INSURANCE INSOLVENCY GUARANTEES

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EXECUTIVE SUMMARY

This Report is about guarantees which protect policyholders and claimants when property-liability insurance companies go broke.

Insurance is a large private industry in the United States and is important to the way we do things in our economy and society. The insolvency of an insurance company is disruptive economically and socially. It hurts people most when they have unpaid claims, which can amount to hundreds of times what they paid as premiums.

We have seen enough of guarantees in the savings and loan industry to know that this is a serious subject. It is neither one to ignore nor one to take up carelessly. In insurance, that means starting by a review of how the business works and is regulated, what the threats and challenges have been in the past and what they are now, and how well we can expect existing arrangements to protect us.

Insurance is regulated by the states. Judging by the insolvency record, they have done a good job. In the past there have been relatively few insolvencies, except during three episodes. In each one, the industry and government took action to limit future damage to the public.

The first episode was in fire insurance in the latter half of the 19th century. Fire insurance was central to the building of cities and of industry. Large fires bankrupted many insurers. The answer was to help the companies keep rates high enough to absorb the occasional disaster.

The second episode was in the Great Depression, when stocks, bonds and real estate lost much of their value and many banks went under. Insurers writing mortgage guarantees and surety bonds on bank deposits failed. The answer was to do away with the need for those kinds of private insurance.

The third episode was in substandard auto insurance in the late 1950s and early 1960s. Competition among large auto insurers brought profound changes in that business. The competition left inner city drivers with higher rates or no insurance at all. Small insurers sprang up to meet the need but could not handle it. Many went broke. The answer was to act directly to reduce the public harm, by rescuing companies and by creating insolvency guaranty funds.

The three episodes of insolvency called forth three different responses for dealing with such problems in the future – making insolvency largely impossible through price maintenance and restrictive rules, making the insurance itself unnecessary or illegal, and covering the shortfall with guarantees.

The three episodes had a lot in common. The insolvent companies were small with commensurately small insolvency losses. The insolvencies were local and not connected with each other. They were simple and quick to resolve.

Now we seem to be entering upon a fourth episode, this time centering on general liability. Those insolvencies are apt to be large, even for small companies, and they may involve large companies. They are complex. They are national and international in their impact. They will take decades to resolve.

It seems unlikely that we could solve a problem of insolvency of general liability insurers by either of the first two approaches of the past – subsidizing their rates or eliminating private insurance entirely. Nor is it likely we would just leave the losses where they fell, for they hit innocent claimants who had nothing to do with picking the liability insurer. Most likely we would take the third approach and act directly to minimize the public harm from insurer insolvency.

Much of the present system of minimizing the harm is appropriate to the task. Over the years the states have built up expertise in the detection of insolvency. It includes conservative accounting, periodic examinations and statistical early warning indicators. It should be preserved and strengthened.

But the present system for dealing with an insolvency, once it has been detected, was built on experience with small, local and easily isolated insolvencies. Rescuing individual companies had a good chance of success, and the public did not lose much when the regulator tried and failed. When a company went under in those days, the states could control the damage through their own resources for liquidation and guarantee.

All that is changing. Future insolvencies will be the opposite – large, national, complex and interconnected. The delay for attempted rescue will be less rewarding and more costly. The state system of liquidation and guaranty funds is inherently ill suited to the new kind of insolvencies.

For an episode of general liability insolvencies, simply improving state regulation for solvency will not do the job. Vows to improve state regulatory technique are not fully responsive to the nature of the problem. To be effective now, the system has to be changed in concept and structure.

In concept, the goal of solvency regulation has to be reformulated as minimizing public harm rather than keeping companies afloat. In structure, the resources available after recognition of insolvency have to be given national scope in the two areas of liquidation and guarantee. Acting in advance of a crisis should make it possible to stop there and leave the rest of state regulation intact.

In developing a proposal to strengthen the way we deal with insolvency, we need to make two big choices which will govern what we do for the future. One is how to deal with general liability insolvencies. The other is whether to have guarantees at all.

Of the ways of dealing with insolvencies, only a combination of early detection, prompt action and guarantees against loss can deal with a wave of insolvencies caused by general liability. But guarantees do not come without cost, both directly and in altering the

balance of risk and reward for managers, policyholders and regulators. Guarantees will be beneficial, but they have to be designed carefully.

Five principles should govern the design of any specific program. First, the program should build on the existing structure of the industry and its regulation. Second, the liquidation of insolvent companies and guarantee of their obligations should be national in scope. Third, insolvency costs should be charged back to the activities causing them. Fourth, the program should encourage close monitoring of financial condition. Fifth, the national program should assign significant roles to the state insurance departments and the private insurance industry.

Based on those five principles, the Report sets out a concrete proposal for a national system of liquidation and guarantees. An Act of congress would create a national Insurance Guaranty Corporation (NIGC). Like the state funds, the national one would be privately financed by assessments on insurance companies. It would not use tax money. It would charge guarantee costs back to insurers in the state and line of insurance involved. NIGC guarantees would be designed so that policyholders, brokers, reinsurers and others in the private sector would have financial incentives for close surveillance of the financial condition of insurance companies.

The NIGC would not be a regulatory agency. Responsibility for insurance regulation, including detection of insolvency and action to take over companies, would remain with the states. Nor would the NIGC be designed to rescue insurance companies. It would act only as rehabilitator or liquidator of companies already placed in receivership by state regulators and courts. The NIGC's guarantee obligations, and its power to assess members to fulfill them, would extend only the policy claims owed by insolvent companies in liquidation.

The idea of the proposal is to combine the strengths which private industry, the state regulatory agencies and the federal government can bring to this emerging challenge. Whatever the exact shape of a plan, it should be decided upon now, while events are still within our control and while there is time to make balanced and calm decisions.

BACKGROUND

This Report is about guarantees against loss when an insurance company goes bankrupt. Today the guarantees are provided by other companies under state law. The reason for the Report is the importance and timeliness of asking ourselves whether the present guarantees are what we as a society should want and, if they should be changed, what the changes ought to be.

The guarantees do not stand on their own. They are part of a larger system. Its purpose is to protect people and organizations against loss from events beyond their control, events such as fires, accidents or legal liability. The system is made up of the insurance business and the state agencies which regulate it. For this Report, the insurance business means property-casualty, that is, not life or health or pensions. It means only the private insurance business, not the government programs which offer insurance too. Finally, the Report is limited to the insurance business done in the United States by companies based here.

The first chapter of this Report is about the larger world of which insolvency guarantees are part – the insurance business and its regulation. Following chapters look at the reasons why insurance companies go broke, the present ways of heading off insolvency and holding down the harm the public suffers from it, and, finally, ways to make the system stronger for the future.

The Insurance Business

Insurance is a large business. About 4% of our gross national product goes for premiums to private insurance companies. Insurance has an important role in our kind of society and economy. It takes on the risk of losses, such as damage to property or liability under law, which would be too disruptive and expensive for us to bear individually.

For reasons this Report will get into, a large number of companies is in the insurance business – well over 2000, with over 250 rather big ones. Taken as a whole, the insurance business holds a lot of money, mainly other people's money. Its invested assets are $400 billion. That is a big trust in every sense.

The trust and dependence of other people are the main reasons for public concern with the health and performance of the insurance business. But many people work in it too – some 850,000 throughout the country.

Insurance companies write many kinds or lines of insurance. The largest are automobile and homeowners, for individuals, and workers compensation, general liability, fire, marine and multiple-peril insurance for businesses, non-profit agencies and units of government. Insurance for individuals and insurance for businesses and other organizations are each about half of the total.

In one sense, insolvencies in insurance have a worse impact than in other businesses. With most businesses, when a company goes bankrupt the people who dealt with it stand to lose no more than what they paid to it. When we pay for insurance, however, we buy protection against the chance we will have a loss much greater than the amount we paid. Most policyholders will not have a loss. If the company goes broke, they are not affected except for having to replace the policy and perhaps give up some premium. But a few policyholders will have had insured losses. What insolvency costs them may be hundreds of times the premium they paid, exactly the catastrophic burden they bought insurance to avoid.

Protecting those people was the original reason government regulated the insurance business and it is still the main reason. Guarantees are a part, but only one part, of the regulatory system. To address guarantees intelligently, we have to know something about regulation.

Insurance Regulation

Insurance regulation in the United States began in the mid-19th century, first with a requirement of filing financial reports with the state and then with the creation of specialized regulatory agencies, the state insurance departments.

The predecessor of the National Association of Insurance Commissioners (NAIC) was formed in 1871. The welcoming address at the first meeting surveyed the previous thirty years in British insurance, where "some 200 companies have...gone out of existence." The host commissioner asked "what was the cause of this surprising mortality of companies, and is there any danger of a similar experience here?" He found the causes to be "too great facilities afforded for organizing companies,...incompetence, extravagance and dishonesty in their management," and "lastly and mainly, the want of any proper governmental check or supervision to either prevent or suppress the above named evils."

The earliest concern of regulation thus was solvency. It was a reflection of the importance of insurance for the new and growing cities, with their vulnerability to fire. The insurance business was fragmented, with local companies writing fire insurance in their own towns and with little reinsurance to spread risks. A big city fire could overwhelm them, driving them to insolvency or to evasive claims practices to stave it off. Early regulators were active on both fronts.

In 1869 the jurisdiction of the states was challenged under the interstate commerce clause of the Constitution. The Supreme Court held that insurance was not commerce at all and that, even if it were commerce, it was so local a transaction as not to be interstate. Hence it was beyond the reach of Congress and exclusively within that of the states.

Their jurisdiction confirmed, the state insurance departments covered the field, licensing companies and agents, promulgating a standard fire policy and a standard format for financial reports, and organizing multi-state examinations of the larger companies.

The system was not entirely uniform at any time, even in its priorities. The east coast and mid-west financial centers tended to emphasize the financial condition of insurers and hence strict accounting and examination practices. The newer states were more concerned with the availability and price of insurance and with the conduct of those who sold it and settled claims.

Until the mid-20th century, the most important line of insurance was fire. The solvency of fire insurers was a major public concern, and it was jeopardized by recurrent price wars and urban conflagrations. The financial center states regulated solvency in two ways – strict accounting rules and encouragement of uniform premium rates set by agreement among the companies. The companies from those states dominated the business nationwide.

Three quarters of a century after giving the states exclusive jurisdiction over insurance, the Supreme Court reversed itself and held insurance to be interstate commerce. At once the business became subject to the antitrust laws, which threatened the price stability of fire insurance. It also became subject to the regulatory jurisdiction of Congress, which enacted a partial antitrust exemption and a confirmation, repealable at any time, of the regulatory role of the states. Since then, insurance regulation has developed around the decline of fire insurance and its method of market stabilization, around the rise of auto insurance as a public concern and around the tension between the actual jurisdiction of the states and the potential jurisdiction of the federal government.

Among its many activities, insurance regulation has traditionally concentrated on solvency. Its first involvement with pricing and underwriting was to reinforce the industry's efforts to maintain standard rates and classifications of risks, all to protect the financial condition of insurers.

In recent years, however, public attention has turned to the level of insurance prices and to the way they are apportioned among segments of society. That development puts upon the regulator the strain of somewhat conflicting goals. So far the efforts to hold rates down and to equalize them have not appeared to be constrained by concerns for solvency, probably because any adverse effects will be indirect and delayed. We know from experience in many fields that government is not good at balancing present, direct benefits against future, indirect costs.

The record of insurer insolvencies is not the record of regulation alone. It is the record of the whole insurance enterprise. That includes the structure and environment of the business. For the first half of this century, the structure of the industry kept rates up. As that structure dissolved, the postwar economic boom provided a favorable environment for premiums, claims and investments. How much of the solvency record is due to regulation and how much is due to a supportive structure and environment we will never know. But we should look at the record.

INSURANCE COMPANY INSOLVENCIES

Insolvency guarantees are one way of dealing with the social costs of insurer insolvency. To decide whether guarantees are a desirable way, we need to understand how insolvencies come about. They are not random events. They have causes, and those causes change over time. They exhibit patterns and, in a general way, they can be predicted. Understanding what has caused insolvencies in the past, and what is likely to cause them in the future, is essential to evaluating the present regulatory responses and to designing responses for the future.

Causes of Insolvencies

Some insurance insolvencies result from mundane reasons that affect all businesses, such as bad management. But the key factors in widespread insurance insolvencies are specific to the insurance business.

Two basic characteristics of American insurance have led to insolvencies in the past and will surely do so in the future. First is the way prices are made. Second is the industry's structure and the way it developed.

Insurance companies set prices before they know the largest component of their costs – the losses they will have to pay. The longer the promise to pay lasts, the more at risk the insurance companies are. The longer the time at risk and the broader the promise of coverage, the harder it is to price accurately. Among other things, that difficulty leads a seller to set prices more by comparison with what his competitor is charging, which is concrete and immediate, than against his own costs, which are uncertain and in the future. Competition can feed freely upon itself.

The way prices are set can lead to fierce price competition and to a terrible reckoning if the cost estimates turn out to be wrong. Pricing before costs is not a flaw of insurance. It is a characteristic, and indeed the very one which makes insurance so useful.

The second basic characteristic that has contributed to insolvencies is the way insurance grew up in the United States. That history has given our insurance business a very large number of participants, including many small companies.

In the United States almost two hundred years ago, the insurance business began as a scattering of local enterprises. Many were merely agents for foreign insurers. What local companies there were had almost no capital and stated no surplus or reserves. Later they rented capital, in a sense, from assessable policyholders and, still later, rented it from reinsurers. They distributed insurance through independent agents. They grew by hiring more clerks and commissioning more salesmen. They delegated to bureaus the essential functions of pricing, loss estimation and claims. They could even contract out for management itself. From the outset, insurers could hire everything done and needed little

physical or financial capital. So seen, the managing general agent was not an aberration. He was the epitome of the system.

With that organizational structure, and so with most costs directly variable with volume, insurance offered few economies of scale (falling unit costs as volume increases) or scope (falling unit costs as products are added). The firms stayed small and numerous. With little to be gained by merging for size, they stayed independent. To stabilize the market, they turned, as industries so constituted usually do, to setting prices, costs and territories by agreement. The vehicle was the fire insurance rating bureaus. The bureaus reinforced the structure which bred them – many firms with small shares of the national market.

But until the bureaus could protect pricing long enough for capital to accumulate, the companies could not withstand a catastrophic loss. A company's writings tended to be concentrated in a single geographic area and, within that area, might even be concentrated in the neighborhood of a particularly energetic agent. So the companies were vulnerable to the urban fires which were especially bad during the 19th century – New York, Boston, Chicago. Indeed the supreme rating bureau, the National Board of Fire Underwriters, arose in 1866 out of the ashes of Portland, Maine. But not until the San Francisco earthquake and fire fifty years later were the companies and bureaus able to make the pricing agreements stick. The hundreds of fire insurance company insolvencies in the latter half of the 19th century make it the first period of widespread insolvency in the American insurance business.

The second wave of insolvencies came during the Great Depression. Many were mortgage guarantee companies, with defaulting borrowers and depressed real estate as collateral. They had been caught in a national financial conflagration, but the individual companies were small and local. The state response was to outlaw mortgage guarantee as a line of business. In 1934, with private guarantees no longer available, the Federal Housing Administration began providing mortgage insurance.

Many surety companies also became insolvent in the 1930s. Their biggest problem was depository bonds, which were widely used to guarantee deposits of public money. Public officials were personally responsible for those deposits, and they turned to surety companies. In the widespread bank failures during the Depression, many of those bonds were called upon, and sureties were unable to meet their obligations. Starting in 1933, similar guarantees by the Federal Deposit Insurance Corporation drove out the private depository bonds.

Also in the Depression, workers compensation writers suffered the highest underwriting losses on record, just as their stock and bond portfolios fell to new lows. But compensation rates at the time were centrally controlled, and they were pushed up sharply, much as the fire rating bureaus had raised rates after the San Francisco earthquake. Only a few workers compensation insurers actually went bankrupt, but owing to the political sensitivity of industrial accident compensation, the anxiety led to the formation of the first insolvency security funds.

The third wave of insolvencies came 25 years later. It happened in auto insurance, following a profound structural change in the industry.

Commercial fire insurers had thrived under the bureau system, and fire was the dominant kind of insurance. It was a phenomenon of cities, where valuable buildings stood close together. The fire companies attended less to the countryside and, with the coming of the automobile, rural drivers, aware they had fewer occasions for accidents, found themselves neglected and overcharged.

Largely to fill that rural gap, and later to meet the needs of the postwar suburbs, new insurers grew up. They wrote directly, using exclusive agents and employees for distribution, which was a form of capital investment. Once they built up volume, they had lower operating costs. Eventually they overcame bureau resistance to price deviation and were able to pass their operating economies along as lower premiums. That attracted customers and helped them underwrite by risk selection.

The direct writing insurers grew rapidly and profitably after 1950 and, in their tradition of independence, reinvested the profits in their own productive capabilities. In an era of automated transaction processing and data management, that is a big investment. In industrial terms, the direct writers enjoy "first mover" economies of scale and scope.

But in the early years, the strength of their competitive position was not apparent. The independent agency companies were still by far the largest segment of the industry, and they fought back. Starting in the 1950s, they tried to match the lower prices of the direct writers at least for the better risks. The method was to refine their underwriting rules and rating classifications. That response, together with the continuing selectivity of the direct writers, left without insurance or with higher rates the less attractive risks. They tended to be lower income people in larger cities. That development led to extensive government responses.

There were private responses as well. Among them was the formation of marginal insurers serving the "substandard market" which competition had left behind. Many of those companies were founded on an underestimation of the difficulty of that market as a specialty. Many were understaffed, undercapitalized and underregulated. Some were run dishonestly. Many went broke. Out of 109 insurance companies placed in liquidation in the 1958 to 1968 period, 106 were high risk auto insurers.

The three big episodes of insolvency all followed from the basic characteristics of American insurance – pricing before costs and a fragmented structure. Mainly they trace to the structure. The small, local, mono-line insurers went down with their cities, banks or motorists. Whether the industry fragment was defined by geography, by line or by target insured, when a conflagration hit the precise market, it brought widespread insurance failures.

The Government Response

As just described, there have been three periods of especially heavy failures in the insurance business. Each led to a regulatory response addressed to a possible recurrence of the problem. It helps to study those responses, both to see what is possible and to see how tailored each response was to its own precipitating events.

State Regulation

During the fire insurance episode, which lasted over fifty years, state regulation began. Its role was limited to receiving financial reports, recording insolvencies and sometimes administering the bankrupt estates under the state rules of equitable receivership. Dealing with the causes of insolvency was undertaken by the industry, which repeatedly tried to establish a system of setting rates and commission levels in concert. Finally it worked, but only with the help of the regulators.

The expanded role of the state insurance departments was to supervise the technical work of the fire rating boards, to reinforce the stamping offices of the boards in policing adherence to the rates, to collect taxes dedicated to fire fighting, to set minimum capital and special deposit requirements for fire insurers, to examine the companies for sound finances and prudent management, and to develop accounting conventions which stated income and wealth very conservatively.

The role of the states in the fire insurance system was more important than is usually supposed. It was directly supportive of a public policy decision to prevent insolvency losses by preventing insolvency itself by, in turn, creating an economic environment in which going insolvent was almost impossible. It entailed active enforcement, not just standing by while a cartel ran the market. Finally, for the few cases of failure despite the market, the states stepped in to force the stronger companies to absorb the weak by merger. The figures on company mergers, bulk reinsurance and other quiet retirements are doubtless swelled by companies that would have crashed if allowed to do so.

The second wave of insolvencies, in mortgage guarantee and deposit surety, was met by the states in eliminating the private insurance itself and by the federal government in replacing it with government insurance for mortgages and bank accounts.

The third episode was in automobile insurance for inner city people in the 1950s and 1960s. Many regulatory actions of the time can be traced to the needs of those people. They included expanded assigned risk plans, spreading financial responsibility laws and the first serious instances of political rate suppression. When a private business response to those needs culminated in numerous insolvencies, it touched a political nerve in Washington and the states.

Committees of Congress held hearings at which regulatory shortcomings were displayed and analyzed. On two occasions prominent Members introduced legislation for

a federal guaranty fund (the Dodd Bill in 1965 and the Magnuson Bill in 1969). The hearings of the 1960s are a valuable record of the period. They show that the insolvency losses were widely considered to be failures of regulation alone.

Since the two biggest insurance states had been spared the failures, their regulatory approaches were, explicitly or not, widely taken as models. They were New York, with restrictive regulation and a guaranty fund, and California, with a competitive rating law.

Burned by the hearings and fearing federal intrusion, the states did what Congress seemed to want. In 1970, the NAIC adopted the first Model Guaranty Fund Law and within two years every state but one had adopted a guaranty law. Senator Magnuson had been right when he remarked in one hearing, "Just thinking out loud, maybe these hearings might have an effect on the states doing their job."

The insolvency guarantee system in effect today was a response to the problem of the insolvency of substandard auto insurance writers in the 1960s. Those insolvencies were characterized by meager initial capital, loose underwriting, management rascality and lax regulation. But the most significant characteristics of the insolvencies in the substandard auto episode were that they were local and they were small. And they were gradual. The bad managements just ran the little companies into the ground.

Federal Activities

In addition to being a huge provider of insurance, the federal government has often looked at, and acted in ways affecting, insurance regulation. Relatively few of the actions have been aimed squarely at the quality of solvency regulation or at guaranty funds, but some have done so directly and others have been related indirectly. Not all have been supportive. The federal activities fall into five categories.

First has been where insurance was part of a larger federal agenda, such as the general economy. An example was loans to insurance companies by the Reconstruction Finance Corporation in the Depression. Another was the investigation in the late 1930s, by the Temporary National Economic Commission, of concentrations of economic power, which looked into life insurance. Others related to foreign relations and war, such as the use of marine insurance to promote an American flag merchant marine after World War I and the workers compensation rating rules for military contractors in World War II. In the 1960s, federal programs to deal with riot damage included government reinsurance, and the swine flu inoculation program in the 1970s included mandatory insurance with a filter for tort claims.

Second has been where insurance companies tried to use federal power to escape state regulation. Examples include the agitation among large life companies for preemptive federal regulation before World War I and the occasional moves to obtain federal charters or to enter national commerce through licensure in only one state, on the model of the European Community.

Third has been where insureds and brokers wanted to escape state regulation, usually to ease the availability of coverage. Examples are the tax treaties and closing agreements for important overseas sources of capacity, especially in London and the Caribbean, and the Risk Retention Act of 1986 for commercial liability insurance. Some legislation has been in response to dislocations in the availability and price of liability insurance, but, as the state regulators have warned, one consequence may be dislocations later from the insolvency of the exempted entities.

Fourth has been oversight and review, especially by Congress, of the performance of state regulation. Such oversight is to be expected, because state regulation is conducted under the federal McCarran-Ferguson Act of 1945. Subjects have been rate regulation, especially as compared with antitrust principles, and regulation for solvency. Two sets of Congressional hearings went into the auto insurer insolvencies of the 1960s. The recent hearings by the House Energy and Commerce Committee under Chairman Dingell are of this fourth type. Looking at insurance regulation as a whole, Congressional oversight is a helpful part of the system, serving to focus attention on areas needing improvement and to relieve pressure for more radical change.

The fifth kind of federal action has been to set the framework within which competition and regulation are to go on. Apart from the two Supreme Court decisions about whether insurance was interstate commerce, the one example is the McCarran-Ferguson Act of 1945, following the decision that insurance was subject to the antitrust laws. While the Act became the charter for continued state regulation, that was not an issue at the time. Nor was the granting of some antitrust immunity. The issue was whether the immunity should be broad enough to permit the pervasive enforcement of rate, form and commission uniformity which then prevailed in fire insurance. The decision was that the exemption should not be so broad, but instead should only allow the collective making of rates and forms, as then done in the casualty lines of automobile, general liability and workers compensation.

Prospects for Future Insolvencies

Like the previous episodes of insurer insolvency, the one which is probably coming will derive from two fundamental characteristics of the American insurance business – pricing before costs and a fragmented structure. But this episode will trace not so much to the structure as to the need for insurers to set their prices before they know their costs.

Insurance prices and insurance company balance sheets depend on predicting future loss costs. The more the insurance promise is exposed to social, legal and economic forces, the more uncertain the prediction. The broadest insurance promise is in the comprehensive general liability policy, and exposures in that line take the longest time to resolve as well. General liability is written as a separate line for businesses and individuals, and it is also included in the commercial multiple peril and homeowners multiple peril policies.

As used in this Report, the term "general liability" includes all those forms plus the professional liability coverages. Taken more restrictively, as the "Other Liability" and "Medical Malpractice" lines in the annual statement, it accounts for 11% of premiums, compared with 13% for workers compensation and 35% for personal auto insurance. Either way, its capacity for mischief is out of all proportion to its premium volume.

General liability traces to public liability insurance, an old line which began as an adjunct to employers liability in the 1880s. First it covered premises liability, then street railways and then manufacturing operations. It was written for particular exposures of particular businesses. In the 1920s, the idea caught on of covering liabilities of essentially all sorts for a wide variety of businesses, and general liability as we know it began.

Public liability and then general liability grew rapidly and were highly profitable. Legal rules were stable and safety improvements across society kept the underlying accident costs headed down. Yet compared to fire, auto and workers compensation, the general liability line was small and had few participants. Price competition was not severe. In only three years between 1930 and 1966 did it fail to earn an underwriting profit. The long premium float added good investment income.

Eventually the profits attracted competitors. Because of the long period of loss uncertainty and the complexity of forces at work, the estimation of costs was very difficult. In a competitive market, uncertainty as to costs usually leads to underpricing. Aggressive pricing, in turn, invites optimistic cost estimation when setting loss reserves.

Starting in the mid-1950s, the underlying law of torts began to turn against insurers, as did the rules of insurance contract construction. The rising cost of the law first broke through in the late 1960s. But uncertainty about future costs has made it easy to underestimate them. Since the late 1960s, despite rising alarm about the tort explosion, there have been three price wars – in the early 1970s, the early 1980s and today.

The way general liability can deceive insurers about their costs and their prices adds to the violence of the underwriting cycle. While a firm in a cyclical business may average a certain level of profit over the long run, that presupposes it can stay in business for the long run. If it goes broke at the bottom of a cycle, it is gone forever. The more violent the cycles, the more companies will be shaken out at the bottom of each one. That is starting to happen in general liability.

One especially tricky aspect of general liability is the setting of reserves for future claims and the susceptibility of those loss reserves to error. An insurer may have reserves equal to four times its surplus. That means a 25% increase in reserves wipes out the surplus entirely and breaks the company. General liability reserve increases, unlike steady losses from auto underwriting, can hit the balance sheet suddenly. The insurers are vulnerable to the modern casualty equivalent of a 19th century conflagration. It need be no more fiery than an upward revision of actuarial estimates.

With special exposure to large, target insureds, the large insurers of general liability are no more secure than the small ones. Size can improve spread of risk, but the risk here may be the legal system itself, more than any particular insured activity. If so, then the real risk in general liability insurance is systematic and not amenable to diversification, just as even the largest common stock portfolio cannot diversify away the risk of being in the stock market.

If general liability is so difficult and dangerous, then why do companies write so much of it? Because it is the only line of insurance which offers the prospect of good profit for a company with an average market position. The insurance market is very big. But for the half of the total which is personal lines, only competitors with lower overhead costs, typically direct writers, can expect to attract the best risks and make a consistent profit. The others decided twenty years ago to concentrate on commercial lines. The rate rollbacks and freezes in personal auto are just hastening the completion of that shift.

But in most commercial lines, demand is growing slowly and there is too much capacity to serve it. The excess capacity is both financial and organizational. It is being squeezed out by low profits and increasingly steep cycles. That is not pleasant for those involved. So they look for more promising areas. The only one in insurance is general liability. It is growing fast and companies can easily, and quite innocently, underestimate costs to justify low prices and good profit reports for a time. So they rush into the general liability market and, after the real costs hit home, rush back out. This is a predictable response to the difficult situation they are in, but it exacerbates the instability already inherent in general liability.

Just as insurers are drawn into the general liability market because of its growth, corporate customers have been getting out of it because of its price and instability. Where that is easiest is in the low dollar levels of loss. With many losses of rather uniform severity, the low levels are statistically more predictable than the higher ones, and hence more stable from year to year. So for the past thirty years more and more corporate risk managers have retained those lower layers through self-insurance and similar devices. Insurance companies get what is left, and it is obviously less stable than the total would have been.

In insurance terms, those are the reasons why general liability is likely to be central to the next wave of insolvencies. A deeper look at the role and economics of insurance leads to the same conclusion.

Insurance is a large and important business, but it is not a system unto itself but rather a participant in much larger social and economic systems of various kinds. Usually the role of insurance is to fund and allocate the accident costs of the larger system. Thus fire insurance played a part in the building of the cities and the factory economy of the 19th century. Workers compensation is part of the industrial system, and auto insurance of the automotive transportation system.

As one of many participants in the overall system, insurance lives and dies with the vitality of the system and of its relations with it. When cities rise, fire insurers prosper, but not when cities decay. When industry thrives, workers compensation thrives as well. When industry is in trouble, workers compensation gets squeezed in the larger cause of economic development. When the automobile is serving society well and at reasonable cost, auto insurance does well. When the cost of automobile travel threatens to deprive part of the community of that virtual necessity, auto insurance gets pushed around. Worst of all, when insurance is seen as hindering the larger system, it is in deep trouble indeed, and usually its interests will be sacrificed to the needs of the whole.

Something of the sort may be happening with general liability. The larger system it serves is, of course, the legal system. While by some measures it is not as large as the systems of transportation, industry or urbanization, it excels them all in strategic position. Right in insurance, some of the biggest decisions as to corporate direction and resource allocation that were once made by executives and regulators have been recast as questions of law for decision by courts. When insurers take on "the lawyers", they are reminded from all sides how far they have already walked into the law's parlor.

The legal system appears to be fighting the way liability insurance funds and allocates its costs. The temporary result is suppression of the passing through of system costs via insurance. While it is commonplace to criticize general liability rates as too high, in all probability they are now, in most situations and most of the time, too low. One reason the rates are too low is that they are not loaded for the risk of insolvency.

The business of general liability insurance is intertwined with a dynamic and demanding legal system. It is technically unable to know its costs. Its roster of competitors shifts almost daily. No wonder that sometimes it goes entirely out of control.

The general liability episode of insolvencies may be emerging now, with the early instances being American Reserve, Mission, Transit, Integrity, Ideal, Midland and American Mutual of Wakefield. The largest of them was based in California and two were in New York. Together with the events unfolding in London with H.S. Weavers, they suggest five features to the new episode which, taken together, would distinguish it from all of the earlier ones. First, a small company can have a large insolvency. Second, a large company can become insolvent. Third, an insolvency can be national and international in scope. Fourth, an insolvency can reverberate through the whole insurance system. Fifth, this time the leading states will not be spared.

THE PRESENT SYSTEM

Before going further, we must inquire whether we already have in place arrangements for coping with a wave of insolvencies involving general liability. If we do, then we can stay with what we have. If we do not, then the S&L experience teaches that we ought not rush headlong to legislation but ought rather to analyze what the shortcomings are and what the reasons for them may be. Then we can prescribe, with more confidence in the remedy and foreknowledge of its side effects. What are the tools at hand and how good are they?

The prospect is for the future insolvencies related to general liability to be quite different from the predominately fire and auto insolvencies in the past. It raises the possibility that our existing arrangements may not be entirely suited to the emerging demands. But before deciding on that point, we should review the way we now protect people against loss due to insurer insolvency.

The present system developed over a long time. It includes the ways state insurance departments detect insolvency, what they do about it once detected, how they administer the estates of insolvent companies and how the guaranty funds work. The system also includes some beliefs about the regulator's responsibility which deserve a fresh look.

Detection of Insolvency

The techniques for detecting insolvency have been expanded and refined over many years. They include accrual accounting, regular reports and examinations, and early warning systems. Early detection of insolvency has become even more critical today as state regulators no longer have available the options they once did for preventing it.

Accounting

An insurance company becomes insolvent when it can no longer pay what it is obligated to pay. That is insolvency on a cash basis. The main obligation of insurance companies is to pay claims in the future on policies issued in the present or the past. If those future obligations are greater than the premiums collected for them and the retained income on the premiums, then cash insolvency is on the way. If the future obligations and resources can be compared earlier, then the future cash insolvency can be anticipated, prepared for and perhaps headed off.

Establishing reserve liabilities for tomorrow's losses and matching them against assets on a balance sheet for today is the biggest challenge for insurance accounting. Under accrual accounting, a company is insolvent when its balance sheet liabilities are larger than its assets. Regulation for solvency tries to detect accrual insolvency as early as possible, while options for heading off cash insolvency are still open and before too many people get hurt.

Regulatory or "statutory" accounting requires loss reserves to be carried at their ultimate value, that is, without discounting for the time value of money. Statutory accounting also requires front-end costs, such as commissions, to be expensed when paid rather than set up as a prepaid expense asset. Both those conventions deliberately mismatch income and expenses, in order to generate a conservative balance sheet. Such a balance sheet contains a cushion for error in estimating costs, particularly as related to time, because over time the reserve liability will not change but income from the related insurance operations and, specifically, from investment income on the premium float will build up.

In general liability, prone to error in loss estimation and with a long time dimension, such a cushion is a useful safeguard for solvency. But accounting has become far less of a cushion than it once was and probably less than we think it still is. How and why did we give up the cushion, now that we are about to need it most?

When statutory accounting developed, there was every reason for it to be conservative. It protected solvency. It promoted high rates. It restrained headlong growth. Once there was an income tax, it reduced taxable income. Reported earnings were not much of a factor, as most of the industry's capital came from private subscription, from policyholders and from retained earnings. All that has changed.

Company managements now are sensitive to reported earnings and to the desire of security analysts for short-term results and for smooth and rising trends. Reinsurers offer arrangements which, in effect, discount reserves. Banks offer arrangements which, in effect, spread front-end costs over the life of a policy.

Federal tax authorities have moved away from having tax accounting follow statutory accounting. In the 1970s, they denied the deductibility of reserves for infrequent catastrophes. In the 1980s they required discounting of casualty loss reserves. Now they are considering the treatment of premium refunds to policyholders as returns on capital and a requirement for setting up selling costs as a prepaid expense asset.

The state insurance departments have permitted discounting in politically sensitive lines like workers compensation and medical malpractice and have required it for rate approval. They only intermittently try to control financial reinsurance and have encouraged it selectively in company rescues. Most serious, in the context of rate rollbacks and enforced cross-subsidies, they have moved away from regulating rates in terms of return on sales and have gone to using return on equity. The proximate cause is that the rollbacks raise constitutional issues of expropriation, and courts have used return on equity for other industries in that predicament. The long-term consequence is a further departure from conservative statutory accounting.

While those moves toward lower current values have been taking place on the liability side of the balance sheet, the carrying value of bonds, the principal invested asset, has remained fixed at amortized cost rather than being marked to market.

The effect of all those changes is that in real money settings such as rates, taxes and the price of one's own stock, conservatism in statutory accounting has no strong constituency until, after an insolvency, everyone recriminates about why it was not observed.

Reports and Examinations

All insurance companies issue financial reports on a statutory basis and those whose stock is publicly held issue them on a GAAP basis as well. The reports are filed with the insurance departments and are public.

To verify the presence of assets and the reliability of filed reports, and to get information directly from company records and personnel, the insurance department of a company's state of domicile also conducts on-site examinations. Examiners from other departments, representing other geographic regions, may participate. Usually made at three-year intervals, the examinations report on conditions as of a recently past date.

Because of their three-year intervals and their retrospective orientation, the examinations are mainly useful for verifying accounting and management practices. They can not be current enough to track a rapidly changing situation unless a special examination is called to deal with one believed to be occurring.

Early Warnings

The most important and most difficult part of detecting insolvency is in catching it on an accrual basis long before it becomes obvious on a cash basis. That requires estimating reserves for future liabilities and estimating values for present assets. Some of that estimating is easy, because the liability is known and soon to mature or because the asset has a ready market. But much of it is difficult, and the most difficult is the estimation of loss reserves for liability claims.

Insurance regulators have grappled with that problem for a long time. After the introduction of workers compensation in the early 1900s, the statutory annual statement began to call for figures on the changes from year to year in the reserves set up in the past (called loss development). Since then, as the time lengthened between the first establishment of a reserve and its final payment, the statement called for more years of development.

Since delays exist not just in development of known losses but also in learning about them in the first place, regulators have since the early 1900s required incurred but not reported losses (IBNR) to be added to the loss reserve. Over the years IBNR has become more important, especially in the general liability line. As with the display of loss development, the IBNR reserve was an attempt to press into the balance sheet the full value of anticipated future claim payments. Underlying those efforts was the desire for a conservative balance sheet, and underlying that was the quest for early warning of trouble.

In the early 1970s, state regulators devised yet another way to get early warning. Originally called the early warning tests and now the Insurance Regulatory Information System (IRIS), it is a set of ratios of various liabilities and assets measured against past patterns, industry norms and the surplus available to absorb adverse change. Its usefulness is for deploying regulatory resources toward companies needing attention. Inevitably IRIS has come to be used as a convenient indicator of financial strength. IRIS does have a high batting average in identifying in advance the companies which later become insolvent, but it also identifies many others.

The various early warning techniques are based on reported numbers, as are familiar rules of thumb such as the ratio of premiums to surplus. They are only as good as the numbers they use. Examinations go behind the reported numbers to test the ways companies prepare them and even to develop the numbers from raw data. All those regulatory resources serve one purpose – to warn the regulator as early as possible of trouble with the financial condition of an insurance company. Prompt and sensitive financial information and analysis are absolutely essential to good regulation for solvency. That is true regardless of the appropriate regulatory response in a given case. For example, the regulator with an early indication of trouble can best warn or order the company away from dangerous activities, restrict its accumulation of new business, act to rescue it or put it into orderly liquidation. Every one of those courses of action works best when started early.

The Regulator's Goal

The appropriate goals of insurance regulation are constant at the most abstract level – the protection of policyholders and claimants. But at a more practical level the goals change as circumstances change, so that regulation can protect policyholders and claimants from present day threats and serve their present day needs.

Insurance companies have gone broke ever since there have been insurance companies. Evidence exists that more did so in the turbulent fire insurance business of the 19th century than do today.

In the 19th century and the first half of the 20th, it was considered proper for companies to maintain premium rates by agreement among themselves, and to maintain them high enough to minimize the risk of insolvency. Companies underwrote, priced and distributed insurance in prescribed and uniform ways. It was the first line of defense for solvency.

An industry so organized tends to think as an industry. So when a company nonetheless became threatened, the first recourse was to merge it into a stronger one, often under regulatory pressure. In that way, the cost of insolvency was absorbed into the insurance system without creating an insolvency statistic. Early warning of trouble was essential, but the duty of the regulator was to merge or otherwise save the company. Preventing insolvency became the overriding goal of insurance regulation.

Having the preservation of company solvency as the goal of regulation was appropriate for the infant insurance industry of the 19th century. Since the 1940s, and particularly during the last 25 years, other goals have been placed alongside solvency as regulatory objectives of equal importance. One was encouraging competition among insurers, and competition normally entails some failure. A second was assuring the availability of insurance to people who could not get it, and restraining selection normally dilutes profits. A third was keeping insurance prices down at the consumer level, rather than keeping them up. A synthesis of availability and low prices, together with a leveling out of the cost-based rate differences which competition leads to, has become popular under the name "affordability."

No real effort has gone into examining how those three new goals of regulation fit in with the earlier one of solvency. Often versions of the affordability goal are simply imposed by law or regulation. Common sense suggests that there is a complex interrelationship among the goals, and that the suppression of overall prices or the flattening of rate relativities is bound to weaken the finances of some insurers and hence make insolvency dangers worse. But we do not know how much.

For purposes of analyzing the insolvency problem, it is at least clear that regulation no longer pursues a single-minded objective of preserving solvency and that some government programs cut in the opposite direction. It should be no surprise that, given the complex and somewhat conflicting goals of regulation today, the old mission of preventing insolvencies and saving companies meets with less success.

Facing an impending insolvency today, the regulator finds some of his best old tools no longer work. Agreements on premium rates are against the law, and regulators are expected more to hold rates down than to hold them up. The last round of rescue mergers is known to have brought fearsome reserve deficiencies. In general, merger is less attractive here than in industries with greater economies of scale and scope. Rescue attempts which delay other action can be costly as never before. Just as the overall goals of regulation have changed over the years, the solvency goal needs to change too.

With the growth of liability insurance and the volatile forces to which it is subject, insolvencies are bound to occur rather frequently and for large sums. The regulator needs early warning more than ever, but for a different purpose. His goal has to become the direct reduction of public harm. Rescuing troubled companies is now only one way of achieving that goal. That is a big change.

The regulator will most often minimize public harm in today's insurance market by taking insolvent companies out of it. That new focus of regulatory responsibility puts new pressure on the means of early detection and also on the mechanisms for handling insolvency – liquidation and guarantee.

Liquidation of Insolvent Companies

When a company is recognized to be insolvent under statutory accounting, the state insurance department has at least two options. Those options may follow a preliminary stage called "supervision", which is intensive oversight of a troubled company without formally taking possession.

The first option after recognition of insolvency is rehabilitation or conservatorship, which is state control and operation of the company. That is appropriate where the department believes the company can come back. The other option is liquidation, which calls for stopping business and winding up the company. Either step requires an order of a state court.

The public goal of insurer liquidation is fairness among competing claims against an estate that will not be able to pay them all in full. To that end the laws have strict rules against preferences, the payment of more to one claimant than to another similarly situated. The usual preference is one of timing, with the earlier recipient likely to get more than the later. The emphasis on fairness leads to protracted decision-making and to a large number of individual decisions about assets and liabilities. That uses time and money.

Like other aspects of solvency regulation, the liquidation rules developed when the typical insolvency centered on fire insurance. In fire, claims are prompt, definite, local and quickly resolved. Later insolvencies centered on auto insurance. Claims there are also definite, local and quickly resolved.

None of those qualities of fire and auto insolvencies is present in general liability. There the claims are complex, unclear and geographically spread out. Sometimes a small and stodgy company will have turned overnight into a crazy-quilt of target marketing programs and general agency deals. Assets, affiliates, obligations and worried claimants may be spread across the country. Reinsurance collection is essential and can be spread around the world. The liquidation process, just for the domiciliary state, is inherently more demanding of time and money, and the geographic dispersion invites ancillary receiverships.

Those tendencies show already in the recent insolvencies featuring general liability. Claimants are waiting a long time for their money, because it takes a long time to collect reinsurance and resolve individual liability and coverage questions. The process also uses up the money in the estate and leads to uneven results among claimants in different places and with different kinds of claims. It may tempt lawyers and others handling the estate and the claims to be more thorough than efficient. That is not a temptation to place before anyone without expecting it to be taken up. With the paying client safely deceased, the bar luxuriates in the dreary length of the proceedings.

The liquidation arrangements are inherited from the fire and auto insolvencies of another era. Despite the efforts of the NAIC to set standards and promote uniformity, the system is inherently fragmented, uneven, slow and expensive.

Insolvency Guaranty Funds

When an insurance company becomes insolvent and is taken over by the state insurance department, the last resort to fill gaps in its obligations is the state guaranty funds. As we have seen, nearly all of them were created in response to federal pressure after the insolvencies of substandard auto insurers in the 1960s.

The guaranty funds do not cover all obligations. Nor do they guarantee covered obligations in full. They spread guarantee costs very widely. They have particular rules for their governance. All that was deliberate and was based on the perceived problem at the time of their creation. The existence and the terms of guarantees offer inducements and impose pressures which affect behavior. That may not have been deliberate and it certainly was less explicit and understood.

Description

The guaranty funds are created by state law, usually similar to the NAIC Insurance Guaranty Association Model Act. Except for New York's 1947 statute, they came around 1970 under pressure from Congress. The following description is of the NAIC model. Worth noting, however, is that the actual statutes and implementing practices of state insurance departments and courts are not uniform. For national insolvencies, the unevenness is a serious problem.

The funds provide coverage for the principal lines of personal and commercial insurance. Coverage is for admitted, direct writings only, that is, no surplus lines and no reinsurance. Covered lines do not include fidelity, surety, title or financial guarantee.

The insolvency guarantees are up to $300,000 per claim and give full coverage, that is, 100 cents on the dollar up to the limit. Defining coverage per claim rather than per policyholder can be expensive with mass torts. For example, under the model law a manufacturer holding a products liability policy from a failed insurer would be a single policyholder facing perhaps 20,000 claims. At $7,000 per claim, that is $140 million of insured liability, all covered by the guaranty fund. But the design of the model law seems to follow from our use of liability insurance for compensation of victims even more than for indemnity of perpetrators.

Geographically the coverage is by location of risk, which is clear enough for property and personal lines, but less so for large liability accounts. Guarantees follow the claim, in the sense of responding only after payment in the liquidation. Hence they await individual resolution of claims. Buying out all the claims of an insured in advance is severely constrained by the rules against preferences in liquidation.

Under state statutes, guaranty costs have to be apportioned to the state where the shortfall in covered claims was. Within the state, apportionment among companies follows their premiums in all the covered lines taken together. An alternative provides for apportionment among three premium pools or accounts – workers compensation,

automobile and all other lines. Cash assessments are at the time of payment and are for each insolvent company separately. The system is called post-insolvency assessment and the organizations are sometimes called post-assessment funds. Putting the timing of assessment together with the timing of liability claim payment means long lags before the impact of insolvency is felt. Assessments were made in 1989 for companies put into liquidation as far back as 1970.

Governance of each state's guaranty fund is by a board of directors, selected by the companies which are guaranteed and assessable in that state. The directors are usually insurance company personnel serving part time. Each fund has either a small staff or a designated outside counsel. Serving the funds is the National Conference of Insurance Guaranty Funds, which succeeded an earlier committee in 1990 with the stated purpose "to assist the individual guaranty funds in fulfilling their statutory obligations and to facilitate interfund communication and cooperation in meeting the increasingly complex demands of those objectives." That statement describes a clearing house for information, not a national coordinator and certainly not an executive or governing body.

Evaluation

The present guaranty fund arrangement clearly reflects its origins and the priorities of those who created it. It was directed at the insolvency of small, simple auto insurers in local specialty markets. The funds were conceived by the NAIC and the established insurance companies, and they accord absolute deference to state regulation. As enacted in the several states, they are not particularly uniform, but for small and local insolvencies that did not matter. In short, they have done successfully what they were designed to do in dealing with the situations they were designed for.

The funds were not designed for what seems to be coming. Specifically, they were not designed for large, complex, national and international situations. They were not designed for general liability insurers faced with mass torts, where disputes over coverage and underlying liability routinely last a decade.

Any simple description of existing state guarantees, particularly one based on the Model Act, can leave the impression that they are uniform from state to state. They are not. Vital differences are in the amounts guaranteed, the extent of coverage, persons eligible for protection, the premium base for assessment, caps on assessments, rights to recoup guarantee payments, and so forth. In a large, national insolvency, those differences can lead to seriously uneven economic results and to drawn out litigation over large amounts of money.

It is essential to see that a collapse or a litigation gridlock in the state guaranty fund system would not be a failure of execution. After the fact we would surely find villains but villains would not be the point. The failure would be inherent in the structure of the present system and in its conceptual foundation. It was never intended for the insolvencies of the future and could not hope to handle them. If we want to make changes for the

future, they must be structural and they must be made now. The clinching reason is the incentives guarantees provide.

Influence on Behavior

The incentives which guarantees put into the market affect sellers, buyers and regulators. There is an apposite insurance concept. It is called moral hazard. It exists when the presence of insurance induces behavior which causes insured losses. The moral hazard of insolvency guarantees is a very serious consideration in deciding whether to have them and, if so, how to design them.

The moral hazard of insolvency guarantees lies in how they can weaken market regulation, particularly the motivation of buyers to look into the security of the promises they buy. Unconstrained by quality in that sense, the buyers would be free to shop for the lowest price and their brokers for the easiest underwriting and highest commission. Sellers would adapt and, eventually, a Gresham's Law of financial markets would see to it that adapted (undercapitalized) insurers took over the market.

There is moral hazard for regulators too. Regulators are already pressed from all sides to delay action on borderline insolvencies. The subject company wants more time to write its way out of trouble. Buyers want more time to get away. Claimants want more time to get paid off the top. Courts want more time to amass convincing evidence. The regulator is imbued with the vision of himself as a physician, saving the sick and wounded. He does not aspire to be an undertaker and certainly not an executioner. He knows that public action, even if premature, is apt to kill the company. He knows that taking over a company against its will can be unpleasant and thankless.

The knowledge that guarantees will take care of much of an eventual collapse is surely a comfort to everyone who wants to delay, which is just about everyone. In insurance we do not know for sure that guarantees do in fact delay regulatory action, and some early proponents of guarantees even hoped they would free regulators to act faster. But inducing delay was seen as a danger of insurance insolvency guarantees as early as the 1960s, and the S&L experience is so dramatic that a prudent prescription for insurance now has to assume it is so.

BUILDING A STRONGER SYSTEM

So far, we have seen that the national insurance business is regulated by the states, for reasons which are largely historical. By common sense measures, and certainly compared to banks, the solvency record of the insurance business and the state regulators has been good.

Our analysis of the prospects, however, indicated that more insolvencies are coming, that they will be different from those before, that the present system of liquidation and guarantees is not ready for them, and that the structure and fundamental ideas of the present system will prevent it from being made ready through routine improvement. We also saw that, because of the likely speed and finality of future troubles, we would not be wise to wait for more trouble before strengthening the system.

We still have time to protect ourselves from the next wave of insurer insolvencies. We should approach the task in the spirit of preventive maintenance. The other attitude – if it ain't broke, don't fix it – is too expensive when applied to a financial machine like insurance. Here preventive maintenance begins with our making some basic policy decisions. Then we can go on to more specific principles of program design and then to the program itself.

Choices for the Future

There are two basic choices to be made at the outset. First is the choice of methods to reduce the harm from insolvencies. Second is the question whether, even if guarantees would reduce harm in individual cases, their systemic cost would be so high that the better public policy would be not to have them at all.

Ways to Reduce Harm

There are three ways to avert public harm from insurer insolvency. First is to make it nearly impossible, economically or legally, for a company to become insolvent. Second is to eliminate the kind of insurance causing the insolvency problem. Third is to act directly on the harm itself. The three are not pure or mutually exclusive approaches or goals or techniques of regulation. But they are convenient ways of catching the essence of the three main approaches used over the years.

For example, the first approach, making insolvency economically impossible by keeping rates up, was used to good effect in fire insurance after the turn of the century. In life insurance, making insolvency impossible through restrictive rules underlay the New York insurance law after 1906. It limited expenses, mandated reserves and confined investments, and it reached nationwide.

The second approach, eliminating the insurance or the need for it, was used in the Depression. Private mortgage guarantee insurance was outlawed and then replaced by

government agencies. Private surety bonds for bank deposits were superseded by guarantees from government corporations.

The third approach – directly minimizing harm – comprehends the daily work of financial regulation plus two kinds of extraordinary measure. One is to save individual companies from failing. The other is to close the shortfall from the insolvencies which do occur. That means guarantees. Those two ways to minimize harm are not mutually exclusive.

Of the three big approaches, the first – making insolvency impossible – is not promising here. General liability is not amenable to that degree of intervention. The public would hardly tolerate the cost of creating an environment in which insurance companies could never go broke. In addition to the direct cost, the indirect and long-term cost of shielding this industry from the discipline of competition would be high. How high is suggested by how much prices have come down in industries regulated that way once the price supports were taken off.

What about the other version of the first approach – legal restrictions so tight that companies could not go broke? Restrictions on risk taking are an essential part of all financial regulation. They have been part of insurance regulation from the start. But they can only go so far before impairing the social function and business purpose of the regulated industry. Rules will help in this situation, but they will not do the whole job. Insurance is supposed to assume the risks of others, and not just the easy ones. Today many essential economic and civic activities need protection from legal liability. If the insolvency risk to insurers is from meeting that need, it would be hard to confine the risk without curtailing the function.

Nor could the second approach – eliminating the insurance or the need for it – be looked to for help. Outlawing general liability insurance would leave a huge hole in the funding of our legal reparations system. It would confound rational decision-making about risks and rewards in many industries. It would frustrate the use of market prices to internalize liability costs to related business activities.

The foregoing means that making insurer insolvency impossible and eliminating the need for insurance will be of little use in the next episode. The main effort of regulation will have to be to minimize directly the harm from insurer insolvency. We have seen that the two avenues to minimizing harm are to prevent insolvency and to close the shortfall. Can the first of them do the job by itself?

The market for general liability is unstable and will remain so for a long time. When fire insurance was a new line, it took a hundred years to settle down. General liability was effectively born anew in the 1960s, when the law turned adverse, and it has acted like a wild new line ever since. Like fire long ago, it is characterized by shocks over costs, by sharp swings in price and supply and by savage fighting over coverage for its equivalent of conflagrations, the new mass torts and statutory liabilities. Such a market will break some companies beyond any hope of rescue.

The chances of successfully rehabilitating such a company are slim. A competitive market does not allow any participant the extra profits needed to rebuild. The promissory nature of insurance makes informed buyers afraid to go along.

Accordingly, however great our efforts to prevent insolvencies, some will occur. Prevention of insolvency was a systematic approach which depended on cartel pricing sponsored by government. It worked for fire insurance long ago. It is not an option now. Early detection of trouble will remain essential to regulation, but usually it will serve to reduce the damage from a company's exit rather than to preserve it as a going concern.

Regulators and the rest of us have to accept that fact, lest we temporize too long with hopeless situations. Postponement of action because insolvency looks like regulatory failure gives the last reprieve for a desperate company to make foolish bets. The bets can hugely increase the size of the eventual shortfall. Rescue is fine when it can be done, but not when it becomes the public face of procrastination. During any delay, innocent people are drawn in. The regulator should not let it go on any longer than he has to.

So to meet a challenge of general liability insolvencies, we are left with early detection and swift action, to confine the original gap, plus guarantees to close it.

Whether to Have Insolvency Guarantees

Guarantees may be part of the only realistically available response, but they would not come without costs. That is true even though we are only considering the guarantee of policy obligations of future insolvents and not institutional bailouts or retrospective cleanups. Direct costs would still come from reallocating insolvency losses to insurance companies, and thence to other premium payers, or to government and thence to taxpayers. Indirect costs would come from inducing behavior by companies, policyholders or regulators which would increase the insolvency loss. A rational society could decide such costs were too high. The question whether to have guarantees at all deserves examination. The answer may turn on a precise understanding of how far the protection now extends and why.

In first-party insurance, the policyholder who chooses the insurance company and the claimant who is paid by it are usually the same. The possibility of the policyholder and the claimant being in different circumstances does not come up. But in liability insurance they are different parties, who often are antagonistic to each other and who may differ widely in such circumstances as wealth and ability to protect themselves.

Liability insurance has two distinct, explicit purposes – defending and indemnifying the policyholder and compensating the claimant. Of those two protected groups, the public policy behind insolvency guarantees to date has emphasized the interest of claimants.

When the first guaranty funds were created in the 1930s for workers compensation, the stated purpose was to protect the injured worker, not the employer who had purchased

the insurance. When the first auto liability security fund was created in New York in 1947, it was to buttress the state's compulsory liability insurance law. All the enactments were for the stated purpose of protecting claimants who were not policyholders. None of the guaranty laws, then or now, relieved policyholders of liability except by discharging it with payment.

Then in 1969, when New York broadened its fund to cover first-party coverages such as homeowners, the legislation expressed the intent as "securing policyholders and claimants against loss due to insurance company insolvency." When the NAIC adopted the Model Act in 1970, it declared the same purpose. Policyholders were protected in their role as claimants. Guaranty coverage for the return of unearned premiums to policyholders without claims was only an optional provision. The extension to first-party insurances was not considered radical by the sponsors. The focus at the time was on auto and other personal lines. The contemporaneous understanding was that guarantees were to protect the little guy.

The insurance principle being the shifting of losses from the few to the many, guarantees are a logical extension of it to the one situation for which the insurer itself cannot provide. The idea is especially sound where the claimants are small and dispersed. The indirect cost of guarantees through inducing reckless behavior by the immediate beneficiary of the guarantee seems remote, as the claimants do not choose the insurer.

This suggests that the history and theory of insolvency guarantees would justify treating policyholders and claimants differently if there were a good reason for doing so. Such a reason might be to motivate policyholders to help reduce the insolvency loss itself.

Guiding Principles for a Proposal

From everything set out so far in this Report, we can distill five principles which ought to guide us in designing a stronger system. First, the system ought to build upon the existing structure of the industry and its regulation. Second, it ought to be national in scope. Third, it ought to allocate costs to the activities causing them. Fourth, it ought to organize responsibilities and spread incentives so that efforts to police the system reinforce each other. Fifth, the private insurance business ought to be assigned a significant role.

Building on What Exists

Insurance in America comprises hundreds of companies regulated by fifty states. On the face of it, such an arrangement does not appear rock solid. Yet except for three episodes, the solvency record is good. How much is due to good regulation and how much to good economics and good fortune, we will never know. But the historical record is good.

We see now the start of an episode for which the present system is not prepared. But the present system has much of value which ought not be casually uprooted. Size can be an advantage, but the underlying economics of the business are such that many

successful companies are small and show little vulnerability to larger ones. Lack of uniformity is a problem for state regulation, but some of the departments do an excellent job and the NAIC is a good coordinator in many areas. Unless the whole system blows up, state regulation and small companies should be permanent fixtures in the American insurance landscape.

Yet in a crisis, insurance is a single industry and solvency is at the heart of regulation. The sudden swing from a commercial liability crisis in the mid-1980s to a consumer revolt in personal auto five years later shows how broadly the public reacts, especially when moved by grievance or fear.

Cool analysis reveals that small size does not predispose to insolvency. It reveals that states can regulate a national business. But conclusions counter to instinct are best reached in a calm setting, which means in advance of a crisis. One way to do that is to focus on parts of the system needing change regardless of how serious a problem is coming in general liability, and to take the necessary precautions now. That is preferable to basing a decision about whether to act now on a calculation of the odds that a bad crisis is coming soon, and on the odds about how bad and how soon, so that we do nothing but talk until the odds are frightening enough and, even then, probably wait for hard evidence that a disaster is indeed upon us. That is to wait too long. Then the bell tolls for everyone.

Prompt action permits a moderate response. That means concentrating now on two areas needing reform beyond the reach of the states and certain to be overrun by a general liability crisis – liquidation and guarantee. It means doing so in a way that does not wantonly interfere with the structure of the industry and that builds on work already done by the state insurance departments and the NAIC.

National Scope

Key features of the emerging insolvencies are that they are large, complex and national. Those features go right to the inherently weakest point of the present system – its fragmentation. The process of liquidation and of administering guarantees is where that weakness will cause the most trouble. We now confront a learning curve in handling these insolvencies and we confront the inherent differences among the states and the limitations on coordination across them. That has been a problem to live with in the past. It is about to become intolerable. There are limits to what can be accomplished by voluntary cooperation among sovereign states and by admonitions and threats from the federal government. The situation now calls for the judicious application of federal legislative power.

Separating what must be structurally changed from what can be left alone or improved in place turns on the fact that state regulation embodies two concepts, not just one. Of its strengths and weaknesses, some are traceable to its being state and some to its being regulation. Looking ahead to a national problem in general liability insurance, the weaknesses to concentrate on are those traceable to the state basis of jurisdiction. They can only be reached by Congress as maker of national law.

The application of federal law making power should be confined to the need, which is for a national reach in two areas only – the liquidation process and the administration of guarantees. Indeed those two areas are so interlocked as to amount to only one.

By contrast, evaluation of financial condition and detection of trouble can be done well by the states, with primary responsibility in the state of domicile, augmented by inquiry and peer pressure from concerned commissioners elsewhere. The states are more sophisticated at detection than is commonly believed, and their efforts deserve more support from responsible members of the industry than they usually get. Unless problems of federal-state interface at the juncture of detection and liquidation prove insurmountable, the federal role ought to stop with liquidation and guarantees. Generalized federal regulation of insurance, the great bugbear of the industry and state regulators, is not justified on the merits and certainly not on the record.

The downside of that conservative approach to the federal role is splitting the jurisdiction. It would be hazardous at any time if it lulled each to assume the other was doing the whole job. It would be worse if it tempted one to suppress rates, deny underwriting and shave margins of safety in the belief that the other would clean up the mess. Trusting in the self-restraint and responsibility of each government would, in fact, probably work most of the time. But it would be a little too cheery about human nature to rely on it entirely. The connecting point or interface between the states and any new national organization has to be very carefully designed.

Broadly stated, the most promising design is for the states to continue to be responsible for regulating financial condition and market conduct and for detecting insolvency, just as they are now. When a state determined that a company which was a member of the national guarantee program was insolvent under state law, the state would take control of it and hand it over, as it were, to the national organization.

In order to strengthen the total system and to safeguard the national fund, the new national organization should have power to warn a state that a domestic company was in hazardous condition. To make that power meaningful, the new body should have a financial analysis staff and the ability to request the state to conduct a special examination of a named company. The authority to warn of hazard should be backed by the possible withdrawal of guarantees. In the long term, the ultimate sanction for responsible behavior would be in a single agency's gaining a sustained national perspective on the effectiveness of state detection and enforcement and on how well divided power actually worked.

Allocating Costs to Causes

Sound regulatory economics would call for allocating insolvency costs to the activities causing them. Ideally that would cause prices in the responsible line or state to reflect insolvency costs, which would act as a market deterrent.

As with other questions of causation and responsibility, however, doing so would involve judgment. It would not be so simple as a formula charging shortfalls back to the

line receiving guaranty payments. That is the difference between tracking benefits and tracking causes. The line of insurance which causes an insolvency may or may not be the one to which the guaranty benefits go. A company may write auto and workers compensation successfully for years, only to be bankrupted by a single liability program for interstate trucks. The latter would be the cause, but most of the benefits would go to claimants in auto or workers compensation. That seems fair, but it does nothing to build insolvency costs into future prices for the lines which cause them.

Yet a company is more vulnerable to a line it writes heavily. Where it is not practicable to allocate to causes, allocating to benefits is fairer and a better approximation of tracking causes than simply raising the money from the whole premium base.

The Model Act does not explicitly match costs either with causes or with benefits. Guaranty payments are charged back to companies in proportion to premiums in the state in all covered lines. There is no allocation by line. An alternative provision in the model, designed for states with a larger premium base, calls for charging back to three accounts – workers compensation, auto and everything else. The alternative allocation follows the history of guaranty funds but does not separate lines within the catchall account. Since a state's assessments cannot get at premiums elsewhere, it is understandable that the Model Act looks beyond the line responsible and the line benefited and levies instead on the broadest premium base.

Allocating costs to causes, to let them work out through prices, is best done in advance, that is, by pre-insolvency charges. Those charges could vary according to risk of insolvency posed by a line, state or even company. Such risk-based variations have been proposed in a general way for insolvency charges and for capital requirements. They are intuitively appealing but have not yet been worked out in convincing detail. Allocating costs to benefits can best be done after they are known, that is, through post-insolvency assessment. Both pre-insolvency charges and post insolvency assessments exist in the present guarantee arrangements, with most of the money raised through post-assessment.

Using both post-assessment and pre-funding would be better than either one alone. The advance portion should cover operating costs and the initial costs of administering the estates of failed companies. The post-insolvency assessments should try to reach the areas of activity responsible and benefited, in the interest of fairness and of getting costs back into market prices so as to affect behavior. That means charging back by line and by state.

When it needed new cash for a liquidation, the national organization would draw upon carriers according to their premiums in the line and state requiring payment. As now, those assessments would have an annual cap, to preclude having the guarantee system destabilize the market. Above the cap, the assessment would remain upon the line but would reach nationally. That too would be capped. For any one year, the second or national cap would mark the limit for guaranty payments. Above it, claimants would have to wait for the next year's assessment.

The lines of insurance for allocation purposes should be as prescribed by the NAIC for statements filed with insurance departments. At the moment, other liability, medical malpractice and commercial multiple peril (with a substantial general liability component) are reported as separate lines. That seems reasonable for allocations because, while the three have broad liability coverage in common, they serve quite different sets of buyers.

Charging back by state reflects the differences among states in diligence of financial monitoring and readiness to act quickly, both of which should be encouraged by market price differentials. It would also counteract any tendency for a state to use liberal tort law, suppressed rates and easy regulation to obtain a transfer of wealth from others. That sounds outlandish, but it would echo the early difference in regulatory priorities between the eastern financial centers (solvency, prudent management) and the developing west (availability, price, claims).

Reinforcement and Incentives

It should be possible to design a system whose efforts reinforce each other and whose participants have incentives to do what society wants them to do. It would be the opposite of what we did with deposit guarantees, which was dysfunctional, that is, it induced people to do wrong. There are several ways to do better with insurance guarantees.

First, the relations between the two levels of government must be mutually reinforcing. The proposed division of responsibility should encourage both parties to do their best in detecting and acting on insolvencies. To that end, four categories of incentives and quiet pressures are built into the proposed arrangement.

One category has to do with the guarantees themselves. Most direct of those would be the loss of guarantees if the state did not respond promptly to a warning of hazard. The second category comes before insolvency and is in the rules and standards for eligibility, once the initial enrollment was accomplished, and in the possible differentials in the level of pre-funding charges. The third category is after insolvency, in charging back first to premiums in the affected states. In the fourth category are analysis, education and publicity, including post-mortem reports on how a company had become insolvent and what had been done about it.

The second way to have the new liquidation and guarantee system help insurer solvency overall is for it to make more certain the punishment of wrongdoing. The responsibility for collecting the assets of a bankrupt company should be kept separate from the responsibility for disciplining people who wrongfully got it in trouble. Today the liquidator is the agent of the insurance department. The department as regulator may want to go after management for fraud, but the scheme may have involved reinsurance which could be rendered uncollectible for the estate if fraud were proved.

The separation of responsibility for liquidation, which would be only by the federal agency, from enforcement, which would remain with the state regulators and criminal

justice agencies as well, should make pursuit of wrongdoers more effective. It is not that a lot of money can be expected from them or even that wrongdoing will account for a large proportion of future insolvencies. But general liability insurance has a proven appeal for charlatans. Its complexity, uncertainty, time delays, layers of intermediation, multifold reinsurance, interstate complication and susceptibility to delegation and dispersion of responsibility come together to make it a most inviting prospect for their trade. The masters, Stewart Hopps and Lowell Birrell, wrote the book on this sort of thing in 1952 with the Inland Empire Insurance Company. That was just with fire and auto. Imagine what they could have achieved with general liability. So it is important to punish some such people now to deter others later. They may be incorrigible in the moral sense, but they do respond to rational stimuli like the prospect of going to jail.

Third, buyers in the private market should have every economic reason to uphold its solidity. If the main cause of insolvency in the next episode will be commercial general liability, then general liability buyers and their brokers should have incentives to look into security. Such an incentive would be most effective in the case of large buyers, as they and their advisers are better able to scrutinize financial security and their voices carry in the marketplace.

The key to providing the surveillance incentive while preserving the purpose of guarantees would be to emphasize the dual role of liability insurance and make the guarantee of indemnity for the policyholder less complete than the guarantee of compensation for the claimant.

In mass tort situations, which are the biggest threat now, compensation would be secured mainly by keeping the present design – having the dollar limit on guarantees expressed per claim. Then several complementary ways are available to curtail the indemnity, especially for large policyholders. One is in the NAIC model: giving the guaranty fund the right, after paying liability claims on behalf of the policyholder of an insolvent insurer, to recover from the policyholder if it had a corporate net worth above a specified amount. That approach seems well suited to general liability insolvencies, where a single policyholder can have many claims against it and where the policyholder may be large but the claimants individually small. It keeps the compensation money flowing and saves the channeling of costs for later.

Other incentives for buyer vigilance could be put into the program too. One would be to count the guaranteed amount starting at the first dollar of the claim, not the first dollar of defaulted insurance. Another would be to employ techniques long used to encourage loss control – deductibles and coinsurance.

Fourth, trading partners who keep insurers in the market should have an incentive to uphold the financial integrity of that market. Insolvency is not just a problem of direct insurance companies. It is a problem of the entire insurance system. Everyone in the system with the ability to play a part should do so. The trading partners with that ability are agents, brokers and reinsurers.

As an incentive for agents and brokers to be watchful about security, the guarantees should go only for losses. Unearned premiums and unpaid commissions have lower priority. Losses are where the need is greatest and the beneficiary's involvement the least.

As an incentive to reinsurers to watch credit quality, they should not enjoy a secured position in their client's bankruptcy. Today reinsurers are permitted to set off the premiums owed them by an insolvent ceding company against the reinsurance they owe it on losses. Reinsurance is a familiar resource for primary companies needing capital or just needing to make their balance sheets look stronger. The reinsurer can thus play the role of keeping a marginal company in the market and looking good while it makes its last desperate bets. Yet it is easy to set payment terms so that the amounts owed as reinsurance premiums and as reinsurance proceeds balance each other. When the liquidator comes after the proceeds the reinsurer pays only the net amount owing on the total account. That may be so even though the reinsurance delayed the withdrawal of the company and obscured the warnings in its balance sheet.

In such circumstances, it is not appropriate to give the reinsurer the benefit of offsets as in routine and arms-length commercial transactions. The purpose is not to punish the reinsurer for keeping the insolvent company in the market too long but rather to give it the same stake in the eventual outcome as others have.

Significant Private Role

In order to possess the essential jurisdiction over a national problem, any new agency would need federal legislative auspices. That does not mean it would have to be a federal government bureau of the usual kind. It could be that, but it could also be largely state run or largely private. The state and private roles could be of many kinds. The point is that the nature of the instrumentality is not determined by the need for it to be created by an Act of Congress.

On the question of state and federal government roles in a new organization, the reason for having both is entirely practical. The states know the subject and would have the rest of the regulatory jurisdiction. Cutting them out now would be asking for trouble later. But it would be equally unrealistic to expect Congress to use federal power to create a new vehicle and assume a measure of federal responsibility for it, and then just to turn it over to the states.

On the question of public and private roles, the record of purely government bodies as regulators is hardly so good as to require adherence to that pure case, whether state, federal or combined. But the name self-regulation is suggestive rather than descriptive. Over the years it has been applied to many things, sometimes to industry bodies which set standards for entry, product and price, from the medieval guilds onward. Indeed the fire insurance rating boards in their heyday were self-regulatory bodies of that kind.

Here we can design whatever we want. Our motive should be pragmatic – whatever will best serve the cause of minimizing the public harm from insurer insolvency.

Considerable latitude in design follows from the fact that the new national organization would have only a limited role. If it were not be a full regulatory agency, it could be more private than if it had general policing powers, especially ones which could reduce competition.

In American practice, the trade-off is quite clear. If a body has powers which could restrict entry, force exit or maintain prices or profits, it cannot be controlled by competitors and usually it has to be a full-fledged government agency. If it does not have such a potential for reducing competition, it can be private. The better choice here is to limit the role of the new national organization to liquidation and guarantee, where the need is greatest and the opportunities to lessen competition are nil. That way not only can familiar state responsibilities be preserved, but the organization can accord the private insurance business a significant role.

The usefulness of having a significant private role and of having the right incentives surrounding it would be in three areas – responsiveness to change, inventiveness and motivation to hold down costs.

Responsiveness will be of unusual value in the new situation, whose very fluidity is a big part of the problem. Reporting and examination techniques may have to be changed, particularly to keep abreast of the lengthening and causal complexity of the loss development tail. A private body would be more apt to develop new accounting methods for reporting and new accounting standards for ongoing financial solidity. The NAIC has been sensitive to the need. In the 1970s it created a Statutory Accounting Principles Board with private accountants and insurance financial executives as well as regulators and academics as members. With a stronger practical mandate, such as one tied to guarantees, such panels could contribute more to keeping regulatory accounting up to date.

Inventiveness will be important because of the variety of ways public and private efforts can supplement each other. An example might be private monitoring by a surety company, authorized to bond the policy contracts of client insurers or to be co-surety with the new national organization. Another might be to require all insurers to have outstanding some publicly traded subordinated debt, to get market pricing of credit quality. It is not necessary here to determine whether such ideas are useful, but rather to acknowledge that the effort to reduce harm can use help from many quarters, and setting up novel private monitors, with purely economic incentives, could be useful.

Holding down costs will be crucial for any guarantee arrangement. A mainly private entity, responsible to insurance companies in the guarantee program, will have a strong business motive to minimize the insolvency shortfalls and liquidation overheads to be charged back to them. Insurers are now competing against risk retention and self-insurance devices which are not subject to guarantees and the associated costs. Non-admitted carriers are often direct competitors, and they are not guaranteed or charged for it. Licensed and guaranteed insurers will not find it easy to pass along to customers the cost of insolvencies. They can be expected to press a private organization to hold those costs down.

The same is true of the overhead costs of the liquidation process. Those costs are already high, but they will become much higher with the greater complexity and geographic reach of general liability insolvencies. Administering them will call for expertise which no insurance department now has. If it is only built by outside law, accounting and consulting firms, then the public will pay for it over and over. With a business motive to keep costs down, the new national organization will have every incentive to build its own expertise and use it for more efficient liquidation.

For all those reasons, any new organization should be mixed as between public and private participation and mixed as between state and federal governments. The reasons are not to vindicate any theory, but to get something which will work economically and fairly. If we are looking for a catchword for what we seek, it is not self-regulation or countervailing power or state rights or free markets. It comprehends all those ideas, but the best catchword is balance.

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The five principles – building on what exists, addressing a national problem with a national remedy, allocating costs to causes, fashioning incentives to make the system work better, and assigning a significant role to the states and the private insurance business – have guided us in designing the proposed legislation. The specific recommendation is outlined in the next section of this Report, and the text of implementing legislation is in the Legislative Appendix.

A PROPOSAL FOR A STRONGER SYSTEM

The five principles governing a stronger guarantee system lead to a federal statute along lines set out below. An explanation of the chosen approach to bill drafting and the text of the legislation itself are in the Legislative Appendix.

The program recommended in this Report would be embodied in an Act of Congress. The purpose of the proposal, as set out in the Act, would be to protect the public from loss due to insolvency of property-liability insurance companies, by establishing a nationally uniform and efficient system of

- rehabilitation and liquidation of companies, and
- guarantees against loss to policyholders and claimants,

through the use of federal government power to supplement and strengthen, but not displace, state regulation for solvency. In summary, the Act would provide as follows.

Form of Organization

1. The National Insurance Guaranty Corporation (NIGC) would be chartered by an Act of Congress.

2. Operation of the NIGC would be governed by federal law.

3. The NIGC would have a board of directors from specified backgrounds, including insurance companies, state insurance departments and the federal government.

4. The directors and staff of the NIGC would be immune from legal liability in the performance of their duties.

Membership

1. Under the federal law, any property-liability company domiciled and licensed in the United States would have the privilege, but not the obligation, to join the NIGC.

2. Any state could, but would not have to, require companies to join the NIGC as a condition to licensure in the state.

3. Any company certified by its state of domicile as complying with the financial and other requirements to do business would be eligible to join, and the NIGC would have to accept all such applicants for membership.

4. The NIGC could set higher qualifications for membership, to take effect five years after adoption.

Consequences of Membership

1. The NIGC guarantees and powers of rehabilitation and liquidation would apply to member companies only.

2. Once a member, a company could withdraw only after irrevocable, public notice one year in advance.

3. A withdrawing company would remain liable for NIGC assessments relating to insolvencies declared before its membership terminated.

4. Member companies would be exempt from coverage by and assessment for state guaranty funds as to insolvencies declared after they joined NIGC.

5. Member companies would remain liable for state guaranty fund assessments relating to insolvencies declared before they joined NIGC.

Extent of Guarantees

1. NIGC guarantees would apply to companies which were members at the time they were taken over for rehabilitation or liquidation.

2. NIGC guarantees would apply to admitted writings only, not to surplus lines and not to writings outside the U.S.

3. NIGC guarantees would apply to direct writings only, not to reinsurance.

4. NIGC guarantees would apply to the same lines as under the NAIC Insurance Guaranty Association Model Act.

5. The dollar limit of the NIGC guarantees would be $300,000 per claim, measured from the first dollar of a claim.

6. Allowance of claims and NIGC guarantees would have deductible and coinsurance features, varying by amount or line of insurance.

Rehabilitation and Liquidation

1. The state of domicile of an NIGC member company would have the option, after taking over the company for rehabilitation or liquidation, to transfer it to the NIGC.

2. The NIGC would be required, on request of the domiciliary insurance department, to accept a member company for purposes of rehabilitation and liquidation.

3. The states would not be required to transfer insolvent member companies to the NIGC, but NIGC guarantees would only be available in liquidations conducted by the NIGC.

4. The NIGC would not itself have the power to take over a member company, but the NIGC could notify the domiciliary insurance department that a company was in hazardous condition.

5. If the domiciliary state did not act within 60 days after an NIGC notice of hazard, and the NIGC did not formally withdraw the notice and was not ordered to withdraw it by a reviewing court, the NIGC guarantees would not apply.

6. If the domiciliary state did not act within 60 days after an NIGC notice of hazard, the insurer itself could apply for the appointment of the NIGC as receiver in order to preserve the guarantees.

7. The NIGC could, in its discretion but only at the request of the domiciliary state, accept appointment as receiver of an insurer which was not covered by NIGC guarantees.

8. When conducting a rehabilitation or liquidation, the NIGC would have exclusive jurisdiction as against domiciliary or ancillary state proceedings.

9. NIGC rehabilitations and liquidations would be conducted according to rules and procedures set out in the Act, which have been developed based on review of the NAIC models, other state laws and the federal bankruptcy laws.

Funding

1. The NIGC would be funded by both advance fees and post-insolvency assessments from members.

2. The advance fee or pre-funded portion would vary as among members in proportion to premiums subject to guarantee and could be graded for risk of insolvency.

3. For pre-funding, the risk adjustment would be determined pursuant to audits by NIGC staff under accounting rules and objective risk categories established by the NIGC.

4. The purpose of the pre-funded portion would be to pay for the ongoing staff operations of the NIGC and for the initial operating costs of rehabilitating and liquidating member companies.

5. Funds needed for insolvency guarantees in excess of the pre-funded amounts would come from post-insolvency assessments upon members.

6. Post-insolvency assessments would be apportioned by premium writings in the state and line in which a shortfall had to be covered.

7. Assessments would be capped for the line at the state level and thereafter be charged against national writings in the line.

8. Assessments against national writings would also be capped for the line, with the national cap applying to the total of a company's NIGC assessments at both the state and national levels.

9. Funds of the NIGC could be invested only in U.S. Treasury obligations and could not be used or lent for any private purpose, for the rescue of troubled member companies or for any public purposes other than those of the NIGC.

10. The NIGC could borrow only against assessments for the current year.

State Insurance Departments

1. State insurance departments would continue to have primary jurisdiction over financial supervision and regulation of insurance companies.

2. The power to place an insurance company in rehabilitation or liquidation would continue to rest exclusively with the state insurance departments.

3. The domiciliary insurance department of an insolvent member company would have the option but not the duty to transfer the company to the NIGC.

4. Even after transfer of a company to the NIGC for rehabilitation or liquidation, the domiciliary insurance department would retain jurisdiction as regulator for disciplinary and enforcement action against persons who wrongfully caused the insolvency.

5. NIGC actions as to standards for membership and risk-based charges would require a two thirds majority of the NIGC board, including the affirmative votes of a majority of the commissioners and other government designees.

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The text of the National Insurance Guaranty Corporation Act, and explanatory memoranda, are in the Legislative Appendix to this Report.

LEGISLATIVE APPENDIX

BILL DRAFTING APPROACH

The legislation setting up the National Insurance Guaranty Corporation (NIGC) has to do more than establish the agency. It also contains much of the substantive law of rehabilitation and liquidation for the NIGC to apply. Unfortunately, as explained below under Drafting Objectives, it adds length and complication to the statutory text. The drafting has been approached with the following objectives in mind.

Drafting Objectives

We have pursued four technical objectives in organizing and drafting the legislation. The first is to implement the five principles which guide the proposal, as set out in chapter IV of the Report on insurance insolvency guarantees. The second is to have the bill self-contained, so as to facilitate debate and initial implementation. The third is to build on what exists, as to both substance and statutory language. The fourth is to respect the uniqueness of insurance law and institutions.

Adherence to those four technical objectives has been at the sacrifice of brevity and simplicity. It makes for a long bill. But the objectives are more important than considerations of form for a subject of this novelty and importance. Within each broad objective are subsidiary ideas, such as the following.

The first objective, implementing the five principles in the Report, requires spelling out those of the proposed arrangements which are novel, such as the incentives. It also means, in the interest of national uniformity, not leaving many areas to state law or state courts.

The second objective, making the new law self-contained, requires setting out virtually all the basic rights and duties, rather than either incorporating other laws by reference or leaving sensitive issues for the federal courts to resolve later.

The third objective, building on what exists, is a reflection of the conservative principles underpinning the Report and is also in recognition of the accomplishments over the years of the insurance departments, the NAIC, the courts, the insurance industry and insurance bar in the field of insurer rehabilitation and liquidation law. This objective calls for using much of the substance and language of NAIC models and state statutes.

The fourth objective, recognizing the uniqueness of many insurance rules, traditions and public policies, means foregoing the convenience of relying on general commercial law.

Purpose of the Act

The Act would create a federally chartered membership corporation empowered to act as rehabilitator or liquidator of insolvent member property and casualty insurers and to

guarantee claimants under most types of insurance policies issued by such insurers against loss, under specified limitations. In addition, the Act would provide a comprehensive and self-contained uniform body of substantive law and procedures for the public administration of the business, assets and affairs of member insolvent insurers. Finally, the Act has as a pervasive goal the fostering of financial, accounting, managerial and regulatory policies and practices which will enhance the solidity of insurers, reduce the likelihood of publicly harmful insolvencies, and improve the early detection of hazardous financial practices and impending insolvencies.

State Law

The Act maintains continuity with the historically developed body of law and practice in the financial regulation of insurers. That is particularly true with respect to the circumstances under which insolvent and financially hazardous insurers are placed under public control and the procedures and substantive law applied in their rehabilitation and liquidation proceedings as well as with respect to the collective guarantee of insurance policy obligations. Since the ongoing general regulation and financial supervision of insurers would continue to be the responsibility of the states, the substantive principles and procedures provided by the Act should be consistent and complementary with the state administration. These considerations led to reliance, as sources for drafting guidance, on the NAIC Insurers Rehabilitation and Liquidation Act and the NAIC Post-Assessment Property and Liability Insurance Guaranty Association Model Act, as well as the Wisconsin statute on Insurer's Rehabilitation and Liquidation, which was an important source for the NAIC Model Act.

Notwithstanding the extensive borrowing from those models, our draft departs from them in numerous ways to fit the needs of the proposed new national system for insolvency administration, and also to deal with additional matters that our study of the problem has shown require attention. Some of these are not dealt with in the Report. Hence a careful examination of the entire statute is in order even for readers fully familiar with the model acts.

Federal Law

As a federal statute the Act rests upon an exercise of the legislative power of Congress for its effectiveness. This means that the arrangements created must be consistent with the requirements and constraints of many other federal statutes and regulations and must comply with various conventional administrative practices of the federal government. Attention to these concerns has been particularly necessary as to the parts of the Act creating NIGC and providing for its structure, administration, personnel and fiscal operations. They suggest borrowing from existing models, such as the Security Investors Protection Corporation Act and the Federal Deposit Insurance Corporation Act. To facilitate comparison with those models, an Appendix is attached that sketches the major features of those two federal entities.

In order to achieve the broadest effective jurisdiction and uniformity of administration, the judicial supervision of rehabilitations and liquidations conducted by the NIGC will be by federal district courts. Hence those portions of the Act have been drafted with consideration of the principles of federal judicial rules, procedures, venue and practices.

Interaction of State and Federal Law

The Act deals crisply with a critical transition point from state law and administration to federal law and judicial supervision. The state insurance regulators will be responsible for licensing, regulating, and examining the insurers. Moreover, they will continue to have the sole responsibility for the decision as to when to place a financially distressed insurer in official custody.

It is the state insurance regulator who must take the formal proceedings under state law, and in the state court in the first instance, to acquire or confirm the taking of official control of the business, assets and affairs of the insurer. Only when these processes have taken place under state law and the state insurance regulator has tendered control of the insurer to the NIGC for rehabilitation or liquidation that the transition to federal law occurs. From there on, however, it is to be entirely federal law and federal court jurisdiction which prevail.

Outline of the Act

The Act would have four major parts.

Part I: General. This part states the purposes of the Act, defines its scope, and through definitions of important terms sets the analytic approach to a large extent. In this part also are located the provisions necessary to coordinate with other aspects of federal law and legislative and administrative practice.

Part II: The National Insurance Guaranty Corporation. This part establishes the corporation and has extensive provisions defining its structure and administration and its power to assess members to pay guarantees.

Part III: Rehabilitation and Liquidation of Insurers. This part sets out the procedures by which the NIGC would acquire control of an insolvent insurer and conduct the rehabilitation or liquidation. It draws heavily on the current state law patterns as expressed in the model acts.

Part IV: Guarantee of Insurance Obligations. This part provides for the claimant guarantees and their method of administration.

NATIONAL INSURANCE GUARANTY CORPORATION ACT

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NATIONAL INSURANCE GUARANTY CORPORATION ACT

An Act to provide a means for the expeditious payment of defined claims under certain kinds of insurance policies in the event of insurer insolvency, to provide an efficient national system for the administration of insurance company insolvencies, to assist in the detection and prevention of insurance company insolvencies, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States in Congress assembled,

PART I

GENERAL PROVISIONS

Section 1. Short Title.

This Act shall be known as the National Insurance Guaranty Corporation Act.

Section 2. Purposes.

The purpose of this Act is to provide a means for the payment of covered claims under certain insurance policies to avoid excessive delay in payment and to avoid financial loss to claimants or policyholders because of the insolvency of an insurer, to assist in the detection and prevention of insurer insolvencies, to provide an organization to assess the cost of such protection among insurers, and to provide a uniform national system of administration for the rehabilitation or liquidation of insolvent or financially hazardous insurers.

Section 3. Scope.

(a) **Insurers subject to receivership**. The receivership provisions of this Act shall apply to any insurer, and to all of its assets, liabilities, business and affairs, the legal possession and control of which for purposes of rehabilitation or liquidation has been tendered to the Corporation and for which the Corporation has been appointed receiver pursuant to the provisions of this Act.

(b) **Scope of guarantee**. The guarantee provisions of this Act shall apply to all kinds of direct insurance other than the following:

(1) life, annuity, health or disability insurance;

(2) mortgage guaranty, financial guaranty or other forms of insurance offering protection against investment risks;

(3) fidelity or surety bonds, or any other bonding obligations;

(4) credit insurance, vendor's single interest insurance, or collateral protection insurance or any similar insurance protecting the interests of a creditor arising out of a creditor-debtor transaction;

(5) insurance of warranties or service contracts;

(6) title insurance;

(7) ocean marine insurance;

(8) any transaction or combination of transactions between a person (including affiliates of such person) and an insurer (including affiliates of such insurer) which involves the transfer of investment or credit risk unaccompanied by transfer of insurance risk;

(9) any insurance provided by or guaranteed by government; or

(10) any insurance written or transacted on an excess lines or surplus lines basis.

Section 4. Definitions.

As used in this Act, unless the context otherwise requires:

(a) "Ancillary state" means any state other than a domiciliary state.

(b) "Affiliate" means a person who directly, or indirectly, through one or more intermediaries, controls, or is controlled by or is under common control with an insurer. As to an insolvent insurer, "affiliate" includes any person who is or was included within the definition of "affiliate" on or following December 31 of the year next preceding the date the insurer becomes an insolvent insurer.

(c) "Corporation" means the National Insurance Guaranty Corporation.

(d) "Claimant" means any insured making a first party claim or any person instituting a liability claim, provided that no person who is an affiliate of the insolvent insurer may be a claimant.

(e) "Control" means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or non-management services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies

representing, ten percent or more of the voting securities of any other person. This presumption may be rebutted by a showing that control does not exist in fact.

(f) "The district court" and "the court" mean the United States District Court which by order approves the transfer of the receivership of an insurer to the Corporation and which thereafter has general jurisdiction and control over the receivership proceeding.

(g) "Covered claim" means an unpaid claim, excluding one for unearned premiums, submitted by a claimant, which arises out of and is within the coverage and is subject to the applicable limits of an insurance policy to which this Act applies issued by an insurer, if such insurer becomes an insolvent insurer after the effective date of this Act.

"Covered claim" shall not include any amount awarded as punitive or exemplary damages; sought as a return of premium under any retrospective rating plan; or due any reinsurer, insurer, insurance pool, or underwriting association as subrogation recoveries or otherwise.

(h) "Creditor is a person having any claim, whether matured or unmatured, liquidated or unliquidated, secured or unsecured, absolute, fixed or contingent.

(i) "Doing business" includes any of the following acts, whether effected by mail or otherwise:

(1) The issuance or delivery of contracts of insurance;

(2) The solicitation of applications for such contracts, or other negotiations preliminary to the execution of such contracts;

(3) The collection of premiums, membership fees, assessments, or other consideration for such contracts;

(4) The transaction of matters subsequent to execution of such contracts and arising out of them; or

(5) Operating under a license or certificate of authority, as an insurer, issued by a state insurance regulator.

(j) "Domiciliary state" means the state in which an insurer is incorporated or organized; or in the case of an alien insurer, its state of entry.

(k) "Fair consideration" is given for property or obligation:

(1) When in exchange for such property or obligation, as a fair equivalent therefore, and in good faith, property is conveyed or services are rendered or an obligation is incurred or an antecedent debt is satisfied; or

(2) When such property or obligation is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared to the value of the property or obligation obtained.

(l) "Foreign country" means any other jurisdiction not a state or in any state.

(m) "General assets" means all property, real, personal, or otherwise, not specifically mortgaged, pledged, deposited or otherwise encumbered for the security or benefit of specified persons or classes of persons. As to specifically encumbered property, "general assets" includes all such property or its proceeds in excess of the amount necessary to discharge the sum or sums secured thereby. Assets held in trust and on deposit for the security or benefit of all policyholders or all policyholders and creditors, in more than a single state, shall be treated as general assets.

(n) "Insolvency" or "insolvent" means that an insurer is unable to pay its obligations when they are due, or that its admitted assets (as determined under the laws and regulations of the state of domicile) do not exceed its liabilities plus the greater of:

(1) Any capital and surplus required by law for its organization; or

(2) The total par or stated value of its authorized and issued capital stock.

For purposes of this subsection "liabilities" shall include but not be limited to reserves required by statute or by general regulations or specific requirements imposed by the state insurance regulator upon a subject company at the time of licensing or subsequent thereto.

(o) "Insolvent insurer" means an insurer against whom an order of liquidation with a finding of insolvency has been entered after the effective date of this Act by a court of competent jurisdiction and which order of liquidation has not been stayed or been the subject of a writ of supersedeas or other comparable order.

(p) "Insurer" means any person who has done, purports to do, is doing or is licensed to do an insurance business, and is or has been subject to the authority of, or to liquidation, rehabilitation, reorganization, supervision, or conservation by, any state insurance regulator. As to an "alien insurer", that is one domiciled in a foreign country, the word "insurer" means and includes only the United States branch, division, or operations, of the insurer.

(q) Unless the context shows otherwise, "Liquidator" means the Corporation when acting as receiver of an insurer in carrying out an order that the insurer's assets, business and affairs be liquidated.

(r) "Member insurer" means an insurer which is a member of the National Insurance Guaranty Corporation.

(s) "Net direct written premiums" means direct gross premiums written on insurance policies to which this Act applies, less return premiums thereon and dividends paid or credited to policyholders on such direct business. "Net direct written premiums" does not include premiums on contracts between insurers and reinsurers.

(t) "Person" means any individual, corporation, partnership, association or voluntary organization.

(u) "Preferred claim" means any claim with respect to which the terms of this Act accord priority of payment from the general assets of the insurer.

(v) "Receiver" means a person which has possession and control, or the right to possession and control, of the assets, business and affairs of an insurer pursuant to appointment by a court of competent jurisdiction for the purpose of rehabilitating or liquidating the business and affairs of the insurer. The term includes a receiver, liquidator, rehabilitator or conservator as the context requires. Except where the context shows otherwise "the receiver" means the Corporation acting as receiver of an insurer.

(w) "Rehabilitator" means the Corporation when acting as receiver of an insurer in carrying out an order that the insurer's business and affairs be rehabilitated.

(x) "Secured claim" means any claim secured by mortgage, trust deed, pledge, deposit as security, escrow, or otherwise; but not including special deposit claims or claims against general assets. The term also includes claims which have become liens upon specific assets by reason of judicial process.

(y) "Special deposit claim" means any claim secured by a deposit made pursuant to any statute, regulation, or order or requirement of a state insurance regulator for the security or benefit of a limited class or classes or groups of persons, but not including any claim secured by general assets.

(z) "State" means any state, district, territory, or other separately governed political division under the authority of the United States.

(aa) "State insurance regulator" means the state officer, board, commission or agency having the legal authority under state law to take possession of the business, affairs and assets of an insurer for purposes of conserving, rehabilitating, or liquidating it, or to initiate and control judicial proceedings to that end. When the context is not so limited, it refers generally to the principal insurance regulatory authority of a state.

(bb) "Transfer" shall include the sale and every other and different mode, direct or indirect, of disposing of or of parting with property or with an interest therein, or with the possession thereof or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily, by or without judicial proceedings. The retention of a security title to property delivered to a debtor shall be deemed a transfer suffered by the debtor.

PART II

NATIONAL INSURANCE GUARANTY CORPORATION

Section 5. Corporation formed.

There is hereby established a body corporate to be known as the "National Insurance Guaranty Corporation" (hereinafter in this Act referred to as "the Corporation" or "NIGC"). NIGC shall be a nonprofit membership corporation and shall have succession until dissolved by Act of the Congress. Except to the extent inconsistent with any provision of this Act, NIGC shall be subject to, and have all the powers conferred upon, a nonprofit corporation by the District of Columbia Nonprofit Corporation Act (D.C. Code, section 29-1001 and fol.) in addition to the powers conferred in this Act.

Section 6. Relation to Federal Government.

(a) NIGC shall not be an agency or establishment of the United States Government.

(b) NIGC shall receive no financial assistance from the United States Government.

Section 7. Corporate powers.

In addition to the powers granted to NIGC elsewhere in this Act, NIGC shall have the power:

(a) to sue and be sued, in its corporate name and through its own counsel in any state, federal or other court;

(b) to adopt a corporate seal, which shall be judicially noticed;

(c) to adopt, amend, and repeal, by its board of directors, such bylaws as may be necessary or appropriate to carry out the purposes of this Act.

(d) to conduct its business (including the carrying on of operations and the maintenance of offices) and to exercise all other rights and powers granted to it by this Act in any state or other jurisdiction without regard to any qualification, licensing or other statute in such state or other jurisdiction;

(e) to elect or appoint such officers, attorneys, employees, and agents as may be required, to determine their qualifications, to define their duties, to fix their salaries;

(f) to lease, purchase, accept gifts or donations of or otherwise acquire, to own, hold, improve, use, or otherwise deal in or with, and to sell, convey, mortgage, pledge, lease, exchange or otherwise dispose of, any property, real, personal or mixed, or any interest therein, wherever situated;

(g) to enter into contracts, to execute instruments, to incur liabilities, and to do any and all other acts and things as may be necessary or incidental to the conduct of its business and the exercise of all other rights and powers granted to NIGC by this Act.

(h) to act as a receiver, trustee, rehabilitator or liquidator of insolvent or financially distressed insurers pursuant to the provisions of this Act;

(i) to pay, as guarantor, claims against insolvent members to the extent and in the manner provided elsewhere in this Act;

(j) to levy and collect assessments upon its members, in the manner and to the extent provided elsewhere in this Act, to cover the administrative expenses of the Corporation and to provide the funds necessary to discharge the guaranty obligations of the Corporation imposed by this Act.

Section 8. Membership.

(a) Except as provided in subsection (b), membership in NIGC shall be open to any insurer admitted to write direct insurance, other than the kinds excluded by section 3(b) of this Act, in any state or the District of Columbia. The board of directors shall have power to prescribe by by-law additional qualifications for membership but such additional qualifications shall not be applicable except to new applications for membership made at least five (5) years after the adoption of any such additional qualification. Such additional qualifications shall be reasonably related to the enhancement of the financial solidity of insurers and should be of uniform application. Any such by-law must be approved by directors constituting two-thirds of the board of directors, including two of the directors appointed by the National Association of Insurance Commissioners and the director designated by the Secretary of the Treasury.

(b) An insurer is eligible for membership in the National Insurance Guaranty Corporation only if all affiliated insurers otherwise eligible for membership are either members or apply for membership concurrently. The Corporation, by action of its board of directors approved by two-thirds of the directors including two of the directors selected by the National Association of Insurance Commissioners and the director selected by the Secretary of Treasury, may by by-law or resolution provide for general or specific exceptions from this requirement.

(c) No state or state official shall in any way prohibit or deter any eligible insurer from becoming or remaining a member of the Corporation of from exercising any of the rights or incidents of membership.

(d) A state may require an insurer to become or to remain a member of the National Insurance Guaranty Corporation, but only if the state requires either

(1) that all insurers licensed to transact any covered line of insurance in the state and otherwise eligible for membership, or

(2) that all domestic insurers licensed to transact any covered line of insurance in the state and otherwise eligible for membership become and remain members of the Corporation. Any such requirement of membership shall be uniformly imposed, except that a state may uniformly exempt from the requirement any insurer with an aggregate net direct written premium for the preceding three years for all covered lines of insurance which, when taken together with the aggregate net direct written premium for all covered lines of insurance written by its affiliates, is below an amount specified by law or regulation.

Section 9. Board of Directors.

(a) **Composition**. The power to direct the affairs of the Corporation shall be vested in a board of directors consisting of nine persons, chosen as follows: One shall be designated by the Secretary of the Treasury from among the officers and employees of the Department; three shall be designated by the National Association of Insurance Commissioners from among its member state insurance regulators; and five shall be elected by the members. If within 180 days after the date of enactment of this Act the president of the National Association of Insurance Commissioners has not certified to the Secretary of the Treasury three state insurance regulators designated by the National Association of Insurance Commissioners to serve as directors and who are willing to serve, the Secretary of the Treasury shall appoint up to three other directors from among the officers and employees of the Department to serve in lieu of those to be designated by the National Association of Insurance Commissioners. Such additional directors shall serve at the pleasure of the Secretary. If the National Association of Insurance Commissioners subsequently certifies directors for those positions the Secretary may at such time as may be convenient create vacancies to enable such new directors to take office.

(b) **Interim board**. The first four designees referred to in subparagraph (a) shall serve as the interim board for purposes of organizing the Corporation. Within _____ days after the enactment of this Act they shall meet, at the call of the director designated by the Secretary of the Treasury, who shall act as interim chairman. The interim board shall prescribe a procedure for receiving applications for membership, determining the initial membership of the Corporation, holding an election for the remaining five seats on the board, and certifying the results of such election. Thereafter the full board shall meet within _____ days, at the call of the interim chairman, to adopt by-laws of the Corporation, elect officers, and take all other steps necessary to enable the Corporation to carry out its functions.

(c) **Terms**. The term of office of each director shall be three years, except that the initial terms shall be staggered as follows: The terms of the director appointed by the Secretary of the Treasury and of two of the directors elected by the members shall be four years and the terms of one of the directors appointed by the National Association of Insurance Commissioners and of two of the directors elected by the members shall be five years; provided, that the director appointed by the Secretary of the Treasury shall serve at the pleasure of the Secretary and the term of any director designated by the National

Association of Insurance Commissioners shall terminate on the thirtieth (30) day following the termination of the person's official position as a state insurance regulator but the person shall continue to serve until a successor director has been designated by the National Association of Insurance Commissioners and has taken office as director.

(d) **Vacancies**. Vacancies occurring in the board shall be filled in the same manner as the vacant position was filled, except that in the case of a vacancy in an elected position the board may appoint a director to serve until the next regular election. The term of a director chosen to fill a vacancy shall be the remainder of the unexpired term of the predecessor. Directors shall be eligible to succeed themselves.

Section 10. Officers.

The officers of the Corporation shall consist of a chairman, a vice-chairman, a president, a secretary, and a treasurer, and may include one or more vice presidents and such other officers and assistant officers as may be deemed necessary, each of whom shall be elected or appointed at such time and in such manner and for such terms not exceeding three years as may be prescribed in the articles of incorporation or the bylaws. In the absence of any such provision, all officers shall be elected or appointed annually by the board of directors.

Section 11. National Insurance Guaranty Fund.

(a) There is hereby established a fund to be known as the National Insurance Guaranty Fund, hereinafter referred to as the "Fund." The Fund shall consist of all payments made by members pursuant to assessments, interest received on bank accounts or investments, amounts borrowed by the Corporation pursuant to Section 13, and amounts recovered under Section 74. Moneys in the Fund shall be invested only in obligations of the United States or in obligations guaranteed as to principal and interest by the United States.

(b) The Fund shall be used to pay the administrative expenses of the Corporation, to advance if necessary the initial administrative expenses of the rehabilitation or liquidation proceedings of member insurers for which the Corporation has been appointed receiver, and to pay the guaranty obligations of the Corporation set forth in section 73.

(c) The Fund may not be used or loaned for any purposes other than those specified in subsection (b).

Section 12. Assessments.

(a) **Persons subject to assessments**. All members of the Corporation shall be subject to assessments as provided in this section.

(b) **Assessments for administrative expenses**. Within _____ days after the organization of the Corporation the board of directors shall estimate the amount reasonably necessary to establish the operations of the Corporation, to provide for its ongoing staff and other administrative expenses for the ensuing twelve months, and to advance the initial administrative expenses of acting as rehabilitator or liquidator of member insurers. The amount shall be assessed upon the members in the proportion that the net direct written premiums written by each in the preceding calendar year on insurance covered by guaranty under this Act bear to the total such premiums of all members; provided, that such assessments may be further apportioned or modified within a range of fifty percent (50%) greater or lesser than the premium-based apportionment alone would produce, on the basis of standards reasonably measuring risks of financial insolvency and provided for by a by-law that has been approved by two-thirds of the members of the board of directors, including two of the three members appointed by the National Association of Insurance Commissioners and the director designated by the Secretary of the Treasury. The board shall annually make a similar assessment to cover the estimated operating and administrative expenses of the Corporation for the ensuing year.

(c) **Post-insolvency assessments**.

(1) Claims accounts. The Corporation shall establish a "guaranteed claims account" for each line of insurance to which this Act applies for each state.

"Line of insurance" for purposes of this section shall mean a category of insurance to which premiums are allocated for purposes of reporting on the form of annual financial statement prescribed by the National Association of Insurance Commissioners.

Covered insurance claims, including the direct expenses of handling such covered claims, which the Corporation pays or becomes obligated to pay by reason of its guaranty obligations, shall be allocated to state claims accounts based upon standards approved by the board of directors. The standards shall allocate claims to states from which the losses resulting in the claims arise according to reasonable and customary principles for determining the sources of loss.

Amounts recovered from any source as reimbursement, subrogation, deferred assessments, or other recovery of amounts previously paid out or incurred pursuant to the Corporation's guaranty obligations shall be credited to the appropriate state and line account which had been charged with the guaranteed claim.

(2) Assessment method. Annually, the Corporation shall determine the amount of additional funds needed to pay the guaranteed claims charged to each guaranteed claims account. It shall assess its members for such amounts as follows:

(A) First, it shall assess each member an amount equal to the proportion of the total amount needed for the account (including additional amounts needed by reason of deferred or exempted assessments, or by reason of limitations on the assessments of member insurers) which the net direct written premium of the member insurer attributed to that state for that line of insurance for the calendar year preceding the assessment bears to the net direct written premium of all member insurers attributed to that state for that line and year. Such assessment, however, as to any member insurer shall not exceed two percent of the member insurer's net written premium attributed to that state for that line of insurance for the preceding calendar year. This assessment shall be known as the "state assessment."

(B) Second, if the "state assessment" does not provide the full funds needed for any guaranteed claims account for that year, each member insurer shall be assessed as a "national assessment" an amount equal to that proportion of the balance of the amount needed (including additional amounts needed by reason of deferred or exempted national assessments, or by reason of limitations on the national assessments of member insurers) which the net direct written premium of the member insurer for that line of insurance in the United States in the preceding calendar year bears to the net written premium of all member insurers for that line of insurance in the United States in the preceding calendar year. Such assessment, however, as to any member insurer, when taken together with all state assessments on the insurer for that line of insurance for that year, shall not exceed two percent of the member insurer's net written premium in the United States for that line of insurance for the preceding calendar year.

(d) **Payment of assessments**. All assessments shall be paid not more than thirty days after notice thereof is sent by the Corporation to the member unless the notice specifies that the assessment or a portion thereof is not payable until a later date.

(e) **Information**. Each member shall file with the Corporation such information as the Corporation shall determine to be necessary or appropriate for the purpose of making the assessments authorized by this section.

Section 13. Borrowing authority.

The Corporation shall have no authority to borrow except to the extent that assessments payable in the fiscal year in which the borrowing occurs have been made and remain unpaid. Any such borrowing shall be made upon such terms and conditions as the board of directors may determine, except that any funds so borrowed shall be repaid out of the assessments as collected and the funds resulting from such collection shall not be applied to any other purpose until the borrowed funds have been repaid. To secure the

payment of principal and interest on any such borrowings the Corporation may pledge the assessments actually made that are payable within the fiscal year of the borrowing.

Section 14. Financial surveillance of members.

(a) **Responsibility of state authorities**. Except to the extent inconsistent with any provision of this Act, state insurance regulators or other authorities in the states having authority over members shall continue to exercise all regulatory powers given them under state law, including financial examination and enforcement of compliance with applicable state financial rules.

(b) **Inspection by NIGC**. The Corporation shall require members to file with it such reports and records, or copies of reports and records filed with state authorities, and each member shall permit the Corporation on request to make such financial examinations of the business and affairs of the member or any affiliate and such inspections and investigations of the member's records, as the Corporation deems necessary to keep itself informed of the financial condition of its members.

(c) **Exchange of information**. At the request of the Corporation, state insurance regulators and other state authorities, shall furnish it with any records, reports, results of examinations and inspections, orders, recommendations, or other information in their possession relevant to the financial condition of a member. The Corporation shall cooperate with and assist state insurance regulators in the carrying out of their responsibilities for overseeing the financial condition of member insurers by providing to the state insurance regulators, upon request, any evaluations made by the Corporation of the financial condition of members and by consulting with the state insurance regulators concerning the condition of members.

Section 15. Notice of hazardous condition of member.

(a) **Notice to state authority**. Whenever the Corporation shall conclude from all the information available to it that a member insurer is insolvent or in a hazardous financial condition or conducting its business in a financially hazardous manner, it shall give written notice to the state insurance regulator of the state of domicile of the member insurer that it deems the member to be insolvent or in a hazardous financial condition or is conducting its business in a financially hazardous manner. A copy of the notice shall be served on the member insurer.

(b) **Withdrawal of notice**. The notice provided in subsection (a) may be withdrawn by the Corporation at any time within 60 days after the date of notice if the Corporation concludes, after consultation with the state insurance regulator or after receiving additional information, that the condition causing the notice to be given has been corrected or that the notice was erroneous.

(c) **Termination of guarantee**. Unless the notice given under subsection (a) is withdrawn, the state insurance regulator of the state of domicile of the member insurer shall have 60 days from the date of receipt of the notice in which to take possession and control of the assets, business and affairs of the member summarily and/or to petition the appropriate court to appoint the state insurance regulator or other proper person as receiver of the member, or to take such other action as may be prescribed by the laws of the state for placing the member in receivership. If the state insurance regulator fails to take such action within the 60 day period, the guarantee provided by Section 73 shall terminate with respect to the member and the Corporation shall have no further obligation to the member, its policyholders or claimants against the insureds of the member insurer, unless the member insurer files within 75 days from the date of the notice given under subsection (a) a petition pursuant to Section 24(b)(2) for the appointment of the Corporation as receiver. Upon termination of the guarantee the Corporation shall have no obligation to accept any responsibility in connection with rehabilitation or liquidation proceedings of the member insurer.

(d) **Contest of notice of hazardous condition**. If the state insurance regulator is of the opinion that the Corporation's notice of hazardous condition is unjustified, the state insurance regulator may within the 60-day period bring an action against the Corporation for an injunction to compel the Corporation to withdraw its notice. Such an action may be maintained only in the United States district court for the district in which the member insurer has its principal place of business or the United States District Court for the District of Columbia. If the court finds that the insurer is not insolvent or in a hazardous financial condition or conducting its business in a financially hazardous manner, it shall order that the notice be withdrawn and that the guaranty be reinstated. The member insurer shall not have standing to bring such an action.

Section 16. Withdrawal and termination of membership.

(a) **Withdrawal**. A member insurer may not withdraw from membership in the Corporation except after written notice of its intention to withdraw given to the Corporation and to the state insurance regulator of its domicile one year in advance of withdrawal. A member that has withdrawn shall not be eligible to become a member again. Withdrawal of a member renders its affiliated insurers ineligible for continued membership, in accordance with, and subject to the exception stated in Section 8(b).

(b) **Termination**. Membership may be terminated by the board of directors if a member fails to pay any assessment when due or fails to provide any information as to its financial condition requested by the Corporation, unless such failure to pay or to provide requested information is cured within ten days after the member receives written notice from the Corporation requesting that the default be cured.

(c) **Effect of withdrawal or termination**. Notwithstanding its withdrawal or termination, a member shall remain liable for any assessments made prior to the withdrawal or termination and shall be liable, to the same extent as if it had remained a

member, for any assessments made after the withdrawal or termination with respect to any member insolvencies as to which the Corporation became a receiver before the date of the withdrawal or termination. The withdrawal or termination of a member shall terminate all guaranty obligations of the Corporation with respect to the withdrawn or terminated member, its insureds, and claimants against its insureds, with respect to all policies issued by the member, whether before or after the date of withdrawal or termination.

Section 17. Liability of members.

(a) **Liability as to NIGC obligations**. The liability of members with respect to the guarantees provided by this Act shall be limited to the assessments authorized herein and the members shall have no other liability arising from this Act to any other member insurer, its policyholders, or other claimants resulting from the insolvency of a member insurer, and shall have no liability for any indebtedness incurred by the Corporation or for any act or omission of any officer, agent, or employee of the Corporation.

(b) **Liability under state guaranty funds**. A member shall have no liability under any state law or state guaranty fund for any assessments on account of insolvencies of insurers as to which insolvency proceedings have not been commenced on or before the date it becomes a member of NIGC. A member shall remain liable, notwithstanding its membership in NIGC, for any assessments for which it would have been liable under any state law or state guaranty fund on account of an insolvency as to which insolvency proceedings commenced on or before the date it became a member of NIGC.

Section 18. Advertising.

No member of NIGC shall advertise or publicize its membership in NIGC. The board of directors shall implement this prohibition by appropriately detailed by-laws.

Section 19. Tax exemption.

NIGC, its property, its franchise, capital, reserves, surplus, and its income, shall be exempt from all taxation now or hereafter imposed by the United States or by any state or local taxing authority, except that any real property and any tangible personal property (other than cash and securities) of NIGC shall be subject to state and local taxation to the same extent according to its value as other real and tangible personal property is taxed. Assessments made upon a member of NIGC shall constitute ordinary and necessary expenses in carrying on the business of such member for the purpose of Section 162(a) of Title 26.

Section 20. Exemption from other laws.

The Corporation and its directors, officers, agents and employees shall be exempt from any liability, civil or criminal, under the antitrust laws of the United States or the

Federal Trade Commission Act, or under the analogous laws of any state, on account of any acts committed or activities carried on by them in good faith in executing the powers granted to the Corporation by this Act. The Corporation shall not be deemed to be an insurer for any purpose and shall not be subject to any state statute, law or regulation regulating or imposing liabilities or penalties, civil or criminal, on insurers or persons acting for insurers in the transaction of any part of the business or insurance including the administration of claims arising under policies of insurance.

Section 21. Improvement of insolvency prevention and detection.

The Corporation shall, in cooperation with state insurance regulators, the National Association of Insurance Commissioners, and other appropriate agencies or entities, assist in the development of improved standards for financial requirements, reporting and examination, or other procedures, methods, or techniques for avoiding insurance insolvencies and for promoting early detection and protective action in the case of insurers that are insolvent or approaching insolvency.

Section 22. Public reporting.

As soon as practicable after the close of each fiscal year, NIGC shall prepare a written report on the conduct of its business and the exercise of the powers granted by this Act during such fiscal year. Such report shall include financial statements setting forth the financial position of NIGC at the end of such fiscal year and the results of its operations (including the source and application of its funds) for such fiscal year. The financial statements shall be examined by an independent public accountant or firm of independent public accounts, selected by NIGC, and shall be accompanied by the report thereon of such accountant or firm. The report shall be submitted to the Secretary of the Treasury, to the National Association of Insurance Commissioners, to the members of NIGC, and to the state insurance regulators in each of the states, and shall be made available for dissemination to the public.

PART III

REHABILITATION AND LIQUIDATION OF INSURERS

Section 23. Jurisdiction.

The Corporation shall act as receiver of a member insurer for purposes of conservation, rehabilitation or liquidation when appointed as receiver in proceedings instituted in accordance with the provisions of this Act. The United States district courts shall have exclusive jurisdiction of proceedings to appoint the Corporation as receiver of a member insurer and, following such appointment, to supervise the rehabilitation and liquidation of such member in conformity with the provisions of this Act.

Section 24. Petition for appointment.

(a) **Filing and service of petition**. A proceeding to appoint the Corporation as receiver of a member insurer shall be commenced by the filing of a petition seeking such appointment in a United States district court and the service of a copy of the petition upon the Corporation. In the event the petition is filed by a member insurer, service thereof shall also be made on the state insurance regulator of the member insurer's state of domicile.

(b) **Who may file**. A petition may be filed by:

(1) a state insurance regulator or a receiver acting under its authority, either of which has the unconditional right to possession and control of the business, assets and affairs of the member insurer for purposes of preservation, rehabilitation or liquidation pursuant to an order of a court of competent jurisdiction which has not been stayed or superseded; or

(2) a member insurer as to which the Corporation has given a notice of hazardous condition pursuant to Section 15 of this Act, which notice has not been withdrawn.

(c) **Time for filing**. If filed by a state insurance regulator or a receiver acting under its authority, the petition shall be filed within 30 days of the effective date of the court order referred to in subsection (b)(1) above. If filed by a member, the petition shall be filed within 75 days of the date on which the notice of hazardous condition pursuant to Section 15 was received by the state insurance regulator.

(d) **Where filed**. The petition, if filed by a state insurance regulator or a receiver acting under the authority of a state insurance regulator, shall be filed in the United States district court for the district in which the member insurer has its principal office or domicile or in which is located the court that issued the order referred to in subsection (b)(1). If filed by a member insurer, the petition shall be filed in the United States district court for the district in which the member insurer has its principal office or domicile.

(e) **Response to petition**. Within 10 days after the service upon it of a petition under subsection (a) the Corporation shall file and serve a response thereto, accepting or rejecting the proposed appointment as receiver and, if it rejects the proposed appointment, stating the ground or grounds of such rejection.

Section 25. Action on petition.

(a) If the Corporation rejects the proposed appointment on one or more of the grounds set forth in subsection (b), the district court shall deny the petition unless the petitioner or any other person having standing controverts the ground or grounds stated, in which case the district court shall determine, after hearing, the validity of the ground or grounds. If the court determines that any of the grounds stated is valid, it shall dismiss the petition. If it determines that none of the grounds is valid it shall enter an order appointing the

Corporation as receiver unless subsection (d) applies. (b) The grounds on which the Corporation may reject the proposed appointment pursuant to subsection (a) are:

(1) that the insurer was not a member of the Corporation on the date the petition was filed; or

(2) that the petition was not filed within the time specified in Section 24(c); or

(3) if the petition was filed under Section 24(b)(1), that the Corporation previously gave written notice pursuant to Section 15 of the hazardous condition of the member insurer to the state insurance regulator of the state of domicile of the member insurer and the state regulator did not within 60 days of receipt of the notice take possession of the business, assets and affairs of the insurer summarily and/or petition the appropriate court to appoint the insurance regulator or other proper person as receiver of the insurer and pursue the petition with due diligence, or take such other actions as were provided by the laws of the state to place the insurer in receivership, and such notice has not been withdrawn by the Corporation nor has the guaranty obligation of the Corporation been reinstated in the manner provided in Section 76(c); or

(4) if the petition was filed under Section 24(b)(2), that the state insurance regulator has within the 60-day period referred to in the preceding subparagraph (3) taken the action referred to in subparagraph (3).

(c) The Corporation may accept the proposed appointment notwithstanding the existence of grounds (2) or (3) in subsection (b) above that entitle it to reject the appointment. If it does so, its response to the petition shall set forth such grounds and the court shall determine whether the grounds so set forth are valid and shall make such findings as part of its order appointing the Corporation as receiver.

(d) If the Corporation rejects the proposed appointment for any reason other than the grounds set forth in subsection (b), the court shall determine whether the reasons given constitute exceptional circumstances that justify the rejection and if it so finds it may dismiss the petition. In that event, however, the Corporation's rejection shall have the effect stated in Section 30(c).

Section 26. Order appointing Corporation receiver.

(a) If the Corporation accepts the proposed appointment as receiver of the member insurer or if the court orders such appointment over objection as provided in Section 25(a), the court shall grant the petition and appoint the Corporation as receiver. The order shall specify whether the Corporation is to act to rehabilitate the insurer or to liquidate it. Unless the preceding appointment of a state receiver was for the purposes of liquidation, the Corporation shall be appointed as receiver for rehabilitation until a petition for liquidation is filed and granted.

(b) The order shall require regular accountings of the Corporation's administration of the insurer's estate to the court. Accounting shall be at such intervals as the court specifies in its order or by rule, but no less frequently than semi-annually. Copies of the accounting shall be served upon the state insurance regulators of the state of the insurer's domicile and of each state in which it is or was licensed or transacted any insurance business.

Section 27. Effect of order.

(a) The order appointing the Corporation as receiver shall have the effect of immediately transferring to the Corporation the possession and control and the unconditional right to possession and control of all of the business, assets and affairs of the insurer. The state insurance regulator, the state receiver, and any ancillary state receivers theretofore appointed shall, upon demand by the Corporation, promptly transfer all assets and records of the insurer or of their respective receiverships to the Corporation.

(b) The entry of an order appointing the Corporation as receiver shall not constitute an anticipatory breach of any contract of the insurer, nor provide ground for revocation or cancellation of any such contract other than by the receiver.

Section 28. Exclusive jurisdiction over property of insurer.

(a) Petition by state regulator. The filing of a petition under Section 24(b)(1) shall immediately vest the district court with exclusive jurisdiction over the insurer and its property wherever located and over all parties to the proceedings by which the state insurance regulator or the receiver acting under its authority acquired the right to possession and control of the business, assets and affairs of the insurer and shall suspend the further jurisdiction of other courts and administrative bodies with respect to any such proceedings.

(b) Petition by member insurer. The entry of an order appointing the Corporation as receiver pursuant to a petition filed by a member insurer under Section 24(b)(1) shall vest the district court with exclusive jurisdiction over the property of the insurer wherever located and no other administrative or judicial proceeding for the conservation, rehabilitation or liquidation of the insurer shall thereafter be maintained.

Section 29. Process.

In any receivership proceeding under this Act, the process of the district court having jurisdiction over the receivership may be served anywhere in the United States; provided, however, that no subpoena shall issue to a witness living outside the district in which the court appointing the receiver is held and at a distance greater than 100 miles from the place where the court sits without the permission of said court being first had upon proper application and cause shown.

Section 30. Effect on guarantee.

(a) If the Corporation rejects the proposed receivership on one or more of the grounds set forth in Section 25(b) and the district court upholds the rejection, the court's dismissal of the petition shall have the effect of terminating the guarantee obligation of the Corporation with respect to the member insurer.

(b) If the Corporation accepts the proposed receivership but asserts one or more of the grounds set forth in Section 25(b) as grounds for objecting to the receivership, a finding of the district court sustaining one or more of such grounds shall have the effect of terminating the guarantee obligation of the Corporation with respect to the member insurer.

(c) If the Corporation rejects the proposed receivership on any ground other than those set forth in Section 25(b) and the district court denies the petition pursuant to Section 25(d), the action of the Corporation in rejecting the proposed receivership shall be treated as having withdrawn any notice of hazardous condition previously given pursuant to Section 15 of this Act and the guarantee obligation of the Corporation with respect to the member insurer shall remain in effect.

Section 31. Injunctions and orders.

The receiver may at any time apply for such restraining orders, preliminary and permanent injunctions, and other orders as may be deemed necessary and proper to prevent:

(a) the transaction of further business;

(b) the transfer of property;

(c) interference with the receiver or with a proceeding under this Act;

(d) waste of the insurer's assets;

(e) dissipation and transfer of bank accounts;

(f) the institution or further prosecution of any actions or proceedings;

(g) the obtaining of preferences, judgments, attachments, garnishments or liens against the insurer, its assets or its policyholders;

(h) the levying of execution against the insurer, its assets or its policyholders;

(i) the making of any sale or deed for nonpayment of taxes or assessments that would lessen the value of the assets of the insurer;

(j) the withholding from the receiver of books, accounts, documents, or other records relating to the business of the insurer; or

(k) any other threatened or contemplated action that might lessen the value of the insurer's assets or prejudice the rights of policyholders, creditors or shareholders, or the administration of any proceeding under this Act.

Section 32. Actions by and against receiver as Rehabilitator.

(a) The entry of the order of the district court appointing the Corporation as receiver for the purpose of rehabilitating the insurer shall automatically stay every action or proceeding pending in any state or federal court in which the insurer is a party, or is obligated to defend a party, for ninety (90) days to enable the receiver to obtain representation and prepare for further proceedings. The district court upon application of the receiver may grant injunctions and orders directed to any and all courts, persons, and parties as necessary to confirm or secure such stays of proceedings, or to extend any such stay upon a showing by the receiver that additional time is necessary for it to participate competently in the further conduct of the action or proceeding. The receiver may apply to any court in which any action or proceeding involving or affecting the insurer or its estate is pending to stay the action or proceeding for the times and purposes described above.

(b) The receiver shall take such action respecting all pending litigation as it deems necessary in the interests of justice and for the protection of creditors, policyholders, and the public.

(c) No statute of limitations or defense of laches shall run with respect to any cause of action by or against an insurer between the filing of the petition for appointment of the Corporation as receiver and the order granting or denying that petition. Any action against the insurer that might have been commenced when the petition was filed may be commenced for at least sixty (60) days after the order appointing the Corporation as receiver has been entered or the petition is denied. The receiver may within one year, or such longer time as applicable law may permit, institute an action or proceeding on behalf of the insurer upon any cause of action against which the period of limitation fixed by applicable law has not expired at the time of the filing of the petition.

Section 33. Actions by and against receiver as Liquidator.

(a) The entry of an order appointing the Corporation as liquidator shall operate as a stay of the commencement or continuation of any action or proceeding in any state or federal court, or any administrative or other proceeding, against the insolvent insurer or against an insured of the insurer on a claim for which the insurer may be liable, or against the Corporation as receiver, except as provided in subsection (b).

(b) The district court shall have power to grant relief from the stay provided in subsection (a) in such cases, and upon such terms, as the court determines to be consistent

with the preservation of assets and the efficient administration of the estate of the insurer. Such relief may be granted upon the application of any party in interest, including the receiver, and may be granted as to particular cases or as to classes of cases as may be prescribed by the court's order.

(c) Upon issuance of an order appointing the Corporation as liquidator, the Liquidator may within two (2) years from such order, or such other longer time as applicable law may permit, institute an action or proceeding on behalf of the estate of the insurer upon any cause of action against which the period of limitation fixed by applicable law has not expired at the time of the filing of the petition upon which such order is entered. Where by any agreement a period of limitation is fixed for instituting a suit or proceeding upon any claim, or for filing any claim, proof of claim, proof of loss, demand, notice, or the like, or where in any proceeding, judicial or otherwise, a period of limitation is fixed, either in the proceeding or by applicable law, for taking any action, filing any claim or pleading, or doing any act, and where in any such case the period had not expired at the date of the filing of the petition, the Liquidator may, for the benefit of the estate, take any such action or do any such act, required of or permitted to the insurer, within a period of 180 days subsequent to the entry of an order for liquidation, or within such further period as is shown to the satisfaction of the court not to be unfairly prejudicial to the other party.

(d) No statute of limitations or defense of laches shall run with respect to any cause of action against an insurer between the filing of a petition for liquidation and the denial of the petition. Any action against the insurer that might have been commenced when the petition was filed may be commenced for at least 60 days after the petition is denied.

Section 34. Jurisdiction over actions by and against receiver; transfer.

(a) Subject to the provisions of Sections 28 and 33, the district courts shall have original but not exclusive jurisdiction over cases brought by or against the Corporation acting as a receiver pursuant to this Act, and such cases may be brought in any state or federal court in which jurisdiction and venue would be proper apart from the provisions of this Act. Any such action shall be deemed to be an action arising under this Act for purposes of the removal jurisdiction of the district courts.

(b) Any such action filed in or removed to a district court may be transferred to the district court having jurisdiction over the receivership proceeding, upon order either of the district court in which the action is pending or of the court having jurisdiction over the receivership, if it appears that such a transfer is likely to promote the efficient and fair administration of the estate of the insurer.

Section 35. Expenses of establishing receivership.

(a) All expenses of the Corporation or of any state insurance regulator or of any person acting under their authority and direction in the taking possession of the insurer and of conducting the proceedings placing it in receivership, and of obtaining the appointment

of the Corporation as receiver, and in the administration of the receivership and in the conduct of all proceedings related to it, shall be paid out of the funds or assets of the insurer.

(b) In the event that the estate of the insurer does not contain sufficient cash or liquid assets to defray the costs incurred, the Corporation may advance the costs so incurred from its general funds. Any amounts so advanced for expenses of establishing the receivership of the insurer and for its administration shall be repaid to the Corporation out of the first available money of the insurer.

Section 36. Cooperation of officers, owners and employees.

(a) Any officer, manager, director, trustee, owner, employee or agent of any insurer, or any other person with authority over or in charge of any segment of the insurer's affairs, including any person who exercises control directly or indirectly over activities of the insurer through any holding company or other affiliate of the insurer, shall cooperate with the receiver. "To cooperate" shall include, but shall not be limited to, the following:

(1) to reply promptly in writing to any inquiry from the receiver requesting such a reply; and

(2) to make available to the receiver any books, accounts, documents, or other records or information or property of or pertaining to the insurer and in the possession, custody or control of such persons.

(b) No person shall obstruct or interfere with the receiver in the conduct of any proceeding or any investigation preliminary or incidental thereto.

(c) This section shall not be construed to abridge otherwise existing legal rights, including the right to resist a petition for liquidation or other orders.

Section 37. Proceedings against culpable persons.

If it appears to the receiver that there has been criminal or tortious conduct, or breach of any contractual or fiduciary obligation detrimental to the insurer by any officer, manager, agent, broker, employee or other person, it may pursue all appropriate legal remedies on behalf of the insurer.

Section 38. Special deposits.

Except where it is expressly contrary to the terms of a special deposit, or of a bond made in lieu of a deposit, of the insurer, on application by the receiver, any depositary, trustee, or other person holding or having rights to receive deposit assets of the insurer, or the proceed of bonds in lieu of assets, shall be directed by the court to transfer the deposit or the proceeds or right to the proceeds of bonds given in lieu of deposit and all rights

thereunder, to the receiver. The receiver shall apply such funds in accordance with the terms of the trust or special deposit instrument.

Section 39. External audit of the receiver's books.

The district court may, as it deems desirable, cause audits to be made of the books of the Corporation relating to any receivership established under this Act, and a report of each audit shall be filed with the court and with the state insurance regulators of all jurisdictions where the insurer was domiciled, licensed or transacted insurance business. The books, records and other documents of the receivership shall be made available to the auditor at any time without notice. The expense of each audit shall be considered a cost of administration of the receivership.

Section 40. Standing of state guaranty associations.

Any state guaranty association shall have standing to appear in any court proceeding concerning the rehabilitation or liquidation of an insurer by the receiver if such association has paid guaranty obligations for which it has not been reimbursed or is or may become liable for guarantees of obligations of the insurer in rehabilitation or liquidation.

Section 41. Powers and duties of Rehabilitator.

(a) The Rehabilitator may appoint an advisory committee of representatives of policyholders, claimants, other creditors, and other persons or groups with substantial direct interest in the business and affairs of the insurer, should such a committee be deemed necessary. The members of any such committee shall serve without payment by the insurer or from the insurer's assets of compensation or of reimbursement for costs, expenses or fees of attorneys or other consultants or assistants, other than reimbursement for reasonable travel and per diem living expenses. No member of any other committee or representative of any interested person or group, other than the receiver and its employees, agents, attorneys, and consultants, or a person directly appointed by the district court upon the sole initiative of the court itself to assist or advise it, shall be paid by the insurer or from the insurer's assets for any costs, expenses, or fees of attorneys or other consultants or assistants.

(b) The Rehabilitator may take such actions as it deems necessary or appropriate to reform and revitalize the insurer. It shall have all the powers of the directors, officers, and managers, whose authority shall be suspended, except as they are redelegated by the Rehabilitator. It shall have full power to direct and manage, to hire and discharge employees subject to any contract rights they may have, and to deal with the property and business of the insurer.

(c) If the Rehabilitator determines that reorganization, consolidation, conversion, reinsurance, merger or other transformation of the insurer is appropriate, it shall prepare a plan to effect such changes. Upon application of the Rehabilitator for approval of the plan,

and after such notice and hearings as the court may prescribe, the court may either approve or disapprove the plan proposed, or may modify it and approve it as modified. Any plan approved under this section shall be, in the judgment of the court, fair and equitable to all parties concerned. If the plan is approved, the Rehabilitator shall carry out the plan.

(d) The Rehabilitator shall have the power to avoid fraudulent transfers.

Section 42. Termination of rehabilitation.

(a) Whenever the Rehabilitator believes further efforts to rehabilitate the insurer would substantially increase the risk of loss to creditors, policyholders or the public, or would be futile, it may petition the district court for an order of liquidation. The district court shall permit the directors of the insurer to take such actions as are reasonably necessary to defend against the petition and may order payment from the estate of the insurer of such costs and other expenses of defense as justice may require.

(b) The protection of the interests of insureds, claimants and the public requires the timely performance of all insurance policy obligations. If the payment of policy obligations is suspended in substantial part for a period of six (6) months at any time after the appointment of the Rehabilitator and the Rehabilitator has not filed an application for approval of a plan of rehabilitation, the Rehabilitator shall petition the district court for an order of liquidation on grounds of insolvency.

(c) The Rehabilitator or the directors may at any time petition the district court for an order terminating rehabilitation of the insurer on the ground that the insurer is rehabilitated and may safely recommence transaction of an insurance business. If any such petition by the directors is denied, another such petition shall not be made by the directors for at least six months. The district court may order payment from the estate of the insurer of the costs and other expenses of such petition as justice may require. If the district court finds that rehabilitation has been accomplished and that grounds for rehabilitation no longer exist, and that the insurer may safely recommence the transaction of the insurance business under the control of its owners and directors, it shall order that the insurer and its owners and directors be restored to possession of its property and the control of the business. The district court may also make that finding and issue that order at any time upon its own motion.

Section 43. Grounds for liquidation.

The receiver may petition the district court for an order directing it to liquidate the insurer on the grounds:

(a) that the insurer is insolvent; or

(b) that the insurer is in such condition that the further transaction of business would be hazardous, financially or otherwise, to its policyholders, its creditors or the public; or

(c) that one or more of the following conditions exists, or would exist but for the receivership, and it is unlikely that the condition can be eliminated and not reoccur if the insurer were released from rehabilitation:

(1) a person who is a director of the insurer or who in fact has, or would have were it not for the receivership, executive authority in the management of the insurer, whether as an officer, manager, general agent, employee, or other position, is dishonest or untrustworthy, or after notice has refused to appear and be examined under oath concerning its business and affairs;

(2) control of the insurer, whether by stock ownership or otherwise, and whether direct or indirect, is in a dishonest or untrustworthy person or persons;

(3) control of the insurer, whether by stock ownership or otherwise, and whether direct or indirect, is in a person or persons whose business, financial condition, legal difficulties, or methods of business operation are likely to jeopardize the stability and financial solidity of the insurer.

Section 44. Liquidation orders.

(a) An order to liquidate the business of the insurer shall appoint the Corporation as receiver for liquidation of the insurer (or "Liquidator"). The Liquidator shall hold and have title to all of the assets, property, contracts and rights of action, and all of the books and records of the insurer, wherever located. The filing or recording of the order of liquidation with the clerk of the district court and the recorder of deeds of the county in which the insurer's principal office or place of business is located, or, in the case of real estate, with the recorder of deeds of the county where the property is located, shall impart the same notice as a deed, bill of sale or other evidence of title duly filed or recorded with that recorder of deeds would impart.

(b) Upon issuance of the order, the rights and liabilities of the insurer and of its creditors, and all other persons interested in its estate, shall be fixed as of the date of entry of the order of liquidation, except as provided in Section 45 and Section 61.

(c) An order to liquidate the business of an alien insurer shall have the same legal effect as an order to liquidate a domestic insurer, except that the assets and the business in the United States shall be the only assets and business included in the order.

(d) At the time of petitioning for an order of liquidation, or at any time thereafter, the receiver if it has determined that the insurer is insolvent may petition the court for a judicial declaration of such insolvency. After providing such notice and hearing as it deems proper, the court may make the declaration.

(e) (1) Within five (5) days after the initiation of an appeal of an order of liquidation, which order has not been stayed or superseded, the receiver shall present for the court's approval a plan for the continued performance of the insurer's

policy claims obligations, including the duty to defend insureds under liability insurance policies, during the pendency of an appeal. Such plan shall provide for the continued performance and payment of policy claims obligations in the normal course of events, notwithstanding the grounds alleged in support of the order of liquidation including the ground of insolvency. In the event the insurer's financial condition will not, in the judgment of the receiver, support the full performance of all policy claims obligations during the appeal pendency period, the plan may prefer the claims of certain policyholders and claimants over creditors and interested parties as well as other policyholders and claimants, as the receiver believes to be fair and equitable considering the relative circumstances of such policyholders and claimants. The court shall examine the plan submitted by the receiver and if it finds the plan to be in the best interests of the parties, the court shall approve the plan. No action shall lie against the receiver based on preference in an appeal pendency plan approved by the court.

(2) The appeal pendency plan shall not supersede or affect the guarantee obligations of the Corporation or any insurance guaranty association.

(3) Any such plan shall provide for equitable adjustments to be made by the Liquidator to any distributions of assets to the Corporation or to any state guaranty associations, in the event that the Liquidator pays claims from the assets of the estate, which would otherwise be the obligations of the Corporation as guarantor or of any state guaranty association but for the appeal of the order of liquidation, such that the Corporation and/or all guaranty associations equally benefit on a pro rata basis from the assets of the estate. Further, even though the order of liquidation is set aside upon any appeal, the insurer shall not be released from receivership unless and until all funds advanced by the Corporation or any state guaranty association, including reasonable administrative expenses in connection therewith relating to obligations of the company, shall be repaid in full, together with interest.

Section 45. Continuance of coverage.

All policies, including bonds and other noncancellable business, in effect at the time of issuance of an order of liquidation shall continue in force only for the lesser of:

(a) a period of thirty (30) days from the date of entry of the liquidation order;

(b) the date of expiration of the policy coverage;

(c) the date when the insured has replaced the insurance coverage with equivalent insurance in another insurer or otherwise terminated the policy;

(d) the effective date the Liquidator has effected a transfer of the policy obligation; or

(d) the date proposed by the Liquidator and approved by the court to cancel coverage.

Section 46. Dissolution of insurer.

The receiver may petition for an order dissolving the corporate existence of the insurer, or its United States branch in the case of an alien insurer, at the time it applies for a liquidation order or subsequently. The court shall order dissolution of the Corporation upon or after the granting of a liquidation order.

Section 47. Powers of Liquidator.

(a) The Liquidator shall have the power:

(1) To employ employees and agents, legal counsel, actuaries, accountants, appraisers, consultants and such other personnel as it may deem necessary to conduct the liquidation.

(2) To appoint, with the approval of the court, an advisory committee of representatives of policyholders, claimants, other creditors, and other persons or groups with substantial interest in the liquidation proceeding, if such a committee be deemed necessary. The members of any such committee shall serve without payment by the insurer or from the insurer's assets of compensation or of reimbursement for costs, expenses, or fees of attorneys or other consultants or assistants, other than reimbursement for reasonable travel and per diem living expenses. No member of any other committee or representative of any interested person or group, other than the Liquidator and its employees, agents, attorneys, and consultants, or a person directly appointed by the district court upon the sole initiative of the court itself to assist or advise it, shall be paid by the insurer or from the insurer's assets for any costs, expenses, or fees of attorneys or other consultants or assistants.

(3) To fix the reasonable compensation of employees and agents, legal counsel, actuaries, accountants, appraisers and consultants with the approval of the court.

(4) To pay reasonable compensation to persons appointed and to pay from the funds or assets of the insurer all expenses of taking possession of, conserving, conducting, liquidating, disposing of, or otherwise dealing with the business and property of the insurer. In the event that the estate of the insurer does not contain sufficient cash or liquid assets to defray the costs incurred, the Corporation may advance the costs so incurred from its general funds. Any amounts so advanced for expenses of administration shall be repaid to the Corporation out of the first available moneys of the insurer.

(5) To petition the court to appoint one or more special masters to hold hearings, subpoena witnesses to compel their attendance, to administer oaths, to examine any person under oath, to compel any person to subscribe to its testimony after it has been correctly reduced to writing; and in connection therewith to require the production of any books, papers, records or other documents relevant to the liquidation.

(6) To audit the books and records of all agents of the insurer insofar as those records relate to the business activities of the insurer.

(7) To collect all debts and moneys due and claims belonging to the insurer, wherever located, and for this purpose:

(A) To institute timely action in other courts to forestall garnishment and attachment proceedings against such debts;

(B) To do such other acts as are necessary or expedient to collect, conserve or protect its assets or property, including the power to sell, compound, compromise or assign debts for purposes of collection upon such terms and conditions as he deems best; and

(C) To pursue any creditor's remedies available to enforce its claims.

(8) To conduct public and private sales of the property of the insurer.

(9) To use assets of the estate of an insurer under a liquidation order to transfer policy obligations to a solvent assuming insurer, if the transfer can be arranged without prejudice to applicable priorities.

(10) To acquire, hypothecate, encumber, lease, improve, sell, transfer, abandon or otherwise dispose of or deal with, any property of the insurer at its market value or upon such terms and conditions as are fair and reasonable. It shall also have power to execute, acknowledge and deliver any and all deeds, assignments, releases and other instruments necessary or proper to effectuate any sale of property or other transaction in connection with the liquidation.

(11) To borrow money on the security of the insurer's assets or without security and to execute and deliver all documents necessary to that transaction for the purpose of facilitating the liquidation. Any such funds borrowed may be repaid as an administrative expense and have priority over any other claims in Class 1 under the priority of distribution.

(12) To enter into such contracts as are necessary to carry out the order to liquidate, and to affirm or disavow any contracts to which the insurer is a party.

(13) To continue to prosecute and to institute in the name of the insurer or in its own name any and all suits and other legal proceedings, and to abandon the prosecution of claims it deems unprofitable to pursue further. If the insurer is dissolved, it shall have the power to apply to any court for leave to substitute itself for the insurer as party to any action or proceeding.

(14) To prosecute any action which may exist in behalf of the creditors, members, policyholders or shareholders of the insurer against any officer of the insurer, or any other person.

(15) To remove any or all records and property of the insurer to the offices of the Corporation or to such other place as may be convenient for the purposes of efficient and orderly execution of the liquidation.

(16) To deposit in one or more banks such sums as are required for meeting current administration expenses and dividend distributions.

(17) To invest all sums not currently needed, unless the court orders otherwise.

(18) To file any necessary documents for record in the office of any recorder of deeds or record office where property of the insurer is located.

(19) To assert all defenses available to the insurer as against third persons, including statutes of limitation, statutes of frauds, and the defense of usury. A waiver of any defense by the insurer after a petition for order of liquidation has been filed shall not bind the Liquidator.

(20) To exercise and enforce all the rights, remedies, and powers of any creditor, shareholder, policyholder, or member, including any power to avoid any transfer or lien that may be given by the general law and that is not included with Sections 50 through 52.

(21) To intervene in any proceeding wherever instituted that affects the insurer or its assets.

(22) To enter into agreements with any receiver or state insurance regulator relating to the rehabilitation, liquidation, conservation or dissolution of the insurer or any other insurer.

(23) To exercise all powers now held or hereafter conferred upon receivers by the laws of the United States.

(b) (1) If a company placed in liquidation issued liability policies on a claims-made basis, which provided an option to purchase an extended period to report claims, then the Liquidator may make available to holders of such policies, for a charge, an extended period to report claims as stated herein. The

extended reporting period shall be made available only to those insureds who have not secured substitute coverage. The extended period made available by the Liquidator shall begin upon termination of any extended period to report claims in the basic policy and shall end at the earlier of the final date for filing of claims in the liquidation proceeding or eighteen (18) months from the order of liquidation or the order appointing the Corporation as Liquidator whichever order was the last to be made.

(2) The extended period to report claims made available by the Liquidator shall be subject to the terms of the policy to which it relates. The Liquidator shall make available such extended period within sixty (60) days after the order of liquidation at a charge to be determined by the Liquidator subject to approval of the court. Such offer shall be deemed rejected unless the offer is accepted in writing and the charge is paid within ninety (90) days after the order of liquidation. No commissions, premium taxes, assessments or other fees shall be due on the charge pertaining to the extended period to report claims.

(c) The enumeration, in this section, of the powers and authority of the Liquidator shall not be construed as a limitation upon it, nor shall it exclude in any manner its right to do such other acts not herein specifically enumerated or otherwise provided for, as may be necessary or appropriate for the accomplishment of or in aid of the purpose of liquidation.

(d) Notwithstanding the powers of the Liquidator as stated in subsections (a) and (b) above, the Liquidator shall have no obligation to defend claims or to continue to defend claims subsequent to the entry of a liquidation order.

Section 48. Notice to creditors and others.

(a) Unless the court otherwise directs, the Liquidator shall give or cause to be given notice of the liquidation order as soon as possible:

(1) by first class mail and either by telephone in facsimile transmission or telephone to the state insurance regulator of each jurisdiction in which the insurer was domiciled, licensed, or transacted insurance business;

(2) by first class mail to any state guaranty association which has paid guaranty obligations on behalf of the insurer, or is or may become obligated to do so;

(3) by first class mail to all insurance agents of the insurer;

(4) by first class mail to all persons known or reasonably expected to have claims against the insurer including all current policyholders, at their last known address as indicated by the records of the insurer; and

(5) by publication in a newspaper of general circulation in the county in which the insurer has its principal place of business and in such other locations as the Liquidator deems appropriate.

(b) Except as otherwise established by the Liquidator with approval of the court, notice to potential claimants under subsection (a) shall require claimants to file with the Liquidator their claims together with proper proofs thereof on or before a date the Liquidator shall specify in the notice. All claimants shall have a duty to keep the Liquidator informed of any changes of address.

(c) If notice is given in accordance with this section, the distribution of assets of the insurer shall be conclusive with respect to all claimants, whether or not they received notice.

Section 49. Duties of agents.

Every person who receives notice that an insurer which the person represents as an agent is the subject of a liquidation order shall within thirty (30) days of such notice provide to the Liquidator the information in the agent's records related to any policy issued by the insurer through the agent, and, if the agent is a general agent, the information in the general agent's records related to any policy issued by the insurer through an agent under contract to the general agent, including the name and address of such subagent. A policy shall be deemed issued through an agent if the agent has a property interest in the expiration of the policy, or if the agent has had in its possession a copy of the declarations of the policy at any time during the life of the policy, except where the ownership of the expiration of the policy has been transferred to another.

Section 50. Fraudulent transfers prior to petition.

(a) Every transfer made or suffered and every obligation incurred by an insurer within one year prior to the filing of a successful petition for rehabilitation or liquidation is fraudulent as to then existing and future creditors if made or incurred without fair consideration, or with actual intent to hinder, delay or defraud either existing or future creditors. A transfer made or an obligation incurred by an insurer ordered to be rehabilitated or liquidated, which is fraudulent under this section, may be avoided by the receiver, except as to a person who in good faith is a purchaser, lienor or obligee for a present fair equivalent value, and except that any purchaser, lienor or obligee, who in good faith has given a consideration less than fair for such transfer, lien, or obligation, may retain the property, lien or obligation as security for repayment. The court may, on due notice, order any such transfer or obligation to be preserved for the benefit of the estate, and in that event the receiver shall succeed to and may enforce the rights of the purchaser, lienor, or obligee.

(b) (1) A transfer of property other than real property shall be deemed to be made or suffered when it becomes so far perfected that no subsequent lien obtainable

by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee.

(2) A transfer of real property shall be deemed to be made or suffered when it becomes so far perfected that no subsequent bona fide purchaser from the insurer could obtain rights superior to the rights of the transferee.

(3) A transfer which creates an equitable lien shall not be deemed to be perfected if there are available means by which a legal lien could be created.

(4) Any transfer not perfected prior to the filing of a petition for liquidation shall be deemed to be made immediately before the filing of the successful petition.

(5) The provisions of this subsection apply whether or not there are or were creditors who might have obtained any liens or persons who might have become bona fide purchasers.

(c) Any transaction of the insurer with a reinsurer shall be deemed fraudulent and may be avoided by the receiver under subsection (a) if:

(1) The transaction consists of the termination, adjustment or settlement of a reinsurance contract in which the reinsurer is released from any part of its duty to pay the originally specified share of losses that had occurred prior to the time of the transactions, unless the reinsurer gives a present fair equivalent value for the release; and

(2) any part of the transaction took place within one year prior to the date of filing of the petition through which the receivership was commenced.

(d) Every person receiving any property from the insurer or any benefit thereof which is a fraudulent transfer under subsection (a) shall be personally liable therefor and shall be bound to account to the Liquidator.

Section 51. Fraudulent transfers after petition.

(a) After a petition for rehabilitation or liquidation has been filed, a transfer of any of the real property of the insurer made to a person acting in good faith shall be valid against the receiver if made for a present fair equivalent value; or, if not made for a present fair equivalent value, then to the extent of the present consideration actually paid therefore, for which amount the transferee shall have a lien on the property so transferred. The commencement of a proceeding in rehabilitation or liquidation shall be constructive notice upon the recording of a copy of the petition for or order of rehabilitation or liquidation with the recorder of deeds in the county where any real property in question is located. The exercise by a court of the United States or any state of jurisdiction to authorize or effect a judicial sale of real property of the insurer within any county in any state shall not

be impaired by the pendency of such a proceeding unless the copy is recorded in the county prior to the consummation of the judicial sale.

(b) After a petition for rehabilitation or liquidation has been filed and before either the receiver takes possession of the property of the insurer or an order of rehabilitation or liquidation is granted:

(1) A transfer of any of the property of the insurer, other than real property, made to a person acting in good faith shall be valid against the receiver if made for a present fair equivalent value; or, if not made for a present fair equivalent value, then to the extent of the present consideration actually paid therefor, for which amount the transferee shall have a lien on the property so transferred.

(2) A person indebted to the insurer or holding property of the insurer may, if acting in good faith, pay the indebtedness or deliver the property, or any part thereof, to the insurer or upon his order, with the same effect as if the petition were not pending.

(3) A person having actual knowledge of the pending rehabilitation or liquidation shall be deemed not to act in good faith.

(4) A person asserting the validity of a transfer under this section shall have the burden of proof. Except as elsewhere provided in this section, no transfer by or on behalf of the insurer after the date of the petition for liquidation by any person other than the Liquidator shall be valid against the Liquidator.

(c) Every person receiving any property from the insurer or any benefit thereof which is a fraudulent transfer under subsection (a) shall be personally liable therefore and shall be bound to account to the Liquidator.

(d) Nothing in this Act shall impair the negotiability of currency or negotiable instruments.

Section 52. Voidable preferences and liens.

(a) (1) A preference is a transfer of any of the property of an insurer to or for the benefit of a creditor, for or on account of an antecedent debt, made or suffered by the insurer within one year before the filing of a successful petition for liquidation under this Act, the effect of which transfer may be to enable the creditor to obtain a greater percentage of its debt than another creditor of the same class would receive. If a liquidation order is entered while the insurer is already subject to a rehabilitation order, then such transfers shall be deemed preferences if made or suffered within one year before the filing of the successful petition for rehabilitation, or within two (2)

years before the filing of the successful petition for liquidation, whichever time is shorter.

(2) Any preference may be avoided by the Liquidator if:

(A) the insurer was insolvent at the time of the transfer; or

(B) the transfer was made within four (4) months before the filing of the petition; or

(C) the creditor receiving it or to be benefited thereby or his agent acting with reference thereto had, at the time when the transfer was made, reasonable cause to believe that the insurer was insolvent or was about to become insolvent; or

(D) the creditor receiving it was an officer, or any employee or attorney or other person who was in fact in a position of comparable influence in the insurer to an officer whether or not he held such position, or any shareholder holding directly or indirectly more than five percent (5%) of any class of any equity security issued by the insurer, or any other person, firm, corporation, association, or aggregation of persons with whom the insurer did not deal at arm's length.

(3) Where the preference is voidable, the Liquidator may recover the property or, if it has been converted, its value from any person who has received or converted the property; except where a bona fide purchaser or lienor has given less than fair equivalent value, it shall have a lien upon the property to the extent of the consideration actually given by it. Where a preference by way of lien or security title is voidable, the court may on due notice order the lien or title to be preserved for the benefit of the estate, in which event the lien or title shall pass to the Liquidator.

(b) (1) A transfer of property other than real property shall be deemed to be made or suffered when it becomes so far perfected that no subsequent lien obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee.

(2) A transfer of real property shall be deemed to be made or suffered when it becomes so far perfected that no subsequent bona fide purchaser from the insurer could obtain rights superior to the rights of the transferee.

(3) A transfer which creates an equitable lien shall not be deemed to be perfected if there are available means by which a legal lien could be created.

(4) A transfer not perfected prior to the filing of a petition for liquidation shall be deemed to be made immediately before the filing of the successful petition.

(5) The provisions of this subsection apply whether or not there are or were creditors who might have obtained liens or persons who might have become bona fide purchasers.

(c) (1) A lien obtainable by legal or equitable proceedings upon a simple contract is one arising in the ordinary course of such proceedings upon the entry or docketing of a judgment or decree, or upon attachment, garnishment, execution, or like process, whether before, upon, or after judgment or decree and whether before or upon levy. It does not include liens which under applicable law are given a special priority over other liens which are prior in time.

(2) A lien obtainable by legal or equitable proceedings could become superior to the rights of a transferee, or a purchaser could obtain rights superior to the rights of a transferee within the meaning of subsection (b), if such consequences would follow only from the lien or purchase itself, or from the lien or purchase followed by any step wholly within the control of the respective lienholder or purchaser, with or without the aid of ministerial action by public officials. Such a lien could not, however, become superior and such a purchase could not create superior rights for the purpose of subsection (b) through any acts subsequent to the obtaining of such a lien or subsequent to such a purchase which require the agreement or concurrence of any third party or which require any further judicial action or ruling.

(d) A transfer of property for or on account of a new and contemporaneous consideration which is deemed under subsection (b) to be made or suffered after the transfer because of delay in perfecting it does not thereby become a transfer for or on account of an antecedent debt if any acts required by the applicable law to be performed in order to perfect the transfer as against liens or bona fide purchasers' rights are performed within twenty-one (21) days or any period expressly allowed by the law, whichever is less. A transfer to secure a future loan, if such a loan is actually made, or a transfer which becomes security for a future loan, shall have the same effect as a transfer for or on account of a new and contemporaneous consideration.

(e) If any lien deemed voidable under subsection (a)(2) has been dissolved by the furnishing of a bond or other obligation, the surety on which has been indemnified directly or indirectly by the transfer of or the creation of a lien upon any property of an insurer before the filing of a petition which results in a liquidation order, the indemnifying transfer or lien shall also be deemed voidable.

(f) The property affected by any lien deemed voidable under subsections (a) and (e) shall be discharged from such lien, and that property and any of the indemnifying property transferred to or for the benefit of a surety shall pass to the Liquidator, except that the court may on due notice order any such lien to be preserved for the benefit of the estate and the court may direct that such conveyance be executed as may be proper or adequate to evidence the title of the Liquidator.

(g) The district court shall have summary jurisdiction of any proceeding by the Liquidator to hear and determine the rights of any parties under this section. Reasonable notice of any hearing in the proceeding shall be given to all parties in interest, including the obligee of a releasing bond or other like obligation. Where an order is entered for the recovery of indemnifying property in kind or for the avoidance of an indemnifying lien, the court, upon application of any party in interest, shall in the same proceeding ascertain the value of the property or lien, and if the value is less than the amount for which the property is indemnity or than the amount of the lien, the transferee or lienholder may elect to retain the property or lien upon payment of its value, as ascertained by the court, to the Liquidator, within such reasonable times as the court shall fix.

(h) The liability of the surety under a releasing bond or other like obligation shall be discharged to the extent of the value of the indemnifying property recovered or the indemnifying lien nullified and avoided by the Liquidator, or where the property is retained under subsection (g) to the extent of the amount paid to the Liquidator.

(i) If a creditor has been preferred, and afterward in good faith gives the insurer further credit without security of any kind, for property which becomes a part of the insurer's estate, the amount of the new credit remaining unpaid at the time of the petition may be set off against the preference which would otherwise be recoverable from him.

(j) If an insurer shall, directly or indirectly, within four (4) months before the filing of a successful petition for liquidation, or at any time in contemplation of a proceeding to liquidate it, pay money or transfer property to an attorney-at- law for services rendered or to be rendered, the transactions may be examined by the court on its own motion or shall be examined by the court on petition of the Liquidator and shall be held valid only to the extent of a reasonable amount to be determined by the court, and the excess may be recovered by the Liquidator for the benefit of the estate provided that where the attorney is in a position of influence in the insurer or an affiliate thereof payment of any money or the transfer of any property to the attorney-at-law for services rendered or to be rendered shall be governed by the provision of subsection (a)(2)(D).

(k) (1) Every officer, manager, employee, shareholder, member, subscriber, attorney or any other person acting on behalf of the insurer who knowingly participates in giving any preference while having reasonable cause to believe the insurer is or is about to become insolvent at the time of the preference shall be personally liable to the Liquidator for the amount of the preference. It is permissible to infer that there is a reasonable cause to so believe if the transfer was made within four (4) months before the date of filing of this successful petition for liquidation.

(2) Every person receiving any property from the insurer or the benefit thereof as a preference voidable under subsection (a) shall be personally liable therefore and shall be bound to account to the Liquidator.

(3) Nothing in this subsection shall prejudice any other claim by the Liquidator against any person.

Section 53. Claims of holders of void or voidable rights.

(a) No claims of a creditor who has received or acquired a voidable preference, lien, conveyance, transfer, assignment or encumbrance voidable shall be allowed unless it surrenders the preference, lien, conveyance, transfer, assignment or encumbrance. If the avoidance is effected by a proceeding in which a final judgment has been entered, the claim shall not be allowed unless the money is paid or the property is delivered to the Liquidator within thirty (30) days from the date of the entering of the final judgment, except that the court having jurisdiction over the liquidation may allow further time if there is an appeal or other continuation of the proceeding.

(b) A claim allowable under subsection (a) by reason of the avoidance, whether voluntary or involuntary, or a preference, lien, conveyance, transfer, assignment or encumbrance, may be filed as an excused late filing under Section 59 if filed within thirty (30) days from the date of the avoidance, or within the further time allowed by the court under subsection (a).

Section 54. Setoffs and counterclaims.

(a) Mutual debts or mutual credits between the insurer in liquidation and another person shall be set off and the balance only shall be allowed or paid, except as provided in subsection (b) and Section 57.

(b) No setoff or counterclaim shall be allowed in favor of any person where:

(1) the obligation of the insurer to the person would not at the date of the filing of a petition for liquidation entitle the person to share as a claimant in the assets of the insurer;

(2) the obligation of the insurer to the person was purchased by or transferred to the person with a view to its being used as a setoff;

(3) the obligation of the person is to pay an assessment levied against the members or subscribers of the insurer, or is to pay a balance upon a subscription to the capital stock of the insurer, or is in any other way in the nature of a capital contribution; or

(4) the obligation of either the person or the insurer is to pay, or pay over, premiums to or for the account of the other, whether earned or unearned, and whether for direct insurance, reinsurance, joint or shared insurance, assumed insurance, or the division of pooled insurance.

Section 55. Assessable policies.

(a) As soon as practicable but not more than two (2) years from the date of an order of liquidation of an insurer issuing assessable policies, the Liquidator shall make a report to the court setting forth:

(1) the reasonable value of the assets of the insurer;

(2) the insurer's probable total liabilities;

(3) the probable aggregate amount of the assessment necessary to pay all claims of creditors and expenses in full, including expenses of administration and costs of collecting the assessment; and

(4) a recommendation as to whether or not an assessment should be made and in what amount.

(b) (1) Upon the basis of the report provided in subsection (a), including any supplements and amendments thereto, the district court may levy one or more assessments against all members of the insurer who are subject to assessment.

(2) Subject to any applicable legal limits on assessability, the aggregate assessment shall be for the amount that the sum of the probable liabilities, the expenses of administration, and the estimated cost of collection of the assessment, exceeds the value of existing assets, with due regard being given to assessments that cannot be collected economically.

(c) After levy of assessment under subsection (b), the district court on application of the Liquidator shall issue an order directing each member who has not paid the assessment pursuant to the levy to show cause why judgment should not be entered on the assessment.

(d) The Liquidator shall give notice of the order by publication and by first class mail to each member liable thereunder mailed to its last known address as it appears on the insurer's records, at least twenty (20) days before the return day of the order to show cause.

(e) (1) If a member does not appear and serve duly verified objections upon the Liquidator on or before the return day of the order to show cause under subsection (c), the court shall make an order adjudging the member liable for the amount of the assessment against it pursuant to subsection (c), together with costs, and the Liquidator shall have a judgment against the member therefor.

(2) If on or before such return day, the member appears and serves duly verified objections upon the Liquidator, the Liquidator may hear and determine the matter, or may appoint a referee to hear it and make such an order as the facts warrant. In the event that the Liquidator determines that such objections do

not warrant relief from assessment, the member may request the court to review the matter and vacate the order to show cause.

(f) The Liquidator may enforce any order or collect any judgment under subsection (e) by any lawful means.

Section 56. Reinsurer's liability.

The amount recoverable by the Liquidator from reinsurers shall not be reduced as a result of the liquidation proceedings, regardless of any provision in the reinsurance contract or other agreement. Payment made directly to an insured or other creditor shall not diminish the reinsurer's obligation to the insurer's estate except when the reinsurance contract provided for direct coverage of a named insured and the payment was made in discharge of that obligation.

Section 57. Recovery of premiums owed.

(a) (1) An agent, broker, premium finance company, or any other person, other than the insured, responsible for the payment of a premium shall be obligated to pay any unpaid premium for the full policy term due the insurer at the time of the declaration of insolvency, whether earned or unearned, as shown on the records of the insurer. The Liquidator shall also have the right to recover from such person any part of an unearned premium that represents commission of such person. Credits or setoffs or both shall not be allowed to an agent, broker, or premium finance company for any amounts advanced to the insurer by the agent, broker, or premium finance company on behalf of, but in the absence of a payment by, the insured.

(2) An insured shall be obligated to pay any unpaid earned premium due the insurer at the time of the order of liquidation as shown on the records of the insurer.

Section 58. Liquidator's proposal to distribute assets.

(a) Within 120 days of a final determination of insolvency by the district court the Liquidator shall make application to the court for approval of a proposal to disburse assets out of marshalled assets, from time to time as such assets become available, and to reimburse the Corporation for amounts paid on guarantee obligations. If the Liquidator determines that there are insufficient assets to disburse, the application required by this section shall be considered satisfied by a filing by the Liquidator stating the reasons for this determination.

(b) Such proposal shall at least include provisions for:

(1) reserving amounts for the payment of expenses of administration and the payment of claims of secured creditors, to the extent of the value of the security held, and claims falling within the priorities established in Section 67, Classes 1 and 2;

(2) disbursement of the assets marshalled to date and subsequent disbursement of assets as they become available;

(3) equitable allocation of disbursements to the Corporation or state guaranty associations for reimbursement of costs advanced or guarantee obligations paid.

(c) The Liquidator's proposal may provide for disbursements to the Corporation or to state guaranty associations for amounts estimated to be the amounts of the claim payments to be made in the future by the Corporation or state guaranty associations upon guarantees and for which claims could be asserted against the estate. The Corporation or any state guaranty association receiving such advances shall account to the court from time to time as to the application of such advances, the claims obligations paid and the investment yield on the advances, which shall be applied as if part of the advances.

(d) Notice of such application shall be given to the state insurance regulators of each of the states. Any such notice shall be deemed to have been given when deposited in the United States certified mails, first class postage prepaid, at least thirty (30) days prior to submission of such application to the court. Action on the application may be taken by the court provided the above required notice has been given and provided further that the Liquidator's proposal complies with subsection (b)(1) and (b)(2).

Section 59. Filing of claims.

(a) Proof of all claims shall be filed with the Liquidator in the form required by Section 60 on or before the last day for filing specified in the notice required under Section 48.

(b) The Liquidator may permit a claimant making a late filing to share in distributions, whether past or future, as if it were not late, to the extent that any such payment will not prejudice the orderly administration of the liquidation, under the following circumstances:

(1) the existence of the claim was not known to the claimant and that it filed its claim as promptly thereafter as reasonably possible after learning of it;

(2) a transfer to the creditor was avoided under Sections 50 through 52, or was voluntarily surrendered under Section 53, and that the filing satisfies the conditions of Section 53.

(3) the valuation under Section 65 of security held by a secured creditor shows a deficiency, which is filed within thirty (30) days after the valuation; and

(c) The Liquidator shall permit late filing claims to share in distributions, whether past or future, as if they were not late, if such claims are claims of a state guaranty association for reimbursement of covered claims paid or expenses incurred, or both, subsequent to the last day for filing where such payments were made and expenses incurred as provided by law.

(d) The Liquidator may consider any claim filed late which is not covered by subsection (b), and permit it to receive distributions which are subsequently declared on any claims of the same or lower priority if the payment does not prejudice the orderly administration of the liquidation. The late-filing claimant shall receive, at each distribution, the same percentage of the amount allowed on its claim as is then being paid to claimants of any lower priority. This shall continue until its claim has been paid in full.

Section 60. Proof of claim.

(a) Proof of claim shall consist of a statement signed by the claimant that includes all of the following that are applicable;

(1) the particulars of the claim including the consideration given for it;

(2) the identity and amount of the security on the claim;

(3) the payments made on the debt, if any;

(4) that the sum claimed is justly owing and that there is no setoff, counterclaim or defense to the claim;

(5) any right of priority of payment or other specific right asserted by the claimants;

(6) a copy of the written instrument which is the foundation of the claim; and

(7) the name and address of the claimant and the attorney who represents it, if any.

(b) No claim need be considered or allowed if it does not contain all the information in subsection (a) which may be applicable. The Liquidator may require that a prescribed form be used, and may require that other information and documents be included.

(c) At any time the Liquidator may request the claimant to present information or evidence supplementary to that required under subsection (a) and may take statements under oath, require production of affidavits or depositions, or otherwise obtain additional information or evidence.

(d) No judgment or order against an insured or the insurer entered after the date of filing of a successful petition for liquidation, and no judgment or order against an insured or the insurer entered at any time by default or by collusion, need be considered as evidence of liability or of amount of damages. No judgment or order against an insured or the insurer entered within four (4) months before the filing of the petition need be considered as evidence of liability or of the amount of damages.

(e) All claims of a state guaranty association shall be in such form and contain such substantiation as may be agreed to by the Liquidator.

Section 61. Special claims.

(a) The claim of a third party which is contingent only on its first obtaining a judgment against the insured shall be considered and allowed as if there were no such contingency.

(b) A claim may be allowed even if contingent, if it is filed in accordance with Section 59. It may be allowed and may participate in all distributions declared after it is filed to the extent that it does not prejudice the orderly administration of the liquidation.

(c) Claims that are due except for the passage of time shall be treated as absolute claims are treated, except that such claims may be discounted at the legal rate of interest.

(d) Claims made under employment contracts by directors, principal officers, or persons in fact performing similar functions or having similar powers are limited to payment for services rendered prior to the making of any order of rehabilitation or liquidation.

Section 62. Special provisions for third party claims.

(a) Whenever any third party asserts a cause of action against an insured of an insurer in liquidation, the third party may file a claim with the Liquidator.

(b) Whether or not the third party files a claim, the insured may file a claim on its own behalf in the liquidation. If the insured fails to file a claim by the date for filing claims specified in the order of liquidation or within sixty (60) days after mailing of the notice required by Section 48, whichever is later, it is an unexcused late filer.

(c) The Liquidator shall make its recommendations to the court under Section 68 for the allowance of an insured's claim under subsection (b) after consideration of the probable outcome of any pending action against the insured on which the claim is based, the probable damages recoverable in the action and the probable costs and expenses of defense. After allowance by the court, the Liquidator shall withhold any dividends payable on the claim, pending the outcome of litigation and negotiation with the insured. Whenever it seems appropriate, it shall reconsider the claim on the basis of additional

information and amend its recommendations to the court. The insured shall be afforded the same notice and opportunity to be heard on all changes in the recommendation as in its initial determination. The court may amend its allowance as it thinks appropriate. As claims against the insured are settled or barred, the insured shall be paid from the amount withheld the same percentage dividend as was paid on other claims of like priority, based on the lesser of (i) the amount actually recovered from the insured by action or paid by agreement plus the reasonable costs and expense of defense, or (ii) the amount allowed on the claims by the court. After all claims are settled or barred, any sum remaining from the amounts withheld shall revert to the undistributed assets of the insurer. Delay in final payment under this subsection shall not be a reason for unreasonable delay of final distribution and discharge of the Liquidator.

(d) If several claims founded upon one policy are filed, whether by third parties or as claims by the insured under this section, and the aggregate allowed amount of the claims to which the same limit of liability in the policy is applicable exceeds that limit, each claim as allowed shall be reduced in the same proportion so that the total equals the policy limit. Claims by the insured shall be evaluated as in subsection (c). If any insured's claim is subsequently reduced under subsection (c), the amount thus freed shall be apportioned ratably among the claims which have been reduced under this subsection.

(e) No claim may be presented under this section if it has been paid or is obligated to be paid by any state guaranty association.

Section 63. Disputed claims.

(a) When a claim is denied in whole or in part by the Liquidator, written notice of the determination shall be given to the claimant or its attorney by first class mail at the address shown in the proof of claim. Within sixty (60) days from the mailing of the notice, the claimant may file its objections with the Liquidator. If no such filing is made, the claimant may not further object to the determination.

(b) Whenever objections are filed with the Liquidator and the Liquidator does not alter its denial of the claim as a result of the objections, the Liquidator shall ask the court for a hearing as soon as practicable and give notice of the hearing by first class mail to the claimant or its attorney and to any other persons directly affected, not less than ten (10) nor more than thirty (30) days before the date of the hearing. The matter may be heard by the court or by a court-appointed master who shall submit findings of fact and a recommended decision.

Section 64. Claims of surety.

Whenever a creditor whose claim against an insurer is secured, in whole or in part, by the undertaking of another person, fails to prove and file that claim, the other person may do so in the creditor's name, and shall be subrogated to the rights of the creditor, whether the claim has been filed by the creditor or by the other person in the creditor's name, to the

extent that it discharges the undertaking. In the absence of an agreement with the creditor to the contrary, the other person shall not be entitled to any distribution, however, until the amount paid to the creditor on the undertaking plus the distributions paid on the claim from the insurer's estate to the creditor equals the amount of the entire claim of the creditor. Any excess received by the creditor shall be held by it in trust for such other person. The term "other person" as used in this section is not intended to apply to the Corporation as guarantor or to a state guaranty association.

Section 65. Secured creditors' claims.

(a) The value of any security held by a secured creditor shall be determined in one of the following ways, as the court may direct:

(1) by converting the same into money according to the terms of the agreement pursuant to which the security was delivered to such creditor; or

(2) by agreement, arbitration, compromise or litigation between the creditor and the Liquidator.

(b) The determination shall be under the supervision and control of the court with due regard for the recommendation of the Liquidator. The amount so determined shall be credited upon the secured claim, and any deficiency shall be treated as an unsecured claim. If the claimant shall surrender its security to the Liquidator, the entire claim shall be allowed as if unsecured.

Section 66. Equalization of secured claims against insurers.

(a) In the liquidation of the general assets of the insurer unsecured creditors shall be preferred to secured creditors to the extent necessary to equalize the advantage gained by virtue of such security.

(b) The following shall be treated as secured claims for the purpose of this section:

(1) Claims secured by adequate process of law or by lien.

(2) Claims secured individually by deposit of funds, by funds held in escrow or in trust, or by bond.

(3) Claims secured generally by deposit or bond to secure the payment of claims of a particular class or group of insureds. This provision, however, shall not be construed to include claims which are secured by deposit or bond for the benefit of all claimants of the company within the United States.

(4) Claims which have been filed with another receiver not predecessor or ancillary to the proceeding.

(c) Any or all of the above shall be treated as unsecured provided all rights to the specific security have been surrendered to the Liquidator or provided that the assets in the possession of a non-ancillary receiver or liquidator have been transferred to the Liquidator.

Section 67. Priority of distribution.

The priority of distribution of claims from the insurer's estate shall be in accordance with the order in which each class of claims is herein set forth. Every claim in each class shall be paid in full or adequate funds retained for such payment before the members of the next class receive any payment. No subclasses shall be established within any class. The order of distribution of claims shall be:

(a) Class 1. The costs and expenses of administration during rehabilitation and liquidation, including but not limited to

(1) the actual and necessary costs of preserving or recovering the assets of the insurer;

(2) compensation for all authorized services rendered in the rehabilitation and liquidation, including reasonable compensation to the Corporation as approved by the court to cover the portion of the total expenses of the Corporation which are reasonably related to the conduct by it of the rehabilitation or liquidation of the insurer, without provision for any profit to the Corporation;

(3) any necessary filing fees;

(4) the fees and mileage payable to witnesses;

(5) authorized reasonable attorney's fees and other professional services rendered in the rehabilitation and liquidation;

(6) the reasonable expenses of a state guaranty association for unallocated loss adjustment expenses, if the association paid claims on behalf of the insurer or is obligated to do so.

(b) Class 2. Reasonable compensation to employees for services performed to the extent that they do not exceed two (2) months of monetary compensation and represent payment for services performed within one year before the filing of the petition for liquidation or, if rehabilitation preceded liquidation, within one year before the filing of the petition for rehabilitation. Principal officers and directors shall not be entitled to the benefit of this priority except as otherwise approved by the Liquidator and the court. Such priority shall be in lieu of any other similar priority which may be authorized by law as to wages or compensation of employees.

(c) Class 3. All claims under policies, including such claims of the federal or any state or local government, for losses incurred ("loss claims") and including third party claims and all claims of the Corporation and a state guaranty association for claims paid by it except the first $300 of any claim, other than a claim for workers' compensation, where the obligation of the insurer is direct to the insured (or "first party"). That portion of any loss, indemnification for which is provided by other benefits or advantages recovered by the claimant, shall not be included in this class, other than benefits or advantages recovered or recoverable in discharge of familial obligation of support or by way of succession at death or as proceeds of life insurance, or as gratuities. No payment by an employer to its employee shall be treated as a gratuity.

(d) Class 4. Claims under nonassessable policies for unearned premium or other premium refunds, claims of general creditors including claims of ceding and assuming insurers and reinsurers in their capacity as such, claims for the first $300 of any claim excepted from payment by the deduction in subsection (c) above, and claims of the federal or any state or local government except those under Class 3 above. Claims, including those of any governmental body for a penalty or forfeiture, shall be allowed in this class only to the extent of the pecuniary loss sustained from the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby. The remainder of such claims shall be postponed to the class of claims under subsection (g).

(e) Class 5. Claims filed late and all other claims other than claims under Classes 6 and 7.

(f) Class 6. Surplus or contribution notes, or similar obligations, and premium refunds on assessable policies. Payments to members of domestic mutual insurance companies shall be limited in accordance with applicable state law.

(g) Class 7. The claims of shareholders or other owners in their capacity as shareholders.

Section 68. Liquidator's recommendations to the court.

(a) The Liquidator shall review all claims duly filed in the liquidation and shall make such further investigation as it shall deem necessary. It may compound, compromise or in any other manner negotiate the amount for which claims will be recommended to the court except where the Liquidator is required by law to accept claims as settled by any person or organization. Unresolved disputes shall be determined under Section 63. As soon as practicable, it shall present to the court a report of the claims against the insurer with its recommendations. The report shall include the name and address of each claimant and the amount of the claim finally recommended, if any.

(b) The court may approve, disapprove or modify the report on claims by the Liquidator. Such reports as are not modified by the court within a period of sixty (60) days

following submission by the Liquidator shall be treated by the Liquidator as allowed claims, subject thereafter to later modification or to rulings made by the court pursuant to Section 63. No claim under a policy of insurance shall be allowed for an amount in excess of the applicable policy limits.

Section 69. Distribution of assets.

Under the direction of the court, the Liquidator shall pay distributions in a manner that will assure the proper recognition of priorities and a reasonable balance between the expeditious completion of the liquidation and the protection of unliquidated and undetermined claims, including third party claims. Distribution of assets in kind may be made at valuations set by agreement between the Liquidator and the creditor and approved by the court.

Section 70. Unclaimed and withheld funds.

(a) All unclaimed funds subject to distribution remaining in the Liquidator's possession when it is ready to apply to the court for discharge, including the amount distributable to any creditor, shareholder, member or other person who is unknown or cannot be found, shall be deposited with the state treasurer of the state of domicile of the insurer and shall be paid without interest except in accordance with Section 67 to the person entitled thereto or its legal representative upon proof satisfactory to the state treasurer of its right thereto. Any amount on deposit not claimed within six (6) years from the discharge of the Liquidator shall be deemed to have been abandoned and shall be escheated in accordance with the law of that state.

(b) All funds withheld under Section 61 and not distributed shall upon discharge of the Liquidator be held by the Corporation and disbursed in accord with that section. Any part of those sums which under Section 67 would revert to the undistributed assets of the insurer shall be distributed in accordance with any residual dispository provision in the final order of discharge or in accordance with an order made upon petition by the Corporation to reopen the liquidation if the Corporation deems it worthwhile, or in accordance with subsection (a) above.

Section 71. Termination of proceedings.

(a) When all assets justifying the expense of collection and distribution have been collected and distributed the Liquidator shall apply to the court for discharge. The court may grant the discharge and make any other orders, including an order to transfer any remaining funds that are uneconomic to distribute, as may be deemed appropriate.

(b) Any other person may apply to the court at any time for an order under subsection (a). If the application is denied, the applicant shall pay the costs and expenses of the Liquidator in resisting the application including a reasonable attorney's fee.

(c) After the liquidation proceeding has been terminated and the Liquidator discharged, the Corporation or other interested party may at any time petition the district court to reopen the proceedings for good cause, including the discovery of additional assets. If the court is satisfied that there is justification for reopening, it shall so order.

Section 72. Disposition of records during and after termination of liquidation.

Whenever it shall appear to the Corporation that the records of any insurer in process of liquidation or completely liquidated are no longer useful, it may recommend to the court and the court shall direct what records should be retained for future reference and what should be destroyed.

PART IV

GUARANTEE OF INSURANCE OBLIGATIONS

Section 73. Guarantee obligation of the Corporation.

If the Corporation is appointed as Liquidator of a member insurer, and the guaranty obligation of the Corporation has not been discharged, the Corporation shall as guarantor be obligated to pay covered claims existing prior to the order of liquidation, arising within thirty days after the order of liquidation, or before the policy expiration date if less than thirty days after the order of liquidation, or before the insured replaces the policy or causes its cancellation, if it does so within thirty days of the determination. Such obligation shall extend to covered claims reported pursuant to an optional extended period to report claims sold to the insured by the Liquidator. The guaranty obligation as to covered claims shall be satisfied by paying to the claimant an amount as follows:

(a) The full amount of a covered claim for benefits under a workers, compensation insurance coverage;

(b) an amount not exceeding $300,000 per claim for all other covered claims, subject to the following limitations:

(1) The amount of each covered claim to be recognized in determining the guaranty obligation of the Corporation shall not exceed that part of the first $300,000 of the loss or liability giving rise to the covered claim which the insurer would have been obligated to pay under its policy or policies but for the order of liquidation.

(2) On claims where the obligation of the insurer to the claimant is direct (or "first party"), the Corporation shall not be obligated to pay more than 90% of the amount by which the recognized part of each covered claim exceeds $100,000 but is less than $200,000 and 80% of the amount by which the recognized part of each covered claim exceeds $200,000 up to $300,000.

In no event shall the Corporation be obligated to pay a claimant more than the insurer would have been obligated to pay, but for the order of liquidation, under the policy from which the claim arose.

Notwithstanding any other provision of this Act, the Corporation shall not be obligated to pay any part of any claim filed with the Liquidator after the final date for the filing of claims against the Liquidator.

Section 74. Effect of paid claims.

(a) Any person whose claim is paid by the Corporation under this Act shall be deemed to have assigned its rights under the policy to the Corporation to the extent of its payment from the Corporation. Every insured or claimant seeking the protection of this Act shall cooperate with the Corporation to the same extent as such person would have been required to cooperate with the insolvent insurer. The Corporation shall have no cause of action against the insured of the insolvent insurer for any sums it has paid out except such causes of action as the insolvent insurer would have had if such sums had been paid by the insolvent insurer and except as provided in subsection (b). In the case of an insolvent insurer operating on a plan with assessment liability, payments of claims of the Corporation shall not operate to reduce the liability of the insureds to the receiver, liquidator or statutory successor for unpaid assessments.

(b) The Corporation shall have the right to recover from the following persons the amount of any covered claim paid on behalf of such person pursuant to this Act:

(1) any insured whose net worth on December 31 of the year next preceding the date of the order of liquidation exceeds $50 million and whose liability obligations, including those under workers compensation policies, to other persons are satisfied in whole or in part by payments made under this Act; and

(2) any person who is an affiliate of the insolvent insurer and whose liability obligations to other persons are satisfied in whole or in part by payments made under this Act.

Section 75. Nonduplication of payment of claims.

Any person having a claim against an insurer under any provision in an insurance policy, other than a policy of an insolvent insurer which is also a covered claim, shall be required to exhaust first its right under such policy. Any amount payable on a covered claim under this Act shall be reduced by the amount of any recovery under such insurance policy.

Section 76. Discharge of guaranty obligations.

(a) If the Corporation gave written notice to the state insurance regulator and to the member insurer of the state of domicile of a member insurer that the insurer was believed by the Corporation to be insolvent or was in a financially hazardous condition or conducting its business in a financially hazardous way, and either:

(1) the state insurance regulator did not within 60 days of the date of receipt of that notice take possession and control of the assets, business and affairs of the insurer summarily and/or petition the appropriate court to appoint the state insurance regulator or other proper person as receiver of the insurer and pursue the petition with due diligence, or take such other actions as were provided or required by the laws of the state to place the insurer in receivership, or,

(2) the member insurer did not within 75 days of the receipt of the notice by the state insurance regulator petition the district court for appointment of the Corporation as receiver of its assets, business and affairs, in accordance with Section 24(b)(2), and

(3) the notice has not been withdrawn by the Corporation, then the Corporation shall not be obligated to pay as guarantor any covered claims against the insurer or any receiver, rehabilitator, or liquidator of it.

(b) The discharge of the Corporation from its obligation as guarantor as provided in subsection (a) above shall be effective irrespective of whether there is any evidence or showing of prejudice to the Corporation.

(c) The guaranty obligation of the Corporation as to the member insurer may be reinstated only by specific resolution of the board of directors of the Corporation. The decision whether to reinstate the guaranty obligation of the Corporation as to that member insurer shall be within the sole discretion of the board of directors and shall not be subject to judicial review or control in any manner or proceeding.

(d) The Corporation may agree to be appointed as receiver of the member insurer or of any insurer even though it has been or will be discharged from its guaranty obligation in accordance with subsection (a) and such acceptance and appointment and acting as receiver for purposes of rehabilitation or liquidation or both shall not constitute any waiver of such discharge or election to not be discharged or as reinstatement of the guaranty obligation.

COMPARISON WITH OTHER GUARANTY PROGRAMS

This section describes briefly, for purposes of comparison with the proposed National Insurance Guaranty Corporation, the two most nearly analogous existing federal entities, the Federal Deposit Insurance Corporation ("FDIC") and the Securities Investor Protection Corporation ("SIPC"). The statutes creating those corporations have been consulted in drafting the proposed NGIC Act but the concept of the NGIC is substantially different in important respects from either of those models, in part because NGIC is to be fiscally independent of the federal government and therefore should not be a government agency, and in part because of the extent to which the NGIC Act builds on existing state law and machinery.

The section also describes briefly the National Association of Securities Dealers ("NASD") because of references that have been made to the "self-regulation" model as possibly relevant in the insurance context.

Federal Deposit Insurance Corporation

The FDIC was created to insure the deposits of banks and savings associations. The FDIC has a five person board of directors consisting of the Comptroller of the Currency, the Director of the Office of Thrift Supervision and three individuals appointed by the President with the advice and consent of the Senate.

Insured institutions must pay annual assessments at rates fixed annually by the FDIC at a level sufficient to maintain specified reserve ratios in the Bank Insurance Fund and the Savings Association Insurance Fund, respectively.

In addition the FDIC is authorized to borrow up to $5 billion from the U.S. Treasury and, subject to certain limitations, to borrow from other sources on the full faith and credit of the United States. Further, the Secretary of the Treasury is directed to make certain other payments for the benefit of the Savings Association Insurance Fund.

The FDIC acts as conservator or receiver of insured institutions under conditions specified by the statute. In general, if a federal banking agency determines that a conservator of a federal depositary institution is necessary, the banking agency may tender the appointment to the FDIC, which may accept the appointment or not; but if the banking agency determines that a receiver for liquidation is necessary, it must appoint the FDIC. As to state depositary institutions, a state banking authority may tender appointment to the FDIC; but if certain specified conditions exist, the FDIC may appoint itself as conservator or receiver, subject to the right of the insured state depositary institution to bring an action in a federal district court to require the FDIC to remove itself.

The statute provides in detail the manner in which the FDIC is to carry out its powers as receiver but in addition gives the FDIC broad rulemaking authority governing the allowance or disallowance of claims. In effect, the FDIC carries out its receivership functions as an administrative agency rather than as a court-appointed receiver or trustee.

It thus acts as an agency of the United States, and its actions are subject to judicial review pursuant to the provisions of the Administrative Procedure Act.

Securities Investor Protection Corporation

By contrast with the FDIC, SIPC, while federally chartered, is not an agency or establishment of the United States Government. It is, however, heavily regulated by the SEC. Its members are registered brokers or dealers, and its directors include one appointed by the Secretary of the Treasury from his department, one appointed by the Federal Reserve Board from among its officers and employees, and five directors appointed by the President with the advice and consent of the Senate. Changes in the by-laws of SIPC are subject to approval of the SEC, and while SIPC has some rule making authority, that, too, is subject to SEC review.

SIPC is funded by assessments upon its members and may also borrow money from the SEC which, in turn, is funded by the Secretary of the Treasury in an amount not to exceed $1 billion for such purpose.

If SIPC determines that certain statutory conditions exist with respect to a member, it may make application to a federal district court for a protective decree. Filing of the application vests the court with exclusive jurisdiction over the failing broker or dealer and its property and stays pending actions. If the court makes certain specified findings as to the financial condition of the member broker or dealer, it must enter a protective decree and appoint SIPC, or such person as SIPC designates, as trustee. At that point, the entire proceeding is removed to the bankruptcy court for liquidation proceedings under the supervision of that court.

The proposed NIGC Act contemplates that the Corporation's appointment as receiver will be made by a federal district court and that the receivership functions will be carried out under the aegis of the federal court, in a manner similar to federal equity receiverships that once were common but with federal statutory provisions conferring powers on the receiver and specifying the rules governing liquidation. Such receiverships, whether for rehabilitation or for liquidation, would operate outside the bankruptcy courts and the Bankruptcy Code. The rationale for this approach is that insurer receiverships and liquidations have their own unique problems and procedural background, having historically been conducted under state law and having been excluded from the federal bankruptcy laws, and therefore a federal substitute for the existing fragmented state procedures should stand on its own footing rather than being absorbed into the bankruptcy process.

From the standpoint of minimizing additional tasks for the regular federal district courts, the model of the SIPC statute might have certain advantages. Under that statute the initial proceedings brought by SIPC are free-standing from the bankruptcy courts, but once the federal district court has assumed jurisdiction over the debtor and appointed a trustee, the liquidation proceeding is removed to the bankruptcy court, which thereafter exercises

the powers conferred by the SIPC statute. In addition, the statute provides that the proceeding shall be conducted "in accordance with" the Bankruptcy Code to the extent not inconsistent with the SIPC Act itself. Thus while the liquidation takes place "under" SIPCA and not "under" the Bankruptcy Code, and while many of the substantive rules are distinct and are specified by SIPCA itself, bankruptcy law and bankruptcy rules fill in the gaps and the proceeding is administered in the first instance not by the district court but by the bankruptcy judge.

National Association of Securities Dealers

The principal functions of NASD are different from those the NIGC is intended to perform. Its main functions are to establish and enforce rules of practice to be followed by brokers and dealers in executing securities transactions. NASD was an outgrowth of the NRA "codes of fair competition" that were adopted pursuant to the National Industrial Recovery Act of 1933. The code of fair competition adopted for the banking industry included certain rules of fair practice applicable to brokers and dealers. After the Supreme Court caused the demise of the NRA on constitutional grounds, representatives of the securities industry discussed with the SEC the feasibility of having an organization to regulate brokers and dealers, in a manner similar to the stock exchanges' regulation of their members. The discussions led to the Maloney Act of 1938, which amended the Securities Exchange Act by providing for the registration of national securities associations and specifying their powers and their relationship to the SEC. NASD is the only such registered association. Its membership includes most brokers and dealers.

NASD prescribes detailed rules of conduct that must be observed by members, rules described in the statute as rules "to promote just and equitable principles of trade" and "to remove impediments to and perfect the mechanism of a free and open market." NASD also enforces such rules, by instituting and conducting disciplinary hearings against members accused of infractions of the rules and by imposing sanctions where infractions are found.

In addition to those functions, NASD is the examining body for its members with respect to their financial condition and their compliance with financial requirements imposed by the SEC. In this capacity the NASD has an important relationship to SIPC. NASD is required to file with SIPC reports of NASD's examinations or inspections of members, and to notify SIPC if it is aware of facts indicating that a member is in financial difficulty. Such information provides SIPC with the basis for seeking a protective decree from a federal court, a proceeding that begins the process by which SIPC becomes trustee for liquidation. SIPC is also directed by its statute to work with NASD in developing procedures designed to detect approaching financial difficulty of its members. Finally, NASD acts as collection agent for SIPC for the assessments imposed by SIPC to maintain the protective (i.e. guaranty) fund.

Under the plan of the proposed NIGC Act, the primary regulatory and financial examination functions would remain with the state regulators, and would not be transferred

to a federal agency for supervised delegation to the NIGC. The proposed NIGC Act in various of its provisions is designed to accord the NIGC an indirect contributing and supporting role to that of the state regulators in the financial surveillance of member insurers without, however, casting it as the regulatory agency.

As to the NASD's role in setting rules of fair practice for brokers, the analogy in the insurance industry would be an organization prescribing ethical standards for insurance agents and brokers, a matter that is beyond the purposes of the proposal for a national insurance guaranty organization.

The term "self-regulatory" is somewhat of a misnomer as applied to the NASD. The authority of the SEC over the NASD is in fact very broad. Thus, any rules adopted by NASD as well as any changes of rules must be submitted to the SEC before going into effect and must be approved by the SEC. Similarly, any disciplinary action taken by NASD against a broker or dealer for violation of a rule is subject to review by the SEC before it can take effect. Thus within its fairly limited sphere the NASD functions much like a subordinate administrative agency exercising delegated powers under the control of the SEC. In addition, since the original enactment of the Maloney Act the SEC's own powers over brokers and dealers have been broadened to give the SEC direct regulatory authority similar to and paralleling the NASD's rules, resulting in some degree of dual regulation.