SURPLUS LINES INSURERS AND GUARANTY FUNDS*

*Richard R. Spencer, Jr., Esq.***

I. Introduction[1]

The insurance regulatory climate in New Jersey, at least in recent years, has not been known for its gentle or predictable breezes. Quite to the contrary, insurers and insureds alike have frequently felt the effects of strong and sometimes sudden winds which have emanated from the Commissioner's office,[2] the State Legislature,[3] and the courts.[4] A reader, aware of this somewhat turbulent insurance environment, should not be surprised to

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** Richard R. Spencer Jr. is a partner in the Newark, New Jersey law firm of Stryker, Tams & Dill. His practice is concentrated in the area of insurance law, particularly as it relates to the corporate and regulatory activities of insurance companies and producers. He and his firm serve as legal counsel to the New Jersey Property-Liability Insurance Guaranty Association and its statutory affiliate, the New Jersey Surplus Lines Insurance Guaranty Fund which is the subject of this Article.

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1 The views expressed in this paper are the author's own. Although he believes them to reflect views also held by others who have played a role in the development and administration of the New Jersey Surplus Lines Insurance Guaranty Fund, they should not be attributed to any particular representative of the Guaranty Fund, its Board of Directors, or the New Jersey Department of Insurance.

2 On September 16, 1985, New Jersey's Commissioner of Insurance adopted on an emergency basis, new rules governing the cancellation and nonrenewal of property and casualty/liability insurance protection which severely restricted the ability of insurers to terminate or modify most lines of property and casualty/liability insurance coverage. *See* 17 N.J. Admin. Reg. 2460(a) (1985) (codified as amended at N.J. ADMIN. CODE tit. 11, § 1-20 (1985)).

3 *See, e.g.*, the New Jersey Commercial Insurance Deregulation Act of 1982 (N.J. STAT. ANN. § 17:29AA-1 (West 1985)).

4 For instance, in a recent trial court opinion it has been held that the pollution exclusion provisions of a general liability policy are inapplicable to claims arising from the dumping of liquid waste at a municipal landfill. *See* Jackson Twp. Mun.

learn that it was New Jersey, in 1984, which enacted the first and, as of this writing, the only statutory guaranty fund for surplus lines insolvencies.[5] The surprising aspect is not the enactment itself, but rather, the fact that it followed on the heels of a series of legislative and judicial rejections to the grafting of the concept on similar legislation, passed in 1974, for admitted insurer insolvencies.[6]

The following article will: (i) chronicle the events which formed the backdrop for passage of the New Jersey Surplus Lines Insurance Guaranty Fund Act ("Guaranty Fund Act"),[7] (ii) analyze the fundamental structure of the Act itself, (iii) discuss similarities and dissimilarities to New Jersey's earlier Property-Liability Insurance Guaranty Association Act ("Guaranty Association Act"),[8] (iv) evaluate the early days of the Guaranty Fund's administration and, finally, (v) provide a guarded but probably realistic prognosis concerning the wisdom and effectiveness of any future attempts in other jurisdictions to replicate the New Jersey legislation.

II. Terminology

It will undoubtedly aid an understanding of the evolution and operation of the New Jersey Guaranty Fund Act if several key operative insurance terms are first defined.

Util. Auth. v. Hartford Acc. & Indem. Co., 186 N.J. Super. 156, 451 A.2d 990 (Law Div. 1982).

[5] The New Jersey Surplus Lines Guaranty Fund Act, 1984 N.J. Laws 101, *as amended by* 1984 N.J. Laws 207 (codified at N.J. STAT. ANN. §§ 17:22-6.70 to -6.83 (West 1985)). A copy of the complete text of the Guaranty Fund Act appears as Appendix A at the end of this article.

[6] *See* New Jersey Property-Liability Insurance Guaranty Association Act, N.J. STAT. ANN. § 17:30A-1 (West 1985). On February 22, 1980, the Act was amended to expressly exclude surplus lines insurers from its coverage. *See* N.J. STAT. ANN. § 17:30A-5(e) and (f) (West Supp. 1985). The amendment constituted the legislature's response to actions in which claimants, seeking benefits pursuant to policies issued by insolvent surplus lines insurers, argued unsuccessfully that their claims fell within the protection of New Jersey's Property-Liability Insurance Guaranty Association Act. *See* Railroad Roofing & Bld'g Supply Co. v. Financial Fire & Cas. Co., 171 N.J. Super. 375, 409 A.2d 300 (App. Div. 1979), *rev'd*, 85 N.J. 384, 427 A.2d 66 (1981).

[7] *See supra* note 5.

[8] *See supra* note 6.

A. *Regulatory Status Of Insurers*

There are several regulatory categories into which any given insurer might be placed. In some instances, the category will apply to the insurer itself, whereas in others it will apply to the type or line of coverage written by that insurer.

1. *Authorized Insurer*: The term "authorized" is typically used to describe an insurer which is domiciled, i.e., incorporated, in a given jurisdiction. For instance, Company X, if incorporated in New Jersey, is said to be a domestic New Jersey company which is domiciled there and "authorized" to conduct the business of insurance in the State.[9]

2. *Admitted Insurer*: An insurance company which is not incorporated or domiciled in New Jersey may nonetheless obtain a license to transact the business of insurance in New Jersey as a foreign admitted insurer. The term "foreign" as used in this context typically refers to any U.S. jurisdiction other than the state of domicile, although it may refer to an overseas jurisdiction.[10] For example, Company Y, incorporated in the Commonwealth of Massachusetts and, therefore, conducting business as an authorized insurer in that state, may also be able to obtain a New Jersey license by being "admitted" to New Jersey upon demonstrating its ability to satisfy the various statutory requirements set forth in New Jersey's Insurance Code.[11] There are few, if any, meaningful distinctions between a domestic authorized insurer and a foreign admitted insurer. Most importantly, the two are generally treated in precisely the same fashion from the

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9 *See* N.J. STAT. ANN. §§ 17:17-4 (Certificate of incorporation), 17:17-5 (Approval by attorney general; recording and filing certificate) and 17:17-10 (Certificate of authority) (West 1985).

10 Generally, an insurer organized under the laws of a foreign country is denominated an "alien" insurer. However, alien insurers may be considered as foreign insurers under laws governing the transaction of business within a jurisdiction. *See, e.g.*, N.J. STAT. ANN. § 17:32-1 (West 1985) (Transaction of business by foreign companies). Some states may place less emphasis on this distinction than New Jersey.

11 *See* N.J. STAT. ANN. §§ 17:32-1 to -22 (West 1985). Prerequisites to admission appear in N.J. STAT. ANN. § 17:32-2. As will be discussed later in this article, the failure of a panel of New Jersey's intermediate appellate court to recognize the technical meaning accorded by insurance regulatory law to the term "admitted" led to the erroneous decision that claims against insolvent surplus lines insurers were included within the scope of the Guaranty Association Act. *See* Railroad Roofing, 171 N.J. Super. at 380-388, 409 A.2d at 302-306.

standpoint of those features of state insurance regulation which have the maintenance of insurer solvency as their primary objective.

3. *Nonadmitted Insurer*: A definition of this third category is pivotal to an understanding of the operation of, and alleged need for, guaranty fund protection for surplus lines insolvencies. The term "nonadmitted" does not pertain so much to the insurer's domicile as it does to the regulatory status accorded from jurisdiction to jurisdiction to the various lines of coverage issued by the insurer. To illustrate, Company Z may be authorized as a domestic carrier in Illinois and admitted as a foreign insurer in California and a number of other U.S. jurisdictions. It may write lines of coverage A, B, and C in all such jurisdictions as a fully-licensed, fully-regulated insurer. However, company Z may elect to do business in certain other jurisdictions, New Jersey for example, on a nonadmitted basis. The Company in that instance would be able to accept New Jersey risks only through export of those risks by a specially licensed New Jersey surplus lines broker. Thus, the company would be able to write business directly in Illinois, Massachusetts and other jurisdictions in which it was willing to submit to the full spectrum of local insurance regulation. In states such as New Jersey where it had *not* been admitted, i.e., where it was "nonadmitted", the company could accept only those risks which were placed with it pursuant to the requirements of the state's surplus lines law.[12]

4. *Surplus Lines Insurer*: This phrase, although widely used and commonly accepted, is somewhat of a misnomer since it is the particular line of coverage which either is or is not a "surplus" line in a given jurisdiction and not the company itself. Surplus lines refer to those coverages which are available for "export" through specially licensed brokers to companies which will accept them on a surplus lines basis. At the risk of oversimplification, it may be said that such lines typically encompass the specialty coverages which the regular or "admitted" market is unprepared or unable to accept.

B. *Statutory Funds For Insurance Insolvencies*

The preceding discussion reveals that two broad categories

[12] *See* N.J. STAT. ANN. §§ 17:22-6.40 to -6.65 (West 1985).

of regulatory classifications must be kept in mind. The first is composed of those authorized domestic and admitted foreign insurance companies which, in a given jurisdiction, are said to be "licensed" there. The vast majority of such companies are included within the scope of the guaranty association acts which have been enacted in all states over the past fifteen years. New Jersey has had such legislation on its books, applicable to authorized and admitted property/casualty insurers, since 1974.[13] The second broad category is that of the nonadmitted insurer. Although periodic efforts have been made over the years, including an almost successful one in New Jersey, to force-fit nonadmitted company insolvencies into the existing statutory apparatus designed for admitted insurers, all such efforts have ultimately failed. The practical result has been that insureds holding surplus lines policies, as well as third-party claimants having claims against such insureds, have been left without the type of statutory safety net which has universally been made available to insureds and third-party claimants of insolvent admitted insurers.

Why, it is logical to ask, was the surplus lines community not included within the sweep of original guaranty fund enactments or, at least, provided some sort of separate but perhaps mirror-image legislative relief? The question defies a simple or single answer. It is probably safe to conclude that some regulators and many insurers, particularly those national companies which typically conduct their business on a fully admitted basis in most or all jurisdictions, felt that it would be unfair to accord the same statutory benefits to both the admitted and nonadmitted sectors of the industry. It was thought that such benefits should not be available, upon financial demise, to those surplus lines insurers which, for whatever valid or nefarious reasons, made an intentional corporate decision *not* to submit to the full panoply of regulatory controls found in most state insurance codes. Policyholders of companies which were not willing to "play by the rules of the game", so the argument concluded, ought not to be afforded the protection which such rules might make available to losers. So-called "well-managed" and financially sound companies did not want managers of less responsible or reputable companies to be able to market their products with the same

[13] *Id.*

FDIC-type backing available to the admitted market. This view, held by the admitted segment of the industry, was reinforced by the allegation of a number of industry representatives that non-admitted carriers were not effectively regulated for solvency, and were, in an alarming number of instances, insolvencies waiting to happen. Whether or not there actually is a greater incidence of company failures among the ranks of surplus lines insurers is a matter about which room for debate likely exists.

Another reason for the disparity, probably more curious than compelling in the eyes of judges and legislators, was that a significant number of industrial purchasers of surplus lines insurance had clearly announced that they were uninterested either in being involuntarily swept within the protections of surplus lines guaranty funds or in shouldering its costs. Larger purchasers of commercial insurance which have professional risk managers on their staffs frequently consider themselves to have an adequate level of sophistication to detect and avoid companies which may be financially marginal and, therefore, candidates for some form of insolvency proceeding.[14] Additionally, because of the significant level of premium expense already confronting them, such purchasers are particularly sensitive to the cost increases which would result from a guaranty fund surcharge.

For whatever reason or combination of reasons, surplus lines insurers, their insureds, and their claimants were obliged to sit on the sidelines while guaranty fund statutes for admitted companies were enacted around the country. Although some periodically advocated the establishment of a separately structured and separately funded statutory guaranty scheme for surplus lines companies,[15] none was established. That is, until 1984 in New Jersey.

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[14] Such insolvency proceedings may result in an order of rehabilitation, liquidation or conservation. *See, e.g.*, N.J. STAT. ANN. §§ 17:30C-6, 17:30C-8 and 17:30C-11 (West 1985).

[15] Descriptions of such efforts appear in Pugh, *Surplus Lines and Insolvency Funds* (for the National Association of Independant Insurers) (December 1981) at 16-17 and in Johnson, *Surplus Lines Guaranty Funds — New Jersey and Beyond*, 20 FORUM 773-74 (1985).

III. The New Jersey Legislation — A Brief Look Back

A. *The NAIC Model Act*

During the late 1960's, various economic and marketplace conditions led to considerable interest in, and concern over, the financial soundness of certain members within the property/casualty insurance industry. That focus did not escape the attention of the NAIC, numerous individual insurance commissioners, and, to the dismay of more than a few industry representatives, certain members of the United States Congress. It seemed evident that, unless state regulatory efforts to address the insolvency issue were undertaken, federal legislation would be forthcoming. The end product of this scrutiny and threat of federal involvement was a Model Act prepared under the auspices of the NAIC,[16] the design and purpose of which was to ameliorate many (although certainly not all) of the economic burdens visited upon policyholders and claimants of insolvent property/casualty insurers.

The structural underpinnings of the Model Act are uncomplicated. A private nonprofit association is provided, governed by a Board of Directors comprised of representatives of those companies which are obliged to maintain membership in the guaranty association as a condition of continued licensure.[17] The Model Act contemplated a *post* assessment funding mechanism[18] which, as its name implies, defers collection of funds necessary to pay claims until *after* an insolvency occurs and it is possible to measure with some certainty the aggregate value of claims attributable to the insolvent insurer in that state. The Model Act provides that such funds will be generated, in the first instance, by an assessment on member companies based upon a formula geared to the volume of net direct premiums written by the company.[19] Those companies, in turn, would theoretically recoup the assessments they advance through future rate increase applications

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16 The Model Act appears at 253 National Association of Insurance Commissioners, 1970 *Proceedings*.

17 Model Act § 6.

18 In contrast, New York's statute, enacted in 1947, utilizes preinsolvency assessments, thereby creating a standby statutory fund. N.Y. Insurance Law § 333 (McKinney 1966).

19 Model Act § 8(1)(c).

filed with the local insurance regulator.[20] The drafters of the Model Act, supportive of the notion that policyholders of nonadmitted companies should likewise be "nonadmitted" to guaranty fund protection, limited the Act's applicability to licensed, i.e., admitted, companies.

B. *The New Jersey Guaranty Association Act*

Once the NAIC released its post assessment Model Act in 1969, it quickly became the standard for local legislation introduced in numerous state legislatures.[21] In 1974, the New Jersey Legislature, confronted with the impending insolvency of Professional Insurance Company of New York, adopted, with certain variations, the NAIC model form.[22] The New Jersey Act, too, was drafted with the view firmly in mind that it would be restricted to admitted insurers. One obvious attempt to enforce this view, later to be challenged in court, was a drafting modification to the Model Act's definition of "insolvent insurer." The Model Act provided the following definition:

> "Insolvent Insurer" means (a) an insurer authorized to transact insurance in this state either at the time the policy was issued or when the insured event occurred and (b) determined to be insolvent by a court of competent jurisdiction.[23]

The New Jersey drafters defined "insolvent insurer" as follows:

> "Insolvent insurer" means (1) an insurer *admitted or authorized* to transact the business of insurance in this State either at the time the policy was issued or when the insured event occurred,

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[20] Many companies viewed the assessment/recoupment approach as a tardy if not altogether illusory means of replenishing the dollars paid out by them. Recognition of this fact has resulted in the enactment of policy surcharge funding mechanisms in both New Jersey and California. Other states have enacted premium tax offsets.

[21] At present, all 50 states, Puerto Rico, and the District of Columbia have enacted guaranty fund acts. The statutes of California, Wisconsin and New York predate the Model Act. However, California's and Wisconsin's statutes resemble the NAIC model. Cooperation between the states has been aided by the National Committee on Insurance Guaranty Funds, an industry organization, which provides a national forum for discussion and exchange of information regarding the implementation of guaranty fund laws, and offers information on and assistance in the operation and administration of guaranty funds.

[22] New Jersey Property-Liability Insurance Guaranty Association Act, 1974 N.J. Laws 17 *as amended by* 1979 N.J. Laws 448 and 1981 N.J. Laws 201 (codified at N.J. Stat. Ann. §§ 17:30A-1 to -20 (West 1985)).

[23] Model Act § 5(4).

> and (2) who is determined to be insolvent by a court of competent jurisdiction.[24]

This definition was further modified in 1981 to show, with exceptional clarity, the Legislature's conviction that surplus lines insurers were not included. The further modification read as follows:

> "Insolvent insurer" does not include any unauthorized or nonadmitted insurer whether or not deemed eligible for surplus lines pursuant to [The New Jersey Surplus Lines Law] P.L.1960, c.32 (c.17:22-6.37 et seq.).[25]

The construction intended by the Legislature was further reinforced by an amendment to the definition of "member insurer" set forth in the Act as follows:

> "Member insurer" does not include any unauthorized or nonadmitted insurer whether or not deemed eligible for surplus lines pursuant to [The New Jersey Surplus Lines Law] P.L.1960, c.32 (c.17:22-6.37 et seq.).[26]

One rather profound departure from the NAIC version was New Jersey's funding mechanism. Rather than adopting an assessment/rate recoupment procedure, the New Jersey Legislature installed an assessment/policy surcharge device[27] which, both in theory and fact, allows for faster recoupment. As will be seen, this feature was repeated ten years later when the Surplus Lines Guaranty Fund Act became law.[28]

Since 1974, the New Jersey Guaranty Association has been activated with respect to twenty-four insolvencies of admitted insurers, only one of which was a domestic company. In the course of its payment of claims and related expenses arising under those insolvencies, the Guaranty Association has expended in excess of $70 million. Although several nonadmitted surplus lines insurers became insolvent during this period, the Board of the Guaranty Association, believing their action to be consistent with the scope of their statutory authority, adamantly declined to respond to claims arising out of those insolvencies.[29]

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24 1974 N.J. Laws 17 § 5(e).

25 1981 N.J. Laws 201 § 5(e).

26 1981 N.J. Laws 201 § 5(f).

27 N.J. STAT. ANN § 17:30A-16 (West 1985).

28 N.J. STAT. ANN 17:22-6.75 a.(2) (West 1985).

29 The insolvencies of Financial Fire & Casualty Co., declared in 1975 in Florida, and All-Star Insurance Corporation, declared in 1977 in Wisconsin, were particularly troublesome to New Jersey.

C. *Litigated Challenge To The Exclusion Of Surplus Lines Insurers — The Railroad Roofing Case*

The inevitable challenge of the exclusion of surplus lines insurers from the New Jersey Guaranty Association Act occurred in 1976 with the filing of test cases by injured claimants in several New Jersey courts. The challenges, unsuccessful at the trial level, met with success in New Jersey's Appellate Division which held in *Railroad Roofing & Bld'g Supply Co. v. Financial Fire & Cas. Co.* that eligible surplus lines insurers came within the scope of the Guaranty Association Act.[30] In reaching its conclusion, the court focused primarily on the liberal construction mandate contained in the New Jersey Guaranty Association Act,[31] while ignoring the technical importance of the various industry-related terms utilized by the Legislature in the definitional sections of the Act.[32] The New Jersey Supreme Court accepted the case on the Guaranty Association's petition for certification and granted the applications of each of the three major property/casualty insurance trade associations to submit amicus support.[33] In March 1981, five years after the commencement of litigation, the Supreme Court reversed the decision of the Appellate Division thereby restoring the trial court's determination and establishing the legitimacy of the exclusion of surplus lines claims from "covered claim" status.[34] The Supreme Court decision rapidly became important precedent to developing case law dealing with the scope

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30 171 N.J. Super. 375, 409 A.2d 300 (App. Div. 1979).

31 The legislative purpose of the Act was stated as follows:

> The purpose of this act is to provide a mechanism for the payment of covered claims under certain insurance policies, to avoid excessive delay in payment, to avoid financial loss to claimants or policyholders because of the insolvency of an insurer, to assist in the detection and prevention of insurer insolvencies, and to provide an association to assess the cost of such protection among insurers.

N.J. STAT. ANN. § 17:30A-2(a) (West 1985). Section 4 of the Guaranty Association Act requires that the foregoing statutory purposes be "liberally construed." *See* N.J. STAT. ANN. § 17:30A-4(a) (West 1985).

32 See text, *supra* at Section II.

33 Alliance of American Insurers, American Insurance Association and the National Association of Independent Insurers. Amicus briefs were also presented on behalf of State Farm Mutual Automobile Insurance Company and Risk and Insurance Management Society, Inc.

34 85 N.J. 384, 427 A.2d 66 (1981).

of guaranty association laws[35] and provided the death-knell to any further serious efforts to engraft surplus lines insolvency protection on existing state insurance guaranty fund statutes.

D. *Proposals For Separate Statutory Remedies*

Due to the court's rejection of the inclusion of surplus lines insurers some separate form of statutory apparatus, or at least a separate revenue-generating mechanism, was now required if any kind of surplus lines insolvency relief were to be made available. Scholarly studies were commissioned,[36] and proposals were discussed informally among insurance department staff personnel and legislators in New Jersey and, in all probability, other jurisdictions.

The socioeconomic dilemma at hand was real. It had frequently been contended that the risk of insolvency was greater among the ranks of surplus lines insurers. The comparatively greater frequency of admitted insurer failures which has been experienced since 1974 may diminish the force of that contention. However, if that greater risk actually exists and could be attributable to the states' inability to adequately regulate surplus lines insurers for solvency, then any statutory safety net could arguably be viewed as providing inappropriate protection. It would take companies "off the hook" and, in effect, reward them for their refusal to seek admission. On the other hand, it was clear that not every policyholder of a surplus lines insurer was a large corporate insured with a salaried risk manager. Even more obvious was the fact that not every third-party claimant could be so categorized. Indeed, many such insureds and claimants bore no features distinguishing them from their counterparts who sought and were given access to claims payments doled out by the national network of guaranty funds created to respond to failures of admitted insurers. This dilemma simmered until 1984 when, by reason of the crisis presented by Ambassador Insurance Com-

35 *See* Osborne v. Edison, 211 N.W.2d 696 (Iowa Sup. Ct. 1973); Adams v. Illinois Ins. Guar. Fund, 41 Ill. Dec. 140, 85 Ill. App.3d 867, 407 N.E.2d 638 (1980).

36 *See, e.g.*, Weese, *A Study of Surplus Lines Insurance and the Insolvency Issue* (for the National Association of Professional Surplus Lines Offices, Ltd.) (May 1981); Pugh *supra* note 15; Weese, *Are Guaranty Funds for Surplus Lines Insurers Really Necessary?*, Risk Management 36 (February 1982).

pany, the luxuries of formal studies and informal dialogue were forced to give way to decisive action.

E. *The Ambassador Insolvency*

Ambassador Insurance Company was domiciled in Vermont. Accordingly, when the need for insolvency proceedings concerning the company became apparent, the Vermont Commissioner assumed primary jurisdiction. On September 4, 1984, the Superior Court of Vermont entered an order which held Ambassador to be insolvent but which did not compel its liquidation.[37] One of many complicating factors presented by the Ambassador situation was the fact that, despite its domicile in Vermont, its principal place of business and a substantial portion of its policyholders were found in New Jersey. From an operational viewpoint, it could be argued that Ambassador really was more a New Jersey company than it was a Vermont company. A difference of views developed between the two states concerning the proper scope and interpretation of their respective versions of the Uniform Liquidation Act. It was not long before the New Jersey Department of Insurance soon found itself embroiled in a litigated dispute in New Jersey with the Vermont Commissioner over the continued custody and control of company assets and statutory deposits.[38]

Further, because Ambassador wrote substantial amounts of high visibility coverage such as liquor law liability, municipal government, and product liability insurance, substantial public and political interest arose. It soon became clear that if a liquidation of Ambassador were to occur without the protection of some statutory analogue to New Jersey's Guaranty Association Act,

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37 As of this writing, an appeal from the order of insolvency entered with respect to Ambassador is still pending before the Vermont Supreme Court.

38 In Murphy v. Ambassador Ins. Co., 195 N.J. Super. 274, 478 A.2d 1243 (Ch. Div. 1984), a New Jersey court of equity rejected the attempt of New Jersey's Commissioner of Insurance, who had been designated as an ancillary receiver of Ambassador, to conserve Ambassador's New Jersey assets, to disburse those assets in accordance with the Vermont Commissioner's directions and to assist Vermont's receiver in rehabilitating or conserving Ambassador's assets in the absence of instructions from the domicilary state. The court concluded that the Vermont receiver was not only entitled to Ambassador's New Jersey assets but also was entitled to the outstanding balances being held by Ambassador's New Jersey agents and brokers.

that fact would, at least in New Jersey, be politically unpalatable and economically undesirable. Unfortunately, there was no NAIC model bill available for use as a blueprint by staff representatives of the New Jersey Department of Insurance or members of the New Jersey Legislature. The result was a necessarily accelerated drafting effort, patterned substantially after the 1974 Guaranty Association Act. It was introduced hurriedly, considered and passed by both houses of the Legislature under emergency conditions, and signed into law on July 27, 1984.[39]

IV. The New Jersey Guaranty Fund Act

Interestingly, the advent of the Guaranty Fund Act was not unlike that of the Guaranty Association Act ten years earlier. Both moved quickly through the legislative process, without generating any extensive formal legislative history and were designed to head off imminent insolvencies at the pass. When the Guaranty Fund Act was signed by Governor Kean, it was, in a functional sense, as though the Guaranty Association had given birth to a statutory offspring. As noted, the Act's structure in many instances mirrored provisions which, for the most part, had proven themselves workable during the period of the Guaranty Association's existence. However, the New Jersey Guaranty Fund Act contained provisions which departed in several substantial respects from those of the Guaranty Association Act.[40]

The following section of this article will highlight some of the important similarities and differences between the two statutes.

A. *Similarities*

The concept of a private, nonprofit, unincorporated legal entity serving to administer statutory relief was maintained.[41] Similarly, mandatory company membership as a condition of eligibility was continued, as was the pivotal definition of "covered claim."[42] Also retained were the scope restrictions present in the

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[39] The complete text of the Guaranty Fund Act appears as Appendix A to this article.

[40] A summary of the passage of the Legislature's "cut-and-paste" bill appears in Johnson, *supra* note 15, at 774.

[41] N.J. STAT. ANN. § 17:22-6.73 (West 1985).

[42] N.J. STAT. ANN. §§ 17:22-6.72b and 6.73 (West 1985).

Guaranty Association Act.[43] In order to be eligible for covered claim status, the claim must arise out of direct coverage, not reinsurance.[44] Additionally, the risk must not be covered by those lines of insurance which were specifically carved out of the Act's protection.[45]

B. *Differences*

One of the more noteworthy departures in the new legislation was the absence of a free-standing board of directors. Rather, the Legislature utilized the existing Guaranty Association Board, which was henceforth to function in a dual capacity as the governing body for both the Guaranty Association and its progeny, the Guaranty Fund.[46]

One of the more controversial provisions was the hybrid funding formula contained in the statute. The original version of the Act provided that member surplus lines companies should be assessed in the first year at a rate of 4% of their New Jersey net business.[47] This feature drew immediate hostile reaction and, as will be discussed, was one of the core issues framed in test litigation. The funding mechanism of the Act was subsequently amended to partially eliminate the direct imposition of fees upon member surplus lines companies. Under the amendments, three separate sources of revenue are available: (i) a one-time mandatory $25,000 fee; (ii) a policy premium surcharge of up to 4%; and (iii) a statutory standby loan which, up to a maximum of $10 million, can be drawn by the Surplus Lines Guaranty Fund from the assets administered by the Guaranty Association.[48]

The need for the statutory loan arrangement arises from another substantial difference between the Guaranty Association Act and the Guaranty Fund Act. The former has a fund raising capability which, except for the occurrence of one or more "jumbo" insolvencies or a rapid succession of smaller ones, gives the Guaranty Association access to assets in whatever amounts, and at whatever times, the aggregate value of pending covered

43 N.J. STAT. ANN. §§ 17:22-6.71 and 6.74a.(1)(West 1985).
44 N.J. STAT. ANN. § 17:22-6.71 (West 1985).
45 *See* N.J. STAT. ANN. §§ 17:22-6.71 and 17:22-6.72(b) (West 1985).
46 N.J. STAT. ANN. § 17:22-6.73 (West 1985).
47 1984 N.J. Laws 101 § 6a(2).
48 N.J. STAT. ANN. § 17:22-6.75 (West 1985).

claims dictates. Indeed, subject to the statutory cap on assessments,[49] the Guaranty Association can replenish its treasury through policy surcharges out of a bottomless well. The Guaranty Fund, on the other hand, has a very finite funding capacity.[50] The $25,000 statutory fee, when multiplied by the thirty-three companies which are eligible surplus lines writers in New Jersey, yields a one-time "quick-fix" of only $825,000. As noted, the statutory loan also has a cap which can never exceed $10 million at any one time. Finally, even in times of rising premiums and a heavy concentration of surplus lines business, the 4% policy surcharge has obvious limitations insofar as its ability to produce substantial revenue.[51]

An innovative feature of the Guaranty Fund Act which is not found in either the Model Act or the Guaranty Association Act is the provision giving the New Jersey Commissioner of Insurance authority to adjust the Fund's obligation to make payments for covered claims.[52] Such a provision is essential, since the aggregate income producing capabilities of the Guaranty Fund are, even when measured against projected New Jersey claims for Ambassador alone, woefully inadequate. As a consequence, the New Jersey Commissioner has exercised his statutory adjustment power and, by Departmental Order, has determined that only 40% of the principal amount of any Ambassador covered claim may be paid at present.[53] The resulting lowered claim payments, depending upon one's vantage point, may be viewed in one of two ways. Insureds with first-party claims and third-party claimants obviously may feel frustrated and somehow cheated when the "guarantee" of payment of the full amount of their claims which they mistakenly believed to be provided by the statute is not received. Those persons face, at best, a protracted and, at

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49 N.J. STAT. ANN. § 17:30A-8a.(3) (West 1985). The cap on assessments is fixed at a maximum of 2% of each member insurer's net direct written premiums for the calendar year preceding the assessment. In New Jersey the statutory limit has never been reached.

50 N.J. STAT. ANN. § 17:22-6.75 (West 1985).

51 The 1985 Surplus Lines New Jersey Premium base was approximately $80 million, therefore the amount which can be collected from the 4% surcharge on that base is only $3.2 million.

52 N.J. STAT. ANN. § 17:22-6.74a(1) (West 1985).

53 *See* New Jersey Department of Insurance Order No. A85-109 issued May 29, 1985.

worst, an endless wait for the balance of their claims to be satisfied out of assets available to the Guaranty Fund. On the other hand, a more dispassionate observer can say that, aside from whatever liquidating dividend might be obtainable from the insolvent estate, even a 40% pay-out is 40% more than the claimant would have received had the Guaranty Fund not been established. Regardless of which of these points of view one adopts, the fact remains that the inadequacy of revenues available to the Guaranty Fund is a problem which is acute in terms of dollars and is chronic in terms of duration.

One final difference is worthy of mention. The Guaranty Association Act provides specifically that no unfair competitive market advantage should be obtained by an insurer because of the availability of Guaranty Association protection. Accordingly, any advertising of such protection is statutorily forbidden.[54] Curiously, and to the author's comprehension, inexplicably, the Guaranty Fund Act not only eliminates the prohibition on advertising but comes full circle and specifically requires that a notice of the availability of Guaranty Fund protection be displayed on each policy. Worse yet, advertising the availability of Guaranty Fund protection is specifically and officially permitted.[55]

V. Litigated Challenge To The Inclusion Of Surplus Lines Insurers — The Evanston Case

Just as surplus lines claimants were offended by their initial exclusion from the Guaranty Association Act, so now other representatives of the surplus lines community were offended by the inclusion of such claimants within the scope of statutory relief provided by the Guaranty Fund Act. Ironically, whereas only a few years earlier a substantial, and almost successful, litigated challenge had been mounted in an attempt to include surplus lines insureds and claimants within the reach of statutory guaranty protection,[56] now there was an equally serious, and poten-

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[54] N.J. STAT. ANN. § 17:30A-20 (West 1985).

[55] N.J. STAT. ANN. § 17:22-6.83 (West 1985). Initially, the Act did not require that the statutory notice express the limitation on protection afforded by the Act as the result of the Commissioner's power to adjust the Fund's obligations. Although that defect was corrected, no similar qualification is imposed on insurer advertising.

[56] Railroad Roofing, 171 N.J. Super, 375, 409 A.2d 300 (App. Div. 1979), *rev'd*, 85 N.J. 384, 427 A.2d 66 (1981).

tially successful, litigated challenge aimed at excluding such persons from those benefits. Unlike the earlier test case, however, which consumed a period of six years, justice was swift in the case of *Evanston Insurance Company v. Merin*.[57]

Only thirty-two days had elapsed between the date upon which the Guaranty Fund Act, Assembly Bill No. 2273, was first introduced in the New Jersey Legislature and the date upon which Governor Kean signed the measure into law. It took only an additional seventy-nine days before a broadside constitutional challenge was filed seeking to have the Guaranty Fund Act invalidated. The entire challenge was prepared, heard by the court, and decided by it with a thorough written opinion within slightly more than two months of the filing of the complaint and within four months of the Guaranty Fund's enactment. The *Evanston* test case was commenced as an action in the Federal District Court for the District of New Jersey alleging the infirmity of the Guaranty Fund Act on a number of constitutional grounds.[58]

Simultaneously, a state court action was commenced in the Chancery Division of the Superior Court of New Jersey by other plaintiffs as an abstention-avoidance device. In that action the plaintiffs sought a judicial declaration that the Guaranty Fund Act was inapplicable to the claims being generated by the Ambassador insolvency.[59] The substantive reasons which gave rise to the claim of inapplicability were most interesting. A considerable amount of political and regulatory credit had been sought from the passage of the Guaranty Fund Act, particularly since the Act was widely broadcasted to be a "just in time" cure for the plight of Ambassador claimants. However, the original text of the Act had been drafted in a manner which precluded "covered claim" status to any claim against a company whose insolvency did not predate the enactment of the bill. It turned out that Arizona had been the first jurisdiction out of the gate with any attempt to have Ambassador declared insolvent. That action had occurred some

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57 598 F. Supp. 1290 (D.N.J. 1984).

58 A thorough analysis of the background, litigation strategy, and effect of the *Evanston* litigation, as viewed from the perspective of the plaintiffs and their legal counsel in that action, appears in Johnson, *supra* note 15.

59 Henry Ralph Rokeby — Johnson v. Kean, No. C-3808-84E (Super. Ct. Ch. Div. Mercer Co. 1984).

months earlier, on February 14, 1984.[60] As a consequence, it was contended that this first-in-time declaration, even though by a nondomestic jurisdiction, was the operative event for purposes of construing the new Guaranty Fund Act. The Arizona declaration, so the argument continued, necessarily caused Ambassador to be a pre-Act insolvent and, therefore, beyond the reach of the statute.

A second unexpected impediment to the inclusion of Ambassador within the scope of the Guaranty Fund Act was the fact that the Act defined "insolvent insurer" in a manner which required that the declaration of insolvency occur at a time when the company was listed as an eligible surplus lines insurer in New Jersey. In what was to become a Catch-22 development, the New Jersey Department of Insurance had delisted Ambassador from the State's "white list" of eligible surplus lines insurers several months before the passage of the Guaranty Fund Act as the result of a regulatory recognition of the company's financial woes. Had that action not been taken it might well have brought criticism against the New Jersey Department. However, it was the revocation of the Company's eligible status which prevented Ambassador from being able to meet the Guaranty Fund Act's qualifying criteria.[61]

Notwithstanding the obvious practical importance of the ruling sought from the state court, the Federal constitutional challenge was clearly the main event. The *Evanston* plaintiffs presented vigorous arguments that (a) there was no legislative jurisdiction on which the intended regulation of surplus lines insurers could be predicated; (b) the Act constituted an unlawful delegation of legislative power to the preexisting Guaranty Association; (c) the Act constituted an unlawful impairment of contract to the extent it sought retroactively to impose assessments on surplus lines insurers; and (d) the six percent interest rate imposed on statutory loan proceeds by the Act was confiscatory and resulted in an unlawful taking of property.

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60 *See* Order entered February 14, 1984 by the Superior Court of Arizona, Maricopa County, in proceedings styled State of Arizona v. Ambassador Insurance Co., Inc., Docket No. C505968.

61 Amendments to the Act, approved on December 4, 1984 and made retroactive to July 27, 1984, cured the infirmities just discussed. *See* 1984 N.J. Laws 207 § 2 (codified at N.J. STAT. ANN. § 17:22-6.72b (West Supp. 1985)).

Since the Act, by its terms, was to be effective immediately some prompt, if only temporary, relief was imperative. Once the Act's funding procedures were implemented, obvious complications and possible prejudice would result from any attempt to halt or unravel those procedures at a later date. In recognition of such problems, the Insurance Commissioner by Departmental Order and the parties to the *Evanston* litigation by Consent Order, established a sixty day moratorium on claim payments. Further, an escrow account was created to receive any revenues generated while the Federal litigation was pending.

The Guaranty Association Board carefully considered the delicate position into which it had been thrust by the litigation and endeavored to arrive at the appropriate legal stance to take as one of the named defendants. The Guaranty Association is a ministerial body designed primarily to carry out the general mandate of its enabling legislation and the specific instructions of the New Jersey Commissioner. It therefore seemed inappropriate and perhaps even imprudent for the Association to adopt a position either favoring or contesting the validity of the Guaranty Fund Act. Accordingly, the Association Board decided to adopt a posture of neutrality on the validity issue. The Board did, however, take issue with the allegations in the Federal complaint that it could not faithfully discharge the additional duties which the Guaranty Fund Act imposed on it, and that the Board members were in an unavoidable conflict of interest position. It was felt that, whatever one thought about the wisdom of the Guaranty Fund Act or the merits of the other constitutional issues, the allegations of conflict and fiduciary infidelity had to be addressed headon and snuffed out. That was accomplished.

On November 19, 1984 in an expansive and typically thorough opinion, U.S. District Court Judge Sarokin upheld the Guaranty Fund Act against virtually all of the constitutional arguments which were directed against it. Addressing the allegations which had attracted the interest and concern of the Guaranty Association Board, Judge Sarokin recognized that the Board members were drawn solely from the ranks of admitted companies, thereby allowing for no direct representation on the Board on behalf of nonadmitted companies, and indicated the possible preferability of an arrangement allowing direct representation of surplus lines insurers.[62] However, the court held that the Board, as constituted, could faithfully discharge its duties, thereby refusing to indulge in any prejudgment of its bias or corporate incapacity.[63] With respect to the issue of legislative jurisdiction, Judge Sarokin held that the purchase of surplus lines insurance, which he characterized as an in-state transaction, and the receipt of premiums from New Jersey insureds, along with the State's power to tax surplus lines insurers, constituted sufficient contacts with the State and the derivation of sufficient benefits from it to justify the exercise of the State's jurisdiction as set forth in the Act.[64] The court rejected plaintiffs' arguments regarding retroactivity, stating that the imposition of assessments on surplus lines insurers was not an impairment of existing contracts, but rather merely the imposition of a new condition on continued eligibility.[65] The court also rejected plaintiffs' contention that the six percent interest rate imposed originally[66] on loans from the Fund was confiscatory, finding that interest did not constitute property to which the just compensation clause of the Fifth Amendment applied.[67]

Both before and during the federal litigation, various efforts had been made to negotiate legislative and regulatory commitments to a series of amendments to the Guaranty Fund Act which, if adopted, might win the acceptance if not the affection of the surplus lines community. In this respect the test litigation was both productive and counterproductive. In one sense, and undoubtedly by design, the possibility that plaintiffs might pre-

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62 The technical amendments to the Guaranty Fund Act, *supra* note 61, adopt this viewpoint by creating an Advisory Body, drawn from the ranks of surplus lines insurers and producers, to assist the Commissioner and the Guaranty Association Board in implementing the Guaranty Fund Act. *See* N.J. STAT. ANN. § 17:22-6.73 (West 1985).

63 Amendments to the Act, *supra* note 61, enacted after the issuance of Judge Sarokin's opinion, also created an advisory body to the Board to be comprised of two members representing eligible surplus lines insurers and two members representing surplus lines agents. 1984 N.J. Laws 207 § 3 (codified at N.J. STAT. ANN. § 17:22-6.73 (West Supp. 1985)).

64 Evanston, 598 F. Supp. at 1304-10.

65 *Id.* at 1315.

66 Notwithstanding the judicial approval of a fixed six percent interest rate on standby loan proceeds, the rate was subsequently amended to provide a rate of return equivalent to a "current rate of interest, using an index or indexes to be selected by the Commissioner." N.J. STAT. ANN. § 17:22-6.75b. (West 1985).

67 Evanston, 598 F. Supp. at 1315-16.

vail in the litigation provided some leverage for them to try to exact concessions by way of legislative amendments. On the other hand, the Commissioner of Insurance took the position that no negotiations with plaintiffs would be tolerated unless the litigation were withdrawn. The litigation was not dismissed, and even though direct visible negotiations came to a halt, efforts to achieve a modified but mutually acceptable piece of legislation persisted. The result was in a series of technical amendments which received the approval of both houses of the Legislature on November 19: ironically, the same day on which Judge Sarokin released his opinion in the *Evanston* case. Those amendments were signed into law on December 4, 1984.

The technical amendments, in essence, met the major economic concerns of the surplus lines insurers by substituting a policy surcharge on insureds for the prior assessment on insurers, providing a cap on the standby loan to the Fund of $10 million, establishing a variable market rate of interest on money loaned to the Fund by The Guaranty Association, and clarifying the applicability of the Act to Ambassador. The $25,000 initial assessment, however, was retained.[68]

VI. Early Administration Of The Guaranty Fund

An objective evaluator of the New Jersey Guaranty Fund's initial period of operations would likely come up with mixed conclusions. It is probably fair to say that the Fund's administrative apparatus has worked better than its detractors, and possibly even its proponents, had first thought. This, no doubt, is due in large measure to the extraordinary efforts and combined talents which have been contributed to the administration of the Guaranty Fund by its Executive Director, his staff, the Guaranty Association Board, the Advisory Body to the Guaranty Fund and as well, the New Jersey Commissioner and members of the Commissioner's staff. On the other hand, the administration of the Guaranty Fund to date, though still in its infancy, has revealed some serious flaws which neither the talent nor effort of those charged with its operation can cure. These flaws draw into question the

68 *See* 1984 N.J. Laws 207 § 5 (codified at N.J. STAT. ANN. § 17:22-6.75 (West Supp. 1985)).

very justification of a guaranty fund for surplus lines insurers — at least as presently structured in New Jersey.

A. *Baptism By Fire: The Ambassador Crisis*

1. *The Funding Crisis*: As has been observed, the very minute the Guaranty Fund opened for business it found the Ambassador insolvency standing at the door. Although there have been larger and probably more complicated insurer insolvencies over the years, the Ambassador insolvency is a strong candidate for top honors in presenting novel and difficult circumstances to those responsible for trying to pick up the pieces. The fact that Ambassador has been the New Jersey Guaranty Fund's first (and, happily, thus far, only) customer has been both a blessing and a burden. It has been a blessing in the sense that the Ambassador insolvency has strained the Guaranty Fund to the very limits of, and in some cases perhaps beyond, its capabilities. In the course of doing so, the Ambassador insolvency has drawn those capabilities and their obvious limitations into sharp focus. The insolvency has been a burden because, like the beleaguered household budget as to which there always seems to be too much month at the end of the money, it has presented a nightmarish situation in which there clearly appears to be too much insolvency at the end of the funding.

Initial projections of Ambassador claims which reasonably could be allocated to New Jersey set their amount at $10 million to $12 million. However, once the Guaranty Fund staff began receiving claim files, reviewing them, and adjusting reserves, it soon became apparent that the original projections were grossly optimistic, and that a more likely aggregate claim value for New Jersey would be $39 million. That figure, over the course of time, has again been adjusted upwards and is now more accurately believed to be $50 million. However, there is no assurance that the number will not again be adjusted until the Ambassador claims portfolio has been definitively established. The unhappy consequence of the initial undervaluation of claims was that the drafters of the Guaranty Fund Act, who clearly designed the Act with Ambassador in mind, were forced to rely on claims projections since shown to have been incomplete and inadequate. As a result, despite their attempts to be both objective and accurate, they necessarily underestimated the funding required to fully implement the statutory scheme.

Under circumstances prevailing at the time the Guaranty Fund Act was passed and amended, the most favorable first year revenue projection which could be justified would have been $1.2 million from statutory eligibility fees, $2.6 million from the 4% policy surcharge, and $10 million from the standby loan proceeds available from the Guaranty Association. The aggregate revenue realized from these sources might have been enough to make a significant impact on Ambassador claims in New Jersey at the level at which they were first estimated. However, the total funding capacity of the Guaranty Fund was inadequate to allow for any significant increase in the original estimates of the Fund's immediate cash needs or to meet the even more alarming cash demands of a second, third, or fourth surplus lines insolvency.

Granting the Commissioner of Insurance statutory authority to make downward adjustments to covered claim payments has certainly alleviated what, at least in a technical sense, would otherwise have constituted the Guaranty Fund's own insolvency. The ability of the Guaranty Fund to pay only 40% of the value of each covered claim at this time has reduced its cash flow need by $2.3 million for the first twelve months of the Fund's operation and an additional $2.9 million for the second year of operation up to the time this article was prepared. Despite this ability to conserve assets, even a 40% payment of all Ambassador claims will likely consume approximately $20 million, a 66% increase over the amount first believed to be adequate to pay all such claims *in full*.

Although it is a controversial revenue source, the statutory loan is one of the easiest funding methods to administer and upon which to make projections. For instance, the $10 million cap on outstanding loan proceeds provides one of the few constant factors in the funding formula. Even though the rate on interest now required to accompany repayment of principal fluctuates,[69] debt service cost, when compared to the other costs of operating the Guaranty Fund and paying its claims, is rather insignificant.

The statutory one-time eligibility fee of $25,000 per com-

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69 N.J. STAT. ANN. § 17:22-6.75b (West 1985).

pany also has a ring of certainty about it. However, the exodus of a number of surplus lines insurers from New Jersey as a consequence of the Guaranty Fund Act's passage has reduced the revenue attributable to that source to a level below that which had been hoped.[70] Except for those surplus lines insurers which may hereafter seek and be granted eligible status by the New Jersey Department and placed on its white list, thereby triggering further $25,000 payments, the Guaranty Fund has realized all that it can expect to receive from this source.

The 4% policy surcharge provides the only meaningful revenue source of a continuing nature. If market conditions allow for expansion of availability and capacity, and if premium rates are on an upward trend, the 4% surcharge will serve as the funding workhorse.[71] The potential adverse effect of market contraction and less sharply escalating premium rates on the revenue stream attributable to policy surcharges is obvious.

On balance, the various funding features of the Guaranty Fund Act have, within a reasonable tolerance, lived up to original legislative expectations. However, as has been noted, those expectations were based on preliminary and, as it turned out, inaccurate projections. As a consequence, a critical shortfall of available resources has resulted. Unresolved is the problem of how to augment the statutory funding devices in a manner which will alleviate that shortfall and permit full payment of claims which, as of now, will be satisfied only at the end of a protracted payout period or, perhaps, not at all.[72] At present, a bill is pending in the New Jersey Legislature which would change the effective date of the Guaranty Fund Act so as to permit coverage of

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70 Since the inception of the New Jersey Surplus Lines Insurance Guaranty Fund Act, 15 eligible surplus lines insurers have removed themselves from New Jersey's white list. This reduction in eligible surplus lines insurers translates into a statutory fee loss of $375,000.

71 The original estimated premium volume and the resulting surcharge was $65 million and $2.6 million respectively. This compared to an actual premium volume and surcharge of $80 million and $3.2 million respectively, during the Guaranty Fund's first year of operations.

72 By Order dated May 29, 1985, the Commissioner of Insurance approved a 40% adjustment factor for the payment of Ambassador-related "covered claims." The ability of the New Jersey Commissioner to authorize one or more future payments is dependent upon such unknown and uncontrollable factors as the ultimate magnitude of the Ambassador claim portfolio as well as the size and timing of any future surplus lines insolvencies. *See* note 53.

claims arising from the insolvency on June 1, 1984 of Northeastern Fire Insurance Company of Pennsylvania.[73] Passage of such a bill would further exacerbate New Jersey's existing funding crisis.

2. *The Claims Crisis*: The early administration of the Guaranty Fund has also revealed a number of claims related difficulties which, in some instances, may be attributable to the magnitude of the Ambassador insolvency.[74] In others, it may reflect some of the weaknesses and limitations inherent in the Guaranty Fund Act. For example, questions have arisen concerning the continuing obligation, if any, of the Guaranty Fund to provide a defense to those claimants who have already received their 40% adjusted claim payments but who are being pursued by judgment creditors closing in on personal assets to satisfy the unpaid 60% portion of their claims. Related problems have arisen in connection with the negotiation and preparation of settlement agreements, releases, and other documents so that they insulate the Fund from claims for the 40% of benefits paid, yet preserve the rights of the parties to collect the remaining 60% through execution on judgments, actions against the liquidator, or other legal means. The potential for further recovery from the Fund further complicates this already complex situation.

VII. Preliminary Evaluation And Recommendations For The Future

Although it is probably too early to attempt any sweeping, meaningful evaluation of the New Jersey Guaranty Fund, certain preliminary conclusions can be drawn. On the bright side, beleaguered Ambassador claimants in New Jersey have at least been provided with an absolute assurance that 40% of the total value of their claims will be satisfied without the need to stand in line as a general unsecured creditor against the Ambassador estate which, it should be noted, has not been able to pay even an interim liquidating dividend to date. Moreover, the virtual destruction of a surplus lines market in New Jersey which some had

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[73] *See*, New Jersey Senate Bill No. 788. The Bill was considered favorably by the Senate Labor, Industry and Professions Committee on June 16, 1986 and currently awaits further legislative action.

[74] To date, there have been 4,498 Ambassador-related claims filed. Of those claims, 1,570 have been settled, and 745 have been paid.

predicted has not occurred. This development is likely attributable in large measure to the fact that the early amendments to the Guaranty Fund Act lessened the "cost" of conducting a surplus lines business in New Jersey from that which companies would have had to endure under the Act's original provisions. There has, however, been a noticeable reduction in the number of companies willing to remain on the white list. Additionally, some risks, previously placed pursuant to the New Jersey Surplus Lines Law,[75] are undoubtedly now being booked on a direct basis in other jurisdictions. The extent to which access to local surplus lines markets previously enjoyed by New Jersey insureds has been eroded is a matter for speculation, as is a quantification of the New Jersey business now placed elsewhere. It is nonetheless clear that each trend has resulted in a concomitant shrinkage of the revenue base which would otherwise be available to the Guaranty Fund.

On the darker side, the conclusion seems inescapable that neither the New Jersey Surplus Lines Guaranty Fund Act nor any statutory mechanism funded in a manner similar to it can provide enough of an economic shield to meet the Legislature's mandate to "avoid financial loss to claimants or policyholders because of the insolvency of an eligible, nonadmitted insurer."[76] It may be true that any payment made by the Guaranty Fund is reflective of an act of legislative mercy. However, in the real world, that is not the way persons who receive those payments view them. Accordingly, the question must be asked whether it does not offend the very principles of consumer protection and fairness which the Act ostensibly seeks to advance for the statute to permit insurers to advertise the fact of Guaranty Fund protection but not to require that the limitations of that protection also be stated.[77] This question seems especially appropriate under prevailing circumstances in which current claim payments constitute only partial recovery and future payments may be delayed considerably or altogether illusory.

Another observation may be made based on the experience of the New Jersey Guaranty Fund to date. Unlike situations in

[75] N.J. STAT. ANN. § 17:22-6.40 (West 1985).

[76] N.J. STAT. ANN. § 17:22-6.71 (West 1985).

[77] Such a potential limitation is now required to be disclosed on policies themselves. *See* N.J. STAT. ANN. § 17:22-6.83 (West Supp. 1985).

which guaranty associations for admitted insurance companies are involved, and a virtually nationwide network of state funds exists to respond to any insolvency, New Jersey's Surplus Lines Insurance Guaranty Fund remains the only such fund in the country. Because it is the only game in town, imaginative claimants, and their equally creative brokers and legal advisors, have endeavored to force-fit claims having little or no relationship to New Jersey into "covered claim" status. This exercise has brought about two results. First, the Guaranty Fund claims staff has been required to expend extra effort to identify those claims which, because they are the product of the strategy just described, may be suspect and unacceptable. Second, a number of claims have been presented to the New Jersey Guaranty Fund which, although they may qualify for "covered claim" status, would nonetheless have been presented to the guaranty fund of some other state if only such other state had a guaranty fund to receive them. Both results have caused a further drain on the Guaranty Fund's limited resources and have exacerbated the funding shortfall which, as noted, is inherent in the statutory structure.

VIII. What About The Future?

It is not the purpose of this article to attempt a broad indictment of either the Act itself or, to be sure, those who created it or who have been obliged to adminster it under intensely difficult circumstances. It would, however, be disingenuous to encourage a conclusion that the so-called "New Jersey experience" has not cast light on a number of features of the Act which, at least in hindsight, might have been avoidable.

No one can be certain whether states other than New Jersey will some day initiate or renew[78] consideration of a guaranty fund for surplus lines insolvencies. In view of the New Jersey experience thus far, proponents of such a fund elsewhere would be well advised to give sober, thorough consideration to the many limitations and shortcomings which have been so clearly exhibited by the New Jersey experience.

Obviously there have been many sideline observers watching

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[78] Mississippi, Pennsylvania, Michigan and Louisiana had considered such legislation previously. See Johnson, *supra* note 15, at 774.

carefully while New Jersey has given birth to and nurtured its Guaranty Fund through infancy. It is the author's view that the New Jersey experience has, together with ongoing antiguaranty fund lobbying and other efforts at persuasion, served to chill the interest of those who might be inclined to reproduce a surplus lines guaranty fund elsewhere. Perhaps intense legislative or regulatory pressure will override that chilling effect if a significant surplus lines insolvency occurs in the future. However, it should be hoped that other alternatives are pursued rigorously before other jurisdictions are tempted, in effect, to photocopy the New Jersey legislation.

It is possible that the New Jersey Act itself will someday be taken off the books.[79] However, the very nature of statutory insurance funds invites the axiom: here today, here forever. What, then, so long as it continues to exist, can be done to improve the utility of the New Jersey Guaranty Fund or any fund in another state which might be patterned after it? First, a series of further technical amendments would seem to be in order. Several obviously unintended language problems which remained undetected through the drafting and printing process require cure. Second, some substantive changes may also be of help in resolving the Fund's cash problems.

In this connection there appears to be little room to maneuver. It is likely that any significant increase in the policy surcharge rate would drive a significant portion of the surplus lines coverages into other jurisdictions which do not exact such a cost of doing business. An increase in the statutory eligibility fee would likely have the same effect and, in any event, could provide no more than a one-time quick fix of bandaid proportions. A proposed increase in the statutory loan feature would seem to border on recklessness since the Guaranty Association has a legitimate, ongoing need to utilize its own assets in connection

79 An amendment which would establish a sunset date for New Jersey Guaranty Fund operations with respect to future surplus lines insolvencies has been introduced recently in the New Jersey Legislature. The amendment would, in effect, allow a run-off of covered claims arising under insolvencies of eligible surplus lines insurers occurring prior to enactment of the amendment. However, as was the case in New Jersey prior to 1984 and as remains the case in virtually every other U.S. jurisdiction, subsequent surplus lines insolvencies would receive no guaranty fund protection.

with insolvencies of admitted insurers.[80] However, the Act could be modified in two significant ways. First, the statutory cap of $300,000 per occurrence could be reduced. Second, the scope of claimants entitled to the Act's protection could be narrowed by, perhaps, excluding those having a specified substantial net worth or allowing insureds an election, under specified safeguards, to decline the statutory protections at the time the policy is issued. Although such actions would likely be branded as antiinsured or anticonsumer, they seem to be the only types of statutory modification which would make any real difference given the lack of options available to increase the funding base. Even if pursued, however, these types of surgical amendments simply work within the problem without coming to grips with it.

The inescapable conclusion in all this is that preventive rather than patch-up steps are necessary if the effects of surplus lines insolvencies are to be ameliorated, i.e., the insolvency must be avoided in the first place. In order to reach this goal, legislatures must draft laws which provide insurance commissioners with effective controls on financial stability and "early warning" signals of financial distress among the members of the surplus lines community. New Jersey has recently moved in this direction.[81] Additionally, the executive branches of state governments must provide their insurance departments with the budgets and staffs necessary to give teeth to the departments' expanded statutory powers. Finally, the surplus lines segment of the industry must be willing to undertake a higher degree of responsible management and self-policing techniques if it truly wishes to operate in a guaranty fund-free environment. Only when the seriousness of potential surplus lines insolvencies is recognized and assigned an appropriate priority by government and industry alike will statutory guaranty funds designed to provide a buffer against their effects begin to constitute an appropriate, and hopefully unnecessary, social response.

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80 Constitutional issues could also be presented if significant funds generated from the admitted insurance market were utilized on a permanent, or near permanent, basis by the Guaranty Fund with so little likelihood of recapture as to result in a forfeiture of Guaranty Association assets.

81 1985 N.J. Laws 16 § 1.

IX. Conclusion

It is easy to adopt extremist views when speaking for or against the concept of guaranty fund protection for surplus lines insolvencies such as that embodied within the New Jersey Guaranty Fund Act. There are undoubtedly still some (although certainly far fewer than before) who would have us believe that the New Jersey Act is a panacea for the economic ills visited upon so many of the state's citizens by the Ambassador insolvency. Such talk constitutes rhetoric without substance. At the other end of the spectrum, and probably gathering strength in numbers, is the view that, as demonstrated by the Ambassador experience in New Jersey, the concept of a guaranty fund for surplus lines insurers can be nothing more than a placebo.

In truth, neither view is entirely accurate. The fact is that the jury is still deliberating on the actual, long-range advantages and disadvantages of this particular type of guaranty fund concept. No such statutory scheme should receive final judgment until the administration of at least one significant insolvency has been concluded. That has not yet occurred.

However, to the extent judgments can and will be made on the basis of what has been experienced thus far, it must, in candor, be conceded that the overall effectiveness of the New Jersey Guaranty Fund is, by its very nature, seriously flawed, and that its future must be viewed with concern. The Fund is perhaps analogous to a heart transplant procedure in which a very small donor-heart must be implainted in a very large body. The transplanted heart may perform its function for a time but the extraordinary demands placed upon it draws into question its long-range ability to perform.

APPENDIX A

NEW JERSEY SURPLUS LINES INSURANCE GUARANTY FUND ACT [N.J.Stat. Ann. §§ 17:22-6.70 to -6.83 (West 1985)]

17:22-6.70. *Short title*

This act shall be known and may be cited as the "New Jersey Surplus Lines Insurance Guaranty Fund Act."

17:22-6.71. *Purpose; application of act*

The purpose of this act is to provide a mechanism for the payment of covered claims under certain insurance policies issued by eligible surplus lines insurers; to avoid excessive delays in the payment of the covered claims against insolvent, eligible, nonadmitted insurers; and to avoid financial loss to claimants or policyholders because of the insolvency of an eligible, nonadmitted insurer.

This act shall apply to all property and casualty lines of direct insurance authorized under R.S. 17:17-1, except workers' compensation insurance, title insurance, surety bonds, credit insurance, mortgage guaranty insurance, municipal bond coverage, fidelity insurance, investment return assurance, and ocean marine insurance. This act shall also not apply to reinsurance of any kind.

17:22-6.72. *Definitions*

As used in this act:

a. "Association" means the New Jersey Property-Liability Insurance Guaranty Association created pursuant to P.L.1974, c. 17 (C. 17:30A-1, et seq.).

b. "Covered claim" means an unpaid claim, including 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, and which was issued by a surplus lines insurer which was eligible to transact insurance business in this State at the time the policy was issued and which has been determined to be an insolvent insurer on or after July 27, 1984, if (1) the claimant or policy-holder is a resident of this State at the time of the occurrence of the insured event for which a claim has been made, or (2) the property from which the claim arises is permanently located in this State.

"Covered claim" shall not include any amount due any reinsurer, insurance pool or underwriting association, as subrogation recoveries or otherwise, except that a claim for any such amount, asserted against a person insured under a policy issued by a surplus lines insurer which has become an insolvent insurer, which, if it were not a claim by or for the benefit of a reinsurer, insurer, insurance pool, or underwriting association, would be a "covered claim", may be filed directly with the receiver of the insolvent insurer, but in no event may any such claim be asserted in any legal action against the insured of that insolvent insurer. "Covered claim" shall also not include amounts for interest on unliquidated claims, punitive damages unless covered by the policy, counsel fees for prosecuting suits for claims against the fund, and assessments or charges for failure by an insolvent insurer to have expeditiously settled claims.

c. "Fund" means the New Jersey Surplus Lines Insurance Guaranty Fund created pursuant to section 4 of this act.[1]

d. "Insolvent insurer" means an insurer which was an eligible surplus lines insurer at the time the insurance policy was issued or when the insured event occurred, and which is determined to be insolvent by a court of competent jurisdiction in this State or the state or place in which the surplus lines insurer is domiciled. "Insolvent insurer" does not include an admitted insurer issuing insurance pursuant to section 10 of P.L.1960, c. 32 (C. 17:22-6.44).

e. "Member insurer" means an eligible, nonadmitted or surplus lines insurer required to be a member of, and that is subject to assessments by the fund.

f. "Net direct written premiums" means direct gross premiums on insurance policies written by a surplus lines insurer to which this act applies, less return premiums thereon and dividends paid or credited to policyholders on that direct business. If a policy issued by a surplus lines insurer covers risks or expo-

[1] Section 17:22-6.73.

sures only partially in this State, the "net direct written premiums" shall be computed, for assessment purposes, on that portion of the premium subject to the premium receipts tax levied in accordance with section 25 of P.L.1960, c. 32 (C. 17:22-6.59) "Net direct written premiums" do not include premiums on contracts between insurers or reinsurers.

g. "Surplus lines insurer" means a nonadmitted insurer approved as an eligible, nonadmitted or unauthorized insurer pursuant to section 11 of P.L.1960, c. 32 (C. 17:22-6.45) at the time the policies were issued against which a covered claim may be filed in accordance with this act.

17:22-6.73. *Surplus lines insurance guaranty fund; membership; management and administration; advisory board*

There is created a private, nonprofit, unincorporated, legal entity to be known as New Jersey Surplus Lines Insurance Guaranty Fund. All surplus lines insurers shall be and remain member insurers of the fund as a condition of their continued eligibility pursuant to section 11 of P.L.1960, c. 32 (C. 17:22-6.45). The fund shall be managed and administered by the New Jersey Property-Liability Insurance Guaranty Association. The association shall exercise all of the powers vested in the fund under this act, and such other powers as may be necessary or appropriate to the fulfilling of its responsibilities under this act. The association shall administer the affairs of the fund in accordance with the "New Jersey Property-Liability Guaranty Association Act," P.L.1974, c. 17 (C.17:30A-1 et seq.) and its plan of operation adopted pursuant to section 9 (C. 17:30A-9), insofar as the provisions of that act and that plan are not thereof inconsistent with the provisions of this act, and subject to any amendments to the plan as may be necessary or appropriate to effectuate the purposes of this act.

In order to assist the association in implementing the provisions of this act, there is created an advisory body to the board of directors of the association to be comprised of two members representing eligible surplus lines insurers and two members requesting surplus lines agents to be appointed by, and to serve at the pleasure of the commissioner. The association shall consult the advisory body on any matter relating to the provisions of P.L.1984, c. 101 (C. 17:22-6.70 et seq.).

17:22-6.74. *Powers; duties and obligations*

a. The fund shall:

(1) Be obligated to the extent of the covered claims against an insolvent insurer incurred prior to or 30 days after the determination of insolvency, or before the policy expiration date, if less than 30 days after that determination, or before the policyholder replaces the policy or causes its cancellation, if he does so within 30 days of the determination. The fund's obligation for covered claims shall not be greater than $300,000.00 per occurrence, subject to any applicable deductible contained in the policy. The commissioner may adjust the fund's obligations for covered claims based on the monies available in the fund. In no event shall the fund be obligated to a policy-holder or claimant in excess of the limits of liability of the insolvent insurer stated in the policy from which the claim arises;

(2) Be deemed the insurer to the extent of its obligation on the covered claims and to such extent shall have all rights, duties, and obligations of the insolvent insurer as if the insurer had not become insolvent;

(3) Assess member insurers in accordance with section 6 of this act in amounts necessary to pay:

(a) Obligations of the fund under paragraph (1) of this subsection,

(b) Expenses of handling covered claims,

(c) Any other expenses incurred in the implementation of the provisions of this act;

(4) Investigate claims brought against the fund; and adjust, compromise, settle, and pay covered claims to the extent of the fund's obligation; and deny all other claims; and may review settlements, releases and judgments to which the insolvent insurer or its policyholders were parties to determine the extent to which the settlements, releases and judgments may be properly contested;

(5) Notify those persons as the commissioner directs under

section 8 of this act;[2]

(6) Handle claims through the association's employees or representatives, or through one or more insurers or other persons designated as servicing facilities; and

(7) Pay the other expenses of the association in administering the provisions of this act.

b. The fund may:

(1) Sue or be sued;

(2) Negotiate and become a party to those contracts which are necessary to carry out the purpose of this act;

(3) Perform those other acts which are necessary or appropriate to effectuate the purpose of this act;

(4) Refund to the member insurers in proportion to the contribution of each member insurer that amount which the commissioner determines to be in excess of the needs of the fund; and

(5) With the approval of the commissioner, borrow monies from any source, including but not limited to the New Jersey Property-Liability Insurance Guaranty Association, in accordance with subsection b. of section 6 of P.L.1984, c. 101 (C. 17:22-6.75), as may be necessary to effectuate the purposes of that act, except that the use of the proceeds of any loans shall be limited to the payment of covered claims, including claim adjustment expenses.

17:22-6.75. *Financial support; surcharges; loans*

a. In order to provide the monies necessary to meet the fund's obligations and expenses under this act:

(1) Each member insurer, including a surplus lines insurer made eligible on or after the effective date of this act, shall make an initial one time payment of $25,000.00, to be made to the fund within 60 days of the effective date of this act; and

(2) A surcharge on the policy premium, as determined by the commissioner, shall be levied and collected on any surplus lines coverage issued or renewed on or after the effective date of this amendatory act. The surcharge shall be collected by the surplus lines agent at the time of delivery of the cover note, certifi-

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2 Section 17:22-6.77.

cate of insurance, policy or other initial confirmation of insurance. No premium receipts tax, commissions or assessments shall be levied or collected on the surcharge. The surplus lines agent shall forward to the fund the amount of the surcharge on a quarterly payment basis. Each member insurer and surplus lines agent shall be notified of the policy surcharge not later than 10 days before it is due. The amount of the surcharge may be, from time to time, adjusted, terminated or reinstituted by the commissioner, as he may deem necessary to meet the current and projected obligations and expenses of the fund, except that in no case shall the surcharge in any year exceed 4% of the policy premium.

b. The fund may, from time to time, borrow monies from the New Jersey Property-Liability Insurance Guaranty Association to pay the fund's obligations and expenses under this act, which are in excess of the monies available to the fund therefor. The aggregate amount owed by the fund to the association shall at no time exceed $10,000,000.00, exclusive of interest charges, except that the commissioner may limit the amount of loans outstanding at any one time to less than $10,000,000.00 upon a finding that the additional monies requested by the fund would reduce the monies available to the association below a level necessary to meet the current and prospective obligations of the association pursuant to paragraph (3) of subsection a. of section 8 of P.L.1974 (C. 17:30A-8). Monies borrowed under this subsection shall be paid back to the association in accordance with a payment schedule approved by the commissioner. An interest charge shall be levied on all monies borrowed under this subsection at the current market rate of interest, using an index or indexes to be selected by the commissioner.

c. No policy surcharge shall be levied or collected upon a determination by the commissioner that the fund's unencumbered assets exceed the fund's outstanding and anticipated obligations and other liabilities, including expenses chargeable to the fund, by $10,000,000.00 or more.

17:22-6.76. *Suspension of eligibility of member insurer or license of surplus lines agent; interest on unpaid assessment or surcharge; reinstatement*

The commissioner may, after notice, suspend the eligibility of a member insurer or the license of a surplus lines agent that fails to pay an assessment or policy surcharge under section 6 of this act when due, or any interest accruing thereon, or fails to comply with the applicable provisions of the plan of operations. The commissioner may, after notice and hearing in accordance with the "Administrative Procedure Act", P.L.1968, c. 410 (C. 52:14B-1 et seq.), withdraw the eligibility of that insurer or suspend or revoke the surplus lines agent's license.

Interest shall be charged on the amount of the unpaid assessment or surcharge subject to the provisions of this section. The interest charge shall be at the current market rate of interest, using an index or indexes to be selected by the commissioner, and shall be payable at the time the unpaid assessment or policy surcharge is paid to the fund.

Eligibility of a surplus lines insurer or the license of an agent shall not be restored or reissued until all monies owing under this section have been paid to the fund.

17:22-6.77. *Declaration of insolvency; complaint seeking liquidation; transmittal; duties of commissioner*

a. An insolvent insurer shall forward to the commissioner and to the association a copy of the declaration of insolvency within three business days of the date of the determination of the insolvency. A surplus lines insurer shall forward to the fund and commissioner a copy of any complaint seeking an order of liquidation with a finding of insolvency against the insurer at the same time that such complaint is filed with a court of competent jurisdiction;

b. The commissioner shall:

(1) Order the termination of all inforce policies of an insolvent insurer within 30 days of the date of determination of the insolvency;

(2) Upon request, provide the fund with a statement of the net direct written premiums of each member insurer; and

(3) Order surplus lines agents to notify, within five days of the date of the order, the policyholders of the insolvent insurer and any other interested parties of the determination of insolvency and of their rights under this act. Notification shall be by mail at their last known address, where available, but if sufficient information for notification by mail is not available, notice by publication in a newspaper of general circulation shall be sufficient.

17:22-6.78. *Subrogation; cooperation of claimant; settlement of claims; filing statements of claims paid; access to records*

a. Any person recovering under this act shall be deemed to have assigned his rights under the policy from which the claim arose to the fund to the extent of his recovery from the fund. Every policyholder or claimant seeking the protection of this act shall cooperate with the fund to the same extent as that person would have been required to cooperate with the insolvent insurer. The fund shall have no cause of action against the policyholder of the insolvent insurer for any sums it has paid out, except for those causes of action as the insolvent insurer would have had if the sums had been paid by the insolvent insurer. In the case of an insolvent insurer operating on a plan with an assessment liability, payments of claims by the fund shall not operate to reduce the liability of policyholders to the receiver, liquidator, or statutory successor for unpaid assessments.

b. The receiver, liquidator, or statutory successor of an insolvent insurer shall be bound by settlements of covered claims by the fund or its representatives. The court having jurisdiction shall grant the covered claims paid by the fund priority, against the assets of the insolvent insurer, over any claims against the assets of the insolvent insurer by claimants having received any payment from the fund for the covered claims, to the extent of the amount of the payments made by the fund. The expenses of the fund in handling claims shall be accorded the same priority as the liquidator's expenses.

c. The fund shall periodically file with the receiver or liquidator of the insolvent insurer statements of the covered claims paid by the fund and estimates of anticipated claims on the fund, which shall preserve the rights of the fund against the assets of the insolvent insurer.

d. The liquidator, receiver, or statutory successor of an insolvent insurer covered by this act shall permit access by the fund or its representative to all of the insolvent insurer's records which would assist the fund in carrying out its functions under this act with regard to covered claims. In addition, the liquidator, receiver or statutory successor shall provide the fund or its representative with copies, or permit copies to be made of the insolvent insurer's records upon request, and at the expense of the fund.

17:22-6.79. *Priority of claim of associations in other states*

Any person having a covered claim that may be recovered from more than one insurance guaranty association, or its equivalent, shall seek recovery first from the association of the place of residence of the policyholder at the time of the insured event, except that if it is a first party claim for damage to property with a permanent location, he shall seek recovery first from the association of the jurisdiction in which the property is located. Any recovery under this act shall be reduced by the amount of recovery from any other insurance guaranty association; except that, if recovery is denied or deferred by that association, a person may proceed to recover from any other insurance guaranty association from which recovery may be legally sought.

17:22-6.80. *Examination of insurers in financial condition hazardous to policyholders or public; request to domiciliary jurisdiction for examination and report*

In the event the commissioner has sufficient basis to believe that the financial condition of a member insurer is hazardous to the policyholders or the public, the commissioner shall request the appropriate regulatory authority of the domiciliary jurisdiction of that member insurer to examine and report back to the commissioner on the financial condition of the member insurer.

17:22-6.81. *Examination and regulation of fund; financial report*

The fund shall be subject to examination and regulation by the commissioner. The association, on behalf of the fund, shall submit, not later than March 31 of each year, a financial report for the preceding calendar year in a form approved by the commissioner.

17:22-6.82. *Immunity from liability of persons acting under this law*

There shall be no liability on the part of, and no cause of action of any nature shall arise against any member insurer, the fund, the association or its board of directors, or agents or employees, or the commissioner or his representatives for any action taken by them in the performance of their powers and duties under this act.

17:22-6.83. *Coverage under this act; notice on application and policy or certificate; advertisement*

A member insurer shall include on the application and on the face of the policy or certificate for insurance subject to this act, a notice stating that the insurer is not an admitted company in New Jersey, but that the policy coverage has the protection in whole or in part, of the New Jersey Surplus Lines Insurance Guaranty Fund, if the eligible surplus lines insurer becomes bankrupt or insolvent. A member insurer or an agent or broker may advertise that policy coverages offered by a member insurer and subject to the provisions of this act are protected by the New Jersey Surplus Lines Insurance Guaranty Fund, should the surplus lines insurer become bankrupt or insolvent. The commissioner shall determine the contents and form of the notice.