The Elephant in the Courtroom

Or how the Receivership Process has failed Executive Life Insurance Company of New York, its policyholders and annuitants

In 1991, Executive Life Insurance Company of New York (ELNY), the stressed but solvent subsidiary of its insolvent parent, Executive Life Insurance Company of California, was placed in rehabilitation in New York to protect it from cash surrenders becoming "a run on the bank." Twenty-one years later, the rehabilitator petitioned the court to declare ELNY insolvent, order it liquidated and approve a plan for the restructuring of its remaining policies alleging that ELNY's liabilities exceeded its assets by $1.6 billion.

The burden of this deficit will fall largely on individual annuitants, policy owners and the insurance companies that fund the state life insurance guaranty funds. How ELNY got to this position after two decades of receivership charged with the preservation of the company and protection of its policyholders is a cautionary tale of the failure of the receivership process to do either.

The hearing on the rehabilitator's petition to liquidate ELNY and approve the restructuring plan[1] commenced on March 15, 2012 before Acting New York Supreme Court Justice, John Galasso, in Nassau County. After ten days of testimony and one day of closing arguments, the court issued a decision on April 17, 2012 approving the rehabilitator's petition, determining that ELNY is insolvent, ordering it liquidated, and approving the proposed restructuring plan. A word of caution, however, to anyone who might consider the court's approval of the petition and plan a final resolution of the long ELNY saga. The Court's ruling is more about the allocation of pain than a solution to the underlying problem. *The elephant in the courtroom — the lack of accountability in the receivership process in New York — remains unaddressed.*

On its ELNY web page, the New York Liquidation Bureau sets the blame for the failure of ELNY squarely on the economy:

Illustration / Rafael Edwards

The rehabilitation of ELNY has been negatively impacted by sustained periods of adverse economic conditions, including low interest rate environments and unfavorable equity markets. In addition, the stock market collapse of 2008 worsened ELNY's already fragile financial condition. As a result of these adverse economic conditions, ELNY's assets are no longer adequate to continue to support the payment of 100% of the benefits ELNY annuity contract owners and other payees and beneficiaries expect to receive into the future.[2]

However, ELNY was *de facto* insolvent long before the current economic downturn. The economy may have contributed to the pace of expansion and size of the deficit but does not explain or excuse the long, painful story of ELNY's failed receivership.

Saving ELNY

When ELNY's parent was placed in receivership in California, the New York Insurance Department determined that an "increase in surrenders had caused a material erosion of ELNY's assets to the detriment of policyholders with nonsurrenderable policies, primarily structured settlement annuities."[3] As a result, New York's Superintendent of Insurance sought and obtained an order of rehabilitation in April 1991, and was appointed as rehabilitator charged with the management of ELNY. A year later, in March 1992, the rehabilitator submitted and the court approved a plan of rehabilitation for ELNY. Under the 1992 plan, ELNY's traditional whole life, term life and deferred annuity books of business were transferred to Metropolitan Life Insurance Company with substantially all the supporting statutory reserve assets. The book of single premium immediate annuities (SPIAs), primarily issued to meet structured settlement obligations, remained with ELNY together with the remaining assets, mostly of "junk" status. Neither the 1991 rehabilitation order or the 1992 order approving the rehabilitation plan declared ELNY to be insolvent.

For the twenty plus years since the approval of the rehabilitation plan, the rehabilitator continued to pay all annuitants in full. However, faced with a $1.6 billion shortfall, in September 2011 the rehabilitator asked for the first time that the court declare ELNY insolvent, order its liquidation and approve a restructuring plan for the ELNY annuities.[4]

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Restructuring Plan

Under the restructuring plan, the remaining ELNY assets are to be transferred to a new entity — a District of Columbia captive — owned and controlled by the participating state life insurance guaranty funds, which will contribute funds to the new entity in amounts based on their individual state fund laws. The ELNY contracts will be restructured to a level that can be supported by these assets, and the obligations as restructured will be assumed by the new entity. Because most of the annuities are relatively small and fall within guaranty fund caps, the rehabilitator estimated that roughly 84% of all annuitants would continue to receive their full periodic annuity payments. That percentage does not tell the full story, however.

ELNY's assets, based on its December 31, 2010 statements,[5] cover only about 36% of its obligations and the rest will come from the various state life insurance guaranty funds. These guaranty funds, however, have statutory caps. The most common cap is $300,000 although the New York cap is $500,000. As applied by the restructuring plan, the cap is the maximum allocated to each contract, so that the guaranty fund contributes the difference between a contract's pro-rata share of ELNY assets and the applicable fund cap.[6] Because of the life guaranty fund limitations, the benefits under any annuity with a present value in excess of the applicable guaranty fund cap will be cut significantly – many of them by a half or more.

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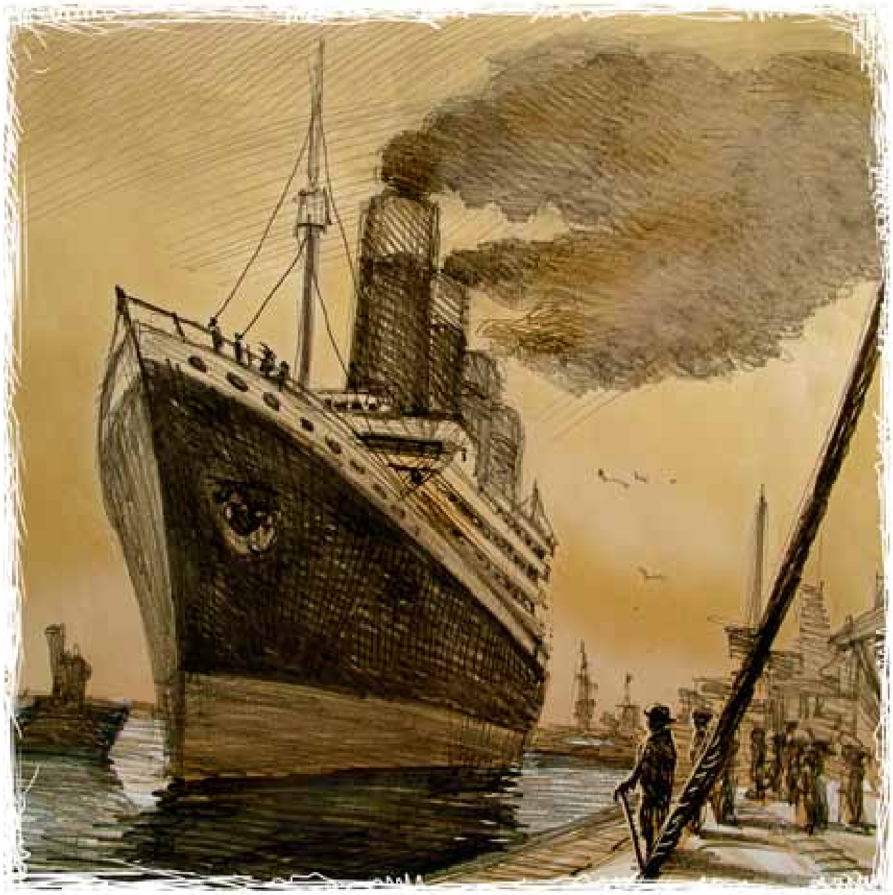

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The restructuring plan also includes a few enhancements, and a consortium of contributing life insurance companies have committed to establishing a $100 million “hardship fund” to be administered outside of the plan. These additional benefits may or may not prove to be meaningful, but they will not come close to making many annuitants whole.

Failure of the Receivership Process

To understand the dilemma facing the current rehabilitator, it is helpful to go back to the beginning. *The 1992 ELNY rehabilitation Plan, like the Titanic, was doomed the moment it left port, and the current rehabilitator is the one left to deal with the consequences.* How was it doomed? The original rehabilitation plan stripped out all the traditional life and annuity business and transferred it to Met Life with the supporting, statutory reserve assets. These contract holders received an equivalent policy from Met Life and suffered no material financial consequences. Unlike the typical property/casualty insolvency, where contracts are terminated, assets marshaled, and claims assessed and paid as of a pre-determined cut-off date, transferring policy obligations to another carrier or carriers has been the historic method of addressing financially stressed life insurance companies. The single premium individual annuities (SPIAs) did not fit this mold, however, and for whatever reason the most volatile, long-tailed book of ELNY business was left in ELNY together with its weakest assets.[7]

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The assessment of the portfolio in the 1992 rehabilitation plan was remarkably prescient stating that:

> The cash flows produced by ELNY’s bond investments and Common Stock dividends are projected to be sufficient to cover current SPIA payouts for at least ten (10) years.[8]

That is precisely what happened. The cash flow from ELNY’s remaining assets was sufficient to meet the SPIA payments for almost ten years as predicted. As shown by the annual reports of the Liquidation Bureau (unaudited for years prior to 2006) obtained over the years through Freedom of Information Law requests,[9] *ELNY’s cash flow went negative in 2002, ten years after the Plan of Rehabilitation and six years before the economic downturn of 2008* (see table).

To fully understand how ELNY could have been allowed to continue to pay full benefits while insolvent for a decade and with no action taken to address the inevitable, one must consider the receivership process in New York.

Counter intuitively, when a company is placed in rehabilitation in New York the company ceases to be regulated. The superintendent of insurance (now the superintendent of financial services), as rehabilitator, stands in the shoes of the company and is charged with its management. The superintendent delegates this management role to the Liquidation Bureau, a separate entity that acts solely as the superintendent’s agent in his non-regulatory role as rehabilitator. The rigorous statutory requirements for filings, reports or certifications imposed on other licensed companies are no longer imposed on estates in rehabilitation; there are no periodic regulatory reviews, examinations or communications; there is no regulatory oversight of the operations, assets or finances; and there is no mechanism for regulatory oversight of financial condition or

Year	Assets ($Millions)	Liabilities ($Millions)	Surplus/ (Deficit)	Percent of Coverage
1994	$1,648	$1,632	$16	100.0%
1995	$1,657	$1,624	$33	100.0%
1996	$1,678	$1,633	$45	100.0%
1997	$1,794	$1,697	$97	100.0%
1998	$1,857	$1,710	$147	100.0%
1999	$1,926	$1,724	$202	100.0%
2000	$1,770	$1,613	$157	100.0%
2001	$1,646	$1,605	$41	100.0%
2002	$1,465	$1,575	($110)	93.0%
2003	$1,528	$1,643	($115)	93.0%
2004	$1,495	$1,642	($147)	91.0%
2005	$1,429	$1,621	($192)	88.2%
2006	$1,379	***$2,645**	***($1,266)**	52.1%
2007	$1,345	$2,539	($1,194)	53.0%
2008	$1,042	$2,438	($1,396)	42.7%
2009	$984	$2,516	($1,532)	39.1%
2010	$906	$2,474	($1,568)	36.6%

*** Note: $1.02 Billion added to reserves based on a revision to the life and annuity valuation basis as of 12/31/06.**

compliance with the insurance law or regulations.

The Bureau often argues that it is subject to statutory oversight by each receivership court. However, receivership courts in New York are courts of general jurisdiction and not dedicated receivership courts like Federal bankruptcy courts. Also, courts generally only consider matters that are brought before them, and certainly do not consider themselves to be regulators. Even if they were so inclined, however, because there are no statutory requirements for filing any financial or actuarial statements or other periodic reports with the court, they would not have the tools necessary to do so.[10] And, curiously, the rehabilitator can change venue on its own *ex parte* motion.[11]

From the time it was placed into rehabilitation in 1991 until after 2006 no audit of ELNY was required…

That ELNY was insolvent for years and becoming progressively and irreparably beyond recovery was quite evident from a study of the Liquidation Bureau's own albeit limited published records. From the time it was placed into rehabilitation in 1991 until after 2006 no audit of ELNY was required or had been conducted. As shown on the chart above, the 2006 audit resulted in a 63% increase in reserves and a 650% increase in the stated deficit. This reserve adjustment was not a sudden awakening, however. Even before the audit the Liquidation Bureau acknowledged that the reserve standard used in the annual statements were substantially understated. From 1998 through 2005 the Liquidation Bureau's unaudited statements for ELNY included the following note:

> The Balance Sheet was prepared for the internal use of the New York Liquidation Bureau. Specifically, the Balance Sheet reflects the use of historic reserve standards solely for the purpose of comparison to prior periods. *The use of historic reserve standards substantially understates reserves when compared to reserves that would be required to satisfy regulatory requirements for a going concern insurance carrier*. As a consequence, the use or interpretation of these financial statements by anyone other than the New York Liquidation Bureau would be materially misleading. [*Italics* added for emphasis][12]

This incredibly telling note begs the question: why weren't proper accounting and reserve levels required or maintained, particularly for an entity that was solvent at the time it was taken into rehabilitation to protect it and its policyholders?

The Hearing

To many observers, the Court's approval of the rehabilitator's petition approving ELNY's liquidation and restructuring its remaining contracts was a forgone conclusion given the condition of ELNY and the statutory limitations. Although the decision gives the receiver and the guaranty funds the result they sought, a review of the testimony and arguments presented by all sides at the hearing provides a useful window on the issues that are likely to continue to haunt this estate and the receivership process in New York.

The rehabilitator argued that ELNY was insolvent to the tune of over $1.6 billion, that it could not be allowed to continue to operate in rehabilitation and that the proposed plan was the best available outcome under the law considering the current condition of ELNY. Furthermore,

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the rehabilitator argued that under the proposed plan:

- The vast majority of annuitants (about 84%) will have no reduction in benefits;
- ELNY's assets will be allocated pro rata to all contracts so there is no class preference;
- The life guaranty fund contributions are controlled by each state's statute, and cannot be changed by this court;
- The relatively small number of annuitants whose benefits are reduced (primarily because of the limitations of guaranty fund coverage) will still be better off under the plan than in a straight liquidation; and
- If the plan were not approved, the commitments by the 40 participating guaranty funds and the voluntary enhancements provided by the consortium of 39 life insurance companies would likely be lost to the detriment of all annuitants.

Poignancy was brought to the proceeding by the appearance and emotional testimony of a number of "shortfall payees" – representative of the 16% of payees who will have their benefits reduced under the proposed plan, many by 50% or more. Among the principal points by these plan objectors were:

- Given the complexity and consequence of the proposed plan, the notice provided to payees was inadequate and untimely;
- The plan will be administered and overseen by the very people that caused the shortfall — the rehabilitator and his agents;
- The people most affected by the plan, the shortfall payees, were not consulted in the development of the plan and have not been given any reasonable opportunity to consider and propose an alternative plan;
- The requested judicial immunity for the rehabilitator and everyone connected with the plan and its implementation is unprecedented and unwarranted given the failed history of the rehabilitation;

illustration / Rafael Edwards

- By placing the full burden of the shortfall on a small percentage of the payees, the plan is neither fair nor equitable, and creates an improper sub-class of claimants; and
- Collectively these objections, including a denial of any right to opt out of the plan, constitute an unconstitutional taking of property without due process.

Understanding the ELNY math is important to fully appreciate the scope and effect of the plan on a small segment of annuitants. According to the report and testimony by the rehabilitator's expert,[13] the market value of ELNY's assets at year-end 2011 was $957 million against an estimated current value of liabilities of $2.604 billion, a shortfall of $1.647 billion. Assuming a plan closing on or about July 1, 2012, the new entity would receive about $1.691 billion in assets to assume roughly an equal amount of current value liabilities, leaving in excess of $900 million in present value liabilities uncovered.

Following is a breakdown of the contributions (in millions) to the new entity:

Remaining ELNY assets	$ 919
Guaranty Fund Contributions	$ 701
Life Insurance Company Contributions:[14]	$ 71
Total Funding for New Company	$1,691

The $900 million remainder of current liabilities not assumed by the new entity is eliminated through the reduction in benefits to annuitants. But this reduction in benefits is not spread across the board.

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As stated repeatedly by counsel for the rehabilitator and the guaranty associations, about 84% of all annuitants will continue to receive their full annuity payments under the restructuring plan. This means that about 8,150 of the 9,700 current payees will not have their benefits reduced or changed at all – they will continue to receive 100% of their future periodic and lump sum payments. *So the entire $900 million in reductions is borne by the remaining 1550 payees, and all but 31 of these contracts are structured settlement annuities. The **average** loss in current value of benefits being borne by each of these 1550 annuitants is $600,000!*

Shortfall annuitants who testified at the hearing included victims of trauma dependent on the income from their settlements for their basic quality of life; and people who put their life savings into an investment they were assured was fully guaranteed by the law and the insurance industry.[15] In the objectors' view, the financial burden of the shortfall is unfairly, and without due process, falling on the most vulnerable segment of annuitants. The plan proponents countered that the plan is a far better deal for all annuitants, including the shortfall annuitants, than under a straight liquidation, and that it was the best result under the law.

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In the end, the court accepted the rehabilitator's arguments substantially *en toto*, concluding that the law gave him no choice but to either approve the petition and plan as presented or risk a straight liquidation that would put even more payees at risk of losing significant benefits. [16] Justice Galasso seemed to accept that he had little authority or flexibility to address issues raised by the objectors, although even in the court's self-imposed limitation of authority, he recognizes that there are a number of unresolved issues:

"This means, the scope of the hearing before the undersigned was limited by the Insurance Law and could not include inquiries into why the insurer failed in the first instance, its investment and operation prior to failure, how the Superintendent and his agents supervised the affairs of the insurer, or why a settlement was not reached or this order to show cause brought before the Court sooner."[17]

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With several objectors vowing to appeal or take other action to seek redress for their losses, there are a number of legal issues relating to the ELNY rehabilitation and eventual liquidation that could linger in the courts for years, including:

- The propriety of the court including the rehabilitator's request for judicial immunity for himself and his agents in the signed liquidation order;
- Whether the up front netting of the guaranty funds' subrogation rights (so that no guaranty fund actually pays its full cap on any claim) contradicts the legislative intent of the caps;
- Whether the plan results in an improper sub-class of claimants — the shortfall annuitants;
- The scope of claim-over rights of shortfall annuitants against policy owners, insurance brokers, attorneys or others involved in the original settlements;[18]
- The role and rights of factors that acquired claim payments from annuitants;[19] and
- The scope of responsibility of the rehabilitator and his agents as fiduciaries for all ELNY policyholders and payees for the failed rehabilitation.

The fact remains that the $1.6 billion loss occurred during twenty-year's of unregulated management by the proponents and overseers of the plan – the rehabilitator and his agents. Throughout the hearing counsel for the rehabilitator succeeded in diverting attention away from an examination of the failed history of the rehabilitation arguing, among other things, that the original rehabilitation plan was approved by the court (It's the court's fault!?); and the economic recession ate the assets! These arguments fail under scrutiny and are nothing more than smokescreens to hide the elephant in the courtroom: *New York's receivership system has failed ELNY, its policyholders and beneficiaries, as well as the insurance industry and its customers.*

Who Protects Us from the Receiver?

Without any regulatory interference, and with little if any incentive to take remedial action so long as the cash flow permitted continuing payment on all annuities, the ELNY estate was allowed to move slowly toward the inevitable day of reckoning recognized by the 1992 rehabilitation plan. When economic circumstances worsened, and the reserve deficiencies became too significant to ignore, the pace quickened to the point where the inevitable could no longer be postponed.

If ELNY had not been in rehabilitation, and had been required to continue to file statutory financial statements, including annual independent accounting and actuarial certifications, it is highly unlikely that the regulators would have allowed it to get to the point where the estate is today. It is also inconceivable that the company's management and its agents would be allowed to propose and carry out a plan to correct its financial woes once it was materially impaired. If its dire condition had for some reason eluded the regulators, the company's officers and directors, its independent auditors, actuaries and other agents, could all potentially — and probably would — have been held accountable for their actions or inactions contributing to its failure.

With ELNY in rehabilitation, however, the parties charged with the management of the company for the past two decades are the proponents and overseers of the restructuring plan. And they sought

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and obtained court immunity for doing so! The court's order includes the following provision as requested by the superintendent:

> Judicial immunity is extended to the Superintendent in his capacity as Receiver and his successors in office, the New York Liquidation Bureau, and their respective attorneys, agents, and employees, and such immunity is extended to them for any cause of action of any nature against them, individually or jointly, for any action or omission by any one or more of them when active in good faith, in accordance with this order, or in the performance of their duties pursuant to Insurance law Article 74; . . .[20]

The New York Insurance Law does not provide immunity for the superintendent or his agents in his separate, non-regulatory role as receiver. The grant of judicial immunity at the request of the rehabilitator further exacerbates the lack of accountability under the current receivership process in New York and raises the question: *if the court protects the receiver from us who protects us from the receiver?*

Faux Protection?

ELNY's failure at the hands of the agents of the rehabilitator has also apparently exhausted the New York life insurance guaranty fund, so that following ELNY *there will be no viable life insurance guaranty fund coverage in New York.*

A bill working its way through the New York Legislature would increase the $500 million aggregate cap for all life insurance company failures to $558 million to cover funding of the ELNY restructuring plan.[21] This is an acknowledgement that the funds available to the life guaranty funds in New York are insufficient to meet their total obligations to the ELNY policyholders under the plan, but provides nothing more than the funds necessary for the ELNY liquidation. Therefore, once ELNY is liquidated, whether under the approved plan, some variation of the plan, or in a straight liquidation, the cap will be exhausted and no further funds will be available for any future life insurance company insolvency in New York without an act of the Legislature.

Conclusion

The ELNY story is yet another consequence of the failure of the New York receivership process that took control of a solvent company and managed it for twenty years under the radar and without the most basic elements of accountability. The restructuring plan touted by the current rehabilitator and approved by the court may solve the immediate problem (at the expense of the most vulnerable group of annuitants), but it does not address the underlying systemic defects. Regulators, legislators, guaranty funds, and interested industry and consumer groups should thoroughly examine how ELNY got to this point – from its ill-conceived rehabilitation plan in 1992 to the steady, predictable but unchecked management of liabilities and erosion of assets leading to ELNY's current condition.

The rehabilitator failed in his mission to protect ELNY, its policyholders and annuitants due largely to a receivership process lacking in basic standards of accountability. The elephant needs to be recognized and properly addressed! •

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