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Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Voidable Preference In Pa. Insurer Liquidations?

Law360, New York (December 04, 2009) -- An innocent policyholder may not realize that a claim payment it receives on its policy may be subject to a preference claim should its insurer be placed into an insurance company receivership even if the insured had no knowledge of the insurer's perilous financial condition when the payment was made.

Whenever a policyholder receives a payment from a financially troubled insurer, the policyholder may be faced with a later voidable preference challenge from the liquidator of the insurer (or rehabilitator in a few states) should the company be placed into liquidation or rehabilitation.[1]

This could result in the insured having to return the payment, and then be left with just a claim on its policy that will almost certainly result in a diminished recovery far in the future.

Almost every state in the United States has statutory provisions that authorize an insurance company receiver to avoid a preferential transfer and recover the payment under certain circumstances.[2]

Recently, however, the Pennsylvania Supreme Court found that a claim payment on an insurance policy was not a voidable preference even though made in the preference period. *Ario. v. Ingram Micro Inc.*, 965 A.2d 1194 (Pa. 2009).[3]

A preference is defined generally as a transfer of money or property whereby a creditor receives more on its debt than similarly situated creditors during some specified period (usually one year) prior to a successful petition for the liquidation or rehabilitation.

Many states, including Pennsylvania, also require that the transfer be on account of an "antecedent debt" for it to constitute a preference.

Although this is an important term, it is not defined in any of the state insurance rehabilitation and liquidation acts that include the antecedent debt requirement.

Even if the transfer is a preference, it can only be avoided by the receiver and the payment recovered from the creditor in certain circumstances.

The majority of states including Pennsylvania have enacted a provision that allows for the avoidance of a preferential transfer in any of the following circumstances:

- 1) the transfer was within four months of a successful liquidation petition;
- 2) the transfer was within one year of the successful liquidation petition and the insurer was insolvent at the time of the transaction; or
- 3) the transfer was within one year of a successful liquidation petition and the creditor receiving the payment had “reasonable cause to believe at the time the transfer was made that the insurer was insolvent or about to become insolvent.” See e.g. 40 Pa. Cons. Stat. § 221.30.[4]

The first two circumstances allow for avoidance even if the creditor had no intent to do better than other creditors or even had any knowledge of its insurer’s precarious financial situation. The Ario decision would give some comfort to these innocent creditors although the decision is limited to Pennsylvania.[5]

Pennsylvania Supreme Court Recognizes Ordinary Course of Business Exception to Preference in Ario v. Ingram Micro Inc.

Ario involved the liquidation of the Pennsylvania company, Reliance Insurance Company. Ario, 965 A.2d at 1196-1207.

Several policyholders of Reliance had received claims payments on their trade credit insurance policies within one year of the successful liquidation petition for Reliance.

The Reliance liquidator sued to recover the payments on the grounds that they were preferential payments made within the one year preference period. The policyholders contended that they were not preferences because they were not on account of an antecedent debt.

On other grounds, the lower court held they were not preferences and the Liquidator appealed to Pennsylvania’s highest court.

The Pennsylvania Supreme Court agreed with the policyholders that the insurance payments were not on account of an antecedent debt as they were made in the ordinary course of business. Id. at 1207.

The court reached this decision although there is no explicit exception in Pennsylvania's preference statute for payments made in the ordinary course of business.

The reasoning of the Pennsylvania Supreme Court is instructive as it may be a conclusion reached in other states that have similar voidable preference provisions as Pennsylvania's.

The Pennsylvania Supreme Court first noted that the term "antecedent debt" is not defined in Pennsylvania's preference statute and that in interpreting legislation the court's function is to ascertain and effectuate the intent of the legislature.

Where the words are clear, they should be enforced. Here, the court found the term "antecedent debt" to be ambiguous as the legislature had not defined the term and the parties had offered differing reasonable interpretations of its meaning. *Id.* at 1202.

The court then turned to divining the intent of the legislature regarding the meaning of the term.

It first determined that the intent of the Pennsylvania rehabilitation and liquidation act was to protect policyholders, other creditors and the general public.

It then considered federal bankruptcy law on preferences, which the court said may be relied upon to interpret state insurance receivership statutes because bankruptcy law is a basis of the state laws.

Bankruptcy law contains an exception to preferences for ordinary course of business payments.

The court further considered the general purposes of the preference laws and the requirement of an antecedent debt, which is to prevent out of the ordinary payments by a troubled insurer which would hasten its slide into receivership to the disadvantage of creditors who were not the beneficiaries of such payments.

It also considered the consequences of a finding that insurance payments could be voidable preferences and decided that it could disrupt Pennsylvania's large insurance market.

Policyholders may be inclined to purchase policies from companies not domiciled in Pennsylvania if they were faced with the threat that an insurance payment could be recovered by an insurance receiver of that company and therefore put Pennsylvania at a competitive disadvantage with other states.

It also looked at the couple of other decisions on the issue in other states which are discussed below. *Id.* at 1203-1205.

Considering these various facts, the Pennsylvania court concluded that the legislature intended the term “antecedent debt” not to include transfers made in the ordinary course of business.

The court found that its interpretation upheld the economic expectations of the public and the interests of insurers and at the same time protected against unusual transfers. Id. at 1205.

The Ario decision is only one of three court decisions in the United States on the issue of whether ordinary course of payments are preferential under the state insurance laws where there is no explicit exception in the state statute.

A similar decision was reached by an Ohio appellate court, but it did not involve an insurance claim payment.

The Ohio court held that payments for printing and mail services by an insolvent insurer prior to its liquidation during the preference period were in the ordinary course of business and therefore not on account of an antecedent debt. *Covington v. HKM Direct Market Commc'ns Inc.*, 2003 Ohio 6306 (Ct. App. 2003).

Ohio at the time had a similar preference statute as Pennsylvania which did not contain a definition of “antecedent debt” or an exception for ordinary course of business payments.[6]

An opposite conclusion, though, was reached by the Nebraska Supreme Court on payments to an obligee on a performance bond under the same preference statute as enacted in Pennsylvania.

The Nebraska court concluded that the surety’s payments were made during the preference period and refused to read into the state statute an exception for ordinary course payments since the legislature did not specifically include one in the Nebraska statute. *Wagner v. Gilbane Building Co*, 757 N.W.2d 194 (Neb. 2008).

Finally, four states currently have explicit statutory exceptions to a preference claim for ordinary course of business payments.[7]

Conclusion

To conclude, let us look at our innocent insured who has no idea that its insurer is about to fall into the abyss of liquidation.

If the insured received a payment during the preference period from an insurer domiciled in Pennsylvania, Utah, Texas, Illinois or Ohio, it could argue ordinary course of business payment in the face of a preference claim from a receiver.

Nebraska, though, does not recognize the exception.

For the rest of the jurisdictions in the United States, our insured would have no clear answer because the state insurance laws do not address the situation.

--By Donald J. Mros, Chadbourne & Parke LLP

Don Mros is counsel with Chadbourne & Parke in the firm's Washington, D.C., office.

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[1] Eight states authorize a rehabilitator to seek to avoid preferential payments. Ala. Code § 27-32-27; Ark. Code Ann. § 23-68-125; Del. Code Ann. tit. 18, § 5925; Md. Code Ann., Ins. § 9-221; Nev. Rev. Stat. § 696B.410; N.J. Rev. Stat. § 17:30C-25; N.Y. Ins. Law § 7425; Or. Rev. Stat. § 734.350; Va. Code. Ann. § 38.2-1513; and Wyo. Stat. Ann. § 26-28-124. For convenience in this article, we will refer to an insurance company liquidator or rehabilitator as a receiver.

[2] Three states do not have statutory preference provisions. See Mass. Gen. Laws Ann. ch. 175, §§ 6, 180A-180L; Okla. Stat. tit. 36, § 1901-1920; Wash. Rev. Code. § 48.99.

[3] Insurance companies in the United States are not subject to the United States Bankruptcy Code. 11 U.S.C. § 109(b) (insurance companies are excluded from being debtors). The rehabilitation or liquidation of an insurance company is subject to the state insurance law of the domicile of the insurance company. State law varies on preference requirements as well as other matters related to insurance company receiverships.

[4] Insider dealings or non-arms length transactions may also be avoided as preferential. See e.g. 40 Pa. Cons. Stat. § 221.30(a)(iv).

[5] A minority of states have a different provision which includes intent and knowledge elements. The New York provision is an example: “[a]ny transfer of, or lien created upon, the property of an insurer within twelve months prior to the granting of an order to show cause under this article with the intent of giving the creditor or enabling [it] to obtain a greater percentage of [its] debt than any other creditor of the same class and which is accepted by such creditor having reasonable cause to believe that such a preference will occur, shall be voidable.” N.Y. Ins. Law § 7425(a). Generally, the minority provision does not include the element that the transfer be on account of an antecedent debt.

[6] Subsequent to the Covington decision, Ohio revised its preference statute to include an ordinary course of business exception. Ohio Rev. Code. Ann. § 3903.28(A)(4)(a).

[7] 215 Ill. Comp. Stat. Ann. § 5/204(m)(A); Texas Ins. Code. Ann. § 4443.204(c)(1)(A); Utah Code Ann. § 31A-27-321; and Ohio in 2004, Ohio Rev. Code Ann. § 3903.28(A)(4)(a).