NEWSSTAND

The Challenges for Secured Creditors in Insurance Insolvency: When Having a Secured Claim May Not Guarantee Payment

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In the case of banking institutions dealing with the unique world of insurance insolvency, the results may not be as dramatic as in other cultural clashes, but they can be equally confused. This is because insurance insolvency operates in its own separate world, where the usual rules of bankruptcy do not apply and where, without appropriate safeguards, having a secured claim may not guarantee repayment. For banks and other secured creditors, lending to insurance companies is governed by a separate set of rules to which careful attention must be paid.

Unlike other corporate entities, licensed insurance companies that become insolvent do not go through the usual federal bankruptcy process. Rather, every state has its own separate insurance insolvency system with its own rules that govern the process. As a result, everything that a creditor thinks he or she knows about collecting secured debts under the bankruptcy code does not necessarily apply. In this separate world, if care is not taken, regulators may attempt to subrogate the rights of secured creditors in order to carry out the strong public policy preference under the insurance laws of most states for the protection of policy holders over other creditors.

The reason for all of this is rooted in a basic truth: Insurance is just different from other businesses. An insurance company's customers are deeply dependent on the long-term reliability of the product, insurance coverage, to make them whole and thus avoid financial ruin. Moreover, customers may be depending upon the product years, or decades, after they have paid for it with their premiums. As a result, the government regulates insurance companies closely to make sure they remain solvent, and where they do not, has an elaborate system to wind down these companies in a way that protects the insureds. The result is a process different from traditional bankruptcy, with a unique set of goals and biases.

While every state has its own regulatory structure, the basic process is similar in many jurisdictions, including New York. When the state insurance regulator determines that an insurance company is insolvent or otherwise poses a danger to consumers, he or she will seek a court order placing the company in receivership with that state's statutory receiver. In New York, for example, the Insurance Superintendent would be named as the receiver and the process would be managed by his agent, the Special Deputy Superintendent in Charge of the New York Liquidation Bureau (the NYLB).

Generally, at the same time that the Insurance Commissioner is taking charge of an insolvent company's operations, a state-run security fund or guarantee association will evaluate and, as appropriate, pay claims of the company's policy holders from a fund created by annual assessments of solvent insurers. That fund will then step into the shoes of the insureds and become a creditor of the insolvent insurance company. As a general rule, the managers of the various security funds and guarantee associations take their role as creditors quite seriously, viewing collections as an important part of keeping their funds solvent for the next crisis. They will work closely with the receiver – in New York they are all part of the NYLB – to ensure the maximum collection from the insolvent company.

The actual insolvency goes through a two-step process. The first step is for the receiver to take control of all of the insolvent company's assets. This is typically a very broad mandate, which would very likely include taking control of any assets held by an insurance company but pledged as security for a loan made by a bank or other entity. Typically, once the assets have been marshaled, the receiver will conduct an audit or other review to determine the full scope of the insolvent company's assets and liabilities and report back to the receivership court when this is completed.

While this is only the first step in the process, there is a practical point to be noted here. It is unlikely that the receiver would agree to release any assets (even those held as security against secured claims if held by the insolvent company) until after this initial accounting and report to the court, and until a court has approved any particular claim. Indeed, in many instances, such a distribution is prohibited outright. While the time for this step is difficult to predict and will vary widely depending on many factors, it is not unreasonable to assume that it will take at least a year if not more. Thus, even a secured claim will not likely be paid without some considerable wait.

As a general rule, after paying the receiver's own costs and certain other claims, the first priority on an insolvent company's assets belongs to the various insureds, who must all be made whole before other creditors. In many states, including New York, the priority statute does not expressly distinguish between secured and unsecured creditors, simply lumping all creditors together to be paid only after the insureds (including security funds) have been made whole. This is not the end of the story, however. The liquidation statutes of most states, despite the poorly drafted priority provisions, should be read to require that secured claims, to the extent of their security, receive a priority above both insureds and other creditors. For example, New York's code provides:

The owner of a secured claim against an insurer for which a receiver has been appointed in this or any other state may surrender his security and file his claim as a general creditor, or the claim may be discharged by resort to the security, in which case the deficiency, if any, shall be treated as a claim against the general assets of the insurer on the same basis as claims of unsecured creditors. If the amount of the deficiency has been adjudicated in ancillary proceedings as provided in this act, or if it has been adjudicated by a court of competent jurisdiction in proceedings in which the domiciliary receiver has had notice and opportunity to be heard, such amount shall be conclusive; otherwise the amount shall be determined in the delinquency proceeding in the domiciliary state.

N.Y. Ins. Law § 7413(d). New York law further provides that secured assets when properly segregated should not be considered part of the estate's general assets available to pay policy- holders. N.Y. Ins. Law § 74089(a)(7).

A plain reading of the statute would suggest that it protects secured creditors. Indeed, at least one New York court has expressly held that the statute gives secured creditors a preference. *In re Allcity Insurance Company*, 66 A.D.2d 531, 536 (1st Dep't 1979); *see also G.H. Murphy Co. v. Reserve Insurance Co.*, 54 N.Y.2d 69, 80 (1981) (noting the need to distinguish between secured and unsecured creditors). *See also 0GS* Opinion No. 08-12-08. A number of other states have similar provisions. Seen this way, the statute appears to require that once the receiver has completed his/her review of the estate, a secured creditor should be entitled to be paid the secured assets as against its loss on the loan.

Again, however, practical considerations intervene. To begin with, in the event of an insolvency, the regulator's first concern is to make sure that individual policyholders are made whole. While the security funds will cover much of this, those funds have a variety of limits. Moreover, the security fund administrators themselves become creditors and, as noted above, will be forceful in demanding payment. All of this places considerable pressure upon the receiver to find alternate ways to fund such obligations. One way to do so would be to employ the imprecise drafting in many state statutes and take the position that, even if the statute does say that a secured claim "may be discharged by resort to the security", the section of the statute listing the order of priority of claims simply refers to creditors generally and relegates them all to a priority below insureds.

There are numerous and compelling arguments to be made against such a reading of the law, including the legal arguments noted above and public policy arguments to the effect that such a stance would make it virtually impossible for insurance companies to obtain secured loans and financing in the future. Indeed, if litigated, it would be difficult for a receiver to prevail, but such a proceeding could be time consuming and costly. The real concern, of course, is that an activist receiver would use what uncertainty does exist as the basis for trying to negotiate a partial payment that would allow some of the security to be used to pay insureds.

In conclusion, while there could be a considerable delay in payment, as a legal matter a secured creditor should be able to collect on its debt to the extent of the security posted. However, in the event of an economic event large enough to cause the insolvency of a significant insurance company, the possibility exists that pressure to make policyholders whole will force a receiver to attempt to negotiate a reduction in the payment on such a claim, and the insurance insolvency laws in many states provide room to maneuver. Finally, the unique state-by-state status of insurance insolvency means that the usual assumptions applicable to federal bankruptcy may not be made. This is a different world and should be seen as such.