MEALEY'S LITIGATION REPORTS
INSURANCE INSOLVENCY

Vol. 6, #15 January 5, 1995

Drafting A Guaranty Association Agreement

By

Markus May

[Editor's Note: Mr. May is an attorney in Denver, Colo. He is a member of the Society of Insurance Receivers and has worked on a number of liquidations. His article on the sale of insolvent insurance company charters appeared in the May 18, 1994 issue of ***The Report.****]*

COMMENTARY

GENERAL OVERVIEW OF GUARANTY ASSOCIATIONS

Guaranty associations are creatures of state statute created to protect policyholders from insurance company insolvencies. All 50 states, Puerto Rico and the District of Columbia have guaranty associations in place for the payment of claims arising from property and casualty liquidations. Further, all 50 states and Puerto Rico have guaranty associations for life and health insurance company insolvencies. Generally, the state statutes mirror the NAIC Model law regarding guaranty associations with modifications to meet the specific needs of each state. These laws create guaranty associations which provide coverage to insureds of insolvent companies in liquidation.

In addition, there are two national bodies which act as information clearing houses which will send information to guaranty associations involved in certain liquidations, create advisory committees to work with liquidators to resolve issues arising during a liquidation, and schedule meetings between liquidators and guaranty associations. The National Conference of Insurance Guaranty Funds ("NCIGF") represents property and casualty guaranty associations and the National Organization of Life and Health Insurance Guaranty Associations ("NOLHGA") represents life and health guaranty associations.

NCIGF and NOLHGA can analyze various proposals for guaranty association involvement in the liquidation of an insolvent insurance company. They can also coordinate with liquidators in the development and implementation of a general plan covering the disposition of covered claims and contracts. Rather than having to deal with 50 different state guaranty associations in a large receivership, a liquidator may begin by negotiating a guaranty association agreement directly with NOLHGA or NCIGF, which can then recommend approval of the agreement by member associations. This approach can reduce administrative expenses and create uniformity in the area of dealing with guaranty associations. Further, both NOLHGA and NCIGF, because of their national stature, are exposed to a greater range of problems and solutions than is any single guaranty association and can use this extra expertise in discovering the best solution in a given situation.

© COPYRIGHT 1995 MEALEY PUBLICATIONS, INC., WAYNE, PA

Once an insurance company enters into liquidation, insureds send their claims to the liquidator. The liquidator forwards the claims to the appropriate guaranty association which then adjudicates them. If a claim is a covered claim, the guaranty association pays the insured the amount of coverage provided under the insured's policy less the applicable deductible. Claim payments are limited by the lesser of the amount covered under the policy or an applicable statutory limit.

Prior to the existence of guaranty associations, policyholder claimants might have had to wait several years before a liquidator recovered all of the assets into a liquidation estate in order to determine the amount to pay each claimant. However, guaranty associations are able to begin processing claims almost immediately after a liquidation begins. This serves the needs of individual policyholders who might have a great need for the money and would be subject to undue hardship if they had to wait years to receive their payments - assuming there was enough money in the liquidation estate to pay policyholders. More importantly, in liquidations with few assets, policyholders are protected because guaranty associations pay policyholder claims, up to the appropriate limit, whether or not there are enough assets in the liquidation estate to pay policyholders.

Guaranty associations generally obtain the funds to operate and pay insureds in two ways. First, after claims have been paid and expenses incurred, guaranty associations file claims with the liquidation estate which pays the guaranty associations according to a statutory priority of distribution scheme. For example, guaranty associations' administrative claims will generally be paid as administrative expenses and if payments are made to the policyholder class of claimants, guaranty associations receive a pro rata share of the distribution for claim payments incurred. Second, guaranty associations obtain funds by statutorily assessing the insurance industry for the associations' expenses. Each assessed insurance company in turn passes the amount of the assessments on to policyholders or deducts the assessments from the insurer's premium tax liability to the state.

In order for insureds to receive payment from their state guaranty association, the liquidator needs to properly "trigger" the guaranty association coverage. In order to do this, the liquidator will need to review the laws of each of the various states where the insolvent insurer was licensed to do business and determine what the applicable triggering circumstances are in each state.

Before guaranty association coverage is triggered, most states require that a liquidation order be entered by a court with competent jurisdiction over the insurer and that the order include a finding of insolvency. Secondly, coverage will only be provided to insureds in those states where the insolvent insurer was properly licensed to do business. If an insurer was not a licensed insurer, yet was conducting the business of insurance in a particular state, the policyholders in that state will generally not be entitled to guaranty association coverage. It is imperative, therefore, that the liquidator and/or his legal counsel review the provisions in each of the various states in which the insurer was licensed in order to determine the proper triggering events. The liquidator will need to work with each of the states or the NCIGF or NOLHGA to ensure that the liquidation order is properly drafted in order to ensure coverage to as many of the insolvent insurers' policyholders as possible.

THE GUARANTY ASSOCIATION AGREEMENT

Once guaranty association coverage is triggered, a guaranty association and a liquidator begin a relationship which can last for years. A guaranty association agreement is an agreement between a state guaranty association and a liquidator which sets forth the terms of their relationship, including the

© COPYRIGHT 1995 MEALEY PUBLICATIONS, INC., WAYNE, PA

rights and responsibilities of the parties. This meets the need of both the guaranty association and the liquidator to know how each party is to act in the future. Further, a properly drafted guaranty association agreement will fill in the details not covered by the guaranty association and liquidation statutes.

In addition to meeting the parties' needs, guaranty association agreements are generally required by state statutes. Most liquidation statutes require a liquidator to submit a proposal to disburse assets to guaranty associations, prior to the payment of other policyholder claims, if it appears such a distribution will be likely. The statutes require that prior to such a distribution, there be an agreement between the liquidator and the guaranty associations. Because these agreements contemplate "early access" to distributions made by liquidation estates, guaranty association agreements are often referred to as early access agreements. The reason for an early access distribution to guaranty associations is to minimize the burden on the guaranty associations, which in turn reduces the burden on the assessed insurance industry members, thereby reducing the burden on the insurance buying public.

Generally a liquidator can only avoid filing an early access plan if there are insufficient assets in the estate to make a distribution to guaranty associations. However, the liquidator is then required to file a statement with the liquidation court setting forth the insufficiency of assets as the reason for not filing an early access plan.

GUARANTY ASSOCIATION AGREEMENT PROVISIONS

A. Classification of Guaranty Association Expenses

The guaranty association agreement should classify various guaranty association expenses incurred with respect to the liquidation estate so that both the guaranty association and the liquidator agree as to the classification of certain expenses incurred by the guaranty association. Because Class 1 claims (administrative expenses) are paid before Class 3 claims (policyholder claims) and because an estate which may be able to fully pay Class 1 claims may not be able to pay Class 3 claims, it is important for the parties to fully define what qualifies as a covered expense in a given class.

The importance of properly defining terms can be illustrated with a simple example. State statutes generally provide that unallocated loss adjusting expenses incurred in the payment of covered claims are administrative expenses of the estate and will be paid first along with the other administrative expenses of the estate as Class 1 claims. Further, most state statutes also provide that covered claims payments by guaranty associations are accorded the same priority as normal policyholder claims in the state statute. Generally, these are Class 3 claims which also include the allocated loss adjusting expenses incurred in the handling of claims. Because Class 1 claims are almost always paid and Class 3 claims may not be paid, it is important for the guaranty association agreement to specifically define what is an allocated loss adjusting expense and what is an unallocated loss adjusting expense. For example a guaranty association may attempt to include expenses incurred in defending insureds as an unallocated loss adjusting expense, while a liquidator may believe such expenses should be classified as an allocated loss adjusting expense. If the parties enter into an agreement of what is covered in each class, then potential future arguments and litigation expenses can be more easily avoided.

The following are suggested definitions for the critical items of unallocated loss adjusting expenses and allocated loss adjusting expenses.

© COPYRIGHT 1995 MEALEY PUBLICATIONS, INC., WAYNE, PA

1. Unallocated Loss Adjusting Expenses

In drafting a guaranty association agreement, it is suggested that unallocated loss adjusting expenses be defined to mean:

> The reasonable expenses that would otherwise have been incurred by the liquidator in the absence of the activity of the guaranty association, including, but not limited to, expenses for evaluating coverages, setting reserves, reporting and any other administrative expenses apportioned among the receiverships being handled by the guaranty association that the liquidator recommends for approval by the court under state statute; but, excluding all allocated loss adjusting expenses. Unallocated loss adjusting expenses do not include the guaranty association's expenses incurred in defending insureds.

This definition allows a guaranty association to recover as Class 1 claims expenses which the liquidator would incur, including reasonable overhead expenses. This is equitable because if the guaranty association had not performed its services, the liquidator would have incurred additional expenses to provide those services which would have been reimbursed as a Class 1 administrative expense. Clearly, if the liquidator would have had to perform the same services, the guaranty association should be paid at the same priority level as the liquidator. Further, because the guaranty association specializes in what it does, the ultimate expense to the liquidation estate should be lower than if a liquidator with no claims experience adjudicated the claims. However, this definition also gives the liquidator the leeway to challenge claims by a guaranty association for expenses which are not reasonable or would not have been incurred by the liquidator in liquidating the estate (i.e., trips to conventions or staying at five star hotels would not be covered).

2. Allocated Loss Adjusting Expenses

The definition of allocated loss adjusting expenses should also be specific and the following is a suggested definition for these expenses:

> Those expenses paid or insured by the guaranty association that are identifiable to specific claims or that are required to be paid or incurred by the terms of the contracts and policies of the insurance issued by the insolvent insurance company including, but not limited to, expenses for outside service fees, independent adjuster fees, attorney fees, appraiser fees, court costs, expert or witness fees, and internal adjuster costs where little or no outside service or adjuster fees are incurred in the handling of specific claims.

Thus expenses which are related to the adjudication of specific claims by the guaranty association will be classified as allocated loss adjusting expenses while general expenses incurred in dealing with matters related to a liquidation will be unallocated loss adjusting expenses.

© COPYRIGHT 1995 MEALEY PUBLICATIONS, INC., WAYNE, PA

3. Disputes Regarding the Classification of Expenses

The guaranty association agreement should specifically grant the liquidator the right to challenge any of the guaranty association's classifications of claims at a given priority level. In the event of a dispute between the parties, they should be required to follow the claims denial procedures set forth in the state liquidation statute which includes subjecting the guaranty association to the jurisdiction of the domiciliary state liquidation court for the sole purpose of adjudicating claims under the guaranty association agreement. This will avoid the potential problem of different states making different decisions regarding classification of claims within a liquidation estate and ensures that all guaranty association claims will be treated equally.

B. Access to Business Records

The guaranty association agreement should provide that the domiciliary liquidator and the guaranty association mutually agree to provide each other with reasonable access to certain business records and information. Both parties should provide each other with access during normal business hours to the books, records and files held by the other, and the agreement should require both parties to respond affirmatively and in good faith to all reasonable requests for information, files and documents pertaining to the insolvent company.

C. Information Reporting

A guaranty association agreement should also specifically require the guaranty association to provide the liquidator with information regarding the status of the claims involved in the liquidator's estate in a format which is in accordance with the Uniform Data Standards. These reports should be mailed on a quarterly basis to the liquidator so that the liquidator may be able to properly set forth paid claims and reserves.

1. Liquidator Information Requirements

Both the liquidator and the guaranty association should make certain calculations on a quarterly basis. The liquidator should be required to determine the amount of liquid assets in the possession of the liquidator. This would not include real estate, the book value of a subsidiary, assets pledged as security, special or general deposits held by other states, or any other assets over which the liquidator does not have complete control. Further, the liquidator should not be required to increase the amount of liquid assets available for purposes of the early access plan by making a forced or quick sale which would result in obtaining less than the market value for any assets. The liquidator should also be responsible for reporting the reserve for administrative expenses. This is the total amount of reserves reasonably necessary to pay all administrative expenses through the estimated closing date of the estate. This reserve would include the costs of preserving or recovering the assets of the insurer, payment of all fees and expenses for services rendered in the liquidation, professional and attorneys' fees, and the unallocated loss adjusting expenses of guaranty associations, which are estimated by the guaranty associations as mentioned below. The liquidator should also be required to determine the amount of reserve for employee wage claims. In many states, employees of the insurer are entitled to certain wage claims under the liquidation statutes which are accorded Class 2 priority under the state distribution statutes. The liquidator should also have to determine the amount of the reserve for non-covered policy claims. This will be the amount of Class 3 claims which are not covered by guaranty associations, but which are entitled to the same priority of payment as the guaranty associations' Class 3 claims.

©COPYRIGHT 1995 MEALEY PUBLICATIONS, INC., WAYNE, PA

2. Guaranty Association Information Requirements

A guaranty association should report to the liquidator the following items: The total amount of payments on covered claims to date. The allocated loss adjusting expenses incurred specifically identifiable to individual claim files. The amount of incurred unallocated loss adjusting expenses. The amount to reserve for covered claims. This would be the total amount of reserves for unpaid liabilities which are covered claims. The amount to reserve for future allocated loss adjusting expenses. The amount to reserve for future unallocated loss adjusting expenses. A full report to the liquidator, accounting for all liquidation estate assets received by the guaranty association, disbursements made from those assets, any interest earned by the guaranty association on such assets, and any other matter as the liquidation court may direct.

Obviously, the amount of many of these items, such as reserves which estimate future expenses, will be estimates and the agreement should provide that estimates will be made upon the best information available to the party at the time such estimate is made.

D. Guaranty Association Proof of Claim.

Before the liquidator pays an early access advance to a guaranty association, the guaranty association should be required to file a proper proof of claim with the liquidator. The proof of claim should be accepted if it meets the requirements set forth in the liquidation statute, provided that the guaranty association may file a single proof of claim which will be updated with data for all amounts the guaranty association claims it is owed as reasonable unallocated loss adjusting expenses and for all amounts claimed under policies including allocated loss adjusting expenses. The proof of claim form should also provide detailed information in the Uniform Data Standards format along with a summary format which is substantially similar to the Financial Information Questionnaire commonly used in these matters. The proof of claim form should contain the calculation of the items noted above, which the guaranty association is required to report to the liquidator, and also include the supporting detailed documentation setting forth the calculation of the assets and reserves. Finally, the proof of claim form should be notarized and sworn to by the Chief Financial Officer or other appropriate official of the guaranty association.

E. Early Access

The guaranty association agreement should also set forth the rules and standards regarding early access distributions to the guaranty association by the liquidator. It should specifically provide that if the assets available for early access advances from time to time do not exceed the amounts claimed by the guaranty association, then advances should be made in the amount of available assets on a pro rata basis. Any early access advances should accrue to the guaranty association's benefit along with special deposit funds received by the state insurance department in which the guaranty association is located, subrogation recoveries retained by the guaranty association, funds received under expense reimbursement agreements, and interest.

Under most statutes, a guaranty association is required to return to the liquidator any part or all of the accrued advances to the guaranty association if such repayment is determined to be necessary for the payment of claims of secured creditors or claims of an equal or higher priority than those of the guaranty association. Note that it is important to properly define an accrued advance to a guaranty

© COPYRIGHT 1995 MEALEY PUBLICATIONS, INC., WAYNE, PA

association as being all amounts advanced to the guaranty association as a direct early access advance plus amounts deemed to be advances on claims plus the applicable advance interest.[1]

A guaranty association should accrue interest on early access distributions from the date of early access distribution until the date of distribution to all other claimants in the class for which the early access distribution was made. If interest does not accrue, the guaranty association effectively is allowed to receive a return on the funds in its possession while other Class 3 claimants do not receive a similar return on their distributions. For example, if a guaranty association receives $1 million in an early access payment one year before another claimant in the same class receives $1 million, the guaranty association, assuming a return rate of eight percent, would effectively receive $80,000 more than a similarly situated claimant. This would result in an inequitable distribution of liquidation estate assets to different members of the same class and technically violate the liquidation statutes. Thus, by accruing interest on early access advances, equity is served because all similarly situated claimants in the class receive the same percentage of class assets with respect to the amount of their claim.

In order to incorporate the state liquidation statute, the agreement should provide that if the liquidator is ordered by a court to pay a claim of an equal or higher priority than a priority established for the guaranty association, the association is required to return the required portion of any accrued advances within thirty days, or within sixty days after such notice if it is necessary for the guaranty association to make an assessment, so that funds may be reallocated accordingly.

F. Amount of Early Access Distribution

The amount available for early access distribution to all guaranty associations should be determined by taking the amount of liquid assets and subtracting the amount of the reserve for administrative expenses, the reserve for employee wage claims, and the reserve for unallocated loss adjusting expenses for all guaranty associations. Once the amount available for an early access distribution is determined, the amount available for early access distribution to each guaranty association can be determined. Generally, this distribution should be made in a pro rata amount which takes into account the payments made by each guaranty association as well as the amount of outstanding, non-covered policy claims. Some liquidators and guaranty associations prefer that the amount distributed to a guaranty association be based directly upon a proportion determined by the amounts actually paid by the guaranty association. Other liquidators and guaranty associations will also include the amount of reserves into the amount to be paid to the guaranty associations. The former approach encourages swift payment by guaranty associations because early payers will receive a greater amount in any early access distribution. Swift payment is generally favored because injured policyholders are compensated faster and the estate can be closed faster; however, a swift payment procedure may also result in a greater number of errors and unnecessary payments. If reserves are included in the calculation, this favors guaranty associations in states in which there are a larger numbers of claims as opposed to those in which there are a smaller number of claims. In any event, if a liquidator is dealing with more than one guaranty association, each guaranty association agreement should contain identical provisions regarding the calculation of early access advances.

G. Salvage and Subrogation

The subject of salvage and subrogation recoveries made by the guaranty association on behalf of the liquidation estate should also be addressed by the guaranty association agreement. Because the guaranty association is integrally involved in the claims process in its state, the guaranty association

© COPYRIGHT 1995 MEALEY PUBLICATIONS, INC., WAYNE, PA

agreement should provide that all rights of the insolvent insurer in net salvage and subrogation recoveries and collection in connection with losses paid by the guaranty association, to the extent such rights exist, will be retained and accounted for by the guaranty association. However, such recoveries should remain assets of the liquidation estate and the guaranty association agreement should specifically provide that the guaranty association send such salvage and subrogation recoveries to the liquidation estate on a monthly basis. In the event such recoveries are not sent to the liquidation estate, the recoveries retained by the guaranty association should be deemed to be early access advances under the guaranty association agreement.

H. Audit of Guaranty Association

The guaranty association agreement should also provide that prior to any final distribution of assets, the liquidator should be allowed to audit the financial accounts, records and procedures of the guaranty association with respect to the receipt of assets, early access distributions, and payments of covered claims. If pursuant to such an audit, the guaranty association has received more than its fair pro rata share of assets, the guaranty association would be required to return any early access distributions which are in excess of the amount ultimately determined by the liquidator to be due the guaranty association.

CONCLUSION

It is almost certain that some guaranty associations or liquidators will disagree with certain provisions suggested above and will attempt to draft future agreements with an eye toward maximizing their power or assets. However, the above suggestions will hopefully help most guaranty associations and liquidators to enter into equitable and fair agreements which fulfill the objectives of the liquidation and guaranty association statutes; i.e. protection of policyholders, faster payment to guaranty associations, and equitable distributions to all similarly situated claimants. By entering into this type of agreement, a liquidator would no longer delay payments to guaranty associations out of fear of a later inequitable distribution to Class 3 claimants. Guaranty associations could submit claims to a liquidator without having to guess what priority to claim for each expense. The liquidator would have the right to challenge a given priority and with open records each party will be more likely to perform to the best of its ability and in accordance with the terms of the agreement. No longer will a liquidator be able to delay estimating or paying early access distributions nor will guaranty associations be reimbursed for improperly paid claims (i.e. claims paid on expired policies) or five star hotels. In sum, by entering into well drafted guaranty association agreements, there will ideally be an even playing field with known expectations, fairness, greater efficiency in the administration of liquidation estates, and more efficient service to policyholders.

© COPYRIGHT 1995 MEALEY PUBLICATIONS, INC., WAYNE, PA

ENDNOTE

1. Note there are many ways of addressing the rate of interest which should accrue on funds advanced to guaranty associations. Some agreements may provide that a fixed rate, such as eight percent should accrue, others may tie the rate of return into an outside index such as a bank's lending rate, others may set the rate at the actual amount earned by the guaranty association, while others will set the rate as being what the liquidator would have earned on the funds. The latter approach is the best appraisal of what the funds would have been worth to the estate.

Further, in some instances a liquidator may enter into an agreement with the guaranty association whereby the guaranty association actually does the investing of the funds of the liquidation estate. In this instance, the rate of return on funds accrued to the guaranty association would equal the rate earned by the liquidation estate's funds.

MEALEY'S LITIGATION REPORT: INSURANCE INSOLVENCY.
Teresa Kent Zink, editor.

The Report is published twice monthly by Mealey Publications, Inc., P.O. Box 446, 512 W. Lancaster Ave., Wayne, PA 19087-0446, USA. Telephone (610) 688-6566. Fax (610) 688-7552. ISSN No. 1043-8416.

© COPYRIGHT 1995 MEALEY PUBLICATIONS, INC., WAYNE, PA