# Insurer Insolvency Under Federal Law

Authors from left to right:
***Fred Karlinsky***
***Rich Fidei***
***Benjamin Zellner***

The 2008 Financial Crisis led to significant reforms of the financial services industry, most notably the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Enacted in 2010, Dodd-Frank primarily affects the banking industry, but it also includes provisions applicable to insurance companies, which have traditionally been regulated by individual state insurance departments. One such area is insurer insolvency, which has been regulated by the states since enactment of the Federal Bankruptcy Act of 1898. While Dodd-Frank does not usurp the states' authority in this regard, there is some potential for federal involvement in the insolvency of insurance companies that have been designated Systemically Important Financial Institutions (SIFIs) under Dodd-Frank.

A company may be designated a SIFI by the Financial Stability Oversight Council (FSOC) based on considerations related to the size, interconnectedness, lack of substitutes, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny applicable to the company. To date, four entities have been designated SIFIs: American International Group, Inc.; General Electric Capital Corporation, Inc.; Prudential Financial, Inc.; and MetLife, Inc. FSOC subsequently rescinded its designation of G.E. Capital following that company's down-sizing, and MetLife successfully had its designation overturned in court.

Insurers that have been designated SIFIs, or which are part of groups that have been designated SIFIs, will experience some federal oversight if they become insolvent. This involvement is known as Orderly Liquidation Authority, and can be found in Title II of Dodd-Frank (12 U.S.C. § 5381 et seq.). Many issues are posed by the Orderly Liquidation Authority process, but first an overview of the process is in order.

**Insurers that have been designated SIFIs, or which are part of groups that have been designated SIFIs, will experience some federal oversight if they become insolvent.**

Orderly Liquidation Authority applies to both banks and non-bank financial institutions, including insurance companies, that have been designated SIFIs.[1] If the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) believe that a "financial company," as defined in Dodd-Frank, is in hazardous financial condition, they can make a written recommendation to the Treasury Department that the FDIC be appointed receiver for the company.[2] If the financial company is an insurer, the Director of the Federal Insurance Office (FIO) must approve the recommendation.[3] All recommendations, for both insurers and non-insurers, require a two-thirds vote of the Federal Reserve Board of Governors.[4]

In making such a recommendation the agencies must generally provide a comprehensive analysis of why the company is in hazardous condition, the potential impact of the company's failure, other potential alternatives to FDIC receivership, and why the normal bankruptcy process is inappropriate.[5] The Federal Reserve must also study the potential impact on low-income and minority communities, as well as the shareholders, creditors, and other parties related to the company, and balance competing interests.[6] The overarching requirement is that the agencies find that the troubled company's failure, if subject to the

[1] 12 U.S.C. § 5383. See also 12 U.S.C. § 5381(a)(11).
[2] 12 U.S.C. § 5383(a)(1).
[3] 12 U.S.C. § 5383(a)(1)(C).
[4] 12 U.S.C. § 5383(a)(1).
[5] 12 U.S.C. § 5383(a)(2).
[6] 12 U.S.C. § 5383(a)(2)(C), (G).

**This article first appeared in the Fall 2016 issue of *The Demotech Difference*, a publication of Demotech, Inc., www.demotech.com**

Gajus/shutterstock.com

normal bankruptcy process, will have a systemic impact on the U.S. financial system, thus necessitating a more orderly process.

Once the Federal Reserve and the FDIC make the recommendation to the Treasury Department, the Treasury Department and the President determine whether FDIC receivership of the company is appropriate.[7] If the Treasury Department and President agree, the company will be notified of the determination and asked to consent to appointment of the FDIC as receiver.[8] The company may consent to FDIC receivership, but if it refuses the Treasury Department must file a petition in Federal District Court for an order appointing the FDIC receiver.[9] The petition is filed under seal and kept strictly confidential in order to prevent a run on the markets or other disruption, and the hearing is closed to the public.[10] The Treasury Department needs to demonstrate to the court that the company is in default or danger of default, and satisfies the definition of a financial company under the statute, before an order appointing the FDIC receiver may be issued.[11] For the company to prevail, the standard it must overcome is that the agency's action was arbitrary and capricious.[12] This is a difficult standard to prove, and it seems unlikely that many companies will be able to successfully oppose appointment of the FDIC as receiver once the federal government has determined that such appointment is necessary. Lastly, the court must render an opinion within 24 hours of the petition being filed, or the petition is deemed granted by operation of law.[13]

Up to this point in the process, only a small number of individuals in the federal government and the company know about the proposed FDIC receivership of the company. As previously indicated, secrecy is necessary to protect the company's financial position, and to prevent a run on the market that will further imperil the company's already troubled condition. However, once the FDIC becomes receiver, Congress must be notified within 24 hours, at which point the event will become public knowledge. The FDIC must provide a more detailed report to Congress within 60 days of the date of appointment.[14] Congress will be able to maintain oversight of the process, and can also hold hearings with FDIC officials to obtain more information.[15]

The Government Accountability Office (GAO) is required to conduct a study and report to Congress on the appointment of FDIC as receiver.[16] GAO will review the basis for the determination, as well as the likely effect on the market as a whole.[17] In doing this, GAO is to evaluate the incentives that are created by appointment of FDIC as receiver.[18] GAO will therefore study the potential precedent the federal government has set in making the determination to appoint the FDIC receiver for a company. Further, GAO will also study whether the rights of creditors and other stakeholders of the covered financial company will be disrupted.[19]

There are significant variations to the process described above when it is applied to insurance companies. When an insurance company is determined to be a covered financial company, or is a subsidiary or affiliate of a covered financial company, the insurer will be liquidated or rehabilitated under "applicable State law."[20] Generally, the Orderly Liquidation Authority process results in liquidation of the covered financial company, so the potential rehabilitation of an insurance company represents a significant departure from the process for non-insurers.

**There are significant variations to the process described above when it is applied to insurance companies.**

The application of state law also means that when an insurance company becomes a covered financial company or is a subsidiary or affiliate of a covered financial company, the FDIC does not become the insurer's receiver; instead, the

[7] 12 U.S.C. § 5383(b).
[8] 12 U.S.C. § 5382(a)(1)(A)(i).
[9] 12 U.S.C. § 5382(a)(1)(A)(i).
[10] 12 U.S.C. § 5382(a)(1)(A)(iii).
[11] 12 U.S.C. § 5382(a)(1)(A)(iv).
[12] 12 U.S.C. § 5382(a)(1)(A)(iv)(I) and (II).
[13] 12 U.S.C. § 5382(a)(1)(A)(v).
[14] 12 U.S.C. § 5383(c)(3)(A).
[15] 12 U.S.C. § 5383(c)(3)(C).
[16] 12 U.S.C. § 5383(c)(5).
[17] 12 U.S.C. § 5383(c)(5)(A)-(D).
[18] 12 U.S.C. § 5383(c)(5)(C).
[19] 12 U.S.C. § 5383(c)(5)(D).
[20] 12 U.S.C. § 5383(e)(1).

CONTINUED ON PAGE 46

## Insurer Insolvency

CONTINUED FROM PAGE 9

insurance commissioner of the insurer's state of domicile becomes receiver pursuant to the applicable provisions of the state's insurance code.[21] Non-insurance subsidiaries or affiliates are still subject to FDIC receivership,[22] so a state regulator may find itself working with the federal government if an insurance group becomes insolvent. If the insurer's state regulator does not file appropriate judicial action within 60 days of the insurer or its parent becoming a covered financial company, then the FDIC has the authority to "stand in the place" of the state regulator and act as receiver under state law.[23] This is referred to as "backup authority" in the statute.[24] Thus, there is still some potential for federal resolution of insolvent insurers.

A question that arises when considering the potential impact on insurers is how a state regulator is expected to coordinate receivership with the federal government. While Dodd-Frank does not provide any guidance for the necessary coordination, the National Association of Insurance Commissioners (NAIC) has indicated that it expects state regulators to work closely with the federal government in the event that a state regulator is receiver for an insurer, and the FDIC is receiver for non-insurance affiliates. To try to address some of the uncertainties, the NAIC added a chapter to the Receiver's Handbook for Insurance Company Insolvencies (Handbook) describing in detail how state regulators should plan for and react to Dodd-Frank receivership scenarios.[25] In the Handbook, the NAIC has made clear that states should immediately take action to initiate receivership proceedings, and should not wait until the end of the 60 day window to take action. The NAIC has also urged regulators to develop plans in advance to implement Dodd-Frank receiverships as quickly and efficiently as possible. This should include plans to coordinate with guaranty funds, federal agencies, attorneys general, and other entities that will be involved in the receivership process. The NAIC itself could also become involved through its working groups, some of which have expertise with Dodd-Frank and insolvency issues.

The NAIC also recognizes that the Orderly Liquidation Authority could be triggered before insolvency proceedings would traditionally be initiated against the insurer under state law. This could potentially create roadblocks for state regulators trying to react to an Orderly Liquidation Authority determination because certain state-law requirements for regulatory intervention may not have been triggered. To address this issue, the NAIC recommends that the states consider enactment of statutory provisions which expressly grant the insurance commissioner the authority to begin rehabilitation or liquidation proceedings. This will allow state regulators to react quickly and avoid necessitating an FDIC receivership of an insurance company.

Many questions remain regarding the Orderly Liquidation Authority process and its application to insurance companies. In addition to issues related to federal/state coordination of insolvency proceedings, there is a need for consultation between the federal government and state insurance departments prior to a determination to proceed with the Orderly Liquidation Authority. While the FIO must approve determinations when insurance companies are involved, there is no provision that state regulators must be consulted. This could lead to differences of opinion as to the need to proceed with an insurance company liquidation or a federal requirement to proceed based on group issues even though that may or may not be in the best interests of the insurance company's policyholders. Appropriately close coordination between the federal and state governments will help to better define the process that will apply in the case of an insurer subject to Orderly Liquidation Authority, thereby reducing uncertainty and permitting all stakeholders to appropriately plan for such an eventuality.

*Fred E. Karlinsky is Co-Chair of Greenberg Traurig's Insurance Regulatory and Transactions Practice Group, with over twenty years of experience representing the interests of insurers, reinsurers, health plans, managing general agencies, brokers, third-party administrators, claims companies and other insurance entities on their regulatory, transactional, corporate and governmental affairs matters. Fred is experienced in the formation, licensure and capitalization of insurers, business expansion activities, regulatory examinations, reinsurance and alternate risk transfer mechanisms and many other operational and regulatory issues. He is recognized as one of the top insurance lawyers by Chambers and Partners. Fred can be reached at 954.768.8278 or karlinskyf@gtlaw.com.*

*Rich J. Fidei focuses his practice on national insurance regulatory and compliance matters as well as insurance transactional matters, representing a wide variety of insurance entities, including insurance companies, health plans, reinsurers, producers and other insurance-related entities, in connection with regulatory, corporate, compliance and transactional issues. Rich is experienced in the formation, licensure and capitalization of insurers, business expansion activities, financial and market conduct examinations, reinsurance and alternate risk transfer mechanisms, product filings, as well as many other operational issues applicable to insurance entities. Rich can be reached at 954.768.8286 or fideir@gtlaw.com.*

*Benjamin Zellner focuses his practice on government law and policy matters. He is experienced in handling a wide range of insurance regulatory and corporate transactions, including company and agent/agency compliance, throughout the country. Zellner can be reached at zellnerj@gtlaw.com.*

*Greenberg Traurig, LLP is an international, multi-practice law firm with approximately 1,900 attorneys serving clients from 38 offices in the United States, Latin America, Europe, Asia, and the Middle East. The firm is No. 1 on the 2015 Law360 Most Charitable Firms list, third largest in the U.S. on the 2015 Law360 400, Top 20 on the 2015 Am Law Global 100, and among the 2015 BTI Brand Elite. For additional information, please visit www.gtlaw.com*

[21] 12 U.S.C. § 5383(e)(1).

[22] 12 U.S.C. § 5383(e)(2).

[23] 12 U.S.C. § 5383(e)(3).

[24] 12 U.S.C. § 5383(e)(3).

[25] Receiver's Handbook, Ch. 11.