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Special Interests at Stake When Dealing with Distressed Insurers

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While most attorneys are familiar with the automatic litigation stay under Section 362 of the federal Bankruptcy Code, few may be aware of the different procedures for pursuing claims against distressed insurers. A recent Delaware Court of Chancery decision, *In the Matter of the Liquidation of Freestone Insurance*, C.A. No. 9574-VCL (Del. Ch. July 7), illustrates the unique landscape for such claims in which federal bankruptcy law—and its automatic stay provisions—are supplanted by state laws, including the Uniform Insurers Liquidation Act (Uniform Act).In *Freestone*, Vice Chancellor J. Travis Laster addressed the issue of whether the court should lift a discretionary anti-suit injunction imposed in an insurer liquidation barring parties from pursuing claims against the liquidated insurer outside the statutory claims process pursuant to the Uniform Act. The case arose during the liquidation of Freestone Insurance Co., a Delaware-domiciled insurer, and related to reinsurance agreements under which Freestone, as reinsurer, was obligated to fund a trust account to cover reinsured claims underwritten by a fronting insurer.

During Freestone's liquidation, the fronting insurer sued the trustee bank holding the trust account in a separate South Carolina proceeding, alleging that the bank had permitted Freestone to substitute assets of inferior value as collateral into the reinsurance trust account. The bank, in response, filed two notices of claim against Freestone in the liquidation proceeding pursuant to the claims process and then sought to name Freestone as a third-party defendant in the South Carolina action. By naming Freestone, the bank hoped to obtain a judgment that would establish its status as a general creditor in the Delaware liquidation, as prejudgment contingent claims would not share in the distribution of assets under the Uniform Act's priority scheme for payment of claims.

In evaluating the bank's request, the court in *Freestone* began by noting the guiding principle that regulation of insurance is left to the states, with federal law itself expressly carving out insurance companies from the purview of the federal Bankruptcy Code, (15 U.S.C. Section 1012(a); 11 U.S.C. Section 109(b)). The court then noted the "dearth of case law" in Delaware and elsewhere addressing whether and when a court overseeing a liquidation proceeding should lift an anti-suit injunction. Only one Delaware case had even addressed the issue of lifting the injunction—In re Rehabilitation of Manhattan Re-Insurance Co., 2011 WL 4553582 (Del. Ch. Oct. 4, 2011)—but it did not provide a framework or factors to be considered, though it did hold generally that courts have the discretion to lift the injunction if it "would not be inconsistent with the Uniform Act or its goals."

As in other states, insurer liquidations in Delaware are governed by state law, including the Uniform Act, a key purpose of which is to leave the "business of insurance" and insurer insolvency to the states. Such laws, as the court noted, centralize the liquidation of insurers under the control of the chief insurance regulator of the domiciliary state, who is responsible for "establishing a mechanism for filing, processing, and paying claims in accordance with a statutory prioritization scheme." Under the Uniform Act's prioritization scheme, there are nine classes of claims, with distributions from the insolvent insurer's assets paid out to each class in order of priority and ratably within each class. This process ensures that higher priority claimants—i.e., state pension plans (Class II) and policyholders (Class III)—receive priority over other claimants—i.e., federal tax obligations (Class IV) and general creditors (Class VI).

Within this context, the *Freestone* court found that the anti-suit injunction at issue directly advanced the purposes of the Uniform Act by preventing the premature and inequitable distribution of assets that would occur if the state regulator was forced to defend claims of all types, no matter where brought. After reviewing the purpose and history of the Uniform Act and the role of the anti-suit injunction, the court then analyzed analogous frameworks used by bankruptcy courts when evaluating whether to lift the automatic bankruptcy stay to determine whether either would provide an appropriate framework for the instant case. These bankruptcy court frameworks included the 12 commonly used factors from *In re Curtis*, 40 B.R. 795 (Bankr. D. Utah 1984) or the three-prong balancing test articulated by the bankruptcy court in Delaware, see *In re Scarborough-St. James Corp.*, 535 Br. 60 (Bankr. D. Del. 2015), both of which consider respective hardships, judicial economy, the potential for resolution of the issues, and the connection between the foreign litigation and the bankruptcy proceeding.

Ultimately, in light of the unique regulatory overlay and the importance of centralized liquidation under state oversight, *Freestone* declined to adopt either bankruptcy framework wholesale. Instead, the court opted for a hybrid approach, with the burden on the party seeking to lift the injunction, that focused on four key factors: the nature and extent of any connection between the foreign litigation and the liquidation proceeding; the interests of judicial efficiency and litigant economy; prejudice to interests of the state regulator, claimants, and other parties; and balance of the hardships.

Examining the request under this framework, the court found that the bank had failed to demonstrate that lifting the stay "would not be inconsistent with" the Uniform Act or its goals. For example, the court noted that the South Carolina action was directly related to the liquidation proceeding insofar as the bank sought to recover from the same assets that would be distributed in the claims process. Thus, requiring the insurance commissioner to defend the South Carolina action would force a dispersal of resources without additional efficiency benefits to the liquidation and claims process. The court also perceived no special benefit to the adjudication of the claims by a nonspecialized foreign forum in which the litigation was not well-advanced. As for prejudice to other parties, the court recognized that even if the bank prevailed in the South Carolina litigation, its odds of recovery in the liquidation proceeding would not substantially increase because the bank's litigation claims would become Class VI general creditor claims, which would still be far behind the higher priority classes and unlikely to result in recovery in the absence of a surplus. Thus, permitting the South Carolina litigation to proceed would do little but divert resources away from higher priority claimants in the form of litigation costs without a material difference to the anticipated resolution of claims. Finally, as to the balance of hardships, the court concluded that the South Carolina litigation yielded "no benefits, only costs" for the insurance commissioner while providing "at best intangible benefits" to the bank because its odds of financial recovery would still be speculative. In light of these considerations, the court held that lifting the stay would be contrary to the "philosophy, structure, and purpose of the Uniform Act"—and simply dissipate funds destined for higher priority claimants—and therefore denied the bank's motion.

Freestone demonstrates the unique issues confronting creditors dealing with distressed insurers. First and foremost, *Freestone* provides a reminder that federal bankruptcy laws do not apply to insolvent insurers and that courts remain sensitive to the significant state interests implicated by insurer liquidations, which necessitate special protections for the primacy of liquidation proceedings and the authority of state insurance regulators. Second, a logical step beyond *Freestone*'s holding suggests that creditors should not only consider promptly bringing claims under the Uniform Act (or similar statutes), but in the case of contingent claims, should be aware that failure to bring such claims to judgment before liquidation may risk forgoing the opportunity to recover.

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