

Eye on the Experts

MY INSURANCE COMPANY IS BANKRUPT, BUT IS REINSURED. CAN I MAKE A CLAIM DIRECTLY AGAINST THE REINSURER?

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Insurance companies, like other businesses, can struggle financially—sometimes so severely that they become insolvent. A state-appointed receiver will oversee distribution of the insolvent insurer's assets. For example, Real Legacy Assurance Company in Puerto Rico suffered large losses related to claims from hurricanes Irma and Maria. As a result, Real Legacy became insolvent and entered liquidation proceedings. According to reports, Puerto Rico's Insurance Commissioner has fined various insurers for delays in handling claims, which suggests that other insurance companies operating in Puerto Rico may be struggling to handle the large number of claims resulting from the storms. Generally, policyholders' claims have first priority in insolvency proceedings. Priority is the order in which claims are satisfied from the assets of the defunct entity. Even though claims by policyholders enjoy a high level of priority, full payment of claims is often unlikely. Thus, other sources of recovery can prove valuable.

Reinsurance

One such source is reinsurance. Insurance companies frequently buy insurance for themselves. That insurance for insurance companies is called reinsurance. The companies that issue reinsurance are called reinsurers. Policyholders may be able to collect insurance proceeds directly from reinsurers if their insurer is insolvent.

The general rule is that a policyholder cannot make a claim directly against the reinsurer because there is no contractual relationship between the policyholder and the reinsurer. Instead, the policyholder makes a claim against the insurance company and, if necessary, the insurance company can make a claim against the reinsurer. However, there is an important exception to the rule.

"Cut-Through" Provisions

The exception is implicated when the reinsurance contract contains a "cut-through" provision.[1] Basically, cut-through provisions allow policyholders to pursue reinsurers directly for insurance proceeds. In relevant part, here is an example of "cut-through" language:

In the event of the insolvency of the Reassured, this reinsurance shall be payable directly (except where the policy of insurance or this contract specifically provides another payee of such reinsurance in the event of the insolvency of the Reassured) to the Reassured, or to its liquidator, receiver, conservator or statutory successor on the basis of the liability of the Reassured without diminution because of the insolvency of the Reassured or because the liquidator, receiver, conservator or statutory successor of the Reassured, has failed to pay all or a portion of any claim.

As one can see, only the occurrence of specified events such as the insolvency of the insurance company generally triggers cut-through clauses.

The policyholder's ability to enforce cut-through clauses is an important issue. Indeed, jurisdictions in the United States have statutes regarding cut-through clauses in reinsurance contracts. For instance, Florida Statutes provides in pertinent part:

All reinsurance proceeds payable under a contract of reinsurance to which the insolvent insurer is a party are to be paid directly to the domiciliary receiver as general assets of the receivership estate unless the reinsurance contract contains a clause which specifically names the insolvent insurer's insured as a direct beneficiary of the reinsurance contract.[2]

Thus, based on the plain language of the statute, if the reinsurance contract specifically names the policyholder as a beneficiary, then the policyholder has a right to be paid insurance proceeds directly from the reinsurer. Section 413 of the Insurance Code of Puerto Rico is somewhat similar to Florida's statute providing for a direct action by the policyholder against the reinsurer. That section recognizes that a reinsurance contract can provide for a policyholder to have a direct right of action against the reinsurer. It provides in relevant part:

The original insured or policyholder or any person other than the ceding insurer, who enters a claim by virtue of any insured or policyholder's insurance, shall not have any direct right of action against the reinsurer which is not specifically set forth in the reinsurance contract, or in a specific agreement between the reinsurer and such original insured or policyholder.[3]

Florida and Puerto Rico are not alone. Other states have similar laws, including but not limited to Illinois, Wisconsin, New York, California, and Arizona. The central issue is how courts interpret cut-through clauses in light of these statutes.

How are Cut-Through Clauses Interpreted?

For instance, the Supreme Court of Puerto Rico has implicitly acknowledged that cut-through clauses are an exception to the general rule that policyholders do not have a direct cause of action against the reinsurer.[4] In *Garantia*, a group of insureds tried to recover insurance proceeds directly from the reinsurer of their insolvent insurance company. They relied on cut-through clauses that gave them the right to make a claim directly against the reinsurer in "the event that [the insurance company] fails to pay, within the time provided in the above identified policy." [5] The court held that the cut-through clauses "did not alter the relationship between" the policyholder, the insurer, and the reinsurer "as to exclude the proceeds of the reinsurance contracts from the assets subject to distribution in the insurer's liquidation process." [6] Nevertheless, because the cut-through clauses did not include insolvency as a triggering event (as the one excerpted above), the decision did not rule expressly on the rights of policyholders when such a clause is contained in the reinsurance contract.

Other courts have enforced cut-through clauses, allowing policyholders to pursue reinsurers directly in the case of insolvency of the policyholder's insurer. For example, in *Trenwick Am. Reinsurance Corp. v. CX Reinsurance Co.*, [7] CX Reinsurance ("CX Re") initiated arbitration proceedings to collect proceeds directly from the reinsurer after the insurance company became insolvent. The reinsurer moved to enjoin the arbitration permanently. CX Re argued that it had a direct claim against the reinsurer under the cut-through provision in the reinsurance contract. The provision provided that the reinsurer's obligations were subject to "all terms, conditions, retentions and limits of liability" of the reinsurance contract. [8] The contract contained a mandatory arbitration clause to resolve disputes. CX Re argued that the cut-through provision allowed it to make a claim directly against the reinsurer in arbitration. It, therefore, asked the court to compel the arbitration of its claim pursuant to the cut-through clause. The court agreed that CX Re was entitled to assert its claim directly against the reinsurer under the cut-through and arbitration clauses. Accordingly, the court allowed CX Re's claim against the reinsurer to proceed.

Similarly, the Office of the General Counsel for the Department of Financial Services of New York (the "Office") issued an informal opinion addressing the effectiveness of cut-through clauses in the event of the insolvency of a policyholder's insurance company. [9] The informal opinion involves a hypothetical situation where an insurance company's credit rating is downgraded. In response, the insurance company decides to purchase reinsurance for some of the risk it has underwritten. The insurance company purposely includes a cut-through provision in its reinsurance contracts. The company's intent is for its insureds to be able to collect insurance proceeds directly from the reinsurer—especially in the event that it becomes insolvent.

In its informal opinion, the Office explained that an insurance company generally could purchase reinsurance to cover its risks and policy liabilities. As discussed above, however, the issue is that there is no privity of contract between the reinsurer and the policyholder when an insurance company purchases reinsurance. Consequently, if the insurance company becomes insolvent, the reinsurer is required to pay proceeds for any loss to the insurance company directly or the receiver appointed by the bankruptcy court as opposed to the policyholder.

Nevertheless, the Office explained that the insurance company could preserve the right of the policyholder to collect from the reinsurer directly by including a cut-through clause in the reinsurance contract. The Office noted, however, that while a cut-through clause protects the insured if the insurance company becomes insolvent, whether the policyholder is able to collect from the reinsurer during insolvency proceedings depends on the applicable rules governing voidable transfers. Accordingly, even if the reinsurance contract contains a cut-through clause because for instance, the insurance company included the cut-through clause in the reinsurance contract in anticipation of insolvency with the intent that a policyholder has priority over other creditors or policyholders to the insurance proceeds, then the bankruptcy court might find the cut-through clause invalid as a voidable transfer.

Other decisions have required that the clauses specifically identify the party entitled to the direct claim. For instance, in *Jurupa Valley Spectrum, LLC v. National Indem. Co.*, [10] the court explained that New York law recognizes the "cut-through" exception, but the provision must sufficiently specify to whom the reinsurer should make the direct payments. Indeed, in *Jurupa*, the beneficiary under bonds argued that it could bring a direct claim against the reinsurer based on the following cut-through clause:

[T]he parties to this Reinsurance intend that Reinsurer, through the Claims Administrator, shall pay all amounts ... due Insureds and other persons as and when due directly on behalf of the Reinsured.[11]

The court rejected the beneficiary's argument that the cut-through clause was enforceable. It explained that while the clause provides that the reinsurer pay all amounts due to the insured, it did not sufficiently specify to whom the reinsurer should make the payments. Similarly, in *In re The Bennett Funding Grp., Inc.*,^[12] investors could not maintain a direct action against the reinsurer because they were not insured parties under the reinsurance contract and there was evidence that the parties actually negotiated and ultimately rejected the inclusion of a cut-through provision.

Summary

To summarize, cut-through clauses in reinsurance contracts are generally enforceable. They are an important tool that policyholders can use to recover insurance proceeds even if their insurance company is insolvent. Policyholders must carefully evaluate the enforceability of these provisions if they are considering a direct action against the reinsurer. Significantly, whether policyholders can sustain a direct action against a reinsurer can turn on whether the cut-through clause identifies the policyholder, with sufficient specificity, as the party entitled to insurance proceeds directly from the reinsurer. Complications can arise when there are competing claims for reinsurance proceeds. For instance, the receiver, in the insolvency proceeding, may also claim to have a right to collect proceeds directly from the reinsurer. Accordingly, policyholders that believe they are entitled to insurance proceeds from a reinsurer must act swiftly to determine not only the likelihood that their claim is enforceable, but also whether there are any other potentially competing claims that might reduce or eliminate the ability to collect from the reinsurer.

Notes

- [1] Besides the cut-through provision, there are other grounds under which policyholders can pursue a direct action against the reinsurer, such as a theory of third-party beneficiary. These other grounds are beyond the scope of this article.
- [2] Fla. Stat. § 631.205.
- [3] 26 L.P.R.A. § 413.
- [4] *Asoc. de Garantia v. Cmmw. Ins. Co.*, WL No. 204211 (P.R. Apr. 13, 1983).
- [5] *Id.* at 217.
- [6] *Id.* at 220.
- [7] 2014 U.S. Dist. LEXIS 70823 (D. Conn. May 23, 2014).
- [8] *Id.* at *5.
- [9] *Cut-Through Endorsements and Insolvency*, NY Dept. of Financial Servs., <https://www.dfs.ny.gov/insurance/ogco2000/rg006141.htm> (last visited June 13, 2019).
- [10] 555 F.3d 87 (2d Cir. 2009).
- [11] *Id.*
- [12] 60 F. App'x 863, 864 (2d Cir. 2003).

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