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A Quiet Tyrant: The Insurers Rehabilitation And Liquidation Model Act

By

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At its December, 1994 Annual Winter Meeting in New Orleans, the National Association of Insurance Commissioners ("NAIC") adopted a completely rewritten Insurers Rehabilitation and Liquidation Model Act ("IRLMA").¹

Despite the complexity of the issues covered by IRLMA, the length of the product (it consumes over 50 printed pages in the NAIC Model Acts volumes), and the billions of dollars in assets IRLMA potentially governs, the approval was accomplished in a quiet fashion — at least by NAIC standards — with limited industry interest or involvement. This approval is not so remarkable, however, when you consider that IRLMA was drafted, critiqued and rewritten by the very people it governs: the receivers and liquidators themselves. In fact, nowhere else in the world of U.S. insurance regulation do the regulated draft their own rules of conduct, and they have done so here without any separate, independent regulatory oversight. This unique situation — where the regulated and the regulator are one and the same entity — should require even closer consumer and industry scrutiny than most Model Acts, but just the opposite seems to have been the case with IRLMA.

COMMENTARY

Whatever the reason, most consumer and industry groups provided little or no substantive input to the proposed drafts of IRLMA, leaving the primary task of protecting insureds and the industry to the guaranty funds. While the interest of the guaranty funds is understandable, and their efforts to improve the proposed Model Act substantial, their perspective was limited, and they were in no position to challenge the basic underpinnings of the Model Act. Accordingly, the rules of conduct adopted by the receivers and liquidators are substantially what they determined to be appropriate. The result is a document which appears designed more to protect the interests of the receivers and liquidators than the interests of the public, claimants or the industry. With the increased incidents of the failure of reinsurers as well as primary carriers, the industry should have as much of an interest in the Model Act's defects as anyone.

Nothing underscores this distorted focus of IRLMA more than the glaring absence of any requirement to provide meaningful public information or basic due process protections for claimants.

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The Availability Of Financial Information

Many estates in liquidation or rehabilitation involve hundreds of millions of dollars of assets. Receivers/liquidators of these estates actively engage in all of the functions of the conduct of the business of insurance except for underwriting new or renewal business.² Notwithstanding the activities conducted by receivers/liquidators and the amount of assets under their control, IRLMA is totally devoid of any requirement for the filing of financial statements with any regulatory authority. In fact, there is no requirement for financial statements at all. The only requirement is that the receiver/liquidator file a list of assets with the Court under Section 28.A. which reads as follows:

A. As soon as practical after the liquidation order but not later than 120 days thereafter, the liquidator shall prepare in duplicate a list of the insurer's assets. The list shall be amended or supplemented from time to time as the liquidator may determine. (emphasis added)

That's it! There is no requirement to provide financial reports to regulators; no requirement to provide financial information to creditors; and no requirement to even provide regular financial reports to the supervising court. Quite simply, policyholders, creditors, reinsurers or other parties interested in a company in rehabilitation or liquidation have no access to any information about that company, except to the extent the receiver/liquidator decides to make information available at his or her sole discretion.³ That is an inexcusable situation which the NAIC should not have condoned.

Receivers and liquidators generally oppose issuing financial statements on several grounds. Among their arguments are that the courts have authority over estates and can require disclosure of information as they deem necessary; the cost of preparing regular financial statements would be burdensome on the estate; or such statements would provide little benefit to policyholders or creditors because of their "limited" scope. Not only are these positions erroneous, they also miss the point.

Courts are not insurance regulators. Without the establishment of specialized courts like the Federal Bankruptcy Court to handle liquidations and rehabilitations of insurers, the courts are simply not equipped nor are they in a position to supervise the conduct of receivers or liquidators. They decide particular matters presented to them, usually by the receiver or liquidator, and do not have the time or the wherewithal to independently assert any kind of effective regulatory control over the process. That is not their role.

Cost is also a non-issue. Good financial information is an absolute necessity to any responsible, competent manager. Receivers/liquidators manage insurance entities. Therefore, it is essential in their role as managers to ensure that they have the financial information available to them which would be included in any statutory or GAAP financial statement. If they are not doing so, then IRLMA should force them to. If they are doing so as good managers, the cost of filing those statements would be minimal.

Finally, the argument that the availability of such information is of little or no value to policyholders, creditors or other interested parties, is patronizing at best. As is well known from long experience in the securities and insurance regulatory fields, the best tool to prevent abuse or

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fraud is the availability of good information. The failure to require the filing of financial statements by receivers/liquidators benefits only those receivers/liquidators with something to hide. It is highly unlikely that any insurance regulator would accept the argument by management of an insurance company that it should not have to file regular statutory financial statements because it is inconvenient or costly to do so. Why should it be any different for receivers/liquidators?

In addition to a requirement for filing regular statutory financial statements which should be publicly available, estates in liquidation or rehabilitation should also be required to submit to annual financial audits, which audited financial statements should also be made publicly available. IRLMA contains a provision for audited statements which reads in its entirety as follows:

Section 53. External Audit of the Receiver's Books

The [insert proper court] Court may, as it deems desirable, cause audits to be made of the books of the commissioner relating to any receivership established under this Act, and a report of each audit shall be filed with the commissioner and with the court. The books, records and other documents of the receivership shall be made available to the auditor at any time without notice. The expense of each audit shall be considered a cost of administration of the receivership.

As can be seen, however, such audits are discretionary with the court, and are not an annual or periodic requirement. The reasons for requiring each estate to file annual audited statements are the same reasons why any licensed insurance company is currently required to file such statements — to insure the financial integrity of the estates' management. There is no compelling reason why managing estates in liquidation or rehabilitation should be considered any less the business of insurance, or for there to be any less concern for the protection of the policyholders and creditors of such companies. In fact there is an additional compelling reason to require such audited statements of estates in liquidation or rehabilitation, namely: there is no regulatory oversight of estates in liquidation or rehabilitation, while there is extensive regulatory oversight of other licensed insurers.

Requiring receivers/liquidators to make financial statements available, and to file regular audited statements, will go a long way toward eliminating many of the suspicions of waste and mismanagement in the liquidation and rehabilitation process. These requirements should be welcomed by the professional receivers/liquidators, should enhance the stature of those who do their jobs well, and should lead to greater cooperation among all parties interested in an orderly, timely and effective resolution of estates. Full disclosure is a positive — not a negative — for receivers/liquidators.

Due Process For Claimants

A very interesting phenomenon has occurred in the evolution of the liquidation and rehabilitation process over the years: receivers/liquidators have essentially become the sole determiners of valid claims. As a result, claimants (including other insurers) have effectively been deprived of all normal rights of due process under an Orwellian "we-know-what's-best-for-you" banner. This process is further perpetuated by IRLMA,⁴ where a claimant disputing the receiver/liquidator's rejection of a claim has very limited procedural recourse. The claimant is entitled to a hearing by

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the court or court-appointed referee "in an informal manner," without the need to follow formal rules of evidence and civil procedure, without a jury, and with limited pre-hearing discovery.⁵ It is a process that is anti-industry as well as anti-consumer, yet has been quietly accepted by both without much question.

What is the justification for depriving a claimant against an insolvent estate — whether a policyholder, cedent or other creditor — the right to pursue the determination of the validity of the claims with the same due process protections as a claimant against a solvent insurance company? The most often cited reason is the cost to the estate of litigation, arbitration or other traditional dispute resolution mechanisms. This is a two-edged sword, however. As a practical matter, people are not going to expend funds to pursue frivolous claims against insolvent companies. And why is cost any less a compelling argument for limiting the rights of claimants against solvent companies?

As many insurers have learned, the limitations on due process have the greatest impact on claims that are already in litigation or subject to other proceedings at the time insolvency occurs, and on claims involving multiple parties or different layers of insurance and reinsurance. There are many situations where months or even years of expensive proceedings have been thrown out the window by the receiver/liquidator to force a different procedure *ab initio* because the claimant or other parties could not compel the completion of the proceeding already commenced.⁶ That is a true waste of assets: not only of insolvent estates, but also of claimants and other insurers and reinsurers.

Recommendations

The NAIC should reopen consideration of IRLMA and establish a panel of consumer and insolvency experts, none of whom are actively engaged in the liquidation or rehabilitation business, to review the Model Act with regard to protecting the interest of insurance consumers, policyholders, creditors, reinsurers and other interested parties, and to provide proper regulatory oversight for this aspect of the business of insurance. This review should consider the purpose and role of the liquidation process, and reconfirm that the protection of the interests of all creditors remains a principal obligation of receivers/liquidators.

In such a review, this panel should closely examine the provisions of the Model Act with regard to availability of information, the need for greater policyholder or creditor participation in the formal process (yes, the dreaded creditors committee!), and the protection of the due process rights of claimants and other parties interested in such estates. While the NAIC may balk at reopening a Model Act so soon after its revision and adoption, its current self-analysis of its role and purpose should be used as an opportunity to re-examine the entire purpose and function of the liquidation and rehabilitation process, and to give due consideration to the opening up of that process to greater scrutiny for the protection of the public in general and creditors in particular.

Well-managed estates, like well-managed licensed companies, will not object to reasonable scrutiny, and since greater availability of information and greater protection for creditors can improve the quality of management and remove prejudices and suspicions, everyone benefits.

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ENDNOTES

1. See Model Laws, Regulations and Guidelines, Volume III, 1995 Revision, published by The National Association of Insurance Commissioners, Publication Department, Kansas City, MO.
2. Fabe v. U.S. Dept. of Treasury, 939 F.2d 341 cert. granted 112 S.Ct. 1934, 118 L.Ed.2d 541 affd. in part, rev. in part 113 S.Ct. 2202, 124 L.Ed.2d 449, on remand 9 F.3d 1548.
3. In fact, IRLMA specifically provides in Section 21.D., that the records of a "delinquent insurer" are not subject to a state's public records act.
4. Section 43. Disputed Claims, is set forth herein in full, including the drafting note:

Section 43. Disputed Claims

A. When a claim is denied in whole or in part by the liquidator, written notice of the determination shall be given to the claimant or the claimant's attorney by first class mail at the address shown in the proof of claim. Within thirty (30) days from the mailing of the notice, the claimant may file objections with the liquidator. Any filed objections shall clearly set out all facts and the legal basis, if any, for the objections and the reasons why the claim should be allowed. If no such filing is made, the determination is final.

B. Whenever objections are filed with the liquidator and the liquidator does not alter the determination of the claim as a result of the objections, the liquidator shall ask the court for a hearing as soon as practicable and give notice of the hearing by first class mail to the claimant or the claimant's attorney and to any other persons directly affected, not less than ten (10) nor more than thirty (30) days before the date of the hearing. The matter may be heard by the court or by a court-appointed referee. The hearing shall be conducted on the record in an informal manner and the formal rules of evidence and civil procedure need not be strictly applied. Hearings shall be held without a jury. Prehearing discovery shall be limited to such pretrial discovery as expressly permitted in arbitration proceedings under [cite to state's uniform arbitration act].

C. When a disputed claim is heard by a referee, the referee shall submit written findings of fact and conclusions of law along with the recommendations for deposition to the court. The referee's recommendation shall become the final judgment of the court, unless objections to the referee's recommendation are filed by the liquidator or claimant with the court within fifteen (15) days after the recommendation is mailed to the liquidator and claimant.

D. The final disposition by the court of a disputed claim whether after a hearing by the court or after a recommendation by a referee, shall be deemed a final judgment for purposes of appeal.

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E. The court of this state may make special rules of civil procedure for disputed claims, provided that the rules are not inconsistent with this Act.

Drafting Note: This procedure is not intended to govern determinations of disputed claims conducted by guaranty associations as part of their statutory claims handling obligations.

5. IRLMA Section 43, supra.

6. See IRLMA Section 5, Injunctions and Orders, for the scope of restrictions on the prosecution of proceedings involving an insolvent insurer. ■

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