November 30, 2005

Commissioner M. Diane Koken
Pennsylvania Insurance Department
President—National Association of Insurance Commissioners
1326 Strawberry Square
Harrisburg, PA 17120

Re: NAIC Insurer Receivership Model Act

Dear Commissioner Koken:

The Executive Committee of the National Association of Insurance Commissioners is scheduled to consider the Insurer Receivership Model Act (IRMA) for adoption at the winter meeting in Chicago. The American Insurance Association strongly opposes adoption of the current draft of the IRMA model.

AIA was hopeful when the NAIC first began the process of reviewing its receivership model that a modern, effective, and balanced receivership law could be drafted. This goal cannot be achieved, however, unless the model: 1) provides a transparent receivership process with an appropriate standard of accountability on the receiver; 2) establishes a fair and equitable balancing of all stakeholder interests; and 3) recognizes the critical role the state guaranty funds play in providing an essential, but necessarily limited, safety net for those policyholders and third party claimants most in need of protection when their insurer becomes insolvent. The current IRMA draft, unfortunately, misses the mark of these three standards in several critical provisions. Without significant revisions to the current draft, IRMA risks re-living the fate of the prior NAIC receivership model, which has been enacted in only one of fifty-one jurisdictions since its adoption in the early 1990s.

The most critical flaw with the current draft is the omission of a large deductible provision. A model receivership law must clarify that a state guaranty fund is entitled to the subsequent deductible reimbursement by the policyholder in instances where the guaranty fund pays the claim amount within the large deductible. Common sense, basic rules of fair play, and public policy all argue that the guaranty fund has the right to any subsequent policyholder reimbursements for claim payments made by the guaranty fund. The absence of an appropriate large deductible provision
colors one’s perception of the basic fairness, effectiveness and viability of the entire IRMA draft.

A receivership model that is out of balance and fails to consider the just interests of all stakeholders is a model that cannot be supported. In addition to the failure to include a large deductible provision, the draft model also authorizes receivers—at their “sole discretion”—to ignore the statutory priority of distribution by simply designating certain payments to lower classes of priority as “administrative costs.” This blanket power to ignore the statutory priority of distribution is unprecedented and provides the receiver with too much discretionary power. As with the large deductible provision, it is not possible to support a model that sets forth provisions that seem to clash with fundamental concepts of fairness and public policy.

There are additional provisions in the current draft that fail to balance the interests of all stakeholders participating in the receivership process. The current draft, for example, would allow receivers to unravel business transactions between affiliated companies as far back as five years, which seems an inappropriately long time. The current draft also excludes obligations to insurers arising from an insolvent insurer’s policy from policyholder class status.

IRMA is being considered at a time when state guaranty funds are experiencing severe financial stress. Due to a record number of recent large commercial insurer insolvencies, the financial capacity of state guaranty funds is being seriously stretched in order to allow guaranty funds to continue to make full and timely payments of guaranty fund claims to policyholders, injured workers and third-party claimants. Legislatures in all states are seeking solutions to the financial capacity problems being experienced by guaranty funds. An October 31, 2005 Interim Report issued by the New York Insurance Department to the governor and the state legislature is illustrative of the need to enact reform legislation to increase guaranty fund capacity. The New York Department’s Interim Report notes that the combined effect of recent insolvencies “has been catastrophic on the [guaranty] funds.” The Interim Report notes that the independent analysis it has commissioned “recommends structural reforms to the liquidation process to ensure long-term stability of the [guaranty] funds.” The Department advocates that these reform measures must be enacted to “provide much needed relief to the funds [that] would reduce demand on the system.”

As suggested by the October 31 Interim Report of the New York Insurance Department in a slightly different context, the value of any receivership model will be ultimately judged by state legislatures by whether or not the proposed receivership model will “provide much needed relief to guaranty funds and whether the proposed model will or will not reduce demand on the guaranty fund system.” Clearly the answer for the current IRMA draft is “No.”
IRMA is replete with provisions that would impair a guaranty fund’s ability to fulfill its statutory obligations. By failing to include a large deductible provision, the current model suggests that the receiver rather than the guaranty fund deserves the large deductible reimbursement for claims paid by the guaranty fund and not the receiver. Moreover, Section 801 (option two) would lower—rather than increase—the guaranty fund’s order of priority in estate distributions and Section 105(I) fails to provide guaranty fund with the automatic right to intervene in insolvency proceedings even where the guaranty fund could be adversely effected by those proceedings. Such provisions directly conflict with the current need to enact laws to improve the ability of guaranty funds to fulfill their essential statutory obligations of paying injured workers, policyholders and claimants in a timely and appropriate manner.

AIA would request that IRMA be sent back to the Financial Condition Committee for the purposes of making the following changes to the model:

● **Large Deductible Provision:** Inclusion of a large deductible provision is essential to any receivership model. Omission of language clarifying that when a guaranty fund pays injured workers or other claimants amounts within the policyholder’s large deductible, the guaranty fund is entitled to the subsequent policyholder reimbursement, highlights the unbalanced nature of the current IRMA model. It is basic fairness that where a guaranty fund pays a claim within the large deductible, the guaranty fund deserves to stand in the shoes of the insolvent insurer and recoup the subsequent reimbursement. This is not simply AIA’s view, but is the unanimous view of the state legislatures of Pennsylvania, Illinois, California and Texas. All these state legislatures enacted large deductible provisions by more or less unanimous votes.

During an October 28 Financial Condition Committee conference call, a few regulators claimed it was “too controversial” to include a large deductible provision in the draft model. It is difficult to ascertain what is controversial about clarifying that the reimbursements for amounts paid by guaranty funds should properly belong to the guaranty fund. Certainly no legislators in Pennsylvania, Illinois, California or Texas found the provision controversial. Legislators from both the most extreme conservative to the most extreme liberal orientation seem to understand the concept that if the guaranty fund pays the injured worker, it is just and fair to ensure that the subsequent policyholder reimbursement for that payment goes to the guaranty fund.

A truly controversial concept would be to suggest that the guaranty fund not be obligated to pay any claims within the large deductible. No one is suggesting such a resolution of the issue, but it certainly is the only logical conclusion to be drawn from the intent of the current IRMA draft. If the sponsors of the model do not believe guaranty funds are entitled to the policyholder reimbursement and that the receivers should receive the reimbursements, it is logical to assume that the receivers, and not the guaranty fund, should also make the initial payments within the deductible.
AIA certainly does not adhere to this view, but it would be a reasonable legislative response to the model as currently drafted. It would be much better for all concerned if the model simply clarified that where the guaranty fund makes the large deductible payment, the guaranty fund receives the subsequent policyholder deductible reimbursement.

Public policy urges in favor of a large deductible provision. An appropriate large deductible provision is needed to protect the personal or small business policyholder who benefits from guaranty fund protection. Failure to include a large deductible section would mean that certain policyholders—those policyholders state legislators do not believe are most in need of the safety net provided by the guaranty fund system—will reap an unjust windfall via increased estate distributions. These policyholders are typically those least in need of financial help. Guaranty fund coverage is generally provided to all property and casualty policyholders, except the following three categories: 1) commercial surplus lines policyholders who purchase insurance on an unlicensed basis and who are advised by state law that guaranty fund coverage is not available for surplus lines; 2) very high net worth policyholders (guaranty fund coverage is excluded for insureds whose net worth exceeds a certain very high amount—usually somewhere between $10 million to $50 million, depending on state law); and 3) claimants, other than injured workers, to the extent their claim exceeds maximum guaranty fund limits, typically $300,000 (the claim limit typically does not apply to workers’ compensation claims). An appropriate large deductible provision helps ensure that those most in need of protection do not bear the burden of financing increased windfall estate distributions to a class of non-covered insureds who are typically in a much more favorable financial situation.

● **Section 504(A)(3)(b) and Section 801 Drafting Note: Receiver’s Discretion to Ignore Statutory Priority of Distribution:** Section 504(A)(3)(b) and the drafting note to Section 801 authorizes the liquidator, in his or her “sole discretion”, to reclassify payments to lower priority classes as Class 1 “administrative cost” payments in order to pay lower priority claims ahead of higher priority claims. Allowing the receiver sole discretion to disregard the statutory order of distribution shows an unhealthy disregard for the rule of law and is another example of an IRMA provision that permits way too much discretionary power in the hands of the receiver.

Drafting a provision that allows the liquidator to disregard the order of distribution at his or her sole discretion increases the potential for mischief and abuse by the receiver in the administration and payment of the estate’s claimants. It would seem more legitimate and fair to simply require the liquidator to pay claimants according to the order of priority set forth by law.

● **Section 801: Lowering Class Priority Status of Guaranty Fund Reimbursements:** Section 801 contains optional language (Option Two) that would lower the priority class for guaranty fund defense costs. Guaranty funds were
created by state legislatures to fulfill a significant public policy goal—to pay policyholders, injured workers and other claimants promptly and in full (except for a few legislatively-mandated coverage defenses) when an insurer becomes insolvent. It is imperative that guaranty funds have sufficient financial capacity to fulfill their public policy role to aid receivers in the prompt payment of claims.

At a time when many state legislatures are looking for ways to increase the financial capacity of guaranty funds (for example by improving early access to estate distributions, inserting claim bar dates and net worth provisions, and allowing guaranty funds to issue bonds) it is extremely disconcerting that IRMA is now actually proposing new ways to lower the financial capacity of guaranty funds. Section 801’s optional language would impair guaranty funds’ ability to have adequate financial resources to pay policyholder claims and workers’ compensation benefits promptly and in full and should be stricken from the model.

- **Section 105(I): Eliminating the Guaranty Fund’s Automatic Right to Intervene:** Section 105(I) has been revised to restrict the guaranty fund’s power to intervene as of right in receivership proceedings where the guaranty fund may become liable as the result of the receivership proceeding. It seems reasonable to allow the guaranty fund, which is invariably the largest creditor group, a right to intervene in a receivership proceeding. Requiring intervention only after a hearing and court order would only unnecessarily wastes scarce resources of both the estate and the guaranty fund.

- **Section 602(A): Recovery from Affiliates—Five Year Look-back**

Section 602(A) would permit the receiver to go back as long as five years preceding the petition for receivership to unravel transactions made with an affiliate of the insurer. A five year look-back period seems to be over-reaching and would place completely legitimate transactions between affiliates in danger of unraveling by over aggressive receivers. A five year period is unreasonably long and casts unnecessary uncertainty regarding legitimate affiliate transactions.

While the receiver should have the ability to recover property transferred to affiliates where such transactions are inappropriate and illegitimate, a balancing must be achieved between the need to unravel illegitimate transfers of property with the need for certainty and finality to legitimate affiliate business transactions. A five year look-back period errs on the side of creating unnecessary uncertainty. A two year period strikes a more reasonable and fair balance.

- **Section 801(C)(3): Priority of Distribution—Obligations to Insurers Excluded from Class 3 Status**

Section 801(C)(3) makes claims derived from an insurance policy issued by the insolvent insurer a Class 3 claim in the priority order. However, Section 801(C)(3)
makes claims by insurers, insurance pools or underwriting associations, including subrogation, indemnity and contribution claims, specifically excluded from Class 3 status. Instead, all insurer claims that are derived from an insurance policy other than direct claims are reduced to Class 6 status via Section 801(F).

No sound policy reason exists to exclude the legitimate policy claims of insurers from the policyholder class. Insurer claims derived from the insurance policy deserve to be treated on the same level as other policyholder claims. Moreover, as the members that constitute the guaranty associations, insurers are already providing the funding necessary for the guaranty funds to pay covered claims to the insolvent insurer’s policyholders and third party claimants. There is no justification to penalize the insurer community by denying their rightful position within the policyholder class.

AIA thanks you for your consideration of these issues.

Sincerely,

Steve Bennett    Tammy Velasquez