INSURER INSOLVENCIES AND GUARANTY ASSOCIATIONS

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I. INTRODUCTION

The insolvency of insurance companies has become a more visible issue in recent years. Originally, attention was paid to the number of non-life insurer insolvencies in the 1980s. The well publicized failure of Executive Life in the 1990s, however, increased scrutiny of the entire industry.

This Article will give an overview of the insolvency process and the manner in which guaranty associations respond. This discussion will include the interplay of federal law.[1]

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1. For a comprehensive listing of pertinent cases, see TORT & INSURANCE PRACTICE SECTION OF THE AMERICAN BAR ASSOCIATION INSURANCE COMPANY INSOLVENCY (3d ed. 1993); *see also* Richard Spencer, *Obligations of Guaranty Associations*, 8 J. INS. REG. 330 (1990) (suggesting state guaranty associations will need to be better equipped in the future); Daniel Winkler et al., *Analysis of State Guaranty Fund Assessments*, 12 J. INS. REG. 341 (1994) (comparing state guaranty funds from different states for a twelve year period); Richard Spencer, *Guaranty Associations: A Look Ahead*, 10 J. INS. REG. 184 (1991) (suggesting improvements for "second generation" associations based on analysis of "first generation" associations).

II. THE PROBLEM

The insolvency of insurance companies has been with us since the inception of the insurance industry. In a free market economy, failures are inevitable, despite heavy regulation of the insurance industry.

Because the insurance industry is so highly regulated, the public perception is that failures should not happen.[2] This dichotomy between perception and reality has undoubtedly caused much of the attention to insurer failures by state regulators, the federal government, the insurance industry, and the public. Anyone with an interest in the area should be aware of the seriousness of the problem. The problem is more one of severity than of frequency.

A.M. Best Company issued a "Special Report" in June 1991 that reviewed the history of insolvencies among non-life insurers (usually described as property/casualty insurers).[3] The report covered all property/casualty insurer insolvencies from 1969 to 1990.[4]

The study indicates, in this twenty-one year period, out of approximately 3200 property/casualty insurers domiciled in the United States, only 372 were declared insolvent.[5] Iowa, with an average of 173 insurers domiciled in the state during the period covered by the study, had five insurers declared insolvent during this time-period.[6] On the other hand, California, with an average of 120 insurers, had 35 fail.[7] Illinois had the highest average number of insurers, 291, and out of those, 22 failed.[8]

The severity of these failures in terms of cost, however, presents a more dramatic picture. A.M. Best estimates the projected cost of the twenty-five largest insolvencies to be $3.2 billion.[9] A.M. Best anticipates that guaranty associations will spend $4 billion on the claims of all insolvencies that occurred during the twenty-one year period.[10]

According to the National Conference of Insurance Guaranty Funds, by year-end of 1993, the assessments of the associations rose to almost $5.5 billion and payments totaled $6.1 billion.[11] The guaranty associations, however, recovered funds from the estates of insolvent insurers so that by the end of 1993, they

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2. For a historical discussion of problems of insurer insolvencies, see SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS OF THE HOUSE COMM. ON ENERGY AND COMMERCE, 101st Cong., 2d Sess., FAILED PROMISES: INSURANCE COMPANY INSOLVENCY 5-54 (Comm. Print 1990).

3. A.M. BEST CO., SPECIAL REPORT: BEST'S INSOLVENCY STUDY (1991) [hereinafter BEST SPECIAL REPORT].

4. *Id.* at 3.

5. *Id.* at 2.

6. *Id.* at 19-20.

7. *Id.*

8. *Id.*

9. *Id.* at 18.

10. *Id.* at 14.

11. NATIONAL CONFERENCE OF INSURANCE GUARANTY FUNDS, 1993 ASSESSMENT AND FINANCIAL INFORMATION 6-7 (1994) [hereinafter NATIONAL CONFERENCE].

had received about $1.5 billion, and the net loss was nearly $4 billion.[12] This net loss to the insurance companies, who fund the associations through assessments, is ultimately passed on to policyholders, or in some states, to taxpayers by a premium tax credit.

In its study, A.M. Best attempted to identify the causes of insolvencies. The study said: "Deficient loss reserves . . . and rapid growth were the dominant causes of insolvencies. . . . [T]hese accounted for 50% of the insolvencies . . . . These two causes were followed by alleged fraud and overstated assets, each accounting for 10%, significant change in business–9%, reinsurance failure–7%, catastrophic losses–6%, and miscellaneous causes–9%."[13]

Another interesting result of the A.M. Best Company's study was the relationship between failures, the Consumer Price Index (CPI), and the Prime Rate (PR).[14] From 1972 to 1974, the CPI increased from 3.2% to 11%, and the PR rose from 5.3% to 10.8%.[15] This was followed in 1975 by the then highest annual percentage of failure, 1% (29 insurers).[16] From 1977 to 1981, the CPI increased from 6.5% to 10.3%, and the PR increased from 6.8% to 18.9%.[17] This was followed by an annual failure rate in 1985 of 1.4% (49 companies).[18]

III. INTERPLAY WITH FEDERAL LAW

The initial question sometimes raised is why insolvent insurers are liquidated on a state-by-state basis, with varying rules, rather than having the insolvencies administered under one uniform scheme, such as the Federal Bankruptcy Act. The easy answer is that the Federal Bankruptcy Act expressly excludes insurance companies from its provisions.[19] This exclusion has been present from the initial bankruptcy statute through all of its revisions. Congress has apparently concluded that because insurers and other financial institutions, which are also exempt, are regulated by the states, their insolvencies were best

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12. *Id.* This figure, as total cost, is understated because guaranty associations only assess the amounts they need for current operations. As they continue to pay claims, and in turn assess, this figure will rise.

13. BEST SPECIAL REPORT, *supra* note 3, at 6. These are statistics through 1991. They do not include the natural disasters of recent years, such as Hurricane Andrew and the California earthquakes.

14. *Id.* at 42.

15. *Id.*

16. *Id.* at 43.

17. *Id.*

18. *Id.*

19. 11 U.S.C. § 109(b)(2) (1988). The bankruptcy law does not contain a definition of an insurance company. The definition depends on how the law of each state defines the term. For example, under Wisconsin law, a health maintenance organization was included as a domestic insurance company and excluded from bankruptcy protection. *In re* Family Health Servs., 143 B.R. 232, 234 (C.D. Cal. 1992).

left to state administration.[20] In more recent times, the rationale for excluding insurers has received support by the adoption of the McCarran-Ferguson Act,[21] which reinforces the primacy of state regulation of insurers.

This exemption has not been without controversy. In *Oil & Gas Co. v. Duryee*,[22] the president of the insolvent insurer filed a petition seeking to invoke the provisions of the Federal Bankruptcy Act in connection with the insolvency to bar the state liquidator from proceeding.[23] The president argued once an insurer was declared insolvent, it was no longer a domestic insurer and therefore was eligible for bankruptcy protection.[24] The district court held it remained an insurer because it still had responsibilities on its policies.[25] The court of appeals affirmed and was so incensed by the lack of merit of the appeal that it awarded sanctions and double costs.[26]

One provision of the Federal Bankruptcy Act affects insurance company insolvencies.[27] Section 304 allows alien debtors to invoke certain provisions of the Act to enjoin United States litigation or the disposition of assets belonging to the debtor and located in the United States.[28]

This provision was recently invoked by the provisional liquidators of five English insurers, known as the KWELM companies, in support of a Scheme of Arrangement administered under British Law.[29] The court enjoined disposing of any of the debtor's property, commencing or continuing any actions against them, or enforcing any judgments or orders against the insurers.[30]

Another area of interaction between federal and state law involves claims of the United States brought against the liquidated estates of insolvent insurers. Section 3713 of the United States Code accords a first priority to debts owed by

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20. *See* Oil & Gas Co. v. Duryee, 9 F.3d 771, 772 (9th Cir. 1993). "In Ohio as in other states, when an insurance company gets in financial trouble, a state court may appoint a rehabilitator to run it and try to get it back on track." *Id.*

21. 15 U.S.C. §§ 1011-1015 (1988).

22. Oil & Gas Co. v. Duryee, 9 F.3d 771 (9th Cir. 1993).

23. *Id.* at 772.

24. *Id.*

25. *Id.*

26. *Id.* at 773.

27. 11 U.S.C. § 304 (1988).

28. *Id.*

29. The five companies were Kingscroft Insurance Company, Ltd.; Walbrook Insurance Company, Ltd.; El Paso Insurance Company, Ltd.; Lime Street Insurance Company, Ltd.; and Mutual Reinsurance Company, Ltd. The liabilities of the KWELM companies exceeded assets by $5 billion, making it the largest insurer insolvency ever to occur. COMMITTEE ON ENERGY AND COMMERCE, WISHFUL THINKING: A WORLD VIEW OF INSURANCE SOLVENCY REGULATION (Oct. 1994). The Section 304 proceedings were docketed in the Southern District of New York as *In re* Petition of Hughes, Case Nos. 92-B-41974 through 92-B-41977 (1992).

30. *In re* Petition of Hughes, Case Nos. 92-B-41974 through 92-B-41977.

an insolvent person to the United States.[31] Many state liquidation statutes only accord a Class 5 status to the claims of the United States.[32]

In *United States Department of Treasury v. Fabe,*[33] the United States was an obligee on certain bonds issued by American Druggists Insurance Company, which had been declared insolvent and ordered liquidated under Ohio law.[34] The Insurance Commissioner of Ohio, as Liquidator, classified the claim in Class 5, and the United States objected.[35] The Liquidator argued the United States claim was in Class 5, along with other government claims, and because of the mandate of the McCarran-Ferguson Act, liquidating insolvent insurers was a part of the "business of insurance."[36] The United States adopted the position that liquidation was not a part of the "business of insurance" and therefore, it was entitled to a Class 1 claim.[37]

The United States Supreme Court, relying on the McCarran-Ferguson Act, held the Ohio liquidation law was part of the business of insurance and that the federal priority statute does not specifically relate to the business of insurance.[38] The Court gave precedence to the Ohio law, nullifying the first priority of the United States claim.[39] The Court, however, limited the supremacy of the Ohio statute so that it only placed claims for administrative costs of the estate and claims of policyholders ahead of the United States.[40] Claims of general creditors and other claimants still ranked below those of the United States.[41]

IV. STATE LIQUIDATION ACTS

A. *Generally*

All states have enacted some provision for administering the estates of insolvent insurers. Many states have adopted the National Association of Insurance Commissioners Model Act (NAIC Model Act).[42] Iowa enacted the Act

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31. 31 U.S.C. § 3713 (1988).

32. *See, e.g.*, IOWA CODE § 507C.42 (1993). Under many state liquidation statutes, including Iowa, Class 1 is administrative expenses, Class 2 is certain limited employee wage claims, Class 3 is policyholders and guaranty associations, Class 4 includes general creditors, and Class 5 is city, state, and federal government claims. *Id.*

33. United States Dep't of Treasury v. Fabe, 113 S. Ct. 2202 (1993).

34. *Id.* at 2205.

35. *Id.*

36. *Id.* at 2205-06; *see* 15 U.S.C. § 1012 (1988).

37. United States Dep't of Treasury v. Fabe, 113 S. Ct. at 2206.

38. *Id.* at 2216-17.

39. *Id.*

40. *Id.*

41. *Id.* at 2204. One issue not addressed is the priority of guaranty association claims. When the associations pay claims of policyholders, they are entitled to have their payments allowed as Class 3 claims. *See, e.g.*, IOWA CODE § 507C.42(3) (1993). No case to date has addressed whether these subrogation claims will receive priority over the claims of the United States.

42. CONN. GEN. STAT. §§ 38a-903 to -961 (1992); HAW. REV. STAT. §§ 431:15-101 to -411 (1988); IDAHO CODE §§ 41-3301 to -3360 (1991); IND. CODE ANN. §§ 27-9-1-1 to -4-10 (Burns

as Chapter 507C of the Iowa Code.[43] Other states have enacted the National Conference of Commissioners on Uniform State Laws Uniform Insurers Liquidation Act or some variation of it.[44] Wisconsin adopted its own law in 1967; this law became the forerunner of the NAIC Model Act, which was promulgated in 1977.[45]

The purpose of these statutes is the establishment of an orderly scheme to marshall the assets of the insolvent insurer, to allow persons to file claims, and to provide for a distribution of the assets to claimants. The Uniform Insurance Liquidation Act, however, is much briefer (only 15 sections), as compared to the NAIC Model Act (61 sections), and does not contain the priority of distribution or claims classes of the NAIC Model Act.[46] Because the NAIC Model Act is much more comprehensive, this discussion will concentrate on it and the Iowa enactment, Chapter 507C of the Iowa Code.[47]

1994); KY. REV. STAT. ANN. §§ 304.33-010 to -600 (Michie/Bobbs-Merrill 1992); ME. REV. STAT. ANN. tit. 24-A, §§ 4351-4407 (West 1990); MINN. STAT. ANN. §§ 60B.01–.61 (West 1986 & Supp. 1994); MONT. CODE ANN. §§ 33-2-1301 to -1394 (1993); NEB. REV. STAT. §§ 44-120 to -133 (1988); N.H. REV. STAT. ANN. §§ 402-C:1 to :61 (1983 & Supp. 1993); N.C. GEN. STAT. §§ 58-30-1 to -310 (1991 & Supp. 1993); OHIO REV. CODE ANN. §§ 3903.01 to .99 (Anderson 1989 & Supp. 1993); PA. STAT. ANN., tit. 40, §§ 221.19–.63 (1992); S.C. CODE ANN. §§ 38-27-10 to -200 (Law. Co-op. 1989 & Supp. 1993); S.D. CODIFIED LAWS ANN. §§ 58-29B-1 to -161 (Michie 1990 & Supp. 1994); UTAH CODE ANN. §§ 31A-27-101 to -411 (1991).

43. IOWA CODE ch. 507C (1993).

44. ALA. CODE §§ 27-32-1 to -41 (1975); ALASKA STAT. §§ 21.78.010–.330 (1962); ARIZ. REV. STAT. ANN. §§ 20-611 to -648 (1956); ARK. CODE ANN. §§ 23-68-101 to -132 (Michie 1987); CAL. INS. CODE §§ 1064.1–.12 (West 1988); COLO. REV. STAT. §§ 10-3-501 to -559 (1963); DEL. CODE ANN. tit. 18, §§ 5901–5944 (1974); D.C. CODE ANN. §§ 35-2801 to -2857 (Supp. 1994); FLA. STAT. ANN. §§ 631.001–.399 (West 1959 & Supp. 1994); GA. CODE ANN. §§ 33-37-1 to -50 (Harrison 1990 & Supp. 1993); ILL. REV. STAT. ch. 215, para. 5/221.1–.13 (Smith-Hurd 1992); LA. REV. STAT. ANN. §§ 22:731 to :764 (West 1958 & Supp. 1994); MD. CODE ANN., INS. §§ 132–164A (1957); MASS. GEN. LAWS ANN. ch. 175, §§ 180A–180L (West 1987 & Supp. 1994); MICH. COMP. LAWS ANN. §§ 500.7800–.7868 (West 1983); MISS. CODE ANN. §§ 83-23-1 to -9 (1972 & Supp. 1994); MO. ANN. STAT. §§ 375.950–.990 (Vernon 1991); NEV. REV. STAT. §§ 696B.010–.570 (1991); N.J. STAT. ANN. §§ 17:30C-1 to -31 (West 1994), 17B:32-1 to -30 (West 1984 & Supp. 1994); N.M. STAT. ANN. §§ 59A-41-1 to -57 (Michie 1992); N.Y. INS. LAW §§ 7401–7435 (McKinney 1985 & Supp. 1994); N.D. CENT. CODE §§ 26.1-07-01 to -21 (1989); OKLA. STAT. ANN. tit. 36, §§ 1901–1936 (West 1990 & Supp. 1995); OR. REV. STAT. §§ 734.014 –440 (1993); R.I. GEN. LAWS §§ 27-14-1 to -23 (1989); TENN. CODE ANN. §§ 56-9-101 to -337 (1994); TEX. INS. CODE ANN. art. 21.28, 21.28-A, 21.28-B (West 1981 & Supp. 1994); VT. STAT. ANN. tit. 8, §§ 7031–7100 (1995); VA. CODE ANN. §§ 38.2-1500 to -1521 (Michie 1994); WASH. REV. CODE ANN. §§ 48.31.030–.360 (West 1984 & Supp. 1994); W. VA. CODE §§ 33-10-1 to -39 (1992 & Supp. 1993); WYO. STAT. §§ 26-28-101 to -131 (1991).

45. *See* WIS. STAT. ANN. § 645.01–.90 (West 1980 & Supp. 1994).

46. *Id.* NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, 1969 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 241 (1969). The Wisconsin Act was the basis for the NAIC Model Act. The NAIC Model Act and the Wisconsin statutes are generally identical in the matters covered and in terms of format.

47. IOWA CODE ch. 507C (1993).

B. *Stages of Regulatory Action*

Iowa Code Chapter 507C includes three different levels of regulatory action by the Insurance Commissioner.[48] These levels are mutually exclusive because only one may be applied at a time, but they are intended to be mutually complimentary.[49]

The three alternatives are supervision, rehabilitation, and liquidation.[50] They are generically referred to as delinquency proceedings.[51] While the alternatives may be applied in successive stages, the Commissioner may use only one, to the exclusion of the others.[52] The Commissioner has discretion to select a regulatory tool and is ordinarily governed by the regulator's analysis of the severity of the problem.[53]

The Commissioner has the sole discretion to decide whether to undertake delinquency proceedings, and a refusal to do so may not be challenged by mandamus.[54] In contrast to bankruptcy, creditors have no standing to invoke delinquency proceedings because the sole authority to do so rests with the Commissioner.[55]

Supervision may be invoked when the Commissioner determines that an insurer has engaged in or is about to engage in conduct hazardous to its policyholders or to the public.[56] Significantly, the emphasis is on hazards to the policyholders, not the insurer's creditors or stockholders.

The Supervision Order lists the steps required to cure any deficiency and may also forbid the insurer from taking certain action without the Commissioner's consent.[57] The Supervision Order will be confidential, unless the insurer demands a public hearing or seeks judicial review.[58] In addition, the Commissioner may petition the court for injunctive relief in support of the Supervision Order.[59]

If the Commissioner determines during Supervision that the problem is more acute or more broad-based than can be addressed by Supervision, the Regulator can apply to the court for more formal proceedings in the nature of a

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48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.* § 507C.2(4).
52. *Id.*
53. *Id.*
54. First Nat'l Bank v. Commonwealth, 528 A.2d 696, 698 (Pa. Commw. Ct. 1987).
55. Hamilton v. Safeway Ins. Co., 432 N.E.2d 996, 999 (Ill. Ct. App. 1982); *see* IOWA CODE §§ 507C.9, .12, .18 (1993).
56. Section 507C.9 sets forth in more detail the precise grounds by referring to any act that would subject the insurer to delinquency proceedings. IOWA CODE § 507C.9 (1993). Those acts are listed in § 507C.12 and in § 507C.17. *Id.* §§ 507C.12, .17. The Commissioner may be immune from liability for his activities during supervision. *See* Builders Transport, Inc. v. State, 421 N.W.2d 539, 542 (Iowa 1989).
57. IOWA CODE §§ 507C.9(2)(b), .9(3) (1993).
58. *Id.* §§ 507C.9(5), .9(6), .11.
59. *Id.* § 507C.9(9).

Rehabilitation Order[60] or an Order of Liquidation.[61] The choice between these alternatives will often be a "business judgment" as to whether the insurer can be "salvaged" by more direct control of its affairs or whether it is so hopelessly insolvent that there is no reasonable hope of returning it to a viable entity. In making this determination, the Commissioner must look beyond a pure balance sheet approach to determine whether new capital can be infused, whether profitable lines of business may be retained and unprofitable ones disposed of, whether its assets can be restructured appropriately, and whether alterations in its reinsurance relationships can provide significant relief.

If the Commissioner elects to attempt rehabilitation, the statute sets out at least twelve grounds as the basis for the petition.[62] Again, the emphasis is on protection of the policyholders, not creditors or shareholders. This emphasis contrasts with a bankruptcy approach, which more often evaluates the impact on creditors and their ultimate ability to be paid.[63]

The Rehabilitation Order vests title to all assets in the Commissioner[64] and gives him the powers of the board of directors and officers.[65] The statute envisions that a Plan of Rehabilitation will be drafted and approved by the court if it finds it fair and equitable.[66] As a practical matter, many attempts at rehabilitation have proven unsuccessful and are only the first step on the "slippery slide" to insolvency.[67] Quite often, a regulator will invoke rehabilitation in order to gain control of an insurer and prepare for the orderly transition to insolvency.

If rehabilitation appears fruitless, the Commissioner may petition the court for an Order of Liquidation.[68] The grounds for liquidation are the same as those for rehabilitation with the added requirement that the insurer is insolvent.[69] An additional ground is provided if the further transaction of business would be hazardous to policyholders, creditors, or the public.[70] While the statute does not attempt to define conditions that are hazardous to policyholders, one court has said: "'[H]azardous condition' may best be defined as imminent insolvency, a state in which there is a dwindling surplus and a substantial likelihood based on

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60. *Id.* § 507C.12.

61. *Id.* § 507C.17.

62. *Id.* § 507C.12; *see* People v. Progressive Gen. Ins. Co., 229 N.E.2d 350, 353 (Ill. Ct. App. 1967) (rejecting the argument that financial irregularity must be proven).

63. *See generally* IOWA CODE ch. 507C (1993) (emphasizing interests of claimants and insureds as the primary goals).

64. *Id.* § 507C.13.

65. *Id.* § 507C.14(2).

66. *Id.* § 507C.15(5).

67. Practically any proceeding that begins as rehabilitation and moves to liquidation could be characterized as a failure. Quite often, rehabilitation is viewed as a "breathing period," with no real hope of saving the insurer, but it gives the Regulator time to organize for the insolvency.

68. IOWA CODE § 507C.17 (1993).

69. *Id.* Although insurers are required to use statutory accounting rather than Generally Accepted Accounting Principles (GAAP), there may be a dispute concerning which is appropriate to determine insolvency. *See* In re Ambassador Ins. Co., 515 A.2d 1074, 1077 (Vt. 1986) (rejecting the use of GAAP in determining whether an insurer was insolvent).

70. IOWA CODE § 507C.17 (1993).

recent trends within the company, that a condition of actual insolvency will be reached in the near future."[71]

When liquidation is ordered, the Commissioner is appointed Liquidator, with two major tasks to accomplish.[72] The first one is to take possession of the assets of the insurer, and the second is to administer the assets under the supervision of the court.[73]

In order to protect the assets and maintain an orderly administration, the Iowa Code prohibits suits against the Liquidator or continuing any suits against the insolvent insurer.[74] Instead, the creditor must pursue his claim in the liquidation proceeding.

While this injunctive order may be analogous to the automatic stay provisions of the Federal Bankruptcy Act, the attempts to provide interstate enforcement of the Order have met with mixed results. The Alabama Supreme Court enforced the injunctive order contained in a Rehabilitation Plan, previously approved by an Illinois court, and stayed litigation over entitlement to policy proceeds, which was pending in an Alabama state court.[75] On the other hand, the Minnesota Supreme Court struck down an injunctive order entered by an Iowa court in a liquidation proceeding and did not preclude Minnesota courts from asserting jurisdiction over the insolvent insurer.[76] The court held the Iowa order had no extraterritorial effect and could not impact the rights of a Minnesota citizen who was not subject to the jurisdiction of the Iowa courts.[77] The court expressly rejected the Iowa order based on the doctrine of comity.[78]

An insurer's assets usually fall into three basic categories. One is the hard assets it owns, such as its investment portfolio, and buildings. These quite often present problems of liquidity that must be resolved in order to make the assets available. A historical asset problem involves an insurer who heavily invests in "junk" bonds or real estate mortgages or other depreciating or ill-liquid assets.[79] The timing of the reduction of these to cash or its equivalent can be critical to the ultimate outcome, as was demonstrated in the Executive Life Insurance proceedings, in which the insurer was heavily invested in depressed "junk" bonds.[80] The bonds were sold in a depressed market when, if they had been held a few months longer, a significantly higher price could have been achieved.[81]

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71. Commonwealth v. Safeguard Mut. Ins. Co., 336 A.2d 674, 681 (Pa. Commw. Ct. 1975), *aff'd*, 387 A.2d 647 (Pa. 1978).

72. IOWA CODE § 507C.18(1) (1993).

73. *Id.*

74. *Id.* § 507C.24(1).

75. *Ex parte* Equitable Life Ins. Co., 595 So. 2d 1373 (Ala. 1992).

76. Fuhrman v. United Am. Insurers, 269 N.W.2d 842, 848 (Minn. 1978).

77. *Id.*

78. *Id.* at 847.

79. *See, e.g.*, SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS OF THE HOUSE COMM. ON ENERGY AND COMMERCE, WISHFUL THINKING: A WORLD VIEW OF INSURANCE SOLVENCY REGULATION (Comm. Print 1994).

80. *Id.*

81. *Id.*

The second category of assets to be marshalled is reinsurance recoverables. Practically every insurer, in varying degrees, is entitled to collect funds from its reinsurers as the insurer settles losses with or on behalf of its policyholders. At the time of liquidation, there will be sums then due from reinsurers, and as the liquidator establishes claims against the estate, future sums will become due. Most reinsurance contracts or treaties are agreements by the reinsurer to indemnify the reinsured or ceding, but now insolvent, insurer. At one time, reinsurers contended that because the liquidator could not pay policyholder claims in full due to insufficient assets, their obligation to indemnify was likewise diminished or eliminated.[82]

In *Fidelity & Deposit Co. v. Pink*,[83] the reinsurers prevailed with this argument.[84] The Commissioner, stung by this result, in what has been called "Pink's Revenge," had the law changed so that insolvency does not diminish the reinsurer's liability and it must pay, just as though no insolvency had occurred.[85]

Another major asset to be collected in many insolvencies are balances owed by agents to the insurer. These arise because the insured pays the premium to the agent who then may have from forty-five to seventy-five days, depending on when the policy was issued, to pay the insurer.

The Liquidation Order cancels the policy[86] and, as a result, creates claims for earned and unearned premiums, as well as earned and unearned agents' commissions. These competing claims have resulted in litigation between the estate and agents over the amounts due and credits or offsets available.[87]

One asset of a liquidation that historically had been ignored was the value of the liquidated insured company's licenses to do business in the various states where it sold insurance. Generally, it was assumed that the Liquidation Order resulted in the dissolution of the corporation, and, as such, there was no longer a legal entity with the power to retain its licenses.[88]

Iowa was the first state to realize the value of this asset. Section 507C.20 of the Iowa Code allows for a Liquidation Order without dissolving the corporation.[89] Rather, it allows the liquidator to sell the corporate entity, along with its licenses to do business.[90] Section 507C.20A goes so far as to allow foreign insurers in liquidation to be removed to Iowa and their corporate entities and

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82. *See infra* text accompanying notes 83-85.

83. Fidelity & Deposit Co. v. Pink, 302 U.S. 224 (1937).

84. *Id.* at 230.

85. For Iowa's version of "Pink's Revenge," see IOWA CODE § 507C.32 (1993).

86. Shloss v. Metropolitan Sur. Co., 128 N.W. 384, 384 (Iowa 1910).

87. Hershey v. Kennedy & Ely Ins., Inc., 294 F. Supp. 554, 555 (S.D. Fla. 1967), *aff'd*, 405 F.2d 888 (5th Cir. 1968); Hager v. Doubletree, 440 N.W.2d 603, 604 (Iowa), *cert. denied*, 493 U.S. 934 (1989).

88. People v. Peoria Life Ins. Co., 34 N.E.2d 829, 831 (Ill.), *cert. denied*, Harwick v. O'Hern, 314 U.S. 668 (1941); *In re* National Sur. Co., 26 N.Y.S.2d 370, 373 (N.Y. Sup. Ct. 1941).

89. IOWA CODE § 507C.20 (1993).

90. *Id.* The licenses of the insolvent insurers–Carriers Insurance Company, Iowa National Mutual Insurance Company, and American Excel Insurance Company–were all sold by the liquidator, resulting in the realization of several hundred thousand dollars in additional assets.

licenses sold, with the proceeds of the sale, less expenses, to be returned to the foreign liquidator.[91]

The other major task of the liquidator is to evaluate the claims of policyholders or claimants against policyholders and the claims of other creditors. The Liquidation Order commonly contains a deadline for filing claims or they will be barred. Creditors are furnished with Proof of Claim forms that must be timely filed with the Liquidator in order to preserve the claim.[92] The exclusive remedy for creditors is to file a claim in the proceeding; they may not maintain an independent action.[93] The liquidation statutes, in contrast to the bankruptcy law, establish classes of creditors, which must be paid in full before the creditors in the next lower class can receive any funds.[94]

V. GUARANTY ASSOCIATIONS

The liquidation statutes and their mandated processes comprise only a part of the resolution of problems presented by an insolvent insurer. Beginning in the late 1960s and early 1970s, there were publicly expressed, as well as congressionally expressed, concerns about the plight of policyholders, or of claims against policyholders, of insolvent insurers.

In response to those concerns, the NAIC, in conjunction with the non-life insurance industry, developed the NAIC Model Insurance Guaranty Association Act. A Model Act was later developed to deal with the claims against life and health insurers.[95] Iowa adopted this Model Act in 1970 as Chapter 515B of the Iowa Code.[96] Chapters 507C and 515B provide an integrated and complementary plan to manage insolvencies.[97]

The normal procedure in a liquidation will be stretched out over time as assets are marshalled and claims are established. This means that creditors or claimants against the estate will be unable to receive any payment for years, and then perhaps only a small percent. One of the purposes behind adoption of Chapter 515B was to create an entity that could begin payment more promptly, and then the entity, rather than policyholders, could await the long delay before receiving any reimbursement from the insolvent estate.

A. *Insurers and Policies Covered*

In order for policyholders of an insolvent insurer to have their claims covered, the insurer must have been licensed to do business in Iowa or organized

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91. IOWA CODE § 507C.20A (1993).

92. *Id.* § 507C.22(2).

93. Medallion Ins. Co. v. Wantenbee, 568 S.W.2d 599, 601 (Mo. Ct. App. 1978); *see* IOWA CODE § 507C.24(1) (1993).

94. IOWA CODE § 507C.42 (1993); *see Ex rel.* Hager v. Iowa Nat'l Mut. Ins. Co., 430 N.W.2d 420, 421-22 (Iowa 1988).

95. IOWA CODE ch. 508C (1993).

96. IOWA CODE ch. 515B (1993).

97. *Id.* chs. 507C, 515B.

under the laws of Iowa.[98] It is not unusual in the insurance industry for foreign insurers to sell insurance in Iowa without being licensed by the state.[99] These companies are commonly referred to as excess and surplus lines writers. Claims arising out of their insolvencies are not covered by chapter 515B.[100]

Not all non-life insurance policies are covered under the Model Act. Life and health insurance covering accidents, which is covered under the Life Association, is excluded.[101] Also excluded are marine insurance and surety, as well as policies issued by risk retention groups[102] and other minor types of policies.[103] In addition, coverage is only afforded for "direct insurance."[104] This is to distinguish that type of policy from one of reinsurance.[105]

B. *Persons and Claims Covered*

The statute provides coverage for any unpaid claim, including unearned premium, arising out of a policy issued by an insolvent insurer.[106] To be eligible for payments, however, the claimant or insured must be a resident of Iowa at the time of the event, or the claim must be by an insured for damage to property permanently located in Iowa.[107]

It does, however, exclude claims by other insurers or reinsurers.[108] These claims are excluded because the purpose of the Act is to pay claims to persons who have no other source and not to reimburse other member insurers for their subrogation claims.[109]

Subrogating insurers are also prohibited from pursuing their claims against the insured of the insolvent insurer,[110] unless the claim exceeds the insured's policy limits or is within an insured's deductible.[111] The insurers may, however, present the claim to the Liquidator.[112] Also excluded are attorney fees incurred

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98. *Id.* ch. 515B.

99. *Id.* § 515.147.

100. Osborne v. Edison, 211 N.W.2d 696, 697 (Iowa 1973).

101. IOWA CODE § 515B.1 (1993).

102. *Id.*; 15 U.S.C. § 3902 (1988) specifically prohibits Risk Retention Groups from being covered by Insurance Guaranty Associations.

103. IOWA CODE § 515B.1 (1993).

104. *Id.*

105. *Id.*; Iowa Contractors Workers' Compensation Group v. Iowa Ins. Guar. Ass'n, 437 N.W.2d 909, 913 (Iowa 1989).

106. IOWA CODE § 515B.1 (1993).

107. *Id.* § 515B.2(3).

108. *Id.*; E.L. White Inc. v. City of Huntington Beach, 187 Cal. Rptr. 879, 882 (Cal. 1982).

109. E.L. White Inc. v. City of Huntington Beach, 187 Cal. Rptr. at 882.

110. IOWA CODE § 515B.2(3) (1993); Cordani v. Roulis, 395 So. 2d 1276, 1277 (Fla. Ct. App. 1981).

111. Maston v. Harper, 859 P.2d 405, 406 (Kan. Ct. App. 1993); Minnesota Mining & Mfg. v. H&W Motor Express, 507 N.W.2d 622, 624 (Minn. Ct. App. 1993).

112. IOWA CODE § 515B.2(3)(2)(b)(8) (1993).

prior to the insolvency, policy deductibles, certain types of unearned premium, and punitive damages or fines.[113]

Some states have adopted "net worth" exclusions that deny coverage to an insured whose net worth exceeds a stated amount, such as $5 million.[114] The rationale for this exclusion appears to be that larger, more sophisticated insureds can protect themselves by being more selective in deciding from whom they buy insurance.

C. *Amount of the Claim*

All states will pay the lesser of the policy limits or some statutory maximum amount. In most states this is $300,000.[115] There is also a $100 deductible on all claims.[116] There is no cap or deductible with respect to workers' compensation claims.[117]

D. *Non-Duplication of Recovery*

With the possibility of insureds and claimants residing in different states came the claimant's ability to assert a covered claim in more than one state and some device was needed to prevent duplicate coverage. To avoid this result, the guaranty association of the claimant's residence became primary on workers' compensation claims and the guaranty association of the residence of the insured or the state where the property is located became primary on all other claims.[118]

E. *Exhaustion*

A claimant or insured is required to exhaust the benefits of any other insurance the claimant or insured has available for the claim against the guaranty association.[119] This rule is a direct outgrowth of the philosophy underlying the Act that the guaranty association is to be the "payer of last resort," and other solvent insurers are not entitled to reduce their liability because of the insolvency.[120] In addition to the requirement of exhausting other coverage, the guaranty association is entitled to a stay of any proceedings until the claimant has complied with this requirement.[121]

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113. *Id.* § 515B.2(3)(2)(b)(2)-(5).

114. Bormans, Inc. v. Michigan Property & Casualty Guar. Ass'n, 925 F.2d 160, 163 (6th Cir.), *cert. denied*, 502 U.S. 823 (1991); Georgia Ins. Insolvency Pool v. Elbert County, 368 S.E.2d 500, 501 (Ga. 1988).

115. IOWA CODE § 515B.5(1)(a) (1993).

116. *Id.*

117. *Id.*

118. *Id.* § 515B.9(2).

119. *Id.* § 515B.9(1); *see* Spearman v. State Sec. Ins. Co., 372 N.E.2d 1008, 1009 (Ill. Ct. App. 1978); Heninger v. Riley, 464 A.2d 469, 472-73 (Pa. Super. Ct. 1983).

120. *See, e.g.*, Betha v. Forbes, 548 A.2d 1215, 1218 (Pa. 1988).

121. Heninger v. Riley, 464 A.2d at 472-73.

F. *Credits*

Once the claimant has exhausted other coverages, the amount the claimant receives,[122] or could have received,[123] is applied to reduce the guaranty association's liability.[124] The obvious purpose of this requirement is to eliminate double recovery. Some common examples of this are uninsured motorist coverage,[125] underinsured motorist coverage,[126] liability coverages,[127] or workers' compensation benefits.[128] If more than one guaranty association had coverage, the secondary or excess guaranty association can take credit against its liability for the amount paid by the primary guaranty association.[129]

G. *Procedure*

Iowa has a claim filing deadline and requires any claim against the guaranty association to be filed with the guaranty association prior to the deadline set by the court for filing claims against the insolvent insurer.[130] The guaranty association is entitled to have all actions against it or an insured of an insolvent insurer stayed until the expiration of the claim filing deadline set by the court.[131] The guaranty association may also have any default set aside.[132] The guaranty association is also immune from any liability, including bad faith claims.[133]

H. *Association Finances*

In order to pay claims, the guaranty association has the right to assess all insurers admitted in the state.[134] However, the assessments cannot exceed two percent of an insurer's net written premiums in any one year.[135]

Generally, guaranty associations only assess on an "as needed" basis. That is, they will not assess in one year the entire expected costs of any insolvency, but only assess what they estimate will be needed for next year and then repeat

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122. IOWA CODE § 515B.9(1) (1993); *see* Lucas v. Illinois Ins. Guar. Ass'n, 367 N.E.2d 469, 471 (Ill. Ct. App. 1977).

123. California Ins. Guar. Ass'n v. Liemsakul, 238 Cal. Rptr. 346, 349 (Cal. Ct. App. 1987).

124. IOWA CODE § 515B.9(1) (1993).

125. *Id.* § 516A.1; Lucas v. Illinois Ins. Guar. Ass'n, 367 N.E.2d at 471.

126. Stecher v. Iowa Ins. Guar. Ass'n, 465 N.W.2d 887 (Iowa 1991).

127. P.I.E. Mut. Ins. Co. v. Ohio Ins. Guar. Ass'n, 611 N.E.2d 313 (Ohio 1993).

128. Ferrari v. Toto, 402 N.E.2d 107 (Mass. App. Ct. 1980), *aff'd*, 417 N.E.2d 427 (Mass. 1981).

129. IOWA CODE § 515B.9(2) (1993); Palmer v. Montana Ins. Guar. Ass'n, 779 P.2d 61, 64 (Mont. 1989).

130. IOWA CODE § 515B.17 (1993).

131. *Id.* § 515B.15.

132. *Id.*

133. *Id.* § 515B.14; *see* Isaacson v. California Ins. Guar. Ass'n, 244 Cal. Rptr. 655, 664-65 (Cal. 1988).

134. IOWA CODE § 515B.5(1)(a) (1993).

135. *Id.* § 515B.5(1)(c).

the assessment the following year.[136] This results in some time lag between the year of the insolvency and the effect of assessments for that insolvency.

For example, in 1987, the Associations assessed the greatest amount ever levied in their twenty-three year history, $913 million.[137] Yet there were only nineteen insolvencies in 1987.[138] There had been, however, fifty-one in the prior two years, 1985 and 1986.[139] Their impact was undoubtedly felt in 1987.

Under the Model Act, insurers are allowed to include the assessments in calculating premiums, thus ultimately passing on the cost to policyholders.[140] In some states, however, the insurers are entitled to offset their premium tax payments by the amount of the assessments, thus passing the cost to taxpayers.[141]

One of the issues raised by critics is whether the guaranty associations have the capacity to cover major insolvencies.[142] The NCIGF, in its annual report for 1993, reported capacity, or ability to assess, of about $3.2 billion for 1993, with only about $546 million in actual assessments in that year.[143] Even in the worst year, 1987, assessments were just $913 million.[144]

There may be isolated instances, however, in which the limit on annual assessments may be exceeded.[145] When Hurricane Andrew hit Florida, the Florida Guaranty Association was forced to borrow money and pledge its future assessments to meet the claims of several insurers who were declared insolvent as a result of Andrew.[146]

Finally, as guaranty associations pay claims, they are entitled to recover from the estate of the insolvent insurer those payments, as well as their

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136. *See* Dale Kasler, *Insurer's Comeback Includes Lengthy Deal: A Government Takeover of Mutual Benefit Life is Forcing Policyholders to Make a Different Decision: Should They Stay or Should They Go?* DES MOINES REGISTER, Mar. 9, 1994, at 105.

137. NATIONAL CONFERENCE, *supra* note 11, at 6.

138. *Id.* at 3.

139. *Id.*

140. *Insurance Guaranty Funds and the Involuntary Transfer of Insurance Policies: Hearings on S.1644 Before the Subcomm. on Anti-trust Monopolies & Business Rights of the Senate Comm. on the Judiciary*, 102d Cong., 2d Sess. 266-67 (1992) (statement of Daniel A. Mica, Executive Vice President American Council on Life Insurance and Richard Minck, Executive Vice President American Council on Life Insurance) [hereinafter *Hearings*]. *See* IOWA CODE § 515B.13 (1993).

141. Fourteen states have such a procedure: ALA. CODE §§ 27-42-1 to -20 (Michie 1986); ARIZ. REV. STAT. ANN. §§ 20-661 to -675 (1990); ARK. CODE ANN. §§ 23-90-101 to -123 (Michie 1992); IND. CODE ANN. §§ 27-6-8-1 to -19 (Burns 1994); LA. REV. STAT. ANN. §§ 22:1375-94 (West 1978); MO. ANN. STAT. §§ 375.771-.779 (Vernon 1995); NEB. REV. STAT. §§ 44-2401 to -2418 (1988); NEV. REV. STAT. §§ 687A.010-.160 (1991); OR. REV. STAT. §§ 734.510-.710 (1993); TENN. CODE ANN. §§ 56-12-101 to -120 (1994); TEX. INS. CODE ANN. § 21.28C (1993); UTAH CODE ANN. §§ 31A-28-201 to -221 (1994); VA. CODE ANN. §§ 38.2-1600 to -1623 (Michie 1994); WASH. REV. CODE ANN. §§ 48.32.010-.170 (West 1995).

142. *Hearings*, *supra* note 140, at 276 (letter of Richard Minck & Daniel A. Mica); *see, e.g.*, NATIONAL CONFERENCE, *supra* note 11, at 6, 8-58 (compiling 50 states analysis).

143. NATIONAL CONFERENCE, *supra* note 11, at 6.

144. *Id.* at 7.

145. NATIONAL CONFERENCE, *supra* note 11, at 6.

146. *Id.* at 17.

administration expenses.[147] These amounts, in turn, may be refunded to member insurers.[148] As noted above, out of the $5.1 billion paid from 1969 to 1991, the guaranty associations have recovered $1.3 billion from the estates and have thus far refunded about $390 million.[149] Their recovery, however, will never be complete. The loss claims paid by the guaranty associations are only entitled to share pro rata with other policyholder claims, and there are normally not enough funds to pay these in full.[150]

VI. CURRENT PROPOSALS

The incidence and magnitude of insurance company insolvencies have not gone unnoticed. The insolvencies of property and casualty companies in the 1960s served as the backdrop for the NAIC Model Insurance Guaranty Association Act.[151] The major property and casualty insolvencies of the 1980s caught the attention of Congress. In February 1990, the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, chaired by Representative Dingell, issued its report entitled *Failed Promises: Insurance Company Insolvency*.[152] The Committee delved into the insolvencies of Mission Insurance Companies, Transit Insurance Company, Integrity Insurance Company, and Anglo-American Insurance Company.[153] The report concludes that these insolvencies were the result of inadequate regulation by the states.[154]

This conclusion of the Committee should be compared with the A.M. Best Company's Special Report.[155] For example, Florida had the highest failure rate of domestic insurers (1.63%), but had five domiciled companies per examiner and its average Insurance Department budget per company was about $214,000.[156] Iowa, on the other hand, had one of the lowest failure rates (.13%), with one examiner per seven companies and an average budget of $17,225 per

147. IOWA CODE § 507C.42 (1993).

148. *Id.* § 515B.5(2)(g).

149. NATIONAL CONFERENCE, *supra* note 11, at 68-75.

150. IOWA CODE § 507C.42 (1993).

151. WILCOTT B. DUNHAM, JR. & DONAL A. KINNEY, *Insurance Company Solvency: Capital Adequacy, Regulatory Development, and Liability Issues*, *in* LIFE AND HEALTH GUARANTEE ASSOCIATIONS 277 (PLI Commercial Law & Practice Course Handbook Series No. A4-4343, 1991).

152. SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS OF THE HOUSE COMM. ON ENERGY AND COMMERCE, 101st Cong., 2d Sess., FAILED PROMISES: INSURANCE COMPANY INSOLVENCIES (1990). For a discussion of a fraud that was perpetrated on the insurance industry in the 1980s, see Carlos Miro, *Miro Criticizes States, Calls for Federal Regulation*, 5 MEALEY'S LITIGATION REPORTS—INSURANCE INSOLVENCY, June 2, 1993, at 11.

153. *Id.*

154. *Id.* at 72-74.

155. BEST SPECIAL REPORT, *supra* note 3.

156. *Id.* at 22, 26.

company.[157] Best observed: "budget dollars per domiciled company and domiciled companies per examiner do not correlate well with failure frequency."[158]

As a result of the Committee investigation, Congressman Dingell introduced H.R. 4900, the Federal Insurance Insolvency Act of 1992.[159] This bill would make sweeping changes in regulation and the guaranty associations' system by largely "federalizing" the process.[160] The proposal would destroy the long established primacy of state regulation, the roots of which are grounded in the McCarran-Ferguson Act, and substitute a federal system for most insurers.[161]

Also as a result of insurer insolvencies, and spurred on by major life insurer insolvencies such as Executive Life, the NAIC has established standards for "risk-based capital."[162] These are complex formulas that attempt to establish action levels for state regulators based on the financial status of both life insurers and property/casualty insurers.[163] It remains to be seen whether these new standards will result in earlier regulatory involvement and the prevention of insolvencies.

On another front, Iowa, Illinois, and Nebraska, under the umbrella of the NAIC, have begun to develop a plan for interstate compacts. This proposal would regionalize the management of insolvencies, and supplant the current state-by-state administration of both insolvencies and guaranty associations.[164]

In 1994, a special Task Force on Insurance Insolvencies, which was created by the American Bar Association's Commercial and Financial Services Committee, adopted a report calling for amendments to the Federal Bankruptcy Act to provide for insurer insolvencies and guaranty associations to be administered in federal bankruptcy courts. It remains to be seen which, if any, of these proposals will receive sufficient support to be enacted. It is clear, however, that the specter of federal intervention in what has historically been an area of state regulation will continue to cause concern and may spawn other proposed solutions.[165]

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157. *Id.*

158. *Id.* at 27.

159. H.R. 4900, 102d Cong. 2d Sess. (1992).

160. *Id.*; see Ingersol et al., *Federal Regulation of Insurance*, 23 SPG. BRIEF 10 (1994) for a further discussion. *See also* Debra Hall, *Insurance Company Insolvencies*, 12 J. INS. REG. 145 (1993).

161. 15 U.S.C. § 1012 (1988).

162. *See generally* John M. Covaleski, *After Dumping Properties, Carriers Await RBC Filing*, 94 BEST'S REV.: LIFE & HEALTH INS. ED. 42 (Supp. 1994) (discussing risk-based capital standards promulgated by the National Association of Insurance Commissioners).

163. *Id.*

164. *See* John Manders, *Insurance Regulation in the Public Interest: Where Do We Go From Here?*, 12 J. INS. REG. 285 (1994).

165. For a discussion of the tension between federal and state supervision, see Earl R. Pomeroy, *Political Prospects for Changes in Insurance Regulation*, 11 J. INS. REG. 5 (1992); Robert D. Haase, *Federal Regulation Revisited*, 11 J. INS. REG. 14 (1992); J. Glen Morrow, *Regulatory Environments: Do They Matter?*, 11 J. INS. REG. 19 (1992).