
Insurance Guaranty Funds: A Reassessment

Bernard E. Epton

Roger A. Bixby

Follow this and additional works at: <https://via.library.depaul.edu/law-review>

Recommended Citation

Bernard E. Epton & Roger A. Bixby, *Insurance Guaranty Funds: A Reassessment*, 25 DePaul L. Rev. 227 (1976)

Available at: <https://via.library.depaul.edu/law-review/vol25/iss2/2>

This Article is brought to you for free and open access by the College of Law at Via Sapientiae. It has been accepted for inclusion in DePaul Law Review by an authorized editor of Via Sapientiae. For more information, please contact digitalservices@depaul.edu.

INSURANCE GUARANTY FUNDS: A REASSESSMENT

Bernard E. Epton* and Roger A. Bixby**

In 1971 the Illinois legislature enacted the Illinois Insurance Guaranty Fund to protect the policyholders of casualty insurance companies in the event their insurer became insolvent. Similar laws have been enacted in 47 states. This Article discusses various provisions of casualty guaranty funds which prevent policyholders from receiving complete insolvency protection. In addition, the Article examines the Model Life and Health Guaranty Association Bill promulgated by the National Association of Insurance Commissioners and suggests that such legislation be enacted with several changes. The Article also analyzes a few of the proposals which have been offered for financing guaranty funds. Finally, the authors conclude that the guaranty fund legislation enacted heretofore has received insufficient evaluation in terms of the overall goals of insurance regulation.

It has been a little over fifteen years since the first comprehensive analysis of insurance company insolvencies was concluded.¹ Since that time supplemental studies have been undertaken² and

* Illinois State Representative; Chairman, Illinois Insurance Laws Study Commission; Partner, Epton & Druth, Ltd., Chicago, Illinois.

** Administrative Assistant to the Illinois Insurance Laws Study Commission; J.D. 1974, University of Chicago.

1. H. Bishara, *An Analysis of Insurance Company Financial Insolvencies and the Public Interest*, 1961 (unpublished doctoral dissertation in the University of Wisconsin Library).

2. See, e.g., Bennett, *Liquidation of Insurance Companies: Part A*, in *INSURANCE AND GOVERNMENT* 191 (C. Center & R. Heins eds. 1962); Heins, *Liquidation of Insurance Companies: Part B*, in *INSURANCE AND GOVERNMENT* 282 (C. Center & R. Heins eds. 1962); *Hearings on S. Res. 40 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 89th Cong., 1st Sess., pt. 12 (1965) [hereinafter cited as *1965 Hearings*]; *Hearings on S. Res. 40 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 91st Cong., 1st Sess., pt. 15 (1969) [hereinafter cited as *1969 Hearings*]; D. OLSON, *INSOLVENCIES AMONG AUTOMOBILE INSURERS: ADVISORY REPORT TO THE DIVISION OF INDUSTRY ANALYSIS, BUREAU OF ECONOMICS, FEDERAL TRADE COMMISSION FOR THE DEPARTMENT OF TRANSPORTATION* (1970); D. Olson, *Insolvencies Among High-Risk Automobile Insurance Companies*, 1969 (unpublished doctoral dissertation in University of Pennsylvania Library). A partial list of other materials is contained in *1 Proceedings of the National Association of Insurance Commissioners* 52 (1963) [hereinafter cited as *Proceedings of the NAIC*].

various solutions have been proposed³ and adopted.⁴ The most important of the solutions to the problem of insurer insolvencies has been the creation of guaranty funds which are intended to protect policyholders and injured third parties regardless of the financial condition of the company which issued the policy. Because the preponderance of insolvencies which have occurred within the last fifteen years have involved "high risk" automobile insurers, the guaranty fund legislation enacted to date has focused on property and casualty insurance.⁵

Prior to 1969, only a few states had enacted guaranty fund legislation. New York for many years had had guaranty funds covering workmen's compensation,⁶ public motor vehicles,⁷ private motor vehicles,⁸ and life insurance.⁹ In addition, Maryland¹⁰ and New Jersey¹¹ had enacted motor vehicle guaranty fund legis-

3. The proposed solutions include expanding the uninsured motorist endorsement to include protection against insurer insolvency; creation of unsatisfied judgment funds, state guaranty funds, and federal guaranty funds; higher capital requirements for insurance companies; and stricter regulatory supervision.

4. Insolvency coverage under the uninsured motorist endorsement expanded rapidly in the 1960's, at least in part through legislative and industry reaction to Senator Dodd's proposal for a Federal Motor Vehicle Insurance Guaranty Corporation. See 2 *Proceedings of the NAIC* 599 (1967). In 1967 Illinois mandated the purchase of uninsured motorist coverage and defined "uninsured" to include claims against subsequently insolvent insurers. ILL. REV. STAT. ch. 73, § 755a(2) (1973). For cases arising under the uninsured motorist endorsement before July 1, 1967, the Supreme Court of Illinois determined that insolvency constituted a denial of coverage by the tortfeasor's insurer within the provisions of the endorsement and that coverage should therefore be provided. *Kaszkeski v. Fidelity & Cas. Co.*, 54 Ill.2d 241, 296 N.E.2d 743 (1973). However, if the endorsement did not provide for coverage upon the denial of coverage by the tortfeasor's insurer, the victim could not recover under the uninsured motorist endorsement. *Dreher v. Aetna Cas. & Sur. Co.*, 83 Ill.App.2d 141, 226 N.E.2d 287 (2d Dist. 1967).

As of September 1, 1974, guaranty fund legislation covering virtually all property and casualty lines had been enacted in 47 states and the District of Columbia. The only states which did not have a guaranty fund on that date were Alabama, Arkansas, and Oklahoma. See Supplement to Letter of the National Committee on Insurance Guaranty Funds, Oct. 9, 1974 [hereinafter cited as NCIGF Letter].

5. See NAIC State Post-Assessment Insurance Guaranty Association Model Bill § 3, 1 *Proceedings of the NAIC* 253 (1970) [hereinafter cited as Model Casualty Bill]. See also ILL. REV. STAT. ch. 73, § 1065.83 (1973).

6. N.Y. WORKMAN'S COMP. LAW §§ 107-109 (d) (McKinney 1965).

7. N.Y. INS. LAW § 330 (McKinney 1966).

8. N.Y. INS. LAW § 334 (McKinney Supp. 1974).

9. N.Y. INS. LAW § 224 (McKinney 1966).

10. MD. ANN. CODE art. 48A, § 482A (1957).

11. N.J. STAT. ANN. §§ 39:6-92 to 104 (1961).

lation and several other states had created workmen's compensation funds.¹² All these funds tended to be limited in scope.¹³ Present guaranty funds, although much broader in scope, still do not fully protect policyholders.

While guaranty fund legislation is no exception to the general rule that insurance statutes are conceived on an ad hoc basis,¹⁴ many of the gaps in guaranty fund legislation are a direct result of the insurance industry's reluctance to embrace the concept. A primary objection to guaranty funds has been that they create a disincentive for the vigilant supervision of the insurance industry by regulatory officials.¹⁵ Yet in continually harping upon the need for more stringent regulation for insolvency¹⁶ the insurance industry has ignored the historical failure of regulators to prevent insolvencies. Even more importantly, the industry, and some regulators,¹⁷ seem to forget that company solvency is not an ultimate goal of insurance regulation.¹⁸ Rather, as Professor Patterson noted in his comprehensive study of insurance regulation, "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 un-

12. See generally 1 *Proceedings of the NAIC* 45 (1962).

13. D. OLSON, *INSOLVENCIES AMONG AUTOMOBILE INSURERS*, *supra* note 2, at 32.

14. S. Kimball & H. Denenberg, *Problems of Comprehensive Insurance Revision Programs*, in *INSURANCE, GOVERNMENT, AND SOCIAL POLICY* 44 (S. Kimball & H. Denenberg eds. 1969).

15. See generally 1 *Proceedings of NAIC* 43 *passim* (1962); 1 *Proceedings of the NAIC* 176 (1971); Note, *Insurance Company Insolvencies: Relief for Victims in Illinois*, 15 *DEPAUL L. REV.* 170,174 (1965).

16. See Trieschmann & Pinches, *A Multivariate Model for Predicting Financially Distressed P-L Insurers*, 40 *J. RISK & INS.* 327 (1973).

17. See text accompanying note 80 *infra*.

18. Cf. Kimball, *The Goals of Insurance Law: Means Versus Ends*, 1962 *J. INS.* 19. Professor Kimball perceptively observed that:

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, 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. The enterprise must be more than solvent, it must be solid.

Id. at 21.

sound enterprises. . . ."¹⁹ In short, unless solvency regulation can be made perfect,²⁰ other solutions are necessary to ensure that the policyholder is secure. In light of this ultimate goal of insurance regulation, guaranty funds appear to offer the best means of providing complete protection to the policyholder.

The industry's begrudging acceptance of guaranty fund legislation in 1969 was prompted in large part by the threat of substantial federal intervention in insurance regulation as envisioned by the proposal for a federal insurance guaranty corporation.²¹ Although Senator Thomas Dodd had introduced similar legislation before 1969,²² the 1969 bill was assigned to the Senate Committee on Commerce which eventually reported it out with a favorable recommendation.²³ An indication of the substantiality of the federal threat as perceived by insurance companies can be found by comparing the public statement of the American Mutual Insurance Alliance (AMIA), a major industry trade association, strongly opposing any form of guaranty fund as of May 6, 1969²⁴ with its vigorous support for state post-insolvency assessment guaranty funds as of November 12, 1969.²⁵ A further indication is that as of February 24, 1972, forty-five states had enacted guaranty fund legislation covering over ninety percent of the property-casualty premium volume nationwide.²⁶ Thus, excluding the existing funds in New York, Maryland, and New Jersey forty-two states had rushed to enact guaranty fund legislation in a little less than three years.

19. 1 E. PATTERSON, *THE INSURANCE COMMISSIONER IN THE UNITED STATES: A STUDY IN ADMINISTRATIVE LAW AND PRACTICE* 192 (Harvard Studies in Administrative Law reprinted 1968) (emphasis added).

20. Some commentators have even suggested that complete solvency protection for each company, as compared to each policyholder, may be undesirable. See N.Y. Ins. Dept., *Regulation of Financial Condition of Insurance Companies*, 95 n.114, 96 nn.115 & 116 (1974).

21. S. 2236, 91st Cong., 1st Sess. (1969).

22. S. 3919, 89th Cong., 2d Sess. (1966); S. 688, 90th Cong., 1st Sess. (1967).

23. S. Rep. No. 91-1421, 91st Cong., 2d Sess. (1970).

24. Statement of the American Mutual Insurance Alliance (AMIA) submitted for the Record. *Hearings on S. 2236 Before the Senate Comm. on Commerce*, 91st Cong., 1st Sess., ser. 91-26, at 45-61 (1969).

25. Testimony of Andre Masionpierre, Vice President of AMIA, *Hearings on S. 2236 Before the Senate Comm. on Commerce*, 91st Cong., 1st Sess., ser. 91-45, at 70-71 (1969). See also 1 *Proceedings of the NAIC* 271 (1970).

26. NCIGF Letter, Feb. 24, 1972, at 1.

The place of Illinois in these events is both prominent and ignominious. The hearings on the insurance industry conducted by the Senate Antitrust and Monopoly Subcommittee²⁷ disclosed that Illinois had more insolvencies in the period between 1958 and 1968 than any other state.²⁸ Furthermore, despite the assuasive statements of public officials,²⁹ the measures which were enacted by the Illinois legislature provided less than complete protection for policyholders.³⁰ Finally, in 1971 because of the threat of federal intervention and continued uncertainty regarding the solvency of several insurers,³¹ guaranty fund legislation was enacted in Illinois.³²

Since the initial rush to establish post-insolvency guaranty funds at the state level there has been only one substantial attempt to re-examine the purposes of guaranty fund legislation and the relationship of such legislation to other insurance laws, especially those concerning the rehabilitation and liquidation of companies.³³ Moreover, although guaranty funds have been the

27. 1969 Hearings, *supra* note 2, at 8968.

28. *Id.* This fact was also disclosed in the *Hearings Before the Senate Comm. on Commerce*, 91st Cong., 1st Sess., ser. 91-26, at 6 (1969).

29. 1965 Hearings, *supra* note 2, at 6753-76 (testimony of John F. Bolton, Jr., Director of Insurance, State of Illinois). See also Bolton, *The Illinois Program: A Two Year Plan to Modernize Regulation of the Insurance Industry*, 2 *Proceedings of the NAIC* 355-62 (1967).

30. Among the bills included in the Department of Insurance's package of legislation for 1967 was a bill to create a Motor Vehicle Liability Security Fund. S.B. 122, 75th Ill. Gen. Assembly (1967) (Introduced January 8, 1967). The bill was not passed however; instead, legislation was enacted which required that uninsured motorist coverage be included in any bodily injury liability automobile insurance policy. ILL. REV. STAT. ch. 73, § 755a (1973). See also 1969 Hearings, *supra* note 2, at 8967.

31. For example, the Freedom Insurance Company was placed in liquidation on March 31, 1970; the Fidelity General Insurance Company was placed in liquidation on December 4, 1970; the LaSalle National Insurance Company was placed in liquidation on December 28, 1971. See 1973 Ill. Dept. Ins. Ann. Rep. 47-49.

32. Illinois Insurance Guaranty Fund Act, ILL. REV. STAT. ch. 73, §§ 1065.82-.03 (1973).

33. The best discussion of guaranty funds and their effect on other aspects of insurance regulation is found in N.Y. Ins. Dep't Regulation of Financial Condition of Insurance Companies (1974). Prior to the enactment of most guaranty fund laws, Professor Douglas Olson set forth several criteria for guaranty fund legislation and speculated on a few of the possible consequences of such legislation as part of a study of automobile insurer insolvency. D. OLSON, *INSOLVENCIES AMONG AUTOMOBILE INSURERS*, *supra* note 2, at 31.

In addition, the insurance industry has established the National Committee on Insurance Guaranty Funds. The Committee monitors developments in the various states, maintains extensive materials on guaranty funds, and serves as a clearinghouse for information

subject of recent articles in insurance literature, no attempt has been made to examine them from the policyholder's viewpoint.³⁴ It is the purpose of this article to reassess several sections of the Illinois Insurance Guaranty Fund Act³⁵ to determine if policyholders are adequately protected and, if not, what changes should be made in the Illinois laws. In addition, because of their relevance to the issue of policyholder safety, provisions of the NAIC Life and Health Insurance Guaranty Association Model Act,³⁶ unique provisions of other state guaranty fund laws, and other proposals for amending guaranty funds will also be examined to see if they meet the elusive goal of securing the "protection of the insured."³⁷

DEDUCTIBLE PROVISIONS

Loss Claims

The Illinois guaranty fund,³⁸ the NAIC Model Act,³⁹ and most other guaranty fund laws⁴⁰ contain provisions for a deductible,

on guaranty funds. Although the NCIGF has not published a comprehensive study of guaranty fund legislation, it is an excellent source of information regarding specific provisions of property and casualty guaranty funds.

The newly found interest of insurance companies in actively participating with state insurance departments in regulating for solvency, particularly with regard to recent NCIGF proposals to modify provisions of both guaranty fund and liquidation laws, is probably a consequence of the fact that most property-liability guaranty funds require companies, and thus indirectly their policyholders, to have a direct stake in the solvency of other companies. As will be discussed, this may be a forceful reason for not incorporating a tax offset provision within guaranty fund legislation. See text accompanying notes 119-36 *infra*.

34. See, e.g., Harrison, *Insurance Companies Insolvencies, Guaranty Funds and Broker's Responsibilities*, 1975 INS. L.J. 517 [hereinafter cited as Harrison]; Korsan, *Guaranty Funds: Trapeze or Trap?* 1975 J. INS. 8.

35. ILL. REV. STAT., ch.73, §§ 1065.82-.103 (1973).

36. 1 *Proceedings of the NAIC* 160-73 (1971) [hereinafter cited as Model Life Bill].

37. Kimball, *supra* note 18, at 20.

38. ILL. REV. STAT. ch. 73, § 1065.87-2 (1973).

39. Model Casualty Bill § 8, *supra* note 5, at 255.

40. As of January 1, 1975 only Maine, Massachusetts, Michigan, New Hampshire, New Mexico, New York, Ohio, Rhode Island, and Vermont did not impose a deductible on any claims other than workmen's compensation claims. Arizona imposes a \$200 deductible on all claims except those for unearned premiums. ARIZ. REV. STAT. ANN. § 20-664 (A) (1) (Supp., 1974). Note that the Arizona Guaranty Fund Association has recently been declared unconstitutional. *Fireman's Fund Ins. Co. v. Arizona Ins. Guaranty Ass'n*, 112 Ariz. 7, 536 P. 2d 695 (1975). The Supreme Court of Arizona found that the act establishing

typically \$100 or \$200. This deductible is to be distinguished from that which is ordinarily included in the standard automobile insurance policy for collision and comprehensive coverages. The deductible in the Guaranty Fund Act applies to the amount the insolvent insurer is obligated to pay to the insured and is distinct from a policy provision deductible which applies against the total loss incurred.⁴¹ Originally, the use of deductible provisions in guaranty funds may have resulted from relying on similar provisions in existing statutes.⁴² Alternatively, deductible provisions may have been adopted because similar provisions were commonplace in automobile physical damages coverages.⁴³ In any event, deductible provisions were incorporated in the NAIC Model Bill⁴⁴ and the Illinois Guaranty Fund Law.⁴⁵

Upon review, the inclusion of a deductible provision for claims within the context of a guaranty fund appears objectionable on many grounds.⁴⁶ First, the use of a deductible for claims, exclud-

the association violated the Arizona Constitution, art. 14, § 2 which states: "Corporations may be formed under general laws, but shall not be created by special Acts. . . ."

House Bill 1739 (Epton) was recently passed by the Illinois General Assembly. P.A. No. 79-1011 (Sept. 17, 1975), *amending* ILL. REV. STAT. ch. 73, § 1065.87-2 (1973). The Act eliminates the \$100 deductible applicable to all claims except unearned premiums and expands coverage from \$50,000 to \$100,000. The bill originally eliminated both the deductible and ceiling applicable to all claims, but was amended to accommodate spokesmen for both the insurance industry and the Illinois Department of Insurance, and to ensure passage.

41. For example, a policyholder with a \$500 loss and a \$100 deductible policy provision would normally collect \$400 from his insurer. If the insurer is insolvent, the policyholder would collect only \$300, plus any unearned premium, from the guaranty fund because of the application of the guaranty fund deductible. The New Jersey statutes specify that the guaranty fund deductible is separate from the deductible contained in the policy. N.J. REV. STAT. § 17:30A-8 (Supp., 1975).

42. In an informal conversation between one of the authors and the Staff Director of the Insurance Laws Revision Committee of Wisconsin, it was suggested that this was probably the case in that state. Prior to the enactment of the Wisconsin Insurance Security Fund, an elaborate revision of the rehabilitation and liquidation laws of that state had been made which included a \$200 deductible for loss claims. A \$200 deductible was also made applicable to security fund coverage. WIS. STAT. ANN. § 646.11 (3) (Special Supp., 1975).

43. Cf. D. OLSON, *INSOLVENCIES AMONG AUTOMOBILE INSURERS*, *supra* note 2, at 38.

44. The Comment to section 8 of the NAIC bill provides the unenlightening information that "The deductible amount (\$100) and the maximum (\$300,000) represent the subcommittee's concept of practical limitations." Model Casualty Bill § 8, Comment, *supra* note 5, at 256.

45. ILL. REV. STAT. ch. 73, § 1065.87-2 (1973).

46. These comments are based in large part upon a prior article of one of the authors.

ing claims for refund of unearned premiums, is an inequitable means of reducing the contribution required from a guaranty fund in the case of an insolvency. In the absence of a guaranty fund statute, deductibles have the salutary effect of increasing the proportion of the assets of an insolvent insurer which are available for distribution in liquidation to persons with larger losses.⁴⁷ However, with the presence of a guaranty fund, the primary effect of a guaranty fund deductible provision is to reduce the liability of the guaranty fund for covered claims; it does not affect the amount of claims in liquidation and, hence, does not increase the proportion of assets which can be utilized to compensate those persons with large claims. Instead, a guaranty fund deductible merely reduces the amount of the assessments made upon solvent insurance companies.

It is also important to note that the deductible provision as applied to claims does not affect all policyholders of the insolvent company. A deductible provision applied against loss claims only hurts those who have had the misfortune to be involved in an accident while insured by the insolvent insurer. Thus, a guaranty fund deductible provision has the untoward result of arbitrarily selecting a small group of policyholders who are likely to be least able to suffer the cost of an insolvency, and requires them to bear an extra burden in liquidation in order that the assessments levied against solvent insurance companies by the guaranty fund will not be so great. Because the fundamental purpose of guaranty fund legislation is to shift the burden of an insolvency from a limited group of policyholders to a larger group of policyholders, it makes little sense to have a provision that shifts some of the burden of an insolvency back onto the very policyholders who have suffered the greatest loss. Moreover, even if the deductible can be viewed as a means of creating an incentive for policyholders to carefully select insurers,⁴⁸ its application to loss claims is

See Epton, *Deductible Provision - Illinois Insurance Guaranty Fund*, ILL. INS., Mar.-April, 1974, at 2.

47. In liquidation a deductible reduces the total amount of claims against the remaining assets. More importantly, since a deductible has its greatest impact on small claims, the claims remaining after the application of a deductible are the larger ones—the very events in which there is the greatest need for insurance.

48. See KROGH, *INSURER POSTINSOLVENCY GUARANTY FUNDS* 51-52, Appendix B (Working Paper No. 55, University of Kansas School of Business 1971), and authorities cited in note 118, *infra*.

still inequitable. All the policyholders of the insolvent insurer have made the same mistake, yet only those with loss claims will be penalized for their actions through the application of a loss claims deductible.

This point has generally been overlooked by commentators with the result that the only support for eliminating the deductible provision has come from agents or brokers who have a strong self-interest in minimizing the effects of an insolvency on their clients, especially independent agents and brokers who have placed a policy with a company which subsequently becomes insolvent,⁴⁹ or from persons who object to the deductible provision because it has in the past most often affected policyholders who were least able to bear the additional burden. While these arguments are of some merit, the best reason for objecting to loss deductible provisions is that they are an inequitable means of distributing the cost of an insolvency within the framework of guaranty fund legislation. There is no valid reason to use deductibles for loss claims when the specious savings that result really involve determining whether a small or large group of policyholders should shoulder the cost of an insolvency.

*Unearned Premiums*⁵⁰

The application of a deductible to unearned premiums presents a different and much more complex problem than that of loss claims deductibles.⁵¹ Opinions about whether to include un-

49. See, e.g., Report submitted by Ralph A. Petrarca, Spokesman for the National Association of Mutual Insurance Agents, 2 *Proceedings of the NAIC* 318 (1971). His report focuses on the attempts to eliminate unearned premiums from inclusion within the provisions of guaranty fund legislation and only in passing advocates full protection for policyholders. See also Harrison, *supra* note 34, at 517.

50. Insurance policies are typically not purchased on an installment basis. While the premium payment may be financed by a third party, the entire premium is usually due to the insurer when the policy commences. The prepaid portion of the premium at any point in time is known as the unearned premium.

51. D. OLSON, *INSOLVENCIES AMONG AUTOMOBILE INSURERS*, *supra* note 2, at 34-35. Unearned premiums are not covered at all in California, Idaho, Michigan, Missouri, Nebraska, Nevada, New Mexico, Oregon, Tennessee, Utah, Washington and Wyoming. Limitations on the amounts of unearned premiums considered to be covered are found in Connecticut, CONN. GEN. STAT. ANN. § 38-278 (1) (a) (i) (Supp., 1975), (50% of unearned premiums with a \$1,000 limit); Indiana, IND. ANN. STAT. § 27-6-8-7 (a)(i) (1975), (\$500); Tennessee, TENN. CODE ANN. § 56-4004 (4) (Supp., 1974), (\$500); and Texas, TEX. INS. CODE art. 21.28-C, § 5 (2) (Supp., 1974) (\$500).

earned premiums in property-casualty guaranty funds usually reflect one of two positions. One, the unearned premium is declared to be a cost of insolvency to the policyholder which should be covered in full.⁵² Two, it is said that including unearned premiums within the scope of guaranty funds should not be permitted because it will remove an incentive for policyholders to select a company with care. A third possible position might be that the unearned premium claim should be considered a part of the economic cost of an insolvency, but that it deserves a lower priority.⁵³ Of these three positions, the last is by far the most supportable because the insurance premium represents the amount of money the policyholder was willing to pay in order that he might be protected against the possibility of a much larger loss. In other words, an insurance premium is an acceptable loss. This distinction between premium losses and claim losses is crudely reflected in the Illinois guaranty fund provision which applies a deductible to unearned premiums but not to other claims.⁵⁴ Nevertheless, none of these positions adequately analyzes the appropriateness of deductibles for unearned premiums within the framework of guaranty fund legislation.

A prime objection to post-insolvency guaranty funds has been the allegation that such funds subsidize mismanaged companies at the expense of well-managed ones.⁵⁵ While this argument has been properly rejected insofar as it applies to incentives for management to knowingly cause their company to become insolvent,⁵⁶ it retains an element of truth. For instance, assume that a guaranty fund has unlimited coverage and contains no deductibles for claims or unearned premiums.⁵⁷ In that situation the only economic loss a policyholder would suffer upon insolvency would be

52. N.Y. Ins. Dep't., Regulation of Financial Condition of Insurance Companies, *supra* note 20, at 93 n. 109 (1974).

53. See WIS. STAT. ANN. § 645.68 (4), Comment (Special Supp., 1975). The Comment applied to liquidations but appears to be equally valid with regard to guaranty funds.

54. P. A. 79-1011 (Sept. 17, 1975), amending ILL. REV. STAT. ch. 73, § 1065.87-2 (1973).

55. See 2 *Proceedings of the NAIC* 677 (1969); 1 *Proceedings of the NAIC* 178 (1971).

56. 2 *Proceedings of the NAIC* 1101 (1970). See also WIS. STAT. ANN. § 646, Comment (Special Supp., 1975).

57. This statement assumes no other gaps in insolvency coverage. The cost of an insolvency may be quite great to a person who incurs a loss after the liquidation order is entered, or whose claim is in excess of any guaranty fund ceiling, or who otherwise suffers because of a gap in the coverage of guaranty funds.

the value of any extra delay in receiving compensation for claims from the administrator in liquidation or the guaranty fund, and any costs associated with unexpectedly having to obtain new coverage. While these costs in a particular case may be quite substantial, they nevertheless appear quite speculative. Thus, without some sort of a deductible provision, only the policyholders of solvent insurers under a post-insolvency fund will ultimately bear the cost of any assessment which occurs. Because guaranty funds constitute a unique form of reinsurance,⁵⁸ it does not appear unreasonable to suggest that the insureds of an insolvent insurer be charged their proportionate share of the cost of such reinsurance. However, the implementation of such a provision might unnecessarily complicate and delay guaranty fund or liquidation proceedings.⁵⁹ Hence, a small deductible applied against the unearned premium account appears to be the simplest means by which to apportion a charge for insolvency protection among insolvent insureds roughly equivalent to that which will fall on the policyholders of all solvent insurers.⁶⁰

Although some deductible for unearned premiums seems appropriate, deductibles of \$100 or more appear excessive.⁶¹ A deductible of perhaps \$1 to \$5 applied only against unearned premium claims would be fairer, although it would probably still be

58. Reinsurance has been defined as "[a] type of insurance that involves acceptance by an insurer, called a reinsurer, of all or a part of the risk of loss of another insurer, known as the ceding company." GLOSSARY OF INSURANCE TERMS 134 (R. Osler & J. Bickley eds. 1972). Because the guaranty fund assumes the risk of one eventuality, insolvency, it can be considered a reinsurer. Cf. Kobler, *Guaranty Funds—A Form of Re-Reinsurance*, *Best's REVIEW* (Property/Liability ed., Nov. 1973) at 10.

59. The final precise assessment might not be determined for many years. Moreover, although most policyholders probably have unearned premium claims, some policyholders might not have sufficient amounts of unearned premiums to cover their assessment. In these instances expensive collection proceedings would be necessary.

60. The authors acknowledge that this form of assessment will not be entirely satisfactory. However, since most policyholders of the insolvent insurer will have an unearned premium claim, the application of a deductible against such claims will achieve reasonable equity.

61. As a crude test, the authors compared the premiums earned in Illinois in one year by the top ten property and casualty companies, approximately \$810,000,000 in 1973, with the total assessments projected to be made by the Illinois guaranty fund throughout its entire existence, approximately \$10,800,000 as of March 1, 1975. Such a calculation yields total projected assessments equal to 1.3% of the premiums written by the top ten companies in 1973. See also Harrison, *supra* note 34, at 520.

too large when considered alone. However, because a guaranty fund should also provide for a continuation of insurance coverage for a reasonable time after the date of an order of liquidation, a somewhat larger deductible may be appropriate. If stopgap coverage is provided which will allow the policyholder a reasonable amount of time to purchase alternative coverage, a deductible of perhaps \$25 to \$50 could be justified as an appropriate charge for both insolvency "reinsurance" and limited post-insolvency insurance coverage.⁶²

THIRTY DAY POST-LIQUIDATION COVERAGE

One of the salutary provisions of the Wisconsin rehabilitation and liquidation law is the provision that claims for injuries arising within fifteen days after an order of liquidation has been entered will be covered within the liquidation proceedings.⁶³ Such a provision takes cognizance of the fact that it is unrealistic to expect an insured to be able to purchase, or even be aware of the need for, alternative insurance coverage upon the filing of an order of liquidation. A similar provision permitting stopgap coverage for thirty days was included in the NAIC Model Bill⁶⁴ and was intended to be included in the Illinois law.⁶⁵

Unfortunately, the legislation establishing the Illinois guaranty fund was amended so that temporary post-insolvency insurance coverage is probably not mandated by law. The Illinois definition of a covered claim differs from the NAIC version in that in Illinois a policy must be "in force at the time of the occurrence giving rise to the unpaid claim."⁶⁶ Illinois has no statutory provision which explicitly states that policies shall continue "in force" after an

62. Although the discussion herein has distinguished between unearned premium claims and other policyholder claims, the application of a single deductible to all policyholder claims is probably more practicable if both unearned premiums and loss claims are fully covered.

63. WIS. STAT. ANN. § 645.43 (Special Supp., 1975). The section provides that coverage will continue for the lesser of: (a) fifteen days from the entry of the liquidation order; (b) until the policy normally terminates; (c) until the policy has been transferred to a solvent insurer; or (d) until the policy has been replaced.

64. Model Casualty Bill § 8, *supra* note 5, at 255.

65. *See* ILL. REV. STAT. ch. 73, § 1065.87-2 (1973).

66. *Id.* at § 1065.84-3. A similar definition will be found in ORE. REV. STAT. § 734.510 (4)(a) (1974).

order of liquidation is issued.⁶⁷ The Liquidation Article of the Illinois Insurance Code does indicate that the rights of policyholders and others "shall be fixed as of the date of the entry. . . unless otherwise provided by order of the court."⁶⁸ Thus, it appears that for post-insolvency guaranty fund coverage to continue the court issuing the liquidation order would have to extend the date for the fixing of the rights and liabilities of policyholders and this extension would have to be found sufficient to satisfy the "in force" test of the Guaranty Fund Act. This in fact is the procedure which is currently being followed in Illinois.⁶⁹

While this indirect process of establishing that policies remain in force for purposes of the Guaranty Fund Act is not necessarily objectionable, it does make temporary post-insolvency protection contingent upon the content of the order of liquidation. If the order of liquidation did not provide for a thirty day continuation of coverage, it would be difficult to show that the Illinois guaranty fund was obligated to provide post-insolvency coverage. In contrast, the NAIC Model Bill provides that during that thirty day period the Guaranty Fund Association "be deemed the insurer to the extent of its obligation on covered claims. . . ." ⁷⁰ Moreover, the NAIC Model Bill only requires that a covered claim arise out of and be within the coverage of the insurance policy.⁷¹ However, both of these NAIC provisions were changed in Illinois. In Illinois the guaranty fund is only deemed to stand in the shoes of the insolvent company if the fund itself processes and reviews claims.⁷² The fund has rarely chosen to do this and instead relies upon the Illinois Bureau of Liquidations to administer claims. In addition, as already mentioned, the "in force" test was added to

67. The Wisconsin statute differs with Illinois in this regard, see WIS. STAT. ANN. § 645.43 (Special Supp., 1975).

68. ILL. REV. STAT. ch. 73, § 806 (1973).

69. For example, the petition for an order of the cancellation of the policies of the LaSalle Insurance Company requested that all policies be cancelled "except with respect to covered claims under the Illinois guaranty fund. . . ." The final order adopted this language. *In re LaSalle Nat'l Ins. Co.*, No. 71CH4744 (Cook Cty. Ill. Jan. 3, 1972).

70. Model Casualty Bill § 8 (1)(b), *supra* note 5, at 256.

71. "'Covered Claim' means an unpaid claim, including one for unearned premiums, which arises out of and is within the coverage, and not in excess of the applicable limits of an insurance policy to which this Act applies. . . ." Model Casualty Bill § 5 (3), *supra* note 5, at 254.

72. ILL. REV. STAT. ch. 73, § 1065.87-4 (1973).

the definition of covered claims. Thus, in Illinois the guaranty fund is only obligated for post-liquidation coverage if the court order provides for it, while under the NAIC Model Bill the guaranty fund is responsible regardless of the content of the court order.

It was originally believed by the authors that the differences between the NAIC Model Bill and the Illinois guaranty fund were of little practical consequence. However, recently in Missouri a court issued an order of liquidation that did not specify that the covered policies should remain in force.⁷³ The guaranty fund of Missouri is concerned because the court's action might preclude recognition of its post-insolvency claims in liquidation. While such a situation might be of some concern to insurance companies, it is important to note that policyholders of the insolvent Missouri company would nevertheless be protected because the Missouri liquidation and guaranty fund provisions are not interdependent on the question of thirty day post-liquidation coverage. The guaranty fund is obligated to policyholders regardless of the status of the claims it will present in liquidation. On the other hand, the omission of a post-insolvency extension of coverage in Illinois would affect both the policyholders of the insolvent company and the obligation of the Illinois guaranty fund. This result is undesirable. Policyholders should be entitled to at least thirty days of post-insolvency coverage and this coverage should not be dependent on the skill of the judge issuing the order of liquidation.

CEILINGS ON GUARANTY FUND COVERAGE

Even more objectionable than the inclusion of deductible provisions in most guaranty funds has been the inclusion of limitations on the amount of coverage which is provided.⁷⁴ These per policy claim limitations range from \$50,000⁷⁵ to

73. NCIGF Letter, Oct. 7, 1975, at 2.

74. As of Jan. 1, 1975 no upper limits, other than policy limits, are imposed on the liability of the funds in Maryland, New Jersey, Ohio, Rhode Island, and Wisconsin.

75. COLO. REV. STAT. § 10-4-508 (a) (1973); GA. CODE ANN. § 56-3403a (4), (5) (1971); IDAHO CODE § 41-3608 (a) (Supp., 1975); ILL. REV. STAT. ch. 73, § 1065.87-2 (1973) amended by P.A. 79-1011 (Sept. 17, 1975); IND. ANN. STAT. § 27-6-8-7 (i) (1975); KY. REV. STAT. § 304.36-080 (a) (Supp., 1974); LA. REV. STAT. ANN. § 22:13 (1) (a) (Supp., 1975); ME. REV.

\$1,000,000.⁷⁶ A substantial number of states have adopted the ceiling of \$300,000 recommended by the NAIC.⁷⁷

In those states which impose a ceiling the drafters apparently ignored the fact that an insurance policy

is not an ordinary mercantile contract, but one of great public importance. In the usual case, if a policyholder loses a premium, he is not seriously harmed, but if a loss goes unpaid, or even unpaid in a substantial measure, great harm is likely to be done.⁷⁸

Large claims consequently deserve full reimbursement because they are the very claims which the policyholder was most anxious to insure against. It is unreasonable to declare that the guaranty fund should only protect individuals or average losses.⁷⁹ If a per-

STAT. ANN. tit. 24-A, § 4438 (1) (A) (1974); MO. ANN. STAT. § 375.785 (4)(1)(a) (Supp., 1975); N.M. STAT. ANN. § 58-28-4 (D)(2) (Supp., 1973); TEX. INS. CODE art. 21.28-C, § 5 (2) (Supp., 1974).

76. N.Y. INS. LAW. § 334 (2) (McKinney Supp., 1974).

77. ALASKA STAT. § 21.80.060 (a)(1) (Supp., 1974); CONN. GEN. STAT. ANN. § 38-278 (1) (a) (Supp., 1975); DEL. CODE ANN. tit. 18, § 4208 (a) (1) (1974); FLA. STAT. ANN. § 631.57 (1)(a)(3) (1972); HAWAII REV. LAWS § 431 D-8 (a) (1) (Supp., 1974); IOWA CODE ANN. § 515 B.5 (1)(a) (Supp., 1975); KAN. STAT. ANN. § 40-2906 (a)(1) (Supp., 1972); MASS. GEN. LAWS ANN. ch. 175 D, § 5 (1)(a) (1972); MINN. STAT. ANN. § 60C.09 (2) (Supp., 1975); MISS. CODE ANN. § 83-23-115 (1) (a) (1972); MONT. REV. CODES ANN. § 40-5708 (1)(a) (Supp., 1974); NEV. REV. STAT. § 687A.060 (1)(a) (1973); N.H. REV. STAT. ANN. § 404-B:8 (I)(a) (Supp., 1973); N.C. GEN. STAT. § 58.155.48(a)(1) (1975); N.D. CENT. CODE § 26-36-08 (1)(a) (Supp., 1973); ORE. REV. STAT. § 734.570 (1)(c) (1974); PA. STAT. ANN. tit. 40, § 1701.201 (b)(i) (1971); S.C. CODE ANN. § 37-825 (1)(a) (Supp., 1974); S.D. Compiled Laws Ann. § 58-29A-16 (Supp., 1975); UTAH CODE ANN. § 31-40-8 (1)(a) (1974); VT. STAT. ANN. tit. 8, § 3615 (a) (1) (1970); VA. CODE ANN. § 38.1-763 (1)(a) (1970); WASH. REV. CODE ANN. § 48.32.060 (1)(a) (Supp., 1974); W. VA. CODE ANN. § 33-26-8 (1)(a) (1972).

78. WIS. STAT. ANN. § 645.68 (3), Comment (Special Supp., 1975).

79. Commissioner Lorne R. Worthington, in his testimony before Congress on behalf of the NAIC regarding the NAIC Model Guaranty Bill said:

We have included in our model bill provision for paying back to the policyholders on a deductible basis all claims in excess of \$100, including unearned premium [sic] as well as the claims they might have as an [sic] result of losses. We have placed a limitation of \$300 [sic] on any claim in order to avoid having the association paying out large claims which would go to people who would not be hurt as significantly as the average person would, because the thrust of our bill is to protect the average person, to provide them with immediate payment as though the company was not insolvent and to provide a payment whereby the public can maintain its confidence in the insurance industry.

Hearings on S. 2236 Before the Senate Commerce Comm., 91st Cong., 1st Sess., ser. 91-45, at 150 (1970) (statement of Lorne R. Worthington, Commissioner of Insurance for the

son or corporation is willing in good faith to pay a premium to trade uncertainty for certainty, such risk aversion is important and should be protected.

The ludicrousness of attempting to place limits on the coverage of guaranty funds once the general concept has been accepted was recently evinced in Illinois. An official of the Illinois Department of Insurance suggested that the Department would only support a bill to increase the ceiling on the Illinois guaranty fund⁸⁰ if the proposed limit was reduced from \$300,000 to \$100,000. The professed reason for such a request was that a major writer of hospital malpractice insurance was experiencing financial difficulty and therefore the proposed increase would potentially subject other insurers to larger assessments. It is undoubtedly of little comfort to those hospitals which had coverage with the shaky insurer to know that the Illinois Department of Insurance was more concerned with minimizing the guaranty fund assessments which might have been made on a large group of solvent companies than it was with reducing the disastrous effect a large malpractice judgment could have on an "uninsured" hospital and, perhaps, the general level of health care in the hospital's locality.

When the primary problem was the insolvency of automobile insurers, a \$100,000 or \$300,000 limit may have been reasonable, if not rational. This was true because most automobile policies which were sold contained coverages which were less than most guaranty fund ceilings. However, with the escalation of claim settlements and the threat of insolvencies in many other lines of insurance, this is no longer the case. In short, because it is impossible to predict what types of risks and losses will be the subject of an insolvency there seems to be little justification for ceilings or other restrictions in guaranty fund legislation except to placate the shortsighted attitude of some members of the insurance industry.⁸¹

State of Iowa). Also note efforts to restrict coverage on the basis of the claimant's net wealth. 1 *Proceedings of the NAIC* 284 (1970); GA. CODE ANN. § 56-3403 (a) (f) (b) (1970); R.I. GEN. LAWS ANN. § 27-34-3 (5) (Supp., 1974).

80. The ceiling has recently been raised to \$100,000. P. A. No. 79-1011 (Sept. 17, 1975), amending ILL. REV. STAT. ch. 73, § 1065.87-2 (1973). See note 40, *supra*.

81. The authors do not deny that liquidity problems may arise if there is no ceiling on guaranty fund laws, but these problems are best handled by means other than establishing limits on the coverage of guaranty funds. It is better to spread the risk of insolvency rather

RECOVERY FOR "ECONOMIC" LOSS⁸²

At least three states, Indiana,⁸³ Nebraska,⁸⁴ and Missouri,⁸⁵ specifically limit recovery from their respective guaranty funds to economic loss in the case of a bodily injury claim. In effect, these states declare that the nonpecuniary costs of an accident will be borne by the policyholders or third parties who might otherwise have been compensated by insurance.

While the merits of awarding damages for nonpecuniary losses can be, and have been, extensively debated,⁸⁶ any statutory limitation on nonpecuniary losses should apply to all injured parties, not just those who happen to be insured by or seek compensation from an insolvent insurer. If nonpecuniary losses are recognized as determinable in cases not involving the insureds of insolvent insurers, distinguishing between regular insurance claims and guaranty fund claims once the guaranty fund concept is adopted is inequitable.⁸⁷ The policyholder is entitled to the full protection of his policy.⁸⁸ As in the case of deductibles, limiting recovery to economic losses capriciously places an extra burden of insolvency on those who are least likely to be able to bear it.

SUBROGATION

Subrogation has long been a unique and elusive part of insur-

than have a few policyholders bear the burden, and adopt other means of resolving liquidity problems. For example, more flexible approaches to funding can minimize the "domino effect" of an insolvency on other insurers. Moreover, it should be noted that property-liability guaranty fund assessments may already be deferred in rare cases. ILL. REV. STAT. ch. 73, § 1065.87-6 (1973). See discussion in note 149, *infra*.

82. For purposes of this section, economic loss is used to indicate the pecuniary losses suffered by a policyholder or injured third party. The term economic loss has received wide currency as a means of describing the losses compensable under a no-fault reparations system. The authors feel the term should represent all costs, not just pecuniary ones, associated with an accident. Cf. R. POSNER, *ECONOMIC ANALYSIS OF LAW* 3, 82 (1973).

83. IND. ANN. STAT. § 27-6-8-7 (1) (1975).

84. NEB. REV. STAT. § 44-2406 (3) (Supp., 1972).

85. MO. ANN. STAT. § 375.785 (4)(1)(a)(b) (Supp., 1975); H.B. 562, 89th Tenn. Gen. Ass. (April 16, 1975).

86. See, e.g., G. CALABRESI, *THE COST OF ACCIDENTS* 215-25 (1970); R. POSNER, *supra* note 82, at 3.

87. Neither Indiana, Nebraska, nor Missouri have enacted a no-fault provision limiting nonpecuniary claims.

88. The policyholder may still be subject to claims for general damages in such a case. See text accompanying notes 89-105 *infra*.

ance law.⁸⁹ With regard to insolvency, a more than sufficient description was provided by Professor Oscar R. Goodman when he said "that this whole problem of subrogation of insurance companies against consumers is a can of worms. . . ."⁹⁰

When the insurance industry was proposing the uninsured motorist endorsement as a solution to the insolvency problem, specific recognition was taken of the abuses which can occur when an insurance company retains the option to sue the "insured" of an insolvent insurer rather than pursue the claim in liquidation.⁹¹ Consequently, many statutes were amended to prohibit subrogation in such cases.⁹² It is noteworthy that this action was necessary despite the statements of insurance industry spokesmen that subrogation was a problem of little consequence.⁹³ Surprisingly, despite the well-known problems of subrogation in liquidation proceedings, the NAIC Model Guaranty Association Bill merely excluded subrogated claims from its scope without comment.⁹⁴ This provision has engendered anomalous results.

For example, an injured party (Valerie Victim) has a cause of action against the insured (Ralph Reckless) of an insolvent insurer (Belly Up Insurance Company) and Valerie Victim also has first party coverage for such a loss with her own insurer (Merciless Insurance Company). Valerie Victim would appear to have the option of seeking compensation from either her own insurer, Ralph Reckless, the liquidator of Belly Up Insurance Company, or the Illinois guaranty fund.⁹⁵ If Valerie Victim sought compen-

89. See generally KEETON, *BASIC INSURANCE TEXT* 147-68 (1971); Kimball & Davis, *The Extension of Insurance Subrogation*, 60 MICH. L. REV. 841 (1962).

90. 1969 Hearings, *supra* note 2, at 8955 (testimony of Oscar R. Goodman, Professor of Finance, Roosevelt University).

91. ILL. REV. STAT. ch. 73, § 755a (1973); *cf. id.* § 821(3).

92. See *id.* at § 755a. See also 2 *Proceedings of the NAIC* 680 (1969).

93. Hearings on S. 2236, *supra* note 25, at 69. Nevertheless, the characterization of the insured as being worse off with mandatory uninsured motorist coverage was apparently true in some cases. If subrogation were permitted, an insurer with the wherewithal to pursue the claim, instead of an individual policyholder, would be the real party in interest in any litigation. See also 1969 Hearings, *supra* note 2, at 8955 (testimony of Oscar R. Goodman, Professor of Finance, Roosevelt University).

94. Model Casualty Bill § 5(3), *supra* note 5, at 253.

95. However, the Illinois guaranty fund requires that any claimant who has a claim against his own insurance company which is also a covered claim shall exhaust his rights under his own policy before seeking compensation from the fund. ILL. REV. STAT. ch. 73, § 1065.96 (1973). See also Model Casualty Bill § 11 (2), *supra* note 5, at 260.

sation from either Ralph Reckless or the Illinois guaranty fund, the claim would be treated as a covered claim,⁹⁶ subject of course to applicable limits and deductibles. However, if instead Valerie Victim sought compensation from her own insurer,⁹⁷ Merciless, who then elected to pursue the subrogated claim of Valerie Victim by suing Ralph Reckless, the results would be quite different. A subrogated insurer's claim cannot be treated as a covered claim under the NAIC Model Bill⁹⁸ or the Illinois guaranty fund⁹⁹ because of the exclusion of all subrogated claims. Therefore, the subrogated insurer, Merciless, can only pursue the claim against the liquidator of the Belly Up Insurance Company or the "insured" of the insolvent insurer, Ralph Reckless.

Naturally, the claim will only be pursued by Merciless against the insured policyholder if the policyholder has sufficient assets in his own right to satisfy the claim. Unfortunately, even if Ralph Reckless does satisfy the claim of Merciless, his only source of compensation is the liquidator of the Belly Up Insurance Company. This occurs because the exclusion from coverage in both the NAIC Model and the Illinois Guaranty Fund Act applies to all subrogated claims regardless of who satisfies them. Thus, if an "insured" compensates an injured party directly, or the injured party makes a direct claim against the guaranty fund, the claim is deemed a covered claim.¹⁰⁰ However, if the same claim is made by, or paid to, a subrogated insurer, it is not treated as a covered claim and the "insured" policyholder suffers.¹⁰¹

There is no valid reason to distinguish between subrogated claims and other insurance claims within the context of guaranty fund laws. Just as in the case of claims deductibles and ceilings, provisions prohibiting coverage for subrogated claims prevent the spreading of the cost of an insolvency. Although a provision to

96. Despite the provision that Valerie Victim must first pursue her claim against her own insurer, her claim nevertheless falls within the definition of *covered claim* in Illinois. ILL. REV. STAT. ch. 73, § 1065.84-3(b)(ii) (1973). In contrast, once the subrogated insurer presents the claim, it no longer falls within the definition. See also Model Casualty Bill § 5 (3)(b), *supra* note 5, at 254.

97. As is required by the Illinois guaranty fund, ILL. REV. STAT. ch. 73, § 1065.96 (1973).

98. Model Casualty Bill § 5 (3) (b), *supra* note 5, at 254.

99. ILL. REV. STAT. ch. 73 § 1065.84-3(b)(ii) (1973).

100. *Id.*; Model Casualty Bill § 5 (3)(b).

101. See note 95 and accompanying text *supra*.

prohibit subrogation in such cases would also protect insureds,¹⁰² it may be that this is not the best solution. If subrogated recoveries are permitted, the cost of an insolvency would be spread among companies in relation to their premium writings. If subrogated recoveries are prohibited, the spreading of the cost of an insolvency will depend on the incidence of accidents between the policyholders of solvent carriers and those of the insolvent insurer. Moreover, one commentator has stated that the removal of subrogation privileges might even have serious consequences for small insurers.¹⁰³ Whether this would be true is uncertain; the point is that the present treatment of subrogated claims under guaranty fund laws inadequately protects policyholders.¹⁰⁴ Therefore, to eliminate some of the problems of subrogation and at the same time achieve adequate loss spreading, it is recommended that the claims of subrogated insurers be recognized as covered claims within guaranty fund laws.¹⁰⁵

NO-FAULT COVERAGE

The current Illinois Insurance Guaranty Fund Law applies to almost all casualty, fire, and surety coverages.¹⁰⁶ However, because a substantial portion of the coverages provided under most of the no-fault bills proposed in Illinois to date would be categorized as being within Class 2(a),¹⁰⁷ it appears that the enactment

102. Cf. ILL. REV. STAT. ch. 73, § 755(a)(3) (1973); and H.B. 1710, 79th Ill. Gen. Assembly (1975) (Introduced April 10, 1975).

103. D. OLSON, *INSOLVENCIES AMONG AUTOMOBILE INSURERS*, *supra* note 2, at 36.

104. Arizona has acted by prohibiting subrogation by insurers. ARIZ. REV. STAT. ANN. § 20-668 (A) (Supp., 1974). The NCIGF has also recognized the problem. NCIGF Letter, April 30, 1973, at 4. However, the formal proposal to prohibit subrogation was only recently submitted to the NAIC. See 2 *Proceedings of the NAIC* (unpublished draft 1975).

105. See H.B. 1713, 79th Ill. Gen. Assembly (1975) (Introduced April 10, 1975).

106. [The guaranty fund] applies to all kinds of direct insurance written under Class 2 and Class 3 of Section 4 of the "Illinois Insurance Code" except that it shall not apply to accident and health insurance written under clause (a) of Class 2 or to marine insurance other than inland marine, written under clause (d) of Class 3 of Section 4 of this Code.

ILL. REV. STAT. ch. 73, § 1065.83 (1973).

107. Class 2(a) insurance is "Insurance against bodily injury, disablement or death by accident and against disablement resulting from sickness or old age and every insurance appertaining thereto." ILL. REV. STAT. ch. 73, § 616 (Class 2(a)) (1973). Essentially it is accident and health insurance sold by casualty insurers. Class 2(b) may cover some, but not all, no-fault coverages. Class 2(b) applies to "any loss or liability resulting from or

of a no-fault bill without either a corresponding amendment to the Guaranty Fund Law or the enactment of a life, accident and health insurance guaranty fund law would effectively eliminate a great portion of the coverage of a no-fault law from the scope of the Illinois guaranty fund. This is because the Guaranty Fund Law presently excludes insurance provided under the authority of Class 2(a).¹⁰⁸

Although the Illinois regulatory process has been much improved in many ways since the days when the failure of high risk automobile insurers prompted the enactment of the original guaranty fund law, there seems very little reason to exclude from the Guaranty Fund Law benefits due from automobile insurers just because the automobile reparations system has been modified. Such a change has no discernable positive impact on the financial condition of insurance companies. In fact, to the extent an automobile insurer might have little prior experience with no-fault coverages, the risk of an insolvency may even increase. Thus, in the absence of more expansive guaranty fund legislation, any no-fault automobile insurance bill should be accompanied by an appropriate amendment to the Illinois Guaranty Fund Law which would maintain the solvency protection presently afforded to all purchasers of automobile insurance in Illinois.

LIFE GUARANTY FUNDS

It seems manifest that policyholders desire the security of knowing that an insurer's obligation will be performed regardless of the type of policy, yet efforts to have a life, accident and health insurance guaranty fund bill enacted in Illinois have been continually frustrated.¹⁰⁹ Such a bill would expand the coverage of guar-

incident to the ownership, maintenance or use of any vehicle . . ." *Id.* 616 (Class 2(b)). However, the section is further delimited as follows:

Any policy insuring against loss or liability on account of the injury or death of any person may contain a provision for payment of disability . . . , and death benefits . . . , irrespective of legal liability of the insured, . . . and such provision shall not be deemed accident insurance.

Id. (emphasis added). While the relationship of Class 2(a) to Class 2(b) is less than clear, it is submitted that no-fault medical coverages, except those specifically coming within the exception of Class 2(b), are authorized under Class 2(a).

108. *Id.* § 1065.83 (1973).

109. See H.B. 150, 78th Ill. Gen. Assembly (1973) (Introduced Jan. 30, 1973); H.B. 838,

anty funds to protect almost all insurance policyholders in Illinois. While insolvencies among life insurers are much less frequent than in the property-casualty lines, they are not unknown.¹¹⁰ The potentiality for insolvency in the life insurance business was recently re-emphasized in a dramatic manner by the Equity Funding scandal.¹¹¹ Nevertheless, the life insurance industry does not believe that a life insurance guaranty fund supported by the life insurance policyholders is desirable.¹¹²

There are two primary objections made by the life insurance industry to the enactment of life guaranty fund legislation. First, even in those rare cases where life insurers are found to be impaired or insolvent, there is usually no permanent loss to policyholders¹¹³ because life policies can be continued through the use of such measures as policy liens,¹¹⁴ moratoriums,¹¹⁵ merger, and reinsurance.¹¹⁶ Second, the life insurance industry has paraded the familiar argument that guaranty funds are undesirable because the policyholders of well-managed companies will be subsidizing the mismanaged companies.¹¹⁷

78th Ill. Gen. Assembly (1973) (Introduced Mar. 28, 1973); H.B. 1735, 79th Ill. Gen. Assembly (1975) (Introduced April 10, 1975).

110. For example, Federal Old Line Insurance Company was placed in liquidation in the State of Washington on December 14, 1971. Assessments of \$2.6 million were made against the life guaranty fund members of that state. NCIGF Letter, April 26, 1972, at 5. See also Heins, *Liquidation of Insurance Companies, Part B*, *supra* note 2, at 245-51; *Illinois Official Warns of 20 Life Insurers' Financial Problems*, Wall Street Journal, Sept. 18, 1970, at 4, col. 2.

111. *In re Equity Funding Corp. of Am. Sec. Litigation*, No. 142, Multi-Dist. Litigation (Cent. Dist. Cal., filed June 1, 1973). An extremely brief review of the Equity Funding insolvency can be found in the 1973 Ill. Dep't Ins. Ann. Rep. 33.

112. See generally 1 *Proceedings of the NAIC* 157-206 (1971). The American Life Insurance Ass'n will only support a life guaranty fund bill if it includes a tax offset provision. See text accompanying notes 119-36 *infra*.

113. 1 *Proceedings of the NAIC* 175 (1971). See also 2 *Proceedings of the NAIC* 564-93 (1969), for a study of the losses suffered by life insurance policyholders.

114. Under a lien plan, the policies continue in force, but reductions in the cash value are made. See, e.g., ILL. REV. STAT. ch. 73, § 804(3) (1973).

115. A moratorium prevents policyholders from exercising a contractual right. It most often applies to policy loans which may be made against the cash value of a policy. See ILL. REV. STAT. ch. 73, § 804(3) (1973).

116. In liquidation, the life insurance policies may be purchased by another company. In Illinois the power to reinsure creates a preference in liquidation for policyholders. However, the preference is contingent upon another company being willing to assume the policies. *Id.* § 805(4).

117. See generally 1 *Proceedings of the NAIC* 174-206 (1971).

Neither of these arguments is persuasive. If there is usually no loss associated with the insolvency of a life insurance company, then it surely is not asking too much of the life insurance industry to formally guarantee such security. On the other hand, if losses are possible, the policyholders of life insurance companies should be protected. With regard to the subsidization issue, the life insurance industry, like the casualty industry before it, has not explained why it is better to have a limited number of policyholders bear the cost of an insolvency rather than spread such costs among all life or health policyholders. Moreover, if regulators and insurance experts cannot predict insolvencies easily and accurately, it makes little sense to suggest that uninformed policyholders can do so.¹¹⁸

TAX OFFSET PROVISIONS

In addition to the two previously mentioned objections to life guaranty fund legislation, the life insurance industry has been effectively demanding that life guaranty fund legislation include a tax offset provision. The tax offset provision has been advanced by the industry as the only reasonable means of preventing discrimination between old and new life policyholders under a post-insolvency assessment procedure.¹¹⁹ The discrimination is said to arise because life insurance premiums are fixed and hence only new policyholders will bear the cost of an insolvency.

While this may be true as of the enactment date of a guaranty fund law, the continued sales of life insurance policies will mean that in the long run most policies will have been sold with knowledge of the potential guaranty fund liability. Furthermore, the discrimination thesis assumes that only new policies will shoulder any insolvency assessment. However, because whole life insurance contracts involve long-term risks, companies build margins for contingencies into their pricing structure to allow for unanticipated eventualities. It would seem that a guaranty fund assess-

118. Cf. A. Mayerson, *Ensuring the Solvency of Property and Liability Insurance Companies* in *INSURANCE, GOVERNMENT AND SOCIAL POLICY* 149 (S. Kimball & H. Denenberg eds. 1969). See also Denenberg, *Is "A-Plus" Really a Passing Grade?* 34 *J. RISK & INS.* 371-84 (1967).

119. 1 *Proceedings of the NAIC* 205 (1971).

ment is no different than any other unpredictable expense; consequently, it is not borne just by new policyholders. Finally, and perhaps most telling, if life insurance insolvencies have cost individual policyholders little or nothing in the past, can it be argued in good faith that there is substantial discrimination in establishing a means whereby all life policies will benefit from insolvency protection in return for permitting an insignificant or nonexistent cost to be spread among all solvent life insurance companies. Nevertheless, of the sixteen states which have enacted some form of life guaranty fund,¹²⁰ ten have included a tax offset provision.¹²¹

Upon close inspection the use of a tax offset provision does not appear desirable. To understand this, a brief description of life insurance taxation is necessary. In Illinois no insurance premium taxes are levied on domestic companies; domestic companies only pay a tax on income to the state.¹²² Furthermore, because of the effect of retaliatory insurance statutes,¹²³ the two percent premium tax levied on foreign (out-of-state) companies is treated as an excess tax. For example, if one company owed \$2,000 in insurance premium tax before consideration of the Illinois income tax and had a \$1,200 income tax obligation, the Illinois premium tax payable would only be \$800 so that the company's total obligation

120. CONN. GEN. STAT. ANN. §§ 38-301 to 318 (Supp., 1975); KAN. STAT. ANN. §§ 40-3001 *et seq.* (Supp., 1972); MD. ANN. CODE art. 48A, §§ 520-537 (1972); MONT. REV. CODE ANN. §§ 40-5801 *et seq.* (Supp., 1974); NEB. REV. STAT. ch. 44, §§ 2701-10 (Supp., 1975); NEV. REV. STAT. §§ 686C.010 *et seq.* (1973); N.H. REV. STAT. ANN. §§ 404—D: 1-18 (Supp., 1975); N.M. STAT. ANN. §§ 58-32-1 *et seq.* (Supp., 1975); N.Y. INS. CODE § 224 (McKinney 1966); N.C. GEN. STAT. §§ 58-155.65-.83 (1975); ORE. LAWS ch. 251 (Advance Sheet, 1975); S.C. CODE ANN. §§ 37-561 to 579 (Supp., 1974); TEX. INS. CODE ANN. art. 21.28-D (Supp., 1974); VT. STAT. ANN. tit. 8, §§ 4151-69 (Supp., 1975); WASH. REV. CODE ANN. §§ 48.32A.010-.930 (Supp., 1974). Puerto Rico has also enacted such a provision. P.R. LAWS ANN. tit. 26, ch. 39, §§ 3902-3918 (Supp., 1975).

121. CONN. GEN. STAT. ANN. § 38-309(i) (Supp., 1975); KAN. STAT. ANN. § 40-3016 (Supp., 1972); MONT. REV. CODE ANN. § 40-5817 (Supp., 1974); NEB. REV. STAT. ch. 44, §§ 2701-20 (Supp., 1975); NEV. REV. STAT. § 686C.280 (1973); ORE. LAWS ch. 251, § 14 (Advance Sheet, 1975); S.C. CODE ANN. § 37-577 (Supp., 1974); TEX. INS. CODE art. 21.28-E, § 15 (Supp., 1974); VT. STAT. ANN. tit. 8, § 4167 (Supp., 1975); WASH. REV. CODE ANN. § 48.32A.100 (Supp., 1974).

122. ILL. REV. STAT. ch. 73, § 1021(1973).

123. *Id.* § 1056. Retaliatory premium tax statutes are designed to encourage similar treatment for a state's domestic insurers when they do business out-of-state. For example, if Indiana taxed Illinois companies at a 6% rate, Illinois would tax Indiana companies doing business in Illinois 6%, but all other companies would still pay the 2% tax. The provision creates an incentive for Indiana not to unreasonably tax Illinois companies.

for premium and income taxes would be \$2,000. In other words, the Illinois premium tax on foreign insurance companies is only levied to the extent that the total of the income tax on Illinois business plus the premium tax actually levied is equivalent to a two percent premium tax. Thus, a large part of the Illinois two percent premium tax on out-of-state insurers really is an Illinois income tax obligation.

Companies currently treat guaranty fund assessments as business expenses for federal income tax purposes. More importantly, because the Illinois income tax is based on federal adjusted gross income,¹²⁵ the end result is that even without a premium tax offset a guaranty fund assessment made against either a foreign or domestic company is deducted from federal, and hence, state, taxable income.

Viewed in this light, the issue of whether to include a premium tax offset in a guaranty fund bill involves deciding whether the burden of an insolvency is better shared by the federal government¹²⁶ and the policyholders of all solvent insurance companies doing business in the state or, in the alternative, having the taxpayers of the State of Illinois bear the entire burden of such an insolvency. The authors believe it is far better to internalize some of the costs of an insolvency among all similar types of policyholders through assessments and have the federal government absorb the remainder of the cost of an insolvency through income tax deductions rather than have Illinois taxpayers exclusively bear the cost of an insolvency. At the very least, in the former case those policyholders who are eligible for insolvency protection will make a direct contribution for it.¹²⁷

The use of a tax offset provision is even more objectionable when analyzed in conjunction with the provisions of the Model Life and Health Guaranty Association Act proposed by the NAIC.¹²⁸ In fact, an NAIC type bill which includes a tax offset

124. ILL. REV. STAT. ch. 120, §§ 1-102, 2-203(b)(2) (1973).

125. *Id.* § 2-203 (a)(1).

126. The State of Illinois would of course also bear some of the burden since its income tax is based on the federal income tax. However, because the Illinois corporation tax rate is only 4%, the Illinois tax loss is negligible. *Id.* § 201(b)(2).

127. It should be noted that the same reasoning is applicable to any type of insurance guaranty fund tax offset provision.

128. Model Life Bill, *supra* note 36.

provision might be anathema to legislators because the taxpayers of the domiciliary state of the insolvent insurer will be required to subsidize not only their own resident policyholders, but also the policyholders of the insolvent company throughout the country. This undesirable result occurs because the NAIC Model Life and Health Guaranty Association Bill assumes that the life policies of the insolvent insurer will be reinsured as a unit. Thus, section 8 of that bill makes the Guaranty Association of the domiciliary state of the insolvent insurer responsible for all the policies of the insolvent insurer.¹²⁹ This was done in order to avoid the problem of determining the deficiency applicable in each state to the policies issued by the insolvent insurer and to facilitate reinsurance of the policies.¹³⁰ While this approach is understandable, it is not appropriate when co-joined with a tax offset provision.

For example, imagine two states: A and B. Assume that one hundred percent of the life insurance sold in state A is issued by companies domiciled in state B which has adopted the NAIC Model Act with a tax offset provision. Furthermore, assume that all of the insurance in state B is sold by state B insurers. Under the NAIC Model with a tax offset provision, all of the life insurance policyholders in state A would have guaranty fund protection paid for by the taxpayers of state B. This occurs because state B assumes responsibility for guaranteeing all of the policies issued by state B insurers, including those of state A residents. Of course, the cost of such protection reduces the tax revenues of state B whenever a guaranty fund assessment is made.

If instead, no tax offset provision is included in the guaranty fund of state B, the results are quite different. The guaranty fund of state B still protects the policyholders of both state A and state B. However, when an insolvency occurs in a state B company, the burden of the assessments will be passed onto the policyholders of state B companies instead of state B taxpayers. Because many

129. *Id.* § 8, at 163. Compare the property-casualty funds which apply only to residents or risks located in the state. *See, e.g.*, Model Casualty Bill § 3, *supra* note 5, at 253; and ILL. REV. STAT. ch. 73 § 1065.84-3 (b) (1973). *But see* Harrison, *supra* note 34, at 524.

130. It should be noted that the Wisconsin law, which was enacted before the NAIC model was drafted, does contemplate that the Wisconsin Insurance Security Fund will only bear the cost of preserving Wisconsin policies in liquidation. WIS. STAT. ANN. §§ 646.01, 646.11 (Special Supp., 1975).

policyholders of solvent state B companies reside in state A, state A policyholders are less likely to escape bearing their fair share of the cost of a life company insolvency despite the fact that the guaranty fund of a single state initially assumes the full burden of the insolvency.¹³¹

In short, the surprising result of not including a tax offset provision within a life guaranty fund is to reduce the tax loss of one state while simultaneously achieving the goal of guaranty funds: spreading the cost of an insolvency among all similar policyholders.¹³²

AN ALTERNATIVE REASON TO REJECT TAX OFFSETS

Although insurance companies will ultimately pass the cost of insolvency assessments on to their policyholders, it should be noted that because of the threat of guaranty fund assessments each insurance company initially has an immediate interest in the well-being of all other insurance companies. A similar concern with the solvency of all other members of the insurance industry does not exist when the cost of an insolvency is only borne by the policyholders of an insolvent company or when the cost of an insolvency is shifted onto a state's taxpayers through a tax offset provision.

Allegations that the regulators of a state will be more vigilant if a tax offset provision is enacted seem unsound.¹³³ Regulators, as political creatures, are probably much more responsive to individual losses than they are to impersonal losses suffered by the state treasury. The uncompensated insureds of an insolvent insurer have a specific issue with which to challenge the compe-

131. The NAIC Model Life Bill contemplates assessing member companies on the basis of both the amount of business they write in each state and the premium volume of the insolvent insurer in each state. Model Life Bill § 9 (8), Comment, *supra* note 36, at 168.

132. The spreading will not be perfect by any means. With regard to any particular non-domiciliary state, it is unlikely that all companies doing business in the non-domiciliary state will also be members of the guaranty fund in the domiciliary state. It is also unlikely that the policyholders of solvent state B companies will be distributed in exactly the same manner that the policyholders of the insurer were. Despite such imperfections, it appears far more reasonable and equitable to spread the cost of an insolvency among the policyholders of all companies doing business in the domiciliary state than to have the cost borne solely by the taxpayers of the domiciliary state.

133. Krogh, *INSURER POSTINSOLVENCY GUARANTY FUNDS* 54, *supra* note 48.

tence and tenure of a regulator in the media or by other means; it is unlikely that the effect on state revenues of a tax offset provision would engender a similar regulatory response. Nevertheless, the sensitivity of regulators to public outcry has not prevented insurance company insolvencies.

The omission of a tax offset provision from guaranty fund legislation offers a much more promising means of encouraging regulatory action against insolvencies. Insurance companies are by far the greatest source of expertise regarding the solvency and management of other insurance companies. Moreover, the transmission and evaluation of information regarding other insurers is made easier by the well-organized nature of the insurance industry. Not only are there five active company trade associations,¹³⁴ but the property-casualty industry has also established a national clearing house for information on guaranty funds.¹³⁵ In addition, the communication of information about the financial condition of other insurers is already statutorily protected under the Model Guaranty Fund Laws. Perhaps most importantly, it is the insurance industry rather than policyholders which often has the greatest influence on regulators.¹³⁶ Thus, it must be concluded that better, not worse, solvency regulation will result from the adoption of post-insolvency guaranty funds which do not include tax offset provisions.

THE LIQUIDITY PROBLEM

Recently, the insolvency of the Gateway Insurance Company has made property and casualty insurers more fully aware of their liabilities under guaranty fund laws.¹³⁷ This concern was prompted by the realization that a guaranty fund is usually obligated for the total amount of the claims of the policyholders of the insolvent insurer, not just the difference between the claims

134. The American Insurance Association (New York), the American Mutual Insurance Alliance (Chicago), and the National Association of Independent Insurers (Des Plaines, Illinois) represent a substantial portion of the companies selling property and casualty insurance. The Health Insurance Association of America (Chicago) represents health and disability insurers and the American Life Insurance Association (Washington D.C.) represents life insurers.

135. See discussion in note 33, *supra*.

136. K. ORREN, *CORPORATE POWER & SOCIAL CHANGE* 41-48 (1974).

137. See, e.g., Korsan, *supra* note 34, at 8.

and the assets of the insolvent insurer.¹³⁸ This of course was the intent of the original legislation: to shift the full cost of insolvency, including delay, from the innocent "insureds" of the insolvent company to a larger group, the policyholders of solvent companies.¹³⁹ However, because the law makes property and casualty insurance companies subject to initial assessments which are much larger than any ultimate deficiency, the insurance industry has been seeking ways to minimize the assessments which companies must actually pay.

Among the proposals submitted for consideration are: "quick take" provisions; priority in liquidation provisions; policyholder security deposits accounts; tax offsets for assessments; the creation of special insolvency reserves; and special deposit assessments. All these proposals are designed to limit the amount of assessments which will be made upon the members of a guaranty fund if a company becomes insolvent. This objective is not unreasonable as long as the protection afforded policyholders is not diminished. However, it appears that at least some of these proposals militate against the protection of the policyholder in the absence of complete guaranty fund coverage.

For example, the Illinois guaranty fund is assigned the rights of any person receiving a recovery from the fund.¹⁴⁰ Such assigned claims have the same priority in liquidation as the covered claims of the individuals would have had.¹⁴¹ As a result in states which have deductible provisions, or where policyholders have claims which are in excess of the guaranty fund ceiling, the guaranty fund and the "insured" policyholders who have not been made whole because of the gaps in guaranty fund coverage will be competing at the same level of priority in liquidation for whatever assets remain after the liquidator's expenses and higher priority items are paid.¹⁴²

It is likely that the guaranty fund, because it has been assigned

138. See ILL. REV. STAT. ch. 73, § 1065.84-3 (1973); Model Casualty Bill § 5 (3), *supra* note 5, at 254.

139. See WIS. STAT. ANN. § 646.01, Comment (Special Supp., 1975).

140. ILL. REV. STAT. ch. 73, § 1065.95 (1973).

141. *Id.* § 1065.92.

142. *But see* NEB. REV. STAT. § 44-2410 (4) (Supp., 1972), which deems the payment of covered claims to be expenses of the liquidator.

the rights to the covered claims it has paid, will present a total claim in liquidation substantially larger than the total of the claims of policyholders or third parties whose claims in whole or in part were not covered by the guaranty fund. Claims in liquidation in Illinois generally share on a dollar for dollar basis.¹⁴³ Hence, the bulk of any recovery which occurs in liquidation will not go to those who have suffered uncompensated injuries because of gaps in guaranty fund coverage. Instead, the remaining assets will for the most part be used to pay the claims assigned to the guaranty fund and thereby reduce the net assessments levied upon solvent insurance companies.¹⁴⁴ Such a result is undesirable. Those individual policyholders who have uncompensated claims should receive priority in liquidation over guaranty fund claims if the guaranty fund has been structured to preclude complete recovery of losses. Of course, it should be emphasized that the use of priority provisions in liquidation is not necessary to protect policyholders if complete guaranty fund coverage is provided within the context of a guaranty fund law. Priority provisions may nevertheless be desirable in liquidation to facilitate rescue operations by the liquidator or the guaranty fund,¹⁴⁵ or to distinguish guaranty fund claims from those of other creditors.

143. *People v. Marquette Nat'l Fire Ins. Co.*, 267 Ill.App. 478 (1st Dist. 1932).

144. Because most policyholder claims except for the deductible will be assigned to the guaranty fund, an overwhelming portion of the "policyholder" claims presented in liquidation will really be the claims of solvent insurers. Thus, in dividing whatever assets remain in liquidation, policyholders who have suffered because of gaps in guaranty fund coverage are unlikely to be fully compensated. *Cf.* 1973 WIS. INS. DEP'T, SPECIAL DEPUTY COMMISSIONER'S REPORT ON MARKET MENS MUTUAL INS. CO. 135-36, where it is stated:

From the figures developed it is apparent that the elimination of the small claims would have an insignificant impact on the amounts realized by those having larger claims. From the administrative point of view, the processing of the small claims would have to be done regardless of whether they are to be denied ultimately.

The debilitating effects of disproportionately large "policyholder" claims presented by the guaranty fund on real policyholder claims is magnified when the guaranty fund is also given priority in liquidation. See S.B. 1108, 79th Ill. Gen. Assembly (1975) (Introduced April 11, 1975); and, NEB. REV. STAT. § 44-2410 (1973). Although guaranty fund expenses and claims may deserve some priority in liquidation, they should be subordinated to the claims of policyholders or third parties who have actually suffered as a result of an insolvency.

145. If the guaranty fund has a specified priority in liquidation, its efforts to reinsure or otherwise mitigate losses should be less subject to third party challenge.

However, they should only be adopted in conjunction with provisions eliminating deductibles and ceilings for loss claims.

In addition to suggesting that guaranty funds receive a priority in the distribution of assets,¹⁴⁶ several industry spokesmen have advocated various other means by which liquidity problems associated with property-casualty guaranty funds can be minimized. These proposals sometimes involve suggestions for a pre-funded insolvency fund.¹⁴⁷ Pre-funding has been advocated because it ensures that even those companies which become insolvent will have made a contribution to the fund. More importantly, it is suggested that pre-funding will minimize the disruptive effects associated with post-insolvency assessments. However, neither of these arguments is forceful. As has been previously mentioned, properly circumscribed deductibles on unearned premiums can serve as an adequate substitute for pre-funding for purposes of assessing policyholders of the insolvent insurance company for the cost of guaranty fund protection.¹⁴⁸ It also appears that the assessment provisions of guaranty fund statutes can be modified to minimize the disruptive effects of post-insolvency assessments.¹⁴⁹ Moreover, traditionally the insurance industry has opposed pre-funded guaranty funds for a very practical reason: the ravenous appetite of state legislatures for revenue has often resulted in the diversion of guaranty fund monies for other purposes.¹⁵⁰

In response to this problem two modified pre-funding mecha-

146. See Statement of Kenneth Nails on behalf of the AMIA to the NAIC Subcommittee on Guaranty Funds, 2 *Proceedings of the NAIC* (1975).

147. See, e.g., Korsan, *supra* note 34, at 8.

148. See text accompanying notes 59-62 *supra*.

149. Those advocating pre-funding believe it is better to impose a yearly predictable charge rather than to be intermittently subject to a charge of 1% (Illinois) or 2% (NAIC Model). ILL. REV. STAT. ch. 73, § 1065.87-6 (1973); Model Casualty Bill § 8 (1)(c), *supra* note 5, at 256. It is the authors' opinion that the sources of revenue for assessments need not be as narrow as at present. While it may be important that the ultimate cost of an insolvency be internalized to the appropriate lines of insurance, this does not preclude other companies or segments of the industry from making loans to the guaranty fund so that assessments will not create a severe liquidity crisis in a particular company or line of business. Compare Model Life Bill § 9(4), *supra* note 36, at 167 which permits deferral of assessments, with the relatively limited deferral provisions of Model Casualty Bill § 8(1)(c), *supra* note 5, at 256. In addition, pre-funding may constitute only a temporary advantage. See Harrison, *supra* note 34, at 522.

150. See NCIGF Letter, June 25, 1975, at 4.

nisms have been suggested. One is the creation of an autonomous national guaranty fund corporation.¹⁵¹ The primary attraction of this proposal is that it would place pre-insolvency assessments outside the grasp of state legislatures. However, because such a proposal might require the corporation to obtain a national charter, the states, and insurance companies which advocate continued regulation by the several states, would be put in the somewhat anomalous position of requesting federal intervention to enhance state regulation.

As an alternative, the creation of special insolvency reserves has been suggested. Although the Accounting Principles Board has eliminated the use of catastrophic reserves,¹⁵² it is felt that the creation of special surplus insolvency funds remains a possibility. Such a fund is already required in Ohio.¹⁵³ However, such a fund remains in the complete control of a company and requires only a bookkeeping entry for its creation. There is no guarantee that bona fide assets will actually underlay the surplus account.¹⁵⁴ For these reasons, the Ohio provision appears to be an illusory means of pre-funding.

A much more promising proposal is the Policyholder Security Deposit Account advocated by the State Farm Insurance Company.¹⁵⁵ Although the label is somewhat of a misnomer because the proposal does not provide complete insolvency protection to policyholders and is instead primarily intended to minimize the liability of the guaranty fund by creating a pool of assets which should be available upon an insolvency, the proposal has merit.

The Policyholder Security Deposit Account is established with

151. For a detailed description of this proposal, see 2 *Proceedings of the NAIC* 685-90 (1969).

152. The National Underwriter (Property-Casualty ed., April 18, 1975) at 1, col. 3.

153. OHIO REV. CODE ANN. § 3955.11 (Page 1971).

154. Cf., D. OLSON, *INSOLVENCIES AMONG AUTOMOBILE INSURERS*, *supra* note 2, at 74-77.

155. 2 *Proceedings of the NAIC* (1975). State Farm has advocated this proposal for several years. See 1 *Proceedings of the NAIC* 293 (1970); and, 2 *Proceedings of the NAIC* 319-35 (1971). State Farm would not support guaranty fund legislation in Illinois that did not include a provision for a Policyholder Security Deposit Account. The guaranty fund legislation enacted in Illinois was amended to include such a provision. ILL. REV. STAT. ch. 73, §§ 767.9, 767.16 (1973). Also see the cogent speech of Thomas C. Morrill, Vice President, State Farm Mutual Automobile Insurance Company on Property-Liability Insurers and Guaranty Funds before the College of Insurance, 2 *Proceedings of the NAIC* (1975).

an independent custodian. The amount of marketable securities deposited with the custodian must be no less than seventy-five percent of the gross premiums written for the prior year.¹⁵⁶ In order to minimize the expense of maintaining custodial accounts, the custodian's duties are deemed to not be those of a trustee. The insurance company retains complete authority to transfer assets into and out of the account and receive earnings and dividends on the assets in the account.¹⁵⁷ The responsibility for determining that the assets placed with the custodian comply with the law falls on the Director of Insurance.¹⁵⁸ Nevertheless, the State Farm proposal is far superior to other proposals because it creates a pool of assets before an insolvency is imminent and segregates these assets from the company's regular assets. Moreover, because the Department of Insurance is provided with monthly reports on security transactions within the account, monitoring is facilitated.

Alternative provisions already existing in other state laws are not as effective. For example, the Texas Asset Protection Act¹⁵⁹ requires every insurer to maintain unencumbered assets equal to its reserve liabilities. While the Texas Act does make any transfer in violation of this provision subject to the superior lien of "claimants,"¹⁶⁰ no other means of policing this provision is provided. Moreover, the section does not preclude the manipulation of reserve liabilities.¹⁶¹

A related Kansas statute permits the Insurance Commissioner to require deposits to be made equal to reserves or premiums on Kansas insurance business, after a hearing and a determination

156. The most recent State Farm proposal suggests that the account contain the greater of: (a) the sum of reserves for losses due and unpaid; reserves for losses incurred but unreported; reserves for loss adjustment expense and reserves for unearned premiums; or (b) 75% of gross premiums written for the prior year. 2 *Proceedings of the NAIC* (1975). Because reserves are subject to manipulation the requirement that 75% of gross premiums be deposited in marketable securities is the key provision. *Cf.*, D. OLSON, *INSOLVENCIES AMONG AUTOMOBILE INSURERS*, *supra* note 2, at 110-16.

157. ILL. REV. STAT. ch. 73, § 767.14 (1973).

158. *Id.* at § 767.12. The latest proposal by State Farm requires monthly reports of transactions in the account to be sent to the commissioner of insurance in addition to yearly examinations. 2 *Proceedings of the NAIC* (1975).

159. TEX. INS. CODE ANN. art. 21.39-A, § 5 (Supp., 1975).

160. *Id.*

161. *See* D. OLSON, *INSOLVENCIES AMONG AUTOMOBILE INSURERS*, *supra* note 2, at 74-77.

that the continued operation of a company may be hazardous to Kansas policyholders.¹⁶² This provision is faulty because it is only applicable after an insurer is in financial difficulties; it is not a preventive remedy. Therefore, the State Farm proposal appears to be the most reasonable proposal submitted by the insurance industry for minimizing the cost of an insolvency which will be shifted onto the members of a guaranty fund.¹⁶³

BLUE CROSS/BLUE SHIELD

Although Blue Cross and Blue Shield¹⁶⁴ sell a substantial portion of the health insurance in the United States,¹⁶⁵ these organizations were not included in the NAIC Model Life and Health Insurance Guaranty Association Act.¹⁶⁶ This omission is inexcusable.

Despite the fact that well-reasoned arguments have been made for not including Blue Cross within the framework of a guaranty fund,¹⁶⁷ the fundamental fact remains that a substantial number of persons rely on the health insurance provided by Blue Cross. These persons deserve no less protection than other insureds. The counter-argument has been made that Blue Cross benefits are guaranteed by the contracts negotiated between the providers of

162. KAN. STAT. ANN. § 40-222b (1972).

163. Small companies may object to the cap of \$40,000,000 on the size of the Policyholder Security Deposit Account suggested by State Farm. However, it can be supported on at least two grounds; first, insolvencies have historically occurred most frequently among small companies; and second, small companies may be subject to more risk because they insure smaller numbers of persons and hence their results may display a wider degree of variation. *Cf.*, D. OLSON, *INSOLVENCIES AMONG AUTOMOBILE INSURERS*, *supra* note 2, at 36-37.

164. Hereinafter referred to as Blue Cross unless otherwise specified.

165. It is estimated that about 35% of the civilian population under 65 has coverage with Blue Cross. S. LAW, *BLUE CROSS WHAT WENT WRONG?* 11 (1974).

166. The Industry Advisory Committee to the Insurance Guaranty Funds (B-3) Subcommittee of the NAIC has proposed that the scope section of the NAIC Model Life and Health Insurance Guaranty Association Act (Model Life Bill) be amended to include a provision that the Act may not apply to Blue Cross. 2 *Proceedings of the NAIC* 391 (1974). As of October 18, 1975, only four states, Maryland, MD. ANN. CODE art. 48A, § 522(1) (1972); New Mexico, N.M. STAT. ANN. § 58-32-3 (Supp., 1975); South Carolina, S.C. CODE ANN. § 37-822(6) (Supp., 1975) (covered as a mutual fund); and Texas, TEX. INS. CODE ANN. art. 21.28-D, § 3(1) (Supp., 1974), provide guaranty fund coverage for Blue Cross contracts.

167. N.Y. Ins. Dep't, *Regulation of Financial Condition of Insurance Companies* 92 (1974).

health services and the plan. Hence, because the providers are contractually obligated to offer services, the subscribers are said to be fully protected.

This argument must be rejected. First, not all the benefits of Blue Cross contracts are offered by parties who have contracted with Blue Cross to provide such services. Second, there is no guarantee that a provider, despite its contractual liability, will not shortchange or even deny benefits to a subscriber of Blue Cross if the solvency issue arises. In such a case the subscriber is in substantially the same position as the "insured" of an insolvent insurer; the expected coverage will not be provided. While it is true that the subscriber could sue the provider for services due, this does not appear to be a reasonable alternative. In addition to the probable disparity between the financial positions of the provider and the subscriber in any lawsuit, an individual in need of health care is in an even more disadvantageous position; it does not appear unreasonable to assume that individuals in ill-health have a very inelastic demand for health care.

Third, the suggestion that a separate Blue Cross guaranty fund be created is questionable,¹⁶⁸ if not fanciful. Most states have only one Blue Cross Plan, eight states have two Blue Cross Plans, and only four states contain more than two Blue Cross Plans within their boundaries.¹⁶⁹ Even in those states with multiple plans, the insolvency of one Blue Cross Plan would probably severely impair the other participating Blue Cross Plans and thereby compound the problem of an insolvency without alleviating the harm suffered by subscribers.

Admittedly, health insurers may be somewhat leery of participating in the guaranty fund with Blue Cross because the capital and reserve requirements applied to Blue Cross may be different. However, the very fact that Blue Cross may operate under insufficient capital and reserve requirements militates against excluding Blue Cross from guaranty fund coverage because the chance of an insolvency may therefore be greater. It seems senseless to exclude from the coverage of a guaranty fund the very persons who may be most in need of guaranty fund coverage.

168. 1 *Proceedings of the NAIC* 279 (1974).

169. *BLUE CROSS AND BLUE SHIELD FACT BOOK* (1974).

Furthermore, two positive benefits may result from including Blue Cross and Blue Shield within a guaranty fund applicable to all accident and health insurance companies. First, health insurers may encourage insurance commissioners to have Blue Cross establish more adequate reserves, a larger surplus, or undertake other solvency strengthening measures. Second, if a health insurance company becomes insolvent, the inclusion of Blue Cross within a health guaranty fund reduces the assessments which will be required of each non-Blue Cross member. Therefore, it is recommended that Blue Cross and Blue Shield be included within any health insurance guaranty fund plan.

CONCLUSION

Although guaranty fund laws offer the best means by which the several states can ensure that persons purchasing insurance actually receive the benefits they purchase, certain imperfections exist both in present property-casualty guaranty funds and proposed life, health and accident guaranty funds. Some of these imperfections are obvious. In those states which have enacted property-casualty guaranty funds, the presence of deductibles and ceilings on coverage is unwarranted. Moreover, guaranty fund legislation must be modified to prevent subrogated insurers from making claims against the insureds of insolvent insurers. Also, in many states guaranty fund coverage has not been extended to life, health and accident insurance policies. It is the authors' conclusion that Illinois and other states should amend their guaranty fund laws to eliminate these gaps in coverage.

However, even more complex problems must be resolved. For instance, tax offset provisions are an unjustified means of financing guaranty funds. The use of tax offsets eliminates the direct incentive property-casualty insurance companies now have to actively assist the insurance commissioner in preventing insolvencies. Concomitantly, tax offset provisions also externalize the cost of an insolvency because the group which benefits the most from insolvency protection, policyholders, will not be directly assessed for the cost of such protection. In addition, the sharp decline in stock portfolio values which was experienced in 1974 indicates that much more attention must be paid to the capitalization requirements of insurance companies and the fi-

nancing of guaranty fund laws. Lastly, and perhaps of greatest importance, legislators and regulators should recognize the close interplay of the liquidation and guaranty fund laws and analyze each amendment to these laws to make sure that the protection of the policyholder is always being adequately secured.