PUBLIC REGULATION AND THE BANKRUPTCY CODE:
SELECTED ISSUES ARISING IN THE CONTEXT
OF INSURERS AND THEIR HOLDING COMPANIES

by

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I.

INTRODUCTION

A. The insolvency of insurance companies or their holding companies, which has received so much recent publicity, is nothing new to the American economy. For more than 100 years, however, the regulation of domestic insurance companies and, particularly, the administration of the insolvency of a "domestic insurance company," has been left to the states.

1. In Paul v. Virginia, 75 U.S. 168 (1868), the Supreme Court held that the "business of insurance" did not constitute "commerce" — a ruling which may have led Congress to believe it had no authority to include insurers as eligible for relief under the bankruptcy laws.


3. In 1944, Paul v. Virginia was overruled by the Court in United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944) on the ground that the commerce clause of the Constitution, U.S. Const., Art. I, § 8, cl. 3, empowered Congress to regulate insurance as part of interstate commerce.

4. However, reflecting a strong federal policy of deference to the states, Congress — by enacting the McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015, in 1945 — chose not to exercise the power the Court held it possessed. Section 1012(a) of that statute states that the "business of insurance . . . shall be subject to the laws of the several states." 15 U.S.C. § 1011.

5. Continuing this federal "hands off" policy, section 109(b)(2) of the Bankruptcy Code ("the Code"), 11 U.S.C. § 109(b), specifically excludes a "domestic insurance company" from becoming a debtor. Foreign insurance companies doing business in this country are also ineligible for relief. 11 U.S.C. § 109(b)(3). (However, a foreign insurer not doing business here, but having assets here, is eligible. Cf. Israel-British Bank (London) Ltd. v. Federal Deposit Insurance Corp. (In re Israel-British Bank (London) Ltd., 536 F.2d 509 (2d Cir. 1976) (foreign bank).)

B. This strong federal policy favoring state regulation of insurance companies and, in particular, the administration of their insolvencies, is — in a sense — at odds with the strong uniform federal policies that support reorganization of corporations under the Code and the benefits the reorganization process brings to debtors, creditors, and equity holders. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 220-21 (1977).

C. The tension between these conflicting federal policies has led predictably to a variety of clashes between state insurance regulators and debtors in possession or trustees in cases under the Code. These contests have occurred in two different settings: (1) where the regulated entity is/or seeks to be a debtor in a title 11 case; or (2) where a holding company, owning the stock of an insurer, is so situated.

D. Among the issues discussed in or suggested by reported cases are:

(1) What is an "insurance company" for purposes of section 109(b)?
(2) What standing does the state regulator of an insurer have in a title 11 case for an eligible regulated entity or in such a case for the company holding its shares?

(a) Is the regulator a "party in interest" in either case?

(b) Even if the regulator is not a party in interest, can the regulator raise and be heard on issues other than rates, e.g., approval of a transfer of shares?

(3) What is the reach of the bankruptcy court's jurisdiction?

(a) To what extent, if any, can the court in the title 11 case of the holding company affect the assets, debts, or affairs of the ineligible subsidiary insurer or those asserting claims against that insurer?

(b) To what extent, if any, does the doctrine of alter ego bear on the question of jurisdiction?

(c) How is the question of jurisdiction over a bankrupt holding company affected when the subsidiary insurer is in its own insolvency proceeding before a state court?

(4) Does the automatic stay provided by section 362(a) of the Code, 11 U.S.C. § 362(a), affect a subsidiary's state insurance conservatorship or receivership, and does an injunction entered by the state court to protect the conservatorship/receivership estate affect the debtor in possession or trustee of the bankrupt holding company?

(5) In confirming a plan of reorganization:

(a) Can the bankruptcy court proceed without the approval of the state regulator on matters other than rates which, absent the title 11 case, would require such approval under state law, e.g., a sale of the shares of the insurance subsidiary to a third party?

(b) What standard of valuation should be adopted for the subsidiary insurer in establishing a reorganization value of the holding company debtor in a title 11 case?

(c) How do state requirements for capitalization bear on the issue of feasibility?
II.

COMMENCEMENT OF THE CHAPTER 11 CASE;

THE QUESTION OF ELIGIBILITY.

A. While the non-insurer parent holding company is eligible to be a bankrupt under the Code, even where its assets consist of the shares of insurers or other subsidiaries ineligible for relief under the Code, See In re Firstcorp, Inc., 122 Bankr. 484 (Bankr. E.D.N.C. 1990), there is considerable debate over what qualifies as an "insurance company" for purposes of section 109. This debate has occurred most recently in cases of health maintenance organizations (so-called "HMO's").\(^2\) Compare In re Beacon Health, Inc., 105 Bankr. 178 (Bankr. D.N.H. 1989); In re Family Health Services, Inc., 104 Bankr. 279 (Bankr. C.D. Cal. 1989); In re Michigan Master Health Plan, Inc., 44 Bankr. 642 (Bankr. E.D. Mich. 1984); and In re Portland Metro Health, Inc., 16 Bankr. 102 (Bankr. D. Or. 1981).

B. The Code does not define the term "insurance company." However, the Court — in other contexts — has looked to basic references for meaning. In Webster's New International Dictionary, cited by the court in Group Life v. Royal Drug, 440 U.S. 205, 211 n.7 (1979), "insurance" is defined as follows:

Insurance is the act of "insuring, or assuring, against loss or damage by a contingent event; a contract whereby, for a stipulated consideration, called a premium, one party undertakes to indemnify or guarantee another against loss by a certain specified contingency or peril, called a risk, the contract being set forth in a document called the policy . . . ."

C. In the course of their decisions, several "tests" have been applied by the bankruptcy courts to determine whether an HMO is an insurance company for purposes of section 109 of the Code. These include the "state classification test" (which some courts

\(^2\) In a typical HMO, plan members (called "enrollees") pay a fixed monthly fee to the HMO, usually through their employer, and are eligible for all covered routine and emergency medical services. Health care providers, such as hospitals, doctors and other professionals, provide services to plan members under one or more fee arrangements with the HMO. The provider either agrees to deliver care for a monthly charge (a co-called "capitation" fee) or to render services on a "fee-for-service" basis, and is paid by the HMO accordingly. In re Family Health Services, Inc., supra.
will only apply after a "functional analysis"), the "independent classification test", and the "alternate relief test." The reported decisions reflect an ambivalence among the courts as to how these tests should be applied and what weight should be given to each test in reaching a decision.

1. In the first reported case on eligibility involving an HMO debtor, In re Portland Metro Health, 15 Bankr. 102 (Bankr. D. Or. 1981), the state had placed the debtor into state court receivership. While the receivership was pending, the debtor filed for relief under Chapter 11 and brought a complaint against the state insurance commissioner to determine the debtor's eligibility for relief under the Code. The court granted the insurance commissioner's motion to dismiss, holding that the debtor was a domestic insurance company. 15 Bankr. at 104.

(a) Of the several tests, the state classification test pays the greatest deference to the state, in effect leaving it to that governmental unit to decide eligibility. Under a strict application of this test, how the state classifies a debtor, rather than the court's analysis of the debtor's activities, controls. Sims v. Fidelity Assurance Co., 129 F.2d 442 (4th Cir. 1942).

(b) To Bankruptcy Judge Sullivan, who decided Portland Metro Health, and to other courts however, this test was an important but not exclusive guideline, available to a bankruptcy court in determining whether the exclusion from eligibility set forth in section 109(b)(2) of the Code was applicable.

(c) In his view, other tests (to which he gave no label) read together with the "state classification test" provided the following common criteria in deciding what entities may be excluded from relief: (1) The entities are extensively regulated by well-organized departments of the state and of the United States; (2) They are subject to express statutory procedures for nonbankruptcy liquidation; (3) The nature of their business is public or quasi-public and involves interests other than those of creditors. (Per Judge Sullivan, other nonbankruptcy tests which focus upon the contract between the company and its subscribers, to the exclusion of its contracts with providers of service, describe the primary element of insurance as the "spreading and underwriting of a policy-holder's risk," citing Group Life v. Royal Drug Co., 440 U.S. 205, 211 (1979).)
(d) Under these criteria, Sullivan concluded that the debtor was an insurance company for purposes of section 109:

(i) The debtor's business affected "the interest of the public at large" and was, therefore, subject to extensive regulation and liquidation as an insurance company by Oregon's Insurance Commissioner. 3

(ii) "From the standpoint of its subscribers, the debtor acts as an insurer. . . . [T]he debtor's subscriber rates are determined based upon a projected risk factor [and] . . . FMH, like other insurers also reinsures its excess liability with another carrier." 15 Bankr. at 104-05.

(iii) "The central insurance concept of the underwriting of, and the spreading of risk is not changed by non-insurance or non-traditional features of the debtor's operation which involve provider agreements rather than cash dividends, which spread the risk among all subscribers in a mandatory market comprising a large community, which impose rules on both provider and user to discourage unnecessary utilization of services, and which do not impose a dollar limit upon contractual obligations to subscribers. These differences are variations in methodology rather than departures from the broad concept of insurance. The debtor is a domestic insurance company in the same sense that building and loan companies and trust companies have been held to be banks for purposes of 11 U.S.C. § 109(b)(2)." 15 Bankr. at 105. (emphasis added)

2. In 1989, eight years after Portland Metro Health was decided, two other HMO cases on eligibility were reported involving different factual settings from one another and reflecting different judicial views of how the competing federal policies of (1) hands off insurance companies and (2) support of corporate reorganization should be resolved. These were the opinions of Bankruptcy Judge Wilson of the Central District of California in the Maxicare cases, In re Family Health Services, Inc., 104 Bankr. 279 (Bankr. C.D. Cal. 1989), and of Bankruptcy Judge Yacos in

3 Moreover, Judge Sullivan felt it was inappropriate for the debtor to argue otherwise when the Commissioner's authority to act had been previously decided by the state court adversely to the debtor. 15 Bankr. at 104.

3. Although not discussed previously in the analysis of Portland Metro Health case contained above in these materials, the debtor there conducted a rather provincial operation limited to the states of Washington and Oregon. By contrast, in the Maxicare cases, much more expansive enterprise confronted the court. Forty-seven related corporations, including Maxicare Health Insurance Company ("MHIC"), filed for relief under chapter 11. According to their petitions, the assets of the combined debtors totalled $2.1 billion dollars while liabilities were scheduled at $1.4 billion. More than 100,000 creditors were listed together with an unknown number of the one million current or former members of the health plans who conceivably had claims. Taken as an enterprise, Maxicare operated a national network of health maintenance organizations which furnished health care services to approximately 400,000 people (down from an excess of one million members some months before the cases were filed). At the top of the Maxicare corporate pyramid was Maxicare Health Plans, Inc., a publicly held California corporation, which owned 100% of the stock of Maxicare, Inc., a holding company, which in turn owned 100% of the stock of Maxicare Health Plans of the Midwest, Inc., which in turn owned 100% of MHIC. The entities were, in terms of their cash management, interrelated through an elaborate system pursuant to which the HMO's transmitted daily both bills and funds to Maxicare, Inc. Maxicare, Inc., in turn, used the funds to pay the debts of the numerous HMO's as they were incurred throughout the network and loaned money to HMO's where required. MHIC itself was a Wisconsin corporation doing business only within that state, Wisconsin's insurance code contained regulations for both HMO's and traditional insurance companies. Both types of entities were under the supervision of its commissioner of insurance. Following the filing, the Wisconsin Insurance Commissioner moved to dismiss MHIC's title 11 case on the basis that MHIC was a "domestic insurance company" and therefore was ineligible to be a debtor under section 109(b)(2) of the Code.

(a) In the introduction to his opinion, Judge Wilson observed that in determining whether an entity is excluded under section 109(b)(2) from seeking bankruptcy relief, courts have followed one or more of several approaches: The process of applying traditional rules of statutory construction had come to be known as the "independent classification test." Courts also considered the classification of an entity under state law — the so-called "state classification test" and a third approach had been used, labeled the "alter-
native relief test." Judge Wilson had, in prior decisions, applied all three tests in denying similar motions to dismiss filed by regulators from Arizona, Illinois, Indiana, Louisiana, Ohio and Texas.\textsuperscript{4} However, the facts of the Wisconsin entity differed significantly from the prior cases where the particularities of state law or policy made eligibility apparent in his view. Indeed, Judge Wilson admitted that in the instance of MHIC, he was faced with a situation where his decision on MHIC would differ if he chose one test rather than another. The approach he selected was something of an amalgam, using criteria and factors from all three tests after which he determined that "as an HMO, MHIC was eligible for Chapter 11 relief." 104 Bankr. at 282.

(b) State Classification Test: Wisconsin had enacted legislation which classified MHIC and other HMO's as domestic insurance companies. The formation and regulation of HMO's in Wisconsin were governed by provisions of its insurance code and its insurance commissioner supervised their operation. Ultimately, the state insurance commissioner issued a certificate of authority to transact "the business of insurance" to all companies intending to operate HMO's. In such circumstances, Judge Wilson observed that other courts had suggested that the inquiry on eligibility was complete, citing In re Cash Currency Exchange, Inc., 762 F.2d 542, 548 (7th Cir.), cert. denied, 474 U.S. 904 (1985), and the 9th Circuit's decision Security Building and Loan Ass'n v. Spurlock 65 F.2d 768 (9th Cir. 1933).

(c) However, despite the prior decision in Portland Metro Health (and what might be considered compelling precedent in at least one of the two circuit court opinions cited by Judge Wilson), and despite the federal policy of hands off insurers, Judge Wilson expressly refused to apply the state's classification as controlling. "Congress dictates which entities are precluded from seeking bankruptcy relief and Congress has not delegated that authority to the states. Therefore, the state can never transform an eligible entity, such as an HMO, into an insurance company, which is ineligible under section 109. . . . Congress intended to exclude the companies which are not merely named and organized as insurance companies but which actually

\textsuperscript{4} A discussion of these rulings can be found in Branch & Fitzgerald, HMO Insolvency: Implications of the Maxicare Decisions, 25 TORT & INS. L.J. 766, 767-70 (1990).
conduct the business of insurance." In Judge Wilson's view, a more appropriate analysis on eligibility than state classification per se was to adopt a "functional analysis" which examined the criteria used by the state to determine classification. Where there was a rational basis for the classification, the bankruptcy court could properly decide the issue using the state law method. "If, however, the basis for Wisconsin's classification is suspect, then the court may reject the conclusion urged by the commissioner." 104 Bankr. at 283.

(d) In comparing the junction of an HMO with those of an insurance company, Judge Wilson concluded that the distinctive function of an HMO is the provision of medical services to its members. Insurance companies as a rule do not exercise that function, but rather contract to reimburse the cost incurred by the insured when or after the service is rendered. In his view, based on the Supreme Court's decision in Royal Drug, cited supra, the central indispensable element of an insurance company was the underwriting or spreading of risks. 104 Bankr. at 284. The foundation of the HMO was its ability to control costs - an ability that at least in Wilson's view, distinguished HMO's from traditional notions of insurance. "The conflict between the state's classification of MHIC and the actual functions performed by that entity undermines the validity of the state classification test as applied in this case." Id.

(e) Independent Classification Test. As noted earlier in these materials, this test is based upon the statutory construction of the Bankruptcy Code." Id. Since the Code did not define the term "domestic insurance company" nor mention health maintenance organization, the court was obliged to determine what Congress intended. Unable to find any persuasive guidance from the legislative history of section 109, Judge Wilson proceeded to apply traditional rules of statutory construction. He observed that the general rule of statutory construction was expressio unius est exclusio alterius, i.e., that the enumeration of exclusions from the operation of a statute indicates that the statute applies to all cases not specifically excluded. Since section 109 broadly defined who may be a debtor subject to an exhaustive list of specific exclusions, it had to be presumed, in his view, to "narrowly circumscribe the limits of this exemption." The fact that Congress knew about the existence of HMO's when it enacted and later amended the Code, but never chose to add them to the list of entities excluded under section 109, led the
judge to conclude "it is this court's view that MHIC, which clearly operates not as an insurance company but as an HMO, is eligible for Chapter 11 . . . ." 104 Bankr. at 284.

(f) Since inconsistent results were dictated on the motion to dismiss by the application of the state classification test,\(^5\) causing the state to prevail, and the independent classification test, producing a ruling for the debtors, Judge Wilson turned to an examination of the policies upon which the Bankruptcy Code was based or what he labeled the "alternative relief test." Under this approach, courts ought to compare the process available in a bankruptcy case with available state and federal non-bankruptcy methods of reorganizing or liquidating a would be debtor — with, apparently, the better system prevailing. Because Wisconsin law gave a priority to loss claimants ahead of other creditors, state proceedings were, in Judge Wilson's view, an unacceptable alternative to title 11. "Moreover, the centralized administration of the Maxicare enterprise available under the Code was far preferable to a series of separate proceedings before state courts. 104 Bankr. at 287. "The clear policy of the Bankruptcy Code is for uniform laws. . . . To permit some states to liquidate segments of a multi-state business leaving other parts of the business to be reorganized in a bankruptcy proceeding would lead to a confusion, if not chaos, lack of consistency rather than uniformity and uncertainty rather than predictability." Id. Accordingly, the motion of the Wisconsin insurance commissioner to dismiss MHIC's case was denied.

(g) Ironically, Judge Wilson later confirmed a plan of reorganization providing more favorable treatment to the very claims whose priority under state law he labeled "anathema to . . . federal bankruptcy law." "Order Confirming Joint Plan of Reorganization Dated May 14, 1990, As Modified" entered in In re Family Health Services, Inc., Case No. SA 89-01549-JW; U.S. Bankr. Ct., C.D. Cal. on August 31, 1990, amended August 31, 1990.

(h) Appeals from the order of confirmation and from the order denying dismissal of the MHIC case are pending.

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\(^5\) Such would have been Judge Wilson's ruling had he applied the state classification test without using "functional analysis." 104 Bankr. at 283.
(4) A few months after Maxicare was reported, Judge Yacos of the bankruptcy court in New Hampshire was confronted. In the case In re Beacon Health, Inc., 105 Bankr. 178 (Bankr. D.N.H. 1989) where, following a chapter 11 filing by the HMO, the state requested dismissal, in the alternative, a declaratory ruling that certain administrative and state court regulatory proceedings could continue without regard to the automatic stay. The facts involving the Beacon Health HMO more closely resembled those of the HMO in Portland Metro Health. However, a careful review of Judge Yacos' opinion suggests that it was not, in the end, factually driven and that Judge Yacos very much disagreed with the approach taken by Judge Wilson in Maxicare.

(a) Beacon was a New Hampshire corporation chartered by the state as a "for profit" HMO and regulated by the New Hampshire insurance department under provisions of a chapter entitled "Health Maintenance Organizations." A certificate of authority to operate as an HMO was issued to Beacon by the insurance department of New Hampshire. Five years later, the state determined that Beacon's surplus was deficient, that the company was insolvent, and demanded that additional capital be infused. When Beacon indicated it could not comply, it requested an opportunity to seek a qualified buyer and the state acquiesced for 30 days, following which a petition for liquidation was filed by the state with the New Hampshire Superior Court. Administrative actions were also commenced to revoke Beacon's license as an insurer. The same day that the state filed its petition, Beacon filed for relief under chapter 11.

(b) It was the state's position before the bankruptcy court that Beacon was an insurance company for section 109 purposes regardless of its status as an HMO because Beacon was engaged in "the business of insurance". The debtor, predictably, argued that an HMO was not an insurance company. Responding to these arguments, Judge Yacos noted that there were several approaches for determining whether an entity is excluded from federal bankruptcy relief under section 109, i.e., the state classification test, the independent classification test, and the alternative relief test. Unlike Judge Wilson in Maxicare, however, Judge Yacos' analysis under each of the tests led him to the conclusion that Beacon was a domestic insurance company and therefore ineligible for chapter 11 relief. Under the state classification test, it was clear to Judge Yacos that New Hampshire treated an HMO as being
engaged in the business of insurance. With regard to
the "alternative relief test," Judge Yacos parted
company with Judge Wilson: "A bankruptcy court is not
authorized in my judgment to ignore the command of
section 109(b) of the Bankruptcy Code just because it
believes relief in its court will be more effective."

(c) While Judge Yacos felt that Maxicare was
distinguishable rejected on its facts. He rejected the
underlying rationale used by the Maxicare court as not
compelling in any event. The fact that numerous states
were involved in Maxicare which could lead to piecemeal
results was unpersuasive. "Such an argument could be
made in the case of any large multistate insurance com-
pany, for example, the Metropolitan Life Insurance
Company." 105 Bankr. at 186.

5. Neither courts hearing title 11 cases nor bank
ruptcy practitioners should assume that the legislation
states have enacted to rehabilitate or liquidate is less
than comprehensive. Beginning in 1967 with a sophisticated
insurer rehabilitation and liquidation statute enacted in

6 That the statutory provisions regulating New Hampshire HMO's
were found in the New Hampshire insurance codes was
relevant, but not determinative. However, other aspects of
New Hampshire's regulations were determinative. "In my
judgment, there are ultimately three key attributes to an
insurance company: (1) actuarial determination of costs; (2)
rates/premiums that are charged to subscribers subject to
approval by a regulatory authority; and (3) provision for
reinsurance to back up the insurance entities obligations." The
New Hampshire Code contained provisions on all three
attributes. 105 Bankr. at 183-85. Judge Yacos did not buy
the distinctions made by the Maxicare court under its "func-
tional analysis" between the providing of medical services
and the reimbursement for medical services received. "The
provision of services as opposed to direct indemnification
is merely a service in kind rather than cash. The HMO is
simply an insurance company covering its obligation to pro-
vide subscribers against medical care charges in excess of
the premium collected from them by providing the services
directly in kind, or indirectly in kind through contract
positions, rather than after the fact reimbursing in cash
for charges paid directly by the subscriber elsewhere. From
the viewpoint of the subscriber or policyholder, there is no
functional difference between an HMO and an insurance com-
pany." Id. (Note that this distinction used by the court
in Maxicare, 104 Bankr. at 284, was also rejected by the
court deciding Portland Metro Health, 15 Bankr. at 105.)
Wisconsin, a trend of continuing reform at the state level has occurred. In 1977, the National Association of Insurance Commissioners ("NAIC") adopted a new model act, the "Insurers Supervision, Rehabilitation, and Liquidation Model Act" (hereinafter "Model Act"), which among other things recognized the existence of guarantee funds and their interaction with the liquidation process. Since then, the Model Act has been amended a number of times as new problems in the rehabilitation and liquidation process were perceived. The number of states enacting comprehensive state liquidation laws has continued to grow. Some 17 states have adopted the Model Act or similar legislation; 29 other states have adopted related legislation and/or regulations. The Model Act contains provisions which, unlike the Bankruptcy Code, include the supervision of distressed insurance companies by the regulator prior to the commencement of formal proceedings before a court. Obviously, it is beyond the scope of these materials to provide a comprehensive analysis of the model act. However, among its provisions, which are particularly relevant to these materials and to the potential of conflict between state courts and the bankruptcy courts, are the following: The act is to be liberally construed. Art. I, § 1, ¶ C. The term "insurer" is defined as "any person who has done, purports to do, is doing, or is licensed to do an insurance business and is or has been subject to the authority of, or to liquidation, rehabilitation, reorganization, supervision, or conservation by any Insurance Commissioner." Art. I, § 3, ¶ L. A receiver appointed in a proceeding under the act may at any time apply for and any court of general jurisdiction may grant such restraining orders, preliminary and permanent injunctions, and other orders as may be deemed necessary and proper to prevent, among other things, interference with the receiver or with a proceeding under the Act, the withholding from the receiver of the books and records of the insurer, or any other threatened or contemplated action that might lessen the value of the insurer's assets or prejudice the rights of policy holders, creditors, or shareholders or the administration of any proceeding under this Act. Art. I, § 5, ¶ A (¶¶ 3, 10, and 11). Among the grounds for the commencement of rehabilitation under the act is the control of the insurer, whether by stock ownership or otherwise, and whether direct or indirect by persons found to be "untrustworthy". Art. III, § 12(d). Upon the issuance of an order appointing a liquidator for the insurer, no action at law or equity be brought against the insurer or liquidator in any forum, nor shall any existing actions be maintained. Art. III, § 24, ¶ A. The Act contains provisions for the recovery of fraudulent transfers, voidable preferences and voidable liens. Art. III, §§ 26, 27, and 28. Pursuant to § 31 of Art. III of the Model Act, the court in which the liquidation case is pending may levy one or more assessments
against "members of the insurer" who are subject to assessment. Insofar as distribution is concerned, the Act contains a comprehensive scheme for the distribution to those holding claims against the insurer. The major difference in the priorities established by the Act versus those established in the Bankruptcy Code — and which contributed to the court's ruling in the Maxicare cases — is the priority provided by section 42 for claims under policies for losses incurred (including third party claims), claims against the insurer for liability for bodily injury or destruction of tangible property which are not under policies, and all claims of a guarantee association. Art. III, § 42, ¶ C.

III.

EFFECT OF A PENDING RECEIVERSHIP OR CUSTODIANSHIP.

A. The pendency of a state court receivership or conservatorship should not determine the issue of eligibility per se, but it can influence the outcome of a case. For example, as noted above in the Portland Metro Health case, there is language to the effect that a debtor should not be heard to contest its classification as an insurance company when the state court, in the pending receivership action, had already decided the issue against the debtor. 15 Bankr. at 104.


C. Alternatively, the bankruptcy court could leave the state regulator in possession but permit the chapter 11 case to proceed for purposes not related to the operation or disposition of assets.

1. As a receiver, the state insurance commissioner would qualify as a "custodian" under section 101(11) of the Code, 11 U.S.C. § 101(11) and, therefore, would be subject to the provisions of section 543 of the Code, 11 U.S.C. § 543, including:

(a) Prohibition against administration of property of the debtor or property of the estate in possession, custody, or control of the custodian;
(b) Turnover to the chapter 11 debtor or trustee; and
(c) The filing of an accounting.

2. However, under section 543(d), 11 U.S.C. § 543(d), the bankruptcy court may excuse compliance if "the interests of creditors and, if the debtor is not insolvent, of equity security holders would be better served..." (This type of relief, although sought as modification of the automatic stay, was requested — absent dismissal — by the regulator in Beacon Health, 105 Bankr. at 178 (Bankr. D.N.H. 1989).

IV.

SCOPe OF JURISDICTION ISSUES

A. Perhaps there is nothing of special relevance on questions of jurisdictional scope where the eligible debtor is the operating entity, e.g., Maxicare. Nothing in the Judicial Code suggests that the court's jurisdiction in that title 11 case is any different necessarily from what it would be in any other title 11 case.

1. However, special issues of insurance law might arise that require or allow:

(a) Matters requiring consideration of both title 11 and federal insurance laws to be heard in the title 11 case only by the district judge (28 U.S.C. § 157(d)); or

(b) A particular controversy to be heard by a state court because of comity or because under § 1334 (c) of title 28 questions of state law must be decided.

B. Where the debtor in the title 11 case is a holding company eligible for relief, however, there has been occasion where the court hearing that case has found jurisdiction to protect, at least from certain creditor claims, the debtor's insurer subsidiary that is ineligible for relief under the Code.

1. An aggressive example occurred in Equity Funding Corp. of America, 396 F. Supp. 1266 (C.D. Cal. 1975). This case arose under Chapter X of the Bankruptcy Act and was decided by then District Judge Harry Pregerson, now a judge of the Ninth Circuit Court of Appeals. The reorganization case had commenced when the debtor, Equity Funding Corporation of America ("EFCA"), filed its petition for reorganiza-
tion in 1973. More than a year later, the trustee filed a plan of reorganization contemplating the formation of a new company whose primary assets would consist of all the stock of two insurance subsidiaries owned by EFCA. Among creditors classified under the proposed plan were the debtor's present and former securities holders, whose claims were based on fraud committed contrary to federal securities laws and other applicable law. Apart from the reorganization proceedings, numerous individual and class actions had been brought against the insurance subsidiaries by such claimants. The amount of these claims was estimated, by those asserting them, to exceed $200 million. While hearings were being held before the court in the title 11 case to determine whether the proposed plan of reorganization should be approved, the trustee filed an application in the Chapter X case requesting that the court enjoin the prosecution of their claims against the subsidiaries. The requested relief to enjoin "certain narrowly described claims" applied only to a claim which: (1) sought recovery against a subsidiary; (2) was based upon damages suffered from an investment in EFCA, (3) was based upon the alleged participation of the subsidiary as "an aider, abettor, or conspirator" in the fraud; and (4) which arose out of the action taken by the subsidiary at the direction of a person, who at the time was an officer or employee of EFCA. The requested injunction would prohibit the prosecution of any and all claims against any subsidiary (with one exception) in any court other than the reorganization court, where it was intended the court would hear and determine such claims. The trustee's application was based on two theories: First, the subsidiaries were alter egos of EFCA and, therefore, constituted "property" of the debtor within the meaning of Chapter X; second that the court had inherent jurisdiction to adjudicate controversies which would frustrate reorganization if jurisdiction were not exercised.

(a) On the first theory, i.e., whether the debtor had a "property interest" in its subsidiaries, Judge Pregerson noted the broad language of section 511 of the Bankruptcy Act which provided that the court "shall, for purposes of this Chapter, have exclusive jurisdiction of the debtor and its property wherever located." (emphasis added) While ordinarily a parent was not deemed under section 511 to have a property interest in the assets of an independent subsidiary, Judge Pregerson found authority to support an exception to that rule when the subsidiary was seen

7 The Judicial Code, of course, contains its own broad jurisdictional grants to federal courts in title 11 cases. 28 U.S.C. § 1334(d).
as an alter ego of its parent or "when the parent and subsidiary are 'so completely one that the corporate veil may be pierced with impunity and technicalities laid aside.'" 396 F. Supp. at 1270. In Judge Pregerson's view, the exceptional facts of the Equity Funding case suggested good reason for the court to disregard the separate corporate existence of the subsidiaries but to do so "solely for the purpose of asserting jurisdiction over the described claims." Specifically: First, the fraudulent scheme which caused EFCA's insolvency was the very basis for the claims against the subsidiaries. Next, the claimants did not justify their actions against the subsidiaries on the basis of reliance on the subsidiaries' independent corporate existence, but rather based upon the claimants' relationship as a security holder of the parent. Third, the debtor, EFCA, was a holding company whose "value in these reorganization proceedings depends upon the earning power of the operating assets which such outstanding stock represents." Finally, the described claims directly affected the reorganization proceedings because their existence made it impossible to determine how the reorganization value should be distributed. Accordingly, Judge Pregerson concluded that on these facts "a holding company has a 'limited property' interest in its subsidiaries solely for the purpose of asserting jurisdiction in Chapter X proceedings over such narrowly defined claims against its subsidiary." 396 F. Supp. at 1271.

2. Judge Pregerson next discussed the issue as to whether the court had "inherent jurisdiction" over the described claims against the subsidiaries. In answering that inquiry, Judge Pregerson wrote: "This court believes that section 2a(15) of the Bankruptcy Act (11 U.S.C. § 11a(15)) provides an alternative and a more appropriate basis upon which to assert jurisdiction to enjoin and to hear the described claims in these reorganization proceedings . . . [where] the pendency of those actions would frustrate reorganization or make it impossible for this court to enforce specific provisions of Chapter X." Section 2a(15) invested the court with jurisdiction to "make such orders, issue such process, and enter such judgments, in addition to those specifically provided for, as may be necessary for the enforcement of the provisions of this [A]ct . . . ." (emphasis by the court). Judge Pregerson's opinion goes on to describe all of the reasons why the pendency of the subject claims would both frustrate reorganization and make it impossible for the court to enforce the
pending plan were they not enjoined. 396 F. Supp. at 1272-74. 8

3. While the court in Equity Funding was prepared to enjoin creditor action, other courts in title 11 cases have quite consistently refused to interfere with the state regulator's efforts to liquidate, under state law, entities ineligible for relief under the Code. In re Bankers Trust Co., 566 F.2d 1281 (5th Cir. 1978); MCorp. Financial, Inc. v. Bd. of Governors, Fed. Reserve Sys., 900 F.2d 852 (5th Cir. 1990), cert. granted, ___ U.S. ___, 111 S. Ct. 1101 (1991); In re Deltacorp, Inc., 111 Bankr. 419 (Bankr. S.D.N.Y. 1990); and In re Peoples Bankshares, Ltd., 68 Bankr. 536 (Bankr. N.D. Iowa 1986). While all but one of these cases involve bank holding companies, there is no persuasive reason why the same policy should not be followed in the case of an insurance holding company.

4. In Peoples Bankshares, the only assets of a debtor holding company were five state chartered banks, each subject to Iowa regulatory authority. The debtor brought a declaratory judgment action seeking to enjoin the state from liquidating the banks. The court refused to issue the injunction, holding that the automatic stay of section 362 did not apply to the debtor's subsidiaries, which — regardless of Judge Pregerson's perceptions in Equity Funding — were not property of the estate or property in which the estate had an interest. The court held:

Although a debtor owns 100 percent of the stock of a corporation, the property interest of the debtor's bankruptcy estate extends only to the intangible personal property rights represented by stock certificates; the technical, legal distinctions between

8 Judge Pregerson rejected any notion that section 4 of the Bankruptcy Act, which enumerated those entities not eligible for relief under the Act, stood as a bar to the entry of the requested injunction. In his view, section 4 merely prevented the court from reorganizing the subsidiary or adjudging it to be a bankrupt under the Act, but it did not prevent the court from asserting jurisdiction over the described claims against the subsidiary. Rather, the exercise of such limited jurisdiction was consistent with the Congressional intent to preserve exclusive state jurisdiction over the liquidation of insurance companies. The court would not interfere with the rights of insureds or with state regulation of insurance companies. 396 F. Supp. at 1275.
corporations will be respected and applied with reference to the automatic stays of actions against property of the estate.

68 Bankr. at 539.

The court refused to ignore section 109 by taking jurisdiction over the five state banks as assets of the debtor's estate. According to the court, "it is difficult to imagine a more clear statement of Congressional intent; the bankruptcy court shall not have jurisdiction over banks for purposes of liquidation or reorganization." Id. at 540. The court was "greatly influenced by the purpose of [section 109], the breadth with which it names the institutions covered, and the financial and public policy ramifications of divesting those officers of state government, possessed with both expertise and authority to regulate state chartered banks, from the power to do so." Id. On these policy grounds, the court dismissed the debtor's complaint.

5. In re Deltacorp, Inc., 111 Bankr. 419 (Bankr. S.D.N.Y. 1990), relied on Peoples Bankshares to reach a similar conclusion. The Deltacorp debtor was a fifty-three percent owner of a non-debtor holding company that, in turn, owned an insolvent savings and loan association. The debtor, hoping to sell the savings and loan, requested the bankruptcy court to issue an injunction to prevent federal and state banking agencies from appointing a receiver for the association. Although an injunction and sale would have relieved the debtor of nearly $23,000,000 in liabilities under a net worth agreement with the savings and loan association, the court refused to grant the desired relief. The Deltacorp court recognized that the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)\(^9\) did not expressly restrain it from prohibiting the appointment of a receiver. 111 Bankr. at 421. The court, however, declined to exercise such power, holding that it is "clear not only from FIRREA but also from section 109 of the Bankruptcy Code itself, that Congress did not mean to entrust to bankruptcy judges, who are specialists in an area other than banking, the determination of when a receiver should be appointed." 111 Bankr. at 419.

6. The Fifth Circuit severely limited the rights of a bankruptcy judge to interfere with the reorganization process of an ineligible entity in *Bankers Trust Savings & Loan Association v. Travis (In re Bankers Trust Co.)*, 566 F.2d 1281 (5th Cir. 1978). In *Bankers Trust*, a case decided under the former Bankruptcy Act, a holding company owned an insolvent savings and loan association that was in state receivership. After the holding company filed a bankruptcy petition, the bankruptcy judge issued an order, designed to protect the debtor's estate, that had the effect of enjoining a proposed reorganization plan for the savings and loan. On appeal from this order, the Fifth Circuit recognized that the issue was "an unresolved conflict between the role of state and federal authorities in the bankruptcy of a company whose subsidiary is a state-chartered savings and loan association." 566 F.2d at 1286. The court held that "delicate balancing" was needed to apply federal bankruptcy law without hindering the state's right to reorganize the savings and loan. *Id.*

The court rejected the debtor's argument that stock ownership in the subsidiary gave it the right to interfere with the savings and loan reorganization process. The court concluded "that to permit the blocking of state reorganization herein would be tantamount to imposing a federal reorganization which is clearly forbidden by the Act's exemption of savings and loan associations and inconsistent with the congressional [bankruptcy] scheme." 566 F.2d at 1288. As a result, the court reversed the district court's order. In doing so, it looked extensively to the policy behind the Bankruptcy Act: "If any meaning is to be given to congressional exclusion of savings and loan associations from the Act, it must be that determination of rights among savings and loan's creditors, a core function of bankruptcy, must be left to state governments. Any order to the contrary exceeds the district court's statutory authority." 566 F.2d at 1286.10

7. Another Fifth Circuit case that limits the power of a bankruptcy judge to act regarding a debtor's ineligible subsidiary is *MCorp Financial, Inc. v. Bd. of Governors Fed. Reserve Sys.*, 900 F.2d 852 (5th Cir. 1990), cert. denied, ___ U.S. ___, 111 S. Ct. 1101 (1991). In *MCorp*, the bankruptcy court had issued an order enjoining the Federal Reserve Board from prosecuting administrative proceedings

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10 *Bankers Trust* also involved claims by the holding company against the subsidiary. The court took notice of, but did not comment on, the fact that the bankruptcy court — as opposed to the state court — was scheduled to hear such claims at a later date. 566 F.2d at 1285-86.
against the debtor regarding the debtor's dissipation of the assets of the subsidiary bank.\textsuperscript{11}

The Fifth Circuit reversed the order, finding that the lower court's injunction effectively repealed 12 U.S.C. § 1818(i) of title 12 of the United States Code \textsuperscript{12}, which provides that "no court shall have jurisdiction to affect by injunction or otherwise the issuance or enforcement of any notice or order under this section." The court held that 28 U.S.C. § 1334 of title 28, the bankruptcy jurisdictional provision, does not supersede section 1818(i), and that the two statutes must be "harmonized." \textit{Id.} at 855. The court ultimately concluded that section 1818(i) "deprives the district court of jurisdiction to enjoin the Board's administrative proceedings." \textit{Id.} at 857. As a result, the court permitted the Federal Reserve to bring proceedings that could potentially result in a large monetary judgement against a chapter 11 debtor.


8. \textit{In re First Financial Enterprises, Inc.}, 99 Bankr. 751 (Bankr. W.D. Tex. 1989) is perhaps the most extreme example of judicial deference to state reorganization proceedings. In \textit{First Financial}, a holding company of several insolvent life insurance companies attempted to file for bankruptcy. The bankruptcy court used section 305 of the Bankruptcy Code to dismiss the petition, holding that the "obvious purpose of the filing of this Chapter 11 case is an attempt by the Debtor and its sole shareholder to halt the state court receivership and conservatorship of the Debtor's subsidiary insurance companies and take control of their assets." \textit{Id.} at 754-55. The court did not permit the holding company to file for bankruptcy because the filing was "for the sole purpose of doing indirectly what cannot be done directly . , to defeat the receivership and conservatorship" of its subsidiaries. 99 Bankr. at 755. In dismissing the petition, the court relied on \textit{Peoples Bankshares} and its discussion of the policy considerations behind section 109.

9. There have been, however, several cases that recognize more power in the bankruptcy court to deal with situations where the holding company files under the Bank-

\textsuperscript{11} 101 Bankr. 483 (S.D. Tex. 1989).

\textsuperscript{12} The Financial Institutions Supervisory Act of 1966, as amended.
ruptcy Code and its subsidiary is under state receivership. In re Firstcorp, Inc., 122 Bankr. 484 (Bankr. E.D.N.C. 1990) is a good example. In Firstcorp, the debtor was a holding company that wholly owned several savings and loan associations. After the debtor's filing, one of its savings and loans became insolvent and fell under receivership by the Resolution Trust Corporation. After the receiver attempted to require the debtor to meet certain capital requirements to its savings and loan, the debtor brought an adversary proceeding in the bankruptcy court seeking to stay the action.

The court, noting that the case brings "into sharp focus the conflict" between bankruptcy law and savings and loan regulations, granted the injunction against the receiver. Firstcorp, 122 Bankr. at 488. The court distinguished MCorp, holding that a regulatory body may act against a debtor only until such action "involves property of the estate, at which point the action may no longer proceed." 122 Bankr. at 489. (emphasis added) Because the court viewed the administrative proceeding against the debtor as "essentially an action to collect a monetary claim," it held that the automatic stay of section 362 applied to the proceeding. 122 Bankr. at 491. 13

10. Even if the court in the title 11 case does not act to stay proceedings by creditors against the non-debtor subsidiary, relief may nevertheless be available in the forum in which the claims against the subsidiaries are being asserted. Stoller v. Baldwin-United Corp., 41 Bankr. 884 (Bankr. S.D. Ohio 1984), the district judge before whom class actions were pending granted motions by the defendants for a limited stay of the continued prosecution of the actions against non-debtor defendants. The court concurred with an opinion of the bankruptcy court in the reorganization case, expressed in a different context, that it was not efficient and prudent to allow these creditors to liquidate their claims outside the reorganization proceedings. "Given the time and money required to litigate a securities class action of this magnitude, the interests of all parties would be best served by liquidating the plaintiff's claims through plan negotiations. In the alternative, their claims could be estimated under the procedure contemplated by Section

13 In a subsequent decision, the court also denied a motion brought by the receiver to require the debtor to cure capital deficiencies of its subsidiary. The court's opinion, however, was based largely on the termination of the debtor's contractual commitment to meet such capital requirements. In re Firstcorp, Inc., 126 Bankr. 688 (Bankr. E.D.N.C. 1991).
502(c)(1)." 41 Bankr. at 886 n.3. In granting the requested relief, the district court noted that the defendants seeking the relief could not seek the benefit of a stay under section 362 of the Code but rather, were required to justify any requested stay upon other authorities such as Rule 19 of the Federal Rules of Civil Procedure which confers upon the district court in a civil action the power to regulate its docket. In part, the result in Stoller occurred because of prior positions taken by the attorneys for the plaintiffs in earlier proceedings before the reorganization court where, in a motion for relief from the automatic stay, the attorneys contended that the claims against the debtor were inextricably woven with the claims of the solvent insurance subsidiaries and arose from the same factual and legal basis as those claims. 41 Bankr. at 891. Hence, given the inappropriateness as admitted by the plaintiffs of proceeding against the solvent insurers without being able to proceed against the holding company, a stay in the civil litigation was appropriate. 41 Bankr. at 891. Based on the foregoing and on other considerations not discussed here, the court granted a stay slightly in excess of seven months hoping that during the interval, progress could be made in the bankruptcy proceedings and in other proceedings state rehabilitation proceedings for the subsidiaries that might make the need for further litigation of the issues before the district court unnecessary. (The court left open the question whether it would extend the stay further after having received reports after the end the period for which it was granted.) 41 Bankr. at 893.

C. Where the affairs of the holding company are being adjudicated in the title 11 case by the bankruptcy court and the affairs of the insurance subsidiary are under the jurisdiction of the state court, which court can or should decide:

1. The claims of one entity against the other;

2. Conflicting entitlements to property; or

3. Conflicting avoiding powers.

4. Issues relating to the retention or transfer of the shares of the subsidiary;

There is little law bearing directly on these issues. As noted above, the court in In re First-Corp. Inc., 122 Bankr. 484 (Bankr. E.D.N.C. 1990) clearly viewed it to be the province of the bankruptcy court to determine claims against the debtor even if asserted by the state regulator. (This is consistent with section 1334 of title 28 of the United States Code granting jurisdiction to the court in title 11 cases over claims, but is less than consistent with the ruling of the Fifth Circuit in
MCorp Financial where administrative proceedings which could result in large claims against the debtor were allowed to proceed.) Perhaps if only on notions of supremacy, the title 11 court should also decide questions on conflicting claims to property. See U.S. Const. Art. VI. Of course to say federal law is supreme is not to say that federal law makers will choose invariably to preempt state law. Issues of comity may lead Congress or the courts to defer to state law. See generally, Countryman, "The Use of State Law in Bankruptcy Cases" (pts. I & II), 47 N.Y.U. L. Rev. 407 (June 1972), 47 N.Y.U. L. Rev. 631 (October 1972). With regard to circumstances where a particular transfer may be voidable by both the state regulator and the debtor/trustee perhaps the court with possession of the property will resolve the issue. Cf. In re New York, New Haven and Hartford R.R., 457 F.2d 683 (2d Cir.), cert. denied, 409 U.S. 890 (1972) (court with possession of disputed property has jurisdiction). Issues relating to the retention or transfer of shares are discussed below in Part VI.

V.

CASE ADMINISTRATION.

A. Impact of the automatic stay on regulatory authorities:

1. In the context of an eligible debtor, e.g., an HMO in California, this inquiry primarily involves an analysis of the regulatory power exception to section 362(a)'s automatic stay as provided in section 362(b)(4) of the Code, 11 U.S.C. § 362(b)(4).

(a) Section 362(b), read together with subsection (4), provides inter alia that the automatic stay does not apply: "The filing of a petition . . . does not operate as a stay — under subsection (a)(1) of this section, of the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power."

(b) The issue most likely facing the bankruptcy court is whether what the regulator is doing is pursuing a pecuniary interest held by the state or those for whom it acts or is actually exercising the regulatory power. Arguably, the exception to the stay of section 362(a) contained in section 362(b)(4), should be narrowly construed under the principles of statutory construction articulated by Judge Wilson in the Maxicare cases. By its terms, section 362(b)(4) provides an exception only to the stay arising "out of subsection (a)(1) of section 362." The exception does not
except from applicability the provisions of section 362(a)(3) (which stays "any act to obtain possession of property of the estate or of property from the estate, or to exercise control over property of the debtor") nor does not except from applicability section 362(a)(6) (which stays "any act to collect, assess or recover a claim against the debtor that arose before the commencement of the case . . . ."). If the rights of the debtor under its contracts with its enrollees and its providers are considered property of the estate, an argument can be made that the regulator's action which interferes with these rights is in violation of the stay which protects them contained in section 362(a)(3). Moreover, if the regulators action against the HMO is seen as a method to force payment of claims owed to creditors, it might be argued that such action is prohibited by the stay set out in section 362(a)(6). Perhaps most importantly, it is well established that the exception to the stay contained in section 362(b)(4) was not intended to, and did not apply to regulatory actions which primarily sought to protect a pecuniary interest and were not necessary for the public health, safety or welfare. 124 Cong. Rec. H-11089 (reprinted in 1978) U.S. Code. Cong. & Admin. News 6436, 6444-6445. The Bankruptcy Appellate Panel for the Ninth Circuit has, indeed, adopted a "pecuniary purpose test" for determining the applicability of section 362(b)(4)'s exception. Under that test, governmental actions which are aimed at obtaining a pecuniary advantage for the government unit involved or its citizens are not excepted from the stay. See Thomassen v. Division of Medical Quality Assurance (In re Thomassen), 15 Bankr. 907, 909 (1981). Accord Missouri v. United States Bankruptcy Court, 647 F.2d 768, 776 (8th Cir. 1981), cert. denied, 454 U.S. 1162 (1982) (holding section 362(b)(4)'s exception inapplicable to state law authorizing the appointment of a receiver to operate or liquidate the business of a grain warehouseman which is insolvent or unable to satisfy the claims of all depositors; In re Rath Packing Co., 35 Bankr. 615, 621-22 (Bankr. N.D. Iowa 1983); In re King Memorial Hospital, 4 Bankr. 704, 708 (Bankr. S.D. Fla. 1980).

B. Even if the automatic stay is inapplicable in such a case, section 105(a) of the Code, 11 U.S.C. § 105(a) provides an alternative for relief, e.g., for enforcement of the anti-discrimination provisions of section 525(a). See discussion in part IV.D, ¶ D infra.
1. Section 105(a) provides in part: "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

2. Can or should the rule in the Equity Funding case, be extended to preclude action by the regulator against the subsidiary?

   (a) There is language in Judge Pregerson's opinion suggesting not. 396 F. Supp. at 1275.

   (b) Other decisions also reflect predominant view that court in the title 11 case of the holding company should not interfere with action by the regulator against the subsidiary or over it affairs. In re Peoples Bankshares, Ltd., 68 Bankr. 536 (Bankr. Iowa 1986) (in title 11 case of holding company, injunction refused to prohibit state liquidation of subsidiary); In re Deltacorp, Inc., 111 Bankr. 419 (Bankr. S.D.N.Y. 1990) (in title 11 case of holding company, injunction refused to prohibit state regulator from seeking appointment of a receiver); In re Bankers Trust Co., 566 F.2d 1281 (5th Cir. 1978) (overturning order of trial court enjoining regulator from reorganizing subsidiary) (see detailed discussion at part IV.B, ¶ 3-9 supra).

C. The debtor in possession or the trustee must, in operating the debtor's business, comply with all valid state laws. 28 U.S.C. § 959(b) (see discussion in Part VI.B., ¶ 3, infra).

D. However, section 525(a) of the Code, 11 U.S.C. § 525 (a), does preclude a governmental unit from denying, revoking, suspending, or refusing to renew a license, permit, charter, franchise or other similar grant to condition such grant to, discriminate with respect to such grant against ... a person that is or has been a debtor under this title ... or another person with whom such ... debtor has been associated, solely because such ... debtor is or has been a debtor under this title ... [or] has been insolvent before ... or during the case ... ."

1. The list of prohibited discriminations set out in section 525(a) is not exhaustive. It is left to the courts to prohibit other types of discrimination by governmental units when such discrimination is at odds with the policy of fresh start upon which the Code is based. H.R. Rep. No. 595, 95th Cong., 1st Sess. 366-67 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 81 (1978). Consistent with legislative history, bankruptcy courts have construed section 525(a) in broad terms. In re Watts, 76 Bankr. 390, 403 (Bankr. E.D.
2. Arguably then, a state regulator could be enjoined by the court in the title 11 case where regulatory action is threatened against the subsidiary solely because the parent is a debtor or because of the other grounds proscribed in section 525(a). See also In re First-Corp., Inc., 122 Bankr. 484 (Bankr. E.D.N.C. 1990) discussed at IV.B, ¶ 9, supra).

3. The prohibited discrimination does not preclude the imposition of state laws or regulations dealing with future financial responsibility. 3 COLLIER ON BANKRUPTCY 525-9, 525-10 (15th ed. 1991). Therefore, it has been held that section 525(a) does not prohibit the imposition of requirements such as net capital rules, so long as they are applied without the specifically precluded discrimination. In re Alessi, 4 C.B.C. 2d 1003 (Bankr. N.D. Ill. 1981).

E. Standing of the state regulator in title 11 case:

1. Section 1109(b) provides that "a party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or an indenture trustee may raise and may appear on any issue in a case under this chapter." 11 U.S.C. § 1109(b). (emphasis supplied)

2. Clearly, the state insurance regulator has standing to seek dismissal of a case brought by a debtor who, the regulator contends, is not eligible for relief; In re Beacon Health, Inc., 105 Bankr. 178 (Bankr. D.N.H. 1989); In re Family Health Services, Inc., 104 Bankr. 279 (Bankr. C.D. Cal. 1989); In re Portland Metro Health, Inc., 16 Bankr. 102 (Bankr. D. Or. 1981).

3. Nowhere does the Code define "party in interest." but the list provided in section 1109(b) was not intended to be exhaustive.14 Under the case law interpreting that section, the basic test for party in interest status appears to be "whether the prospective party in interest has a sufficient stake in the outcome of the proceeding so as to require representation."15


15 In re Cematex, 755 F.2d 1034, 1042 (3d Cir. 1985).

(a) Assuming that a state's insurance code gives its insurance regulator authority over premiums, a similar result should follow, especially in the case of a debtor eligible for relief such as in Maxicare. Arguably, however, the decision in Public Service leaves open the issue whether a regulatory agency without specific rate-setting authority would be deemed to have an interest sufficient to warrant full party in interest status. Section 1129(a)(6) is the only Code section which specifically preserves regulatory jurisdiction. All other regulatory jurisdiction appears to be preempted by section 1123(a)(5). (See preemption discussion below at VI.B, ¶ 2(e).) This preemption of regulatory jurisdiction may sever the connection between the various agencies and the reorganization proceedings, thereby precluding the agencies from obtaining party in interest status.

(b) Nonetheless, the case for allowing regulatory agencies to participate in a reorganization in some capacity is a strong one, given the agencies' jurisdiction over the entities post-bankruptcy activities in the case of an eligible debtor.

It has been suggested that the court, pursuant to Federal Rule of Bankruptcy Procedure 2018(a) and its powers as a court of equity, could fashion an order granting such agencies the right to be heard on relevant issues, but possibly without the right to appeal from any decision or to propose a plan of reorganization.16

5. Federal Rule of Bankruptcy Procedure 2018(a) provides that "in a case under the Code, after hearing on such notice as the court directs and for cause shown, the court may permit any interest entity to intervene generally

or with respect to any specific matter." The court in *In re E. Maine Elec. Coop., Inc.* permitted just such intervention. The court there denied party in interest status for the state Public Utilities Commission ("PUC"), but granted its motion to intervene.

VI.

ISSUES PERTAINING TO CONFIRMATION OF A

PLAN OF REORGANIZATION.

A. Quite obviously, if the debtor before the bankruptcy court is one whose rates are established under state law, there is no question but that the approval of the state regulator must be obtained for the rates to be charged by the debtor in future. 11 U.S.C. § 1129(a)(6).

B. The more interesting issues in the context of plan confirmation are those relating to valuation and whether the plan of reorganization can contain provisions other than those relating to rates which, despite provisions in state law, can be effectuated under the provisions of section 1142(a) of the Code, 11 U.S.C. § 1142(a).

1. Valuation.

(a) It is beyond the scope of these materials to provide an exhaustive discussion of valuation under chapter 11. For such discussions, the reader is referred to Fortgang and Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061 (1965) and Pachulski, *Cramdown and Valuation Under Chapter 11 Of The Bankruptcy Code*, 58 N.C.L. REV. 925 (1980). Suffice it to say that valuing assets is often required in the course of a chapter 11 case for a variety of purposes, including: whether relief should be granted from the automatic stay; whether a fair price is being received for assets proposed to be sold; whether "priming" ought be permitted; how real estate lease claims should be calculated; how distributions to be made under a plan should be valued, etc. Of these, it is submitted that the most interesting question raised in the context of

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17 Federal Rule of Bankruptcy Procedure 2018(a).

these materials is what standard of valuation should be selected in connection with determining the value of a holding company whose principal assets consist of shares of an "insurance company".

(b) Generally speaking, the method of valuation adopted by bankruptcy courts in determining the value of the reorganized debtor ("reorganization value") is the "going concern value" computed by a capitalization of prospective earnings. See Consolidated Rock Prods. Co. v. DuBois, 312 U.S. 510 (1941). However, this method may be inappropriate where special circumstances exist. At least one court has held that such special factors do exist in the case of an insurance holding company. In re Equity Funding Corp. of America, 416 F. Supp. 132 (C.D. Cal. 1975).

(c) The facts of the Equity Funding case have summarized above in part IV.B. ¶1. As recited, the reorganized debtor was going to consist primarily of the stock of two life insurance companies. Each of these insurers historically reported its earnings on the basis of "statutory accounting," a method of accounting prescribed by state insurance laws or regulators. Statutory accounting, generally speaking, contains rules primarily designed to ensure the protection of the public interest, i.e., policy holders. Accordingly, these accounting rules are comparatively stiff when measured against generally accepted accounting principles. For example, the substantial sums spent by a life insurance company in selling a policy and placing it on the company's books are, under principles of statutory accounting, required to be charged as an expense in the first year of the policy, rather than spread out over its life as would be the case under generally accepted accounting principles. Again, statutory accounting requires the buildup of reserves for new policies at a rate that is higher than experience generally proves necessary. As a result of these requirements of statutory accounting, a life insurance company that is writing large amounts of new business may show low earnings or even losses in the early years, although the new business will produce large income over the life of the new policies. By comparison, a company that is writing no new business or very little new business may show large profits from policies previously written in earlier years, even though the company is, in effect, going out of business. Accordingly, in the view of the court in Equity Funding, while statutory accounting as a methodology used in preparing projected earnings was appropriate for regulatory purposes, it was not necessarily the
most reliable guide to future earnings and could be misleading to public investors for the reasons set forth above. 416 F. Supp. at 142.

Based on the foregoing, it was the view of Judge Pregerson in Equity Funding that a more reliable way to predict future earnings of a life insurance company was to analyze the following elements: its in-force business, its forecasted future sales of new policies, and its income from assets not attributed to policy reserves. Since a life insurance company was permitted by law to pay dividends to its parent only on the basis of its statutory income, the projected statutory income, however, was critical to a determination of feasibility of the plan, since dividends would be the principal source of funds to the new company. What the court proceeded to do was to project the future earnings of the insurance subsidiaries using the analysis of their in-force business, their future sales capability, and their income from assets not attributed to policy reserves. Then, each segment of future earnings was discounted (or capitalized) to arrive at the present value of the future earning capacities of each insurance company as follows:

(a) The value of each company's existing business was determined by projecting profit flow from that business for 30 years and then discounting to present value at 15%.

(b) The value of each company's future sales capability was determined by capitalizing at five times the present value of the future profits from one year's production of business.

(c) The value of the assets not attributed to the policy reserves was determined by adjusting these assets to their market value.19

19 Pachulski, Cramdown and Valuation Under Chapter 11 Of The Bankruptcy Code, 58 N.C.L. Rev. 925, 963-64 (1980). These assets, consisting of stocks, bonds, mortgages, and other (continued...
2. Issues Arising Under section 1142(a) Of The Code — Plan Implementation.

(a) Section 1142(a) of the Bankruptcy Code, 11 U.S.C. § 1142(a) provides: "Notwithstanding any otherwise applicable nonbankruptcy law, rule, or regulation relating to financial condition, the debtor and any entity organized or to be organized for the purpose of carrying out the plan shall carry out the plan and shall comply with any orders of the court."

(b) Section 1142(a) is derived from section 224(2) of Chapter X of the Bankruptcy Act. However, the Code departs from Chapter X by mandating compliance with the terms of the plan notwithstanding "any other applicable nonbankruptcy law, rule, or regulation relating to financial condition. Thus, if the debtor cannot comply with net capital or reserve rules which would otherwise serve as cause for regulatory authorities to shut down the business and if the debtor operates the reorganized entity in accordance with the plan, regulatory authorities arguably are bound by the plan to permit such operation. 5 COLLIERS ON BANKRUPTCY 1142-1 (15th ed. 1991).

(c) The leading commentator states that section 1142(a) also covers any potential conflict between the provision of the plan and applicable nonbankruptcy law. For example, the terms of a plan which provides for the issuance of securities of the debtor take precedence over a provision of state law requiring approval of the commissioner of corporations of the state of incorporation prior to issuance of such securities.

(d) How do you reconcile these interpretations of section 1142(a) with the limits suggested on the type of discriminatory conduit covered by section 525(a)? Is the answer that section 525(a)'s list of proscribed discrimination is not exhaustive? But, what about the cases decided under section 525(a) holding that non-discriminatory regulations relating to future financial condition are acceptable? Does section 1142(a) allow the plan, and the court's orders pursuant thereto, to override such regulations?

19(...continued)

investments, had a readily determinable market value. In the instance of such assets, market value — rather than capitalization of projected earnings — is recognized as the appropriate measure of value for reorganization purposes. 416 F. Supp. at 144.
(e) While section 1129(a)(6) of the Code, 11 U.S.C. 1129(a)(6), expressly preserves regulatory jurisdiction over rate setting under a reorganization plan, section 1123(a)(5) of the Code, 11 U.S.C. 1123(a)(5), appears to preempt, through a plan of reorganization, regulatory control over a broad range of other matters. In re Public Service Co., 108 Bankr. 854 at 881-85. Section 1123(a)(5) explicitly states in part, that:

Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall provide adequate means for the plan's implementation, such as --

... ...

(B) transfer of all or any part of the property of the estate to one or more entities, whether organized before or after the confirmation of such plan;

(C) merger or consolidation of the debtor with one or more persons;

(D) sale of all or any part of the property of the estate ... or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate;

... ...

(J) issuance of securities of the debtor ... for cash, for property, for existing securities, or in exchange for claims or interests, or for any other appropriate purpose.\(^{20}\)


Section 1141(a) provides in pertinent part that: "Except as provided, ... the provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor. ... ."

rules which would otherwise serve as cause for regulatory authorities to shut down the business, and if the debtor operates the reorganized entity in accordance with the plan, regulatory authorities arguably are bound by the plan to permit such operation. 5 COLLIER ON BANKRUPTCY 1142-2 (15th ed. 1991).


   (a) Section 959(b) of the Judicial Code provides that a trustee or debtor in possession "shall manage and operate the property in his possession . . . according to the valid laws of the state in which such property is situated, in the same manner that the owner or possession thereof would be bound to do if in possession thereof." 28 U.S.C. § 959(b).

   (b) Hence, it has been stated that the Bankruptcy Code does not change the business and regulatory environment in which the debtor in possession operates. In re Beker Industries, Corp., 57 Bankr. 611 (Bankr. S.D.N.Y. 1986).

   (c) Does section 1142(a) allow the post-confirmation debtor to do what section 959(b) precludes the debtor in possession from doing during the case?