INTERNATIONAL RESPONSES TO INSURER INSOLVENCY

Peter Axelrod, Attorney at Law
Reid, Axelrod, Ruane & McCormack

INTRODUCTION

The recent failure of HIH in Australia, and the resulting burden on its insureds and the Australian taxpayer, demonstrated that the Australian government had not contemplated the possibility and consequences of the failure of a major insurer. The resulting ad hoc attempts by government to relieve the suffering are neither equitable nor satisfactory.

The status of pending litigation where HIH insured one or more of the parties remains in doubt and larger insureds are without remedy of any kind. Public funds will be used to fill the gap created by private defalcation. Despite all of this, there is still no movement in the parliament to provide a better result when the next failure occurs.

Both the United Kingdom and the United States have for 30 years had in place mechanisms for the orderly resolution of insurer insolvency and the protection of insureds without the use of public funds. Australia would benefit from the adoption of either the U.K or U.S. systems.

THE HIH DISASTER

After months of decline, on March 15, 2001, HIH became provisionally insolvent. The cause of the failure does not appear to have been related to a sudden underwriting casualty, such as a cyclone or major widespread disaster, creating an unusual increase in claims, but rather to a combination of mismanagement, inadequate regulation, and, it has been alleged, criminal conduct. Regardless of the cause of the failure, there was no mechanism in place to deal with the consequences of the insolvency.

The immediate results were devastating. HIH wrote disability and other first party policies upon which people's day-to-day lives depended. Thousands of insureds were also defendants in civil proceedings where HIH was providing attorneys for defense and the funds to pay settlements and judgments. Whatever peace of mind that insurance had provided was gone and their personal assets were suddenly exposed. Lives were endangered and disrupted.

Over the last months the government has put together a support plan that addresses some, but far from all, of the urgent needs of former HIH insureds, all at the expense of the Australian taxpayer. Many problems remain unresolved and many insureds still lack both protection and recourse.

THE AUSTRALIAN SOLUTION

The Australian government announced a scheme to provide some limited relief. Its details include:

The government will pay 100 cents on the dollar for people with salary continuance policies who are Australian citizens or permanent residents; personal injury claims where the insured is an Australian citizen or permanent resident or a small business; claims for a total loss on a primary

place of residence where the insured is an Australian citizen or permanent resident; and claims where the insured is an Australian not-for-profit organization.

The government will pay 90 cents on the dollar support for other claims where the insured is subject to an income test as follows: Where family taxable income is less than $77,234 (increased by $3,139 for each additional child), a policyholder qualifies regardless of the size of the claim. Where family taxable income is more than $77,234 (increased by $3,139 for each additional child), a policyholder qualifies for assistance if the claim is more than 10 per cent of family taxable income and claims where the insured is an Australian small business that has 50 employees or fewer.

Excluded from the scheme are claims where the insured is not an Australian citizen or permanent resident; claims for reinsurance contracts or in the nature of a reinsurance contract issued by HIH; insurance mandated by State and Territory Governments including compulsory third party motor vehicle insurance (CTP), workers' compensation, builders' warranty and professional indemnity for legal practitioners (to the extent that it is compulsory); any business that is not an Australian business or does not meet the definition of a small business; claims where the insured was a director or officer or an associate of a director or officer (as defined under the Corporations Law) of any company within HIH 3 years before its failure; and claims where the insured was an individual, or an associate of an individual, who was in a position to influence or advise the directors or officers of any companies within HIH 3 years before its failure.

The payment of support will only be available where a claim is made before 11 June 2001 or a claim relates to an event that occurred before 11 June 2001. This means that for most types of insurance policies it is only necessary that the event giving rise to the claim (for example, the car accident or injury) occurred before 11 June. (Source: HIHsupport.com.au)

The government's response to the question, "What is the Government doing about this?" posed on the HIH Support web site (HIHsupport.com.au) was:

> The Commonwealth Government has announced a package of assistance for eligible HIH policy holders with claims to be funded by the Federal Budget. It has also put in place assistance through Centrelink for urgent hardship cases.
>
> In addition, the Commonwealth has announced a package of new laws to tighten controls on the insurance industry, and a Royal Commission into the HIH collapse.

Since existing controls failed, the solution is not, it is submitted, more controls nor a Royal Commission. More study and more government will not solve the problem nor provide in any way for the next insurance company failure. It is a recipe for disaster made all the more tragic by the fact that regulation has already proved to be inadequate to prevent failures and totally useless in dealing with their aftermath. These are clearly the same folks who created the BAS.

THE U.K. SOLUTION

The United Kingdom has the Policyholders Protection Act 1997 ("PPA 1997"), which amended the Policyholders Protection Act of 1975 ("PPA 1975"). The 1975 Act established a

compensation scheme to protect consumers in the event of an insurance company insolvency. The scheme is administered by the Policyholders Protection Board ("PPB"), which is empowered to levy all U.K. authorized insurance companies. The levy cannot exceed 1 per cent of the net premium income in any calendar year. Thus the U.K. does not depend on tax revenue to protect policy holders and claimants.

If an insurance company goes into liquidation, the PPB must ensure that all insurance liabilities to policyholders are met in full where the insurance is compulsory (as it is under the Road Traffic Act 1988, for example). Where private individuals (including individuals transacting business in partnerships) have taken out non-compulsory, non-life insurance and long-term life insurance policies, the PPB must ensure payment of 90 per cent of outstanding claims and arrange continuity of life insurance with benefits at 90 per cent.

There is no monetary ceiling on the payment which the PPB can be required to make. The details of the restrictions are that a policy is only covered by the compensation scheme if it is issued by a U.K. authorized insurance company. Not surprisingly, the plan (as of the 1997 amendments) excludes claims arising from the United States. (Source: International Insurance Law Review 1997, 5(7), G112-114.)

For over 25 years the U.K. has had a plan in place to manage insurance company failures in a legal system similar to that of Australia. The United States likewise has had a long standing plan in place.

THE U.S. SOLUTION

A Brief History

In the United States insurance insolvency is a matter of state rather than federal law. The U.S. bankruptcy statutes specifically exempt insurance companies. 11 USC §109(b)(2). Most state laws governing insurance company insolvency date from the 1930s. For example California's current laws were passed in 1935 and provided the basic framework for rehabilitating and liquidating failing insurance companies. (Calif. Insurance Code §§1010-1062).

Most states, as part of these provisions, also enacted statutes that created guarantee associations for both first and third party insurance coverages. In California (the state most familiar to the author), the basic structure was put in place in 1969. (Calif. Insurance Code §§1063 *et seq*.)

In 1988, California adopted the Uniform Insurers Liquidation Act (Calif Ins. Code §§1064.1 - 1064.12). The Uniform Insurers Liquidation Act was approved by the National Conference of Commissioners on Uniform State Laws, and the American Bar Association, in 1939, and has since been adopted by 26 states. The word "uniform" requires some explanation. Because of the split sovereignty created by the U.S. Constitution between the states and the federal government, it is often not possible for a common framework of laws to be imposed by the federal government on the states. But since consistency from one state to the next is often desirable, the states work together to devise proposed "uniform" laws which are then adopted by each state. Not all states adopt every "uniform" act and not all that do adopt them do so without modification. Thus a "uniform" act may not be universal throughout the United States and may not even be uniform.

The Uniform Insurers Liquidation Act

The Uniform Insurers Liquidation Act generally provides that when the state regulator (usually the Insurance Commissioner) determines that an insurer based in that state is in danger of collapse, a conservator (or if, it's clearly hopeless, a liquidator) is appointed and the state assumes control of the insurance company.

The conservator or liquidator then goes to state court to obtain an order staying all proceedings involving the insurer and, most significantly, claims involving its insureds. The conservator then marshals the assets of the company, gives notice to all potential claimants and gathers the claims, and collects debts owed to the company. The conservator may also sue those responsible for the carrier's failure, including former directors, agents, accountants, auditors and officers.

Since most insurers write policies in more than one state, and since the acts of a state court judge are generally not binding on those outside the state's borders, the Uniform Act provides that the liquidation and stay orders of the court where the company is domiciled will be honored by the other states. This permits an orderly handling of all the claims regardless of where they arise. As noted above, this is necessary because the national bankruptcy laws do not apply.

The Guarantee Associations

While the insurance company is being liquidated or rehabilitated, the insureds and claimants of the insureds are protected by the state guarantee associations. These organizations are created by statute and, as in the U.K, are funded by a levy on each premium dollar collected by each insurer as a precondition of being allowed to write insurance in each state. They do not receive tax dollars.

Non-admitted carriers, called surplus lines, of which Underwriters at Lloyds is the most famous example, are not covered either by this scheme nor by the scope of this paper. They are subject to special rules but insureds accept greater risks when choosing coverage from non-admitted carriers.

In California there are two guarantee associations: the California Insurance Guarantee Association which deals with third party policies such as public liability, and the California Life and Health Guarantee Association which covers the first party life, disability and health policies.

While the guarantee associations replace the failed insurer they are not treated as insurers by the law and have many immunities and privileges that the insurance companies lack. The point of most of these exceptions is to protect the assets of the associations to conserve them for use to protect the insureds. Some examples include:

The California Insurance Guarantee Association (CIGA) is not subject to the California Fair Claims Practices Act (Calif. Ins Code §790) and thus need not comply with a host of requirements for communicating with claimants and settling claims on particular time table. CIGA can not be sued for bad faith nor can its insureds be sued by subrogating insurers. Also its liability is limited to $500,000 USD (A$961,500) or the limit of the original policy whichever is less.

Like the current Australian program, CIGA does not cover re-insurance contracts, or any obligations to other insurers. While CIGA only pays claims of California residents, residents of other states can apply to the guarantee association in their home state. Claims against residents are covered wherever they arose. The California Life and Health Guarantee Association pays 80% of the insurer's obligations up to $250,000 USD for life insurance policies and $200,000 USD for heath policies.

Another protection afforded the guarantee associations is exemption from the collateral source rule. Under the collateral source rule:

> Where a person suffers personal injury or property damage by reason of the wrongful act of another, an action against the wrongdoer for the damages suffered is not precluded nor is the amount of damages reduced by the receipt by him of payment for his loss from a source wholly independent of the wrongdoer. (*Anheuser-Busch, Inc. v. Starley* (1946) 28 Cal.2d 347, 349, 170 P.2d 448

What this means is that in most of the U.S. tort defendants can not benefit from first party insurance purchased by plaintiffs. Most often this is health insurance. Thus an ordinary tort defendant (and its insurer) will be liable to the plaintiff for the cost of medical care arising from the accident even if every penny was paid by plaintiff's health insurer. CIGA, by contrast, gets full credit for such payments. Calif. Insurance Code §1063.1(c)(4).

Unlike the Australia HIH support scheme, the guarantee associations cover workers' compensation, professional error and omissions (including, happily, lawyers), and all other liability policies.

CONCLUSION

There is no substitute for planning. Recognizing that insurance company failures will occur and that those failures will, if not managed, result in substantial harm to insureds who relied upon the coverage they bought, is the first step to mitigating that harm. Australia had no plan prior to the HIH failure, and shows no signs of developing one despite the lesson it should have learned.

Both the U.K. and U.S. models, while certainly not perfect, have worked well over the last 30 years and have managed the failures of countless insurers, big and small. Since it is only a matter of time until the next failure in Australia, adopting some plan, whether the U.K. model, the U.S. model or some other, is a matter of urgency.

APPENDIX:

HIH in the U.S. HIH wrote insurance in California through an affiliate and recently the U.S. affiliate also failed and has gone into liquidation. Attached is the brochure sent out by the liquidator to all policy holders and other potential claimants. Contrast this document with the confusion and despair following the HIH collapse in Australia.