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If Your Insurer Fails: Don't Be Left Holding the Bag

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No business buys insurance expecting that its insurer will be unable to pay a claim when necessary. After all, aren't insurance companies paragons of stability and business conservatism? We all are familiar with the reassuring images that insurers present in their advertising: as stable as a rock, as sure-footed as a mountain ram, as sheltering as a trusty umbrella. But insurers have not been immune to the economic difficulties of the last two years. AIG, one of the world's largest insurance holding companies, continues to be among the highest-profile recipients of federal bailout money. Other leading commercial insurers have received federal bailout funds as well. In addition, because insurers maintain large portfolios of corporate and securitized commercial real estate debt, many of them have experienced adverse investment returns over the last two years and remain exposed to significant investment-portfolio risk.

A number of commercial insurance companies are so concerned about their ability to pay claims that they have commenced "run-off" programs. An insurer in run-off stops issuing new policies (thus foregoing the premiums it would have collected on those policies) and uses its remaining assets to meet its obligations to policyholders. In some cases (Kemper Insurance, for example), an insurer enters run-off as a precursor to eventual liquidation. In other instances, an otherwise healthy insurer establishes a run-off company as part of a strategy to exit a line of business or to deal with a particularly intractable category of claims (asbestos, for example). Increasingly, run-offs are handled by specialized administration firms whose compensation is tied to their ability to preserve assets by minimizing claims payments and imposing tight cost controls. In practical terms, a policyholder may feel pressure to settle claims for less than they are worth because the certainty of a discounted payment today is preferable to waiting for an uncertain future recovery if the run-off insurer becomes insolvent. In the decade before the current economic crisis, a number of domestic insurance companies became insolvent, including The Home, Reliance, Highlands and Legion.

From the perspective of a policyholder, an insurer's insolvency often seems like a black hole from which little or nothing ever emerges. When an insurer becomes insolvent, for example, some of its coverage obligations (including paying for your defense in a lawsuit) may terminate. As an insured, you, along with the insurer's other creditors, must submit a claim (for what you believe you are owed under your policy) to the insurer's liquidator by a court-ordered deadline. And then you wait.

In the realm of liability insurance policies—such as general, auto, D&O, employment practices and the like—your claim might include liabilities that have been reduced to a judgment or settlement ("fixed" liabilities), estimates of liabilities that you might incur in pending claims and projections concerning anticipated claims ("pending" or "contingent" liabilities), and defense costs. Typically, fixed liabilities are paid before pending or contingent liabilities. But before any payments are made to claimants, a number of things must happen.

Claims must be allowed by the liquidator and confirmed by the court overseeing the insolvency. The liquidator must finish marshalling the insurer's assets, which may involve protracted disputes with reinsurers and the unwinding of investments. Also, the discount rate to be applied to the pool of allowed claims must be determined. This process can continue for 10 years or more before any claims are paid. At the end of the day (or decade), depending on the magnitude of the approved claims and the extent of the insurer's remaining assets, the amount paid out may be merely a fraction of the amount approved. Moreover, liquidators have considerable leeway in deciding whether to approve a claim and how much of the claim to approve. The result is an opaque claims process and considerable uncertainty for policyholders. Furthermore, state guaranty funds (which are intended to provide a quicker means of recovery for some policyholders) are not likely to be of much help. Such funds are subject to limitations that bar recovery for many businesses. In Illinois, for example, policyholders whose net worth exceeds $25 million are not allowed to recover from a guaranty fund.

The Upshot for Policyholders

What does all this mean for businesses that buy insurance? If your insurer becomes insolvent, are you left holding the bag? Is your only option to submit a proof of claim, hope that the liquidator approves it, and pray that there are enough assets left over to pay at least *some* portion of what you are owed?

Not necessarily. There are no foolproof routes for achieving a satisfactory recovery from an insolvent insurer's estate. The insolvency process will be protracted, the liquidator's determination is uncertain, the payout ratio for approved claims may be disappointing and the economic rationale for challenging the liquidator's determination in court will often be nonexistent. But one thing is certain: if you do not make your case for coverage and for why your claim should be allowed, you cannot expect the liquidator to do so for you. Thus, there are things a policyholder can do to improve the odds of getting at least a partial recovery. As soon as practicable, you should submit a thoroughly documented proof of claim. If there are claims against you that have not been "fixed" when a proof of claim is submitted, be diligent in providing the liquidator with supplemental information and frequent updates on your claim's progress.

In addition, there are steps a prudent policyholder can take to reduce the likelihood of doing business with an insurer that will become insolvent. Even though rating-agency scores are not infallible predictors of long-term financial health, they remain important. It is not enough, however, to look solely at the final letter or numerical rating; equally important is any outlook advice provided by the rating agency and the explanation for the outlook opinion. (It is surprising how many A-rated companies have "negative" outlook opinions.) When considering purchasing insurance from a company that is part of a larger group, have your broker provide the ratings of the group and the other constituent companies. Are there inconsistencies across the group? If so, take a closer look because a weak unit can bring down a much larger enterprise, particularly if there is the possibility of intra-company transactions or relationships about which little information is available. In the same vein, do not be shy about asking other management personnel within your organization, as well as your insurance and legal advisors, about their views.

The following hypothetical scenarios are intended to shed light on potential landmines, as well as additional strategies that may help policyholders avoid or reduce some of the risk and uncertainty associated with insurer insolvencies.

Scenario One: You Won't Get It If You Don't Even Ask

AlvyCo and AnnieCo have both received proposals from Thunderbolt Insurance Company, whose premiums are significantly lower than those of its competitors. In the last two years, Thunderbolt has had several ratings downgrades and has seen considerable turnover in its executive suite. Thunderbolt is a unit of McLuhanCo, a financial services conglomerate that has experienced dramatic losses in some of its other operating entities. There have also been a number of rumors concerning the long-term future of the insurance unit.

AnnieCo's risk manager is delighted to lock in coverage at such a favorable price and jumps at the offer. AlvyCo also finds Thunderbolt's proposal too good to pass up but is concerned about the future and requests an endorsement that provides favorable cancellation and premium repayment terms in the event of additional ratings downgrades. Three years ago, Thunderbolt would have rejected this request from a potential policyholder. In a difficult economic environment, however, it is willing to live with this condition.

Scenario Two: View Every Insurance Policy in the Context of the Entire Program

Freedonia Corporation has decided to purchase its primary D&O insurance from the financially stable Teasdale Insurance Company. In order to save on premiums, however, Freedonia obtains its first-layer excess coverage with Firefly Insurance Company. Freedonia also purchases several additional layers of excess insurance but pays no attention to the "maintenance of underlying coverage" and "attachment" terms of those policies. Freedonia is later hit with a major lawsuit that is covered by these D&O policies. After several years of litigation, for which Teasdale has paid the defense costs, it appears that the best possible outcome is a settlement that will reach into the upper layers of its excess coverage.

Unfortunately, during the course of the litigation, Firefly collapsed in a financial scandal and has become insolvent. Freedonia turns to the excess insurers above Firefly's layer of coverage, only to learn that those policies release the insurers from any obligations to pay in the event an underlying insurer becomes insolvent. To make things worse, those policies also state that the excess insurers' obligation to pay is triggered only after the underlying limits have been paid by the underlying insurers (not the insureds)! As it turns out, several of the competing proposals for excess insurance contained more favorable terms.

Scenario Three: Don't Take Fronting/Self-Insured Programs for Granted

For cost savings reasons, the general liability and workers compensation insurance programs of Bialystok Productions have been issued on a fronting basis by Springtime Insurance Company, which is admitted to issue insurance in all of the states in which Bialystok operates. After retaining an administrative fee, Springtime transfers the bulk of the premium and all of the coverage obligations to reinsurers that are not admitted to issue insurance in the relevant states.

As a fronting insurer, Springtime is able to generate a steady stream of fees while retaining no actual underwriting risk, and it hopes that this business model will allow it to recover from the negative underwriting history and investment returns it experienced in previous years. Unfortunately, Springtime's recovery strategy fails and it is forced into insolvency. The liquidator takes the position that Springtime's reinsurance agreements are an asset of the insolvency estate, leaving Bialystok with no direct claim against the reinsurers. When Bialystok's insurance coverage attorneys ask about their client's "cut-through" rights, the response is, "What are you talking about?"

Scenario Four: A Bird in the Hand is Worth…More than Nothing?

Ludovico Corporation has been hit with multiple lawsuits relating to a product it no longer makes. The lawsuits allege that the product contained a material that causes a serious illness that can take decades to develop. During the years that Ludovico sold this product, it purchased general liability insurance from Droog Insurance Company. The Droog policies cover these claims, and the potential liabilities are significant. Droog has experienced significant losses from claims covered under general liability policies issued decades ago. Its parent company, LudwigVan Holdings, decides to rid itself of Droog's lines of insurance and its open-ended exposures. Following a spin-off, Droog obtains regulatory approval to enter into run-off. The estimates prepared by Droog's consultants and approved by the regulators suggest that Droog will be able to continue to pay claims for approximately two decades. After just five years, however, Droog's financial condition is worse than projected, and the insurer likely will be insolvent within two years. Droog proposes a settlement in which it will pay a lump sum to Ludovico in return for a complete release of Droog's coverage obligations. The proposed settlement amount, although sizeable, is less than half of the total limits issued by Droog.

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While there is no way to completely avoid the risk of insurer insolvencies, these scenarios help illustrate how a prudent policyholder can take steps to lower that risk.

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