by the guaranty funds, their member companies, and the public that ultimately pays for a deal that does

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something very different than what the public policy embodied in the guaranty association and liquidation acts would have called for.

To summarize-run offs are messy. They lack a certain structure. In some cases, if handled properly, there is some potential for good to come of them. There are some inherent dangers and a real opportunity for an unfair result.

So what do we do next? Oh, what the hay, lets legislate! Run off bills have been introduced in a couple of state legislatures. The bills I saw were an attempt to make some sense of the non sensical. There was a truly valiant effort to cage this tiger. In volume, the proposals were not as lengthy as the liquidation acts but in my opinion they were equally complex. Perhaps this reflects my lack of experience with some unfamiliar concepts that they introduced. The proposals did not afford nearly the protections that a liquidation act would. The run off bills presented the opportunity for a certain class of claimants to receive a certain treatment – in some cases the class would be impaired- in other words the class would get less than 100 cent dollars on their claims. If most of the class voted in favor of the deal the treatment of the impaired class would precede as planned-despite the feelings of the dissenters. A claimant could run to the court house to challenge the outcome on the grounds that he/she

or the corporate entity known as “IT” would get more if the company were liquidated. Needless to say, “IT, ” at least an IT of substantial size and sophistication, is probably in a much better position to engage the needed attorney and actuary than he or she would likely be. When I saw these bills, I had to ask why. Sure there were some insurance department and court controls but a lot was left to the policy claimants and other creditors as far as protecting their rights. I’ve heard insolvency law criticized for its complexity-these bills in my view were equally complex. I identified many issues with the legislation I saw. If everything was done to the bills that needed to be done, they would most likely rival the size of a state liquidation acts. Most troubling to me was there was no priority of distribution in a context where folks claims were being truncated in some cases involuntarily. But gee, if we add that why don’t we just use the liquidation act that’s already in place. I’m thinking we don’t need another big ole statute.

So what should we do? Let’s put more focus on greatly diminishing the need for these kinds of run-offs and for statutory liquidations, for that matter. Embodied in both the liquidation and the “in” solvent run-off concept is a pain sharing mechanism. Let’s put our energy in to avoiding pain to begin with. Publications such as the NAIC’s Troubled Company Handbook

provide a good starting point on methods that could accomplish this.<sup>1</sup> Let’s try to arrange things such that a company can be run off when there’s still enough cash left to pay everybody in full. That way, our good friend someone doesn’t need to be making some hard decisions that will not be to someone else’s liking. When a statutory liquidation is necessary, let’s do so with sufficient assets left to minimize the bad effects.

Until we get to that point, I would suggest that those taking charge of the ongoing run-off operations be mindful of the pitfalls. The interests of the policyholders and other policy claimants should always be paramount. Compromises in claims should be made with folks who have adequate sophistication and financial wherewithal to adequately protect their interests. Such compromises should not be coerced. GA representatives should be kept informed. If things go wrong they will be key players. Like a campsite, the run-off team should leave the company in better, not worse condition, than what they started with if the run-off operation must be abandoned at some point and the company must be placed in liquidation. Adequate time and assets should be allocated to planning for liquidation if a liquidation becomes necessary.

## Bermuda is a Familiar World

by Kehinde A.L. George

“Bermuda is another world” are the opening words of the calypso song with which you may be greeted with in the arrivals hall of the Bermuda International Airport. But when it comes to Bermuda’s corporate insolvency law, it may be more apt to say “Bermuda is a familiar world”; at least to practitioners in the UK and in other Commonwealth countries. Bermuda is still a colony of the UK or, I should say, an Overseas Territory, to give it its modern designation; and its laws are based, to a very large extent, on the laws of England and Wales which were current prior to the UK’s entry into the EEC (now the European Union).

The corporate insolvency laws are no exception. The Bermuda Companies Act 1981 (“the Companies Act”) Part XIII deals with the winding-up (liquidation) of companies and is based on the winding-up provisions of the English Companies Act 1948, with some incorporation by reference of provisions relating to the insolvency of individuals from the Bermuda Bankruptcy Act 1989, which in turn is based on the English Bankruptcy Act 1914. In addition, there are rules relating to company liquidation procedures in the Companies (Winding-up) Rules 1982 and these are based on the English Companies (Winding-Up) Rules 1949. In each case very little change has been made to the English provisions.

However, the seeming familiarity of Bermudian insolvency law can be dangerous to the unwary practitioner who may assume that it is the same as current English law which was modernised by the Insolvency Act 1986 (“the Insolvency Act”) and subsequent amendments to that act. This can be illustrated by the provisions of Bermudian law under which transactions entered into, or the actions of persons running a company’s business, may be challenged in a liquidation (and otherwise).

### Fraudulent Preferences

In common with many jurisdictions, Bermuda law contains provision for the challenge of transactions entered into by a creditor which may prefer certain creditors at the expense of others. Under Bermudian law such transactions are known as ‘fraudulent preferences’; although this title is somewhat misleading as it is not necessary for a transaction to involve fraud in order for it to be a fraudulent preference. A fraudulent preference is a transaction by a company in favour of any creditor, made within the six months before the commencement of its winding-up, with the dominant intention of preferring that creditor at the expense of other creditors at a time when the company was insolvent. A typical fraudulent preference would be where a creditor was granted additional security for an existing debt.

A transaction which is found to be a fraudulent preference is invalid. The liquidator can bring proceedings to have a fraudulent preference set aside and claim back the assets of the company which were the subject of the transaction. However, the invalidity of the transaction does not affect the rights of any person making title in good faith and for valuable consideration through or under a creditor of the company.

In the corresponding Insolvency Act provision, section 239, “fraudulent” is appropriately dropped from the title. Under Bermudian law, the test of whether a transaction is a fraudulent preference is a subjective one: the liquidator must prove that it was the company’s dominant intention to prefer the creditor who benefited from the transaction. This is similar to the preference provision in section 239 of the Insolvency Act where the test of what constitutes a preference still contains a subjective element. However, under English law, the liquidator no longer has to prove that the dominant intention of the company was to give a preference, he need only prove that the company was influenced by a desire to give a preference, which is a lower standard.

Another important difference is that whilst under the Insolvency Act the preference period is also usually six months, when the transaction in question is between the company

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and a connected person (such as a director), the preference period is extended to two years. Also there is a presumption that, where the company has given a preference to a connected party, the company was influenced by the desire to give a preference; thus shifting the burden of proving that it was not onto the connected person who benefited from the transaction.

### **Transactions at an Undervalue**

There is no direct equivalent in Bermudian law of section 238 of the Insolvency Act which provides for the liquidator of a company to apply for an order setting aside a transaction at an undervalue made in the six months prior to the commencement of the winding-up proceedings (or two years in the case of a transaction with a connected person). There is provision under Bermudian law for the avoidance of transactions at an undervalue in the Conveyancing Act 1983, Part IVA. The definition of “transaction at an undervalue” is very similar to that in section 238, being a transaction at for no consideration, or a consideration which is significantly less than the value of the property which is the subject of the transaction.

However, this provision is more akin to section 423 of the Insolvency Act, in that it may be used at any time; the company does not have to be in liquidation in order for the provision to apply. And, the Bermudian

provisions have a subjective element like section 423, in that one has to prove that the dominant purpose behind the transaction was to put the property of the company beyond the reach of persons with claims against the company. A difference between the provisions is that only an eligible creditor may bring proceedings under Bermudian law; compared to the liquidator or a person prejudiced by the transaction under the Insolvency Act.

### **Floating Charges**

The provisions relating to the invalidity of floating charges created by insolvent companies is similar under Bermudian law and English law. Section 239 of the Companies Act provides that where a company is being wound up, a floating charge on the undertaking or property of the company created within 12 months of the commencement of the winding-up is invalid (except to the amount of any cash paid to the company, such as any new advances, in consideration for the charge), unless it is proved that immediately after the creation of the charge the company was solvent. Section 245 of the Insolvency Act is of comparable effect, the test for invalidity being that the company is unable to pay its debts at the time of the creation of the floating charge, or is unable to pay its debts in consequence of the transaction under which the charge is created.

However, there are provisions under

the Insolvency Act which are not part of Bermudian law. If the chargee was a connected person at the time of creation of the charge, the period within which the floating charge will be invalid is extended from one to two years prior to commencement of the liquidation, and the solvency of the company at the time of the creation of the floating charge will not prevent the charge from being valid. Also, under the Insolvency Act “floating charge” is defined so as to include any charge which was originally created as a floating charge, but has since become a fixed charge.

### **Fraudulent Trading**

Under Bermudian law, a company may continue to trade whilst it is insolvent, but at the risk that transactions in the period preceding the commencement of liquidation proceedings may be challenged in a liquidation as detailed above. The directors and any other persons carrying on the business of the company whilst insolvent do so at the risk of fraudulent trading proceedings (if the company goes into liquidation) under section 246 of the Companies Act in which, if they are found to have knowingly carried on the business of the company with intent to defraud creditors of the company, they may be held personally liable for the debts of the company.

The test of a person knowingly carrying on the business of a

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company with intent to defraud creditors has been established by English case law as follows:

- (a) at the time when debts were incurred by the company the person had no good reason for thinking that funds would be available to pay those debts when they became due or shortly thereafter; and
- (b) there was dishonesty involving real moral blame according to current notions of fair trading.

There appears to be no decided case in Bermuda of any person being held liable for fraudulent trading with respect to a Bermuda company. The Bermuda Courts are likely to follow the approach of English Courts prior to the enactment of the 1986 Insolvency Act and require a high standard of proof of dishonest intent, making it very difficult to succeed in such an action.

Comparable provisions relating to fraudulent trading still exist under UK law in section 213 of the Insolvency Act, although they provide that only the liquidator has standing to bring proceedings (under Bermudian law creditors and shareholders may also bring fraudulent trading proceedings). So far as actions against directors under English law are concerned, the English fraudulent trading provision has been rendered somewhat redundant by the introduction in

the Insolvency Act of liability for wrongful trading. Under section 214 of the Insolvency Act, if company goes into insolvent liquidation and before the commencement of the liquidation a director knew or ought to have concluded that there was no reasonable prospect that the company would avoid insolvent liquidation, the director may be held liable to contribute to the company's assets by the court. There is no requirement to prove fraud or dishonesty. Directors of companies are therefore at much greater risk under English law if they continue to allow the company to trade once insolvent, than their counterparts in Bermuda.

### **Conclusion**

These are just a few examples of the familiar yet different provisions of Bermudian insolvency law. Practitioners who are doing business relating to Bermudian companies would be wise to dig out the old commentaries on the English Companies Act 1948 as these will provide invaluable guidance relating to the corporate insolvency process under Bermudian law. Bermudian law still shares many fundamental principles with English law which were not altered by the Insolvency Act. Therefore, texts on modern English insolvency law may also be of assistance, but should be approached with caution.

## Pari Passu – Aussie rules or English fair play?

by Clare Costello, Kendall Freeman

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How does English insolvency law fit with foreign insolvency laws in the context of the insolvency of an international insurance company?

### **Introduction**

In the matter of HIH Casualty & General Insurance Ltd & Others [2005] EWHC 2125 (Ch), Mr Justice David Richards had to resolve a dispute concerning the distribution of the UK assets of four members of the HIH group. The Companies were being wound up in New South Wales and English joint provisional liquidators (JPLs) had been appointed by the English Court. There were material differences in the basis of distribution of assets among unsecured creditors under the laws of the two countries so the JPLs planned to set up a separate fund, comprised of English assets, which would be distributed in accordance with English insolvency law. However, and this was challenged by some creditors in Australia who said that in the event of a winding-up order, assets realised by the JPLs and English liquidators should be transmitted to the Australian liquidators pursuant to section 426 of the Insolvency Act

1986, for distribution in accordance with Australian law. Their challenge was unsuccessful and the judge refused to order the transfer. As a result of this decision, overseas insurers who purchase reinsurance in the London Market will now have to give careful consideration before appointing provisional liquidators to secure assets in the UK, as this may in effect force the assets to be distributed in accordance with English insolvency law.

### **Background**

The principle of ‘pari passu’ is fundamental to both English and Australian insolvency law. However, under Australian law, reinsurance recoveries are paid to insurance creditors in priority to other unsecured creditors (section 562A of the Australian Corporations Act 2001). At the time the company went into provisional liquidation, there was no equivalent provision under English law. Thus there were significant differences between the two systems as to the assets available for particular groups of creditors and the priority given to certain groups of creditors either as to particular assets or as to the assets generally.

### **Re BCCI (No 10) [1997] Ch 213**

Re BCCI (No 10) [1997] Ch 213, provides authority that the court has the power to direct an English liquidator to transmit the net proceeds of any realisations by him to a foreign liquidator in order to achieve a ‘pari passu’ distribution to worldwide creditors. However, in exercising that power:

“[The Court] has no power to dis-apply any substantive rule forming part of the English Statutory Insolvency Scheme under the Insolvency Act and Rules 1986.”

The judge held that equal treatment and a ‘pari passu’ distribution were mandatory features of the English Statutory Insolvency Scheme.

### **Transfer of Funds Not Allowed**

The judge concluded that despite s426 of the Insolvency Act 1986 which provides for co-operation with foreign courts, in an English liquidation of a foreign company the court had no power to direct the liquidator to transfer funds for distribution in the foreign liquidation, if the scheme for ‘pari passu’ distribution in that liquidation was not substantially the same as under English law. Procedural rules may be disapplied to further the interests of creditors in a single global liquidation (Re BCCI No. 10), but no such power exists as regards substantive rules.

## Pari Passu – Aussie rules or English fair play?

*by* Clare Costello

### **Application to the Insolvency of European Insurers**

The European Directive on the Reorganisation and Winding-up of Insurance Undertakings (Directive 2001/17/EC) was originally implemented by the Insurers (Reorganisation and Winding Up Regulations 2003 (SI2003/1002)), standardised priority laws across Europe and insurance creditors now have priority over reinsurance creditors. As member states were allowed to choose how to implement the directive, certain differences still remain. Thus, in each circumstance the court will have to look at the rules of priority in the appropriate jurisdiction to establish whether this would contravene the mandatory provisions of English insolvency law before deciding whether to order the transfer of net realised assets to another European jurisdiction, where that is the seat of the main liquidation.

### **International Co-operation**

This somewhat insular decision shows that the ‘pari passu’ principle for the equal treatment of creditors is one that an English court is not prepared to overlook, even in the interests of international co-operation.

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## 2006 INSOLVENCY WORKSHOP RECAP

by Daniel J. Price, Associate, Cantilo & Bennett, L.L.P.

The 2006 IAIR Insolvency Workshop brought insurance receivers and insurance insolvency practitioners from around the globe to sunny San Diego, California for a “Cosmic Tour of Receivership Issues.” Titled “The Hitchhiker’s Guide to Receiverships,” and sponsored by the stellar law firms of Bingham McCutchen, L.L.P., Cantilo & Bennett, L.L.P., Robinson, Curley, & Clayton, P.C., Sidley, Austin, Brown, & Wood, L.L.P., and Sonnenschein, Nath & Rosenthal, and the equally stellar Navigant Consulting, Inc., this year’s event proved to be an out of this world experience. Over 140 insurance insolvency professionals enjoyed presentations by a diversity of panelists, including representatives from the academic, government, and legal communities. The following is a recap of the 2006 Insolvency Workshop.

### **So Sue Me! What Can You Do To Me In Jail?**

With corporate malfeasance playing a central role in the majority of insurance receiverships, cooperation between insurance receivers and law enforcement officials is critical to ensure that both parties may effectively administer to their duties. In addition to giving a brief description of federal laws that are commonly violated during a period of corporate malfeasance leading up to a receivership, the Hon. David Maguire, Assistant U.S. Attorney

for the Eastern District of Virginia, discussed the value of the receivers’ expertise to the local United States Attorney. The receivers’ understanding of insurance laws and regulations allows them to more quickly recognize and understand when violations of insurance laws and regulations have occurred. Accordingly, when receivers recognize and report criminal violations of the insurance laws, it is in the receivers’ best interest to take the time to ensure that law enforcement officials understand the nature and extent of the crimes being reported.

Echoing Mr. Maguire’s statements, co-panelist Betty Cordial advised receivers of the importance of maintaining a good working relationship with law enforcement officials. Despite the best of those intentions, potential conflicts may arise between law enforcement endeavors and the receivers’ duties to represent the rights of the estate. Because subject property in federal criminal actions may be forfeited to the federal government, it is imperative that receivers vigorously pursue their rights as victims of a federal crime and avail themselves to all resources available under the federal Victim and Witness Protection Act.

Aside from the complexities that receivers and law enforcement officials may face in their

relationships with each other, the panelists discussed using the threat of local law enforcement action as leverage in working with former officers or directors of an insolvent insurer in order to obtain vital facts regarding the business practices that led to the receivership. For example, to the extent that a former officer of an insolvent insurer is convicted of a federal crime, is federally incarcerated, and is judgment proof, the threat of a lawsuit may carry little weight in persuading the individual to cooperate with the receiver. On the other hand, if the former officer understands that federal minimum-security prison time may be followed with a subsequent sentence in the state penitentiary, then it is likely that the officer will cooperate with the receiver.

In sum, recognizing violations of the federal and local laws early in the life of the receivership is important, not only to a synergistic relationship between receivers and law enforcement, but also in order to preserve estate assets while achieving the objectives of the estate.

### **Faster and More Furious: Accelerating The Pace and Closure of Receivership**

Expediting the closure of receivership estates is a major focus of insurance receivers around the country. Cathleen Travis, Office of the Special Deputy Receiver,

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Illinois, and James Kennedy, Texas Department of Insurance, explained procedures and initiatives that have been effective in increasing the pace of the closing of receiverships in their respective states.

Since 1991, with drastic amendments to the Texas Insurance Code, the Texas Legislature has actively sought to increase the pace of closure of insurance receiverships in the state. As a result of the amendments, the Texas Commissioner of Insurance assumed the role of Receiver, while the day-to-day administration of the receiverships was delegated to Special Deputy Receivers (“SDRs”). The SDRs are now subject to performance standards and oversight by the Receiver through the Liquidation Oversight Division (“Oversight”), with the goal being an overall increase in the efficiency of the administration of the estates. In addition to other Oversight requirements, the SDRs are constantly focused on the goal of closing receivership estates. The SDRs are required to send quarterly reports to Oversight that project the length of all receivership activities through the closure of the estate, as well as monthly reports updating Oversight on the expenses incurred, the status of the previous months activities, the status of ongoing litigation, the current month’s cost-benefit analysis, and financial statements that explain major changes. As a result of these fairly

recent initiatives, the Commissioner of Insurance as Receiver has largely accomplished the legislature’s goal of expediting the closure of receiverships in Texas by decreasing the number of pending receiverships from 162 in 1991 to 19 at the end of 2005.

Similarly, in Illinois, the key to efficient administration and closing of receivership estates has been strategic planning. Much like the system in Texas, every receivership estate has a strategic plan, updated quarterly, that tracks major tasks and issues of the estate. Included in the strategic plan should be a consideration for the handling of long-term claim liabilities, commutations and reinsurance collections, tax issues, on-going litigation, and the liquidation of speculative assets. When an estate reaches a point where potential closure is two years out, strategic planning in an Illinois receivership goes into overdrive. At that point, detailed closing plans and time-lines are developed for each estate, including the development of a highly detailed closing activity checklist. A crucial task on this checklist should be the filing of a waiver or release of personal liability with respect to federal claims with the Department of Justice (“DOJ”). This waiver should be filed early (at least two months prior to the anticipated closing date) and with sufficient documentation (preferably on disk) to allow the DOJ to

intelligently review the waiver. When combined, the foresight that the continuous strategic planning provides in Illinois has resulted in increased efficiency and more frequent closures of receivership estates in the state.

### **Money IS Everything: Guaranty Association Legal Update**

As a final protection for the policyholder claims of insolvent insurers, guaranty associations face constant challenges in funding their ever increasing liabilities. With insurance guaranty associations currently facing an exposure of over \$15 billion, as Mark Steckbeck of the National Conference of Insurance Guaranty Funds explained, these challenges are constantly becoming more complex. Chief among funding challenges is the erosion of the premium asset base due to the more frequent use of the non-traditional alternatives of self insurance, risk retention groups, and dedicated state funds. Additionally, delays in reinsurance collections following insolvencies coupled with smaller and slower distributions to guaranty associations, have increased the strains on the system. These strains on the guaranty association system have created the potential for a real risk of funding shortfalls in the near future. Possible solutions to ameliorate the constraints include providing early access distributions to the associations and changing

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liquidation statutes to combine assessment accounts, redefine “covered claim,” align the goals of guaranty associations and receivers, encourage advance planning and coordination, and achieve a guaranty pooling mechanism.

A recent legislative initiative, the Insurance Receivership Model Act (“IRMA”), takes a substantial step toward accomplishing some of these changes. From the guaranty association perspective, IRMA has its benefits because it clarifies priorities of guaranty association claims and expenses, encourages pre-insolvency coordination between the receivers and the associations, and includes an effective early access provision. However, IRMA does have several draw backs, including, the omission of a large deductible provision, ambiguity as to association intervention rights, and the invitation to second guess association claim determinations. On the whole, and from the guaranty association perspective, IRMA represents a good first step toward remedying the funding challenges of the guaranty association system.

### Insurance Commissioners Panel

Regulators from the Mississippi and Illinois Insurance Departments provided the conference with observations, commentary, and insight with respect to current issues they are facing. Thanks to the witty

and entertaining exchanges between conference participants and panelists Lee Harrell, Deputy Insurance Commissioner, Mississippi, and Michael T. McRaith, Insurance Director, Illinois, a good time was had by all.

### What You Don’t Know Can Definitely Hurt You! The New Bankruptcy Code

In October 2005, the Bankruptcy Code received a bit of an overhaul through the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”) of 2005. Panelists Robert W. Biederman of Hubbard and Biederman, L.L.P., and Gregory J. Jordan of Dykema Gossett, P.L.L.C., gave a brief but informative overview of the recent changes to the Bankruptcy Code, including some of the key provisions of import to insurance receivers.

Based on the model law proposed by the United Nations Commission on International Trade Law, BAPCPA repealed 11 U.S.C. § 304, which provided a vehicle for foreign petitioners to petition a U.S. bankruptcy court in a case ancillary to a foreign insolvency proceeding. In place of section 304, Congress enacted chapter 15, which expands the scope of “foreign proceedings” to include both “foreign main proceedings” and “foreign nonmain proceedings.” 11 U.S.C. 1517(b) (2006). In contrast, section 304

had the more limited application to a proceeding “in a foreign country in which the debtor’s domicile, residence, principal place of business, or principal assets were located at the commencement of such proceeding . . . .” 11 U.S.C. § 101(23) (2000) amended by 11 U.S.C. § 101(23) (2005).

In addition to the jurisdictional expansion provided by BAPCPA, the panelists discussed additional provisions in chapter 15 of interest to insurance receivers. First, the panelists described chapter 15’s exclusion of statutory insurance deposits from the bankruptcy court’s jurisdiction. Specifically, the new law excludes these assets from the jurisdiction of the court, stating that a court, “may not grant relief under this chapter with respect to any deposit, escrow, trust fund, or other security required or permitted under any applicable state insurance law or regulation for the benefit of claim holders in the United States.” 11 U.S.C. § 1501(d). Second, unlike section 304, the new law grants an automatic stay “with respect to the debtor and the property of the debtor that is within the territorial jurisdiction of the United States.” 11 U.S.C. § 1520(a)(1). However, the automatic stay is limited to petitions pursuant to “foreign main proceedings” and does not apply to “foreign nonmain proceedings.” Third, while the former law did not specifically address the limits of

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relief, chapter 15 prohibits certain relief in specific circumstances. For example, section 1521 (a)(7) states that recognition of a foreign proceeding alone does not empower a foreign representative to exercise the avoidance powers under sections 544, 545, 547, or 550. See 11 U.S.C. § 1521(a)(7). Moreover, the bankruptcy court cannot enjoin a “police or regulatory act of a governmental unit, including a criminal action or proceeding, under this section.” 11 U.S.C. § 1521(d). Finally, the panelists explained that chapter 15 is limited in application to situations where the chapter does not: (I) conflict with a treaty or agreement with a foreign country, or (ii) run afoul of public policy.

With the many changes that BAPCPA brings to the Bankruptcy Code, the panelists were only able to offer a brief overview of the changes that affect insurance receivers. However, they did advise insurance receivers of the importance of becoming familiar with all of the changes and new provisions in the Code.

### **You Can’t Fire Me: I Quit! Personnel Management and Employment Retention In Receivership**

Receivership staffing can be one of the most important and immediate issues facing an insurance receiver. As Jo Ann Howard described, there is an inherent tension created

between a receiver’s duties to reduce expenses and maximize distributions to policyholders and creditors, and the receiver’s need for experienced personnel and fair treatment of employees. The best manner to address this tension is with a spirit of honesty and open communication with the company’s employees. Receivers should be mindful that, while the company will require staffing to continue the day-to-day operations of the company, the institutional memory that current company employees offer may be invaluable to the receiver. An honest and open relationship with the employees may encourage future cooperation from the employees should they be needed as witnesses in litigation or for some other critical matter. Therefore, the receiver should be mindful that the estate’s personnel are a vital asset of the estate and should be protected as such. Accordingly, security of the personnel and from intrusion by former personnel should be a vital concern of an incoming receiver. The receiver should implement a security plan that addresses how the estate will deal with hostile or uncooperative employees, the security of the premises and the estate’s property, and the protection of confidential or privileged information.

In addition to issues that may arise regarding the treatment and protection of estate personnel

as an asset, Ms. Jordan advised receivers to consider the personnel issues that may arise and that may expose the receiver and the state to liability. To address this concern, receivers should consider hiring a staff leasing corporation. The staff leasing corporation would take on the current staff of the company as its employees, thereby avoiding state liability for, among other things, worker’s compensation and discrimination. Hiring a staff leasing corporation is just one solution for receivers to consider in managing personnel liability.

Regardless of the particular issue faced, personnel management is a constant concern in any receivership. A receiver should be mindful of these concerns and proceed with a plan that has the flexibility to address any number of the issues that may arise.

### **The Infinite World of Finite Reinsurance**

Finite insurance is a product of multiple definitions. Generally, finite insurance is a product of insurance that limits the insured’s risk in a particular area and, in the event that the risk does not materialize, the insurer may pay the insured’s premium back over a short period of time. Panelist Frankie Bliss, Frontier Insurance Co. in Rehabilitation, described the characteristics, costs and underwriting factors that identify finite insurance, as well as

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problems that often arise due to the nature of the insurance. Principal among these problems is when an otherwise beneficial finite insurance instrument is manipulated to achieve illegitimate objectives. This happens when no risk is transferred, when the insurance is not properly disclosed, or when side agreements change the deal between the parties. The manipulation of finite insurance has raised the concerns of insurance regulators, who want increased regulatory activity to protect the integrity of the system. Additionally, the manipulation has raised the concerns of law enforcement. Panelist Bryan Fuller, National Association of Insurance Commissioners, explained that in investigating the finite insurance manipulation schemes, the FBI appears to be looking for potential violations of 18 U.S.C. §§ 1033 and 1034. Sections 1033 and 1034 make it a crime for a member of the insurance industry to “knowingly, with the intent to deceive, make[] any false statement or report or willfully and materially overvalue[] any land, property or security . . . .” 18 U.S.C. § 1033.

When addressing finite insurance as a receiver of an insolvent insurance company, the receiver should be mindful of not only potential civil and criminal liability of finite insurance manipulation schemes, but also the financial costs that finite insurance may have against the

estate. The receiver should analyze the finite insurance agreement and the accompanying accounting practices to determine whether the amount that the company is paying in finite insurance premiums is grossly disproportionate to the return it expects to receive if the risk materializes. If the return is grossly disproportionate, Neal Connolly, Frontier Insurance Co. in Rehabilitation, explained, then the receiver may have grounds to rescind the finite insurance contract.

In sum, receivers should be knowledgeable about the types of finite insurance to which the company is a party in order to preserve the estate and avoid criminal and civil liability.

### Here Comes The Judge: Receivership Legal Update

Presenting this year’s receivership legal update was Deborah Cotton of Sidley, Austin, Brown, & Wood, L.L.P. Ms. Cotton gave a brief, but very informative, legal update on a broad range of issues affecting receiverships. The cases discussed covered topics ranging from abstention and administrative expenses to letters of credit and set-off. Of particular interest was Ms. Cotton’s summary of *Koken v. Legion Ins. Co.*, 878 A.2d 51 (Pa. 2005), where the Supreme Court of Pennsylvania allowed policyholders to “cut-through” the reinsurance

relationship and directly sue the reinsurer. The court, adopting the opinion of the lower court’s decision in *Koken v. Reliance Ins. Co.*, 846 A.2d 167 (Pa. Commw. Ct. 2004), reasoned that the policyholders had the right to sue directly because they were third-party beneficiaries to the reinsurance contract.

### It’s A Small World After All – Is It A Comity Of Errors?

Cross border insolvencies are complex and are increasing in frequency. The administration of these international insolvent estates requires the coordination of multi-jurisdictional proceedings. Jonathan F. Bank, Josh Wester, and Stephen Bailey of Lord, Bissell, & Brook, L.L.P. and Mike Walker of KPMG, U.K., comprised a panel discussing a number of issues that cross border insolvencies raise.

The panelists began by focusing on the differences between insolvencies in the United States and insolvencies in the United Kingdom. In the U.S., when an insurer is insolvent, the state insurance commissioner appoints a receiver, who administers the estate under power vested by a state receivership court applying state law. In contrast, in the U.K., the creditors take control of the company by voting on the appointment of an Administrator or Liquidator. The Administrator/Liquidator is then under the control of a U.K. court and

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application of U.K. law is assured. In each system, domestic law and domestic rights prevail, but the realities of the international nature of insurance and reinsurance are recognized. For example, statutory insurance deposits or reinsurance trusts are created for precisely the contingency of protecting policyholders from getting left in the lurch by an insolvent foreign reinsurer. These statutory deposits should serve this purpose and not be subject to distribution to creditors in the foreign estate.

With comity as a central principal, the recent changes to the Bankruptcy Code seek to encourage coordination between jurisdictions. Yet, with the independence and discretion afforded U.S. bankruptcy judges, coupled with the natural desire to maximize returns for U.S. creditors, even with the improvements in the new chapter 15, a question remains as to whether comity is ever really possible in the U.S. bankruptcy courts.

### **No Man's Life, Liberty, Or Property Are Safe When The Legislature Is In Session: The Latest On Federal Initiatives And Model Acts**

Several federal initiatives have been presented in response to criticisms of the current state regulated insurance system. With each federal solution, however, additional questions are

raised. As Catherine England, Ph.D. explained, if the federal government takes over the role of regulating insurance companies, what role will state regulators play, if any? Additionally, if the federal government regulates insurance, will it also guarantee the policies of the insureds? Notwithstanding a total preemption of the state regulatory system, other federal initiatives include proposals for federal involvement in the guaranty fund system. One proposal offers a federal guaranty system for all insurers, or alternatively, a second proposal offers coexisting state and federal guaranty systems. There are questions inherent in federal involvement in the guaranty system, just as there are questions inherent in federal involvement in the insurance regulatory system. For example, how will the federal government fund the system? How large of a fund? How many funds will need to be created? Will two coexisting fund systems (between the state and federal governments) result in two weaker systems? None of these questions have clear answers. The good news is that federal initiatives have not gained much steam and, for now, there are no real efforts to change the status quo.

While Dr. England addressed federal initiatives to change the status quo, Douglas A. Hartz of Bingham McCutchen discussed state-based initiatives to improve the status quo.

The focus of Mr. Hartz' presentation centered on the Insurance Receivership Model Act ("IRMA"), its advantages and disadvantages, as well as its improvements over the older Insurance Rehabilitation and Liquidation Model Act ("IRLMA"). Additionally, Mr. Hartz offered a spirited response to Mr. Steckbeck's description of IRMA in his Guaranty Association Legal Update.

### **A Trip To The Receivership Tool Locker**

This year's conference featured an hour and a half breakout session where conference participants chose from one of the following five "nuts & bolts" interactive sessions addressing practical receivership issues.

### **Outsourcing, Subcontracting, And Just Getting Help**

Panelists Dan Watkins, Law Offices of Daniel L. Watkins, and James Schacht, Navigant Consulting, Inc., led an interactive discussion covering a range of topics addressing outsourcing and subcontracting issues. Topics of discussion included: early identification of outsourcing needs; the importance of cost benefit analysis in evaluating activities and engaging professionals; alternatives to outsourcing; seeking court approvals; monitoring and overseeing vendors; balancing politics and expertise; and the pros

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and cons of retaining a single firm for multiple services.

### **Issues In Collecting On Professional Liability Insurance**

Corporate officers and directors are often the targets of litigation and are subjected to liability from a number of different sources. A Directors and Officers (“D&O”) policy protects officers and directors from the burden of bearing the costs of defending these suits, as well as protecting the officers and directors from settlements and judgments in these cases. James Skarzynski of Boundas, Skarzynski, Walsh, & Black, L.L.C., and Robert Brace of Hollister & Brace, explained that when the company that the officers and directors serve becomes insolvent, access to D&O policy proceeds often becomes complicated by, among other things, questions of good faith or fraud. In explaining these complications, the panelists each briefly described issues that they have faced in collecting on D&O policies while representing insolvent estates in two recent cases.

### **Keeping The Hat White: The Ethics Of Dealing With Creditors**

Leading a discussion regarding the ethical issues receivers may encounter in dealing with creditors was Hal Horwich of Bingham McCutchen, L.L.P. The format of the discussion presented participants

with hypothetical fact patterns inviting discussion of alternative solutions to various ethical dilemmas.

Mr. Horwich was so impressed with the group’s ability to “keep the hat white” that he rewarded each participant with a brand new white hat.

### **It’s The Revenooer’s! Federal Tax Issues And Developments**

The complexities of federal tax law can be daunting for any taxpayer, but when the taxpayer is a receiver for an insolvent company, the complexities may become overwhelming. Mark H. Kovey, Hall & Thompson, L.L.P., and Michael C. Warren, The Warren Group, attempted to shed some light on the tax laws as they relate to receiverships while, at the same time, debunking some common myths and fantasies regarding an estate’s tax filing obligations. By all accounts, most participants found the topic surprisingly riveting.

### **Your Place Or Mine? Special Problems In Multi-State Receiverships**

Citing recent experiences from their own practices, Lennard Stillman of Stillman Consulting Services, and Alan Curley of Robinson, Curley, & Clayton, P.C., discussed special problems that receivers may face in administering multi-state receiverships.

### **Is The End Finally Near? The Ambassador Estate**

Dating back to November of 1983, the Ambassador Receivership has been a fixture of legal discussions and receivership conferences for over twenty years. Recently, the Ambassador estate was awarded a judgment in the amount of \$119.9 million in compensation for net loss incurred from the continuing of operations of the already insolvent organization. Panelists Richard B. Whitney and Fordham E. Huffman of Jones Day, and Loren B. Kramer of Kramer Consulting Services, not only described the litigation strategy that led to the extraordinary judgment for the deepening insolvency, but also explained the lessons to be taken from the Ambassador case. The panelists noted that critical to the case’s success was the fact that the Commissioner moved quickly to action. The Receivership court’s oversight, in addition to compelling cases of CEO mismanagement, “reserve negotiation,” and avoidable loss, also militated in favor of successful resolution of the case.

### **The Top Ten Ways To Ensure That Your Receivership Is Perfect**

Finally, the conference concluded with a light-hearted summary and top-ten list that provided receivers with guideposts to receivership success. Presented by co-chairs of the conference, Philip Curley

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of Robinson, Curley, & Clayton, P.C., and Patrick Cantilo of Cantilo & Bennett, L.L.P., receivers were reminded of the importance of having a well-researched, well-thought out, and well-executed plan. Additionally, the receivers were also repeatedly reminded of who the reigning BCS National Champion is in college football.

Thank you to all panelists for your time and thoughtful preparation. Special thanks also to Paula Keyes, Paula Keyes & Associates, and Sheri Hiroms, Cantilo & Bennett, L.L.P., for their tireless efforts in ensuring that this year's Hitchhiker's Guide to Receiverships Insolvency Workshop took off with out a hitch.

## Meet Your Colleagues

by Joseph J. DeVito, AIR - Accounting/Financial Reporting, Reinsurance, and Claims/Guaranty Funds.



### Sharon Luarde

is an attorney at the law firm of Calfee, Halter & Griswold LLP, in Cleveland, Ohio,

whose litigators have extensive experience in insurance liquidation matters. Sharon is a member of both the NAIC and IAIR. She has experience in insurance insolvency and she is currently representing an insurance liquidator in a lawsuit against the former directors and officers of the insolvent carrier. She has also recently represented an insurance liquidator in a lawsuit against a major accounting firm, which resulted in a significant settlement. In addition to this experience, Sharon litigates complex business disputes, representing both corporate plaintiffs and defendants on a variety of issues. Her diverse experience includes serving as first-chair in arbitrations, where she has successfully secured favorable judgments for her clients. Sharon has also lectured on a variety of topics, including appellate advocacy, trial notebooks, and litigation techniques.

Sharon received her B.A. from Indiana University where she majored in Speech Communication and minored in Business. She graduated cum laude from Indiana University School of Law. Upon graduation, Sharon clerked for the Honorable Edward W. Najam, Jr. of the Indiana Court of Appeals. Sharon spends her free time with her husband and three daughters. She is also an avid reader and dabbles in acting, photography, painting, and quilting.



### Jeremy W. Capell

Jeremy Capell is a Managing Director in the Chicago office of Navigant Consulting,

Inc. Jerry leads the firm's international insurance and reinsurance practice, which is located in Chicago, London and several East Coast offices of NCI. Jerry has consulted to clients on a variety of issues including complex claims, reinsurance disputes, claim allocation, project management, systems development, insurance coverage issues, special investigations, regulatory prudence reviews, cost justification studies, information management and statistical sampling analysis.

Among other projects, Jerry was engaged to assist the liquidator of a reinsurer with a large assumed reinsurance claims evaluation project. This project required the evaluation of numerous cedent claims filed by reinsurers from around the world, the adjudication of those claims, including the provision of notice to potentially impacted retrocessionaires, as well as the ultimate preparation of the retrocessional billings. In his role as Project Manager, Jerry supervised both the staff of the liquidator as well as other outside consultants who were retained to assist with the project. Jerry was primarily responsible for all project planning activities, including staff scheduling, project budgeting, project reporting, as well as oversight of the application developed to support the project.

Jerry received his Bachelor of Business Administration degree in Finance and Accounting from the University of Michigan. He is actively involved with several not-for-profit organizations. Jerry chairs the board of Chances by Choice, a foundation which links U.S. adoptive families with children impacted by the HIV crisis in third world countries. He also sits on the Finance Committee for The Children's Place Association, an organization which serves Chicagoland children and families impacted by HIV and AIDS. Jerry has also been an active supporter and fundraiser for Share Your Soles, an organization which collects and distributes gently worn children's shoes to impoverished regions all over the world. Jerry has two adopted children, ages 5 and 3, and, in his infrequent spare time, is an avid tennis player.

## Meet Your Colleagues

by Joseph J. DeVito, AIR



### JONATHAN SACHER

Jonathan Sacher is the senior reinsurance and insurance partner and head of Litigation and Dispute Resolu-

tion at a top 15 London law firm, Berwin Leighton Paisner.

Jonathan has been a specialist reinsurance lawyer for some 23 years and has been described as a "reinsurance guru" by leading client research publication "Chambers" (2005)

Jonathan developed an interest in reinsurance soon after requalifying as a solicitor in England, having studied law at University in the then turbulent city of Cape Town. He has been a solicitor of the Supreme Court of England and Wales since 1981.

His practice over the past 20 years has covered advice ranging from reinsurance aggregation issues on WTC and War and Riots to kidnap and ransom and includes advising on a wide range of treaty and facultative disputes in the international reinsurance market. He acts for the world's largest reinsurance and insurance companies and brokers on strategic issues and losses and recoveries, and is currently leading a team advising on one of the largest market disputes in London.

He is a former Chairman of the Brit-

ish Insurance Law Association (the UK Chapter of AIDA). Jonathan is also an Associate Member of the Chartered Institute of Arbitrators, a member of the London Court of International Arbitration, ARIAS UK and ARIAS US.

Apart from his writing and speaking engagements at International Reinsurance Conferences, Jonathan was on the panel of judges for the first Insurance Day Insurance Industry Awards, held in December 2001



### Carl H. Poedtke III

Carl Poedtke is an attorney with the international law firm DLA Piper Rudnick Gray Cary. He

is a member of the firm's Global Insurance and Reinsurance practice group, resident in the Chicago office.

Carl is principally engaged in litigating insurance and reinsurance matters, including court disputes, arbitration and mediation. He has represented receivers, creditors, policyholders, cedents, brokers and reinsurers in numerous national and international disputes. Receivership and insolvency experience includes, among other things, representation of the Delta American Re Rehabilitator and the Illinois OSD. He co-chaired the defense in the liquidation trial of Legion Indemnity Company, which extended over

a period of 4.5 months. Carl has a broad commercial litigation background, having litigated claims in state and federal courts for breach of contract, injunctive relief, class certification, unfair competition, misappropriation of trade secrets, and fraud. Carl is also involved in the drafting of reinsurance agreements.

Recent articles Carl has co-authored include: Berrable Alternatives For Reinsurance Litigation, Part II: Pre-Hearing Rules of the Game, American Bar Association Excess, Surplus Lines and Reinsurance Newsletter (Fall 2005), and Berrable Alternatives For Reinsurance Litigation, Part I: Panel Selection, American Bar Association Excess, Surplus Lines and Reinsurance Newsletter (Summer 2005). He is also co-author of International Insurance Law and Regulation: Insurer Receiverships (United States), published by Oceana Publications, Inc.

Carl is a 1992 graduate of Stetson University in Deland, Florida, and a 1996 graduate, magna cum laude, from the John Marshall Law School in Chicago, Illinois. After law school, Carl served as a law clerk to justices of the Illinois Appellate Court and the United States District Court for the Northern District of Illinois. He lives in the Chicago suburb of Naperville, Illinois with his wife and three children. If you see him at an upcoming event please say hello. If you are a baseball fan you will strike up an immediate friendship; if you are a Cubs fan, it will be life-long.

## News From Headquarters

Congratulations to Douglas A. Hartz for attaining the CIR-ML designations. There are currently 33 members with the CIR designation and 23 members with the AIR designation.

The International Association of Insurance Receivers would like to thank the sponsors of the 2006 Insolvency Workshop:

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