

# **FEDERAL PRIORITY AND SIMPLY TERRIBLE PUBLIC POLICY: THE EFFECT OF THE MCCARRAN-FERGUSON ACT ON FEDERAL CLAIMS IN INSURER INSOLVENCIES**

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## ***Introduction***

We all know the rules in an average bankruptcy. Uncle Sam holds the trump card, the federal priority statute, and he plays it. When an insurance company becomes insolvent, the story is a little different. The McCarran-Ferguson Act allows states to create laws that pay claims of policyholders above the claims of the United States. In *Ruthardt v. United States*, Linda Ruthardt, the Insurance Commissioner of Massachusetts, asked two questions. First, when a state statute provides a guaranty fund with a priority higher than that of the United States, who is paid first? Second, if a state law sets a deadline for all claims to be filed, do the claims of the United States government also have to meet that deadline? The answer to those questions requires a closer look at the interplay between the Massachusetts Liquidation Act ("the Mass. Liquidation Act") the federal priority statute and the McCarran-Ferguson Act.

The federal priority statute states that in a traditional bankruptcy case "the claims of the United States are paid first"<sup>2</sup> and federal supremacy prevents any state law from superceding it. Insurance insolvencies are unique, however, because the McCarran-Ferguson Act<sup>3</sup> ("McCarran-Ferguson") creates an exception to this general rule. It states that:

"No Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance."

15 USC ' 1012. This creates a reverse preemption, whereby a state law may preempt a federal one if: (a) the state law was enacted for the purpose of regulating the business of insurance; and (b) the federal law does not itself specifically relate to insurance. In other words, if a state law is enacted to regulate the business of insurance and conflicts with a federal law like the Federal Priority Act, then under McCarran-Ferguson, the state law trumps the federal law. Sounds simple enough. The trick, of course, is determining when a state law regulates the business of insurance.

In *U.S. Department of the Treasury v. Fabe*,<sup>4</sup> the Supreme Court read McCarran-Ferguson narrowly and determined that a law regulates the business of insurance only to the extent that it protects policyholders. By this definition, if a state law is primarily designed to further the interests of other creditors, it is outside the scope of McCarran-Ferguson and normal preemption applies. In *Fabe*, the Court reviewed an Ohio state law that gave administrative claims and policyholder claims priority above the United States. Normally that law would be preempted by the federal priority statute. Instead, the court found that to the extent that the Ohio law was primarily designed to protect policyholders it escaped federal preemption.

## ***Guaranty Associations Join the Party***

The question that *Fabe* left unanswered was whether a guaranty fund would also receive priority at the policyholder level. State guaranty funds provide protection for policyholders when an insurance company becomes insolvent. Instead of pursuing a claim directly, a policyholder is paid by the guaranty fund, and the guaranty fund, in turn, receives a claim against the assets of the insurance company. In *Fabe*, the Supreme Court told us that policyholder claims receive priority above the United States, but what about when that claim is transferred to a guaranty fund. Who is paid first then?

Enter, Linda Ruthardt. In 1989, two Massachusetts Insurance Companies, American Mutual Liability Insurance Company ("AMLICO") and American Mutual Insurance Company of Boston ("AMI") (collectively "the companies") were declared insolvent. Linda Ruthardt, as the Commissioner of Insurance for the Commonwealth of Massachusetts,<sup>5</sup> was appointed Permanent Receiver and thus had the exclusive authority to recover all assets of the companies. Several states, including

Massachusetts, have statutes giving guaranty funds priority as a policyholder to the assets of an insolvent insurance company. The Mass. Liquidation Act gives administrative claims first priority, policyholder claims including guaranty funds second priority, and non-policyholder claims of the United States, third priority.

The policyholders' claims were transferred to Massachusetts Insurer's Insolvency Fund and other state insurance guaranty funds. In accordance with Massachusetts state law, the receivership court entered an order requiring all creditors to file their claims within one year. Over 37,000 claims were filed by the deadline, including claims by 51 property-casualty guaranty funds in 46 jurisdictions. The claims of the United States totaled \$636,742 against AMLICO and \$5,740 against AMI, and included several that were filed after the one-year claims filing deadline.

The Commissioner set out a plan for the distribution of the remaining assets. The claims were to be paid in accordance with the Mass. Liquidation Act, which gave priority to guaranty funds at the policyholder level (second priority), above those claims of the United States government (fourth priority).<sup>6</sup> Several distributions were made to the guaranty funds after obtaining a written waiver of objection from the United States. Then, on June 1, 1999, the court approved a proposed 5th distribution to guaranty funds for \$10,125,000, but this time the United States would not waive its claim. The Commissioner, who faced personal liability for any distribution paid out before the United States, refused to permit the distribution and brought action against the United States.

### *District Court*

The Commissioner requested two specific findings from the court. First, that the guaranty funds be given priority as policyholders under the Mass. Liquidation Act, and second, that the claims of the United States were subject to the filing deadline set by that statute. If the provisions of the Mass. Liquidation Act were enacted to protect policyholders, then under *Fabe*, they were enacted to regulate the business of insurance, and McCarran-Ferguson's reverse-preemption should apply. Similarly, if the Massachusetts claims filing deadline was enacted to regulate the business of insurance then the state law filing deadline would also preempt federal law and the United States would be required to submit all claims before that deadline.

### *Guaranty Associations Have Priority As A Policyholder*

The United States argued that the Mass. Liquidation Act was not enacted to regulate the business of insurance and was therefore, preempted by the federal priority statute. Under *Fabe*, a state law must directly benefit policyholders for it to qualify as regulating the business of insurance and thereby preempt federal law. The United States also emphasized that guaranty funds can still file their claims under the federal priority statute, but will have a priority after the United States.

The Commissioner countered that the guaranty funds were entitled to the same priority afforded policyholders because the funds function to facilitate the performance of insurance contracts. In this way, affording guaranty funds priority as policyholders directly protects policyholders and therefore the Mass. Liquidation Law escapes preemption. In several *Amicus Curie* briefs, guaranty funds described the detriment that would result if guaranty funds were not entitled to the same priority level as policyholders.<sup>7</sup> They pointed out that Massachusetts had "established a legislative balance of interests that finance[d] the policyholder protection system" and that with its challenge the United States "would undermine the state's efforts to regulate the business of insurance for the purpose of protecting policyholders."<sup>8</sup> The District Court agreed. It found that the Massachusetts scheme was indeed enacted to benefit policyholders. Therefore, under *Fabe*, it was a law regulating the business of insurance and it was saved from preemption by McCarran-Ferguson. The Mass. Liquidation Act trumped the federal law and the Commissioner could pay the guaranty fund claims before the federal claims.

### *Claims Bar - The District Court Was Bound By First Circuit Decision In Garcia*

The United States argued that its claims were not subject to the claims filing deadline because: (a) federal claims are not subject to state statutes of limitation;<sup>9</sup> and (b) the federal priority statute preempted the Mass. Liquidation Act. The Commissioner argued to the contrary that the filing deadline benefitted policyholders by "permitting final determination of claims and a final distribution of assets" and that "[a]bsent a deadline for claims applicable to all creditors, neither the affairs of the Companies, nor the interests of pending claimants can be finalized."<sup>10</sup>

The court first rejected the argument that a deadline was inapplicable as an imposition of a state statute of limitation on a federal claim. Although the court recognized the principle that the federal government was not generally subject to statutes of limitation, it could not "overcome the particular niche for state authority carved out by the McCarran-Ferguson Act."<sup>11</sup> Next, it concluded that although McCarran-Ferguson did apply to claims of the federal government, it was bound by the First Circuit's prior decision in *Garcia v. Island Program Designer, Inc.*<sup>12</sup> that claim deadlines do not regulate the business of insurance. In *Garcia*, the IRS had missed a state filing deadline set by a Puerto Rico statute. Under Puerto Rico law, any claims filed after the deadline could only be paid after all other claims have been paid with interest. The First Circuit applied the rule from *Fabe*, and held that the Puerto Rico filing deadline was not a law enacted to regulate the business of insurance because it was not a law designed to directly benefit policyholders. It explained that the filing deadline helped all creditors by penalizing late filers and therefore under *Fabe's* definition, it was not enacted to regulate the business of insurance. Thus, the McCarran-Ferguson Act did not apply, and the federal priority statute preempted Puerto Rico law.

The District Court in *Ruthardt* found that the First Circuit's decision in *Garcia* was controlling. Under *Garcia*, the Massachusetts filing deadline was not directed at protecting policyholders, but instead benefitted all creditors. However, the court did note that "[t]he record . . . suggests the *Garcia* panel may have underestimated the disruption which an open-ended opportunity for federal government claims has upon insurance liquidation proceedings."<sup>13</sup> Therefore, McCarran-Ferguson could not save the state law from preemption, and normal federal priority applies.

### ***First Circuit Court of Appeals Court of Appeals Affirms the District Court***

The United States unsuccessfully appealed the District Court's ruling that its claims did not have priority over the claims of guaranty funds. The Commissioner defended the District Court's application of the *Fabe* rule. The Court of Appeals agreed. It affirmed the District Court, finding that guaranty funds have priority at the policyholder level. The Court noted that the *Fabe* decision not only gave priority to policyholders, but to administrative claims as well. It explained that "*Fabe's* premise was not that priority (over the United States) for policyholders is all right and priority for anyone else is not; *Fabe* itself upheld a priority for administrative expenses of liquidation (and apparently administrative expenses of guaranty funds too)."<sup>14</sup> It noted that "the guaranty funds are little more than a mechanism for advancing the money to pay policyholders promptly and then recovering those advances out of the estate assets . . . just as the policyholders could have done directly."<sup>15</sup> Therefore, a law giving priority to guaranty funds was a law enacted to benefit policyholders. Under the definition from *Fabe*, it was a law enacted to regulate the business of insurance and McCarran-Ferguson's reverse preemption applied.

The Commissioner appealed the finding that the United States was exempt from Massachusetts' filing deadline. The Court of Appeals was not persuaded by the Commissioner's argument that the First Circuit had *sub-silentio* overturned *Garcia* by failing to cite it in other cases where it could have been invoked."<sup>16</sup> Finding that it was indeed bound by its own *Garcia* decision,<sup>17</sup> the court affirmed the District Court's finding that the McCarran-Ferguson Act does not protect the state filing deadline from preemption.

Although the court defended its decision in *Garcia* as having properly applied *Fabe*, it was not hesitant to critique the inevitable consequences. It opined that "giving the United States an open-ended exemption from deadlines is (in the liquidation context) simply terrible public policy and was almost certainly not the result of any considered judgment by Congress."<sup>18</sup> The court did not stop there. It continued on, listing as examples that "the defunct insurance company cannot be fully liquidated, until all claims of the United States are satisfied to the extent that remaining assets permit . . . the Commissioner B who is personally liable for ignoring the Federal Priority Act . . . cannot ever pay off creditors with lower priorities, unless she can wrangle a waiver from the United States."<sup>19</sup>

### ***Conclusion***

*Ruthardt* is a mixed blessing. Guaranty funds won the right to be paid at the policyholder level. The United States won the right to continue its practice of refusing to adhere to a claims filing deadline. The Supreme Court declined to issue certiorari leaving *Garcia* alive to see another day. The only thing that seems certain is that everyone, except for the

federal government, agrees that some uniform time limit for filing claims is needed. The First Circuit declared that "this is a matter for the legislature and not for the courts." What remains to be seen is whether Congress will accept the First Circuit's invitation to correct this "terrible public policy".

### *Endnotes*

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1. Frank O'Loughlin is a partner in the Denver law firm, Rothgerber Johnson & Lyons LLP. Joy Woller, a summer associate with the firm, is a law student currently attending Syracuse University School of Law with an anticipated graduation date of May 2004.
  2. 31 U.S.C. ' 3713(a)(1)(A).
  3. 15 U.S.C. ' 1012.
  4. 508 U.S. 491 (1993).
  5. By the resolution of this case, Julianne Bowler had been appointed Massachusetts Commissioner of Insurance.
  6. Mass. Gen. Law ch. 175, ' 180(C) list the priority of claims to an insolvent insurer's assets as follows: administrative claims; claims under policy (including subrogated claims of the Guaranty Association); claims for unearned premium; *claims of the United States* other than under policies; governmental claims other than those of the United States; and general creditor claims.
  7. Rothgerber Johnson & Lyons LLP acted as counsel for the National Organization of Life and Health Insurance Guaranty Associations with respect to its *Amicus Curiae* filing. The opinions expressed in this article are solely those of the authors.
  8. Amicus Brief of the National Organization of Life and Health Insurance Guaranty Associations (D. Mass. 3/19/2000).
  9. *See United States v. Summerlin*, 310 U.S. 414, 416 (1940) "it is well settled that United States is not bound by state statutes of limitation."
  10. Affidavit of Linda L. Ruthardt at 9.
  11. *Ruthardt*, 164 F. Supp.2d 232, 242 (D. Mass. 2001).
  12. 4 F.3d 57 (1st Cir. 1993).
  13. *Ruthardt*, 164 F. Supp.2d at 243.
  14. *Ruthardt*, 303 F.3d at 382.
  15. *Ruthardt*, 303 F.3d at 382.
  16. *Ruthardt*, 303 F.3d at 384.
  17. *Ruthardt*, 303 F.3d at 384 (explaining "[w]e are bound by Garcia which can be overturned only by this court sitting en banc").
  18. *Ruthardt*, 303 F.3d at 385 (emphasis added).

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19. *Ruthardt*, 303 F.3d at 385.