

New Jersey Appellate Court Rejects Integrity Final Dividend Plan

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On October 2, 2006, the Appellate Division of the Superior Court of New Jersey rejected the Fourth Amended Final Dividend Plan, submitted by the Liquidator of Integrity Insurance Company. Prior to the recent issuance of surprising orders by the New Jersey Supreme Court, this decision appeared to mark the end of the Liquidator's decade-long effort to bring the Integrity estate to an early close. The following article briefly recounts the rather convoluted history of the case, summarizes the recent appellate decision and attempts to evaluate its significance.

History of the Case

Integrity was a New Jersey domiciled stock company that wrote a variety of volatile risks. Its book of business included excess and umbrella policies, issued to numerous large manufacturing companies, which subjected the company to massive long-tail exposure for environmental contamination and product liability. The Liquidation Court declared Integrity insolvent in 1987. By the 1988 bar date, over 26,000 claims were filed against the estate. The vast majority of these were "policyholder protection" claims, by which an Integrity insured that was not aware of any specific claim asserted against it could reserve the right to seek coverage in the event a claim were to materialize, based on events that occurred prior to entry of the liquidation order. By early 1996, thousands of these claims remained contingent. The Liquidator estimated that the IBNR losses on these claims amounted to \$1.321 billion.

The Liquidator weighed a number of alternative methods for administering the Integrity estate. One such alternative was a "run-off" scheme, by which the contingent claims would be paid as they were substantiated. The Liquidator rejected this scheme because it necessarily entailed leaving the estate open for decades. Another alternative was a "cut-off" scheme, by which contingent claims that were not substantiated



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by a date certain would not be paid. The Liquidator rejected this approach because, if it were employed, the three quarters of Integrity's policyholders who had submitted contingent, policyholder protection claims would receive no distributions from the estate. The Liquidator also feared that a run-off approach would leave approximately \$876 million in potential reinsurance recoverables uncollected.

The Liquidator finally settled on a Final Dividend Plan ("FDP"). Although the FDP was amended several times over the years, its essential terms remained constant. The FDP contemplated that the value of a policyholder's contingent claim would be determined by an actuarial estimate of its IBNR, discounted to net present value. Once the estimated claim was approved by the Liquidator, it was to be presented to Integrity's reinsurers on the risk for the relevant policy years. The reinsurers were entitled to object to the allowance of a claim. They were, however, required to submit their objections to a special master appointed by the Liquidation Court.

The Liquidator filed the FDP with the Liquidation Court on June 17, 1996. The reinsurers, led by Munich Reinsurance Company ("Munich Re"), objected vehemently to the FDP on two principal grounds. First, they argued that neither the New Jersey Liquidation Act nor their reinsurance agreements authorized the Liquidator to allow claims based on actuarial estimates of IBNR. According to the reinsurers, the Liquidator could allow only "absolute" claims, in which the injured party and loss are known and where insurance coverage has been established. Second, the reinsurers argued that the FDP infringed their contractual and statutory rights to resolve disputes by arbitration.

The Liquidation Court judge, William C. Meehan, decided to follow a bifurcated procedure in evaluating the FDP. Initially,

he would entertain arguments on the issue of whether the Liquidator possessed statutory authority to declare contingent claims absolute on the basis of actuarial estimates of IBNR liability. If the answer was yes, then he would allow a period of discovery and conduct an evidentiary hearing on the issue of whether the FDP is fair and commercially reasonable.

The Liquidator's Statutory Authority

In November 1996, Judge Meehan held that the Liquidator has authority to estimate net present value of IBNR losses and Integrity's pending case reserves on behalf of future claimants and to allow such contingent claims to participate in the final distribution of assets. Both the Appellate Division of the Superior Court and the New Jersey Supreme Court rejected the reinsurers' motions for leave to file interlocutory appeals from this ruling. By spring of 1997, a period of extensive discovery had commenced.

The Deliberative Process Privilege

Proceedings came to a virtual halt, however, for the better part of the period from spring of 1998 through the summer of 2000. This period was consumed by a dispute over whether the Commissioner of Banking and Insurance, in her role as Liquidator of Integrity, was entitled to assert the "deliberative process privilege" to avoid the reinsurers' requests for discovery of intra-agency documents analyzing and evaluating the FDP. The Superior Court required the Commissioner to produce the documents. The Appellate Division remanded the case for an in camera review of the documents. The dispute reached the New Jersey Supreme Court, which held that although a qualified deliberative process privilege exists to protect agency documents, the Commissioner, in her capacity as Liquidator, could not invoke it because, as such, she functions in both a public and private status. Accordingly, it was necessary for the court to conduct an in camera review and hearing in order to balance the Liquidator's need for confidentiality against the reinsurers'

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need for production. While these discovery issues were being resolved, yet another dispute between the Liquidator and Munich Re was unfolding.

The Suter Arbitration

In a matter that, at first, appeared unrelated to the proceedings on the FDP, the Integrity estate claimed it was entitled to reinsurance proceeds for certain policyholder claims for defense costs that the Liquidator had allowed. In January 1999, after Munich Re asserted these claims were not covered by its reinsurance agreements, the Liquidator filed an adversary complaint in the Liquidation Court. Munich Re removed the case to the United States District Court for the District of New Jersey, pursuant to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "Convention"). The Liquidator moved for remand, arguing that the Munich Re had waived its right to remove the case by virtue of the "service of suit" clause in its reinsurance agreements. The District Court granted the Liquidator's motion and Munich Re appealed. The Third Circuit Court of Appeals reversed in August 2000, holding that: (i) the service of suit clause did not clearly and unambiguously waive the right to remove the case under the Convention; and (ii) New Jersey's Liquidation Act did not reverse-preempt the Convention under the McCarran-Ferguson Act.

Soon after the arbitration commenced in September 2002, Munich Re and the Liquidator settled their disputes -- including their dispute over the validity of the FDP. Thereafter, the Reinsurance Association of America ("RAA") prosecuted the challenge to the FDP.

Approval of the Plan

Finally, in November 2003, the Liquidation Court conducted the evidentiary hearing that was first proposed seven years earlier. The court entertained three days of testimony and arguments. On July 19, 2004, Judge Meehan entered an order approving the

FDP, ruling that it employed generally accepted claims estimation techniques in a commercially reasonable manner, while protecting Integrity's policyholders and the public. In doing so, the court observed that although "an actuarial estimate is not a 100% guarantee . . . it is an evaluation . . . generated by an actuary using the most up-to-date technology available . . . that is employed and relied upon by insurance and reinsurance companies including the RAA and its members on a regular basis for such transactions as commutations, takeovers and mergers." Judge Meehan did not specifically address the RAA's objection that the FDP impaired the reinsurers' arbitral rights. Instead, Judge Meehan merely noted that the FDP "provides for an objection process whereby a reinsurer may voice an objection for, *inter alia*, commercial unreasonableness that will then be considered before a Special Master and then be reviewed by this Court thereby protecting the reinsurer from an unreasonable estimate." The RAA appealed this ruling to the Appellate Division, which reversed.

The Appellate Decision

The principal grounds upon which the Appellate Division relied in rejecting the FDP were essentially those upon which the reinsurers based their motion for interlocutory appeal in 1996: that IBNR losses do not meet the statutory requirements for participation in the estate. The court first quoted the New Jersey Liquidation Act, which provides in pertinent part as follows:

"No contingent claim shall share in a distribution of the assets of an [insolvent] insurer . . . except that such claims shall be considered, if properly presented, and may be allowed to share where . . . [s]uch claim becomes absolute against the insurer on or before the last day fixed for filing of proofs of claim against the assets of such insurer."

The court reviewed dictionary definitions of the term "absolute" and concluded that

the term as used in the Act is "synonymous with 'unconditional' or 'non-contingent.'" According to the court, actuarial estimates of IBNR losses could not meet the statutory requirements.

"IBNR claims are actuarial estimates and are, therefore, not absolute. They are derived from standards of measurement that vary according to the judgment of the valuator. They are nothing more than an estimate of the value of a potential actual loss that accounts both for the possibility that the loss will not occur and for the possibility that the extent of the loss will differ from the actuarial estimate. Accordingly, IBNR claims are not absolute and are prohibited by the statute from sharing in the estate."

The court examined case-law from jurisdictions with statutes similar to New Jersey's and, thereafter, characterized the Liquidator's argument, that a contingent claim can become absolute upon her determination to settle it, as "alchemy." Nor did the court find any relevance in the Liquidation Court's observation that actuarial estimates of IBNR are commonly employed in the industry. According to the court, such estimates "are limited to voluntary agreements", which are unsuited to the mandatory claims allowance procedures such as those advocated by the Liquidator in the FDP.

The court then addressed the FDP's dispute resolution procedures. These prohibited arbitration of several disputes that would otherwise be arbitrable under the reinsurance agreements, including disputes over setoffs, as well as the allowance, amount, priority and allocation of claims. The court held that by thus prohibiting arbitration, the FDP impaired the reinsurers' rights under the Federal Arbitration Act and the Convention. In doing so, the court rejected the Liquidator's argument that because the FDP was approved pursuant to the New Jersey Liquidation Act, which regulates insurance, the reinsurers' federal arbitration rights were reverse-preempted by the McCarran-Ferguson Act. Citing the Third Circuit's decision that ordered the Suter arbitration,

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the court found that allowing arbitration of the Liquidator's contractual claim against Integrity's reinsurers did not impair any provision of the Liquidation Act.

"This is not a delinquency proceeding or a proceeding similar to one. Nor is it a suit by a party seeking access to assets of the insurer's estate. Moreover, even if it were such, the Superior Court would have express authority to enjoin the plaintiff from proceeding in the event that it were to interfere with the proceedings before it. What this proceeding is a suit instituted by the Liquidator against a reinsurer to enforce contract rights for an insolvent insurer, which, if meritorious, will benefit the insurer's estate. Accordingly, we fail to perceive any potential for interference with the Liquidation Act proceedings before the Superior Court."

It is difficult to gauge the effect of the appellate court's decision. Over the ten-plus years during which the proposal for the FDP has been pending, the Integrity estate executed commutation agreements with most of its major reinsurers. The prices of these commutations were largely based on the same actuarial techniques the Liquidator proposed to employ in the FDP.

The FDP saga underscores the importance of the legislative process in assuring the approval of such innovative measures. Ultimately, the Liquidator's proposal to allow claims based on actuarial estimation of IBNR losses could not survive scrutiny under a statute requiring a claim to be "absolute" before it could be allowed. Receivers who seek early closure of their estates in jurisdictions with statutory schemes similar to New Jersey's might contemplate advocating a change in the law. In this regard, they may wish to consider the NAIC's Insurer Receivership Model Act ("IRMA"). IRMA authorizes the liquidator to set a date certain for all contingent and unliquidated claims to become final. The liquidator is authorized to compel payment of claims thus allowed by reinsurers of the estate. These provisions effectively codify

the provisions of the FDP and resemble a statutory scheme already in effect in Rhode Island.

Post Script

Because the Liquidator chose not to appeal the appellate court decision, it appeared the litigation over the FDP was concluded. However, in a wholly unexpected development, the Supreme Court of New Jersey issued orders on January 25, 2007, which granted an Integrity policyholder (i.e., the American Standard Companies Inc.) leave to intervene and file an appeal of the appellate court decision. The Supreme Court also allowed another policyholder (i.e., Foster Wheeler L.L.C.) to file an amicus curiae brief in the appeal. It, therefore, appears that reports of the FDP's demise were premature.

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- In the Matter of the Liquidation of Integrity Ins. Co., 2006 WL 2795343 (N.J. Super. App. Div. Oct. 2, 2006).
- In the Matter of the Liquidation of Integrity Ins. Co., 299 N.J. Super. 677, 691 A.2d 898 (Ch. Div. 1996).
- In the Matter of the Liquidation of Integrity Ins. Co., 165 N.J. 75, 754 A.2d 1177 (2000).
- 9 U.S.C. § 205.
- Suter v. Munich Reins. Co., 223 F.3d 150 (3d. Cir. 2000).
- Order, In the Matter of the Liquidation of Integrity Ins. Co., No. C-7022-86 (N.J. Super., Ch. Jul. 19, 2004).
- Id. at 4.
- Id. at 7.
- N.J.S.A. 17:30C-28(a) (1) (emphasis added).
- In the Matter of the Liquidation of Integrity Ins. Co., 2006 WL 2795343 at *3.
- Id.
- Id. at * 4.
- 15 U.S.C. §1012(b).
- In the Matter of the Liquidation of Integrity Ins. Co., 2006 WL 2795343 at *7 (quoting Suter, 223 F.3d at 160).
- IRMA, at §705.F.
- IRMA, at §611.I.