

INSURANCE INSOLVENCIES AND LARGE DEDUCTIBLE INSURANCE PROGRAMS

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I. Overview of Large Deductible Programs

A. Definition Of LDP

In a Large Deductible Policy (“LDP”), the insurer assumes full statutory liability for all coverage under the policy while the policyholder assumes a contractual obligation to the insurer to pay claims within the deductible.¹ LDPs typically cover workers' compensation,² commercial auto and general liability exposures of a medium to large commercial insured. The deductibles typically vary from \$100,000 to \$1 million or more per claim. Although the LDP obligates the insurer to pay all claims within the deductible, side agreements and endorsements define the large-deductible arrangements and create the insured's obligation to pay claims within the deductible.³ Accordingly, an LDP arrangement has characteristics of both self-insurance and traditional insurance coverage.

In the last decade, LDPs became an attractive alternative to pure self-insurance arrangements for a number of reasons:

- **Protection of Workers** – Workers, at least in theory, are protected against an insolvency of employer.
- **Regulation** – A large, multi-state employer need only deal with the requirements of one insurance underwriter rather than with multiple self-insurance requirements and regulations that can vary considerably from state to state.
- **Security Requirements** – Many states require independent actuarial opinions on the accrued liabilities of their self-insured employers, and the amount and type of security that must be posted varies by state. While large account underwriters will have similar requirements, the risk manager only has to deal with one underwriter. It can often be difficult for self-insurers to get their security deposits back from, or reduced by, self-insurance regulators, but this is also true of some insurers writing large deductibles, and the risk manager may have to hire an actuary to assist in negotiations with the insurance underwriter.
- **Privacy** – Many self-insurance regulators require the filing of confidential financial, payroll, loss and other information that may not be protected by state privacy laws. This is generally not a problem with large deductibles, making them particularly appealing to privately held employers.
- **Statutory Excess Coverage** – Post 9/11/2001, statutory excess coverage for self-insured employers is available but increasingly difficult to find. Insurers writing large deductibles must offer statutory coverage.

There are two common types of large deductible arrangements that have been used in recent years: insurer-funded and policyholder-funded. Under insurer-funded arrangements, the insurer pays claims within the deductible and then bills the insured for the reimbursement. Conversely, in policyholder funded arrangements, the insurer agrees to allow the policyholder to fund its own claims within the deductible and the policyholder typically provides funds directly to a third party administrator who administers the claims. In order to secure the insured's liability under both types of LDPs, insurers usually require the insured to post collateral.⁴

II. Background on the Reliance Dispute and Large Deductible Legislation in Pennsylvania

In the last few years there has been focus on LPD's in insolvency proceedings as both Reliance Insurance Company, In Liquidation (“Reliance”) and Legion Insurance Company, In Liquidation (“Legion”) were large writers of LDPs.

The issues involving LDPs first arose as part of a public dispute between the Liquidator of Reliance and state guaranty funds as to who was entitled to the benefit of the collateral held by Reliance for LDPs. Because the insurance policies in the large-deductible arrangements are written with the insurer responsible for first-dollar coverage, when the insurer becomes insolvent the guaranty funds may be responsible under their respective state laws to handle and pay covered claims falling within the deductible. This is especially prevalent under state workers' compensation statutes. Consequently, the availability of collateral to pay claims became a key issue for the guaranty funds.

The dispute ultimately resulted in the guaranty funds instituting litigation in Pennsylvania Commonwealth Court contending that they were entitled to be reimbursed by the policyholder or the policyholder's collateral for any

amounts they paid on a claim within the deductible. Nearly simultaneously, the Reliance Liquidator filed a suit against the guaranty funds claiming that the deductible reimbursements and collateral securing the deductible liability were assets of the estate to be used for the benefit of all policyholder claimants. Meanwhile, policyholders in policyholder-funded programs wanted to continue to handle their own claims, while the policyholders were concerned that they might have to pay twice—some had originally posted large amounts of collateral and were now being requested to pay again by guaranty funds under the net worth exemptions in the various state laws.

While the litigation was pending, the National Conference of Insurance Guaranty Funds (“NCIGF”) proposed a legislative solution to the issue through Pennsylvania Senate Bill 815. The NCIGF intended SB815 to serve as model legislation. The NCGIF’s version of the bill was slightly modified in response to concerns expressed by various Legion policyholders that the legislation failed to capture the unique large deductible arrangement offered by that company. On June 28, 2004, Pennsylvania Governor Rendell signed Senate Bill 815 into law. Now known as "Act 46," 40 P.S. § 523.1 *et seq.* it amends the Pennsylvania's Insurance Department Act to address the treatment of commercial lines large deductible policies in insurance company insolvencies.⁵

The legislation attempts to recognize that LDP’s are in fact a form of self-insurance that need to be treated differently than traditional insurance in an insolvency context. In so doing, it creates a new class of claimant, claimants under LDP, who are treated differently than claimants under non-LDPs.

III. ACT 46 – KEY PROVISIONS

A. Definition of “Deductible Agreements”

Act 46 regulates “deductible agreements” in the context of a liquidation. “Deductible agreements” do not include first party claims or claims funded by a guaranty association not within the deductible and are defined as follows:

[A]ny combination of one or more policies, endorsements, contracts or security arrangements which provide for the policyholder to bear the risk of loss within a specified amount per each claim or occurrence covered under a policy of insurance and may be subject to aggregate limit of policyholder reimbursement obligations as set forth in an endorsement to a policy or in a program agreement.⁶

B. Treatment of Deductible Agreements in a Liquidation

Act 46 provides for some general “rules” that apply to all deductible agreements:

- **Any collateral related to a deductible agreement is not a general asset of the estate, but shall be maintained and administered to secure a individual policyholder’s obligation to fund or reimburse claims within the agreed deductible amount.**⁷ Accordingly, a Liquidator can only use a LDP policyholder’s collateral for the benefit of that individual policyholder and not for the collective benefit of the estate.
- **The Liquidator is required to maintain and use the collateral for the benefit of the individual policyholder.** To the extent that the collateral was also meant to secure other policyholder obligations (*i.e.*, reinsurance premiums) or other lines of insurance, then the Liquidator is to equitably allocate the collateral among these different policyholder obligations.⁸
- **If a policyholder is unwilling or unable to take over the handling and payment of non-guaranty fund covered claims, then claims subject to a deductible agreement, but not covered by any guaranty association, shall be paid and administered by the estate from a policyholder’s collateral account.**⁹ This provision allows the policyholder to essentially wash its hands of the claims and give the burden of claims administration to the Liquidator. It does not, however, relieve the policyholder of the obligation to pay claims within the deductible. Indeed, to the extent that the collateral is not sufficient to cover all claims, the Liquidator may institute a collection action against the policyholder to collect further amounts due. In the event that all collection actions have been exhausted and there is not enough collateral available, then the Liquidator is relieved of the obligation to pay the claim and the claim becomes general claim against the estate.
- **The Liquidator is authorized to periodically “adjust” any collateral held directly by the estate.** Act 46 requires that “adequate collateral” be maintained “plus a reasonable safety factor.”¹⁰ The Liquidator is entitled to hold and adjust the collateral during the entire claims run-off period. Once all claims covered by the collateral have been paid and the Liquidator is satisfied that no new claims can be presented, the Liquidator will release any remaining collateral to the policyholder. The Liquidator does not have to adjust

the collateral more than once a year and is required to share with the policyholder and the guaranty funds the basis for any adjustment.

- **The Commonwealth Court has jurisdiction to resolve all disputes arising under Act 46.** This section essentially deprives the guaranty funds and policyholders of the ability to litigate issues in out-of-state courts.

In addition to these general rules, the legislation creates different claims payment procedures for policyholder-funded and estate-funded (insurance funded) LDPs.

1. Policyholder-Funded Arrangements

a. Description: An arrangement where the policyholder and insurer contractually agree that the policyholder will fund its own deductible payments either directly or through a TPA.

b. Treatment: The treatment of contractually self-funded arrangements under Act 46 essentially allows Policyholder-Funded employers to opt out of the Liquidation for claims within the deductible. The Act provides that such arrangements shall be permitted to continue as they had prior to liquidation with companies continuing to fund their own deductible payments.¹¹ In fact, the Liquidator is required to “enforce such arrangements to the fullest extent possible.”¹² Once a policyholder has paid a claim it will act as a bar against any person, including the policyholder or third party, from making a claim for the same amount against the estate. Also, a policyholder’s payment of a claim extinguishes: (1) the policyholder’s obligation to pay or reimburse any guaranty fund for such claim; and (2) any obligation of a guaranty fund to pay such claim within the deductible amount. Guaranty funds are still liable for amounts in excess of the deductible to the extent they qualify as covered claims.¹³

2. Estate-Funded Arrangements

a. Description: An arrangement in which the insurer in liquidation directly pays claims and holds and administers the collateral on behalf of the policyholder as a reimbursement mechanism for its claim payments.

b. Treatment: This section anticipates that guaranty funds will initially pay covered claims. Once the claim has been paid, the Liquidator is required to “promptly bill the policyholder for such reimbursement and the policyholder will be obligated to pay such amount to the receiver for the benefit of the guaranty associations who paid such claims.”¹⁴ If the policyholder fails to pay within 60 days, the receiver is entitled to use the collateral to the extent necessary to reimburse the guaranty funds, and at the same time may pursue other collection efforts against the policyholder.¹⁵ The guaranty funds are also entitled to pursue collection actions against the policyholder to the extent the Liquidator’s efforts are unsuccessful.¹⁶

Section 523.1(g)(2) also provides that to the extent a policyholder must reimburse a guaranty fund for a claim the fund has paid, the policyholder is entitled to reduce that claim by the amount of any premium paid by the policyholder for a policy issued “by a wholly owned affiliate or subsidiary of the insurer, which affiliate or subsidiary was either licensed to do business in this Commonwealth or was an eligible surplus lines insurer.”¹⁷ The provision places even further restrictions on a policyholder’s setoff rights in requiring that the insurer and affiliate must have merged prior to the entry of the order of liquidation.¹⁸

IV. Act 46 Open Issues

After Act 46 was passed, many in the industry claimed that it would finally bring resolution to the large deductible issue for pending and future insolvencies and otherwise provide a clear guide to the complexities of commercial insurance programs. Unfortunately, this optimistic view has thus far not proven to be accurate. Act 46 has given rise to as many issues as it resolved, including:

A. Collateral:

1. **Allocation among covered/non-covered claims** – Section 523.1(c) requires the Liquidator to allocate collateral between covered claims and non-covered claims. Determining covered vs. non-covered claims requires an account by account analysis. For example, if a claim has paid by a guaranty fund subject to a “net worth” provision, an apparently covered claim should in fact be treated as non-covered since the policyholder is directly liable to guaranty funds. A final “covered/non-covered” split will not be determinable with certainty until related Proofs of Claim are all evaluated. One possible solution is to use an estimate. distributing collateral to guaranty funds using an “early access”

type approach, with a payback requirement if estimated funds exceed the value of covered claims.

2. **Allocation among different policies/programs.** Current information on the Legion and Reliance programs is also inadequate to allocate collateral among different lines/programs as required by Act 46. So, for example, where collateral secures the insured's performance under a large deductible WC program, but also secures insured's obligations say for retrospectively rated premiums, or AL/GL deductible reimbursements, there is not sufficient data to determine exposure under different policies to allocate collateral.

3. **Guaranty fund involvement in collateral reviews.** Act 46 requires that guaranty funds be informed of collateral reviews performed by Liquidator. The Legion and Reliance Liquidator has expressed a willing to cooperate and provide information to the guaranty funds. Thus, collateral adjustments become a three way process involving the policyholder, the guarantee fund and the Liquidator.

B. Accounts where Liquidator has exhausted collection efforts.

The Liquidator indicated that there are a small number of accounts for which the Liquidator has nearly exhausted all efforts to collect. Under Act 46 these accounts can be turned over to the guaranty funds for further collection efforts. The mechanics and coordination of how the various state guaranty funds will undertake these collections actions has yet to be determined. The Liquidator has offered to provide the collection services but the actual cost of collection would have to be paid by the guaranty associations.

Conclusion

Act 46 represents a necessary step of reforming the insolvency laws to deal with the realities of today's complex insuring relationships. At the same time, however, it creates a new class of LDP claimant, who may obtain preferable treatment to other claimants under an identical insurance policy issued by the same carrier that was not a LDP.

Endnotes

1. A typical large deductible clause reads: "We will pay benefits and damages that are covered under this policy. We will only seek reimbursement for those amounts that are within the applicable deductible shown above. You will reimburse us promptly for any deductible amounts and all Allocated Loss Adjustment Expenses that we have addressed. . . . The Aggregate Deductible is the most you will pay for the sum of all deductible amounts payable by you for all Occurrences during the policy period."
2. In 2000 the NCCI reported 34% of manual workers' compensation premium was attributable to LDPs.
3. *See* NAIC, Survey of State Workers' Compensation Agencies, January 29, 2003, for an overview of the regulatory implications of large deductible policies.
4. In some of the large-deductible programs written by Legion Insurance Company, In Liquidation ("Legion") the policyholder purchased a deductible reimbursement policy from an offshore affiliate.
5. Pennsylvania is not the only state to pass the NLIFG legislation. In 2004, Illinois enacted an almost identical act (HB 5928). The NCIGF is expected to push this model legislation in other states as well.
6. Section 523.1(N). It is important to note that the definition excludes amounts in excess of the deductible limit which are still covered by the guaranty fund. Net worth caps and other limitations on whether a claim qualifies as a "covered claim" under a state guaranty fund statute still apply.
7. Section 523.1(a)&(b).
8. Section 523.1(j).
9. Section 523.1(c).
10. *See* Section 523.1(f)(3).
11. Section 523.1(e).

12. Id.

13. Id.

14. Id.

15. Id.

16. *See* Section 523.1(g)(2).

17. *See* Section 523.1(f)(2).

18. Id.