

A Proposal for a Tort Remedy for Insureds of Insolvent Insurers Against Brokers, Excess Insurers, Reinsurers, and the State

GRACE M. GIESEL*

No court has ever held that brokers, excess insurers, or reinsurers, collateral parties to the basic insurer and insured relationship, owe a tort duty to owners of property and liability insurance policies to monitor the solvency of primary insurers with whom the collateral parties deal. The few insureds¹ of insolvent insurers who have attempted to recover losses occasioned by insurer insolvency from these collateral parties have been largely unsuccessful regardless of the tort or contract character of the action. Nor has a court ever allowed an insured who suffers a loss as a result of an insurer insolvency to recover from a state for a failure to properly regulate the solvency of the insurer.

Yet, perhaps the time has come for the judiciary to consider imposing such a tort duty upon these collateral parties and the states, and to consider removing barriers to recovery by insureds of insolvent insurers. The potential benefit from such judicial action is twofold. First, recognition of a tort duty creates a viable avenue for complete compensation of individual insureds who have already suffered a loss. Second, and more important, is the social engineering aspect. The possibility of being held liable provides a needed incentive to the collateral parties and the states to improve the present insurer insolvency prevention mechanism such that, in the future, insureds would receive improved protection from the incidence of insolvency.² Finally, the potential liability would create pressure for more

* Associate Professor of Law, University of Louisville; B.A., Yale University; J.D., with distinction, Emory University School of Law, 1985.

¹ Whenever this Article uses the term "insured," the reader can assume that the term refers to the insured and any party standing in the shoes of the insured such as a third party claimant. A third party claimant alleges injury at the hands of the insured and seeks payment from the insured's liability insurer. References to the "public" are generally references to the class of potential third party claimants.

² The insurance industry is highly active and persuasive with regard to changes in the regulatory framework of the states. For example, after the Supreme Court in *United States v. South-Eastern Underwriters Association*, 322 U.S. 533 (1944), held that the insurance industry was subject to federal regulation, the industry supported legislation prepared by the National Association of Insurance Commissioners (NAIC) that returned regulatory power to the states. The legislation became law as the McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15

economically efficient insolvency prevention.³

Businesses and individuals purchase property and liability insurance to prevent financial loss. If, by chance, they suffer a destruction of insured property, the insurance provides monetary recompense. If the insured becomes liable to another entity, a third party claimant, for a loss the claimant suffers, insurance usually pays for the loss to the claimant. The insured may never incur liability and the insured property may never be damaged, but by purchasing the insurance product, the insured shifts the risk of the financial consequences of the loss to the insurer and away from the insured and, in the liability context, away from the injured third party claimant.⁴ In exchange for the premiums paid, the safety net of insurance allows the insureds to rest, confident that a loss that might fortuitously befall them will not cause financial ruin.⁵

U.S.C. §§ 1011-1015 (1982)). For a discussion of the Act, see Lent, *McCarran-Ferguson in Perspective*, 48 INS. COUNS. J. 411 (1981). An all-industry committee cooperated with the NAIC in developing model acts which the groups recommended that states adopt. The model acts related primarily to rate regulation and by 1950 all states had enacted rate regulation legislation. See generally R. KEETON & A. WIDISS, INSURANCE LAW § 8.1, at 931-32 (1988); R. JERRY, UNDERSTANDING INSURANCE LAW § 21[c] (1987); Kimball & Boyce, *The Adequacy of State Insurance Rate Regulation: The McCarran-Ferguson Act in Historical Perspective*, 56 MICH. L. REV. 545 (1958).

Another example of the power of the industry is the American Insurance Association's involvement in developing a federal role in solvency regulation. The Association is working closely with John D. Dingell, House Energy and Commerce Committee Chairman. See Brostoff, *AIA Planning Self-Regulatory Body to Monitor Company Solvency*, THE NATIONAL UNDERWRITER COMPANY: PROPERTY AND CASUALTY/EMPLOYMENT BENEFITS EDITION, Nov. 26, 1990, at 1.

³ The tort duty places the burden of monitoring the financial condition of insurers on the parties who can do so at a lower cost and who can distribute the cost appropriately. See *infra* part IV.

⁴ If the insured is incapable of paying the judgment, the loss rests on the third party.

⁵ The purpose of insurance is to provide insureds and the public with security against financial loss. Rawlings v. Apodaca, 151 Ariz. 149, 154, 726 P.2d 565, 570 (1986); Egan v. Mutual of Omaha Ins. Co., 24 Cal. 3d 809, 816-17, 620 P.2d 141, 145, 169 Cal. Rptr. 691, 695 (1979), cert. denied, 445 U.S. 912 (1980); Chavers v. Nat'l Sec. Fire & Casualty Co., 405 So. 2d 1, 6 (Ala. 1981). See INSURING REAL PROPERTY § 45.01, at 45-3 (S. Cozen, ed. 1989). Liability insurance originated as a device to protect an individual from financial hardship or ruin due to an adverse liability judgment. See Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1177 n.99 (1954); Note, *Primary and Excess Insurers and Their Common Insured: The Triangular Relationship with No Love Lost*, 32 CASE W. RES. L. REV. 265, 265-66 (1981). See generally R. KEETON & A. WIDISS, *supra* note 2, § 1.1, at 1-5, § 1.3, at 8-15 and K. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORIES, AND PUBLIC POLICY 1-2 (1986) (discussing the general *raison d'être* of insurance). Insurance encourages productive investment and, thus, is an

Unfortunately, more and more frequently, insureds find that the safety net is a chimera when they discover, after incurring a loss covered by the terms of the insurance contract, that the loss is not covered because the insurer is insolvent. The National Conference of Insurance Guaranty Funds noted that in 1990 at least twenty-one property and casualty insurers became insolvent.⁶ This number reflects a trend of increasing numbers of insolvencies in the 1980s and 1990s.⁷ According to the Conference, at least

essential feature of the economic system of the United States. K. ABRAHAM, *INSURANCE LAW AND REGULATION* 1 (1990). See also, Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law*, 45 *MINN. L. REV.* 471, 478 (1961).

⁶ See INSURANCE INFORMATION INSTITUTE, *INSOLVENCIES/GUARANTY FUNDS*, (Gastel ed. Jan. 1991) (LEXIS, Inslaw library, lirtpts file, No. 7) [hereinafter Gastel]. The number reflects insurers ordered liquidated in that year. See National Conference of Insurance Guaranty Funds 1969-1989 Assessment Report, Exhibit 3, June 15, 1990, noting twenty-three insolvencies in 1989. In contrast, *Best's Review* noted forty-three involuntary retirements of property and casualty insurers in 1989. *Corporate Changes 1989*, *BEST'S REVIEW*, Mar. 1990, at 20 (Property and Casualty Insurance Edition). See also *Is An Insurance Crisis Next?*, *NEWSWEEK*, Mar. 25, 1991, at 44.

The insolvency phenomenon exists in other areas of the insurance industry as well. In 1989, thirty-seven life insurance companies filed for bankruptcy. Weinstein, *Too Risky to Insure?*, *INVESTMENT VISION*, Nov.-Dec. 1990, at 25, 26. Because the life insurance industry and product differ fundamentally from the property and casualty area, this Article limits discussion to the latter. For a general discussion of the life insurance industry, see B. HARNETT & I. LESNICK, *THE LAW OF LIFE AND HEALTH INSURANCE* § 1.01-08 (1988).

⁷ State guaranty funds have paid or will pay for companies becoming insolvent during 1969 to 1990 as follows:

Year	No. of Cos.	Year	No. of Cos.
1990	21	1979	4
1989	23	1978	6
1988	16	1977	5
1987	11	1976	4
1986	17	1975	22
1985	21	1974	5
1984	20	1973	1
1983	4	1972	2
1982	9	1971	8
1981	6	1970	4
1980	4	1969	1

Gastel, *supra* note 6, contains the data for 1981 to 1990. THE NATIONAL CONFERENCE OF INSURANCE GUARANTY FUNDS, *STATE INSURANCE GUARANTY FUNDS AND INSURANCE COMPANY INSOLVENCY ASSESSMENT INFORMATION 1969-1989* (June 15, 1990) [hereinafter ASSESSMENT REPORT]. Exhibit 4 contains the data for 1969 to 1980. Guaranty funds exist to pay otherwise covered claims of insolvent insurers. When insureds and third parties make claims against insolvent insurers, the

197 property or casualty insurers became insolvent from 1969 to 1989.⁸ Each of these insolvencies represents thousands of insureds who suffer losses covered by insurance policies for which those insureds paid premiums. Because the insurer is insolvent, the insurer lacks the funds to pay according to its contractual obligations. Once the loss occurs, the insureds cannot minimize their losses by purchasing other insurance.

In an attempt to protect insureds and the public from insurer insolvency,⁹ each state has a regulatory framework to monitor and regulate the financial condition of insurers operating within the state.¹⁰ The incidence of insolvencies calls into doubt the effectiveness of such regulation. Indeed, a consensus exists that the present regulatory system needs improvement.¹¹

guaranty funds pay all or a portion of the qualified claims. See discussion of the guaranty fund system *infra* part II.

⁸ The ASSESSMENT REPORT, *supra* note 7, states that guaranty funds have paid or project to pay claims relating to 197 property and casualty insurers. The report does not include 1990 insolvencies.

Best's Review notes the following involuntary retirements of property and casualty insurers:

<i>Year</i>	<i>No. of Cos.</i>	<i>Year</i>	<i>No. of Cos.</i>
1989	43	1983	7
1988	21	1982	3
1987	15	1981	2
1986	26	1980	6
1985	26	1979	9
1984	27		

Corporate Changes 1989, *supra* note 6, at 20.

⁹ The protection of insureds and third parties, especially in the insolvency context, recurs as a theme in insurance. See R. JERRY, *supra* note 2, §§ 20, 22, at 47-50, 69-73; R. KEETON & A. WIDISS, *supra* note 2, § 8.2, at 938-40 (objectives are to prevent insurer overreaching to assure solvency and to assure equitable rating). See also WIS. STAT. § 601.01 (1987) (a statutory formulation of purpose); NEV. REV. STAT. ANN. § 679A.140 (Michie 1989).

Professor Kimball has noted that protection of the economic and emotional interests of insureds occurs through the principle of solidity. See Kimball, *supra* note 5, at 478.

¹⁰ See *infra* part I.

¹¹ See, e.g., *Failed Promises: Insurance Company Insolvencies*, Report by the Subcommittee on Oversight and Investigation of the Committee on Energy and Commerce, 101st Cong., 2d Sess. 12 (1990) [hereinafter *Failed Promises*]; UNITED STATES GENERAL ACCOUNTING OFFICE, INSURER FAILURES: PROPERTY/CASUALTY INSURER INSOLVENCIES AND STATE GUARANTY FUNDS (July 1987), GAO/GGD-87-100 (available from the U.S. General Accounting Office) [hereinafter *INSURER FAILURES*]; Freedman, *State Solvency Regulation in Jeopardy*, BEST'S REVIEW, Jan. 1991, at 91 (Property/Casualty Insurance Edition); Gottheimer, *Apocalypse When?*, BEST'S REVIEW, Nov. 1989, at 30, 32 (Property/Casualty Insurance Edition); Dauer,

In an additional effort to protect insureds and the public, each state has developed a guaranty fund to pay claims otherwise covered by the contract with the insolvent insurer.¹² The funds, however, have claim ceilings and other limitations.¹³ The ultimate recovery by the insured can fall short of the full amount of coverage owed by the insolvent insurer. Thus, state financial regulation and guaranty funds provide incomplete protection to insureds.

Should the insured, and in the liability context, the injured third party claimant, bear the ultimate burden for the loss caused by the insolvency—the amount of the underlying insured loss which exceeds any possible guaranty fund recovery? Or should courts require the collateral actors in the insurance situation or the state to bear the loss?

This Article suggests that brokers, excess insurers, reinsurers, and perhaps state regulators should account in tort to the insured when the primary insurer becomes insolvent. The form of accountability should be negligence. To hold a party liable for negligence, the party must breach a duty owed and that breach must cause provable damages.¹⁴ This Article argues that modern society will benefit from judicial recognition of a duty on the part of the collateral parties and the state to monitor the financial stability of insurers.

This suggestion arises from the following conclusions. First, the insured deserves compensation and protection. The present regulatory framework reflects a general policy of protecting the class of insureds from insurer insolvency, but fails to accomplish its goal. Without such protection, the economic and emotional value of insurance vanishes. Also, typical insureds do not know of the need to protect themselves from potential insurer insolvency and lack the ability and information to do so. Thus, requiring insureds to protect themselves places the risk on the party least able to avoid loss.¹⁵

Incoming CPCU President Urges Professionalism, THE NATIONAL UNDERWRITER COMPANY: PROPERTY AND CASUALTY/EMPLOYEE BENEFITS EDITION, Oct. 8, 1990, at 3; Fletcher, *Regulators Support NAIC Accreditation*, BUS. INS., Dec. 3, 1990, at 12; McIntyre, *Report Recommends National Guaranty Fund*, BUS. INS., Dec. 3, 1990, at 18.

¹² See *infra* part II.

¹³ For example, the Michigan Guaranty Fund does not pay any insured with an otherwise covered claim if the insured has a net worth of one-tenth of one percent of the premiums written by insurers in the preceding year. The provision has withstood challenge. See *Borman's Inc. v. Michigan Property & Casualty Guar. Ass'n*, 925 F.2d 160 (6th Cir. 1991). See also MICH. COMP. LAWS § 500.7925(3) (1990).

¹⁴ W. KEETON, PROSSER AND KEETON ON TORTS § 58, at 164-65 (5th ed. 1984).

¹⁵ See *infra* part IV.

Second, imposing the duty to monitor solvency on the collateral parties is fair and more efficient. Collateral parties know of the possibility of insolvency and have access to the information and expertise necessary to monitor solvency. Such monitoring by these parties is more efficient than monitoring by each insured. Collateral parties can more easily absorb the loss, can distribute the cost of monitoring to those who benefit from it, and, can distribute the losses incurred by a failure to abide by the duty. In addition, collateral parties profit from the insurance relationship. Thus, courts can fairly require the collateral parties to carry a burden derived from that benefit. Finally, these collateral parties are highly organized into powerful groups that can implement and direct modifications in insurer solvency regulation, an area in desperate need of reform.¹⁶

By statute, the states have a duty to monitor insurer solvency. Courts should allow insureds to recover on the basis of this duty when the state has acted negligently and the insured has been injured as a result. State regulators are appropriate loss bearers because society charges them with the regulation of insurers to protect the public from insurer insolvency.¹⁷

In addition to preventing a particular insured from being the ultimate payor in a particular insolvency setting, the potential for tort accountability should lead brokers, excess insurers, reinsurers and, most importantly, the state regulators to improve the investigation, monitoring and general regulation of insurer stability. The potential for tort liability should lead to increased self-regulation by members of the industry and more effective government regulation as the industry assumes more of the regulatory burden. The final regulatory product should be a framework of cooperative effort on the part of the industry and state regulators. Such improved scrutiny of solvency, especially with increased involvement by members of the insurance industry, should help to achieve, eventually, the ultimate goal of protecting insureds and the public by reducing the number of insolvencies and eliminating sudden, unforeseen insolvencies.

This Article suggests that tort accountability, by way of a negligence standard, best suits the insolvent insurer situation. The other actors in the insolvency situation have an affirmative duty to exercise care in the monitoring of primary insurer insolvency. Only strict liability guarantees that insureds do not bear the short-term loss. A negligence standard, however, protects insureds in the long run by increasing the incentive for monitoring and detecting insolvencies, and requiring consideration of the culpability of the individual excess insurer, broker, reinsurer, and state regulator.

¹⁶ *Id.*

¹⁷ *See infra* part V.

The author recognizes that suggesting the imposition of tort liability amounts to a suggestion of judicial activism. However, the proliferation of insolvencies and the present plight of insureds create an extreme situation. Such drastic action may constitute the only effective mechanism to spur appropriate insolvency prevention. Without effective prevention, the insured suffers economic and emotional loss from an insolvency. In addition, as insolvencies become more common, insureds as a group suffer a greater psychological loss in that they cannot purchase peace of mind—the certainty of recompense no longer exists in their minds. The insurance industry suffers because the product sold no longer shines with the same brilliance. This Article does not mandate tort liability; rather, it illustrates the feasibility and effects of imposing a tort duty on the collateral parties.

The Article begins by discussing, in sections I and II, the present regulatory protections of state insolvency monitoring and guaranty funds. Section III reviews the unsympathetic treatment that insureds' actions against brokers, excess insurers, and reinsurers, respectively, have received from the courts. Section IV discusses the creation of a tort duty for each of the collateral actors. Section V discusses the possibility of tort recovery from the state on the basis of negligent regulation.

I. INSURER INSOLVENCY REGULATION

All jurisdictions recognize that protecting insureds and the public necessitates monitoring insurer solvency. In fact, states view solvency regulation of insurers as one of their most important tasks.¹⁸ In addition to

¹⁸ K. ABRAHAM, *INSURANCE LAW AND REGULATION* 93 (1990). See also R. KEETON & A. WIDISS, *supra* note 2, § 8.2, at 938-39 (listing the following as the three main objectives of insurance regulation: (1) Avoiding overreaching by insurers; (2) assuring solvency; and (3) assuring equitable rating classifications); R. JERRY, *supra* note 2, § 22, at 69 (listing (1) ensuring fair prices; (2) protecting solvency; (3) preventing unfair practices; and (4) guaranteeing the availability of coverage). Professor Patterson stated: "The chief object in view in creating separate insurance departments and in delegating to them extensive powers of regulation and investigation was to protect the public against financially unsound enterprises. . . ." Epton & Bixby, *Insurance Guaranty Funds: A Reassessment*, 25 DE PAUL L. REV. 227, 229-30 (1976) (emphasis in original) (citing 1 E. PATTERSON, *THE INSURANCE COMMISSIONER IN THE UNITED STATES: A STUDY IN ADMINISTRATIVE LAW AND PRACTICE* 192 (Harv. Studies in Administrative Law, reprinted 1968)). See also Kimball, *The Goals of Insurance Law: Means Versus Ends*, 1962 J. INS. 19. Kimball stated:

If insurance is to do its job—i.e., if it is to insure—then the insurance enterprise, both in the aggregate and company by company, must be secure and solvent. Solvency is the most important goal of all insurance law and regulation, though it is not always given effect by individual courts or insurance commissioners. But the goal sought is not solvency in the technical sense, or more accurately,

rate regulation, which relates directly to the goal of insurer solvency,¹⁹ states have comprehensive plans for reporting and review of the general financial status of insurers licensed to do business within their borders.²⁰ For example, the states require submission of annual financial statements to the state insurance department.²¹ State laws usually require detailed examinations every three to five years.²² The states require minimum capital, surplus, and reserve levels and restrict investment by the insurance companies.²³ In addition, the National Association of Insurance Commissioners (NAIC)²⁴ administers the Insurance Regulatory Information

technical solvency is not enough to satisfy the needs of the going insurance institution. There must be a degree and type of solvency that ensures that the policyholder will continue to be protected in any reasonably foreseeable situation.

Id. at 21.

¹⁹ Rate regulation relates to solvency because the state allows an insurer to sell the insurance product at a reasonable price in light of the cost to the insurer. For a discussion of rate regulation, see Kimball & Boyce, *supra* note 2. See also R. KEETON & A. WIDISS, *supra* note 2, § 8.4, at 954; 19 J. APPLEMAN, INSURANCE LAW AND PRACTICE §§ 10491-10496, at 429-72 (1982 & Supp. 1990).

²⁰ See generally K. ABRAHAM, *supra* note 18, at 93; 19 J. APPLEMAN, *supra* note 19, §§ 10431-10432. For an example of a state's plan, see ALA. CODE §§ 27-2-1 to -6-16 (1990); KY. REV. STAT. ANN. §§ 304.2-010 to .8-190 (Baldwin 1991); NEV. REV. STAT. ANN. §§ 679B.010-682B.250 (Michie 1989).

²¹ See INSURER FAILURES, *supra* note 11, at 11. See, e.g., ALA. CODE § 27-3-26 (1990); KY. REV. STAT. ANN. § 304.3-240 (Baldwin 1991); NEV. REV. STAT. ANN. § 680A.270 (Michie 1989).

²² In Kentucky, for example, each domestic insurer must be examined at least every four years. See KY. REV. STAT. ANN. § 304.2-210 (Baldwin 1991). The scope of the examination in Kentucky includes all documents, records and such relating to the subject of the examination. See KY. REV. STAT. ANN. § 304.2-230 (Baldwin 1991). See also ALA. CODE § 27-2-21 (1990); NEV. REV. STAT. ANN. § 679B.230 (Michie 1989). The National Association of Insurance Commissioners coordinates zone review of insurers operating significantly in more than one state. This program avoids needless duplication. Examiners from the zone states conduct the review. See INSURER FAILURES, *supra* note 11, at 11.

²³ See INSURER FAILURES, *supra* note 11, at 11; 19 J. APPLEMAN, *supra* note 19, §§ 10351-10385. For examples of these requirements, see KY. REV. STAT. ANN. § 304.3-120 (Baldwin 1991) (capital and surplus); § 304.3-140 (deposits); § 304.6-100 (reserves); § 304.7-030 (investments). See also DEL. CODE ANN. tit. 18, § 511 (1990) (capital); § 513 (deposits); § 1111 (reserves); § 1303 (investments); NEV. REV. STAT. ANN. § 680A.120 (Michie 1989) (capital); § 680A.140 (deposits); § 681B.050 (reserves); § 682A.030 (investments).

²⁴ The NAIC consists of the heads of insurance departments of all fifty states, the District of Columbia, and the four territories. It was developed to encourage uniformity and cooperation among the states. The NAIC has no statutory or regulatory authority but serves as a clearinghouse for information, data, and model laws. INSURER FAILURES, *supra* note 11, at 8. See also R. JERRY, *supra* note 2, § 23, at 81.

System to analyze annual financial data of insurers and report the information to the states. The system also designates certain insurers for special attention.²⁵

The incidence of insolvencies casts doubt on the effectiveness of the present system of oversight. Numerous entities have noted shortcomings in the present system.²⁶ The NAIC has completed several studies on the present regulatory system and has suggested several changes to increase the sophistication of solvency regulation such as requiring independent verification of filings.²⁷ In addition, the Subcommittee on Oversight and Investigations of the United States House of Representatives Committee on Energy and Commerce released a report in 1990 which severely criticized the present regulatory system and suggested federal regulation as the

²⁵ See INSURER FAILURES, *supra* note 11, at 11. The Insurance Regulatory Information-System (IRIS) develops eleven measures of financial condition from data regarding premiums received, investment yield, reserves, and surplus. The insurers furnish the raw data to IRIS. See K. ABRAHAM, *supra* note 18, at 93. The General Accounting Office has recommended that IRIS be expanded. *GAO Report Recommends Expanded IRIS Program*, BEST'S REVIEW, Jan. 1991, at 7 (Property/Casualty Insurance Edition).

²⁶ See, e.g., *Failed Promises*, *supra* note 11; INSURER FAILURES, *supra* note 11; *GAO Report Recommends Expanded IRIS Program*, BEST'S REVIEW, Jan. 1991, at 7 (Property/Casualty Insurance Edition); Hall, *Solvency Monitoring Theme Gathers More Steam*, BEST'S REVIEW, Jan. 1991, at 100 (Property/Casualty Insurance Edition); Gottheimer, *supra* note 11, at 30, 32; *Regulators Support NAIC Accreditation*, BUSINESS INS., Dec. 3, 1990, at 12.

²⁷ See INSURER FAILURES, *supra* note 11, at 12-13. In 1974, a McKinsey and Co., Inc. report indicated serious flaws in the present system such as low quality of financial reports, lack of communication among the states, infrequent examinations, and poor resource allocation in choosing the targets of the examinations. *Id.* at 12. See *Strengthening the Surveillance System: Final Report* (McKinsey and Co., Inc. (NAIC) April 1974). In 1979, the Government Accounting Office found that no significant progress had been made to improve regulation. *Id.* See *Issues and Needed Improvements in State Regulation of the Insurance Business* (PAD-79-72, Oct. 9, 1979); INSURER FAILURES, *supra* note 11, at 12 n.2. In April 1981, the NAIC appointed a Special Joint Committee on Examinations to study the modifications in regulation made in response to the McKinsey study. The Committee concluded that state regulation had not moved toward increased effectiveness. *Id.* The Committee recommended priority based examinations, annual examinations by certified public accountants, use of specialists, and continuing education for examiners. *Id.* at 13. See also Gottheimer, *supra* note 11, at 36.

Earl Pomeroy, outgoing President of NAIC, stated in 1990 that regulation could be improved by having minimum standards for solvency regulation, certification, independent verification of reports, NAIC direct regulatory support, and regulator peer review. See Gastel, *supra* note 6.

possible answer to the problem of insurer insolvency.²⁸ Noting the lack of effectiveness of the present system, the American Insurance Association has explored the idea of more effective self-regulation.²⁹

In addition to general oversight provisions, states have developed provisions relating to supervision, rehabilitation, and liquidation of insurers in dire financial straits.³⁰ If, as a result of general oversight, a state insurance department determines that an insurer is experiencing financial difficulties but that the insurer's condition does not require formal rehabilitation or liquidation, the state insurance Commissioner may directly supervise the insurer, issuing such orders and performing any other acts required to remedy the situation.³¹ Typically, before such supervision may commence, the Commissioner must have reasonable cause that an insurer has committed or has engaged in or will commit or engage in, an act that would make the insurer subject to rehabilitation or liquidation. Furthermore, the Commissioner must have a reasonable belief that the continuance of an insurer's business creates a hazard to the public or policy

²⁸ See *Failed Promises*, *supra* note 11. The insurance industry has examined the possibility of federal regulation. See, e.g., Bradford, *Insurance Regulation: Support Begins to Build for Federal Regulatory Role*, BUS. INS., Dec. 3, 1990, at 3; Schwartz & Ballen, *Solvency Regulation: A Basket of Options*, BEST'S REVIEW, Oct. 1990, at 53 (Property/Casualty Insurance Edition); Neis, *Brokers Tackle Market Volatility, Solvency: National Association of Insurance Brokers Annual Meeting*, BEST'S REVIEW, July 1990, at 141 (Property/Casualty Insurance Edition); Fletcher, *NAIC Responds To Critics: Says State Solvency Regulation is Adequate*, BUS. INS., Aug. 6, 1990, at 2; *When Risk Managers Talk . . .*, BUS. INS., Sept. 10, 1990, at 8. For a more academic discussion of a federal regulatory role, see R. KEETON & A. WIDISS, *supra* note 2, § 8.1(b), at 934.

²⁹ See Bradford, *supra* note 28.

³⁰ See, e.g., ALA. CODE §§ 27-32-1 to -41 (1990); ARIZ. REV. STAT. §§ 20-611 to -648 (1989); CAL. INS. CODE §§ 1010 to 1062 (Deering 1991); CONN. GEN. STAT. §§ 38a-903 to -961 (1991); DEL. CODE ANN. tit. 18, §§ 5901 to 5944 (1990); KY. REV. STAT. ANN. §§ 304.33-010 to -600 (Baldwin 1991); MASS. ANN. LAWS ch. 175, § 180A to 180L (Law. Co-op. 1990); N.Y. INS. LAW §§ 7401 to 7436 (1990); N.C. GEN. STAT. §§ 58-30-1 to -30-305 (1990); PA. CONS. STAT. ANN. tit. 40, §§ 221.1 to .63 (1989).

Many of the statutes derive in whole or in part from the INSURERS SUPERVISION, REHABILITATION AND LIQUIDATION ACT (National Association of Insurance Commissioners 1969) (LEXIS, Insrw library, NAIC file) [hereinafter NAIC MODEL ACT], a model act promulgated by the NAIC in 1969. The NAIC MODEL ACT can be found at 1978-1 NAIC Proc. 238 (1977). A majority of the states also include the UNIFORM INSURERS LIQUIDATION ACT (Conference of Commissioners on Uniform State Laws 1939). See generally INSURING REAL PROPERTY, *supra* note 5, § 45.02[1], at 45-3 to -5.

³¹ See, e.g., CONN. GEN. STAT. § 38a-911 (1991); KY. REV. STAT. ANN. § 304.33-110 (Baldwin 1991) (no general supervision discussed); PA. CONS. STAT. ANN. tit. 40, § 221.11 (1989). See also NAIC MODEL ACT, *supra* note 30, § 9.

holders.³² The insurer may request a hearing or may apply for immediate judicial review of the Commissioner's action.³³ The supervision generally lasts sixty days from the initial order of supervision, but the Commissioner can extend it or commence formal rehabilitation or liquidation.³⁴

Some jurisdictions allow the Commissioner to seize the insurer's property and enjoin the continued transaction of business.³⁵ The Commissioner must first obtain a court order based upon a claim that grounds for an order of formal delinquency exist and delay will injure policy holders, creditors, or the public.³⁶ The seizure order is simply an interim measure. If the Commissioner fails to pursue liquidation or rehabilitation after a reasonable period of time, the court will vacate the seizure order.³⁷

The Commissioner pursues formal rehabilitation by petitioning the designated court for an order of rehabilitation if the insurer appears salvageable and the rehabilitation will not harm interests of creditors, policy holders, and the public.³⁸ Generally, the Commissioner requests rehabilitation if the continuance of business under present management and policies appears financially hazardous to the interests of creditors, policy holders, or the public.³⁹ Usually, the Commissioner becomes the

³² See KY. REV. STAT. ANN. § 304.33-110 (Baldwin 1991) (requirement for summary orders; general supervision not discussed); PA. CONS. STAT. ANN. tit. 40, § 221.11 (1989). See also NAIC MODEL ACT, *supra* note 30, § 9.

³³ See KY. REV. STAT. ANN. § 304.33-110 (Baldwin 1991) (review of summary orders); PA. CONS. STAT. ANN. tit. 40, § 221.10 (1989). See also NAIC MODEL ACT, *supra* note 30, § 9.

³⁴ See PA. CONS. STAT. ANN. tit. 40, § 221.11 (1989). See also NAIC MODEL ACT, *supra* note 30, § 9.

³⁵ See *e.g.*, CONN. GEN. STAT. § 38a-912 (1991); DEL. CODE ANN. tit. 18, § 5943 (1990); ILL. REV. STAT. ch. 73, ¶ 800.1 (1988); KY. REV. STAT. ANN. § 304.33-120 (Baldwin 1991). See also NAIC MODEL ACT *supra* note 30, § 10.

³⁶ See *e.g.*, CONN. GEN. STAT. § 38a-912 (1991); DEL. CODE ANN. tit. 18, § 5943 (1990); ILL. REV. STAT. ch. 73, ¶ 800.1 (1988); KY. REV. STAT. ANN. § 304.33-120 (Baldwin 1991). See also NAIC MODEL ACT, *supra* note 30, § 10.

³⁷ See *e.g.*, DEL. CODE ANN. tit. 18, § 5943 (1990); KY. REV. STAT. ANN. § 304.33-120 (Baldwin 1991). See also NAIC MODEL ACT, *supra* note 30, § 10.

³⁸ See *e.g.*, KY. REV. STAT. ANN. § 304.33-140 (Baldwin 1991); ME. REV. STAT. ANN. tit. 24-A, § 4356 (1989); NEV. REV. STAT. ANN. § 696B.210 (Michie 1989); N.H. REV. STAT. ANN. § 402-C:15 (1989). See generally INSURING REAL PROPERTY, *supra* note 5, § 45.04, at 45-13 for a discussion of rehabilitation.

³⁹ See *e.g.*, ALA. CODE § 27-32-6 (1990); DEL. CODE ANN. tit. 18, § 5905 (1990); KY. REV. STAT. ANN. § 304.33-140 (Baldwin 1991). See also NAIC MODEL ACT, *supra* note 30, § 12(a).

rehabilitator and has the right to control the insurer's assets and conduct the insurer's business under the general supervision of the court.⁴⁰

The rehabilitator works with the insurer to eliminate the problematic condition.⁴¹ When the rehabilitation succeeds, the court and Commissioner restore the insurer to self-managed operation.⁴² If the rehabilitation efforts fail or if no rehabilitation occurs but an insurer's continued transaction of business would substantially increase the risk of loss to creditors, policy holders, or the public, the Commissioner may petition for the insurer's liquidation.⁴³ Many states specify insolvency as a particular basis for liquidation.⁴⁴ The states generally deem a company insolvent if assets do not equal liabilities and required reserves.⁴⁵

The Commissioner usually acts as the liquidator and must take possession of the assets of the insurer and administer them under the

⁴⁰ See, e.g., ALA. CODE § 27-32-6 (1990); DEL. CODE ANN. tit. 18, § 5905 (1990); KY. REV. STAT. ANN. § 304.33-150, -160 (Baldwin 1991). See also NAIC MODEL ACT, *supra* note 30, § 13. See generally INSURING REAL PROPERTY, *supra* note 5, § 45.04[3][a], at 45-22 to 45-23.

⁴¹ See, e.g., DEL. CODE ANN. tit. 18, § 5910 (1990); KY. REV. STAT. ANN. § 304.33-160 (Baldwin 1991); PA. CONS. STAT. ANN. tit. 40, § 221.16 (1989). See also NAIC MODEL ACT, *supra* note 30, § 14(b).

⁴² See, e.g., DEL. CODE ANN. tit. 18, § 5910 (1990); KY. REV. STAT. ANN. § 304.33-180(2) (Baldwin 1991); PA. CONS. STAT. ANN. tit. 40, § 221.18 (1989). See also NAIC MODEL ACT, *supra* note 30, § 16.

⁴³ See, e.g., CONN. GEN. STAT. § 38a-919(c) (1991); IND. CODE § 27-9-3-6(3) (1990); KY. REV. STAT. ANN. § 304.33-180, -190 (Baldwin 1991). See also NAIC MODEL ACT, *supra* note 30, §§ 16, 17.

"The business of insurance is affected with a public interest, and the state has an important and vital interest in the liquidation or reorganization of such a business." 19A J. APPLEMAN, *supra* note 19, § 10621, at 4.

⁴⁴ See, e.g., CONN. GEN. STAT. § 38a-919(b) (1991); IND. CODE § 27-9-3-6(2) (1990); KY. REV. STAT. ANN. §§ 304.33-190, -140 (Baldwin 1991). See also NAIC MODEL ACT, *supra* note 30, § 17.

Some jurisdictions allow liquidation if the insurer conducts no business in one year or the insurer has pursued voluntary liquidation. See, e.g., ALA. CODE § 27-32-7 (1990); DEL. CODE ANN. tit. 18, § 5906 (1990); GA. CODE ANN. § 33-37-7 (1990); KY. REV. STAT. ANN. § 304.33-190 (Baldwin 1991) (pursued voluntary liquidation provision). For a general discussion of voluntary liquidation, see 19A J. APPLEMAN, *supra* note 19, § 10622, at 13.

⁴⁵ See, e.g., ALA. CODE § 27-32-1(1) (1990); DEL. CODE ANN. tit. 18, § 5901(1) (1990); GA. CODE ANN. § 33-37-2 (1990). See generally 19A J. APPLEMAN, *supra* note 19, § 10641, at 40-41 (definitions of insolvency). The NAIC MODEL ACT defines insolvency as the inability to pay any obligation within thirty days after the due date or when assets do not exceed liabilities plus the greater of any capital and surplus required by law or the total par or stated value of its authorized and issued capital stock. See NAIC MODEL ACT, *supra* note 30, § 3(k).

general supervision of the court.⁴⁶ The liquidator may request a declaration of insolvency to trigger the applicable guaranty fund obligations.⁴⁷ The liquidator marshals the assets of the insurer and distributes them.⁴⁸ In so doing, the liquidator must give claims of insureds and third party claimants priority after administrative costs and debts due employees.⁴⁹ Of course, insureds who do not have access to guaranty fund recovery may receive little from the liquidation proceeding because of the general paucity of assets.

II. GUARANTY FUNDS

In the late 1960s Congress became concerned about the effects of the increasing number of liability insurer insolvencies.⁵⁰ Though insurance regulation has historically been the domain of the individual states,⁵¹ the

⁴⁶ See, e.g., DEL. CODE ANN. tit. 18, § 5911 (1990); KY. REV. STAT. ANN. § 304.33-200 (Baldwin 1991); PA. CONS. STAT. ANN. tit. 40, § 221.20 (1989). See also NAIC MODEL ACT, *supra* note 30, § 18(a). See generally INSURING REAL PROPERTY, *supra* note 5, § 45.05[4], at 45-30.

⁴⁷ See, e.g., DEL. CODE ANN. tit. 18, § 5911 (1990); KY. REV. STAT. ANN. § 304.33-200 (Baldwin 1991); PA. CONS. STAT. ANN. tit. 40, § 221.36 (1989). See also NAIC MODEL ACT, *supra* note 30, § 18(d).

⁴⁸ See, e.g., KY. REV. STAT. ANN. § 304.33-240 (Baldwin 1991); WIS. STAT. § 645.46 (1990). See also NAIC MODEL ACT, *supra* note 30, § 25. See generally INSURING REAL PROPERTY, *supra* note 5, § 45.05[5][d],[e], and [f], at 45-41 to 45-50.

⁴⁹ See, e.g., KY. REV. STAT. ANN. § 304.33-430 (Baldwin 1991); PA. CONS. STAT. ANN. tit. 40, § 221.44 (1991); WIS. STAT. § 645.68 (1990). See also NAIC MODEL ACT, *supra* note 30, § 42. Federal bankruptcy law does not apply. See 11 U.S.C. § 109(b)(2) and (d). Section 109(b)(2) provides that Chapter 7 of the bankruptcy code does not apply to a domestic or foreign insurance company. Section 109(d) states that Chapter 11 does not apply if the entity was not a debtor under Chapter 7.

⁵⁰ Congress became concerned about the insolvency of "high risk" automobile liability insurers and, in 1965, a United States Senate Subcommittee investigated the issue. See *High-Risk Automobile Insurance: Hearings Before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary*, S 3919 89th Cong., 1st Sess. (1965). Senator Thomas Dodd, Chairman of the Senate Antitrust and Monopoly Subcommittee, noted at hearings that these insolvencies prevented innocent victims from being compensated. *Id.* See also Note, *Insurance Company Insolvencies and Insurance Guaranty Funds: A Look at the Nonduplication of Recovery Clause*, 74 IOWA L. REV. 927 (1989). See generally INSURER FAILURES, *supra* note 11, at 26.

⁵¹ The McCarran-Ferguson Act, Pub. L. No. 15, 59 Stat. 33 (1945) (current version at 15 U.S.C. §§ 1011-1015 (1982)), assigned insurance regulation to the states. Regulating the insurance industry was considered the province of the states until the Supreme Court, in *United States v. South-Eastern Underwriters Association*, 322 U.S. 533 (1944), opened the door to federal regulation of the industry. The

inaction of the states in counteracting the injustice caused by insurer insolvency⁵² has led several senators to introduce bills designed to establish a federal guaranty fund to pay claims covered by policies with insolvent insurers.⁵³ The threat of federal regulation of a sector of the insurance industry convinced the NAIC to draft model guaranty fund legislation.⁵⁴ The states quickly embraced the model legislation, and by 1972, forty-five states had in place guaranty funds similar to that espoused in the model legislation.⁵⁵ By 1981 virtually all states had some form of guaranty fund for property and casualty insurers.⁵⁶

McCarran-Ferguson Act, responding to that decision, closed the door on general federal regulation. *See* K. YORK & J. WHELAN, *INSURANCE LAW* 27-39 (1988). *See also supra* note 2.

⁵² A few states created property and casualty guaranty funds prior to 1965. *INSURER FAILURES*, *supra* note 11, at 26. *See also* Epton & Bixby, *supra* note 18, at 227-30.

⁵³ In 1966, Senator Thomas Dodd introduced a bill to create a federal guaranty fund for automobile insurers. *See* S. 3919, 89th Cong., 2d Sess. (1966). Senator Warren Magnuson introduced a bill in 1969 to create a federal guaranty fund for all property and casualty insurers. *See* S. 2236, 91st Cong., 1st Sess. (1969) (Federal Insurance Guaranty Corporation bill paralleling the Federal Deposit Insurance Company). The 1969 bill received a favorable recommendation from the Senate Committee on Commerce. *See* S. Rep. No. 91-1421, 91st Cong., 2d Sess. (1970). *See generally* *INSURER FAILURES*, *supra* note 11, at 26; Epton & Bixby, *supra* note 18, at 230.

⁵⁴ *See* Epton & Bixby, *supra* note 18, at 230; *INSURER FAILURES*, *supra* note 11, at 27. The states and the insurance industry feared that once the federal government regulated an area of the industry, it would be more likely to regulate other areas in the future. The result would be two tiers of regulation. Epton & Bixby, *supra* note 18, at 230. The motivational effect of the federal regulatory threat is apparent. In May of 1969, the American Mutual Insurance Alliance, a major trade association, strongly opposed any form of guaranty fund. However, in November of 1969, that same association strongly supported state guaranty funds. Compare *DOT's Study of Automobile Accident Compensation: Hearings on S. 2236 Before the Senate Comm. on Commerce*, 91st Cong., 1st Sess. 46 (1969) (statement of American Mutual Insurance Alliance submitted for the record) with *Federal Insurance Guaranty Corporation: Hearings on S. 2236 Before the Senate Comm. on Commerce*, 91st Cong., 1st Sess. 70-72 (1969) (testimony of Andre Masionpierre, vice president of American Mutual Insurance Alliance).

The model act is known as the NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS STATE POST ASSESSMENT INSURANCE GUARANTY ASSOCIATION MODEL ACT (National Association of Insurance Commissioners 1970) [hereinafter *GUARANTY MODEL ACT*]. The Act is found at 1970-1 NAIC Proc. 253 (1970). *See generally* *INSURING REAL PROPERTY*, *supra* note 5, § 45.07, at 45-62.

⁵⁵ *See* Epton & Bixby, *supra* note 18, at 230. *See also* Note, *supra* note 50.

⁵⁶ *See* *INSURER FAILURES*, *supra* note 11, at 27. *See also* *INSURING REAL PROPERTY*, *supra* note 5, § 45.07, at 45-62 to 45-67. *See, e.g.*, ALA. CODE §§ 27-42-1 to -42-20 (1990); ALASKA STAT. §§ 21.80.010-.190 (1990); ARIZ. REV. STAT.

Property and casualty guaranty funds pay claims covered by the policies of the insolvent⁵⁷ member insurer. There are, however, limitations on the obligations of the various funds. Most funds have a maximum statutory limit for any one claim.⁵⁸ Generally, the funds pay only those claims which arose before the insolvency determination or within thirty

ANN. §§ 20-661 to -695 (1989); ARK. STAT. ANN. §§ 23-90-101 to -123 (1990); CAL. INS. CODE §§ 1063-1063.14 (Deering 1991); COLO. REV. STAT. §§ 10-4-501 to -250 (1990); CONN. GEN. STAT. §§ 38a-836 to -853 (1991); DEL. CODE ANN. tit. 18, §§ 4201-4221 (1990); FLA. STAT. §§ 631.50-.70 (1989); GA. CODE ANN. §§ 33-36-1 to -18 (1990); HAW. REV. STAT. §§ 431:16-101 to -219 (1990); IDAHO CODE §§ 41-3601 to -3621 (1990); ILL. REV. STAT. ch. 73, ¶ 1065.82 (1988); IND. CODE ANN. §§ 27-6-8-1 to -19 (Burns 1990); IOWA CODE §§ 515B.1-.26 (1989); KAN. STAT. ANN. §§ 40-2901 to -2919 (1989); KY. REV. STAT. ANN. §§ 304.36-010 to -170 (Baldwin 1991); LA. REV. STAT. ANN. §§ 22:1375-1394 (West 1990); ME. REV. STAT. tit. 24-A, §§ 4431-4451 (1989); MD. ANN. CODE art. 48A, §§ 504-519 (1990); MASS. GEN. L. ch. 175D, §§ 1-16 (1990); MICH. COMP. LAWS §§ 500.7901-7949 (1990); MINN. STAT. §§ 60C.01-.20 (1990); MISS. CODE ANN. §§ 83-23-101 to -137 (1990); MONT. CODE ANN. §§ 33-10-101 to -117 (1990); NEB. REV. STAT. §§ 44-2401 to -2418 (1989); NEV. REV. STAT. §§ 687A.010-.160 (1989); N.H. REV. STAT. ANN. §§ 404-B:1-18 (1983); N.J. REV. STAT. §§ 17:30A-1 to -20 (1990); N.M. STAT. ANN. §§ 59A-43-1 to -18 (1990); N.C. GEN. STAT. §§ 58-12-1 to -20 (1990); N.D. CENT. CODE §§ 26.1-42-01 to -15 (1990); OHIO REV. CODE ANN. §§ 3955.01-.21 (Baldwin 1991); OKLA. STAT. tit. 36, §§ 2001-2020 (1990); OR. REV. STAT. §§ 734.510-.710 (1989); PA. CONS. STAT. ANN. tit. 40, §§ 1701.101-.605 (1989); R.I. GEN. LAWS §§ 27-34-1 to -18 (1989); S.C. CODE ANN. §§ 38-31-10 to -170 (Law. Co-op 1989); S.D. CODIFIED LAWS ANN. §§ 58-29A-1 to -53 (1990); TENN. CODE ANN. §§ 56-12-101 to -119 (1990); TEX. INS. CODE ANN. art. 21.28-C §§ 1-22 (Vernon 1989); UTAH CODE ANN. §§ 31A-28-201 to -221 (1990); VT. STAT. ANN. tit. 8, §§ 3611-3626 (1989); VA. CODE ANN. §§ 38.2-1600 to -1623 (1990); WASH. REV. CODE §§ 48.32.010-.930 (1990); W. VA. CODE §§ 33-26-1 to -19 (1990); WIS. STAT. §§ 646.01-.73 (1990); WYO. STAT. §§ 26-31-101 to -117 (1990).

⁵⁷ Many jurisdictions require that the insurer be in liquidation and insolvent before the guaranty fund's duties arise. *See, e.g.*, ALA. CODE § 27-42-5(5) (1990); FLA. STAT. § 631.54(6) (1989); ILL. REV. STAT. ch. 73, ¶ 1065.84-4 (1988); KY. REV. STAT. ANN. § 304.36-050(4) (Baldwin 1991); MINN. STAT. § 60C.03(8) (1990). Other jurisdictions require that there be a determination of insolvency regardless of a liquidation proceeding. *See, e.g.*, ARIZ. REV. STAT. ANN. § 20-661(5) (1989); CONN. GEN. STAT. § 38a-838(7) (1991); MASS. ANN. LAWS ch. 175D, § 1(4) (Law. Co-op. 1990); N.J. STAT. ANN. § 17:30A-5(e) (1990); TENN. CODE ANN. § 56-12-104(5) (1990).

⁵⁸ Many states have a per-claim limit. *See, e.g.*, ALASKA STAT. § 21.80.060 (1990) (\$500,000); ILL. REV. STAT. ch. 73, ¶ 1065.87-2 (1988) (\$300,000); PA. CONS. STAT. ANN. tit. 40, § 1701.201(b)(1)(i) (1989) (\$300,000). New York has a limit of \$1,000,000. *See* N.Y. INS. LAW § 7603(a)(2). Other states have much lower limits. *See, e.g.*, ALA. CODE § 27-42-8(1)(8) (1990) (\$150,000); ARIZ. REV. STAT. ANN. § 20-667(b) (1989) (\$100,000); KY. REV. STAT. ANN. § 304.36-080(a) (Baldwin 1991) (\$100,000).

days after the insolvency determination.⁵⁹ Some states have deductible amounts⁶⁰ and others refuse payment if the claimant has a certain net worth.⁶¹ To recover, the claimant must reside in the guaranty fund state.⁶² An insurer must be a member of the state guaranty fund to be licensed to transact business within the state in the insurance lines covered by the guaranty fund.⁶³

The fund statutes state the goal of these funds as paying claims without lengthy delays so that claimants or policyholders do not suffer financial

⁵⁹ See *Arizona Property & Casualty Ins. Guar. Fund v. Helme*, 153 Ariz. 129, 735 P.2d 451 (1987) (ARIZ. REV. STAT. ANN. § 20-667(c) (1989)). See generally 19A J. APPLEMAN, *supra* note 19, § 10801, at 11 (Supp. 1990).

⁶⁰ See, e.g., N.D. CENT. CODE § 26.1-42-05(1)(a) (\$100); WASH. REV. CODE § 48.32.060(1)(a) (1990) (\$100).

⁶¹ See, e.g., GA. CODE ANN. § 33-36-3(2)(F) (\$3 million) (1990); ILL. REV. STAT. ch. 73, ¶ 1065.84-3(b)(iv) (\$50 million) (1988); MICH. COMP. LAWS § 500.7925(3) (1990) (one-tenth of one percent of the premiums written by insurers in the preceding year).

⁶² See GUARANTY MODEL ACT, *supra* note 54, § 5(b). See also INSURER FAILURES, *supra* note 11, at 28; INSURING REAL PROPERTY, *supra* note 5, § 45.07[4][a], at 45-88. For examples of courts dealing with the determination of "covered claim," see *Hardester v. Eubanks*, 292 Ark. 610, 731 S.W.2d 780 (1987); *Nianick v. Edgewater Beach Hotel*, 28 Ill. App. 3d 33, 328 N.E.2d 82 (1975).

Guaranty funds do not pay other creditors of the insolvent insurer. See *Commissioner of Ins. v. Massachusetts Insurers Insolvency Fund*, 373 Mass. 798, 370 N.E.2d 1353 (1977). See generally 19A J. APPLEMAN, *supra* note 19, § 10801, at 371.

⁶³ See GUARANTY MODEL ACT, *supra* note 54, § 5. See also INSURING REAL PROPERTY, *supra* note 5, § 45.07[3][c], at 45-83. See generally 19A J. APPLEMAN, *supra* note 19, § 10801, at 370.

loss.⁶⁴ The statutes also charge the funds with the added responsibility of preventing and detecting insolvencies.⁶⁵

Financing for the funds comes from two sources: assets of the insolvent insurer and assessments on other solvent insurers. In exchange for assuming the insolvent insurer's obligation to pay claims, the claimant's rights against the insurer on the policy are constructively assigned to the guaranty fund to the extent of the recovery from the fund.⁶⁶ The guaranty fund may file a proof of claim with the liquidator of the insolvent insurer and the claim may have priority over other claims against the assets of the insolvent insurer to the extent the guaranty fund claims reimbursement for the reasonable expenses of handling the claims. Guaranty fund requests for the payment of a claim have the same priority as the claim discharged.⁶⁷ Thus, the guaranty fund recovers after the insurer's assets pay administrative costs and debts due to employees for services rendered.⁶⁸

⁶⁴ See, e.g., ALA. CODE § 27-42-2 (1990); DEL. CODE ANN. tit. 18, § 4202 (1990); FLA. STAT. § 631.51 (1989); ILL. REV. STAT. ch. 73, ¶ 1065.82 (1988). See also GUARANTY MODEL ACT, *supra* note 54, § 2. The "guaranty legislation is an integral part of an overall scheme to protect claimants, policyholders and the general public from loss due to the financial instability of insurers." INSURING REAL PROPERTY, *supra* note 5, § 45.07[2]. See *Lucas v. Illinois Ins. Guar. Fund*, 52 Ill. App. 3d 237, 367 N.E.2d 469 (1977) (intention of the legislature in establishing the fund was to protect the public from losses arising from insolvency of insurers doing business in the state); *New Jersey Property-Liability Ins. Guar. Ass'n v. Sheeran*, 137 N.J. Super. 345, 349 A.2d 92 (1975), *cert. denied*, 70 N.J. 143, 358 A.2d 190 (1976) (act must be interpreted to protect the policy holders and claimants and to advance their interests rather than the interests of the association); *O'Malley v. Florida Ins. Guar. Ass'n*, 257 So. 2d 9 (Fla. 1971) (the dominant purpose of the association is to avoid delay and to settle claims as soon as possible). See generally 19A J. APPLEMAN, *supra* note 19, § 10801, at 368.

⁶⁵ See GUARANTY MODEL ACT, *supra* note 54, § 2 and statutes cited *supra* note 64. See also *Louisiana Ins. Guar. Ass'n v. Bernard*, 393 So. 2d 764 (La. Ct. App. 1980) (association has the right to challenge activities of companies that indicate insolvency or which will produce insolvency). See generally 19A J. APPLEMAN, *supra* note 19, § 10801, at 366.

⁶⁶ See, e.g., ALA. CODE § 27-42-11 (1990); CONN. GEN. STAT. § 38a-844(1) (1991); DEL. CODE ANN. tit. 18, § 4211(a) (1990). See also GUARANTY MODEL ACT, *supra* note 54, § 11(a).

⁶⁷ See, e.g., FLA. STAT. § 631.60 (1989); KY. REV. STAT. ANN. § 304.36-110 (Baldwin 1991); ME. REV. STAT. ANN. tit. 24-A, § 4442 (1989). See also NAIC MODEL ACT, *supra* note 30, § 42(a); statutes cited *supra* note 66; *supra* note 49 and accompanying text. See generally INSURING REAL PROPERTY, *supra* note 5, § 45.07[3][d], at 45-85.

⁶⁸ See *supra* note 49 and accompanying text. See also INSURING REAL PROPERTY, *supra* note 5, § 45.05[5][f][iii], at 45-48.

To fill the gap between what the guaranty funds pay claimants and the amount that the funds recover from the liquidation proceeding, the guaranty funds assess member insurers in proportion to the net direct written premiums of the member insurer for the calendar year preceding the assessment.⁶⁹ In all states, except New York, the assessment occurs after insolvency and after the guaranty fund responds to claimants.⁷⁰

The guaranty fund framework provides only incomplete protection to the insureds of an insolvent insurer. The limitations on guaranty fund coverage leave many insureds with claims covered by the insolvent insurer's policy but which guaranty funds do not pay in whole or in part. In this time of high medical costs and large jury verdicts, claims in excess of the statutory maximum are not unusual.

In addition, the guaranty funds, as they now exist and operate, may not satisfy the claims that the statutes mandate. Several studies have suggested that the present funds cannot handle a large scale insolvency.⁷¹ Once again commentators are evaluating the possibility of a federal guaranty fund as a way of providing more protection to insureds and the public.⁷²

To attempt to acquire full recovery, the insured or claimant of the insolvent insurer may make a claim for the loss not compensated by guaranty funds against the assets of the insurer in the insolvency

⁶⁹ See, e.g., FLA. STAT. § 631.57 (1989); KY. REV. STAT. ANN. § 304.36-080 (Baldwin 1991). See also GUARANTY MODEL ACT, *supra* note 54, § 8(1)(c). The Act states that no member insurer may be assessed in any year an amount greater than two percent of that member insurer's net direct written premiums for the calendar year preceding the assessment. See generally Harrison, *Insurance Company Insolvencies, Guaranty Funds and Brokers' Responsibilities*, 1975 INS. L.J. 517-19.

⁷⁰ See statutes cited *supra* note 69. In New York, the assessment takes place before the insolvency. The Superintendent of Insurance runs the New York fund and requires insurers to contribute one-half of one percent of the direct written premiums each year unless the fund has a certain minimum balance. N.Y. INS. LAW § 7603(b)(1), (2). See generally INSURER FAILURES, *supra* note 11, at 28. Other states do not like this because they fear that the states will use the money for some other purpose. *Id.* at 28-29.

⁷¹ Several studies since 1984 suggest that the funds could not handle a large scale insolvency. INSURER FAILURES, *supra* note 11, at 33. Stewart Economics Inc., an insurance consulting firm, noted in a recent study that the present state funds "were not designed" for insolvencies of the size and complexity of general liability insolvency. See McIntyre, *supra* note 11, at 18.

⁷² See, e.g., McIntyre, *supra* note 11, which discussed the Stewart Economics Inc. study which recommended a national guaranty fund which insurers could elect to join. If an insurer joined, that insurer would no longer be part of the state system. See also Hall, *Solvency Monitoring Theme Gathers More Steam*, BEST'S REVIEW, Jan. 1991, at 100 (Property/Casualty Insurance Edition); Hall, *If Solvency Regulation is a Problem, is Federal Regulation the Solution?*, BEST'S REVIEW, Feb. 1991, at 108 (Property/Casualty Insurance Edition).

liquidation proceeding. The policyholder is a creditor to the extent of unearned premiums paid by the policyholder and accrued losses.⁷³ In the liquidation proceeding, the insured or claimant has priority to the assets only after the liquidator pays administrative costs and debts to employees in their entirety.⁷⁴ Thus, the insured or claimant may not recover anything in the proceeding. Even if the insured or claimant recovers an amount, the recovery occurs only after time-consuming marshaling and distribution of assets.

III. CLAIMS AGAINST COLLATERAL PARTIES

A. *Claims Against Brokers*

Insureds of insolvent insurers have sought recovery from their brokers when the insurer with whom the broker placed the insurance became insolvent.⁷⁵ Insureds have based these suits primarily on claims of negligence. All courts agree that a broker may not place insurance negligently. If a broker fails to exercise care in the selection of the insurer

⁷³ Most state statutes provide that any person recovering from the fund shall be deemed to have assigned his rights under the policy to the fund to the extent of his recovery against it. *See, e.g.*, ALA. CODE § 27-42-11 (1990); CONN. GEN. STAT. § 38a-844(1) (1991); DEL. CODE ANN. tit. 18, § 4211(a) (1990); MASS. ANN. LAWS ch. 175D, § 8(1) (Law. Co-op. 1990); N.J. STAT. ANN. § 17:30A-11(a) (1990). *See also* GUARANTY MODEL ACT, *supra* note 54, § 11(a). The insured retains rights above that amount. *See generally* 19A J. APPLEMAN, *supra* note 19, § 10724, at 194-95, 216.

⁷⁴ *See supra* note 50 and accompanying text. *See also* INSURING REAL PROPERTY, *supra* note 5, § 45.05[5][f][iii], at 45-48 to 45-49.

⁷⁵ *See, e.g.*, Goldstein v. Milton Brokerage Assocs., 632 F. Supp. 285 (E.D. Pa. 1986); Williams-Berryman Ins. Co. v. Morphis, 249 Ark. 786, 461 S.W.2d 577 (Ark. 1971); Wilson v. All Serv. Ins. Corp., 91 Cal. App. 3d 793, 153 Cal. Rptr. 121 (Dist. Ct. App. 1979); Kane Ford Sales, Inc. v. Cruz, 119 Ill. App. 2d 102, 255 N.E.2d 90 (1970); Bordelon v. Herculeans Risks, Inc., 241 So. 2d 766 (La. Ct. App. 1970); August v. British Int'l Ins. Co., 201 So. 2d 194, 198 (La. Ct. App. 1967); Farmers & Merchants State Bank of Pierz v. Bosshart, 400 N.W.2d 739 (Minn. 1987); Ritchie v. Smith, 311 So. 2d 642 (Miss. 1975); Gerald v. Universal Agency, Inc., 56 N.J. Super. 362, 153 A.2d 359 (Super. N.J. 1959); Preston Ins. Agency v. May, 788 S.W.2d 608 (Tex. Ct. App. 1990), *writ granted, sub nom.*, May v. United Servs. Ass'n, 34 Tex. Sup. Ct. J. 154 (Tex. 1990); Higginbotham & Assocs., Inc. v. Greer, 738 S.W.2d 45 (Tex. Ct. App. 1987); Sternoff Metals Corp. v. Vertecs Corp., 39 Wash. App. 333, 693 P.2d 175 (1984). *See also* Master Plumbers Ltd. Mutual Liab. Co. v. Cormany & Bird, Inc., 79 Wis. 2d 308, 255 N.W.2d 533 (1977) (reinsurance setting).

A breach of contract claim could be used regarding the purchase of the insurance by the broker.

and therefore places the insurance with an insolvent insurer, the insured may recover. If the state has licensed the insurer, however, the courts have not recognized a continuing duty on the part of the broker to monitor the insurers with whom he or she has placed insurance.⁷⁶ As long as the broker at the time of placement, after appropriate investigation,⁷⁷ had no reason to know of a precarious financial condition of the insurer, the broker has no liability for future insurer insolvency. The insured has no recovery if the insurer is in apparently good financial health when the broker places the insurance but later becomes insolvent. If the broker places the insurance with an insurer not licensed to issue insurance in the particular state, a surplus lines insurer, the broker must abide by all statutory requirements or face potential liability if the surplus lines insurer becomes insolvent.⁷⁸

Courts have found support for these broker negligence rules in the fact that state regulators must monitor solvency status and protect the public. The courts reason that brokers can rely on the state regulators. For example, in *Wilson v. All Service Insurance Corp.*,⁷⁹ a California appellate court found that a broker had a duty to exercise care to avoid the placement of insurance with an insolvent carrier. After outlining the regulatory framework, the court stated:

⁷⁶ See cases cited *supra* note 75. See also 3 COUCH ON INSURANCE 2D § 25:48 (Rev. ed. 1984); 43 AM. JUR. 2D Insurance § 143 (1982). This standard allows a claim that every renewal of insurance is a procurement. In the typical liability insurance setting in which renewals occur rather frequently, a court's recognition of renewal as a procurement would provide great protection for insureds because the duty to place the insurance with a solvent insurer would be applicable.

⁷⁷ In *Higginbotham* the court noted that the insurer was subject to state financial regulation, paid claims promptly at the time of issuance, paid dividends to policyholders, made an underwriting profit, and was rated B+ (very good) by the Alfred M. Best rating service. A reasonable insurance broker would not have known that the insurer was an unreasonable risk. The analysis implies that the reasonable broker should investigate this sort of information. *Higginbotham & Assocs., Inc. v. Greer*, 738 S.W.2d 45, 48. In *Williams-Berryman Ins. Co. v. Morris*, 249 Ark. 786, 788, 461 S.W.2d 577, 579 (Ark. 1971), the court indicated that consulting Best's was not necessary. See *Bordelon v. Herculean Risks, Inc.*, 241 So. 2d 766, 769 (La. Ct. App. 1970) (an example of insufficient investigation).

⁷⁸ See, e.g., *Goldstein v. Milton Brokerage Assocs.*, 632 F. Supp. 285 (E.D. Pa. 1986); *Farmers & Merchants State Bank of Pierz v. Bosshart*, 400 N.W.2d 739 (Minn. 1987); *Sternoff Metals Corp. v. Vertecs Corp.*, 39 Wash. App. 333, 693 P.2d 175 (1984). For example, in *Goldstein*, the court determined that a broker's failure to abide by the surplus lines statute was negligence per se. *Goldstein*, 632 F. Supp. at 290.

⁷⁹ 91 Cal. App. 3d 793, 153 Cal. Rptr. 121 (1979).

The code imposes on the Insurance Commissioner the continuing duty to oversee the financial condition of an insurer holding a certificate of authority, and gives the Commissioner the power necessary to execute such duty. It would be superfluous, and would create a conflict with the regulatory scheme outlined in the Insurance Code, to impose upon an insurance broker a similar duty to ascertain the financial soundness of an insurer.⁸⁰

The theory that the state regulator protects the insureds and the public from insurer insolvency explains the surplus lines statutes. A broker enjoys protection if the state licenses an insurer to do business in the state because the state then monitors and regulates the insurer.⁸¹ If, however, the state does not license and therefore regulate an insurer, a broker placing insurance with such an insurer has potential liability. This position assumes that the present regulatory framework protects insureds and the public adequately from insurer insolvency.

In *Higginbotham & Associates, Inc. v. Greer*,⁸² the court suggested an expanded tort duty for the broker. In *Higginbotham*, the broker placed a multi-peril policy on a bowling center with Proprietors Insurance Corporation in 1980. After a fire destroyed the insured bowling center in 1981, the insolvency of Proprietors Insurance became evident.⁸³ The insured sought to hold the broker liable for negligence. The court stated:

[A]n agent is not liable for an insured's lost claim due to the insurer's insolvency if the insurer is solvent at the time the policy is procured, unless at that time *or at a later time when the insured could be protected*, the agent knows or by the exercise of reasonable diligence should know, of facts or circumstances which would put a reasonable agent on notice that the insurance presents an unreasonable risk.⁸⁴

After applying the law to the facts, the *Higginbotham* court concluded: "There is nothing in this testimony constituting evidence that a reasonable agent would have known or should have known that PIC [Proprietors Insurance Company] constituted an unreasonable risk at the time the insurance was procured, *or at any time prior to the loss.*"⁸⁵

⁸⁰ *Id.* at 798; 153 Cal. Rptr. at 124.

⁸¹ *See, e.g., Goldstein*, 632 F. Supp. at 290; *Farmers & Merchants State Bank of Pierz*, 400 N.W.2d at 744. *See also* Harrison, *supra* note 69, at 527 (argues that brokers cannot be expected to be a better watchdog than the state).

⁸² 738 S.W.2d 45 (Tex. Ct. App. 1987).

⁸³ *Id.* at 46.

⁸⁴ *Id.* at 47 (emphasis added). *See also* *Preston Ins. Agency v. May*, 788 S.W.2d 608, 611 (Tex. Ct. App.), *writ granted*, 34 Tex. Sup. Ct. J. 154 (Tex. 1990) (quoting the *Higginbotham* language in text). *See generally* Gottheimer, *supra* note 11, at 30.

⁸⁵ *Higginbotham*, 738 S.W.2d at 48 (emphasis added).

Since the loss in *Higginbotham* occurred roughly one year after the broker procured the insurance, the analysis of the broker's knowledge at the time of procurement and at the time of loss is virtually identical. Thus, the court may not have intended to suggest a broader duty for brokers.

B. *Claims Against Excess Insurers*

Insureds of insolvent insurers often have turned to the excess insurer for compensation.⁸⁶ These actions have been actions on the contract of

⁸⁶ See, e.g., *Hudson Ins. Co. v. Gelman Sciences, Inc.*, 921 F.2d 92 (7th Cir. 1990); *Lumar Marine, Inc. v. Insurance Co. of N. Am.*, 910 F.2d 1267 (5th Cir. 1990); *Shapiro v. Associated Int'l Ins. Co.*, 899 F.2d 1116 (11th Cir. 1990); *Interco Inc. v. National Sur. Corp.*, 900 F.2d 1264 (8th Cir. 1990); *Sifers v. General Marine Catering Co.*, 892 F.2d 386 (5th Cir. 1990); *Transco Exploration Co. v. Pacific Employers Ins. Co.*, 869 F.2d 862 (5th Cir. 1989); *Harville v. Twin City Fire Ins. Co.*, 885 F.2d 276 (5th Cir. 1989); *Boudreaux v. Shannon Marine, Inc.*, 875 F.2d 511 (5th Cir. 1989); *Steve D. Thompson Trucking, Inc. v. Twin City Fire Ins. Co.*, 832 F.2d 309 (5th Cir. 1987); *Zurich Ins. Co. v. Heil Co.*, 815 F.2d 1122 (7th Cir. 1987); *Mission Nat'l Ins. Co. v. Duke Transp. Co.*, 792 F.2d 550 (5th Cir. 1986); *Continental Marble & Granite v. Canal Ins. Co.*, 785 F.2d 1258 (5th Cir. 1986); *Molina v. United States Fire Ins. Co.*, 574 F.2d 1176 (4th Cir. 1978); *Ware v. Carrom Health Care Prods., Inc.*, 727 F. Supp. 300 (N.D. Miss. 1989); *New Process Baking Co. v. Federal Ins. Co.*, 923 F.2d 62 (7th Cir. 1991); *Washington Ins. Guar. Ass'n v. Guaranty Nat'l Ins. Co.*, 685 F. Supp. 1160 (W.D. Wash. 1988); *Highlands Ins. Co. v. Gerber Prods. Co.*, 702 F. Supp. 109 (D. Md. 1988); *TXO Prod. Corp. v. Twin City Fire Ins. Co.*, 685 F. Supp. 156 (E.D. Tex. 1988); *McGlynn v. Salen Protexa Drilling Co.*, No. Civ. D. B-88-0266-CA (E.D. La. 1988) (1988 WL 70108); *Radiator Specialty Co. v. First State Ins. Co.*, 651 F. Supp. 439 (W.D.N.C. 1987), *aff'd*, 836 F.2d 193 (4th Cir. 1987); *Holland v. Stanley Scrubbing Well Serv.*, 666 F. Supp. 898 (W.D. La. 1987); *Occidental Chem. Corp. v. Stolt-Nielsen, Inc.*, No. Civ. D. 86-875 (E.D. La. 1987) (1987 WL 19050); *Harrison v. General Marine Catering*, No. Civ. D. 86-1577 (E.D. La. 1986) (1986 WL 12689); *McNeal v. First State Ins. Co.*, No. Civ. D. 85-3927 (E.D. Pa. 1986) (1986 WL 4477), *aff'd*, 822 F.2d 53 (3d Cir. 1987); *Guaranty Nat'l Ins. Co. v. Bayside Resort, Inc.*, 635 F. Supp. 1456 (D.V.I. 1986); *Alabama Ins. Guar. Ass'n v. Kinder-Care, Inc.*, 551 So. 2d 286 (Ala. 1989); *Alabama Ins. Guar. Ass'n v. Magic City Trucking Serv., Inc.*, 547 So. 2d 849 (Ala. 1989); *Alaska Rural Elec. Co-op Ass'n, Inc. v. INSCO, Ltd.*, 785 P.2d 1193 (Alaska 1990); *Maricopa County v. Federal Ins. Co.*, 157 Ariz. 308, 757 P.2d 112 (Ariz. Ct. App. 1988); *Span, Inc. v. Associated Int'l Ins. Co.*, 227 Cal. App. 3d 463, 277 Cal. Rptr. 828 (1991); *Reserve Ins. Co. v. Pisciotta*, 30 Cal. 3d 800, 640 P.2d 764, 180 Cal. Rptr. 628 (1982); *Fageol Truck & Coach Co. v. Pacific Indem. Co.*, 18 Cal. 2d 748, 117 P. 2d 669 (1941); *Ross v. Canadian Indem. Ins. Co.*, 142 Cal. App. 3d 396, 191 Cal. Rptr. 99 (1983); *Fontenot v. Haight*, 764 P.2d 378 (Colo. Ct. App. 1988); *Golden Isles Hosp., Inc. v. Continental Casualty Co.*, 327 So. 2d 789 (Fla. Dist. Ct. App. 1976); *United States Fire Ins. Co. v. Capital Ford Truck Sales, Inc.*, 257 Ga. 77, 355 S.E.2d 428 (1987); *Lamb Bros. Lumber Co. v. South Carolina Ins. Co.*, 186 Ga. App. 51, 366 S.E.2d 388 (1988); *Donald B. MacNeal, Inc. v. Interstate*

Fire & Casualty Co., 132 Ill. App. 3d 564, 477 N.E.2d 1322 (1985); Kelly v. Weil, 563 So. 2d 221 (La. 1990); Ursin v. Insurance Guar. Ass'n, 412 So. 2d 1285 (La. 1981); Weaver v. Kitchens, 570 So. 2d 508 (La. Ct. App. 1990), *writ denied*, 573 So. 2d 1123 (La. 1991); McWright v. Modern Iron Works, Inc., 567 So. 2d 707 (La. Ct. App.), *cert. denied*, 571 So. 2d 651 (La. 1990); Gibson v. Kreihs, 538 So. 2d 1057 (La. Ct. App.), *cert. denied*, 541 So. 2d 856 (La. 1989); Louisiana Ins. Guar. Ass'n v. International Ins. Co., 551 So. 2d 50 (La. Ct. App. 1989); Robichaux v. Randolph, 555 So. 2d 581 (La. Ct. App.), *cert. granted*, 556 So. 2d 1288 (La.), *cert. denied*, 559 So. 2d 127 (La.), *aff'd*, 563 So. 2d 226 (La. 1990); McGuire v. Davis Truck Serv., 518 So. 2d 1171 (La. Ct. App.), *cert. denied*, 526 So. 2d 791 (1988); Nasello v. Transit Casualty Co., 530 So. 2d 1114 (La. 1988); Radar v. Duke Transp., Inc., 492 So. 2d 532 (La. Ct. App. 1986); Beauregard v. Salmon, 211 So. 2d 732 (La. Ct. App.), *cert. denied*, 252 La. 882, 214 So. 2d 550 (1968); Massachusetts Insurers Insolvency Fund v. Continental Casualty Co., 399 Mass. 598, 506 N.E.2d 118 (1987); Gulezian v. Lincoln Ins. Co., 399 Mass. 606, 506 N.E.2d 123 (1987); Northmeadow Tennis Club, Inc. v. Northeastern Fire Ins. Co., 26 Mass. App. Ct. 329, 526 N.E.2d 1333, *review denied*, 403 Mass. 1103, 529 N.E.2d 1345 (1988); Morbark Indus., Inc. v. Western Employers Ins. Co., 170 Mich. App. 603, 429 N.W.2d 213 (1988), *appeal denied*, 432 Mich. 896 (1989); American Hoist & Derrick v. Employers' of Wausau, 454 N.W.2d 462 (Minn. Ct. App. 1990), *review denied*, (1990); Seaway Port Auth. of Duluth v. Midland Ins. Co., 430 N.W.2d 242 (Minn. Ct. App. 1988); United States Fire Ins. Co. v. Coleman, 754 S.W.2d 941 (Mo. Ct. App. 1988); Central Waste Sys., Inc. v. Granite State Ins. Co., 231 Neb. 640, 437 N.W.2d 496 (1989); Werner Indus., Inc. v. First State Ins. Co., 112 N.J. 30, 548 A.2d 188 (1988); Steyr-Daimler-Puch A.G. v. Allstate Ins. Co., 151 A.D.2d 942, 543 N.Y.S.2d 538, *appeal denied*, 74 N.Y.2d 617, 550 N.Y.S.2d 277, 549 N.E.2d 479 (1989); Ambassador Assocs. v. Corcoran, 143 Misc. 2d 706, 541 N.Y.S.2d 715 (Sup. 1989), *aff'd*, 168 A.D.2d 281, 562 N.Y.S.2d 507 (1990); American Reins. Co. v. SGB Universal Builders Supply Inc., 141 Misc. 2d 375, 532 N.Y.S.2d 712 (N.Y. Sup. Ct. 1988); Gladstone v. D.W. Ritter Co., 133 Misc. 2d 922, 508 N.Y.S.2d 880 (N.Y. Sup. 1986); Prince Carpentry, Inc. v. Cosmopolitan Mutual Ins. Co., 124 Misc. 2d 919, 479 N.Y.S.2d 284 (Sup. Ct. 1984); St. Vincent's Hosp. & Medical Center v. Insurance Co. of North Am., 117 Misc. 2d 665, 457 N.Y.S.2d 670 (N.Y. Sup. Ct. 1982); Zurich-American Ins. Co. v. Mead Reins. Corp., 161 A.D.2d 403, 555 N.Y.S.2d 333, *appeal denied*, 76 N.Y.2d 710, 563 N.Y.S.2d 61, 564 N.E.2d 671 (1990); Pergament Distrib., Inc. v. Old Republic Ins. Co., 128 A.D.2d 760, 513 N.Y.S.2d 467, *appeal denied*, 70 N.Y.2d 607, 519 N.Y.S.2d 1031, 514 N.E.2d 389 (1987); Pergament Distrib., Inc. v. Twin City Fire Ins. Co., 128 A.D.2d 759, 513 N.Y.S.2d 650, *appeal denied*, 519 N.Y.S.2d 1031, 514 N.E.2d 389 (1987); Newton v. United States Fire Ins. Co., 98 N.C. App. 619, 391 S.E.2d 837, *cert. denied*, 327 N.C. 637, 399 S.E.2d 329 (1990); Wurth v. Ideal Mut. Ins. Co., 34 Ohio App. 3d 325, 518 N.E.2d 607 (1987); Value City, Inc. v. Integrity Ins. Co., 30 Ohio App. 3d 274, 508 N.E.2d 184 (1986); Luko v. Lloyd's of London, 393 Pa. Super. 165, 573 A.2d 1139, *appeal denied*, Petition of Lloyd's of London, 526 Pa. 636, 584 A.2d 319 (1990), Luko v. Lloyd's of London, 526 Pa. 637, 584 A.2d 319 (1990); Donegal Mut. Ins. Co. v. Long, 387 Pa. Super. 574, 564 A.2d 937 (1989), *appeal granted*, 582 A.2d 323 (Pa. 1990); Rapid City Regional Hosp., Inc. v. South Dakota Ins. Guar. Ass'n, 436 N.W.2d 565 (S.D. 1989); Federal Ins. Co. v. Pacific Sheet Metal, Inc., 54 Wash. App. 514, 774 P.2d 538, *review denied*, 113

excess insurance. If the insured recognizes or fears that insurance provided by its primary insurer does not protect it sufficiently against the possible high verdicts available to plaintiffs on a variety of liability bases, the insured may obtain excess insurance. The insured purchases additional insurance to cover the same loss covered by the primary insurer as part of a comprehensive plan of risk management.⁸⁷ True excess insurance provides coverage only when, and to the extent that, the loss exceeds a certain amount or exceeds the contemplated coverage provided by primary insurance.⁸⁸

The excess insurer contracts directly with the insured. The contract may state that it provides a certain amount of indemnity coverage for a loss only to the extent that the loss exceeds a specific dollar amount.⁸⁹ In the alternative, the contract may not list a specific dollar amount but may simply provide that the insurer will pay the "ultimate net loss in excess of the retained limit" which is defined as "the total of the applicable limits of the underlying policies listed . . . , and the applicable limits of any other

Wash. 2d 1008, 779 P.2d 727 (1989); *Lechner v. Scharrer*, 145 Wis. 2d 667, 429 N.W.2d 491 (Wis. Ct. App. 1988).

⁸⁷ See 8A J. APPLEMAN, *supra* note 19, § 4909.85, at 452; Marick, *Excess Insurance: An Overview of General Principles and Current Issues*, 24 TORT & INS. L.J. 715, 715 (1989). Verdicts that exceed primary coverage are a recent phenomenon. Griffin, *Excess Liability Insurance*, 62 MARQ. L. REV. 375, 376 (1979).

⁸⁸ Primary coverage is that "whereby, under the terms of the policy, liability attaches immediately upon the happening of the occurrence that gives rise to liability." Excess coverage is that "whereby, under the terms of the policy, liability attaches only after a predetermined amount of primary coverage has been exhausted." *Whitehead v. Fleet Towing Co.*, 110 Ill. App. 3d 759, 764, 442 N.E.2d 1362, 1366 (1982). See also *Olympic Ins. Co. v. Employers Surplus Lines Ins. Co.*, 126 Cal. App. 3d 593, 597-98, 178 Cal. Rptr. 908, 910 (1982). See also P. MAGARICK, *EXCESS LIABILITY INSURANCE: THE LAW OF EXTRA CONTRACTUAL LIABILITY OF INSURERS* § 17.01, at 17-2 (3d ed. 1989); B. OSTRAGER & T. NEWMAN, *HANDBOOK ON INSURANCE COVERAGE DISPUTES* § 6.03(a), at 164-65 (3d ed. 1990). See generally Marick, *supra* note 87, at 717.

⁸⁹ See, e.g., *American Hoist & Derrick Co. v. Employers' of Wausau*, 454 N.W.2d 462 (Minn. Ct. App. 1990). In *American Hoist* the policy in question stated: "The company shall indemnify the insured for loss sustained by the insured in excess of the underlying insurance in accordance with the insurance agreements, exclusions and other terms and conditions of the immediate underlying policy." "Underlying insurance" was defined as "\$15 MILLION." The limit of liability was "\$10 MILLION EACH OCCURRENCE AND AGGREGATE (WHERE APPLICABLE) IN EXCESS OF THE UNDERLYING INSURANCE STATED . . ." *Id.* at 465. See also *Interco Inc. v. National Sur. Corp.*, 900 F.2d 1264, 1265 (8th Cir. 1990) ("the Company shall be liable only for the limit of liability stated in Item 3 of the Declarations (Item 3: \$40 million) in excess of the limit or limits of liability of the applicable underlying insurance policy or policies (Item 4: \$30 million) all as stated in the declarations of this policy"). *Id.*

insurance collectible by the insured. . . ."⁹⁰ The policy may use other language such that it provides coverage "in excess of the *amount recoverable* under the underlying insurance."⁹¹ All of these variations of contract language may provide true excess insurance.⁹²

True excess insurance contrasts with a type of primary insurance containing, in effect, an "other insurance" clause which uses excess insurance language. Such a policy states that it provides coverage in excess of any other insurance but that if no other insurance exists, the policy provides primary coverage.⁹³ Insurers use this type of excess insurance

⁹⁰ *Newton v. U.S. Fire Ins. Co.*, 98 N.C. App. 619, 623, 391 S.E.2d 837, 839 (1990) (covering "the ultimate net loss in excess of the retained limit" with "retained limit" defined in part as "the total of the applicable limits of the underlying policies listed in Schedule A hereof, and the applicable limits of any other insurance collectible by the insured"), *reh'g denied*, 327 N.C. 637, 399 S.E.2d 329 (1990). *See also* *State Farm Fire & Casualty Co. v. LiMauro*, 65 N.Y.2d 369, 375, 482 N.E.2d 13, 19, 492 N.Y.S.2d 534, 540 (N.Y. 1985) (covering risks "in excess of the retained limit" which was defined as "the total limit(s) of liability of any underlying insurance collectible" by the Insured).

⁹¹ *Werner Indus., Inc. v. First State Ins. Co.*, 112 N.J. 30, 34-35, 548 A.2d 188, 190 (1988) (emphasis added by the court). Many courts dealing with this language have indicated that in some circumstances the coverage provided is primary. *See, e.g.*, *Reserve Ins. Co. v. Pisciotto*, 30 Cal. 3d 800, 640 P.2d 764, 180 Cal. Rptr. 628 (1982); *Donald B. MacNeal, Inc. v. Interstate Fire & Casualty Co.*, 132 Ill. App. 3d 564, 477 N.E.2d 1322 (1985); *McGuire v. Davis Truck Serv., Inc.*, 518 So. 2d 1171 (La. Ct. App. 1988), *cert. denied*, 526 So. 2d 1114 (La. 1988).

⁹² Excess insurance may provide its own exclusions and conditions with regard to general coverage or it may adopt by reference the exclusions and conditions of the underlying insurance. *See* *Marick, supra* note 87, at 718. Umbrella insurance contains an excess insurance component but may also contain a primary insurance component in that it may cover losses not covered by the underlying primary policy of insurance. For example, an umbrella policy may provide "personal injury" protection that includes coverage for libel, slander and malicious prosecution while the primary policy excludes these bases of liability. *See* 8A J. APPLEMAN, *supra* note 19, § 4909.85, at 452; R. KEETON & A. WIDISS, *supra* note 2, § 3.11(a)(3), at 257. *See also* *Garmany v. Mission Ins. Co.*, 785 F.2d 941, 948 (11th Cir. 1986); *Continental Casualty v. Roper Corp.*, 173 Ill. App. 3d 760, 761-62, 527 N.E.2d 998, 1001-03 (1988); *Bryan Constr. Co. v. Employers' Surplus Lines Ins. Co.*, 60 N.J. 375, 290 A.2d 138 (1972).

⁹³ *See* R. KEETON & A. WIDISS, *supra* note 2, § 3.11(a)(1), at 253-55; *Marick, supra* note 87, at 717-18; A. WINDT, *INSURANCE CLAIMS AND DISPUTES: REPRESENTATION OF INSURANCE COMPANIES AND INSUREDS* § 7.01-03 (2d ed. 1988).

The excess insurance clause in *Western States Mutual Ins. Co. v. Continental Casualty Co.*, 133 Ill. App. 2d 694, 272 N.E.2d 439 (1971), stated in pertinent part:

If there is other valid and collectible insurance, whether primary, excess or contingent, available to the garage customer and the limits of such insurance are

clause to deter overinsuring for the purpose of double recovery.⁹⁴ The clauses create a situation whereby an insured may pay premiums for two primary coverages but can recover from only one unless the loss exceeds the first policy. The insured holding a policy with such a clause will be deterred, if he knows of the clause, from purchasing other insurance because he obtains very little in protection with his second premium payment.⁹⁵

An insured suffering a loss covered by a policy with an insolvent primary insurer may attempt to recover any loss not compensated by a

insufficient to pay damages up to the amount of the applicable financial responsibility limit, then this insurance shall apply to the excess of damages up to such limit.

Id. at 696, 272 N.E.2d at 440. See also *State Farm Fire & Casualty Co. v. LiMauro*, 65 N.Y.2d 369, 376, 482 N.E.2d 13, 19, 492 N.Y.S.2d 534 (N.Y. 1985).

⁹⁴ In the property insurance context, the presence of two or more insurance policies covering property may provide incentive for that property to meet an end not entirely fortuitous. R. KEETON & A. WIDISS, *supra* note 2, § 3.11(a)(2), at 255-56.

⁹⁵ For a general discussion of other insurance clauses, see Kurtock, *Overlapping Liability Coverage—The “Other Insurance” Provision*, 25 FED’N INS. COUNS. Q. 45 (1974); Note, *Conflicts Between “Other Insurance” Clauses in Automobile Liability Insurance Policies*, 20 HASTINGS L.J. 1292 (1969); Note, *Concurrent Coverage in Automobile Liability Insurance*, 65 COLUM. L. REV. 319 (1965); Note, *Automobile Liability Insurance—Effect of Double Coverage and “Other Insurance” Clauses*, 38 MINN. L. REV. 838 (1954).

Premiums for true excess insurance have been low historically compared to primary premiums for the same dollar amount of coverage because premiums for excess policies reflect the lower risk that a covered loss will exceed the limits of the primary insurance or the floor of the excess coverage. See 8A J. APPLEMAN, *supra* note 19, § 4909.85, at 452. The low premiums also reflect the anticipated minimal involvement in the claims handling and defense by the excess insurer. Marick, *supra* note 87, at 715. The Alaska Supreme Court in *Alaska Rural Electric Coop. Assoc. v. INSCO Ltd.*, 785 P.2d 1193, 1194 (1990), noted that excess insurance policies have low premiums because of the limited liability.

Unlike primary insurance with an excess insurance clause, the true excess insurer does not accept premiums for primary coverage but then attempt to escape responsibility. The true excess insurer accepts a premium reflecting the actual risk assumed, not a risk of primary coverage. See 8A J. APPLEMAN, *supra* note 19, § 4909.85, at 453-55. Cases have held that policies with excess clauses must pay losses before true excess insurance applies. See, e.g., *Carriers Ins. Co. v. American Home Assurance Co.*, 512 F.2d 360, 364 (10th Cir. 1975); *State Farm Fire & Casualty Co. v. LiMauro*, 65 N.Y.2d 369, 482 N.E.2d 13, 492 N.Y.S.2d 534 (1985). In *State Farm*, the court noted that in addition to the contract language, the amount of the premiums was indicative of the type of insurance purchased. The true excess policy premium was \$144 for \$1,000,000 of coverage. The excess insurance clause policy premium was \$119 for \$100,000/\$300,000 automobile liability coverage. *Id.* at 540, 482 N.E.2d at 20, 492 N.Y.S.2d at 541.

Thus, if courts find that the insurance in question is true excess insurance, the courts do not require the excess insurer to "drop down" and provide coverage. If the courts find that by the language of the contract, the insurer agreed to provide primary coverage in certain instances and insolvency is one of those instances, the courts find that the excess insurer must pay the insured when the initial insurer becomes insolvent. The courts have not dealt with claims of tort duty of the excess insurer in the insolvency setting.

C. Claims Against Reinsurers

The insured of an insolvent insurer may pursue the reinsurer of the insolvent insurer if one exists. Courts treat these actions as actions on the contract of reinsurance.¹⁰⁹ The reinsurer enters into an arrangement with the original insurer, who later becomes insolvent, to assume part of the risk assumed by the insurer in contracts with the original insureds.¹¹⁰ In effect, the reinsurer insures insurers. Reinsurance takes two basic forms. In treaty reinsurance, the original insurer cedes all or a part of a particular class of risk to the reinsurer in exchange for a portion of the premiums paid relating to those risks. No separate agreement exists as to specific policies.¹¹¹ Facultative reinsurance covers only a single risk or policy

The problem with focusing on the premiums is that the excess insurer may have intended to insure in the event of primary insolvency. The excess premium is smaller than the primary premium because the risk that the primary will become insolvent is conceived to be small. Perhaps the courts' reliance on the premiums paid reflects the courts' belief that the excess insurer did not foresee the possibility of primary insurer insolvency.

¹⁰⁹ See, e.g., *Leff v. NAC Agency, Inc.*, 639 F. Supp. 1426, 1427 (E.D. Mich. 1986); *Arrow Trucking Co. v. Continental Ins. Co.*, 465 So. 2d 691 (La. 1985); *Ainsworth v. General Reins. Corp.*, 751 F.2d 962 (8th Cir. 1985).

¹¹⁰ See CAL. INS. CODE § 620 (Deering 1991), which states: "A contract of reinsurance is one by which an insurer procures a third person to insure him against loss or liability by reason of such original insurance." *Fontenot v. Marquette Casualty Co.*, 258 La. 671, 682, 247 So. 2d 572, 575-76 (La. 1971), notes the following purposes of reinsurance: 1) increase the ceding company's capacity; 2) stabilize the ceding company's operating results; 3) allow the ceding company to attain greater spread of risk; 4) allow the ceding company to withdraw quickly from a particular line of business; 5) allow the ceding company to reduce reserves; 6) allow the ceding company to spread risk of catastrophe. See also *Nutter, Insurer Insolvencies, Guaranty Funds, and Reinsurance Proceeds*, 29 FED'N INS. COUNS. Q. 373, 373-74 (Summer 1979); 13A J. APPLEMAN, *supra* note 19, § 7681, at 480; 19 COUCH ON INSURANCE, *supra* note 77, § 80:2, at 624-25.

¹¹¹ See 13A J. APPLEMAN, *supra* note 19, § 7681, at 481; 19 COUCH ON INSURANCE, *supra* note 76, § 80:3, at 626. See also *Old Reliable Fire Ins. Co. v. Castle Reins. Co.*, 665 F.2d 239, 241 (8th Cir. 1981); *Fontenot v. Marquette Casualty Co.*, 258 La. 671, 247 So. 2d 572 (1971). The treaty may apply to future contracts.

written by the original insured. For example, an insurer may enter into a policy to provide liability coverage of 1 million dollars and then acquire reinsurance to cover 800,000 dollars of that amount.¹¹² With either type of reinsurance contract, the original insured is not a party to the contract, has no contact with the reinsurer and may not even know of the reinsurer's existence.¹¹³ Reinsurance reduces the exposure of the primary insurer to liability on specific risks and allows a greater spread of risk. In addition, it permits a reduction of reserves by the ceding company.¹¹⁴

Most, if not all reinsurance contracts contain an insolvency clause which provides that upon the insolvency of the original insurer, the reinsurer must pay the liquidator on the basis of the liability of the original insurer, the ceding company, not on the basis of the amount paid by that company.¹¹⁵ Insurers first developed the clause to overcome the holding of *Fidelity & Deposit Co. of Maryland v. Pink*,¹¹⁶ a United States Supreme

¹¹² 13A J. APPLEMAN, *supra* note 19, § 7681, at 481; 19 COUCH ON INSURANCE, *supra* note 76, § 80:3, at 626. *See also* INSURING REAL PROPERTY, *supra* note 5, § 46.03[2], at 46-7 to 46-9. *See also* Sumitomo Marine & Fire Ins. Co. U.S. Branch v. Cologne Reins. Co. of Am., 75 N.Y.2d 295, 552 N.E.2d 139, 552 N.Y.S.2d 891 (1990); Arrow Trucking Co. v. Continental Ins. Co., 465 So. 2d 691, 692 (La. 1985) (Reserve Ins. Co. issued excess insurance covering liability for losses between \$100,000 and \$2.1 million and then reinsured \$1.8 million of that).

¹¹³ 13A J. APPLEMAN, *supra* note 19, § 7681, at 480. The original insurer handles all matters relating to the loss of the original insured. *Id.* *See also* 19 COUCH ON INSURANCE, *supra* note 76, § 80:1, at 624. Nontypical reinsurance contracts contain "cut through" endorsements which create rights in favor of the original insured. 19 COUCH ON INSURANCE, *supra* note 76, § 80:70, at 679; Semple & Hall, *The Reinsurer's Liability in the Event of the Insolvency of a Ceding Property and Casualty Insurer*, 21 TORT & INS. L.J. 407, 411 (1986).

¹¹⁴ Nutter, *supra* note 110, at 374; Semple & Hall, *supra* note 113, at 415.

¹¹⁵ *See* Semple & Hall, *supra* note 113, at 409-410. A typical insolvency clause states:

In the event of the insolvency of the Company, reinsurance under this Certificate shall be payable by the reinsurer on the basis of the liability of the Company without diminution because of insolvency, directly to the Company or its liquidator, receiver, or statutory successor, except as otherwise provided by law.

Semple & Hall, *supra* note 113, at 410 n.11. *See* Arrow Trucking Co. v. Continental Ins. Co., 465 So. 2d 691, 699 (La. 1985); Ainsworth v. General Reins. Corp., 751 F.2d 962, 964 (8th Cir. 1985).

¹¹⁶ 302 U.S. 224 (1937), *reh'g denied*, 302 U.S. 780 (1938). In *Pink* the New York Superintendent of Insurance, acting as liquidator, requested payment from the reinsurer. The insurance contract required the reinsurer to pay only "against loss," which the reinsurer argued was payment by the insolvent insurer, not liability. The court agreed. *See* Skandia Am. Reins. Corp. v. Schenck, 441 F. Supp. 715, 725 (S.D.N.Y. 1977) (discussing the *Pink* case).

guaranty fund from a true excess insurer or from an insurer whose contract contains an excess "other insurance" clause. Typically, the insured argues that (1) the contract language requires the insurer to "drop down" and provide primary coverage for the otherwise covered loss, and that (2) even if the contract language does not provide coverage, the reasonable expectations of the insured does.⁹⁶

The contract interpretation position argues, in effect, that the supposed excess policy provides primary insurance. Courts have decided this issue by carefully analyzing the language of the contracts and by applying traditional contract interpretation principles.⁹⁷ When courts face an insurance contract that states a specific dollar floor for coverage, they have determined generally that the insurance provided does not "drop down."⁹⁸ This is a finding that the supposed excess policy provided is true excess insurance. When courts have interpreted contracts which provide insurance above a retained limit defined as the insurance listed in the contract and "the applicable limits of any other insurance collectible by the insured,"⁹⁹ many have found that the insurance contract does not provide indemnity for the covered loss in the event of insolvency of the primary insurer.¹⁰⁰

⁹⁶ See, e.g., *American Hoist & Derrick Co. v. Employers' of Wausau*, 454 N.W.2d 462 (Minn. Ct. App. 1990); *Alaska Rural Elec. Coop. Ass'n v. INSCO, Ltd.*, 785 P.2d 1193 (Alaska 1990). The reported opinions do not deal with tort claims. For a general discussion of reasonable expectations, see R. KEETON & A. WIDISS, *supra* note 2, §§ 6.1, 6.3; Giesel, *The Knowledge of Insurers and the Posture of the Parties in the Determination of the Insurability of Punitive Damages*, 39 U. KAN. L. REV. 355, 406 (1991).

⁹⁷ See, e.g., *Interco Inc. v. National Sur. Corp.*, 900 F.2d 1264 (8th Cir. 1990); *Transco Exploration Co. v. Pacific Employers Ins. Co.*, 869 F.2d 862, 864-65 (5th Cir. 1989); *Ware v. Carrom Health Care Prods., Inc.*, 727 F. Supp. 300, 304-05 (N.D. Miss. 1989). For a discussion of the various interpretations given to certain contract language, see Note, *Insolvency in the Insurance Industry and "Drop Down" Coverage: A Realistic Solution*, 8 J.L. & COM. 423 (1988); Brady & Grogan, *The Excess Drop Down Issue: When is the Excess Carrier Responsible for the Insolvency of a Primary Carrier?* 39 FED'N INS. COUNS. Q. 63 (1988); Goldstein, *Recent Insurance Cases: Umbrella Policies and Insolvent Primary Insurers*, FOR DEF., Aug. 1988, at 3.

⁹⁸ See, e.g., *American Hoist & Derrick Co. v. Employers' of Wausau*, 454 N.W.2d 462, 467 (Minn. Ct. App. 1990); *Alaska Rural Elec. Coop. Ass'n v. INSCO, Ltd.*, 785 P.2d 1193, 1195-96 (Alaska 1990); *Luko v. Lloyd's of London*, 393 Pa. Super. 165, 171-73, 573 A.2d 1139, 1142-43 (1990).

⁹⁹ *Newton v. United States Fire Ins. Co.*, 98 N.C. App. 619, 623, 391 S.E.2d 837, 839 (1990).

¹⁰⁰ See *Id.* at 624-25, 391 S.E.2d at 839-40 (no drop down); *Kelly v. Weil*, 563 So. 2d 221 (La. 1990) (no drop down); *Federal Ins. Co. v. Pacific Sheet Metal, Inc.*, 54 Wash. App. 514, 774 P.2d 538 (1989) (no drop down). Compare *Alabama Ins. Guar. Ass'n v. Magic City Trucking Serv., Inc.*, 547 So. 2d 849, 853-56 (Ala. 1989) (drop down required).

Some courts, in evaluating contracts providing coverage for losses "in excess of the amount recoverable under underlying insurance,"¹⁰¹ find no amount of underlying insurance recoverable and thus the insurer must "drop down" to provide primary coverage.¹⁰² Other courts dealing with this language find that the "amount recoverable" language refers to the amount that would have been recoverable had the primary insurer not become insolvent.¹⁰³ The insurance provided is true excess insurance. Occasionally, courts evaluating contract language focus on the amount of premiums paid to clarify the intent of the parties regarding the contract.¹⁰⁴

Courts entertaining the reasonable expectations argument have found it unpersuasive.¹⁰⁵ In *American Hoist & Derrick Co. v. Employers' of Wausau*,¹⁰⁶ the Minnesota Court of Appeals found that the contract unambiguously provided true excess coverage because the policy provided coverage "in excess of the the underlying insurance" and the "underlying insurance" was defined as "\$15 million."¹⁰⁷ The court found that given the fact that the insured, a sophisticated business with experienced insurance employees, paid much less for the excess policy than for the underlying policies, it was not reasonable for the insured to expect that the excess policy covered not only the risk assumed by the underlying policies but also the risk above the primary policy.¹⁰⁸

¹⁰¹ *Werner Indus., Inc. v. First State Ins. Co.*, 112 N.J. 30, 34-35, 548 A.2d 188, 190 (1988).

¹⁰² *See, e.g.*, *Reserve Ins. Co. v. Pisciotto*, 30 Cal. 3d 800, 640 P.2d 764, 180 Cal. Rptr. 628 (1982); *Donald B. MacNeal, Inc. v. Interstate Fire & Casualty Co.*, 132 Ill. App. 3d 564, 477 N.E.2d 1322 (1985); *McGuire v. Davis Trucking Serv.*, 518 So. 2d 1171 (La. Ct. App. 1988); *Lechner v. Scharrer*, 145 Wis. 2d 667, 429 N.W.2d 491 (1988).

¹⁰³ *See, e.g.*, *Rapid City Regional Hosp., Inc. v. South Dakota Ins. Guar. Ass'n*, 436 N.W.2d 565 (S.D. 1989); *Werner Indus., Inc. v. First State Ins. Co.*, 112 N.J. 30, 548 A.2d 188 (1988).

¹⁰⁴ *See, e.g.*, *American Hoist & Derrick Co. v. Employers' of Wausau*, 454 N.W.2d 462 (Minn. Ct. App. 1990); *Alaska Rural Elec. Coop. Ass'n v. INSCO, Ltd.*, 785 P.2d 1193 (Alaska 1990). The courts in both of these cases look to the relative amounts of the premiums paid to determine the reasonableness of the insureds' expectations. *American Hoist*, 454 N.W.2d at 467; *Alaska Rural*, 785 P.2d at 1194-95.

¹⁰⁵ *See, e.g.*, *American Hoist*, 454 N.W.2d 462; *Alaska Rural*, 785 P.2d 1193.

¹⁰⁶ 454 N.W.2d 462 (Minn. Ct. App. 1990).

¹⁰⁷ *Id.* at 465-67.

¹⁰⁸ The insured paid \$50,000 and \$42,500 for two policies with insurers who became insolvent. In contrast, the insured paid only \$20,000 for the excess policy at issue. *Id.* at 467. In *Alaska Rural*, the court noted that the primary insurance premium was \$150,000 while the putative excess insurer accepted a premium of \$43,992. Thus, the court concluded that it was unreasonable to expect the excess insurer to provide coverage in place of the primary insurer. *Alaska Rural*, 785 P.2d at 1194.

Court case which overturned prior law by holding that the reinsurer need not pay an otherwise covered claim unless and until the ceding company paid the claim.¹¹⁷ The *Pink* rule created a windfall for reinsurers in the insolvency setting because insolvent ceding companies rarely, if ever, had the ability to pay the claim. Thus, reinsurers rarely would pay the reinsurance proceeds in an insolvency situation.¹¹⁸ In response to *Pink*, many states developed statutes requiring that reinsurance agreements contain insolvency clauses if the ceding insurer desired credit for the reinsurance so it could reduce the mandatory reserves held.¹¹⁹ Because reduced mandatory reserves is one of the primary attributes of obtaining

¹¹⁷ Prior to *Pink* the reinsurer had to indemnify the liquidator when the insolvent insurer became liable, regardless of contract language. See *Allemannia Fire Ins. Co. v. Fireman's Ins. Co. ex rel. Wolfe*, 209 U.S. 326 (1908).

¹¹⁸ See generally Comment, *Reinsurance and Insurer Insolvency: The Problem of Direct Recovery by the Original Insured or Injured Claimant*, 29 U.C.L.A. L. REV. 872, 878-81 (1982).

¹¹⁹ LA. REV. STAT. § 22:941(B)(2) (1990) provides:

B. The ceding insurer may take credit for the reserves on such ceded risks to the extent reinsured, except that: . . .

(2)(a) No credit shall be allowed to any ceding insurer for reinsurance, as an admitted asset or as a deduction from liability, unless the reinsurance shall be payable, in the event of insolvency of the ceding insurer, to its liquidator or receiver on the basis of the claim or claims allowed against the insolvent ceding insurer by any court of competent jurisdiction or any justice or judge thereof, or by any receiver or liquidator having authority to determine and allow such claims, except either where the reinsurance contract with the consent of the direct insured or insureds specifically provides another payee of such reinsurance in the event of the insolvency of the ceding insurer or when the assuming insurer with the consent of the direct insured or insureds has assumed such policy obligations of the ceding insurer as direct obligations of the assuming insurer to the payees under such policies and in substitution for the obligations of the ceding insurer to such payees.

For other examples of such statutes, see ALASKA STAT. ANN. § 21.12.020 (1990); ARIZ. REV. STAT. § 20-261 (1989); ARK. STAT. ANN. § 23-62-204 (1987); CAL. INS. CODE § 922.2 (Deering 1991); ILL. REV. STAT. ch. 73, ¶ 785.2, § 173.2 (1988); ME. REV. STAT. ANN. tit. 24-A, § 731B(5) (1989); MD. CODE ANN. § 74 (1989); MASS. GEN. LAWS ANN. ch. 175, § 20 (1991); MO. REV. STAT. § 375.246 (1991); NEB. REV. STAT. § 44-417 (1988); N.M. STAT. ANN. § 59A-7-11 (1978); N.Y. INS. LAW § 1308 (1990); N.C. GEN. STAT. § 58-7-30 (1990); OR. REV. STAT. § 731.508 (1989); TENN. CODE ANN. §§ 56-2-207, -13-122 (1990); TEXAS INS. CODE ANN. art. 5.75-1 (1991); VA. CODE § 38.2-131.65 (1991); WASH. REV. CODE § 48.12.160 (1991); W. VA. CODE § 33-4-15 (1966).

reinsurance,¹²⁰ a statute of this nature virtually mandates universal insolvency clauses.

Unfortunately for the insured, the typical insolvency clause has the added effect of requiring the reinsurer to pay the proceeds due in an insolvency situation to the "liquidator, receiver or statutory successor" of the insolvent insurer.¹²¹ Several cases have relied upon the clause to deny causes of action of insureds attempting to recover directly from reinsurers.¹²² Various guaranty funds have argued that they are the "statutory successor(s)" of the insolvent insurer such that they should be able to recover directly from the reinsurer. However, the courts have held that the liquidator receives the reinsurance proceeds absent specific language to the contrary.¹²³

*American Reinsurance Co. v. Insurance Commission of California*¹²⁴ presents the typical treatment by the courts regarding the insolvency clause. In *American*, the court noted that the applicable insolvency clause statute stated that reinsurance proceeds must be paid to the "conservator, liquidator or statutory successor" unless the reinsurance contract provides specifically to the contrary.¹²⁵ The court then concluded that the California Insurance Commissioner was the designated liquidator and that therefore the reinsurance proceeds must be paid to the Commissioner.¹²⁶

¹²⁰ See Semple & Hall, *supra* note 113, at 415; Nutter, *supra* note 110, at 374; B. OSTRAGER & T. NEWMAN, *supra* note 88, § 14.08(a), at 453-56. See also *American Re-Ins. Co. v. Insurance Comm'n of Cal.*, 527 F. Supp. 444, 452 (C.D. Cal. 1981).

¹²¹ See insolvency clause contained *supra* note 115.

¹²² See, e.g., *Ainsworth v. General Reins. Corp.*, 751 F.2d 962, 965-66 (8th Cir. 1985); *American Reins. Co. v. Insurance Comm'n of Cal.*, 527 F. Supp. 444, 453-56 (C.D. Cal. 1981); *Fontenot v. Marquette Casualty Co.*, 258 La. 671, 247 So. 2d 572, 580-82 (1971). See also *Estate of Osborn v. Gerling Global Life Ins. Co.*, 529 So. 2d 169, 172 (Miss. 1988) (health insurance context).

¹²³ See, e.g., *General Reins. Co. v. Missouri General Ins. Co.*, 596 F.2d 330, 332 (8th Cir. 1979); *Skandia America Reins. Corp. v. Barnes*, 458 F. Supp. 13, 15 (D. Colo. 1978). Cf. *First Nat'l Bank v. Higgins*, 357 S.W.2d 139 (Mo. 1962). A few reinsurance contracts contain "cut through" endorsements or other similar clauses that specifically redirect reinsurance proceeds to the insured rather than to the liquidator. See *supra* note 113. If contract language is honored, such clauses should make recovery by an insured certain. Yet, these endorsements are the exception, not the rule, and may not be enforced by courts. See Semple & Hall, *supra* note 113, at 411, n.14 (discussing *Warranty Ass'n v. Commonwealth Ins. Co.*, No. R-80-334 (April 13, 1983 P.R.) in which the court stated that the cut through endorsements were improper preferences)). See, e.g., *Ascherman v. General Reins. Corp.*, 183 Cal. App. 3d 307, 311, 228 Cal. Rptr. 1, 4 (1986).

¹²⁴ 527 F. Supp. 444 (C.D. Cal. 1981).

¹²⁵ *Id.* at 452.

¹²⁶ *Id.* at 453.

Courts also deny causes of action of insureds against reinsurers because no privity of contract exists. The reinsurer does not owe the insured because the reinsurer has no contract with the insured.¹²⁷ For example, in *Ainsworth v. General Reinsurance Corp.*,¹²⁸ the court, when dealing with a claim for reinsurance proceeds, stated: "An ordinary contract of reinsurance, in the absence of provisions to the contrary, operates solely as between the reinsurer and the reinsured. It creates no privity between the original insured and the reinsurer."¹²⁹

Insureds have attempted unsuccessfully to recover on the theory that the insured is the third-party beneficiary of the reinsurance contract.¹³⁰ In

¹²⁷ See, e.g., *Morris & Co. v. Skandinavia Ins. Co.*, 279 U.S. 405 (1929); *Credit Managers Ass'n v. Kennesaw Life & Accident Ins. Co.*, 809 F.2d 617 (9th Cir. 1987); *Ainsworth v. General Reins. Corp.*, 751 F.2d 962, 964-65 (8th Cir. 1985); *Citizens Casualty Co. v. American Glass Co.*, 166 F.2d 91 (7th Cir. 1948); *Taggart v. Keim*, 103 F.2d 194, 197-98 (3d Cir. 1939); *United States v. Federal Sur. Co.*, 72 F.2d 964 (4th Cir. 1934), *cert. denied*, 294 U.S. 711 (1935); *Allendale Mut. Ins. Co. v. Crist*, 731 F. Supp. 928, 930 (W.D. Mo. 1989); *Employers Reins. Corp. v. American Fidelity & Casualty*, 196 F. Supp. 553 (W.D. Mo. 1959); *American Cast Iron v. Statesman Ins. Co.*, 343 F. Supp. 860, 865 (D. Minn. 1972); *McDonough Constr. v. Pan Am. Sur.*, 190 So. 2d 617 (Fla. Ct. App. 1966); *Baylor v. Highway Ins. Co.*, 57 Ill. 2d 590, 316 N.E.2d 633 (1974); *Reid v. Ruffin*, 503 Pa. 458, 463, 469 A.2d 1030, 1033-34 (1983); *Eastern Eng'g & Elevator Co. v. American Reins. Co.*, 309 Pa. Super. 578, 580-82, 455 A.2d 1235, 1236 (1983); *Schuylkill Prods. Inc. v. H. Rupert & Sons*, 305 Pa. Super. 36, 40, 451 A.2d 229, 231 (1982); *McFarling v. Mayfield*, 510 S.W.2d 108, 109 (Tex. Ct. App. 1974). See generally 19 COUCH ON INSURANCE, *supra* note 76, § 80:69; 13A J. APPLEMAN, *supra* note 19, § 7694, at 527-32.

¹²⁸ 751 F.2d 962 (8th Cir. 1985).

¹²⁹ *Id.* at 965 (quoting *O'Hare v. Pursell*, 329 S.W.2d 614, 620 (Mo. 1959)).

¹³⁰ For cases dealing with the third-party beneficiary theory, see *Ainsworth v. General Reins. Corp.*, 751 F.2d 962, 965 (8th Cir. 1985); *Allendale Mut. Ins. Co. v. Crist*, 731 F. Supp. 928, 930-31 (W.D. Mo. 1989); *Leff v. NAC Agency, Inc.*, 639 F. Supp. 1426, 1429 (E.D. Mich. 1986); *American Cast Iron v. Statesman Ins. Co.*, 343 F. Supp. 860, 864-65 (D. Minn. 1972); *Safeway Trails, Inc. v. Stuyvesant Ins. Co.*, 211 F. Supp. 227 (M.D.N.C. 1962), *aff'd*, 316 F.2d 234 (4th Cir. 1963); *Melco Sys. v. Receiver of Trans-Am.*, 268 Ala. 152, 105 So. 2d 43 (1958); *Clark & Co. v. Department of Ins.*, 436 So. 2d 1013 (Fla. Ct. App. 1983); *Arrow Trucking Co. v. Continental Ins. Co.*, 465 So. 2d 691, 700-01 (La. 1985). For a general discussion of third-party beneficiary theory, see J. CALAMARI & J. PERILLO, *CONTRACTS* 605 (1977).

Insureds have attempted to recover in related settings on the theory that the primary insurer acts as the agent of the reinsurer. In *Reid v. Ruffin*, 503 Pa. 458, 469 A.2d 1030 (1983), the insured pursued a claim against the reinsurer on the theory that the original insurer, which was insolvent, had acted as the agent of the reinsurer when that original insurer committed acts of bad faith. *Id.* at 461, 469 A.2d at 1032. The court stated that although the reinsurer had reserved the power to consent to all settlements, it had no power over the original insurer with regard to decisions to

Allendale Mutual Insurance Co. v. Crist,¹³¹ insureds claimed that they were third-party beneficiaries of the reinsurance contract. The court stated that the reinsurance contract must clearly state that the contracting parties intended the third party to benefit from the contract performance and that the presumption was to the contrary.¹³²

As a result of these holdings, the reinsurer pays the liquidator of the insolvent insured who then disburses all sums according to the general distribution order. The insureds receive proceeds via guaranty fund payment or individually in the liquidation proceeding after administrative costs and debts to employees are paid.

IV. JUSTIFICATION OF TORT DUTY FOR COLLATERAL PARTIES

A. *Recognition of Tort Duty*

The law of torts allocates losses arising from human activities.¹³³ Courts have considered various factors in the placement of loss including the interest of the plaintiff, the interest of the defendant, the interest of the public, and "social engineering" goals.¹³⁴ The relative ability of the respective parties to bear the loss by absorption, avoidance, or distribution acts as an important factor in the tort recognition calculus.¹³⁵ Also, the financial benefit gained by a party may support a recognition of a tort duty owed by that party.¹³⁶ Courts often recognize new tort duties.¹³⁷ Because

refuse to settle. *Id.* at 462-63, 469 A.2d at 1033. For examples of agency cases, see *Aetna Ins. Co. v. Glen Falls Ins. Co.*, 453 F.2d 687 (5th Cir. 1972); *Reid v. Ruffin*, 503 Pa. 458, 469 A.2d 1030 (Pa. 1983). The agency theory may be more successful now that "fronting" is recognized. Fronting is the process by which an insurer licensed to operate within a state issues insurance and then, often in accord with a prearranged plan, cedes most or all of the risk to an unlicensed reinsurer. This is really only circumvention of the licensing requirements. See *Failed Promises*, *supra* note 11; *Gastel*, *supra* note 6.

¹³¹ 731 F. Supp. 928 (W.D. Mo. 1989).

¹³² *Id.* at 931. Some courts have found a third-party beneficiary. See, e.g., *Homan v. Employers Reins. Corp.*, 345 Mo. 650, 136 S.W.2d 289 (1939); *O'Hare v. Pursell*, 329 S.W.2d 614 (Mo. 1959); *First Nat'l Bank v. Higgins*, 357 S.W.2d 139 (Mo. 1962).

¹³³ W. KEETON, *supra* note 14, § 1, at 6.

¹³⁴ W. KEETON, *supra* note 14, § 3, at 16.

¹³⁵ Feezer, *Capacity to Bear Loss as a Factor in the Decision of Certain Types of Tort Cases*, 78 U. PA. L. REV. 805 (1930) and 79 U. PA. L. REV. 742 (1931); *Morris*, *Hazardous Enterprises and Risk Bearing Capacity*, 61 YALE L.J. 1172 (1952).

¹³⁶ *McNiece & Thornton*, *Affirmative Duties in Tort*, 58 YALE L.J. 1272 (1949). See also W. KEETON, *supra* note 14, § 56, at 374.

¹³⁷ *Albertsworth*, *Recognition of New Interests in the Law of Torts*, 10 CAL. L. REV. 461 (1922). Recent torts include wrongful birth and prenatal injury. W.

insolvencies are common, insureds and the public as a whole receive inadequate protection. The solution to the problematic plight of insureds may be judicial recognition of a tort duty on the part of collateral parties to monitor the solvency of primary insurers.

B. *The Insured Should Not Bear the Loss*

One facet of the justification of placing the tort duty on the collateral parties is the conclusion that the risk of loss in the insolvency setting should not rest with the insured or the claimant. An important goal of state insurance regulators, in the past and to date, has been protection of insureds and the public¹³⁸—specifically, protection from insurer insolvency.¹³⁹

The typical insured or claimant needs complete protection. In a traditional contract relationship, each party to the contract bears the risk that the other party cannot perform for whatever reason, including insolvency. The law assumes that each party can choose its contract partner, can investigate the financial condition of those with whom it contracts, and can structure the deal to protect itself against the insolvency of the contracting partner.¹⁴⁰ If this rule applied to insurance contracts, one would expect the insured to bear the loss and accept the remedies any other creditor of any insolvent company might have.¹⁴¹

Several characteristics of the insurance relationship make such a rule unfair. The insured cannot protect itself by contract. Rarely in the insurance context are the insurer and the insured equal parties to the contract. The insurer provides the standard policy and the insured accepts

KEETON, *supra* note 14, § 55. An example of a particularly recent expansion of tort law is the liability of providers of alcohol for injuries caused by drinkers. *See, e.g., Coulter v. Superior Court*, 21 Cal. 3d 144, 577 P.2d 669, 145 Cal. Rptr. 534 (1978).

¹³⁸ *See supra* notes 9 & 18. For example, states have statutes to prevent unfair practices and overreaching by insurers. States also have statutes dealing with marketing practices and claims processing. *See, e.g., CAL. INS. CODE* §§ 780-790.10 (Deering 1991); *N.Y. INS. LAWS* §§ 2401-2409; 2602-2610 (1990); *MASS. ANN. LAWS* ch. 175, § 2B (1990). *See also* Davis, *Protecting Consumers from Overdisclosure and Gobbledygook: An Empirical Look at the Simplification of Consumer-Credit Contracts*, 63 VA. L. REV. 841 (1977).

¹³⁹ *See* discussion *supra* note 18. *See generally* R. JERRY, *supra* note 2, § 22, at 73.

¹⁴⁰ 17 AM. JUR. 2d *Contracts* § 22 (1964); 17 C.J.S. *Contracts* § 30 (1963).

¹⁴¹ A creditor's remedy depends on whether the claim is secured or unsecured. A secured claim is one that has collateral protecting the debt. Such claims will be satisfied first. Unsecured claims will receive a share of the remaining proceeds according to a system of priorities listed in 11 U.S.C. § 507, a provision of the United States Bankruptcy Code. *See generally* B. WEINTRAUB & A. RESNICK, *BANKRUPTCY LAW MANUAL* Ch. 5 (1986).

or rejects it. The insured cannot bargain.¹⁴² Thus, if the insured knows of the possibility of insurer insolvency and wants to protect itself by a contract provision, it might find that it cannot do so. The insured can only seek other insurance with a more stable company. The third-party claimant cannot possibly protect itself because it does not choose to enter a relationship with any insurer with regard to the loss at issue.

This discussion assumes that the insured knows of the danger of insurer insolvency. The typical insured probably has no knowledge of the need to protect against insurer insolvency.¹⁴³ The typical insured may not anticipate the possibility of insurer insolvency, or reliance on the state insolvency prevention mechanisms may lull the insured into a false sense of security.

Even if the insured knows of the possibility of insurer insolvency in general and wishes to investigate the financial position of a potential insurer, the typical insured lacks the knowledge and experience necessary to evaluate financial statements of, and reports about, the insurer. Solvency-related concepts such as reserves and surplus do not exist in most business spheres other than banking and related financial institutions.¹⁴⁴

¹⁴² See R. KEETON & A. WIDISS, *supra* note 2, § 2.8(c). See generally Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943).

¹⁴³ In 1990, Caleb Fowler, President of CIGNA's property and casualty companies stated that he had not seen a change in customer awareness of the possibility of insurer insolvency. Albert Counselman, President and Chief Executive Officer of Riggs, Counselman, Michaels and Downes, Inc., a Baltimore agency, stated that he has seen a "miniscule change going on that is significant" in that there is some heightened consumer awareness of the possibility of insurer insolvency. McIntyre, *Industry Executives Focus on Reform: Solvency, Workers Compensation Top Panelists' Agenda*, BUS. INS., Oct. 22, 1990, at 81.

¹⁴⁴ John Gardner, managing director of Insurance Solvency International Ltd., a rating agency now owned by Standard and Poor's Corp., described ways that insurance buyers can investigate the solidity of the insurer under consideration at the 17th Annual Captive Insurance Companies Association Inc. conference in 1990. Mr. Gardner noted the presence of the rating system and stated that buyers should also analyze the financials that are public. In the analysis the buyers should consider the premiums to surplus ratio, the kind of business the company is doing, the rapidity of the growth of the premium volume, adequacy of loss reserves as related to premium volume and policyholder surplus, adequacy of total reserves, the net value of assets and the quality of the assets and liabilities, the ability to raise money in a catastrophe, underwriting losses compared to investment income, amount of reinsurance, ability and willingness to pay, dividend payment, and size of the insurer. L. Kertesz, *Buyers Cautioned on Insurer Insolvency*, BUS. INS., April 30, 1990, at 135. Obviously, this sort of analysis could only be done, if at all, by a sophisticated consumer such as a corporation.

Even sophisticated insureds would find the task of evaluating and monitoring solvency substantial.

In addition, the insured does not have access to the data necessary for a solvency evaluation. Nor would insurers want insureds to have access, on a regular basis, to that information. The large numbers of potential insureds make the possibility of periodic investigations by all insureds an efficiency nightmare for insurers and insureds alike, even if the insureds can evaluate the financial information and have access to it. Finally, the insured cannot "mitigate" damages since an insured cannot purchase insurance after a loss occurs.

If the burden for any loss not covered by the guaranty funds falls on the insured, that party has the incentive to eliminate the risk. Yet, an insured or claimant cannot eliminate or even minimize the risk. The only risk shifting available to those parties may be, ironically, the purchase of insurance to cover the possibility of insolvency or to double cover possible losses. Basically, the loss falls on the insured or third-party claimant, the parties who have traditionally received, and deserve to receive, protection. Placing the loss on the insured furthers no socially beneficial goal. It creates no impetus for improving solvency regulation and prevention.¹⁴⁵

C. Placing a Tort Duty on Collateral Parties Is Fair and Socially Beneficial

When one considers all of the factors of tort recognition, including the social policy aspects, the argument for the establishment of a tort duty on the part of the collateral parties to the insurance relationship is compelling. Placing a duty on the collateral parties to investigate and monitor reasonably the solvency of insurers with which they deal yields a much more socially advantageous result. This duty logically extends the duty already existing for brokers to exercise care in the placement of insurance with solvent insurers. The proposed duty, however, requires affirmative investigation and monitoring. This investigation and monitoring should, at least, include an evaluation of NAIC data, Insurance Regulatory Information System data, ratings service data, and any other public information and general information circulating within the industry. Thus the duty requires a more thorough investigation than present law apparently requires brokers to make. In addition, the duty continues past the placement of the insurance or the commencement of the insurance relationship. In the case of brokers and excess insurers, these parties owe

¹⁴⁵ The only significant incentive for improving solvency regulation is the possibility that an insurer will be assessed by the guaranty fund. See discussion at notes 69-70 *supra*.

the duty to the insureds with whom those parties deal. In the case of the reinsurer, the insured may not be linked to the reinsurer by a specific relation. Thus, all insureds of the insolvent insurer should have the possibility of a recovery for a breach of the duty. Though present law contains an analogous duty for brokers, a duty to investigate and monitor is a novel concept with regard to excess insurers and reinsurers.

Courts can justify imposing a duty to investigate and monitor. First, brokers, excess insurers and reinsurers profit from the business of insurance, and specifically, in a parasitic way, from the existence of other insurers in the industry. The smooth operation of the other insurer creates a profit for the broker and creates a market for the excess insurer and reinsurer. The insolvency of the other insurer creates the problem addressed by this article.

Each of these collateral parties depends on the existence of insureds as a class served by the industry. In any insurance relationship, the broker and excess insurer are aware of the specific insured. They deal directly with the insured. The reinsurer may not know of the particular insured, but does know of the existence and involvement of insureds as a class.

Courts have long recognized that entities such as innkeepers and carriers who provide services to the public have a duty to exercise particular care in the rendering of those services.¹⁴⁶ The insurance industry serves the public. Pound assumed the public nature of insurance in *The Spirit of Common Law* in which he stated:

[W]e have taken the law of insurance practically out of the category of contract, and we have established that the duties of public service companies are not contractual, as the nineteenth century sought to make them, but are instead relational; they do not flow from agreements which the public servant may make as he chooses, they flow from the calling in which he has engaged and his consequent relation to the public.¹⁴⁷

Numerous courts have noted the public nature of the industry.¹⁴⁸ Thus, recognizing that collateral parties owe a duty to insureds with whom they deal and to the public accords with prior principles.

¹⁴⁶ See W. KEETON, *supra* note 14, §§ 28 & 56, at 161 & 373; Arterburn, *The Origin and First Test of Public Callings*, 75 U. PA. L. REV. 411 (1927); Winfield, *The History of Negligence in the Law of Torts*, 42 L.Q. REV. 184 (1926). Courts have, on the basis of policy and prevailing attitudes, recognized affirmative duties to act. See W. KEETON, *supra* note 14, § 56 at 374; Owen, *Civil Punishment and the Public Good*, 56 SO. CAL. L. REV. 103 (1982).

¹⁴⁷ R. POUND, *THE SPIRIT OF THE COMMON LAW* 29 (1921).

¹⁴⁸ See, e.g., *Barrera v. State Farm Mut. Auto. Ins. Co.*, 71 Cal. 2d 659, 668-69, 456 P.2d 674, 680-81, 79 Cal. Rptr. 106, 112-13 (1969); *Bekken v. Equitable Life Assur. Soc'y of United States*, 293 N.W. 200, 210 (1940).

The duty owed by these public parties is a high duty that encompasses nonfeasance.¹⁴⁹ Imposing a duty on collateral parties to conduct a reasonable investigation and monitoring of the solvency of insurers, and imposing liability for a failure to abide by that duty accords with prior treatment of public entities.

Each of the collateral parties have superior expertise for the analysis of solvency data. The collateral parties are intimately familiar with topics such as reserves, underwriting, and reinsurance. They understand the effect and value of information regarding such concepts. These concepts, after all, comprise the substance of the collateral parties' livelihood.

These parties have access to ratings services, trade publications, other public financial information about insurers, and nonpublic information which they glean from conversations with others in the industry. The parties' position in the industry gives them the ability to spot strange activities by insurers that might indicate a financially troubled insurer.¹⁵⁰ Though, theoretically, the insureds have access to some of the same information, collateral parties are much better equipped to evaluate the information and make judgments as to insurer solvency.

Many commentators in the industry argue that collateral parties do not have access to inside information.¹⁵¹ Even if these parties have no inside information, they have expertise superior to that of insureds to evaluate the public information.¹⁵² Others argue that solvency evaluation is a "formidable matter, involving rules which can baffle even actuaries and

¹⁴⁹ For example, common carriers must use great caution to protect passengers. This duty has been described as "the utmost caution characteristic of very careful prudent men." *Pennsylvania v. Roy*, 102 U.S. 451, 456 (1880). See also *Ware v. Yellow Cab, Inc.*, 193 Neb. 159, 225 N.W.2d 565 (1975).

¹⁵⁰ Mazzuca, *Expanded Role Urged for Brokers in Monitoring Insurer Insolvency*, BUS. INS., June 11, 1990, at 35. Illinois Deputy Governor John E. Washburn noted that brokers "know the troubled companies long before the regulators do." *Id.*

¹⁵¹ Richard Peterson, outgoing head of the National Association of Insurance Brokers, addressed the suggestion that brokers should guarantee the financial solvency of insurers because brokers have access to inside information by stating that brokers have no inside information and in fact have less information than regulators. *Editorial Comment, Producers & Insolvencies*, THE NATIONAL UNDERWRITING COMPANY: PROPERTY AND CASUALTY/ EMPLOYEE BENEFITS EDITION, May 28, 1990, at 44 [hereinafter *Editorial Comment*]. However, brokers have more information than do insureds. See Mazzuca, *supra* note 150; Katz, *Solvency: Brokers, States, Feds Clash*, THE NATIONAL UNDERWRITING COMPANY: PROPERTY AND CASUALTY/ EMPLOYEE BENEFITS EDITION, May 7, 1990, at 3, 61.

¹⁵² One commentator lists the following signals of possible insolvency that may be available to brokers but arguably are not available to the public: Reinsurance cancellation, discontinuation of lines of insurance, delays in processing, personnel changes, mass cancellations, and large loss ratios. Harrison, *supra* note 69, at 528.

insurance accountants.”¹⁵³ This argument proves the point. If brokers, excess insurers, and reinsurers are incapable of the evaluation, the typical insurance consumer certainly is ill-equipped to evaluate the solvency status of an insurer. The courts’ application of a duty to brokers in the procurement of insurance arises, in some part, from the brokers’ presumed knowledge and ability in the insurance industry.¹⁵⁴ Enlarging the duty to include continuing monitoring is simply a greater recognition of that superior ability.

Collateral parties should be required to evaluate relevant available data. Without any increased information flow or other improvements, courts could require brokers to investigate and evaluate NAIC information, Insurance Regulatory Information System data and ratings services information.

A strict liability standard makes full compensation to the hapless insured a certainty. With a negligence standard there will be insureds who are not compensated because the collateral parties are not negligent. The negligence standard, however, allows consideration of the blameworthiness of a particular collateral party. Such consideration will result in increased investigation and monitoring of solvency as brokers attempt to avoid liability by acting within the standard of care. A strict liability standard may have the unwanted effect of discouraging monitoring because the parties may feel that monitoring is unnecessary if they will be held liable whether or not they monitor.¹⁵⁵

Imposing a duty on collateral parties to monitor insurer solvency should provide an incentive to these segments of the industry to investigate and monitor insurers with whom they deal. When these parties discover problems with an insurer, they can cease doing business with the insurer, notify the state regulator, or notify the insured. Notice to the insured allows the insured to protect itself.¹⁵⁶ Notice to the regulator allows the

¹⁵³ B. HARNETT, RESPONSIBILITIES OF INSURANCE AGENTS AND BROKERS § 3.15[1], at 3-144 (1990).

¹⁵⁴ B. HARNETT, *supra* note 153, § 3.15[1], at 3-146.

¹⁵⁵ For a general discussion of strict liability, see W. KEETON, *supra* note 14, §§ 75-81.

¹⁵⁶ Once the broker calls the problem to the attention of the insured and the insured continues to deal with the insurer, the broker cannot be responsible for future losses occasioned by insurer insolvency. See *Editorial Comment, supra* note 151, which notes that some clients are more interested in the price of the insurance and will place insurance with risky insurers if the cost is less. Richard Katten, President of the Society of Chartered Property and Casualty Underwriters, noted that he was unable to dissuade nine insureds from buying insurance from a troubled insurer. *Id.*

The possibility of slander, libel, or interference with contract actions would have to be eliminated. David A. Olsen, Chief Executive Officer of Johnson and Higgins, a leading insurance brokerage, has raised this issue as a reason not to apply a duty to

regulator to take action to perhaps save the problem company and prevent injury to the insureds. Refusing to deal with a particular insurer sends an indirect message to insureds regarding the financial condition of the insurer. This action also protects the collateral party, but will not always protect the insureds and the public if they do not receive the indirect message.

Once the collateral parties are aware of their duty and potential liability, they can, individually and as a group, not only work within the present regulatory framework for monitoring but can create better systems of monitoring and investigation. They can work to improve the flow of information within the industry and to and from the state regulator.

Centralizing the investigation and monitoring functions in collateral parties as opposed to the vast number of insureds creates efficiencies. Most brokers, excess insurers and reinsurers deal repeatedly with a set of insurers and so can monitor those insurers' solvency for the many insureds more efficiently than the insureds of those insurers. The cost of the investigation and monitoring can be passed on to the insureds who are receiving the protection. Any loss occasioned by a failure to abide by the duty can also be absorbed as a cost of doing business and distributed as such. The tort duty is simply a mechanism through which an insured can be protected and pay for the protection since the insured cannot protect itself.

Of course, the most efficient system would be one in which there is one monitor. The state regulators historically have been viewed as the centralized monitors. Yet, the collateral parties, industry insiders who have potential liability for failing to abide by the monitoring duty, are more capable and precise monitors. These parties have superior expertise and motivation to maximize potential profit. Imposing a duty to monitor solvency creates an environment in which industry insiders evaluate information and ferret out problem insurers. The state regulator, though not supplanted by the private monitors, gains from the efforts of the private sector. The entire solvency prevention and detection mechanism is improved. Imposing the duty on all collateral parties may very well prod the industry as a whole to have one efficient solvency monitoring agency, thus realizing the benefit of centralization. Bad business practices, including fraud,¹⁵⁷ in a particular insurer cannot continue under such scrutiny by members of the industry and the state regulator. By putting the

brokers. Otis, *New J&H Chief Eyes Int'l Options*, THE NATIONAL UNDERWRITING COMPANY: PROPERTY AND CASUALTY/ EMPLOYEE BENEFITS EDITION, Nov. 19, 1990, at 25. Courts now impose a duty, however, on brokers with regard to the placement of insurance, and slander, libel, and interference with contract actions do not appear to be a problem.

¹⁵⁷ See *Failed Promises*, *supra* note 11, at 16-20.

burden on the collateral parties, the insured, at least in situations in which the insurer has been negligent, suffers no economic loss and the emotional value of insurance can be retained in large part because insureds need not doubt their security.

An evil of a tort duty of investigation is that financially troubled but solvent insurers may be forced into insolvency. A broker, excess insurer, or reinsurer decides, using good business judgment, not to deal with a particular company. The lack of business may exacerbate the troubled insurer's financial problems and cause it to spiral into insolvency. The demise of an insurer that, absent the rule, might have salvaged its position in the insurance industry, may not be a result that ultimately benefits society. The overall result of increased monitoring, however, should be positive.

V. THE STATE REGULATORS

Another responsible party in the insurer insolvency setting is the state.¹⁵⁸ Each state has a department of insurance charged with the job of monitoring insurers' financial stability and taking action when an insurer is troubled.¹⁵⁹ When an insurer becomes insolvent and an insured suffers a loss, the insured may seek to hold the state responsible for negligent

¹⁵⁸ Other parties include the state department of insurance and the individuals comprising that department. A suit against a department of state government or against individuals as agents of the state is, in most situations, a suit against the state. Generally, an action is an action against the state if a judgment for the plaintiff would control the action of the state or would subject the state treasury to liability or would otherwise affect the interests or rights of the state. See *Holloway v. Dougherty County School Sys.*, 157 Ga. App. 251, 277 S.E.2d 251, 252 (1981); *High Grade Oil Co. v. Sommer*, 295 N.W.2d 736, 737 (S.D. 1980). See generally CIVIL ACTIONS AGAINST STATE GOVERNMENT §§ 2.30-35 (1982); 57 AM. JUR. 2D *Municipal, County, School, and State Tort Liability* § 68 (1988).

Though insureds might pursue actions against regulators personally, individual employees of the government may not be capable of paying a substantial judgment if the insureds prevail. Individuals may also benefit from official immunity. For a discussion of official immunity, see CIVIL ACTIONS AGAINST STATE GOVERNMENT §§ 6.1-6 (1982 & Supp. 1990); Bermann, *Integrating Governmental and Officer Tort Liability*, 77 COLUM. L. REV. 1175 (1977); McManis, *Personal Liability of State Officials Under State and Federal Law*, 9 GA. L. REV. 821 (1975); Fox, *The King Must Do No Wrong: A Critique of the Current Status of Sovereign and Official Immunity*, 25 WAYNE L. REV. 177 (1979).

¹⁵⁹ For example, KY. REV. STAT. ANN. § 304.1-050 (Baldwin 1991), defines the Department of Insurance and the Commissioner; § 304.2-100 provides the Commissioner's general powers; § 304.2-210 provides for the Commissioner's examination of the financial condition of the insurers; and §§ 304.33-010 to -600 provide the rehabilitation and liquidation powers of the Commissioner.

regulation of the insurer.¹⁶⁰ Indeed, the other actors in the insolvency situation have repeatedly suggested that the state, not the brokers, reinsurers, or excess insurers, is responsible when an insurer becomes insolvent.¹⁶¹

Imposing liability on the state is not difficult to justify. The state has undertaken to regulate the financial condition of insurers with the goal of protecting insureds. One can argue that because the state assumed a protector's role no one else such as the insured, the reinsurer, the excess insurer, or the broker investigates and monitors the financial status of the insurers. Everyone relies on the state to monitor solvency. Because the state has undertaken to provide this service and thus induced reliance from insureds and others, courts should hold that the state owes a duty of care to those parties.

Other rationales also justify the imposition of tort liability upon the state. As the regulatory framework presently exists, the state has easy access to all manner of confidential financial information useful to the analysis of insurer financial stability. The insurers file financial statements with the state and the state has the ability and power to delve further into the financial strength of an insurer. The state can even move to place the insurer under supervision, rehabilitation, or liquidation. No other actor in the insurer insolvency setting presently has such access to information or powers to investigate or remedy the problem. The state can best protect insureds and itself from liability by proper monitoring, investigation, and action.

Imposition of liability on the state, as opposed to the insured, the reinsurer, the excess insurer, and the broker, is also an efficient method of improving regulation of insurers. If the burden to oversee insurers falls only on the state, there is but one investigator. The state would then have an incentive to improve the regulatory mechanism. If, however, all parties

¹⁶⁰ Several suits against states brought on the basis of negligent regulation of insurers have reached the courts. *See, e.g.,* *Perez v. Government of the Virgin Islands*, 847 F.2d 104 (3d Cir. 1988) (dismissed on the basis that the government owed no duty to the public at large and the plaintiff was simply a member of the public); *Builders Transp., Inc. v. State*, 421 N.W.2d 539 (Iowa 1988) (dismissed on the basis of a statute that eliminated state liability for negligent supervision). *See also* *Roseville Community Hosp. v. State*, 74 Cal. App. 3d 583, 141 Cal. Rptr. 593 (1977), in which a hospital sued the state for failure to properly regulate a prepaid health care service. The service became bankrupt and the service did not pay the hospital. The California Court of Appeals dismissed the suit on the basis that the action of the state was immune because the challenged action was discretionary.

¹⁶¹ *See* *Mazzuca*, *supra* note 150 (comments of Richard Petersen, National Association of Insurance Brokers President); *Katz*, *supra* note 151 (comments of Earl Pomeroy, NAIC President); *Editorial Comment*, *supra* note 151 (comments of Richard Petersen).

to the insurer insolvency situation, with the exception of the insured, are potentially liable, the protection of the insured is maximized, but a less efficient monitoring system may result.

The imposition of liability should cause states to improve the regulation of insurer finances which in turn should result in fewer insolvencies. If the new oversight is more expensive, the state can pass on any increased costs to taxpayers as a whole, to insureds, or to insurers licensed in the jurisdiction as a cost of doing business.

The case for state tort liability is defensible and logical. Yet, actions by insureds against the state, on the basis of improper regulation, have two significant doctrinal obstacles: sovereign immunity and the public duty doctrine. The traditional doctrine of sovereign immunity allows no action against a state.¹⁶² Various rationales for the doctrine exist. These include protection of the public treasury, the supremacy of the public interest over the interest of an individual, the supremacy of the state, and the orderly administration of government without interference from individuals and the judiciary.¹⁶³

¹⁶² See *Beers v. Arkansas*, 61 U.S. (20 How.) 527, 529 (1858). See also *W. KEETON*, *supra* note 14, § 131; Borchard, *Government Liability in Tort*, 34 *YALE L.J.* 1 (1924-25).

The doctrine of sovereign immunity probably was first developed in the reign of Henry III and was described by the phrase, "The King can do no wrong." See Holdsworth, *The History of Remedies Against the Crown*, 38 *L.Q. REV.* 141 (1922). See also *Owen v. City of Independence*, 445 U.S. 622 (1980). One of the first cases discussing the doctrine was *Russell v. The Men of Devon*, 2 *Term Rep.* 667, 668, 100 *Eng. Rep.* 359, 360 (1788). In *Russell*, several members of the public sought to bring an action against the county for a failure to adequately maintain the highways and bridges. The court denied the plaintiffs the right to bring such an action.

Sovereign immunity prevents suits against the state and protects states from liability even if the suit can be maintained. See *Hattiesburg Realty Co. v. Mississippi Highway Comm'n*, 406 So. 2d 329 (Miss. 1981), *cert denied, sub nom. Pine Belt Land Co. v. Mississippi State Highway Comm'n*, 456 U.S. 961 (1982). For example, some states allow proceedings against the state in board of claims proceedings but do not waive sovereign immunity with regard to liability. See, e.g., *KY. REV. STAT. ANN.* § 44.072 (Baldwin 1991). See also 57 *AM. JUR.* 2d *Municipal, County, School, and State Tort Liability* § 82 (1988).

¹⁶³ See *Russell v. Men of Devon*, 2 *Term Rep.* 667, 100 *Eng. Rep.* 359 (1788) (public over the individual); *Brown v. Wichita State Univ.*, 217 Kan. 279, 540 P.2d 66, 77 (1975), *vacated on other grounds*, 219 Kan. 2, 547 P.2d 1015 (1976) (protect the treasury); *Stanhope v. Brown County*, 90 Wis. 2d 823, 857-58, 280 N.W.2d 711, 717 (1979) (public over the individual); *Berek v. Dade County*, 396 So. 2d 756, 758 (Fla. Dist. Ct. App. 1981) (orderly administration); *O'Neill v. State Highway Dept.*, 50 N.J. 307, 235 A.2d 1, 5 (1967) (control of the judiciary); *Holloway v. Dougherty County School Sys.*, 157 Ga. App. 251-52, 277 S.E.2d 251, 252 (1981) (state supremacy).

States never completely embraced absolute immunity because the concept conflicted with the tort concept that liability flows to the negligence and the constitutional concept that every individual is entitled to a remedy for injury.¹⁶⁴ As a result, most jurisdictions have substantially limited the doctrine.¹⁶⁵

Though absolute immunity is now rare in the United States, many jurisdictions retain an immunity for discretionary acts¹⁶⁶ as does the federal government in the Federal Tort Claims Act.¹⁶⁷ The federal Act renders the government liable for certain torts "in the same manner and to the same extent as a private individual under like circumstances."¹⁶⁸ The federal immunity provision retains sovereign immunity for: any claim based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or an employee of the Government, whether or not the discretion involved be abused.¹⁶⁹

¹⁶⁴ See *Owen v. City of Independence*, 445 U.S. 622 (1980). In *Barker v. City of Santa Fe*, 47 N.M. 85, 136 P.2d 480, 482 (1943), the New Mexico Supreme Court stated:

It is almost incredible that in this modern age of comparative sociological enlightenment, and in a republic, the medieval absolutism supposed to be implicit in the maxim, "the King can do no wrong," should exempt the various branches of the government from liability for their torts, and that the entire burden of damage resulting from the wrongful acts of the government should be imposed upon the single individual who suffers the injury, rather than distributed among the entire community constituting the government, where it could be borne without hardship upon any individual, and where it justly belongs.

¹⁶⁵ See, e.g., ALASKA STAT. §§ 9.50.250-300 (1975); COLO. REV. STAT. §§ 24-10-101 to -120 (1973); FLA. STAT. ANN. § 768.28 (1976); IDAHO CODE §§ 6-901 to -929 (1990); NEV. STAT. ANN. §§ 41.031-.39 (Michie 1989). There has been a steady movement away from sovereign immunity. See 57 AM. JUR. 2D *Municipal, County, School, and State Tort Liability* § 61 (1988).

¹⁶⁶ The discretionary acts exception seems to be the preferred approach to limiting sovereign immunity. See 57 AM. JUR. 2D *Municipal, County, School, and State Tort Liability* § 111 (1988). See, e.g., ALASKA STAT. § 9.50.250 (1990); DEL. CODE ANN. tit. 10, § 4001(1) (1990); HAW. REV. STAT. § 662-15 (1990); IOWA CODE ANN. § 25A.14 (1989); ME. REV. STAT. ANN. tit. 14, § 8103(2)(c) (1990); NEB. REV. STAT. §§ 81-8, -219(1)(a) (1987 & Supp. 1990).

¹⁶⁷ 28 U.S.C. § 2680(a) (1990). See Wyant, *The Discretionary Function Exemption to Governmental Tort Liability*, 61 MARQ. L. REV. 163 (1977).

¹⁶⁸ 28 U.S.C. § 2674 (1990).

¹⁶⁹ 28 U.S.C. § 2680(a) (1990).

State statutes that provide discretionary act immunity often use similar language.¹⁷⁰ For example, section 9.50.250 of the Alaska Statutes states, in reference to the ability of individuals to bring an action against a state:

[A]n action may not be brought under this section if the claim
 (1) . . . is an action for tort, and based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a state agency or an employee of the state, whether or not the discretion involved is abused.¹⁷¹

Discretionary act immunity is based at least in part on the goal of insulating policy decisions from judicial review so that the judiciary does not infringe upon the powers of a coordinate branch of government.¹⁷² Discretionary act immunity also prevents interference by private citizens with basic governmental policy decisions and processes.¹⁷³

Federal and state courts have long struggled with developing a method of determining whether particular conduct is discretionary for immunity purposes.¹⁷⁴ In the recent case of *United States v. Gaubert*,¹⁷⁵ the Supreme

¹⁷⁰ See *supra* statutes cited in note 166.

¹⁷¹ ALASKA STAT. § 9.50.250 (1990).

¹⁷² See *Owen v. City of Independence*, 445 U.S. 622 (1980); *Johnson v. State*, 69 Cal. 2d 782, 447 P.2d 352, 73 Cal. Rptr. 240 (1980).

¹⁷³ See 57 AM. JUR. 2D *Municipal, County, School, and State Liability*, §§ 115-17 (1988). See also *Japan Air Lines Co. v. State*, 628 P.2d 934 (Alaska 1981).

¹⁷⁴ The Supreme Court has evaluated the issue several times prior to *United States v. Gaubert*, 111 S. Ct. 1267 (1991). In *Dalehite v. United States*, 346 U.S. 15 (1953), the Supreme Court evaluated a claim of liability resulting from a government administered fertilizer program. The Court stated:

[Discretionary act immunity] includes more than the initiation of programs and activities. It also includes determinations made by executives or administrators in establishing plans, specifications or schedules of operations. Where there is room for policy judgment and decision there is discretion. It necessarily follows that acts of subordinates in carrying out the operations of government in accordance with official directions cannot be actionable In short, the alleged "negligence" does not subject the Government to liability. The decisions held culpable were all responsibly made at a planning rather than operational level and involved considerations more or less important to the practicability of the Government's fertilizer program.

Id. at 35-36, 42 (footnotes omitted).

Indian Towing Co. v. United States, 350 U.S. 61 (1955). Involved the negligent operation of a lighthouse which resulted in a barge running aground. The Court phrased the policy/ operational distinction in the following way: "[O]nce [the Coast Guard] exercised its discretion to operate a light . . . and engendered reliance on the guidance afforded by the light, it was obligated to use due care to make certain that the light was kept in good working order. . . ." *Id.* at 69.

Court attempted to distinguish discretionary and, therefore, immune acts from nondiscretionary acts. The *Gaubert* opinion is especially useful in analyzing claims of negligent regulation of insurers because *Gaubert* involved the analogous claim that the Federal Home Loan Bank Board negligently regulated a savings association. Gaubert, chairman of the board and majority shareholder, claimed that federal officials had been negligent in selecting replacement officers and directors and in managing the savings association on a daily basis after the federal officials perceived that the savings association was in financial straits but before the officials placed it in receivership.¹⁷⁶

In *United States v. S.A. Empresa de Viacao Aerea Rio Grandense (Varig Airlines)*, 467 U.S. 797 (1984), a case in which families, and representatives of passengers killed when a plane crashed, sued the Federal Aviation Administration claiming that the Administration erred in certifying that type of plane, the court held that the discretionary act immunity applied because "Congress wished to prevent 'second guessing' of legislative and administrative decisions grounded in social, economic, and political policy through the medium of an action in tort." *Id.* at 798.

In *Berkovitz v. United States*, 486 U.S. 531 (1988), the Supreme Court considered a suit by an infant for damage caused by polio contracted after receiving a polio vaccine. The infant claimed that the National Institute of Health had acted wrongly in licensing the production of the vaccine and in approving the release of the particular lot of vaccine ingested by the infant. The Court held that discretionary act immunity did not apply because the statutory framework left no room for policy judgment with regard to the lot release and because the license to produce had been issued without appropriate data as mandated by statute.

¹⁷⁵ 111 S. Ct. 1267 (1991). For a discussion of the lower court opinion, see Note *United States v. Gaubert: Potential Liability for Federal Regulations Under the "Discretionary Function" Exception of the Federal Tort Claims Act*, 36 S.D. L. REV. 180 (1991).

¹⁷⁶ *Id.* at 1272. Specifically, the plaintiff alleged the following:

1. the regulators "arranged for the hiring for IASA of . . . consultants on operational and financial matters and asset management;"
2. the officials "urged or directed that IASA convert from a state-chartered savings and loan to a federally-chartered savings and loan in part so that it could become the exclusive government entity with power to control IASA;"
3. the regulators "gave advice and made recommendations concerning whether, when, and how to place IASA subsidiaries into bankruptcy;"
4. the officials "mediated salary disputes between IASA and its senior officers;"
5. the regulators "reviewed a draft complaint in litigation" that IASA's board contemplated filing and were "so actively involved in giving advice, making recommendations, and directing matters related to IASA's litigation policy that they were able successfully to stall the Board of Directors' ultimate decision to file the complaint until the Bank Board in *Washington* had reviewed, advised on, and commented on the draft;"
6. the regulators "actively intervened with the Texas Savings and Loan Department (IASA's principal regulator) when the State attempted to install a supervisory agent at IASA;" and

The Supreme Court explained that discretionary act immunity applies when the state actor does some act that requires judgment or choice and when the judgment or choice is made in consideration of public policy.¹⁷⁷ The requirement of an exercise of judgment or choice means that the discretionary act immunity will not protect the government actors if a statute or regulation mandates a particular action and the actor fails to abide by that direction.¹⁷⁸ If, however, the statute, regulation, or other directive allows discretion, the existence of the directive creates “a strong presumption that a discretionary act authorized by the regulation involves consideration of the same policies which led to the promulgation of the regulations.”¹⁷⁹ To overcome the presumption, the challenger must show that the actions are not grounded in the policy underlying the regime.¹⁸⁰

Applying this test to the actions of the federal officials in *Gaubert*, the Court first concluded that the regulatory regime allowed much room for discretion because a federal statute¹⁸¹ gave the federal actors authority to regulate federal savings and loan associations “giving primary consideration to the best practices of thrift institutions in the United States.”¹⁸² Thus, the situation was not one of action contrary to mandate. Secondly, the Court concluded that all of the actions of which the challenger complained involved “the kind of policy judgment that the discretionary function exception was designed to shield.”¹⁸³ The day-to-day decisions were undertaken to further the underlying policies of the regulatory regime: to protect the solvency of the savings and loan industry and this association in particular and also to bolster public confidence in savings and loan associations.¹⁸⁴ Thus, discretionary function immunity protected the challenged actions.

Several federal negligent regulation cases decided before *Gaubert* delineated discretionary act immunity slightly differently but reached equally disheartening results for potential insured plaintiffs.¹⁸⁵ For

7. the regulators wrote to the board of directors “affirming that [the] agency had placed that Board of Directors into office, and describing their mutual goal to protect the FSLIC insurance fund.”

Id. at 1276-77.

¹⁷⁷ *Id.* at 1274.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ *Id.* at 1274-75 & n.7.

¹⁸¹ 12 U.S.C. § 1464(a) (1990).

¹⁸² *Gaubert*, 111 S. Ct. at 1277 (citing 12 U.S.C. § 1464(a)).

¹⁸³ *Id.* at 1278.

¹⁸⁴ *Id.* at 1278 (discussing *Gaubert v. United States*, 885 F.2d 1284, 1290 (5th Cir. 1989)).

¹⁸⁵ See, e.g., *Federal Deposit Ins. Corp. v. Irwin*, 916 F.2d 1051 (5th Cir. 1990); *Federal Deposit Ins. Corp. v. Mmahat*, 907 F.2d 546 (5th Cir. 1990), cert.

example, in *Emch v. United States*,¹⁸⁶ investors in a bank sued the government for failure to “adequately supervise, examine and control the condition, performance, operations, liquidity and solvency” of a bank and as a result the bank became insolvent.¹⁸⁷ In effect, this is the same claim that insureds would pursue in the insolvency setting. The court noted that the existence of a discretionary act “ultimately rests upon the characterization of the challenged behavior as ‘policy’ or ‘operations.’”¹⁸⁸ The court stated:

In making this determination, relevant considerations include whether or not the nature of the judgment exercised called for policy considerations, . . . and whether the Act complained of is ‘the result of a judgment or decision which it is necessary that the Government official be free to make without fear or threat of vexatious or fictitious suits and alleged personal liability.’¹⁸⁹

The court concluded that the allegations were strictly claims of “negligent performance of regulatory and statutory supervision or monitoring of the bank entities” and therefore deserving of immunity.¹⁹⁰ The *Emch* court distinguished *In re Franklin National Bank Securities Litigation*,¹⁹¹ in which the court found the day-to-day running of a bank to be operational and not discretionary.¹⁹² The *Emch* court noted that the facts before it did not present operational actions.¹⁹³

State courts have applied discretionary act immunity to negligent regulation claims in a fashion similar to the federal courts.¹⁹⁴ In *Nordbrock v. State*,¹⁹⁵ bank shareholders claimed that the state had been negligent in examining and supervising the financial condition of the bank and as a

denied, 111 S. Ct. 1387 (1991); *Emch v. United States*, 630 F.2d 523 (7th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981); *Huntington Towers, Ltd. v. Franklin Nat'l Bank*, 559 F.2d 863 (2d Cir. 1977), *cert. denied*, 434 U.S. 1012 (1978); *In re Franklin Nat'l Bank Sec. Litig.*, 445 F. Supp. 723 (E.D.N.Y. 1978). *See also* Comment, *Government Liability for Defective Regulation in Bank Insolvency Cases*, 20 SANTA CLARA L. REV. 911 (1980).

¹⁸⁶ 630 F.2d 523 (7th Cir. 1980).

¹⁸⁷ *Id.* at 525.

¹⁸⁸ *Id.* at 527.

¹⁸⁹ *Id.* (citation omitted).

¹⁹⁰ *Id.* at 528.

¹⁹¹ 445 F. Supp. 723 (E.D.N.Y. 1978).

¹⁹² *Emch*, 630 F.2d at 527 (referring to *Franklin*, 445 F. Supp. at 735).

¹⁹³ *Id.* at 527-28.

¹⁹⁴ *See, e.g.*, *Nordbrock v. State*, 395 N.W.2d 872 (Iowa 1986); *Security Inv. Co. v. State*, 231 Neb. 536, 437 N.W.2d 439 (1989); *Scott v. Department of Commerce*, 104 Nev. 580, 763 P.2d 341 (1988).

¹⁹⁵ 395 N.W.2d 872 (Iowa 1986).

result the bank became insolvent.¹⁹⁶ The court analyzed the legislative guidance given the regulator of banks and determined that the statutes gave the regulator no specific guidelines on the methodology of monitoring. Further, the regulator had no mandate of action to take when he or she discovered a problem. Rather, the statutes gave the regulator discretion to take several different courses of action. The court concluded that the conduct of which the plaintiff complained constituted policy decisions deserving of immunity.¹⁹⁷

Though no court has evaluated the actions of a state to determine the applicability of the traditional discretionary act immunity to insurer financial regulation, one court has dealt with the issue obliquely. In *Roseville Community Hospital v. State*,¹⁹⁸ a hospital sued the state for negligent regulation of a prepaid health care service. The hospital claimed that as a result of the negligence of the state, and especially the Attorney General, the health care service became bankrupt and the hospital suffered the loss of unpaid bills for services rendered to plan participants.¹⁹⁹ The hospital sought to show that the state and the Attorney General were liable because, among other things, the conduct at issue was not discretionary.²⁰⁰ Though not admitting that the discretionary act immunity case law controlled, given the statutory immunity framework, the court found that the actions of the Attorney General were clearly discretionary. The court stated:

Law enforcement and regulatory activity entail continual choices among priorities. A decision to devote available facilities and personnel to selected areas and to abstain from active pursuit of others is a policy or planning decision at a relatively high internal level. The hospital's injury resulted from the discretion-impelled absence of a government activity, not from the activity's negligent conduct.²⁰¹

These negligent regulation cases indicate that claims against state insurance regulators for negligent regulation face a significant obstacle in

¹⁹⁶ *Id.* at 873.

¹⁹⁷ *Id.* at 876-77. See also *Scott v. Department of Commerce*, 104 Nev. 580, 763 P.2d 341 (1988) (claim of failure to regulate mortgage company resulting in insolvency dismissed on basis of discretionary act exclusion); *Security Inv. Co. v. State*, 231 Neb. 536, 437 N.W.2d 439 (1989) (claim of failure to regulate industrial loan and investment company dismissed on basis of discretionary act exclusion).

¹⁹⁸ 74 Cal. App. 3d 583, 141 Cal. Rptr. 593 (1977).

¹⁹⁹ *Id.* at 594, 141 Cal. Rptr. at 585.

²⁰⁰ *Id.*, 141 Cal. Rptr. at 594.

²⁰¹ *Id.* at 590, 141 Cal. Rptr. at 597.

discretionary act immunity states. The state courts often refer to the federal cases for guidance on the issue of discretionary act immunity.²⁰²

If state courts follow the teaching of *Gaubert*, an insured pursuing a negligent regulation claim can succeed by proving that the state regulator had a statutory or regulatory mandate to act in a certain manner and yet acted contrary to that directive. If there is no mandate, the insured, to succeed, must prove that the action taken was not taken in consideration of the policies underlying the regulation. Insurance regulation exists for many purposes including protection of insureds and the public from insurer insolvency.²⁰³ The insured, however, may not be able to prove that the actions in question were not taken in furtherance of the goal of protection of insureds and the public from insurer insolvency.

If a state court applies the policy/planning/operational test to determine the applicability of discretionary act immunity, the insured must argue that the acts were contrary to mandate or were operational. Generally, courts applying this test state that acts are not operational unless the acts involve the day-to-day operations of the insured.²⁰⁴ Rarely will this be the case in suits by insureds.

²⁰² See, e.g., *Nordbrock v. Iowa*, 395 N.W.2d 872 (1986); *Security Inv. Co. v. Nebraska*, 231 Neb. 536, 437 N.W.2d 439 (1989); *Scott v. Department of Commerce*, 104 Nev. 580, 763 P.2d 341 (1988). See generally 57 AM. JUR. 2D *Municipal, County, School, and State Tort Liability* § 121 (1988).

²⁰³ See *supra* text parts I and II.

²⁰⁴ Another potential hurdle for insureds pursuing actions against states for negligent regulation is governmental function immunity. A few states allow state liability only if the activity in question is nongovernmental, a proprietary act. See, e.g., *Papenhausen v. Schoen*, 268 N.W.2d 565, 568 (Minn. 1978); *Abruzzo v. State*, 444 N.Y.S.2d 739, 740 (1981); *American Trucking Assocs. v. Conway*, 146 Vt. 579, 586-87, 508 A.2d 408, 413 (1986). The clear trend, however, is to eliminate the governmental/proprietary distinction, especially in relation to suits against states *per se*. See 57 AM. JUR. 2D, *Municipal, County, School and State Tort Liability* §§ 87 & 92 (1988). See, e.g., *Niles v. Healy*, 115 N.H. 370, 343 A.2d 226 (1975).

In the jurisdictions applying the governmental/proprietary distinction, courts use various tests to determine the character of the act in question and reach inconsistent results that often reflect policy judgments. A test which apparently guides the decision making of many courts in cases against states, and all forms of government entities, focuses on whether the act performed is for the common good of the general public or for the special benefit of the specific government unit. See, e.g., *Imperial Prod. Corp. v. Sweetwater*, 210 F.2d 917 (5th Cir. 1954); *Johnson v. Atlanta*, 171 Ga. App. 296, 319 S.E.2d 506 (1984); *Harris v. Des Moines*, 202 Iowa 53, 209 N.W. 454 (1926). Courts have interpreted activities expressly or impliedly mandated or authorized by statute or other law as governmental activities benefiting from immunity from liability. See, e.g., *Genzer v. Mission*, 666 S.W.2d 116 (Tex. Ct. App. 1984).

If a jurisdiction retains governmental function immunity, that immunity would, in all probability, bar an action against the state on a negligent regulation theory. The regulatory activities challenged are activities which perhaps are impliedly authorized

The public duty doctrine presents another major obstacle to recovery from the state. The public duty doctrine states that duties imposed on state actors by statute are duties owed to the public in general but not to a particular individual.²⁰⁵ Thus, the individual cannot recover in a negligence action because the state owes no duty, a required element of a tort cause of action, to the insured plaintiff. The public duty doctrine remains the majority rule,²⁰⁶ but a substantial number of courts have rejected the doctrine altogether,²⁰⁷ or have limited the doctrine if the plaintiff can prove

but which certainly are designed to benefit the public at large. The activities are not local in nature and do not generate a profit for the state insurance regulator or department.

²⁰⁵ See Note, *Governmental Liability and the Public Duty Doctrine*, 32 VILLANOVA L. REV. 505 (1987) [hereinafter *Governmental Liability*]; W. KEETON, *supra* note 14, § 131, at 1049-50. THE RESTATEMENT (SECOND) OF TORTS § 288 states: "[A] legislative enactment . . . whose purpose is found to be exclusively . . . (b) to secure to individuals the enjoyment of rights or privileges to which they are entitled only as members of the public" does not create conduct for the imposition of liability. The Comment to this section states:

[Certain] legislative enactments and regulations are intended only for the purpose of securing to individuals the enjoyment of rights and privileges to which they are entitled as members of the public, rather than for the purpose of protecting any individual from harm. Thus a statute may be intended only to secure the public right of unobstructed passage on the public highway, or freedom from excessive noise or immoral conduct in the community. Under some circumstances, where an individual has been interfered with in his exercise of such a public right, and as a result has suffered special harm, distinct from that suffered by the rest of the community, he may be entitled to maintain a tort action for the violation. . . . In the ordinary case, however, harm suffered by such an individual is not within the purpose of the provision, and the statute or regulation will not be taken to lay down a standard of conduct with respect to such harm.

For other discussions of the doctrine, see Annotation, *Modern Status of Rule Excusing Governmental Unit From Tort Liability on Theory that Only General, Not Particular Duty Was Owed Under Circumstances*, 38 A.L.R. 4th 1194 (1985); 65 C.J.S. *Negligence* § 4(8) (1966 & Supp. 1991). For particular applications of the doctrine, see Note, *State Tort Liability for Negligent Fire Inspection*, 13 COLUM. J.L. & SOC. PROBS. 303 (1977); Note, *Police Liability for Negligent Failure to Prevent Crime*, 94 HARV. L. REV. 821 (1981).

²⁰⁶ See *Governmental Liability*, *supra* note 205, at 507 n.10; *Perez v. Government of the Virgin Islands*, 847 F.2d 104, 105 (3d Cir. 1988). For examples of application of the public duty rule, see *Gordon v. Bridgeport Hous. Auth.*, 208 Conn. 161, 544 A.2d 1185 (1988); *Cunningham v. District of Columbia*, 584 A.2d 573 (D.C. App. 1990); *In re Estate of Vasconcelles*, 170 Ill. App. 3d 404, 524 N.E.2d 720 (1988); *Fudge v. City of Kansas City*, 239 Kan. 369, 720 P.2d 1093 (1983).

²⁰⁷ Some states have clearly rejected the doctrine. See, e.g., *City of Kotzebue v. McLean*, 702 P.2d 1309 (Alaska 1985); *Pritchard v. Ariz.*, 788 P.2d 1178 (1990); *Leake v. Cain*, 720 P.2d 152 (Colo. 1986); *Wilson v. Nepstad*, 282 N.W.2d 664

the existence of a special duty or relationship.²⁰⁸ Generally, courts recognize the existence of a special duty if the plaintiff proves that the governmental entity or agents induce reliance by affirmative action and should foresee injury to the plaintiff if the entity ceases the affirmative action or acts negligently.²⁰⁹ One situation in which courts recognize a special duty is that in which legislation indicates a clear intent to protect an identifiable class of persons and the plaintiff is a member of that class.²¹⁰

If a jurisdiction does not recognize the public duty doctrine, the insured suing the state must establish the existence of a tort duty and breach of that duty in accord with traditional tort principles. If, however, the jurisdiction follows the public duty doctrine, the doctrine may act as an absolute bar to any insured's claim against the state. If the jurisdiction recognizes the special duty limitation of the public duty rule, the insured must establish the existence of a special duty.

The only court to review an insured's claim that the government failed to regulate an insurer properly, in light of the public duty doctrine, determined that the doctrine barred the action. In *Perez v. Government of the Virgin Islands*,²¹¹ the plaintiff claimed that the Insurance Commissioner's office was so understaffed that it could not properly monitor insurers as required by statute. As a result of the negligence, the insured's automobile liability insurance policy became worthless when the insurer became insolvent.²¹² The plaintiff argued that the statutory scheme of insurance regulation created a special relationship between the government and its citizens.²¹³

The Third Circuit determined that the fact that the statutes required automobile liability insurance, and required the Insurance Commissioner to monitor and approve insurers, did not create any special relationship or duty on the part of the government to protect insureds from the "fiscal

(Iowa 1979); *Stewart v. Schmeider*, 386 So. 2d 1351 (La. 1980); *Schear v. Board of County Comm'rs of Bernalillo*, 101 N.M. 671, 687 P.2d 728 (1984); *Commercial Carrier Corp. v. Indian River County*, 371 So. 2d 1010 (Fla. 1979); *Brennen v. City of Eugene*, 285 Or. 401, 591 P.2d 719 (1979).

²⁰⁸ See *Governmental Liability*, *supra* note 205, at 516-17; Comment, *The Special Duty Doctrine: A Just Compromise*, 31 ST. LOUIS U.L.J. 409 (1987). For an example application, see *Lowe v. Patterson*, 492 So. 2d 110 (La. Ct. App. 1986), *cert. denied*, 496 So. 2d 355.

²⁰⁹ See 57 AM. JUR. 2D, *Municipal, County, School, and State Tort Liability* § 142 (1988). See also *Irwin v. Ware*, 392 Mass. 745, 467 N.E.2d 1292 (1984).

²¹⁰ See *Governmental Liability*, *supra* note 205, at 515-16; Comment, *supra* note 208, at 420. See generally 57 AM. JUR. 2D, *Municipal, County, School, and State Tort Liability* § 143 (1988).

²¹¹ 847 F.2d 104 (3d Cir. 1988).

²¹² *Id.* at 104-05.

²¹³ *Id.* at 107.

irresponsibility” of insurers. The court stated that the statutes imposed discretionary authority on the Commissioner. The statutes did not mandate duties which conceivably could be the basis of an action for negligence. For example, the court noted that the statute required the Commissioner to examine and investigate the affairs and records of a domestic insurer only “as often as he deems advisable.”²¹⁴ Perhaps the legislation required the Commissioner to bar the insurer if the insurer did not file an annual report, but the court was unwilling to find from this fact that the Commissioner might be liable for any injury which resulted from financial problems that analysis of the annual report might have disclosed.²¹⁵ Finally, the court noted that a statutory provision specifically stated that the insurer, the insured, and their representatives have “the duty of preserving inviolate the integrity of insurance.”²¹⁶ Because the provision did not mention the state, the court was unwilling to include the state in that group.²¹⁷

Other negligent regulation cases have received a similar reception when the issue is the public duty doctrine.²¹⁸ For example, in *Metzger v. Superintendent of Building & Loan Associations*,²¹⁹ mortgagors brought an action against the state claiming that the state negligently regulated the association and as a result the association raised rates to unlawful levels. The court stated:

[B]reach of a duty imposed by statute for the benefit of the public at large does not give rise to a claim for relief by an individual citizen harmed as a result of the breach. While claims against defendants in the private sector for such violations are widely recognized, such as in the products liability field, this court is unwilling to extend the theories to the general statutory duties of governmental entities and employees.²²⁰

In light of *Perez* and *Metzger*, an insured’s claim of improper regulation in a public duty or special duty jurisdiction has a significant and substantial obstacle to recovery. An insured perhaps can overcome the obstacle by citing legislation, if legislation exists in the particular jurisdiction, which more clearly imposes mandatory duties on the state for the protection of the insured.

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ *Id.*

²¹⁷ *Id.*

²¹⁸ *See, e.g., Commonwealth v. Department of Banking and Sec. v. Brown*, 605 S.W.2d 497 (Ky. 1980); *Metzger v. Superintendent of Bldg. & Loan Assocs.*, 31 Ohio App. 3d 212, 510 N.E.2d 404 (1986).

²¹⁹ 31 Ohio App. 3d 212, 510 N.E.2d 404 (1986).

²²⁰ *Id.* at 213; 510 N.E.2d at 405.

The Third Circuit in *Perez* stated, after denying the plaintiff's claim, that the court was "not unsympathetic" to the insured and similarly situated citizens.²²¹ Perhaps such sympathy will lead courts to find immunity inapplicable to claims of insureds, and to find a duty owed by the state to the insureds of insolvent insurers.

VI. CONCLUSION

An insured of an insolvent insurer should be allowed the possibility of recovering in tort for all damage resulting from the insolvency from the broker, the excess insurer, the reinsurer, and the state, if those parties have negligently monitored the solvency of the insurer. If the courts allow such recovery, they must recognize that each of these parties owes a tort duty to insureds to monitor the solvency of insurers with whom the collateral parties and the state deal.

One basis for recognizing such far-reaching potential liability is that insureds deserve compensation and protection. Insureds cannot protect themselves against insolvency in any particular situation or in general. Insureds lack the bargaining ability, information and expertise to protect themselves from insurer insolvency. Placing the loss on insureds is, therefore, unjust and inefficient.

Imposing a tort duty on the collateral parties and the state is more efficient and fair. Recovery from the state should be allowed because society entrusts the states with the job of regulating insurers to protect the public. The state should be liable for negligence in carrying out this regulatory task. The collateral parties have knowledge of the possibility of insurer insolvency, the expertise and information to evaluate insurer solvency, and the ability to distribute any loss caused by insurer insolvency or by the process of monitoring. The collateral parties profit from the insurance industry and are capable of implementing changes within the industry.

Tort liability should result in increased industry self-regulation, which, in turn, should decrease the incidence of insolvencies, thus benefiting all insureds. All insureds eventually contribute to any resulting increased industry costs. Tort liability should also allow some individual insureds to avoid tremendous loss by providing recovery from negligent collateral parties.

Recognition of such tort liability may constitute the only effective mechanism to spur appropriate insolvency prevention. Without such

²²¹ *Perez v. Government of the Virgin Islands*, 847 F.2d 104, 108 (3d Cir. 1988).

prevention, the insured suffers economic loss and emotional loss in that insureds cannot purchase peace of mind.