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HEADLINE: Analyzing the life cycle of an insolvency: the "life" cycle of a property/casualty insurer insolvency often takes place in an opaque world bereft of accountability. Taxpayers and policyholders end up payingthe most; INSURANCE

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BODY:

The principal public-policy objective of an insurance insolvency proceeding is to return to policyholders and claimants as much as possible of their claim as quickly as possible.

One need only look at the case of Transit Casualty Co. and many others to see the difficulty the current system has in meeting this objective. The first distribution to claimants in the case of Transit, was in 1995, 10 years after the company's collapse in 1985. This payment was just 10 percent for noncovered claimants and 25 percent to theguaranty funds for the covered claims they paid.

Significant impediments to achieving an insolvency proceedings objective are commonplace. Why? Because:

* When a company is found to be insolvent, liquidation may not be the most effective method of maximizing available assets to meet the claims of policyholders. Stakeholders are not encouraged to develop alternative solutions.

* In certain circumstances, companies are placed into liquidation proceedings when alternative resolutions might be possible and less costly.

* Government's involvement in receiverships may impede effective and efficient resolution.

* Generally, the interests of claimholders--including claimants, reinsureds and guaranty funds seeking reimbursement--are not protectedsufficiently.

* U.S. receiverships are administered not by professional, licensed insolvency practitioners, as is the ease in the

United Kingdom and many other countries, but by an individual selected by the insurance commissioner who may or may not be experienced in receivership and insurance matters. Stakeholders have no voice in the selection process.

* No effective oversight of insurance receivership administration occurs, which may result in mismanagement, unnecessarily prolonged receiverships and excessive costs.

* Guaranty funds, the safety net for customers of a failed insurer, pay covered claims of policyholders and claimants, but at a cost tononcovered claimants.

* Claimants covered by the guaranty funds get paid relatively quickly, but noncovered claimants have to wait years or even decades to receive payment.

* A lack of transparency and accountability increases concerns about excessive costs and the delays in getting policyholders and claimants paid.

* A postmortem of major insolvencies, which may help prevent future insolvencies or lessen their impact through earlier detection, is not routinely done.

This is not to suggest that the current system is entirely dysfunctional, but rather it indicates what needs to be done to move toward a more optimal system for all stakeholders.

CREATIVE LIQUIDATION

Through any number of means, a state insurance regulator will identify insurers as troubled. Surprisingly, in recent years, many of have been identified as a result of the insurers' management disclosing to regulators that they have solvency issues, or of downgrades by ratings agencies that effectively force a commercial insurer to close its doors.

The regulator will then begin an assessment and evaluation to determine the extent of the problem, evaluate the company's corrective plan, if any, and take such other steps as may be necessary. The regulator's focus is curing the balance-sheet insolvency, not how the interest of policyholders can be best served if the insolvency cannot be corrected.

After the regulator determines the company to be insolvent, it is highly unlikely that major policyholders and creditors are advised, let alone asked for input and advice, as to solutions or a "creative" liquidation plan. The move to liquidation is usually swift.

Before the existence of guaranty funds, the regulator's first recourse was to try to merge a troubled insurer or to do a "reinsurance deal" that would create surplus to fix the balance-sheet insolvency, allowing the company to continue in business.

Regulators often applied pressure on the industry to get these deals done. That was a time when regulators viewed their prime responsibility as avoiding a failure and saving a company if at all possible.

One of the unintended consequences of the guaranty funds has been the disincentives it has created in saving companies or exploring alternatives to liquidation. Even when a company is placed in rehabilitation, more often than not it is a prelude to liquidation. No serious attempt is made to use it as a vehicle for other solutions to avoid liquidation.

Guaranty funds will be advised of the insolvency, but solely so they can prepare to receive, adjust and pay claims. While the guaranty funds will likely be the largest creditor, the system does not contemplate the funds being anything more than a payor. The drafters of guaranty-fund law never contemplated the large insolvencies that have occurred. Guaranty funds were created well before the more recent explosion in litigation.

Today, insolvencies are viewed as a natural consequence of a competitive environment. Few get upset when they occur. When an insolvencyis announced, there is a rush to get the insurer into liquidation and trigger guaranty funds.

Guaranty fund costs will ultimately be passed on to taxpayers or policyholders through higher premiums. For government officials, thereis some safety and comfort to liquidation. Many, if not most, personal and small commercial losses will be paid by guaranty funds, and regulators no longer will have to worry about the insurer. There is a certain amount of political expediency involved.

However, if you are a policyholder not covered by guaranty funds because of net-worth limitations in a particular state's guaranty association act, or only partially covered or reinsured, you may soon wish alternatives had been explored, as it will likely be years, if not decades, before cents on a dollar on any claim is received.

The Transit Casualty Co. situation is but one example of the yearsit takes for resolution. The extent to which claims are left unpaid is unclear, as there is no data on, nor central repository for, insolvency and receivership statistics, unlike in the federal bankruptcy system for noninsurance failures.

After finding a company insolvent, regulators will petition a state court to seize control of the insurer and/or file a request to havethe company placed in liquidation.

If management or shareholders give their consent, the petition forliquidation and order of liquidation can, and likely will, be done the same day.

It is unlikely that stakeholders be given adequate notice to appear and be heard, though creditors may later intervene. Only the government, through the state's attorney general, on behalf of the insurance commissioner, can petition for receivership. Only the commissioner can be named the statutory receiver.

The commissioner is thus in control of the company, subject only to the oversight of the court, which may not be well-positioned to conduct effective oversight.

The entry of a liquidation order cancels all in-force policies, and the rights of policyholders and claimants are fixed as of the liquidation date.

One of the most important initial decisions the commissioner as receiver needs to make is the appointment of a person who will administer the receivership. Even though major creditors and the guaranty funds have a vital interest in who is appointed, they do not have a rolein the selection process.

Unlike the United Kingdom, Bermuda and other countries, the UnitedStates does not have licensed insolvency practitioners who must be appointed to administer a receivership estate.

Several years ago, an American Bar Association Task Force on Insurer Insolvency identified the selection of receivers as a weakness in the receivership system.

Not all receivers are chosen on the basis of competence or commitment to efficient performance. The lack of standards for who is appointed can create a temptation not everyone is able to resist. A situation where almost any person can be appointed a special deputy receiverin a system that lacks transparency and oversight can create inefficiencies.

Receivers may have little incentive to bring an estate to an earlyclosure. In fact, there is almost a disincentive to do so since the government usually does not base compensation on results.

Winding up the affairs of insolvent insurers of the recent past and likely the future is a business and management function not well-suited for government.

When insolvencies were modest affairs, there was no need to question the government's role, but, today, insolvencies are often large, complex and national, and in some cases international.

This makes the two primary functions of estate administration--one, marshalling or monetizing the company's assets and, two, approving and fixing claims--anything but simple and straightforward.

Approving and fixing the amount of claims is a long process compared with the auto and fire claims of years ago. Liquidation rules don't help. With government in charge, the temptation is to be more thorough than efficient, and resolution takes longer. The United States has yet to develop an effective means of accelerating the slow and expensive evaluation process for long-tail claims.

The system needs to find a way to accelerate this process so that estates are not kept open until all potential claims are liquidated.

The most significant asset to marshal for a company writing general liability is likely reinsurance ceded. Customarily, reinsurance is not collectible until the underlying claim is paid; however, because in liquidation claims cannot be paid in full, the rules of liquidation require payment by the reinsurer when a claim is fixed and approved.

There is no effective means of accelerating reinsurance collections, unless both parties can agree to a commutation, a voluntary process where the amount of the claim is fixed by a negotiated agreement.

Liquidations seem to generate a lot of disputes between the receivership estate and reinsurers. Some attribute this to the desire of the reinsurer to delay payments. Others say that government cannot be trusted to present a proper reinsurance claim.

In either case, these disputes delay the receivership process and bum up estate money through legal and other fees to pursue reinsurance collection, money that ought to be going to claimants. Investment income to the estate is also lost--another hidden cost of insolvency.

Files for those claims believed to be covered by a guaranty fund are sent to the appropriate fund shortly after entry of the liquidation order.

This results in more than 50 state guaranty funds, unfamiliar withthese claims and their history, handling and seeking to resolve these claims. While data is not available for analysis, it is believed bysome that this situation, coupled with the receiver's need to again review these claim files, raises costs and drains away funds available for noncovered claimants.

The receiver has the responsibility for collecting assets related to policies and claims, such as retro premiums, salvage, subrogation,contribution and reinsurance. This requires communication and coordination between the guaranty funds and the receiver. Such coordinationdoes not completely exist, resulting in what some believe to be significant "leakage" or loss of these assets.

The defense of the insured, a benefit provided under a general liability policy, ceases when a company is placed in liquidation. If thepolicy is covered by a guaranty fund, defense may be provided up to the fund's limits of liability with the balance, if any, submitted asa claim against the estate.

The receivership proceeding is under the oversight of the court; however, the court is ill-equipped to perform effective oversight. Thecourts are well-equipped to handle disputes, such as the value of a claim where the receiver and the claimant may differ. But most courtshave neither the time, nor the resources, nor the expertise, to examine data and information to evaluate performance and hold a receiver accountable.

There are no common standards governing the accountability of receivers to the courts, creditors or the public. Lack of information hampers the ability of stakeholders to monitor and encourage efficient management.

In 2002, professors of insurance and finance at Georgia State University sought to study and analyze the cost of insurance receivershipin the United States. The project was abandoned due to the lack of meaningful information.

Even if one had the ability to visit every courthouse where a receivership is pending, it is unlikely that useful information to evaluate the receivership administration would be found. There are no uniform standards on what data and information must be reported to the court. In some courts, the information is not public.

At some point the receiver will begin the payment of dividends or distributions to claimants. Initial distributions, if made at all, will be a very small percentage of approved claims.

The eventual amount of those dividends will depend on the success of the asset marshalling process and costs incurred. The receiver's cost of administration and the guaranty fund's expense of administration are paid out of available assets first.

The guaranty fund will also have a subrogation claim for the fundsused to pay the claims of policyholders that are on equal footing with those of noncovered claimants. This means that it is noncovered claimants, likely large commercial insureds, that are most affected by inefficient administration and excessive costs.

The final step in the receivership process is the dissolution of the failed insurer. This occurs after all assets have been marshaled and claims have been paid to the extent of available funds. Unfortunately, a postmortem on the insurer is not part of the process. Understanding how and why the insurer got into trouble and how regulators performed are never revealed. The receivership history and results will also be unknown because no one collects this information, and government is not required to report it to the public. This lack of transparency and accountability is perhaps the most serious problem with the present system.

RELATED ARTICLE: The lagging tradition.

The insurance insolvency laws of today are intended for the fairlysimple insolvencies of an earlier period, leaving today's policyholders and claimants underserved.

The guaranty-fund system was created with little debate as to who ought to be covered and how it should function. Soon after its creation, industry and other observers questioned what had been done.

The liquidation of a property/casualty insurer is a complex and difficult process under the best of circumstances. There is a reason companies become insolvent, and it usually relates to poor underwriting, rating, systems, and the breakdown of management processes and controls.

Compounding the challenge is the "brain drain," as those most experienced and knowledgeable about the company's history will look for new employment as soon as the company's financial distress becomes apparent.

Despite the well-intentioned efforts of the National Association of Insurance Commissioners and the National Committee on Insurance Guaranty Funds, the current insolvency system is fragmented, uneven, slow and expensive. The lack of transparency and accountability creates an environment that not only allows inefficiencies to continue, but also poor performance and questionable practices to be hidden. While the guaranty funds have proven successful in protecting policyholders and their beneficiaries from loss, they have had difficulty in addressing some of the large recent insolvencies.

Insurance products not directly addressed by guaranty-fund statutes, most recently high-deductible workers' compensation policies, cause delays while issues are sorted out, not only between individual state guaranty funds, but also with the receiver.

Legalistic debates can override practical solutions in such situations, especially when government is involved. Because it is impractical for guaranty-fund acts to keep up with the marketplace and complexproducts being sold, these issues will likely increase.

--James W. Schacht and Lynne Prescott Hepler

RELATED ARTICLE: Solutions for the insolvent.

Editor's note: Insurer insolvencies are expensive. With the Reliance Insurance Cos. insolvency in its fifth year and the Mission Insurance Cos. insolvency taking 21 years to close, this is an issue that is compelling enough to be on the radar screen of any commercial insurance buyer. There is a need to expose and increase awareness of the flaws in the nation's insurance system. The articles are not intended to be an indictment of those that work within this system, but simplya recognition that readers could benefit from a system laced with more transparency, accountability and efficiency, whether that system is state-based or federal. This series is also intended to alert readers and commercial buyers who find their insurance company in receivership, and to provide a glimpse of what to expect.

FEBRUARY 2007

Insurance Insolvencies, Part 2

The second article in this series takes a look at the treatment ofclaimants, creditors and other stakeholders and how more complex receiverships under the present system do not serve these constituencieswell. Here the systemic shortcomings, redundancies and deficiencies in the current approach will be made apparent, as well as how the lack of political will and the vested interests in the status quo have stood in the way of reform.

MARCH 2007

Insurance Insolvencies, Part 3

The third article will feature a case study on the failure of a major U.S. insurer. To provide insight, the case will be contrasted with the collapse of the HIH Insurance Group, Australia's second-largestinsurer.

APRIL 1, 2007

Insurance Insolvencies, Part 4

The fourth and final article in the series--to be published in theApril 1 issue--will identify and discuss recommendations to make thesystem more efficient, less costly and more responsive to creditors.

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