

Commentary**Guaranty Funds:
Inside Or Outside The Liquidation Process?
The Union Indemnity/Royal Bank Decision**

By
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New York's property/casualty insurance security fund has always been a little out of step with guaranty funds in the rest of the country. With one possible exception,¹ the New York fund is the only pre-assessment fund.² Furthermore, the New York fund is simply a financial account which the liquidator can draw upon to pay claims against an estate in liquidation.³ It is not a separate entity (or so we thought) and does not have its own board of directors or staff.⁴ A recent decision of the New York Court of Appeals, New York's highest court, however, raises some serious concerns about the control over a unified liquidation process by the liquidator or receiver in the administration of insolvent estates nationwide.

In *Royal Bank & Trust Co. v. Superintendent of Insurance*⁵ the New York Court of Appeals affirmed the determination by the lower courts that the property/casualty insurance security fund is liable for post-liquidation interest and attorneys fees on claims against the estate of Union Indemnity under certain surety bonds issued by Union Indemnity to Royal Bank Trust Company. Despite New York Insurance Law Section 7434(b), which provides that "no creditor shall be entitled to interest on any dividend by reason of delay in the payment of such dividend," the Court of Appeals determined that Royal Bank, as a claimant against the security fund rather than the insolvent estate, was allowed to recover post-liquidation interest and attorneys fees under the facts before the Court.

The Facts

Royal Bank filed fifty-five separate proofs of claim in the Union Indemnity liquidation proceeding, for payments due under bonds issued by Union Indemnity to the Royal Bank to secure the payment of promissory notes of limited partners in investment limited partnerships. When the limited partners failed to meet their payment obligations, Royal Bank demanded payment from Union Indemnity. Before significant payments could be made, Union Indemnity was placed in liquidation with the New York Superintendent of Insurance as Liquidator (the "Liquidator"). Royal Bank made demand for payment for the principal of the bonds, plus interest and attorneys fees as provided for under the terms of the bonds. The Liquidator denied the claims because the bonds were not based upon risks located in New York. The liquidation court rejected this position, however, and held the Security Fund responsible for payment of the claims, including interest and attorneys fees.

The Liquidation Court Decision

The Court of Appeals described the liquidation court's decision as follows:

The court held that although Insurance Law § 7434(b) limits the payment of interest on dividends from the estate of the bankrupt insured, this was not a request for payment from Union's estate but, rather, a claim against the statutory Security Fund, a distinct source.⁶

The lower court also rejected the argument that the term 'limit of liability' in Insurance Law § 7608(c) limits recovery to the face amount of the bond, emphasizing the absence of any language in the bonds themselves pertaining to limits of liability. The liquidation court also held that interest was an integral component of the risk covered by the bonds, and awarded attorneys fees because the bonds expressly authorized them.

The Court Of Appeals Decision

The Appellate Division affirmed the liquidation court⁷ and the Superintendent appealed to the Court of Appeals arguing that "(1) Insurance Law § 7434(b) prohibits payment of post liquidation interest out of the Security Fund, and (2) Insurance Law § 7608(c) prohibits the Security Fund from paying interest and attorneys fees because inclusion of these amounts will result in a total payment over the limited liability of the underlying bonds.⁸ The Court affirmed the Appellate Division in a five to two decision. The majority opinion, written by Judge Bellacosa, rejected the Superintendent's arguments, concluding that:

These restrictions do not appear in the statutes themselves and we are not persuaded that interpretive contentions justify such substantive transformations of the governing principles. Moreover, the express language of the underlying bonds provides for payment of interest and attorney's fees and those contractual undertakings more specifically apply and cogently prevail in these circumstances. Thus, we are satisfied that the courts below ruled correctly in each respect⁹

After rejecting the Superintendent's argument that his interpretation of the statutes should be given preference, the Court provided its own analysis of the statutory provisions. On the prohibition of the payment of post-liquidation interest in Section 7434(b), the Court stressed the fact that Section 7434(b) prohibits the payment of interest on 'dividends,' but Section 7608 refers to 'payments' from the security fund, not dividends. Thus the Court concluded:

We are satisfied that the weight of analysis, authority and sustainable interpretation of these complex, regulatory and security type statutes support the lower courts' determinations that the prohibition of section 7434(b) against the payment of interest applies to claims against liquidation estates only. It has no relevant or dispositive impact, in the circumstances presented here, to the Security Fund, as to pre or post-liquidation interest.¹⁰

The Court applied the same logic to the Superintendent's other arguments and ruled that the security fund is a separate and distinct entity from the liquidation estate. For instance, in rejecting the Superintendent's argument that the limitation in Section 7434(b) must apply to the security fund payments because the security fund only pays 'allowed claims,' the Court stated that '. . . although insolvent Union's estate assets are evidently insufficient to pay all estate claims in full, no comparable plight is advanced with respect to the Security Fund's inability to pay claims in accordance with its statutory mission, with interest.'¹¹

The Court also addressed the Superintendent's argument that Insurance Law § 7608(c) prohibits payment of interest and attorneys fees because allowing such payments would result in total payments over the limit of liability of the surety bonds. While finding some inconsistencies in the Superintendent's practice with items the Superintendent has allowed to be included in the limits of liability under insurance contracts, the Court concluded that the financial guarantee bonds at issue expressly provided for the payment of interest and attorneys fees and, thus, these payments were within the limits of liability.

The Dissent

In a very brief partial dissent/partial concurrence, Chief Judge Kaye agreed with the dissenting opinion of Judge Levine that interest should not be paid under Section 7434(b), but otherwise concurred in the majority opinion.¹² The Chief Judge also urged the legislature to consider whether it intended the prohibition against the payment of interest to apply to the security fund as well as to the liquidation estate.

The dissenting opinion of Judge Levine emphasized the role of the Superintendent in the administration of both the liquidation of an insolvent insurer and of the security fund and urged the Court to defer to the Superintendent's interpretation of the statute. The dissent also emphasized that for claims to be paid by the security fund they must be 'allowed' by the Superintendent. Therefore, the dissent reasoned, the restriction on the payment of interest under Section 7434(b) is applicable to payments from the security fund as well as from the estate. The dissent argued that, to find otherwise, would impose significant additional liabilities on the security fund that were not contemplated by the legislation. Judge Levine stated that:

Thus, the Security Fund, if it pays post liquidation interest to Royal, will have a greater claim against the liquidated estate than Royal itself would have had, thereby increasing the estate's overall debt to the detriment of all other creditors sharing in the liquidated assets of the estate. Such a result clearly would contravene Insurance Law § 7434(b), and the established principles underlying that statute. [citation omitted]¹³

Further, Judge Levine stated:

. . . of course a claimant will ordinarily get more from the Security Fund than from the liquidated estate. But, so long as post liquidation interest is denied because of its disallowance under article 74, what a claimant receives from the Security Fund will not be at the expense of other creditors in the liquidated estate.¹⁴

The dissent also argued that the 'limit of liability' should be as defined by the face of the bond, and that the Superintendent's position was not patently unreasonable, and should be deferred to by the Court.

Consequences For Estate Administration: Property/Casualty Insurers

The consequences of the *Royal Bank* decision may take some time to fully develop. While the law had been changed in New York years ago to eliminate financial guaranty obligations from security fund coverage¹⁵ the decision could still leave the security fund open to potential claims on many other types of obligations, particularly because of the Court of Appeals' characterization of the security fund as a separate and distinct entity from the liquidation estate. This characterization could also have consequences in other jurisdictions as well.

It is interesting that neither the majority nor the dissenting opinions went into any detail about the treatment by the majority opinion of the security fund as distinct and separate from the estate in liquidation. For instance, Section 7608(a) states that "payments from the funds shall be made by the commissioner [of finance] to the superintendent acting as liquidator, rehabilitator or conservator . . ." (underlining added) In other words, the statute does not provide for payment by the security fund directly to claimants. Rather, the security fund payments are made to the Superintendent who then distributes the payments to the claimant. This supports the concept that the liquidation process is a unified proceeding and is not segregated into separate components (i.e. the estate vs. the security fund). While the security fund exists to protect certain classes of claimants and to insure that they will be paid in full while other claimants may not, the security fund is still an integral part of a unified statutory liquidation process, a fact that the Court (including the dissenters) seems to ignore.

In fact, it seems that the New York superintendent of insurance, as liquidator, has also missed this issue. Shortly after the issuance of the Court of Appeals decision, legislation was introduced in the waning days of the legislative session in June, 1998, to overturn the decision.¹⁶ This proposed legislation, which was not acted on before the close of session, (i) narrows the definition of "limit of liability," (ii) limits the payments from the security fund to the amount of claims allowed by the superintendent, and (iii) specifically bars payment of post-liquidation interest by the security fund. What it does not address, however, is the treatment by the court of the security fund as a separate entity, and the effect of this bifurcation on a unified liquidation process.

By separating the security fund from the liquidation estate, the New York Court of Appeals may have opened the door to creative new avenues for future claims directly against guaranty funds nationwide in an attempt to avoid the estates of insolvent insurers altogether. While a few states allow creditors direct access to guaranty funds under certain circumstances, the general rule is that the liquidation process, including guaranty funds participation, is a unified process controlled by the liquidator/receiver and the liquidation court.

Most states have determined that a unified process is necessary to avoid chaos of conflicting claims and remedies of creditors, and to prevent unintended preferences to those creditors finding their way around the process. The guaranty funds are an integral part of this process even though they may be separate entities (except in New York). The New York Court of Appeals, however, may have provided imaginative creditors with the means and the incentive to take actions in an attempt to maximize their recovery which could result in the undermining of the unified liquidation process by separating guaranty funds from the liquidation process.

The legislation proposed in New York to overturn the *Royal Bank* decision attempts to limit the security fund's exposure as expanded by the court, but it does not address the potential for bifurcation of the liquidation process. In the long run it is this potential for bifurcation rather than the expansion of the security fund's liability that may prove to be the most damaging aspect of the *Royal Bank* decision.

ENDNOTES

1. The New Jersey surplus lines guaranty fund is also a pre-assessment fund, but only covers policies written by non-admitted carriers on New Jersey risks. See N.J. Rev. Stat. § 17:22-6.70 et seq.
2. See N.Y. Ins. Law § 7603. Under § 7603(c)(1), contributions are made based ratably on the kinds of insurance as to which the fund made payments until the fund exceeds \$150 million, and resume if the fund falls below that amount.
3. N.Y. Ins. Law § 7608.
4. Compare the property/casualty insurance security fund to the life insurance company guaranty corporation of New York Act contained in Article 77 of the New York Insurance Law, where the life guaranty fund is a separate legal entity with its own board of directors.
5. *Royal Bank & Trust Co. v. Superintendent of Insurance*, No. 79, 1998 LEXIS 1426 (N.Y. June 11, 1998).
6. *Id.* at *4.
7. *Royal Bank & Trust Co. v. Superintendent of Insurance*, 179 A.D. 2d 374 (1st Dep't), 578 N.Y.S.2d 409 (1992).
8. *Royal Bank & Trust Co.*, No. 79, 1998 LEXIS 1426 at *6.
9. *Id.*
10. *Id.* at *16.
11. *Id.* at *20.
12. *Id.* at *41.
13. *Id.* at *57.
14. *Id.* at *58.
15. See N.Y. Ins. Law § 6909.
16. New York Assembly Bill Number 11379-A and Senate Bill Number 7813-A. ■