The Insurance Receiver

PROMOTING PROFESSIONALISM AND ETHICS IN THE ADMINISTRATION OF INSURANCE RECEIVERSHIPS

WINTER 2003

Volume 12, Number 3

Feature Articles

4 Legion and Villanova: Guaranty Fund Coverage and Policyholder Access to Reinsurance
Teresa Snider

9 Will Reinsurance Arbitrations Become a Legal Dinosaur?
Katherine L. Billingham

12 New Perspectives on Insurer Insolvency
Holly Bakke and Doug Hartz

15 Guaranty Associations Need Cash
Edward B. Wallis

23 Chicago Roundtable Recap
Robert Loiseau

26 CIAB Education Foundation Releases New Report on Insurance Industry Solvency
Reprinted from Business Insurance

Departments

2 President's Message
Robert L. Greer, CIR-ML

3 View from Washington
Charlie Richardson

18 Receivers' Achievement Report
Ellen Fickinger

21 Meet Our Colleagues
Joe DeVito

21 News from Headquarters
Paula Keyes, AIR

www.iair.org

President's Message

Robert L. Greer, CIR-ML

Dear Members,

I recently had the opportunity to visit with Jim Dickinson, a former member of the IAIR Board and also Special Deputy Receiver of Delta America Re (Kentucky). He and his wife are living the good life in Florida, traveling the country visiting family and friends and also pursuing his family roots through genealogical research. Seems that many of Jim's ancestors may have walked some of the same ground as mine more than 100 years ago in Clarksburg, West Virginia.

In addition to being an SDR, Jim was also a Certified Financial Examiner and a member of SOFE. Jim was pleased to hear that IAIR's current work with the NAIC may lead to a SOFE-like marriage of the NAIC and IAIR's accreditation process. As a member of the liaison group established between IAIR and the NAIC to work on this matter I would encourage all members to follow this closely and to support IAIR as we undergo a self critical evaluation of our designation program. At the same time, we are enthusiastic about the possible incorporation of the IAIR designations into the NAIC structure. It is obviously too early to speculate but the NAIC's accreditation/designation working group has agreed to a detailed timeline to produce a White Paper. The paper will most likely address the importance of professional receivers as well as key factors of the IAIR designation process.

The IAIR Annual Meeting will be held on Saturday, December 6, from 4:00 pm to 5:00 pm in the Anaheim Hilton. We look forward to seeing you. If you are unable to attend, please submit your proxy to vote for Directors. In addition, in September the Board passed a revised Code of Ethics for the organization. The Code must be approved by the members and we will be voting on it at the Annual Meeting. You received emails from Executive Director, Paula Keyes, *(pkeyes@iair.org)* regarding both of these matters. Please contact her with questions.

We look forward to another excellent Roundtable at the upcoming NAIC at the Anaheim Hilton on December 6. Among other topics, we will hear from California Commissioner John Garamendi and California Special Deputy Receiver, Fred Buck. Please mark your calendars for 1:00 pm to 3:30 pm.

As we look to next year, I am pleased to announce that the brochure for the Winter Insolvency Conference, "Contested Receiverships" is now available. We have an excellent program for February 5 and 6, 2004 in South Beach, Miami. We have excellent speakers and panels and look forward to your participation.

Sincerely yours,

Robert Greer
President
greerlaw@aol.com

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

The Insurance Receiver is published quarterly by the International Association of Insurance Receivers, 174 Grace Boulevard, Altamonte Springs, FL 32714, Tel: 407.682.4513, Fax 407.682.3175, Email: IAIRHQ@aol.com.

Paula Keyes, CPCU, AIR, ARe, CPIW, Executive Director; Jeanne Lachapelle, Assistant Director; Jaime Mills, Office Manager; Gregg Burga, Administrative Coordinator.

EDITORIAL BOARD:
Robert Loiseau, CIR-P&C; Joe DeVito; Ellen Fickinger; Linda Lasley; Liz Lovette, CIR-ML; Charlie Richardson; Debra Roberts; Mary Cannon Veed.

OFFICERS:
Robert Greer, CIR, President; George Gutfreund, CIR, First Vice President; Daniel Orth, Second Vice President; Joe DeVito, CPA, Treasurer; James Gordon, CIR, Secretary.

DIRECTORS:
The Honorable Holly Bakke; Kristine J. Bean, CPA; Francesca Bliss; Steve Durish, CIR; Trish Getty, AIR; Robert Loiseau, CIR; Elizabeth Lovette CIR; Michael Marchman, CIR; Dale Stephenson, CPA; Vivien Tyrell.

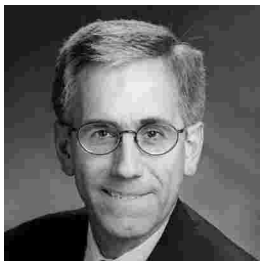
LEGAL COUNSEL:
William Latza and Martin Minkowitz of Stroock Stroock & Laven LLP.

ACCOUNTANT:
Stephen Phillips, CPA, FLMI, AIR of Cunningham, Porter & Phillips.

View from Washington

Charlie Richardson

NAIC High on GRID



The National Association of Insurance Commissioners is exploring the development of the Global Receivership Information Database (GRID) to monitor insurance company insolvency issues, expedite and maximize the payment of consumer claims against insolvent insurers, and streamline state communication about particular insolvent or troubled companies. Should the GRID be utilized, its initial impact will be making information that individual states have already collected in state databases on their own receiverships more usable. In the long run, the GRID is intended to allow regulatory and receivership activities to be streamlined and pursued more efficiently, providing more protections to consumers.

Asbestos Bill: Is it Fair?

Having limped out of the Senate Judiciary Committee last summer, Chairman Orrin Hatch's (R-UT) "FAIR" Act (S. 1125) continues to face opposition from several Republican senators who originally backed it in committee. The Senators have said "flaws," including the absence of a cap on attorney fees, make it wide open to abuse. The FAIR Act would take current and future asbestos claims out of the tort system and process them through a $108 billion trust fund. The trust's funding would be from mandatory annual assessments over 27 years against defendant companies and insurers. Even though S. 1125 endured four days of markup, Chairman Hatch has conceded he is open to modifying his bill to ensure passage. An aide to Senate Majority Leader Bill Frist (R-TN) hinted in early September that although Frist is "dedicated" to resolving disagreements over S. 1125, a vote won't happen until March 2004.

Medical Malpractice Reform: On Life Support

Not to be deterred, Senate Republicans plan to take a second shot this year or next at passing medical malpractice reform legislation. Momentum which had been building toward passage of legislation to place federal limits on medical malpractice lawsuits was stymied last July. With votes mostly along party lines, Senate Republicans failed to garner enough backing to bring up the "Patients First Act of 2003" (S. 11). The House passed the "HEALTH Act of 2003" (H.R. 5) on March 13. Both bills would cap non-economic damages at $250,000 and limit punitive damages to two-times economic damages (not to exceed $250,000) in health care lawsuits.

Do Not Call; Do Not Fax; Do Not…What?

One week before the national "do-not-call" registry was to go into effect, the U.S. District Court for the Western District of Oklahoma ruled September 24 that the Federal Trade Commission overstepped its authority in creating its anti-telemarketing list. Under rules written last year by the FTC and the Federal Communications Commission, the right of every citizen to receive telemarketing calls and faxes is to be severely regulated. Designed to start October 1, marketing to consumers through telephone calls would be subject to "do-not-call" list restrictions. Similar restrictions (especially tricky for associations) for faxes were to become effective on August 25, but the FCC, under severe pressure from small business and associations, postponed the rules until January 2005. The rules are complex, including several significant exemptions from the new standards for "existing customers."

Congress reacted September 25 with most unusual speed by passing legislation meant to make sure the FTC has the authority it needs to compile and implement the (50 million numbers) registry. President Bush has signaled his willingness to sign the bill. However, this may not be the end of the tug-of-war. Hours after the Congressional vote, a judge for the U.S. District Court for the District of Colorado ruled that the no-call list unduly burdens free speech rights.

charles.richardson@bakerd.com

Legion and Villanova: Guaranty Fund Coverage and Policyholder Access to Reinsurance

Teresa Snider [1]

The rehabilitation and subsequent liquidation of Legion Insurance Company ("Legion") and Villanova Insurance Company ("Villanova")[2] highlight two areas of particular interest to state regulators of insurance companies: interstate cooperation and ownership of reinsurance recoveries. Pennsylvania's Conservation, Rehabilitation and Liquidation Act (the "Pennsylvania Act") is intended to "lessen the problems of interstate rehabilitation and liquidation by facilitating cooperation between states in the liquidation process." (40 Pa. Stat. § 221.1(c).) The orders entered in the Pennsylvania proceedings involving Legion and Villanova raise questions about the actual nature and level of cooperation between states in the liquidation process, particularly with respect to the triggering of guaranty association coverage and the rights of states to retain and use statutory deposits. The purpose of the Pennsylvania Act is to protect "the interests of insureds, creditors, and the public generally." *(Id.)* The Orders of Liquidation for Legion and Villanova, however, contain an unusual provision giving individual policyholders the right to intervene in the liquidation proceeding to seek a judicial determination of the ownership of reinsurance proceeds. The enforceability and impact of this provision has yet to be determined. Ultimately, state regulators may need to consider statutory and regulatory changes to address the issues raised by the Legion and Villanova proceedings and discussed in this article.

Background

Legion and Villanova are affiliated Pennsylvania-domiciled property and casualty insurance companies that conducted business throughout most of the United States. Legion and Villanova specialized in workers compensation and medical malpractice coverage, but also wrote many other lines of business, including general liability, group accident and health, auto, and aviation insurance. Legion derived significant premiums from California business and also had substantial writings in New York, Massachusetts, Georgia, New Jersey, and Texas. Villanova, like Legion, wrote predominantly California business, but also wrote a significant amount of business in Texas, Oklahoma, New York, and Pennsylvania. Because Villanova and Legion wrote business in multiple states, their respective precarious financial conditions have had ramifications in each of those states.

In March 2002, the Pennsylvania Insurance Commissioner filed petitions to place Legion and Villanova into rehabilitation because of their respective hazardous financial conditions; Legion and Villanova consented to these petitions. On March 28, 2002, the Pennsylvania Commonwealth Court ordered that Legion and Villanova be placed into rehabilitation effective April 1, 2002, and appointed the Pennsylvania Insurance Commissioner as the Rehabilitator for both companies. The Orders of Rehabilitation each expressly provided that "[t]his Order shall not be deemed a finding or declaration of insolvency such as would activate the provisions of the Pennsylvania Property and Casualty Insurance Guaranty Act, 40 P.S. §§ 991.1801-9911.1820 [sic], or the provisions of similar acts of any other state or territory." (Orders of Rehabilitation, ¶ 30.) The Orders also gave the Rehabilitator discretion to pay claims for losses and loss adjustment expenses under insurance policies, with the exception of bad-faith claims and claims for extra-contractual damages. *(Id. at ¶ 20.)* Since the effective dates of the Orders of Rehabilitation, the Rehabilitator has paid only periodic workers compensation benefits, certain accident and health claims, and limited hardship claims.

On August 28 and 29, 2002, the Insurance Commissioner of Pennsylvania petitioned the Commonwealth Court to place Legion and Villanova, respectively, into liquidation. The Rehabilitator contended that Legion and Villanova did not have sufficient funds to pay claims as they became due and were, therefore, insolvent. *(See 40 Pa. Stat. §§ 221.3, 221.14(1), and 221.19.)* In addition, the Rehabilitator asserted that any further transaction of business by Legion and Villanova would be financially hazardous to their policyholders, creditors and the public. *(See 40 Pa. Stat. § 221.14(1).)*

On September 25, 2002, prior to any decision on the petitions for liquidation, the Pennsylvania Commonwealth Court modified the March 28, 2002 Orders of Rehabilitation for Legion and Villanova. Specifically, the Court revoked the Rehabilitator's authorization to pay workers compensation claims, claims under policies providing accident and health benefits, and certain hardship claims in those states where statutory deposits for

[1] Teresa Snider is a partner at Butler Rubin Saltarelli & Boyd LLP. The views expressed in this article do not necessarily reflect the views of Butler Rubin Saltarelli & Boyd LLP, any of its individual partners, counsel, or associates, or those of its clients.

[2] Legion Indemnity Company, a sister company of Legion and Villanova, is in liquidation in Illinois. Following a contested hearing, on April 9, 2003, the Circuit Court of Cook County granted the Illinois Director of Insurance's September 13, 2002 Complaint for Liquidation.

Legion and Villanova: Guaranty Fund Coverage and Policyholder Access to Reinsurance

Teresa Snider

the benefit of such claimants were not made available to the Rehabilitator for the payment of said claims. (Orders of September 25, 2002, ¶ 6.) The Amended Orders, however, permitted the Rehabilitator to seek authorization from the Court to pay such claims "where good cause exists to make such payments notwithstanding the refusal of state officials to make available statutory deposits." *(Id.)* Through the end of 2002 and first half of 2003, Legion and Villanova filed a series of petitions with the Pennsylvania Court, seeking to continue claims payments in certain states with statutory deposits. In response to those petitions, the Court regularly entered orders granting the Rehabilitator the authority to pay claims in some states with statutory deposits but not in others. In particular, the Rehabilitator did not seek leave to continue to pay workers compensation claims in California, Arizona, Massachusetts, North Carolina, and Nevada; accordingly, the court never entered any Orders permitting the payment of claims in those states. *(See, e.g., Petition for Temporary Relief to continue Claims Payments in States with Statutory Deposits from March 21, 2003 to April 4, 2003.)* Although the March 28, 2002 Rehabilitation Orders were explicitly not intended to activate guaranty fund coverage in any state, the effect of the September 25 modification of the Orders and the Rehabilitator's refusal to seek permission to pay claims in certain states had the effect of forcing some states to trigger guaranty fund coverage.

Also on September 25, 2002, the Court ordered that a hearing be held on the petitions for liquidation. (Orders of September 25, 2002, ¶ 1.) Under Pennsylvania law, "an order of the Commonwealth Court to liquidate the business of an insurer shall be issued only after a hearing before the court or pursuant to a written consent of the insurer." (40 Pa. Stat. § 221.20(b).) In October 2002, the Rehabilitator filed Emergency Amended Petitions for Liquidation of Legion and Villanova. No immediate ruling on the petitions or amended petitions for liquidation was forthcoming. The court heard testimony on the petitions for liquidation over the course of several months, finally issuing an Opinion and Order on June 26, 2003, stating the court would place Legion and Villanova into liquidation. One month later, on July 25, 2003, the Court issued its Order of Liquidation for each company, effective July 28, 2003. The Liquidator has appealed certain portions of the Orders of Liquidation.

Guaranty Association Coverage and Statutory Deposits

State legislatures create guaranty associations in order to establish a fund to provide financial assistance to policyholders and claimants in the event of an insurer's insolvency. When a guaranty association pays a covered claim, it takes a statutory assignment of the policyholder's claim against the insolvent insurer. An amendment to the NAIC Post-Assessment Property and Liability Insurance Guaranty Association Model Act provides that guaranty fund coverage is triggered only when the domiciliary state court with jurisdiction over the insurer has entered a final order of liquidation with a finding of insolvency. *(See Model Act, § 5(G).)* Thus, the Model Act contemplates that guaranty fund resources will not be used unless a court of competent jurisdiction in the state of the insurer's domicile declares the insurer insolvent. Although most states have enacted the Model Act in some form, this amended provision of the Act has not been uniformly enacted by all states that otherwise use the Model Act as the basis for their guaranty association structure. Rather, the majority of guaranty funds can make payments after a finding of insolvency and appointment of a liquidator entered by any court of competent jurisdiction – which need not be the state court of the domicile of the insurer. *(See July 16, 2003 Supplemental Amicus Brief filed by the National Conference of Insurance Guaranty Funds ("NCIGF Supplemental Amicus Brief").)* Accordingly, in order to trigger guaranty fund coverage – and thereby prevent an interruption in the benefits received by worker's compensation and other claimants who depend upon insurance proceeds for their living expenses – during the time the petitions for liquidation of Legion and Villanova were pending in the Pennsylvania Court, some other state courts made findings of insolvency and entered their own liquidation orders with respect to Legion and Villanova.

According to the Rehabilitator's Amended Petitions for Liquidation, 21 states held statutory deposits and were therefore affected by the September 25, 2002 Order. *(Id. ¶ 9.)* Some states returned their statutory deposits to the Rehabilitator and other states requested hardship exemptions. Several states began to pay claimants directly, using the statutory deposits to do so. *(Id. ¶¶ 9-10.)*

Under California law, insurers who seek admission to write workers compensation insurance or reinsurance business in California must deposit security as a precondition to writing such business. (Cal. Ins. Code § 11691(a).) The deposit is to be used to pay compensable workers compensation claims and expenses "in the event the insurer or reinsurer fails to pay those claims when they come due." *(Id.)* Under the statute requiring such deposits, once a delinquency proceeding has commenced against an insurer, the proceeds from the deposit can only be transferred to the general assets of the

Legion and Villanova: Guaranty Fund Coverage and Policyholder Access to Reinsurance

Teresa Snider

insurer's estate if: (1) all compensable claims have been paid; or (2) it is actuarially demonstrated that the deposit exceeds the liabilities for such claims. (Cal. Ins. Code § 11698(a).) If the California Insurance Guarantee Association must pay covered claims because an insurer is the subject of an order of liquidation with a finding of insolvency that has been entered by a court of competent jurisdiction, the Commissioner is required to transfer the security deposit to the Guarantee Association. (Cal. Ins. Code § 11698.3(a).)

Legion and Villanova deposited over $119 million in letters of credit and securities to secure their obligations to California workers compensation policyholders. *(See Verified Application for Order of Liquidation, ¶ 10, filed by the California Insurance Commissioner in the Superior Court of California, Los Angeles County.)* After Legion and Villanova stopped paying claims, the California court appointed the Insurance Commissioner as Ancillary Receiver. *(Id. ¶¶ 7-9.)* The Ancillary Receiver drew down the $119.3 million, which was then used to pay covered workers compensation claims, with the California Insurance Guarantee Association acting as the claims handler under contract to the Ancillary Receiver. *(Id. ¶¶ 11-12.)* When those statutory deposits neared exhaustion, the California Insurance Commissioner sought an order of liquidation. *(Id. ¶¶ 12, 20.)* On April 25, 2003, the Los Angeles County Superior Court declared Legion and Villanova insolvent and appointed the California Insurance Commissioner as Liquidator for the companies. This declaration of insolvency triggered the California Insurance Guarantee Association's obligation to pay covered workers compensation claims for insureds of Legion and Villanova in California. *(See Cal Ins. Code §§ 1063.1-1063.2.)*

North Carolina was also holding security deposited by Legion and Villanova. The state could not, however, use the $14 million that it held to pay claims without a formal declaration of insolvency by Pennsylvania. *(See N.C. Gen. Stat. § 58-5-70.)* In the meantime, Legion and Villanova stopped making claim payments to North Carolina policyholders. *(See November 4, 2002 Memorandum from Chairman Buck Lattimore, N.C. Industrial Commission, at www.comp.state.nc.us/ncic/pages/1104memo.htm.)* North Carolina's Department of Insurance, Guaranty Association, and Industrial Commission collectively asked state legislators to pass a law that would allow the use of the deposit even though Legion and Villanova had not been declared insolvent in Pennsylvania. *(See Lee Weisbecker, Insurer's failure to cost N.C. Taxpayers, in Triangle Business Journal, November 11, 2002.)* The bill passed, enabling use of the $14 million to pay claims. (2002 N.C. Sess. Laws 185, part VIII.) Further, on November 1, 2002, the Wake County General Court of Justice issued an Order declaring Ancillary Liquidation of Legion in North Carolina. The effect of the Order was to require the North Carolina Insurance Guaranty Association to pay Legion's covered claims in North Carolina to the extent the deposited funds are insufficient to do so.

Texas, one of the states that did not hold statutory deposits and would have been unaffected by the September 25, 2002 Order, nonetheless assumed payment responsibility for Texas claimants. On October 23, 2002, the 200th Judicial District Court of Travis County found Legion and Villanova insolvent and entered a Temporary Restraining Order and Order Appointing Temporary Ancillary Receiver. On October 25, 2002, the Commissioner of Insurance of Texas issued an official order finding that Legion should be and is "designated as an impaired insurer." The Commissioner's Order, in conjunction with the finding of insolvency, triggered guaranty fund coverage in Texas under the Texas Property and Casualty Insurance Guaranty Act. *(See Tex. Ins. Code § 21.28-C-5(9).)* On February 19, 2003, the District Court of Travis County Texas issued a Permanent Injunction and Order Appointing Permanent Ancillary Receiver.

In states where guaranty fund coverage was activated – for example, by entry of an order of ancillary receivership – the guaranty funds began paying claims and, in turn, may assert claims against the estate(s) of Legion and Villanova. Other insurers who do business in those states may then be assessed in order to raise funds to pay policyholders and claimants. Insurers, in turn, will recoup the assessment via a surcharge on insurance policies or changes in insurance premium rates. Alternatively, insurers may be granted a reduction in premium taxes. Thus, as the guaranty funds expend money to pay claims, insurers face a financial burden, which they pass along to policyholders or taxpayers, to replenish the coffers of the guaranty associations.

The Rehabilitator of Legion and Villanova continued to pay claims in some states, however. Thus, guaranty associations in those states were not required to expend their resources to pay Legion and Villanova claims, did not build up claims against the Legion and Villanova estates, and did not need to assess insurers doing business in those states. Accordingly, those guaranty associations have been able to preserve their resources and avoid imposing new assessments.

Because Legion and Villanova have now been placed into liquidation by their domiciliary state, the guaranty associations will have a priority one claim for expenses

Legion and Villanova: Guaranty Fund Coverage and Policyholder Access to Reinsurance

Teresa Snider

in handling claims, and a priority two claim against the estate for loss payments (40 Pa. Stat. § 221.44(a) and (b).) Under Pennsylvania law, the right and liabilities of creditors, policyholders and the insurer itself are fixed as of the date of filing of the petition for liquidation. (40 Pa. Stat. § 221.20(d).) However, the fact is that some guaranty associations have been paying post-petition claims for a much longer time period than others. As a practical matter, no provision in the Pennsylvania insurance insolvency statute places guaranty associations that have been paying claims because of an early trigger date for guaranty fund coverage on equal footing with guaranty associations whose coverage was triggered only after a finding of insolvency by the Pennsylvania court. Arguably, this inequity results from public policy considerations, namely, by enacting statutes that permit the trigger of guaranty association coverage without a declaration of insolvency by a court in the insurer's state of domicile, certain state legislatures have made a policy decision to assist citizens of their states to be paid timely, notwithstanding the implications for the guaranty funds, taxpayers, and insurers writing business in their states.

Although the Rehabilitation Order required the return of statutory deposits, statutory deposits are not necessarily general assets of the insurer, depending upon the particular state law at issue. Such deposits may be special deposits for the benefit of particular insureds that cannot, as a matter of law, be turned over to the estate. The Pennsylvania Court's September 25, 2002 Order barring the payment of claims in states with statutory deposits, in effect, penalized the states that had the foresight to collect those deposits and to statutorily restrict their use, forcing some states to create ancillary receiverships. The effect of the ancillary receiverships, and the delay in ruling on the petitions for liquidation, likely exacerbated the cash flow problems plaguing Legion and Villanova. Although the Court suggested in its June 26, 2003 Opinion that guaranty funds were in part to blame for the need to put Legion and Villanova into liquidation by taking the position, purportedly based on "custom and practice" or improper statutory construction, that guaranty fund coverage was not triggered until a finding of insolvency was made and an order of liquidation entered, this suggestion has no factual basis. The statutory language creating the guaranty funds also governs when those funds are triggered. *(See NCIGF Supplemental Amicus Brief for a summary of trigger provisions in the 39 states that require an order of liquidation and a finding of insolvency.)* The Model Act Revision Working Group of the NAIC is currently considering revising the Receivership Model Act to recognize that special or statutory deposits are not general assets of an insolvent insurer's estate. *(See June 18, 2003 Memo to Model Act Working Group, at www.naic.org/receivership/documents/special_deposits_6-18-03.doc.)* If states were to pass such a revised Act, the Court's findings in this regard would be legislatively overruled.

Policyholder Access to Reinsurance

Several policyholders intervened in the Legion proceeding to assert that they had a right to direct access to reinsurance. Normally, direct access rights are granted to policyholders only in very limited situations, such as where an explicit cut-through or alternate payee clause exists providing that the insured or some other named person or entity has the right to collect the reinsurance directly from the reinsurer in the event of the insurer's insolvency. Alternatively, a reinsurer may have entered into an assumption agreement by which it assumed the direct insurer's obligations to the policyholder. Direct access rights are traditionally disfavored in insurance insolvencies because the effect of granting direct access is to remove assets from the estate – and reinsurance normally constitutes an insolvent insurance company's largest asset. In recognition of the importance of reinsurance to an insolvent insurer, the Pennsylvania Act provides:

> *The amount recoverable by the liquidator from reinsurers shall not be reduced as a result of delinquency proceedings, regardless of any provision in the reinsurance contract or other agreement. Payment made directly to an insured or other creditor shall not diminish the reinsurer's obligation to the insurer's estate except when the reinsurance contract provides for direct coverage of an individual insured and the payment was made in discharge of that obligation. (40 Pa. Stat § 221.34.)*

Notwithstanding this statutory direction, the Pennsylvania Court allowed four policyholders of Legion to intervene in the case, ostensibly to present evidence that liquidation would be harmful to their interests, but actually to present their cases that they were entitled to gain direct access to reinsurance. The Court held a series of hearings in March and April of 2003 where the policyholder-intervenors presented evidence that Legion's reinsurance was purportedly obtained for their benefit.

On June 26, 2003, the Court issued its Opinion and Order ruling on the Petitions for Liquidation and the policyholder-intervenors' claims that they were entitled to direct access to reinsurance. The court admitted that some of the reinsurance agreements did not contain cut-through

Legion and Villanova: Guaranty Fund Coverage and Policyholder Access to Reinsurance

Teresa Snider

provisions and acknowledged that the general rule was to deny policyholder claimants direct access to reinsurance. (June 26, 2003 Opinion, at 26, 63-64.) The Court found, however, that the general rule was not applicable because Legion was a fronting insurer rather then an orthodox insurer who bore underwriting risk. *(Id. at 64.)* The Court held that the intervenors could claim third party beneficiary rights, citing factors such as its findings that: (1) the intent was that the reinsurer would assume all underwriting risk and that proceeds from reinsurance would be used to pay claims under a particular program rather than become part of the general assets of Legion; (2) Legion did not underwrite the risk; (3) Legion did not participate in claims handling or funding of claims payments; and (4) claims handling and the funding of claims were the responsibility of reinsurers. *(Id. at 68-71.)* The Court also concluded that, in order to exclude third party beneficiary rights, reinsurance contracts must have express language that does so state. *(Id. at 72-73.)*

Finally, the Court found that the granting of third-party beneficiary rights was not an unlawful preference under Pennsylvania law. *(Id. at 73-74.)* In so holding, the Court noted that the Rehabilitator asserted that there was likely to be 100% recovery by policyholders when all of the reinsurance was collected. *(Id. at 74.)* The Court granted the Rehabilitator's petition to terminate the Rehabilitation Order of March 28, 2002, but ordered that the Rehabilitation Order remain in effect until entry of the Order of Liquidation. *(Id. at 89.)*

On July 25, 2003, the Court entered Orders of Liquidation for Legion and Villanova, effective July 28, 2003. Paragraph 20 of the Orders sets forth a process by which policyholders can intervene in the liquidation proceeding and obtain a finding as to their entitlement to direct access to reinsurance, stating:

> *Policyholders asserting a right to proceeds of a reinsurance agreement, to which Legion [or Villanova] was a party, shall pursue that right by filing a petition to intervene with this Court for a determination of whether the reinsurance amounts owed are general assets of the estate of Legion [or Villanova] or assets of the policyholder intervenor. Where policyholder intervenors establish a right to direct access to reinsurance proceeds, Legion's [or Villanova's] responsibility for the handling of the policyholder intervenor's claims, if any, terminates, and the policyholder intervenor is vested with exclusive control of claims handling, all claims files and claim-related records. Further, policyholder intervenors may not recover from the estate of Legion [or Villanova] for a claim to the extent it is covered by a reinsurance agreement to which the right of direct access has been established. The petition to intervene shall not, without further order of this Court, serve as the procedure for resolving disputes as to the amounts owed by a reinsurer or other terms and conditions of the reinsurance agreement. Upon good cause shown, such other relief as the Court deems appropriate may be granted the policyholder intervenor.*

The Liquidator has appealed the June 26 Opinion and Order, and portions of the Orders of Liquidation, including paragraph 20.

Since the entry of the Orders of Liquidation, other policyholders have filed petitions to intervene, asserting a direct right to reinsurance recoveries. The resolution of the Liquidator's appeal – assuming that the Supreme Court of Pennsylvania decides it has jurisdiction to hear the substance of the appeal – will likely determine the scope of policyholder rights in the Legion and Villanova liquidations. The breadth of the direct access rights granted by the Pennsylvania Court to policyholders creates uncertainty over whether and to what extent reinsurance collectibles should be classified as assets of the insurance companies. Thus, affirmance of the June 26, 2003 Opinion would ultimately result in the movement of a substantial number of claims out of the estates, but would also result in a need to reevaluate the statutory guidelines for determining whether insurance companies should be entitled to take credit for reinsurance and for evaluating their financial solvency.

tsnider@butlerrubin.com

Correction to 2003 Membership Directory

The following entry was inadvertently omitted:

Alexander T. Farley, President
American Insurance
Management Group, Inc.
86 Bethlehem Pike, Suite 200
Philadelphia, PA 19118
Tel: 215.242.3200
Fax: 215.242.4511

Will Reinsurance Arbitrations Become a Legal Dinosaur?

Katherine L. Billingham [1]

The reinsurance arbitration process has grown well beyond its ancestral proportions. This form of dispute resolution is groaning under the weight of increased time and expense as it evolves from its original purpose. Since arbitrations are generally private affairs, there is little in the way of available statistics but those operating within the system are expressing concerns.

The run-off sector of the insurance and reinsurance industry is growing at an unprecedented rate. Chiltington estimates reflect that the liabilities associated with currently discontinued business in the United States total approximately $300 billion, and the projected growth for the run-off industry is exceeding that of the industry as a whole. Because of the long tail of liabilities for many of the companies in run-off, and the administrative costs required to sustain the process, many if not most, of these companies ultimately wind up – literally – in insolvency. This phenomenon has its genesis in a multitude of factors, not the least of which is market underpricing, reduced returns on investments, mergers and acquisitions, catastrophic losses and a sharp increase in environmental, including asbestos, claims.

Run-off tends to breed more disputes between the reinsured and its reinsurer. When the reinsurer is in run-off, management strategy can include the slowing of the payment stream to cedants in order to generate more income on assets. Also, a run-off reinsurer will often increase its auditing of the cedant to facilitate, and even justify, the delay in the payment of claims. Conversely, when a cedant is in run-off and takes this approach with its own reinsureds, those same reinsureds are often reinsuring the cedant on some other program(s), and the reinsurer will exercise its legal or equitable rights of offset, with the net effect being that neither pays the other. Ultimately, one party becomes dissatisfied and seeks resolution.

The flood of pollution and asbestos claims into the market in the last several years has also contributed to the number of reinsurance disputes. When faced with the prospect of otherwise litigating various coverage issues in the context of an actual or threatened insured bankruptcy, cedants often compromise such claims on proof arguably insufficient, and in some cases the claims are settled en masse or even with a policy buy-back. These claims have caused a wave of case law in regards to issues of trigger and allocation that varies from state to state. Reinsurers have questioned the allocation of such claims and at times have challenged the cession. As a result, the concept of "follow the fortunes" is now the subject of intense scrutiny.

Consequently, in the past decade the number of reinsurance arbitrations has increased dramatically, as has the amount of money at stake. These developments have had the effect of steering the process into a new era, one more resembling litigation than arbitration. This evolution is generating some doubts as to the value of the time-honored process and would seem to be eroding the long-standing fundamental precept of "utmost good faith."

Most treaty reinsurance agreements contain an arbitration clause. Arbitration clauses arose under the English 1891 Stamp Act and the Marine Insurance Act of 1906 when treaties were underwritten prior to the inception of the contract itself and therefore, were considered to be legally unenforceable in the courts. (For this reason, and other practicalities, facultative agreements often do not contain an arbitration clause.) Since reinsurance treaties have continued to be processed in this manner, that is to say they are frequently signed after the coverage period has begun, and in some cases after the period has expired, it is impractical to negotiate and draft a lengthy and complex agreement, including an arbitration clause. Arbitration clauses have been referred to as the "Cinderella" clause because they receive little attention from underwriters who are more focused on the extent and price of the cover. This market reality is what founded the concept of good faith and fair dealing in the industry. In the case of the arbitration clauses, the parties expect that in the event of a dispute, experts in the industry will fill in the blanks by following "custom and practice."

Most arbitration clauses state that disputes will be resolved by a panel of three arbitrators, often requiring that those arbitrators be active or retired executive officers of an insurance or reinsurance company. The trade has historically preferred to have reinsurance disputes resolved privately by industry executives, not because these professionals necessarily possess honed dispute resolution skills but because they have practical business experience and can further the notion that following the customs and practices in the industry should be the guiding prin-

[1] Katherine L. Billingham, JD, CPCU is the former Vice President and General Counsel of Universal Reinsurance Corporation. In 1989 she founded her own firm and is a reinsurance consultant and arbitrator.

Will Reinsurance Arbitrations Become a Legal Dinosaur?

Katherine L. Billingham

ciple. Arbitration clauses also often state that the arbitrators are not bound by strict rules of law that would apply in court and that the reinsurance agreement is to be deemed an "honorable engagement." Experienced veterans in the industry are capable of understanding and favoring the intent of the parties rather than the language of the contract itself.

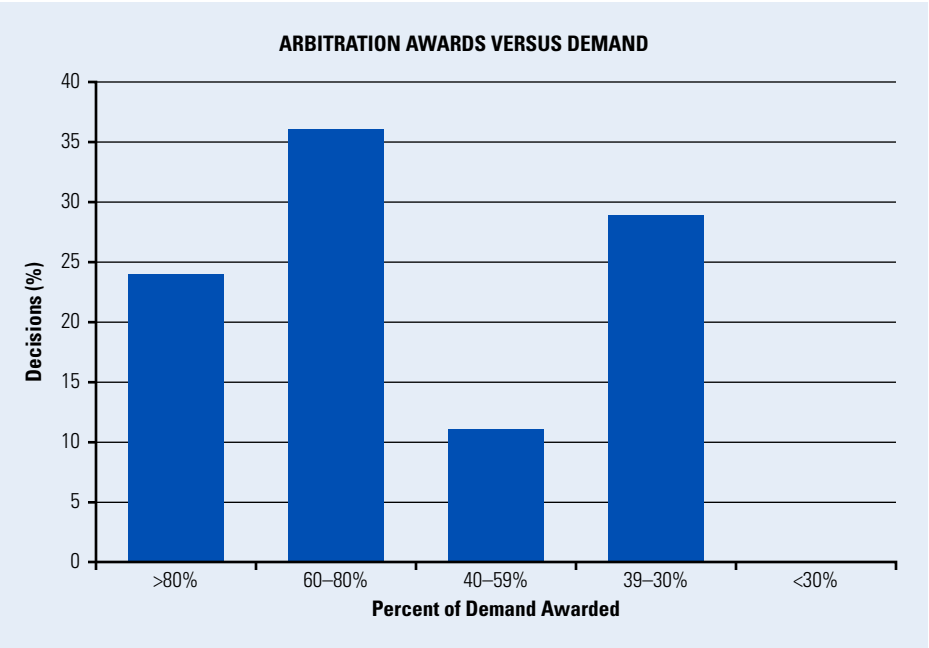
In a typical arbitration clause of a reinsurance agreement, each party will select an arbitrator and the two arbitrators together will choose an umpire. If they cannot agree on an umpire then each party will suggest three names to its arbitrator. Each arbitrator will then strike two names from the other arbitrator's list and lot drawing from the two remaining candidates chooses the umpire.

In the past, arbitrators and umpires were chosen swiftly and often by consensus. Now the process is often fraught with delay, posturing and controversy. In some cases, parties have filed suit at this stage over disputes about such things as the qualifications or alleged bias of a potential umpire on a party's list. What once took only a matter of weeks can now take months, long before the real dispute is the focus of the parties' resources.

To add to the problem, increasingly the question arises as to whether a party-appointed arbitrator is to act as a partisan advocate, or is to simply be predisposed to the position of the party appointing him or her, or is to maintain complete neutrality. Some assume that because the party appointing that arbitrator pays the arbitrator's fees, that arbitrator's vote is, or should be, a foregone conclusion, a concept that can breed tension throughout the arbitration process. Most arbitrators take the position that they are to facilitate, not advocate, that they are to assist the umpire in understanding the position of the party appointing that arbitrator, and that they can ensure that the party will have an unfettered opportunity to take reasonable discovery and present its case in a fair manner. A party-appointed arbitrator will generally subscribe to the position of the party appointing him or her at the outset but will do so with the understanding that he or she will maintain an open mind with regard to making a final decision after considering all the facts at the arbitration hearing. In fact, if a poll were to be taken it would likely reveal that, more often than not, reinsurance arbitration panels render unanimous decisions.

The customary practice of open communication between the party and its appointed arbitrator until the final hearing has also been the subject of criticism over the years as the process has moved towards more rigorous formalities. However, the value of this approach should not be underestimated. The free flow of information can allow the arbitrator to be pivotal in transferring helpful observations in both directions. An experienced arbitrator can assist the party in gaining a better appreciation for the flaws in its position and can help to move the parties toward more common ground and even a settlement.

As the arbitration process becomes more litigious, parties are questioning whether they might be better off to simply forego the whole affair and take their matters through the court system. There is a prevailing theory that arbitrators tend to favor compromise decisions over aligned positions. If that were the case, with the time and expense of arbitrations being what they are, it is easy to understand why some might question the value of following the arbitration track. In truth, however, most arbitration panels avoid



Will Reinsurance Arbitrations Become a Legal Dinosaur?

Katherine L. Billingham

"splitting the baby." The American Arbitration Association has performed a study which shows that only 11% of the panel decisions represent awards in the 40–60% range of the demand, as illustrated below.

Years ago, arbitration proceedings were completed in a matter of weeks or months. Now they can last for a couple of years or more, and the cost associated with them has grown proportionately if not exponentially. Where once the process was streamlined by comparison to litigation, now parties engage in prehearing disputes surrounding such issues as discovery and security. Often, these disputes are accompanied by several rounds of briefing. Arbitration panels are reticent to limit the parties in these quests because arbitrations are binding and there is little opportunity for appeal. Additionally, unlike overloaded court dockets, arbitrators can devote more time to these matters so they tend to give the parties wider latitude.

Some of the long-valued advantages of arbitrations still prevail. Parties almost always agree at the outset of the matter that the arbitration will be confidential, thereby avoiding a precedent that could prove unfavorable for one or both of them in future disputes. They can also avoid the public exposure of an embarrassing example of market practice. Further, because the arbitration clause sets few mandates about how the matter should proceed, the parties are able to fashion a system that meets their specific needs. In response to the growing number of arbitrations, ARIAS (AIDA Reinsurance & Insurance Arbitration Society) was formed in the early 1990's to provide arbitrator training and to set standards for the arbitration process. The AAA, the RAA (Reinsurance Association of America) and ARIAS maintain lists of reinsurance arbitrators.

ARIAS is also exploring mediation as a means of reinsurance dispute resolution, and while it may be slow to acceptance, mediation may revive some of the original concepts underpinning the arbitration clause. Mediation has many benefits. A typical mediation will last one day, thereby cutting costs significantly. Each side has an opportunity to view its case from the vantage point of a neutral and skilled mediator, and each has an opportunity to advise the opponent directly about its viewpoint and can learn about any surprises the other side holds. A party can reevaluate its position with the freedom to walk away. Mediation can often achieve results that appeared unattainable.

Mediation is gaining much favor in England. Ten years ago the Center for Effective Dispute Resolution (CEDR) was founded and now mediates hundreds of disputes each year, including reinsurance matters. Last year the Claims Mediation Centre opened an office in Lloyd's and expects that it can reduce the approximately $1.16 billion in annual legal costs by as much as one-third. In June of this year the International Underwriting Association and Lloyd's retained Intermediation, a commercial mediation service, to provide a series of clinics for Lloyd's. This fall, in Chicago, Mealey's hosted a dispute resolution conference that included a reinsurance mediation, a series of workshops and roundtable discussions that was well attended and received.

In the end, arbitration is still less expensive and faster to finality than litigation as a means of resolving reinsurance disputes but if current trends continue, it could be a distinction without a difference. Mediation may provide a viable alternative for those who are willing to consider a compromise solution, even if the compromise only involves avoiding further legal costs, commonly known as "nuisance value." In any event, unless the dinosaur is reigned in, arbitration clauses may become a thing of the past, the "Ice Age" past.

katherineb@ameritech.net

SAVE THE DATE

"The Challenges of Contested Receiverships"

IAIR's Annual Insolvency Workshop

February 5 and 6, 2004
Miami, Florida

For more information, please contact the Event Chair, Paige Waters at *pwaters@sonnenschein.com.*

New Perspectives on Insurer Insolvency

Holly Bakke (NJ Commissioner) and Doug Hartz (NAIC Staff Support) [1]

We are again at that point in insurance regulation where the cyclical nature of the industry is presenting challenges to regulators on how to manage the marketplace. For several years now the property and casualty industry has fallen far short of expectations. It is no secret that insolvencies are on the rise and recent ones have been dramatic. While the overall capacity of the national state based system of state guaranty associations (SGAs) is nationally adequate, there are some state SGAs that are under great stress due to these insolvencies. The forecast is that the increasing assessments on ongoing insurers to fund the SGAs payments on covered claims from insolvent insurers will continue increasing.

Proponents of federal regulation have long targeted state receiverships in order to advance their agenda, making this issue an appropriate and timely one for the NAIC to address and for all regulators to examine. Much of the body of recent federal chartering proposals deals with receiverships. If chartering (birth) of federal insurers is going to exist, then processes for the medical (troubled company), hospital (rehabilitation), hospice (liquidation) care, and burial (closed estate) of such insurers appears, logically, to also be needed. Regulation of any part of the life cycle of insurers, arguably, necessitates regulation of every part of the entire life cycle of such insurers. This interest has also been fueled by reports critical of the receivership/SGAs systems, which have recently been published and publicized.

State insurance regulator's responsibilities to both monitor and to make timely determinations and properly administer receiverships become more scrutinized during difficult markets. Traditionally, emphasis has been generally and rightfully placed on the first responsibility, insuring that insurers meet their obligations. This results in a reluctance to place companies in receivership until all remedies have been investigated.

A progressive proactive approach to the financial monitoring of companies can help regulators satisfy the need to exhaust all reasonable remedies, while allowing for opportunity to make that timely determination of when a company should be placed in receivership. A strong financial analysis program including on-site financial examinations offers the regulator an opportunity to truly understand the company and head off any potential problems before they start. Through this careful monitoring, the regulator will ultimately identify companies in trouble. When confronted with such a company, a corrective action plan should be developed and evaluated for reasonableness. If the company fails to meet the benchmarks established in that plan, the regulator should place that company in Administrative Supervision, which provides close monitoring and the lowest level of regulatory intervention in the day-to-day operations of the insurer. If this fails to improve the company's condition, the regulator needs to think seriously about placing the company in a solvent run-off or further intervention such as removing management and placing the insurer in receivership.

Throughout this process, regulators must acknowledge that the financial failure of insurers occurs as a natural by-product of a free market system. Even though regulators desire that companies continue serving their policyholders, they need to be sensitive to their obligation to protect policyholders by placing a company into receivership in a timely manner to preserve the assets of the insurer. Receiverships are not intrinsically bad. They are merely a regulatory means to a regulatory goal. That goal is ensuring that claims are paid. Regulators should recognize the goal of solvency regulation is not avoiding receiverships, but rather it is ensuring the obligations to the policyholders are met. The thing most damaging to consumer confidence in the insurance industry, as well as those that regulate it, is claims not being paid. There is, for example, high confidence in banks, not because banks never fail, but because when they do consumers are confident that they can still get their money – with little or no delay. When insurer receiverships occur, the concerns of consumers remain the same – they expect their money with little or no delay. In most receiverships, like bankruptcies, when consumers get their money it is usually only part of it. In other words, regulators should not prolong the efforts to avoid liquidation when it is clear that an insurer cannot meet its obligations.

Faced with a potential receivership, regulators must consider their duty to marshal the assets of an insurer in order to maximize the claim payments; minimizing the

[1] Holly Bakke is the Commissioner of the New Jersey Department of Banking and Insurance. She was formerly the Executive Director of the New Jersey Property-Liability Insurance Guaranty Association, the New Jersey Surplus Lines Guaranty Fund and the New Jersey Medical Malpractice Reinsurance Association. Doug Hartz is a Senior Counsel for Financial and Insolvency Regulation in the NAIC Legal Department. In several prior posts, he has directed or supervised dozens of insurer receiverships and troubled companies for many State Insurance Commissioners.

New Perspectives on Insurer Insolvency

Holly Bakke (NJ Commissioner) and Doug Hartz (NAIC Staff Support)

financial impact on guaranty associations, ultimately the public and general creditors. That being said, the determination of when to place an entity into liquidation remains a difficult task. The process becomes more of an art than a science, forcing the regulator to weigh the possibility of a true turnaround of the insurer, the likelihood of a rehabilitation, versus the inevitability of a liquidation. As this process engages the regulator, it is important to remember that assets used in the rehabilitation effort will not be available to the estate in the event of liquidation.

As the assets shrink, the pressure placed on state guaranty funds in the event of a liquidation increase and the bill is passed on to the public. After all, guaranty funds are the safety nets when insurers can no longer meet their obligations to policyholders. The funds are derived from insurance consumers through assessments on their policies. In fact the public has paid $7,841,490,000, through 2001, according to the NCIGF. See, *www.ncigf.org/* under Assessment History. The SGAs have made payments on ALAE and claims through 2002 of $13,266,400,000 and have been paid from the estates of insolvent insurers *(recoveries)* of $5,022,400,000. *See Figure 2.*

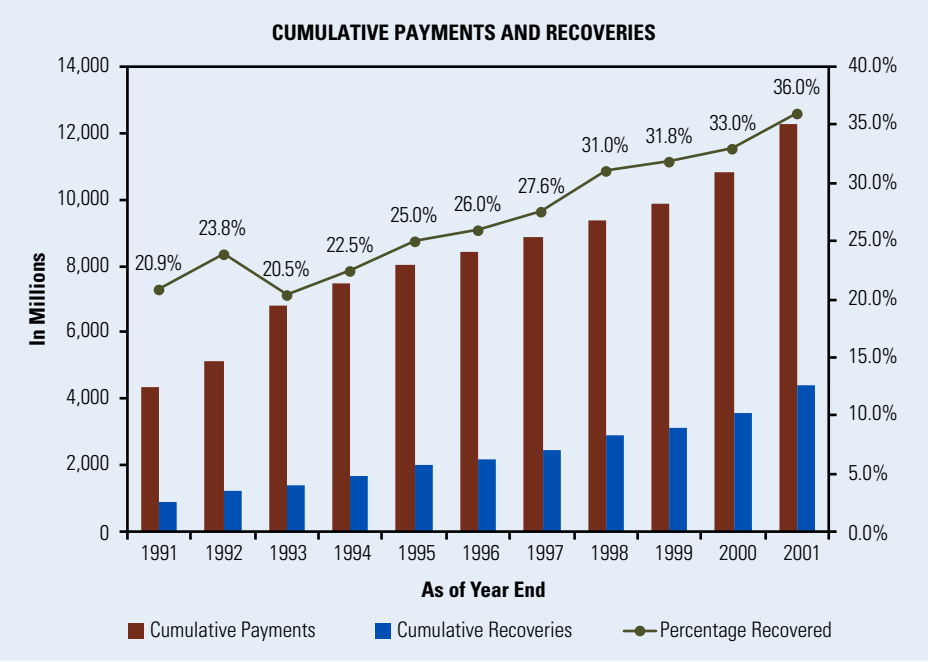
The good news is that higher percentages of the accumulated payments on claims are being covered by recoveries from the insolvent estates – 36% in 2001 versus a low of 20.5% in 1993. This is the result of many estates making larger payments *(as early access or interim distributions)* to the SGAs since 1993 when the ITF and NCIGF began pushing for this result. The bad news is that much more is needed. *See Figure 2.*

One of the major points that can be drawn from *Figure 2* is that there are 25 estates that make up 59.8% of the total Net Expense *(amounts not recovered from estates)* of the SGAs. Further, these 25 estates have paid to the SGAs, on average, only 27.6% in relation to the payments made on covered claims by the SGAs. This does not compare well to the 48.7% that the 460 with lower Net Expenses have paid to the SGAs. Some of these estates have paid the SGAs far below 10-cents-on-the-dollar on their SGA claims. This means that all of the claimants with policy-related claims (not just the SGAs) in those estates have been paid far below 10-cents-on-the-dollar so far. The real question here is how much more could these estates pay on these claims.

If regulators are to truly meet their obligations to policyholders, limit the public's exposure on insolvencies, and maximize the ability of companies to meet their obligations in realistic ways, a proactive approach is critical. Regulators should insist on frequent and meaningful communication between those invested in monitoring the company's financial condition, and those assigned the duty of administering receiverships. Coordination between these units will assist Commissioners in making the determination of when to place an insurer in receivership. In some states the responsibility for monitoring insolvencies is housed off-site, making communication and coordination more difficult, but no less necessary. The NAIC is doing its part to foster this type of communication. Recently, the NAIC Insolvency Task Force has established three subgroups comprised of representatives of financial regulators, receivers, and guaranty fund representatives to engage in this important discourse. As state regulators, we must foster this communication within our borders. Policyholders can only benefit when regulators have all the information and tools necessary to manage the marketplace and better protect their interests.

tcrowley@dobi.state.nj.us
dhartz@naic.org

Figure 1 to New Perspectives Article



New Perspectives on Insurer Insolvency

Holly Bakke (NJ Commissioner) and Doug Hartz (NAIC Staff Support)

Figure 2 to New Perspectives Article

TOP 25 ESTATES BASED ON LARGEST NET EXPENSE TO THE PROPERTY & CASUALTY ASSOCIATIONS

Source: NCIGF, http://www.ncigf.org/assesshist/ashistory-04.htm at Inception-to-Date by Company *(last visited 11/26/03)* modified to incorporate corrected Recoveries from Estates numbers for several estates domiciled in one state.

NAIC # – Insolvent Company	Year of Receivership	Claims & ALAE Payments [1]	Cash Received from Estates [2]	Net Expense	Percent Recovered
22284 – California Compensation Ins. Co.	2000	565,500,000	18,000,000	547,500,000	3.2%
23493 – Midland Insurance Company	1986	453,400,000	8,200,000	445,200,000	1.8%
24457 – Reliance Insurance Company	2001	719,300,000	288,500,000	430,800,000	40.1%
37753 – Superior National Insurance Co.	2000	316,200,000	18,800,000	297,400,000	5.9%
19569 – American Mutual Liability Ins. Co.	1989	418,700,000	156,100,000	262,600,000	37.3%
33928 – PIE Mutual Insurance Company	1998	384,800,000	153,700,000	231,100,000	39.9%
14230 – Ideal Mutual Insurance Company	1985	367,100,000	137,600,000	229,500,000	37.5%
11584 – Integrity Insurance Company	1987	338,200,000	117,600,000	220,700,000	34.8%
31836 – Champion Insurance Company	1989	224,500,000	11,200,000	213,300,000	5.0%
15253 – Texas Employers Ins. Association	1991	274,600,000	70,100,000	204,500,000	25.5%
25739 – PIC Insurance Group, Inc.	1998	199,300,000	3,600,000	195,700,000	1.8%
19550 – American Mutual Ins. Co. of Boston	1989	227,300,000	43,200,000	184,100,000	19.0%
12955 – Transit Casualty Company	1985	428,000,000	246,700,000	181,400,000	57.6%
12971 – Union Indemnity Ins. Co. of NY	1985	186,200,000	8,800,000	177,400,000	4.7%
23639 – MCA Insurance Company	1992	196,600,000	30,600,000	166,000,000	15.6%
12912 – Credit General Insurance Company	2001	153,900,000	12,700,000	141,200,000	8.3%
29882 – Florida Fire & Casualty Ins. Co.	1979	140,700,000	19,300,000	121,400,000	13.7%
22446 – United National Insurance Co., Ltd.	1993	112,200,000	—	112,200,000	0.0%
12505 – Rockwood Insurance Company	1991	136,500,000	27,000,000	109,500,000	19.8%
23604 – Mission Insurance Company	1987	464,600,000	361,800,000	102,800,000	77.9%
28975 – Consumers Insurance Company	1985	103,300,000	14,500,000	88,800,000	14.0%
20656 – HIH American Comp. & Lia. Ins. Co.	2001	188,400,000	99,900,000	88,600,000	53.0%
15741 – United Community Insurance Co.	1995	81,500,000	17,000,000	64,500,000	20.9%
30660 – Home State Insurance Company	1997	67,600,000	10,300,000	57,300,000	15.2%
30570 – Superior Pacific Casualty Company	2000	58,000,000	1,000,000	57,000,000	1.7%
Total Top 25 Estates Based on Largest Net Expense to SGAs		**6,806,400,000**	**1,876,200,000**	**4,930,500,000**	**27.6%**
Other 460 NCIGF Tracked Estates and Amounts Not Tied to One Insolvency		**6,460,000,000**	**3,146,200,000**	**3,313,500,000**	**48.7%**
Grand Total		**13,266,400,000**	**5,022,400,000**	**8,244,000,000**	**37.9%**

[1] As of December 31, 2002.

[2] As of December 31, 2002 including ALAE where statutorily allowed as well as subrogation and salvage.

Guaranty Associations Need Cash

Edward B. Wallis [1]

Beginning in 2001, property and casualty insurance company liquidations have dramatically risen over past years in number and in size led by Reliance Insurance Company's demise in the fall of 2001. Seventeen companies with more than $8 billion in claim reserves were ordered liquidated with thousands of covered claims being delivered to guaranty associations during 2001. The trend continued in 2002 and during 2003 with 20 insolvencies in 2002 and 10 new insolvencies through the first seven months of 2003. Operating insurers are experiencing dramatically increased guaranty fund assessments; the guaranty associations are receiving many new claims and are facing future cash demands of unprecedented levels as these new insurer insolvencies involve insurance coverages with long tails of continuing claims. Continuing assessments and raising cash from other sources are now urgent topics for many guaranty associations. As a result, guaranty associations are renewing efforts to seek cash in the form of distributions from older insolvent insurer estates based on past guaranty association payments.

Post assessment property and casualty guaranty associations in their modern form began in 1969 when the NAIC adopted a model law and urged states to adopt it. Between 1969, when associations were first formed, and 2000 several hundred insolvencies of property and casualty companies were recorded, and claims were turned over to guaranty associations who paid a total of $10.4 billion dollars in claims and loss adjustment expenses during the same period. Upon payment of claims, guaranty associations become subrogated to the insured's rights against the liquidated insurer, and they consequently file claims in the liquidated insurer's estate in order to share in the dividend distribution from the assets marshaled by the liquidator. To date, guaranty associations have recovered $3.5 billion in distributions from these liquidated insurer estates or from deposits that the insurer made with the state insurance departments to conduct business in the state. Almost $7 billion dollars in past payments remain unpaid from liquidated insurer estates. The amount of remaining assets in these estates is unknown to the guaranty associations but they represent a substantial source of additional cash for present claim payment demands.

To no one's surprise, the current spate of insurer insolvencies has increased assessments as new claim payment obligations are transferred to guaranty associations. Over two hundred thousand new claims have arrived at guaranty associations. Just from the seven largest recently liquidated insurers, new workers compensation claim exposure equals $10.7 billion and new claim loss reserves total $2.9 billion for auto and general liability. Total payouts in 2001 and 2002 reached two billion eight hundred and fifteen million dollars ($2,815,363,285). The largest exposure is now in the workers compensation business written by commercial insurers where almost $11 billion dollars in claims reserves have been found among these seven liquidated commercial insurers. Workers compensation benefits require immediate payments of weekly indemnity benefits and medical bills for treatment of injuries with continuing treatment and disability benefits often extending for several years. Consequently, cash demands upon guaranty funds have been immediate as these claim files are transferred as soon as the liquidation order is entered.

Guaranty Associations' first source of funds for claim payments are assessments upon the premium of insurers writing business in their state. Assessments are made against premium written in the line of business for which cash for claim payments is required. Many state guaranty associations have three assessment accounts, workers compensation coverage, auto insurance coverage and all other covered lines of insurance business. In those associations, workers compensation premium assessments have been the accounts most often assessed to the maximum amount available. Some smaller states have guaranty funds with only one account. However, all assessments are limited by a cap of a percent of premium which each insurer wrote in the previous year. Most commonly, the cap is either 1% or 2% of premium, thus limiting the amount of assessment dollars available to the guaranty association in any single year.

Assessments in several states have reached maximum levels for 2002 and 2003 especially in the workers compensation line. During 2002, nineteen guaranty associations levied assessments on insurers for amounts equal to their maximum assessment capacity in their workers compensation accounts. Almost as many guaranty associations made maximum assessments in 2001 in their workers compensation accounts, based on NCIGF's

[1] Edward B. Wallis is Assistant General Counsel of the National Conference of Insurance Guaranty Funds (NCIGF). Mr. Wallis joined NCIGF following his retirement from The Lafayette Life Insurance Company. Mr. Wallis' experience in the insurance industry includes 18 years as Corporate Counsel and General Counsel for The Lafayette Life Insurance Company; five years as a senior executive officer and chief executive officer of The Lafayette Life Insurance Company.

Guaranty Associations Need Cash

Edward B. Wallis

review of gross assessments reported by guaranty associations. During the same time periods, guaranty associations have been assessing large sums in other accounts for auto and general liability claims.

In 2003, several state guaranty associations are finding that their workers compensation obligations are such that even maximum assessments are not sufficient to meet the immediate cash needs for workers compensation claim payments due from that account. California has been experiencing this problem in workers compensation for the past two years. Alaska is now experiencing the problem because of the Fremont liquidation on top of Reliance, Superior National, Home and Legion. Alaska has been doubly affected by both claims payments and a diminishment in assessment capacity for workers compensation because Fremont Indemnity Company wrote more than one third of the workers compensation insurance in the State of Alaska. Additional guaranty associations are finding that workers compensation payments in 2003 are exceeding their annual assessment capacity in their workers compensation accounts. With the latest addition of companies to liquidation status in 2003, demands on the workers compensation accounts will continue to accelerate in 2004 and beyond.

Collection of assessments in the workers compensation account has also been curtailed because of modern marketplace approach to insuring commercial risks. Today, insureds with sufficient financial strength, assume the first layer of their own risk exposure by purchasing commercial policies with large deductible provisions. This means that the insured agrees to pay the first x amount of dollars of any one claim; typically these deductibles will range from $25,000 up to $250,000 or even higher as to any one loss. Under these "now typical" arrangements, the insurer pays the claim and immediately collects its payment from the insured for all amounts up to the deductible limit. Since there is no insurance risk transfer within the deductible, no premium is collected and thus the total premium for the policy is considerably smaller than it would be if the insurer were covering the entire risk without right of reimbursement. This reduction in premium subsequently results in a smaller amount of premium available for assessment by the guaranty associations. This phenomenon causes a "double shock" effect – higher claim payments coupled with smaller assessment capacity – for guaranty associations as we will explain below.

Large deductible policies, especially for workers compensation insurance, are written so that the insurer promises to pay the claims from the first dollar of the insured's exposure, and the insured promises to immediately reimburse the insurer for all claims paid under the policy by the insurer up to the deductible limit. When the insurer is liquidated, the guaranty association must now pay the claims against the insured including those within the deductible amount because the policy promises to do so. However, the guaranty associations are not getting direct access or immediate payment of the amounts owed by the insured to the insurer because of the guaranty associations' payments. The net result of this arrangement is that guaranty associations are paying more claims and greater amounts on all claims under large deductible policies than the insurer actually agreed to insure. Because of immediate repayment within the deductible amount, the insurer had no insurance risk for this layer of coverage. The insurer had only a credit risk of non payment by the insured. But the guaranty association is now required to pay the whole claim and it is not getting immediate access to the amount of the risk exposure which the insured agreed to assume and immediately repay. At the same time, there are fewer premium dollars against which assessments to pay these claims can be made because no premium charge is levied for the risk within the deductible assumed by the insured employer. This very real situation is creating immense cash problems for many guaranty associations because the guaranty associations must pay claims within the deductible, but they do not get immediate access to reimbursement by the policyholders for these claim payments. This same situation can arise in large deductible commercial general liability policies if the underlying policy is written with first dollar payment promises by the insurer.

Both the number of recent large insurer insolvencies and the nature of the business these insurers wrote in the marketplace have combined to place enormous claim paying obligations on guaranty associations. Although NCIGF does not yet have assessment data for assessments made in 2003 by its members, we know from reports of guaranty association managers that maximum assessments are continuing in many accounts. The guaranty association community has been discussing other sources of funding for immediate cash needs for several months.

The other obvious source of potential cash for guaranty associations lies in their claims pending in older liquidated insurer estates. Conceivably at least, the $7 billion dollars of past claim payments before 2000 have generated recovery of reinsur-

Guaranty Associations Need Cash

Edward B. Wallis

ance monies by the liquidated insurer, and more money may be available for distribution on these claims to guaranty associations. Since the cash needs are becoming acute, guaranty associations are beginning to look to these older estates for more partial distributions on their claims. Guaranty Associations working through the NCIGF are beginning a concentrated effort to locate potential estate assets and urge receivers to examine the possibility of further distributions as soon as possible.

NCIGF publishes financial data on guaranty association payments for and recoveries from liquidated insurers based on information provided by guaranty associations. The latest compiled data through 2001 shows net expenses, or amounts still eligible for dividend recovery in many old insurer estates. Hundreds of liquidated insurers are listed showing the dollar amount of claim and loss adjustment expenses paid by guaranty associations during the life of the liquidation proceedings. After recording recoveries reported to NCIGF, the total amount of net claims which remain eligible for dividends exceeds $7 billion dollars. However, a review of the liquidated insurers reveals several familiar names to the insurance community-familiar because of the size of the companies when liquidated. Names like Integrity, Transit Casualty, Mission, Ideal Mutual, American Mutual, PIC and PIE, Midland, Champion, and Superior National are included in those liquidating estates with more than $50 million in pending claims by guaranty associations. In fact, the combined pending claims of the twenty largest liquidated insurers, without including Reliance, is slightly greater than $4 billion dollars because in several estates more than $200 million dollars in pending claims have been filed by guaranty associations. While we do not have information about the amount of assets which liquidators have marshaled in these estates and have available for distribution, it is easy to speculate that distributions of fifty percent or even 25 percent on these pending claims would dramatically impact guaranty associations' cash needs over the next 18 months to two years. NCIGF and the guaranty associations are now reaching out to liquidators of open estates seeking dividend distributions to ease the cash crunches of property and casualty guaranty associations.

ewallis@ncigf.org

IAIR 2004 Insolvency Workshop

Register Now!

February 5–6, 2004

International Association of Insurance Receivers 2004 Insolvency Workshop

"Contested Receiverships"

The Palms Hotel, South Beach
3025 Collins Avenue
Miami Beach, Florida 33140

Topics include:

- Troubled Company and Regulator Concerns
- Rehabilitations and Development of Plans
- Litigation Strategies and Expert Witnesses
- Valuation Strategies and Opposing Plans
- Issues in Reinsurance Recoverables Post-Receivership
- Data and Records Challenges in Estate Transitions

Speakers include:

- Kevin McCarty, *Florida Director Office of Insurance Regulation*
- Jack Messmore, *Illinois Department of Insurance*
- Susanne Twomey, *California Conservation & Liquidation Office*
- Holly Bakke, *New Jersey Department of Banking & Insurance*
- Joe DiMemmo, *Pennsylvania Insurance Department*
- Belinda Miller, *Florida Office of Insurance Regulation*

A Workshop brochure with a detailed agenda will follow shortly.

For more information, please contact the Event Chair, Paige Waters at *pwaters@sonnenschein.com.*

On-line registration begins November 1 on the IAIR website, *www.iair.org.*

Receivers' Achievement Report

Ellen Fickinger

Under **OSD** supervision, this company is managing the reinsurance run-off of **American Mutual Reinsurance in Rehabilitation.** Total claims paid inception to date for Loss & Loss Adjustment expense total $30,449. Reinsurance payments total $162,087,234 and LOC Drawdown disbursements $9,613,386. **OSD** also continues to supervise the run-off of the business for **Centaur Insurance Company, In Rehabilitation.** Claims paid inception to date total $53,294,714 for Loss & Loss Adjustment Expense, $4,945,493 in Reinsurance payments and $13,876,555 in LOC Drawdown disbursements.

W. Franklin Martin, Jr. (PA) reported that as of June 30, 2003, **The Fidelity Mutual Life Insurance Company (FML) in rehabilitation,** showed a statutory surplus in excess of $100,000,000 after reserving for all policyholder liabilities and paying most creditors. Claims continue to be paid at 100% and policyholders have full access to their cash value. The Rehabilitator is paying out approximately $42.5 million in policyholder dividends in 2003 and requested court authority to pay approximately $30 million in dividends for 2004. The Commonwealth Court approved, on a preliminary basis, the Third Amended Plan for Rehabilitation on August 20, 2003. This means that the Bid Process can proceed, as approved by the Court, to select an investor. Once an investor is selected, final approval by the Court will be necessary. Legg Mason, the investment banker retained by the Rehabilitator, has begun to contact investors and obtain confidentiality agreements.

Evelyn Jenkins (TX) states that **The Millers Insurance Company** reports additional recoveries of $2,919,711 which include Reinsurance of $888,309.79, Agent Balances of $182,666, Subrogation of $24,497 and Premium Tax refunds of $84,731. Other recoveries not reported in the last issue are Securities of $989,456, Premium Collection of $26,978, Other Receivables of $56,971 and a Judgment/ Settlement Collection of $880,718. There has been $1,535,000 collected in Statutory Deposits. Total asset recoveries from inception of the estate are $5,097,627. The **AmCare Health Plans of Texas, Inc.** reports the following recoveries to date: Premiums of $1,875,800, Reinsurance of $350,700, Subrogation of $103,000 and Other Receivables of $316,829 for a total of $2,646,329 in recoveries.

No new **Texas** receiverships are reported for this quarter. A Special Deputy Receiver, Ernest Garza, has been appointed in the **Western Indemnity Insurance Company** estate.

efickinger@osdchi.com

Receivers' Achievement Report

Ellen Fickinger

Ellen Fickinger, Chair

Reporters:
Northeastern Zone: J. David Leslie (MA); W. Franklin Martin, Jr. (PA)
Midwestern Zone: Ellen Fickinger (IL); Brian Shuff (IN)
Southeastern Zone: James Guillot (LA)
Mid-Atlantic Zone: Joe Holloway (NC)
Western Zone: Mark Tharp, CIR (AZ); Evelyn Jenkins (TX)
International: Jane Dishman (England); John Milligan-Whyte (Bermuda)

Our achievement news received from reporters for the second quarter of 2003 is as follows:

RECEIVERS' ACHIEVEMENTS BY STATE

FLORIDA (Mary Schwantes, State Contact Person)

Early Access Distributions

Estate	Early Access Distributions	Early Access Distribution to the Florida Workers Compensation Insur. Guar. Assoc. (FWCIGA)
First Southern Insurance	6,620,000	$2,610,000

Estate	Amount of Reinsurance Recovery
ABCIC	542,152.05
Aries Insurance	1,291,448.01
Armor Insurance	1,266,209.00
FESA-SIF	72,855.55
Fidelity National	27,328.00
First Alliance	2,028.24
First Southern Insurance	126,957.40
Florida Workers' Compensation Fund	21,112.70
FTBA Mutual, Inc.	375,996.60
Insurance Company of Florida	2,708.31
Queensway Casualty	24,357.14
Total	**3,753,153.00**

Discharged Estates

Estate	Date of Discharge
Reliance Insurance Company	4/14/03

ILLINOIS (Mike Rauwolf, State Contact Person)

Distributions: Disbursements to policy/contract creditors, Early Access & other funds paid to Guaranty Funds or Associations

Estate	Loss And Loss Adjustment Expense	Early Access Distribution	Return Premium	Reinsurance Payments
Alliance General Insurance Co.	0	24,248	0	0
American Horizon Insurance Co.	0	0	0	(4,826)
American Mutual Reinsurance Co.	0	0	0	467,875
Associated Physicians Insurance	0	25,000	0	0
Centaur Insurance Company	26	0	0	0
Coronet	271	0	0	0
Delta Casualty Company	2,839	34,899	0	0

Receivers' Achievement Report

Ellen Fickinger

Estate	Loss And Loss Adjustment Expense	Early Access Distribution	Return Premium	Reinsurance Payments
Gallant Insurance Company	3,536	0	0	0
Illinois Healthcare Insurance Co.	0	380,177	0	0
Illinois Insurance Co.	(730)	25,916	0	0
Inland American Insurance Co.	50	69,155	0	0
InterAmerican Insurance Co.	0	100,072	0	0
InterContinental Insurance Co.	0	932	0	0
Merit Casualty Co.	0	80,000	0	0
Millers National Insurance Co.	0	2,494	0	0
Optimum Insurance Co. of Illinois	0	483	0	0
Pine Top Insurance Co.	0	964	0	0
Prestige Casualty Company	0	3,744	0	0
United Capitol Insurance Co.	1,643	11,716	0	0
Valor Insurance Co.	10,395	0	0	0
Western Specialty Insurance Co.	0	277,413	0	0

MARYLAND (James A. Gordon, State Contact Person)

Distributions: Disbursements to policy/contract creditors, Early Access & other funds paid to Guaranty Funds or Associations.

Estate	Amount	
Grangers Mutual Ins. Co.	12,099.92	D.C. Ins. Guar. Assoc.
	19,960.88	GA Insurer's Insolvency Pool
	62,335.60	MD Prop. & Cas. Ins. Guar. Corp.
	3,603.60	TN Ins. Guar. Assoc.
Total	**98,000.00**	

NEW YORK (F.G. Bliss, State Contact Person)

Distributions: Disbursements to Security/Guaranty Funds and other Creditors

Receivership	Security/ Guaranty Funds	Policy/Contract Creditors	Other Creditors	Total
American Consumer	4,082.00	0.00	0.00	4,082.00
American Fidelity Fire	2,411.00	0.00	15.00	2,426.00
Consolidated Mutual	9,638.00	0.00	18,670,962.00	18,680,600.00
Cosmopolitan Mutual	21,648.00	0.00	0.00	21,648.00
First Central Insurance Co.	3,610,673.00	0.00	0.00	3,610,673.00
Horizon	14,606.00	0.00	0.00	14,606.00
Ideal Mutual	2,257,881.00	0.00	22,731.00	2,280,612.00
Long Island Insurance Co.	23,931.00	0.00	0.00	23,931.00
NewYork Merchant Bakers	9,871,530.00	0.00	0.00	9,871,530.00
Northumberland (US Branch)	631,334.00	0.00	14,622,613.00	15,253,947.00
Whiting National	0.00	0.00	10,694.00	10,694.00
Total	**16,447,734.00**	**0.00**	**33,327,015.00**	**49,774,749.00**

PENNSYLVANIA (W. Franklin Martin, Jr., State Contact Person)

Distributions: Disbursements to Guaranty Funds

Estate	Guaranty Funds
PHICO Insurance Co.	16,565,250.00

Meet Our Colleagues

Joe DeVito

Marcella E. Campana

Marcella Campana is a Senior Analyst for Paragon Strategic Solutions, Inc., a subsidiary of Benfield Group, and is currently involved in the execution of State Insurance Department examinations and reviews, assisting statutory liquidators in the processing and collection of reinsurance balances. She is also involved the reinsurance administration of ongoing insurance entities.

In 1998, Marcella began her career in reinsurance as a Reinsurance Analyst Trainee in the Risk Management and Distribution Department at E.W. Blanch, currently known as Benfield Group. At E.W. Blanch, Marcella assisted in the marketing, placement, and servicing of various large reinsurance programs. She has experience in contract writing, review, and analysis and the monitoring and analysis of reinsurance program accounting.

Marcella earned her MBA from the University of Texas at Dallas and holds the professional designation of ARe. In her spare time Marcella enjoys playing soccer for the North Texas Women's Soccer Association.

Fred E. Karlinsky

Fred E. Karlinsky is a partner in the law firm of Colodny, Fass, Talenfeld, Karlinsky & Abate, P.A. Fred received his Bachelors of Science Degree from the University of Miami and his Juris Doctorate Degree from Florida State University College of Law. He is a member of the Florida Bar and admitted to practice law in all state and appellate courts as well as all federal courts in Florida, the Supreme Court of the United States, the United States Tax Court and the United States Court of Federal Claims.

Fred has previously held positions with the Florida House of Representatives, the Florida Department of Community Affairs and the Florida Residential Property & Casualty Joint Underwriting Association.

Fred works closely with senior officials within the Florida Office of Insurance Regulation as well as key industry and legislative leaders. He has a thorough knowledge of the legislative process and has worked extensively with the executive, administrative and regulatory agencies of the State of Florida, as well as the federal government and various state insurance departments. Fred and his firm have worked with the Florida Division of Rehabilitation and Liquidation on numerous matters.

Fred practices in the area of executive, legislative and municipal governmental affairs, administrative law, corporate representation and insurance related matters. He currently serves 60 executive and legislative clients and is general counsel and chief lobbyist for the Florida Property & Casualty Association.

In 2001 and 2003, Fred was one of the chief architects of a substantial revision to the Florida automobile insurance law on behalf of the Florida Property & Casualty Association and its members. In 2002, he was deeply involved in the re-write of Florida's property residual market statue.

Fred has been an IAIR member since 2001.

News from Headquarters

Paula Keyes, AIR

Congratulations to Belinda H. Miller for receiving the CIR-ML designation from IAIR at the June 2003 Board of Directors meeting in Chicago.

2003 Annual Meeting

The IAIR annual meeting will take place from 4:00 pm–5:00 pm on Saturday, December 6 at the Hilton and the Marriott in Anaheim, California. Detailed information on the meeting is listed on *Page 26.* At the annual meeting, five Directors will be elected. The ballots, proxies and candidates' bios will be posted to the IAIR website and will be e-mailed to members before November 1, 2003. We are only mailing these documents to those members for whom we do not have a valid e-mail address. Please complete your ballot and proxy and either fax or mail it to IAIR headquarters or bring it with you to the meeting. It is important that each member vote for the Directors, so please make your vote count!

Meet Our Colleagues

Joe DeVito

Bob Nefsky

Bob Nefsky has practiced law in Lincoln, Nebraska, since his graduation from the University of Nebraska College of Law in 1977. He is a 1973 graduate of the University of Pennsylvania.

A lifelong Lincoln resident whose family first settled there in 1882 and avid Nebraska football fan, Bob decided to return home after college. He is married to Mary Nefsky, has four stepchildren and three step grandchildren. Mary and Bob like to travel but the combination of a heavy work schedule and 9/11 have reduced their travel for the last couple of years.

Bob has been involved in civic and volunteer work throughout his legal career. He co-founded and is president of the Nebraska Cultural Endowment, which is raising $5 million to stabilize the arts and humanities in Nebraska. He was a leader of the group which brought statewide public radio to Nebraska, is past Chair of the Nebraska Humanities Council, and is President-elect of the Nebraska Art Association, which supports the nationally acclaimed American art collection of the University of Nebraska's Sheldon Memorial Art Gallery. He co-founded and served as president of Camperships for Nebagamon, Inc., a charity which raised $1 million to provide private camping experiences for underprivileged children. He is past president of the Jewish Federation of Lincoln and his synagogue.

Bob spends most of his professional time representing rehabilitators and liquidators of insurance companies. His insurance liquidation focus includes surety, property and casualty, reinsurance, claims, tax allocation agreements, and asset recovery actions. His 26-year law practice also includes experience in the corporate, business, and creditors rights areas. He is AV rated by Martindale-Hubbell and is listed in the Best Lawyers in America in corporate law.

J. John Spinella

John Spinella, the principal of Spinella & Associates, Inc. (SAI), is a management consultant within the Property & Casualty industry emphasizing operations effectiveness, strategic planning, financial modeling, reinsurance structures, and due diligence analysis for mergers and acquisitions. He specializes in Casualty lines, especially those with significant volatility such as Professional Liability and non-standard Private Passenger Auto.

John earned his undergraduate degree in Mathematics from State University of New York subsequent to his military service, which included assignment to the US Air Force White House Communications Facility where he flew aboard and worked with Air Force One.

Following an actuarial career with Aetna Life and Casualty and INA/CIGNA (now ACE-USA) where he served as a senior actuarial pricing and reserving officer at the primary and reinsurance companies, John joined a Maryland medical malpractice mutual insurer facing regulatory receivership. Reporting to its Board of Directors, he led a successful turnaround within two years by restructuring and refining administrative and operational functions. As a result, the company achieved sufficient operating profits to overcome regulatory oversight, continuously earned auditor's opinions without qualification, and became the first physician-owned company to earn a rating from A.M. Best. Simultaneously, he served for three years on the Governor-appointed Joint Executive and Legislative Commission for Tort Reforms. Subsequently, he served as President of a specialty startup division of the Great American Insurance Company.

John established Spinella & Associates, Inc. in 1988 and is based in Hunt Valley, Maryland, a suburb north of Baltimore. Clients include insurers, reinsurers and intermediaries, Lloyd's syndicates, captives and Managing General Agents and Underwriters. He has provided expert testimony relating to insurance ratemaking, claims reserving and operations, and served as an arbiter in reinsurance disputes. A recent member of IAIR, he has been a longtime member of the Professional Liability Underwriting Society (PLUS).

John and his wife MaryAnn look forward to weekend retreats in their West Virginia "Cabin at the Woods" enjoying racquet sports. When time allows, John plays golf and makes golf clubs.

jjdevito1@cs.com

Chicago Roundtable Recap

Robert Loiseau, CIR-P&C

Informative as always, Chicago's Roundtable was one of the most entertaining in recent memory. The entertainment value derived largely from the host, **Rick Bingham** of the Illinois' Office of the Special Deputy Receiver (OSD), who not only hosted, but chaired the first presentation "Legion Litigation Insolvency and Cut-Through." High praise is due anyone who can make insolvency litigation both entertaining and informative, but Rick did so with aplomb and was ably assisted by **Stephen Schwab. Teresa Snider** followed them with a presentation about reinsurance cut-through litigation and a trial court ruling certain to be appealed and debated for some time to come.

The subject of the first discussion was Legion Indemnity, an Illinois insurance company which had become the subject of an "aggressive rehabilitation order" under the direction of Pennsylvania regulators and which OSD believed to be insolvent and in need of receivership. Conflicts of insolvency laws (Pennsylvania v. Illinois) was a major theme and gave rise to constitutional law issues including notice to interested parties, and due process. Additionally, the trial court's standard of review, and ultimately whether rehabilitation or liquidation should be the vehicle for unwinding Legion's troubled Illinois subsidiary became fodder for intensive litigation.

This litigation was spawned by the controversy over Illinois' election to liquidate the subsidiary contrasted with Pennsylvania's decision to rehabilitate its parent. Some of the trial court's rulings still cause the participants to scratch their heads. The court found Legion Indemnity to be "insolvent" but not to be operating in a "hazardous financial condition;" even insolvency was hotly contested, with the OSD having to prove that Legion was either cash flow insolvent or balance sheet insolvent. The ultimate finding of insolvency determined whether guaranty associations would be triggered.

Facing legal issues this arcane, the OSD elected to prove cash flow insolvency in order to initiate a conventional receivership, while the company *(represented by Stephen Schwab)* sought consolidation of the Illinois subsidiary's operations with those of the parent. The consolidation argument was bolstered by the fact that the company's operations and management were heavily intertwined and mutually dependent, and that the interests of judicial economy and equal treatment of creditors mitigated in favor of consolidation, especially in light of the fine distinction between the nature of the company's insolvency *(cash flow vs. balance sheet)* on which the OSD had the burden of proof.

After a 4 1/2 month trial which included 18 days of live testimony, many ancillary skirmishes over qualification of experts, discovery and privileged communications, the trial court made numerous rulings from the bench on complex insolvency issues; rulings which never saw the light of day. Instead, only a plain vanilla liquidation order was issued, leaving the litigants wondering about exactly what happened but also leaving Legion Indemity in a stand alone liquidation handled by the OSD instead of one that was consolidated with its parent.

If "state vs. state" litigation, rehabilitation vs. liquidation and consolidation issues weren't enough, one of *(Pennsylvania)* Legion's major reinsurers, represented by Teresa Snider, complicated matters further. Here, contrary to convention, the reinsurer was allowed to intervene in the trial court on the basis that Legion's insureds were seeking cut-through to her client's treaties. The reinsurer argued it might be prejudiced by the court's order since it had its own collateral, reinsurance and contractual obligations that were materially different in an insolvency than in a rehabilitation. In short, the reinsurer faced the possibility of double exposure under its Legion treaties.

As in the Illinois case, hearings on the cut-through issues were argued without the benefit of adequate discovery and were the subject of extensive post trial briefing. Ultimately, Pennsylvania's court found that Legion's insureds were third party beneficiaries of the reinsurance contracts with the intervenor, a ruling which is presently on appeal. The court considered the nature of Legion's business *(it was largely a fronting company)* and the sophistication of insureds, finding they had different "expectations" *vis a vis* reinsurance than did rank and file policyholders. The court ignored the anti-cut-through language of the reinsurance treaty, interpreting the standard insolvency clause to encompass an express agreement between policyholders and the reinsurers allowing cut-throughs. In the end, the court's order permitted any Legion policyholder desiring a cut-through to intervene in the liquidation proceedings and ask for it. Because of the uniqueness of the ruling and uncertainty about the nature of the reinsurers' obligations, Teresa's client and the policyholder entered into

Chicago Roundtable Recap

Robert Loiseau, CIR-P&C

an escrow agreement pending outcome of the appeal, thus allowing the reinsurer to discharge its obligations without the risk of double jeopardy.

The next presentation came from two Texans, **Steve Durish** and **Bob Loiseau,** who explored coordination and information sharing between receivers and guaranty associations and their importance to the process of making early access distributions in multi-state insolvencies. The Employers Casualty Company (ECC) receivership, which has made nine early access distributions totaling nearly $200 million to 43 participating guaranty associations was used to illustrate this topic. In ECC, early access began in the first year of the company's receivership and continued annually thereafter until all IGAs' claims were paid in full. The speakers detailed how the guaranty associations' ability to rapidly assume claims handling responsibilities and then to provide data needed by the receiver benefited immensely from early involvement (pre-receivership) by both parties and coordination of their efforts from the company's takeover forward.

This coordination included identifying and gathering claims and financial information needed for early access and also included joint participation in the distribution of claim files, arrangements for continuation of worker's compensation indemnity payments, shared use of the company's legacy computer system and access to its records archives. Concurrently with putting the Uniform Data Standard (UDS) reporting system in place and developing financial information reporting formats, the language of the early access agreement between the receiver and participating guaranty associations had to be negotiated, approved by the receivership court and executed by all parties. A coordinating committee designated by the NCIGF streamlined this process and facilitated early resolution of conflicts and disagreements inherent in the receiver/IGA relationship.

The guaranty associations' reporting to the receiver of data and financial information needed for early access had a counterpart at the receiver's office which reported to the guaranty association *(and all other creditors)* ECC's financial information, operating status and planned activities. This somewhat atypical disclosure of detailed information about receivership operations allowed the guaranty associations to stay abreast of the estate's activities as well as monitor the timing and payment of early access distributions, including the amount of funds available to be distributed and how those funds were to be apportioned among guaranty associations.

Steve Durish presented statistical information from NCIGF and NAIC sources which showed ECC among the top 10 multistate insolvencies where early access was paid, and one of only two such receiverships which paid early access in the first year of receivership. The importance of early access distributions to the financial health of the guaranty association structure was emphasized. Your reporter then did his best to lull the audience to sleep by presenting the nuts and bolts of the early access process through a fairly detailed look at the spreadsheets, formulas and calculations required to administer an ongoing early access distribution process.

The Roundtable's finale speakers were **Peter Gallanis,** NOLHGA's President, and **Dick Klipstein,** NOLHGA's Chief Operating Officer, who addressed LAH insolvencies in a far-ranging presentation that touched on the differences in administration between LAH and P&C insolvencies, significant challenges faced by NOLHGA's members and industry trends expected to impact future insolvencies.

In general, recent LAH insolvencies have been smaller, regional carriers but, despite close calls, no major life companies have become insolvent. However, the industry's diminished investment returns, downgrades by many rating agencies and massive consolidation pose increased risks that a major carrier could suddenly find itself in trouble.

In LAH receiverships, life insurance policies must typically remain in force so it falls to the life and health IGAs to continue coverage by finding homes for the insolvent company's products and making up the shortfall between the insolvent carriers' assets and the liability exposure faced by the assuming carrier. Principal sources of those funds are early access distributions from receivers and contributions from guaranty associations, which are funded by industry assessments. Both speakers emphasized the importance of assessment capacity to the viability of the LAH guaranty association structure. Assessments have been fairly stable at between $100 to $200 million per year for the past five years, but the assessment capacity from the industry as a whole is a massive $7.5 billion. This assessment capacity is comforting when viewed in light of the aggregate cost of insolvencies to IGAs during the 17 years of NOLHGA's existence has been less than $6 billion, and this period encompasses the major insolvencies of Executive Life, Confederation Life and Mutual Benefit Life.

The speakers also provided an overview of significant changes going on within the

Chicago Roundtable Recap

Robert Loiseau, CIR-P&C

LAH industry. Insurance products have become extremely complicated and the assets backing them are similarly complex. To remain profitable, carriers take on more risks; credit, capital erosion and interest rate sensitivity, and increasingly rely on outside expertise to manage these risks as well as their investment portfolios. Moreover, many of them are becoming parts of financial services holding companies which offer hybrid products that are part insurance and part securities. The speakers cautioned that a major insolvency involving such an entity and its products will pose significant challenges to NOLHGA's members, not in terms of ability to pay covered claims *(capacity)* but in terms of whether these new products fit the legal standards for insurance contracts where policyholders are entitled to guaranty association protection.

In summary, the diversity of topics at this Roundtable provided all members with some exposure to areas outside the fields in which they generally practice, and since the room was still packed at the conclusion of the last presentation, it was a resounding success.

bobl@jackwebb.com

IAIR Anaheim Meetings

Saturday–Sunday, December 6–7, 2003
Anaheim Hilton

Note: Due to space constraints the meetings will take place in two hotels – the Hilton and the Marriott.

Saturday, December 6

8:00 am–Noon	IAIR Board Meeting: *Coronado Room, Hilton* *Open to all IAIR members*
1:00 pm–4:00 pm	IAIR Roundtable: *Los Angeles and La Jolla Rooms, Marriott* *Open to all IAIR members and NAIC attendees*
4:00 pm–5:00 pm	IAIR Annual Meeting: *Newport Beach and Rancho Las Palmas Rooms, Marriott* *Open to IAIR members only*

Sunday, December 7

8:00 am–5:00 pm	IAIR Committee Meetings: Coronado, Hilton *Open to all IAIR members except A&E, which is open to committee members only*
8:00 am–9:00 am	Website Committee: *Chair, Bob Loiseau, CIR*
9:00 am–Noon	A&E Committee: *Chair, George Gutfreund, CIR*
10:00 am–11:00 am	Publications Committee: *Chair, Jerry Capell*
11:00 am–Noon	Marketing Committee: *Chair, Trish Getty, AIR-Reinsurance*
Noon–1:00 pm	Education Committee: *Chair, Steve Durish; Vice Chair, Kristine Bean*
5:30 pm–7:30 pm	NOLHGA & IAIR Joint Reception: Mezzanine #14, Hilton *Open to all NOLHGA and IAIR members and invited guests*

IAIR would like to thank the patron sponsors of the Winter 2003 Meeting

Baker & Daniels, *Indiana, Washington DC, and China*
BIRO Bannister International Research Organisation Ltd., *Kent, England*
Colodny, Fass, Talenfeld, Karlinsky & Abate, P.A., *Ft. Lauderdale, FL*
Cross River International, Inc., *New York, NY*
DeVito Consulting, Inc., *Guttenberg, NJ*
Mound, Cotton, Wollan & Greengrass, *New York, NY*
Office of Daniel Watkins, *Lawrence, KS*
Ormond Insurance & Reinsurance Management Services, Inc., *Ormond Beach, FL*
Quantum Consulting, Inc., *Brooklyn Heights, NY*
Paragon Strategic Solutions Inc., *Minneapolis, MN*
Pluschau Consultants, *Dix Hills, NY*
Randall America, *Alpharetta, GA*
Regulatory Technologies, Inc., *Roswell, GA*
Reinsurance Association of America, *Washington, DC*
Robinson Curley & Clayton, P.C., *Chicago, IL*
Smart & Associates, *New York, NY*
Volpe, Bajalia, Wickes & Rogerson, *Tallahassee and Jacksonville, FL*

And a special thank you to the **National Organization of Life & Health Guaranty Funds** *for co-hosting the Sunday evening cocktail reception*

CIAB Education Foundation Releases New Report on Insurance Industry Solvency

Reprinted with permission from Business Insurance, Press Release 9/10/2003, copyright 2003, Crain

WASHINGTON – A new study by the Foundation for Agency Management Excellence (FAME), the nonprofit education foundation of The Council of Insurance Agents & Brokers, says if state regulators move quickly to shut down insolvent insurance carriers, they can minimize harm to policyholders.

The report, titled "Managing Insurer Insolvency," was prepared by Stewart Economics, Inc., at the request of FAME, a 501c(3) charitable and educational organization that is guided by a volunteer board of directors consisting of insurance agents and brokers and administered by CIAB. FAME promotes leadership and excellence in the agent/broker profession through agency management education and training programs and research exploring issues impacting insurance brokerage firms.

The study said the state system of insurance regulation is preoccupied with saving weak companies rather than minimizing damage to the public by quickly removing troubled companies from the market.

"The declared purpose of insurance regulation is to have a sound industry and to protect policyholders. What has happened recently is an inversion of those regulatory priorities," the report said. "Failed companies are being kept alive, so the industry is less sound."

"The grind of competition by itself will eliminate a large number of property-casualty insurers," the report continued. "Regulators cannot prevent it, nor should they wish to."

Ken A. Crerar, president of The Council, said the study is important because insurance brokers rely on the findings of regulators and rating agencies for information about insurer solvency.

"Improved solvency regulation and ratings are critical to brokers because they do not have access to the sort of detailed financial information about insurance companies that state regulators and rating agencies have," Crerar said.

Postponing recognition of insolvency is "an inefficient way" to protect the public and can have bad side-effects, the report said. If the regulator delays acting, the company's financial cushions will have been used up. Also, regulators are no longer the only group watching the finances of insurers, and they alone may not be able to stop the failure.

The study suggested that a number of insurance carriers will exit the market over the next few years because they are insolvent.

"A lot of exits are coming," predicts the report. "They may not come all at once, but they will come sooner or later. They will not necessarily be by acknowledged insolvency. Some will be called restructuring or merger or strategic repositioning or discontinued operations or outsourcing of claims administration. But by any name, they will be exits in the face of impending failure."

The study authors said the highly competitive insurance market makes the exit of many carriers because of solvency problems "inevitable."

"The usual reason insurers go broke is that they do not charge enough for their product. That is obvious, but fixing it is not easy," the study said. "Charging an adequate price calls for two difficult tasks – forecasting costs accurately and getting a price that will cover those costs. Both tasks are far more difficult than in the past."

"Only a very few companies will be able to achieve the expense reductions that are required," the report said. "For many, it is literally impossible, no matter how good the management is."

Crerar said the solvency study shows the benefit of having an education foundation that can conduct important research.

"It is vital for state regulators and lawmakers to have access to a study like this to assist them in charting a course of action as we head into what may be some difficult times ahead," Crerar said.

REMINDER

A reminder to return ballots and proxies no later than Thursday, December 4 by 5:00 pm because the IAIR Annual Meeting is Saturday, December 6 at 4:00 pm in the Newport Beach and Rancho Las Palmas Rooms of the Marriott Hotel, Anaheim, California. All IAIR members are welcome to attend. Ballots/proxies can be mailed to 174 Grace Blvd., Altamonte Springs, FL 32714 or faxed to 407.682.3175.