

SHOULD THE SUPERINTENDENT OF INSURANCE ALWAYS BE THE LIQUIDATOR?*

(FORC Journal: Vol. 19 Edition 1 - Spring 2008)

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Introduction

Insurance liquidation statutes throughout the country require that when a domestic insurance company is placed into liquidation, the Superintendent of Insurance must be appointed the Liquidator by the Court supervising the liquidation. ¹ That requirement has not always been in place in this country and is not the case in England, parts of Europe and other countries. This article addresses the question of whether it makes sense to allow persons other than the Superintendent of Insurance to be appointed Liquidator of an insolvent insurance company.

When I started considering the issue for this article, I thought I was well suited to provide an objective analysis of this question since in my thirty plus years of being an attorney, I was outside counsel to the Superintendent of Insurance for twenty years on several different insurance company liquidations, I was in-house counsel at the Ohio Department of Insurance at a time in which there were several very active insolvencies and liquidations, and, since my return to private practice, I have been counsel for more than a dozen clients with significant issues in a half dozen or more liquidations. Whether I am being objective, however, may be subject to question because my view after the research and working on this article is much more one-sided. That is, I believe that the Superintendent should not always be the insurance Liquidator and statutes should therefore be amended to allow private parties to become appointed the Liquidator by the court supervising the liquidation.

I will discuss briefly the history of the Liquidator of an insolvent insurance company below, point out a number of issues that commonly arise because the Superintendent is the Liquidator and address the pros and cons of the Superintendent having the dual role.

History of Appointment of the Liquidator

For an insurance company to be placed into liquidation, the domestic regulator of the insurance company must file a complaint in court alleging the company is insolvent or that some other grounds exist which warrant the company be liquidated. The complaint is filed at the trial court level and the trial court, by statute, must appoint the Superintendent of Insurance as the Liquidator. The role of the Liquidator, like the role of a court-appointed receiver of an insolvent non-insurance company, is to marshal the assets, wind-down the business and pay the liabilities.

The role of Liquidator has not always been filled by the state's Superintendent of Insurance. Prior to the Uniform Insurers Liquidation Act, a model act promulgated by the National Association of Insurance Commissioners in 1939, the role of Liquidator was filled by a private citizen.² At common law, "a receiver's only purpose was to provide a presumably neutral party to carry out a particular task or set of tasks pursuant to

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the supervision of a court. Such a receiver was not performing a regulatory function on behalf of the sovereign state, but acted on behalf of the particular court that appointed him." 3 Thus, Liquidators were private parties.

In 1944, the United States Supreme Court decided *United States v. South-Eastern Underwriters Association*, holding that insurance companies were subject to federal regulation under the Commerce Clause.⁴ Due to a backlash from the insurance industry and the state regulators, Congress passed the McCarran-Ferguson Act in 1945.⁵ The McCarran-Ferguson Act (the "Act")⁶ grants states the authority to control state systems for the regulation and taxation of the insurance business.⁷ "McCarran-Ferguson, therefore, permits the states to determine the rules of insurance regulation" ⁸

Under the Act, state laws regulating the business of insurance are not preempted by conflicting federal laws that do not relate to the business of insurance unless the federal law specifically provides otherwise.⁹ As the United States Supreme Court explained in *SEC v. National Securities, Inc.*, "The McCarran-Ferguson Act was an attempt to turn back the clock, to assure that the activities of insurance companies in dealing with their policyholders would remain subject to state regulation."¹⁰ In *United States Dept. of the Treasury v. Fabe*, the Supreme Court explicitly held that the receivership of insolvent insurance companies was subject to state control.¹¹

Pursuant to that authority under the Act, almost every state has adopted a version of the Uniform Insurers Liquidation Act. The Model Act provides that an order to liquidate the business of an insurer shall appoint the superintendent of insurance as the Liquidator.¹² "Accordingly, only an elected or appointed officer of the state acting in his official capacity may be appointed an insurance receiver . . . [and] [t]he [Superintendent] is the embodiment of the state's police power in the insurance insolvency context."¹³

Until recent years, liquidations of insurers were infrequent and there was little need to question the role of the Superintendent as Liquidator.¹⁴ With the more recent rate of insolvencies, and their increasing size and complexity, it is time to re-examine the mandatory nature of the Superintendent's dual role.

Issues Raised by Superintendent's Dual Role

The fact that the Superintendent is first the regulator of a company that becomes insolvent and then the Liquidator of that same company has been the subject of considerable litigation over the years. Although the issues have arisen in a number of different ways and contexts, they basically relate to the question of whether the Superintendent as regulator is a separate and distinct person or entity from the Superintendent as court-appointed Liquidator.

Although state courts agree that a counterclaim against a Liquidator for conduct that occurred while the Superintendent was functioning as the regulator will not be maintained, other issues are the subject of conflicting views. These issues include whether the actions or non-actions of the Superintendent as Regulator can be a defense to the Liquidator's claims, whether the Liquidator is an arm of the state, whether the Deliberative Process Privilege applies to Liquidators and whether the state or the Liquidator personally is the real party in interest.

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Defenses to Liquidator's Claim Based Upon Regulator's Conduct

In *In the Matter of the Liquidation of Ideal Mutual Insurance Co.*, the Superintendent of Insurance for the State of New York, acting in his capacity as Liquidator, charged various officers and directors of Ideal Mutual Insurance Co. with breach of their fiduciary duties and mismanagement, which allegedly led to the company's insolvency.¹⁵ The defendants asserted two affirmative defenses against the Liquidator's claims: contributory negligence and lack of proximate cause.

The New York court held that the Superintendent, as Liquidator of an insurance company, occupies "a legal personality separate and distinct from the Superintendent of Insurance as the public official charged with regulating the industry generally." Therefore, the court dismissed the contributory negligence defense because the allegedly negligent acts were committed while the Superintendent was exercising his regulatory function, prior to the time he became Liquidator of Ideal. However, the court did not dismiss the lack of proximate cause defense. The court held that "because that defense is predicated upon the thesis that a subsequent act of a third party interrupted the causal nexus between the defendant's initial negligence and the plaintiff's injury thereby relieving the defendant of liability, the defense should not be dismissed."

In *Covington v. Buckner*, an action brought by the Ohio Superintendent of Insurance in his role as Liquidator, the court dismissed various affirmative defenses asserted against the Superintendent for conduct that occurred while he was functioning as regulator.¹⁶ Two defendants asserted that the Liquidator's claims were barred for several reasons, including the doctrines of unclean hands and in pari delicto, lack of proximate cause, intervening and superseding cause, contributory negligence, assumption of risk, waiver, and estoppel.

The Ohio trial court held that the two positions of the Superintendent, that of the regulator and that of the Liquidator, are not interchangeable and that "any affirmative defense asserted against the Superintendent must relate to his conduct as Liquidator. The Liquidator cannot be held accountable for behavior which is attributed to the Regulator . . . who [is] not a [party]" Therefore, the court dismissed defendants' affirmative defenses, other than the intervening and superseding cause defense which related to the Liquidator's ability to show proximate cause.

Counterclaims Against Liquidator for Conduct While Acting as Regulator

Just as defenses based upon the Superintendent's conduct as regulator have been the subject of litigation, courts have been faced with counterclaims by defendants against Superintendents for their action or non-action in their role as Regulator. On this issue, the courts are in agreement as a number of states, including Pennsylvania,¹⁷ Ohio,¹⁸ North Carolina,¹⁹ and Illinois,²⁰ have applied the court's ruling in *Ideal* and held that because the Superintendent as court-appointed Liquidator is a legal personality separate and distinct from this Superintendent in his previous role as regulator, defendants cannot pursue counterclaims in lawsuits by the Liquidator based upon the Superintendent's role as regulator.

Applicability of Deliberative Process Privilege

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States have disagreed, however, as to whether the Superintendent of Insurance, when acting as Liquidator, may claim the deliberative process privilege to protect information pertaining to actions that occurred while the Superintendent was acting in his regulatory capacity. For those states that recognize a deliberative process privilege, the privilege permits the government to withhold documents from discovery that contain confidential deliberations of law or policymaking that reflect opinions, recommendations, or advice.²¹

In *Ario v. Deloitte & Touche*, Reliance Insurance Company was placed into liquidation in Pennsylvania and the Superintendent was appointed as Liquidator. When the defendants sought to discover certain information, the Liquidator asserted the deliberative process privilege.²² The Pennsylvania court held because a governmental entity acting in one capacity is treated as a separate entity when acting in another capacity, the privilege applied to information pertaining to events that occurred during the decision making process while the Superintendent was acting in her regulatory capacity and to information related to the Superintendent's regulatory conduct.

When faced with a similar issue, however, in the Integrity Insurance Company liquidation, the Supreme Court in New Jersey found that the Superintendent acting as Liquidator could not claim the deliberative process privilege to prevent discovery.²³ The New Jersey Supreme Court held that the deliberative process privilege is inapplicable if the person asserting it is not performing a governmental function. The court found that the Superintendent as Liquidator functions, at least in part, in a private role. His fiduciary responsibilities are to the creditors of the insolvent insurer, not to the public at large. Because the insurance business affects the public interest, the Superintendent "functions in a hybrid status, part public and part private, when he oversees the liquidation of an insolvent insurer." Therefore, the court found the Superintendent was not performing a purely governmental function and the deliberative process privilege was inapplicable.

Is the Superintendent or the State the Real Party In Interest?

States also disagree as to whether the State or the Superintendent is the real party in interest when the Superintendent brings a claim in his role as Liquidator. Resolution of the real party in interest issue often determines, among other issues, the availability of federal court jurisdiction, the application of estoppel principles, whether there is a bond requirement, and the applicability of public records laws.

In *Crawford v. Employers Reinsurance Corp.*, the Superintendent, in his capacity as Liquidator of MCA Insurance Co., brought an action against Employers Reinsurance Corp. asserting that the defendant breached treaties of reinsurance entered into between it and MCA, prior to MCA being placed into liquidation.²⁴ The Superintendent moved to remand the action to state court on the theory that diversity of citizenship was not present. The court held that the Superintendent initiated the action to enforce a contract against the defendant in his capacity as Liquidator for MCA, not as a state official seeking to assert or protect significant state interests. The court found that the Superintendent, as Liquidator, not the state of Oklahoma, was the real party in interest for purposes of determining diversity and therefore found that diversity was present.

Courts in Texas and Louisiana, however, have held that when the Superintendent brings a claim while functioning as the Liquidator, the state is the real party in interest. In *El Paso Electric Company v. Texas Dept of Ins.*, the issue was whether a claim prosecuted by the Liquidator was a claim by a state agency within the meaning of Chapter 105 of the Texas Civil Practice and Remedies Code which allows a litigant to recover fees and expenses when a state agency brings a frivolous claim.²⁵

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The court held that even assuming that the Liquidator assumes a separate legal identity upon being appointed receiver for an insolvent insurer, the Liquidator acted on behalf of the State, and therefore the Liquidator's conduct was subject to the Texas statutes. Key factors in making that determination were the lack of discretion a court has to appoint someone other than the Superintendent or the Superintendent's designated special deputy as Liquidator and the fact that the Superintendent controls the activities and compensation of any special deputy receivers that are appointed.

In *Louisiana v. Preferred Accident Insurance Co.*, the Louisiana Court held that proceedings against the Liquidator were against a state official, and therefore the Liquidator did not have to furnish bond on appeal.²⁶ The Louisiana court found that because the Superintendent alone may be appointed ancillary receiver or Liquidator of an insurance company, and the duties of the Liquidator are part of the duties of the Superintendent charged with the administration of the Insurance Code, that the Liquidator acts as an officer of the state in a public capacity, and therefore, that the proceedings were against a state official.

In many instances, the issues discussed above should be eliminated if the Superintendent of Insurance is not appointed the Liquidator and instead a private party takes over that function. On the other hand, that does not mean there will necessarily be less litigation. In fact, if the Liquidator is an independent third-party, we can probably expect a number of cases where a private party Liquidator will file a complaint against the Superintendent in his role as regulator based upon some variation of a theory of negligent regulation or otherwise causing or permitting the insurance company to become insolvent.

Analysis of Arguments Supporting the Dual Role

Although there are several arguments in favor of the Superintendent also being the Liquidator that appear to have merit on their face, upon analysis, most of them are not necessarily valid.

- The Superintendent of insurance is a public official, and therefore is accountable to the public. The fallacy of this argument is that once a company is placed into liquidation, while the liquidation may in theory occur "publicly," in reality, almost everything occurring after the liquidation order is beyond the public eye. Insurance liquidations are complicated, very slow moving and uninteresting, which means both the press and the public lose interest in following them.
- Insurance departments are well versed in the insurance business and have a lot of experience to draw upon. While that statement is hopefully true in every state, the liquidation of an insurance company is not the business of insurance. The Liquidator marshals and then liquidates assets, pays claims and pursues litigation against creditors and wrongdoers. The only aspect that has much to do with the insurance business is the payment of claims, which in most instances is actually done by the insurance guaranty associations, not the Liquidator. Running an insurance liquidation is a management and administrative process, not a regulatory function.
- The Superintendent does not receive any additional compensation for serving as the Liquidator, whereas utilizing a third-party would involve additional compensation, making the liquidation more expensive. That statement is true in part, but misleading since Superintendents are otherwise fully occupied and do not have time to run liquidations themselves. As a result, they must either hire additional state employees or subcontract with independent contractors. It is very unlikely there is any real cost savings by having the Superintendent be the Liquidator.
- A third-party Liquidator would have an incentive to drag out a liquidation to continue his own source of income. While this argument could be true not only in theory but also in fact, there are dozens of

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well respected and competent independent consultants to manage liquidations and, thus, there will be no shortage of finding "good people" who will perform their duties responsibly. At the same time, the fact is that most liquidations take many years to close. Based just on how long liquidations take, there appears to be very little incentive for Superintendents that are Liquidators to bring estates to a close as soon as possible.

Arguments Supporting Having an Independent Party Serve as Liquidator

The Superintendent may have a conflict of interest

In many situations there is an inherent conflict of interest between the Liquidator and the regulator if the same person has those separate and distinct roles, although, of course, at different times. It is unrealistic to expect that the same person acting in one capacity will act completely independent of his role in the other capacity. This conflict becomes obvious in situations where the Liquidator sues former directors and officers of the insurance company for negligence and they raise a defense based upon the regulator's own conduct. If the Superintendent is the Liquidator, then in his role as Liquidator, he has to defend his own conduct when he was acting in a different capacity, that of regulator.

Moreover, in states where sovereign immunity has been waived, conduct by the Superintendent as regulator may deserve scrutiny and justify a claim against the Superintendent. How can the Superintendent acting as Liquidator bring a claim against himself for action or non-action he should have taken when he was the regulator?

A large part of the Liquidator's responsibilities is pursuing claims for debts owed to the estate. In some instances, another insurance company is a large debtor of the estate. In situations where that insurance company debtor is a domestic insurance company, another conflict of interest situation may arise because, although in the role as Liquidator the Superintendent wants to vigorously pursue the claim, he is not going to want to put his own domestic insurance company in peril financially and maybe cause another domestic insurance company liquidation. Looking at another side of the same situation, will that company really want to take on its domestic regulator and aggressively defend its position?

Reinsurance is usually the main asset of an insurance company liquidation and pursuing reinsurance claims is a prime responsibility of the Liquidator. Many of the larger insurance companies act as reinsurers and thus may be a target of a Superintendent acting as Liquidator. Even in situations where the insurance company which is a reinsurer is not a domestic, the Superintendent as Liquidator can use his power and authority as regulator of that insurance company to directly, or indirectly, put undue pressure on the reinsurer to settle a claim.

In addition to the conflict of interest when the Superintendent serves in the dual role as regulator and Liquidator, there are a number of other arguments supporting using an independent third-party as the Liquidator. These include:

- Superintendents who serve many years are the exception. Liquidations take many years, often even more than a decade. Very few Superintendents serve in that position for more than a few years, particularly those that are appointed, and therefore, a new Superintendent and his senior staff must be brought up to speed before major decisions can be made, such as deciding whether to initiate lawsuits

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or settle those that are pending. This is inefficient and leads to many delays which means more expense.

- Potential economies of scale. In states that do not have many liquidations pending at the same time, the cost of staffing liquidations will generally be higher than it would be if the claims manager or the reinsurance expert in-house can be utilized on several liquidations at one time. Liquidations are almost always done within the state of domicile's boundaries. Permitting a private party with considerable experience in liquidations to handle a number of smaller liquidations in different states at the same time would be more efficient and less expensive.
- Limiting Political Considerations. Since Superintendents are public officials, it would be naive to think that politics do not play a role in many of the Liquidator's decisions. While liquidations generally operate in the dark, many a politician is going to try to make sure that if specific decisions do come to light, he, or the Governor that appointed him, will be perceived as having made good decisions. In contrast, an independent party serving as Liquidator should be making decisions about whether to bring litigation or settle litigation based upon a cost-benefit analysis, without regard to any political ramifications.
- Liquidations require different experience and skills than regulating insurance companies. The role of the Superintendent as regulator is to protect the public, particularly policyholders, by regulating the insurance industry. Insurance regulation involves primarily risk assessment of insurance companies' financial condition and monitoring the performance of insurance companies and insurance agents in the marketplace. In contrast, in a liquidation, the Liquidator's objective is to protect creditors of the estate, not the public. Therefore, the risk assessment relates to the assessment of claims, which is something the Superintendent does not do as a regulator. The functions of the Liquidator in marshalling and liquidating the assets are totally different from the actions of the Superintendent as regulator. There are no true consumer protection activities taken in liquidations. Instead, the guaranty associations established in each state are the ones that protect the policyholders.
- Acting as Liquidator distracts the Superintendent from his primary role as regulator. With some of the large insolvencies over the last several years, there is no doubt that some Superintendents and their staff have been spending an inordinate amount of time in their role as Liquidator, taking away from their time as regulator. Insurance department staffs have been taxed by some of the larger insolvencies or the number of insolvencies of domestic insurance companies, again taking time away from their roles as regulators.
- There is a large pool of excellent people that are experienced in this type of work. Although in some situations, it would still make sense for the Liquidator to be the Superintendent, depending upon a number of factors including the potential for conflicts of interests, the size of the estate, the issues likely to arise in the liquidation estate, the amount of time that appears necessary to handle the estate and the short-term and long-term staffing of the insurance department in terms of both experience and availability, in those instances where it makes sense to have someone other than the Superintendent be the Liquidator, there are a good number of experienced people working in the private sector that are very competent and experienced in insurance liquidation. They include accountants, actuaries, attorneys, former insurance company executives and former insurance department superintendents or liquidation bureau officials. Most of these people are very well known to the industry and particularly the trade associations such as the National Conference of Insurance Guaranty Funds and the International Association of Insurance Receivers.

Conclusion

The Superintendent of Insurance should not always be the Liquidator of an insolvent insurance company. Insurance liquidation statutes should be amended so that consideration can be given on a case-by-case basis to appointing an independent party with sufficient experience and expertise to manage the liquidation process.

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Courts should have the freedom to appoint an independent party as the Liquidator in the appropriate circumstances which should lead to increased efficiencies, better run liquidations and less expense for all parties involved.

* Thanks to Sarah Porter, Esq. for her assistance in the research and writing of this article.

Endnotes

1. Some states refer to the head of its insurance department as "Superintendent" while others use the term "Commissioner." Although the term "Superintendent" is used in this article, it is meant to be interchangeable with "Commissioner."
2. *In the Matter of the Liquidation of Integrity Insurance Company*, 165 N.J. 75, 90 (2000).
3. Rubinstein, Karl L., *The Legal Standing of an Insurance Insolvency Receiver: When the Shoe Doesn't Fit*, 10 Conn. Ins. L.J. 309, 319-20.
4. 322 U.S. 533, 548-39 (1944).
5. See Note 3, *supra*, at 316.
6. 15 U.S.C. § 1011 *et seq.*
7. See Note 3, *supra*, at 316.
8. See Note 3, *supra*, at 317.
9. 15 U.S.C. § 1012.
10. 393 U.S. 453 (1969).
11. 508 U.S. 491 (1993).
12. NAIC Model Laws, Regulations and Guidelines 555-1, § 501.
13. See Note 3, *supra*, at 317.
14. Bickford, Peter H., *Insurer Solvency Regulation; Destroying Myths That Now Surround the Solvency Issue*, Business Insurance, March 18, 1991.
15. 140 A.D.2d 62 (S. Ct. NY 1988).
16. *Covington v. Buckner*, Franklin County Court of Common Pleas, Case No. 98CVH-07-5242, Decision and Entry, June 1, 2000.
17. *Koken v. One Beacon Insurance Co.*, 911 A.2d 1021 (Commw. Ct. Pa. 2006); *Foster v. Monsour Med. Foundation*, 667 A.2d 18 (Commw. Ct. PA 1995).
18. *Benjamin v. Ernst & Young*, 167 Ohio App.3d 350 (Ohio Ct. App. 2006).

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19. *North Carolina v. Alexander & Alexander Services, Inc.*, 711 F.Supp 257 (E.D. N.C. 1989).
20. *Williams v. Continental Stock Transfer & Trust Co.*, 1 F.Supp.2d 836 (N.D. Ill. 1998).
21. *Ario v. Deloitte & Touche*, 934 A.2d 1290 (Commw. Ct. Pa. 2007).
22. *Id.*
23. *In the Matter of the Liquidation of Integrity Insurance Company*, 765 A.2d 1177 (S. Ct. N.J. 2000).
24. 896 F.Supp 1101 (W.D. Okla. 1995).
25. 937 S.W.2d 432 (S.Ct. Tex. 1996).
26. 115 So. 2d 384 (S.Ct. LA 1959).