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# In Re Liquidation of Integrity Insurance Company: Cutting Off the "Long-Tail" of IBNR Claims

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In a decision carrying significant implications for reinsurer liability in insurer insolvency proceedings, the Supreme Court of New Jersey held on December 13, 2007, in a 3-2 decision, that incurred but not reported claims ("IBNR claims") do not qualify for participation in the final distribution of an insolvent insurer's liquidated estate pursuant to New Jersey's Rehabilitation and Liquidation Act, N.J.S.A. 17:30C-28(a). *In re Liquidation of Integrity Ins. Co.,* Nos. A-91-06/A-29-07, (N.J. Sup. Ct. Dec. 13, 2007) (the "Decision"), at 2. Affirming the Appellate Division's holding that a claim against the liquidated estate must be "absolute" and that the statute does not permit the substitution of estimated claims for "absolute" ones – even when those estimated claims result from the application of sophisticated actuarial estimation methodologies – the Supreme Court blocked the Integrity Liquidator's ability to seek reinsurance recoveries for IBNR claims based upon their estimated value and consequently freed Integrity's reinsurers from potentially billions of dollars of exposure.

This memorandum briefly summarizes this important decision.

**BACKGROUND**

Integrity Insurance Company was a property and casualty insurer licensed to transact business in every state. Decision at 3. Most of its risks were subject to reinsurance and many of the risks (*e.g.*, environmental and products liability) were not expected to translate into reportable claims until many years after the policies were issued. *Id*.

Integrity was declared insolvent in December 1986 by of the Superior Court, Chancery Division. *Id*. On March 27, 1987, the Chancery Division ordered Integrity into liquidation and appointed the New Jersey Commissioner of Insurance as Liquidator. *Id*. On June 17, 1996, the Liquidator filed a Final Dividend Plan ("FDP") with the court to effect the early termination of the Integrity estate. Under this "novel plan," the actuarial estimates of Integrity's future liabilities were reduced to present value. *Id.* More specifically, under the FDP, the Liquidator was to:

> (1) estimate and allow the present value of all Contingent Claims, including claims for IBNR losses; (2) collect from reinsurers the present value of any reinsurance that will be due on such claims; (3) arrive at a final determination of Integrity's assets and liabilities; (4) calculate the percentage to be paid on the Fourth Priority [policyholder] claims; and (5) pay a final dividend on all claims accorded Fourth Priority or higher status.

*Id*. at 3-4 (quoting *In re Liquidation of Integrity Ins. Co.*, 165 N.J. 75, 80 (2000)).

Allowing IBNR claims as part of Integrity's final distribution plan, the Chancery Division explained that the Liquidator had presented three possible options. *See In re Liquidation of Integrity Ins. Co.*, 299 N.J. Super. 677, 680 (Ch. Div. 1996). The first option involved a run-off approach whereby the liquidation would continue until all or substantially all contingent claims had become absolute as to value and amount. The Liquidator argued that this would result in prolonging the liquidation for at least another 10 years, causing the estate to incur administrative expenses of approximately $45 million over that period. The second option involved a cut-off approach whereby the estate's liability for any IBNR losses would be terminated. The Liquidator argued that this approach would be manifestly unfair to many policyholders and third parties with contingent claims who would lose any recourse to the assets of the estate. The third option was a proposal to estimate and, in appropriate cases, allow contingent claims at their net present value using an independent actuarial consulting firm, and collect any reinsurance that may be due on such claims. The Liquidator believed that implementation of such a plan would hopefully lead to the conclusion of the liquidation within three years. Decision at 5 (citing *In re Liquidation of Integrity Ins. Co.*, 299 N.J. Super. at 680-81).

The Chancery Court embraced the third option, concluding that the "'the Liquidator has the statutory authority to determine contingent claims and to permit such contingent claims to participate in distributing [the] assets from the Estate.'" Decision at 6 (quoting *In re Liquidation of Integrity Ins. Co.*, 299 N.J. Super. at 692).

Eight years later, the Chancery Court had occasion to consider Integrity's fourth amended final dividend plan. Because it had already determined that IBNR claims could be included as part of the distribution of Integrity's estate, the Chancery Division considered the central issue before it to be limited to "whether the proposed Fourth Amended Final Dividend Plan achieve[d] that objective (1) using generally accepted estimation techniques; (2) in a commercially reasonable manner; and (3) while protecting the policyholders, insureds, and the public." Decision at 6. Acknowledging that an actuarial estimate is not a "100% guarantee," the Chancery Court concluded that the proposed procedure satisfied the three prongs of the court's test, and thus authorized the final dividend plan using actuarial estimates for IBNR claims and allowing for a special master to resolve any disputes arising therefrom. *Id*.

At the time of its decision, the Chancery Court was keenly aware of the significance of resolution of the issue of Integrity's IBNR claims to Integrity's reinsurers. Indeed, the Chancery Court noted in 1996 that "'there are an estimated $1.321 billion of [IBNR] losses as of December 31, 2005, which may not become absolute as to liability, coverage, and amount for thirty years or more,'" and that "'[p]ursuant to the plan, Integrity's reinsurers will be obligated to pay on these contingent claims an estimated $876 million.'" Decision at 7 (quoting *In re Liquidation of Integrity Ins. Co.*, 299 N.J. Super. at 680).

The Reinsurance Association of America ("RAA") subsequently appealed the Chancery Division's order approving Integrity's Fourth Amended Final Dividend Plan. Specifically, the RAA challenged (i) the provisions of the plan that permit the Liquidator actuarially to estimate claims not yet known but which may be presented at some time in the future and to compel Integrity's reinsurers to pay the sums thus computed to be distributed in accordance with the plan and (ii) the provision of the plan requiring the reinsurers to forfeit their contractual right to arbitration of disputes in favor of a dispute resolution monitored by the Chancery Division. *See In re Liquidation of Integrity Ins. Co.*, No. A-6972-03T5, 2006 WL 2795343, at *2 (N.J. Super. A.D. Oct. 2, 2006).

Siding with the RAA, the Appellate Division reversed the Chancery Division, concluding that 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 [N.J.S.A. 17:30C-28(a)] from sharing in the estate.

*Id*. at *3. The Appellate Division also held that the arbitration provisions in Integrity's reinsurance contracts must be enforced. *Id*. at *7.

Following the Appellate Division's reversal, Integrity policyholder American Standard Companies, Inc. sought leave to intervene and leave to appeal, which the Supreme Court granted. The Court also granted the Liquidator's motion for leave to appeal. In addition, Foster Wheeler L.L.C. was granted leave to file a brief amicus curiae. Decision at 8.

**SUMMARY OF THE DECISION**

Writing for the 3-2 Court, Justice Rivera-Soto explained that the very straightforward issue on appeal was "to determine the meaning of N.J.S.A. 17:30C-28(a)(1)." Decision at 10. The statute provides that, in the liquidation of an insurer's estate:

> ***[n]o contingent claim*** shall share in a distribution of the assets of an insurer which has been adjudicated to be insolvent . . ., except that such claims shall be considered, if properly presented, and may be allowed to share where
>
> (1) Such 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

N.J.S.A. 17:30C-28(a)(1) (emphasis added).

The dispute centered on the meaning of the word "absolute." The Liquidator, intervenor and amicus argued that, in the context of the statutory scheme governing the liquidation of insolvent insurers, the term "absolute" must also encompass those claims that are the product of generally accepted estimating techniques applied in a commercially reasonable manner, so long as those estimating techniques protect the policyholders, the insureds and the public. Decision at 11-12. The RAA, on the other hand, argued that "absolute" means absolute and that the clear legislative choice concerning which claims are cognizable in an insurance liquidation must be honored. *Id*. at 12.

The Supreme Court agreed that "[t]he unambiguous terms of N.J.S.A. 17:30C-28(a) demonstrate that the Legislature specifically selected which claims would be honored in the insurance company liquidation context." *Id.* The Court also found that the "overarching legislative intent plainly is to bar any contingent claim," subject only to two exceptions—the relevant one here being when a contingent 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." *Id.* (citing N.J.S.A. 17:30-C28(a)(1)). The Court found this Legislative intent also to be reflected in subsection (b) of the statute, which addresses non-final, contingent third-party claims, and adopts a different standard for such claims than the "absolute" standard prescribed by subsection (a). *Id.* at 12 n.2 (noting that under N.J.S.A. 17:30C-28(b), third-party claims may be allowed if, among other requirements, it may be "reasonably inferred" from the proofs that the person "would be able to obtain a judgment upon such cause of action").

The Supreme Court also was persuaded by the Appellate Division's definition of IBNR claims as "those that may, by virtue of historical experience, be expected to be filed, although the claimant, the nature of the claim, the responsibility for the claim and the amount of the claim are all unknown[,]" as well as the Appellate Division's reasoning and conclusion that, given the plain meaning of N.J.S.A. 17:30C-28, "IBNR claims are actuarial estimates and are, therefore, not absolute." Decision at 13. Moreover, the Supreme Court agreed with the Appellate Division's finding that it is generally accepted that the term "absolute" is "synonymous with 'unconditional' or 'non-contingent'" and further noted that the Court's own independent review of the meaning of "absolute" yielded similar results. *Id*.

Ultimately, the Supreme Court concluded that in this context, the most apt definition is that "absolute" means "[s]omething considered to be independent of and unrelated to anything else." Decision at 13-14 (quoting Webster's II New College Dictionary). Accordingly, the Court held that "[b]ecause the process by which the Liquidator proposes to estimate IBNR claims necessarily entails looking outside of each claim to other similar claims in respect of their very existence, nature, extent and cost, IBNR claims fail to satisfy that most basic of requirements in order to be 'absolute': that in order for a claim to participate in the liquidation of an insolvent insurer's estate, the claim, in each of its fundamental respects, must stand on its own, and not by reference to any other claim." Decision at 14 (footnote omitted). Therefore, the Court held, Integrity's Fourth Amended Final Dividend Plan approved by the Chancery Court cannot be sustained.

Acknowledging that their holding will no doubt further delay the final liquidation of Integrity's estate and compound administrative costs, the Supreme Court maintained that their holding "is compelled by [their] obligation to hew to the Legislature's mandate." *Id*. at 15. The Court further noted that while the Legislature may, in the future, amend the statute, as presently written it does not permit any claim other than an "absolute" or unconditional claim to share in the estate of an insolvent insurer. *Id*.

Because the Court concluded, as the Appellate Division did, that IBNR claims are not cognizable as "absolute" claims under N.J.S.A. 17:30C-28(a), the Court did not need to consider whether the special master/dispute resolution mechanism for the processing of IBNR claims adopted by the trial court improperly violated the parties' choice of arbitration as their dispute resolution mechanism. In any event, the Court held that to the extent the Appellate Division did reach that issue, that portion of the judgment below is vacated as moot. *Id*. at 15-16.

In a dissenting opinion (the "Dissent"), in which Justice Albin joined, Justice Long argued that permitting the Liquidator to rely on estimations of IBNR claims is consistent with the aims underlying the Liquidation Act. First, Justice Long argued that the statute does not clearly prohibit the estimation of IBNR claims because the text of N.J.S.A. 17:30C-28(a) does not define "contingent" or "absolute as to the insurer," and the legislative history is silent as to the meaning and scope of those terms. Dissent at 8-9. Justice Long also pointed to the fact that scholars do not even agree on the meaning of the term "contingent claim." *Id*. at 9. Second, Justice Long argued that the Legislature never even considered IBNR claims when it enacted the Liquidation Act in 1975, toxic tort litigation did not fully emerge until the 1980s and 1990s, and therefore "[i]t is almost certain . . . that the treatment of long-tail IBNR claims was not in the legislative cross-hairs when the Rehabilitation and Liquidation Act was passed." Dissent at 9-10. Finally, Justice Long urged that the Commissioner's interpretation – which would permit the broadest class of potential claimants to participate in the liquidation proceeding – should be deferred to in light of her broad discretion and wide ranging power to "fashion any remedy that is necessary" to protect the public and the policyholders in a liquidation. *Id.* at 11-12. In closing, Justice Long also urged the Legislature to specifically address the issue of IBNR claims in the liquidation context.

**CONCLUSION**

Reinsurers wary of estimation approaches employed by receivers and liquidators of insolvent insurance companies to approximate the value of IBNR claims and to seek reinsurance recoveries based on those estimates, and the potential for courts to disregard reinsurer rights in pursuit of purported efficiencies in liquidated estate administration, should applaud the Court's adherence to the statutorily-prescribed limitations on the Commissioner's authority in this case.

If you have any questions concerning this decision, please contact Mary Kay Vyskocil (212-455-3093) or Andrew Amer (212-455-2953).

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