nolhga journal
Volume XIX, Number 2 | June 2013
A Publication of the National Organization of Life and Health Insurance Guaranty Associations

Can the Beast Be Tamed?

Unclaimed property developments in life insurance

By Phillip E. Stano, Steuart H. Thomsen & Wilson G. Barmeyer

Unclaimed property issues impacting insurance companies continue to evolve on legislative, judicial, and regulatory fronts. Approximately eight states have enacted legislation mandating a duty for companies to search the Social Security Administration's Death Master File (DMF). States are now auditing small to mid-sized life insurance companies, with multiple auditors competing to sign up states. Litigation abounds, with suits filed by private plaintiffs, state treasurers, and insurance companies. A ruling by the Ohio Court of Appeals that insurers are not required to undertake death matches survived the Ohio Supreme Court.

Audit Developments

Regulators previously focused on the top 40 insurance companies, which resulted in several multi-state unclaimed property settlements. Represented by Verus Financial, LLC, state auditors and insurance regulators have asserted that insurers have engaged in improper handling of life insurance policies and annuity contracts by failing to proactively identify death claims and locate missing beneficiaries. Regulators claim that insurers consulted the DMF to terminate annuity payments when annuitants died but not to determine whether life insurance benefits may be due. Regulators further assert that insurers fail to timely escheat death benefits and matured policy/contract proceeds.

Witnessing the Verus settlements with certain large insurers, two other auditors have thrown their hats into the ring: Unclaimed Property Clearinghouse (UPCH) and Kelmar. States have been targeting small to mid-sized companies through these two audit firms, as well as through Verus. It appears that auditors are racing to sign up as many states as possible, as new audits are being initiated at an increased pace.

Litigation Developments

What is Reportable Property?

Unclaimed property audit issues have spilled over into litigation. *Chiang v. American National Insurance Company* (Sacramento County Superior Court) involves a suit for injunctive and other relief brought in May 2013 by the

["Unclaimed Property" continues on page 6]

See You in the Windy City!

Phillip Stano and Wilson Barmeyer, two of the authors of this article, will discuss new developments in the unclaimed property and insurance litigation arenas at NOLHGA's 21st Legal Seminar, which will be held on July 11–12 at the Ritz-Carlton Chicago. Visit the seminar Web page (www.nolhga.com/2013LegalSeminar.cfm) for more information about the meeting.

21st nolhga legal seminar
July 11-12 | Chicago, IL

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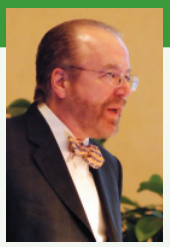

Protecting U.S. Consumers Against Insolvencies

I was honored to be asked by my friends at the National Association of Insurance Commissioners (NAIC) to speak at the NAIC's recent annual International Insurance Forum in Washington, D.C. The NAIC assembled a panel of people from around the world who work on insurer insolvency cases. As a member of that panel, I was asked to offer some observations about key attributes of the U.S. regime for resolving failed insurers and protecting their consumers.

Insurance markets vary enormously from country to country, as do the legal systems for regulatory intervention when companies approach insolvency. In addition, consumer safety net mechanisms (called elsewhere "policyholder protection schemes") are not present in every country, and where they do exist, they sometimes look quite different from the U.S. safety net.

The following items made up my list of key attributes of the U.S. insurance market, the regulatory intervention provisions, and the receivership and safety net system; I'd be interested in your thoughts on what should be added, deleted, or changed.

Diversified Market. The U.S. insurance marketplace is quite diversified compared to markets in many countries. Depending on how one counts them, there are between 2,000 and 3,000 licensed insurers in the United States. While some of those companies are quite large, none is so large as to occupy a market-dominant position in common lines of life or property/casualty insurance.

Companies Compete, and a Few Fail. At least for the past 50 years or so, the prevailing U.S. regulatory philosophy has been to regulate aggressively for solvency, while at the same time encouraging competition among insurers. In that time, it has not been part of the regulatory philosophy that weak or failing insurers should be "propped up" by governmental assistance. In other words, though regulators strive to require insurers to have the financial means to meet their obligations to consumers—and the regulators do a good job at that—failing companies are allowed to fail.

Our Safety Net Protects Consumers, not Failing Companies. In the rare cases when a U.S. insurer fails, our guaranty system is designed to provide a substantial (though not unlimited) cushion against the financial consequences of such a failure

to the company's consumers. However, the system was not designed to, and does not, operate to bail out financially ailing insurance companies.

The Financial Crisis and Other Concerns Have Turned a Spotlight on Insurance Consumer Insolvency Protection. Very little attention was paid in the United States to actual or potential insurer insolvencies and their consequences until relatively recently. That has changed in recent years for several reasons. First, the financial crisis in general—and the role in it of AIG, which is commonly (though incorrectly) thought of as an insurer failure—has drawn considerable public, media, and political scrutiny to the protection of consumers whose insurers might fail. Second, the passage of the Dodd-Frank Act in response to the crisis has increased the federal role in overseeing the insurance marketplace and its regulatory systems, including insolvency safeguards. And third, new marketplace needs have emerged (e.g., providing stable retirement income for the baby boom generation, and "de-risking" corporate pension programs), and new insurance products have emerged to meet those needs (e.g., variable annuities with guaranteed living benefits, pension closeout annuity products, and contingent deferred annuities). These new products have been scrutinized closely by many from the standpoint of insolvency protection.

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The Acid Test Question. The recent heightened scrutiny generally leads to a core question: Should we feel confident that U.S. insurance consumers are appropriately protected against the risk that an insurer may fail?

How the System DOES Protect Consumers. The short answer to that question is "yes." The slightly longer version is this: The U.S. system provides a comprehensive complex of protective mechanisms that work together to provide a very effective and interrelated system for protecting consumers against the risk that an insurer might fail. Here are the key components of that system:

1. *Industry Conservatism.* Insurance is an industry that, by and large, has long operated in a manner that is financially conservative. Anyone who watches television ads knows that one area in which insurers seek to "brand" themselves is stability, not volatility. It's not just talk, but rather a real part of the culture and norms for the industry. The fact that insurers view a core element of their mission to be the preservation of their ability to meet policyholder obligations itself keeps most insurers well away from financial danger.
2. *Effective Solvency Policing.* Insurers are overseen by overlapping (and, in a sense, competing) solvency regulators in the states, who take their job seriously and who have done that job well—especially since the NAIC solvency regulation initiatives of the early 1990s. They are aided by rating agencies (which, despite shortcomings in the structured finance arena have done a good job rating insurers), equity analysts, and other private sector watchdogs. As a consequence, the failure of a U.S. insurer—particularly an insurer of any national significance—is a rare event.
3. *Pro-Consumer Receivership Process.* The process for resolving failed insurers in the United States is developed and, with rare exceptions, generally effective. In particular, the requirement that assets of a failed insurer be applied first to discharge policy-level claims (rather than claims of general creditors and equity owners) works in most cases to deliver substantial payments from the assets of the failed insurer to satisfy promises to policyholders.
4. *A Guaranty System That Works.* The groundwork for today's guaranty system was put in place over 40 years ago, and since then the system has been tested by, and has proven itself in, many cases of insurer failures. Most of those failures involved small companies, but there have been several top-25 carriers that have failed, both on the life and property/casualty sides of the industry. Because the U.S. guaranty system is soundly designed, ably staffed, and well financed, it has always been able to meet all of its obligations to consumers.

The Proof Is in the Pudding. We have all recently passed through the worst financial crisis in 75 years. Between the start of 2008 and the end of 2012, over 400 banks and thrifts failed; 2 of the 3 largest U.S. automakers went bankrupt; Fannie Mae and Freddie Mac were put in conservation; the investment banking industry as we previously knew it disappeared; and many hedge funds and "shadow banking" entities failed. In that same stretch of time, only a small handful of very small life and health insurers were liquidated, having in the aggregate liabilities to policyholders of about $900 million. (By contrast, the general creditor liabilities of Lehman Brothers alone in September 2008 were estimated at $765 billion.) Those liabilities to policyholders were virtually all fully satisfied. Indeed, in insurance insolvency cases over the past 20 years, average recoveries by policyholders—including those with claims exceeding guaranty association coverage limits—have been approximately 96 cents on the dollar on life insurance claims and 94 cents on the dollar on annuity claims.

Conclusions. With all the talk lately about stress tests and living wills, we should recall that the recent financial crisis presented the most significant, live-fire stress test that the U.S. insurance solvency protection system has ever faced. The system passed that test with flying colors. ★

Peter G. Gallanis is President of NOLHGA.

Branching Out

NOLHGA has been telling the guaranty system story to Congress for years—now the Executive Branch is listening too

By Sean M. McKenna

The drive from NOLHGA's Herndon, Virginia, office to Capitol Hill is a short one, and it's a trip NOLHGA President Peter Gallanis and representatives of the Financial Services Modernization Committee have made frequently over the past few years. As part of NOLHGA's "education initiative," Gallanis and other committee representatives have visited members of Congress and their staff members to explain how the guaranty system works and how effective it's been through the years. Gallanis has even delivered testimony for Congressional hearings.

In the last few months, Gallanis and the NOLHGA team have been back to Washington on a regular basis—but not just to visit Congress. Thanks to the recent financial crisis and the expected boom in the retirement income market, the Executive Branch—the Department of Labor, the Federal Insurance Office (FIO), and the Financial Stability Oversight Council (FSOC)—have asked NOLHGA, as well as the NAIC and the National Conference of Insurance Guaranty Funds (NCIGF), to explain how the guaranty system works and how much confidence consumers can have in the promises made by the insurance industry.

Rising Concerns

The financial crisis of 2008/2009 shook the faith of consumers—and the federal government—in the stability of the financial services industry. Despite the insurance industry's impressive performance during the crisis (only a few small insurance companies failed, and none of the failures were directly attributable to the crisis), the industry was not spared from additional regulation when the Dodd-Frank Act was passed in 2010. The Act positioned the federal government squarely in the insurance regulatory sphere, with bodies such as the FIO and FSOC having a direct or indirect impact on how insurance companies would be regulated and, if need be, liquidated.

The changing marketplace also played a role in the government's heightened interest in insurance regulation and the guaranty system. As Baby Boomers get closer to retirement age, they're seeing the "three-legged stool" of retirement—Social Security, employer pensions, and personal savings—grow increasingly wobbly as two of the three legs appear likely to be shortened in the future. Many Boomers are looking to boost their retirement income, and the insurance industry has moved to meet

their needs with new annuity products aimed at ensuring that retirees don't outlive their savings.

This has caused regulators on the state and federal level to take a closer look at insurance regulation and the probable outcome for consumers whose companies might fail. While state regulators are familiar with the safety net provided by the guaranty system, federal regulators unfamiliar with insurance have a number of questions about the guarantees offered by the industry. They've turned to NOLHGA for answers.

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How the Pieces Fit

Concerns about the growing annuity market for retirement income aren't new—both the House and Senate have been examining the issue for years, and NOLHGA has been engaged in an ongoing dialogue with the FIO on the subject. The Department of Labor, however, has only recently taken up the issue.

In March 2013, Gallanis and other NOLHGA representatives (NOLHGA's William O'Sullivan and Kevin Griffith and Charles Richardson of Faegre Baker Daniels) met with a senior-level division of the Department of Labor and a representative of the Council of Economic Advisors to discuss the concerns of pension plan sponsors in selecting annuity contract providers. The question posed to the NOLHGA representatives and to Jim Mumford, Iowa First Deputy Insurance Commissioner and Chair of the NAIC's Receivership/Insolvency Task Force (who also participated in the discussion), boiled down to this: Would the promises made by an insurance company be kept, even if that company were placed in liquidation?

The answer came in the form of a presentation entitled *Keeping Insurance Promises: The Context & Operation of the U.S. Insurance Guaranty System*. The presentation illustrated that insurance company promises are kept, and will continue to be kept, because of a tested and proven system of regulation and insolvency resolution that puts consumers first. Guiding attendees through insurance industry operations and culture, as well as insurance regulation, Gallanis and his team showed that policyholder protection is accomplished by a number of factors that complement each other: the conservative business practices of the insurance industry itself, the evolving state insurance regulatory system, the receivership process, and the guaranty system that serves as a safety net if an insurance company is placed in liquidation. Gallanis stressed that the guaranty system may be the final backstop for policyholders of failed insurers, but it can only be understood in the context of these other factors. The system works both to prevent insolvencies—the industry's successful weathering of the financial crisis was not an accident, Gallanis said—and to ensure that the needs of policyholders come first when an insolvency does occur.

The presentation also made the point that such insurer failures are rare, and that when they do occur, the receivership process is designed to put policyholders at the front of the line to recover their policy values. It also showed that, through the years, the system has worked exceedingly well. In large multi-state insolvencies over the past 20 years, policyholders on average have recovered approximately 96% of their life insurance policy values and almost 95% of their annuity values—even including claims for account values above guaranty association limits.

While insurer failures are rare, they are still of interest to regulators—especially to the FSOC, which is responsible for identifying systemically important financial institutions (SIFIs) that will merit an enhanced degree of regulatory scrutiny. It's widely expected that at least a few insurance companies will receive the SIFI designation, and while Dodd-Frank specified that resolution of these companies will be handled by state regulators and the guaranty system, FSOC is keenly interested in how the receivership system would handle the failure of a systemically important insurance company.

For this reason, in March 2013 Gallanis, Griffith, and Richardson—accompanied by NCIGF President Roger Schmelzer and Vice President–Legal and Regulatory Affairs Barbara Cox—met with approximately 80 federal regulators (FSOC members, staff, or the staff of FSOC constituent agencies and interests) to outline how the guaranty systems for life/health and property/casualty insurance work and how well they have performed through the years, even on large company insolvencies. The presentation touched on many of the same points as the *Keeping Insurance Promises* presentation made to the Department of Labor, but it also delved into the mechanics of large insurance company resolutions. A lively question and answer session following the presentation (along with follow-up conference calls) touched on the timing of various stages in the receivership process, the guaranty system's ability to work with backstop mechanisms in other countries, and a number of other insolvency-related issues.

Myth Busters

Both the FSOC and Department of Labor presentations were made to audiences that had a limited familiarity with the insurance industry and the guaranty system, and so Gallanis and the other presenters took advantage of the opportunity to clear up some misconceptions that some people have come to regard as facts. These misconceptions included:

- *There's a High Historical Frequency of Major Insurer Failures:* The numbers show that major insurer failures are exceedingly rare, even during tough economic times.
- *"Runs on the Bank" Are Common with Insurance Company Failures:* Due to the nature of insurance contracts, consumers usually do not attempt to cash out their policies when an insurer experiences financial difficulties.
- *All Liabilities Come Due When a Receivership Commences:* Unlike in bank failures, where an institution's liabilities are predominantly "demand" deposits, insurance company liabilities tend to come due only over much longer periods—over years and even decades—meaning that a successful resolution does not require funding up front for all liabilities on the day of liquidation.
- *Few if Any Insurer Assets Are Available to Respond to Failure:* Thanks to strict solvency regulation, insolvent insurers often have substantial assets—up to 80% or 90% of their liabilities—when placed in liquidation.
- *Few if Any Operational Resources Are Available for Resolutions:* The staffs and operating systems of failed insurers are often used by receivers to make the transition to liquidation as easy as possible for policyholders.
- *Guaranty System Resources Are Inadequate:* Thanks in part to the extended duration of insurance liabilities and the presence of substantial assets in the estates of insolvent insurers, the aggregate capacity of the state guaranty associations is more than adequate to handle one or more large insurer failures. The ability of the guaranty system to either transfer the policies of a failed insurer to a healthy carrier or administer the business itself also provides flexibility for the system.

Return Trips

As the federal government's impact on the insurance industry grows (and it's worth noting that a number of regulations in Dodd-Frank have yet to be written, so the full impact of the Act is unknown), it's likely that Congress and various agencies in the Executive Branch will continue to consult NOLHGA on issues relating to policyholder protection. Which means that Gallanis and representatives of the Financial Services Modernization Committee will be making the trip to Washington again.

It's a drive they're happy to make, because their visits to Congress and federal agencies are having an effect. It's not uncommon to hear industry representatives say that a few years ago, no one in Washington knew anything about insurance. That's doubly true of the guaranty system, but through patient effort, members of NOLHGA's education initiative team have introduced decision makers all over the city to the guaranty system and its history of success. And while future presentations will be tailored to the needs of whatever agency invites us to speak, the central message will be the same: Consumers can rely on the promises of the insurance industry, because the combination of a conservative, low-risk industry; strict regulation; a well-designed receivership process; and an effective guaranty system safety net ensures that commitments will be honored, even in troubled times. ✯

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California State Comptroller, who alleges that the insurer has failed to turn over all documents requested by the state pursuant to its unclaimed property audit.

The complaint alleges, in part, that the insurer refuses to turn over its "currently in-force" policies, thereby preventing the Comptroller from having access to records allegedly necessary to complete the unclaimed property audit. The insurer apparently asserts in part that in-force policies do not constitute reportable property under California's unclaimed property laws and, thus, are irrelevant to the audit. A ruling in this case could have a substantial impact on the industry in terms of the scope of records subject to an unclaimed property audit and should be closely followed by the industry.

Ohio Court of Appeals: No Duty to Search DMF

The most promising development to date arose from private litigation in Ohio, where the Ohio Court of Appeals held that life insurance companies in Ohio have no affirmative duty to search the DMF or otherwise seek out information on possible deaths. *Andrews v. Nationwide Mutual Insurance Company, No. 97891* (Ohio Ct. App. Oct 25, 2012). Affirming the dismissal of a putative class action filed by private plaintiffs, the court held that the life insurance contracts at issue "do not impose a duty on [the insurer] to search the DMF to determine whether their insureds are deceased," and therefore "obligating [the insurer] to solicit or gather information pertaining to an insured's death would be contrary to the terms contained in the insurance policy." The court found "no validity to appellants' allegations that [the insurer] has breached the implied covenant of good faith and fair dealing by failing to utilize the DMF for the benefit of its life insureds."

The court found that the life insurance contracts instead "expressly require[d] 'receipt' of 'proof of death.'" (In Ohio, all life insurance policies are required to include a provision stating that "when a policy becomes a claim by the death of the insured, settlement shall be made upon receipt of due proof of death. ..." Ohio R.C. 3915.05(K).) The plaintiffs argued that the proof of death provision was ambiguous, because the contracts "are silent as to

A ruling by the Ohio Court of Appeals that insurers are not required to undertake death matches survived the Ohio Supreme Court.

the party upon whom the responsibility for providing proof falls," but the court rejected this argument, observing that while "[t]he terms 'receipt' and 'receiving' demonstrate [the insurer's] passive role in establishing an insured party's proof of death; they do not connote an obligation to procure such information."

Further, the court held that both the plaintiffs' contracts and Ohio law "placed the burden on the claimant or the beneficiary to produce the proof of death." The court stated that "we will not import additional unspoken duties and obligations onto [the insurer] that will conflict with the parties' contracted term," holding that the insurer had not breached its duty of good faith and fair dealing by failing to search the DMF "when it is not contractually or legally obligated to do so." The Ohio Supreme Court has declined to review this decision, leaving it as the law in Ohio.

West Virginia Treasurer Sues Just About Everybody

The West Virginia State Treasurer, despite largely staying on the sidelines during the multi-state audits, entered the fray by filing 69 separate actions against life insurers. (One lawsuit has been dismissed with prejudice.) The complaints are virtually identical except for the name of the defendant and its purported market share.

The suits allege that insurers have an affirmative duty under West Virginia's unclaimed property statute to search the DMF to determine deaths of life insurance policyholders and to escheat policy proceeds if those proceeds cannot be paid to a beneficiary. The Treasurer asserts that this duty arises from an alleged obligation of "good faith" under the West Virginia Unclaimed Property Act or other sources.

The Treasurer alleges that, as a result of the insurers' failure to use readily available information such as the DMF to search for proof of death and report unclaimed or abandoned life insurance policy proceeds, the insurers have breached an alleged affirmative duty by failing to report abandoned or unclaimed property to the State Treasurer. The Treasurer further alleges that, by underreporting unclaimed life insurance policy proceeds, the insurers are unlawfully converting those proceeds into premium policy payments, thereby eroding policy proceeds available to potential beneficiaries. Alleging a willful violation of the Act, the Treasurer seeks escheatment of unclaimed policy proceeds and civil penalties, as well as injunctive relief requiring the insurers to immediately implement policies and procedures for using the DMF or other similar databases to annually identify unclaimed proceeds.

On April 1, 2013, many of the defendant insurers filed motions to dismiss the Treasurer's complaints, arguing that no such "duty to search" exists. No hearing date had been set when this article went to press.

Beneficiary Challenges Insurer's Alleged Asymmetric Use of the DMF

On January 30, 2013, a beneficiary filed a putative class action in the United States District Court for the District of Massachusetts against John Hancock Life Insurance Company, alleging that the insurer has a "pattern and practice of avoiding payment of life insurance policy death benefits that are owed to beneficiaries." The complaint accuses the insurer of using the DMF asymmetrically, by routinely searching the database to end payments to annuity clients but not using it to promptly notify beneficiaries of life insurance policies when a policy-holding relative dies.

The lead plaintiff, who was the beneficiary of a life insurance policy purchased by his mother, claims that he was notified four years after his mother's death, and only then by the Illinois Treasurer. After receiving only a small amount of dividends from the State, the lead plaintiff later received an additional sum of life insurance proceeds without explanation as to why the money "was not escheated to the state of Illinois when the dividend monies were escheated." The complaint alleges that the insurer is liable for damages caused to policyholders and beneficiaries as a result of its asymmetric death benefit payment practices; the plaintiff further alleges that the Global Resolution Agreement and settlements with individual states entered into by the company do not shield it from liability to those such as the plaintiff who were neither parties to the agreement nor recipients of compensation from the Global Resolution Settlement. The insurer has filed a motion to dismiss, which remains pending before the court.

Insurer Challenges Kentucky's New DMF Statute

A declaratory judgment action was filed on November 8, 2012, challenging the constitutionality of certain aspects of the new Kentucky statute mandating that insurers search the DMF for potential deaths of policyholders. The insurers sought a declara-

tion that the new statute applies only prospectively to new policies and not retroactively to policies already in effect.

The Kentucky statute, which took effect January 1, 2013, mandates that insurers search the DMF on a quarterly basis for potential deaths of their insureds. The statute further requires insurers to follow up on matches by making good faith efforts to confirm deaths, determine whether benefits are due, locate the beneficiaries, and facilitate claims submissions. The Kentucky statute is based on a model act prepared by the National Conference of Insurance Legislators (NCOIL). A version of the NCOIL Model Act or legislation having a similar effect has been enacted in approximately seven states, and similar legislation has been introduced in several others.

A Kentucky state trial court rejected the insurers' challenge, holding that the statute neither violated any rules against retroactive application nor impaired any vested contractual rights. *United Ins. Co. of Am. v. Kentucky* (Ky. Cir. Ct. April 1, 2013). The court held in part that, because the statute merely confirms beneficiaries' rights to proceeds based on premiums already paid by insureds, the statute must be construed as a remedial or procedural requirement not subject to the prohibition against retroactive legislation. Although insurance companies have a reasonable expectation that the state will not alter its contractual obligations, the court further stated that a company "has no reasonable expectation that the state will not impose reasonable regulatory requirements designed to enforce the pre-existing contract rights of insureds and beneficiaries." The insurers have appealed the ruling to the Kentucky Court of Appeals.

Conclusion

What do these developments portend for the unclaimed property arena? Regulatory efforts are being recalibrated from "regulation-by-settlement" to "regulation-by-litigation." Despite professing the importance of unclaimed property, regulators seem reluctant or unable to work with the life industry to craft legislation and regulations to govern the topic. One wonders if a robust economy with a resulting flow of significant tax revenues would have altered the current regulatory approach to the unclaimed property issue. ✭

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NOLHGA Calendar of Events

2013

July 10	**MPC Meeting Chicago, Illinois**
July 11–12	**NOLHGA's 21st Legal Seminar Chicago, Illinois**
August 24–27	NAIC Summer National Meeting Indianapolis, Indiana
October 21–22	**MPC Meeting Manalapan, Florida**
October 22–23	**NOLHGA's 30th Annual Meeting Manalapan, Florida**
October 27–29	ACLI Annual Conference New Orleans, Louisiana
December 15–18	NAIC Fall National Meeting Washington, D.C.

NOLHGA Journal
Vol. XIX, No. 2 | June 2013

The *NOLHGA Journal* is a publication of the National Organization of Life and Health Insurance Guaranty Associations dedicated to examining issues affecting the life and health insurance guaranty system.

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