Commentary

Insurance Insolvencies: The Reinsurer's View

By
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Introduction

The relationship between a reinsurer and a cedant is meant to be a mutually beneficial partnership. It is characterized by a high degree of trust and good faith dealings. But when the reinsured company gets into financial difficulty and ultimately fails, that relationship can change overnight. The bond is loosened; the benefits are no longer mutual; and, the level of trust between the parties often declines.

For most of those involved with the insolvent reinsured — its policyholders, employees, investors, brokers, officers and directors — the failure of the company is an unmitigated calamity quite apart from any changing relationship with the company's reinsurers. Coverages, jobs, investments and careers are lost. To those directly involved with the sinking enterprise, whether the company has a strong relationship with or can recover from its reinsurers is of secondary importance, and best left to the appropriate regulator to address.

For the reinsurer of the insolvent, on the other hand, the significant change in the relationship can be a mixed blessing. No reinsurer deliberately begins a relationship with a cedant that is clearly headed towards liquidation. But the failure of the ceding company can surprisingly bring some financial benefits as well as the expected headaches.

In the following section, we discuss the storm clouds that gather over the reinsurer when its cedant fails. Later, some unexpected silver linings are pointed out.

The Storm Clouds Gather

Once the ceding company is declared insolvent and a receiver for the estate is named, the company is transformed. It has changed from an ongoing insurance enterprise to a ghost of its former self, under state supervision with the receiver standing in the shoes of the insolvent.

To the reinsurer, the cedant isn't the same cedant anymore. Before insolvency, it investigated and mitigated policyholder claims; now that it has become insolvent, it is sometimes perceived as searching for claims.[1] Before the cedant asked for money only when it actually paid a claim; now it asks for reimbursement even though it has not actually paid anything.[2] Once the cedant tried to commercially resolve disputes with its reinsurers informally; now litigation and arbitration are commonplace.[3] Previously, the cedant protected the reinsurer from excessive financial shocks[4]; nowadays it tries to engineer a commutation of the entire reinsurance contract.[5] Formerly, the cedant would not draw down on a letter of credit; now it may threaten to do so.[6]

Previously, the companies could set off losses against premium; that has changed — the insolvent may now want to hold on any premium for as long as possible but have the reinsurer pay all losses as well. To sum up, before insolvency the cedant was a business partner of the reinsurer; now it is a cash flow drain and a burdensome administrative strain.

There are other drawbacks for the reinsurer. Valuable resources, such as time, staff, office space and money for travel costs, are devoted to winding down obligations under the terminated reinsurance contracts. These resources would otherwise be better used for working with continuing *profitable* active cedants. Trust and agreement between the parties is often at low ebb, so more expenses are incurred to monitor claim handling and litigate or arbitrate disputes.

Reserves stay on the reinsurer's books longer because of inherent delays and uncertainty and because the liquidator needs more time to get organized. There is also a danger of damaging the reinsurer's reputation as a dependable, promptly paying partner because of the increasingly public and antagonistic disputes with the insolvent reinsured.[7] In short, the environment is less predictable and more hostile for the reinsurer.

Involvement with a failed ceding company leads the reinsurer from the familiar world of private enterprise to the alien environment of government regulation, politics, and close public scrutiny, where all the rules seem to be turned on their head.

With normal cedant/reinsurer relationships, the goal of both parties is to have a long-standing mutually profitable relationship. With insolvency, the goals diverge. The receiver is seeking generally to (1) fix the estate's liabilities; (2) marshal its assets; and, (3) wind down the estate as promptly but as fairly as possible. The reinsurer, on the other hand, is trying to become disentangled from the estate with the least damage in losses and expense costs.

The Reinsurer's Silver Lining-Paying Less And Paying It Later

For the reinsurer, there can be a brighter side: lower settlements and delayed payments. These often are the advantages of a cedant's failure. For many insolvencies, especially those with long tail exposures, it is certain the reinsurer would have paid more money more quickly if the company had survived. The ceding company's failure generally throws a monkey wrench into the process, creating confusion and discouraging claimants from filing their claims in the first place or at least dampening their enthusiasm to pursue their claim.

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<u>Lower Payments</u>. Policyholder settlements with receivers are often lower than they would have been on an identical claim with a solvent company. Reinsurers, of course, benefit from this phenomenon. Here are some of the reasons:

- Liquidations impose claim bar dates — in most states, 18 months or less after liquidation unless specially extended. Policyholders with long tail claims can find their claims have been barred before they were even asserted. When extensions are available, discouraged claimants don't always apply for them.

- Even if they get past the bar date problem, insureds are not familiar with the protracted insolvency process and are, therefore, not as diligent or effective during the negotiations in maximizing their recovery and protecting their interests. Also, they may not invest sufficient time and effort to maximize their recoveries because they are doubtful they will ever recover much from the insolvency;

- Many large insureds abandon or ignore their claims against the estate completely, believing they would be throwing good money after bad in pursuing a small recovery in the insolvency court;

- Guarantee funds and receivers can play hardball in the negotiations with the policyholder, knowing threats of a bad faith claim are remote;

- In environmental and toxic tort claims, which can trigger many policies, policyholders ordinarily seek first to maximize recoveries from all solvent carriers and later seek discounted reimbursements from insolvents; and,

- In environmental and toxic tort claims, liquidators are not involved in costly coverage and defense litigation. Once it has been declared insolvent, all actions against the liquidated company are ordinarily stayed.[8] The cost of this litigation can be quite considerable.

This is not a one-way street though. There can be instances where the insolvency itself may increase the amount of the reinsurer's claims payments. For example, solvent insurers can at times resolve long-tail claims for less than the ultimate loss exposure by settling with the insured on a present value basis. The reinsurer may benefit from this lower settlement.[9] Policyholders are generally not willing to give any credit for the present value of money in negotiations with the insolvent since it will not pay the insured any part of a settled allowance until a court approved distribution from the estate is made (which can be many years in the future.) The reinsurer in this case may pay more on an identical loss because of the insolvency.

The reinsurer of an insolvent may also pay a higher amount more quickly, if the receiver estimates the ultimate value of the claims against the estate and demands immediate payment on these estimates from the reinsurer. Some states have provisions in their statutes that allow the receiver to do this.[10] The proposed Uniform Receivership Law

(URL) also has a claim estimation provision with some limitations allowing what amounts to an arbitrated forced commutation.[11] Reinsurers contend that these estimates can be unreliable and often are too high.[12] They also argue that accelerating reinsurance recoveries breaches the fundamental terms of the agreement with the ceding company. On the other hand, claim estimation based on projections of past experience may understate the cost of late-developing claims. By "cutting off the tail" of long term liability policies, estimation may save reinsurers significant sums.

Delayed Payments. Liquidation slows the entire claim evaluation and disposition process, frequently to a crawl, sometimes to what appears to be a standstill. There are instances of insurers taken over by receivers in the 1970's, which are not yet, in the new millennium, finalized.[13] Reinsurers may benefit when the day of reckoning is postponed (or never reached.) The interest that a reinsurer can earn on years of postponed reimbursements can be significant.

Several factors, unique to the insolvency of the company, impede the flow of money from the reinsurer to the cedant to the policyholder to the claimant. Here are some of the common ones:

- Many years can be spent just locating and organizing the records of the failed insurer. Insolvents' accounts are often found by the receiver to be disordered, incomplete, kept in diverse places, or difficult to decipher. Disorganized records are often the reason why the company got into trouble in the first place, or else a consequence of the chaos that preceded its failure. With many of the original employees quickly leaving the insolvent, the receiver has a difficult time finding and reconstructing basic information, including insurance policies and reinsurance contracts.

- Unless appropriate financial and employment incentives are put in place, the receiver's staff can slow the process, consciously or not. Faced with the prospect of losing their jobs once the estate is finalized, they may not be in a hurry to speed things along. They deserve to be given a financial or other good reason why a swift winding down of the estate is in their best professional and personal interest. Many estates have done this, but others have not.

- Policyholders often drag their heels in submitting timely and complete information to the receiver. Ordinarily, they are not acquainted with the receivership claim process, which includes completing a proof of claim and cooperating with the liquidator. They lose time just understanding what they must do to recover. Often may they become active only when they learn that the estate is going to pay an interim dividend or that the bar date is imminent.

- Reinsurers cause delays by scrutinizing settlements and coverage decisions more closely. Since the insolvent is no longer a business partner, the reinsurer is less likely to be overly accommodating, or to view a questionable claim with magnanimity.

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- In the case of latent injury claims, which often trigger numerous policies, insureds usually first seek recovery from solvent carriers. Afterward, sometimes many years later, they may actively pursue their claim against the receivership, if they are not time barred.

As the reinsurer of a very unprofitable insurance company it is, in some ways, a stroke of luck and good fortune that the cedant is declared insolvent. For the reinsurer, the ceding company's insolvency tends to diminish the damaging effects of unprofitable underwriting.

Conclusion

The reinsurer's difficulties with an insolvent cedant are well documented and easily understood. The benefits, meager as they sometimes are, can be overlooked or discounted.

The reinsurer needs to accept the new, sometimes harsh, realities stemming from the insolvency of a cedant and develop a pragmatic and cost-effective exit plan. Understanding why things are suddenly turned on their head is the first step towards these goals. The second step is to meet all obligations under the reinsurance contracts in this challenging new environment so that the situation does not go from bad to worse.

Developing a close and supportive working relationship with the receiver's claims operation will ensure that defendable claims are skillfully handled. Communicating and cooperating in general with the receiver makes good business sense.

ENDNOTES

1. See, for example, in Missouri § 375.1208 R.S.Mo 3: "At any time the liquidator may request the claimant to present information or evidence supplementary to that required under subsection 1 of this section and may take testimony under oath, require production of affidavits or depositions, or otherwise obtain additional information or evidence." Reinsurers sometimes grumble that liquidators are too exuberant in encouraging claimants to pursue their claims in the receivership.

2. Most reinsurance contracts are indemnification agreements requiring the reinsurer to reimburse the cedant only for the amount of losses actually paid. Since the estate does not pay policyholders immediately for allowances, reinsurers may believe that they are not required to make a reimbursement until actual payment is made. The insolvency clause, contained in nearly all US reinsurance contracts, requires the reinsurer to pay the liquidator without diminution because of the insolvency. See NY Insurance Law Section 1308(a)(2).

3. Quackenbush v. Allstate Ins. Co., 517 U.S. 706 (1996); Corcoran v. Andra, 77 N.Y.2d 225; 567 N.E.2d 969 (1990).

4. If they lose money in a contract year, reinsurers traditionally expect to be made whole by the cedant in the following years. Cedants also protect their treaty reinsurers by buying

specific (i.e. facultative) reinsurance protection for a particularly volatile risk that would otherwise fall under the treaty contract.

5. In Quackenbush v. Mission **Insurance** Co, 46 Cal. App. 4th 458, 54 Cal. Rptr. 2d 112 (1996), the California Court of Appeal upheld objections of reinsurers and the Reinsurance Association of America (RAA) to a plan by which the California **Insurance** Commissioner proposed to wind up the Mission estate through the estimation of outstanding claims and incurred but not reported (IBNR) losses. However, in Quackenbush v Mission Ins. Co. (1998, 2nd Dist) 62 Cal App 4th 797, 73 Cal Rptr 2d 95 the court approved an amended plan which expressly prohibited the Commissioner from requiring payment of incurred but not reported loss amounts from reinsurers until their liability for and the amounts of such losses were determined. See Angoff v. Holland-America Insurance. Court of Appeals Missouri, Western District 937 S.W.2d 213; (1996) where the court found no objections to collection of IBNR estimates from the reinsurers.

6. See, Robert Hall, Drawing Down Letters of Credit in an Insurer Receivership Context. 11 **Mealey's Lit. Rep.: Ins. Insolvency** 21 (April 6, 2000).

7. This may be the greatest loss of all. A reinsurer lives or dies by its reputation as a long-term dependable partner of the cedant. An important element of its good name is the ability and willingness to pay claims promptly. A negative report involving a claim dispute with an insolvency can damage its image.

8. For example see 215 ILCS 5/189 ". . . The court may also restrain all persons, companies, and entities from bringing or further prosecuting all actions and proceedings at law or in equity or otherwise, whether in this State or elsewhere, against the company or its assets or property or the Director except insofar as those actions or proceedings arise in or are brought in the conservation, rehabilitation, or liquidation proceeding."

9. The reinsurer may not benefit. The cedant could argue that its present value settlement should be shared with the reinsurer in the same ratio that the ultimate loss would have been shared in the absence of the settlement.

10. See for example in Illinois 215 ILCS 5/209(7); and in New Jersey see 8 **Mealeys Lit. Rep.: Ins. Insolvency** 13, at 4 (Dec. 2, 1996). Also see Note 5 above.

11. See Hall. Estimation of Claims and Acceleration of Reinsurance Recoverables: The Uniform Receivership Law. **10 Mealey's Insolv. Rep**. No. 17 at 16 (1999).

12. For a discussion of the prominent issues in claim estimations see Veed, Cutting the Gordian Knot: Long Tail Claims in Insurance Insolvencies. 34 Tort and Insurance Law Journal, No. 1, p. 167 (Fall 1998).

13. For example, Signal and Imperial in California were placed in liquidation in 1978. American Reserve in Illinois went into liquidation in 1979. These estates are still open. ■

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