

## **Managing the Future of Insurance Insolvency**

by

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The subject of insurance insolvency suffers from a lack of attention. To be sure, insolvent insurers will steal the spotlight, especially when a large company is left in ruins – and policyholders, who are the insurance regulators’ top priority in all events, are left confused, angry, and at risk of losing coverage, payment on claims or years of investment value – because of fraud or other scandalous conduct. Threats to the financial health of the industry itself, or, at least, segments of it, get noticed, too, as has been the case with pending asbestos and class action legislation, the terrorism bailout of 2001, and the concern that large, news-making insolvencies will create a run on guaranty funds, placing other carriers and their policyholders in the jurisdiction in immediate jeopardy.

Lost in the debate over these and similar issues is meaningful inquiry into the laws that govern the rehabilitation or liquidation of an insolvent insurer. The substance of insolvency laws, and with it the expertise of insolvency professionals, too often gives way to broader debates regarding insurance regulation generally, regulation that for the most part has its greatest effect on the solvent segment of the industry. When insolvency is the topic of discussion, it commonly serves only as a catalyst; the focus quickly turns to finding the cause and crafting a regulatory fix. Such a forward-looking approach is indeed important, but it obscures the need for an adequate remedy for those to whom the damage was done.

Part of the problem lies in the history of the debate over insurance regulation, a debate that traces back to the Civil War. Then, the overriding question concerned who should do the regulating, the states or the federal government. Because that question remains at the forefront today, a brief review of history is in order.

### History of the Control of the Insurance Industry

In its 1869 *Paul v. Virginia*<sup>i</sup> decision, the United States Supreme Court passed on the constitutionality of Virginia's regulation of out-of-state insurers and agents. Paul, an agent for a number of New York insurance concerns, argued that Virginia had run afoul of the Constitution because the business at hand was interstate commerce, which was exclusively within the authority of Congress to regulate. The Court disagreed:

Issuing a policy of insurance is not a transaction in commerce. The policies are simple contracts of indemnity against loss by fire, entered into between the corporations and the assured, for a consideration paid by the latter. These contracts are not articles of commerce in any proper meaning of the word.<sup>ii</sup>

Thus, *Paul v. Virginia* placed authority to regulate insurance squarely in the states.

Interestingly, some state officials believed insurance regulation should, in fact, be handled on a national basis by the federal government:

Early state regulators believed that the national nature of the insurance business and considerations of efficiency supported federal regulation. Elizur Wright, known as the "Father of Insurance Regulation," opined that "insurance, being of widespread interest, should be secure against the adverse operation of local causes – that simplicity required a national bureau, and that a state could probably not protect itself as well with reference to insurance of other states as it could be protected by the federal government."<sup>iii</sup>

Because *Paul v. Virginia* ruled out federal involvement, state officials did the next best thing – they associated to further their common goals, and in 1871 what is now known as the National Association of Insurance Commissioners ("NAIC") was born. From the start, the

NAIC emphasized the need for collaboration and uniformity among the states. There was also an early recognition that insurance regulation necessitated a balance between insurers' ability to freely carry on their business while maintaining the public's interest in a sound and stable insurance system. According to one account, the initial 1871 meeting left state commissioners:

fully prepared to go before their various legislative committees with recommendations for a system of insurance law which shall be the same in all states – not reciprocal, but identical; not retaliatory, but uniform. That repeated consultation and future concert of action will eventuate in the removal of discriminating and oppressive statutes which now disgrace our codes, and that the companies and the public will both be largely benefited, we have no manner of doubt.<sup>iv</sup>

For the nearly 70 years that *Paul v. Virginia* was the law of the land, state regulation took hold, as did state officials' belief in their ability to regulate. The insurance industry mounted legal challenges along the way, but without much success. At the same time, a policy doctrine was taking hold that "insurance is business coupled with a public interest," justifying regulation irrespective of whether it is imposed at the federal or state level. The 1914 Supreme Court decision in *German Alliance Insurance Co. v. Lewis*,<sup>v</sup> for example, upheld state rate regulations on the basis of a collective interest: "the loss is spread over the country, the disaster to an individual is shared by many, the disaster to a community shared by other communities; great catastrophes are thereby lessened, and it may be, repaired . . . We can see, therefore, how it has come to be considered a matter of public concern to regulate it."<sup>vi</sup>

It should come as no surprise that in the New Deal era the pivotal question in *Paul v. Virginia* – whether insurance contracts constitute interstate commerce – would be answered in the affirmative. This was the Supreme Court's holding in its 1944 *United States v. South-Eastern Underwriters Ass'n*<sup>vii</sup> decision, where the Court looked not at the isolated event of

contract execution, but its role in a series of related events and transactions that was interstate in character.

Much more interesting is the industry's position in the case. Invoking the *Paul v. Virginia* rule, South-Eastern Underwriters, which was but one of nearly 200 companies charged with violating federal antitrust laws, argued that the federal government had no authority to bring the charges because contracts of insurance are not interstate commerce. Despite the contradiction in the legal argument, there is consistency in the industry's position: the desire for less regulation. Success in *Paul v. Virginia* would have meant no insurance regulation, for there was no competing federal scheme in place at the time, nor was Congress inclined to enact one. More generally, *Paul v. Virginia* pre-dated a number of events and social movements, all of which culminated in a massive shift in the public mindset about the role of government in a capitalist society.

In any event, *South-Eastern Underwriters* firmly established insurance as interstate commerce and, consequently, Congress as the ultimate regulatory authority. But, while *South-Eastern Underwriters* could change the rule, it could not change 70 years of regulatory development. Interested in preserving state authority over insurance matters, the NAIC in 1945 successfully lobbied for passage of the McCarran-Ferguson Act, in which Congress expressly ceded regulatory authority over the business insurance to the states.

The combined effect of *South-Eastern Underwriters* and McCarran-Ferguson was to create a tension between state and federal regulatory power that remains to this day. The states preserved their authority to regulate, but lost a measure of discretion in the process.

Congressional satisfaction with the states' performance is an ever-present consideration because

Congress can step in with its own regulations at any time and, more severely, just as surely as it was enacted, McCarran-Ferguson can be amended or even repealed.

Unfortunately, this tension dominates discussion even today, obscuring necessary inquiry into discrete substantive issues under the larger umbrella of insurance regulation; the efficacy of insolvency laws is a notable example among them.

One must look no further than the current Congress for examples. In July 2003, Senator Hollings (D-SC), introduced S. 1373, the Insurance Consumer Protection Act of 2003. S. 1373 would completely federalize the regulation of interstate insurance. As it must, S. 1373 provides for rehabilitation and liquidation of insolvent insurers, but these provisions received scant attention from interested parties or from Senator Hollings himself. Instead, any debate over S. 1373 focused on the age old battle over state-versus-federal control of insurance regulation.

Perhaps this focus is just what Senator Hollings intended because three months later, on October 29, 2003, he and Senator McCain (R-AZ) heard testimony before the Senate Committee on Commerce, Science and Transportation. The stated intent of the hearing, federal involvement in regulation of the insurance industry, as well as the actual testimony, purposefully continued to emphasize the “who” over the “what” of regulation. Such an emphasis inevitably means that the subset of insurance regulation dealing with insolvent insurers will simply get taken along for the ride without inquiry into the substance of those provisions.

Perhaps the most telling statement given at the October 29 hearing came from the Consumer Federation of America representative: “The prime issue with consumers is not who regulates insurance; it is whether insurance regulation is effective and efficient.” In other words, at the end of the day, it is the quality of the regulation, not its source, that matters. So it is with

insurance insolvency. What is needed for a focus on quality is a severance of insolvency laws from the rest of the debate. More specifically, there is a compelling need for a comprehensive review of the insolvency laws throughout the nation to examine the effectiveness and efficiency of the various processes in place.

For example, we know that insurance insolvency laws are not uniform and that some states' laws resemble the old Chandler Act, the federal bankruptcy statute that was completely overhauled in 1978. What we must learn is how a lack of uniformity and the presence of old laws might be affecting the administration of insolvent insurance estates in the modern world. Concern has also been expressed regarding state officials' exclusive authority to commence insolvency proceedings. The current regime produces the undesirable incentive for the official to forestall the inevitable for too long, making the eventual insolvency proceedings more expensive and risking both a reduction in distribution to claimants and increased pressure on guaranty funds.<sup>viii</sup> One critique of regulatory exclusivity examines the relative merits of company management initiation of insolvency proceedings, concluding that it is a viable alternative.<sup>ix</sup> Because the company management initiation proposal focuses largely on incentives to act or refrain from acting, there is no discussion of its broader impact, particularly whether private citizens can or should be able to make decisions that would assuredly affect guaranty funds. Nevertheless, the manager initiation proposal does articulate a legitimate need to review regulatory exclusivity insofar as initiating insolvency proceedings is concerned.

Here we cite just two areas of concern, but any number of other problems could exist among the states, many of which may not even be revealed without an independent, comprehensive review.

## Past Reviews of and Recommendations for Improved Insurance Insolvency Laws

This is not to say that this article is the first to recognize the need to sever insurance insolvency from insurance regulation generally for purposes of review and recommendations to improve existing law. In the 1970s, there was considerable discussion of whether insurance companies should be permitted to seek federal bankruptcy relief. The National Conference of Bankruptcy Judges supported legislation that would have repealed the insurance exclusion from the then existing Bankruptcy Act, and the Commission on the Bankruptcy Laws of the United States, the 1970s counterpart to the 1990s National Bankruptcy Review Commission, considered such an exclusion. Ultimately, of course, the repeal of the insurance exclusion never made its way into Title 11, but for a time there was reasoned deliberation and debate regarding the appropriate manner in which to handle insolvent insurers. Like its predecessor, the National Bankruptcy Review Commission's 1997 report also did not recommend repealing the insurance exclusion but, unlike the 1970s Commission, it seems the NBRC never even considered the matter.

Another bankruptcy oriented review was undertaken within the American Bar Association ("ABA"). In the 1990s, the ABA's Business Law Section formed an Insurance Insolvency Task Force, which produced its federal Insurance Reorganization and Liquidation Act. This proposal would have created a mechanism much like Chapter 11 of the Bankruptcy Code, even vesting the Bankruptcy Courts with the jurisdiction over the proceedings. However, oversight would be provided by a federal Insurance Certification and Oversight Board, and an insurance commissioner is vested with the authority to file the petition commencing the proceeding. Unfortunately, little information is readily available about the Insurance Insolvency

Task Force’s deliberative process, nor is it clear why there appears to no continued effort with respect to promulgating the Act. In addition, according to another ABA Task Force, discussed below, neither the ABA nor its Business Law Section endorsed the Act.<sup>x</sup>

The Task Force on Insurer Insolvency of the American Bar Association’s Tort and Insurance Practice Section released in May 2000, and updated in January 2003, its Final Report on Receivership of Insolvent Companies (“TIPS Report”). The TIPS Report represents what is perhaps the most comprehensive review of the various inquiries into the effectiveness of existing insurance insolvency laws and, indeed, proved a useful resource for this article. Among the conclusions in the TIPS Report was the following:

The Task Force does not endorse the current state insurance receivership system in all respects. After studying the deficiencies in the present system and noting the absence of reliable cures in alternative approaches, however, the Task Force concluded that a complete replacement, or even a major modification, of the present system is not warranted.<sup>xi</sup>

Given the breadth of the TIPS Report’s examination, this conclusion is a bit disappointing. But the “least of all evils” feel buttresses a major point of this article – that too little attention has been paid to the specific issue of the efficacy and efficiency of insurance insolvency laws. It was not the goal of the TIPS Report to create something new, but to review existing laws and the alternatives that have been proposed. As discussed above, those alternatives tend to be proposed sporadically from disconnected and divergent sources. Where there is continuity, it rests in the NAIC, but given the dynamics of the state-versus-federal tug of war, fostering open, robust debate might not be a viable option for the NAIC in this current political environment.

## The National Association of Insurance Commissioners

The NAIC is without question an organization that has earned respect in its 130 year history. It was through the work of the NAIC that the states managed insurance regulation in the 70 years that *Paul v. Virginia* was the law of the land, and many state insolvency statutes are enactments of the NAIC model law. After *South-Eastern Underwriters* and McCarran-Ferguson, the NAIC lost some of its freedom of movement; its priorities could be set by Congress under the threat of federal intervention. A recent example of Congressional pressure came from passage of the Gramm-Leach-Bliley financial modernization act in the late 1990s, which repealed Depression-era legislation designed to separate banking and insurance business. Although Congress affirmed the continued viability of McCarran-Ferguson, it also threatened to impose federal licensing standards if a majority of states had not done so with a specified time period. Moreover, Senator Hollings' S. 1373 is just one of several bills introduced over the last 15 years that threatened to either completely federalize insurance regulation or to create an optional federal charter. This sort of pressure understandably leads to some measure of conservatism in thought and action because controversy creates a risk too great for the NAIC and, consequently, the states to bear.

In addition to Congressional pressure, the NAIC suffers from criticism that it is too heavily influenced by industry itself. In a detailed examination of the history and current role of the NAIC, Professor Susan Randall summarized that influence as including:

(1) the NAIC provides multiple mechanisms for direct industry participation in regulatory issues; (2) the NAIC's budgetary reliance on the industry ensures its responsiveness to the industry's interests; and (3) the NAIC permits the industry to combine the advantages of centralized participation and lobbying (at the NAIC level) with the advantages of multiple (state) regulatory systems.<sup>xii</sup>

Given the prevalence of industry influence in NAIC decision making, combined with increasingly frequent threats to state control of insurance regulation, it is hardly surprising that the analyses of insurance insolvencies that do exist come from sources other than the NAIC. Indeed, in its “A Reinforced Commitment: Insurance Regulatory Modernization Action Plan,” adopted in September 2003, the NAIC says this, and only this, about insolvency regulation:

The NAIC will promote uniformity by reviewing the Insolvency Model Act, maximizing use of technology, and developing procedures for state coordination of imminent insolvencies and guaranty fund coverage. The Financial Regulation Standards and Accreditation Committee will consider the requirements no later than January 1, 2008.

We are by no means attempting to single out the NAIC for especially harsh criticism, and we do not – and credibly could not – contend that industry influence is a problem unique to state regulatory authorities. But the priorities of the NAIC, as reflected in its recently adopted action plan, are evident and attention to insolvency laws among the states is not high on the list. More specifically, the NAIC seems to have eschewed the Interstate Insurance Receivership Compact, developed within the NAIC Midwest Zone. There appears to be little publicly available information about the creation of this Compact or deliberations within the NAIC regarding its merit. According to the TIPS Report, neither the NAIC nor the insurance industry endorsed it.

Despite the lack of endorsement and other challenges to the viability of the Compact, it does represent a step in the right direction. The Compact created an Interstate Insurance Receivership Commission, which drafted a Uniform Receivership Law. Thus, the Compact accomplished the first step of what this article argues is necessary: it severed insolvency law from the general debate over insurance regulation in order to put forth what it believes to be an effective model insolvency law.

## What Lies Ahead?

With all this in mind, the question becomes one of where we go from here. At the risk of stating the obvious, doing nothing is not an option. The insurance industry itself is changing, and its evolution will not slow down just to let insolvency law keep pace. Indeed, while there is some deliberation of the various insolvency mechanisms, the industry itself continues to change at a rapid pace. Competition has been intensifying for several decades. Since the enactment of Gramm-Leach-Bliley, the character of the insurance industry has become more uniform and national, even international in some case, and the industry is in a competitive battle with banks and similar financial institutions, which write an increasing share of insurance policies each year. Under these circumstances, predictions of the inevitability of insolvencies, occurring sooner rather than later, are hardly surprising. Adding in the consequences of unanticipated catastrophe, including natural disasters and terrorist attacks, and the fact that future insolvencies will likely be even larger and more complex than has been seen in the past, the need for action becomes clear.

That action should come in the form of a commission on insurance insolvency, one that is truly independent and which relies on a broad base of expertise. The impetus for the formation of such a commission could come from among the private, reputable associations of insolvency and insurance professionals or through a legislative directive, much like the creation of the National Bankruptcy Review Commission.

Whatever the source, however, the composition must be broad-based. The perspectives of those within the industry, be they state officials, insurance executives, trade associations or attorneys, provide necessary insight, but they do not necessarily complete the process.

Insolvency professionals must weigh in as well. Bringing insolvency professionals into the review process, particularly individuals with experience in a range of insolvency proceedings including bankruptcy, assignments for the benefit of creditors, and receiverships, both broadens and narrows discussion. Breadth will derive from the individuals' experience in cases not involving insurance, thus generating ideas that are new and innovative within the insurance world. At the same time, the discussion will stay focused on the process of rehabilitating or liquidating the insolvent insurer.

The TIPS Report, discussed above, presents a useful example. In rejecting bankruptcy as an alternative to the state-based insolvency process, the TIPS Report noted that the goal of the Bankruptcy Code “is to keep the debtor in business by forcing creditors to accept a lesser percentage of what is owed to them. The bankruptcy courts actually conduct few liquidations in which the debtor is dissolved. It is questionable how this would work in the context of effective insurance regulation.”<sup>xiii</sup> The question of whether Chapter 11 reorganization is appropriate for insolvent insurers is indeed a valid one, particularly in light of the ability of Congress to deal with the unique concerns raised in an insurance insolvency, as it has done for other specific industries with specialized regulatory issues. But the report seems to underestimate the number of liquidations that do occur in bankruptcy, whether under Chapter 7 or 11, as well as the power of the courts and Congress to force insolvent insurers into liquidation without the option for reorganization. The TIPS Report cited other concerns about the bankruptcy alternative, but this example does show the substantive value insolvency professionals bring to any review process.

Generating interest in an independent review commission would not likely be difficult.

The efforts over the last decade set forth above indicate that the interest is already there; a

commission would simply provide a mechanism for bringing together otherwise scattered and disconnected efforts. Moreover, there are individuals and groups interested in the topic of insurance insolvency beyond those mentioned here.

### Conclusion

As stated at the outset of this article, the law of insurance insolvency suffers from a lack of attention. As everyone well knows, nothing worthwhile thrives in such an environment. The reviews and proposals that have emerged in the last decade or so represent a good start toward achieving the goal of a complete, independent review of the states' insolvency statutes with recommended changes necessary to keep pace with the evolution of the insurance industry. With cooperation and commitment, insurance and insolvency experts can ensure that goal is fulfilled.

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<sup>i</sup> 75 U.S. 169 (1869).

<sup>ii</sup> *Id.* at 183.

<sup>iii</sup> Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 Fla. St. U.L.R. 625, 631 (1999).

<sup>iv</sup> *Id.* at 632.

<sup>v</sup> 233 U.S. 389 (1914).

<sup>vi</sup> *Id.* at 412-13.

<sup>vii</sup> 322 U.S. 533 (1944).

<sup>viii</sup> See e.g., Stewart Economics, Inc., *Managing Insurer Insolvency 2003: Updating the 1988 Report* (2003).

<sup>ix</sup> David A. Skeel, Jr., *The Law and Finance of Bank and Insurance Insolvency Regulation*, 76 Tex. L. Rev. 723 (1998).

<sup>x</sup> For more information on the Insurance Reorganization and Liquidation Act, see generally *Receivership of Insolvent Companies: Final Report of the Tort and Insurance Practice Section Task Force on Insurer Insolvency*, 63-66 (May 2000, as updated January 2003) (“TIPS Report”).

<sup>xi</sup> *Id.* at 2

<sup>xii</sup> Randall, *supra*, n.3 at 677.

<sup>xiii</sup> TIPS Report, *supra*, n.10 at 62.