

A proposed response to international insurance insolvencies

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Many, if not most, of the articles in this and similar journals discuss, dissect and ruminate over the current state of a particular practice, or involve tried and true means of approaching essentially the same restructuring paradigm from a different perspective. We propose to do something a little different. We'd like to get you to stop and think about the bigger policy and regulatory trends that those of us in the restructuring and insolvency arena will face in the next decade or two.

Of all of the topics that lend themselves to this type of forecasting, the one we've chosen to explore here is that of insurance industry insolvencies on both sides of the Atlantic. The premise that drives this article is that both in the United States and within the European Union, the larger financial services sector is dramatically changing, most notably in the banking and insurance areas. Yet, when it comes to the administration of insolvent insurance companies, practices are plagued by a hodgepodge of fragmented laws and regulations that, in the main, are outdated and inadequate to address these changes now occurring in the marketplace. Despite the ongoing worldwide consolidation among major insurers, the governance and regulatory structures dealing with those companies that fail still remains largely a matter of parochial and local concern. Our argument, as well as our forecast, is rather simple. Given the impact of global insurance company consolidations, it is certain that the inevitable failures among these companies will cross international borders and therefore so, too, must the regulations that deal with these insolvencies.

In the US, for example, the individual states have historically regulated the business of insurance, including the decision to place an insurer into insolvency proceedings. The federal legislature can, however, step in and regulate the industry if it chooses to do so, and within the recent past, selected members of Congress have introduced legislation or taken other steps towards federalising the oversight of the insurance industry.

The most notable of these efforts at the federal level has come from the US House

of Representatives, in the person of Congressman Michael Oxley (the "Oxley" in the recent US law known as "Sarbanes-Oxley"). Earlier this year, he expressed to the various state insurance regulators his concern regarding market inefficiencies that exist in the state-by-state regulatory process and his promise (or threat, depending on one's perspective) to manage at least some aspects of insurance regulation from now on with federal oversight.

Once distilled, Mr Oxley's solution appears to be more along the lines of a national standardisation of practices rather than an absolute federalisation of insurance regulation. A Discussion Draft of proposed federal legislation released in July 2004 would impose national standards on the states in a number of insurance practices, including insolvency, but enforcing those standards would still be left up to state regimes.

Whether Mr Oxley's approach, involving nationally standardised practices rather than direct federal regulatory supervision, is the best path upon which to embark is a question better left to experts on US Constitutional law, but as a practical matter, the assumption that the individual states will be able to continue to administer their insolvent insurers' estates might not hold true in the future given the increasing likelihood of some type of federal supervision. To be sure, if the Discussion Draft involving the proposed legislation becomes law, the states' insolvency mechanisms would wind up being substantially similar because one of the primary aims of Mr Oxley's efforts is the standardisation of these practices.

There would remain, however, obvious differences. Initially, these differences would appear to be largely procedural, but over time as the various state courts interpret and apply the language of this proposed uniform insolvency law, it is axiomatic that substantive variances will emerge based on regional practices. The United States is well accustomed to these substantial variances arising across a broad range of its purportedly uniform laws, and these differences are often inevitable in a nation the size of America, where cultural attitudes differ widely across regions. In

addition, these differences may be attenuated because some states' regulatory interpretations could reflect a degree of resentment over the perceived paternalism on the part of the federal government. Moreover, although each state can look to other states' decisions for precedential guidance, a particular state's decision on a given provision of the insolvency law will, in reality, have no binding effect whatsoever on the other states. As Mr Oxley conceives of this nationally standardised system of insurance insolvency, it is possible that even the US Supreme Court may be precluded from settling interstate conflicts of legal interpretation.

As the term implies, the Discussion Draft is just that – a draft. Although important as an indicator of the direction in which the US is moving with respect to insurance regulation, including insurance company insolvencies, the Discussion Draft does not presently have the force of law. Obviously, until the Discussion Draft or some other form of federal legislation is enacted, insurance insolvency for the foreseeable future will continue to be a regime governed separately by the individual states.

The EU, in its ongoing efforts towards integration, essentially shares the philosophical approach of freeing insurers and other financial service providers from certain national governmental barriers to competition, especially in the case of geographical state borders. Currently, with regard to the specific issue of insurance insolvency, however, the EU has affirmatively let the various Member States retain a large degree of local control, with the members keeping in place their regimes governing insurance insolvency, as stated in EU Directive 2001/17.

Rather than suggesting that the EU strive for uniform insolvency laws, this Directive "aims at ensuring mutual recognition of Member States' reorganisation measures and winding-up legislation concerning insurance undertakings as well as the necessary cooperation" to do so among the Member States. This Directive embodies six principles: unity, universality, coordination, publicity (Notice), equivalent treatment and the protection of insurance ►►

creditors. Central to this Directive is its designation of controlling law. The Member State in which an insurance concern has its registered office is considered the "home state" under the Directive, and the home nation's laws will govern both the initiation of insolvency proceedings and the subsequent administration of the insolvent insurer, including its operations and assets located in other Member States.

Certain aspects of Directive 2001/17 are mandatory. For example, with respect to insurance claims, there are only two options: such claims must be granted either absolute precedence or, if not absolute, they may be preceded only by claims on salaries, social security and rights in property. Further, the publicity or notice of the commencement of the insolvency proceedings in an appropriate manner is required, including notification to all known creditors.

Taken together, this Directive and a handful of other similar mandates by the EU create a system not unlike that which presently exists in the US: that is, a collection of many sovereigns empowered to enact insurance insolvency laws that can both vary widely and reflect divergent cultural distinctions and preferences. Exacerbating this situation in the EU is the Directive's treatment of insurer insolvencies when branches of the enterprise are maintained in more than one Member State, but the main office is outside the EU. In these instances, each Member State is to be treated independently, with a mandate only that they cooperate and coordinate in their efforts to manage the insurance insolvency.

Clearly, and as we have noted above, the trend in the US is, albeit haltingly, towards uniformity of insurance insolvency laws and regulation. Whether the EU will decide to follow that trend remains to be seen. With only about four years under the current regime as mandated by the Directive, there has been far too little time and case development as yet from which to draw conclusions regarding the success or failure of the EU's policy and regulatory pronouncements on insurance insolvencies.

Yet, for the purposes of this article, let us posit that the trends we see towards a greater standardisation of insurance insolvency regimes within the economies of both the US and Europe will continue to mature in the present direction. Clearly, as this occurs, pressure will build and practices will evolve that will tend to reinforce the likelihood of regulatory oversight of insur-

ance insolvencies at the larger economic level: a Federal Code for the US and a market-wide dictate from Brussels for the EU.

In our opinion, the potential disparities and inequities involving claims resolution and treatment of policy beneficiaries as a result of insolvencies administered at a state or member level will inevitably lead to this increasing national or community-wide role, given the cross-national consolidation of the industry that has already preceded it. The reality is that the response to the larger insolvencies which will ultimately occur as a result of this consolidation trend has lagged behind, in lockstep, with adjustments to the necessary regulatory schemes needed to govern these new insurance behemoths.

Assuming that this trend towards uniformity in insolvency regimes continues in both the US and the EU, it would seem that the next logical step would be to address a protocol for the transnational insurance insolvencies which are certainly going to occur in the near future, given the fact that the consolidation of the insurance industry is presently global in nature. As of this writing, it seems that neither the EU nor the US has yet considered the need to address the all-but-certain likelihood of such an insurance insolvency. However, the pace at which insurance concerns are becoming global in reach and the extent to which the insurance industry is increasingly merging with other financial service providers, in our opinion, requires a more forward-looking inquiry into the insurance insolvency schemes on both sides of the Atlantic, and as to how fundamental cross-border cooperation can initially be found.

An important first step is to expand the already-existing dialogue between the US and the EU on this subject. Much discussion has taken place between the two with respect to securities and banking regulatory issues, but insolvency mechanisms are rarely, if at all, the primary focus of discussion. Ideally, the commencement of a dialogue between the two on insurance insolvency would move directly to specific issues, such as:

(1) Formation of an international commission to engage in a comparative study of the insurance insolvency laws of the members of the EU and those prevailing in the US, be they the individual state laws now in place or something akin to the provisions embodied in the Oxley Discussion Draft. (2) Creation of an international regu-

latory entity that would have jurisdiction over the administration of insolvent insurers' estates in accordance with agreed upon substantive rules. (3) Adoption of a version of the United Nations Commission on International Trade Law's Model Law on Cross-Border Insolvency specifically tailored to the unique concerns that can arise in insurance insolvencies.

These proposals are presented mainly by way of example and each undoubtedly raises its own subset of issues that are far too numerous to detail in this article. They do, however, provide a useful starting point for a necessary discussion.

Equally important, a fair degree of self-criticism will be required. The US, for example, must accept its own unwillingness to address insolvency laws until after a momentous company failure has occurred and the damage is done. For their part, EU Member States could examine their tendency to resist the US concept of management control of insolvent but reorganising companies and open their minds to the notion that liquidation is not the only, or even the best, response to insolvency.

There is no doubt that the risks now underwritten by insurance companies have grown to dwarf any of those of previous historical precedence. One obvious response to this demand for the concentration of capital has been the ongoing worldwide consolidation of industry players. Regulatory bodies across a broad spectrum of the financial world have already recognised the need to avoid impeding these mergers and acquisitions so as to better allow the insurance industry to respond to the demands of the world market in terms of the risks it now faces and insures. With this consolidation, our belief is that the time has also come for these regulatory and legislative authorities to recognise and confront the likelihood that the insurance companies that have, with the active encouragement of the governments involved, acquired this global reach will soon experience an insurer insolvency that spreads extensively into the constituencies of all. To do this, these regulatory authorities need to spend as much time focusing on the potential likelihood and ramifications of such an insolvency as they do providing attention to the issues surrounding the industry's global consolidation. ■

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