Are Cut-Through Clauses Enforceable?

By

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I. Introduction

Sophisticated insureds often have size and quality rating standards for their insurers. Sometimes, however, such insureds may be willing to accept insurers with lower ratings if: (1) such insurers are backed by large, quality reinsurers; and (2) such reinsurers are willing to allow the insured to "cut-through" and collect from the reinsurer if the ceding insurer becomes insolvent. However, there is a line of cases in which the courts have denied such a cut-through just when it is most needed – when the ceding insurer is insolvent.

These decisions may be the result of an inadequate understanding the history of cut-throughs and their interaction with receivership-related laws. The purpose of the article is to examine this history and the cases which do not reflect it

II. *Fidelity & Deposit Co. v. Pink,* 302 U.S. 224 (1937) and Its Aftermath

In this case, the ceding insurer was insolvent and its quota share reinsurer argued that since the reinsurance contract is one of indemnity, the reinsurer was not required to pay its portion of the loss until the cedent paid its portion. Unfortunately, the cedent was unable to do so due to its insolvency. The Supreme Court found for the reinsurer on the indemnity issue.

The "Pink" in this case was the Superintendent of Insurance in the state of New York. He devised a statutory remedy by requiring an "insolvency clause" in each reinsurance contract if the cedent wanted to take credit for the reinsurer in its financial statements – effectively a mandatory clause. The relevant statute required that the reinsurer pay claims "without diminution" because of the insolvency of the ceding company. However, through compromise, the statute recognized two exceptions: (a) where the contract specifically provides another payee of such reinsurance in the event of the insolvency of the ceding insurer (cut-through); and

(b) another insurer has assumed the obligations of the insolvent ceding insurer (assumption reinsurance).

The requirement for an insolvency clause, with these exceptions, currently appear in New York statute 13 § 1308 (a). Other states require an insolvency clause with these same exceptions or accept them *de facto* since such a clause is in universal use in the reinsurance industry. Thus, the cut-through exception is an express or *de facto* exception to the authority of state insurance company receivers to marshal the reinsurance recoverables of the cedent.[2]

III. Caselaw Adverse to Cut-Throughs

There is a line of cases adverse to cut-throughs on the basis that they undercut the ability of the receiver to marshal assets and control the receivership proceeding. These cases fail to recognize the cut-through clause as the contractual manifestation of a statutory exception to the requirement that reinsurers pay reinsurance payables to the receiver and no other entity. Perhaps this has become lost in the mists of reinsurance history.

When Mutual Fire, Marine and Inland Insurance Company ("Mutual Fire") was placed in rehabilitation by the Pennsylvania Insurance Department, a rehabilitation plan was adopted which impaired a variety of contractual rights (including cut-throughs) on the part of third parties. The Pennsylvania Supreme Court rejected challenges to the plan: "While this [impairment of contractual rights] may in fact be an accurate assessment of the consequences of the proposed rehabilitation, such an impairment is not a *per se* violation of law and . . . any actual impairments are insubstantial."[3]

Following the *Mutual Fire* case was *Colonial Penn Ins. Co. v. American Centennial Ins. Co.,* 1992 U.S. Dist. LEXIS 17552 (S.D.N.Y.) This involved a primary insurer, Colonial Penn, that ceded business to Mutual Fire and then obtained a cut-through to Mutual Fire's retrocessionaire. When Mutual Fire was put into rehabilitation, the Colonial Penn attempted to collect from the retrocessionaire. The Mutual Fire receiver objected on the basis that enforcement of the cut-through violated the rehabilitation plan. The district court declined to override the rehabilitation plan approved by the Pennsylvania courts:

> The Pennsylvania courts have addressed Colonial Penn's requests to limit the reach of the [Rehabilitation] Plan and refused to impose any limitations upon the

> Rehabilitator's ability to impair Colonial Penn's rights as third party beneficiary under the Treaties. This court should not enter such relief collaterally.[4]

Apparently, it was never argued that the cut-through was an express or *de facto* limitation on the authority of the receiver to marshal assets.

Performance bonds in Indiana were involved in *Cummings Wholesale Electric Co. v. Home Owners Insurance Co.*, 492 F.2d 268 (7th Cir. 1974). By statute, Indiana limited the size of the bond a surety could issue as a per centage of paid up capital, surplus and contingent reserves. However, this sum could be exceeded through reinsurance that gave a direct right of action against the reinsurer to the beneficiary of the bond. When the surety that issued the bond became insolvent, the beneficiary of the bond attempted to collect from the reinsurer. The court declined to enforce this statutory cut-through as it undercut the ability of the receiver to marshal assets and distribute them in an orderly fashion:

> While we agree with the claimants that [the statutory cut-through] accorded them a direct right of action against the insurer jointly with the reinsurers, we do not agree that the Indiana legislature intended to give them a preference over general creditors of an insolvent reinsured. . . [Indiana law] provides that an Indiana court may issue any orders necessary to prevent the obtaining of any preferences against any part of the assets of an insolvent insurance company. . . We conclude that if the Indiana Insurance Law were intended to give claimants a preference in the assets of an insolvent insurance company, the statutory expression would have been equally explicit. Our determination that there is no preference leads to the conclusion that the direct cause of action does not survive the commencement of liquidation proceedings.[5]

The court recognized that a Puerto Rican statute allowed a cut-through by insureds to reinsurers and that the reinsurance contract involved was so endorsed in *Ass'n of Warranty v. Commonwealth Ins. Co.,* 1983 P.R Sup. LEXIS 98 (1983). However, the court declined to enforce the cut-through as it was an improper preference to the assets of the estate.

IV. Commentary

While not all courts have rejected cut-throughs,[6] it has happened with sufficient frequency to create doubt as to their efficacy when they are most needed – the insolvency of the cedent. In doing so, the courts have elevated the avoidance of preferences over contractual rights but have failed to address cut-throughs as an express or de facto statutory limitation on the powers of receivers.

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[2] Semple and Hall, *The Reinsurer's Liability in the Event of the Insolvency of a Ceding Property and Casualty Insurer,* Tort & Ins. Law Jour. Vol. XXXL No. 3 407 – 411 (1986).

[3] *Foster v. Mutual Fire, Marine and Inland Ins. Co.*,614 A.2d 1086 at 1094 (PA. 1992)(emphasis in the original).

[4] 1992 U.S. Dist. LEXIS *18.

[5] 492 F.2d at 272.

[6] *See e.g. International Matex Tank Terminals v Louisiana Ins. Guar. Ass'n.* 663 So.2d 712 (Ct.App.LA 1993).