

CHAPTER 6 – GUARANTY FUNDS / ASSOCIATIONS

NOTE: ALL PAGE NUMBERS WILL BE UPDATED IN THE FINAL

- I. INTRODUCTION325**
- II. PROPERTY AND CASUALTY GUARANTY FUNDS326**
 - A. Introduction..... 326
 - B. Triggering Fund Liability 326
 - 1. General Statutory Activation Requirements..... 326
 - 2. Regulatory Status of Company..... 327
 - 3. Court of Competent Jurisdiction 327
 - 4. Liquidation Order 328
 - C. Scope of Coverage 328
 - D. Notice and Proof of Claims..... 329
 - 1. Notice 329
 - 2. Proof of Claim 330
 - 3. Late-Filed Claims 330
 - E. Claim Files Information..... 331
 - 1. Information Needed by Guaranty Funds 331
 - 2. Claim Files 332
 - F. Unearned Premium Claims 332
 - G. Claim Reporting..... 333
 - H. Claims Exceeding Guaranty Fund Limits and Aggregate Claims 334
 - 1. Claims Exceeding Guaranty Fund Limits or Claims Excluded from Guaranty Fund Coverage..... 334
 - 2. Aggregate Claims 335
 - I. Early Access 336
 - 1. Timing 336
 - 2. Reserves 336
 - 3. Liquid or Distributable Assets..... 337
 - 4. Early Access Agreements..... 337
 - 5. Expenses..... 338
 - 6. Basis of Distribution..... 338
 - 7. Special Deposits 338
 - 8. Salvage/Subrogation..... 338
 - J. Large Deductible Policies 339
 - K. Coordination among Regulators, Receivers and Guaranty Funds 339
- III. LIFE AND HEALTH GUARANTY ASSOCIATIONS..... 340**
 - A. Introduction..... 340
 - B. Triggering Fund Liability 341
 - 1. “Insolvent” Insurers..... 341
 - 2. “Impaired” Insurers 341
 - C. Scope of Coverage 341
 - 1. Covered Policies and Limits of Coverage..... 341
 - 2. Exclusions 342
 - 3. Residency Requirements 343
 - D. Guaranty Association Claims Administration 343
 - 1. Information Needs of the Guaranty Associations..... 344
 - 2. Notice to Claimants 345
 - 3. Notice to Guaranty Associations 345
 - 4. Proof of Claim 346

5. Claim Files 346

6. Premiums..... 346

E. Early Access 346

F. Claim Reporting..... 347

G. Guaranty Association Obligations During the Formulation of a Rehabilitation or Liquidation Plan 347

H. Reinsurance..... 347

I. Special Issues..... 347

J. Guaranty Association Procedures for Collective Action 347

IV. RECEIVERS' EXPECTATIONS FOR GUARANTY FUND/ASSOCIATION DUES AND EXPENSESERROR! BOOKMARK NOT DEFINED.

A. Introduction..... **Error! Bookmark not defined.**

B. Principles and Expectations **Error! Bookmark not defined.**

I. INTRODUCTION

This chapter provides an overview of the operation of state Property and Casualty Insurance Guaranty Funds and the Life and Health Insurance Guaranty Associations and their relationship to a receivership. All 50 states, Puerto Rico, the United States Virgin Islands (property/casualty only) and the District of Columbia have a guaranty mechanism¹ in place for the payment of covered claims arising from the insolvency of insurers licensed in their state. In the case of life/health insurance, the guaranty mechanism also provides for the continuation of eligible contracts that would otherwise terminate because of the insolvency. Before the creation of guaranty association systems, a typical claimant might wait years for payment of a claim and then receive only a small percentage of what was due under the policy or contract. Guaranty associations, subject to statutory limitations, alleviate these problems. Section II of this chapter will discuss in greater detail the operation of property/casualty guaranty funds. Section III is devoted entirely to life/health guaranty associations.

Insurance guaranty mechanisms obtain the funds necessary to pay claims from remaining estate assets, in some cases from statutory deposits collected by states and by assessing member insurers. Assessments are limited by state law to a certain percentage of the members' written premium. In the case of property casualty guaranty funds, the members may be permitted by statute to recoup the assessments through premium increases, premium tax offsets or policy surcharges. As for the life/health guaranty associations, recoupment of assessments through premium increases or policy surcharges is typically not feasible because many life/health contracts are issued on a level premium basis.² The burden of the assessments on solvent insurers is mitigated in the majority of states, by statutes that allow insurers to offset a portion of the insurer's assessments, over a period of years, against the insurer's premium tax liability. Section 13 of the NAIC's Life and Health Insurance Guaranty Association Model Act (the "Life Model Act"), some version of which has been adopted in most states, permits offsets against premium, franchise or income taxes over a five year period for amounts paid by life/health insurers to meet their assessment obligations. In addition, Section 9G of the Life Model Act allows life/health insurers to consider the amount reasonably necessary to meet their assessment obligations in the determination of the premiums they charge.

Guaranty associations (both life and health and property and casualty) in most states are overseen by a board of directors, largely composed of representatives of member insurers. Some guaranty association boards also include public members. A minority of guaranty associations also have representatives of state departments of insurance or legislative representatives sitting on the guaranty association's board. The guaranty associations typically employ a Manager, Administrator or Executive Director to oversee daily operations.

Before a claim against an insolvent insurer can be considered a "covered claim" and eligible for guaranty association coverage, the guaranty association must be "triggered" with respect to the particular insolvency. Guaranty associations generally are triggered by the issuance of a court order of liquidation with a finding of insolvency. Some guaranty associations may be triggered under other circumstances. In the event of a multi-state insolvency, it is important that the receiver communicate and coordinate with NOLHGA or NCIGF as appropriate, before preparing an order of rehabilitation or liquidation. This will ensure that guaranty associations are triggered as intended, and are not triggered prematurely or inadvertently. NOLHGA and NCIGF have the ability to help with coordination and communication to affected GAs.

The guaranty associations and the receiver both have statutory duties to protect policyholders of the insolvent insurer. The duties of the guaranty associations to protect policyholders are limited to covered policies or claims, as set forth in state guaranty association statutes. The guaranty associations can be very helpful, if not critical, to

¹ The term "guaranty fund" typically refers to a property and casualty insurance guaranty fund. The term "guaranty association" typically refers to a life and health insurance guaranty association. However, in various places throughout this handbook, the terms "guaranty fund" and "guaranty association" are often used synonymously, particularly when referring to both types of guaranty mechanisms. Efforts have been made in this chapter to specify property and casualty or life and health when referring specifically to one or the other type of guaranty mechanism or insurer insolvency proceeding.

² A few states do permit policy surcharges to recoup assessments for health insurance insolvencies.

the receivership process. In a life/health insolvency, for example, the guaranty associations may, in some cases, be able to arrange for and facilitate transfer of covered obligations to a solvent insurer upon entry of an order for liquidation with a finding of insolvency, provided there has been sufficient pre-liquidation planning and coordination.³ Maintaining open communication and cooperation between the guaranty associations and the receiver (subject to appropriate confidentiality agreements) during pre-receivership planning and throughout the course of the proceedings will enable both the guaranty associations and the receiver to function more efficiently for the benefit of those whose interests they are obligated to serve.

II. PROPERTY AND CASUALTY GUARANTY FUNDS

A. Introduction

Most property/casualty guaranty fund enabling acts are based on the NAIC Post-Assessment Property and Liability Insurance Guaranty Association Model Act (Model Act). Although the Model Act is useful for a better understanding of how guaranty funds operate, the law in each state should be consulted, as most states have modified provisions of the Model Act.

The property and casualty guaranty funds have formed an organization known as the National Conference of Insurance Guaranty Funds (NCIGF). Its address is:

National Conference of Insurance Guaranty Funds
300 North Meridian Street
Suite 1020
Indianapolis, IN 46204
Phone: (317) 464-8199
Facsimile: (317) 464-8180
Web site: <http://www.ncigf.org>

NCIGF can be a useful source of information to receivers when a new property/casualty insolvency occurs. It can help disseminate information to triggered guaranty funds, schedule initial meetings between the receiver and guaranty funds, and establish a coordinating committee to work with the receiver to resolve issues that may arise during the receivership. This organization can also provide names and addresses of guaranty fund contacts and assistance in establishing data reporting to and from the guaranty funds. The Secure Uniform Data Standards (SUDS) is managed by the NCIGF and has become the standard mechanism to transfer data in a secure manner. (See *supra* for more information on UDS and SUDS.)

The NCIGF Web site (See at <http://www.ncigf.org>) has tables that summarize the key provisions contained in each state's property/casualty guaranty fund enabling act, including lines of insurance covered, whether coverage is provided for unearned premium, whether the guaranty fund has net worth limitations or a claims bar date and the per claim limit and deductible that applies to each claim. The tables are intended to provide a general summary of the guaranty fund laws. The applicable state statute should be reviewed to determine coverage for a specific claim.

B. Triggering Fund Liability See Chapter 1(II) (G) (4)

1. General Statutory Activation Requirements

Previously, the Model Act defined insolvent insurer as "(a) an insurer authorized to transact insurance in this state either at the time the policy was issued or when the insured event occurred, and (b) determined to be insolvent by a court of competent jurisdiction." Due to a variety of triggering related

³ In some instances, it is possible to arrange for the transfer to close as of the effective date of the liquidation order.

issues that could not be readily resolved by such a general, simplistic definition, amendments to the Model Act expanded the definition of “insolvent insurer” to read as follows:

“Insolvent insurer” means an insurer licensed to transact insurance in this state, either at the time the policy was issued or when the insured event occurred, and against whom a final order of liquidation has been entered after the effective date of this Act with a finding of insolvency by a court of competent jurisdiction in the insurer’s state of domicile.

This amended language makes it clear that guaranty fund resources are only to be used in situations where any doubt pertaining to the insurer’s insolvent status has been fully considered and resolved by a judicial proceeding. It must be noted, however, that there are a number of variations found within enacted guaranty fund statutes around the country. While many jurisdictions have either adopted or moved toward the current Model Act triggering test, there are numerous others that fall at various points along the spectrum between the current version and the original 1969 version. It is imperative that the statutes be carefully reviewed in each jurisdiction where activation is anticipated.

2. Regulatory Status of Company

In addition to being declared insolvent, an insurer must have been “licensed,” either at the time the policy was issued or when the loss occurred, to be eligible for guaranty fund coverage.⁴

New Jersey has a separate statutory mechanism for the payment of covered claims arising in connection with coverages issued by eligible surplus lines insurers. This mechanism exists in addition to the guaranty fund for insolvent licensed property and casualty insurers. Even in New Jersey, however, there is no statutory protection for ineligible surplus lines insurers.

The initial triggering inquiry must not be limited to whether the insurer in question was licensed at the time of the finding of insolvency.⁵ Many, probably most, guaranty fund acts contain language that is sufficiently broad to include claims against an insurer whose license has been surrendered or revoked prior to the declaration of insolvency, so long as the insurer was licensed at the time the policy was issued or when the insured event occurred. When this situation arises, the receiver should contact the relevant guaranty fund as it will be most familiar with its enabling statute and local court decisions interpreting the statute.

3. Court of Competent Jurisdiction

The requirement of a finding of insolvency can only be satisfied by a judicial declaration. The rationale for this requirement is that activation triggers numerous consequences, many of which are irreversible once put in motion. Judicial review is perceived to be an effective safeguard against arbitrariness and ambiguity.

The current version of the Model Act gives exclusive competent status to the court that is within the insurer’s state of domicile. Although it is theoretically possible for a court in another jurisdiction to be viewed as competent for the purpose of triggering guaranty fund obligations, the Model Act’s current version does not confer jurisdiction on these courts.

⁴ In this context, “Licensed” means holding a Certificate of Authority, which authorizes an insurer to do business in a state. Such insurers are also referred to as “admitted insurers.” Insurers doing business on a surplus lines or other non-admitted basis are not authorized.

⁵ At the time of publication of this Handbook, the NAIC is considering “restructuring mechanisms” permitted under the laws of some states (i.e., insurance business transfers and corporate divisions). Whether claims of an assuming or resulting insurer in one of these transactions would be considered “covered claims” eligible for guaranty fund coverage in the event of its liquidation is a question of state law. NCIGF is working with the NAIC to address this issue and provide clarity going forward.

4. Liquidation Order

Were a court of competent jurisdiction to issue a declaration of insolvency that is later modified or reversed on appeal, after guaranty funds have been triggered and claim payments have been initiated, problems can arise. To remedy such consequent dilemmas, both the Model Act and many state legislatures have modified the triggering test, requiring that the judicial declaration of insolvency be final. In other words, activation of guaranty funds in such jurisdictions can be deferred, and perhaps avoided, depending upon the pursuit or exhaustion of stays or appellate remedies.

Nonetheless, although the Model Act drafters clearly contemplated that activation of the guaranty funds would occur only where liquidation had been ordered, the wording of the initial triggering clause left open the possibility that companies placed in rehabilitation could trigger guaranty fund benefits. The more current view, which has also been incorporated in the Model Act, is to require not only a final determination of insolvency, but rather an actual order of liquidation with a finding of insolvency. This limiting language precludes the use of guaranty fund resources as bail-out funds to be used in an attempt to rehabilitate—rather than liquidate—the company. There are a few guaranty funds, however, which still trigger with a finding of insolvency without an order of liquidation. Because of the complexity and variation from state to state of the trigger, it is important to seek legal assistance and to work with the NCIGF when drafting the orders of liquidation or rehabilitation to ensure the appropriate activation of the guaranty funds. (See the Laws and Laws Summaries under Resources on the NCIGF Web site at <http://www.ncigf.org>).

C. Scope of Coverage

Guaranty funds that have been properly triggered by a liquidation order are obligated to pay “covered claims,” that is, claims that are defined as covered under the applicable guaranty fund act(s). Generally speaking, unpaid loss and unearned premium claims under specified property/casualty lines of business written by an insolvent insurer are covered claims, but only to the extent of the lesser of either (1) the applicable policy limits; or (2) the statutory guaranty fund limits on covered claim payments. Residency is usually determined at the time of the insured event. In addition, in order for claims to be covered, the various acts typically require that: the claim be incurred either prior to the entry of the liquidation order or within 30 days of the entry of the order, or before the policy expires or the insured replaces the policy if either of the latter occurs within 30 days of the entry of the liquidation order. Claims of an affiliate of the insolvent insurer typically are not covered, even if such claims otherwise meet the definition of covered claims.

Property/casualty lines of business usually not covered by a guaranty fund include: mortgage guaranty; financial guaranty; fidelity and surety; credit insurance; insurance of warranties or service contracts; title insurance; ocean marine insurance; and any insurance provided by or guaranteed by government. Only direct insurance (not reinsurance) is covered. The receiver should consult with the affected guaranty fund(s) to determine which lines are covered and which lines are excluded.

Usually the guaranty fund of the state of the insured’s residence has primary responsibility for a claim, and the guaranty fund of the state of the claimant’s residence has secondary responsibility. One exception to this rule involves workers’ compensation claims. The guaranty fund of the state of residence of the claimant has primary responsibility for these claims. With respect to claims involving property with a permanent location, the guaranty fund of the state where the property is located has primary responsibility. Guaranty funds are usually entitled to take credit for amounts paid by other guaranty funds on the same claim.

Some guaranty fund statutes provide for a per claim deductible. A majority of guaranty association statutes provide that coverage is limited to \$300,000 per covered claim, except for workers’ compensation claims, which are covered to the extent of benefits provided by state law.⁶

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Most guaranty fund statutes require a claimant to first exhaust all other sources of recovery, including other insurance. The guaranty association’s obligation is reduced by any amounts recovered from other sources.

The majority of the property casualty guaranty funds’ enabling acts contain “net worth” limitations. These net worth limitations either exclude high net worth insureds (and in a few cases, third party claimants) from coverage in the first instance or permit the guaranty fund to recover from the high net worth insured amounts paid on their behalf.

Most of the guaranty funds’ enabling acts also require the claim to be timely filed either with the liquidator or the guaranty association. Bar date restrictions vary from state to state and specific state law should be reviewed on this matter. See Section D (3) for more information regarding bar dates.

D. Notice and Proof of Claims

1. Notice

a. Notice to Claimants

Most state receivership statutes give the receiver the primary responsibility for issuing notice to all persons known or reasonably expected to have claims against the insolvent insurer. The guaranty funds have a secondary responsibility in this regard under the Model Act. Because of the extensive interrelationship between the receiver and the guaranty funds regarding claims resolution, the receiver should coordinate the drafting of the receivership claims notice with the guaranty funds so that accurate information concerning the following is included:

- Brief general explanation of the guaranty fund system: the policyholder protection it offers, its anticipated role in the receivership and any delay that will be necessary while the receiver assembles and forwards the files to the guaranty funds.
- Receivership bar date and its legal significance: the fact that many guaranty funds will have no obligation regarding claims filed after the receivership bar date, recommendation to check with the appropriate guaranty fund immediately in order to ascertain whether the guaranty fund has a separate bar date in addition to the receivership bar date.
- Receivership proof of claim form: information, if available, about whether a separate guaranty fund proof of claim form may be required by certain participating guaranty funds; information concerning the address to which proof of claim forms must be sent.
- Clarification that questions regarding the claims determination process should be directed to the appropriate guaranty fund; include here any comments deemed necessary regarding the determination process for claims which are in excess of the statutory maximum coverage of the guaranty funds.

Insolvencies involving long-tail business present notice challenges to liquidators. Company records may not exist to provide addresses for occurrence based policyholders that were in force from 5 to 25 years ago. Public policy considerations confront the receiver.

A supplemental notice may also be used in situations where additional relevant information becomes available after the first notice has been sent.

b. Notice to the Guaranty Funds

The receiver must notify the guaranty funds that may become obligated as a result of the receivership as soon as possible. Even if such notice is not a statutory requirement, the receiver should notify all interested guaranty funds as a matter of courtesy. That notice should include a

copy of the claimants' notice issued by the receiver, along with copies of the receivership order and any domiciliary injunction which has been entered. The regulator, receiver, and guaranty funds should coordinate and share information well before the liquidation order is rendered. See Section E for more information in this regard.

2. Proof of Claim

a. Claims Determination Framework

Nowhere is the interrelationship between the receiver and the guaranty associations more prominent than in the area of claims determination. This relationship is defined by Section 11(3) of the Model Act that provides that the receiver shall be bound by settlements of covered claims by the guaranty funds. However, Section 703 A of the Insurer Receivership Model Act (IRMA) and many state receivership statutes contain provisions that prohibit the receiver from accepting any claim for an amount in excess of or contrary to the terms of the policy.

There has been uncertainty between guaranty associations and receivers as to who determines whether a claim is covered under the policy terms. The receiver and the guaranty funds should discuss questionable coverage issues as they arise in order to prevent subsequent problems.

b. Forms of Proof

The information to be contained in the proof of claim form is usually established under the receivership statutes in the insolvent insurer's state of domicile. However, some guaranty associations require that each claimant submits a separate proof of claim form, the contents of which will be dictated by the law and practice of the guaranty association's state. This is because statutes creating the guaranty funds contain a series of specific eligibility requirements and limitations on allowability, each of which may require additional information in order to establish the fund's obligation. For this reason, the receiver should coordinate with the guaranty fund prior to any notification to potential claimants regarding the proof of claim form.

c. Protective Filings via Proof of Claim Forms

Many guaranty funds are not permitted to recognize general proofs of claim (intended as a protective filing for claims that are unknown to the insured at the time of filing) as sufficient notice. These guaranty funds require that specific claim information about known claims must be provided in the proof, including the date and other particulars relating to the insured event.

3. Late-Filed Claims

a. Rationale

Most receivership statutes contain a provision that requires claims to be filed by the claims filing date established by the liquidation court. See IRMA § 701. If a claim is filed after that date, it is usually not allowed or is subordinated to a lower distribution priority. In addition, many guaranty funds are not permitted to pay claims filed after the earlier of the claims filing date or a bar date established pursuant to the guaranty fund's enabling act.

The receiver may have the ability to allow policyholders to file "omnibus" or "policyholder protection" claims to meet the bar date requirements, but guaranty fund statutes may not allow coverage of such claims.

b. Extensions

Once a receivership’s bar date has been established, guaranty funds generally take the position that the receiver should not extend the bar date, as such an extension may result in guaranty fund coverage issues.

c. Excused Lateness

Some receivership statutes provide a procedure for allowance of late-filed claims which authorizes the receiver to allow such claims under certain circumstances. See IRMA § 701. The receiver should consider claimant requests on a case-by-case basis, through the specific mechanism established in the receivership statutes. The receiver should also consider giving notice to those guaranty funds that may be affected prior to allowing a late-filed claim in order to provide those guaranty funds the opportunity to address how allowance of the claim would impact them.

E. Claim Files Information

1. Information Needed by Guaranty Funds

The key to the successful handling of filed claims is cooperation between the receiver and the guaranty funds throughout the claim process. Receivers should keep in mind that the guaranty funds require reasonable access to those insurer’s records which are necessary for them to carry out their statutory obligations.

Recent experience has shown that pre-liquidation coordination and information exchange are essential for the smooth transition of claims servicing responsibilities to the guaranty funds without disrupting ongoing benefit payments. Regulators, receivers and guaranty associations should coordinate and communicate, even if liquidation of the company is not a certainty. A “two-track” approach is recommended. While efforts continue to revitalize the company, the receiver and the guaranty funds should also be taking steps to ensure a smooth transition to liquidation if liquidation becomes necessary.

The receiver’s cooperation in providing information and making files available to the guaranty funds is essential to minimize claim interruption. More specifically, the receiver should locate and forward to the involved guaranty funds the following information (See § 405 of IRMA):

- A general description of the business written or assumed by the insurer;
- Information concerning licensure of the insurer;
- Claim counts and policy counts by state and line of business;
- Claim and policy reserves;
- Unpaid claims and amounts;
- Sample policies and endorsements;
- Listing of locations of claim files;
- Listing of third party administrators, description of contractual arrangements and copies of pertinent executed contracts;
- Listing of claims in litigation or dispute and assigned defense counsel; and
- Such other information as may be needed by the guaranty funds.

Please note, loss adjustment expenses incurred prior to the liquidation order are not covered by guaranty funds, and therefore, should not be sent to the guaranty funds for payment.

2. Claim Files

To facilitate the protection of policyholders and claimants; regulators, receivers and guaranty funds should coordinate transition of claim files well before the company is liquidated. The receiver should forward claim files as soon as possible to the appropriate guaranty funds. Some guaranty funds may require access to or copies of the filed proof of claims forms. Receivers and guaranty funds should consider entering into agreements as to ownership, return of files, auditing rights, inventory controls and reporting.

Most company claim records are held in electronic format. It is essential to address data conversion to Uniform Data Standards (UDS) well before the guaranty funds are triggered. (See chapter 2 of this handbook.) If there are non-electronic claims records, UDS records will need to be prepared.

Priority should be given to identifying and forwarding all active workers' compensation files and all active files where major litigation or settlement is imminent.

Determination of which guaranty fund should be the recipient of a particular file will depend on a series of factors. Generally, the receiver should deliver the file to the guaranty fund of the insured's place of residence. However, if it is a first-party claim for damage to property with a permanent location, the receiver should deliver the file to the guaranty fund where the property is located. In most instances, if it is a worker's compensation claim, the receiver should deliver the file to the guaranty fund of the state with jurisdiction over the claim.

Claim files sometimes are delivered to the wrong guaranty fund. In this situation, the preferable course of action is for the guaranty fund that received the file to secure from the appropriate guaranty fund their concurrence. After that, either fund will ask the receiver to resend the UDS record to the appropriate guaranty fund or will notify the receiver if the receiver does not make the actual UDS records transfer. The receiver will let the parties know if it prefers the original fund to close the file or to report the transfer with UDS "C" record with transaction code "080". See the UDS Manual¹ for additional information. NCIGF can assist in cases where a high volume of files need to be transferred.

In multi-state insolvencies receivers and guaranty funds should work together on protocols for transmitting files to the appropriate guaranty fund.

F. Unearned Premium Claims

Although most guaranty funds cover unearned premium claims, some do not (see the NCIGF Web site at <http://www.ncigf.org> at the Guaranty Fund Laws tab for unearned premium coverage by state). For those states where unearned premium is covered, the receiver should prepare and disseminate the necessary calculations as soon as possible. This will allow guaranty funds to make timely refunds to enable the insureds to make arrangements for replacement coverage.

To make payments possible, guaranty funds will need the following information for each potential claimant: policy identification, insured name and address, policy periods and expiration dates, cancellation date, current payment status, and the amount of the unearned premium. If possible, this information should be provided by the receiver by Uniform Data Standards (UDS) B Record. (The initial B Record may not have the calculation, but will advise of the "potential" claimants. A subsequent B Record would provide the calculation/audit.) In addition, the receiver should forward to the guaranty funds a general explanation clearly showing how the unearned premium was calculated. The calculations should be on a pro rata basis rather than short-rated. The information should be as accurate as possible, given the state of the insurer's records, and should be accompanied by the receiver's initial evaluation of the information's reliability.

The receiver should be prepared to provide a sampling of the insurer's records and the receiver's calculations to demonstrate the reliability of the unearned premium figures to guaranty funds. Where agents have advanced unearned premium to the insureds in exchange for valid legal assignments, the receiver and guaranty fund should coordinate their positions on acceptability.

It should be kept in mind that where the insured's return premium claim is based on a premium audit or retrospective rating plan, it may not be covered by some guaranty funds. Additionally, net worth limitations embodied in a number of guaranty fund acts may preclude payment of unearned premium claims to certain high net worth insureds.

Premium financing arrangements often create special problems for the affected guaranty funds in processing return premium claims. If the receiver has information concerning premium financing arrangements, the receiver should provide that information to the guaranty funds to facilitate payment of returned premium to the appropriate person or entity.

G. Claim Reporting

How guaranty funds report claims and expense payments, outstanding reserves and administrative expenses to a receiver is an item of concern in every insolvency. This reporting is not only important for the guaranty funds as a creditor, but it also assists the receiver in gathering what is usually the major asset in most receiverships—reinsurance recoverables.

The NAIC in December 1993, adopted the UDS to be used for the reporting of policy and claim information between guaranty funds and receivers. UDS was the result of a joint effort of a number of receivers and guaranty funds to facilitate (1) reporting between receivers and guaranty funds, and (2) reporting to reinsurers by the receiver. The use of UDS file formats to transmit information at the policy or claim level will provide both receivers and guaranty funds with needed information in a uniform, easily usable format. Currently, most guaranty funds and receiverships are able to send and receive information in the UDS format. (The NAIC endorsed the use of UDS by receivers and guaranty funds effective March 31, 1995. Most insolvencies instituted prior to that date did not use UDS, nor did they later convert to UDS.) It is very important to note that an Operations Manual exists, and should be reviewed and used by receivers and guaranty funds for understanding UDS. Version 2 of the UDS was adopted by the NAIC for implementation on Jan. 1, 2005. Version 2 includes many improvements and revisions based upon the collective experience of receivers and guaranty funds with the original version over several years and insurer insolvencies. In 2006, the NAIC adopted the Standardized Financial Report (D Record) for addition to the Uniform Data Standards. A copy of the updated UDS Manual and file formats are at the National Conference of Insurance Guaranty Funds (NCIGF) Web site at <https://www.ncigf.org/resources/uds/>.

It is important to remember that the earlier the receiver determines what information is needed, and communicates those needs to the guaranty funds, the better and more efficient the reporting process will be. UDS, through the implementation of several lettered record formats, has simplified the aforementioned receivers' requirements. The formats were designed by the UDSTSD (UDS Technical Support Group), a group comprised of members of the receiver and guaranty fund communities, and approved by the NAIC.

As stated above, almost all claims data for the insolvent insurer will be in electronic format. Security concerns are paramount. The NCIGF addresses the security concerns with a system called the UDS Data Mapper. Using the Mapper, the receivers can map raw data to, or fully created UDS files to UDS record fields in a database. The Mapper will then create new UDS files to be placed in the guaranty associations' SUDS directories. This process has the dual benefit of ensuring UDS compliance and scrubbing the data of any unknown malicious code. This service is available at no charge to the receiver.

Recent estates with significant reinsurance recoveries have found it useful to also develop claims protocols setting out additional information that is needed for reinsurance recovery purposes and dealing with other matters such as new and reopened claims and closed files. Needed information often extends beyond that which can currently be provided by UDS data feeds. Some guaranty funds have agreed to give receivers

limited, read-only access to their claims database. Assistance from the UDSTSG can also be found by submitting a help request to help@udstsg.org.

H. Claims Exceeding Guaranty Fund Limits and Aggregate Claims

1. Claims Exceeding Guaranty Fund Limits or Claims Excluded from Guaranty Fund Coverage

Under the Model Act and state enabling acts, guaranty funds have per claim limits, or “caps,” that can limit the guaranty fund’s obligation to an amount less than the insolvent insurer’s policy limits. For example, the amount paid in satisfaction of a covered claim (either non-workers’ compensation or unearned premium) under the NAIC Model Act may not exceed \$500,000 per claimant, even if the actual policy limits are greater. The caps vary among the states and the receiver must review applicable state guaranty fund acts. Here, the interrelationship between the guaranty fund and the receiver becomes critical (i.e., both act to pay or determine claims made against the insolvent insurer arising under the same policy and are eventually allowed against the insolvent insurer’s estate).

The guaranty fund has a claim against the insolvent insurer’s assets for the amounts paid as indemnity and the expenses and costs of handling the claims it pays. Furthermore, anyone with a claim over the guaranty fund’s cap, subject to a guaranty fund deductible or subject to a statutory net worth exclusion has a claim against the estate for that portion of the claim not covered by the guaranty fund. From this perspective, the role of the guaranty fund and the receiver are not easily distinguishable. The guaranty fund is concerned with determining and paying its covered claims obligations under its statute while the receiver is determining how much of the claim should be allowed as a claim in the receivership. As a result, whenever a covered claim is filed in excess of the cap, it gives rise to a situation where extra effort and cooperation between the guaranty fund and the receiver will be necessary.

It should be noted here that, in some states, the guaranty fund will not settle a claim without a complete release, which may require participation by the receiver prior to any settlement. In some cases, however, the guaranty fund may pay the claim up to its statutory limit, leaving the excess to be paid by the insured, who will then retain a claim against the estate for the excess amount. Where the insured is unwilling or unable to pay the excess, the claimant may have a direct claim against the estate for the unpaid amount. In either instance, there is a portion of the claim above the cap that is left unsatisfied by the guaranty fund’s payment. After approval by the receiver, the “over-cap” claim, as other allowed claims, will be paid as part of a distribution, pursuant to the applicable priority statute.

There may be other situations where the guaranty fund and the receiver will both have an interest in handling a claim. For example, where a claim includes allegations of bad faith or seeks punitive damages, the claim would not be covered by the guaranty fund but may be a claim in the estate.

The successful handling of over-cap claims is dependent upon early communication between the guaranty fund and the receiver. To prevent, or at least minimize, potential conflicts between the guaranty fund and the receiver regarding the payment of over-cap claims, full disclosure, communication and cooperation between the guaranty fund, the insured and the receiver’s claims department must begin as soon as it is determined that an over-cap claim may exist. Prior agreement with the receiver should be obtained, where possible, on the amount of the over-cap claim. The guaranty fund has no authority to settle the claim in excess of its limit, and without the consent of the receiver, the claimant or insured (if paid by the insured) is taking a risk that all or a portion of the over-cap claim may be denied by the receiver. In fact, arranging to have the over-cap claims allowed as a claim in the estate may provide the needed leverage to settle the claim.

Receivers and guaranty funds have found it useful to develop specific procedures for dealing with claims where the cap will be exceeded and including such procedures in the claim protocols described above.

2. Aggregate Claims

Certain types of policies are often written on an aggregate basis. Aggregate policies may be in terms of a policy aggregate, a coverage aggregate, or both. In a policy aggregate, all claims are accumulated until the maximum limit of liability is reached. A coverage aggregate is one where claims against a specific coverage, such as products liability, are accumulated until the maximum coverage limit is reached. When an insurer is solvent, it monitors the erosion of all of its outstanding policies—in other words, the insurer keeps track of how much of a policy’s aggregate limit is left as various claims under it are satisfied.

When an insurer is declared insolvent, and one or more guaranty funds begin to satisfy claims against such aggregate policies, problems can arise. The most obvious problem occurs when a guaranty fund paying claims under a policy is not aware that the policy has an aggregate limit. The receiver should take special care to advise the guaranty funds which policies are subject to an aggregate limit. The receiver should not assume the guaranty funds will discover this information on their own.

It is equally important that the receiver and the affected guaranty funds work together to monitor the erosion of aggregate limits. The receiver should advise the affected guaranty funds of claims that have been paid under the policy by the insurer before insolvency and track payments made by the guaranty funds after insolvency. Similarly, guaranty associations should not pay a claim under an aggregate policy prior to coordinating with the receiver. When the aggregate limits are close to being exhausted, the receiver should alert the guaranty funds and require that they obtain prior approval on any payment against such policy. See IRMA § 706 D.

The following example should help illustrate the problem. Assume that there is a products liability policy with an aggregate limit of \$2,000,000. Assume further that there are 10 claimants filing claims under the policy with 10 separate guaranty funds. If each guaranty fund has a cap of \$300,000, but is unaware of the other claims, then potentially, payments totaling \$3 million could be made, thereby exceeding the aggregate limit. In this situation, regardless of the original extent of an individual guaranty fund’s knowledge of a policy’s aggregate nature, it cannot independently keep track of the policy’s erosion. In situations like this, it is critical that the receiver monitor each guaranty fund’s activity closely and keep all affected guaranty funds apprised of the situation as it develops.

When adequate safeguards are not in place, payments may be made in excess of a policy’s aggregate limit and conflicts will arise between the receiver and the guaranty fund. Although the guaranty fund may have made the payment in good faith and within its statutory guidelines, the receiver may feel compelled to deny reimbursing the guaranty fund for that portion of the claim in excess of the aggregate limit. These problems are sometimes not discovered until long after the guaranty fund has settled all of its claims. To avoid such problems, the guaranty funds should not pay a claim covered by an aggregate policy without first consulting the receiver. State liquidation acts vary on the handling of estate distributions for amounts paid in excess of aggregate caps. These laws should be carefully reviewed in dealing with these matters. Section 706 D of IRMA addresses policies with aggregate limits and provides that the liquidator may apportion the policy limits ratably among timely filed allowed claims or notify the insured, third party claimants and affected guaranty associations of the erosion of the aggregate limit.

In summary, upon taking control of the estate, it is recommended that the receiver institute the following procedures:

- Determine which policies have aggregate limits;
- Determine policy erosion and continue to monitor aggregate accumulations resulting from payments made by guaranty funds;

- Advise guaranty funds of these policies and keep them apprised of any pre- and post-insolvency erosion;
- Require guaranty funds to determine how much of the aggregate limit remains available before making any settlements under these policies;
- As soon as it appears that the aggregate limit is about to be reached, notify the guaranty funds immediately that all future settlements should be cleared with the receiver;
- Require guaranty funds to immediately report to the receiver any paid or settled claims that affect aggregate limits; and
- Initiate a system that can earmark pending settlements. One of the benefits of the UDS is that it facilitates the tracking of policies subject to aggregate limits (See the Publications tab of the NCIGF Web site at <http://www.ncigf.org>).

I. Early Access

Most state receivership statutes contain a provision that requires the receiver to submit to the court a proposal to disburse general assets to guaranty funds. Such proposals are commonly referred to as “early access plans,” and apply equally to life and health and to property and casualty insolvencies. The statutes typically contain provisions specific to both.

The purpose of an early access plan is to distribute funds from the estate to the guaranty funds as soon as possible and in the maximum amount possible in order to reduce the assessment burdens on member companies. Early access distributions are essential to the guaranty funds’ continued ability to fulfill their statutory duties. See IRMA § 803.

1. Timing

The standard early access provision requires that the receiver submit an early access plan within 120 days of entry of the liquidation order. IRMA requires that the receiver apply to the receivership court for approval to make early access distributions, or report that the receiver has determined that there are not sufficient distributable assets to make any distribution to the guaranty funds at that time, within 120 days of entry of the liquidation order, and at least annually thereafter. See IRMA §803 B. In practice, in order for the receiver to make the calculations necessary to demonstrate to the court that there are insufficient assets at that time to make any distribution, receivers should formulate an early access plan and file the form of the plan within the 120-day period for approval by the court. This procedure will fulfill the receiver’s statutory obligation for filing a plan and will ensure that a plan is in place to make distributions when assets become available.

2. Reserves

Most early access provisions in state receivership statutes require an early access plan to include, at a minimum, reserve amounts for the expenses of administration and the payment of the higher priority claims. See also IRMA §803 A(2). The reserve for expenses should take into account all administrative expenses anticipated to be incurred during the duration of the receivership proceeding. (See specific state statutes to determine if guaranty fund administrative expenses are Class I or Class II; see also IRMA §801 A & B.) The reserve for receivership expenses and for other claims that are at a higher priority than the guaranty funds’ claim payments need not, however, be reserved 100% out of current liquid assets of the estate, as long as there are sufficient non-liquid assets that will be liquidated during the course of the receivership proceedings to cover those claims. The receiver should reserve a portion of the liquid assets to cover receivership expenses that will become due in the near term and prior to the liquidation of other non-liquid assets.

It may be difficult for the receiver of some estates to accurately determine the amount of policyholder claims not covered by the guaranty funds. An absolute determination of the amount is not necessary for purposes of the plan, however, as an estimate for calculation purposes is all that is needed. This estimate will be updated from time to time, and any overpayment to guaranty funds must be returned to the receiver. This “claw back” requirement is mandated by Section 803 F of IRMA and should be included in any written agreement between the receiver and the guaranty funds.

3. Liquid or Distributable Assets

Most early access agreements provide for payments from distributable assets, which generally means cash and cash equivalents, less reserves for Classes I and II. In developing early access plans, it is anticipated that the receiver will liquidate non-liquid assets as soon as economically prudent.

The receiver, however, is not required to increase liquid assets for purposes of the plan by making forced or quick sales of non-liquid assets that result in obtaining less than market value. In other words, receivers are not expected to hold “fire sales” in order to generate liquid assets for distribution as early access. It is in the interest of all creditors, including the guaranty funds, for the receiver to attempt to obtain full value for the estate’s assets. On the other hand, where an asset can be sold at a fair market price, the receiver should consider liquidating the asset in order to generate early access funds and thereby reduce the assessment burden on solvent insurers and their policyholders. The public policy behind maximizing the value of estate assets and reducing assessment burdens on guaranty funds through early access distributions sometimes conflict and special understanding and cooperation between the receiver and the guaranty funds is necessary to resolve this conflict amicably.

Liquid assets do not include real estate, the book value of a subsidiary, assets pledged as security, special or general deposits held by other states that are unavailable to the receiver, or any assets over which the receiver does not have complete control.

4. Early Access Agreements

Any payment to be made under the provisions of an early access plan typically is conditioned upon the guaranty fund executing and returning an early access agreement to the receiver., IRMA obviates the need for an agreement by incorporating the key provisions of a typical agreement in the statute; however, currently, only a small minority of states have adopted this IRMA provision Such agreements include provisions requiring the guaranty funds to:

- Submit to the exclusive jurisdiction of the receivership court, but only for the purpose of the early access plan;
- Return to the receiver any previously disbursed assets, plus interest if applicable, that are required to pay claims that are of an equal or higher priority; no bond shall be required of any guaranty fund. See §803 F of IRMA;
- Periodically report to the receiver: all amounts paid by the guaranty fund on claims to date; the amount of expenses entitled to priority that have been paid by the guaranty fund; the reserves established by the guaranty fund on open claims; the amounts collected by the guaranty fund as salvage or subrogation recoveries; the amounts collected by the guaranty fund from any state deposit; and other information needed by the receiver. See §803 B of IRMA; UDS is the platform commonly utilized for the transfer of this data. See Chapter 2 for a broader discussion of UDS.

Calculations and distributions by the receiver should be done at least annually; however, in instances where the guaranty funds are reporting on a quarterly or more frequent basis and sufficient assets are available to make distributions, the receiver may consider making distributions on a more frequent basis.

5. Expenses

Early access plans typically contemplate that the guaranty funds should receive prompt reimbursement of their administrative expenses. The calculation of liquid assets available for distribution as early access should be made after payment of all incurred receivership and guaranty fund administrative expenses.

Certain categories of guaranty fund expenses may or may not be included in the administrative expense priority class. Therefore, it is necessary to consult the applicable statute to determine appropriate treatment.

In a case where there is disagreement between the receiver and guaranty associations concerning the priority of particular guaranty association expenses, it may make sense to make administrative expense distributions under a reservation of rights, clearly specifying that the priority of certain expenses was a matter of dispute and that such payment does not preclude the receiver from later challenging the priority of particular expenses. Dealing with the issue in this manner ensures that the guaranty associations receive maximum distributions early in the proceeding—when the need for cash can often be critical. Resolution of expense classification issues, which may involve protracted discussions or even litigation, can be conducted while the funds have the necessary cash to pay claims.

6. Basis of Distribution

Most early access statutes provide that distributions to guaranty funds will be based on claims paid and to be paid by the guaranty funds. Some states, however, have based distributions solely on paid claims. In states that follow the reserve language, early access should be based on both paid claims and reserves. This permits a more equitable distribution of assets among the guaranty funds instead of benefiting guaranty funds that make claim payments at an early stage of the receivership proceeding (e.g., a state that has mostly workers' compensation claims). See §803 A(2)(c) of IRMA.

7. Special Deposits

Early access plans typically take into account state deposits by excluding such assets from the calculation of liquid assets available. Similarly, the plans typically take into account payment to guaranty funds from general or special state deposits by essentially treating such payments as prior early access distributions, thereby reducing the early access distribution to those guaranty funds receiving state deposits. If after receiving early access distributions, a guaranty fund receives payment from a special state deposit, then the guaranty fund may be required to return all or part of the early access distribution. Most early access plans do not allow the receiver to take credit for a special or statutory deposit that has not been paid to or is unavailable to the guaranty fund. See § 803 G of IRMA.

8. Salvage/Subrogation

Historically, the majority of receivers have taken the position that salvage or subrogation recoveries collected by a guaranty fund, based on payments made by the guaranty fund, are the property of the guaranty fund. The recoveries are applied to reduce the net guaranty fund payment total that is the ultimate claim of the guaranty fund against the insolvent estate. These receivers accept reimbursement on a pro rata basis in instances where a guaranty fund has made a recovery that includes consideration of both pre-liquidation payment by the insurer and subsequent payment by the guaranty fund. Early access agreements will not be affected when receivers take this position.

A minority point of view is that salvage or subrogation recoveries by a guaranty fund become general assets of the liquidation estate, regardless of whether the payment on which the recovery is based was made by the insurer or the guaranty fund. Specific language to address concerns may be needed in early access agreements when a receiver adopts this view.

J. Large Deductible Policies

In 2016, the NAIC adopted a white paper titled *Workers' Compensation Large Deductible Study*. The paper revisits and reconsiders issues raised in an earlier 2006 *Workers' Compensation Large Deductible Study*. The 2016 study provides valuable information about how large deductible policies work and special issues that can arise with their use.

As used in workers' compensation coverages, large deductible policies allow employers to retain a certain amount of claims risk, thereby reducing the cost of their workers' compensation coverage. Typically, these policies are administered by the insurer or a third-party administrator paying claims within the deductible and obtaining reimbursement from the insured employer. In the receivership context, where guaranty funds pay claims within the deductible, there is an issue as to the handling of the insured employer's reimbursement of payments within the deductible. That is, should the reimbursement be paid to the guaranty fund outside the receivership distribution scheme, or should the reimbursement be treated as an asset of the receivership estate subject to the claims of all creditors? Several states have provisions in place in their respective receivership statutes which provided that large deductible reimbursements should be paid directly to the guaranty fund outside the receivership distribution scheme.

Where the insolvent insurer wrote large deductible policies, the receiver should be mindful of this issue and should consult with the affected guaranty funds as soon as possible. The receiver should also review those states' guaranty fund statutes where the claims will be processed to determine whether claims within large deductibles are "covered claims" as defined in the appropriate guaranty fund act. Typically, claims under workers compensation policies will be covered. However, claims under policies for other lines of business may not be covered. The availability of guaranty fund coverage is to some extent dependent upon the specific language of the policy involved.

IRMA provides for a different treatment of large deductible collections. Under IRMA § 712, payments of such monies to the guaranty funds are treated as early access.

Under the *Guideline for Administration of Large Deductible Policies in Receivership* (Guideline #1980) deductible recoveries are paid to the guaranty fund to the extent of their claim payments and are not considered early access distributions. Subsection B of this Guideline states, "Unless otherwise agreed by the responsible guaranty association, all large deductible claims that are also "covered claims" as defined by the applicable guaranty association law, including those that may have been funded by an insured before liquidation, shall be turned over to the guaranty association for handling." Refer to the Guideline subsection B for further discussion of deductible claims paid.

K. Coordination among Regulators, Receivers and Guaranty Funds

In 2005, the NAIC adopted a white paper titled *Communication and Coordination Among Regulators, Receivers, and Guaranty Associations: An Approach to a National State Based System*. The white paper addresses the various issues relating to communication and coordination among regulators, receivers and guaranty associations, and how the parties might better work together to protect consumers.⁷

⁷ A copy of this White Paper may be obtained from the NAIC at: http://www.naic.org/store_home.htm
Phone: 816.783.8300; Fax: 816.460.7593; E-mail: prodserv@naic.org

III. LIFE AND HEALTH GUARANTY ASSOCIATIONS

A. Introduction

In 1970, the NAIC adopted the Life and Health Insurance Guaranty Association Model Act (the Life Model Act). Since 1970, the Life Model Act has undergone several major revisions. The most recent revisions to the Life Model Act were made in 2017.⁸ All 50 states, the District of Columbia and Puerto Rico have enacted guaranty association laws based on some version of the Life Model Act. (For summaries of the provisions in each state's guaranty association laws see the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) Web site at <https://www.nolhga.com/factsandfigures/main.cfm/location/stateinfo>).

The Life and Health Insurance Guaranty Associations were created to protect certain policy, contract and certificate holders (and their beneficiaries, assignees and payees) from loss due to the insolvency or impairment of a member insurer. Life/health insurance guaranty associations pay benefits and continue coverage, subject to statutory limitations, either directly or through a third-party administrator. With early communication, information sharing and coordination between guaranty associations and receivers, the guaranty associations can work with receivers to help develop and put in place the infrastructure and solutions that may be able to provide for a seamless transition into liquidation, thereby avoiding unnecessary delays and disruptions, and maximizing protections for policyholders. Early coordination between the receiver and the guaranty associations will also help minimize confusion, avoid duplication of effort and lead to greater administrative efficiency and lower costs for both the receiver and the guaranty associations.

NOLHGA is a vital resource for receivers in multistate life/health insolvencies. NOLHGA, whose members are the life/health guaranty associations of all the states and the District of Columbia and Puerto Rico, collects and distributes information for its members and receivers. It performs analyses of various alternatives by which guaranty associations can fulfill their statutory obligation to protect policyholders and serves as the guaranty associations' national coordinating mechanism for resolving issues. Through its Members Participation Council, NOLHGA works with its affected member guaranty associations and the receiver to develop and implement plans for the disposition of covered claims and contractual obligations through, for example, assumption reinsurance or claims administration.

Ideally, the receiver and NOLHGA, on behalf of the guaranty associations, should commence planning and coordination efforts at the earliest practicable opportunity. As discussed in the NAIC's 2004 whitepaper on Communication and Coordination Among Regulators, Receivers and Guaranty Associations, cited in Chapter 1 of this handbook, coordination and communication with guaranty associations should begin "no later than when a company is placed into rehabilitation, and in many cases, involvement even earlier will enhance consumers' protection and decrease costs of the insolvency to all stakeholders" subject to entering into a confidentiality agreement as appropriate. NOLHGA can be reached at:

National Organization of Life and Health
Insurance Guaranty Associations
13873 Park Center Rd., Suite 505
Herndon, VA 20171
Phone: (703) 481-5206
Web Site: <https://www.nolhga.com>

⁸ All references in this chapter to the "Life Model Act" are to the 2017 version, unless otherwise specified. As of this writing, a majority of states had adopted or substantially adopted the 2017 amendments, and further legislation is expected in additional states. It is always important, however, to check individual state statutes for variations from the Life Model Act in actual cases.

B. Triggering Guaranty Associations

1. “Insolvent” Insurers

Under the Life Model Act, guaranty associations are triggered when a member insurer is determined to be an “insolvent insurer,” as defined therein, i.e., it has been placed under an order of liquidation by a court of competent jurisdiction with a finding of insolvency. A member insurer is defined in the Life Model Act as “an insurer or health maintenance organization licensed or that holds a certificate of authority to transact in this state any kind of insurance or health maintenance organization business for which coverage is provided under Section 3, and includes an insurer or health maintenance organization whose license or certificate of authority in this state may have been suspended, revoked, not renewed or voluntarily withdrawn...”⁹ Certain types of insurers are excluded from the Life Model Act definition, such as fraternal and mutual assessment companies. Moreover, while a majority of states now include Health Maintenance Organizations (“HMOs”) as member insurers, not all states do. State guaranty association laws will govern whether HMOs are member insurers for purposes of guaranty association coverage in a given state.

2. “Impaired” Insurers

Under the Life Model Act, a guaranty association may act in its discretion if a member insurer is “impaired,” subject to certain conditions and limitations. An insurer is an “impaired insurer” as defined in the Life Model Act, if it has not been declared insolvent but is under a court order of rehabilitation or conservation. In such situations, the Life Model Act provides that the guaranty association may, in its discretion and subject to any conditions imposed by the guaranty association that do not impair the contractual obligations of the impaired insurer, and that are approved by the Commissioner, take certain actions to provide protections to policyholders of the impaired insurer. The primary purpose of the guaranty associations is to protect policyholders, however, not to bail out impaired or insolvent insurers so that they can continue as going concerns. Guaranty associations, therefore, have traditionally been extremely reluctant to provide coverage before liquidation.

There are subtle variations among some state guaranty association triggering provisions which could potentially impact uniform triggering of guaranty associations in affected states. Coordination with guaranty association representatives and NOLHGA (if a multistate insolvency), as early as possible subject to appropriately executed confidentiality agreements before a petition for receivership is filed will help to reduce the risk of complications in regard to guaranty association triggering, or individual state provisions, see the NOLHGA Web site (<https://www.nolhga.com/factsandfigures/main.cfm/location/stateinfo>).

C. Scope of Coverage

1. Covered Policies and Limits of Coverage

Guaranty associations were created to provide a limited, but substantial safety net to protect policyholders from loss as a result of the impairment or insolvency of a member insurer. e Under the Life Model Act, the following coverages are provided:¹⁰

⁹ HMOs were added to the definition of “Member Insurer” as part of the 2017 package of amendments to the Life Model Act. As of this writing, those amendments had been largely adopted in 36 states. However, at least one of those states has continued to exclude HMOs from the definition of Member Insurer.

¹⁰ While there are a few exceptions, these coverage limits have been fairly uniformly adopted in most states. For individual state limits, see the NOLHGA website (<https://www.NOLHGA.com/factsandfigures/main.cfm/location/statinfo>) or consult the applicable state guaranty association.

- Life insurance: \$300,000 in death benefits, but not more than \$100,000 in net cash surrender and withdrawal values, per life. In the case of corporate-owned or bank-owned life insurance, however, overall benefit coverage is capped at \$5,000,000 per owner.
- Health insurance: i) \$500,000 in benefits for health benefit plans, which are defined to include “any hospital or medical expense policy or certificate, or health maintenance organization subscriber contract or any other similar health contract”, subject to certain enumerated exclusions. The term “health benefit plan” which was introduced in the 2017 amendments to the Life Model Act, replaces the prior reference to basic hospital, medical and surgical insurance and major medical insurance, and includes coverage under health maintenance organization subscriber agreements; ii) \$300,000 in benefits for disability income insurance and long-term care insurance; and iii) \$100,000 for other health policies not defined as disability income insurance, long-term care insurance or health benefit plans. All limits are applied per life.
- Individual (allocated) annuities: \$250,000 in present value of annuity benefits, including net cash surrender and withdrawal values, per life.
- Structured settlement annuities: \$250,000 in present value of annuity benefits, per payee or beneficiary. See Chapter 3 for a discussion of structured settlements.
- Unallocated annuities: Coverage for unallocated annuity contracts¹¹ is typically limited. As of this writing, 28 states provide coverage for limited types of unallocated annuity contracts. The remaining 22 states, plus the District of Columbia and Puerto Rico, do not provide coverage for unallocated annuity contracts. For those states that do provide coverage for unallocated annuity contracts, coverage is typically limited to unallocated annuity contracts issued to or in connection with specific employee benefit plans or government lotteries. Life Model Act §3(A)(3). Coverage limits are stated as (i) \$5,000,000 per contract owner/plan sponsor for unallocated annuity contracts issued in connection with either governmental lotteries or private employer employee benefit plans that are not protected by the Pension Benefit Guaranty Corporation, and (ii) \$250,000 per plan participant for unallocated annuity contracts issued to governmental retirement plans. Life Model Act §3(C)(2)(b) and (e). Unallocated annuity contracts are not covered in every state, and the Appendix to the Life Model Act includes alternate Section 3 text adopted by several states that do not provide coverage for unallocated annuities.
- Aggregate limits across policy types: Aggregate benefits covered with respect to any one life for life insurance, individual annuities, and health insurance (other than health benefit plans) are capped at \$300,000. Aggregate coverage for health benefit plans and other policy types is limited to \$500,000 with respect to any one life.

2. Exclusions

Products excluded from coverage, in whole or in part, are described in Life Model Act Section 3(B)(2). Under the Life Model Act, coverage is expressly excluded for policies or portions of policies under which the risk is borne by the policyholder or that are not guaranteed by the insurer, as well as certain interest crediting rates that exceed the limits described therein. Self-funded employer-provided welfare benefit plans are also among the products excluded, as are unallocated annuity contracts issued to employee benefit plans protected by the federal Pension Benefit Guaranty Corporation. Reinsurance is

¹¹ For purposes of guaranty association coverage, an unallocated annuity contract is “an annuity contract or group annuity certificate which is not issued to and owned by an individual, except to the extent of any annuity benefits guaranteed to an individual by an insurer under the contract or certificate.” Life Model Act §5(Y).

also specifically excluded unless assumption certificates have been issued. For a more complete listing of products or portions thereof generally excluded from guaranty association coverage, refer to Section 3(B)(2) of the Life Model Act. For specifics concerning coverage exclusions in any particular state, consult with the guaranty association in that state..

In addition to the product exclusions referenced above, the Life Model Act excludes coverage for policies or products issued by entities that are not regulated under the standards applicable to legal reserve carriers, and are therefore excluded from the definition of Member Insurer under the model, such as insurance exchanges, assessment companies, fraternal, and hospital or medical service corporations. HMOs were added as member insurers under the Model as part of the 2017 amendments. However, these amendments have not yet been adopted in all states. Moreover, a few states may have separate HMO guaranty associations established under state law. Accordingly, it will be important to review state law to determine whether and to what extent a state provides guaranty association coverage for HMO products. Hospital or medical service corporations that are members of the Blue Cross/Blue Shield Association may be required by their franchise to participate in their state’s guaranty association if permitted by statute, or to establish some other form of insolvency protection for their participants. Whether these entities are included as member insurers for purposes of guaranty association protection may vary by state and must be considered based on the circumstances in each case.

3. Residency Requirements

. Residency is determined on the date of entry of a court order that determines a member insurer to be an impaired insurer or an insolvent insurer, whichever occurs first. Typically, this results in the state of residence being determined on the date an order of liquidation with a finding of insolvency is issued. If there is a gap between the start of the receivership and the date an order of liquidation is issued, policy and contract holders may relocate, which could affect the situs of coverage.

The Life Model Act generally provides for coverage of policyholders and certificate holders under group policies who are residents of the state, as well as their beneficiaries, regardless of where the beneficiaries reside. It also provides coverage for contract owners of unallocated annuities if the contracts are issued to or in connection with a specific benefit plan whose plan sponsor has its principal place of business in the state. Nonresident policyholders and contract holders may be covered under certain limited circumstances. If the insolvent insurer’s domiciliary state follows the Life Model Act, coverage would be extended by the domiciliary state to residents of another state if that state also has a similar guaranty association law and the policyholders in that state are not eligible for coverage there because the insurer was not licensed in that state at the time specified in that state’s guaranty association law. An example of such a situation might be a a resident of State A, who owns a policy of the XYZ Life Insurance Company, domiciled in State B, and placed in liquidation in state B. If the State A resident policyholder is not eligible for coverage by the State A guaranty association because the company was not licensed in State A (and therefore was not a member insurer of the State A guaranty association), coverage would be provided by the State B life and health insurance guaranty association.

D. Guaranty Association Claims Administration

In the case of a multi-state insolvency, life/health guaranty associations work through NOLHGA’s Members’ Participation Council (MPC) to develop and implement a plan for providing guaranty association coverage, whether through transfer of the covered policies to a solvent insurer, making arrangements for providing ongoing policy and claims administration, or some combination thereof. I

For multi-state insolvencies, NOLHGA appoints a guaranty association task force that includes representatives from the domestic guaranty association and other state guaranty associations affected by the insolvency. The size of the task force depends in large part on the number of affected state guaranty associations and the size of the insolvency.

1. Information Needs of the Guaranty Associations

For guaranty associations to evaluate and discharge their functions with the least possible duplication and delay, they must have detailed information about the insurer and its business. While information needs may vary from case to case, NOLHGA typically requests this information from the receiver on behalf of its members and, if necessary, will offer to assist the receiver in obtaining and assembling the information. Types of information routinely requested include:

- All administrative and judicial petitions and orders with attachments or exhibits;
- The insurer's most recent annual statement;
- The insurer's most recent financial statement, audited or unaudited, and department or independent financial audits or reviews, including identification of assets that are hypothecated or not publicly traded and unbooked contingent liabilities;
- A list of states that have terminated or suspended the insurer's license;
- A breakdown, by state, of the insurers' estimated liabilities/reserves by line of business;
- A list of third-party administrators and administrative offices, identifying the policies, claims and group policyholders they served, and copies of all provider/vendor agreements;
- Actuarial evaluations of the insurer's business;
- Copies of policy and contract forms;
- Copies of reinsurance contracts, assuming or ceding;
- Drafts of the receiver's notices to policyholders, including any cancellation notices;
- A breakdown of assets, by category, at the most recent market value available and other valuations of assets that would be helpful in cash flow analysis;
- The names and addresses of policyholders and certificate holders with in-force coverage during the preceding year, broken down by state, indicating the type of coverage each had, the date to which premiums have been paid, cancellation or non-renewal dates for business that was canceled or non-renewed according to policy terms, copies of cancellation notices, and the date to which claims have been paid;¹²
- Policy values (face amounts, cash surrender values, policy loans, interest crediting rates, rate crediting history, etc.);
- Premium files (and status indicators, such as Reduced Paid Up, Extended Term, or Waiver of Premium status);
- Claims data/claims history (including plan of care and related information for LTC lines);

¹² Specific policy data needs will depend on the facts and circumstances of each case as well as the types of business involved. Initial, critical data needs will typically include all relevant summary policy and reserve information. If the policy master/eligibility records can be provided, that file may contain sufficient information for preliminary coverage determinations and to consider the potential feasibility of an assumption transfer. Additional information will be needed to coordinate coverage and begin planning for implementation of any administration, transfer or other disposition strategies.

- Rate files/history; and
- Information concerning the receiver’s marketing contacts and expressions of interest received about the insurer’s business.

2. Notice to Claimants

Shortly after a receiver is appointed, the receiver should collaborate with NOLHGA to provide notices to policyholders. Several notices may be necessary over the course of the receivership. Because of the special nature of life and health insurance guaranty association obligations, the receiver and the guaranty associations should collaborate closely on the contents of all notices to policyholders that involve guaranty association obligations, and may, in some instances, send joint communications to policyholders. Normally, the notices should:

- Provide notice of proceedings against the company;
- Explain the existence of the g guaranty associations and their role in the receivership
- Provide basic information concerning guaranty association continuation of coverage, including general reference to the statutory limitations;
- Where applicable, advise regarding the possibility that a portion of the policies or contracts may be assumed or reinsured by another insurer;
- Provide instructions on filing claims under their insurance policies and remitting future premiums (during rehabilitation);
- Indicate how the guaranty associations intend to treat cancelable policies;
- Provide information about conversion policies in the event of policy terminations;
- Provide notice of liens or moratoriums;
- Identify any applicable claims bar date ;
- Describe the receiver’s handling of claims in excess of guaranty association statutory maximums; and
- Describe the receiver’s handling of claims that are ineligible for guaranty association coverage.

When a company goes into liquidation, the guaranty associations will typically send their own notice to policyholders, sometimes as part of a joint mailing with the receiver. The guaranty association notices will provide information about guaranty association coverage and limits, contact information for the state guaranty association providing coverage for insureds in each state, instructions for continuing to pay premiums and submitting claims, customer service contact numbers, and other relevant details depending on the unique facts and circumstances of the case.

3. Notice to Guaranty Associations

In many states, the receiver is required to provide notice of the receivership to all guaranty associations that may be triggered as a result of the receivership. Even if the notice is not a statutory requirement, the receiver should provide NOLHGA (in the case multi-state receiverships) and all affected guaranty associations as much advance notice of receivership as is reasonably possible under the circumstances subject to appropriate confidentiality agreements in order to facilitate the coordination that will be necessary for a successful receivership, and achieve the best outcomes for policyholders. NOLHGA and the affected guaranty associations should also be provided with an advance copy of all notices

being issued by the receiver to policyholders, as well as copies of the receivership order and any domiciliary injunctions that may have been entered.

4. Proof of Claim

A proof of claim form is less frequently required in life/health receiverships, due in part to the fact that in many instances the guaranty associations will be continuing coverage. Generally, policyholders are not required to file formal proofs of claim for policy benefits. However, policyholders may assert claims for extra-contractual liability against the insurer, such as claims for bad faith. The receiver should consider requiring a proof of claim where extra-contractual liability is involved. Neither the guaranty associations nor assuming reinsurers accept liability for extra-contractual claims.

Receivers and guaranty associations must have data on the policy deductibles and benefit caps under health insurance policies. If the business is transferred to a new carrier, incurred claims will have to be allocated between pre- and post-assumption date periods. In addition, special provisions in the assumption agreement may require additional information in the proof of claim form.

5. Claim Files

The information needs of the guaranty associations generally are addressed earlier in this section of the Handbook. To ensure secure data transfer, receivers or insurance department personnel typically establish a secure website portal or FTP site to provide NOLHGA and its member associations with secure access to the data needed. Otherwise, NOLHGA (or a designated Third-Party Administrator or consultant) can establish a secure file portal where designated users can upload records. Files and records should be made available at the earliest practical opportunity to allow for the planning and coordination needed for a smooth transition and to avoid any disruption to benefits and claim payments.

6. Premiums

The continued and timely payment of premiums is necessary in order for a policyholder to receive continued coverage from a life/health guaranty association. Under the Life Model Act, "premiums due for coverage after entry of an order of liquidation of an insolvent insurer shall belong to and be payable at the direction of the Association." Receivers should work with NOLHGA and the guaranty associations to ensure smooth transition of premium collection. For premiums collected before the liquidation order but providing coverage for periods after the liquidation order, the Receiver should coordinate with the guaranty association to facilitate appropriate allocation of those funds.

E. Early Access

The guaranty associations' administrative costs, like the receiver's, typically have the highest priority in distribution of funds from the insolvent insurer's estate. In addition, guaranty associations have a statutory claim and right of subrogation, allowing them to recover from the estate to the extent they pay covered benefits. Guaranty association claims for the payment of covered benefits are accorded the same priority as policyholder claims (Class 3 under §801 of IRMA), and are taken into account in the calculation of association benefits as part of a rehabilitation or liquidation plan. The guaranty associations' claims in the aggregate often make the guaranty associations the largest claimants against the estate.¹³ In recognition of this fact, most state laws provide for the guaranty associations' "early access" to payments from the estate. See §803 of IRMA. Early access is typically accomplished by specific agreement, which should include a provision that the guaranty associations will return excess funds.

¹³ In some cases, the guaranty associations may also present claims against the estate for the insolvent insurer's unpaid guaranty association assessments. These claims have general creditor status ranking below other guaranty association claims and all policyholder claims.

F. Claim Reporting

Guaranty associations should make timely reports to receivers of their costs for policy transfers, policy administration (including TPA costs), claim payments and administrative expenses. In multi-state insolvencies, NOLHGA will typically collect the necessary data from the affected guaranty associations and report to the receiver on their behalf in the form of an Omnibus Proof of Claim, which may be updated from time to time.

G. Guaranty Association Obligations During the Formulation of a Rehabilitation or Liquidation Plan

The successful creation and implementation of a plan to protect policyholders requires good communication and cooperation between receivers and guaranty associations. To the extent consideration may be given to restructuring of covered policies or contracts, the receiver should coordinate with the guaranty associations early in the development of the plan to consider whether the proposed restructuring is consistent with the guaranty association statutory obligations with respect to those policies or contracts. Any restructuring needs to be carefully considered in light of all applicable statutory requirements.

H. Reinsurance

The guaranty associations may find it advantageous to keep in-force ceded reinsurance treaties that the insolvent insurer had in place on covered blocks of business. Accordingly, the receiver should not cancel ceded reinsurance contracts with reinsurers or stop paying premium to reinsurers without consulting NOLHGA or the affected state guaranty associations. The existence of a ceded reinsurance treaty covering a block of business may make the business more attractive to prospective purchasers. In the case of health insurance, reinsurance recoveries may lessen the impact of catastrophic claims upon the affected guaranty associations. See Section 8 N of the Life Model Act and Section 612 of IRMA, both of which provide that the guaranty association(s) may elect to succeed to the rights and obligations of the insolvent insurer under ceded indemnity reinsurance agreements.

J. Special Issues

Under the Life Model Act, guaranty associations have the power and discretion to “guarantee, assume or reinsure . . . the policies or contracts of the insolvent [or impaired] insurer.” Relying on this authority, guaranty associations have, on more than one occasion, acted collectively to establish an insurance company for purposes of collectively managing assets and assuming or administering guaranty association covered obligations. Whether similar arrangements may be appropriate in future insolvencies depends entirely on the circumstances.

J. Guaranty Association Procedures for Collective Action

MANY INDIVIDUAL STATE GUARANTY ASSOCIATIONS MAY BE TRIGGERED IN CONNECTION WITH A MULTISTATE INSOLVENCY. SIMPLY COMMUNICATING WITH EACH GUARANTY ASSOCIATION INDIVIDUALLY WOULD BE A DIFFICULT TASK FOR A RECEIVER’S STAFF. THE RECEIVER SHOULD WORK CLOSELY WITH NOLHGA, THROUGH THE MPC’S APPOINTED TASK FORCE, TO COMMUNICATE AND COORDINATE WITH THE AFFECTED GUARANTY ASSOCIATIONS. RECOGNIZING THE NEED FOR CONCERTED ACTION WHEN MULTIPLE GUARANTY ASSOCIATIONS MUST COVER THE INSURANCE OBLIGATIONS OF AN INSOLVENT COMPANY, THE GUARANTY ASSOCIATIONS HAVE DEVELOPED AND INSTITUTIONALIZED PROCEDURES THAT, THROUGH NOLHGA, ENABLE THEM COLLECTIVELY TO ADMINISTER CONTINUING POLICY OBLIGATIONS, PAY COVERED CLAIMS AND,

ULTIMATELY, DISCHARGE THE COVERED OBLIGATIONS. THESE PROCEDURES PROVIDE A VALUABLE MECHANISM FOR ENTERING INTO BINDING CONTRACTS

V.

¹ UDS Manual link to be included when published from .ncigf wesite

CHAPTER 7—REINSURANCE (THIS WILL CHANGE WITH FINAL)

I.	INTRODUCTION	397
II.	REINSURANCE BASICS	399
	A. Reinsurance Arrangements	399
	1. Treaty Reinsurance.....	400
	2. Facultative Reinsurance	400
	3. Pro Rata and Excess of Loss Reinsurance.....	401
	B. Life Reinsurance Arrangements	402
	1. Types of Reinsurance	402
	2. Types of Acceptance	403
	C. Financial Reinsurance.....	403
	D. Loss Portfolio Transfer	404
	E. Pooling Arrangements	404
III.	INTERMEDIARIES AND THEIR ROLES	404
	A. Reinsurance Intermediaries and Brokers	404
	B. Role Upon Insolvency.....	406
IV.	REINSURANCE ACCOUNTING AND COLLECTION PROCEDURES	406
	A. Introduction.....	406
	B. Unearned Premium Reserves.....	407
	C. Contractual Adjustments.....	407
	D. Ceded Reinsurance Recoverables	408
	1. Premium Processing	408
	2. Reinstatement Premiums.....	409
	3. Losses Recoverable	409
	E. Assumed Reinsurance.....	409
	1. Documentation	410
	2. Accounts.....	410
	F. Reinsurance Accounting Systems.....	411
	1. Minimum Accounting System Requirements	411
	2. Inventory of Reinsurance Accounting Records.....	411
	3. Review of Reinsurance Intermediary Records	412
	G. Reinsurance Audits.....	412
	1. Accounting Audit	413
	2. Claim Audit	415
	3. Underwriting Audit	416
	4. Handling Audits of Receiver’s Records	416
	H. Managing Assumed Reinsurance.....	417
	I. Managing Ceded Reinsurance Collections	419
	1. Direct Claims and Guaranty Funds	419
	2. Reports	419
	3. Insolvency Clause.....	419
	4. Notice to Reinsurers	420
V.	TERMINATION OF REINSURANCE RELATIONSHIP	420
	A. Commutation	420
	1. Commutation During Rehabilitation	420
	2. Commutation During Liquidation.....	421
	3. Technical Aspects.....	421

B.	Cancellation of Reinsurance Treaties	422
1.	Term Treaties	422
2.	Continuous Treaties.....	422
3.	Notice of Cancellation.....	422
4.	Cut-off vs. Run-off Cancellation.....	422
C.	Novation.....	422
1.	Definition	422
2.	Use of Novation.....	423
3.	Practical Difficulties.....	423
4.	Bulk Transfer Distinguished	423
D.	Rescission	423
1.	Definition	423
2.	Technical Aspects.....	423
VI.	SETOFF	424
A.	Overview.....	424
B.	Recoupment and Counterclaims	424
C.	Procedural Steps in Administering Setoffs	424
D.	Priority of Distribution Statutes	425
E.	Setoff Against Insolvent Insurers and Reinsurers.....	425
VII.	ARBITRATION CONTROVERSIES.....	425
VIII.	LETTERS OF CREDIT	426
A.	Nature of the Letter of Credit in Reinsurance Transactions	426
B.	Basic Features of the Letter of Credit	426
C.	What Should a Receiver Know About LOCs?.....	427
1.	Cedent in Receivership.....	427
2.	Reinsurer in Receivership	427
IX.	TRUST FUNDS	428
A.	Nature of the Trust Fund in Reinsurance Transactions.....	428
B.	Basic Features of the Trust Fund	428
C.	What Should a Receiver Do About Trust Funds.....	428
1.	Cedent in Receivership.....	428
2.	Reinsurer in Receivership	429
X.	FUNDS WITHHELD	429
XI.	INSOLVENT NON-UNITED STATES LICENSED REINSURERS	430
A.	The Non-U.S. Proceeding.....	430
B.	Chapter 15 Proceedings	430

I. INTRODUCTION

Reinsurance is often referred to as “insurance for insurance companies,” but it is separate and distinct from the insurance relationship existing between a policyholder and its insurer. The direct (primary, umbrella, or excess) insurer (reinsured or ceding company) cedes to a reinsurer (assuming company) a portion of its risk under policies issued to its policyholder (the original insured) pursuant to a reinsurance agreement. Reinsurance is an agreement of indemnity, whereby the assuming insurer in consideration of premium paid agrees to indemnify the ceding company against all or part of the loss that the ceding company may sustain under the policy or policies it has issued. Generally, absent a cut-through (discussed below at), the reinsurer has no privity with or obligation to the original insured.

Just as reinsurance is important to the operations of an insurer, it is equally important to a receiver. Reinsurance receivables often represent a significant portion of an insurer’s assets. Understanding reinsurance is critical to the efficient collection of this important asset. Generally, ceded reinsurance agreements should be continued. In the context of a life/health company insolvency, IRMA §612 provides for ceded reinsurance to be continued or terminated pursuant to the terms of each contract if the ceding insurer is in conservation or rehabilitation proceedings, but further provides that such contracts *shall be continued in liquidation* unless they were terminated in accordance with their terms prior to liquidation or were terminated pursuant to the liquidation order. In addition, both IRMA §612 and §8(N) of the NAIC’s Life GA Model Act, as adopted in state laws, provide the life and health insurance guaranty associations the right to elect to continue and assume the rights and obligations of the ceding insurer with respect to reinsurance contracts that relate to guaranty association covered obligations, subject to the requirements set forth therein. To the extent those guaranty association covered obligations are subsequently transferred to an assuming insurer, the reinsurance continued on those contracts may also be transferred to the assuming insurer.

Reinsurance is a sophisticated international industry involving various types of unique contractual relationships. Reinsurance is utilized by insurers to achieve a variety of purposes and effects. It can increase an insurer’s capacity to accept larger risks, provide financial support for an insurer, add stability to an insurer’s results, protect against accumulations of losses, and provide the expertise of reinsurers who specialize in a particular area of insurance. Reinsurers may in turn be reinsured by other reinsurers referred to as “retrocessionnaires,” who may also be reinsured, and so on. In this fashion, a broad spreading of risk is achieved.

It is important to note the terms used in reinsurance do not necessarily have the same meaning when used in the insurance context. A classic example is date of loss. In insurance it often means the date of the damage, while in reinsurance it can be the date the contract was accepted, terminates or any other meaning agreed by the parties. Some common definitions are:

Acceptance	Agreement by which a reinsurer consents to underwrite risk from a ceding company under specified circumstances.
Bordereau	A list compiled by a ceding insurer that provides the loss and premium histories of risks ceded or proposed to be ceded to a reinsurer.
Cede	To transfer part or all of a risk to a reinsurer.
Cedent	Company that is transferring the risk to a reinsurer. Generally the term is used when referring to the direct insurance company that is ceding business to the reinsurer.
Ceding Commission	The amount the reinsurer pays (or ceding company retains) when the cedent buys reinsurance. Generally, the amount of the commission is attributable to the cedent’s acquisition costs.

Cession	The portion of the risk that has been ceded to the reinsurer.
Commutation	The manner in which the cedent and the reinsurer will agree to a termination of past and future liabilities under a reinsurance contract.
Cover Note	A document issued by the reinsurance intermediary or the broker, indicating the reinsurance coverage that has been bound.
Cut-through Clause or Endorsement	A guarantee by the reinsurer to a party that is otherwise not in privity with the reinsurance contract (often the insured) that payment will be made by the reinsurer under certain specified conditions, e.g., insolvency of the cedent.
Excess of Loss Reinsurance	Reinsurance that attaches once a loss has exceeded a specific amount.
Facultative Reinsurance	Reinsurance in which the reinsurer retains the "faculty" to underwrite each risk individually.
Inuring Reinsurance	When for the benefit of the reinsurer, it will refer to other reinsurance contracts that will reduce the amount otherwise recoverable under a particular reinsurance cover. When for the benefit of the cedent, it refers to other reinsurance contracts that will not reduce the amount recoverable under a particular reinsurance cover. Sometimes referred to as "common account."
Quota Share Reinsurance	Generally, a reinsurance agreement by a reinsurer to reimburse a cedent in the same percentage in which the reinsurer receives premium from the cedent.
Reinsurer	A person or entity that assumes risk from the cedent.
Retention	The amount of risk retained by the ceding company.
Retrocedent	A reinsurer that transfers risk it has assumed to another reinsurer; e.g., cedent cedes to a reinsurer that in turn retrocedes to a retrocessionnaire.
Retrocession	A transaction whereby a reinsurer transfers risk that it has assumed from the cedent to another reinsurer.
Retrocessionnaire	A reinsurer that assumed risk from the retrocedent.
Surplus Share Reinsurance	A type of reinsurance treaty, similar to quota share reinsurance, which spells out specific amounts to be retained by the cedent.
Treaty	A type of reinsurance contract that differs from a facultative contract because it does not retain the faculty of underwriting the individual risk.
[New row] Unauthorized	A reinsurer that is unlicensed to conduct the business of insurance. The reinsurer is said to be "unauthorized" and not to provide security to the cedent which the cedent may reflect in its statutory financial statements either as an asset or a reduction in liabilities.

Additional definitions may be found in the NAIC's *Credit for Reinsurance Model Law* (#785), *Credit for Reinsurance Model Regulation* (#786), *Term and Universal Life Insurance Reserve Financing Model Regulation* (#787) *Special Purpose Reinsurance Vehicle Model Act* (#789), *Life and Health Reinsurance Agreement Model Regulation* (#797), and *Assumption Reinsurance Model Act* (#803). Glossaries can be found at various Web sites.

Guaranty Association Coverage

When an insolvent insurer is a reinsurer, guaranty associations do not provide coverage for reinsured policies unless there has been an assumption and novation and the insolvent insurer has become directly obligated to the original policyholders. See NAIC Life GA Model Act § 3(B)(2)(b) and NAIC P&C GF Model Act § 5(D) (which has been adopted in a minority of states and sometimes with modification to supporting definitions).

II. REINSURANCE BASICS

There are several reinsurance arrangements that one might expect to find in an insurer's reinsurance program. Whether undertaken in property and casualty, or life, accident and health insurance lines, there are numerous provisions that are required to be included in reinsurance agreements pursuant to state law (e.g., an insolvency clause – see _ below). In addition, all of the terms and conditions of a reinsurance relationship are required to be written as part of the principal agreement; "side" agreements and letters are not permitted.

A. Property and Casualty Reinsurance Arrangements

A reinsurance program can be extremely complex and may consist of multiple interacting arrangements, all responsive to the same loss. Furthermore, an insurer's net retention, after applying treaty reinsurance and facultative reinsurance, may be further protected by catastrophe or stop loss reinsurance. Also, overlap between different treaties may cover aspects of the same loss.

Two particular types of reinsurance arrangements bear specific mention – fronting and cut-through arrangements. Both fronting and cut-through arrangements affect the parties to the transaction, but do not change the ultimate economics involved.

Fronting is an arrangement by which an authorized insurer issues policies to cover risks underwritten by unauthorized or inexperienced insurers (or for the benefit of insureds who cannot transact the business of insurance) and then transfers its own liability to such unauthorized insurer by means of reinsurance. Fronting involves two actions: (1) a substantial cession of business; and (2) a delegation of claims and underwriting authority from a licensed to an unlicensed insurer. The fronting insurer remains financially liable to the policyholder for the entire insured amount even though, in reality, the fronting insurer may only bear a small financial liability, if any. While fronting can serve useful purposes, abuses can occur if the fronting company fails to exercise control with respect to underwriting, claims, or the risk to which it exposes its assets. A certain amount of disclosure, however, is required on Schedule F of the Annual Statement. Ceding companies are required to disclose whether they have contracts ceding 75 percent of direct written premiums in Schedule F.

A cut-through is either a clause in or an endorsement to an insurance policy or reinsurance contract which provides that, in the event of the insolvency of the insurance company, the amount of any loss that would have been recovered from the reinsurer by the insurance company (or its statutory receiver) will, instead, be paid by the reinsurer directly to the policyholder, claimant or other payee, as specified by the clause or endorsement. Cut-throughs may provide a competitive advantage among commercial insurers. Some clients require insurers to obtain a cut-through or face the possibility of losing business to another insurance company. Reinsurers usually provide cut-throughs only when requested by the insured and reinsured. If a reinsurer issues a cut-through, it has a contractual obligation to pay the beneficiary of the cut-through rather than the receiver. The cut-through does not change the amount of the reinsurance recoverable, only to whom

it is paid. Cut-throughs are common in captive arrangements, particularly where the insured owns, rents, or otherwise participates in the captive.

In general, reinsurance agreements are written as proportional or non-proportional and on either a treaty or facultative basis. Proportional reinsurance is reinsurance that involves the cession by the cedent of a specified share of risk, so that premiums and losses are shared proportionately between the ceding insurer and the reinsurer. Non-proportional reinsurance is a form of reinsurance that, subject to a specified limit, indemnifies the ceding company against the amount of loss in excess of a specified retention. It includes various types of reinsurance, such as catastrophe reinsurance, per risk reinsurance, per occurrence reinsurance and aggregate excess of loss reinsurance. Treaty reinsurance (or obligatory reinsurance) refers to an arrangement under which a reinsurer automatically reinsures all the risks of a specific portfolio of the reinsured, without an option to decline specific risks within the portfolio. Facultative reinsurance, on the other hand, refers to the type of risk where the reinsurer has retained the “faculty” to underwrite the individual risk. A facultative contract is generally referred to as a facultative certificate.

1. Treaty Reinsurance

Under a treaty, the reinsurer is obligated to accept the cession of a class or certain classes of business written by the ceding insurer in accordance with the definitions, exclusions, terms and conditions of the reinsurance agreement. There are common treaty clauses, but each treaty must be read in its entirety to determine how subject premiums and losses are to be treated and how the treaty is affected by other treaties, i.e., inuring treaties. (See definitions in I. Introduction, above.)

A treaty can cover different types of risks. Some treaties cover one line of business, such as fire, casualty, marine, aviation, directors and officers, or boiler and machinery. Others cover an entire program or all business written by a managing general agent, program administrator or specific underwriting department. There are two principal categories of treaty reinsurance: (i) pro rata or proportional reinsurance, and (ii) non-proportional or excess of loss reinsurance.

Treaties tend to be long documents with many clauses and provisions. There are no “standard” contracts, and no two are alike.

2. Facultative Reinsurance

Facultative reinsurance is reinsurance of individual risks by offer and acceptance wherein the reinsurer either retains the “faculty” or ability to accept or reject each risk offered by the ceding company, or limits its acceptance to certain risks or lines of business of the cedent.

There are two principal categories of facultative reinsurance: facultative obligatory and semi-automatic facultative.

- **Facultative obligatory reinsurance:** These contracts are hybrids of automatic and facultative reinsurance. Under facultative obligatory reinsurance, the ceding insurer has no obligation to cede a particular risk to the reinsurer, but if it does, the reinsurer has an obligation, within specified limits, to accept the risk. Facultative obligatory treaties are commonly used between reinsurers as a means of securing retrocessions on very large risks or, to a lesser degree, for retrocessions a reinsurer might cede to one of its clients.
- **Semi-automatic facultative reinsurance:** Semi-automatic facultative reinsurance requires the reinsurer to accept certain defined risks of the reinsured, subject to the right of the reinsurer to reject liability for any of such risks within a stated period after submission. Like facultative obligatory reinsurance, semi-automatic facultative reinsurance is also a hybrid of both treaty and facultative reinsurance.

Unlike treaties, many facultative contracts take the form of “certificates” comprising a Declarations page and a page of “standardized” General Terms and Conditions in order to ensure concurrency of terms within the reinsurance market.

3. Pro Rata and Excess of Loss Reinsurance

Pro rata and excess of loss reinsurance are forms of either treaty or facultative reinsurance.

a. Property/Casualty Pro Rata Reinsurance

Pro rata reinsurance, also known as proportional reinsurance, consists of quota share reinsurance and surplus reinsurance. Quota share reinsurance is a cession of a specified portion of the risk up to a certain limit of liability, such as 50 percent of the risk per occurrence up to \$1 million.

Surplus treaties are pro rata reinsurance that are usually designated by such names as first surplus, second surplus, special surplus, etc., reflecting layers of surplus reinsurance over specified retentions. Several reinsurers may each have a percentage of liability on a surplus treaty in each of these layers. Each reinsurer’s liability may be referred to as their “participation.” It is called surplus reinsurance because it is reinsuring over a net retention by the cedent or over other layers of reinsurance. A reinsurer’s respective participation is designated in a document known as an Interests and Liabilities Statement or agreement (I&L) and is designated as being on either a joint (each insurer is liable for the entire amount reinsured) or several (each reinsurer is liable only for a specified amount or percentage) basis.

b. Excess of Loss Reinsurance

Excess of loss reinsurance applies to losses that exceed an agreed dollar amount or percentage of premium. The reinsurance may apply to a single risk, to a number of losses arising out of one event, or to an aggregation of losses. Excess of loss reinsurance written on a per risk basis is most common, sometimes supplemented by aggregate loss limits applied on an annual basis. Because excess of loss reinsurance does not participate in the entire loss, premium and losses are not shared on a proportional basis with the cedent.

There are many types of excess of loss reinsurance, such as working excess, layered excess, per-risk reinsurance, aggregate excess of loss, and catastrophe or clash cover. The following are examples of excess of loss reinsurance:

- Working excess: This form of excess of loss reinsurance focuses on loss frequency, as opposed to loss severity, and is usually written with relatively low indemnity in excess of low retention, e.g., \$400,000 indemnity in excess of \$100,000 retention. (In reinsurance parlance, this is expressed as \$400,000 xs. \$100,000.)
- Layered cover: First excess is usually written over a retention where frequency diminishes and severity of loss is more of a factor. To protect against increased severity, second, third, fourth and higher excess layers may have also been purchased. A single loss may potentially expose any number of these excess covers.
- Per risk: Reinsurance in which the reinsurance limit and the reinsured’s loss retention apply “per risk” rather than per accident, per event, or in the aggregate. With per risk reinsurance, the cedent’s insurance policy limits are greater than the reinsurance retention. For example, an insurance company might insure commercial property risks with policy limits up to \$10 million and then buy per risk reinsurance of \$5 million in excess of \$5 million. In this case, a loss of \$6 million on that policy will result in the recovery of \$1 million from the reinsurer.
- Catastrophe reinsurance: This cover requires more than one loss resulting from a catastrophe or series of events. For example, if only one insured building was damaged due to an earthquake, catastrophe reinsurance would not cover the claim. If multiple losses

resulted, the catastrophe reinsurance might respond, but only after application of other available reinsurance. It is generally very high level, such as xs. \$100 million. It is a form of excess of loss reinsurance that, subject to a specific limit, indemnifies the ceding company in excess of a specified retention with respect to an accumulation of losses resulting from an occurrence or series of occurrences arising from one or more disasters. It generally covers multiple books of business. Catastrophe contracts can also be written on an aggregate basis, under which protection is afforded for losses over a certain amount for each loss in excess of a second amount in the aggregate for all losses in all catastrophes occurring during a period of time, usually one year. There will be two limits that the receiver will have to track: the catastrophe limits and the individual loss limits.

- **Clash cover:** Clash cover is a form of casualty excess of loss reinsurance under which a cedent may combine and cede the losses of multiple direct insureds, subject to a single reinsurance retention, when the losses arise from the same event or occurrence.
- **Aggregate or stop loss reinsurance:** This coverage applies when total losses on a group of risks accumulate to a specified retention, which may be defined as a specific amount or a percentage of premium. Generally, once the retention is reached and the aggregate or stop loss reinsurance kicks in, the reinsurance covers all risks above the designated retention.

B. Life Reinsurance Arrangements

1. Types of Reinsurance

There are three distinct types of life reinsurance: yearly renewable term, coinsurance and modified coinsurance.

- **Yearly renewable term (YRT):** Under yearly renewable term reinsurance, the reinsurer indemnifies only the mortality risk. The mortality risk, but not the permanent plan reserves, is transferred to the reinsurer for a premium that varies each year with the amount at risk and ages of the insureds. While YRT reinsurance allows a ceding company to transfer mortality risk, it leaves the company responsible for establishing reserves. The reinsurer becomes liable for the reinsured portion of the net amount at risk but has no cash surrender value liability. While the precise formula for determining the reinsured portion of the net amount at risk varies from treaty to treaty, in general it equals the death benefit less cash surrender value on the portion reinsured. Thus, as the cash surrender value grows from year to year, the amount of reinsurance decreases.
- **Coinsurance:** Coinsurance is a broader form of reinsurance, under which the reinsurer indemnifies a proportionate share of all risks under the policy. In return, the reinsurer receives a proportionate share of the cedent's gross premium, less an expense allowance or ceding commission, and is responsible for establishing reserves. Under a coinsurance funds withheld treaty, the cedent retains all or some of the reinsurance premiums as security for the reinsurer's obligations. With a reinsurer that is not authorized for credit for reinsurance purposes ("unauthorized reinsurer"), additional security is often provided by trust accounts and letters of credit for any difference between the liability of the reinsurer and the funds withheld by the cedent.
- **Modified coinsurance:** Modified coinsurance differs from coinsurance in that the reserves on the reinsured portion of the policy are not held by the reinsurer; instead, the reserves are held by, and are the responsibility of, the cedent. The reinsurer receives its proportionate share of the cedent's gross premium, less expense allowances. Periodically, a reserve adjustment payment is made, which is equal to the reserves at the end of the reporting period less the sum of (i) the reserves at the beginning of the period and (ii) the earnings on the reserves at the

beginning of the period. The interest element in this calculation is stated in the treaty. If the result of this calculation is positive, the payment is made to the ceding insurer, and if it is negative, the payment is made to the reinsurer. Generally, as long as new business flowing into the account exceeds lapses, the reserve adjustment will be positive.

Each of these forms of life reinsurance are documented in agreements having clauses and provisions unique to the business reinsured. Some contracts empower reinsurers to compel cedents to raise premium rates on the underlying business, which present many unique issues for receivers. Obtaining advice of competent legal counsel in such situations is important.

2. Types of Acceptance

- **Automatic reinsurance:** This is the most common form of life reinsurance. Automatic reinsurance enables the cedent to issue policies in excess of its retention promptly and economically. The maximum amount of reinsurance that may be ceded automatically on a particular life policy is usually a multiple of the ceding insurer's retention. In the past, the most common multiple was four, but in recent years, there has been a tendency toward higher multiples, such as six, eight or ten. Automatic treaty limits may also be expressed as a dollar amount. Reinsurers seek a reasonable relationship between a cedent's exposure and the exposure it can cede automatically to a reinsurer. It is assumed that the proper balance will provide more assurance that the ceding insurer will act prudently in underwriting a risk if it is retaining a meaningful or "material" portion of that risk.
- **Facultative reinsurance:** Virtually all automatic treaties also provide facultative facilities for risks that cannot be ceded automatically and for situations where the ceding insurer seeks the underwriting assistance of the reinsurer. A "facility" is an agreement setting out, among other things, the rules under which a reinsurer will reinsure risks ceded by the other party. Unlike automatic reinsurance where the underwriting assessment is made by the cedent, under facultative reinsurance, the reinsurer determines whether it will accept the risk and, if so, at what underwriting classification.
- **Facultative obligatory reinsurance:** These treaties are hybrids of automatic and facultative reinsurance. Under facultative obligatory reinsurance, the ceding insurer has no obligation to cede a particular risk to the reinsurer, but if it does, the reinsurer has an obligation, within specified limits, to accept the risk. Facultative obligatory treaties are commonly used between reinsurers as a means of securing retrocessions on very large risks or, to a lesser degree, for retrocessions a reinsurer might cede to one of its clients.
- **Second excess reinsurance:** These are automatic reinsurance treaties that are excess of an initial layer of automatic reinsurance provided by another reinsurer. For instance, a cedent might have first excess automatic cover of four times its \$150,000 retention from one reinsurer plus a second excess automatic facility of two times retention from another reinsurer, permitting the cedent to issue up to \$1,050,000 of insurance ($\$150,000 + 4 \times \$150,000 + 2 \times \$150,000$) on its own underwriting authority. Second excess facilities are sometimes provided on a "criss-cross" basis by two reinsurers sharing an automatic account. One reinsurer might provide first excess cover on lives of persons whose surnames begin with any letter from A to K and second excess cover for surnames starting with L to Z. The other reinsurer would then provide first excess for L to Z and second for A to K. It is a convenient way of providing higher automatic cover when appropriate, without either reinsurer having too large a risk on any one life.

C. Financial Reinsurance

A reinsurance contract that fully participates in the insurance risk of the underlying policies and literally follows the fortunes of the ceding company, such as a simple quota share reinsurance treaty, is referred to

as traditional reinsurance. A reinsurance transaction that does not transfer sufficient insurance risk, sometimes referred to as financial reinsurance or finite reinsurance, should be accounted for separately and not commingled with traditional reinsurance transactions. (See SSAP No. 62R, Property and Casualty Reinsurance and SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance, for further discussion on deposit accounting for reinsurance that does not transfer sufficient risk.) Thus, reinsurance transactions that do not transfer sufficient insurance risk are still a viable tool to achieve economic goals, but must be accounted for and reported separately from traditional insurance or reinsurance transactions. See Chapter 9—Legal Considerations.

Although the authoritative language on transfer of risk is in the Statement of Statutory Accounting Principles—SSAP No. 61R for Life, Deposit-type, Accident and Health and SSAP 62R for P&C—of the NAIC's *Accounting Practices and Procedure Manual*, some jurisdictions have enacted legislation, promulgated insurance regulations, or issued insurance bulletins that address transfer of risk issues. The receiver should consult applicable or governing state laws and regulations on this subject.

D. Loss Portfolio Transfer

Loss portfolio transfers are arrangements under which an existing block of loss reserves from events that have already occurred is transferred to a reinsurer acting as retrocessionnaire, and so without privity to the insured. The loss reserves may include known case reserves, reserves for incurred but not reported (IBNR) losses, and loss adjustment expense reserves. Since the losses on casualty business are not payable until future years, the consideration for the loss portfolio transaction is calculated based on present value concepts, i.e., the time value of money. Thus, the ceding company is transferring ultimate loss reserves at a discounted value, and the transaction will create immediate income and surplus relief to such company. The essential elements in this transaction are the payout stream of the loss reserves and the time value of money. The financial responsibility of the reinsurer may be capped.

E. Pooling Arrangements

Pooling arrangements are utilized among two or more insurers or reinsurers to underwrite a particular risk or type of business. An allocation of a share of premium, loss and expense is made to each member of the pool based on the pooling agreement. Pooling can be used among either affiliated or unaffiliated companies. Pooling is common within insurance holding company systems or groups of affiliated insurers, and must be reported as such.¹

III. INTERMEDIARIES AND THEIR ROLES

A. Reinsurance Intermediaries and Brokers

If the ceding insurer chooses direct placement, it will handle all negotiations directly with the reinsurer. However, a ceding insurer may have received the assistance of a reinsurance intermediary (also known as a broker) to place reinsurance coverage. The terms “reinsurance intermediary” and “broker” are sometimes used interchangeably. In a number of jurisdictions, the reinsurance intermediary/broker is legally considered to be the agent of the cedent; this can be reversed by the reinsurance contract.

The reinsurance intermediary facilitates the relationship by acting as the liaison between the ceding insurer and the reinsurer. The reinsurance intermediary may be responsible for documenting the activity between the parties and passing through accounts and payments between the ceding insurer and reinsurer. Should the reinsurance intermediary agree that it is to have any of these obligations, the reinsurance contract should contain a reinsurance intermediary clause. The following is a sample:

Intermediary is hereby recognized as the intermediary negotiating this Agreement for all business hereunder. All communications (including but not limited to notices, statements, premiums, return

¹ NAIC SSAP No. 63; *see also* Statutory Issue Paper No. 97 (Finalized March 16, 1998)

premiums, commissions, taxes, losses, loss adjustment expense, salvages and loss settlements) relating thereto shall be transmitted to Insurer or Reinsurer through Intermediary. Payments by Insurer to Intermediary shall be deemed to constitute payment to Reinsurer. Payments by Reinsurer to Intermediary shall be deemed to constitute payment to Insurer only to the extent that such payments are actually received by Insurer.²

For the cedent, the reinsurance intermediary finds reinsurers willing to accept the risk and helps to negotiate reinsurance agreement terms and produce documentation. For the reinsurer, the reinsurance intermediary brings proposals from cedents and administers the transaction details. The reinsurance intermediary receives a fee (called brokerage or commission), which may be deducted from the premium amounts paid to the reinsurer.

Typically, the reinsurance intermediary will place a cedent's business with one or more reinsurers. When accounts are rendered by the cedent, the reinsurance intermediary will prepare an account for each reinsurer and distribute payments to them or seek reimbursement of amounts due the cedent, as appropriate.

The insolvent cedent, possibly subject to certain limitations, may elect to change the reinsurance intermediary at any time during the treaty and need only notify, in writing, the reinsurance intermediary of its decision and its intended handling of its reinsurance in the future. The receiver should be aware; however, that such change may result in the insolvent cedent incurring an obligation to pay an additional commission. Whether such commission is subject to set-off is an issue to consider with competent legal counsel.

The ceding insurer provides the reinsurance intermediary with a broker of record letter pursuant to which the reinsurance intermediary is granted the authority to solicit reinsurers to subscribe to a program. The reinsurance intermediary then presents a package of information to potential reinsurers, compiled in coordination with the insurer, which documents the program to be written and the insurer it represents. Traditionally the reinsurance contract was rarely signed by all parties prior to the inception date of the coverage. Instead, the reinsurers signed placement slips indicating their percentage participation and containing a summary of the reinsurance coverage—limits, retention, exclusions, standard clauses to be used in the contract, etc. The ceding insurer signed a similar document but referred to it as a cover note. When the reinsurance contract was ultimately circulated for execution, each reinsurer would execute a separate signature page or I&L, binding them to the formal contract. More recently, pursuant to US and international regulations, documentation of the transaction must be executed within nine months. Many brokers and direct reinsurers have been moving toward contract at placement or contract certainty, the idea being that the full contract wording is agreed upon prior to the inception date of the coverage. In such a case, there would be no need for a placement slip; rather, the reinsurer would sign the I&L page to the contract.

The reinsurance intermediary then gathers all executed slips and I&Ls and provides them to the ceding insurer, indicating that the placement has been completed and summarizing its terms and conditions. Thereafter, the reinsurance intermediary often has the responsibility to draft a reinsurance treaty based on the agreed terms.

The ceding insurer reports premiums to the reinsurance intermediary, who then prepares the necessary accounts to the reinsurer or correspondent broker, together with appropriate remittances less the reinsurance intermediary fee, which may be netted against such premiums.

The ceding insurer reports losses through the reinsurance intermediary to the reinsurer. The reinsurer pays losses through the reinsurance intermediary to the ceding insurer. In some instances, a reinsurer will make its check payable to the cedent and forward it to the reinsurance intermediary, who will simply mark his records as paid and forward the check to the cedent. In other instances, the check will be drawn in favor of

² Note that the last sentence of the intermediary clause reverses the general accepted rule that payment to a disclosed agent is payment to the principal.

the reinsurance intermediary, who will then be obligated to pay the cedent. Funds so paid are held in a fiduciary capacity. Most current reinsurance intermediary clauses deem payment as having been made only upon actual receipt by the cedent. For an example, see the NAIC *Reinsurance Intermediary Model Act* (#790) and New York Regulation 98.

State law following the NAIC Model requires reinsurance intermediaries to be licensed and to have written agreements with their cedents.

B. Role Upon Insolvency

The reinsurance intermediary should be immediately notified of the receivership of either the cedent or reinsurer. The reinsurance intermediary should be provided with a copy of any legal documents (insurance department letter or court orders). It is then the responsibility of the reinsurance intermediary to notify and advise all reinsurers or cedents of the status of the insolvent insurer. It may also be necessary to obtain underwriting and premium records of the reinsurance intermediary, since they are generally more complete than those of the company in receivership.

The responsibility of the reinsurance intermediary does not terminate when the insurer is placed in receivership. The reinsurance intermediary must continue to act in the best interest of the insolvent insurer, including rendering accounts and assisting in the collection of funds from reinsurers. In turn, the estate should continue to provide the reinsurance intermediary with timely claims and accounting reports that need to be rendered to reinsurers. Nonetheless, given the change in the relationship due to the receivership, the receiver may have to contemplate making a new arrangement if he/she has difficulty receiving service from the reinsurance intermediary. If not, there may be an issue whether the intermediary is entitled to assert set-off in respect of pre-receivership financial obligations that include commission(s). In that event, the receiver will want to seek advice from competent legal counsel.

IV. REINSURANCE ACCOUNTING AND COLLECTION PROCEDURES

The purpose of this section is to describe the accounting and collection responsibilities of the receiver for assumed and ceded reinsurance.

A. Introduction

For accounting purposes, reinsurance treaties are classified as either prospective or retroactive. A prospective treaty is one that covers future insurable events arising on or after the effective date of the contract. A retroactive reinsurance treaty (e.g., loss portfolio, as described above in) is a treaty that covers past insurable events. A reinsurance treaty, whether prospective or retroactive, must transfer insurance risk. Unless insurance risk is transferred, the treaty must be accounted for as a deposit and not as reinsurance. Deposit accounting postpones recognition of revenues and income until the end of the treaty. Under the "nine-month rule," unless the full treaty wording is signed by the parties within nine months of its effective date, the accounting treatment for the reinsurance treaty must be converted from prospective to retroactive. For statutory accounting, a retroactive treaty must be excluded from the underwriting results of an insurance company and cannot be commingled with a prospective treaty.

SSAP No. 62R requires that, for a transaction to be classified as reinsurance, and to be included in the underwriting accounts of the company, the reinsurance treaty must be prospective, and the transaction must contain both underwriting and timing risk.

1. Underwriting risk is the ultimate amount of net cash flows from premiums, commissions, claims, and claims settlement expenses.
2. Timing risk is the timing of the receipt and payment of such cash flows.

SSAP No. 62R further requires that indemnification of the ceding company against loss or liability relating to insurance risk in reinsurance requires both of the following:

1. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.
2. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

For complex or non-traditional reinsurance contracts, present value cash flow analysis of a transaction is often prudent to determine whether significant risk has been transferred or a loss may be realized. If a transaction does not meet these requirements, then the transaction must be reported in the financial statements as non-reinsurance or as a deposit. The authoritative statutory guidance for deposit accounting is contained in SSAP No. 61R.

The receiver's primary objective should be to examine the reinsurance agreements with a view to what is best for the estate. It is possible that reinsurance agreements may be amended, terminated, rescinded, commuted or continued to meet this objective.

B. Unearned Premium Reserves

There may be unearned premium reserves related to a reinsurance treaty for some time after the termination date of the treaty, as the underlying policies have not yet reached their expiration and premiums have not been fully earned. This situation may be altered by the termination method utilized. Typically, the parties may elect to terminate a treaty on either a "cut -off" or "run-off" basis. In run-off, a reinsurer will remain liable for losses for policies in force at termination, even if the occurrences take place after the termination date. Since cut-off terminates the reinsurer's liability as of a certain date, usually with a return to the cedent of any unearned premium reserves held by the reinsurer, the period for which the reinsurer may be liable for losses may be substantially reduced as compared to a run-off provision.

C. Contractual Adjustments

Reinsurance treaties may be subject to future premium or commission adjustments based upon experience. Common adjustments are retrospective premium rating, deposit premium adjustment and reinstatement premium adjustments. The most common commission adjustments are for contingent (profit) and sliding scale commissions.

A retrospective rated premium adjustment is a calculation of the final reinsurance premium for the treaty based upon the loss experience developed during the term of the treaty. An estimated reinsurance premium, sometimes referred to as a deposit premium, is paid by the cedent until the retrospective premium is determined. The final reinsurance premium is the deposit premium plus or minus the adjustment, often subject to a minimum and maximum dollar limit.

Ceding commission adjustments represent a sharing of profits between the reinsurer and cedent and are usually associated with pro rata reinsurance. A contingent commission, or profit commission, is a sharing of a predetermined amount of the profits, if any, realized by the reinsurer from the reinsurance treaty. A formula is specified in the treaty describing how premium, losses, IBNR, expenses and commissions are calculated for determining profitability. At specified dates, this calculation is made and settlement of accounts is undertaken. No additional premium results from a contingent commission agreement. These arrangements in life reinsurance may be referred to as experience refunds.

A sliding scale commission arrangement is one in which the final ceding commission is determined by calculating the loss ratio and relating this to a predetermined range of commission rates. As the loss ratio increases, the amount of commission decreases, or vice versa, usually subject to stated limitations.

D. Ceded Reinsurance Recoverables

The initial step in establishing control over ceded reinsurance receivables is to gather and update all ceded reinsurance treaties and facultative certificates in order to create working abstracts of these arrangements. Once individual arrangements have been analyzed, a matrix of reinsurance coverages in place, by book of business, should be established so that the relationship of various ceded treaties is known. See Exhibits 7-1 and 7-2.

The most current account rendered for each treaty should be reviewed, and any open balances due to or payable from the estate should be reconciled. If the reinsurance was purchased through a reinsurance intermediary, there are likely to be multiple reinsurers. Each reinsurer and its percentage of participation should be identified and accounts verified.

Each treaty should be reviewed to determine:

- Lines of business covered
- Limits of coverage
- Dates of coverage
- Workflow and procedures needed to generate premium, losses, etc.
- Outstanding balances
- The appropriateness and method of cancellation of the coverage
- The method of termination (run-off or cut-off)
- The location and security of records underlying the placement of the treaty

Once all participants have been identified in the treaty review phase, an analysis of each reinsurer should be made to determine its financial strength. Procedures should be established to periodically monitor the solvency of reinsurers. If the financial stability of a reinsurer becomes a concern, possible commutation of the reinsurer's liability should be considered.

Treaties may contain security provisions requiring or permitting the insurer to obtain collateral for the reinsurers' obligations. If a treaty provides for letters of credit to secure the obligations of the reinsurers, the obligations of reinsurers should be reviewed and letters of credit either obtained or updated to reflect appropriate liability.

The initial step in the ceded reinsurance accounting process is to develop procedures that allow the assembly of data to produce reporting in conformity with requirements under the treaty.

Allowed claims in liquidation proceedings constitute the basis for submitting claims to reinsurers. Generally, rehabilitation follows the rules of the contract. Thus, it is important to maintain record-keeping systems that fully support the calculation of total claims reinsured.

1. Premium Processing

In most property/casualty liquidations, the court order cancels coverage on the insurer's direct in force insurance business within 30 days of the date of the receivership. The cancellation of the underlying business terminates the need for ceded reinsurance for losses occurring after the termination date, but does not terminate the reinsurance under the treaty when the receivership is a liquidation based upon a finding of insolvency. In this event, the first consideration in premium accounting is to calculate any

unearned premium reserves that the reinsurers may be holding at the termination date and request that they be returned to the estate. There may, however, be additional premiums or adjustments to be forwarded to the estate for direct business issued and in-force prior to receivership.

Appropriate calculation of this premium should take into consideration the earned portion due reinsurers. Proportional ceded reinsurance involves a calculation of the gross earned premium that is subject to the agreement and a credit to the reinsurer's account for the appropriate proportion. The gross earned premium is subject to ceding commissions due to the estate and, in most events, may be subject to an offset for paid losses.

2. Reinstatement Premiums

Premium adjustments may become due from the insurer to one or more reinsurers as subject premium is received or loss experience develops on business that was reinsured.

Certain types of excess of loss reinsurance agreements, primarily aggregate excess of loss agreements, may provide for an additional premium to be paid to the reinsurers if the total liability limit under the agreement is exhausted by loss payments. This additional premium is known as a reinstatement premium because its payment reinstates the limit of liability of the reinsurance agreement. Reinstatement may be optional, in which case the liquidator may wish to consider whether it should be paid, or if ultimate liabilities will be reduced due to the termination of the underlying policies.

Losses from direct business may be known sooner by the receiver, and reinstatement calculations, as defined by the treaty, may be prepared more rapidly. Losses from assumed reinsurance, however, usually develop over a period of years. For this reason, appropriate controls in accounting and claims are needed to identify any aggregate losses that may be subject to recovery from reinsurers.

The relative priority of such obligations should be considered in a liquidation, and the potential for preferential transfers should be considered in a rehabilitation. Notwithstanding this, it is important for the receiver to maintain current billing practices.

3. Losses Recoverable

Losses to be recovered from reinsurers may arise from both direct and assumed reinsurance operations. It is desirable for the receiver to coordinate reporting with guaranty funds to ensure complete, accurate and detailed information. Controls over this information are required to meet the data requirements of the reinsurance agreements.

In establishing its reinsurance processing procedures, the insurer should have provided for the capture of loss balances due or owing under each treaty or facultative certificate and for each participating reinsurer. If this information does not exist, it is important for the receiver to analyze each treaty by participation to identify each reinsurer. As a result of closer monitoring, a better control over slow-paying or non-paying reinsurers should be achieved.

In addition to paid losses for which the insurer seeks indemnification, outstanding reserves for losses and expenses (and possibly IBNR calculations) are to be reported to reinsurers. Controls should exist to identify certified and unauthorized reinsurers and to monitor the collateral they should provide, as well as the potential recovery against such collateral.

E. Assumed Reinsurance

Accounts for assumed business usually represent liabilities of the estate, as most premiums, except for premium adjustments, are typically received prior to receivership. Because assumed reinsurance is not covered by guaranty funds, and assumed reinsurance generally falls within the general creditor class of the estate's distribution priorities, its accounting is often not of primary importance in liquidations unless

collateral is involved. The existence of collateral account heightens the importance for ongoing accounting and reporting in the underlying business. Whether collateral is supporting an assumed reinsurance transaction might not be clear on the insurer's financial statement, but that collateral could go back to the ceding company if the reinsurance agreement terminates. That transfer of assets could have an adverse effect on the assuming insurer. Typically, ceding companies have low priority claims in liquidation and GAs don't cover assumed (but not novated) reinsurance, therefore unwinding assumed reinsurance agreements could have an effect on the assuming insurer's financials. The insurer, however, may have purchased reinsurance protection on this business and is required to properly record and report these transactions to its reinsurers or retrocessionnaires in order to realize recoveries from them, which may be significant. Also, it is common for insurers both to assume and cede reinsurance to the same insurers/reinsurers, so that mutual accounts may need to be completed to collect balances.

The general accounting approach to assumed reinsurance is the same as that for ceded reinsurance. The receiver should obtain and safeguard all original documentation, abstract arrangements for working purposes, establish balances as of the receivership date, review each treaty and facultative certificate, develop experience histories by treaty, and assign maintenance responsibilities.

Controls similar to those used for ceded insurance should exist over assumed reinsurance reporting. If business has been solicited directly from cedents, those cedents should be informed of any reporting requirements. If, however, a reinsurance intermediary is involved, then the receiver should communicate the requirements to the intermediary, who has the continuing obligation to report to the ceding insurers.

Intermediaries often remit a net payment for the balance due, which may cause problems in the identification and allocation of payments to various cedents' balances. This becomes more of a problem in liquidations, due to possible statutory limitations on setoff. The receiver should consult with competent legal counsel and determine whether to notify intermediaries not to use net accounting or multiple treaty or reinsurer setoffs. Unless rigorous control is maintained by the receiver, the cash allocation process may become difficult.

The action plan for assumed reinsurance is:

1. Documentation

- Obtain all treaties and update all documentation
- Establish how treaties were assumed (direct/broker)
- Abstract treaties into usable format
- Update any electronic data processing systems used for assumed reinsurance
- Prepare a matrix of the reinsurance program

2. Accounts

- Establish latest account position by treaty and cedent
- Verify balances with broker or cedent, if direct assumption
- Review experience on each treaty
- Develop plan to deal with problem accounts
- Request any missing accounts

- Establish diary for any adjustments due on accounts
- Review documentation to ensure proper reporting of catastrophic losses and aggregate accumulations
- Establish diary control for collection of balances
 - separate responsibility for pro rata reinsurance and excess of loss reinsurance
 - set up procedures for evaluating and recording excess of loss claims

F. Reinsurance Accounting Systems

Reinsurance accounting systems can vary however most systems are web-based. In a few cases, there may be a limited accounting systems.. The type of system used may depend upon the extent and the diversification of the cedent's reinsurance program.

1. Minimum Accounting System Requirements

The reinsurance accounting system must provide information to record the subject business for reinsurance in a manner readily identifiable for each reinsurance contract. The subject reinsurance premium is computed by application of the treaty rate to the subject premium and is adjusted for premiums paid on other reinsurance treaties that inure to the benefit of the treaty.

Losses that emanate from the subject business should be identified. Once the covered losses are identified, reinsurance recoverable under each treaty is computed. If the cedent reports to a reinsurance intermediary, who in turn reports to individual reinsurers, then one summary report should be prepared and mailed to the reinsurance intermediary. If the cedent insurer reports directly to the reinsurers, then individual reports should be prepared. The ceding insurer often retains a percentage of the risk for its account. This can be accounted for on a net basis or as if the ceding insurer is also a reinsurer.

2. Inventory of Reinsurance Accounting Records

The inventory of reinsurance accounting records should be coordinated with the inventory of records for the primary accounting function. The reinsurance accounting records should include:

- Chart and summary of the reinsurance program
- Correspondence files with intermediaries
- Correspondence files with reinsurers
- Formal reinsurance contract wording
- Reinsurance slips (if a formal treaty has not been finalized)
- Signed I&L forms from each reinsurer
- Letters of credit or other forms of security from reinsurers
- Reinsurance accounting folders

The insurer may have a reinsurance accounting procedure manual available that describes the reinsurance accounting cycle and how the data necessary for the reinsurance accounting is obtained and processed to comply with the reinsurance treaties.

The chart and summary of the reinsurance program should describe the various reinsurance treaties, the business covered, and the relationship between the treaties. An individual chart and summary may be available for each reinsurance accounting year. The chart and summary change from year to year as the reinsurance program changes to meet the insurer's needs, objectives and business reinsured.

Correspondence files with intermediaries may include confirmations of reinsurers' participation, accounting reports sent to the intermediaries, or letters requesting payments or cash advances, disputing amounts recoverable, requesting collateral, etc. The reinsurance intermediary is required under the NAIC *Reinsurance Intermediary Model Act* (#790) to retain documents for 10 years. The receiver should instruct the reinsurance intermediary to retain all documents until notified that the documents are no longer needed by the receiver. If the relationship with the reinsurance intermediary is to be terminated, arrangements should be made for the intermediary to deliver all documents in its possession, or copies of the documents, to the receiver.

3. Review of Reinsurance Intermediary Records

The receiver may benefit by reviewing the systems and procedures currently being used by the reinsurance intermediary and evaluating its performance. Where applicable, various reports generated by the insurer should be compared to the reinsurance intermediary's records. When reviewing the records of the reinsurer or of the reinsurance intermediary, consider the following:

- What is the status of the treaty documentation?
- Do the balances developed by underwriting year and by reinsurer conform to the balances generated from the insurer's system?
- Has there been a delay between submission of a request for payment and receipt of the payment? This information may become part of the reinsurer evaluation process. If a reinsurer is habitually late in making payments, the receiver should determine what actions are required. The receiver may wish to have the reinsurance intermediary copy the receiver on all billing transmittals.
- While not customary, the receiver should consider a periodic review of the reinsurance intermediary (every quarter to six months). The purpose of the audit is to verify that the receiver has received complete documentation concerning its reinsurance contracts (e.g., wordings and I&Ls), the reinsurance intermediary has collected all money due from the reinsurer, and all payments received by the reinsurance intermediary have been paid to the appropriate parties.

G. Reinsurance Audits

By custom as well as by contract, reinsurers may have access to the cedents' books and records that pertain to the business reinsured. This section will briefly explain the various types of audits, the purpose of each and the information that one can expect to obtain.

Virtually every reinsurance treaty has an access-to-records clause or an inspection clause, such as, "The reinsurers or their authorized representative shall at all times have access to the books and records of the company, which pertain in any way to the business transacted under this agreement." Most facultative certificates have a similar provision. The same often holds true for agreements with pool managers, managing general agents and reinsurance managers.

Audits typically cover accounting, claims and underwriting. Many reinsurance counterparties conduct separate audits, although it may be more effective to examine all three areas simultaneously. This is especially true in those instances where the audit is being conducted as a result of a dispute or in anticipation of arbitration or litigation. (Note that a "dispute" has statutory accounting consequences, so the prudent receiver will beware declaring a dispute too soon.) The receiver needs to coordinate with the reinsurer and

any affected guaranty funds as to how the audit should be conducted and who should be involved in the audit. The prudent receiver also will negotiate a memorandum of understanding or non-disclosure agreement that summarizes the intent, scope and logistics (onsite vs. remote access, hours and location(s)) for any audit, which may include, e.g., provisions governing confidentiality, admissibility in a dispute resolution forum, etc.

Except in unusual circumstances, the auditors may be limited to review of records directly related to the business their clients assumed. They are generally allowed to review original records together with the cedent's and receiver's summaries of experience, to the extent those are prepared in the normal course of business. However, auditors should be denied material prepared in anticipation of litigation or preparation for trial, and in particular they should be denied access to communications to and from counsel retained in connection with reinsurance collections. These materials should be kept in files separate from the underlying claims and underwriting files. Auditors generally do, however, receive access, under appropriate safeguards to preserve confidentiality, to communications to and from claims counsel.

An important consideration is who needs to be present during an audit, from both the auditing and audited sides.

1. Accounting Audit

The primary scope of this review focuses on verification of the periodic reporting (monthly, quarterly accountings) of the cedent. Although the bulk of the audit will be conducted at the cedent's offices, a significant amount of work, such as the following, may be conducted prior to that time.

- Review terms and conditions of reinsurance contracts, such as:
 - coverage (type of reinsurance contract, limits, underwriting restrictions, classes of risk and territory)
 - reinsurance period (including cancellation and termination provisions)
 - reporting and settlement
 - definitions
 - procurement of common account protection
- Review cedent's recent financial information, including:
 - financial statements
 - independent auditor's reports
 - financial reports filed with the Securities and Exchange Commission or similar authorities
 - financial statements filed with insurance regulatory authorities
 - other insurance department regulatory reports

A schedule of accounts and settlements between the assuming company and the cedent, according to the reinsurer's documentation, should be prepared to verify the balance outstanding on the account. This analysis should then be compared to a similar schedule from the cedent's records. The results can be used as a source of further investigation, if necessary.

Copies of the cedent's procedural manuals for accounting, claims, reinsurance, and audit should be obtained, reviewed and stored.

Documentation on hand should include the most recent experience reports on the program. Investigation should be made into significant deviations from normal business custom and practice. If desired, a comparison to similar programs with other cedents may also be made.

Comparison of such data to actual historical information, especially in the areas of premium volume and loss experience, may be performed to help determine the scope of the audit required.

Prior to inception of the audit, which maybe in person or remote, a list of information and documentation required for the audit should be submitted to the cedent to facilitate its availability. The documentation that may be requested would include digital/electronic, read-only access to document sharing systems, and/or printed copies of:

- Premium and claim registers for originating business (primary or assumed)
- Individual policy and claim files to support registers for originating business
- Premium and claim registers for ceded business
- Individual policy and claim files to support ceded registers
- Accounts and bordereau from the cedent
- Cash receipt and disbursement records (including checks, cash journals, ledgers) applicable to settlement of premiums and losses for originating and ceded business
- All contracts relating to managing general agents, brokers, intermediaries and common account protection for originating and ceded business
- All documentation and support relating to letters of credit, trust accounts and funds withheld

Although generally not specified in the inspection clause, the auditors should have reasonable access to personnel involved in the preparation of any of the cedent's documentation pertinent to the audit procedures.

Having completed review of the pre-audit documentation and assuming the availability of all required information at the cedent's office, the audit may:

- Trace information on originating premium and claim registers through the reports to assuming reinsurers.
- Determine relationship of premium and claim registers for originating business (primary or assumed) to ceded premium and claim registers.
- Verify accuracy of reinsurance accounts and the existing control procedures for preparation of accounts to assuming reinsurers based on review of originating and ceded premium and claim registers.
- Analyze cash records in conjunction with accounts to assuming reinsurers to determine balance due from or to cedents;
- Verify timeliness of reporting and settlement of accounts.

- Sample policy files (reinsurance contract files for assumed business) and claim files from premium and claim registers to verify that:
 - policies are in agreement with treaty terms relative to class of risk, period, limits and other provisions.
 - premium allocations for policies are proper, as are all commissions and other deductions.
 - claims are adequately documented and fall within the policy conditions.

Irregularities encountered in any of the above may be referred to the appropriate staff member of the cedent for resolution of the problem.

This is a simplified outline designed to establish a pattern for the audit. These general steps may not apply to the same degree in all instances. Individual audit programs should be geared to address the needs of the situation, contingent on the nature and volume of the business, as well as the auditor's evaluation of control systems in place.

2. Claim Audit

The ceding insurer should have adequate control procedures in place to allow the assuming insurer to make a determination on the accuracy and validity of the claim information it receives, as well as to assess the competence of the cedent's claims personnel.

- Claims procedure. Preliminary examinations of claim procedures, as outlined in the cedent's current and any prior claims manual(s), should be performed prior to the on-site review. Prior to the examination, a list of documentation required, including the following, should be requested:
 - Claim staffing, including description of positions
 - List of outside vendors, including adjusters, defense/claim attorneys and others
 - Claim control log
 - Claim registers, including aged listing of outstanding claims and salvage and subrogation registers
 - Claim files and related policy/assumed contract files
 - Cash records applicable to claim and expense payments

Assess the Claim Staff. An analysis of the claim control log, claim register and aged listing of outstanding claims, along with the claim handling and diary system procedures outlined in the cedent's claim manual, should be indicative of the adequacy of staffing levels. Discussion with the appropriate claim personnel and review of the claim manual should indicate procedures used to assign claims to outside adjusters and the follow-up procedures used to keep the status on claims current.

A random sampling of claims from the loss registers should be made to determine files to be examined for the remaining portions of the audit. If specific areas or claims are suspect, these files can be requested and examined in addition to the random sample.

- Claims review generally will include the following:

- Determination of adequacy of file documentation, including notice of loss, adjusters' reports, attorneys' reports,³ litigation releases and proofs of loss (including reinsurance notices)
- Verification of coverage of originating policy and reinsurance agreements as to term, risk, limits and other provisions
- Reconciliation of payments (loss and expense) to claim filed documentation
- Determination of third-party recoveries (salvage, subrogation, third-party deductibles and other reinsurance)

Claims accounting may require special attention. The auditor will want to verify the correctness of claim allocation by sampling allocation by claim registers and the cedent's retention. In some instances, a review of the claim registers for originating and ceded business may disclose problems in claim allocation.

3. Underwriting Audit

An underwriting audit conducted by the receiver of an insolvent company may differ from that performed by a reinsurer contemplating a continuing relationship with an insolvent cedent. Some vital areas that may be considered during such audit include verification that:

- Premium volume is within guidelines outlined in the reinsurance agreement, if any.
- Controls are in place to determine effective and complete reporting of premiums.

A sample of policy files may be selected (or the policy files that correspond to those used in the accounting or claims audit should be reviewed) to determine whether:

- Risks written conform to the specifications of the reinsurance agreement relating to class of business, types of coverage, exclusions and other warranties.
- Risks written conform to underwriting guidelines.
- Underwriter's approval has been properly executed in accordance with the reinsurance agreement and any related underlying agreement (e.g., managing general agents, brokers).
- Policy endorsements alter reinsurance obligations.
- Premiums have been properly developed to include reporting forms, business subject to audit and retrospectively rated business.

Auditing counterparties typically prepare summaries of their findings. The receiver will want to request and receive a copy of any such report.

4. Handling Audits of Receiver's Records

Because of the receiver's activity in collection of reinsurance balances claimed due, the receiver frequently receives requests for audit of his or her own records and those of the insolvent company. Allowing an audit is an important step in the ultimate collection of the insurer's reinsurance recoverables, but care should be taken that the audit process neither creates new defenses for reinsurers,

³ Whether the reinsurer is entitled to these reports is the subject of frequent litigation, and the receiver should seek legal counsel before providing or not providing these reports.

disrupts the receiver's own efforts to manage claims and assets, nor violates any applicable statutory confidentiality provisions.

a. Preconditions to audit

After taking possession of the insurer, the receiver is entitled to adequate time to gain control and understanding of the insurer's affairs and records before being subject to audit by reinsurers. Reinsurers may make preemptory demands for audit well before the receiver can respond. The receiver should assure the reinsurer that it will have an opportunity to audit as soon as the receiver has had sufficient time to become familiar with the records he or she has inherited.

The receiver should consider developing a standard audit procedure to be followed. Once the receiver in consultation with triggered guaranty funds is prepared to schedule an audit by the reinsurer(s), several dates should be requested from the auditor, so that the receiver and guaranty funds have the opportunity to ensure availability of requested claim files, crucial staff and space, and possibly counsel. The receiver needs a firm commitment from the auditors as to the time required for completion of the audit, especially where the claims requested include claims that are open and ongoing with guaranty funds.

To facilitate the audit and ensure document control, the receiver should request a list from the auditor of all files to be reviewed. The receiver should contact affected guaranty funds and arrange for file shipment. The receiver should send a letter to the auditor outlining the procedures to be used for the audit and identifying the liaison between the auditor and the company. The receiver should also have the auditor and the reinsurer sign a confidentiality agreement before the audit to protect the interests of the estate and the insured.

b. Preparations for audit

The auditor may be asked to designate in advance the records to be reviewed, so that they can be located and retrieved. Someone on the receiver's staff or counsel is usually designated to become familiar, if they are not already, with the history, terms, accounts and major issues arising from the business being audited, and to serve as principal liaison between the auditors and the receiver. Arrangements should be made to provide the auditors with a designated space, ideally a separate room, to which records can be brought as requested. Control over records produced for the auditors is essential. Arrangements should be made to have copies (and/or screen shots of electronic or digitally stored material) made, at the reinsurer's expense, of any records or documents they designate, and the receiver should keep track of what is copied. Pricing and availability of copying services should be discussed with the auditing company.

c. Conduct of the audit and follow up

Members of the receiver's staff not personally involved in the audit should be advised that an audit is being conducted, and reminded that requests for information from auditors should be in writing and referred to the designated liaison to ensure correctness and consistency of the information provided.

The receiver should request, and often will receive, a copy of the auditor's findings at the conclusion of the audit.

H. Managing Assumed Reinsurance

Even though assumed reinsurance claims have a lower payment priority in liquidation, maintaining and processing assumed reinsurance claim activity may be vital for setoff purposes, to develop satisfactory support for any retroceded reinsurance that the insolvent insurer may have purchased, and to ensure that existing funded security is not improperly drawn down. Preparation of a schedule of reporting due dates for each assumed reinsurance treaty is helpful.

Pro rata reinsurance loss activity will be reported in a summary of all losses on individual policies reinsured. This summary report, or bordereau, should be accompanied by individual policy identification and loss data.

Initially, a reconciliation of the proofs of loss submitted by or on behalf of cedents may be undertaken with the physical inventory of pending or unprocessed assumed reinsurance claims. The receiver's staff should establish procedures so claims submitted by cedents conform with the terms of the reinsurance treaty, including dates of loss, coverage impacted such as lines or classes of business, and types of risks reinsured. Questions or problems may be referred to the reinsurance intermediary or cedent as appropriate.

Next, all assumed claims should be reviewed to ensure that they are being reported to the reinsurer in a manner consistent with the requirements of the reinsurance agreement, including issues of coverage, claim support, and timing of reporting. Each reported loss should also be reviewed to ensure there is an appropriate reserve. The receiver's staff should develop additional case reserves if required and, if appropriate, notify reinsurers and retrocessionnaires. The retrocedent should consider doing the following:

- Review (all) incoming loss advices.
- Match loss advices with treaty or facultative certificates.
- Confirm coverage.
- Create a file and enter data, calculating the appropriate share of paid and outstanding.
- Maintain a diary system, either manual or (preferably) electronic.
- Identify all applicable retrocessional treaties and transmit timely notice based on respective terms and conditions.
- Request updates, pertinent information, and documentation through the intermediaries as needed.
- Establish format for closing and eventual purging and storage, pursuant to applicable law and any litigation holds(s).
- Confirm that catastrophic losses are identified and reported (these should be accumulated with potential retrocessional recoveries in mind).
- Review each loss in detail and post any additional case reserves deemed necessary.
- Inquire as to any inuring reinsurance or common account.
- Monitor cedents' pursuit of subrogation, salvage, and other recoveries.
- A separate file is usually required for each facultative certificate or excess of loss treaty, and a separate claim file for each loss under a certificate or treaty may be desirable.
 - For pro rata reinsurance treaties, a single file encompassing one underwriting period should suffice, provided the bordereaux are informative enough for the technical staff to verify coverage.
- If annual aggregate coverage is involved, a system-produced report is helpful for tracking aggregate exhaustion.
- Develop forms for all the above.

I. Managing Ceded Reinsurance Collections

1. Direct Claims and Guaranty Funds

A primary consideration for the receiver is to prepare for the collection of ceded reinsurance for claims that will eventually be allowed by the liquidation court. To that end, the receiver should:

- If necessary, in addition to Uniform Data Standards (UDS), develop a reporting system to be used by the guaranty funds that conforms to the requirements of the insurer's reinsurance agreement(s).
- Reconcile the insurer's records to periodic reports from the guaranty funds.
- Promptly and adequately document the handling of direct claims that are not covered by guaranty funds so as to be able to notify and bill reinsurers
- Ensure there is adequate control over any claims settled at an amount in excess of the guaranty funds' statutory limits.
- Ensure that the guaranty associations are handling claims properly. This is generally done by audits of the associations.

2. Reports

Accounts rendered should be on forms mutually agreed upon by the cedent and reinsurer, and payments from the reinsurers should be made within the payment terms required by the treaty, without diminution because of the insolvency of the cedent.

The different forms of reinsurance contracts may have different reporting requirements. Because the reinsurer is not required to pay a loss unless the information to support the cedent's payment has been received, it is prudent that the receiver deliver this information as soon as possible. Developing this information often requires coordination with guaranty funds.

3. Insolvency Clause

A reinsurer is obligated to reimburse its ceding insurer for a covered loss after the cedent pays or becomes liable or responsible for underlying loss. This arrangement functions well in ongoing business; however, historically it raised practical problems when the ceding insurer became insolvent. Given the indemnity nature of a reinsurance contract, the receiver often could not demand the reinsurer pay its portion of covered claims until the receiver had paid the underlying claims. Typically, the receiver of a ceding insurer was not able to pay such claims prior to receiving the reinsurance payments and, therefore, had difficulty recovering reinsurance receivables.

In 1939, the New York legislature passed a law requiring that all reinsurance contracts contain an "insolvency clause" if the cedent desired to receive credit for reinsurance. Following the 1939 law in New York, many states enacted a similar requirement, and all states now require some type of insolvency clause, which comes into effect if the ceding insurer is found by a court to be insolvent in an order of liquidation. The insolvency clause obligates the reinsurer to pay recoveries it owes under the reinsurance contract on the basis of the ceding company's allowed claims, not on the basis of whether the insolvent cedent has actually paid the money it owes its policyholders.

Most courts recognize that the main purpose of the insolvency clause is to ensure that a receiver has the requisite access to reinsurance funds.

There may be unusual instances where the reinsurance contract does not contain an insolvency clause, but the contract provides that its interpretation or enforcement is subject to applicable state law (typically the ceding insurer's state of domicile). Many state insurance laws provide that a reinsurance contract must contain required terms before the ceding insurer may claim reinsurance credit for the reinsurance, and one of the required terms provides that the contract must contain insolvency clause language. Thus, a receiver should also determine if the applicable state law requires that reinsurance be paid without diminution because of the ceding insurer's insolvency, as this state law may allow for recovery in situations where an insolvency clause is not otherwise available for the recovery of reinsured claims.

4. Notice to Reinsurers

The insolvency clause usually provides that the reinsurer shall be given notice of the pendency of each claim against the company on the policies insured within a reasonable period of time after such claim is filed in the insolvency proceeding. The clause also provides that the reinsurer has the right to investigate each such claim and to interpose, at its own expense, in the proceeding where such claim is to be adjudicated, any defenses which it may deem available to the company or its liquidator.

V. TERMINATION OF REINSURANCE RELATIONSHIP

There are five principal methods for terminating a reinsurance relationship: commutation, cancellation, novation, rescission, and by operation of law. Before a receiver uses any of these methods, careful consideration should be given to whether the financial consequences will benefit the insolvent insurer and, consequently, the creditors. By assessing the potential benefits, a receiver will be able to prioritize efforts. If a receiver is considering terminating a reinsurance relationship in a life/health insurer liquidation, the receiver will need to coordinate with the affected guaranty associations. As noted above, both IRMA §612 and §8(N) of the NAIC's Life GA Model Act, as adopted in state laws, provide the life and health insurance guaranty associations the right to elect to continue and assume the rights and obligations of the ceding insurer with respect to reinsurance contracts that relate to guaranty association covered obligations, subject to the requirements set forth therein.

A. Commutation

A commutation is simply a mutual release from a contract in exchange for consideration. The mechanics of a loss commutation are that the reinsurer, by a cash payment to the cedent, discounted to present value, removes the outstanding reserves and IBNR from its books. The result on the cedent's books is that its surplus decreases by the amount of the difference between the cash received and the undiscounted reinsurance recoverable; the reinsurer's surplus is benefited in the same amount.

Commutation may be viewed as a special type of cancellation or as a means of ending the relationship after cancellation has occurred. Note that the New York Insurance Law requires commutation clauses to be included in life reinsurance agreements.

1. Commutation During Rehabilitation

It may be advantageous for the receiver to commute assumed business of an insurer or reinsurer in rehabilitations. Under certain circumstances, commutation could permit the receiver to expedite billing and collection from its reinsurers and retrocessionnaires. The alternative is to allow claims to remain open for an extended period, increasing the administrative burden and expense for both the receiver and the cedents. Note that the insolvency clause may apply, especially in property/casualty

Likewise, the receiver in rehabilitation may find a benefit in offering to commute outstanding losses with its reinsurers. There may be factors, such as knowledge of the weakened financial condition of a reinsurer, a desire to quantify IBNR relating to long-tail casualty business, or the ability to obtain immediate cash, which need to be considered when commuting with reinsurers and retrocessionnaires.

Early commutation may benefit the estate by bringing in cash and avoiding controversy and delay in collection. The receiver is unlikely to be as concerned as an insurer outside of receivership would be, with the loss of surplus inherent in discounting loss reserves to present value.

2. Commutation During Liquidation

Commutation of assumed business by an insolvent reinsurer is the equivalent of determining creditors' claims but may raise questions of priorities or preferences to creditors in rehabilitation as well as liquidation, because commutation terms may require immediate payment to a creditor class which otherwise may not share in distributed assets until a later date, if at all. Commutation of an insolvent insurer's ceded business should involve consideration of the factors discussed above for the commutation of ceded business by an insolvent insurer in rehabilitation. The receiver should consider the advisability or necessity of obtaining receivership court approval of commutation agreements.

The NAIC *Insurer Receivership Model Act* (#550) (IRMA) contains provisions regarding commutation of a reinsurer's liabilities. Sections 614 and 615 of IRMA allow a receiver to commence mandatory arbitration of commutation proposals after a certain amount of claims development or in the case of a reinsurer in financial difficulty (as defined by the state's RBC provisions). Section 614 requires receivership court approval for commutations having a gross consideration in excess of \$250,000.

The provisions of IRMA outline the procedures, rights and duties of both receivers and reinsurers in the arbitration process and allow the formation of a reinsurance recoverable trust for the satisfaction of any arbitration award. State law should be consulted to ensure compliance with the specific applicable details.

3. Technical Aspects

a. Data

A successful commutation requires complete, accurate and current data. Therefore, the receiver of a ceding insurer should update loss and premium figures in collaboration with respective state guaranty associations and reinsurance intermediaries before attempting a commutation.

The receiver of a reinsurer is largely dependent on information provided by the ceding insurers and reinsurance intermediaries. As a result, the receiver should consider conducting an on-site review or audit of the cedent's records relative to the program or treaty in question. The purpose of the examination is to ascertain that the reinsurer's accounts accurately reflect the business that was or should have been ceded.

b. Evaluate Future Loss Development

Future loss development is necessary to estimate the cost of the commutation. Actuarial staff should provide the calculation. Three basic steps are involved:

- Project reported outstanding and IBNR losses to ultimate incurred commensurate with the risk reinsured (e.g., auto v. general liability and/or asbestos).
- Project the timing of payment of losses to ultimate incurred.
- Calculate the net present value of ultimate incurred losses based on anticipated payment dates. If the parties can agree on a net present value, that becomes the commutation figure.

B. Cancellation of Reinsurance Treaties

1. Term Treaties

The majority of facultative reinsurance agreements and some reinsurance treaties have a fixed termination date, often an anniversary of the date of inception. Nothing need be done to end coverage as of that date; it simply expires. These contracts often may be canceled as of an earlier date with 60 or 90 days' written notice to the other party, or as specified within the terms of the reinsurance agreement. Cancellation, however, does not usually end the reinsurance relationship, which continues until all claims are submitted and paid, particularly in respect of business written on an occurrence basis.

Non-life business in force at the date of receivership, including assumed reinsurance, is usually terminated within 31 days of the receivership order. Some categories of reinsurance agreements are difficult to terminate midterm (such as aggregate excess of loss and stop loss reinsurance agreements), due to loss accumulation period requirements under the contractual provisions. Under a rehabilitation proceeding, however, the receiver would have the option of continuing in-force reinsurance business during an appropriate run-off period instead of effecting a cut-off or early cancellation date.

2. Continuous Treaties

Most obligatory treaties and some facultative agreements have no fixed termination date and continue until terminated by one of the parties. Often, these agreements may be terminated by written notice 90 or 120 days prior to an anniversary of the inception date, or as defined by the reinsurance agreement.

3. Notice of Cancellation

While the form of the notice of cancellation is usually stated in the reinsurance agreement, there are certain aspects to the cancellation process that are not as obvious. The prudent receiver will consult competent legal counsel on the legality and/or effectiveness of a receivership triggered termination. Reinsurance treaties, both term and continuous, are reviewed annually in what is known as a renewal process. Either party may issue a provisional notice of cancellation while renewal negotiations continue. The provisional notice can be withdrawn once a new agreement is reached. Another means of accomplishing the same purpose is for the parties to agree to a reduced period for notice of cancellation.

4. Cut-off vs. Run-off Cancellation

Facultative reinsurance is generally coterminous with the underlying policy. Treaty reinsurance generally applies to policies incepting during its term, and therefore continues to apply as long as the underlying policies have losses reported (the underlying policies are often canceled by a liquidation order, but claims will continue to be reported). This is referred to as "run-off." The receiver may also elect to cancel treaties on a "cut-off" basis, pursuant to which the reinsurer returns any unearned premiums and has no responsibility for losses that occur after the treaty terminates.

C. Novation

1. Definition

In novation, a new insurer is substituted for the existing insurer, and the insured must look to the substituted insurer for performance and must pay premiums to the substituted insurer. In a reinsurance context, the principles remain the same, although it should be a three-party agreement between the cedent, the reinsurer and the original policyholder.

Insurance terminology tends to call a novation "assumption and reinsurance." This term is more descriptive of implementation techniques but is inaccurate even in this limited role. The novation

usually takes the form of a reinsurance treaty but one with an unusual feature. Not only does the reinsurer assume 100 percent of the risk, the reinsurer also is substituted for the original insurer. It is the latter feature that distinguishes a novation from a reinsurance transaction.

2. Use of Novation

The principal purpose of a novation is to move an existing book of business from one insurer to another. Novation may be more efficient than having the original carrier not renew the business while the new insurer is soliciting the same insureds. Regulatory limitations on nonrenewal of certain lines of business and consumer protection may be primary reasons for novation.

3. Practical Difficulties

Traditionally, a novation requires the consent of all parties to the contract, the insured, the original insurer and the reinsurer. Some states exempt assumption/novation transactions in the context of a rehabilitation or liquidation from the policyholder consent requirement. It may be difficult to obtain the actual consent of thousands of policyholders who may not understand the process and who may not be sufficiently interested. There is considerable debate as to the level of notification and consent necessary for a novation. Some insurance departments have required mass mailings to insureds explaining the transaction and offering the opportunity to object or decline novation. However, in a receivership, a transfer of business can often be arranged under the receivership authority statute and/or the order of the receivership court.

4. Bulk Transfer Distinguished

In general, a bulk transfer is the reinsurance of all or substantially all of a book of business. Often, a bulk transfer requires notice to the cedent's state of domicile. A bulk transfer may or may not involve a novation, and a novation may or may not involve all or substantially all of an insurer's book of business. The difference is whether the prior reinsurer continues to retain any liability or ongoing obligation.

D. Rescission

1. Definition

It is important to distinguish "rescission" from "cancellation." Cancellation means to terminate the unperformed portion of a treaty. Rescission restores the parties to their original position prior to entering into the treaty. Rescission is a remedy available only under limited circumstances.

2. Technical Aspects

Typically, general contract principles apply to reinsurance contracts. Under general contract principles, rescission may be obtained by mutual consent of the parties, by a party that has been injured by acts of the other, or through litigation or arbitration proceedings. Generally, reinsurance agreement rescissions occur because a party contends it has been defrauded or damaged. Most disputes arise because the reinsurer believes the cedent has made material misrepresentations respecting the nature, quality or volume of the business ceded. In these cases, a complete accounting or a reconstruction of accounts for the contract period may be required.

E. By Operation of Law

In some states with enabling legislation, insurance business may be transferred by operation of law. Since 2000, reinsurance counterparties in the EU have been able to transfer direct and assumed insurance

portfolios with continued coverage for re/insureds and a full release for the transferor without completion of either a novation process or concomitant opt-in/out rights for re/insureds. In the US insurance market, a small number of states offer one or both of the following two alternatives: insurance business division and insurance business transfer. Coordination regarding policyholder rights in other jurisdictions and other state laws is an important aspect that is receiving ongoing study in US Insurance regulators. See meeting materials, exposure drafts, and other documents of the NAIC Restructuring Mechanisms Subgroup⁴ for updates in this area.

Business *division* (e.g., in Arizona, Connecticut, Delaware, Georgia, Illinois, Iowa, Michigan, Pennsylvania⁵) offers companies the ability to divide business operations into two or more entities upon the approval of the regulator; business *transfer* is effected via novation following judicial approval (e.g., in Rhode Island, Vermont and Oklahoma⁶); both mechanisms have regulatory and judicial components.

Oklahoma approved the first transfer in an intra-group transaction and Illinois approved the first US division, also in an intra-group transaction. Each of these is highly specialized, and review of the requirements to effect in, and/or the impact upon, a receivership should be undertaken with the advice of competent legal counsel.

VI. SETOFF

A. Overview

Setoff is a device that permits two contracting parties to net reciprocal debt obligations and pay only the remaining balance. It is an important element of any receivership. Setoff is an area of considerable controversy, and it is important to develop an effective approach for handling the various issues that will arise because of its application. It is important to begin this approach early in the receivership with a careful analysis of the applicable provisions of the governing receivership state law. Note that there are/may be unique issues arising from the organizational structure of counterparties; e.g., policyholder-owned reinsurers, fronting insurers, captives (including “pure,” hybrid, and series captives), and special purpose vehicles. For example, “triangular” set-offs are not permitted. Thus, where A owes B, C owes A, and B and C are affiliates, A may not lawfully set off what it owes B against what C owes A.⁷

B. Recoupment and Counterclaims

The concepts of setoff, recoupment and counterclaim are often confused. Although each provides a means by which a debtor may attempt to limit the net amount of a creditor’s recovery, it is important that the receiver have a basic understanding of the distinguishing features of each procedure, as well as the central concept of “mutuality” (and potential differences imposed by varying priorities of asset distribution) which are discussed in Chapter 9—Legal Considerations.

C. Procedural Steps in Administering Setoffs

The receiver should review the governing receivership state’s current statute relating to setoff, and determine the past practices and procedures that have been utilized within the jurisdiction. It would also be prudent to review any court rulings and decisions relating to setoff to determine their applicability to various

⁴ https://content.naic.org/cmte_e_res_mech_sg.htm

⁵ See, e.g., 215 ILL. COMP. STAT. 5-35B.

⁶ See, e.g., OKLA. STAT. tit. 36, § 1681-8

⁷ *In re Orexigen Therapeutics, Inc.*, 990 F.3d 748 (3d Cir. 2021).

issues that may arise. The reinsurance agreement may also have provisions relating to setoff, although they may not override applicable statutes.

Once the receiver has elected a course of action for handling setoff issues, written policy and guidelines should be prepared, and coordinated with and reviewed by counsel. The receiver may file the setoff policy and its guidelines with the receivership court and communicate as soon as practicable to cedents, reinsurers, intermediaries and other interested parties.

It may also be necessary for the receiver to audit or review reinsurance account statements, including payments received and processed earlier by the receiver's internal staff, to ensure that there is a consistent application of the mandated setoff procedures. If it is determined that improper setoffs are being applied, communications to appropriate parties should be initiated, and if the matter cannot thereafter be mutually resolved, the receiver should consider mediation, partial or total rejection of a proof of claim, or appropriate legal action, including arbitration and litigation.

Some receivers require details about claimed set-offs to be included in proofs of claim.,

D. Setoff Against Insolvent Insurers and Reinsurers

To determine if the receiver has a right of setoff against an insolvent insurer or reinsurer, the insurance law of the state of domicile of the insolvent insurer or reinsurer may be applicable and therefore will need to be reviewed. It will be necessary to determine whether the receiver will be able to assert setoff under the other insolvent's domiciliary state laws. See Chapter 9—Legal Considerations.

VII. ARBITRATION CONTROVERSIES

An insolvent insurer will likely be involved in dispute resolution. There will be looming questions, however, of how the resolutions will occur, how the disputes will be resolved, how long they will take and how much they will cost. These are questions a receiver will face on a regular basis.⁸

The insolvent insurer has various options in settling disputes: negotiation, mediation, arbitration and litigation. As a general rule, negotiation is the fastest and least expensive option, and litigation is the most costly and time consuming.

Many reinsurance agreements contain clauses that require parties to a reinsurance agreement to resolve their disputes through arbitration. When one of the parties is in receivership, the issue of whether reinsurers may compel arbitration or are required to resolve their disputes in the receivership court is governed by local law.

A majority of reinsurance agreements provide for arbitration as the sole means of resolving conflict. Most courts, including the U.S. Supreme Court, favor enforcing agreements to arbitrate, but a small number of jurisdictions have held otherwise. Historically, arbitration awards were forthcoming much sooner than a similar decision from a court of law. The result was usually less expensive than litigation and had other advantages, such as being a confidential process, having expert triers of fact, offering broad ranges of relief, and other procedural and substantive benefits. However, there is no right of appeal *per se*, and successful challenges to arbitral awards are difficult to mount.

Arbitration rights within reinsurance agreements are enforceable under Section 105E of the NAIC *Insurer Receivership Model Act* (#550). If there is a balance payable to the receiver after offsets are considered by the arbitrator, that balance must be paid in cash. If, alternatively, the balance is in favor of the reinsurer, that balance becomes a claim against the insolvent insurer to be paid pursuant to the priority scheme, pro rata, when the insolvent insurer's assets are distributed.

⁸ This is a very cursory discussion—please refer to the Legal Chapter for a detailed analysis of this subject.

VIII. LETTERS OF CREDIT

A. Nature of the Letter of Credit in Reinsurance Transactions

In general terms, the letter of credit (LOC) is an undertaking by a bank as issuer to honor a draft drawn upon it by a beneficiary (the cedent) in accordance with the terms of the LOC. The LOC is issued by the bank at the request of a the reinsurer, in furtherance of a separate agreement between the reinsurer and the ceding insurer. Reinsurers may also be beneficiaries of LOCs provided by cedents to collateralize future premium payment obligations and ensure financial statement credit.

The bank is obligated to pay on the LOC when the beneficiary presents a sight draft that complies on its face with the terms of the LOC. In many jurisdictions, compliance with the LOC terms must be exact to trigger the bank's payment obligation. In some jurisdictions, substantial compliance is sufficient to trigger the bank's payment obligation. The bank should not look at whether the underlying reinsurance agreement was properly performed before it pays on the complying sight draft. Any contractual disputes between the account party and the beneficiary involving the reinsurance agreement remain separate from the issuing bank's obligation to pay under the LOC.

In the insurance industry, LOCs are frequently used to enable the reinsurer to secure their obligations to the cedent under reinsurance agreements so that the cedent may take credit for the reinsurance on its financial statement, either as an asset or as a deduction from liability. This is permitted under the *Credit for Reinsurance Model Law* (#785) and *Credit for Reinsurance Model Regulation* (#786).

In the event of a failure of the reinsurer to fulfill its obligations under the reinsurance agreement, the cedent may draw down the LOC. The issuing bank must honor such a demand, unless the demand documents are forged or are otherwise tainted by fraud, or there was fraud in the underlying transaction. These exceptions must be distinguished from mere commercial disputes between the parties, which, as noted above, do not impact the bank's obligation to pay on a complying sight draft.

B. Basic Features of the Letter of Credit

The Credit for Reinsurance Model Law and Regulation are an accreditation standard, and as such the provisions for LOCs in each state's laws must be substantially similar. LOCs supporting reinsurance with certified or unauthorized must be "clean" (that is non-"documentary" under which certain evidence may be required), meaning the LOC must be payable on a sight draft without any supporting documents, and the LOC must be irrevocable, meaning it cannot be terminated prior to expiration by the account party without the beneficiary's consent.

Acceptable LOCs are required to contain an evergreen clause, which requires the bank to give specified advance notice (usually 30 days) of non-renewal to the beneficiary/cedent. Failure of the bank to serve notice of non-renewal prevents expiration, resulting in an automatic renewal of the LOC. On the other hand, non-renewal of the LOC while balances remain due to the cedent is grounds for the cedent to draw down the LOC.

In addition to these basic features, the bank issuing the LOC must meet certain standards in accordance with Model #785, Section 4. Other states require that the LOC be issued or confirmed by either a domestic bank, a foreign bank licensed in the United States, which is either on the NAIC Securities Valuation Office (SVO) list.

C. What Should a Receiver Know About LOCs?

1. Cedent in Receivership

When a cedent is in receivership, the receiver should first identify all of the LOCs and list them in accordance with the treaties collateralized and expiration dates. Any evergreen clauses should be noted on treaties under notice of cancellation.

Counsel should be consulted to confirm that the receiver has the power to draw down the LOCs, or if the receiver does not, this power should be immediately obtained from the supervisory court.

It is recommended that a receiver notify each issuing bank that the cedent is in receivership. The receiver should take whatever steps are necessary to ensure that only the receiver is empowered to draw down the LOCs and that the receiver will receive notices of non-renewal. The receiver should seek to have the LOC amended to change the name of the beneficiary to the estate.

Each reinsurer should be advised by the receiver that it must maintain the outstanding LOCs in accordance with the terms of the specific reinsurance agreement.

Once the above steps have been taken, the receiver should verify the liabilities secured by the LOCs. If an LOC is about to expire and leave outstanding obligations unsecured, the receiver should notify the reinsurer to renew the expiring LOC. If the reinsurer does not agree to renew, counsel should be consulted on the appropriateness of drawing down the LOC to protect the cedent's position.

2. Reinsurer in Receivership

When a reinsurer is in receivership, the receiver must first identify all of the LOCs issued on behalf of the reinsurer and list them in accordance with the contract collateralized and expiration date. If any notices of termination have been issued pursuant to evergreen clauses, these should also be listed. Finally, if any collateral has been posted with an issuing bank to secure the LOC, the receiver should properly identify such collateral.

It is also recommended that a receiver notify each issuing bank that the reinsurer is in receivership, and identify the receiver to confirm that only the receiver is authorized to give the bank instructions with respect to the LOCs, which would normally be given by the account party.

The receiver should also communicate with all cedents in whose favor banks issued LOCs on behalf of reinsurers so that each is aware that the reinsurer is in receivership. The receiver may assure each cedent that the LOCs will be maintained in accordance with the reinsurance agreement. The receiver should also take whatever steps are necessary to ensure that the LOCs will not be improperly drawn down.

Once the receiver properly identifies all of the outstanding LOCs and takes the necessary steps to solidify the receiver's powers with regard to them, the receiver must then manage the LOCs in order to protect the reinsurer's position by preserving its collateral. The receiver should ascertain the liabilities secured by the LOCs and guard against wrongful draws by cedents against the outstanding LOCs. A danger also exists that the collateral posted will be wrongfully used by the bank to gain a preference on other, unsecured debts allegedly owed to the bank by the reinsurer. The receiver can also protect the reinsurer's position by depositing any interest earned on collateral into the reinsurer's estate, assuming this power is consistent with the account agreement.

There also may be unique set-off issues.

IX. TRUST FUNDS

A. Nature of the Trust Fund in Reinsurance Transactions

A reinsurance trust fund is an arrangement between the reinsurer (the grantor) and the cedent (the beneficiary), under which assets are deposited with a trustee, pending the performance of certain contractual obligations between the parties. In some instances the cedent may be the grantor and the reinsurer may be the beneficiary. If the beneficiary makes a demand upon the trustee stating that the contractual obligations are unfulfilled, the trustee is obligated to pay in accordance with the terms of the trust. The Credit for Reinsurance Model Regulation (#786) contains minimum standards for how a trust should be established and operated.

In reinsurance, trust funds serve as an alternative to LOCs. Certified and unauthorized reinsurers establish and fund them to secure their obligations to the cedent. Trust funds serve as security for the risk undertaken by the cedent and ceded to the reinsurer, allowing the cedent to take reinsurance credit for the ceded risk. Only certain specified assets are generally permitted to be used to fund the trust, including: cash, certain readily marketable securities such as United States government obligations and nationally traded stocks, and clean, irrevocable letters of credit.

B. Basic Features of the Trust Fund

The administration of the trust fund is governed by the trust instrument that provides for the term, or duration, of the trust fund. It may also include a provision concerning control of the trust assets. The grantor is often given the power to substitute qualified assets, so long as the value of the corpus remains at the agreed level. The trust instrument may also include a provision concerning the ability to control investment of trust assets.

During the term of the trust fund, the principal will yield interest, and the trust instrument may contain a provision allocating the interest either to the grantor or the trust corpus. The trust instrument may also specify under what circumstances a demand can be made on the trustee, allowing the grantee to obtain trust funds. In the event that the grantor wishes to terminate the trust, the trust instrument will include a provision requiring the grantor to give advance notice to the trustee that the trust will be terminated. Finally, in the event that a trustee should resign or die, a provision may be included that allows for the substitution of trustees.

C. What Should a Receiver Do About Trust Funds

1. Cedent in Receivership

When a cedent is in receivership, the receiver should first identify all of the trust funds established in the cedent's favor and list them in accordance with the treaty collateralized and expiration dates. If any notices of termination have been issued on the identified trust funds pursuant to their termination provisions, these should also be listed.

The receiver should also ensure that he or she is empowered to remove assets from the trust funds if such removal is necessary to fulfill the reinsurer's obligations under the reinsurance agreements. Counsel should be consulted to confirm that the receiver has the power to remove assets and under what conditions assets can be removed, or if the receiver does not, such power should be immediately obtained from the supervisory court.

It is also recommended that a receiver notify each trustee that the cedent is in receivership, clearly identify the receiver, and take whatever steps are necessary in each case to ensure that only the receiver is empowered to remove assets from the trust funds that might otherwise be removed by the cedent.

The receiver should also communicate with each reinsurer on whose behalf a trustee holds a trust fund with the cedent as grantee so that each is aware that the cedent is in receivership. The receiver should assure each reinsurer that no improper removal of assets will occur. It should also be emphasized to the reinsurer that it must maintain the trust funds in accordance with the terms of the specific reinsurance agreement.

Once the receiver properly identifies all of the established trust funds and takes the necessary steps to solidify the receiver's powers with regard to them, the receiver must then manage the trust funds in order to protect the cedent's position by preserving its security. The receiver should ascertain the liabilities secured by the trust funds. If a trust fund is about to expire, and may leave outstanding obligations unsecured, the receiver should call upon the reinsurer to continue the expiring trust fund. If the reinsurer refuses to maintain the fund, counsel should be consulted on the appropriateness of removing assets from the trust fund to protect the cedent's position.

2. Reinsurer in Receivership

When a reinsurer is in receivership, the receiver must first identify the trust funds established on behalf of the reinsurer as grantor and list them in accordance with the agreements collateralized and expiration dates. If any notices of termination have been issued pursuant to the termination provisions of certain trust instruments, these should also be listed.

It is also recommended that a receiver notify each trustee that the reinsurer is in receivership, clearly identify the receiver, and confirm that only the receiver is authorized to give the bank instructions with respect to the trust funds, which would ordinarily be given by the reinsurer.

The receiver should also communicate with all cedents in whose favor a trustee holds a trust fund with the reinsurer as grantor so that each is aware that the reinsurer is in receivership. The receiver may assure each cedent that the trust funds will be maintained in accordance with the reinsurance agreement, although the receiver will probably be unable to comply with the demands for increases in trust funds or LOC balances due to the probability of creating an illegal preference. Occasionally, trust accounts and LOCs are in excess of amounts necessary to secure liabilities, and in cooperation with cedents, the receiver may be able to retrieve those excess amounts. The receiver should also take whatever steps are necessary to ensure that trust fund assets will not be improperly removed.

Once the receiver properly identifies all of the outstanding trust funds and takes the necessary steps to solidify his powers with regard to them, the receiver must then manage the trust funds in order to protect the reinsurer's position by preserving its assets. The receiver should ascertain the liabilities secured by the trust funds and guard against wrongful removal of assets by cedents. The danger that the assets will be wrongfully used to gain a preference on other, unsecured debts, should be addressed. The receiver can also protect the reinsurer's position by depositing any interest earned on the assets into the reinsurer's estate, assuming this power is consistent with the terms of the trust.

X. FUNDS WITHHELD

"Funds withheld" refers to an arrangement whereby the fact that the cedent does not pay the premiums to the reinsurer; instead, the cedent "withholds" the premiums. Generally, this provision is only used with unauthorized reinsurers. The purpose of these provisions is to allow the cedent to reduce the provisions for unauthorized reinsurance in its statutory statement. The reinsurer's asset, in lieu of cash, is "Funds held by or deposited with reinsured companies." So in other words, the receiver will already have the funds under his exclusive control.

XI. INSOLVENT NON-UNITED STATES LICENSED REINSURERS

The estate may have ceded reinsurance with a non-United States licensed reinsurer⁹ that is subject to a rehabilitation or liquidation proceeding in its domiciliary jurisdiction. In addition, that non-United States licensed reinsurer may also be subject to an ancillary proceeding under Chapter 15 of the United States Bankruptcy Code.

A. The Non-U.S. Proceeding

As in the United States, the non-U.S. proceeding may be either a rehabilitation, liquidation or equivalent (e.g., in the UK, there are voluntary arrangements, schemes of arrangement, and winding ups, among other mechanisms). In either event, particularly if ceded reinsurance is involved, the receiver should communicate with the non-U.S. receiver to ensure that the estate receives notice of the proceedings and is identified as a creditor. It will then be necessary to keep current with the proceedings to protect the interests of the estate. The procedures described in this chapter for dealing with ceded reinsurance will generally be applicable to these non-U.S. proceedings.

B. Chapter 15 Proceedings

Insurance receiverships are specifically excluded from the ambit of the U.S. Bankruptcy Code; however, the Code does have an influence on insurance issues in at least one important case: if an insurer purchased reinsurance from a non-U.S. reinsurance company, and that reinsurer has become insolvent.

Chapter 15 permits a representative of a non-U.S. proceeding to petition the United States bankruptcy court for relief and permits the court to: (a) enjoin proceedings against the non-U.S. licensed reinsurer, enforcement of judgments or the commencement or continuation of any action against the debtor; (b) order the delivery of the debtor's property to the representative; and (c) order other appropriate relief. Chapter 15 proceedings are limited in scope, do not commence a full bankruptcy proceeding, and confer broad discretion to the courts. Generally, following the adoption of a plan of rehabilitation or liquidation in the non-U.S. proceeding, the debtor requests the bankruptcy court to give full force and effect to that plan and make it binding and enforceable against all creditors in the United States.

Receivers should consider various approaches when faced with a Chapter 15 proceeding. A receiver should file a notice of appearance and request for service of notice to ensure that it receives copies of the filings made in the proceeding, including periodic status reports. Consideration should be given to participation on the creditors' committee if the amount due to the estate is material, and the expense and time to the estate justify participation. Evaluation of proposed schemes of arrangement may also need to be made to protect the interests of the estate. The estate should also continue to report claims as it did prior to the proceeding and should review and recognize any of its obligations under the existing agreements.

Chapter 15 of the Bankruptcy Code now states that a court may not grant relief under the chapter with respect to any deposit, escrow, trust fund, or other security required or permitted under any applicable state insurance law or regulation for the benefit of claim holders in the United States. The purpose of the language is to make certain a bankruptcy court has no power over U.S.-based reinsurance collateral posted for the benefit of U.S. claimants.

⁹ Also known as alien reinsurers.