

LIFE REINSURANCE YOU CAN COUNT ON

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Are you losing sleep, worrying about how you can protect your life insurance company clients against the possibility that one of their reinsurers may go down the drain?² If so, experts say you're not alone. Bruce Winterhof, of Milliman USA, says that "fear of reinsurer insolvency is a leading cause of anxiety among life insurance company executives." Tim Hart of Navigant Consulting agrees. "Everyone's eager to find a solution, but many companies aren't sure where to begin. It's a real challenge."

While there may not be a perfect solution, your friends at Baker & Daniels are here to help. Not with scholarly language and heavy endnotes, but with practical advice and a few tricks of the trade that could save your career.

Be Afraid. Be Very Afraid.

When a reinsurer hits the rocks, things typically don't go very well for companies that have ceded risk to the reinsurer on an indemnity basis. If you want details, read on. Otherwise, feel free to jump to the next section.

Insurance company insolvencies are not governed by the federal bankruptcy code. Instead, when an insurance company becomes insolvent, the Insurance Commissioner in the state of domicile is appointed liquidator, and the company is liquidated pursuant to the domiciliary state's law under the supervision of a state court. Each state has a liquidation statute that establishes the relative priority of claims against the insolvent insurer. Generally speaking, the insolvent insurer's unencumbered assets are used first to pay the administrative expenses of the liquidator and guaranty associations; claims under policies and claims of guaranty associations are paid second; claims of the federal government are paid third; and claims of general creditors and others occupy lower rungs on the statutory priority ladder. Claimants having secured claims are paid out of their collateral and do not need to worry about which rung they would otherwise occupy (unless the collateral is not sufficient to pay the claim in full). Since insolvent insurers, by definition, do not have enough money to pay all claims, there's a real benefit to having a claim near the top of the priority ladder or one that is fully secured.

If you want to find out how your company would fare in a hypothetical reinsurer insolvency, the place to start is the liquidation statute in the reinsurer's state of domicile. Every state has enacted some version of the priority scheme contained in the NAIC's Insurers Rehabilitation and Liquidation Model Act. Section 47C(1) of the current version of the NAIC Model Act explicitly states that "claims under policies" do not include claims based on an insolvent insurer's "obligations under reinsurance contracts." As a result, claims of a ceding company against an insolvent reinsurer would be deemed to be low-priority, general creditor claims in states having the current version of the Model Act.

As is often the case with NAIC model laws, few states have updated their liquidation statutes to coincide with the current version. Instead, most states have earlier versions of the model that do not specify whether "claims under policies" include claims under reinsurance agreements. While a ceding company might theoretically argue that its claim against an insolvent reinsurer should be entitled to policyholder level priority under the older laws, courts have universally rejected that argument.³ In so doing, the courts have focused on the differences between insurance policies and reinsurance agreements, and on the fact that insurance regulation is aimed at protecting ordinary insurance consumers rather than insurance companies.⁴ All of this is bad, from a ceding company's perspective, because there's rarely enough money to cover general creditor claims.

Ceding companies in some cases have asked the court to impose a constructive trust on assets delivered to the reinsurer so that the ceding company might be deemed a secured claimant rather than a general creditor. This is a difficult argument to make and requires supporting facts.⁵ Most of the time, equitable theories don't trump the

priority statute. In fact, we are aware of just one instance in which the ceding company's equitable claim survived summary judgment.⁶

So those are the brutal facts about reinsurer insolvencies. Now let's talk about what ceding companies can do to protect themselves.

The Traditional Protections

Obviously, one way for a ceding company to protect itself is to avoid like the plague any reinsurer that poses an insolvency risk. Toward that end, a ceding company should perform due diligence on a reinsurer's financial condition *before* entering into an arrangement. For starters, a ceding company should:

- (1) Review a reinsurer's rating agency ratings and accompanying information;
- (2) Review the reinsurer's financial statements, paying particular attention to the level of the reinsurer's surplus;
- (3) Ask about the reinsurer's risk based capital ratio;
- (4) Get your hands on publicly available information about the reinsurer (much of it may be available on-line);
- (5) Meet with the reinsurer's management to get a better feel for the company and to ask any questions that arise as a result of reviewing the other information.

Of course, a reinsurer that looks rock-solid today may not look so great several years from now (and life reinsurance agreements are often long-term deals). The life insurance highway is littered with the debris of large, highly rated companies like Executive Life, First Capital, Mutual Benefit, Confederation Life and others that crashed and burned.

For that reason, a ceding company should limit its exposure to any one reinsurer. You wouldn't invest all of your retirement funds in one company, and a ceding company should approach its reinsurance program the same way.

A ceding company should also consider protecting itself by requiring the reinsurer to secure its obligations using a trust agreement or a letter of credit. Trust agreements and letters of credit have certain transaction costs that may be unattractive, but they give a ceding company secured claimant status, which permits the ceding company to look to the collateral for reimbursement if the reinsurer becomes insolvent. Another way for a ceding company to protect itself is to structure its reinsurance arrangements as modified coinsurance rather than traditional coinsurance. Under modified coinsurance, the ceding company retains the assets and the reserves attributable to the reinsured business.

Getting a trust agreement or a letter of credit at the outset of a reinsurance deal sounds great, but the reinsurer will typically resist because:

- (1) Providing collateral adds complexity and cost;
- (2) Placing assets in trust hampers the reinsurer's ability to manage its business; and
- (3) No one ever wants to admit that there is reason for the ceding company to be concerned.

So what's a cautious ceding company to do?

A Different Approach: Triggering Events

Rather than entering into a deal without any protection, a ceding company can require the reinsurer to provide collateral upon the occurrence of certain triggering events that would give the ceding company an early warning if

the reinsurer's financial condition begins to deteriorate. Those triggers could include:

- (1) A rating downgrade;
- (2) A drop in the reinsurer's risk based capital ratio, either in relative or in absolute terms (but don't focus solely on the annual calculation; consider the quarterly estimates, too);
- (3) A drop in the reinsurer's surplus, either in relative or in absolute terms;
- (4) Failed IRIS ratios;
- (5) Entry of an order placing the reinsurer under administrative supervision (or something similar); or
- (6) A combination of the above.⁷

The idea here is to pick one or more triggering events that would occur at least one year before any actual insolvency. Why? Because most liquidation statutes, patterned after the NAIC Insurers Rehabilitation and Liquidation Model Act, permit receivers of failed companies to undo certain transfers of property that are deemed to be preferences.⁸ Accordingly, any transfer of collateral from a reinsurer to a ceding company that occurs within one year of a successful receivership petition concerning the reinsurer is likely to be scrutinized by the reinsurer's receiver as a potential preference.⁹

Finally, it's important that the reinsurance agreement require the reinsurer to notify the ceding company immediately if a triggering event occurs. Otherwise, a triggering event could occur without the ceding company's knowledge.

What Happens When A Triggering Event Occurs?

Upon a triggering event, the ceding company could have any number of options, some of which are better than others. For example, a reinsurance agreement could give the ceding company the right to:

- (1) Terminate the agreement immediately on a going forward basis (this limits the ceding company's potential exposure, but you still have to worry about risks that have already been ceded);
- (2) Demand a trust or letter of credit (either may provide good protection, but everyone else may be demanding the same thing at the same time);
- (3) Demand a parental or affiliate guarantee (this may provide some comfort, but insolvencies rarely occur in a vacuum; if one company in a holding company system is in trouble, often the others are, too);
- (4) Replace the reinsurer with another, stronger reinsurer (this would be good result, but finding a suitable replacement may take time and may not be easy);
- (5) Convert to modco or funds withheld arrangement; and/or
- (6) Recapture the ceded business (this avoids the problem of having uncollectible reinsurance, but the ceding company may not want all the exposure).

A reinsurer probably won't want the ceding company to have many options or unbridled discretion, so the parties will need to agree upfront on what will happen if a triggering event occurs. Negotiations on this point and on what constitutes a triggering event are often contentious. The ceding company needs to have a clear sense of which protections are an absolute must and which ones it can live without.

Need For Periodic Monitoring

Even if a ceding company bakes triggering events and accompanying remedies into its reinsurance arrangement, prudence dictates that the ceding company continue to monitor the reinsurer's financial condition. Our colleague, Larry Stern (who spent 9 years as an analyst at A.M. Best), recommends that ceding companies review the financial condition and operating performance of their reinsurers at least annually. At a minimum, a ceding company should check to see whether a reinsurer's financial strength rating has been downgraded by any of the major rating agencies.

Ideally, a ceding company will also conduct its own review of a reinsurer's condition. Reviewing a reinsurer's profitability, liquidity and capitalization (based on the company's financial statements) is a good place to start. The ceding company should also perform a simple trend analysis by reviewing any notable changes in the reinsurer's assets, surplus, earnings and premium volume.¹⁰

Conclusion

While none of this provides perfect protection from reinsurer insolvencies, it should help you get to sleep at night. And that's worth something, isn't it?

Endnotes

1. Charlie Richardson and Scott Kosnoff are partners in the law firm of Baker & Daniels, located in Washington, DC and Indianapolis, respectively. They co-chair the firm's Insurance and Financial Services Team.
2. If not, go back to sleep and don't read another word. Everything's going to be just fine. Probably.
3. See *Foremost Life Insurance Co. v. Department of Insurance*, 409 N.E.2d 1092 (Ind. 1980) (a case that Baker & Daniels litigated); *Neff v. Cherokee Insurance Co.*, 704 S.W.2d 1 (Tenn. 1986); *State ex rel. Long v. Beacon Insurance Co.*, 359 S.E.2d 508 (N.C. Ct. App. 1987); *In re Liquidation of Reserve Insurance Co.*, 524 N.E.2d 538 (Ill. 1988); *In re Liquidation of Sussex Mutual Insurance Co.*, 694 A.2d 312 (N.J. Super. Ct. App. Div. 1997); and, most recently, *Covington v. Ohio General Insurance Co.*, 789 N.E.2d 213 (Ohio 2003) (Baker & Daniels filed an amicus brief in that case).
4. The Ohio Supreme Court's reasoning in *Covington*, decided June 11, is instructive:

We conclude that the General Assembly did not intend the words "claims under policies for losses incurred" in R.C. 3903.42(B) to include a claim under a reinsurance agreement. First, the General Assembly uses different terms when referring to consumer insurance policies and reinsurance agreements. Second, including reinsurance claims in Class 2 would not be consistent with the other types of Class 2 claims. Accordingly, claims under a reinsurance agreement must be filed as Class 5 claims.

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In short, the purpose of the priority for Class 2 claims is to protect consumers who have purchased direct insurance and those in related situations, rather than to protect reinsured insurance companies. Interpreting "claims under policies for losses incurred" to be consistent with these other claims requires us to exclude reinsurance agreements.

Covington, 789 N.E.2d at 215, 216.

5. See *Security Casualty Co. v. Dyson*, 537 N.E.2d 775 (Ill. 1989); *Northwestern National Insurance Co. v. Kezer*, 812 P.2d 688 (Colo. Ct. App. 1991); and *Universal Marine Ins. Co. v. Beacon Ins. Co.*, 768 F.2d 84 (4th Cir. 1985).
6. See *Pioneer Annuity Life Insurance Co. v. National Equity Life Insurance Co.*, 765 P.2d 550 (Ariz. Ct. App. 1988) (holding that imposition of a constructive trust may be an appropriate remedy, depending on the evidence presented

at trial).

7. This list is not intended to be exhaustive; for other triggering event ideas, check out the NAIC's Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition.

8. We're too tired to go into an extensive discussion of voidable preferences right now, but we'd be happy to do so for a small fee.

9. To read about ceding companies that waited too long before obtaining collateral, see *Pine Top Insurance Co. v. Century Indemnity Co.*, 716 F. Supp. 311 (N.D. Ill. 1989) and 123 B.R. 287 (N.D. Ill. 1990), *aff'd*, *Pine Top Insurance Co. v. Bank of America National Trust and Savings Association*, 969 F.2d 321 (7th Cir. 1992); *Pine Top Insurance Co. v. Republic Western Insurance Co.*, 123 B.R. 277 (N.D. Ill. 1990), *aff'd*, *Pine Top Insurance Co. v. Bank of America National Trust and Savings Association*, 969 F.2d 321 (7th Cir. 1992); and *In re Receivership of Southeastern Reinsurance Co.*, No. 89-2855 (Leon County, Florida Cir. Ct. March 22, 1991).

10. For more information on solvency monitoring, you'd better talk to Larry. ■
