Clarifying the Insolvency Clause Trade-Off

by

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I. Introduction

For many years, a form of "insolvency clause" has been required in reinsurance contracts for the cedent to take credit for the reinsurance in its financial statements.[1] In such clauses, the reinsurer agrees to pay claims "without diminution" due to the insolvency of the cedent. Stated more clearly, this means that the reinsurer cannot require that the cedent pay the claim first before collecting reinsurance which is typical with indemnity reinsurance. The trade-off, however, is that the clause typically requires the receiver of the cedent to give the reinsurer notice of the claim filed with the estate within a reasonable time and provide an opportunity to investigate the claim and interpose defenses.

The "without diminution" portion of the insolvency clause has been thoroughly explored in case law often involving set off of debts and credits between the insolvent cedent and its reinsurer.[2] The remainder of the insolvency clause, dealing with the reinsurer's rights, has been the subject of little case law. However, considerable clarification is provided by the recent case *In the Matter of the Liquidation of Midland Ins. Co.*, 856 N.Y.S.2d 498 (Sup.Ct. 2008).[3] The purpose of this article is to review the reasoning and conclusions of the court with respect to the reinsurer's rights under the insolvency clause.[4]

II. The Insolvency Clause Language

Midland Insurance Company is being liquidated under the law of the state of New York. Insurance Law § 1308 (a)(3) provides that the insolvency clause:

> [M]ay provide that the liquidator . . . of an insolvent ceding insurer shall give written notice of the pendency of the claim . . . and that during the pendency of such claim any assuming insurer may investigate such claim and interpose, at its own expense, in the proceeding where such claims is to be adjudicated any defenses which it deems available to the ceding company, it liquidator, receiver or statutory successor.

Everest Reinsurance Company (hereinafter "Everest") provided treaty and facultative reinsurance containing compatible language in the insolvency clauses. For instance, the treaty provisions stated:

> In the event of the insolvency of the reinsured Company [Midland], this reinsurance will be payable directly to the Company, or to its liquidator, receiver, conservator or statutory successor on the basis of the liability of the Company without diminution because of the insolvency of the Company or because the liquidator . . . has failed to pay all or a portion of any claim. It is agreed however, that the liquidator . . . shall give written notice to the Reinsurer of the pendency of a claim against the Company indicated [*sic*] the policy or bond reinsured which claim would involve a possible liability on the part of the Reinsurer within a reasonable time after such claim is filed in the liquidation proceeding . . . , and that during the pendency of a [*sic*] such claim, the Reinsurer may investigate such claims and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defense or defenses that it may deem available to the Company or their [sic] liquidator . . . . The expense thus incurred by the Reinsurer shall be chargeable, subject to the approval of the court against the Company as part of the expense o[f] conservation or liquidation to the extent of a prorata share of the benefit which may accrue to the Company solely as a result of the defense undertaken by the Reinsurer.[5]

III. Nature of the Action

As is typical with insurance company liquidations, the receivership court issued an anti-suit injunction prohibiting any suit or other proceeding against the estate:

> [C]laimants, plaintiffs, and petitioners who have claims against Midland are permanently enjoined and restrained from bringing or further prosecuting any action at law, suit in equity special proceeding against the said corporation or its estate, or the Superintendent . . . , as Liquidator thereof, . . . from in any way interfering with the Superintendent, . . . in the discharge of his duties as Liquidator thereof, ...[6]

Everest Re sought to lift this injunction so that it could sue for breach of the reinsurance contracts and for injunctive relief on the bases that:

> [T]he Liquidator (standing in the shoes of Midland) did not provide Everest with timely notice of claims that would trigger Everest's reinsurance obligations; denied Everest the opportunity to participate in the defense and settlement of claims; did not provide information about claims as it requested; and did not provide access to Midland's records. Everest seeks a judgment declaring that it is not required to indemnify Midland as [a] result of those alleged breaches, and Everest seeks a permanent injunction restraining the Liquidator from engaging in any settlement negotiations for claims, unless Everest is given an opportunity to

have meaningful access to Midland's records and to participate in those settlement negotiations.[7]

This was a very ambitious effort given that it would stop the liquidator's claim allowance and payment efforts in its tracks, at least with respect to those claims reinsured by Everest.

IV. Impact on Reinsurers of Claim Allowance Procedure

Midland was placed in liquidation in 1986. In 1997, the receivership court adopted a procedure for allowance of claims. The procedure called for the liquidator to notify the claimant of the recommended disposition of the claim. The claimant could object to this disposition and the objection was heard by a referee. Once that procedure was finished, the liquidator would make an *ex parte* (*i.e.* without notice to reinsurers) recommendation to the court which would rule on the recommendation. Under these procedures, reinsurers had no notice of or involvement in the allowance or approval of claims they would have to pay.[8]

In October of 2005, the liquidator determined that the estate was in a condition to make distributions to class 2 creditors *i.e.* policyholder-related claims and those of guaranty associations. Also in that year, the liquidation bureau began notifying reinsurers of claims that might impact their coverage and after allowing a claim, sent notice to reinsurers giving them 30 days to intervene and assert defenses.[9] As a result, these informal notification procedures went beyond the formal procedures ordered by the court in terms of fulfillment of the liquidator's obligations under the insolvency clause.

V. Court Ruling on Everest's Motion

The idea of lifting an anti-suit injunction with respect to an insurer in liquidation is a very serious matter indeed. The liquidator would be buried by suits, and thereafter default judgments, before the estate could be put in order, assets marshaled and claims reviewed. Absent the most extreme circumstances, a receivership court would be very unlikely to do so. Stated differently, Everest faced long odds on its motion.

Nonetheless, the court articulated the standard tests to lift an injunction, namely "a likelihood of success on the merits, irreparable harm absent the relief or absent an adequate remedy at law and the balancing of the equities in the movant's favor."[10] More specifically, "Everest must demonstrate by a preponderance of the evidence that the facts show a likelihood that its reinsurance contracts were breached and that it suffered actual injury."[11]

A. Inadequate Notice

Everest claimed that the liquidator violated the contractual obligation to provide notice of claims "within a reasonable time by failing to give notice of filed claims for 15 years. This lack of timely notice, Everest claimed, deprived it of the ability to post proper reserves and participate in the investigation and defense of claims.[12]

The liquidator countered that "timeliness" is measured from an indication that the claim would involve reinsurers. The liquidator started assessing reinsurer impact in 2004 and reported to reinsurers in 2005 thus giving them several years to investigate. In any case, the liquidator argued, the reinsurers are notified of allowed claims 30 days before they are submitted to the court for approval.[13]

The court acknowledged that Everest's contractual rights might be impaired by late notice but found that a single lawsuit was not a proper vehicle to make fact-specific determinations on multiple claims. The court found that Everest had not yet demonstrated sufficient prejudice resulting from any late notice to justify adjudicating the issue in a single proceeding. Signaling its ultimate direction, the court observed that the answer to the problem of late notice and inability to investigate is to provide reinsurers with additional time to review and investigate prior to submitting claims to the court for approval.[14]

B. Inadequate Access to Records

Everest's contracts contained clauses requiring Midland to provide free access to books and records at all reasonable times. The liquidator acknowledged Everest's right to access records but the parties disputed the reasonableness of the scope and duration of the request for access (which seemed unusual if accurately characterized in the opinion). The court found that Everest had demonstrated neither prejudice from any lack of access to records nor a likelihood of success in proving that Everest denied access to records at reasonable times.[15]

C. Inadequate Association in Defense and Control of Claims

A limited number of facultative certificates contained language allowing Everest to "associate" with Midland in the "defense and control" of claims which might impact Everest's reinsurance. The liquidator contended that this amounted, merely, to a right to consult with and advise Midland and that, in any case, the "defense and control" language was superceded by the insolvency clause.

The court found that the insolvency clause did not supersede Everest's right to associate in the defense and control of claims. However, it also found that Everest had not yet demonstrated prejudice and for this reason, had not demonstrated likelihood that the liquidator had breached Everest's contractual right to associate.[16]

D. Inadequate Opportunity to Investigate and Interpose Defenses

At the outset of the examination of this topic, the court acknowledged that the insolvency clause in the relevant reinsurance contracts granted Everest the right to investigate claims and interpose defenses.[17] The liquidator contended that it could meet its obligations in this regard by providing Everest 60 days

notice after deciding to allow the claim and before submitting to the court for approval. However, such a procedure was insufficient for Everest:

> Everest wants the Liquidator to place it in a position where it can make a reasoned determination whether to investigate a claim or interpose a defense. Everest wants to participate in the handling and settlement of claims submitted to Midland and to raise and resolve coverage defenses that may exist. Everest believes that it is entitled to be involved in the Liquidator's decision-making process of whether to allow or disallow a claim, and to participate in the Liquidator's settlement negotiations with policyholders.[18]

The liquidator made the somewhat contrary arguments that: (1) the follow the settlements clause in the reinsurance contracts require Everest to accept the liquidator's claim allowances; and (2) Everest can raise defenses that the liquidator should have asserted in a collection action by the liquidator against Everest. The purpose of the first argument is to counteract the second.

The court steered a middle ground affirming Everest's contractual rights but cautioning that such rights did not give Everest "an all-encompassing" right to be involved in the liquidator's internal process of adjusting claims. Everest's right to interpose defenses does not "imply a right to negotiate or settle claims with policyholders."[19]

The court went further and identified the point in time at which Everest's interposition rights should be exercised:

> Thus, the only logical approach is to permit Everest and other reinsurers to exercise their contractual interposition rights after the Liquidator has allowed the claim, but prior to the Court's approval. This approach strikes a balance between the contractual, permissive right of a reinsurer granted under Insurance Law § 1308 (a)(3) with the intent of Article 74 of the Insurance Law to provide a uniform, efficient approach to liquidation proceedings, with finality to policyholders and creditors. This approach also ensures that the expense of interposing a defense is initially borne only by the reinsurer asserting it, as set forth in the insolvency clause. The Liquidator would not be placed into a position of having to decide which defenses to interpose if several reinsurers interpose different defenses. In adjudicating an interposed defense, the Court would have occasion to approve any application from a reinsurer to charge the expenses of interposing a defense to the insolvent estate, which is also permitted under the insolvency clause. Interposition rights to a claim are extinguished once the court has approved (and consequently adjudicated) a claim notwithstanding the fact that the liquidation proceeding is ongoing.[20]

E. Failure to Meet Standards for Lifting Injunction

The court emphasized that the estate was at the front end of approving claims that would impact Everest and that as a result, the adoption of an appropriate claim allowance procedure could avoid

damages to Everest. On this basis, the court found that Everest had not demonstrated a likelihood of success on the merits or the lack of an appropriate remedy if the anti-suit injunction was not lifted.

F. Revisions to Prior Order

The court found that the prior order concerning claim allowance by the liquidator and approval by the court (*see* § IV, *supra*) had to be altered to protect Everest's contractual rights:

> To give effect to the contractual interposition rights of Everest (and other similarly situated reinsurers), this Court is constrained to modify the procedures for judicial approval of allowed claims, to permit reinsurers to assert defenses available to Midland or to the Liquidator to any claim allowed by the Liquidator which is either partially or wholly reinsured, and to establish a process in which those defenses can be adjudicated as part of the judicial approval process, involving a hearing before a referee equivalent to that provided where an objection is filed to the Liquidator's disallowance of a claim. Otherwise, the Liquidator is placed in a position where compliance with Justice Cohen's order could result in a violation of Midland's reinsurance contracts, jeopardizing recovery.[21]

The court ordered the liquidator to formulate new rules and procedures and to recommend them to the court for review and approval.

VI. What did Everest Accomplish?

Everest failed in its initial goad to lift the anti-suit injunction and sue Midland's liquidator directly for breach of contract and for injunctive relief. However, this was an unlikely goal to achieve and, in any case, it was merely a means to a more important goal. This goal was the enforcement of rights given to reinsurers in the insolvency clause as a trade-off for not requiring the liquidator to pay claims before reinsurance is collected which is the proper procedure for indemnity reinsurance. Everest was successful in achieving this goal.

In general, the court affirmed the rights of reinsurers contained in the insolvency clause and that such rights are not subordinated to but must be read in conjunction with such matters as the right of the liquidator to control the claim approval process and follow the settlement rights and obligations. More specifically, the court affirmed the following rights:

- The reinsurer has the right to receive notice of claims pending in the receivership which impact the reinsurer in a sufficiently timely fashion for the reinsurer to protect its interests;
- For those contracts with a "defense and control " clause, the ability to exercise those rights at a time necessary for the reinsurer to protect its interests;
- Access to the liquidator's records at reasonably times;
- A reasonable time period for the reinsurer to review claims and interpose defenses before claims are submitted to the receivership court for approval.

For all of these reasons, this case brings significant clarity to the insolvency clause which is the primary contractual and statutory determinant of liquidator – reinsurer interaction.

ENDNOTES

[1] Insert cite to prior article.
[2] Insert cite to prior article.
[3] This version of the opinion bears the legend: "This opinion is uncorrected and will not be published in the printed official reports."
[4] The author thanks counsel for Everest Re, Vincent Proto of Budd Larner, P.C, for providing background and context for the decision.
[5] 856 N.Y.S.2d 498*12.
[6] *Id.**2-3.
[7] *Id.**4.
[8] *Id.**3-4.
[9] *Id.**14,17.
[10] *Id.**11.
[11] *Id.*
[12] *Id.**13-4.
[13] *Id.**14.
[14] *Id.**15.
[15] *Id.**16.
[16] *Id.*
[17] *Id.*
[18] *Id.**18 (internal citations omitted).
[19] *Id.**24.
[20] *Id.**25.
[21] *Id.**28.