

COMMON ACCOUNT REINSURANCE - CASE LAW, AT LAST

By

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I. Introduction

Primary insurers which are highly leveraged with reinsurance often use common account reinsurance. This is a form of excess of loss reinsurance which is used to net down the exposure of the primary and its quota share reinsurers. Commonly, the reinsured under the common account reinsurance is defined as the primary insurer and its quota share reinsurers. Commonly also, the primary insurer, or its intermediary, administers the premium payables and reinsurance recoverables under both the quota share and common account excess. Rather than have the quota share reinsurers pay their gross liability and be subsequently reimbursed by the excess of loss reinsurers, the primary may bill the quota share reinsurers for their net liability and bill the common account excess of loss reinsurers for the remainder.

When the primary insurer, or any of its reinsurers, is placed in receivership, difficult issues arise concerning rights to reinsurance recoverables. Notwithstanding some useful commentary by counsel,^[i] until very recently, there was virtually no case law in the United States^[ii] to guide insurers and their counsel. However, a recent case handed down by the Federal District Court for the Southern District of New York provides material assistance.

The purpose of this article is to analyze this case and the impact it will have on problem scenarios that occur with some frequency with respect to common account reinsurance.

II. Continental Casualty Co. v. Certain Underwriters at Lloyd's London, 2004 U.S. Dist. Lexis 4060 (S.D.N.Y.)

The common account excess of loss contract defined the reinsured as “Legion Insurance Company . . . and/or their quota share reinsurers” Continental, a quota share reinsurer, sought to recover from syndicates which participated on the common account excess. Continental had secured a power of attorney from Legion and the other quota share reinsurers to pursue excess of loss recoveries. The syndicates defended on the basis that on Legion was the only “reinsured” under the treaty and that the quota share reinsurers had been included in the definition of reinsured merely for informational purposes.

Witnesses for both Continental and the syndicates testified that the purpose of common account reinsurance was to protect both the primary insurer as well as the quota share reinsurers. In addition, the court had little trouble in deducing the plain meaning of the definition of reinsured. The court ruled:

In view of the clear language of the Excess of Loss Reinsurance Agreement, as confirmed by the extrinsic evidence, the court holds that Continental and the other quota share reinsurers are Reinsured parties under that agreement. As Reinsured parties they are third party beneficiaries, and are entitled to enforce the Excess of Loss Reinsurance Agreement.^[iii]

The court noted that Continental probably had a right to pursue recoveries on its own behalf, and not in conjunction with Legion and the other quota share reinsurers. However, the court noted that such a fact situation was not before the court.

III. Common Problem Scenarios with Common Account Reinsurance

A. Primary Insurer is Placed in Receivership

1. Switch from Net to Gross Billing of Quota Share

As an insurer's financial wherewithal declines, it is not unusual for it to seek better cash flow by switching from net to gross billing of the quota share reinsurers. Rather than billing the quota share reinsurers for their net liability, they are billed for their gross liability and are credited with the common account excess of loss recoveries only when received. Not so coincidentally, this may coincide with insolvencies among the excess of loss reinsurers.

The primary's ability to make such a switch depends on the contracts in question as well as course of dealing. Continental v. Certain Underwriters does not provide a remedy on this point. However, it does support the ability of the quota share reinsurers to collect their excess of loss reinsurance directly.

2. Administration of Excess of Loss Recoveries Deteriorates

It is not unusual for the administration of excess of loss recoveries to deteriorate when the primary insurer becomes insolvent. There is often a hiatus while the receiver takes over the operation of the insurer and reinsurers evaluate the totality of their relationship with the insolvent for setoff and other purposes. Depending on timing issues, the quota share reinsurers may be left with reinsurance recoverables due from excess of loss reinsurers and with nobody pursuing them. Continental v. Certain Underwriters provides a remedy in that the quota share reinsurers can pursue recovery against the common account reinsurers.

3. Primary Collects Common Account Recoveries But Invokes Priorities

When an insurer is placed in receivership, its assets are distributed in accordance with a statutory scheme which places policyholders at the head of the line and cedents and reinsurers in the class of general creditors which seldom obtains any recovery. It is possible for a receiver to argue that common account recoveries, even those intended to net down the exposure of quota share reinsurers, are subject to this statutory scheme.^[iv]

Continental v. Certain Underwriters embodies a partial remedy in that the quota share reinsurers are empowered to collect their portion of common account recoverables directly. Unfortunately, this can create an unseemly "race to the courthouse" to collect the funds and reluctance on the part of excess reinsurers to pay any party until all differences can be resolved.

A more useful line of cases in this situation is represented by Lines v. Bank of America et al., 743 F.Supp. 176 (S.D.N.Y. 1990). In this case, the receiver of the reinsurer was substituting letters of credit to provide security for credit for reinsurance purposes when the cedent drew down the old and new letters of credit. The court imposed a constructive trust on the funds wrongfully drawn down. Moreover, the court declined to allow the cedent to setoff the funds drawn down against debts due from the reinsurer due to lack of mutuality of debits and credits and violation of the equitable principles supporting setoff. See also, Application of Serio, 769 N.Y.S.2d 530 (S.C.App.Div.2004). Thus, quota share reinsurers appear to have a remedy when an insolvent primary insurer collects the common account excess recoverables and declines to share them with or credit them to the quota share reinsurers.

B. Common Account Excess Reinsurer is Placed in Receivership

1. Who Can File a Claim Against the Estate?

When common account excess of loss reinsurer becomes insolvent, a question may arise as to whether it is the primary insurer, the quota share reinsurer or both who should be able to file a claim against the estate. Continental v. Certain Underwriters suggests that each may file a claim for their net recoverables.

2. Who Has the Credit Risk?

The quota share reinsurer may argue that the primary insurer, as the designer and administrator of the common account excess program is responsible for the credit risk presented by insolvent excess of loss reinsurers. The primary insurer may counter that each reinsured has to be responsible for its own credit risk and the quota share reinsurer approved or acquiesced in the excess of loss reinsurers selected. In any either case, Continental v. Certain Underwriters is of little assistance on this issue.

C. Quota Share Reinsurer is Placed in Receivership

Should the receiver of the quota share reinsurer feel uncomfortable with allowing the primary insurer to administer reinsurance recoverables from the excess of loss reinsurers, Continental v. Certain Underwriters indicates that the receiver may collect those recoverables himself or herself.

IV. **Conclusion**

Significant problems arise in common account excess of loss programs when one or more players is placed in receivership. Until very recently, there was virtually no case law guidance to the process of sorting out the rights and responsibilities of the various insurers and reinsurers involved. Continental v. Certain Underwriters suggests that henceforth, it will be clear that quota share reinsurers will have the right to collect reinsurance recoverables directly from common account excess of loss reinsurers when it is impractical for the primary insurer to do so.

ENDNOTES

[i]. See, Mendelsohn and Schwab, *Beware Common Account Reinsurance*, Mealey's Lit. Rpts. volume 8, no. 9 (1997).

[ii]. For a British case dealing with excess of loss reinsurance of a pool, see North Atlantic Ins. Co. Ltd. v. Nationwide Gen. Ins. Co. Ltd., [2003] EWHC 449 (Comm).

[iii]. 2004 U.S. Dist. Lexis 4060 (S.D.N.Y.)*14.

[iv]. It is the author's experience that some receivers think through the issue more thoroughly and consider whether they are holding the quota share reinsurers' portion of the recoveries for the benefit of such reinsurers and not as an asset of the estate.