MEMORANDUM

TO: Receivership Large Deductible Workers' Compensation (E) Working Group

FROM: NAIC Staff

DATE: December 2, 2019

RE: Guideline: Alternative to Section 712 of *Insurer Receivership Model Act* (#555), Administration of Loss Reimbursement Policies

Executive Summary

Having the necessary statutory authority specific to large deductible workers' compensation products in receiverships is key to the successful resolution of these insurers. There are currently two statutory authority options available, and there are differences across states as to which authority has been adopted: 1) Section 712 of the NAIC *Insurer Receivership Model Act* (#555), Administration of Loss Reimbursement Policies; and 2) the National Conference of Insurance Guaranty Funds (NCIGF) *Model Large Deductible Legislation*, Administration of Large Deductible Policies and Insured Collateral. Both provide statutory guidance that articulates the respective rights and responsibilities of the various parties, which greatly enhance a state's ability to manage complex large deductible programs in liquidation.

NAIC staff has been asked to draft the attached Guideline: Alternative to Section 712 of *Insurer Receivership Model Act* (#555), Administration of Loss Reimbursement Policies as alternative language to Section 712 of Model #555.

Guideline v. Model Law

The NAIC model law development process helps provide uniformity while balancing the needs of insurers operating in multiple jurisdictions with the unique nature of state judicial, legislative and regulatory frameworks. In 2007, the NAIC changed the way model laws and model regulations were developed. The criteria for development of a model law or regulation now involve a two-pronged test. First, the subject matter of the model law or regulation must call for a minimum national standard or require uniformity among the states. The second part of the test is the NAIC members must be committed to dedicating significant regulator and NAIC staff resources to educating, communicating and supporting the adoption of the model law or regulation.

When issues arise where a proposed model law does not meet the two-pronged test, a group can proceed to develop a guideline to address the regulatory issue. Guidelines are not considered to be equivalent to model laws of the NAIC. They are considered regulatory best practices. While Section 712 of Model #555 is a model law, it is the opinion of NAIC staff that the alternative language to Section 712 should be drafted as a guideline, because it does not meet the two-pronged test to be a model law.

2016 Workers' Compensation Large Deductible Study

Section 712 of Model #555 was originally adopted in 2007 separately from the other provisions of Model #555. After discussion and consideration of recent workers' compensation insurer insolvencies, the growth of the large deductible market and the increased number of workers affected by large deductibles, the NAIC/IAIABC Joint (C) Working Group was charged in 2015 to provide an update to the 2006 *Workers' Compensation Large Deductible Study*. The 2016 Workers' Compensation Large Deductible Study provides the following discussion on the use, business practices and potential risks of large deductible policies in workers' compensation:

> **Current State of the Law**
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> In most states, there is little guidance governing the rights and obligations of the parties when an insurance company with a large deductible portfolio becomes insolvent. One approach to the problem could be called the "secured claim" approach, which places the highest importance on the principle that claims within the deductible are primarily the obligation of the policyholder. Under this approach, deductible reimbursements are earmarked to pay those claims, and any collateral posted by or on behalf of the policyholder is held to ensure that those claims are paid. Accordingly, when the guaranty association takes on the responsibility of paying a claim within the deductible, it earns the benefit of the reimbursement due from the policyholder, and the right to draw on the collateral if necessary, or to initiate a draw by the receiver, for the benefit of the guaranty fund. [Note: this is the approach of the NCIGF Model].
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> Another approach could be called the "reinsurance" approach, which places the highest importance on the principle that the insurer's obligation to pay all covered claims and the policyholder's obligation to reimburse the insurer are unconditional and that each is independent of the other. Under this approach, deductible reimbursements are a general asset of the estate so that large deductible policies and guaranteed cost policies are essentially identical from the guaranty fund's perspective, and the guaranty fund only benefits from the deductible reimbursements in proportion to its share as a creditor of the estate. The NAIC has largely taken the second approach. Under the *Insurer Receivership Model Act* (#555), Section 712—Administration of Loss Reimbursement Policies, the receiver has the right to collect all deductible reimbursements, drawing on collateral as necessary. All such payments are general assets of the estate. Any reimbursements paid to the guaranty association are treated as early access distributions and offset from future recoveries from the estate. However, the receiver also has the option to enter into an agreement under which the policyholder takes on responsibility for claims within the deductible, directly or through a TPA, and any such claims remain off the books of both the estate and the guaranty fund. It should be noted that no state has enacted the reinsurance approach embodied in Model #555. The NCIGF approach, on the other hand, has had some success in state legislatures, as the paragraph below demonstrates. Further, some states may have concerns about the impact of the Model #555 approach on statutory deposit requirements in California.
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> [Update: Eleven states currently have statutes in place: California, Florida, Illinois, Indiana, Michigan, Missouri, New Jersey, Pennsylvania, Texas, West Virginia and Utah.] Most of these states follow the NCIGF approach and have amended their insurance liquidation acts to clarify the following when to secure competing claims such as deductible amounts owed the insurer and retroactive premium balances: 1) the ownership of the deductible reimbursements or collateral drawdowns; 2) claims-handling matters; 3) collection responsibility; and 4) allocation of collateral.

Variations on NCIGF Model

Some states have adopted variations from the NCIGF model that may be considered by states when they are considering adding such language. For example, Illinois, Michigan, and Pennsylvania adopted laws that provide for a three percent administrative fee for the receiver. The following is example language the Working Group included in the Guideline in section F:

> The Commissioner as receiver is entitled to deduct from the collateral or from the deductible reimbursements reasonable and actual expenses incurred in connection with the collection of the collateral and deductible reimbursements as provided pursuant to [insert state priority of claim statute].

Another variation noted by the Working Group was that California law includes a variation in the threshold amount for the deductible. The Working Group edited section A(1)(b) to reflect a reference to each states' definition of large deductible.

See ALTERNATIVE TO SECTION 712 OF *INSURER RECEIVERSHIP MODEL ACT* (#555) "ADMINISTRATION OF LOSS REIMBURSSEMENT POLICIES"