

Insurance Insolvency

Reinsurers' Rights In Insurer Insolvencies

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**A commentary article
reprinted from the
April 2009 issue of
Mealey's Litigation Report:
Insurance Insolvency**



Commentary

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The importance of reinsurance in insurer insolvency proceedings cannot be overstated. Reinsurance is often the most significant asset of an insolvent insurer and the primary source of the funds out of which policyholder claims are paid. In many instances, policyholder creditors of an insolvent insurer would receive little or nothing from the insolvent insurer's estate without reinsurance recovery on proven claims.¹

The right of the liquidator or receiver of an insolvent insurance company to the insolvent's reinsurance recoverables, however, is not automatic. Reinsurance agreements are contracts of indemnity, meaning that reinsurers do not have an obligation to pay a ceding insurer unless the insurer can show that it has actually paid a claim.² An insolvent insurer, by definition has insufficient assets to cover claims and therefore cannot pay policyholder claims first and collect reinsurance later.

How then does the liquidator of the insolvent insurer recover the full amounts reinsured under the insolvent's contracts of reinsurance? The answer lies in the wording of the "standard" insolvency clause, which is

found in most reinsurance contracts. The clause typically contains language such as the following:

In the event of the insolvency of the Reinsured, this reinsurance shall be payable directly to the Reinsured, or to its liquidator, receiver, conservator or statutory successor on the basis of the liability of the Reinsured without diminution because of the insolvency of the Reinsured or because the liquidator, receiver, conservator or statutory successor of the Reinsured has failed to pay all or a portion of any claim.³

The standard nature of the clause results from its genesis over seventy years ago. In the landmark decision *Fidelity & Deposit Co. v. Pink*,⁴ the United States Supreme Court held that a liquidator could recover from the insolvent insurer's reinsurers only to the extent that the liquidator had actually paid a claim. Put another way, "[t]he protection afforded by reinsurance was defeated by the insolvency of the insurer."⁵

This decision was obviously a major setback for insurance regulators and the policyholders of insolvent insurers. To rectify the dilemma imposed by the *Pink* ruling, nearly every state legislature enacted, as a condition precedent to a ceding insurer's right to receive credit for reinsurance on its financial statements, a requirement that in the event of the cedent's insolvency, the reinsurance will be paid directly to the liquidator even if the insolvent cedent has not paid the claim.⁶ All that must be established to trigger a claim for reinsurance is a determination of the insolvent's liability.

This typically occurs when the liquidator, with the approval of the state court overseeing the liquidation “allows,” or accepts as valid, a policyholder claim.

The operation of this standard provision requiring reinsurers to pay based on liability is neither controversial nor in doubt. Indeed, it is the accepted linchpin of a successful liquidation or rehabilitation of an insolvent insurer.

What is less well understood — and what is of far more importance to reinsurers who wish to protect their interests after a cedent becomes insolvent — is a reinsurer’s rights under the standard insolvency clause.

This article considers the scope of reinsurers’ rights under the express language of the standard insolvency clause, under basic reinsurance principles and under principles of fairness and equity. The article concludes that an insolvent’s reinsurers have the right, but not the obligation, to defend policyholder claims in the liquidation without opposition from the liquidator and without waiver of their defenses under their reinsurance contracts.

1. Scope Of The Reinsurer’s Rights Under The Insolvency Clause

The first part of the standard insolvency clause, quoted above, which requires reinsurers to pay the insurer or its liquidator “without diminution because of the insolvency . . . or because the liquidator . . . has failed to pay all or a portion of any claim,” establishes the liquidator’s rights and the reinsurer’s obligations in the event of insolvency. The second part of the clause that is standard in most reinsurance agreements establishes the reinsurer’s rights and imposes certain obligations on the liquidator, typically, as follows:

It is agreed, however, that the liquidator, receiver, conservator or statutory successor of the Reinsured shall give written notice to the Reinsurers of the pendency of a claim against the Reinsured indicating the policy or bond reinsured which claim would involve a possible liability on the part of the Reinsurers within a reasonable time after such claim is filed in the conservation or liquidation proceeding or in the receivership, and that during the pendency of such claim, the

Reinsurers may investigate such claim and interpose, at their own expense, in the proceeding where such claim is to be adjudicated, any defense or defenses that they may deem available to the Reinsured or its liquidator, receiver, conservator or statutory successor. The expense thus incurred by the Reinsurers shall be chargeable, subject to the approval of the court, against the Reinsured as part of the expense of conservation or liquidation to the extent of a pro rata share of the benefit which may accrue to the Reinsured solely as a result of the defense undertaken by the Reinsurers.⁷

2. Rationale For Granting Additional Rights To Reinsurers Of Insolvent Insurers

The inclusion in the standard insolvency clause of reinsurers’ right to assert defenses to claims is an implicit recognition by cedents, reinsurers and some legislatures that granting a liquidator of an insolvent insurer the right to recover reinsurance without payment removes a layer of protection that reinsurers would otherwise have. A solvent insurance company not only must actually pay claims in full before seeking reinsurance recovery, it almost always bears some portion of the risk, either as a quota share participant or through a retention under an excess of loss agreement. This, along with a cedent’s duty of utmost good faith, aligns the cedent’s interests with those of the reinsurers and in so doing, makes it more likely that claims will be handled in a way that protects the reinsurers as well as the cedents.

The liquidator of an insolvent cedent, however, bears no immediate financial risk in allowing claims. Moreover, a liquidator has no ongoing business relationship with the reinsurer, which might exist in the case of a solvent cedent. This means a liquidator’s interests are not aligned with the reinsurers in the same way that a solvent insurer’s interests would be.

The standard insolvency clause, through the rights conferred upon reinsurers, recognizes this and also recognizes that reinsurance recoverables are a significant asset of the estate, making reinsurers in many instances the actual payors and not just the indemnitors, in an insolvency. Thus, in a kind of *quid pro quo*, the standard insolvency clause gives reinsurers a right

to be more actively involved in determining which claims should recover from the insolvent's estate.

3. Is Intervention Required?

The language of the insolvency clause is permissive. It neither imposes a defense obligation nor supports a finding of waiver: "The Reinsurers *may* investigate [a] claim and interpose, at their own expense, . . . any defense or defenses that they may deem available to the Reinsured or its liquidator, receiver, conservator or statutory successor." (Emphasis added) Nothing in the language of the clause supports the imposition of any affirmative obligations on the reinsurer. In this respect, the reinsurers' obligations are much like a reinsurer's obligations under a claims cooperation clause, which "permits the reinsurer to be 'associated,' at its option and expense, with the reinsured in defending any claim involving the reinsurance."⁸

4. The Liquidator's Obligations

a. Reasonable Notice

Reinsurers of an insolvent are entitled to reasonable notice under the standard clause. To be meaningful, notice should be given as soon after a claim is made as possible and certainly before the claim is handled and accepted as a proven claim and approved by the liquidation court. Where notice is not given until after the claim is allowed and approved, reinsurers could make a strong argument that not only was the notice requirement in the contract breached, but also that reinsurers were prejudiced through a denial of their right to interpose the insured's defenses.

The liquidator also runs a risk if notice is not given until after the liquidator recommends allowance but before the court approves the allowance. This creates a situation where the reinsurer is trying to assert defenses that have already been rejected by the liquidator. Reinsurers in this situation can and should object to the liquidator's participation in the adjudication of claims. The liquidator "stands in the shoes of the insolvent cedent"⁹ and thus has the same duty of utmost good faith to the insolvent's reinsurers that the solvent cedent had. In the event that the liquidator actively participates, and the court accepts the liquidator's position over that of the reinsurers, reinsurers should have at least a colorable claim of breach of the duty of utmost good faith when the claim is later presented for reinsurance recovery.

b. Duty To Cooperate

The standard insolvency clause is silent on the related issue of the control of the defense and the liquidator's duty to cooperate. The lack of such express language, however, should not be construed as giving the liquidator the right to oppose a reinsurer who chooses to defend or otherwise not to cooperate. As noted above, the duty of utmost good faith would appear to be breached when a cedent's liquidator takes an adversarial position to a reinsurer that has intervened in a claims dispute pursuant to the insolvency clause.

5. Strategic Considerations For Reinsurers Of An Insolvent Insurer

Since the insolvency clause by its terms does not require reinsurers to intervene in claims handling, a reinsurer's decision whether to intervene in the handling of a claim of an insolvent depends on considerations such as the cost of intervention, the size of the claim, the extent to which the liquidator has taken on a pro-policyholder role and the likelihood that the liquidator will act in accordance with the same standard of utmost good faith that would be expected of a solvent cedent.

Because the reinsurer as intervenor is asserting the defenses of the liquidator, intervention should not waive any defenses under the reinsurance contract.¹⁰ Thus, an adverse coverage decision under an original policy — for example, a decision to construe all asbestos loss as one occurrence — would not preclude an intervening reinsurer from opposing the same claim under the relevant language in the reinsurance treaty.

The cost of intervening in claims handling could be significant for a reinsurer. Reinsurers generally do not have either claims handling capability or the financial resources to fund such capability.

The standard insolvency clause addresses the cost issue to some extent. It provides that reinsurers may apply to the court for reimbursement of any costs incurred in intervening and that such costs "shall be chargeable against the Reinsured" as an administrative expense "to the extent of a pro rata share of the benefit which may accrue to the Reinsured solely as a result of the defense undertaken by the Reinsurers." This provision would appear to allow reimbursement of at least some of the cost of a reinsurer's intervention, including attorneys' fees, where the reinsurer is successful in defeating a policyholder claim. Where the claim

is not successfully defended or where it is settled, reimbursement would likely depend on the reinsurer's showing that the intervention was of "benefit" to the insolvent insurer.

Reinsurers also may choose not to intervene and to rely instead on the liquidator's compliance with the duty of utmost good faith in claims handling. In the event that a claim were allowed in breach of that duty, reinsurers could deny the reinsurance claim.

This strategy presents certain risks. It is the liquidator's role to marshal as many of the assets of the insolvent cedent as possible. A principal asset of most insolvent cedents is reinsurance. Protecting the reinsurers' interests by opposing claims where coverage is unclear may conflict with the liquidator's interest in protecting the insolvent's policyholders. Thus, while a liquidator in theory should be able to assemble a claims handling operation that would operate exactly as it would with a solvent insurer, in practice this may not occur. While the liquidator, standing in the shoes of the insolvent, should still be held to comply with the "utmost good faith" standard, proving bad faith is often difficult. Thus, absent persuasive evidence of bad faith, reinsurers may face an uphill battle in resisting payment for claim allowances where they have not intervened.

Conclusion

In an insurance insolvency, reinsurers are transformed from indemnitors to liability insurers. A successful insurance liquidation depends on payment by an insolvent's reinsurers of allowed claims.

The reinsurers' frequent role as the primary funders of the estate properly gives reinsurers the right to become actively involved in decisions regarding the allowance and denial of claims. To ensure that these rights are meaningful, reinsurers have the right to expect and liquidators must give, sufficient notice of claims against the estate and allow reinsurers the opportunity to intervene. While reinsurers are entitled to rely on a liquidator's good faith claim handling, the sometimes divergent interests of liquidators and reinsurers may make intervention necessary in some instances.

If a reinsurer does intervene, the liquidator must not take an adversarial role against the reinsurer. To do so risks a later denial of the claim for reinsurance based on a breach of the duty of utmost good faith.

Endnotes

1. Whether the cedent is solvent or insolvent, a reinsurer's payment obligation extends only to valid, covered claims.
2. *First American Ins. Co. v. Commonwealth Gen'l Ins. Co.*, 954 S.W.2d 460, 465 (Mo. Ct. App. 1997).
3. See R. Strain, *Reinsurance Contract Wordings* 440 (3d ed. 1998).
4. 302 U.S. 224 (1937).
5. *First American Ins. Co. v. Commonwealth*, 954 S.W.2d at 465.
6. Strain, *supra*, n.3, at 441 (3d ed. 1998). See Code of Ala. § 27-5-12 (f)(5) (2008); Alaska Stat. § 21.12.020 (d) (2008); Ariz. Rev. Stat. § 20-261 (c) (2008); Ark. Stat. Ann. § 23-62-204 (2008); Cal. Ins. Code § 922.2 (a)(2) (2008); Colo. Rev. Stat. §§ 10-3-118 (c), 10-3-531; (3)(b) (2008); 18 Del. Code Ann. § 914 (a)(2009); D.C. Code § 31-50 (b-1)(1), (2); (2008); Fla. Stat. § 624.610(8) (2009); Haw. Rev. Stat. § 431:5-306 (a)(2) (2009); 215 Ill.Comp. Stat. 5/173.2 (2009); Ind. Code Ann. § 27-6-10-7 (2) (2008); Kans. Stat. Ann. § 40-221a (c) (2007); Ky. Rev. Stat. § 304.5-140 (5)(a)(2009); Me. Rev. Stats., 24A, § 731-B (5) (2008); Md. Ins. Code Ann. § 5-904 (1)(ii) (2009); Mass. Ann. Laws, ch. 175, § 20A(4)(A) (2008); Mich. Comp. Laws Serv. § 500.1125(4) (2009); Minn. Stat. § 60A.092(11) (c) (2008); § 375.246.5 (2)(a) R.S.Mo. (2009); R.R.S. Neb. § 44-417 (2008); Nev. Rev. Stat. Ann. § 681A.230. (2008); N.M. Stat. Ann. § 59A-7-11.B (2008); NY Ins. Law § 1308 (2) (7)(i) (2009); N.C. Gen. Stat. § 58-7-30 (a) (2009); N.D. Cent. Code, § 26.1-02-21.1 (2008); Oh. Rev. Code Ann. § 3901.64 (A)(1) (2009); 36 Okla. St. § 711 A.1 (2008); Or. Rev. Stat. § 731.508 (3) (2007); 40 Pa. Stat. § 442.1(c) (2008); R.I. Gen. Laws § 27-1.1-6 (2009); S.D. Codified Laws § 58-14-4 (2009); Tenn. Code Ann. § 56-2-207 (a) (2) (2009); Tex. Ins. Code § 493.106 (a) (1), (2) (2007); Utah Code Ann. § 31A-22-1201(1) (a-c) (2008); 8 Vt. Stat. Ann. § 3635(a) (2009); Va. Code Ann. § 38.2-1316.5 (A)(1),(2) (2009); Rev. Code Wash. § 48.12.160(3) (2009); W. Va. Code § 33-4-15(c) (1) (2008); Wyo. Stat. Ann. § 26-5-115 (2008).

7. Strain, *supra*, note 3, at 440. State statutes vary in whether such language is required to receive credit for reinsurance. In some states, such language is required in order to receive credit for reinsurance. See e.g., Mass. Ann. Laws ch.175, § 20A (4) (C) (2008). In others, it is permissive. See e.g., Ill. Comp. Stat. 5/173.4 (2009).
8. R. Strain, *Reinsurance* 576 (Rev. ed. 1997).
9. See *Michigan Nat' Bank v. American Centennial Ins. Co. (In re Liquidation of Union Indemnity Co. of New York)*, 89 N.Y.2d 94, 109 (1996) ("the general rule is that a Liquidator of an insurance company 'stands in the shoes' of the insolvent, gaining no greater rights than the insolvent had" (quoting *Stephens v. American Home Assurance Co.*, 811 F. Supp. 937, 947 (S.D.N.Y. 1993))).
10. See *Stephens*, 811 F. Supp. at 947 ("reinsurers are free to assert any affirmative defenses, such as fraud, that they may have had against the [insolvent company]" (quoting *In re Union Indemnity*, No. 41292-85, slip op. at 12 (N.Y. Sup. Ct. Oct. 28, 1992))). ■

MEALEY'S LITIGATION REPORT: INSURANCE INSOLVENCY

edited by Shawn Rice

The Report is produced monthly by



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ISSN 1043-8416