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Resolution of Troubled Insurers: Protecting Policyholders in the 21st Century

By William D. Latza and Andrew P. DeNatale

In the more than two decades since state regulation of insurance was taken to task by Congress and the National Association of Insurance Commissioners ("NAIC") first propounded its Financial Regulation Standards, financial condition regulation of insurers has taken enormous strides forward. From the risk-based capital regime, through risk-focused examinations to the own risk and solvency assessment process, regulators today have a wealth of tools to identify and monitor risks to insurer solvency. Yet the regulatory system remains biased toward viewing insolvency as regulatory failure, with the consequence that when policyholders are most in need, they are abandoned entirely to the conventional receivership process.

This need not be so. Free-market capitalism demands the failure of enterprises unfit to compete, and the challenge for the state-based system of insurance regulation is to minimize or prevent the public harm resulting from those failures. Integration, or at least closer coordination, of the regulatory and receivership functions can be the means to minimize the consequences of insurer failure.

Key points at which restructuring or receivership expertise could helpfully inform the process are the financial analysis and supervisory plan elements.

Financial Analysis

In a risk-focused examination approach, examination fieldwork considers solvency risk areas in addition to risks associated with fair presentation of surplus. This informs the work carried forward by the financial analysts, which in turn informs the fieldwork on subsequent examinations, and so forth. The end result of the financial analysis process is a financial analysis of each insurer specifically tailored to concerns about that insurer as a result of its unique investments, underwriting, reserving and operations. There are two levels of financial analysis procedures.

Level 1 procedures are to be performed annually and quarterly on all domestic insurers. These procedures require review of the statutory Annual and Quarterly Financial Statements and review of reports and information for the insurer on NAIC I-SITE, such as Analyst Team System Reports, Scoring System Reports, Insurance Regulatory Information System ratios and Financial Profile Reports. Other materials to be reviewed are the Audited Financial Report, Statement of Actuarial Opinion, Management Discussion and Analysis, holding company filings and examination reports. If there are new or unresolved concerns following completion of the Level 1 procedures, or if the domestic insurer is not merely a single-state insurer, then Level 2 procedures are to be undertaken.

Level 2 procedures are designed to identify potential areas of concern regarding the financial position and operations of the insurer primarily through the use of ratio and trend analysis. At first, Level 2 procedures use only information contained in the statutory Annual Financial Statement, and focus on selected key areas, such as investments, reserves, reinsurance, income, surplus, affiliate transactions, use of managing general agents and so forth. Should new or unresolved concerns exist, additional Level 2 procedures may be undertaken. These additional procedures are designed to focus
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on those areas of the Level 2 procedures, where specific concerns exist and may require additional information. If there are new or unresolved concerns upon completion of additional Level 2 procedures, then a report is to be prepared recommending further regulatory action.

Examples of further action given in the NAIC Financial Analysis Handbooks include targeted examination and enhanced reporting. They also include meetings with management, requiring business and corrective action plans and engaging experts.

Supervisory Plan

A supervisory plan is to be developed and updated at least annually for the on-going regulatory oversight of each insurer. The supervisory plan should outline the type of surveillance planned, the resources dedicated to oversight and communication or coordination with other states. The template contained in the NAIC Financial Condition Examiners Handbooks suggests that the plan discuss prior problem areas, such as solvency issues, as well as current concerns, high-risk areas, changes in risk profile and management, assessment of management strengths and weaknesses relative to corporate governance and risk management. A template plan would specifically address financial analysis monitoring, planned meetings with management and examinations.

Any corrective action plan growing out of the financial analysis element of the risk surveillance cycle would, of course, be part of the ongoing surveillance plan. Additionally, certain NAIC model laws and regulations provide for restorative plans. The risk based capital models require risk-based capital plans of insurers that fall to company action level risk-based capital. Administrative supervision is authorized under the administrative supervision model. A business plan may be required under the hazardous financial condition model. Each of these alternative plans can serve as the path to resolution of a troubled insurer outside of a conventional receivership proceeding.

The FGIC Example

An example of a recent successful and unconventional rehabilitation of an insurer is the rehabilitation of Financial Guaranty Insurance Company ("FGIC"), a monoline financial guaranty insurance company that entered into formal rehabilitation in the State of New York in June of 2012. As described more fully below, FGIC was able to enter and exit its rehabilitation proceeding in just over one year and the insurer, whose deficit had reached $3.7 billion, is currently paying claims (albeit not wholly in cash) for the first time since 2009.

The FGIC experience shows that early and decisive regulatory intervention can greatly reduce the harm of insurer insolvency. The exact means by which policyholders are best protected in any given case will, of course, depend on the unique characteristics of each troubled insurer situation. As a financial guarantor, FGIC’s policy liabilities were sophisticated long-term non-life liabilities, requiring specialized claim handling, intelligent exercise of control rights and sophisticated surveillance. Additionally (i.e., in addition to its self-reported policyholders’ surplus deficit), FGIC had a multi-billion-dollar exposure to counterparty termination claims under credit default swap transactions. FGIC’s policy liabilities had a wide range of maturities, with some guarantied obligations currently in default and others, with maturities as much as forty years hence, not in default. FGIC was a New York domestic financial guaranty insurance corporation, so its policyholders had no guaranty fund protection, it was not subject to a risk-based capital statute and Section 1104(c) of the New York Insurance Law did not apply to it.

Since 1983, FGIC had issued insurance policies guaranteeing the payment of principal and interest on, among other things, municipal bonds, residential mortgage-backed securities, asset-backed securities, collateralized debt obligations and collateralized loan obligations. The foreclosure crisis began in late 2006 and the broader financial crisis began in earnest with Lehman Brothers’ bankruptcy in 2008. All financial guarantors faced severe solvency challenges. In late 2007, FGIC’s business and financial condition began to deteriorate as the result of, among other things, significant losses relating to securities backed directly or indirectly by U.S. residential mortgage loans. As a result, FGIC began paying claims far in
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excess of historical levels and its loss reserve liabilities increased dramatically. FGIC's policyholders’ surplus deficit ultimately deteriorated to approximately $3.7 billion.

In January 2008, FGIC voluntarily ceased writing new policies and stopped paying dividends or other distributions to shareholders. FGIC also undertook certain loss mitigation measures to improve its financial position and restore its statutory surplus position. Notwithstanding these measures, on November 24, 2009, the New York State Insurance Department ("NYSID") issued an order under Section 1310 of the New York Insurance Law (the "1310 Order") requiring FGIC to suspend all claim payments, prohibiting FGIC from issuing any new policies and requiring FGIC to submit a plan to cure its financial impairment.

Following the issuance of the 1310 Order, FGIC attempted to implement a surplus restoration plan through consensual agreements with its creditors. When these efforts were unsuccessful, FGIC determined to pursue other avenues to return to solvency. After working with its financial and legal advisors, FGIC ultimately determined that a court-sanctioned rehabilitation process was the appropriate course of action.

Instead of simply falling into a rehabilitation proceeding without an exit strategy, FGIC worked with its legal and financial advisors before the commencement of formal receivership proceedings to craft a plan of rehabilitation that would restructure FGIC's policy claims and return FGIC to statutory solvency. The plan would involve not only input from the company, its management team and its regulators, but also certain of its large policyholders.

The rehabilitation plan was designed to address, among other things, FGIC's inability to pay claims that would come due over the life of the policies. FGIC's problems were complicated by the fact that certain policyholders had claims that were already due and payable, while other policies may not have claims for another forty years (the remaining term of some of the policies, co-terminus with the guarantied obligations). Additionally, because FGIC possessed a knowledgeable and capable management team, FGIC proposed that its rehabilitation plan be implemented by current management outside of the court-supervised rehabilitation proceeding.

FGIC proposed its plan to the New York Liquidation Bureau ("NYLB") in early 2011. The NYLB spent the following year working with its own advisors and FGIC to review and analyze the proposed plan prior to commencing the rehabilitation proceeding.

On June 11, 2012, the Superintendent of Financial Services of the State of New York (the "NY Superintendent") filed a petition with the New York State Supreme Court (the "NY Court") seeking entry of an order of rehabilitation under Article 74 of the New York Insurance Law. On June 28, 2012, the NY Court granted the NY Superintendent's petition and placed FGIC into a court-supervised rehabilitation proceeding. Shortly thereafter, in September of 2012, the NY Superintendent filed a proposed rehabilitation plan that was primarily based on the plan FGIC and its advisors had provided to the NYLB in early 2011.

The primary purpose of FGIC's rehabilitation was to return FGIC to solvency fairly and equitably. Article 74 of the New York Insurance Law provides a rehabilitator with broad discretion as to how to accomplish this goal. FGIC determined that the best avenue for it was to restructure its policy obligations in a way that maximized the immediate recovery to its near term policyholders, while preserving sufficient assets to provide a similar recovery to those policyholders whose claims would not materialize until sometime in the future.

FGIC's rehabilitation plan, therefore, provided for the modification of FGIC's policies so as to obligate FGIC to pay only a certain percentage of each allowed policy claim in cash. The remaining policy obligations were treated as deferred payment obligations to be paid over time based on then available assets. As an accounting matter, and so long as no new business were written, FGIC's restructured policy liabilities would never exceed its assets. The amount of the initial payment was calculated to ensure that holders of all policy claims, whether outstanding as of the filing of the plan or thereafter arising, would receive the
same ultimate percentage cash payout on account of their claims. From time to time, FGIC would reevaluate the percentage of the policy claims it could pay in cash, increasing the payout amount as appropriate.

In addition to the issuance of deferred payment obligations, FGIC also sought to reduce its policy obligations by entering into certain novation and commutation agreements with third parties. These agreements would allow FGIC to terminate its obligations thereunder and preserve more assets for its remaining policyholders.

Finally, a cornerstone of the FGIC plan was the method of the implementation. Although the rehabilitation plan would be implemented through the payment of deferred payment obligations over a number of years (maybe decades), FGIC’s proposed plan provided that it would not need to remain in its court-supervised rehabilitation proceeding once the plan was approved. This would allow FGIC’s experienced management team the flexibility they needed to implement the plan without court supervision (but subject to the terms of the court-approved plan and the supervision of the regulator), while relieving the New York regulators of the burden of micromanaging the plan implementation.

On June 13, 2013, the NY Court approved FGIC’s rehabilitation plan. On August 19, 2013, FGIC’s rehabilitation plan went effective and the rehabilitation proceeding was terminated. As a result of the plan, FGIC returned to solvency. The initial cash payments made to policyholders under the plan was 17%, with hopes that payment percentages would increase over time.

Protecting Policyholders in the 21st Century

Each troubled insurer presents unique problems. The risk-focused surveillance cycle contains within it the means to identify and monitor problems and their causes like never before. The next step is to solve those problems and resolve troubled insurer situations. Among other things, the FGIC experience teaches that coordination between the regulatory and receivership functions of government helps, and lack of coordination hinders or delays effective resolution. Other lessons include:

Adversary approaches distract from the tasks at hand.

Regulators and regulated must trust one another enough to work together in the best interests of policyholders. The landscape is littered with the consequences of fraud and mismanagement, and those responsible deserve punishment. However, the staff of every troubled or insolvent insurer need not be presumed corrupt. Indeed, staff often possess necessary and irreplaceable knowledge and expertise. Regulated and regulator must earn one another’s trust, preferably before trouble arrives.

Engage experts.

As the NAIC Financial Analysis Handbooks point out, unresolved concerns should lead to further regulatory action, including engaging experts. Regulators may need to obtain specialized skills not available among current employees. Similarly, a troubled insurer may need (or may need to be told) to obtain assistance. The use of a chief restructuring officer (“CRO”) in Chapter 11 cases under the federal Bankruptcy Code provides some useful guidance. Typically, the CRO will be an outside restructuring expert retained by a company in financial distress. The retention of a CRO by the debtor is not specifically provided for in the Bankruptcy Code; but is often viewed as a more constructive alternative to the formal appointment of a Chapter 11 trustee, who is a disinterested party that displaces the debtor’s management, takes control of the debtor’s assets and manages its business and Chapter 11 case.

Despite the lack of specific statutory basis for the retention of a CRO, the practice is quite common in situations where (i) there is a need for crisis management and/or (ii) where the creditors and other parties in interest have lost faith in the ability of the existing management to operate the business or prepare timely and accurate financial information. CROs have been successfully retained in many large Chapter 11 cases, including Enron, WorldCom, Adelphia and ResCap, where the use of the CRO was critical in expediting the Chapter 11 process. The CRO model was also successful in
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the FGIC case, and helped to create the mutual trust between regulator and regulated that was so critical to success.

Consider all stakeholders.

Policyholder protection is, of course, the primary concern. Furthermore, the traditional paradigm is that few if any creditors have standing in an insurance receivership, so that policyholder committees, for example, are not often recognized. However, stakeholders excluded entirely from the resolution process retain the power to hinder, delay or even overturn the outcome through objection and litigation. Moreover, tempered by the statutory priority scheme, the prohibition of sub-classes and other legal requirements, a creative rehabilitation plan can allocate necessary financial losses to those most able to bear them and who may in fact have explicitly considered credit risk when choosing to transact with the insurer.

Remember the holding company system.

Tax assets and intercompany receivables, along with value residing in subsidiaries and affiliates, may materially enhance the prospects for a successful resolution. Placing a parent company into bankruptcy, and the timing of both the petition and the emergence, may have significant positive and/or negative effects. Cooperation and coordination among insurer and non-insurer estates can maximize assets available for distribution. Merging members of an intercompany insurance pool, as was done in the Reliance situation, or otherwise restructuring intercompany reinsurance arrangements may achieve benefits by centralizing estate administration and giving all policyholders equivalent priority in the distribution of the pooled assets supporting the insurance writings.

Think of formal receivership as a means, not an end.

FGIC’s regulators were in frequent contact with its CRO and other members of FGIC management. Periodic detailed meetings, supported by examination and analysis, kept the regulators informed of progress and plans. Consequently, formal receivership would have added little or nothing to administration of the company or the prevention of preferential payments. However, formal receivership was essential to the success of the plan that was devised. A central feature of the plan was the restructuring of FGIC’s policy obligations, and the judicial process was needed to achieve that. Once the plan had been approved by the court after due process, the need for the receivership had ended.

In summary, the state-based system of insurance regulation possesses the tools and the means to treat insurer insolvency not as regulatory failure but as simply the next phase of policyholder protection in the cycle of an insurer’s life.

1 The authors are partners in the New York office of the law firm Stroock & Stroock & Lavan LLP, which acted as counsel to Financial Guaranty Insurance Company prior to commencement of its formal rehabilitation proceeding, in particular in connection with developing the rehabilitation plan proposed by the insurer to the New York Liquidation Bureau. The views expressed are solely the authors’ and do not reflect the views of Stroock & Stroock & Lavan LLP or any past, present or future client. The authors gratefully acknowledge the assistance of their Stroock colleagues Daniel P. Casanove, special counsel; Matthew G. Crotaro, associate, and Vincent L. Laversano, in-house general counsel, in the preparation of this article.


6 Id.

7 See generally, Nat’l Association of Ins. Commissioners, Risk Based Capital (RBC) for Insurers Model Act (Model Regulation Service, Model 321).

8 See generally, Nat’l Association of Ins. Commissioners, Administrative Supervision Model Act (Model Regulation Service, Model 559).

9 See generally, Nat’l Association of Ins. Commissioners, Model Regulation To Define Standards And Commissioner’s Authority For Companies Deemed To Be In Hazardous Financial Condition (Model Regulation Service, Model 385).


11 id. (Plan Approval Order, June 13, 2013 and Notice of Effective Date and Initial CPP, August 19, 2013)

12 See N.Y. Ins. Law §§ 6901(c)(2), 6904(b)(1), 6905(a).

13 Although New York has not adopted the Model Regulation To Define Standards And Commissioner’s Authority For Companies Deemed To Be In Hazardous Financial Condition or the Administrative Supervision Model Act, Section 1104(c) in part provides.

“The superintendent may suspend the license, restrict the license authority, or limit the amount of premiums written in this state of any accident and health insurance company, property/casualty insurance company, co-operative property/casualty insurance company, life insurance company, mortgage guaranty insurance company, reciprocal insurer, Lloyd’s underwriters or nonprofit property/casualty insurance company… if after a hearing on a record… the superintendent determines that such insurer’s surplus to policyholders is not adequate in relation to the insurer’s outstanding liabilities or to its financial needs.”


16 Section 130(a) in pertinent part provides.

“Whenever the superintendent finds from a financial statement, or a report on examination, of any domestic stock insurer that the admitted assets are less than the aggregate amount of its liabilities and outstanding capital stock, he shall determine the amount of the impairment and order the insurer to eliminate the impairment within such period as he designates, not less than ninety days from the service of the order. He may also order the insurer not to issue any new policies while the impairment exists.”

The order was also issued under authority of then Section 201 of the New York Insurance Law, which in pertinent part provided.

“The superintendent shall possess the rights, powers and duties in connection with the business of insurance in this state, expressed or reasonably implied by this chapter or any other applicable laws of this state.” (Emphasis added.)

17 Although its establishment and function are not mentioned in the statute, the NYLB is a standing office and staff that acts for the NY Superintendent in his capacity as the court-appointed receiver of impaired or insolvent insurance companies. It has been held by New York’s highest court to be separate and distinct from the regulator and, indeed, not even a state agency. DiNapoli v. DiNapoli, 877 N.Y.S.2d 665 (N.Y. 2007).