

Rights and responsibilities of reinsurers in receiverships

By DEBRA J. HALL*

I. INTRODUCTION

Reinsurance recoverables are often the largest asset of an insolvent estate. This is not surprising if one reviews the reliance on reinsurance generally in the US insurance industry, the world's largest insurance market. Reinsurance recoveries account for over 63 per cent of the US insurance industry's surplus.¹

Reinsurance is an international business and is becoming even more so annually. According to a study conducted by the Reinsurance Association of America ("RAA") using annual statement data,² \$13.3 billion of reinsurance premiums were ceded in 1993 to more than 2,000 reinsurers in over 90 jurisdictions outside the US.³ This figure represents an 11.8 per cent increase from the \$11.9 billion of premiums ceded to foreign reinsurers in 1992.⁴ In comparison, similar—but not identical—figures for domestic reinsurers indicate that US reinsurers wrote \$13.4 billion in unaffiliated premiums, resulting in an unaffiliated premium breakdown of roughly 57.7 per cent domestic and 42.3 per cent foreign.⁵

As reinsurance premium is ceded to reinsurers worldwide, regulators have become increasingly concerned with the ability to collect reinsurance recoverables, a task which is made more complex by this fact.⁶

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The views expressed herein are solely those of the author alone and do not represent the express or implied opinions of the Reinsurance Association of America or its member companies.

1. See A. M. Best, *Best's Aggregates and Averages 1994*, pp. 92-93. See also Testimony of the Reinsurance Association of America Submitted to the House Energy and Commerce Subcommittee on Commerce, Consumer Protection and Competitiveness, Hearings on H.R. 1290, The Federal Insurance Solvency Act of 1993 7 (22 April 1993).

2. Reinsurance Association of America, *The US Reinsurance Market in 1993: An Analysis of Annual Statement Data*, p. 1.

3. *Ibid.* at p. 1. Approximately \$3.4 billion was ceded to affiliated reinsurers and \$9.9 billion to unaffiliated reinsurers.

4. *Ibid.*

5. *Ibid.* at pp. 8-9. These figures compare to the RAA's study of 1990 data which indicated that 64.7 per cent of unaffiliated premium was ceded to domestic and 35.3 per cent to foreign reinsurers.

6. Regulators, through the National Association of Insurance Commissioners ("NAIC"), have been reviewing the NAIC Model Credit for Reinsurance Law and Regulation over the past few years and have recommended changes that would strengthen the reliability of security devices that protect US ceding insurers.

At the same time, US liquidators struggle with the collection of reinsurance recoveries due to insolvent companies placed in liquidation during the 1980s.⁷ The approach to the collection of reinsurance recoveries varies widely among individual liquidators. Although no sweeping characterisations should be made because there are exceptions to every generalisation, UK liquidators appear to approach collections in a different, more even-handed manner than a number of their US counterparts.⁸

US liquidators are often heard to comment that reinsurers are (1) the primary reason for insolvencies, and (2) unwilling to comply with their obligations to an insolvent estate. In fact, neither of these views is an accurate characterisation of the facts.

In June 1991, A. M. Best Company issued a report⁹ that summarised an analysis of the causes for the insolvencies of property and casualty insurers during the period 1969–1990. Of the primary factors identified for 302 insolvencies (81 per cent of insolvencies occurring during that period) the failure of reinsurers to pay their obligations was ranked as the sixth largest cause, accounting for only 7 per cent of US insolvencies.¹⁰ The *Best Study* attributed these instances to the fact that some reinsurers engaged in cashflow underwriting during the mid-1980s, resulting in financial difficulty or insolvency. Another important consideration was the fact that some ceding insurers purchased the least expensive reinsurance protection available, without sufficient regard to the financial strength of the reinsurer.¹¹ Clearly, the failure of reinsurers to meet their obligations does not deserve the attention nor the enmity often elicited from US liquidators.

On the other hand, those very liquidators who often claim that reinsurers fail to live up to their obligations once a ceding insurer is placed in insolvency are discredited by their own figures and actual experience. For example, the liquidator of Mission Insurance Company¹² has characterised reinsurers and their rights to notice and participation in the liquidation process as follows:

“... It is inequitable and inadvisable if this court were to permit an entity who—whose purpose is to delay payment as long as possible in between the receiver and the policyholders whose claims he needs to adjudicate... Any time you give anybody a right to interfere, they will interfere, particularly where it must be clear to the court that since the objections to this plan are all coming from reinsurers, and since all the reinsurers have as their self-interest delay, and since the only—the benefit to the reinsurers from all these arguments, the one common denominator from all these arguments is ‘Please

7. The statistics concerning the increase in US insurance insolvencies are well-documented. One hundred property and casualty companies became insolvent in the three-year period from 1984 to 1986 with 49 in 1985 representing the largest number of insolvencies in US history. During the 1980s 226 property and casualty insurers became insolvent. See A. M. Best, *Best's Insolvency Study: Property/Casualty Insurance 1969–1990*, p. 11, June 1991 (hereinafter *Best Study*).

8. In fairness, there are a number of reasonable US liquidators and this fact should be noted for their benefit and to their credit.

9. See *Best Study*, note 7, *supra*.

10. See *Best Study*, note 7, *supra*, at pp. 45–46. Ranked as more frequent causes of insolvency were: deficient loss reserves linked to inadequate pricing (28 per cent); rapid growth (21 per cent); alleged fraud (10 per cent); overstatement of assets (10 per cent); and significant change in business (9 per cent).

11. See *Best Study*, note 7, *supra*, at p. 46.

12. The Mission Insurance Company (Mission) was a California-domiciled insurer, the largest of several insurance company and agency subsidiaries owned by the Mission Insurance Group. The Mission liquidator estimates the ultimate cost to the public of Mission's collapse at \$1.6 billion. See Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, 101 Cong., 2d Sess., “Failed Promises: Insurance Company Insolvencies”, pp. 11–12 (Comm. Print 1990) (hereinafter “Failed Promises”).

don't make us pay ever, we would prefer, but at least delay it as long as possible': that must indicate to the court that that's consistently where they're coming from. The more opportunity you give them to get involved in our process, the more they will interfere with it, and the more it makes no sense to have a plan if you put people in the plan who can disrupt it."¹³

Yet, the same liquidator only a month earlier, stated in the same proceeding:

"Almost all of our reinsurers have settled with us, and either have commuted or have keep-current agreements, and there's no litigation with them whatsoever, none, over 300 reinsurers."¹⁴

In further support of this statement, the liquidator submitted a sworn declaration claiming that he had entered into 313 commutation agreements, leaving only 54 reinsurers of Mission's direct business.¹⁵

Similarly, in a recent report issued concerning the Transit Casualty Company¹⁶ the liquidator reported that for each of the last four consecutive years, 1990-1994, the estate has collected over \$100 million in assets which totals \$640.9 million in collections over the past nine years.¹⁷ Most of that figure represents reinsurance recoveries.¹⁸ According to its own account, for the five years prior to its insolvency in December 1985, Transit engaged in "massive reinsurance transactions" by agents operating in all 50 states involving over 900 reinsurers in some 30 foreign countries on five continents.¹⁹ Of those 900 reinsurers, approximately 550 have settled their obligations with the liquidator.²⁰

One is hard pressed to argue, with the complexity of the reinsurance arrangements in which Transit voluntarily engaged and the significant amounts of reinsurance recoverables collected and commuted, that reinsurers are unwilling to meet their obligations to that estate.

As previously noted, UK liquidators appear to approach insolvencies and the collection of reinsurance recoveries in a different manner than some of their US counterparts. This fact is recognised even by experienced liquidators,²¹ one of whom noted at a recent presentation in the US:

13. *Garamendi v. Mission Insurance Company*, Dkt. No. C572 724 (Cal. S. Ct.), Transcript of Proceedings of 23 March 1995, at pp. 143-144 and 146-147 (hereinafter "March Transcript").

14. *Garamendi v. Mission Insurance Company*, Dkt. No. C572 724 (Cal. S. Ct.), Transcript of Proceedings of 16 February 1995, at p. 56.

15. *Garamendi v. Mission Insurance Company*, Dkt. No. C572 724 (Cal. S. Ct.), Declaration of John G. Horner in Support of Insurance Commissioner's Reply to Objections to Final Dividend Plan, 16 February 1995.

16. Transit Casualty Company ("Transit") described as the "Titanic of insurance company insolvencies" is, in the opinion of the Subcommittee on Oversight and Investigations, "the biggest and most outrageous insurance insolvency in history". Prior to its demise, Transit operated from its headquarters in Los Angeles, California, though it was domiciled in Missouri.

17. Transit Casualty Company, *Insolvency and Liquidation Report*, at pp. 1 and 3 (March 1995).

18. *Ibid.*, at p. 3.

19. *Ibid.*, at p. 1.

20. *Ibid.* at p. 3. "The Receivership still has a significant task ahead in collecting reinsurance assets, since of the company's 900 original reinsurers there still remain about 350 reinsurance companies to settle with."

21. Philip J. Singer is a partner in Coopers & Lybrand, London, where he is responsible for the firm's National Insurance Insolvency Group. Over the last 27 years, he has been involved in dealing with the problems of insolvency of more than 60 insurance and reinsurance companies in various jurisdictions. He is a licensed insolvency practitioner. (Unlike the UK, there is no licensing required or available in the US for ensuring that appointed liquidators have adequate qualifications to perform their job.)

"There also seems to be an attitude problem when it comes to dealing with reinsurance companies, even when they are creditors. It seems to me that US liquidators tend to treat reinsurers as the guys in the black hats rather than treating them as creditors with rights similar to all other creditors.

...
In the UK, all creditors (other than a small number of preferential creditors) are created equal whereas in the United States the tendency is for policyholder creditors to rank ahead of reinsurance creditors. What then happens is that reinsurance creditors are encouraged, and indeed on some occasions forced, to put in claims on the estate so that the liquidator can in turn make recoveries from retrocessionaires in order to pay the maximum possible dividend to policyholders and guarantee funds. Normally, however, reinsurance creditors see nothing even though it may be the reinsurance industry which is largely funding the distributions to policyholders."²²

With this backdrop of the international nature of reinsurance recoveries owing to insolvent US insurers and given the somewhat different approaches taken by at least some US liquidators and UK liquidators, we turn to the fundamental issues in the area of reinsurance collections for US insolvent estates: When and how much? To whom are recoveries paid? Who determines disputes that arise?

II. WHEN AND HOW MUCH?

A. US insolvency clause

A reinsurance contract is one by which the reinsurer indemnifies the ceding insurer for losses paid. This is distinguished from a primary liability policy that usually provides that the insurer will "pay on behalf of the insured", the insured's liability to a third party.²³

The pivotal case in the US establishing reinsurance as a contract of indemnity is *Fidelity & Deposit Company v. Pink*,²⁴ decided by the United States Supreme Court. The quota share reinsurer of an insolvent insurer claimed that because the reinsurance contract was one of indemnity, the reinsurer was required to reimburse the liquidator only for the contractual portion of the losses actually paid by the liquidator to claimants. The liquidator claimed that the reinsurer was obligated to reimburse the insolvent insurer based on its *liability* to claimants regardless of the amount the insolvent insurer actually paid. Based upon the language of the reinsurance contract, the Supreme Court held in favour of the reinsurer.

The standard insolvency clause, found in most state insurance codes or regulations was a statutory reaction to *Pink*. At the prompting of state insurance departments, most states have adopted these statutes or regulations as a requirement for credit for reinsurance.²⁵ In order for a ceding insurer to take credit on its annual financial statement for reinsurance

22. P. J. Singer, *Insurer Insolvencies—Do the British Have a Better Idea?* (January 1995) (available from the Strategic Research Institute).

23. See T. Semple and R. Hall, "The Reinsurer's Liability in the Event of the insolvency of a Ceding Property and Casualty Insurer", 21 *Tort & Ins. L.J.* 407 (Spring 1986) (hereinafter "Semple & Hall").

24. *Fidelity & Deposit Co. of Maryland v. Pink*, 302 US 224 (1937) (hereinafter *Pink*).

25. In the 50 states and the District of Columbia 31 maintain statutes requiring an insolvency clause in order to take credit on the annual statement; 19 either do not address the issue or do not require its inclusion in a reinsurance contract. Eleven states do not address insolvency clauses in either their statutes or regulations.

ceded, as an asset or as a reduction from liabilities, the reinsurance contract must contain an insolvency clause.

New York was the first state to enact the requirement of an insolvency clause in 1939,²⁶ followed shortly thereafter by Massachusetts (1941), Illinois (1945), Utah, Washington and Tennessee (1947).²⁷ In 1950, the NAIC adopted a model insolvency clause requirement and noted:

"The Committee was agreed that the insolvency clause in a reinsurance contract should provide that in the event of insolvency of the ceding insurer, the reinsurer will remain fully liable for its share. The language in the several codes of the States was examined by the Committee, and the conclusion was unanimously reached that the following language, which is stated in substantially identical form in most of the State laws on the subject, be uniformly adopted.²⁸

No credit shall be allowed as an admitted asset or as a deduction from liability, to any ceding insurer for reinsurance made, ceded, renewed, or otherwise becoming effective after January first, nineteen hundred and forty, unless the reinsurance shall be payable by the assuming insurer on the basis of the liability of the ceding insurer under the contract or contracts reinsured without diminution because of the insolvency of the ceding insurer nor unless under the contract or contracts of reinsurance the liability for such reinsurance is assumed by the assuming insurer or insurers as of the same effective date. Such reinsurance agreement may provide that the liquidator or receiver or statutory successor of an insolvent ceding insurer shall give written notice of the pendency of a claim against the insolvent ceding insurer on the policy or bond reinsured within a reasonable time after such claim is filed in the insolvency proceeding and that during the pendency of such claim any assuming insurer may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defense or defenses which it may deem available to the ceding company or its liquidator or receiver or statutory successor. The expense thus incurred by the assuming insurer shall be chargeable subject to court approval against the insolvent ceding insurer as part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to the ceding insurer solely as a result of the defense undertaken by the assuming insurer.

Where two or more assuming insurers are involved in the same claim and majority in interest elect to interpose defense to such claim, the expense shall be apportioned in accordance with the terms of the reinsurance agreement as though such expense had been incurred by the ceding company."

At the time the NAIC model insolvency clause requirement was adopted, there was disagreement concerning the precise language—a disagreement that remains alive today. The difficulty revolves around the different, and inconsistent, requirements between New York and California.²⁹

The New York Department of Insurance requires that an insolvency clause contain a reference that reinsurance is payable "on the basis of the liability of the ceding insurer under the contracts reinsured". The Department specifically forbids the use of language to the effect that "reinsurance [would be] payable as finally determined in the liquidation

26. 1936 N.Y. Laws, Ch. 882, § 77.

27. R. J. Olson, "Reinsurers' Liability to the Insolvent Reinsured", 41 *Notre Dame Lawyer* 13 (1965).

28. National Association of Insurance Commissioners Proceedings, I : 48-51 (1951). States have adopted a variety of modifications to this suggested "model".

29. In 1989 there was another attempt to draft a model insolvency clause, but the effort was abandoned on account of what appeared to be an irreconcilable difference between regulators in New York and California.

or receivership proceeding . . . ”.³⁰ The Department’s concern is that use of the forbidden language may give reinsurers a basis for arguing that reinsurance recoveries are not due until completion of the entire liquidation proceeding.

On the other hand, the California Department of Insurance has, since at least 1989, required that contractual insolvency clauses contain the “on demand” language found in the California insolvency statute.³¹ New York opposes the “on demand” language noting that it might cause a liquidator to accelerate reinsurance payments. And indeed, Mission has tried to do just that, albeit unsuccessfully thus far.

In 1989, the Mission liquidator sought more than \$70 million in incurred but not reported losses (“IBNR”) from Underwriters Reinsurance Company (“Underwriters”). The reinsurer moved for summary judgment arguing that it could only be required to pay claims as they become due, not claims based on actuarial estimates of future events. Mission’s supervising court held that Underwriters’ motion was untimely, denying summary judgment without an adjudication on the merits. The court stated, however, that “[m]oving parties cannot be required to pay any amount in relation to any IBNR claim absent an adjudication of a breach of the applicable reinsurance agreement.”³²

Insolvency clauses and insolvency statutes and regulations reflect a trade-off. This trade-off recognises that an insolvency clause alters the indemnity nature of a reinsurance contract requiring the reinsurer to pay on the basis of liability regardless of actual payments by the insolvent ceding insurer. But the reinsurer must be provided certain safeguards. Insolvency clauses recognise that while a solvent insurer is motivated to pay only valid claims, and thereby protect its reinsurers’ interests, no such motivation exists when the insurer is insolvent. In fact, the liquidator may have the opposite motivation—the more claims allowed in the estate, the more reinsurance recoveries the liquidator can collect for payment to policyholders generally.³³ The safeguards contained in an insolvency clause ensure that the reinsurer will have a right to participate in the claims allowance process and protect its *own* interests. To prevent the allowance of speculative or inappropriate claims and to assure adequate investigation and defence of claims, insolvency statutes and regulations allow reinsurers the ability to participate in the proceedings where claims are adjudicated.

B. Insolvency clause developments at the NAIC

Although, the inclusion of an insolvency clause has historically been a condition of credit for reinsurance, parties have been free to exclude such clauses if the ceding insurer did not intend to take credit for the reinsurance ceded. There are legitimate reasons why a ceding company may contract for reinsurance without the intent of taking financial statement credit.

30. See New York Circular letter No. 5 (1988). The required language tracks the language of N.Y. Insurance Law § 1308.

31. See California Insurance Code § 922.2 (NILS, 1994) (hereinafter Cal. Ins. Code). That language reads in part “[reinsurance] shall be payable to [the liquidator] *immediately upon demand*, with reasonable verification, on the basis of claims allowed against the insolvent company . . . ”.

32. *Garamendi v. Mission Insurance Company*, Dkt. No. C572 724 (Cal. S. Ct.), Order Concerning Commissioner’s Reply, 25 April 1990, at p. 3.

33. US law provides that policy holders are paid in full before claims of most other parties.

For example, an insurer may choose to cede risk to an unlicensed reinsurer to obtain capacity for catastrophic exposures. The reinsurer may be very solvent and capable of paying its claims but may simply choose not to post collateral in the US.

Secondly, insurers may enter into contracts that do not qualify for reinsurance accounting because they do not transfer both underwriting and timing risk. Nevertheless, these are legitimate financial transactions.

In 1993, receivers entered the NAIC insolvency clause debate. As part of its effort to amend the Insurers Rehabilitation and Liquidation Model Act, an NAIC working group suggested specific insolvency clause language. The receivers drafted a statutory insolvency clause and then sought to mandate its inclusion in every reinsurance contract, retroactively, regardless of whether the ceding insurer intended to take financial statement credit for the ceded reinsurance. Both industry and regulators objected to this proposal.

At a meeting of the NAIC in December 1994, a compromise was forged and amendments to the Insurers Rehabilitation and Liquidation Model Act were approved.³⁴ That compromise provides that any reinsurance contract which contains an insolvency clause will be unaffected. However, a reinsurance contract that does not contain an insolvency clause will be construed to include the prescribed language, regardless of whether the ceding insurer took credit for the reinsurance recoveries. The impact of this, in those states that adopt the model provision, will be that even reinsurance contracts for which no financial statement credit is taken will be deemed as having the prescribed insolvency clause. Also, the statutory language deemed to be a part of the contract contains language which reinsurers generally oppose, including the requirement that the reinsurer "pay upon demand".

Thus, contracting parties should monitor those states that adopt this model provision, and incorporate into their contracts more reasonable insolvency clauses that provide a better balancing of the interests between liquidators and reinsurers.

C. UK "pay-as-paid" issues

Although the wording of acceptable insolvency clauses and the interpretation of insolvency statutes remain a subject of dispute in the US the fundamental concept that reinsurers must pay their obligations regardless of whether the underlying claim is *actually paid* is well-established. The timing of payment and how the obligation is valued are the primary causes of continued concern for reinsurers.

In contrast, it appears that the fundamental issue is not as well-established in the UK. In December 1994, the Department of Trade and Industry (DTI) wrote to all UK authorised non-life insurers stating its view with respect to the "pay-as-paid" issue in relation to the collection of reinsurance proceeds by insolvent insurers.³⁵

Apparently, the DTI was concerned about the "significant number of reinsurers [which] were refusing to pay claims on the grounds that the reinsureds had not yet paid their own

34. Like any NAIC model law or regulation, this does not mean that individual states will adopt these changes, particularly since specific provisions of the receivership law are not requirements of NAIC accreditation. However, at least some states are expected to recommend wholesale changes to the law in the near future.

35. R. Spiller, *D. J. Freeman Insurance Review*, p. 2 (March 1995).

insureds or reinsureds".³⁶ The DTI expressed the position that reinsurers should not be relieved of their obligations due to the insolvency of their reinsureds.³⁷ Although UK commentators have noted that the issue is more settled in the context of a liquidation,³⁸ there is no decision which addresses the issue in the context of a scheme of arrangement.³⁹

On 28 June 1995, Mr Justice Mance delivered a decision in *Charter Reinsurance Company Ltd v. Patrick Feltrim Fagan*.⁴⁰ The issue was whether Charter Re, as an insolvent reinsurer, was entitled to recover reinsurance recoveries under three excess of loss contracts even though it had not actually paid its original insureds (or reinsureds). Each of the contracts incorporated the standard "ultimate nett loss" clause which defined the "nett loss" as "the sum actually paid by the reinsured". The Feltrim syndicates (540 and 542 for the 1989 and 1990 underwriting years of account) claimed that the contract was clear and not in need of interpretation or construction.

Mr Justice Mance noted that without reinsurance recoveries, many insurers would not be able to fund their own claims, causing regulatory and accounting difficulties if reinsurance recoveries could not be taken into account in assessing solvency.

The decision makes a distinction between excess of loss contracts and proportional contracts. However, because the case involved interpretation of the standard "ultimate nett loss" clause, the judgment may be applicable to the majority of "pay-as-paid" clauses in use in the UK market, whether the reinsured is insolvent or not.

On the other hand, had the Feltrim syndicates' arguments prevailed, the DTI may have intervened in a way similar to U.S. regulatory authorities following the *Pink* decision.⁴¹

The question "When and how much?"—promises to be a significant one in the years ahead, both in the US and the UK. Reinsurers should be vigilant in their dealings with liquidators on these issues and carefully review the pleadings and other documents pertaining to individual estates to ensure that they have a full understanding of how a liquidator intends to address the manner in which underlying claims will be allowed in the estate and the methodology that the liquidator intends to utilise for fixing reinsurers' obligations to the estate.

D. Recent disputes in the US regarding insolvency clauses and the collection of reinsurance recoveries

While insolvency clauses have been in use in the US for decades, the proper interpretation of such clauses has been the subject of vigorous debate. Much of the focus of that recent debate revolves around California.

36. *Ibid.*

37. *Ibid.*

38. *Ibid.* "On liquidation, it has been held that in law there is a notional discharge of liability at the date of the winding-up order, this enabling the insolvent reinsured to claim against its reinsurers as if it had discharged its own liabilities to its insureds."

39. *Ibid.*

40. For a report of this case, see [1995] IJIL 283.

41. See generally *Pink*, note 24, *supra*.

After placing Mission into liquidation, the California Commissioner demanded that all reinsurers of Mission pay in full the amounts owed under their reinsurance contracts.⁴² The reinsurers refused to make such payments claiming that they were entitled to set off the amounts owed by Mission against the reinsurance payments due the estate.⁴³ The Commissioner filed suit against 144 reinsurers and subsequently filed a summary judgment motion against Prudential Reinsurance Company ("Prudential Re").⁴⁴

Among the numerous arguments made by the Commissioner was the claim that allowing setoffs would violate the state's insolvency statute by diminishing reinsurance payments to the estate.⁴⁵ In 1987, the California Supreme Court rejected the Commissioner's claim that the statute destroyed mutuality⁴⁶ and prevented the application of setoffs on the basis of the "no diminution" language. The Court noted that the purpose of the insolvency clause is to provide the Commissioner with "the same rights and obligations of the insolvent insurer pursuant to the terms of the reinsurance contract".⁴⁷ The court noted that Section 922.2

"simply prevents the reinsurer from refusing to pay valid claims 'on the grounds that its obligation was to indemnify the reinsured against loss, and that the reinsured only incurred loss in the amounts of the diminished payments' made by the liquidator."⁴⁸

Despite that pronouncement by the state's highest court less than three years ago,⁴⁹ the California Commissioner has once again sought to use the California statutes for the purpose of accelerating reinsurance recoveries into the Mission estate, disregarding the safeguards provided by the state's insolvency statute.

In December 1994, the Commissioner petitioned Mission's supervising court for an order that would allow the liquidator to value claims on its assumed business, including the allowance of IBNR and bill those amounts to Mission's retrocessionaires. Once allowed in this manner, retrocessionaires would be responsible for payment of all claims, discounted to a present value. The plan provided for the use of actuaries by the liquidator but failed to set forth any qualifications. Further, it allowed the liquidator to disregard the estimates of his actuaries and substitute his own views with respect to the value of such claims.⁵⁰

A number of parties objected to the approval of the proposed plan and submitted

42. *Prudential Reinsurance Co. v. Superior Court of Los Angeles County*, 842 P. 2d 48, 52 (Cal. 1992) (hereinafter *Pru Re* decision).

43. *Ibid.*

44. *Ibid.*

45. Cal. Ins. Code, note 31, *supra*, at § 922.2.

46. The Commissioner also argued that as liquidator, he was a different entity than pre-insolvency Mission and thus, the doctrine of mutuality was not satisfied.

47. *Pru Re* decision, note 42, *supra*, at p. 58.

48. *Ibid.*

49. The Prudential Re decision was entered on 30 November 1992.

50. *Garamendi v. Mission Insurance Company*, Dkt. No. C572 724 (Cal. S. Ct.), Insurance Commissioner's Application to Establish Final Liquidation Dividend Plan, to Establish Final Claims Bar Date for Contingent, Unliquidated, and/or Undetermined Claims and for Related Orders, 28 December 1994; see also *Garamendi v. Mission Insurance Company*, Dkt. No. C572 724 (Cal. S. Ct.), Final Order Approving Insurance Commissioner's Final Liquidation Dividend Plan, 11 April 1995.

extensive briefs.⁵¹ The various objectors asserted that the plan violates reinsurers' statutory and contractual rights and deprives them of constitutional guarantees.⁵²

In particular, the RAA focused on the identity of various types of claims and the applicable California statutory provisions.⁵³ Noting that a contingent claim is one that is uncertain as to liability, an unliquidated claim is uncertain as to amount, and an immature claim is one certain as to liability and amount but upon which payment is not yet due, *the RAA argued that IBNR is not a claim at all* but rather an estimate of a loss that may or may not have occurred and is presently unknown. California law requires that claims be "definitely determined, proved and allowed".⁵⁴ The RAA argued that a claim cannot be definitely determined if the happening of the event itself is unknown.⁵⁵

Additionally, the RAA claimed that the state's insolvency clause statute⁵⁶ entitles reinsurers to receive notice from Mission when the claim is filed and then notice when the claim is to be adjudicated.⁵⁷ The RAA further claimed that because the statute allows reinsurers to participate and interpose defences "in proceedings", the statutory provision guaranteed a judicial "proceeding" for the allowance of claims, not merely the liquidator's sole determination of value.

The Commissioner's proposed plan was entered by the court on 13 July 1995. Various parties, including the RAA and Lloyd's Underwriters have appealed the decision.⁵⁸

Shortly after the completion of the briefing schedule in Mission, the Missouri liquidator of Holland-America, a subsidiary of Mission, filed a similar proposed plan before the Missouri supervising court. That court entered the liquidator's proposed order on 17 August 1995 which is also currently on appeal.⁵⁹ The Missouri estate introduces a somewhat different twist because Missouri previously enacted a statutory provision that provides for the estimation of claims.⁶⁰ Again, the question of what constitutes a claim and what process is due reinsurers is at issue in the appeal.

While US reinsurers are not disputing the validity of the well-established use of contractual insolvency clauses or insolvency statutes, they are battling liquidators' expansive interpretation of such clauses, and in some cases, their total disregard for reinsurers' rights as provided for and preserved in those contractual clauses and statutory

51. Objectors included the RAA, the Illinois Director of Insurance as Rehabilitator of Centaur Insurance Company, the New Jersey Commissioner of Insurance as Liquidator of Integrity Insurance Company and others.

52. *Garamendi v. Mission Insurance Company*, Dkt. No. C572 724 (Cal. S. Ct.), The Reinsurance Association of America's Opposition to Final Order and Revised Final Order Approving Insurance Commissioner's Final Liquidation Dividend Plan, 11 April 1995 (hereinafter "April Brief"). In response to these objections, the liquidator asserted that the reinsurers' motivation was to delay or avoid their obligations to the Mission estate. See March Transcript, note 13, *supra*, for quotes from the transcript of the hearing.

53. *Garamendi v. Mission Insurance Company*, Dkt. No. C572 724 (Cal. S. Ct.), The Reinsurance Association of America's Opposition to Final Order, 29 March 1995, at p. 8 (hereinafter "March Brief").

54. Cal. Ins. Code, note 31, *supra*, at § 1025.

55. See March Brief, note 53, *supra*; and April Brief, note 52, *supra*.

56. Cal. Ins. Code, note 31, *supra*, at § 922.2.

57. See April Brief, note 52, *supra*, at pp. 11-12.

58. A notice of appeal was also filed by the Illinois Director of Insurance as Rehabilitator of Centaur Insurance Company and Borg-Warner Corporation (parent of Centaur).

59. The order has been appealed by the RAA and Borg-Warner Corporation.

60. Missouri Insurance Code § 375.1220; Illinois also recently enacted a provision for the estimation of claims, see Illinois Insurance Code § 15/209(7).

provisions. A reinsurer's obligation to provide reinsurance recoveries regardless of the fact that the liquidator may not pay the underlying loss is well-settled in US law, but US reinsurers are insisting on the recognition of safeguards provided in insolvency clauses which reflect the trade-off discussed earlier in this article—a trade-off which is so integral to the statutory exception to the principle that a reinsurance contract is one of indemnity.

Liquidators' recent attempts to accelerate reinsurance recoveries, including IBNR, even in the absence of a known loss, on the basis of a liquidator's uncontested determination of the fair value owed to the estate is reminiscent of the statement of Matthew J. in the UK decision in *Chippendale v. Holt*⁶¹:

"It was argued for the defendant that he was only bound to indemnify the plaintiffs against loss for which the plaintiffs were liable on their policy. It was said for the plaintiffs that the possibility that a fraudulent use might be made of the plaintiffs' option to pay would not enter into the contemplation of either party and that it was not unreasonable that the reinsurers should trust to the honour and sound judgment of those whose liabilities they had taken upon themselves. *But the contention of the plaintiffs would involve this result, that the clause must be read as if it ran: 'To pay such an amount as the insurers might choose to pay whether liable or not'. This seems to me altogether unreasonable. Such a contract would be a wager and not reinsurance*" (emphasis added).

Indeed, the mechanism for acceleration and allowance of reinsurance recoveries, as currently proposed by some US liquidators, is a wager—on the reasonableness of a particular liquidator with respect to a particular reinsurer. This is not the risk that reinsurers undertook to assume for the premium they charged—and it is not a risk that the reinsurance industry, domestic or foreign, can afford.

III. TO WHOM ARE REINSURANCE RECOVERIES PAID?

In considering this question, one must consider a number of possibilities under US law. Only a few are very briefly addressed in this article in the context of recent developments.

A. Cut-throughs

Most insolvency clause statutes provide for payment to the liquidator unless there is a valid contractual clause naming another payee. Such "cut-throughs" may take different forms. For example, a cut-through clause may be contained in a policy of insurance or in the reinsurance contract.⁶²

61. (1895) 65 L.J.Q.B. 104 at p. 105.

62. It may be considered preferable from the reinsurer's standpoint to include the clause in the reinsurance contract because the obligation in the reinsurance contract is one of indemnification. On the other hand, since there are additional obligations in the underlying insurance policy, e.g., the duty to defend, some may argue that the cut-through clause requires the reinsurer to provide that defence. Additionally, inclusion in the policy could result in the reinsurer paying all sums that the insurer contracted to pay—this amount may be beyond the percentage that a reinsurer agreed to or may disregard any attachment point contained in the reinsurance contract.

On the other hand, a guaranty is different from a cut-through. There are situations in which a company may guarantee the obligations of another. Usually, a guaranty will run to all the obligations in the contract, including, for example, the duty to defend. Additionally, the guaranty may extend to all sums that the insurer contracted to pay.

Unlike a guaranty, a cut-through clause is designed to make direct payment under particular circumstances but not to replace the insurer with the reinsurer. Some states have proposed to legislatively eliminate or restrict cut-throughs on the theory that they create preferences in a liquidation for sophisticated insurance buyers to the detriment of other policy holders.⁶³

A number of states require a complete assumption of obligations by the assuming insurer which constitutes a novation (a substitution of the assuming insurer for the original insurer).⁶⁴

Still other states allow credit for reinsurance for contracts containing cut-through clauses but appear to recognise only assumptions (novations) in the insolvency context. It is unclear how these seemingly inconsistent statutes in such states would be reconciled.⁶⁵

B. Direct actions against reinsurers

Insureds and claimants have continually sought to obtain the payment of reinsurance proceeds directly from the reinsurer when the reinsured is in liquidation. Generally, these attempts have failed based on a lack of privity of contract between the policy holder or claimant and the reinsurer.⁶⁶ An insured or claimant is not a party to the reinsurance contract and, usually, the insured does not enter into an insurance contract based on the knowledge that its insurer has ceded risk to a reinsurer.⁶⁷

A recent New Jersey case caused some consternation among some in the industry⁶⁸ when the appellate court held that the insured had a right of recovery directly against the reinsurer, Homestead Insurance Company ("Homestead"). However, the important factor in that case was that the insolvent insurer, Mutual Fire, Marine & Inland Insurance Company ("Mutual Fire") reinsured 100 per cent of its business with Homestead and delegated all of its claims settling and adjusting authority to the reinsurer. Instead of following the usual formalities wherein the primary insurer adjusts claims and then seeks reimbursement from the reinsurer, the court found that the reinsurer supplanted the decision-making of the insurer. Because the reinsurer had operated as if it were the primary insurer, it was likewise held directly liable for the claim when the primary insurer was placed in liquidation.

This should not have been a great surprise to the reinsurer nor does it appear to erode the law which disfavors direct actions by policy holders against reinsurers.

63. I.e. Ohio, Oregon.

64. I.e. New York, North Dakota.

65. I.e. New Hampshire, Rhode Island, Texas, Utah, Vermont..

66. See *Morris & Company v. Skandia Insurance Company*, 279 U.S. 405 (1929) and *Unigard Security Insurance Company v. North River Insurance Company*, 4 F.3d 1049 (2d Cir. 1993).

67. Semple & Hall, note 23, *supra*, at p. 414.

68. *Venetsanos v. Zucker*, 644 A.2d 614 (N.J. 1994).

C. Claims by guaranty associations

Policy holders are protected by insurance guaranty associations which exist, for purposes of property and casualty business, in all 50 states. A guaranty fund pays claims of an insolvent insurer which fall within the lines of business and limits stated in the fund's enabling legislation. Those claims that exceed the guaranty fund limit or are not covered claims remain the obligation of the estate.

A number of guaranty funds have attempted to collect reinsurance proceeds directly from reinsurers on the basis that the guaranty fund is the statutory successor of the insolvent insurer (to whom reinsurance proceeds are paid pursuant to the insolvency clause) or on the theory that they are third party beneficiaries of the reinsurance contract. Such attempts have been uniformly rejected by the courts⁶⁹ who have held that receivers are entitled to reinsurance proceeds.⁷⁰

An apparent exception to this general rule was carved out in a 1980 Massachusetts case which was decided in favour of the state's guaranty fund.⁷¹ The state established an organisation known as the Massachusetts Motor Vehicle Reinsurance Facility ("Facility") to which all companies within the state were required to belong. The Facility was established to reinsure those insurers providing insurance to high-risk drivers. One of the insurers became insolvent and the Facility owed reinsurance proceeds to the insurer. Finding in favour of the guaranty fund, the court reasoned that once the insurer became insolvent, the guaranty fund would be required to pay all claims made against it while the liquidator would not be required to pay any such claims. The court observed that the intent of the legislature in creating both the guaranty fund and the Facility had been to benefit the public—an intent best carried out by requiring that payment be made to the guaranty fund.

IV. HOW ARE REINSURANCE DISPUTES RESOLVED?

A. Status of arbitration in US liquidations

Arbitration has long been the dispute resolution mechanism of choice for the reinsurance industry⁷² and historically, arbitration clauses have been "universally included in reinsurance contracts".⁷³ But liquidators frequently attempt to override contractual arbitration clauses, instead preferring to have disputes heard before the estate's supervising court, a forum presumably more favourable to the liquidator's interests.

69. See Semple & Hall, note 23, *supra*, at p. 416.

70. See *American Re-Insurance Co. v. Insurance Comm. of California*, 527 F. Supp. 444 (C.D. Cal. 1981); *Excess & Casualty Reinsurance Assoc. v. Insurance Comm. of California*, 656 F.2d 491 (9th Cir. 1981); *Skandia America Reinsurance Corp. v. Barnes*, 458 F. Supp. 13 (D.C. Col. 1978).

71. See *Massachusetts Motor Vehicle Reinsurance Facility v. Commissioner of Insurance*, 400 N.E. 2d 221 (Mass. Sup. Jud. Ct. 1979).

72. J. Butler & R. Merkin, *Reinsurance Law* (1993), § C.5.1-01.

73. R. Carter, *Reinsurance*, p. 146 (1979).

However, US courts have routinely held that the liquidator steps into the shoes of the insolvent insurer, taking the relevant claims and defences as he finds them.⁷⁴ Other courts have affirmed this concept with respect to arbitration clauses,⁷⁵ holding that the liquidator stands in the shoes of the insolvent company and must honour arbitration clauses in a reinsurance agreement.

On the legislative front, two states have enacted "anti-arbitration" statutes which purport to prohibit reinsurance arbitrations in the event of liquidation.⁷⁶ Seven states have enacted statutes of general applicability which make arbitration clauses enforceable in any contract except contracts of adhesion, specifically prohibiting the enforceability of arbitration clauses in insurance contracts.⁷⁷ Two other states have similarly worded statutes excluding "insurer-insured" contracts from their ambit but expressly note that "insurer-insurer" contracts are enforceable.⁷⁸

With respect to those seven states that have enacted statutes that would nullify arbitration clauses in insurance contracts, one state statute has been interpreted as applying to reinsurance contracts.⁷⁹ In that case, the district court distinguished between contracts "for" insurance and contracts "of" insurance, and concluded that the statute at issue did not pertain to contracts "for" insurance (i.e. reinsurance). The appellate court reversed, rejecting the reinsurer's argument that the statute was meant to regulate only "insurance" and not "reinsurance" contracts. The court held that the language used by the Kansas legislature did not make such a distinction, hence it applied to insurance and reinsurance contracts alike.

In light of this decision, the RAA pursued a change in Kansas law to permit arbitration in reinsurance contracts. Senate Bill 368 was recently signed into law by the governor.

In any event, it appears that "anti-arbitration" statutes, when challenged, would be struck down under an analysis of the Federal Arbitration Act ("FAA").⁸⁰ Section 2 of the FAA provides that a written agreement to arbitrate "in any . . . contract evidencing a transaction involving commerce . . . shall be valid, irrevocable, and enforceable". Taken together with its other sections, the FAA creates a body of federal substantive law applicable to any agreement within the coverage of the FAA. The caselaw interpreting the FAA expresses an unequivocal mandate that courts should universally enforce arbitration agreements in commercial disputes.⁸¹

Notwithstanding the compelling federal policy in favour of arbitration, liquidators have attempted to avoid their contractual obligations to arbitrate by claiming that the

74. See generally *Pru Re* decision, note 42, *supra*.

75. *Bennett v. Liberty National Fire Ins. Co.*, 968 F.2d 969, 972 (9th Cir. 1992); *Phillips v. Lincoln National Health and Cas. Ins. Co.*, 774 F. Supp. 1297 (D. Colo. 1991).

76. See Wisconsin Insurance Code § 645.59 and Kentucky Insurance Code § 304.33-010.

77. Kansas: K.S.A. § 5-401; Georgia: O.C.G.A. § 9-9-2; Kentucky: K.R.S. § 417.050; Missouri: R.S. Mo. § 435.350; Nebraska: R.R.s. Neb. § 25-2602; South Dakota: S.D.C.L. § 21-25A-3; and Vermont: 12 V.S.A. § 5652, 5653.

78. Montana: Code § 27-5-114; Oklahoma: Title 15, Ch. 21 § 802; Rhode Island's arbitration statute (Code § 10-3-2) makes arbitration clauses enforceable at the option of the "insured".

79. Kansas: K.S.A. § 5-40. See *Mutual Reinsurance Bureau v. Green Plains*, 969 F.2d 931 (10th Cir. 1992).

80. 9 U.S.C. § 1-14 (1982).

81. See *Prima Paint Corp. v. Flood and Conklin Manufacturing Co.*, 388 U.S. 395 (1967); *Moses H. Cone Memorial Hospital v. Mercury Constr. Co.*, 460 U.S. 1 (1983); *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 221 (1985); *Cf. In re P&G Drywall & Acoustical Corp.*, 156 B.R. 704 (D. Maine 1993).

McCarran-Ferguson Act causes state law to pre-empt the FAA.⁸² However, federal courts agree that the McCarran-Ferguson Act does not preclude the FAA from governing insurance and reinsurance disputes.⁸³

B. Abstention and the exclusive jurisdiction of liquidation courts

In another important development concerning the resolution of reinsurance disputes in a liquidation, the Ninth Circuit Court of Appeals recently held that a federal district court may not abstain under the *Burford* abstention doctrine⁸⁴ when a plaintiff seeks only legal relief.

This dispute also arose out of the Mission liquidation and attempts by the liquidator to recover reinsurance proceeds from reinsurers, including Allstate Insurance Company ("Allstate"). The Mission liquidator had filed an action against Allstate and others. Allstate removed the action to federal court and then moved to compel arbitration pursuant to the reinsurance agreements. The court granted the liquidator's motion and remanded the case back to the state court supervising the liquidation of Mission.

The Court of Appeal reversed, finding that the district court "clearly had jurisdiction" over the dispute noting that the US Supreme Court had recently renewed its recognition that the federal courts may only abstain in equitable cases.⁸⁵ According to the Ninth Circuit, in *NOPSI*, the Supreme Court had reminded the federal courts that "their obligation to hear cases within their jurisdiction grants is 'virtually unflagging' . . .".

This case represents a significant development for reinsurers in the context of disputes with those liquidators who attempt to create exclusive jurisdiction in the state liquidation courts.

The California Commissioner has appealed the Ninth Circuit's decision to the US Supreme Court which has accepted review. Briefing will be completed in early 1996.

V. CONCLUSION

It is time for many US liquidators to reassess the fundamental principles underlying their responsibilities:

- While a liquidator has a duty to marshal the assets of an insolvent estate—how far does that duty go? Does it include expanding and perhaps abusing, the intent of the law—or is there a bigger picture that requires a balancing of results?

82. See McCarran-Ferguson Act, Pub. L. No. 20-15, 59 Stat. 33 (codified as amended at 15 U.S.C. §§ 1011-1015 (1983)). The primary legislative purpose of the McCarran-Ferguson Act was to affirm the states' power to regulate the business of insurance (subject to constitutional limitations) and to ensure that the state regulatory schemes would not be impaired and overridden except by specific and explicit Congressional enactments. See also *Hamilton Life Insurance Company v. Republic National Life Insurance Company*, 291 F. Supp. 225, 230 (S.D.N.Y. 1968).

83. *Bennett v. Liberty National Fire. Ins. Co.*, 968 F.2d 969 (9th Cir. 1992); *Miller v. National Fidelity Life Ins. Co.*, 586 F.2d 185 (5th Cir. 1976); *Hamilton Life Ins. Co. v. Republic National Life Ins. Co.*, 291 F. Supp. 225 (S.D.N.Y. 1968), *affirmed*, 408 F.2d 606 (2d Cir. 1969).

84. *Burford v. Sun Oil*, 319 U.S. 315 (1943).

85. *New Orleans Public Service, Inc. v. Council of the City of New Orleans*, 491 U.S. 350, 359 (1989) (hereinafter *NOPSI*).

- Is it fair to paint reinsurers generally with a broad brush presuming that they are members of an evil cabal—the cause of most insolvencies and the entities unwilling to meet their fair obligations to insolvent estates? Or should one step back and consider that perhaps reinsurers, like the public, were harmed by the business practices of the insolvent estate, that they are too often victimised by the mismanagement and irresponsible actions of the now insolvent insurer?
- Can liquidators fairly represent the interests of all creditors to an estate, including reinsurers, when they advocate excluding a class of creditors from the process? How can they fully comply with their fiduciary obligations to all creditors unless they marshal what fairly belongs to the estate instead of all they can possibly get, regardless of whether it comports with the interest of the law?
- Does the policy holder priority in the distribution scheme really translate into a licence to represent one class of creditors to the exclusion of the others? Or does it impose a duty of fair dealing to all creditors and at the end of the day when justice is done for all, policy holders share first?
- Can some state regulators continue to allow liquidators to run liquidations with little input or understanding of the process or does their position as public officials impose a duty to ensure that liquidations are run consistently with the main stream of regulatory thought—to ensure that they are discharging their public duty as a whole—not just the policy holders of an individual estate?

Clearly, there are some regulators and liquidators who have grappled with these issues and found the appropriate balance—but just as clearly, others have not.

Reinsurers must be vigilant as we are in the midst of developing public policy and law on these issues—it is incumbent that reinsurers have a voice in that process—to educate regulators and liquidators about how reinsurance works, to take responsible positions in order to dispel the inaccurate notions of some, and preserve fundamental principles that serve the market place and consumers well.