# CEDENTS' CLAIMS TO REINSURANCE RECOVERABLES

# AND

# PRIORITY OF DISTRIBUTION

**By**

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## I. Introduction

Veteran observers of the sometimes contentious relationships among receivers, guaranty associations and reinsurers were somewhat surprised by the recent decision of Covington v. Ohio General Ins. Co., 2001 WL 1013126 (OhioApp.). In this case, the court ruled that a cedent under a reinsurance contract has the same priority claim to assets of the estate as guaranty associations, policyholders and claimants against policyholders. The Ohio priority statute designated as Class 2 priority "all claims under policies" but did not specifically exclude cedents' claims.

After consulting several dictionaries, the Covington court concluded that a policy is a contract of insurance and that reinsurance is one form of a contract of insurance. As a result, the court ruled, the cedent's claim under the reinsurance contract fell squarely within the statute. The court further ruled that since the statute was unambiguous, legislative intent did not need to be considered. But if it was considered, the legislature's failure to adopt the relevant language of the NAIC Rehabilitation and Liquidation Model Act, which excludes reinsurance claims from this level of priority, is conclusive on legislative intent.[1]

The issue addressed in Covington v. Ohio General has not been a subject for debate for many years due to the case law and public policy issues addressed below. The purpose of this article is not to advocate a position but to examine this case in light of such case law and public policy issues.

## II. Public Policy Arguments

### A. From the Cedents' Standpoint

It may be argued that reinsurance is merely a subset of insurance. With a few exceptions (*e.g.* rate and form filing), reinsurers are regulated in exactly the same manner as insurers. Most reinsurers write some insurance and even more insurers assume some reinsurance.

The permeable nature of the marketplace suggests several conclusions. To the extent that a receivership code attaches a certain priority to "claims under insurance policies," it is an artificial distinction to exclude reinsurance from the definition of insurance. Would we also exclude bonds?

Secondly, there is a high degree of interdependence among insureds, insurers and reinsurers. Placing cedents to an insolvent reinsurer in a general creditor category may jeopardize the financial health of additional companies. The confluence of events, such as the World Trade Center bombing and the liquidation of Reliance Insurance Company (a reinsurer of significant size), may result in a ripple effect which is damaging to many insurers and their clients. To avoid such a result, it makes sense, the argument goes, to group guaranty associations, insurers and their clients at the same priority level.

While the desire to protect consumers is laudable, not all insureds or cedents are alike. Some insureds are multi-national manufacturing or financial institutions with sophistication and net worth greater than their insurers. Similar to the NAIC Guaranty Fund Model Act,[2] a priority distinction should be made between the priority of ordinary consumers and that of sophisticated business entities.

The retort that the cedent to the insolvent reinsurer could have protected themselves by better selection procedures is off the mark. Often insolvencies result from latent exposures (*e.g.* pollution and asbestosis) that were not understood until many years later. Other insolvencies have been caused by new and ill-advised programs (*e.g.* Transit Casualty and Mission) that could not have been anticipated by those who did business with such companies prior to the initiation of these programs.

**B. <u>From Receivers' and Guaranty Associations' Standpoint</u>**

Insurance is an industry touched with a public interest. For this reason, a large part of insurance regulation in the United States is oriented toward protecting consumers who lack the resources to evaluate the financial wherewithal of insurers and the sophistication to compare insurance products.

This orientation is reflected in the receivership laws and guaranty association laws developed by the NAIC and the various states over the last thirty five years. For instance, the limits and lines covered by guaranty associations are specifically designed to protect consumers, whether as policyholders or claimants, rather than business entities which are better able to protect their own interests. Likewise, priority of distribution provisions in receivership laws have been structured to give a high priority to insureds and claimants while placing others at a lower, general creditor level.

While one cannot expect cedents to be omniscient concerning the future solvency of their markets, they are certainly in a superior position to consumers. Cedents can and do perform sophisticated financial analyses of those with whom they do business. If cedents choose to cede to weak or otherwise troubled companies, they assume the risk that some will fail. In addition, cedents are not without tools to protect themselves (*e.g.* setoff) should such a failure occur.

Priority of distribution statutes should be construed to favor of those least able to protect themselves against the prospect of insurer insolvency.

## III. Early Case Law

Receivership statutes in the United States have not always assigned priorities in the distribution of the assets in insolvent insurers.[3] However, a priorities section was inserted into the NAIC Model Insurers Rehabilitation and Liquidation Model Act adopted in 1977[4] and some version of the priorities provision has been enacted in virtually all states.

Early litigation on priorities was in the context of special deposits required of insurers to write business in particular states. Perhaps the most prominent of such litigation is Shepard v. Virginia State Ins. Co., 91 S.E.140 (Va.1917). In this case, state law required fire insurers to post a bond for the benefit of "the holders of all policies . . ."[5] When the company which made the deposit became insolvent, one of its cedents attempted to collect on the bond. The court ruled against the cedent:

The evident purpose of the Legislature, as it seems to us, and the one naturally attributable to it, was to protect property owners in their fire insurance contracts, and not to protect other insurance companies on their contracts of reinsurance. The business of insurance is in itself of such a character as to have evoked, in the public interest, much special legislation looking to its control. The average individual property owner is uninformed as to many of the details of the business, and, for this and other reasons, is not in a position to judge of the solvency of any particular company. . . .

It is true that reinsurance is a legitimate part of the business of an insurance company, and likewise true that a sound public policy would naturally lead every state to encourage and foster and endeavor to stabilize its resident insurance companies; but we cannot think the Legislature ever contemplated [a cedent making a claim on the bond]. . . .

Contracts on reinsurance are not infrequently designated as "policies," and they are doubtless properly so called; but, unless there is something in the context to indicate reinsurance, the use of the term "policy" in reference to fire insurance business naturally suggests, and will be understood as meaning, the far more usual and commonly known contract of insurance for the protection of a property owner against loss of his property by fire.[6]

In accord are In re New Jersey Fidelity & Plate Glass Ins. Co., 191 A. 475 (Ct.Ch.N.J.1937); Cunningham v. Republic Ins. Co., 94 S.W.2d 140 (Comm.App.Texas1936); Aetna Casualty & Surety Co. v. International Re-Insurance Corp., 175 A. 114 (Ct.Ch.N.J.1934).

## IV. Modern Case Law

In re Liquidation of Reserve Ins. Co., 524 N.E.2d 538 (Ill.1988) involved a statutory priority for the claims of "policyholders, beneficiaries [or] insureds . . . under insurance policies and contracts issued by the [insolvent] company."[7] Several cedents attempted to collect balances under this statute arguing that reinsurance is a form of insurance contact. Initially, the court noted that reinsurance is different from insurance in that reinsurance is a transaction between two insurance companies and that it is unconnected with the underlying insurance policy. The court went on to interpret legislative intent to provide this priority level to policyholders and claimants against policyholders but not to ceding insurers. During the course of its opinion, the court rejected the cedents' argument that policyholders did not need to be preferred over cedents since policyholders are protected by guaranty associations:

The protection under guaranty funds is limited and does not even apply to rehabilitations. Thus, there is a real likelihood that many claims covered under insurance policies and insurance contracts will not be protected fully, if at all, under State guaranty funds. . . If anything, the Illinois Guaranty Fund Act and [priority statute] both reflect the legislature's common purpose to prefer the interests of direct insurance consumers over those of reinsureds and reinsurers.[8]

The meaning of priority language in a rehabilitation plan was the issue in State of North Carolina v. Beacon Ins. Co., 359 S.E.2d 508 (Ct.App.N.C.1987). The plan specifically excluded from coverage in the policyholder priority level "reinsureds or reinsurers." Cedents objected to the plan on the basis that it violated the relevant priority statute which excluded only "reinsurers." The court reasoned that such a distinction was meaningless because the statute applies to claims under policies and reinsurers do not have claims under policies. The court ruled for the rehabilitator on the basis of public policy:

The public policy considerations favoring protection of policyholders are not as applicable, however, to the business of reinsurance. Unlike transactions between insurers and consumers, insurers who negotiate and enter into reinsurance contracts do so from a substantially more equal bargaining position. . . . (W)e believe it unlikely that the General Assembly intended, in the event of the insolvency of an insurer, that other insurers, who had ceded risks to the insolvent insurer through reinsurance agreements would be treated on a par with those who have claims under policies issued directly by the insolvent insurer.[9]

The validity of another rehabilitation plan was at issue in Neff v. Cherokee Ins. Co., 704

S.W.2d 1 (Tenn.1986). The relevant statute granted a high priority to "claims for benefits under policies and losses incurred, including claims of third parties under liability policies . . . ."[10] Cedents argued that their claims for reinsurance recoverables should be treated as claims under policies. The court rejected this argument based on legislative intent:

The definition of an insurance company is found in [the receivership code], but while it would perhaps otherwise encompass a reinsurance agreement, the express inclusion of or reference to reinsurance in a number of places without doing so in this definition implies its exclusion elsewhere for the purposes of [the receivership code] as a whole. . . . Thus, the Legislature intends [the receivership code] primarily to benefit direct policyholders as these agreements are defined in that title.[11]

Foremost Life Ins. Co. v. Department of Insurance, 409 N.E.2d 1092 (Ind.1980) involved a claim by a cedent under a priority statute which gave a high priority to "claims by policyholders, beneficiaries and insureds, . . . and liability claims against insureds . . . ."[12] The court rejected the cedents' attempt to insert itself at this priority level stating:

It is abundantly clear that the legislature could have included "ceding" companies along with policyholders, beneficiaries and the insureds if such was their intention, and reinsurance contracts as well as insurance contracts, if they intended to include reinsurance under Class III. These are well understood terms and statutes in the insurance field and insurance law, and the legislature must be presumed to have considered them in drafting this statute.[13]

An alleged typographical error in the priority statute was the threshold issue in In the Matter of the Liquidation of Sussex Mutual Ins. Co., 694 A.2d 312 (Sup.Ct.N.J.1997). Higher priority was granted to "claims by policyholders, beneficiaries and *insurers* . . . and liability claims against *insurers* . . . ."[14] The receiver argued that "insurer" was a typographical error and that "insureds" was intended. A cedent argued that this language was intended to grant a high priority to reinsureds. The court concluded that the legislature had intended to use the language advocated by the receiver:

If the legislature had intended to contravene the settled policy enunciated in [Aetna Casualty & Surety v. International Re-Insurance Corp., *supra*.], and favor reinsureds along with policyholders and beneficiaries, it would have used the term reinsured not the somewhat ambiguous terms "insurers" which stands in stark contrast to the other terms "policyholders" and "beneficiaries." It is also unlikely that such a change would have been made without any indication of the Legislature's intent to make that change evident in pre-enactment history.[15]

## V. Conclusion

The reader must judge for himself or herself which side of this debate has the better public policy arguments. However, the case law indicates that the position of receivers and guaranty funds has prevailed thus far. The courts, certainly, have interpreted the language of priority distribution statutes, and the legislative intent behind them, against cedents.

As a result, it appears likely that Covington v. Ohio General, *supra*, will be a case of limited influence which could be effectively reversed through amendments to the Ohio priority of distribution statute. Should such a legislative effort be attempted, however, consideration could be given to a consistent priority level of all sophisticated entities, be they cedent or insured.[16]

**ENDNOTES**

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[1] . 2001 WL 1013126 *2 - 3.

[2] . Section 5 F. (3)(d) of the NAIC Post Assessment Property and Liability Insurance Guaranty Association Model Act excludes from the definition of covered claim, any first party claim by an insured with a net worth of $25 million or more.

[3] . The Uniform Insurers Liquidation Act used by many statutes during the early and middle portion of the twentieth century did not contain a priority provision. *See* State of North Carolina v. Beacon Ins. Co., 359 S.E.2d 508 (Ct.App.N.C.1987).

[4] . The legislative history to the model, which is contained in the NAIC compilation of its model acts and regulations, states:

When the first drafting committee met to decide on a list of important items to include in the model, one of the most essential was establishing the order of priority of claims against the estate of the insolvent insurer. They considered it most appropriate to place policyholders, beneficiaries and claimants ahead of general creditors. 1976 Proc. II 363. The scheme adopted in 1977 remains essentially the same today. 1978 Proc. 436 - 438.

[5] . 91 S.E. at 140.

[6] . 91 S.E. at 141 - 2.

[7] . 524 N.E.2d at 539.

[8] . *Id.* at 543.

[9] . 359 S.E.2d at 511.

[10] . 704 S.W.2d at 2.

[11] . *Id.* at 3 - 4.

[12] . 409 N.E.2d at 1094.

[13] . *Id.* at 1097.

[14] . 694 A.2d at 314.

[15] . *Id*. at 317.

[16] . *See* note 2, *supra*.