DRAWING DOWN LETTERS OF CREDIT

IN AN INSURER RECEIVERSHIP CONTEXT

By

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Introduction

Statistics compiled by the Reinsurance Association of American demonstrate that over 40% of the reinsurance ceded by U.S. domiciled insurers to non-affiliates goes to non-U.S. reinsurers.[1] Under U.S. credit for reinsurance laws, a ceding company cannot take credit for reinsurance ceded to an unlicenced or unaccredited reinsurer unless the reinsurer posts security, which often takes the form of a letter of credit. The letter of credit is designed to provide the cedent with a remedy if the reinsurer, due to insolvency or other reason, fails to pay its obligations when due. Nonetheless, there is a lack of clarity in case law, reinsurance contracts and business practice as to the precise rights of the parties with respect to letters of credit, particularly in the receivership context. The purpose of this article is to explore the regulatory, receivership and business issues involved in letter of credit drawn down when one of the parties to the reinsurance contract is in receivership.

U.S. Credit for Reinsurance Clauses

In order to determine the circumstances under which a cedent may take credit on its financial statements for reinsurance recoverables, every state has enacted credit for reinsurance laws. The purpose of these laws is to allow financial statement credit only if there are reasonable assurances that the reinsurer will pay losses when due. In general, credit is granted if the reinsurer is licensed or accredited[2] in the cedent's state of domicile or if the reinsurer posts security in the form of assets in trust or a letter of credit, in an amount equal to the credit taken.

Letters of credit usually must be "clean", irrevocable and "evergreen" and be issued or confirmed by a financial institution meeting the standards stated in relevant state laws and regulations. A letter of credit must be "clean" in the sense that there can be no conditions on the ability of the cedent to draw it down. For instance, the cedent cannot be required to prevail over the reinsurer in an arbitration before drawing down on the letter of credit.

The letter of credit must be irrevocable in the sense that it cannot be terminated before its stated expiration date. Finally, the letter of credit must be "evergreen" meaning that it must continue unless the financial institution which issued or confirmed the letter of credit gives advance notice that it will not be renewed when its term expires. In essence, credit for reinsurance laws require that the letter of credit be the functional equivalent of cash.

The purpose of requiring a clean, irrevocable and evergreen letter of credit is to put funds in the hands of the cedent while a dispute between the parties to the reinsurance contract is being resolved. The purpose is not to resolve the merits of such a dispute through the liquidity of the security device.

Credit for reinsurance laws sometimes address the use that can be made of the funds that are realized by a draw on a letter of credit. For instance, Illinois and New York stipulate that the reinsurance contract provide that such funds may be used to reimburse the cedent for return premium, paid losses and other amounts which the cedent claims to be due under the reinsurance contract or to fund an account under control of the cedent which may include sums equivalent to unearned premium and loss reserves, including IBNR.[3] Other states make such contractual provisions optional[4] or have no equivalent requirements.[5] Some states allow contractual provisions which require the cedent to pay interest on funds drawn down or to return funds in excess of those needed to pay the debts for which the letter or credit can be drawn upon.[6] The considerable variation in state credit for reinsurance laws detract from their ability to resolve disputes over letters of credit.

Funding Clauses in U.S. Reinsurance Contracts

The considerable variation in state credit for reinsurance laws is exceeded only by the variation in the funding clauses by which letters of credit are required for reinsurers which are unlicenced or unaccredited in the necessary states. Some clauses match the more recent variations in state law concerning use of funds drawn down, payment of interest and refunding excess draw downs.[7] However, the clauses which are receiving scrutiny in current disputes often were drafted many years ago, before specificity in use of funds was required. Such clauses may provide little if any guidance on the circumstances under which the letter or credit can be drawn upon and the use of the funds which result.[8]

Business Issues in a Receivership Context

Rightly or wrongly, reinsurance contracts usually are negotiated with the assumption that the parties thereto will remain solvent. When this proves to be untrue, the solvent party faces issues that may not be addressed in the reinsurance contract and for which it may be ill-prepared to deal. Often, the solvent party may find itself in a race to secure its position in respect to creditors represented by the receiver.

When the Reinsurer is Insolvent

When a reinsurer is in or approaching receivership, the cedent faces difficult decisions. By definition, an insolvent reinsurer cannot pay all of its obligations. If the reinsurer is domiciled in the United States, the cedent is a general creditor of the estate and may receive nothing after obligations are paid to higher priority creditors.

It is the practice of some receivers of reinsurers to continue, but not increase, letters of credit. It may be difficult, however, for the cedent to obtain sufficient assurances in this regard. A bank may be reluctant to renew a letter of credit and the assets supporting the letter of credit may become a target for other creditors or may be used to pay higher priority creditors. If the letter of credit is not renewed or is not increased to meet reserve development, the liabilities unsecured will be a direct reduction to the cedent's surplus. Under these circumstances, there is an incentive for the cedent to draw down the letter of credit and use the proceeds, and interest thereon, to pay its own losses. Given the liquid nature of the letter of credit, a cedent has the power to draw down the letter regardless of its contractual right to do so.

Recognizing the vulnerability of the estate to precipitous draw downs of letters of credit, it is possible that the receiver would include in the liquidation order a limitation or prohibition on letter of credit draw downs.[9] It is possible that such a limitation or prohibition would render the letter of credit "unclean" in that there is an impediment to draw down. This would cause the cedent to be unable to reduce its liabilities by the amount of the letter of credit.

When the Cedent is Insolvent

If the cedent becomes insolvent, a reinsurer which has posted a letter of credit faces a less difficult issue namely, whether to maintain and increase, as may be necessary, the letter of credit. A reinsurer typically pays a fee for the issuance of a letter of credit and assets are sometimes encumbered to secure the reinsurer's obligation to reimburse the issuing bank for any draws on the letter of credit.

Declining to renew a letter of credit securing obligations to an insolvent cedent is sometimes justified by funding clauses in the reinsurance agreement which link the obligation to provide the letter of credit with statutory accounting requirements for solvency.[10] If the cedent is insolvent, the theory goes, a letter of credit is superfluous since financial statement credit is of little value at that point. However, this theory requires a reading of credit for reinsurance laws as requiring security merely for accounting purposes but not to provide assurance that reinsurance payables will be forthcoming when due.

A notice of non-renewal of a letter of credit issued on behalf of a reinsurer to a company in receivership encourages retaliatory action. The receiver may draw down the entire amount of the letter of credit when the receiver receives notice of non-renewal.[11] In addition, the receiver may seek language in the liquidation order prohibiting reinsurers from non-renewing letters of credit when balances or reserves remain outstanding.

Legal Issues

The posting and drawing down of letters of credit raise a number of legal issues in the receivership process.

Solvent Reinsurer's Letter of Credit

When the cedent is insolvent and the reinsurer declines to increase or renew a letter of credit, the cedent may seek a remedy for breach of contract in the liquidation court or through an arbitration. Practically, however, it may be uneconomical to bring such an action until the reinsurer has actually defaulted on its obligations to pay claims. In addition, the reinsurer may dispute the receiver's calculation of the reserves to be secured on the basis that there must be a creditable foundation for these reserves. Since this may lead to extensive inquiry into the receiver's claim handling and reserving practices, the receiver might wish to bring an action against such a reinsurer only once he or she has developed sufficient familiarity with the loss portfolio and its development.

Solvent Cedent Drawing Down Letter of Credit

When the reinsurer is in receivership, the rights of the parties are fact intensive in terms of the reinsurance contract. Some older funding clauses[12] merely require security but do not structure how it might be drawn upon or held. Reinsurance is a contract of indemnity meaning that the reinsurer has no liability until the cedent pays a claim or it is allowed in a receivership proceeding.[13] Assuming that the reinsurance contract calls for indemnity for paid claims, it can be argued that under such an older funding clause the cedent has the right merely to draw down on the amount in default and cannot draw down the entire letter of credit to fund outstanding reserves, including IBNR.

Some of the more modern credit for reinsurance laws[14] require reinsurance contracts to contain language which permits the cedent to draw on the letter of credit to create a fund equal to unearned premium, claims, reserves and IBNR which, in the normal course of events, would equal the entire letter of credit. However, this language may not be reflected in reinsurance contracts because they preceded enactment of the law or for some other reason. It might be argued that the language of the more modern laws should be read into reinsurance contracts, however, the philosophy of credit for reinsurance laws is that the parties may comply with such laws and receive credit or not comply and forgo credit, as they see fit. Even if the language of such statutes were read into reinsurance contracts, it is not clear how they would apply to upward development of losses which might be paid by interest on the funds produced by a letter of credit draw down.

The more modern funding clauses contain language which matches the requirements of the more modern credit for reinsurance law, however, there remains uncertainty in how certain facts situations should be addressed. For instance, funding clause 55 A[15] appearing in the *Contract Wording Reference Book* of the Broker and Reinsurer Marketing Association allows the cedent to draw on the letter of credit to fund an account for the "reinsurer's obligations" and that interest on such account "shall accrue to the reinsurer." It is not clear whether the interest which accrues is paid to the reinsurer or is retained to meet the reinsurer's obligation to pay development on the cedent's losses.

Setoff

If contractual authority is questionable, setoff is an argument which might be used to support a letter of credit draw down in excess of paid or allowed claims by: (a) a solvent cedent who doubts the ability or will of a receiver of a reinsurer to maintain or increase the letter of credit; or (b) an insolvent cedent that similarly doubts the ability or will of the reinsurer to maintain security or that wishes to maximize the investment income of the estate. It can be argued that the cedent should be able to set off the funds drawn down and/or interest thereon against future claim development.

For setoff to apply, the debts between the reinsurer and the cedent must be mutual in terms of capacity and time.[16] Mutuality of time requires that the debts to be set off be both pre-receivership or post-receivership and prevailing case law holds that subsequent reporting and development of losses under reinsurance contracts in effect prior to the receivership order are pre-liquidation debts.[17] Thus, to achieve the required mutuality of time, the right to draw down and set off funds and/or interest must arise out of a pre-receivership reinsurance contract.

To meet the mutuality of capacity requirement, the parties must be acting in the same capacity *i.e.,* contracting principles. For instance, salvage recoveries in the hands of a cedent are held in a fiduciary capacity for the reinsurer and may not be set off against funds due from the reinsurer as a contracting principle.[18] More to the point, a cedent who wrongfully draws down a letter of credit becomes a constructive trustee and may not use such funds to set off reinsurance recoverables since the proceeds are not rightfully in the cedent's possession.[19]

In this particular situation it appears that the tests for mutuality of time and capacity are functionally the same *i.e.,* whether the right to draw down and set off the proceeds and/or interest are embodied in the reinsurance contract. If the cedent merely used the liquid nature of the letter of credit to obtain control of the funds without a contractual basis, there would be no mutuality of capacity or time. As a result, setoff appears to be a false issue since it reflects merely the outcome of the underlying contractual issue.

Preferences

A solvent cedent may realize a substantial benefit, in relation to other creditors, if it draws down the entire proceeds of a letter of credit issued on behalf of a company in receivership when a smaller amount is due or when the cedent retains interest on the funds drawn down. It appears, however, that such a draw down cannot be avoided as a statutory preference since this requires a transfer of property prior to the receivership.[20] However, it can be argued that the pre-receivership issuance of a letter of credit to a cedent or providing collateral to a bank to support a letter of credit is a voidable preference if the receiver can show a lack of contemporaneous consideration or knowledge that the reinsurer was insolvent at the time the letter of credit was issued.[21]

In addition, the draw down of a letter of credit may run afoul of other prohibitions against preferences, such as liquidation orders or post liquidation orders. Liquidation orders are designed to preserve assets for a proper distribution to creditors and commonly prohibit preferences to certain creditors over others. For instance, the liquidation order for Crown Casualty Company, an Illinois domestic, provides in part: "That all persons, companies and entities are hereby restrained and enjoined . . . from asserting or enforcing preferences . . . against the defendant, Crown or its property and assets . . . ." More specifically, the order provides: "That the rights and liabilities of Crown, and its policyholders, creditors, and stockholders, and of all other persons interested in Crown's property of assets are hereby fixed as of the date of the entry of this Order of Liquidation . . . ." This language could be interpreted to prohibit a cedent from retaining the excess portion of a draw down or interest thereon. A liquidator may also seek a post liquidation order more specifically focused on letter of credit draw downs.

In addition, priority of distribution provisions in liquidation codes provide for payment of estate assets in accordance with a hierarchy of creditors. All claims in one class much be paid before claims can be paid to the next class.[22] Ceding insurers, usually, are general creditors which receive assets after expenses and policyholder and guaranty fund claims are paid. As a result, retention of an excess draw down on a letter of credit, or interest thereon, can be viewed as a violation of the priority of distribution of estate assets.

Conclusion

A letter of credit issued on behalf of unlicenced reinsurers is a convenient means of securing reinsurance recoverables and obtaining financial statement credit for the reinsurance provided. When a receivership occurs, solvent or insolvent cedents have unfortunate but understandable motivations to draw down the entire letter of credit as a hedge against future development of losses and possible non-renewal of the letter of credit. A solvent reinsurer must resort to its rights under the contract when such a draw down occurs, however, an insolvent reinsurer may have an additional tool to prevent or limit draw downs pursuant to court order.

The more modern credit for reinsurance laws and regulations, and their contractual counterparts, provide additional structure to the use of funds drawn down. However, additional issues remain that have not been resolved, such as interest on funds drawn down in excess of paid losses. It appears that such issues must be resolved in the receivership context through interpretation of contractual intent and the preferential impact on certain creditors over others.

ENDNOTES

[1]. The Reinsurance Association of America periodically publishes *Alien Reinsurance in the U.S.* which is an analysis of reinsurance ceded to non-U.S. reinsurers using annual statement data. The last such study was based on 1996 data. It states that between 1992 and 1996 the percentage of reinsurance ceded to non-U.S. reinsurers varied from a low of 41.6% to a high of 42.4%.

[2]. In general, a reinsurer may become accredited if it is licensed in at least one state, possesses a minimum capitalization level, files financial statements with the insurance department and submits to jurisdiction and examination.

[3]. Illinois Register Title 50 Section 1104.80(i); N.Y. Comp. Codes Rules & Regulations Title 11 section 79.5(a). The Illinois regulation reads in part:

i.) Reinsurance Agreement Provisions

1. The reinsurance agreement in conjunction with which the letter of credit is obtained must contain provisions which:

A. Require the assuming insurer to provide letters of credit to the ceding insurer and specify what they are to cover.

B. Stipulate that the assuming insurer and ceding insurer agree that the letter of credit provided by the assuming insurer pursuant to the provisions of the reinsurance agreement may be drawn upon at any time, notwithstanding any other provisions in the agreement, and be utilized by the ceding insurer or its successors in interest only for one or more of the following reasons:

i. To reimburse the ceding insurer for the assuming insurer's share of premiums returned to the owners of policies reinsured under the reinsurance agreement on account of cancellations of such policies;

ii. To reimburse the ceding insurer for the assuming insurer's share of surrenders and benefits or losses paid by the ceding insurer under the terms and provisions of the policies reinsured under the reinsurance agreement;

iii. To fund an account with the ceding insurer in an amount at least equal to the deduction, for reinsurance ceded, from the ceding insurer's liabilities for policies ceded under the agreement. The amount shall include, but not be limited to, amounts for policy reserves, claims and losses incurred (including losses incurred but not reported) and unearned premium reserves;

iv. To pay any other amounts the ceding insurer claims are due under the reinsurance agreement; and

v. To pay existing liabilities between the insurer and the reinsurer upon commutation of one or more reinsurance contracts.

C. All of the foregoing provisions of subsection (i)(1) above should be applied without diminution because of the insolvency on the part of the ceding insurer or assuming reinsurer.

2. Nothing contained in subsection (i)(1) above shall preclude the ceding insurer and assuming insurer from providing for:

A. An interest payment, at a rate not in excess of the prime rate of interest, on the amounts held pursuant to subsection (i)(1)(B)(iii) above; and/or

B. The return of any amounts draw down on the letters of credit in excess of the actual amounts required for the above or, in the case of subsection (i)(1)(B)(iv) above, any amounts that are subsequently determined not to be due.

[4]. *See* Florida Administrative Code Title 4 Rule 4-144.005(6).

[5]. *See* Pennsylvania Regulations Title 31 Section 163.16.

[6]. *See* Illinois Register Title 50 Section 1104.80(i) and N.Y. Comp. Codes Rules and Regulations Title 11 section 79.5(b). *See* text of the Illinois regulation in endnote 3, *supra.*

[7]. *See* the various "Unauthorized Reinsurance" clauses contained the *Contract Wording Reference Book* issued by the Broker & Reinsurer Marketing Association. Clause 55 A reads as follows:

> As regards policies or bonds issued by the Company coming within the scope of this Contract, the Company agrees that when it shall file with the insurance regulatory authority or sets up on its books reserves for unearned premium and losses covered hereunder which it shall be required by law to set up, it will forward to the Reinsurer a statement showing the proportion of such reserves which is applicable to the Reinsurer. The Reinsurer hereby agrees to fund such reserves in respect of unearned premium, known outstanding losses that have been reported to the Reinsurer and allocated loss adjustment expense relating thereto, losses and allocated loss adjustment expense paid by the Company but not recovered from the Reinsurer, plus reserves for losses incurred but not

reported, as shown in the statement prepared by the Company (hereinafter referred to as "Reinsurer's Obligations") by funds withheld, cash advances or a Letter of Credit. The Reinsurer shall have the option of determining the method of funding provided it is acceptable to the insurance regulatory authorities having jurisdiction over the Company's reserves.

When funding by a Letter of Credit, the Reinsurer agrees to apply for and secure timely delivery to the Company of a clean, irrevocable and unconditional Letter of Credit issued by a bank and containing provisions acceptable to the insurance regulatory authorities having jurisdiction over the Company's reserves in an amount equal to the Reinsurer's proportion of said reserves. Such Letter of Credit shall be issued for a period of not less than one year, and shall be automatically extended for one year from its date of expiration or any future expiration date unless thirty (30) days (sixty (60) days where required by insurance regulatory authorities) prior to any expiration date the issuing bank shall notify the Company by certified or registered mail that the issuing bank elects not to consider the Letter of Credit extended for any additional period.

The Reinsurer and Company agree that the Letters of Credit provided by the Reinsurer pursuant to the provisions of this Contract may be drawn upon at any time, notwithstanding any other provision of this Contract, and be utilized by the Company or any successor, by operation of law, of the Company including, without limitation, any liquidator, rehabilitator, receiver or conservator of the Company for the following purposes, unless otherwise provided for in a separate Trust Agreement:

(a) to reimburse the Company for the Reinsurer's Obligations, the payment of which is due under the terms of this Contract and which has not been otherwise paid;

(b) to make refund of any sum which is in excess of the actual amount required to pay the Reinsurer's Obligations under this Contract;

(c) to fund an account with the Company for the Reinsurer's Obligations. Such cash deposit shall be held in an interest bearing account separate from the Company's other assets, and interest thereon not in excess of the prime rate shall accrue to the benefit of the Reinsurer;

(d) to pay the Reinsurer's share of any other amounts the Company claims are due under this Contract.

In the event the amount drawn by the Company on any Letter of Credit is in excess of the actual amount required for (a) or (c), or in the case of (d), the actual amount determined to be due, the Company shall promptly return to the Reinsurer the excess amount so drawn. All of the foregoing shall be applied without diminution because of insolvency on the part of the Company or the Reinsurer.

> The issuing bank shall have no responsibility whatsoever in connection with the propriety of withdrawals made by the Company or the disposition of funds withdrawn, except to ensure that withdrawals are made only upon the order of properly authorized representatives of the Company.
>
> At annual intervals, or more frequently as agreed but never more frequently than quarterly, the Company shall prepare a specific statement of the Reinsurer's Obligations, for the sole purpose of amending the Letter of Credit, in the following manner:
>
> (a) If the statement shows that the Reinsurer's Obligations exceed the balance of credit as of the statement date, the Reinsurer shall, within thirty (30) days after receipt of notice of such excess, secure delivery to the Company of an amendment to the Letter of Credit increasing the amount of credit by the amount of such difference.
>
> (b) If, however, the statement shows that the Reinsurer's Obligations are less than the balance of credit as of the statement date, the Company shall, within thirty (30) days after receipt of written request from the Reinsurer, release such excess credit by agreeing to secure an amendment to the Letter of Credit reducing the amount of credit available by the amount of such excess credit.

[8]. A funding clause used for cessions to the London Market in the mid-1970's reads in pertinent part as follows:

> If the retrocessionaire is unauthorized in any state of the United States of America or the District of Columbia where authorization is required by insurance regulatory authorities, the retrocessionaire will fund (provided particulars are received forty-five days prior to the date funding is required by the company) outstanding losses by either cash advances, escrow accounts for the benefit of the company, letters of credit, or a combination thereof if a penalty would accrue to the company on its statement without such funding. The retrocessionaire shall have the sole option of determining the method of funding referred to above provided it is acceptable to the insurance regulatory authorities involved.

[9]. While the author is unaware of such language in state liquidation orders, there is precedent in proceedings pursuant to section 304 of the U.S. Bankruptcy code which protects the U.S. assets of insolvent non-U.S. insurers. For instance, the court issued a section 304 order with respect to North Atlantic Insurance Company "[enjoining all persons from drawing down any letter of credit established by, or at the request of North Atlantic, . . .

[10]. *See* endnote 8, *supra*.

[11]. *See Superintendent of Insurance of New York v. Harbor Assurance Co. of Bermuda, Ltd.,* 659 N.Y.S. 273 (Sup.Ct.App.Div. 1997) in which a reinsurer gave notice of cancellation of a treaty on December 4th effective December 31st. The cedent requested renewal of the letter of credit and, it appears, the reinsurer declined. The cedent was placed in rehabilitation on December 24th and the rehabilitator drew down the letter of credit on December 27th.

[12]. *See*, *e.g.*, endnote 8, *supra.*

[13]. *Fidelity & Deposit v. Pink,* 302 U.S. 224 (1937); 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,* Tort & Ins. Law J. No. 3, 407, 408 (1986) (hereinafter *Semple and Hall).*

[14]. *See* endnote 3, *supra.*

[15]. *See* endnote 7, *supra.*

[16]. *Semple and Hall* at 421-2.

[17]. *See, e.g., Stamp v. Ins. Co. of N. America*, 908 F.2d 1375, 1380 (7th Cir. 1990).

[18]. *In re Consol. Indem.,* 38 N.E.2d 119 (N.Y. 1941); *Pink v. Am. Surety Co.,* 28 N.E.2nd 842 (N.Y. 1940).

[19]. *Lines v. Bank of Amer. Nat'l Trust & Sav. Ass'n,* 743 F. Supp. 176 (S.D. N.Y. 1990) at 181-2.

[20]. For instance, section 32 of the NAIC's Insurer Rehabilitation and Liquidation Model Act defines it as a transfer of property "within one year before a successful petition for liquidation . . . ." Section 605 of the Interstate Company Uniform Receivership Law defines a preference as a transfer of property "made or suffered within two years preceding the filing of a successful petition for rehabilitation or liquidation . . . ."

[21]. *Pine Top Ins. Co. v. Bank of America*, 969 F.2d 321 (7thCir.1992); *Pine Top Ins. Co. v. Century Indemnity Co.*, 123 B.R. 287 (N.D.Ill.1990); *Pine Top Ins. Co. v. Republic Western Ins. Co.*, 123 B.R. 277 (N.D.Ill.1990).

[22]. Section 46 of the NAIC Insurers Liquidation and Rehabilitation Model Act states: "[e]very claim in each class shall be paid in full or adequate funds retained for such payment before the members of the next class receive any payment." Section 713 of the Interstate Compact Uniform Receivership Law is virtually identical.