THE TROUBLE WITH ELNY

(Or How The Receivership Process Has Failed Executive Life Insurance Company Of New York, Its Policyholders And Annuitants)

By Peter H. Bickford
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In 1991, Executive Life Insurance Company of New York (ELNY), the stressed but solvent subsidiary of its insolvent parent, Executive Life Insurance Company of California, was placed in rehabilitation in New York to protect it from cash surrenders becoming "a run on the bank." Twenty-one years later, the rehabilitator has petitioned the court to declare ELNY insolvent and order it liquidated based on ELNY's liabilities exceeding its assets by more than $1.5 billion. The burden of this deficit will fall largely on individual annuitants, policy owners and the insurance companies that fund the state life insurance guaranty funds. How ELNY got to this position after two decades of receivership charged with the preservation of the company and protection of its policyholders is a cautionary tale of the failure of the receivership process to do either.

On its ELNY web page, the New York Liquidation Bureau sets the blame for the failure of ELNY squarely on the economy:

> The rehabilitation of ELNY has been negatively impacted by sustained periods of adverse economic conditions, including low interest rate environments and unfavorable equity markets. In addition, the stock market collapse of 2008 worsened ELNY's already fragile financial condition. As a result of these adverse economic conditions, ELNY's assets are no longer adequate to continue to support the payment of 100% of the benefits ELNY annuity contract owners and other payees and beneficiaries expect to receive into the future."[1]

However, ELNY was *de facto* insolvent long before the current economic downturn. The economy may have contributed to the pace of expansion and size of the deficit but does not explain or excuse the long, painful story of ELNY's failed receivership.

The Story of ELNY

When ELNY's parent was placed in receivership in California, the New York Insurance Department determined that an "increase in surrenders had caused a material erosion of ELNY's assets to the detriment of policyholders with nonsurrenderable policies,

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primarily structured settlement annuities."[2] As a result, New York's Superintendent of Insurance sought and obtained an order of rehabilitation in April 1991, and was appointed as rehabilitator charged with the management of ELNY. A year later, in March 1992, the rehabilitator submitted and the court approved a plan of rehabilitation for ELNY. Under the 1992 plan, ELNY's traditional whole life, term life and deferred annuity books of business were transferred to Metropolitan Life Insurance Company with substantially all the supporting statutory reserve assets. The book of single premium immediate annuities (SPIAs), primarily issued to meet structured settlement obligations, remained with ELNY together with the remaining assets, mostly of "junk" status. Neither the 1991 rehabilitation order or the 1992 order approving the rehabilitation plan declared ELNY to be insolvent.

For the twenty plus years since the approval of the rehabilitation plan, the rehabilitator has continued to pay all annuitants in full. Now, faced with a $1.5 billion shortfall, the rehabilitator is asking for the first time that the court declare ELNY insolvent, order its liquidation and approve a restructuring plan for the ELNY annuities.[3] A court hearing on the rehabilitator's petition and the restructuring plan is scheduled for March 15th.

Under the proposed restructuring plan, the remaining ELNY assets are to be transferred to a new entity owned and controlled by the participating state life insurance guaranty funds, which will contribute funds to the new entity in amounts based on their individual state fund laws. The ELNY contracts will be restructured to a level that can be supported by these assets, and the obligations as restructured will be assumed by the new entity. Because most of the annuities are relatively small and fall within guaranty fund caps, the rehabilitator has estimated that roughly 84% of all annuitants will continue to receive their full periodic annuity payments. That percentage does not tell the full story, however.

ELNY's assets, based on its December 31, 2010 statements,[4] cover only about 36% of its obligations and the rest will come from the various state life insurance guaranty funds. These guaranty funds, however, have statutory caps. The most common cap is $300,000 although the New York cap is $500,000. As applied by the restructuring plan, the cap is the maximum allocated to each contract, so that the guaranty fund contributes the

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difference between a contract's pro-rata share of ELNY assets and the applicable fund cap.[5] Because of the life guaranty fund limitations, the benefits under any annuity with a present value in excess of the applicable guaranty fund cap will be cut significantly – many of them by a half or more.

The ELNY book of business consists primarily of annuities issued to fund structured settlements where the annuity provides steady income – sometimes the only income -- to an injured or disabled party, and the present value is based on the projected periodic payments over a lifetime. In many cases, therefore, the parties most affected by the cuts in benefits are the ones that can least afford it. There is no general correlation between high present value and economic ability to bear the loss.

The restructuring plan includes a few "enhancements", including a hardship fund supported by certain contributing life insurance companies to address particularly difficult situations. These enhancements may or may not prove to be meaningful, but they will not come close to making many annuitants whole.

Given the current financial condition of ELNY, the Restructuring Plan may be the best option within the existing statutory receivership structure, and there is no question that the rehabilitator could not allow ELNY to continue on the path set by his predecessors a decade or two ago. *The 1992 ELNY rehabilitation Plan, like the Titanic, was doomed the moment it left port, and the current rehabilitator is the one left to deal with the consequences.*

Failure of the Receivership Process

How was it doomed? The original rehabilitation plan stripped out all the traditional life and annuity business and transferred it to Met Life with the supporting, statutory reserve assets. These contract holders received an equivalent policy from Met Life and suffered no material financial consequences. Unlike the typical property/casualty insolvency, where contracts are terminated, assets marshaled, and claims assessed and paid as of a pre-determined cut-off date, transferring policy obligations to another carrier or carriers has been the historic method of addressing financially stressed life insurance companies. The single premium individual annuities (SPIAs) did not fit this mold, however, and *for*

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whatever reason the most volatile, long-tailed book of ELNY business was left in ELNY together with its weakest assets.[6]

The assessment of the portfolio in the 1992 rehabilitation plan was remarkably prescient stating that:

> The cash flows produced by ELNY's bond investments and Common Stock dividends are projected to be sufficient to cover current SPIA payouts for at least ten (10) years.[7]

That is precisely what happened. The cash flow from ELNY's remaining assets was sufficient to meet the SPIA payments for almost ten years as predicted. As shown by the annual reports of the Liquidation Bureau (unaudited for years prior to 2006) obtained over the years through Freedom of Information Law requests,[8] *ELNY's cash flow went negative in 2002, ten years after the Plan of Rehabilitation and six years before the economic downturn of 2008*:

Year	Assets ($Millions)	Liabilities ($Millions)	Surplus/ (Deficit)	Percent of Coverage
1994	$1,648	$1,632	$16	100.0%
1995	$1,657	$1,624	$33	100.0%
1996	$1,678	$1,633	$45	100.0%
1997	$1,794	$1,697	$97	100.0%
1998	$1,857	$1,710	$147	100.0%
1999	$1,926	$1,724	$202	100.0%
2000	$1,770	$1,613	$157	100.0%
2001	$1,646	$1,605	$41	100.0%
2002	$1,465	$1,575	($110)	93.0%
2003	$1,528	$1,643	($115)	93.0%
2004	$1,495	$1,642	($147)	91.0%
2005	$1,429	$1,621	($192)	88.2%
2006	$1,379	***$2,645**	***($1,266)**	52.1%
2007	$1,345	$2,539	($1,194)	53.0%
2008	$1,042	$2,438	($1,396)	42.7%
2009	$984	$2,516	($1,532)	39.1%
2010	$906	$2,474	($1,568)	36.6%

*** Note: $1.02 Billion added to reserves based on a revision to the life and annuity valuation basis as of 12/31/06.**

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To fully understand how ELNY could have been allowed to continue to pay full benefits while insolvent for a decade and with no action taken to address the inevitable, one must consider the receivership process in New York.

Counter intuitively, when a company is placed in rehabilitation in New York the company ceases to be regulated. The superintendent of insurance (now the superintendent of financial services), as rehabilitator, stands in the shoes of the company and is charged with its management. The superintendent delegates this management role to the Liquidation Bureau, a separate entity that acts solely as the superintendent's agent in his non-regulatory role as rehabilitator. The rigorous statutory requirements for filings, reports or certifications imposed on other licensed companies are no longer imposed on estates in rehabilitation; there are no periodic regulatory reviews, examinations or communications; there is no regulatory oversight of the operations, assets or finances; and there is no mechanism for regulatory oversight of financial condition or compliance with the insurance law or regulations.

The Bureau often argues that it is subject to statutory oversight by each receivership court. However, receivership courts in New York are courts of general jurisdiction and not dedicated receivership courts like Federal bankruptcy courts. Also, courts generally only consider matters that are brought before them, and certainly do not consider themselves to be regulators. Even if they were so inclined, however, because there are no statutory requirements for filing any financial or actuarial statements or other periodic reports with the court, they would not have the tools necessary to do so.[9]

That ELNY was insolvent for years and becoming progressively and irreparably beyond recovery was quite evident from a study of the Liquidation Bureau's own albeit limited published records. From the time it was placed into rehabilitation in 1991 until after 2006 no audit of ELNY was required or had been conducted. As shown on the chart above, the 2006 audit resulted in a 63% increase in reserves and a 650% increase in the stated deficit. This reserve adjustment was not a sudden awakening, however. Even before the audit the Liquidation Bureau acknowledged that the reserve standard used in the annual statements "substantially understates reserves when compared to reserves that would be required to satisfy regulatory requirements for a going concern insurance

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carrier."[10] Given that ELNY was not insolvent at the time it was placed into rehabilitation, the question remains why proper accounting and reserve levels were not required or maintained.

Lack of Accountability

Without any regulatory interference, and with little if any incentive to take remedial action so long as the cash flow permitted continuing payment on all annuities, the ELNY estate was allowed to move slowly toward the inevitable day of reckoning recognized by the 1992 rehabilitation plan. When economic circumstances worsened, and the reserve deficiencies became too significant to ignore, the pace quickened to the point where the inevitable could no longer be postponed.

If ELNY had not been in rehabilitation, and had been required to continue to file statutory financial statements, including annual independent accounting and actuarial certifications, it is highly unlikely that the regulators would have allowed it to get to the point where the estate is today. It is also inconceivable that the company's management and its agents would be allowed to propose and carry out a plan to correct its financial woes once it was materially impaired. If its dire condition had for some reason eluded the regulators, the company's officers and directors, its independent auditors, actuaries and other agents, could all potentially -- and probably would -- have been held accountable for their actions or inactions contributing to its failure.

With ELNY in rehabilitation, however, the parties charged with the management of the company for the past two decades are the proponents and overseers of the restructuring plan. And they are seeking court immunity for doing so! The proposed order being sought by the superintendent includes the following provision:

> "Judicial immunity is extended to the Superintendent in his capacity as Receiver and his successors in office, the New York Liquidation Bureau, and their respective attorneys, agents, and employees, and such immunity is extended to them for any cause of action of any nature against them, individually or jointly, for any action or omission by any one or more of them when active in good faith, in accordance with this order, *or in the performance of their duties pursuant to Insurance law Article 74*; . . ."[11]

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There is no statutory immunity for the superintendent or his agents in his separate, non-regulatory role as receiver, and if any of us had inherited the ELNY estate in its current situation we would certainly want the same protection being sought by the rehabilitator. However, aside from being exceptionally broad – going well beyond immunity for the liquidation and restructuring plan – the perceived need for this protection further underscores the lack of accountability under the current receivership process in New York.

A Word About The Upside Down Guaranty Fund Coverage

With ELNY's assets covering only about one-third of its liabilities, the participation of the various state life insurance guaranty funds is crucial to the success of the restructuring plan. The funds are designed to be a safety net for claims against insolvent life insurers, but the level of coverage is capped to limit the financial strain on the solvent companies that provide the funding. The basic principle is that claims of the "little guy" are to be covered to the fullest extent possible, and if large claimants are left only partially covered because of the caps, at least they are better able to absorb the financial loss of limited coverage. Unfortunately, as shown earlier in this article, the opposite is the case with many ELNY annuitants. They are not the big fish that can fend for themselves, and they are not the ones in the best position to absorb financial loss or pursue other remedies.[12] *The irony of the guaranty fund coverage for ELNY's remaining book of annuity business is that it protects the investor annuitant over the annuitants with the greatest need. In other words, the logic behind guaranty fund caps is upside down in the ELNY scenario.*

The Liquidation Bureau has suggested that the beneficiaries whose benefits are being cut significantly may have recourse against the owners of the policies or others that may still be liable under the original settlements. But even if true, why should the annuitants be the ones to have the burden of pursuing litigation or other means to recover their loses for a second time? And why is there no recourse against the parties that caused the insolvency?

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Conclusion

The proposed restructuring plan to be considered by the court on March 15th may or may not be the best plan available to maximize benefits to annuitants, and to stem the precipitous deterioration of ELNY's assets under its current circumstances. The court's focus will and should be on determining whether the plan is in the best interests of ELNY's policyholders and annuitants considering the condition of ELNY today.

However, the ELNY story should not end with its liquidation, whether through implementation of the proposed restructuring plan or some other plan. Regulators, legislators, guaranty funds, and interested industry and consumer groups should thoroughly examine how ELNY got to this point – from its ill-conceived rehabilitation plan in 1992 to the steady, predictable but unchecked erosion of assets leading to ELNY's current condition.

The current receivership system's lack of accountability failed to protect ELNY's most vulnerable claimants. That cannot be allowed to happen again!

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ENDNOTES

[1] www.elny.org

[2] ELNY Plan of Rehabilitation, March 22, 1992, page 3.

[3] Copies of the superintendent's petition for liquidation and the "Agreement of Restructuring in Connection with the Liquidation of Executive Life Insurance Company of New York," and other documents relating to the superintendent's petition and the plan can be found on the ELNY page of the Liquidation Bureau's website, at www.elny.org.

[4] According to the superintendent's petition for liquidation filed with the rehabilitation court on August 31, 2011, as of December 31, 2010, ELNY had $905,945,201 in admitted assets, and $2,474,317,343 in liabilities, for a deficit of $1,568,372,142.

[5] For example, if a New York annuity has a value of $1 million, the restructured value under the plan is $500,000 with ELNY's assets covering about $170,000 and the guaranty fund covering the balance. Under this interpretation, where the life insurance guaranty funds net out their subrogation rights against the estate, no fund has to pay its full cap amount to any ELNY annuitant. The author gives no opinion on whether this is a correct application of the life insurance guaranty fund statutes.

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[6] It is also interesting to note that, in addition to receiving all the traditional business and related assets, the ELNY estate has paid a fee to Met Life since inception of the 1992 rehabilitation plan to administer the payment of benefits under the SPIAs.

[7] ELNY Plan of Rehabilitation, March 22, 1992, page 12.

[8] The FOIL requests were not made to the Liquidation Bureau, which has successfully argued in court that it is not a State agency and therefore not subject to FOIL (see *Danello v. DiNapoli*, NY Court of Appeals, 9 NY3rd 97, decided October 17, 2007). The FOIL requests were made instead to the superintendent of insurance as the recipient of the reports, not in his role as rehabilitator.

[9] For a full analysis of the receivership process in New York, see my 2009 article, "The Insurance Insolvency Process in New York," which can be found on the Publications page of my website at http://www.pbnylaw.com/publications.html. This article was also published in two installments in the May 18 and June 1, 2009 issues of **Insurance Advocate** magazine.

[10] The full note from the 2005 Annual Report of the Liquidation Bureau for ELNY, which was typical for the periods prior to the 2006 audit, reads in its entirety as follows: "The Balance Sheet was prepared for the internal use of the New York Liquidation Bureau. Specifically, the Balance Sheet reflects the use of historic reserve standards solely for the purpose of comparison to prior periods. The use of historic reserve standards substantially understates reserves when compared to reserves that would be required to satisfy regulatory requirements for a going concern insurance carrier. As a consequence, the use or interpretation of these financial statements by anyone other than the New York Liquidation Bureau would be materially misleading."

[11] Proposed Order of Liquidation and Approval of the ELNY Restructuring Agreement, attached as Exhibit E to the superintendent's verified petition dated August 31, 2011, Paragraph 12.

[12] Many of these claims have been sold by SPIA beneficiaries to factoring companies, which raises a whole other set of issues that are not covered by this article.

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