THE REINSURER'S LIABILITY IN THE EVENT OF THE INSOLVENCY OF CEDING PROPERTY AND CASUALTY INSURER[1]

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INTRODUCTION

A reinsurance agreement is one by which the reinsurer indemnifies the ceding company for losses paid. The reinsurer does not assume the liability of the ceding company.

The insolvency clause is a contractual exception to the indemnity nature of the reinsurance agreement. The insolvency clause allows the liquidator or receiver of the insolvent insurer to collect from the reinsurer the amount that would have been due if the ceding company had not become insolvent and had paid the claim.

The indemnity nature of the reinsurance agreement prohibits direct actions against reinsurers for reinsurance proceeds by insureds, claimants, guaranty funds and ancillary receivers. Pursuant to the insolvency clause, the reinsurer pays reinsurance proceeds to the domiciliary liquidator who assumes the obligations of the ceding company to the reinsurers.

Assumed or ceded premiums due can be offset against assumed or ceded losses payable. Insolvency of the ceding company does not alter this right.

I. REINSURANCE IS A CONTRACT OF INDEMNITY

A primary liability policy usually provides that it will "pay on behalf of the insured," the insured's liability to a third party. The payment is made directly to the third party rather than to the insured. Such an arrangement supports arguments that the claimant is a third-party beneficiary of the liability policy and that the insurer has obligations to negotiate in good faith with the third party.

A reinsurance agreement is a contract of indemnity. Reinsurance proceeds are payable only to a ceding company to reimburse it for amounts paid to claimants. Reinsurers have no contact with and no obligations to third parties.[3]

The pivotal case establishing reinsurance as a contract of indemnity is *Fidelity & Deposite Co. v. Pink*[4] decided by the United States Supreme Court in 1937. A primary company was insolvent and the quota share reinsurer contended that the contract was one of indemnity which required that the reinsurer reimburse the liquidator only for the appropriate proportion of the losses actually paid by the liquidator to claimants. The liquidator contended that he should be reimbursed the appropriate proportion of the primary company's liability to claimants regardless of the amount the insolvent company was able to pay the claimants. Based on the language of the reinsurance agreement, the Supreme Court found for the reinsurer.

Since *Fidelity & Deposit Co. v. Pink*, regulators have initiated legislation to assure that reinsurers would pay reinsurance proceeds based on the total liabilities of the insolvent company rather than on the total payment to claimants.[5] With limited exceptions,[6] however, the courts have continued to regard reinsurance agreements as contracts of indemnity rather than liability.[7]

II. THE INSOLVENCY CLAUSE

A. **The Insolvency Clause and Its Role in the Liquidation Process**

Subsequent to the *Fidelity & Deposit Co. v. Pink*[(8)] decision, regulators sought statutory means of requiring that in the event of the insolvency of a primary company, reinsurers would be obligated to pay reinsurance proceeds based on the liability of the ceding company, as determined in the liquidation proceeding, notwithstanding the indemnity nature of the reinsurance contract.[(9)] At the prompting of state insurance departments, most states have adopted statutes, regulations, rules or practices that prohibit credit for reinsurance unless the reinsurance agreement contains a provision stating that in the event of the insolvency of the ceding company, the reinsurer shall pay reinsurance proceeds to the domiciliary liquidator based on the liability of the ceding company, as established in the liquidation proceeding, regardless of whether or not the liquidator can pay fully such liability.[(10)] The effect of such statutes has been to require an "insolvency clause" in reinsurance agreements. Without such a clause, the ceding company would not be able to take credit for the reinsurance in its statutory financial statements, which is an important reason for the cession of reinsurance.[(11)]

Reinsurers have adopted a standardized insolvency clause to comply with such statutes.[(12)] The effect of the insolvency clause is to preserve the assets of the estate of the insolvent company. In theory, the reinsurer pays the same amount it would have paid had the ceding company remained solvent. The liquidator steps into the shoes of the insolvent insurer and assumes the rights and obligations of the insolvent insurer pursuant to the reinsurance agreement.[(13)] Such obligations include the proper reporting, settlement and defense of claims.[(14)]

B. **Exceptions to the Insolvency Clause**

The New York statute requiring an insolvency clause states that the reinsurance proceeds need not be payable to the liquidator where:

(a) the reinsurance agreement specifies another payee of such reinsurance in the event of the insolvency of the ceding insurer; and

(b) the assuming insurer with the consent of the direct insureds, has assumed such policy obligations to the payees as a replacement for the obligations of the ceding insurer.[(15)]

1. **The Cut-Through Endorsement**

The first exception noted above allows an endorsement to the reinsurance agreement called the *cut-through endorsement*. Typically, this endorsement is requested by a mortgagee or insured who is not satisfied with the financial rating of the ceding company. The cut-through endorsement merely redirects to the insured or mortgagee reinsurance proceeds otherwise payable to the liquidator, pursuant to the insolvency clause, in the event of the insolvency of the ceding company. It assists small and growing insurance companies in competing for business that otherwise would be unavailable.

Some regulators have questioned the use of the cut-through endorsement on the basis that it gives a preference in liquidation to the beneficiaries of the endorsement and is unfair to other claimants who receive a lesser portion of their claims when assets are distributed. One court has refused to allow a reinsurer to pay losses pursuant to a cut-through endorsement and ordered that the reinsurance recoverables be paid to the liquidator.[(16)]

2. **The Guarantee Endorsement**

A variation of the cut-through endorsement is the *guarantee endorsement* whereby the reinsurer in the event of insolvency, *guarantees* payment of some or all of the primary company's obligations. Often the guarantee is for an amount in excess of the reinsurance owed.[(17)] In Texas, a *guarantee bond* is used.[(18)] The guarantee endorsement or bond raises preference issues similar to those involved with the cut-through endorsement.

When Best's ratings decline, many primary companies request cut-through and guarantee endorsements or bonds from reinsurers. Given the administrative problems attendant to such endorsements, regulatory disfavor and the credit risk, many reinsurers restrict the use of these endorsements.

3. **The Assumption Agreement**

Another exception to the New York statute requiring an insolvency clause for reinsurance credit is the *assumption agreement*.[(19)] This usually takes the form of a novation by which one company agrees to assume the obligations and liabilities of the original insurer to the insured, i.e., replaces the original insurer. The original insurer is released from its liabilities to the insured. In order for there to be a true novation, the insured must consent to the substitution of insurers since the insured's right to choose an insurer is impacted.

It may be questioned whether the *assumption agreement* truly is a reinsurance transaction since it involves replacement of insurers rather than a traditional transfer of a portion of a risk from an insurer to a reinsurers. Nonetheless, the form of such a transaction is usually that of an assumption and reinsurance of certain obligations for specified consideration.

4. **Extra Contractual Obligations**

An extra contractual obligation clause in a reinsurance agreement may not be reinsurance and, therefore, may not fall within the ambit of the insolvency clause. An extra contractual obligation arises separately from the coverage of any insurance policy reinsured and results from tortious conduct of the insurer in the course of policyholder service or claim handling pursuant to such insurance policy. An excess judgment, a type of extra contractual obligation, is a loss in excess of the policy limit, the insurer being liable for such excess due to mishandling of the claim. Extra contractual obligations may include both compensatory and punitive damages.

Many reinsurance contracts include coverage for extra contractual obligations despite the fact that such coverage may constitute primary insurance company errors and omissions insurance rather than reinsurance.[(20)] Such a practice raises questions about licensing of the reinsurers, rate and form filings and premium taxes.[(21)]

III. **DIRECT ACTIONS**

When a primary insurance company becomes insolvent, payment of claims ceases for the period of time necessary for the liquidator to take control and for the guaranty funds to obtain and review the claim files. Thereafter, payment of claims becomes problematical. A guaranty fund will pay a claim which falls within the lines of business and limits stated in the fund's enabling legislation.[(22)] Those claims not paid at all or in full by the guaranty fund are referred to the liquidator. There may be insufficient funds in the estate to pay claims in full and it may take several years to marshall and distribute such funds.

The public depends on insurance to fund its personal and business losses. When an insurance company is unable to so fund losses due to insolvency, insureds experience a serious economic disjuncture. For this reason, some insureds and claimants seek to collect reinsurance proceeds directly from reinsurers (direct action).

Direct actions undercut the statutory scheme of liquidation adopted in most states,[23] invite delays and inequitable treatment of claimants, excessive legal fees[24] and are contrary to the indemnity nature of the reinsurance contract.[25] As a result, a body of caselaw has developed which demonstrates that absent an intent to benefit directly or create rights in insureds or other third parties, reinsurance proceeds are payable only to the domiciliary liquidator.[26] The bases upon which the courts have reached this conclusion are explored below.

A. **Direct Action claims by Insureds and Claimants**

1. **Privity**

The traditional and often stated reason to deny direct actions against reinsurers is the lack of privity with the reinsurer.[27] An insured or claimant is not a party to the reinsurance agreement and, usually, the insured does not enter into an insurance contract based on knowledge of the reinsurance obtained by the insurer.[28] The reinsurance agreement is one by which the assuming company indemnifies the ceding company for a portion of the paid loss. The reinsurer does not assume the ceding company's liability.[29]

Reinsurance is not intended to create a source of recovery for an insured or claimant since the primary company is liable for the full amount of the loss covered bv the policy. Reinsurance is purchased by a ceding company for its own benefit in order to:

(A) Increase the ceding company's capacity to accept new risks;

(B) Stabilize the ceding company's operating results;

(C) Allow the ceding company to spread the risk of loss under its policies:

(D) Permit the ceding company to reduce its required reserves;

(E) Enable the ceding company to write risks that otherwise would be beyond its capacity;

(F) Mitigate the impact of catastrophic losses; and

(G) Allow smaller companies to compete with larger companies.[30]

2. **Agency Relationship**

The courts have ruled that the primary company is not the agent of the reinsurer with respect to acceptance of risks[31] underwriting information[32] or claim handling[33] and as a result, the reinsurer is not liable Jointly with the insolvent primary company.[34]

3. **Third-Party Beneficiary**

Insureds and claimants have contended that they should be able to recover directly from the reinsurer as the third-party beneficiaries of the reinsurance agreement. The courts have ruled that the insureds and claimants are not third-party beneficiaries of the reinsurance relationship.[35]

4. **Unfair Insurance Practices**

Finally, it has been argued that reinsurers violate Unfair Insurance Practices Acts by not negotiating losses with claimants or that reinsurers are vicariously liable for the violation of such acts by the ceding company.

The courts have rejected these arguments on the basis that such acts do not apply to reinsurers directly or vicariously through the claim handling deficiencies of the ceding company.[(36)]

B. **Direct Actions by Guaranty Funds**

A number of guaranty funds have attempted to collect reinsurance proceeds directly from reinsurers on the bases that guaranty fund is the statutory successor[(37)] to the insolvent company (to whom reinsurance proceeds are paid pursuant to the insolvency clause) or that they are the third-party beneficiaries of the reinsurance agreement.[(38)] Such attempts uniformly have been rejected by the courts.[(39)]

C. **Direct Actions by Ancillary Receivers**

Ancillary receivers have attempted to attain direct access to reinsurance proceeds on bases similar to those used by guaranty funds with similar results.[(40)] The courts have also rejected the contention that the ancillary receiver should have control over the reinsurance proceeds applicable to the residents of the state represented by the ancillary receiver.[(41)]

IV. **COLLECTING REINSURANCE PROCEEDS**

A. **Contractual Rigbts and Obligations**

Reinsurance agreements usually contain provisions which (i) require the ceding company to provide information concerning claims which reach or are likely to reach the reinsured layer; and (ii) give the reinsurer the right but not the obligation to become involved in the defense of a claim at the reinsurer's expense.[(42)] There are strong economic and business reasons for such provisions. Reinsurers must be aware of claims in order to prepare properly their financial statements and to provide the support and assistance desired by many primary companies.

Moreover, once a loss exceeds a ceding company's retention, the remaining loss dollars at stake belong to the reinsurers. In this situation, the reinsurer is the party who gains or loses from the manner in which claims are handled. As a result, the quality of claim handling and reporting by the ceding company is a key portion of the reinsurance agreement from the reinsurer's standpoint.

The liquidator is the statutory successor of an insolvent company and steps into the shoes of the insolvent ceding company with respect to the reinsurance agreement.[(43)] Therefore, the liquidator is required to comply with the claim reporting and handling conditions in the reinsurance agreement in order to receive the benefit of the reinsurance proceeds. The liquidator has the obligation to collect subrogation and salvage, correct any underwriting improprieties and bring appropriate actions against any individual whose improper behavior contributed to the insolvency. These obligations result from (i) the terms of the reinsurance agreement; (ii) good faith obligations which underlie all contracts; and (iii) the duty of the liquidator to marshall assets for the benefit of all creditors.

The reinsurer's rights and obligations under the reinsurance agreement remain unchanged with the exception of the provisions of the Insolvency Clause.[(44)]

B. **Negotiation and Settlement of Claims**

Although a reinsurer has no obligation to become involved in claims, the reinsurer might be required to negotiate in good faith should it choose to be an active participant.[(45)] Should a reinsurer exercise its right to defend a claim against an insolvent carrier, it is prohibited from paying any settlement directly to the claimant without the approval of the liquidator since such a payment would undercut the statutory scheme of liquidation and take unfair advantage of a claimant's willingness to settle a claim against an insolvent company.[46] Should such a payment be made directly to the claimant without the liquidator's approval, the reinsurer must pay the same claim a second time to the liquidator since reinsurance proceeds are for the benefit of all creditors.

C. **Reinsurance Proceeds Due from the Reinsurer**

Assuming that the liquidator has fulfilled his or her duties under the reinsurance agreement, the amount due from the reinsurer is the reinsurance applicable to the claims which have been approved in the liquidation proceeding.[47] By law in certain states,[48] the liquidator must recommend to the liquidation court recoveries from the insurer for the amounts paid or payable by the guaranty fund. The liquidator has more discretion with respect to claims which are not covered by the guaranty fund or which exceed its limits.

All insurers receive overvalued claims, however, the fact of an insolvency gives claimants added incentives to inflate losses. An insolvent insurer may be able to pay only a portion of the true claim value. It is in the interest of the claimant to submit an inflated claim in cases where reinsurance is involved in the hope that reinsurance proceeds will be increased allowing payment of a percentage of the inflated claim which approximates the true claim value. The liquidator has a responsibility to the liquidation court, the reinsurers and the other creditors to marshall assets and distribute them in proper and equitable fashion.[49] This may require that the liquidator deny in whole or in part a variety of claims including Judgments entered by default, which were uncontested or collusive.[50]

V. **OFFSET AND RECOUPMENT**

Most reinsurance agreements contain an offset clause which allows either party to the agreement to net credits against debts and pay only the balance.[51] This contractual right of offset is reinforced by similar rights in equity and pursuant to statutes.[52] In addition, these are important business considerations which have made use of offset a custom in the reinsurance industry.

A. **Business Considerations**

The practical realities of reinsurance accounting requires a net balance approach, i.e., offset of credits and debits. A monthly account for a single treaty may require hundreds of debits and credits for new and renewal policies, cancellation of policies, return of unearned premium, retrospective rating adjustments, losses and loss adjustment expenses. It would be wasteful of time and effort, and lead to needless expenditure of funds and liquidation of investments, if one party was required to pay all its liabilities and await a check for its credits. Through offset a primary company can obtain the reinsurance recoverables immediately (and improve its liquidity) by netting them against premiums otherwise due the reinsurer.

The right of offset includes all reinsurance agreements, assumed or ceded, between the parties. Thus, the entire relationship between the parties acts as security for the obligations under each reinsurance agreement. In addition, offset minimizes differences between the parties by reducing such differences to their net balances.

The right of offset has a practical use outside of the insolvency context. If this right did not exist or were terminated by an insolvency, the marketplace for reinsurance would suffer. The administrative costs of insurers and reinsurers would increase, leading to higher insurance rates. Reinsurers might require prefunding or payment of maximum premiums leading to decreased liquidity on the part of ceding companies. Payment of all sums due from the ceding company might be made a condition precedent to reinsurance coverage. Small ceding companies with relatively less security would have difficulty in finding reinsurance. There would be inadequate reinsurance capacity for companies domiciled in those states which do not recognize the right of offset.

B. **The Right of Offset**

The right of parties to offset debits and credits was recognized in the English law in equity and in the bankruptcy law.[(53)] This principal was carried forward into the American law in equity and bankruptcy[(54)] and has been applied in the context of an insolvent insurance company. In *Scammon v. Kimball*,[(55)] the United States Supreme Court allowed a banker to offset the insurance company's deposits against an unrelated loss insured by the insolvent insurer. The right of offset applies despite the absence of a written agreement between the parties[(56)] and despite the absence of a specific provision in the relevant state's liquidation law recognizing the right to set.[(57)]

Most states have recognized implicitly the right of offset in their liquidation statutes by defining the "general assets" of the insolvent company as assets other than those encumbered for the security of other parties. Since offset is, in part, a security device, the amounts subject to offset by a reinsurer are not part of the general assets of the insolvent ceding company.[(58)]

A number of states have enacted statutes codifying the right of offset between an insurer and a reinsurer when one party becomes insolvent. By way of example, § 7427 of the New York Insurance Code provides in relevant part:

(a) In all cases of mutual debts or mutual credits between the insurer and another person in connection with any action or proceeding under this article, such credits and debits shall be set off and the balance only shall be allowed or paid, except as provided in subsection (b) hereof.

(b) No offset shall be allowed in favor of any such person, however, where:

(1) the obligation of the insurer to such person would not at the date of entry of any liquidation order . . . entitle him to share as a claimant in the assets of such insurer. . . .

In essence, to be offset, the debts and credits must be mutual. Judge Cardozo provided the dearest definition of mutuality: "To be mutual, they (the debts) must be due to and from the same persons in the same capacity.[(59)] Below, this definition will be explored and applied to the context of an insolvency of a primary carrier.

1. **Mutuality and Capacity**

In order for credits and debts to be mutual, the parties must be acting in the same *capacity*. The capacity to which the definition refers are the legal capacities, *e.g.*, of principal. agent, fiduciary, or beneficiary. The most common capacity is that of contracting principals who are debtors and creditors of each other.[(60)] As a result, insurers and reinsurers can offset credits and debts since both are acting in the capacity of its contracting principals.[(61)]

2. **Offset Among Reinsurance Agreements**

During the initial stages of the liquidation of Ideal Mutual Insurance Company and Union Indemnity Insurance Company of New York, and at various times previous, the New York Insurance Department has stated that it would allow offsets only within the same reinsurance agreement. This position has been honored more in the breach than in practice[*(62)*] and is contrary to the definition of mutuality which makes no distinction between contracts. Moreover, the leading courts have determined that offset may be applied to totally unrelated transactions. *Scammon v. Kimbalt*[(63)] involved an insolvent insurance company and an attempt by private bankers to offset the insurance company's deposits against insurance proceeds on an unrelated loss. The United States Supreme Court stated:

- [S]et-off must be understood as that right which exists between two parties each of whom, *under an independent contract*, owes an ascertained amount to the other to set off their respective debts by way of mutual deduction. . . .[64] (Emphasis added.)

Other cases and commentators are in accord.[65] As long as there is mutuality the number of contracts involved matters not.

3. **Offset Is Not a Preference, Counter Claim, or Action**

It may be argued that the right of offset, applicable through contract, in equity or by statute, constitutes a preference in that it allows a reinsurer a priority higher than that established in the statutory scheme of liquidation. The United States Supreme Court has ruled that this is not the case:

Where a setoff is otherwise valid, it is not perceived how its allowance can be considered a preference, and it is clear that it is only the balance, if any, after the setoff is deducted which can justly be held to form a part of the assets of the insolvent.[66]

It has been asserted that an offset is an action or counterclaim which is barred by the liquidation order. The courts which have considered this argument have drawn a distinction between an affirmative claim in the liquidation proceeding in the nature of an action or counterclaim, and the right of offset.[67] As a result, offset is not barred by the liquidation order.

4. **Offset as a Preliquidation Debt**

Under certain offset statutes a party may not offset a debt that arises after the entry of the liquidation order.[68] The court in the recent decision of *O'Connor v. Ins. Co. of North America*[69] ruled that debts arising out of reinsurance agreements in effect prior to the liquidation order constitute preliquidation debts regardless of the fact that they may be unliquidated or not due on the date the liquidation order is entered.

C. **Recoupment**

Recoupment is a defense that may be asserted in a liquidation proceeding. Unlike offset, it is limited to the same transaction in which a claim is being asserted against the party claiming recoupment.[70] Recoupment is not a claim subject to a liquidation order.[71]Recoupment does not require mutuality to be asserted.[72]

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ENDNOTES

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2. At the time of publication, T. Darrington Semple, Jr. was the Resident Counsel and Secretary of America Re-Insurance Company and Robert M. Hall was counsel and Assistant Secretary of that same organization. Presently, Mr. Hall practices insurance and reinsurance law, and is active in both arbitrations and mediations. The views expressed in this article do not represent the

opinions of Mr. Hall's clients. Comments and questions can be addressed to robertmhall@erols.com.

3. *See* Section III, *infra.*

4. 302 U.S. 224 (1937). The key portion of the quota share treaty stated:

- The Reinsurer's proportionate share of loss under the bond, of costs and expenses as hereinbefore defined, and of interest, shall be paid to the Reinsured upon proof of the payment of such items by the Reinsured. . . . *Id.* at 226.

5. *See* Section II, *infra*.

6. See Mitchell v. State, 22 3 So. 2d 792 (Fl. Dist. Ct. App. 1969) (the court followed Higgins and Homan in light of similar "subject to" language in the certificates); First Nat'l Bank v. Higgins, 357 S.W.2d 139 (Mo. 1962) (the treaty contained language to the effect that the liability of the reinsurer followed in all respects and was subject to the terms and conditions of the ceding company's policies); and Homan v. Employers Reins. Co., 136 S.W.2d 289 (Mo. 1939) (the treaty contained "subject to" language similar to that in Higgins and the reinsurer defended the claim). Mitchell was limited by Clarke & Co. v. Dep't of Ins., 436 So. 2d 1013 (Fl. Dist. Ct. App. 1983) and Higgins and Homan were criticized in Gen. Reins. Co. v. Mo. Gen., 458 F. Supp. 1 (W.D. Mo. 1977), aff'd, 596 F.2d 330 (8th Cir. 1979). The weight and quality of decisions indicate that this is a limited exception and, perhaps, that Mitchell, Higgins, and Homan were decided wrongly. See notes 24-34 and accompanying text, *infra*.

7. *See, e.g.,* Ainsworth v. Gen. Reins. Corp., 751 F.2d 962 (8th Cir. 1985); Gen. Reins. Corp. v. Mo. Gen., 458 F. Supp. 1 (W.D. Mo. 1977), *aff'd,* 596 F.2d 330 (8th Cir. 1979); Safeway Trails v. Stuyvesant Ins. Co., 211 F. Supp. 227 (M.D. N.C. 1962), *aff'd,* 316 F.2d 234 (4th Cir. 1963); McDonough Construction v. Pan Am. Surety Co., 190 So. 2d 617 (Fl. Dist. Ct. App. 1966); Arrow Trucking Co. v. Continental Ins. Co., 465 So. 2d 691 (La. 1985); Fontenot v. Marquette Casualty Ins. Co., 247 So. 2d 572 (La. 1971); O'Hare v. Pursell, 329 N.W.2d 614 (Mo. 1959); McFarling v. Mayfield, 510 S.W.2d 108 (Tex. Ct. Civ. App. 1974) (concurring opinion). *See also Nutter, Reinsurance Issues in the Liquidation of Insolvent Insurers,* 18 FORUM 290, 292 (1983) (hereinafter cited as Nutter); 13 APPLEMAN, INSURANCE LAW AND PRACTICE § 7694 (1976), 46 C.J.S. *Insurance §* 1232 (1946), 44 AM. JUR. 2D *Insurance §* 1841 (1982), 35 A.L.R. 1341, 103 A.L.R. 1468, and Section III, *infra*.

8. 302 U.S. 224 (1937).

9. In referring to Fidelity & Deposit v. Pink the court in Skandia Am. Reins. Co. v. Schenk, 441 F. Supp. 715 (S.D.N.Y. 1977) stated at 725: "To remedy the result, the New York legislature enacted 1939 N.Y. Laws, c. 882, S. 77, codified, as amended, at N.Y. Ins. Law S. 77 (McKinney 1966). "To the same effect, see Arrow Trucking Co. v. Continental Ins. Co., 465 So. 2d 691 (La. 1985); Fontenot v. Marquette Casualty Ins. Co., 247 So. 2d 572 (La. 1971); McFarling v. Mayfield, 5 10 S.W.2d 108 (Tex. Ct. Civ. App. 1974) (concurring opinion). See also Olsen, Reinsurer's Liability to the Insolvent Reinsured, 41 Notre Dame Law. 13 (1965) (hereinafter cited as Olsen) at 22:

In 1939 Superintendent Pink introduced to the legislature and saw written into a law a statute the purpose of which was to overcome the *Pink* decision. He said, "When Section 77 was prepared it was prepared with the intention of overcoming a decision in the case of *Fidelity & Deposit Company v. Pink*."

The essence of this statute was that an insurance company could no longer consider reinsurance as an asset or as a deduction from liability for the amount ceded unless there was a clause in the reinsuring contract making the full reinsurance payable regardless of the reinsured's solvency. Thus, if a reinsurer would not accept a treaty with this insolvency clause in it and forced the reinsured to sign one without it, the result would be to force the reinsured to carry the full amount of reserve for that amount of reinsurance ceded, thus effectively defeating one of the primary reasons for such reinsurance.

Section 77 was the predecessor to the current § 1308 which is substantially the same.

10. *See* the Model Insolvency Statute recommended by the Reinsurance Association of America:

- No credit shall be allowed, as an admitted asset or deduction from liability, to any ceding insurer for reinsurance, unless the reinsurance contract provides, in substance, that in the event of the insolvency of the ceding insurer, the reinsurance shall be payable under contract or contracts reinsured by the assuming insurer on the basis of the claims allowed against the ceding insurer in the insolvency proceedings, without diminution because of the insolvency of the ceding insurer, directly to the ceding insurer or to its domiciliary liquidator or receiver except: (a) where the contract specifically provides another payee of such reinsurance in the event of the insolvency of the ceding insurer or (b) where the assuming insurer with the consent of the direct insured or insureds has assumed such policy obligations of the ceding insurer as direct obligations of the assuming insurer to the payees under such policies and in substitution for the obligations of the ceding insurer to such payees.

  The domiciliary liquidator or receiver of an insolvent ceding insurer shall give written notice of the pendency of a claim against such ceding insurer on the contract reinsured within a reasonable time after such claim is filed in the insolvency proceeding. During the pendency of such claim any assuming insurer may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defenses which it deems available to the ceding insurer, its liquidator or receiver. Such expense shall be chargeable subject to court approval against the insolvent ceding insurer as part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to the ceding insurer solely as a result of the defense undertaken by the assuming insurer. Where two or more assuming insurers are involved in the same claim and a majority in interest elect to interpose defense to such claim, the expense shall be apportioned in accordance with the terms of the reinsurance agreement as though such expense had been incurred by the ceding company.

See, e.g., § 1308 2(A) of the N.Y. INS. Code, § 10-3-118(4) of the COLO. INS. Code, and § 922.2 of the CAL. INS. Code.

11. See Skandia Am. Reins. Co. v. Schenk, 4-41 F. Supp. 715 (S.D.N.Y. 1977) and Olsen, *supra* note 7, at 15-16.

12. An insolvency clause used by American Re-Insurance Company reads as follows:

- The reinsurance provided by this Agreement and each and every reinsurance agreement heretofore or hereafter entered into by and between the parties hereto shall be payable by the Reinsurer directly to the Company or to its liquidator or receiver on the basis of the liability of the Company under the contract or contracts reinsured without diminution because of the insolvency of the Company. In the event of the insolvency of the Company, the liquidator or receiver or statutory successor of the Company shall give written notice of the pendency of each claim against the Company on a policy or bond reinsured within a reasonable time after such claim is filed in the insolvency proceeding; and during the pendency of such claim, the Reinsurer may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defense or defenses which it may deem available to the Company, its liquidator or receiver or statutory successor. The expense thus incurred by the Reinsurer shall be chargeable, subject to court approval, against the Company as part of the expense of liquidation to the extent of such proportionate share of the benefit as shall accrue to the Company solely as a result of the defense undertaken by the Reinsurer. The reinsurance shall be payable as hereinbefore in this paragraph provided except as otherwise provided by Section 4118(a) [relating to Fidelity and Surety Risks] of the Insurance Law of New York or except (a) where the contract specifically provides another payee of such reinsurance in the event of the insolvency of the Company and (b) where the Reinsurer with the consent of the direct insured or insureds has assumed such policy obligations of the Company as direct obligations of the Company as direct obligations of the Reinsurer to the payees under such policies and in substitution for the obligations of the Company to such payees.

13. *See* notes 35 and 37 and accompanying text, *infra.*

14. *See* Section IV(A), *infra.*

15. § 1308 (2)(B(i) and (ii) of the N.Y. Ins. Code.

16. Warranty Ass'n v. Commonwealth Ins. Co. No.R-80-334 (Apr. 13, 1983 P.R.) The Supreme Court ruled that a fair and orderly liquidation required that reinsurance proceeds be paid to the liquidator and characterized cut-through endorsements as improper preferences. *See also,* Nutter, note *5 supra,* at 297-98.

17. *See §* II 14(c) of the N.Y. Ins. Code.

18. *See* Commissioner's Orders No. 3559 and 8311 and Board Order 1595.

19. *See* text accompanying note 13, *supra.*

20. The key issue is whether the risk transferred to the reinsurer is covered by the policy issued by the ceding company. Ott v. All-Star Corp. 1299 N.W. 2d 839 (Wis. 1981) was a suit by an insured for an excess judgment against the reinsurer of an insolvent primary company. The reinsurance agreement in Addendum 5 stated: "[I]t is also agreed that should the Company become legally obligated to pay a loss in excess of the policy limits, the Reinsurer agrees to assume seventy-five percent (75%) of that part of such loss (plus proportionate loss expense) which is in excess of the policy limit." *Id.* at 841. The court noted:

- [T]hat reinsurance covers "a risk which (the insurer) has assumed under a separate and distinct contract," and "all or a portion of the insurer's risks." These statements indicate that the nature of the risk covered by reinsurance is defined and circumscribed by the risk covered in the primary insurer's policy with its own insured. The reinsured risk "must be the same as that covered by the original policy."

Id. at 847 (Citations omitted.). *The court held the reinsurer's liability for excess judgment was insurance rather than reinsurance:*

- Because such liability is not a risk against which protection is extended to the insured, it cannot under the above definitions, be a proper subject for "reinsurance." By definition such risk cannot be reinsured. The subject matter of Addendum 5 is not reinsurance.

Id. at 848.

21. Some reinsurers have agreed to add to their treaties special coverage for this excess of limits exposure either on a total or share basis:

- In view of the sharp legal distinction which exists between the purely contractual undertakings of a reinsurance agreement and the tort liabilities of the insurance company, it is questionable that the special grant of 'excess of limits' coverage should be made in part of a reinsurance agreement. While responsible contracting parties are generally free to contract as they wish, such coverage in a reinsurance agreement is an anomaly. Marketing considerations aside, it is doubtful that the grant of such coverage should be accomplished in this manner. If a reinsurer desires to cover the tort liabilities of the insurance carrier, it must consider the limitations of its own charter and perhaps the licensing requirements of the various state insurance departments relating to the writing of liability insurance.

Hagner, *Punitive Damages-Insurance and Reinsurance*, 47 Ins. Counsel J. 72, 76 (1980).

22. Coverage and limits for guaranty funds vary from state to state. The National Association of Insurance Commissioners (hereinafter NAIC) Property and Liability Post Assessment Guaranty Association Model Act, as amended at the Winter 1985 Meeting of the NAIC, excludes life, annuity, health or disability, mortgage guaranty and financial guaranty, fidelity and surety, credit insurance, insurance of warranties and service contracts, title insurance, ocean marine punitive and exemplary damages, and transactions which do not transfer insurance risk. There are no limits for workers compensation claims and other claims are subject to a $300,000 limit.

23. The NAIC Insurers Supervision, Rehabilitation, and Liquidation Model Act, in § I (D)(3) and (4), states as purposes of the act "enhanced efficiency and economy of liquidation" and "equitable apportionment of any unavoidable loss." The liquidator is directed to marshall and preserve the assets of the insolvent insurer [§21 (A)(6)] and reduce the assets to a degree of liquidity necessary for distribution [§ 25(B)]. Claims and other debts are paid out based on a specific priority [§ 42] which assures equal treatment within the classes of priorities. *See* § 83-23-137 of the Miss. Ins. Code and §§ 10-3-503 and 10-3-507 of the Colo. Ins. Code. See also Motlow v. Southern Holding & Securities Corp., 95 F.2d 721 (8th Cir. 1938), *cert. denied*, 305 U.S. 609 (1938); Consumer Supermarket No. 2 v. Underwriters at Lloyds, 189 So. 2d. 648 (Fl. Dist. Ct. App. 1966).

24. Unless the liquidator marshalls and distributes assets, claimants will engage in a race to the courthouse to obtain a judgment against the reinsurers before the reinsurance is exhausted. Presupposing a $10 million aggregate reinsurance cover and three valid $5 million claims applicable to the reinsurance, the reinsurers absent a centralized liquidator would be able to pay the $10 million to the first two parties to perfect their claims. This is not an equitable way to distribute reinsurance proceeds. In fact, the reinsurer will interplead the reinsurance proceeds and let the court decide the proper recipients. As is demonstrated in Section III(a)-(c), the courts have upheld the principles: (a) that the reinsurer has no liability to a claimant for insurance proceeds; and (b) that the liquidator marshalls and distributes assets pursuant to the statutory liquidation scheme.

25. *See* Section *I, supra,* and Nutter, *supra* note 5, at 290-93.

26. Eastern Engineering & Elevator Co. v. Am. Re-Ins. Co., 455 A.2d 1235 (Sup. Ct. Pa. 1983) was direct action against a reinsurer. The court found for the reinsurers stating at 1237:

- It, therefore, appears that unless the reinsurance contract provided for payments to the individual named insured, the liability of the reinsurer is intended to run to the estate of the insolvent insurer for the eventual benefit of the insureds and not directly to the policyholders of the insurer.

See American Cast Iron v. Statesman Ins. Co., 343 F. Supp. 860 (D. Minn. 1972); People v. Cosmopolitan Ins. Co., 233 N.E.2d 90 (Ill. App. Ct. 1967); State v. Security Gen. Ins. Co., 140 N.W.2d 676 (S.D. 1966); McFarling v. Mayfield, 510 S.W.2d 108 (Tex. Ct. Civ. App. 1974); Marrow v. Burlington Basket Co., 66 S.W.2d 746 (Tex. Ct. Civ. App. 1933). A recent Canadian case on point denying a direct action on a facultative certificate is British Columbia Hydro & Power v. Dunwoody Ltd. (1986) 1 W.W.R. 476 (Man. C.A.), app. den., (S.C. Can. December 16, 1985). For exceptions to the general rule, see note 4, supra, and accompanying text.

27. Taggert v. Kiem, 103 F.2d 194 (3d Cir. 1939) was as action by the Insurance Commissioner alleging that a reinsurance agreement was a guarantee of the obligations of the insolvent ceding company. The court held at 197-98:

- The agreement by its terms was a contract of reinsurance. It provided that "the reinsurer hereby reinsures all the outstanding liabilities of the" (primary company). It was a promise to indemnify the (primary company) and was made directly to that company and not to its policyholders, who could claim under it only as donee beneficiaries. Since there was no privity between the persons originally insured by the (primary company) and the (reinsurer) as reinsurers it was a true agreement of reinsurance and not a contract of guarantee.

After citing cases from other jurisdictions, the court in Schuylkill Products, Inc. v. H. Rupert & Sons, Inc., 45 1 A.2d 229 (Pa. Sup. Ct. 1982) stated at 231-32:

- The rule in Pennsylvania is in accord: "Reinsurance is property applied to an insurance effected by one underwriter with another, the latter wholly or partially indemnifying the former against the risk which he has assumed; that is to say, after an insurance has been effected, the insurer may have the subject of insurance reinsured to him by some other. There is in such case, however, no privity between the original insured and the reinsurer; that latter is in no respect liable to the former, as a surety or otherwise, the contract of insurance and reinsurance being totally distinct and disconnected." *Appeal of Goodrich*, 2A. 209, 211 (1885).

See also Morris & Company v. Scandinavia Ins. Co., 2 79 U.S. 405 (192 9); Citizens Casualty Co. v. Am. Glass Co., 166 F.2d. 91 (7th Cir. 1948); United States v. Fed. Surety Co., 72 F.2d 964 (4th Cir. 19 34); Gen. Reins. Corp. v. Evelyn Williams, 75 Civ. 1336 (S.D.N.Y. April 10, 19 76); Employers Reins. Corp. v. Am. Fidelity and Casualty, 196 F. Supp. 553 (W.D. Mo. 1959); McDonough Construction v. Pan Am. Surety, 19O So. 2d. 617 (Fl. Dist. Ct. App. 1966); Baylor v. Highway Ins. Co., 316 N.E.2d 63 3 (111. 1974); Gill v. Blackhawk Mut. Ins. Co., 152 N.E.2d 220 (Ill. App. Ct. 1959); Winnishiek Mut. Ins. Co. v. Roach, 132 N.W.2d. 436 (Iowa 1965); Crozier v. Lennox Mut. Ins. Co., 110 N.W.2d. 403 (Iowa 1961); Fontenot v. Marquette Casualty Ins. Co., 247 So. 2d. 572 (La. 1971); Greenman v. Gen. Reins. Corp., 262 N.Y.S. 569 (Sup. Ct. App. Div. 193 3), aff'd, 188 NE. 128 (N.Y. 193 3); Squibb-Mathieson Int'l v. St. Paul Ins. Co., 254 N.Y.S.2d 586 (Sup. Ct. Spec. Term 1964); Eastern Engineering& Elevator v. Am. Re-Ins. Co., 455 A.2d 1235 (Pa. Sup. Ct. 1983); Manning v. Security Gen. Ins. Co., 140 N.W.2d 676 (S.D. 1966).

28. Even when the insured is aware of the reinsurance agreement, there is no right of direct action. Safeway Trails, Inc. v. Stuyvesant Ins. Co., 211 F. Supp. 227 (M.D.N.C. 1962), *aff'd,* 316 F.2d 234(4th Cir. 1963).

29. *See* Section 1, *supra.*

30. *See* Fontenot v. Marquette Casualty Ins. Co.,247 So.2d 572, 575-56 (La. 1971); Thompson, Reinsurance (4th ed. 1966) at 9; Olsen, *supra* note 7, at 15-16.

31. In Aetna v. Glens Falls Ins. Co., 453 F.2d 687 (5th Cir. 1972), an underwriter for the ceding company mistakenly ceded an inland marine risk to a treaty which excluded such risks. It was contended that the underwriter, named Palmer, acted as the agent for the primary company in ceding the risk and as the agent for the reinsurer in assuming the risk. The court ruled at 690:

- This misconstrues the nature of the reinsurance relationship between the reinsured and the reinsurers. The reinsurance treaties, not Palmer, bound the reinsurers to accept any reinsurance

> ceded pursuant to the provisions specified in the treaty (citation omitted). Palmer was not authorized to "accept" reinsurance for (the reinsurers). Palmer's function was to choose the reinsurers for the risk to be ceded.

32. A/S Ivarans Rederic v. Puerto Rico Ports Auth., 617 F.2d 903 (I st Cir. 1980) involved a treaty voidable for concealment of material facts. The ceding company failed to pass on to the reinsurer material information conveyed by the insured. After the ceding company became insolvent, the court ruled that the failure to pass on material information voided the reinsurance contract, stating at 905:

- As between the reinsured and the reinsurers there is no principle of imputed knowledge of facts material to the risks that the reinsurer is asked to assume; to the contrary there is a duty on the reinsured to disclose such facts (citation omitted). Indeed, were this not so the business of reinsurance would rest on blind faith in the reinsured.

33. The fact of a reinsured/reinsurer relationship does not make the ceding company the agent of the assuming company for purposes of negotiation and settlement of claims. United States v. Fed. Surety Company, 72 F.2d 964 (4th Cir. 1934); Employers Reins. Corp. v. Am. Fidelity and Casualty, 196 F. Supp. 55 3 (W.D. Mo. 1959); Duber Industrial Security v. Allendale Mut. Ins. Co., Civ. *69,133* (Sup. Ct. No. C. 232 595) (February 16, 1984 Cal. Ct. App.); Reid v. Ruffin, 460 A.2d 757 (Pa. Sup. Ct. 198 *3), affd,* 469 A.2d 1030 (Pa. 198 3).

34. *See* Nutter, *supra* note 5, at 299-304.

35. United States v. Fed. Surety Company, 72 F.2d 964(4th Cir. 1934); Am. Re-Ins. Co. v. Ins. Comm'r, 527 F. Supp. 444 (C.D. Cal. 1981); Am. Cast. Iron v. Statesman Ins. Co., 343 F. Supp. 860 (C.D. Minn. 1972); Safeway Trails, Inc. v. Stuyesant Ins. Co., 211 F. Supp. 227 (M.D.N.C. *1962), aff'd,* 316 F.2d 234 (4th Cir. 1963); Melco v. Receiver of Trans-Am., 105 So. 2d 43 (Ala. 1958); Duber Indus. Sec. v. Allendale Mut. Ins. Co., Civ. 6 9139 (Sup. Ct. No. C. 232 595) (February 16, 1984 Cal. Ct. App.); Clarke & Company v. Dept. of Ins. 436 So. 2d 1013 (Fl. Dist. Ct. App. 1983); Arrow Trucking Co. v. Continental Ins. Co., 465 So. 2d 691 (La. 1985) (no direct action despite fact that insured named in facultative reinsurance certificate); Fontenot v. Muquette Casualty Ins. Co., 247 So. 2d 572 (La. 1971).

36. Am. Re-Ins. Co. v. Ins. Comm'r, 696 F.2d 1267 (9th Cir. 1983) (no obligation under Unfair Insurance Practices Act to negotiate in good faith with claimant since reinsurer must pay proceeds to liquidator). To the same effect is Am. Re-Ins. Co. v. Gilmore, Civ. 80-1620 (March 11, 1982 C.D. Cal.); Duber Industrial Security v. Allendale Mut. Ins. Co., Civ. (69139) (Sup. Ct. No. C. 232 595) (February 16, 1984 Cal. Ct. App.) (reinsurer not vicariously liable for the failure of the ceding company to negotiate in good faith; reinsurer has right but not the obligation to participate in claim handling and reinsurer not subject to Unfair Insurance Practices Act, at least as long as it does not participate in the negotiations with the claimant). *See* Nutter, *supra* note 5, at 304-05.

37. The domiciliary liquidator is the statutory successor to the insolvent insurance company. Skandia Am. Reins. Corp. v. Barnes, 458 F. Supp. 13 (D. Col. 1978).

38. The guaranty fund is not the third-party beneficiary of the reinsurance agreement. Gen. Reins. Corp. v. Mo. Gen., 458 F. Supp. 1 (W.D. Mo. 1977), *affd, 596* F.2d 3 30 (8th Cir. 1979).

39. Am. Re-Ins. Co. v. Ins. Comm'r, 527 F. Supp. 444 (C.D. Cal. 1981); Skandia Am. Reins. Corp. v. Schenk, 441 F. Supp. 715 (S.D.N.Y. 1977); Arizona v. Ins. Comm'r, 682 P.2d 431 (Ariz. Ct. App. 1984). *See* Skandia Am. Reins. Corp. v. Barnes, 458 F. Supp. 13 (D. Col. 1978); and Gen. Reins. Corp. v. Mo. Gen., 458 F. Supp. 1 (W.D. Mo. 1977), *aff'd, 596* F.2d 3 30 (8th Cir. 1979); *see also* Nutter, *supra* note 5, at 292-94.

40. Arizona v. Ins. Comm'r, 682 P 2d 431 (Ariz. Ct. App. 1984).

41. Am. Re-Ins. Co. v. Ins. Comm'r, 527 F. Supp. 444 (C.D. Cal. 1981). The court stated at 454: "An ancillary receiver's function is to collect assets within its state and apply them for local creditor's claims in accordance with the law of that state. . . . Reinsurance proceeds are not local assets over which ancillary receiver can exercise control." *See also* O'Malley v. Dept of Ins., 291 N.E.2d 907 (Ind. Ct. App. 1973).

42. A typical provision used by American Re-Insurance Company is:

(a) As a condition precedent to the Reinsurer's liability under this Treaty, the Company shall give prompt written notice to the Reinsurer of all claims which may develop into losses involving the reinsurance hereunder.

(b) In addition, the following categories of claims shall be reported to the Reinsurer immediately, regarding of any questions of liability of the insured or coverage under the policy:

1. Fatalities;

2. Paraplegics and Quadriplegics;

3. Serious bums;

4. Serious brain injuries;

5. Amputation of any extremity.

(c) The Company has the obligation to investigate and defend any claim affecting this reinsurance, to advise the Reinsurer promptly of subsequent developments pertaining thereto and to pursue such claim to final determination.

(d) It is understood that when so requested the Company will afford the Reinsurer an opportunity to be associated with the Company at the expense of the Reinsurer in the defense or control of any claim or suit or proceeding involving this reinsurance; and the Company and the Reinsurer shall cooperate in every respect in the defense of such suit or claim or proceeding. *See* note 12, *supra*, and accompanying text.

43. *See* notes 35 and 37, *supra*, and accompanying text.

44. See notes 11 and *12, supra,* and accompanying text.

45. *Cf.* Duber Indus. Sec., Inc. v. Allendale Mut. Ins. Co., Civ. 69,13 3 (Sup. Ct. 2 *32* 595) (Cal. Ct. App. February 16, 1984). The court held that reinsurers were not subject to Unfair Insurance Practices Act and were not vicariously liable for the failure to negotiate in good faith of the ceding company. Although the reinsurer did not become involved in claims negotiations, the court observed at 7: "We assume that if a reinsurer voluntarily participated in settlement negotiations alongside the insurer, it would have to do so in good faith. . . ."

46. Ainsworth v. Gen. Reins. Corp., 751 F.2d 962 (8th Cir. 1985) involved a $485,000 verdict against an insured. $100,000 of coverage was supplied by the insolvent primary company. The reinsurer reinsured $75,000 in excess of $25,000. Without the permission of the liquidator, the reinsurer obtained a release for the insolvent primary carrier and its liquidator in consideration of $25,000. Notwithstanding the settlement

with the claimant, the court ruled that the reinsurer should pay $75,000 plus defense costs and interest to the liquidator. *See also* § 32 of the NAIC Insurers Supervision, Rehabilitation and Liquidation Model Act:

- The amount recoverable by the liquidator from the reinsurer shall not be reduced as the result of delinquency proceedings, regardless of any provision in the reinsurance contract or other agreement. Payment made directly to an insured or other creditor shall not diminish the reinsurer's obligation to the insurer's estate except when the reinsurance contract provided for direct coverage of a named insured and the payment was made in discharge of that obligation.

47. *See* note 44, *supra*, and accompanying text.

48. *See*, *e.g.*, § 83-28-137(3) of the Miss. Ins. Code.

49. With respect to the obligations of the liquidator to the reinsurers see notes 41 and 42, *supra,* and accompanying text. The insolvent insurer often owes the reinsurer premiums and for this reason the liquidator is obligated to the reinsurer to conserve the assets in the estate. Reinsurance is often the largest asset of the insolvent carrier and the liquidator is under an obligation to the liquidation court and all creditors not to misapply this asset. The liquidator is obligated to take possession of and preserve the assets of the insolvent carrier pursuant to statute and the order of the liquidation court. *See, e.g.*, Colo. Ins. Code § 10-3-503 and § 7405 of the N.Y. Ins. Code. For example, the Order Appointing a Receiver of Aspen Indemnity Corporation, signed September 6, 1984, by the District Court for the City and County of Denver, Colorado, reads in relevant part:

- [The] receiver is hereby directed and instructed to proceed forthwith to assemble and to take possession of all the assets of the respondent and to preserve the same by liquidation of the business, or otherwise, for the benefit and protection of all policyholders and creditors and to do all other acts generally required of receivers under the direction of this court.

- The receiver shall be and is hereby authorized to institute, prosecute and defend, compromise, adjust, intervene and/or become a party to such suits, actions, proceedings in law or in equity, in state or federal courts as may in his opinion be necessary for the proper protection, maintenance and preservation of the assets of the respondent in order to properly liquidate its affairs. . . .

50. The NAIC Insurers Supervision, Rehabilitation, and Liquidation Model Act states in § 36(D): "(N)o judgment or order against an insured or the insurer entered at any time by default or by collusion need be considered as evidence of liability or of quantum of damages." To the same effect, *see §* 1028 of the Colo. Ins. Code. In a liquidation proceeding the proper issues are liability and reasonable value of the claim and not the legal mechanisms the insured or insurer should have used to contest the claim or its value. The obligations of the liquidator to the other creditors, the reinsurers and the liquidation court requires that the liquidator look through the form of a judgment or settlement to examine its substance.

51. An offset clause used by American Re-Insurance Company reads as follows:

- Each parry hereto shall have, and may exercise at any time and from time to time, the right to offset any balance or balances, whether on account of premiums or on account of losses or otherwise, due from such party to the other (or, if more than one, any other) party hereto under this Agreement or under any other reinsurance agreement heretofore or hereafter entered into by and between them, and may offset the same against any balance or balances due or to become due to the former from the latter under the same or any other reinsurance agreement between them; and the party asserting the right of offset shall have and may exercise such right whether the balance or balances due or to become due to such parry from the other are on account of premiums or on account of losses or otherwise and regardless of the capacity, whether as assuming insurer or as ceding insurer, in which each party acted under the agreement or, if more than one, the different agreements involved, provided, however, that, in the event of the insolvency of a party hereto, offsets shall only be allowed in accordance with the provisions of Section 7427 of the Insurance Law of the State of New York.

52. *See* Subsection (b), *infra*, and Nutter, *supra note* 5, at 294-98.

53. See Anonymous, 86 Eng. Rep. 837 (K.B. 1675) wherein Chief Justice North stated:

- If there are accounts between two merchants, and one of them become (sic) bankrupt, the course is not to make the other, who perhaps upon stating the accounts is found indebted to the bankrupt, to pay the whole that was originally entrusted to him, and to put him for the recovery of what the bankrupt owes him, into the same condition with the rest of the creditors; but to make him pay that only which appears due to the bankrupt on the foot of the account; otherwise it will be for account; betwixt them after the time of the other's becoming bankrupt, if any such were.

See also Curson v. African Co., 23 Eng. Rep. 3 58 (Ch. 1682) and Chapman v. Derby, 23 Eng. Rep. 684 (Ch. 1689). During the era of these decisions, the existing bankruptcy act 13 Eliz. c. 7, contained no offset provision. Later versions of the bankruptcy laws, 4 Ann. c. 17, §11 and 5 Geo. 2 c. 30, § 28, included a right of offset.

54. Scott v. Armstrong, 146 U.S. 499 (1892); Carr v. Hamilton, 129 U.S.252 (1889); 11 U.S.C. § *553.*

55. 92 U.S. 362 (1876). *See also* Carr v. Hamilton, 129 U.S. 252 (1889).

56. Downey v. Humphries, 227 P.2d 484 (Cal. Dist. Ct. App. 1951).

57. *See* Carr v. Hamilton, 129 U.S. 252 (1889); Scott v. Armstrong, 146 U.S. 499 (1892) and Nutter, *supra* note 5, at 295.

58. The definition of "general assets" contained in § 3 of the NAIC Insurers Supervision, Rehabditation and Liquidation Model Act § 3 reads in relevant part:

- "General assets" means all property, real, personal, or otherwise, *not specifically* mortgaged, pledged, deposited, or otherwise *encumbered for* the security or *benefit of specified property* or classes of persons. As to specifically encumbered property, "general assets" includes all such property or its proceeds in excess of the amount necessary to discharge the sum or sums secured thereby. (Emphasis added.)

See, e.g., § 10-3-502(5) of the Colo. Ins. Code. See also Nutter, supra note 5, at 297.

59. Beecher v. Peter A. Vogt Mfg. Co., 125 N.E. 831, 833 (N.Y. 1920).

60. *See, eg.,* Dakin v. Bayly, 290 U.S. 143 (19 3 3); 20 Am. Jur. 2D *Counterclaim, Recoupment and Set-*Off § 80 (1982); 80 C.J.S. *Set-Off and Counterclaim § 50* (1946).

61. Salvage and, presumably, subrogation recoveries are held in the capacity of trustee by the ceding company and cannot be offset against a contractual debt. In re Consol. Indem., 38 N.E.2d 119 (N.Y. 1941); Pink v. Am. Surety Co. 28 N.E.2d 842 (N.Y. 1940).

62. Consolidated Mutual Insurance Company was an assuming and ceding company with respect to American Re-Insurance Company. When Consolidated became insolvent, American Re-Insurance offset credits and debts in all contracts and the Superintendent of Insurance of New York brought suit. Lewis v. Am. Re-Ins. Co., Index No. 9183/81 Supreme Court of the State of New York, County of New York. Eventually, a settlement was reached which, *sub rosa*, allowed American Re-Insurance to offset among reinsurance agreements.

In a letter dated May 8, 1973, from the New York Insurance Department's Office of General Counsel, it was stated that the policy of the Liquidation Bureau was to allow "offsets of mutual debts and credits of the same class between Reinsurance Contracts" entered into between the same parties.

In 1954 the New York Insurance Department published a multivolume work entitled Examination of Insurance Companies prepared under the direction of Deputy Superintendent Adelbert G. Straub, Jr. In volume 3 at 669 there is a section entitled "Miscellaneous Liabilities" which was written by Edward S. Hogan, an insurance examiner for the New York Insurance Department. He states at 683-84:

- A question has arisen whether a company may offset funds held as a ceding insurer against the excess which the funds it has deposited in an assuming capacity bear over the amounts carried for unpaid losses and reserves under the reinsurance agreement or agreements.... (I)t must also be recognized that both classes of funds are alike in nature and serve a common purpose. The funds therefore partake of the complexion of mutual debts, and in a liquidation proceeding the right of offset would be recognized pursuant to Section 538 (now 7427) of the New York Insurance Law. § 1301 (c)(ii) of the New York Insurance Code specifically allows offset among reinsurance agreements in the calculation of admitted assets. Premiums outstanding over 90 days may not be reflected as assets except reinsurance premiums payable which may be offset by amounts carried by the assuming insurer as liabilities for amounts due to the ceding insurer for unpaid losses and other mutual debts.

As support for its position the Liquidation Bureau has cited Hartnett v. Horace Mann Insurance Company decided by the Supreme Court Special Term and reported only in the New York Law journal of September 13, 1977. This case was settled before the perfection of an appeal. The court allowed offset within the same contract but ruled that offset among contracts was impermissible as a counter claim. As is demonstrated in this Subsection (b), this ruling is wrong and against the great weight of authority.

63. 92 U.S. 362 (1876).

64. Id. at 367.

65. Also in the context of an insolvent insurance company are Carr v. Hamilton, 129 U.S. 252 (1889) and New York Title & Mortgage Company v. Irving Trust Company, 198 N.E. 397 (N.Y. 1935), rearg. den., 198 N.E. 569 (N.Y. 1935). A leading bankruptcy treatise states:

- Under the legal and equitable principles of setoff, recognized by section 553(a),the mutual debt and claim contemplated are generally those arising from different transactions. A setoff is usually asserted for the purpose of reducing or extinguishing the creditor's claim against the debtor, but it may be entitled to a judgment in his favor for any excess over and above the creditor's claim to the debtor.

  Recoupment, on the other hand, is the setting up of a demand arising from the same transaction as the plaintiff's claim or cause of action, strictly for the purpose of abatement or reduction of such claim.

4 Collier on Bankruptcy § 553.03 (15th ed. 197 9) (emphasis in original) (footnotes omitted). See also Nutter, supra note 5, at 295-97.

66. Scott v. Armstrong, 146 U.S. 499, 510 (1892); see also Rosoff v. Roth, 262 F.2d 829 (2d Cir. 1959); O'Connor v. Ins. Co. of North Am., 622 F. Supp. 611 (N.D. W. 1985); In re Interstate Record Distribs., Inc., 307 F. Supp. 142 (S.D.N.Y. 1970), affd, 430 F.2d 101 7 (2d Cir. 1970).

67. Schenck v. Coordinated Coverage Corp., 3 76 N.Y.S.2d 131 (Sup. Ct. App. Div. 1975), was an action by a liquidator against an agent for contingent commissions. The agent sought to offset the amount of the commissions received and made a claim for a further amount. The court allowed offset of the amount already received by the agent but prohibited the claim for the excess amount. The court stated that a counterclaim "is broader and more comprehensive than recoupment and setoff. . . . (citation omitted). "[A] defendant who has pleaded set off is not entitled to recover the excess of his claim over the plaintiff's demand" (citation omitted). Id. at 134. The court further stated at 133:

- [W]here affirmative relief is sought-beyond a mere setoff up to the amount claimed by the liquidator-such relief is barred by the injunction provision in a liquidation order and the action or counterclaim seeking the affirmative relief must be dismissed, the claimant being relegated to filing a claim in the liquidation proceeding. . . .

In accord are O'Connor v. Ins. Co. of North Am., 622 F. Supp. 611 (N.D. Ill. 1985); Commonwealth v, Cent. Penn Nat'l Bank, 375 A.2d 874 (Pa. Com. Ct. 1977). *See* Nutter, supra note 5, at 296.

In O'Connor, the court declined to follow Thacher v. H. C. Baldwin Agency, Inc. 283 F.2d 857 (7th Cir. 1960) in which the court interpreted the liquidation order as barring the portion of offset rights by an agent. The Baldwin court was interpreting New York law which was later clarified by Schenck v. Coordinated Coverage Corp. The O'Connor court noted that the district court decision in Baldwin, Holz v. H. C Baldwin Agency, Inc., 140 F. Supp. 860 (S.D. Ind. 1956), disallowed the offset based on lack of mutuality.

It is submitted that the results in Baldwin and other actions between liquidators and agents can best be explained based on principals of agency and mutuality and the fact that premiums are trust funds held by the agent for the benefit of the company and cannot be offset against contract debts. See, e.g., § 2120 of the N.Y. Ins. Law and note 59, supra. Ratchford v. United States Cent. Underwriting Agency, 492 F. Supp. 137 (E.D. Mo. 1980); Manchester Ins. & Ind. v. Manchester Premium Budget Corp., 469 F. Supp. 126 (E.D. Mo. 1979); Harnett v. Nat'l Motorcycle Plan, Inc., 399 N.Y.S.2d 242 (Sup. Ct. App. Div. 1977).

68. See, e.g., § 7427 of the N.Y. INS. CODE.

69. 622 F. Supp. 611 (N.D. Ill. 1985). See also 4 Collins on Bankrutpcy, 68.02(l) and 68.10(2) (14th ed. 1978). In Melco System v. Trans-Am. Ins. Co., 105 So. 2d 43 (Ala. 1958), the court disallowed an offset either on the basis that it created a preference or on the basis that it was a postliquidation debt. Both propositions have been rejected by other courts. Scott v. Armstrong, 146 U.S. 499 (1892) and O'Connor v. Ins. Co. of N. Am., 6 2 2 F. Supp 61 1 (N. D. Ill. 19 8 5). The O'Connor court specifically rejected the reasoning of Melco. Moreover, the fact situation of Melco is distinguishable from most offset cases. The reinsurer settled its outstanding liabilities with the liquidator for $130,000 and later tried to assert a claim for premiums. Once the reinsurance recoverable was settled, there was nothing against which to offset.

70. Bull v. United States, 295 U.S. 247 (1935); Household Finance Corp. v. Hobbs, 3 87 A.2d 198 (Del. Sup. Ct. 1978); Luther v. Mathes, 21 1 Ill. App. 596 (2d Dist. 1918); James Talcott, Inc. v. Werco Sales Corp., 199 N.E.2d 499 (N.Y. 1964); Nat'l Cash Register Co. v. Joseph, 86 N.E.2d 561 (N.Y 1949).

71. In re Yonkers Sanitarium, Inc., 22 B.R. 427 (S.D.N.Y. 1982), aff'd, 34 B.R. 385 (S.D.N.Y. 1983); In re Dean L. Burdick Associates, Inc. 19 B.R. 813 (S.D.N.Y. 1982). *See also* notes 63 and 65, *supra*.

72. Waldschmidt v. CBS, Inc., 14 B.R. 309 (M.D. Tenn. 198 1); Quitner v. Los Angeles Steel Castingco., 202 F.2d 814(9th Cir. 1953); In re Yonkers Sanitarium, 22 B.R. 427 (S.D.N.Y. 1982), aid, 34 B.R. 385 (S.D.N.Y. 1983): 4 Collier on Bankruptcy § 553.12 (15th ed. 1981).