New York Law Journal
MONDAY, AUGUST 25, 2003

Corporate Restructuring And Bankruptcy

ALM

Insurance Company Liquidation Matter of State Law

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THE U.S. Bankruptcy Code, 11 U.S.C. §§101 et seq., which provides a single and uniform body of law at the federal level regarding insolvency, is generally available to all entities domiciled in or having property in the United States. Insurance companies are an exception, however. Indeed, §109(b) of the Bankruptcy Code expressly excludes domestic and foreign insurance companies from the definition of debtors that may avail themselves of the rights and protections afforded by the Bankruptcy Code. As a result of the lack of federal regulation, separate and oftentimes disparate legislation govern at the state level with respect to the rehabilitation or liquidation of insurance companies.

This article discusses some on-going issues and developments with respect to the rehabilitation or liquidation of insurance companies. First, it provides an overview of the various statutory schemes proposed and enacted with respect to the rehabilitation or liquidation of insurance companies. These statutory schemes are intended to maximize interstate cooperation and foster the efficient resolution of claims against an insurance company that is the subject of a rehabilitation or liquidation proceeding.

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The article then analyzes some of the differences among the various statutory schemes adopted, including the frameworks for priority of distribution and the approaches with respect to the right of setoff, in order to highlight some of the disparities among the existing state statutes. The article also discusses the use of claims estimation by the liquidator/receiver of an insurance company as a tool for expediting the rehabilitation or liquidation process. Finally, the article concludes with a discussion of new legislation enacted by Rhode Island providing for the winding up of a solvent insurance company.

Statutory Schemes

In an effort to bring some cohesion to the various state regulations, there have been attempts to achieve consistency among the various states' insurance insolvency legislation. The applicable legislation for nearly every state is based on one or both of two uniform laws: (1) The Uniform Insurers Liquidation Act (the Uniform Act), which was promulgated in 1939 by the National Conference of Commissioners on Uniform State Laws; and (2) the Insurers Rehabilitation and Liquidation Model Act (the Model Act), the most recent version of which was promulgated by the National Association of Insurance Commissioners in 1977. The Uniform Act was intended to remedy the problems associated with the liquidation of insurance companies having assets and liabilities in more than one state. The Model Act, however, is a more comprehensive statutory scheme, containing provisions detailing procedures for a rehabilitation or liquidation as well as provisions relating to interstate relations.

In the late 1990s, three states — Illinois, Michigan and Nebraska — formed the Interstate Insurance Receivership Commission and created an interstate compact, which is a formal agreement between two or more states that binds them to the compact's provisions as if to a contract. Under Article 1, Section 10 of the U.S. Constitution, states may form compacts with the consent of Congress to resolve conflicts or address common problems. The purpose of the Illinois-Michigan-Nebraska Interstate Compact was to form a more comprehensive legislative scheme that promoted quicker and more efficient administration of insurance receiverships. The Interstate Compact was meant to be compatible with both the Uniform Act and Model Act. Although every state is eligible to join the Interstate Compact, Wisconsin has thus far been the only additional state to do so.

The statutory provisions pertaining to the rehabilitation or liquidation of insurance companies in the 50 states are summarized in Table 1 on page 14. In addition, Table 1 indicates whether the Uniform Act or Model Act served as a basis for the state legislation. Table 1 also provides the statutory citations for the Interstate Compact adopted by Illinois, Michigan, Nebraska and Wisconsin. Finally, Table 1 includes reference to provisions for other legislation relating to the rehabilitation or liquidation of an insurance company.

Examples of Differences

Despite the adoption of the Uniform

Act and the Model Act by the majority of states, there are differences among the various statutes as enacted by particular states. The differences may result in different outcomes with respect to a rehabilitation or liquidation of an insurance company. For example, both the Uniform Act and the Model Act have provisions that establish how claims will be prioritized and assets will be distributed.

The priority of claims provisions in the Uniform Act are very general and are meant only to ensure that out-of-state claimants get the same treatment as in-state claimants. Unif. Insurers Liquidation Act §§6 to 8. On the other hand, the Model Act specifically describes the priority of claims among eight classes of creditors. Insurers Rehabilitation and Liquidation Model Act §42. The result is that states that have adopted only the provisions of the Uniform Act will necessarily have developed their own system for priority of distribution. Even states that have adopted the Model Act may have enacted a distribution scheme different from that embodied in the model statute.

Another example of the inconsistencies among the legislation adopted by the various states regarding the rehabilitation and liquidation of insurance companies can be found in the setoff provisions. The right of setoff permits a creditor — for example, a reinsurance company — to reduce the amount owed to the insolvent insurance company by the amount owed by the insolvent insurance company to the creditor (e.g., for unpaid premiums). Two model setoff provisions are currently used throughout the states. One is a provision in the Model Act promulgated by the National Association of Insurance Commissioners and the other is a model provision drafted by the National Conference of Insurance Legislatures (NCOIL).

The setoff provision contained in the 1977 version of the Model Act contained only four restrictions. Setoffs are not allowed in that provision in cases where: there was assignment with a view to setoff; the obligation of the insurer to the creditor would not at the date of the filing of a petition for liquidation entitle the creditor to share as a claimant in the assets of the insurer; the obligation is in the nature of a capital contribution; or the obligation of the creditor is to pay premiums, whether earned or unearned, to the insurer.

The 1977 Model Act's provision is the most liberal of the setoff provisions in that it allows creditors broad, multiple contract setoff rights. Approximately 36 states have based their setoff provisions on the provision contained in the 1977 Model Act. The setoff provision contained in the 1977 Model Act, however, was amended in 1990.

The amended Model Act setoff provision includes six restrictions on the right to setoff and specifically prohibits certain reinsurance setoffs. The 1990 Model Act does not contain the restriction regarding earned or unearned premiums, and adds restrictions that deny a setoff if the obligation is owed not to the principal, but to an affiliate or subsidiary; or if the obligations between the creditor and the insurer arise from business which is both ceded to and assumed from the insurer, except that the rehabilitator, if he or she finds it appropriate, may allow certain setoffs in rehabilitation.

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New Jersey is the only state to have adopted this newer provision, and only for its life and health insurance receiverships. New Jersey retained the older version for its property and casualty insurance laws. NCOIL adopted model language that strikes a balance between the setoff provisions of the 1977 Model Act and those contained in the 1990 Model Act. The NCOIL model language has been adopted by approximately 13 states.

The differences among the setoff provisions applied in a particular insurance insolvency proceeding can result in materially different outcomes in the context of the allocation of assets of a receivership. For example, the Reinsurance Association of America has noted that reinsurers, in particular, are affected by the disparate enactment and application of provisions relating to the right of setoff. Because reinsurance proceeds are often the largest source of potential recovery to an insurance company, the reinsurer may have the most to lose or gain in terms of the availability of the right of setoff.

Claims Estimation

The liquidation of an insurance company may take decades given the nature of the insurance business. In addition to having to account for known and fixed claims, the liquidator of an insurance company must also be prepared to pay out against "long-tail" claims — potential future claims that may arise under asbestos, environmental or other insurance policies. To account for these claims, the runoff period would traditionally last until such claims matured and became fixed.

To accelerate the runoff process, three states — Illinois, Missouri and Utah — passed legislation in the 1990s permitting the liquidators to estimate the value of contingent claims. By estimating the amount of the contingent claims, the liquidator can trigger the payment of obligations by the reinsurer, thereby permitting the estate to be closed in a shorter time period with reduced administrative costs. Despite its potential advantages, claims estimation can be fraught with difficulties. Reinsurers have opposed estimation out of concern that actuarial projections are inherently uncertain, that estimation procedures supervised by state liquidation courts may favor the liquidator and sanction inflated estimates, and that hostility to or uncertainty regarding discounting may deprive them of time value of money — a principal factor in their decision to accept long-tail business in the first place.

Rhode Island

Traditionally, run-off procedures have been more flexible in English law jurisdictions, which have developed the so-called "scheme of arrangement" as an alternative to the traditional liquidation. While schemes of arrangement can provide for liabilities to be run off in the ordinary course, they have increasingly provided mechanisms for estimating liabilities and cutting off the run-off process. Scheme administrators in England and Bermuda have applied these procedures to both insolvent and solvent run-off companies.

In 2002, Rhode Island became the first U.S. jurisdiction to authorize solvent schemes of arrangement for insurance companies. A solvent scheme of arrangement, known in Rhode Island as a commutation plan, allows a solvent insurance company in runoff to implement a plan for the payment of present and future claims to all of its creditors. After the payments are made, the insurance company will be dissolved.

The commutation plan achieves finality and certainty by extinguishing the outstanding liabilities of an insurance company in runoff in a much shorter time period than a standard long-term runoff. The time frame for the completion of a simple scheme is estimated to take 12 to 18 months. A commercial runoff insurer may take advantage of the legislation if it is "domiciled in Rhode Island, has liabilities under policies for property and casualty lines of business, has ceased underwriting new business, and is only renewing ongoing business to the extent required by law or by contract." R.I. Gen. Laws §27-14.5-1(21)(i) to (iv); 14.5-4(a). An insurance company domiciled outside of Rhode Island may take advantage of the law by following procedures for redomestication.

The implementation of a commutation plan is supervised by the Rhode Island Superior Court and is subject to the rules and approval of the Rhode Island Department of Business Regulation. Although not specifically addressed by the legislation, the commutation plan presupposes that the insurance company has reached an agreement with its reinsurers that would provide for the availability of reinsurance payments necessary to help fulfill the obligations of the commutation plan. The reinsurers have an incentive to agree to the commutation plan because, if it is successful, then they will benefit from the efficient runoff of the solvent insurance company.

The mechanics and implementation of voting with respect to the commutation plan are similar to voting under chapter 11 of the Bankruptcy Code. All creditors are given notice of and a right to vote on the commutation plan. The plan must be approved by 50 percent in number of creditors comprising each class of creditors and by 75 percent of the claims, in dollar amount, in each class.

Upon approval, the court will order the implementation of the commutation plan as long as it would not be materially adverse to any of the creditors. The plan becomes binding on all creditors regardless of whether a particular creditor voted to approve the plan or not. The order of the court will also enjoin all litigation by creditors against the insurance company. After payments have been made, the court will order the dissolution of the insurance company and the remaining assets will be distributed to the shareholders.

The Rhode Island statute offers an opportunity for all creditors, including in-state and out-of-state creditors, to recover on their claims against the solvent insurance company. An untested problem, however, is whether the Rhode Island Superior Court has jurisdiction to bind the out-of-state creditor to the commutation plan and enjoin it from pursuing a claim against the insurance company in another state (assuming there would otherwise be jurisdiction in that state).

The Rhode Island statute for Restructuring of Solvent Insurers provides for the same jurisdiction as that granted under the Rhode Island Insurers' Rehabilitation and Liquidation Act. R.I. Gen. Laws §27-14.5-2; 14.3-4. Under this law, like the insurance insolvency laws across the 50 states, when the Rhode Island Department of Insurance commences a rehabilitation or liquidation proceeding against an insolvent insurance company, the Rhode Island Superior Court will (1) appoint a rehabilitator or liquidator who will take possession of the business and its assets; and (2) order an injunction enjoining any action against the insolvent insurer or its rehabilitator/liquidator.

Out-of-State Creditors

However, the Rhode Island court's injunction has no effect beyond the boundaries of that state. Since there will be few insurance companies that have most of their policyholders in Rhode Island, the question arises as to how the Rhode Island scheme proposes to bind out-of-state creditors. Specifically, what if the Rhode Island Superior Court does not have personal jurisdiction over an out-of-state creditor and that creditor chooses not to participate in the commutation plan? Will sister states give effect to the Rhode Island court's injunction restraining proceedings against the debtor outside of the commutation plan? Will they give effect to the final order approving the plan itself?

It is difficult to answer these questions definitively. With respect to the injunction against suits, there should be a strong argument in favor of other states supporting the Rhode Island injunction as a matter of comity. That is the long-established doctrine that encourages courts to respect the proceedings of a coordinate jurisdiction. It would be necessary for the Rhode Island regulator, or potentially the supporters of the plan, to go to the non-participating creditor's home state and obtain an ancillary injunction against suits in that state. But this likely could be done.

In contrast, the final order approving the commutation plan poses a more difficult issue. By definition, Rhode Island never had jurisdiction to adjudicate the rights of the out-of-state creditor. Comity is inapplicable, and state courts have no obligation to afford "full faith and credit" to the judgments of sister states made without jurisdiction over the party sought to be bound.

As a practical matter, however, this issue may not pose a serious obstacle to the smooth operation of the Rhode Island scheme. First, if courts in other states will issue parallel injunctions against suits as a matter of comity, then creditors situated in those states will have no choice but to go to Rhode Island and participate in the plan. Second, in most cases the debtor's redomestication to Rhode Island will also involve moving most of its assets there. If so, then even if the out-of-state creditor is able to obtain a default judgment in an amount greater than its share under the Rhode Island commutation plan, that judgment will have little value and will not affect the distribution of assets under the commutation plan.

Third, it is theoretically possible that a creditor might try to enforce a default judgment obtained in its home state against whatever residual property of the debtor — an office building, for example — can still be found in some other state outside of Rhode Island. However, it seems unlikely that courts in that state would favor the holder of a default judgment over the interests of Rhode Island in the success of its duly approved commutation scheme. Thus, in most cases, the out-of-state creditor will be best served by participating in the Rhode Island proceedings.