

## **TIPS FOR NAVIGATING THE WORLD OF INSURANCE INSOLVENCY**

*When an insurer becomes insolvent, it's up to the policyholder to pursue recovery. There are many alternatives to gaining this recovery, and some work better than others. In this Letter, we explore insolvency proceedings in a general sense and also the specific rules that apply in New York. The Tip of the Month addresses representations and warranties insurance.*

### **HOLDING THE BAG**

The insurance buying public has long been plagued by the failure of insurance companies, big and small, to manage their affairs prudently or even to disclose their true financial condition. As Warren Buffett, chairman of Berkshire Hathaway Inc. famously noted in a letter to Berkshire Hathaway's shareholders:

If liabilities of an insurer, correctly stated, would exceed assets, it falls to the insurer to volunteer this morbid information. In other words, the corpse is supposed to file the death certificate. Under the "honor system" of mortality, the corpse sometimes gives itself the benefit of the doubt.

Insurance insolvencies tend to come in waves, following periods of economic recession or extensive fits of poor underwriting. The latest peak for the property/casualty insurance industry was 2011, when financial impairment frequency spiked to 1.11, well above the industry's historic average of 0.82. While insolvencies have since leveled off, policyholders are still coping with the post-recession fallout.

When an insurance company becomes insolvent, what can policyholders do to avoid holding the bag? While some steps, outlined below, apply to all U.S. markets, it's essential for policyholders to learn the ropes in the state in which their insolvent insurance company is domiciled. Accordingly, we first consider the channels of recovery that are generally available to policyholders around the country. Next, we consider the idiosyncrasies of New York, one of the nation's largest property/casualty insurance markets.

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## CHANNELS OF RECOVERY

Traditionally, policyholders damaged by an insurer insolvency have attempted to recover their losses by, among other things, filing claims: in the insolvency proceedings of the defunct insurance company; with state guaranty funds (providing limited guarantees protecting claims); in relevant supplementary or ancillary (i.e., other state) insolvency proceedings; against reinsurers of the defunct insurer; against brokers or producers who sold policies written by bankrupt insurance companies; and against excess and umbrella insurers.

The state guaranty funds have been the most responsible and responsive sources for ameliorating policyholder losses. However, guaranty funds often have caps on large claims and may exclude claims by large commercial policyholders and typically do not cover claims against nonadmitted insurers. Unfortunately, the success rate of the traditional route for recovery, i.e., in insolvency proceedings against the defunct carrier, has ranged from zero to mediocre. To the extent such remedies prove to be inadequate, the deficiency is borne by the policyholder.

### Insolvency Proceedings

When an insurance company becomes insolvent, a court will appoint a receiver or liquidator to manage the company. (A receiver manages a company's assets for the benefit of creditors. A liquidator turns the company's assets into cash to pay all of the company's creditors.) The court will then set a proof of claim deadline barring all claims thereafter. Up until that point, a policyholder can submit its insurance claim, along with material supporting the claim, to the receiver or liquidator in the hopes that the receiver or liquidator will approve the claim.

Meanwhile, the liquidator or receiver marshals all the company's remaining assets, reviews the policyholders' proofs of claim, collects available reinsurance, and then (many years later) develops a plan for final distribution of the insolvent estate's remaining assets to creditors and policyholders in accordance with a statutorily required order. Administration expenses are the top priority for payments, followed by various classes of claimants and insureds.

The problem is: How does a policyholder assess how productive it will be to spend good money pursuing a claim in an insurance insolvency proceeding when it is unknown what the final payment percentage will be? It is one thing to spend a lot of time and energy pursuing payment where at the end of the day 90 percent of your claim will be paid. It is quite another when only 9 percent is paid.

## NAVIGATING NEW YORK

In New York, one key to answering this question is understanding the main player in insurance insolvencies, the New York Liquidation Bureau (NYLB). Indeed, right now, the NYLB manages many billions of dollars in insurance company assets, including the assets of Lumbermens Mutual Casualty Company, Reliance Insurance Company, the Home Insurance Company, and many others. Knowing more about the NYLB, and how it operates, may help ensure that your recovery will be higher rather than lower and sooner rather than later. (Also, the points we mention in connection with New York illustrate the types of obstacles you are likely to encounter in any state.)

The NYLB acts on behalf of the Superintendent of Financial Services of the state of New York (Superintendent) as a receiver over impaired or insolvent insurance companies. While the NYLB assures the public that it "protect[s] the interests of the policyholders and creditors" and "distribute[s] the proceeds of the company in a timely manner to creditors," there are many procedural and structural obstacles policyholders must overcome to have their claims paid. (Visit the NYLB Web site at [www.NYLB.org](http://www.NYLB.org).)

### Not Your Typical Rules

When the Superintendent believes an insurance company has become impaired or insolvent, he or she petitions a New York court to be appointed as receiver over the company. Based on the Superintendent's application, the court will enter an order of rehabilitation (or liquidation) and a procedural order.

Both orders together, along with the rules contained in Article 74 of the New York Code form the ground rules under which the rehabilitation or liquidation will proceed. These rules typically modify the standard rules for bringing claims under New York's Civil Practice Law and Rules and will directly affect your rights as a policyholder and as a litigant. Knowing the rules, and knowing what they mean, is crucial to protecting your interests.

For example, most rehabilitation and liquidation orders will include a provision staying all proceedings against the insurance company in every other court, except the rehabilitation or liquidation court. A policyholder should read the language of the stay very carefully. If the stay does not specifically apply to litigation, it may not affect a policyholder's suit against the impaired insurance company. See, e.g., Callon Petroleum Co. v. Frontier Ins. Co., 351 F.3d 204, 207 (5th Cir. 2003).

Further, unlike bankruptcy stays, rehabilitation stays may

not be automatic in certain situations. See, e.g., Matter of Frontier Ins. Co., 27 A.D.3d 274, 275 (1st Dep't 2006). A policyholder should be prepared to argue against the application of the stay.

### **Not All Claims are Treated Equally**

A creditor's claim against an insolvent insurance company could take many forms. You could be an in-state policyholder seeking to recover under your policy. (An in-state policyholder is one that resides and/or has insured property in New York.) You could be a judgment creditor of a bankrupt policyholder seeking to recover on your judgment from the policyholder's insurance. You could be an out-of-state policyholder bringing a claim for property loss incurred outside the state.

Depending on what type of creditor you are, you may have different rights and remedies. For example, the NYLB can serve as a receiver in what are called "[guaranty] fund cases" or "non-fund cases." Fund cases involve claims against an impaired insurance company that are guaranteed by the state of New York (up to certain limits and subject to many conditions) regardless of whether the company has sufficient assets to pay the claim, whereas non-fund cases have no such guarantee.

Further, different types of claims have different priorities when the NYLB distributes an insolvent insurance company's assets. How your claim is classified may affect your decision to pursue a claim, and how aggressively to pursue a claim, against an insolvent insurance company.

### **Not Your Typical Forum**

When preparing to file a lawsuit against an insurance company, a policyholder's first inclination may be to proceed in the most convenient forum for the policyholder, i.e. where you live or conduct business. Makes sense. But policyholders should be aware that many times, the only forum to sue an impaired or insolvent insurance company based in New York is in New York, before the court that is overseeing the rehabilitation or liquidation of the insurance company. And even when suit is allowed in New York, policyholders must follow specific rules, discussed above, for filing claims.

In certain cases, policyholders may be able to pursue their claims in more convenient forums than New York. This can happen when the liquidation or rehabilitation court appoints additional ancillary receivers in different states to help administer the assets of the insurance company. For example, in the case of Lumbermens Mutual Casualty Company, the NYLB is an ancillary receiver for the company's property in New

York. In these situations, you will need to decide whether to pursue your claim in New York or submit your claim to one of these additional receivers. Policyholders should bear in mind that each receiver may have different rules that would make one forum more advantageous to the policyholder than another.

### **Timing Is Everything**

The NYLB, as the receiver for an impaired estate, by definition encounters a company with serious financial concerns. Cynics believe the NYLB is looking to find an excuse not to pay a claim in order to conserve assets. Accordingly, the NYLB will rarely volunteer to pay a claim until one is submitted with sufficient substantiating detail.

Policyholders would do well to follow up (in writing) with the NYLB once a claim is submitted to ensure the claim is being processed. Further, a policyholder may benefit from the more flexible rules regarding settlement that tend to apply when an insurance company is in rehabilitation rather than liquidation. If there is reason to believe that an insurance company's rehabilitation will soon be converted to a liquidation, the policyholder may want to seriously consider settlement.

The bottom line: Time is money, and liquidations in New York can take years and even decades.

### **Structural Anomalies**

Various incentives embedded in the NYLB structure militate against swift resolution of claims. For example, private insurance companies operate slowly and bureaucratically. A government take-over of an insurance company further slows the process of paying claims. To minimize this effect, the NYLB will typically "re-hire" the employees from the impaired or insolvent insurance company to continue its day-to-day operations. Many of these employees are still paid from the insurance company's estate. Because of this arrangement, (cynics say) the employees of the impaired and/or insolvent estate now have the incentive to slow down the liquidation because once the NYLB finally liquidates the company, they're out of a job.

Additionally, despite its title, the NYLB is not a state agency of New York. Accordingly, taxpayers do not fund the NYLB, and it is not subject to state freedom of information laws. This means the rehabilitation and liquidation proceedings are not transparent.

Also, after the court appoints the NYLB as receiver over an impaired carrier, the court generally also appoints a team of

referees to hear and resolve individual claims brought by creditors and policyholders against the impaired estate. These referees may have ties to the impaired estate, and are also paid out of the estate.

Further, even if a policyholder prevails before a referee, the NYLB can appeal the referee's decision to the court to review the case anew. This adds an extra layer of appeals to any disputed claim, making the entire process more expensive for a policyholder seeking to have its claim realized.

Even the savviest policyholder must deal with these structural abnormalities in the rehabilitation process. Perhaps the best way for a policyholder to address them is to make reasonable but forceful demands to the NYLB regarding a claim and develop a record showing any unreasonable delay.

In addition, policyholders would do well to take the follow steps to preserve their rights and claims:

- Review all insurance policies.
- Obtain replacement coverage.
- Pursue guaranty fund protection, if any.
- Communicate with the provisional liquidators.
- Review relevant court orders.
- Team up with other policyholders. A group of creditors acting together is much stronger than separate individual creditors.
- Pursue reinsurance cut-through if available.
- Pursue excess and umbrella insurance if available.
- Pursue claims in ancillary state proceedings, if available.
- Contact relevant debt traders (there are markets for allowed claims for most New York insurance liquidations).
- Push – jointly, cheaply, and efficiently if you can. Liquidators rarely pay claims out of the kindness of their hearts.

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