Cut-Through and Guarantee Clauses

By Robert M. Hall*

1. Introduction

When a primary insurer is of insufficient size or rating to meet the standards of a sophisticated insured or loss payee (often a mortgagee) on property or casualty business[1], cut-throughs may be used to allow the insurer to obtain business for which it otherwise would not be able to compete. The effect of a cut-through is to allow the insured or the loss payee to collect the reinsurance recoverables directly from the reinsurer in the event that the insurer becomes insolvent.[2]

In contrast, a guarantee is an undertaking by the reinsurer to pay the entire amount of the claim payment if the primary insurer becomes insolvent, regardless of how much of such claim payment was reinsured.[3] In effect, the reinsurer is acting a surety or financial guarantor of the obligations of the primary insurer which adds regulatory risk (proper licensing) to the heightened financial risk inherent in guarantees. The purpose of this article is to examine the competitive aspects of cut-throughs and guarantees, form and record issues, insolvency clauses and credit for reinsurance laws and the impact of receivership policy and case law.

2. Competitive Aspects

Loss payees and sophisticated insureds often have size and rating standards which they use in selecting or approving insurers. Those insurers which do not meet these standards are not competitive for these potential clients. Cut-throughs and guarantees, however, allow such primary insurers to be competitive by, in effect, borrowing the size and rating of their reinsurers.

Increased competition is usually beneficial to the marketplace. In this case, however, cut-throughs and guarantees allow the small and financially weak insurers to compete with large, strong and sophisticated insurers with reinsurers assuming the risk that the smaller, weaker companies will fail. Why are reinsurers willing to assume this risk? Many reinsurers are quite concerned about the risks inherent in cut-throughs and guarantees but in a very competitive marketplace, they are forced to offer them.

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3. <u>Form and Record Issues</u>

There are no standard forms for cut-throughs and guarantees and many versions circulate in the industry. In some cases, they take the form of a clause in the reinsurance contract. In other cases, they are an endorsement to the policy and in still other cases they are both. (For purposes of simplicity, this article will refer generically to all such forms as cut-throughs and guarantees.) If the cut-through or guarantee is part of the reinsurance contact, it typically gives the cedent the right to bind the reinsurer to a cut-through or guarantee when necessary to write the business. If the cut-through or guarantee is part of the underlying policy, it typically assigns rights to reinsurance recoverables to the insured and the reinsurer must rely on the cedent to supply records of which policies were so benefitted.

In any of these scenarios, it can be difficult, in the event of insolvency, for the reinsurer to know which policies were benefitted by a cut-through or guarantee and which were not. When a primary insurer becomes insolvent, records are often missing or garbled and a reinsurer may need to expend considerable effort to delineate which claims are to be paid to the receiver and which to the beneficiary of a cut-through or guarantee. Payment of reinsurance proceeds to the wrong party can result in the reinsurer paying the same claim twice.

A case in point is *Ainsworth v. General Reinsurance Corp.*[4] The reinsurer settled a claim by a policyholder against an insolvent cedent. Although the claimant never made a claim against the estate, the court ruled that the reinsurer had to pay the claim a second time to the receiver of the cedent. The court reasoned that under the insolvency clause contained in the reinsurance contract, the reinsurer was obligated to pay reinsurance proceeds to the receiver who spreads them among all creditors of the same class. Preempting a claim against the estate by settling it acts as a preference in favor of one claimant. This is a dominant theme with respect to cut-throughs and guarantees. *See* Section V., *infra.*

4. Insolvency Clauses and Credit for Reinsurance

Virtually every state requires that reinsurance contracts contain an "insolvency clause" if the cedent is to receive financial statement credit for the reinsurance. An insolvency clause obligates the reinsurer to pay claims to the receiver of the cedent "without diminution due to the insolvency of the cedent" *i.e.* as if the cedent had paid the full amount of the claim. This clause usually contains language which allows the payment of reinsurance proceeds pursuant to cut-throughs and guarantees. For instance, a contractual insolvency clause might include the following language:

It is further understood and agreed that, in the event of the insolvency of the cedent, the reinsurance under this contract shall be payable directly by the reinsurer to the cedent or to its liquidator, receiver, conservator or statutory successor except (a) where this contract specifically provides another payee of such reinsurance in the event of the insolvency of the cedent or (b) where the reinsurer with the consent of the direct insured or insureds has assumed such policy obligations of the cedent as direct obligations of the reinsurer to the payees under such policies and in substitution for the obligations of the cedent to such payees (emphasis added).

While some state credit for reinsurance laws allow cut-throughs and guarantees, others are ambiguous in this regard.[5] This raises the opportunity for conflict between contractual cut-throughs and guarantees on the one hand, and receivership policy and case law on the other. Such a conflict can have the result of duplicate payment of claims by the reinsurer, once to the receiver and again to the insured or loss payee.

5. Receivership Policy

One of the fundamental principles of insurer receiverships is that all creditors of the same class are treated equally. Ordinarily, this means that all policyholders and loss payees would be paid the same proportion of their allowed losses.

Some receivers argue that cut-throughs and guarantees give an improper preference to sophisticated insurers and loss payees at the expense of consumers and should not be enforced.[6] Other receivers argue that reinsurers have a statutory obligation[7] to pay reinsurance proceeds to the receiver and that reinsurers create contractual obligations to sophisticated insurers and loss payees at their own peril *i.e.* duplicate payment of losses.[8]

It is possible to approach an insurance department in advance for their position on whether cut-throughs or guarantees would require duplicate loss payments by the reinsurer, although the parties, ordinarily, would be reluctant to do so for a variety of reasons.[9] In any case, the author was the general counsel of a large reinsurer which was approached for reinsurance with cut-throughs by a regional insurer which had been well managed except for the convergence of a natural disaster and an unfortunate concentration of risk. The cedent needed the cut-throughs for a program necessary to maintain cash flow. The reinsurer and the primary insurer approached the domiciliary regulator of the primary company together and asked for assurance that if the worst occurred and the reinsurer paid losses pursuant to the cut-throughs, it would not be called upon to pay the claims a second time to the receiver. The regulatory and receivership divisions of the insurance department were unable to reach a common position and the program was never written. One can draw the conclusion that reinsurers issue cut-throughs and guarantees at their peril absent statutes that specifically avoid double payment.[10]

6. Case Law on Cut-Throughs and Guarantees

While there are relatively few cases squarely examining cut-throughs and guarantees, there is a great deal of case law to the effect that absent language demonstrating a specific intent to benefit a loss payee or insured, such parties have no right to collect reinsurance proceeds directly from an insurer.[11] When a direct intent is demonstrated, however, insureds and loss payees may recover. For instance, a court has denied summary judgement to a reinsurer in a collection action by an insured when the policy contained a provision assigning to the insured the right "to collect claims, after settlement of loss, directly from reinsurers . . . ." *Klockner Stadler Hurter Ltd. v. Ins. Co. of State of Pa.*[12]

Colonial Penn Ins. Co. v. American Centennial Ins. Co.[13] involved a cut-through on the reinsurance level. Colonial Penn was the primary company which ceded reinsurance to Mutual Fire Marine which retroceded to American Centennial. The rehabilitator of Mutual Fire Marine developed a rehabilitation plan which prohibited cut-throughs. Colonial Penn objected to this prohibition but its objections were overruled by the Pennsylvania Commonwealth Court and Supreme Court. In this case, Colonial Penn brought an action directly against American Centennial but the federal district court ruled that the issue was res judicata *i.e.* that it had already been decided against Colonial Penn by the Pennsylvania courts and could not be relitigated.

Mercantile & General Reinsurance Co. v. Spanno[14] involved a reinsurance contract in which the reinsurer agreed that in the event of the failure of the cedent, the reinsurer "will take over the handling of claims and other matters direct with the original assured." Although this is not traditional cut-through or guarantee language, the court of appeals upheld a jury verdict that this language made the insured the third party beneficiary of the reinsurance contract.

The most square presentation of the issue remains *Warranty Ass'n v. Commonwealth Ins. Co.*[15] Commonwealth issued policies with cut-through endorsements prior to being declared insolvent. The court characterized claims pursuant to these cut-throughs as improper preferences and ruled that they could not be used to divert reinsurance proceeds which are the property of the estate.

With such a small number of cases and with mixed results, it is hard to argue for any trend in the courts on cut-throughs and guarantees. More salient case law will emanate from those states which have laws specifically avoiding double payment of claims by reinsurers. However, it is likely that cut-throughs and guarantees will continue to be disfavored by receivers.

7. Conclusion

To the extent that they are enforced, cut-throughs and guarantees add significantly to the security of an insured or loss payee which does business with an insurer which does not meet normal size and rating criteria. However, receivers may resist their enforcement since they cut against the grain of receivership policy by preferring sophisticated insureds and loss payees over other creditors of the same class.

From the reinsurer's standpoint, cut-throughs and guarantees are competitive tools which allow reinsurers to capture business in consideration for agreeing to pay loss due to insureds and claimants in the event of the cedent's insolvency. Absent specific statutory language guarding against double payment, however, reinsurers may be caught between conflicting demands for reinsurance recoverables from receivers as well as from insureds and loss payees. As a result, the effort to obtain specific statutory protection against double payments with respect to cut-throughs and guarantees is critical to reinsurers, insurers, insureds and loss payees in order to achieve the intended results of these instruments. [16]

ENDNOTES

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[1]. This article does not encompass surety cut-throughs, often called co-surety, which result from Department of the Treasury or state limitations on the size of the bond issued in relation to the surplus of the surety. *See e.g. Turner Construction Co. v. Seaboard Surety*, 447 N.Y.S. 2d 930 (S.C.App. Div. 1982)

[2]. *Reinsurance*, edited by Robert W. Strain, College of Insurance (1980) [hereinafter *Strain*] at 651defines a cut-through endorsement as:

> An addition to an insurance policy between an insurance company and a policyholder which requires that, in the event of the company's insolvency, any part of a loss covered by reinsurance be paid directly to the policyholder by the reinsurer. The cut-through endorsement is so named because it provides that the reinsurance claim payment "cuts through" the usual route of payment from reinsured company-to-policy holder and then reinsurer-to-policyholder. The effect

> is to revise the route of payment only, and there is no intended increased risk to the reinsurer.

Although *Strain* characterizes the cut-through as an endorsement to a policy, it may also take the form of a clause in the reinsurance contract or both. *See* Section III, *infra.*

[3]. *Strain* at 654 defines a guarantee endorsement as:

> An addition to an insurance policy (between an insurance company and a policyholder covering the policyholder's mortgaged property) which requires that, in the event of the company's insolvency, the mortgagee and/or the policyholder be paid directly by the reinsurer either for any loss covered by reinsurance or (as is often provided) for the full insurance protection afforded by the insurance company. Since the full insurance protection afforded by the insurance company may be above the reinsurance which would be payable to a reinsured company, the reinsurer may be assuming an additional risk in such an endorsement.

Although *Strain* characterizes the guarantee as an endorsement to the policy, it may take the form of a clause in the reinsurance contract or both. *See* Section III, *infra.*

[4]. 751 F.2d 962 (8thCir.1985).

[5] . Statutes / Regulations Relating to Cut-Throughs, *Compendium of State Laws & Regulations*, Reinsurance Association of America (1998). This is part of a 50-state summary of various state statutes related to reinsurance which is marketed by the Reinsurance Association of America in Washington, D.C. The Reinsurance Association of America actively lobbies to include language in credit for reinsurance and receivership statutes to ensure that these laws do not leave a reinsurer open to double payments.

[6] . *See also,* Frederick J. Pomerantz, *A Fresh Look at Cut-Throughs*, Best's Review, April 1986, at 50: "Because only large institutions have the bargaining power to demand cut-throughs, their practical effect is to discriminate against individual insureds and small institutions."

[7] . While payment of reinsurance proceeds "without diminution" is a statutory condition for credit for reinsurance, this cannot properly be characterized as a statutory obligation since the parties to the reinsurance transaction may choose not to use an insolvency clause and to forgo credit for reinsurance. However, many receivership laws contain provisions requiring the

payment of reinsurance proceeds to the receiver without explicitly recognizing the cut-throughs and guarantee exceptions contained in the state's credit for reinsurance law.

[8] . *See* discussion of *Ainsworth v. General Reinsurance Corp.* in section III, *supra.*

[9] . These reasons include: (a) a reluctance to raise an issue which suggests lack of financial wherewithal on the part of the cedent; (b) perceived lack of commercial expertise among regulators; (c) the esoteric nature of the issue and the lack of law on point makes the response a lottery; and (d) fear of getting an answer that the cedent and/or the reinsurer do not want.

[10] . *See* note 5, *supra.*

[11] . *See* T. Darrington Semple, Jr. and Robert M. Hall, *The Reinsurer's Liability in the Event of the Insolvency of a Ceding Property and Casualty Insurer*, 21 Tort & Ins. L. J. (1986) at 413 - 417.

[12] . 780 F.Supp. 148 (S.D.N.Y.1991)

[13]. 1992 WL 350838 (S.D.N.Y.).

[14]. 591 N.Y.S.2d 1015 (1992).

[15]. 1983 WL 204211 (P.R.)

[16]. *See* note 5, *supra.*