What a Receiver Should Do for Valuing Reinsurance (in the Wild World of Lloyd's Syndicates, Reinsurers, and Reinsurance Intermediaries)

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I. Obtaining the Reinsurance Records and Gaining an Understanding of Them – or – How Many Boxes and Piles of Paper Can I Go Though in an Hour and Actually Know What Is There?

Compiling the Reinsurance Records

One of the primary responsibilities of a receiver is asset recovery, and one of the largest asset categories for an insolvent insurer is the reinsurance treaties in which it participates. When walking in the door at a takeover, finding, securing, and inventorying the reinsurance records is a smart way to ensure this asset is available to pay policyholders. At one time, finding the treaties was done by physically locating the file or binder where all such documents were held, and then transferring the documents to a secure location. Today, not so much. Insurance companies are now more likely to eschew physical copies and store everything in a virtual environment, much like accounting systems that went to QuickBooks or some other software years ago. Unfortunately, computer filing systems are highly variable. Often the file you might need is in a folder on a hard drive that was used by people handling the disclosures at the time with no centralized location for the records.

Over the past many years we have worked on many receiverships in their reinsurance areas and the one thing that is often difficult to obtain are the reinsurance financial records. With prior personnel not there, the methodology as to how these records and reports were compiled and calculated is gone with them. It is therefore imperative to ascertain how the company accounted

[1] Special Thanks to Douglas R. Coonfield, Esq., Associate Attorney, Cantilo & Bennett, L.L.P. for his assistance in preparing this article.

for the treaties and documented, via their accounting records, their understanding of them and the reinsurer's acceptance of that understanding.

Some areas to focus on in your review:

1. Organize the reinsurance documents by program and by treaty type.

2. Look at how the company accounted for the treaty to ascertain their understanding of it (and the reinsurer's acceptance of that understanding).

3. Communicate with reinsurers to introduce yourselves and to confirm/verify reinsurance information.

4. Gain an understanding of all the required accounting and reporting provisions of the treaties. Learn how it has been accounted for in the past and determine if this is the correct methodology by reading the reinsurance contracts and preparing synopses of each that identify the formulas needed to calculate premium due, ceding, and contingent commissions, and the periodic adjustments to premium and commissions.

5. On excess of ross ("XOL") agreements, determine whether there are deposit premium adjustment requirements, and ascertain prior and future adjustments made and how they were compiled.

6. Ascertain the reinsurance intermediaries used and obtain their broker of record letter.

7. Contact those reinsurance intermediaries and request records and data for all transactions under the treaty.

8. Analyze the possible offsets to claim payments under the treaty by making the calculations pursuant to the formulas to determine if there is unpaid premium, and the premium and commission adjustments due or owed, as well as unpaid ceded claims.

9. If the reinsurance treaty was distributed among multiple subscribers, identify and track the percentage participation and the individual balances paid by each subscriber to apportion the offset calculation.

II. The Value of the Reinsurance Intermediary and Reinsurers to the Receiver – Obtaining Reinsurance Records and Balances Due

Coming in from The Cold: Working with the Intermediary to Obtain, Understand, and Process the Reinsurance Records and Collect the Balances Due

When taking over a company in rehabilitation/liquidation, you may find that prior management may have thought that the reinsurance contracts "ran themselves," and that the accounting and claims just magically appeared on the reinsurer's desk; and if a reinsurance intermediary is involved, that the intermediary is taking care of everything (*e.g.*, deposit premium adjustments and contingent commission calculations during the term of the treaty, after their expiration, and even after the company's "ending.") Needless to say, this is wishful thinking! **(Note: Possibly refer/footnote/endnote the Reinsurance Intermediary Model Act and the various state adaptations of this act into law for further information of responsibilities of a Reinsurance Intermediary.)**

Reinsurance recoverables are usually the insolvent company's largest asset, and the liquidator should develop a genuine understanding of this area and monitor it closely. It was the company's responsibility to monitor their reinsurance program, and retaining employees after takeover to gain some understanding of the reinsurance records is important. Simply identifying where the records are located is valuable; an understanding of how the records were maintained and the treaties implemented can make the evaluation much easier. When working with the former staff is unproductive or impossible, the receiver should utilize the many resources that the intermediary has to offer. Work with the reinsurance intermediary and reinsurers to gain this understanding.

In 2021, when a receiver is taking control of an insolvent insurer, the reinsurance documents have to be identified, backed up, and printed out so that they can be successfully evaluated. The ease of storing items electronically seems to encourage lax filing methods and naming conventions, so you end up randomly opening documents in the hope of finding what you seek. Creating and pushing a model computer filing structure and naming convention would be

an idea worth pursuing. Nevertheless, the first task is to get a complete set of your reinsurance records. Often the company's records are in poor shape, and contacting the intermediary or reinsurers is essential. The intermediary should have valuable information that it is obligated to provide such as the following:

- copies of the reinsurance agreements,
- the accounting records and related correspondence,
- outstanding balances,
- premium payments,
- deposit premium adjustments,
- ceding and contingent commissions, and
- claim payments.

This is basic information for basic accounting transactions with the amounts paid or received, and the accounts debited or credited for each such transaction. Importantly, if there is a lack of knowledgeable or cooperative company personnel, the reinsurance intermediary can provide one with support for how the treaties work, and how the financial requirements are handled and reported. This is an invaluable service to a receiver trying to obtain an understanding of their reinsurance documents.

When you contact the insurance intermediary, you likely have an expectation of cooperation based on the intermediary contract and legal authority derived from implementation of the model reinsurance intermediary act in the relevant state. Without getting into which state laws control the obligations under the contract for your multistate insurance receivership, when dealing with an intermediary, instead of the experienced staff that originally handled the treaty, you may instead find your calls are not being answered and you start receiving e-mails from a

location in another country that has not previously had any involvement in the reinsurance operations.

Many who work with insurance receiverships believe that a type of "Bastard Child" syndrome—the belief that your defunct company is not a priority—is prevalent among intermediaries and reinsurers. Although this belief is largely exaggerated, it is not uncommon to find that the intermediary is slow to respond or non-responsive to your request for critical information. After all, your insolvent company is unlikely to be considered a top priority for the intermediary since it no longer produces revenue for them. Further, trying to get detailed records out of the foreign office of the intermediary handling the "run-off" treaties can be difficult, whether it is due to a language barrier, their lack of familiarity with your treaty, the intermediary's lack of internal communication, or incompatible computer systems.

Open and direct communication with the intermediaries is certainly ideal, and the more information you can glean internally from your own reinsurance records helps facilitate getting information from the intermediary. If the intermediary is in fact not being helpful, you still have options for obtaining records from an unresponsive intermediary.

III. Options to Obtain Your Reinsurance Records

If you lack critical information from your company's internal records, you have options for obtaining records from an unresponsive intermediary. The alternatives vary based on just how litigious the receiver is comfortable being. Since the receiver is given title to all property of the insurer, the intermediary's records, and specifically the information in the records, are property of the estate.[2] Accordingly, a turnover demand is one of the first options to escalate the seriousness of the demand for information to attempt to get the attention of the intermediary. Under typical

[2] *See e.g.*, Insurance Receiver's Model Act § 118(A); Tex. Ins. Code Ann. § 443.101(a).

state turnover statutes, the recipient has 20 days to contest with the judge or magistrate overseeing the estate the right of the receiver to the information.[3] If no objection if filed, they waive the right to assert the objection and must comply with the request or be subject to sanctions by the receivership court. *Id*. Alternatively, the receiver could use his subpoena power[4] to formally request the records, or he can make a demand under the audit clause of the intermediary agreement and pursue any failure to comply as a breach of contract.[5] Making a turnover demand on the grounds that the information is property of the estate has the advantage of escalating the request the least, and provides a clear waiver of any objections to producing the information if not responded to in a timely manner.

Though the receivership may have lost the interest of the reinsurance intermediary since it is unlikely to generate future business or income, the treaty subscriber(s) are still involved, and the intermediary can ill afford to alienate it/them in resolving any discrepancies or non-payment issues. Contacting the subscriber/reinsurer, or its management firm, is useful to determine the reason for non-payment, and to enlist its support in resolving the issue. Candidly, this can quickly degenerate into a contested issue, but not necessarily initially and not with respect to making sure everyone agrees on the basic accounting for the treaty. If you can determine where the subscriber/reinsurer believes things stand, it might be possible to back into a resolution. Obtaining assistance in demanding the information from the intermediary still goes a long way to get knowledgeable and capable personnel looking at the books and records.

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[3] *See e.g.*, Insurance Receiver's Model Act § 601(A); Tex. Ins. Code Ann. § 443.201(a).

[4] *See e.g.*, Insurance Receiver's Model Act § 504(A)(1); Tex. Ins. Code Ann. § 443.154(d).

[5] Most reinsurance intermediary contracts track the Reinsurance Intermediary Model Act and include a provision such as Section 5(b) which states that "The insurer will have access and the right to copy and audit all accounts and records maintained by the Reinsurance intermediary-broker related to its business in a form usable by the insurer."

IV. When the SDR Gets the Records, What to do With Them: Getting to Sort out the Balances and Offsets

Confirm and Build Detailed Records of the Reinsurance Transactions and Determine What is Owed on Each Treaty and By Whom

Having obtained a reasonable set of books defining payments under the various reinsurance treaties you might have, and detailed the reinsurance claims ceded and the payments made on the claims on the treaties, the next step is to determine the value of those treaties. It is quite common to come into a receivership and find that the premiums on the treaties have not been paid for multiple quarters. Moreover, once notice of the receivership is provided to the reinsurers, many will stop all claim payments whether legally entitled to or not. This provides a unique opportunity to evaluate the value of each contract with respect to each subscriber/reinsurer to the contract. As you know, a debt to the reinsurer is a lower priority claim than the amounts due from a reinsurer.

When looking at a treaty that has, for example, been reinsured with a number of Lloyd's syndicates, the subscriber/reinsurer agreement will typically contain a clause that reads something like:

> "The share of the subscribing reinsurer in the interests and liabilities of the 'Reinsurer' shall be several and not joint with the share of any other subscribing reinsurer. In no event shall the subscribing reinsurer participate in the interests and liabilities of the other subscribing reinsurers."

This provision provides that the share, whether 10% or 50%, is entirely independent from the remainder of the contract. Effectively then, if the estate owes premium of $1,000,000, then if the subscribing reinsurer, let's call it Syndicate 1 for purposes of this example, has 10% of the 2018 XOL treaty, then the estate only owes premium of $100,000 to Syndicate 1.

To further complicate the calculation to determine what each subscriber owes the estate, you will typically find an offset clause that reads something like:

> "The Company and the Reinsurer shall have the right to offset any balance, whether on account of premium, commission, claims or losses, loss adjustment expense, salvage, or any other amount due from one party to the other under this Contract or any other contract heretofore or hereafter entered into between the Reinsurer and the Company when acting in the same capacity."

In other words, if there are multiple subscribers/reinsurers to a reinsurance treaty, the amount any one subscriber may owe the estate or be due has to be considered based on its percentage share of the net due or owed for that year offset with the amount due or owed for other treaty years at its participation percentage for that year. It is important to read each offset clause since the phrase "or any other contract heretofore or hereafter entered into" is sometime omitted and it could restrict the scope of appropriate offsets. Of course, the receivership statute itself allows setoffs fairly broadly and also needs to be considered.[6]

To make a simple example, let's start with the $100,000 owed to Syndicate 1 described above. Now also assume that Syndicate 1 participated in the XOL treaty in 2017 at 20%, and all premiums were paid for that year. However, in 2017, a deposit premium adjustment of $1,500,000 is due to the receivership estate since losses were low that year. Syndicate 1 refused to pay claims that were due after the start of the receivership and owes the receivership an additional $20,000 for 2017 (20% of $100,000 in ceded losses), and $40,000 for 2018 (10% of $400,000 in ceded losses).

Under this scenario, Syndicate 1 has the right to setoff multiple years and owes the estate a total of $260,000, its share of the 2017 premium adjustment plus the claims and less the 2018 unpaid premium. Good news for the receivership!

Now let's look at Syndicate 2 which had 50% of the 2018 contract, and only 5% of the 2017 treaty. For Syndicate 2, this situation looks completely different. It is owed $500,000 in

[6] *See e.g.*, Insurance Receiver's Model Act § 609(A); Tex. Ins. Code Ann. § 443.209(a).

premium for 2018 but is only liable for $75,000 of the premium adjustment, $5,000 for 2017 claims, and $200,000 for 2018 claims. Accordingly, the estate owes Syndicate 2 $220,000.

Fortunately for the receiver, the obligation of Syndicate 1 is presently due under the insolvency clause of the treaty, while the claim of syndicate 2 has a much lower priority that might never be reached. Instead of collecting a total net offset of $40,000, the receiver should pursue collection of the entire $260,000 from Syndicate 1, and based on the subscriber's clause, treat the $220,000 owed to Syndicate 2 as a separate and distinct claim.

Other adjustments outside this basic example will, of course, complicate the process. One such adjustment is for deposit premium under an XOL treaty. The deposit premium adjustment under an XOL treaty frequently incorporates the actual loss history in the calculation such that the adjustment is made by determining the minimum premium percentage plus 100%, or more, of the ceded losses up to a maximum premium that is a higher percentage. Without knowing the ultimate loss history, the actual amount of premium due under the XOL treaty will continue to vary. The ultimate XOL premium then feeds back into the subject premium calculation under your quota share treaty since the XOL treaty is "other" insurance that inures to the benefit of the quota share. Effectively, the adjustments do not end until all claims have been paid.

V. Conclusion

As noted above, obtaining, organizing, and understanding reinsurance information is essential in managing a receivership. Reinsurers and reinsurance intermediaries play a key role in providing the receiver with this vital information. At times it may be difficult to obtain the information, but when received, it should be organized, and the treaty components understood and documented. This will allow for the receiver to more efficiently value and manage the Reinsurance.

The goal of determining what is owed or due for each treaty is to allow the receiver to assess the value of that treaty and try and commute these agreements.

After obtaining the records and calculating the amounts presently due or owed, the value for the contract may be estimated by reviewing the reserves for all timely-filed claims after the filing deadline, incorporating guaranty association payouts and reserve estimates, as well as in-house reserve estimates for claims that exceed the state insurance guaranty association payment cap. Potential XOL claims based on reserves set over the guaranty association claim limit will have to be evaluated independently of the guaranty association to arrive at a strong estimate of the total claims you expect under the treaty. If the amount, plus the previously ceded losses and the adjustment percentage do not approach the maximum premium under the treaty, then it is likely safe to assume that level will not be reached, and individual treaty values can be calculated. Basically, the amount due for the commutation of the XOL treaties is the amount of the deposit premium actually paid, less the premium percentage agreed to in the adjustment clause applied to the subject premium, plus the incurred losses that have been paid by the subscribing reinsurer. With respect to any quota share treaties, the reserve estimates should give you a good idea if the claims that will be ceded will be sufficient to ever exceed the amount of premium that is still owed on the agreement.

Taking the time to analyze each subscribing reinsurer's obligation and the participation percentages over time can be complicated. You will be mixing multiple treaty years, treaty types, and other obligations not discussed in this simplified example. Nevertheless, the ability to relegate amounts owed to a particular subscribing reinsurer to a lower priority class is worth it and can yield significant beneficial results that can insure a smooth liquidation.