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REINSURANCE LITIGATION: A PRIMER

CHARLES F. CORCORAN, III*

INTRODUCTION

Historically, litigation between reinsurers and their reinsureds has been quite rare. As a result, the case law remains very sparse. However, intensifying economic pressures have caused this situation to change rapidly, and in recent years participants in the reinsurance industry have observed a dramatic increase in litigation. This article presents an overview of certain fundamental relationships created by the reinsurance contract, as well as a review of the rules governing litigation when these relationships falter.

I. REINSURANCE: TERMS AND OBLIGATIONS

A. *Definition and Purpose*

The essence of any reinsurance relationship is a written agreement whereby an insurer (here the reinsured or “ceding” company) transfers (“cedes”) to the reinsurer all or an agreed portion of the risk it has assumed from a third party or parties pursuant to a primary insurance contract with that third party. Under the contract of reinsurance, the reinsurer agrees to indemnify the reinsured in return for a portion of the premium received from that third party.¹ “[A] reinsurer is an insurance company’s insurer.”²

The reinsurer may in turn cede a portion of its reinsurance obligation to another reinsurer.³ Such an arrangement is known as a

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1. See *Transcontinental Underwriters Agency v. American Agency Underwriters*, 680 F.2d 298, 299 n.2 (3d Cir. 1982).

2. Donald W. Rees & Carol E. Reese, *Reinsurance: The Basics and Bad Faith Considerations*, 39 FED’N OF INS. AND CORP. COUNS. Q. 323, 323 (1989) (quoting Bart C. Sullivan, *Reinsurance in the Age of Crisis*, 38 FED’N OF INS. AND CORP. COUNS. Q. 3, 4 (1987)).

3. Henry T. Kramer, *The Nature of Reinsurance*, in REINSURANCE 1, 20 (Robert W. Strain ed., 1980).

“retrocession”—a reinsurance of reinsurance liability. If a retrocession is itself reinsured, it is called the first retrocession, and the next retrocession becomes known as the second retrocession, with the process continuing in like manner. The “retrocedent” is the ceding reinsurer and the assuming reinsurer is the “retrocessionaire.”⁴ Each retrocessionaire is free to assume what it determines to be an appropriate amount of risk.

The fundamental purpose of reinsurance is to spread the risk of loss from the original underwriter to another insurer.⁵ Reinsurance can contribute to the risk spreading objective in six basic ways: (1) it reduces the ceding insurer’s net exposure to liability on individual risks; (2) it protects the ceding insurer against the accumulation of losses arising out of catastrophes and natural disasters; (3) it can reduce the total liabilities of the ceding insurer to a level appropriate to its premium volume; (4) it can alter the ceding insurer’s mix of business, thereby reducing exposure in certain (possibly more hazardous) lines of business; (5) it can stabilize the overall operating results of the ceding insurer; and (6) it can assist the ceding insurer in developing new concepts and lines of insurance.⁶

Reinsurance for the ceding insurer is an essentially vertical redistribution of risk. Where an insurer is unwilling to assume the whole risk of the offered insurance, it may reinsure so much of its own risk as necessary to reduce its ultimate exposure to loss. Reinsurers may, in turn, reinsure their own risk with others to reduce their exposures to loss.⁷

It is important to understand that reinsurance is not coinsurance. Rather, the reinsurance contract “is separate and distinct from the [original] policy agreement entered into between the ceding company and its insured.”⁸ The original insured is not a party to the reinsurance agreement and there is no privity of contract between the original insured and the reinsurer.⁹ However, “reinsurance contracts may be drafted . . . [so] as to create a liability on the

4. *Id.*

5. *See* Sumitomo Marine & Fire Ins. Co. v. Cologne Reinsurance Co. of Am., 552 N.E.2d 139, 142 (N.Y. 1990).

6. Donald W. Rees et al., *Reinsurance Issues*, in *BAD FAITH LITIGATION AND INSURER VS. INSURER DISPUTES* 1989, at 57, 72-73 (PLI Com. Law & Practice Course Handbook Series No. 497, 1989); *see also* Rees & Reese, *supra* note 2, at 324-25.

7. Kramer, *supra* note 3, at 6.

8. Rees & Reese, *supra* note 2, at 324 (citing *American Re-Insurance Co. v. Insurance Comm’n*, 527 F. Supp. 444, 453 (C.D. Cal. 1981), *aff’d*, 696 F.2d 1267 (9th Cir. 1983)).

9. *Id.*

part of the reinsurer . . . in favor of the original insured.”¹⁰ This contractual exception to the privity rule is known as a “cut through” clause.

A cut through clause permits an original insured to bring an action directly against a reinsurer.¹¹ Without it, an insured cannot prevail on a claim against a reinsurer when the insurer fails to pay for losses covered under the original insurance policy.¹² Thus, an insured realizes the primary benefit of a cut through clause when an insurer becomes insolvent. The cut through clause enables the insured to look directly to the reinsurer for payment and to avoid dealing with the estate or liquidator of a bankrupt insurer.¹³ However, the reinsurer’s liability to the insured is limited to the amount of its share of the reinsured’s obligation.¹⁴

Generally speaking, reinsurers will be reluctant to incorporate a cut through clause into a reinsurance contract, unless substantial premiums are involved. However, a reinsurer might agree to the presence of a cut through clause to improve the marketability of its client’s (the reinsured’s) policies and thereby generate more reinsurance business.¹⁵ Additionally, a reinsurer might agree to a cut through clause when a mortgagee is unwilling to accept the policies of certain insurers as protection for collateral. This can occur when (1) the insurer does not have a satisfactory insurance industry rating, (2) the insurer is financially unstable or weak, or (3) the insurer is a new business or too small as compared with other insurers in the industry. Under these circumstances, the cut through will satisfy the mortgagee’s concerns because it allows the mortgagee to seek reimbursement directly from the reinsurer if the insurer becomes insolvent.¹⁶

B. *Categories of Reinsurance: Facultative and Automatic*

There are two fundamental varieties of reinsurance contracts:

10. *O’Hare v. Pursell*, 329 S.W.2d 614, 620 (Mo. 1959); *see also* *China Union Lines, Ltd. v. American Marine Underwriters, Inc.*, 755 F.2d 26, 30 (2d Cir. 1985) (noting that the reinsurer may agree to be directly liable to the original insured).

11. *Rees & Reese*, *supra* note 2, at 337.

12. *See Credit Managers Ass’n v. Kennesaw Life & Accident Ins. Co.*, 809 F.2d 617, 623-24 (9th Cir. 1987).

13. *See generally* *Kramer*, *supra* note 3, at 18-19.

14. *Rees & Reese*, *supra* note 2, at 340.

15. Robert A. Baker, *The Purpose of Reinsurance*, in *REINSURANCE* 33, 46-47 (Robert W. Strain ed., 1980); James D. Koehnen, *Administration and Maintenance of Business in Force*, in *REINSURANCE* 491, 508-09 (Robert W. Strain ed., 1980).

16. *Baker*, *supra* note 15, at 46-47; *Koehnen*, *supra* note 15, at 508-09.

facultative and automatic, or "treaty."¹⁷ Under a facultative reinsurance agreement, the ceding insurer contracts with the reinsurer on a policy-by-policy basis. The reinsurer may choose whether to accept or reject the opportunity to reinsure the policy in question, or it may stipulate on what terms it will agree to reinsure.¹⁸ A reinsurer will issue a separate certificate of facultative reinsurance for each policy it reinsures. Frequently, a number of reinsurers will issue certificates of facultative reinsurance, each assuming a portion of the liability for a single policy.¹⁹

By contrast, under an automatic or treaty reinsurance agreement, the reinsurer provides reinsurance on *all* policies of a certain type underwritten by the reinsured.²⁰ The reinsurer does not have the option of reinsuring specific policies, but rather reinsures a certain percentage of all classes or specified classes of the reinsured's business. For example, automatic or treaty insurance might provide that a reinsurer reinsures all of an insurer's homeowners' policies within a particular region for a period of one year.²¹

"Both treat[y] and facultative reinsurance agreements may be issued on either an excess of loss or pro rata basis."²² Under an excess of loss agreement, the reinsurer insures only those losses in excess of a stated retention or deductible. The concept is similar to that of a "deductible" in a primary insurance policy, where an insured pays a certain amount of money towards a loss before the insurer becomes responsible for payment. Under an excess of loss certificate of reinsurance, the reinsurer pays the amount of loss which exceeds a predetermined amount paid by the primary or ceding carrier. Under a pro rata agreement, the insurer and reinsurer share both premiums and losses according to a predetermined proportion.²³

Typically, reinsurance is a contract of indemnity rather than lia-

17. *Sumitomo Marine & Fire Ins. Co., Ltd. v. Cologne Reinsurance Co. of Am.*, 552 N.E.2d 139, 142 (N.Y. 1990); *see also* Rees & Reese, *supra* note 2, at 325.

18. *Sumitomo Marine*, 552 N.E.2d at 142; *see also* Rees & Reese, *supra* note 2, at 326.

19. *Christiana General Ins. Co. v. Great Am. Ins. Co.*, 745 F. Supp. 150, 152 (S.D.N.Y. 1990).

20. Rees & Reese, *supra* note 2, at 325-26.

21. *See* Mary Ann Overholt, *Ethical Considerations in Reinsurance*, in *RESOLVING REINSURANCE DISPUTES: CONTRACTS, ARBITRATION, LITIGATION*, at 109, 113-14 (ABA Tort and Ins. Practice Section 1989).

22. Rees & Reese, *supra* note 2, at 326.

23. *Id.*

bility.²⁴ This means that generally a reinsurer will pay reinsurance proceeds to a ceding company “only after the ceding company has paid for a loss covered by the underlying policy.”²⁵ Because the occasion of a loss is not enough in and of itself to trigger a reinsurer’s liability, litigation involving a reinsurance contract is likely to take either of the following forms: (1) a reinsurer’s action for a declaratory judgment or (2) a reinsured’s action against the reinsurer for the latter’s refusal to indemnify.

II. CASE LAW ON REINSURANCE

A. *Rules of Construction*

Reinsurance contracts are agreements negotiated between insurers. Therefore, both parties to the agreement are presumed to have a degree of sophistication regarding insurance contracts. As a result, courts will generally enforce the written terms contained in reinsurance certificates and treaties without reference to contra-insurer rules of construction.²⁶ For example, in *Great American Insurance Co. v. Fireman’s Fund Insurance Co.*,²⁷ the Court of Appeals for the Second Circuit found that the “general rule [the contra-insurer rule of construction] should not apply when both the insured and insurer are ‘large insurance companies long engaged in far-flung activities in that field of economic activity.’”²⁸

But while the rules of construction protecting unsophisticated

24. *China Union Lines, Ltd. v. American Marine Underwriters, Inc.*, 755 F.2d 26, 30 (2d Cir. 1985); *Rees & Reese*, *supra* note 2, at 323-24.

25. *Rees & Reese*, *supra* note 2, at 324.

26. Contra-insurer rules are those rules of construction which resolve ambiguities in an insurance contract in favor of the insured and against the insurer who drafted the contract. *See, e.g.*, *Continental Casualty Co. v. Cole*, 809 F.2d 891, 895 (D.C. Cir. 1987); *Vargas v. Calabrese*, 714 F. Supp. 714, 720 (D.N.J. 1989), *aff’d*, 949 F.2d 665 (3d Cir. 1991).

For example, courts will resolve uncertainties about coverage in favor of the most inclusive interpretation for the benefit of the insured. *Vargas*, 714 P. Supp. at 724; *Holz Rubber Co. v. American Star Ins. Co.*, 533 P.2d 1055, 1063 (Cal. 1975). Likewise, exclusionary clauses will be interpreted narrowly. *Thomas V. Lipton, Inc. v. Liberty Mutual Ins. Co.*, 314 N.E.2d 37, 39 (N.Y. 1974). Ambiguity in the language of the policy will be resolved by examining a term in the insurance contract as it is understood by a lay person, and not as it is understood by persons in the insurance industry. *Stainless, Inc. v. Employers’ Fire Ins. Co.*, 418 N.Y.S.2d 76, 79 (App. Div. 1979), *aff’d*, 406 N.E.2d 490 (N.Y. 1980). Finally, insurance policies are interpreted according to the reasonable expectations of a lay person, notwithstanding the clarity or ambiguity of the policy language. *Id.*; *Vargas*, 714 F. Supp. at 720.

27. 481 F.2d 948 (2d Cir. 1973).

28. *Id.* at 954 (quoting *Boston Ins. Co. v. Fawcett*, 258 N.E.2d 771, 776 (Mass. 1970)).

insureds are disregarded, general rules of contract interpretation still apply. Therefore, when contract language is ambiguous, the court will interpret the ambiguity against the party that drafted the document.²⁹ For example, in *Travelers Insurance Co. v. Central National Insurance Co.*, the United States District Court for the District of Connecticut held that a notice clause which referred to claims “likely to involve reinsurance” raised an “ambiguity [that] must be construed against [the reinsurer] which drafted the [facultative] Reinsurance Certificate.”³⁰

B. *Liability: Following the Fortunes*

Many reinsurance contracts contain what is known as a “follow the fortunes” clause.³¹ A follow the fortunes clause typically provides that “all claims covered by the reinsurance, when settled by the reinsured, are binding on the reinsurer,”³² or that “the liability of the reinsurer follows that of the reinsured.”³³ When such a clause is made part of the reinsurance contract, the reinsurer must follow the fortunes of the ceding company—meaning that the reinsurer is bound by any settlement or judgment under the original policy that the ceding company paid in good faith and in accordance with the terms of the reinsurance certificate.

The principle behind the follow the fortunes doctrine is to preclude reinsurers from denying payment on a reinsured’s good faith settlement when coverage of the underlying claim under the original policy is undisputed and the reinsured has honored the terms of its contract with the reinsurer.³⁴ When coverage *is* disputed, a follow the fortunes clause will bind the reinsurer only when the ceding company settled a claim which was “reasonably encompassed within the bounds of the underlying policy.”³⁵

29. See, e.g., *Travelers Ins. Co. v. Central Nat’l Ins. Co.*, 733 F. Supp. 522, 528 (D. Conn. 1990).

30. *Id.* at 528.

31. Rees & Reese, *supra* note 2, at 341.

32. See *id.*

33. *Id.*

34. *Id.*

35. *Id.* (quoting *Insurance Co. of N. Am. v. United States Fire Ins. Co.*, 322 N.Y.S.2d 520, 523 (Sup. 1971); see also *Mentor Ins. Co. (U.K.) Ltd. v. Brannkasse*, 996 F.2d 506, 516-17 (2d Cir. 1993). A reinsurer is not bound under a “follow the fortunes” clause by any settlement made by the ceding company which is outside the scope of the original policy. A reinsurer is relieved of liability to its cedent if it can show that a good faith settlement was clearly outside the scope of the policy reinsured or that the settlement was tainted by fraud or bad faith which prejudiced the reinsurer. See *American Ins. Co. v. North Am. Co. for Property & Casualty Ins.*, 697 F.2d 79, 81 (2d Cir. 1982).

A reinsurer recently challenged this tenet, in *Mentor Insurance Co. (U.K.) Ltd. v. Brannkasse*.³⁶ The reinsurer argued that the follow the fortunes doctrine did not require the reinsurer to pay because although the loss eventually was deemed a constructive total loss, the *original* claim was not for a total loss, as required by the reinsurance contract.³⁷ In rejecting that argument, the United States Court of Appeals for the Second Circuit ruled that a reinsurer is obligated to follow the fortunes of a ceding company and pay its portion of the claim whenever the ceding company settles the claim in good faith and satisfies the conditions of the reinsurance contract.

The controversy in *Mentor* arose from an insurance policy issued by Oil Insurance Ltd. ("OIL") for hull and machinery damage on an oceangoing oil rig. The policy also provided for a one million dollar deductible, which Mentor separately insured.³⁸ A.I.G. Oil Rig, Inc. ("AIG"), and other reinsurers, reinsured a portion of the Mentor policy under a contract which provided that the reinsurance was "[s]ubject to all terms, clauses, conditions and settlements as original but only to cover in respect of Total and/or Constructive and/or Arranged and/or Compromised Total Loss of Unit."³⁹ When the oil rig sank, the loss was clearly in excess of the deductible on the OIL insurance policy. Mentor paid its policy limit, while OIL adjusted the loss. OIL ultimately settled the claim with the insured as a "constructive total loss."⁴⁰ Subsequently, Mentor sought reinsurance proceeds from AIG, but AIG denied payment.⁴¹

AIG's refusal to pay was based on a dispute as to whether the oil rig was a total loss under the total-loss-only reinsurance coverage.⁴² The insured originally submitted its claim on a partial loss basis. AIG argued that the loss could not have been covered by the reinsurance contract because it was in fact a partial loss, despite the ceding company's settlement and classification of the loss as a "constructive total loss."⁴³

The Second Circuit disagreed with AIG, and affirmed that part

36. 996 F.2d 506 (2d Cir. 1993).

37. *Id.* at 517.

38. *Id.* at 507.

39. *Id.* at 508.

40. *Id.*

41. *Id.* at 509.

42. *Id.* at 514.

43. *Id.*

of the district court's decision which adopted the following findings of a special master: (1) the loss was covered under both the OIL and Mentor policies;⁴⁴ (2) OIL's settlement of the loss as constructive and total was an arms-length transaction, untainted by fraud, collusion, or bad faith;⁴⁵ (3) Mentor's settlement of the loss was an arms-length transaction, untainted by fraud, collusion, or bad faith;⁴⁶ and (4) the custom and practice of the reinsurance industry required a reinsurer to follow the fortunes of the ceding company when the latter settled a claim in good faith, without fraud, and in accordance with the reinsurance contract.⁴⁷ According to the Second Circuit OIL's settlement of the claim as a constructive total loss actuated the risk assumed by the deductible policy and triggered the total loss risk ceded to the reinsurers.⁴⁸

Another key aspect of the follow the fortunes doctrine is that if the terms of the reinsurance contract differ from the terms of the underlying policy, the terms of the reinsurance contract control.⁴⁹ For example, in *Bellefonte Reinsurance Co. v. Aetna Casualty and Surety Co.*,⁵⁰ the Second Circuit considered whether the plaintiff as reinsurer was required to indemnify Aetna for defense costs in excess of the policy limits set forth in the certificate of reinsurance.⁵¹ Bellefonte did not disagree that it was obliged to follow Aetna's fortunes as to the actual settlement figure of the basic claim. But Aetna contended that the reinsurance certificates also required Bellefonte and the other plaintiff reinsurers to follow Aetna's fortunes and indemnify it for its excess costs of defense.⁵² Aetna argued that the plaintiff reinsurers were obliged to pay beyond the certificate limits when the extra defense costs were reasonable and expended in good faith on the settlement of a dispute covered by the underlying policy.⁵³

The Second Circuit disagreed, holding that Aetna's interpretation of the provision at issue "would strip the limitation clause and other conditions of all meaning; the reinsurer would be obliged

44. *Id.* at 514-15.

45. *Id.* at 515.

46. *Id.* at 517.

47. *Id.* at 516-17.

48. *Id.* at 517.

49. *See, e.g., Bellefonte Reinsurance Co. v. Aetna Casualty and Surety Co.*, 903 F.2d 910 (2d Cir. 1990).

50. *Id.*

51. *Id.* at 912.

52. *Id.*

53. *Id.*

merely to reimburse the insurer for any and all funds paid.”⁵⁴ The court held that the follow the fortunes doctrine did not permit Aetna to collect from the reinsurer any defense costs in excess of the express cap set forth in the certificates.⁵⁵

Logically, then, the follow the fortunes doctrine does not give rise to new reinsurer liabilities outside the specifications of the contract, even when the loss occurs within the underlying insurance policy.⁵⁶ For example, if the loss occurs within the policy period but not within the period provided in the facultative certificate or treaty, the reinsurer will not be liable.⁵⁷

C. *Dispute Resolution Through Arbitration*

Most reinsurance contracts require that disputes between the reinsurer and reinsured be settled by arbitration. Provisions calling for arbitration are generally strictly enforced.⁵⁸ Therefore, when a party agrees to include an arbitration provision in the contract, it forfeits the opportunity to resolve in court any disputes arising out of that contract.⁵⁹ In addition, after an arbitrator has ruled, a “court is compelled to confirm [the ruling] . . . unless the arbitrator was corrupt or thoroughly incompetent.”⁶⁰

The Federal Arbitration Act⁶¹ (“FAA”) demonstrates a strong federal policy fostering arbitration.⁶² This policy, which obligates federal courts to strictly enforce arbitration agreements, has been applied in the reinsurance arena.⁶³ Under the FAA, courts have the power to order a stay of the proceedings before them while arbitration is pending.⁶⁴ In *Clarendon National Insurance Co. v. Transamerica Insurance Co.*,⁶⁵ the United States District Court for the Southern District of New York exercised this right and ordered a stay of the proceedings between a reinsurer and a reinsured pur-

54. *Id.* at 913.

55. *Id.* *Accord* Unigard Security Ins. Co., Inc. v. North River Ins. Co., 4 F.3d 1049, 1070-71 (2d Cir. 1993).

56. Clifford H. Schoenberg, *Follow the Fortunes: The Reinsurance Contract Controls*, 3 MEALEY'S LIT. REP. (REINSURANCE) 17 (1992).

57. *Id.*

58. Michael J. Sehr et al., *Excess, Surplus Lines, and Reinsurance: Recent Developments*, 27 TORT AND INS. L.J. 227, 237 (1992).

59. *Id.*

60. *Id.* at 238.

61. 9 U.S.C. §§ 1-16 (1988 & Supp. IV 1992).

62. Sehr, *supra* note 58, at 237.

63. *Id.*

64. *Id.* at 238.

65. 1992 WL 122781 (S.D.N.Y. May 22, 1992).

suant to an arbitration provision in the reinsurance contract.⁶⁶ The court ruled that the disputes between Clarendon and Transamerica were "clearly within the scope of [the reinsurance agreement]" and therefore proper for arbitration.⁶⁷ The FAA also permits a court to order arbitration when there has been an apparent "failure, neglect, or refusal" by the parties to comply with the agreement.⁶⁸ In addition, federal courts must order arbitration if the reinsurance contract provides for arbitration and either party demands it.⁶⁹

However, there is an exception to the rule requiring that arbitration provisions be strictly enforced. This exception applies when an insurance company has become insolvent and its estate or liquidator is attempting to recover reinsurance proceeds. Two state courts recently dealt with this very issue, with markedly different results.

In *Corcoran v. Ardra Insurance Co.*⁷⁰, the New York Court of Appeals held that the state liquidator of an insolvent insurance company was not obligated to settle the insurance company's claims against foreign reinsurers by arbitration. The reinsurers claimed that the court was required to order arbitration pursuant to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards.⁷¹ The court of appeals, however, rejected that argument and ruled that Article II of the Convention required a liquidator to arbitrate only those claims which were capable of resolution by arbitration.⁷² The court found that the dispute in question was not proper for arbitration because, under New York law,⁷³ courts have exclusive jurisdiction over liquidation proceedings.⁷⁴ Therefore, the state liquidator had no authority to place the insolvent insurance company's claims before an arbitrator.

In sharp contrast to the *Corcoran* decision, a Pennsylvania court considered an arbitration agreement and ruled that under Pennsylvania law, agreements to arbitrate are valid, enforceable, and irrevocable.⁷⁵ In *Foster v. Philadelphia Manufacturers*, the

66. *Id.* at *1.

67. *Id.*

68. Sehr, *supra* note 58, at 238.

69. *Id.*

70. 567 N.E.2d 969 (N.Y. 1990), *cert. denied*, 111 S. Ct. 2260 (1991).

71. *Id.* at 970 (relying on United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 21 U.S.J. 2517 (June 10, 1958)).

72. *Id.* at 973.

73. See N.Y. INS. LAW § 7417 (McKinney 1985).

74. *Corcoran*, 567 N.E.2d at 973.

75. *Foster v. Philadelphia Mfrs.*, 592 A.2d 131, 133 (Pa. Commw. Ct. 1991).

court rejected the *Corcoran* decision, noting that Pennsylvania, unlike New York, did not give courts exclusive jurisdiction over proceedings involving insolvent insurance companies.⁷⁶ As a result, the *Foster* court held that Pennsylvania's insurance commissioner was obligated to arbitrate the insurance company's claims.⁷⁷ As the number of insurer insolvencies increases, enforcement of arbitration provisions is likely to remain at the forefront of reinsurance contract disputes.⁷⁸

D. *Insolvent Reinsureds*

A reinsurer cannot deny reinsurance coverage simply because the reinsured becomes insolvent. In most cases, reinsurance contracts provide that upon insolvency, reinsurance proceeds are payable to the successor of the ceding insurer "without diminution because of such insolvency."⁷⁹ Some reinsurers have claimed that such language is too restrictive because it precludes reinsurers from offsetting liabilities to the insolvent insurer by the amount that the insurer owes to the reinsurer.⁸⁰

Recently, in *Kemper Reinsurance Co. v. Corcoran* (In re *Midland Insurance Co.*),⁸¹ the New York Court of Appeals held that Kemper Reinsurance Company ("Kemper"), a reinsurer, could offset reinsurance proceeds due to Midland Insurance Company ("Midland"), its reinsured, against amounts Midland owed to Kemper under an entirely unrelated contract.⁸² Midland had negotiated a reinsurance treaty with Kemper whereby Kemper agreed to provide reinsurance for certain policy lines.⁸³ Several years later, Midland issued an excess products liability insurance policy to Playtex, Inc. and reinsured seventy-five percent of the risk under a facultative certificate from Kemper. The reinsurance contract contained a clause which stated in pertinent part:

In the event of the insolvency of [Midland], reinsurance under this Agreement shall be payable by [Kemper] on the basis of the

76. *Id.*

77. *Id.* at 134.

78. Sehr, *supra* note 58, at 237-38.

79. See, e.g., William G. Clark, *Facultative Reinsurance: Reinsuring Individual Policies*, in REINSURANCE 117, 134 (Robert W. Strain ed., 1980).

80. James V. Schibley, *The Life Reinsurance Contract*, in RESOLVING REINSURANCE DISPUTES, CONTRACTS, ARBITRATION, LITIGATION, at 1, 17 (ABA Tort and Ins. Practice Section 1989).

81. 590 N.E.2d 1186, 1187 (N.Y. 1992).

82. *Id.* at 1190.

83. *Id.* at 1188.

liability of [Midland] under the Reinsurance Agreement, *without diminution because of such insolvency*, directly to [Midland] or its liquidator, receiver or statutory successor, except as otherwise specified in the statutes of any state having jurisdiction of the insolvency proceedings.⁸⁴

Thus, the reinsurance contract required Kemper to pay reinsurance proceeds regardless of Midland's solvency.⁸⁵

When Midland became insolvent in 1986, it owed Kemper unpaid premiums on the reinsurance treaty. Kemper, in turn, owed Midland an estimated three quarters of a million dollars in reinsurance proceeds for losses under the Playtex contract. Kemper attempted to offset Midland's unpaid premiums under the treaty against the amount Kemper owed Midland under the Playtex contract, but Midland objected.⁸⁶ Midland's liquidator argued that the respective debts could not be offset because (1) they arose out of separate and distinct transactions; (2) the insolvency clause in the Playtex contract precluded Kemper from offsetting the debts; and (3) the debts were owed by, and payable to, different people.⁸⁷

The court rejected the liquidator's reasoning and found that mutual debts need not necessarily arise from the same transaction.⁸⁸ In so ruling, the court looked to the legislative history of section 420 of New York's insurance statute (the predecessor to section 7427, allowing offsets of mutual debts and credits)⁸⁹ and noted that section 420 "was patterned after the conventional provisions commonly found in insolvency laws and the provisions of the Bankruptcy Act."⁹⁰ The court then noted that the bankruptcy laws permit offsets arising out of different transactions. In addition, the court found that the right to offset was an important one because "it provides a form of security to insurers."⁹¹ As a result, the court concluded that the "contractual obligations between Kemper Re and Midland constitute[d] 'mutual debts' for purposes of offset under section 7427 of the Insurance Law despite the fact that they [arose] out of two separate and distinct transactions."⁹²

The court declined to follow the liquidator's argument that the

84. *Id.* at 1191 n.3 (emphasis in original).

85. *Id.* at 1191-92.

86. *Id.*

87. *Id.*

88. *Id.* at 1189-91.

89. N.Y. INS. LAW § 7427 (McKinney 1985) (formerly § 420).

90. *Midland*, 590 N.E.2d at 1189.

91. *Id.* at 1191.

92. *Id.*

insolvency provision in the Playtex agreement forbade offset. The relevant language stated that the reinsurance monies would be tendered to the liquidator “‘without diminution because of such insolvency.’”⁹³ The court ruled that the liquidator had “misconstrued the purpose of the insolvency clause,”⁹⁴ and observed that the insolvency provision merely obligates the reinsurer to indemnify the liquidator for its share under the agreement even if the insolvent insurer had not made payments to the insured.⁹⁵ The court then noted that “liquidation cannot place the liquidator in a better position than the insolvent company he takes over, authorizing him to demand that which the company would not have been entitled to prior to liquidation.”⁹⁶ The court therefore held that Kemper did not lose its right to offset treaty premiums against monies due pursuant to the terms of the facultative certificate “merely because a liquidation order was entered.”⁹⁷

CONCLUSION

Reinsurance is a most imaginative and flexible concept. It allows smaller insurers to become competitive with bigger ones, and enables bigger insurers to grow.⁹⁸ For centuries the reinsurance industry operated on handshakes, without the need to turn to the courts for intervention. But as we move to the end of this century, with the enormous financial stresses created by huge environmental liabilities, changing weather patterns, astonishing jury verdicts, and increasing insurer insolvencies, we see this picture rapidly changing. Our courts are now confronted with the challenge of comprehending this highly complex area of insurance sufficiently well to insure fair and reasonable solutions to the disputes of its participants.

93. *Id.* (quoting the Insurance contract).

94. *Id.*

95. *Id.* at 1192.

96. *Id.*

97. *Id.*

98. Kramer, *supra* note 3, at 30-31.