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Claims Estimation—A Policyholder's View


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It is well known that policyholders throughout the country often suffer through enormous delays in obtaining insurance recoveries from insolvent carriers. The delays can amount to a decade or two while the insolvent estate spends years and years chasing the largest asset available to pay creditors—the monies held by the reinsurers.

What can policyholders and liquidators do? The answer lies in the rising use of claims estimation as the best means policyholders have to obtain speedier relief once the carrier has been placed into liquidation.

Given the ten to twenty years in which insurance insolvency proceedings often remain open, claims estimation is a growing means of shortening this period, thereby decreasing the large administrative costs and delays that dilute policyholders' recoveries.

Insurance company insolvencies are different than normal business failures. Most insolvency proceedings involve businesses that provide goods or services before demanding payment. When insolvent, such businesses encounter a relatively simple liquidation process in which the balance of the outstanding payments is ascertained and marshaled with other assets and applied against known and fixed claims. In contrast, an insurance company receives payments while incurring a contingent obligation which may not mature for several years, if at all. Therefore, insurance insolvency proceedings may remain open for years in order to determine actual creditors and the full amount of their claims. Claims estimation seeks to end this delay, and the ensuing administrative expense, by using actuarial tables to approximate claims thereby speeding up the collection process which in turn will allow for quicker distributions to policyholders and claimants.

Liquidation delay is often complicated by the existence of many long-tail claims. The first Comprehensive General Liability ("CGL") policies were introduced in the 1940's and 1950's as "accident" based policies, meaning that to trigger coverage, the accident must have taken place during the policy period. These CGL policies were written when bodily injury or property damage occurred almost simultaneously with the time of the accident. However, accidents may precede by many years the resulting bodily injury in long-tail claims, such as those arising from DES and larger environmental injuries. As insurance insolvency proceedings become increasingly tangled in long-tail claims, estimation is becoming an increasingly useful liquidation approach.

The Advantages Of Claims Estimation

Claims estimation provides numerous advantages to policyholders and insurance companies alike.

First, claims estimation drastically shortens the insolvency proceeding period and the resulting administrative expenses that otherwise reduces the money ultimately available to claimants. For example, the liquidator for Integrity Insurance Company's insolvency proceeding estimated that the nine-year administrative process had cost Integrity's creditors $8.5 million. The liquidator further estimated that the next ten years would cost an additional $45 million, with the liquidation process possibly stretching on for up to thirty years. A New Jersey superior court ruled that the New Jersey Liquidation Act does not prevent claims estimation where equity requires it. Though the statute did not expressly provide for such estimation, the court concluded that equitable considerations, including the delay and administrative expense, required claims estimation in order to prevent unfairness to future claimants and a waste of Integrity's assets.

Second, it is more equitable for policyholders and claimants to receive some compensation at an earlier date under claims estimation then to receive less or none at all under alternative liquidation procedures. Two approaches to insurance liquidation have been incorporated under a majority of state statutes that fail to benefit all policyholders. Approximately one-third of the states use a "cut-off" approach which allows contingent or unliquidated claims to share in the estate *only* if they become fully established—meaning their liability and amount are determinable—before the final date or "cut-off" for filing claims. This approach greatly disadvantages those policyholders whose claims mature after the arbitrary cut-off date and runs counter to the goal of equal treatment which lies at the heart of the liquidation process. Because of this, liquidators and courts have generally opted for a "run-off" approach which keeps insurance estates open until all claims are determined and presented.

However, the "run-off" approach, which is followed by just over half of the states, also imposes substantial penalties on policyholders, in particular those holding short-tail claims. While proponents of the run-off method state that if the liquidator reserves conservatively, assets will be preserved for distribution to late-developing claims, they neglect the actual cost, delay, and other hardships that the method imposes. A run-off operation involves retaining an administrative staff who will manage emerging claims, bill and collect reinsurance, and periodically make distributions. The administration marshals liquid assets to pay for its own substantial expenses, thereby diluting policyholder recoveries. Short-tail claim holders often cannot be paid in full because of the significant reserves that must be held to pay for potential future claims. Finally, the run-off approach creates uncertainty for policyholders whose ultimate payments depend on the total claims facing the insurance company. While the proponents of both the run-off and cut-off approaches rely on state guaranty funds to pay the policyholders within a "reasonable" period of time; too often such guaranty funds have significant exceptions and monetary limits.

Claims estimation, in contrast, removes the arbitrariness of the cut-off approach and the delay and expense of the run-off approach to provide more policyholders with more money in significantly less time. In essence, the liquidator will place a value on the claims liability of every unliquidated or contingent policy using actuarial tables. The early receipt of some money which may be set aside and invested in case of such an occurrence is better than either the complete lack of money the policyholders would receive under the cut-off approach, or the diluted amount received after the run-off method's expensive delay. Among all approaches, claims estimation best serves policyholders' interests by expediting the liquidation process in an equitable and money-saving manner.

Third, claims estimation is by no means an untested concept. Proof of its practicality and success is evident from its wide usage in federal bankruptcy procedures in the U.S. and insurance insolvencies in England. U.S. federal bankruptcy law permits estimation of contingent claims. Bankruptcy courts have relied on these laws in environmental, breach of contract, and mass tort claims. However, there has been no real federal discussion or experience in estimating claims against insolvent insurance companies. Nonetheless, its usage in federal bankruptcy—especially when dealing with such complicated claims as environmental liabilities and mass torts—supports its usage in insurance insolvency proceedings.

On the other side of the Atlantic, claims estimation has long been used in insurance insolvencies. English law provides for claims estimation, sometimes in combination with a cut-off or run-off approach, in order to protect the interests of contingent claimants. In sum, England's greater experience in this area establishes that while insurance insolvencies require flexibility, claims estimation can work well in all situations and phases.

Estimation Under Attack By The Reinsurance Industry

Opponents of estimation, namely reinsurers, question the accuracy and the legality of claims estimation and argue that it threatens reinsurers and the insurance industry's solvency. Simply put, reinsurers are protecting their financial interests. Reinsurers often voice three specific objections to the approach.

First, reinsurers argue that actuarial tables cannot estimate claims with the "reasonable certainty" that some state statutes require. However, reinsurers themselves rely on actuarial estimation to set premium rates and to establish reserves. As the Missouri Court of Appeals reasoned, since the reinsurers received premiums which were established by taking into account reserves for projected losses, including those incurred but not reported ("IBNR"), it would be unjust to allow the reinsurers to avoid obligations based on a ceding company's liability for such losses. In sum, it is hypocritical for reinsurers to embrace estimation when it furthers their business, and then denounce it when it requires paying policyholders and claimants what is rightfully theirs.

Second, reinsurers argue that claims estimation is beyond most states' statutory authority and that the approach is unconstitutional because it retroactively alters reinsurance contracts. However, even when statutes do not expressly provide for claims estimation, courts have relied on equitable principles to permit estimation in order to grant relief to policyholders and others injured by such insolvencies as Integrity's. Courts have upheld the legality of claims estimation except when the approach is expressly precluded by a state's statute.

Third, reinsurers argue that claims estimation adversely affects the insurance marketplace by placing on reinsurers a "significant credit risk" not previously accounted for, thereby forcing reinsurers to pass this cost onto the consumer. Reinsurers, however, neglect the cost of delay that the liquidation process currently passes onto policyholders and claimants in the absence of estimation. In truth, it is this factor which greatly threatens the industry's reputation and future.

Conclusion

Given the developments in such states as Illinois, Utah, Missouri and New Jersey over the past three years, claims estimation is becoming the most equitable solution to the typical expense and delay of insurance insolvency proceedings. Other alternatives, such as closing an estate by transferring assets into a trust, or an auction approach in which liabilities of failed insurance companies are bid on by operating firms, are entering the discussion table. But for now, claims estimation is the leading approach to ensure that policyholders receive the most favorable treatment in insurance insolvency proceedings. ■

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