WHEN CAN A RECEIVER IGNORE

PRIORITY OF DISTRIBUTION STATUTES?

By

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I. Introduction

On September 22, 2005, the Superior Court of New Hampshire handed down *In the Matter of the Liquidation of the Home Insurance Company* Docket No. 03-E-0106 which has been published in Mealey's Reinsurance Litigation Reports Vol. 16 Issue 11 (Oct. 6, 2005) at B-1. It is worthy of note since it has significant implications for both creditors and debtors of insolvent insurers.

The fact situation of this case is unusual and bears explanation. Home's UK branch was a reinsurer for the AFIA book of business. ACE reinsured Home 100% and agreed to administer the claims of Home's cedents. One of the AFIA cedents, Agrippina, had a clause in its reinsurance contract with Home which allowed Agrippina to cancel back to inception in the event that the Home became insolvent. In addition, the Home liquidation had an unusually long gestation period which allowed both debtors and creditors to obtain a much more precise understanding of the assets and liabilities of the estate than is usually the case.

By the time the facts of this case arose, it was evident that recoveries from ACE on the AFIA business had the potential to be a major asset in the estate. It was equally evident that the AFIA cedents, as general creditors under the New Hampshire priority of distribution statute, were unlikely to recover on their claims against the estate. As a result, the AFIA cedents told the receiver that absent a recovery from the estate outside the priority of distribution statute, that they would decline to file proofs of claim against the estate and/or would seek a cut-through to or other direct recovery from ACE. Failure to file proofs of claim meant that the receiver would be unable to collect reinsurance recoverables on such claims from ACE. As a result, the receiver agreed to pay 50% of the net proceeds of the recoveries from ACE (as much as $72 million[1]) to the AFIA cedents, thus bypassing creditors with a higher priority status.

The above cited decision was on remand from an earlier decision, dated April 24, 2004. The New Hampshire Supreme Court remand was for additional findings of fact. For purposes of this article, the two Superior Court decisions will be considered together.

The Superior Court ruled: (1) that payment of $72 million to AFIA cedents was a practical necessity in order to collect very significant assets due the estate since the AFIA cedents gave notice that they were not going to incur the significant time and expense necessary to file proofs of claim without some financial incentive; (2) there was a real possibility of side deals between the AFIA cedents and ACE which would deprive the estate of reinsurance recoverables; and (3) the receivership code grants the receiver broad power to preserve and collect assets. Each of these rulings will be examined below.

II. Assets of the Estate

The clear tone of the Superior Court was that technical defenses should not stand in the way of the receiver collecting significant assets of the estate. However, the reinsurance recoverables from ACE are not assets of the estate unless and until the estate becomes liable for matching liabilities from the AFIA cedents. Stated differently, the estate must incur substantial new liabilities before it can seek reinsurance recoverables. Even under the best of circumstances, [2] the net worth of the estate is not increased by the deal with AFIA cedents. The only real issue is the shift of assets and liabilities among classes of creditors and debtors.

III. Time and Expense of Proofs of Claim

While at American Re-Insurance Company from 1983 to 1995, I was very active in receivership matters. During the mid-1980's, I organized a team from the financial and law departments to determine the amounts due to and from insolvent cedents and retrocessionaires and to file proofs of claim against estates when appropriate. Since it was and is difficult to determine what assets will be available for distribution early in what may be a 20+ year estate, a policy decision was made to file proofs even when general creditor status might make recovery unlikely. This is not a difficult task to perform since normal retrocessional collection activity requires that the necessary information be available. Moreover, this information is required to be filed in Schedule F of a US insurer's financial statements.

Today, many insurers and reinsurers have entire departments devoted to runoff activities, which includes insolvencies and other discontinued operations. The upshot is that the AFIA cedents, if they so desired, could have produced the information necessary for proofs of claim against an estate in the ordinary course of business. They declined to do so for tactical reasons since it became evident that the receiver might be willing to pay them, outside the priority of distribution statute, for that which ceding insurers do routinely.

It is obvious that the $72 million paid to the AFIA cedents had no connection to the costs of filing proofs of loss in the estate. It was a partial settlement of the cedents' claims against the estate measured in terms of a percentage of the reinsurance recovered from ACE.

One must wonder whether in the future any cedent to an insolvent reinsurer will file a proof of claim without some financial incentive which will reduce the assets available for higher class creditors. With $72 million as the base line for routine proofs of claim, cedents now have a cash cow to offset their general creditor status.

IV. Possible Side Deals between ACE and AFIA Cedents

The treaty between ACE and the Home contained a standard insolvency clause *i.e.* that reinsurance recoverables on claims allowed in the receivership proceeding are paid to the receiver without diminution due to the insolvency. This contractual obligation is mirrored in receivership law in many states. There is no question in the reinsurance community that such clauses are effective as written. In fact, reinsurers usually prefer it so in order to avoid collateral claims for reinsurance recoverables by guaranty funds, insureds, claimants and other creditors.

One of the reasons why the import of the insolvency clause is settled law in the United States is *Ainsworth v. General Reinsurance Corp.*, 751 F. 2d 962 (8th Cir.1985). In this case, General Re had reinsured Medallion which had become insolvent. A third party had obtained a $485,000 verdict against a Medallion insured and a claim based thereon was made against the receiver and General Re. General Re settled the claim for $25,000 and obtained a release for itself and Medallion and the claim against the estate was withdrawn. Nonetheless, the receiver contended that General Re had no right to so reduce its obligations to the estate under the insolvency clause and the court agreed:

General Reinsurance would contend that because the direct settlement discharges the liability of the insurer, . . . and obviates any determination of a claim of liability in the insolvency proceeding, General's obligation is similarly discharged. We think the result contended for is inconsistent with the insolvency clause. It seems very clear that the payment has not been made directly to the Receiver, that the reinsurance has been diminished because of the insolvency, and the obligation of the reinsurer has ceased to be an asset of the insolvent estate.

Clearly, the reinsurer has the right to defend against a claim on its merits, but is not given a right to reduce its obligations by taking advantage of the willingness of the insured and the insured's oblige to take less because of the insolvency.[3]

Thus, any reinsurer which settles a claim with a claimant against an estate faces the possibility of paying the claim a second time to the estate pursuant to the insolvency clause. Obviously, reinsurers are loathe to do so.

The Superior Court noted evidence that the AFIA cedents might attempt some sort of side deal with ACE for direct payment, possibly in the form of a cut-through. Theoretically, this would allow the AFIA cedents to bypass the estate and to collect directly from ACE.[4] Cut-throughs are designed to give an insured prospective security with respect to a small or poorly rated insurer. Cut-throughs which change the rights and obligations of the parties long after losses have occurred cannot be effected without the agreement of all the relevant parties *i.e.* AFIA cedents, the Home and ACE.

Even prospective cut-throughs contain significant risk to reinsurers if the cedent becomes insolvent. The claimant can seek recovery for its loss pursuant to the cut-through and the receiver can seek recovery for the same loss under the insolvency clause and pursuant to *Ainsworth, supra*. Given this risk, ACE would have been foolhardy to negotiate a side deal with the AFIA cedents which did not have the receiver's approval. The bottom line: (a) AFIA cedents were posturing on the side deal in order to achieve compensation outside the priority of distribution statutes; and (b) ACE was seeking a commutation directly with the receiver which did not require the approval of the AFIA cedents.

V. Receiver Authority to Ignore Priority of Distribution Statutes

The Superior Court ruled that $72 million payment to the AFIA cedents to encourage them to file proofs of claim fell within the general powers of the liquidator enumerated in RSA 402-C:25. Among other things, this statute authorizes the liquidator to "do such other acts as are necessary or expedient to collect, conserve or protect its assets or property . . . upon such terms and conditions as he deems best . . . ." The court also ruled that this payment was within the definition of "administrative cost" for purposes of the priority of distribution statute RSA 402-C:44: "the actual and necessary costs of preserving or recovering the assets of the insurer; . . ."

A technical problem with this argument is that described in Section II, *supra.* The reinsurance recoverables are not assets of the estate until the proofs of claim are filed by the AFIA cedents and approved by the liquidation court. Even then, ACE might have defenses to the claims. *See* Endnote 2. Therefore, the receiver is paying $72 million for prospective or anticipated assets and not current assets.

However, the more substantive problem arises from the text of the priority of distribution statute itself. The first section of RSA 402-C-44 states:

The order of distribution of claims from the insurer's estate shall be as stated in this section. . . . [E]very claim in each class shall be paid in full . . . before the members of the next class receive any payment. No subclasses shall be established in any class.

ACE argues with substantial vigor that payment of $72 million to a small slice of general creditors to induce them to file proofs of claim: (a) deprives higher level creditors of assets due them under the priority of distribution statute; and (b) creates a subclass within the general creditor category and provides this subclass with special benefits not available to others. ACE further argues that general language concerning the powers of the liquidator cannot supersede the specific statutory structure given to the distribution of assets.

The Superior Court's answer to these arguments is that at the end of the day, there are more assets in the estate for policyholder claims. The problem with this sort of "end justifies the means" rationale is that it can subsume many if not most of the specific provisions of the receivership code. If, through some unusual factual twist of fate, it would produce more assets for policyholder claimants, could the receiver ignore voidable preferences and fraudulent transfers and allow non-mutual setoff? If the prime directive is more assets for the estate, why not allow the receiver to re-write contracts after the fact to increase assets and decrease liabilities? If receivership codes are meant to create a balance between the rights of debtors and creators, is an "end justifies the means" basis for a court decision of this magnitude an appropriate vehicle to achieve this balance?

VI. Conclusion

Based on the two decisions of the Superior Court in the Home receivership, the answer to the question posed by this article appears to be that a receiver can ignore a priority of distribution statute when to do so will benefit a favored group of creditors. Nonetheless, there are substantial issues to be posed to the Supreme Court on appeal concerning the need for the receiver to comply with a specific distribution statute and the problems presented by providing a windfall benefit of $72 million to a small slice of general creditors for filing routine proofs of claim in the Home estate.

ENDNOTES

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[1] The potential for a $72 million payment to the AFIA cedents was admitted by Peter Roth, counsel to the New Hampshire Insurance Commissioner, in oral argument before the New Hampshire Supreme Court on July 15, 2004. The Supreme Court remanded the case to the Superior Court.

[2] At oral argument before the Supreme Court, Gail Goering, counsel for ACE, argued that claims against ACE by the estate might be unenforceable due to their collusive nature.

[3] 751 F.2d 962 at 965.

[4] *See Cut-Throughs and Guarantee Endorsements*, X Mealey's Reins. Rpt. No. 21 at 18 (2000) which is also available at the author's website: robertmhall.com.