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REINSURERS' LIABILITY TO THE INSOLVENT REINSURED*

James Robert Olson**

The primary objective of this article is to present the history of reinsurers' liability to the insolvent reinsured. This history, however, reflects several instances of discrimination against a reinsurer by statute or judicial decision. Therefore, the strictly historical format has been departed from in order to comment on these instances and to offer an alternative solution to the problem.¹

I. The Nature of Reinsurance

Reinsurance . . . is a contract whereby one [insurer] for a consideration agrees to indemnify another [insurer], either in whole or in part, against loss or liability, the risk of which the latter has assumed under a separate and distinct contract as insurer of a third party.²

According to the provisions of a particular contract, reinsurance is divided into two types. *Facultative* reinsurance employs individual negotiation to arrange coverage of a particular risk. *Treaty* reinsurance is negotiated in advance of actual coverage and usually covers any risk written by the reinsured which falls within a whole class of risks.³

Both treaty and facultative reinsurance are subdivided in the same way according to the type of liability which the reinsurer assumes. Liability can be either *pro rata* or *excess*. This means that when a loss occurs to the reinsured (or ceding company),⁴ the amount of the reinsurer's liability is either (a) a

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1 Because of the variance in history, legislation and legal precedent between the United States and foreign countries in this particular aspect of reinsurance, the scope of this article has been confined to a study of reinsurer's liability in the United States alone. However, since almost every facet of American law has its original precedents dictated to a greater or lesser degree by a foreign source, it will be necessary to cite some foreign sources. Because of the lack of editorial comment on this topic, the interpretation of certain events must be highly subjective in nature.

2 8 COUCH, INSURANCE LAW § 2256 (1st ed. 1931, Supp. 1965).

3 Before discussing further divisions of reinsurance, an outline will facilitate better understanding of them:

- (1) Treaty—types according to the kind of liability which the reinsurer assumes.
 - (a) Pro rata liability.
 - (i) Surplus.
 - (ii) Quota share.
 - (b) Excess liability.
 - (i) Excess of loss—catastrophe.
 - (ii) Spread of loss.
- (2) Facultative—types according to the kind of liability which the reinsurer assumes.
 - (a) Pro rata liability.
 - (i) Surplus.
 - (ii) Quota share.
 - (b) Excess liability.

4 The insurance company which purchases reinsurance is known as the ceding company. GENERAL REINSURANCE CORP., A GLOSSARY OF PROPERTY AND CASUALTY REINSURANCE TERMS 3.

certain percentage of the loss (pro rata) or (b) the remainder of the loss up to a contractually specified sum, after deducting from the loss a fixed dollar amount for which the ceding company has remained liable (excess).

A. Pro Rata Liability

Two types of agreements are employed in pro rata liability contracts, *surplus* and *quota share* agreements. In a surplus contract the reinsured sets a dollar figure, which is called its line. On a risk the total insured value of which does not exceed this amount the reinsurer has no interest. However, when the ceding company insures a risk the value of which exceeds its line, the reinsurer becomes liable for a certain percentage of each loss on that risk. That percentage is determined by dividing the total insured value into the difference between the total insured value and the reinsured's line.

Since the reinsurer does not want his liability to be open-ended at the top (as could be the case in third-party liability policies), an upper limit is usually set on a surplus policy. If the ceding company desires coverage on a risk the value of which exceeds his line plus the first surplus treaty, it must arrange a second and possibly a third surplus treaty.⁵

Under the other type of pro rata reinsurance agreement, the quota share contract, a certain predetermined percentage of every risk of a given nature written by the reinsured determines the reinsurer's liability; thus, this percentage does not fluctuate according to the value of the risk.⁶

B. Excess Liability

In contrast to the pro rata types of reinsurance, there are also those contracts which call for the ceding company to bear the first part of the loss itself (each individual loss, the loss for a year on a certain kind of business or the loss for a year on its business as a whole); these are excess agreements. The two basic subdivisions of excess reinsurance are *excess of loss* and *spread loss* reinsurance. The excess of loss agreement is relatively simple. The reinsurer agrees to indemnify the reinsured for the amount of any loss exceeding an amount stipulated in the contract (which the reinsured bears) up to another

5 For example, assume there exists between company X, the reinsured, and companies Y and Z, the reinsurers, a first and second surplus reinsurance agreement such that:

- (1) ceding company X's line is \$10,000;
- (2) first surplus reinsurer Y's line is \$50,000, over \$10,000;
- (3) second surplus reinsurer Z's line is \$50,000, over \$60,000.

Company Y is not liable on any risk under \$10,000 and company Z has no liability on any risk whose insured value does not exceed \$60,000. Assume now that a risk which is valued at \$75,000 is insured by company X. This means that company X is liable for 10/75 of any loss, company Y is liable for 50/75 and company Z is liable for 15/75 of each and every loss on that policy. It follows that if the value of a risk insured by company X was \$120,000 it would be liable for 20/120 (the first \$10,000 plus the difference between the second surplus and the total value, i.e., \$110,000 and \$120,000), company Y would be liable for 50/120 as would company Z, and all of these fractions would apply to any loss, no matter how small.

6 For example, a reinsurer may agree to indemnify another insurance company for 50% of the latter's fire insurance policies. So if a property were insured by the ceding company A for \$10,000, and there was a \$9,000 fire loss, both company A and its reinsurer company B would ultimately be liable for 50% of the loss, company A owing the original insured \$9,000 and company B owing company A half the loss that it paid, or \$4,500.

stipulated amount (above which the reinsured may have reinsured with another company or bear itself).⁷

Spread loss reinsurance is a type of excess reinsurance in which "each year's reinsurance premium rate is determined by the amounts of the ceding company's excess losses for a specified number of years, usually five."⁸ Under this type of reinsurance, the ceding company is actually borrowing from the reinsurer in order to spread its losses in any one year over a five-year period. This eliminates severe fluctuations in underwriting experience, but does not, as do the real forms of reinsurance, absolve the ceding company from having to pay these losses.⁹

C. Reasons for and Purposes of Reinsurance

In *Insurance Principles and Practices*,¹⁰ eight reasons are listed for reinsurance:

(1) The ceding company is afforded a better spread of risk. This means that a company can have the same net amount at risk as without reinsurance, but with reinsurance it can spread the risk over a larger number of units, insuring each unit for a smaller net amount.

(2) If a company wishes to retire from business or to drop one of its lines of insurance, it will undoubtedly have business from which it wishes to disassociate itself. In this instance, reinsurance takes the form of a total acceptance of the business on the part of the reinsurer.

(3) By having more than one company sign the policy issued to the original insured, "the strength of the protection is increased."¹¹ This, however, amounts to coinsurance rather than reinsurance. In reinsurance the ceding company issues the policy to the original insured in its own name and is fully liable to him for any loss, *i.e.*, if the reinsurer is declared insolvent and there is a loss to the original which normally would be covered by reinsurance, the ceding company is liable to the original insured for all amounts the reinsurer is unable to pay.

(4) It is a new source of business for the reinsurer.

(5) Profits are stabilized. This is best accomplished by the spread loss type of agreement.

(6) Profits are increased.

(7) It enables the reduction of reserves. "Since the reserves required by

7 The catastrophe cover mentioned in the outline refers to a type of excess of loss agreement in which the reinsurer does not become liable until the loss has reached a catastrophic nature. For instance, a reinsurer might issue a catastrophe cover to a direct writer of hurricane damage insurance to cover any seventy-two hour period (the beginning of which the reinsured is free to set) during the course of a year in the amount of \$500,000 excess of \$50,000. This means that should a hurricane damage the reinsured's clients' properties in excess of \$50,000, the reinsurance will cover these losses up to \$500,000. Sometimes in this type of contract there is automatic reinstatement for one more catastrophe. Other times after the first loss the reinsured must pay another pro rata premium before the reinsurance will again give him cover.

8 GENERAL REINSURANCE CORP., *op. cit. supra* note 4, at 19.

9 There are other, more refined types of reinsurance contracts, such as the semi-facultative. However, an explanation of them would not aid in understanding this article nor would it give the reader a better understanding of the overall scheme of reinsurance.

10 REIGEL & MILLER, *INSURANCE PRINCIPLES AND PRACTICES* 90-93 (4th ed. 1959).

11 *Id.* at 92.

law of fire and marine insurance companies make no allowance for expenses, a new and rapidly growing company may write so much new business that the combined expenses, losses and legal reserves exceed the premium receipts. The company can reduce the amount of reserve required by reinsuring a portion of the new business, avoiding financial difficulty but retaining the volume of the new business."¹² The ceding company also acquires the twenty to thirty-five percent commission which the reinsurer allows, while not increasing its reserve requirements for the amount reinsured.

(8) A small or youthful company, unable to write certain nonstandard risks because of a lack of underwriting experience, may be able to do so if it reinsures these risks and seeks the counsel of the reinsurer's more experienced underwriters when a problem of this nature arises.

Another advantage, which accrues to the public, as well as to the industry as a whole, is that a catastrophe, such as the San Francisco Fire or the Texas City Explosion, will be spread over many companies throughout the world.¹³

D. Background to the Insolvency Problem

An "Honorable Undertaking" clause, which is included in most reinsurance treaties, reads, "This agreement is considered by the parties hereto as an honorable undertaking, the purpose of which is not to be defeated by a strict or narrow interpretation of the language thereof."¹⁴ Because of this clause, the system of reinsurance has broken down in amazingly few instances. "There is a great deal of good faith exercised [between parties to a reinsurance agreement] and . . . a genuine understanding of the moral obligations involved."¹⁵ The greatest number of these breakdowns seems to occur when someone other than "the parties hereto" becomes involved. The most frequent cause of this involvement is the ceding companies being declared insolvent.¹⁶

When an insolvency of this nature occurs, a court or the insurance commissioner of the state in which the company is chartered appoints a liquidator or conservator, whose job it is to oversee the disbursement of the firm's remaining assets. In addition to his other duties, it becomes the liquidator's responsibility (a) to allow or disallow claims which were filed before the closing date set by the court, (b) to determine any preference in claims settlement and (c) to set the percentage for the liquidation dividend, *i.e.*, that percentage of their claims which the claimants will actually receive.

An example will best illustrate the problem. Assume company *A* is declared insolvent and that the liquidator has allowed a \$10,000 claim and set the liquidation dividend at twenty-five percent. (\$2,500). If the company pays this amount, what is the liability of a reinsurer?¹⁷ For instance, under a fifty percent quota share agreement, must it pay one-half of the allowed claim (\$5,000) or one-half of the amount actually paid (\$1,250)?

12 *Id.* at 93.

13 RODDA, *INLAND MARINE AND TRANSPORTATION INSURANCE* 461 (2d ed. 1958).

14 *GENERAL REINSURANCE CORP.*, *op. cit. supra* note 4, at 9.

15 Close, *Claims Under Reinsurance Policies and Treaties*, 27 *INS. COUNSEL J.* 44 (1960).

16 These are personal observations which the author made after studying many cases in the area of reinsurance.

17 See text accompanying note 6 *supra*.

If there was a simple answer to this question, there would be no reason for this article. However, courts, writers and state legislators have been debating this issue for more than one hundred years.

II. History of Reinsurers' Liability to the Insolvent Reinsured

A. Early Cases

The first case in the United States in which the liquidator of an insolvent ceding company attempted to collect the full amount of reinsurance without paying the original insured's loss in full was *Hone v. Mutual Safety Ins. Co.*¹⁸ The case concerned two New York retailers, Messrs. Hackenrath and Van Damme, who, on May 13, 1845, purchased \$22,000 worth of fire insurance on merchandise in their store from the American Mutual Insurance Company. American Mutual, in turn, reinsured \$10,000 of this amount with the Mutual Safety Insurance Company on May 17, 1845. The contract of reinsurance was made on the same printed form as the original insurance policy and the only change was the insertion of the prefix "re" before the word "insure" in the insuring clause.

This contract read in part:

The Mutual Safety Insurance Company, by this policy of insurance, in consideration of thirty-five dollars to them paid by the insured herein-after named . . . do reinsure the American Mutual Insurance Company against loss or damage by fire, to the amount of *ten thousand dollars*, on merchandise, hazardous and not hazardous, property of Hackenrath and Van Damme . . . and said company do hereby promise and agree to make *good* unto the said insured . . . *all* such loss or damages, not exceeding in amount the sum insured.¹⁹

On July 19, 1845, a loss of \$14,373.36 occurred, but on November 29 of that year, before it was paid, the American Mutual was dissolved by decree of the court of chancery. The court appointed Philip Hone as receiver. When Hone attempted to collect \$10,000 from Mutual Safety, they demurred and Hone sued.

Counsel for the defense argued that reinsurer's promise to make good "all losses or damage by fire not exceeding in amount the sum insured" meant in this case that they were liable for only $10/22$ of the loss:

[T]here exists a general usage and custom among underwriters in the city of New-York, in cases of reinsurance, for [re] insurers not to pay the full amount named in the policy of reinsurance, but only in proportion to the amount of the loss and the original insurance, that is to say, a sum which shall be in the same proportion to the amount of the property destroyed as the policy of reinsurance bears to the original policy.²⁰

Defense counsel then produced witnesses who testified that they had settled many losses in the manner described above, some on policies quite similar to

¹⁸ 1 Sandf. 137 (1837), *aff'd*, 2 Comst. 235 (N.Y. 1849).

¹⁹ *Hone v. Mutual Safety Ins. Co.*, 2 Comst. 235, 243 (N.Y. 1849). (All italicized in original.)

²⁰ *Id.* at 236.

that of Mutual Safety and others containing a pro rata clause which spelled out the manner of settlement as described above.

The court disagreed with defense counsel, however, and in its decision said, "there could be no security in a written contract, if a usage in a single city can be given in evidence to vary and contradict it."²¹ The court, having thus established that in this particular reinsurance contract, because of the contract wording itself, the reinsurer was liable for the first \$10,000 of any loss, went on to rule that the receiver of an insurance company in liquidation can collect the full amount of reinsurance without having first paid any part of the loss to the original insured.

Because of the interdiction of reinsurance in England,²² American law in this area was drawn from eighteenth century French sources, namely "two French cases decided in 1748 and 1780, respectively, and statements in the text of certain continental and common law writers."²³

This most important first case is cited in a majority of succeeding cases²⁴ and in many articles²⁵ for the rule in America that "the liquidator of an insolvent reinsured can collect reinsurance without paying any part of the loss to the original insured,"²⁶ yet, it was based on eighteenth century French sources because the contract under consideration in no way whatsoever spelled out the liability of the reinsurer to the reinsured.

Between the years 1872 and 1877 there were several cases²⁷ litigated in this area, all of which had two things in common: (a) all the contracts of reinsurance did contain a so-called "pro rata" clause,²⁸ and (b) this fact notwithstanding, the outcome of all was that the liquidator was allowed to collect in full from the reinsurer even though the originally insured person was not able to collect from the reinsured.

The question in each of these cases was whether or not the pro rata clause (which contained the words "payable" or "pay") and the use of the term "sums actually paid"²⁹ made payment by the reinsured to the original insured a condition precedent to the reinsurer's reimbursing the reinsured. Rather than holding that this pro rata clause expressed the intention of the reinsurers to be liable only for a pro rata share of the amount actually paid by the ceding company to the original insureds, the courts ruled that it merely fixed the time of payment by the reinsurer to the reinsured.³⁰

21 *Id.* at 244.

22 28 HARV. L. REV. 302 (1915).

23 Smith, *The Right of the Liquidator of an Insolvent Reinsured To Collect Reinsurance in Full Without Paying the Loss of the Original Insured in Full*, Ins. Counsel J., Jan. 1938, pp. 44, 45.

24 *Allemania Fire Ins. Co. v. Fireman's Ins. Co.*, 209 U.S. 326, 332 (1908).

25 See 8 COUCH, INSURANCE LAW § 2274 & n.9 (1st ed. 1931, Supp. 1965).

26 Smith, *supra* note 23, at 46.

27 *Ex parte Norwood*, 18 Fed. Cas. 452 (No. 10364) (C.G.N.D. Ill. 1873); *Consolidated Real Estate & Fire Ins. Co. v. Cashow*, 41 Md. 59 (1874); *Blackstone v. Allemania Fire Ins. Co.*, 56 N.Y. 104 (1874); *Norwood v. Resolute Fire Ins. Co.*, 47 How. Pr. 43 (N.Y. Super. Ct. 1873); *Fame Ins. Co.'s Appeal*, 83 Pa. 396 (1877).

28 "Loss, if any, payable at the same time and pro rata with the insured." (Emphasis added.)

29 13 APPLEMAN, INSURANCE LAW AND PRACTICE § 7695 (1943, Supp. 1965).

30 *Blackstone v. Allemania Fire Ins. Co.*, 4 Daly 299 (N.Y.C.P. 1872), *aff'd*, 56 N.Y. 104 (1874).

Although the courts probably did not give the pro rata clause the interpretation which the reinsurers had intended, they did at least study the contract's wording in arriving at their decisions, something which was not always done in later cases.

The next case of importance was *Allemannia Fire Ins. Co. v. Firemen's Ins. Co.*³¹ In it, the Supreme Court was asked to decide whether a reinsured company (Firemen's) which became insolvent as a result of the Great Baltimore Fire of 1904 could recover the full amount of its reinsurance without having first paid out the full amount of its claims.

The defendant Allemannia "conceded that it would be liable if certain specific provisions of the arrangement did not make payment by the reinsured a condition precedent to liability on the part of the reinsurer."³² These provisions were a proof of loss clause and a pro rata clause, as follows:

[A]fter said reinsured company shall have adjusted, accepted proofs of, or paid such loss or damage, it shall forward to the said Allemannia Fire Insurance Company, at Pittsburgh, Pa., a proof of its loss and claim against this company . . . together with a copy of the original proofs and claim under its contract reinsured, and a copy of the original receipt taken upon the payment of such loss. . . .³³

[L]osses, if any, shall be payable *pro rata* with, in the same manner, and upon the same terms and conditions as paid by the said reinsured company under its contracts hereunder reinsured, and *in no event shall this company be liable for an amount in excess of a ratable proportion of the sum actually paid to the assured or reinsured by the said reinsured company under its original contracts hereunder reinsured.* . . .³⁴

In its opinion the Court did not agree with the defendant and thus, although it ruled that "the only question before the court is as to the construction of the language of the reinsurance compact,"³⁵ it was held that the term actually paid meant actually payable,³⁶ and further that:

[W]e do not think that the [meaning] of these two subdivisions was intended to entirely nullify and tear up by the roots *the construction given to the contract of reinsurance for so many years throughout the entire civilized world and upon which its chief value is based. The nature of the contract is accurately described in its commencement. It is described as a "compact of reinsurance," and there has been no doubt as to the meaning of such contract for the last two centuries.*³⁷

Therefore, although the court agreed that it was the language of the contract that should determine the reinsurer's liability, it summarily ignored this

31 209 U.S. 326, 332 (1908), affirming 28 App. D.C. 330 (Ct. App. 1906).

32 Smith, *supra* note 23, at 45-46.

33 *Allemannia Fire Ins. Co. v. Fireman's Ins. Co.*, 209 U.S. 326, 328 (1908). (Emphasis added.)

34 *Allemannia Fire Ins. Co. v. Fireman's Ins. Co.*, 28 App. D.C. 330, 333 (Ct. App. 1906). (Emphasis added.)

35 *Allemannia Fire Ins. Co. v. Fireman's Ins. Co.*, 209 U.S. 326, 331-32 (1908).

36 *Id.* at 336-37.

37 *Id.* at 337. (Emphasis added.)

language. It ruled instead on the basis of cases which, although they allowed the liquidator to recover, *were* based on the language of the reinsuring agreement.³⁸

As a result of this interpretation of the reinsurance contract, it became obvious that if a reinsurer were going to make the payment of loss a condition precedent to the reimbursement of the ceding company and thus limit its liability in the event of the latter's insolvency, it would have to use the plainest possible language in order to express that intent.³⁹

In *Globe Nat'l Fire Ins. Co. v. American Bonding & Cas. Co.*,⁴⁰ the court allowed the liquidator of the insolvent reinsured to collect reinsurance in full without first paying the claims to the original claimants. It is noteworthy that the court did not once mention the construction, language or intent of the reinsuring agreement. This agreement was somewhat different from those around which litigation had previously centered, in that it was a standard form drawn up in 1915 and used throughout much of the industry. In those cases each individual reinsurer either drew up the contract or had a broker or other intermediary do it for him.

It was substantially this same language from the 1915 Standard Contract that went into the 1930 Standard Form of Reinsurance Agreement which was drawn up by The Surety Association of America. This agreement was the point at issue in the single most important case in the area of reinsurer's liability to an insolvent reinsured, *Fidelity & Deposit Co. v. Pink*.⁴¹

B. The Pink Case

This case revolved around a New York corporation, the Southern Surety Company. In 1930 this company sold a fidelity bond to John DeMartini, Inc., and the same day reinsured half of that bond with the Fidelity and Deposit Company of Maryland. When in early 1932 the DeMartini Company suffered a loss and sought to collect, a New York court ruled the Southern Surety Company insolvent. At this time Louis H. Pink, the Superintendent of Insurance for New York, took possession of the assets of Southern Surety and began the liquidation proceedings.

After allowing, but not paying the De Martini claim, Pink demanded that the Fidelity and Deposit Company pay their half of the admitted liability. When Fidelity and Deposit refused, Pink decided to obtain a test case for the 1930 Standard Reinsurance Form. The lower courts ruled in his favor.⁴² The United States Supreme Court held:

38 See cases cited note 27 *supra*.

39 Smith, *supra* note 23, at 46. The courts ruled that this was not the situation in some cases and permitted the liquidator to recover the full amount of reinsurance. *Hicks v. Poe*, 269 U.S. 118 (1925); *French Mut. Gen. Soc'y of Mut. Ins. against Theft v. United States Fid. & Guar. Co.*, 203 Fed. 558 (D. Md. 1913), *rev'd on other grounds*, 212 Fed. 620 (4th Cir.), *cert. denied*, 234 U.S. 758 (1914); *Providence-Washington Fire Ins. Co. v. Atlanta-Birmingham Fire Ins. Co.*, 166 Fed. 548 (C.C.N.D. Ga. 1909); *Republic Metalware Co. v. General Reinsurance Corp.*, 245 App. Div. 232, 281 N.Y. Supp. 5, *order amended on other grounds, mem.*, 246 App. Div. 907, 282 N.Y. Supp. 993 (1935).

40 198 Iowa 1072, 195 N.W. 728 (1923).

41 302 U.S. 224 (1937).

42 *Pink v. Fidelity & Deposit Co.*, 15 F. Supp. 715 (S.D.N.Y. 1936), *aff'd*, 88 F.2d 630 (2d Cir. 1937).

We do not question the general rules concerning liability of reinsurers announced in the *Allemannia* case; but *the liability under any written contract must be determined upon consideration of the words employed, read in the light of attending circumstances.*⁴³

The important words in this contract were:

In consideration of the premium payable under section 1 hereof . . . hereinafter called the Reinsurer, does hereby *reinsure* Fidelity & Deposit Company of Maryland, hereinafter called the Reinsured, under bond numbered . . . , together with all riders attached thereto, hereinafter called the *Bond*, issued by the Reinsured in the penalty of . . . Dollars, in favor of . . . (obligee), and in behalf of . . . hereinafter called the Principal, *against loss* thereunder and against costs and expenses, as hereinafter defined, and interest. . . . The Reinsurer's proportionate share of a loss under the bond, of costs and expenses as hereinafter defined, and of interest, shall be paid to the Reinsured *upon proof of the payment of such items* by the Reinsured, and upon delivery to the Reinsurer of copies of all essential documents concerned with such loss and costs and the *payment thereof*.⁴⁴

Counsel for the New York State Insurance Department argued that the case should be controlled by previous cases, especially the *Globe*⁴⁵ and *Allemannia*⁴⁶ cases, since if the drafters of the 1930 Standard Form had intended that the reinsurer's liability be different from that established in these two cases they would have used entirely different language. At this time they so argued with good reason, for the Court of Appeals in their opinion implied that payment would have been condition precedent except for the *Allemannia* case and the similarity of language in these two cases.⁴⁷

Attorneys for the Fidelity and Deposit Company, Ralph S. Harris and Harold L. Smith,⁴⁸ based their defense on the language of the contract:

[T]he word "upon" is commonly used to express the dependence of an obligation upon a condition and the words "upon proof of the payment," etc., correspond with the common proof of loss clause, the effect of which is always to make the proof of loss a condition precedent.⁴⁹

In its decision the Court took into consideration the fact that the policy in question in the *Allemannia* case contained no equivalent clause, and that the 1930 form provided that the reinsurer would "reinsure . . . against loss" and the *Allemannia* contract provided only to "agree to reinsure." The Court ruled:

As the standard form of 1930 was adopted twenty years after the *Allemannia* case it fairly may be assumed that the dissimilar language

43 *Fidelity & Deposit Co. v. Pink*, 302 U.S. 224, 229 (1937). (Emphasis added.)

44 *Id.* at 226. (Emphasis added.)

45 *Globe Nat'l Fire Ins. Co. v. American Bonding & Cas. Co.*, 198 Iowa 1072, 195 N.W. 728 (1923).

46 *Allemannia Fire Ins. Co. v. Fireman's Ins. Co.*, 209 U.S. 326 (1908).

47 *Pink v. Fidelity & Deposit Co.*, 88 F.2d 630, 631 (2d Cir. 1937).

48 It is interesting to note that this is the same Smith who authored the article cited note 23 *supra*.

49 Smith, *supra* note 23, at 48.

employed was intended to impose liability different from the one there found to exist.

The judgement below must be reversed.⁵⁰

Thus, when the three elements: (1) a contract specifically stating reinsurer's liability to the reinsured, (2) the court stating that wording in the written contract will determine liability, and (3) the court's actually ruling on the basis of that language, were all combined in one case, the result was a triumph for the reinsurer.

III. The Insolvency Clause

A. Purpose of the Insolvency Clause

The joy which the *Pink* decision must have occasioned in reinsurance circles throughout the country was to be short lived. In 1939 Superintendent Pink introduced to the legislature and saw written into law a statute,⁵¹ the purpose of which was to overcome the *Pink* decision. He said, "When Section 77 was prepared it was prepared with the intention of overcoming a decision in the case of *Fidelity & Deposit Company v. Pink*."⁵²

The essence of this statute was that an insurance company could no longer consider reinsurance as an asset or as a deduction from liability for the amount ceded unless there was a clause in the reinsuring contract making the full reinsurance payable regardless of the reinsured's solvency. Thus, if a reinsurer would not accept a treaty with this insolvency clause in it and forced the reinsured to sign one without it, the result would be to force the reinsured to carry the full amount of reserve for that amount of reinsurance ceded, thus effectively defeating one of the primary reasons for such reinsurance.⁵³

Section 77 was amended in 1940 to allow the proceeds of an insolvent fidelity or surety company's reinsurance to be paid directly to the claimant of a bond.⁵⁴ The reason for this was that section 315 of the New York Insurance Law forbade a fidelity or surety company to take credit for such reinsurance ceded unless such recovery was possible.⁵⁵ The amendment provided that:

[R]einsurance agreements covering other kinds of risks [were to be] written [so as to] . . . provide for payment by the assuming reinsurer direct[ly] to the policyholder in the event of loss. In the case of insolvency, this amount[ed] to bypassing the liquidator and . . . create[d] a preference in favor of this special group of policyholders rather than a payment to the liquidator's general fund for the benefit of all policyholders.⁵⁶

So another addition to section 77 was proposed and passed in 1952.⁵⁷ It proposed

50 *Fidelity & Deposit Co. v. Pink*, 302 U.S. 224, 230 (1937).

51 N.Y. Sess. Laws 1939, ch. 882, § 77.

52 Memorandum From Superintendent of Insurance, Louis H. Pink, to the Governor, Feb. 26, 1940.

53 See text accompanying note 12 *supra*.

54 N.Y. Sess. Laws 1940, ch. 87.

55 N.Y. INS. LAWS § 315.

56 Memorandum From the Superintendent of Insurance, Alfred J. Bohlinger, to the Governor of New York, March 11, 1952, in Assembly Print No. 703, Int. No. 698, p. 2.

57 N.Y. Sess. Laws 1952, ch. 171.

to give no credit to a ceding reinsurer on account of reinsurance ceded unless the reinsurance [was] payable directly to the ceding insurer or to its liquidator, except where there is an actual novation whereunder the policyholder releases the ceding insurer and accepts the liability solely of the assuming insurer.⁵⁸

B. The Insolvency Clause Adopted by a Majority of States

In 1941 Massachusetts followed the lead of its neighbor and incorporated an insolvency clause into its statutes.⁵⁹ Illinois enacted an insolvency clause into law in 1945.⁶⁰ Two years later Utah, Washington and Tennessee adopted similar clauses. Subsequently, on June 15, 1950, the Reinsurance Subcommittee of the National Association of Insurance Commissioners, chaired by Wallace K. Downey of California, entered a report to the Chairman of the NAIC Executive Committee, Frank J. Sullivan, in which it offered a choice of two model insolvency clauses for the Association to approve.⁶¹ Neither of these were approved, however. It was not until December, 1950, that a model clause was finally approved.⁶² Also at this time an Insurance Industry Commission, headed by Edward L. Mulvehill, was asked to prepare a model insolvency clause of its own.⁶³

By 1961, twenty-two more states and Puerto Rico passed their own insolvency legislation which ranged in length from that of California⁶⁴ to the more succinct version of Kentucky.⁶⁵ It appears that the desire for conciseness won the day with the result that the insolvency clauses of most states resemble that of Kentucky.⁶⁶

IV. Litigation Subsequent to the *Pink* Case

What of the reinsurer's liability between the time of the *Pink* decision and such time as a particular state legislature adopted an insolvency clause, and what of their liability at present in those states which have not as yet enacted this clause into law?

There has been very little litigation in this area since 1940. The probable reason for this is the extraterritorial effect of New York's insolvency clause. If a company desires to write business in New York (and because of its huge

58 Memorandum From the Superintendent of Insurance, Alfred J. Bohlinger, to the Governor of New York, March 11, 1952, in Assembly Print No. 703, Int. No. 698, p. 3. The text of the present New York insolvency clause, N.Y. INS. LAWS § 77 (Supp. 1964), is set out in appendix I.

59 MASS. ANN. LAWS ch. 175, § 20 (Supp. 1964). See appendix II.

60 ILL. ANN. STAT. ch. 73, § 785(b) (Smith-Hurd 1965). See appendix III.

61 See appendices IV & V.

62 See appendix VI.

63 See appendix VII.

64 CAL. INS. CODE § 922.2 (Supp. 1964). See appendix VIII.

65 KY. REV. STAT. ANN. § 304.385 (Baldwin 1963). See appendix IX.

66 As of December 1964, the states which had insolvency clauses were (year of enactment in parentheses): Arizona (1955), Arkansas (1960), California (1950), Colorado (1953), Connecticut (1958), Florida (1959), Georgia (1960), Hawaii (1956), Idaho (1962), Illinois (1945), Kentucky (1950), Louisiana (1948), Massachusetts (1941), Montana (1961), Nebraska (1951), Nevada (1953), New Mexico (1955), New York (1940), Oklahoma (1957), South Carolina (1956), South Dakota (1957), Tennessee (1947), Texas (1949), Utah (1947), Virginia (1952), Washington (1947), West Virginia (1958) and Puerto Rico (1958).

market almost every company does), it must abide by New York law concerning not only the business it transacts in New York, but also that which it does in any other state.⁶⁷

There have been three cases litigated since *Pink* which concerned reinsurer's liability upon the insolvency of the reinsured.⁶⁸

A. *Litigation Favorable to the Reinsurer*

In *Stickel v. Excess Ins. Co.*⁶⁹ the victims of an automobile accident won a judgment against the Erie Motor Freight Company and attempted to collect from its liability insurer, Central Mutual Insurance Company. Subsequently, these companies were declared insolvent. In an attempt to obtain more than a liquidation dividend, the Stickels sued the reinsurer, Excess Insurance Company of America.⁷⁰ They contended that the reinsurance agreement constituted a contract of indemnity against liability, rather than against loss. It read as follows:

Section III. The liability of the reinsurer shall commence simultaneously with that of the company and shall be subject in all respects to all the general and special stipulation clauses, waivers and modifications of the original policy or other undertaking and any endorsements or riders thereon.⁷¹

In addition, plaintiffs argued that the Court's decision in the *Allemannia* case⁷² precluded the reinsurer's denial of liability in a case such as this.

The defense countered by placing emphasis on the section of the contract which read, "The term 'ultimate net loss' shall be understood to mean . . . the sum actually paid in cash in settlement of losses for which the company is liable. . . ."⁷³ They contended that this section made actual payment by the reinsured a condition precedent and that the *Pink* case was controlling.

The court agreed with the defense and ruled:

In further support of their contention that the reinsurance contract is one against liability, the Stickels place emphasis on Section III thereof. However, the interpretation of such section must be undertaken with Sections I and II as a background, and with due regard for the fact that we are dealing with an engagement between two insurance companies exclusively. When this is done, the contention fails. . . .⁷⁴

67 N.Y. INS. LAWS § 42.

68 *Stickel v. Excess Ins. Co.*, 136 Ohio St. 49, 23 N.E.2d 839 (1939); *Fischer v. Excess Ins. Co.*, 31 F. Supp. 651 (N.D. Iowa), *aff'd*, 115 F.2d 755 (8th Cir. 1940); *Homan v. Employers Reinsurance Corp.*, 345 Mo. 650, 136 S.W.2d 289 (1939).

69 136 Ohio St. 49, 23 N.E.2d 839 (1939).

70 The general rule for a reinsurer's liability to the original insured was then, and is now, that "there is, in the ordinary contract of reinsurance, no privity of contract which would enable the insured to bring an action against the reinsurer." 13 APPLEMAN, *op. cit. supra* note 29, § 7694, at 464. Despite this, original insureds have, over the years, brought a number of such suits against reinsurers. To the displeasure of at least the New York Insurance Department, they have been winning with increasing frequency. Interview With Alfred Bennet, March 26, 1964.

71 *Stickel v. Excess Ins. Co.*, 136 Ohio St. 49, 51, 23 N.E.2d 839, 841 (1939).

72 *Allemannia Fire Ins. Co. v. Fireman's Ins. Co.*, 209 U.S. 326 (1908).

73 *Stickel v. Excess Ins. Co.*, 136 Ohio St. 49, 51, 23 N.E.2d 839, 841 (1939).

74 *Id.* at 54, 23 N.E.2d at 842.

In 1940, Excess again found itself involved in litigation.⁷⁵ The Standard Mutual Automobile Association of Council Bluffs had purchased reinsurance on its third party liability policies. The agreement read in effect that Excess would repay Standard the amount of any loss in excess of \$3,000, up to another specified sum. Before Standard was adjudged insolvent it had allowed three claims of \$10,000, \$10,000 and \$3,500, which it had not paid and which would have been partially covered by its reinsurance treaty with Excess.

The liquidation dividend was twenty-five percent, meaning that the original claimants would collect \$2,500, \$2,500 and \$875, respectively. It also meant that since no claim paid was over \$3,000, Excess was no longer liable for the \$14,500 (\$7,000, \$7,000 and \$500) which Standard was claiming. The court dismissed Standard's suit for the \$14,500, saying:

[T]he Pink case is not controlling on the question of Iowa law, but it involves nothing but the application of a rule universally recognized, namely, that liability under any written contract must be determined upon consideration of the words employed, read in the light of attending circumstances.⁷⁶

With these three cases a matter of history (the *Pink* case and the two *Excess* cases), reinsurers must have felt that they need only keep the language of their treaties unambiguous, and an enlightened judiciary, reading the contract and ruling according to its contents, would decide cases of this nature in their favor.

B. *Litigation Unfavorable to the Reinsurer*

Because of at least one case, however, this thinking was premature. In 1940, the Supreme Court of Missouri, decided a case which had begun ten years earlier and which was analogous to the two *Excess* cases. The court allowed collection from the reinsurer for sums not paid by the ceding company.⁷⁷ Plaintiffs, injured in a bus accident, collected all but \$3,500 of their \$67,500 judgment from the liability insurer, which had been declared insolvent at the time of the suit. Since the bus company was also insolvent, plaintiffs sued the reinsurer, Employer's Reinsurance Corporation. By 1940, when the case finally reached the Missouri Supreme Court, the amount sought had increased from \$3,500 to \$24,695 with the addition of interest.

The reinsurance contract contained a clause which stated, "*each reinsurance hereunder shall be subject to all of the general and special terms and conditions of such policies and endorsements.*"⁷⁸ One of the endorsements in the original insurance agreement provided for direct action against the insurer in case of nonpayment of a judgment by the insured. Plaintiffs contended that, in effect, Employer's had agreed to submit to suit by a claimant insured under the original contract of insurance. They further contended that the insolvency

⁷⁵ *Fischer v. Excess Ins. Co.*, 31 F. Supp. 651 (N.D. Iowa), *aff'd*, 115 F.2d 755 (8th Cir. 1940).

⁷⁶ *Fischer v. Excess Ins. Co.*, 115 F.2d 755, 757 (8th Cir. 1940). (Citations omitted.)

⁷⁷ *Homan v. Employers Reinsurance Corp.*, 345 Mo. 650, 136 S.W.2d 289 (1940).

⁷⁸ *Id.* at 657, 136 S.W.2d at 294. (All italicized in original.)

of the original insuring company was no defense, pursuant to a Missouri statute.⁷⁹

The defendant countered with three arguments: (1) The contract was one of indemnity against loss rather than against liability. This was evidenced by the clause in the treaty which read, "'[L]oss' shall mean only those amounts actually paid to claimants in settlement of claims."⁸⁰ (2) There was no privity of contract between the original insured or a claimant under a policy owned by it and the reinsurer of the original insurer, unless it is so stated in the reinsurance contract. (3) The statute relied upon by plaintiffs fixed the liability of the insurer despite the insolvency of the bus company but was not applicable to determine the liability of defendant.⁸¹

The court agreed that a reinsurance contract is ordinarily a contract of indemnity against loss but continued:

The agreement between defendant and Continental [the original insurer], however, is not strictly a reinsurance contract. We must consider it as written and determine its legal effect under proper rules for construction. . . .

[T]he word "indemnify" is used in the petition without stating whether it means indemnify against loss or liability, and the word "loss" is used without a statement as to whether or not it means "amounts actually paid" or "liability from accrued indebtedness."⁸²

The court explained this contradiction by citing several instances where the word "loss" was not redefined as meaning amounts actually paid to claimants. It held that in these instances "the word 'loss' was . . . used as clearly meaning 'liability,' as for example: '. . . where *loss accrues* to the insured. . . .'"⁸³ The court concluded that the contract indemnified against liability.

A motion for rehearing was denied,⁸⁴ but all the gains of the *Pink* case were not lost. Although the court apparently ignored or misinterpreted certain policy provisions (as the courts in the early pro rata cases had), it did not apply a blind rule of reinsurer liability without studying the policy's provisions.⁸⁵

⁷⁹ Pursuant to Missouri statute, the liability of a liability insurer became absolute once a judgment was rendered against a policyholder, and the fact that the latter became insolvent was not a defense. Mo. Laws 1925, p. 274 § 1.

⁸⁰ *Homan v. Employers Reinsurance Corp.*, 345 Mo. 650, 656, 136 S.W.2d 289, 293 (1940).

⁸¹ The defense cited several cases which involved similar statutes in other states. *Greenman v. General Reinsurance Corp.*, 237 App. Div. 648, 262 N.Y. Supp. 569, *aff'd mem.*, 262 N.Y. 701, 188 N.E. 128 (1933); *Gutride v. General Reinsurance Corp.*, 167 Misc. 608, 4 N.Y.S.2d 387 (Sup. Ct. 1938). In both cases the courts were asked to interpret a New York direct action statute so as to allow an injured party to have the same right of recourse against the reinsurer of the negligent party's liability insurer. N.Y. Sess. Laws 1917, ch. 524 (now N.Y. INS. LAWS § 167) (Supp. 1964)). The courts in both cases refused: "[W]hile it is clear that the plaintiff has recourse against its insurer under the provisions of section 109 of the Insurance Law, the statute would have to be stretched considerably to include liability of the reinsurer." *Gutride v. General Reinsurance Corp.*, *supra* at 610, 4 N.Y.S.2d at 389.

⁸² *Homan v. Employers Reinsurance Corp.*, 345 Mo. 650, 661-62, 136 S.W.2d 289, 296-97 (1940).

⁸³ *Id.* at 662, 136 S.W.2d at 297.

⁸⁴ *Id.* at 667, 136 S.W.2d at 300.

⁸⁵ For instance, compare *Homan* with *Globe Nat'l Fire Ins. Co. v. American Bonding Co.*, 198 Iowa 1072, 195 N.W. 728 (1923). See text accompanying note 40 *supra*.

Thus, it appears that in future cases of this nature the reinsurer can expect a decision based on the treaty's wording — and therefore usually rendered in his favor.

It is interesting to note that despite the *Pink* and *Excess* cases some writers on this subject cite "a substantial line of authority to the effect that the reinsured may recover from the reinsurer even though it has not yet discharged the liability by payment."⁸⁶

V. Post Insolvency Clause Situation

A. The Reinsurers' Attempt to Circumvent Insolvency Clauses

After the introduction of the insolvency clause into the statutes of various states the reinsurance industry might have meekly capitulated, having decided it was impossible to fight city hall. With a good bit of ingenuity they acted so as to cause Commissioner Hammel of Nevada to present a complaint at the 1951 NAIC convention. He said that according to a clause added by the industry,

the reinsurer shall have the right to purchase from any person, firm or corporation claiming against the receivership estate [of the ceding insurer,] and take the assignment thereof of any and all liability charged or chargeable by the receiver, liquidator, or statutory successor against the reinsurer, and the reinsurer shall have the right to set off the full amount of such claim or liability so purchased against all liability which may be claimed by the receiver, liquidator, or statutory successor against the reinsurer arising out of the same claim.⁸⁷

As an example of the effect of this clause on a reinsurer's liability, let us consider the case of an insolvent ceding company *A* and its reinsurer, *B* who have a fifty percent quota share reinsurance agreement. Company *A* has allowed a \$9,000 claim, but before it is paid the company is declared insolvent and a liquidation dividend of twenty-five percent declared.

Assume that this occurs after 1939 in New York, so there is an insolvency clause in the treaty. Thus, *A*'s liquidator would seek to recover the full \$4,500 from *B*.

With a clause such as that quoted above, however, it would be legal for a representative of company *B* to go to the original claimant and purchase the claim from him. The price would be, of course, somewhere between the \$2,250 figure which the claimant would collect from *A* and the \$4,500 figure which *B* would have to pay if it was unable to complete the purchase. Company *B* would pay the claimant the agreed upon amount and instruct him to write *A* and withdraw his claim, thus relieving *B* of further liability.

If the purchase is accomplished both the original claimant and the reinsurer are in a better position financially. Only the general creditors of *A*, are in a worse financial position.

⁸⁶ 13 APPLEMAN, *op. cit. supra* note 29, § 7695 & n.93, at 470. To support this statement, the author cites nine cases decided between 1847 and 1937, before the *Pink* case.

⁸⁷ N.A.I.C. PROCEEDINGS 189, Dec. 2-5, 1951.

At the 1951 meeting the Insurance Commissioners saw this and entered the following into the record of the proceedings:

The effect of the contract provision herein above quoted permitting a reinsurer to purchase claims against an insolvent ceding insurer and to settle its obligations under the reinsurance contract by surrendering such claims to the liquidator in offset, is in great part to nullify the insolvency clause and to reduce materially the amount for which the reinsurer can settle its liability as contemplated by the insolvency clause. At the meeting of your subcommittee herein reported, none of the numerous industry representatives present sought to justify this type of provision and it is your subcommittee's view that it is derogation of the insolvency clause and our recommendation that no credit be allowed for reinsurance under a contract containing such a clause.⁸⁸

To date, no law has been passed which would disallow credit for reinsurance ceded by a reinsured if the treaty for that reinsurance contained a purchase clause. The reason for this is not that the state legislators did not agree with the conclusion reached by the NAIC, but that the reinsurers simply removed the clause from future treaties, thus eliminating the need for such legislation.

B. The Reinsurers' Success in Circumventing Insolvency Clauses

The one hundred year war was far from over, however, and the loss of this battle hardly mattered. Instead of incorporating a purchase clause into their treaties, thereby acquiring a contractual right to buy claims made on the reinsured, the reinsurers found that it was perfectly legal to make these purchases without the clause. This is exactly how the problem stands today, *i.e.*, if a reinsurer sees that it can save money by purchasing an original insured's claim, it will approach him and he will almost certainly accept any figure larger than he would receive from the insolvent reinsured.

VI. Alternatives to the Insolvency Clause

A. Why a Discussion of Alternatives?

Twenty-seven states and Puerto Rico have already incorporated the insolvency clause into their statutes, and every year a new state or two is added to the list. Because of the extraterritorial effect of New York's insolvency clause a large segment of the insurance industry must abide by it, regardless of other statutes. In addition there has been no great cry of injustice from any insurance or reinsurance organization in this country. Nor have contemporary academic sources seen fit to comment adversely on the situation. Finally, the insurance departments of the various states seem content with the *status quo*. The question occurs as to the need for discussing alternatives to the insolvency clause.

First, from a pragmatic point of view the system simply does not work. The purpose of New York's original insolvency clause was, in the words of the Superintendent of Insurance,

⁸⁸ *Id.* at 190.

to overcome the decision of the United States Supreme Court in the case of *Fidelity & Deposit Company v. Pink*, 302 U.S. 224 (1937), in which the court ruled that the reinsurer in that case, upon the ceding insurer becoming insolvent, was liable only for its share of the loss on the basis of the amount actually paid to the policyholder, as represented by the dividend paid by the liquidator of the ceding company on the loss reinsured, rather than the full amount of the reinsured loss claim as allowed in the liquidation proceeding.⁸⁹

But the reinsurers are able, through the purchase of claims made against the insolvent reinsured, to completely circumvent this purpose.

A second and more important reason for examination of alternatives is that the whole philosophy behind the clause was ill-conceived.

On the surface it appears that the proponents of the clause have built their arguments on an eminently logical basis, and that its incorporation into the statutes of every state is the only way to insure justice to everyone involved. The apologists for this plan argue that in a reinsurance contract the reinsurer promises to pay a specified amount of the losses which the ceding company suffers under certain of its primary policies. The fact that this company becomes insolvent and is unable to pay these losses is of no consequence, because even if the law did not do so, one's sense of justice would demand that the reinsured should not be deprived of the benefit of the agreement simply because of its own insolvency. The occurrence of the event insured against in the primary policy is what determines the reinsurer's liability, not the solvency of the reinsured. To let the reinsurer dismiss its liability by paying the ceding company only what that company is able to pay out in the form of a liquidation dividend is to permit the reinsurer to make a profit on the difference between this amount and the admitted liability. "[S]ince the reinsurer has received a premium designed to compensate it for assuming the risks incident to a contract of indemnity against liability, there seems to be no reason for allowing the reinsurer to gain because of the reinsured's insolvency."⁹⁰

One such reason is that "the liability under any written contract must be determined upon consideration of the words employed, read in the light of attending circumstances."⁹¹ But aside from this, there are known instances which do not grate against the public's tender conscience when an insurance company, after accepting premiums, refuses to pay because of total insolvency of the insured when the insured-against event occurs.

B. A Parallel Situation

A typical Business Interruption Policy contains a clause which reads, "In the event of such damage or destruction this company shall be liable for the *actual loss sustained* by the insured."⁹² The term "actual loss sustained" has been described as the "loss of net profit and continuing expenses [but only]

89 Memorandum From the Superintendent of Insurance, Alfred J. Bohlinger, to the Governor of New York, March 11, 1952, in Assembly Print No. 703, Int. No. 698.

90 50 HARV. L. REV. 93, 98-99 (1936).

91 *Fidelity & Deposit Co. v. Pink*, 302 U.S. 224, 229 (1937).

92 I-R, Business Interruption Form No. 4, Gross Earnings Form for Manufacturing Risks, Jan. 1959.

to the extent that they would have been earned."⁹³ Thus the fact that company *O* has paid its business interruption premiums in full and on time for the past five years has no bearing on the fact that, if at the time of an interruption the business is operating at a loss, the insurer will pay only those expenses which the company was in fact covering with its earnings. Yet no one has protested that insurance companies were withholding monies which were rightfully the insured's or making an unconscionable profit. The reasons for the lack of protest are probably clear to most businessmen: a company in the above situation did not in fact suffer a loss when it was interrupted, and there is no injustice in denying recovery.

Therefore, a contract allowing the reinsurer to pay only what in fact the reinsured has lost is neither illegal in itself nor is it a totally new concept detrimental to the public's welfare.

One writer has said:

It is somewhat surprising that the opinions in the above cases [*Allemania*, *Globe*, etc.] have shown no concern on the part of the courts over the incongruity of permitting the insolvent estate to realize a profit out of the reinsurance by collecting reinsurance in full and paying the original insured less than it collects, particularly in view of the fact that *a solvent reinsured is not permitted to realize a profit out of the reinsurance by collecting reinsurance in full and settling with the original reinsured [insured] for less than it collects.*⁹⁴

Another writer concurred and pointed out that if the total proceeds under a reinsurance policy are made a part of the general assets of the insolvent reinsured, and

if "the ratio of the face value of the reinsurance policy to that of the original insurance policy exceeds the ratio of the reinsured's other assets to its other liabilities at the time of the accrual of the liability on the insurance policy, [the result] would be to make the transaction a wager, since the general creditors would recover a greater dividend as a result of the reinsured's becoming liable than they would have recovered otherwise."⁹⁵

This means that the larger a person's loss who is insured by the insolvent ceding company, the greater the amount that the insolvent company's general creditors stand to collect. Therefore, to allow reinsureds to collect under insolvency clause legislation is to permit a significant moral hazard to exist between the time the ceding company's insolvency becomes obvious or is declared and such time as the court or liquidator ceases to accept new claims.

C. Suggested Alternatives

If the liability of a reinsurer to the insolvent reinsured is on a pro rata basis and is to be determined by what the latter actually pays out in satisfaction of claims made under the policies reinsured,⁹⁶ a new problem is revealed. This

⁹³ Lecture by Dr. Clyde M. Kahler, Property and Casualty Insurance Course, Wharton School of Commerce and Finance, University of Pennsylvania, Oct. 29, 1962.

⁹⁴ Smith, *supra* note 23, at 47. (Emphasis added.)

⁹⁵ 50 HARV. L. REV. 93, 97 (1936).

⁹⁶ The author considers this method to be the most equitable.

problem is that if the liquidation dividend, figured without benefit of the reinsurance, is paid, and then the reinsurer reimburses the ceding company, this company will then have this amount to distribute among all its creditors. A small part of this will go to the reinsured claimant thus making the reinsurance company liable once again for this second amount. When the reinsurer pays this amount and the ceding company distributes it, some of this, too, will go to the original claimant, and apparently this will continue ad infinitum or until the reinsurer has paid the full loss.

This, however, is not the case. There are two formulas, one⁹⁷ which is a good deal more complicated than the other but which is very easily programmed into a computer,⁹⁸ and another,⁹⁹ which, although not quite as accurate, can easily be worked out by hand. Both solve the problem by swiftly arriving at the figure which the reinsurer would pay. The net result of determining the reinsurer's liability by using these formulas is: (1) the reinsurer pays strictly on the basis of what the reinsured lost to the primary insured; (2) the original insured does not receive a great deal less than he would if an insolvency clause were in effect;¹⁰⁰ and (3) the profit which the general creditors would have made if a policyholder of a reinsured policy made a claim with the insolvency clause in effect is reduced. However, as long as more reinsurance money goes into the treasury of the insolvent company than that company pays out to the original claimant under the policy reinsured, the moral hazard of increasing the loss will persist.

One writer has rejected the above claim as unfair because "the reinsurer did not see fit to limit its liability to indemnity against loss."¹⁰¹ However, this article was written prior to the *Pink* decision, and in the search for an equitable method of determining reinsurer's liability the assumption was that the reinsurer *did* limit his liability to indemnity against loss. Thus, the conclusion which this writer finally reaches is unacceptable. His plan was to permit the reinsurer to determine his liability as outlined above. He would then pay directly to the original claimant any difference between this amount and the amount of his liability had the reinsured not become insolvent.¹⁰²

It is interesting to note that Vermont, in an attempt to solve this problem, has rejected the idea of the insolvency clause and enacted two unique statutes.¹⁰³ They have the effect of: (1) giving the original insured a preferential claim on sums which the reinsurer pays to the reinsured; and (2) allowing this original claimant to sue the reinsurer, in the name of the ceding company, for amounts

97 See appendix X.

98 Interview With Rev. Willard Dressel, S.J., Physics Instructor, Creighton Preparatory School, Omaha, Nebraska, April 29, 1964.

99 Assuming: C = original insured's claim

a = assets of insolvent ceding company, not including reinsurance proceeds

l = liabilities of ceding insurer exclusive of claim reinsured

R = percent of loss which reinsurer is reinsuring

Then: $\frac{R C a}{l}$ = reinsurer's total liability

100 See appendix X.

101 50 HARV. L. REV. 93, 98 (1936).

102 *Id.* at 98-99.

103 VT. STAT. ANN. tit. 8, §§ 3561, 3562 (1958).

the reinsurer has not paid to the ceding company on the claim made on the reinsured policy.

This alternative must be rejected also, for it does not take into account the right of a reinsurer to limit his liability as he sees fit, if this limitation is neither illegal nor against the public interest.¹⁰⁴

APPENDIX I

New York Insurance Laws

§ 77. Reinsurance, when permitted; effect on reserves

No credit shall be allowed, as an admitted asset or as a deduction from liability, to any ceding insurer for reinsurance made, ceded, renewed, or otherwise becoming effective after January first, nineteen hundred forty, unless the reinsurance shall be payable by the assuming insurer on the basis of the liability of the ceding insurer under the contract or contracts reinsured without diminution because of the insolvency of the ceding insurer nor unless under the contract or contracts of reinsurance the liability for such reinsurance is assumed by the assuming insurer or insurers as of the same effective date. Except as otherwise provided by section three hundred and fifteen of this chapter, no such credit shall be allowed any ceding insurer for reinsurance made, ceded, renewed, or otherwise becoming effective after September first, nineteen hundred fifty-two, unless the reinsurance agreement provides that payment by the assuming insurer shall be made directly to the ceding insurer or to its liquidator, receiver or statutory successor except (a) when the contract specifically provides another payee of such reinsurance in the event of the insolvency of the ceding insurer and (b) where the assuming insurer with the consent of the direct insured or insureds has assumed such policy obligations of the ceding insurer as direct obligations of the assuming insurer to the payees under such policies and in substitution for the obligations of the ceding insurer to such payees. N.Y. INS. LAWS § 77(1) (Supp. 1964).

¹⁰⁴ The problem of how to arrive at the reinsurer's share of a loss to an insolvent ceding company when an excess treaty is in effect is the same as for the pro rata liability agreements except that the reinsurer owes nothing unless the loss exceeds the reinsured's retention. When it does, the formula from appendix X can be modified as follows to solve the problem: (1) Drop R from the formula,

$$S = d \cdot c + \frac{R P_{n-1} (C - \sum P_{n-1})}{L + P_l - \sum P_{n-1}}$$

The answer which the formula now gives is the new amount the ceding company will pay the primary insured. (2) Simply subtract the ceding company's retention from this amount and the remainder is the reinsurer's liability.

R is dropped in the case of an excess type agreement because once the amount at which the reinsurer becomes liable is reached, the reinsurer is then liable for 100% of the rest of the loss, up to a predetermined limit. Therefore, if the reader wishes he may simply assume R is l rather than drop it.

APPENDIX II

*Massachusetts Insurance Code***§ 20. Reinsurance**

No credit shall be allowed to any ceding insurer for reinsurance made, ceded, renewed or otherwise becoming effective after September thirtieth, nineteen hundred and forty-one, as an admitted asset or as a reduction of liability, unless, by the terms of the written reinsurance agreement, the reinsurance is payable by the assuming insurer on the basis of the liability of the ceding insurer under any policy or contract reinsured without diminution because of insolvency of the ceding insurer. Any reinsurance agreement may provide that the liquidator or receiver or statutory successor of an insolvent ceding insurer shall give written notice of the pendency of a claim against the insolvent ceding insurer on the policy or contract reinsured within a reasonable time after such claim is filed in the insolvency proceeding and that during the pendency of such claim the assuming insurer may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defense or defenses which it may deem available to the ceding company or its liquidator or receiver or statutory successor. Subject to court approval, the expense thus incurred by the assuming insurer shall be chargeable, against the insolvent ceding insurer as part of the expense of liquidation, to the extent of a proportionate share of the benefit which may accrue to the ceding insurer solely as a result of the defense undertaken by the assuming insurer. MASS. ANN. LAWS ch. 175, § 20 (Supp. 1964).

APPENDIX III

*Illinois Insurance Code***§ 785. Reinsurance authorized and reserve credits**

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

Such reinsurance agreement may provide that the liquidator or receiver of an insolvent ceding insurer shall give written notice of the pendency of a

claim against the insolvent ceding insurer on the policy or bond reinsured within a reasonable time after such claim is filed in the insolvency proceeding and that during the pendency of such claim any assuming insurer may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defense or defenses which it may deem available to the ceding company or its liquidator or receiver. The expense thus incurred by the assuming insurer shall be chargeable against the insolvent ceding insurer as a part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to the ceding insurer solely as a result of the defense undertaken by the assuming insurer. ILL. ANN. STAT. ch. 73, § 785(1)(b) (Smith-Hurd 1965).

APPENDIX IV

*National Association of Insurance Commissioners
Suggested Insolvency Clause (No. 1)*

No credit shall be allowed as an admitted asset or as a deduction from liability, to any ceding insurer for reinsurance, unless the contract of reinsurance provides that the portion of any risk or obligation assumed by the reinsurer, when such portion is ascertained, shall be payable on demand of the ceding insurer at the same time as the ceding insurer shall pay its net retained portion of such risk or obligation, with reasonable provision for verification before payment, and unless the reinsurance shall be payable by the assuming insurer, in the event of insolvency of the ceding insurer, to its liquidator or conservator (except where either the contract of insurance or the contract of reinsurance specifically provides another payee of such reinsurance in the event of the insolvency of the ceding insurer) on the basis of the claim or claims allowed because of such insolvency or because the liquidator or conservator of such ceding insurer has failed to pay all or a portion of any claim. Such reinsurance agreement may provide that the conservator or liquidator of a ceding insurer shall give written notice . . . The original insured shall have no right against the reinsurer which is not specifically set forth in the contract of reinsurance.

APPENDIX V

*National Association of Insurance Commissioners
Suggested Insolvency Clause (No. 2)*

In the event of the insolvency of the company, reinsurance under this agreement shall be payable by the underwriters to the liquidator, conservator, receiver or statutory successor of the company (except where either the contract of insurance or this contract specifically provides another payee of such reinsurance in the event of insolvency of the company) on the basis of the claim or claims allowed against the company by any court of competent jurisdiction

or any justice thereof or by any liquidator, conservator, receiver or statutory successor having authority to allow such claim or claims, without diminution because of such insolvency or because the liquidator, conservator, receiver or statutory successor of the company has failed to pay all or any portion of any claim. . . .

APPENDIX VI

Final Draft of NAIC Recommended Insolvency Clause

The reinsurance shall be payable by the reinsurer on the basis of the liability of the ceding insurer under the contract or contracts reinsured without diminution because of the insolvency of the ceding insurer. In the event of the insolvency and appointment of a liquidator, receiver or statutory successor of the ceding company, such portion shall be payable to such liquidator, receiver or statutory successor immediately upon demand, with reasonable provision for verification on the basis of the claims allowed against the insolvent company by any court of competent jurisdiction because of such insolvency or because any liquidator, receiver or statutory successor has failed to pay all or a portion of any claims. Payment by the reinsurer as set forth above shall be made directly to the ceding insurer and where the reinsurer, with the consent of the direct insured or reinsured has assumed the policy obligations of the ceding insurer as direct obligations of the assuming company to the obligees under such policies and in substitution for the obligations of the ceding insurer to such obligees.

The reinsurance agreement may provide that the liquidator, receiver or statutory successor of a ceding insurer shall give written notice of the pendency of a claim against the ceding insurer indicating the policy or bond reinsured, within a reasonable time after such claim is filed and the reinsured may interpose, at its own expense, in the proceeding where such claim is to be adjudicated, any defense or defenses which it may deem available to the ceding company or its statutory successor. The expense thus incurred by the reinsurer shall be payable subject to court approval out of the insolvent ceding insurer as part of the expense of liquidation or receivership to the extent of a proportionate share of the benefit which may accrue to the ceding insurer in liquidation or receivership, solely as a result of the defense undertaken by the reinsurer.

The original insured or policyholder shall not have any rights against the reinsurer which are not specifically set forth in the contract of reinsurance.

APPENDIX VII

Industry Suggested Insolvency Clause

No credit shall be allowed, as an admitted asset or as a deduction from liability, to any ceding insurer for reinsurance made, ceded, renewed or otherwise becoming effective after January 1, 1940, unless the reinsurance shall be payable by the assuming insurer on the basis of the liability of the ceding insurer

under the contract or contracts reinsured without diminution because of the insolvency of the ceding insurer nor unless under the contract or contracts of reinsurance the liability for such reinsurance is assumed by the assuming insurer or insurers as of the same effective date. Such reinsurance agreement may provide that the liquidator, receiver or statutory successor or an insolvent ceding insurer shall give written notice of the pendency of a claim against the insolvent ceding insurer on the policy or bond reinsured within a reasonable time after such claim is filed in the insolvency proceeding and that during the pendency of such claim any assuming insurer may investigate such claim and interpose, at its own expense, in the proceeding where such a claim is to be adjudicated any defense or defenses it may deem available to the ceding company or its liquidator, receiver or statutory successor. The expense thus incurred by the assuming insurer shall be chargeable subject to court approval against the insolvent ceding insurer as part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to the ceding insurer solely as a result of the defense undertaken by assuming insurer.

Where two or more assuming insurers are involved in the same claim and a majority in interest elect to interpose defense to such claim the expense shall be apportioned in accordance with the terms of the reinsurance agreement as though such expense had been incurred by the ceding company.

APPENDIX VIII

California Insurance Code

§ 922.2. Requirements of reinsurance contract

No such deductions specified in Sections 922.1 and 922.15 shall be made or allowed unless the contract of reinsurance contains provisions in substance as follows:

The portion of any risk or obligation assumed by the reinsurer, when such portion is ascertained, shall be payable on demand of the ceding insurer at the same time as the ceding insurer shall pay its net retained portion of such risk or obligation, with reasonable provision for verification before payment, and the reinsurance shall be payable by the reinsurer, on the basis of the liability of the ceding insurer under the contract or contracts reinsured without diminution because of the insolvency of the ceding insurer. In the event of insolvency and the appointment of a conservator, liquidator or statutory successor of the ceding company, such portion shall be payable to such conservator, liquidator or statutory successor immediately upon demand, with reasonable provision for verification, on the basis of the claims allowed against the insolvent company by any court of competent jurisdiction or by any conservator, liquidator, or statutory successor of the company having authority to allow such claims, without diminution because of such insolvency or because such conservator, liquidator or statutory successor has failed to pay all or a portion of any claims. Payments by the reinsurer as above set forth shall be made directly to the ceding insurer or to its conservator, liquidator or statutory successor, except where the

contract of insurance or reinsurance specifically provides another payee of such reinsurance in the event of the insolvency of the ceding insurer. CAL. INS. CODE § 922.2 (Supp. 1964).

APPENDIX IX

Kentucky Insurance Code

§ 304.385. Reserve credit for reinsurance; insolvent ceding insurers; assuming insurers

(1) An insurer may take credit for reserves on risks ceded to a reinsurer to the extent reinsured, except that:

(b) No credit shall be allowed, as an asset or as a deduction from liability, to any ceding insurer for reinsurance unless the reinsurance is payable by the assuming insurer on the basis of the liability of the ceding insurer under the contracts reinsured without diminution because of the insolvency of the ceding insurer. KY. REV. STAT. ANN. § 304.385 (Baldwin 1963).

APPENDIX X

The somewhat formidable appearing formula below is actually quite a simple progression as is demonstrated in the example which follows. I = total amount of reinsurer's liability to ceding company where:

$$I = R \cdot S, \text{ and}$$

$$S = \frac{dC + R P_{n-1} (C - \sum P_{n-1})}{L + P_1 - \sum P_{n-1}}$$

When: S = total amount of reinsured's liability to original claimant.

R = percent of quota share agreement or percent reinsurer owes under surplus agreement.

$$d = \text{percent of liquidation dividend, or } d = \frac{a}{l + C}$$

When: a = assets to be distributed to creditors by reinsured, exclusive of monies from reinsurance.

l = liabilities of insolvent company, exclusive of reinsured claim.

C = original amount of reinsured claim.

$$L = l + C - a$$

P_{n-1} = the previous term in the progression.

P_1 = the first term in the progression, or dC .

Example:

Let us assume that reinsurance company *AA* has a 50% quota share reinsurance agreement with fire insurance company *BB* and that *BB* has just

been taken over by a court appointed liquidator because of insolvency. Also, let us assume there is one unpaid claim of \$10,000, the liability for which *BB* has already acknowledged, and which is covered by the reinsurance contract.

Also: $a = \$2,000,000$

$l = \$2,490,000$, therefore:

$$d = \frac{a}{l + C} \text{ or } \frac{\$2,000,000}{\$2,490,000 + \$10,000} = \frac{4}{5}$$

and:

$$L = l + C - a \text{ or } \$2,490,000 + \$10,000 - \$2,000,000 = \$500,000.$$

Therefore, the first amount the reinsured would owe the original claimant would be the product of the first term in our progression, $d \times C$ or \$8,000.00. Plugging this figure back into the second term of the formula we find that the second amount the ceding company must pay the original insured is:

$$\frac{R P_{n-1} (C - \Sigma P_{n-1})}{L + P_l - \Sigma P_{n-1}} \text{ or } \frac{50\% \times \$8,000 (\$10,000 - \$8,000)}{\$500,000 + \$8,000 - \$8,000} = \$16.00$$

Doing this same thing again with the \$16.00 we would see that the third and final amount for which the reinsured would be liable to the original claimant would be \$.03. Thus, adding up these three amounts, we arrive at the S in the second formula, which is the reinsured's total liability to the original insured, ($\$8,000 + 16.00 + .03 = \$8,016.03$), and multiplying this by R or 50% we have determined the reinsurer's total liability under the policy reinsured to be \$4,008.02.

In words, rather than numbers or symbols alone, what we have done is to:

- (1) discover the original liquidation dividend d ,
- (2) multiply it by the original claim to arrive at the ceding company's first payment to the original claimant dC ,
- (3) take the amount the reinsurer reimburses the reinsured for, for having paid this claim RdC and use this figure as the new assets of the reinsured in order to get the new liquidation dividend, and then arrive at the new liabilities (which figure is also necessary in order to obtain the new d) by subtracting from them what has already been paid out in the form of the first liquidation dividend or L , then
- (4) multiply this new dividend times the new claim, the latter being the original claim less the amount thus far paid to the original claimant in satisfaction of that claim, and finally
- (5) repeat the sequence until what the reinsured is paying his claimant is a fractional amount, add up all the payments and multiply by R to determine the reinsurer's proportion of the loss.

With an insolvency clause in effect the reinsurer would pay the full amount of his share of the original claim into the ceding company's treasury, thus adding \$5,000 to, for example, the \$2,000,000 from the example above. This new

figure will be distributed among the general creditors with the original claimant receiving $a + C \times C$, or

$$\frac{\$2,010,000 \times \$10,000}{\$2,500,000 \times l} = \$8,040.00.$$

Thus, in our example, the original claimant of a reinsured policy would receive only \$23.98 (\$8,040.00 - \$8,016.02) less than under the plan advocated.

APPENDIX XI

Vermont Insurance Code

§ 3561. Insolvency of ceding company; prior liens

Whenever a domestic insurance company or an insurance company authorized to do business in this state, that has reinsured any risk in this state in another company, becomes insolvent, adjudged bankrupt or is in receivership, and the liability on such reinsured risk becomes fixed and determined, the insured or obligee in such risk shall have a prior lien on the amount payable by such reinsurance company under its reinsuring contract.

§ 3562. Subrogation of rights

The insured or obligee, as the case may be, in any case where liability is fixed and determined, shall be subrogated to the rights of the ceding company and may maintain an action against the reinsuring company for his benefit in the name of the ceding company, but at the expense of such insured or obligee. VT. STAT. ANN. tit. 8, §§ 3561, 3562 (1958).