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# *Reinsurance: The Silent Regulator?*

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# Reinsurance: The Silent Regulator?

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Abstract

*This Essay suggests that a discussion on the regulation of insurance should include considerations of the effect reinsurance may have on the behavior of insurers. The traditional types of reinsurance are reviewed and the ability of private reinsurance contracts to effect insurer actions is considered. Both as a matter of a source of independent and often unexamined contractual influence on insurer activity and as a potential source of interference with regulatory proposals, reinsurance realities have the capacity to misdirect insurance regulatory assumptions if not included in a holistic examination of the field. Though reinsurance is effectuated by private contract, those contracts have the potential for regulatory effect sufficient enough to suggest a positive answer to the question of whether reinsurance may correctly be termed a "silent regulator".*

"The first principle of regulation is: Lawyers and politicians write rules; and markets develop ways to circumvent these rules without violating them."[2]

## I. Introduction

Reinsurance, its nature and availability, is not among those things commonly discussed when evaluating the effectiveness of insurance regulation in general. Yet, as "the insurance of insurance companies"[3], reinsurance should not be so quickly relegated to irrelevancy in the regulatory discussion.[4] Just as insurance is often construed as

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[2] Allan H. Meltzer, Regulatory Overkill, Wall Street Journal at A14, March 27, 2008.

[3] *See* Continental Casualty Co. v. Stronghold Ins. Co., 77 F.3d 16, 20 (2d Cir. 1996).

[4] *See* Gary Marchitello, Ignore Reinsurance at Your Peril, Risk Management Magazine 46 (December 2007) ("Discounting the importance of the vital role of reinsurance in risk spreading and how the pricing, stability and capacity of reinsurance can influence the viability of one's own direct insurance purchases can be a critical and potentially costly mismanagement.").

having a regulatory effect on insured industries, so too should reinsurance be considered as regards its regulatory effect on its reinsureds.

Much insurance regulatory policy is concerned with capital reserves and issues of liquidity. As a primary use of reinsurance is to expand an insurance companies' liquidity, thereby making reinsurance an attractive option for many primary insurers, an examination of reinsurance is certainly useful. [5] Likewise, the reinsurance relationship implicates issues of insurance availability, organic standards for underwriting and claims handling, as well as premium calculations.[6] It is through the medium of reinsurance that insurance companies may contract to gain a certain amount of foreseeable stability in their losses and is frequently used as a "stop gap" in the event of catastrophic losses. More generally, however, reinsurance, as a contract of indemnity with conditions for performance, has all the potential of regular insurance to influence the activity of reinsureds.

That the medium of reinsurance is of grave consequence to insurance loss handling is well understood. Yet there has been little discussion of the way reinsurance interacts with other de jure and de facto efforts of insurance regulation. Importantly, the utmost good faith obligation in reinsurance contract performance is the primary way by which this relationship itself is regulated. As such, reinsurance standards of performance, the potential effect on coverage availability and a derivative effect on the cost and availability of various insurance lines are all implicated by these relationships. Yet,

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[5] Among issues to be addressed is how the existence of reinsurance requires the inclusion of the reinsuring company's stability in the calculus of insurer stability. To a great effect, reinsurance leverages insurance industry assets, for this reason alone its nature should be examined in the regulatory context.

[6] Id. ("Reinsurance plays a fundamental role in providing the capital many insurers need to back their contractual obligations and is often the most important source of liquidity to many insurers, particularly after a catastrophe.").

reinsurance, beyond the risk of reinsurance defaults or insolvencies is not generally discussed beyond a few sentences in most regulatory discussions. Nor is the regulatory capacity of reinsurance announced through statutory constructs. Rather, reinsurance's regulatory effect is accomplished through simple contractual relations, reliance on commercial standards in the performance of those contracts and, importantly, the courts' use of the concept of utmost good faith in the apportionment of contractual duties. In recognition of these effects, this Essay seeks to answer whether reinsurance relationships can appropriately be considered a silent regulator of insurance industry.

## II. Reinsurance: What Is It and Why Have It?

At its most reductive, reinsurance is a relatively straightforward financial transaction by which an insurance company is indemnified for all or a portion of some risk by another insurer. This risk transfer, just as with common consumer or commercial insurance policies is effectuated by contract, with the reinsurance agreement subject to ordinary contract rules and doctrine.[7] Though there exist practices of reinsurance contract interpretation distinct from those used in the interpretation of common insurance policies, at this juncture it is sufficient to recognize that reinsurance is a creature of contract.[8]

### 1. What is Reinsurance?

One of the barriers of entrance to understanding reinsurance is that the term is sometimes used over broadly and applied to relationships other than those which are best

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[7] *See* Graydon S. Staring, The Law of Reinsurance, sec. 1:1.

[8] *See* Couch on Insurance 3d 2007, 9:7 ("although some rules of construction do not apply to contracts I the reinsurance context, the general rules of contract do apply to reinsurance contracts").

understood as within the commonly accepted descriptive definition of reinsurance.[9] For example, reinsurance is best understood as distinct from co-insurance, the better term for the relationship created when separate insurers, either severally or jointly assume direct shares of a given risk. In such cases where all the insurers have a direct relationship with the insured, the relationship is not within the traditional understanding of reinsurance.[10] Likewise, reinsurance should be distinguished from banking even though it may assist in the financing of the reinsured and allow for amortization of insurance losses.[11] Nor is reinsurance a security, since the risk assumed are generally fortuities distinct from the ordinary risks of business and finance.[12]

As a descriptive matter, reinsurance is inherently a contract of insurance, albeit a secondary one. Reinsurance is commonly defined as a contract "by which an insurer procures a third person to insure him against loss or liability by reason of such original insurance."[13] More generally, reinsurance can be seen to include all contractual arrangements where one insurance company transfers to another all or some portion of

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[10] *See* Graydon S. Staring, The Law of Reinsurance at 1:5.

[11] Id. at 1:5.

[12] Id. at 1:5.

[13] Id. at 1:1. Reinsurance discussions, however, commonly and appropriately also extend to cover discussions of contracts which are entered to reinsure in the future. In such circumstances, a contract *to be* reinsured is made between the parties to provide reinsurance on unidentified underlying policies yet to be written.[13] Though these agreements might not actually reinsure specific risks or liabilities, their ubiquity in the industry appropriately places them within any reinsurance discussion.

This definition allows for the inclusion of both an existing policy or contract of reinsurance and assumes that the requirements of contract are met. Starrig at 1:1. A "reinsurance policy" can therefore simply be understood as a "contract for indemnity one insurer makes with another to protect the insurer from risks already assumed." Id. at 1:1. Likewise a treaty looking forward to reinsure would constitute reinsurance, though such agreement my be better understood s a contract for reinsurance, rather that a contract of reinsurance. Id. In either case, reinsurance policies, reinsurance treaties on specific classes of risk and reinsurance treaties entered into for future acquired risk would all come within the heading of reinsurance. *See* Ostrager & Newman, Handbook on Insurance Coverage Disputes, 12th edition at 15:01.

the risk it underwrites to another insurer.[14] Thus the common refrain that reinsurance is insurance for insurance companies.[15]

Perhaps the most difficult aspect of the study of reinsurance lies in the particularly opaque and obscure language endemic to the industry. Some discussion of terms is necessary. As reinsurance involves a minimum of two insurance companies, different terms have developed to identify the various parties. The original insurer who acquired the risk or liability is referred to by a variety of designations including that of direct or initial insurer and sometimes, though less commonly, as the primitive insurer. However designated, once it has entered into an agreement with a new insurer for the purpose of reinsurance, the original insurer is thereafter most commonly referred to as the reinsured. Though that seems clear enough, the original insurer is frequently referred to by another more exotic definition, that of cedent. This designation arises from the idea that the function of reinsurance is for the original insurer to "cede" a certain amount of its business to the reinsurer, hence the term cedent. Likewise, a reinsurer may itself seek

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[14] *See* Colonial America Life Ins. Co. v. Commissioner, 491 U.S. 244 (1989); Ostrager & Newman, Handbook on Insurance Coverage Disputes, 12th edition at 15:01.

[15] *See* Cont'l Cas v. Stronghold Ins. Co., 77 F.3d 16, 17 ,20 (2d Cir 1995). In that case, the Second Circuit offered an additional colorful and intuitive explanation of reinsurance adopted in a New York Court of Appeals decision of the late 1930's. *See* Cont'l Cas v. Stronghold Ins. Co., 77 F.3d 16, 17 (2d Cir 1995) quoting People Ex. Rel. Sea Ins. Co. v. Graves, 274 N.Y. 312, 15 (1937) (The concept of reinsurance "dates back to the time the first bookie, fearful that he could not cover all his bets in the event he were to lose, decided to spread his risk 'laying-off' the risk by getting other bookies to share his exposure.). Though colorful, that assessment is not entirely accurate. The earliest recordings of the use of reinsurance likely predated the iteration of the modern bookie and has bee historically identified as predating the 17th century. *See* Graydon S. Staring, The Law of Reinsurance at 1:4 ("The earliest recorded instance is said to have been a policy written on a voyage from Genoa to Sluys ad reinsured for the more hazardous portion, from Cardiz to Sluys, the insurer retaining the Mediterranean portion of the risk."). The New York courts were not altogether mistaken as England likely recognized the relationship between insurance and speculation in the 18th Century and prohibited marine reinsurance by the Marine Act of 1745. Addressing that Parliamentary Act, Lord Mansfield did note that "The statute doubtless was intended to prevent gambling. I suppose that the mischief was that policies were underwritten at one premium and reassurance affected at another." In Re Norwich Equitable Fire Assurance Soc'y 57 LT Rep. 241, 243 (1887).

reinsurance, called retrocessions, in the same forms and for the same purposes as any other insurers.[16] Hence, the reinsurer of a reinsurer is often called a retrocessionaire.[17]

To constitute reinsurance the risk indemnified against is the risk that the insurer will have to pay on the underlying insured risk.[18] Reinsurance is an aspect of insurance and is regulated as such. By entering into a contract to reinsure, the reinsurer has agreed to indemnify the ceding insurer for any liability incurred by the insurer that is covered by the reinsurance agreement.[19] Importantly for our later discussions, the liabilities covered under a reinsuring agreement frequently extend beyond the cost of losses accrued by the cedent insurer's policyholder under the original policy. Examples of other indemnified liabilities often include such things as the cost of bringing a declaratory judgment against their policyholder and other "expenses" inherent to the cedent insuring company's coverage defense.

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[16] The retrocessional agreement, like any other reinsurance agreement, is a contract and will be effective according to its terms. These terms need not mirror the specific risks of the reinsurance agreement which it is reinsuring. As can quickly be deduced, with the expansion of the insuring scenario from one to three or more separate agreements, all of which may cover different risks and have different exclusions, the resolution of indemnity responsibility can easily become complex. *See* Couch on Insurance 9:3.

[17] The preponderance of French terminology likely arises from the early statutory action by the French Courts in the reinsurance business. For instance, notice of the 1681 Ordonnance de la Marine of Louis XIV provided that:

> The insurers may reinsure with others the effects they may have insured, and the insured may likewise cause to be insured the premium of insurance, and the solvency of the insurers.

Graydon S. Staring, The Law of Reinsurance at 1:4 (providing translation of Article XX, Title Sixth of the 1681 Ordonnance).

[18] Risk is transferred by a variety of financial transactions, not all, or even most of which, constitute insurance. Though insurance itself remains a somewhat elusive definitional concept, the indemnity function, particularly when combined with some aspect of fortuity is often seen as core insurance principles. For an excellent discussion of the nature of various financial intermediaries and on the overlap in definitions for regulatory purpose *See* generally Howell E. Jackson, Regulation in a Multisectored Financial Services Industry: An Exploratory Essay, 77 Wash U. L. Q. 319 (1999)

[19] O&N at 15.01. *See* Travelers Idem. Co. v. Scor Reins. Co., 62 F.3d 74, 76 (2d Cir. 1995). Reinsurance is a contract for indemnity not one of liability. *See* Transcontiental Underwriters Agecy v. American Agency Underwriters, 680 F.2d 298, 299 n.2 (3d Cir. 1982).

The reinsurance industry also has traditions and structures unfamiliar to the regular cognesti of students of insurance, some of which are important to determining the regulatory effect of reinsurance on insurers. For instance, operative standards of interpretation and the financial interests of the parties are treated in a somewhat different manner from the way these subjects are addressed and expressed in primary insurance policies. Primarily, these different legal standards are generally ground in the recognition of the greater sophistication of the parties involved and the somewhat more complex purposes of reinsurance, those beyond issues of simple indemnity.

2. A Brief Taxonomy of Reinsurance

Since reinsurance is a contractual arrangement, the nature, complexity and terms of many contracts are not subject to standardization in the manner common among primary insurance policies. In fact, the remarkable flexibility of reinsurance, its capacity to take on a large variety of risk types and risk levels, incline the policies to vary in their purposes and specifics. The scope of the indemnity offered by the reinsurer will be entirely dependant on the term of the reinsurance contract and the terms of the policies reinsured.[20] Such contracts reflect the business needs of sophisticated commercial entities and, as such, the terms, conditions and costs of a reinsurance contract are all negotiable.[21] However, likely as a result of historical development, these policies general fall into a few recognized categories of reinsurance.

A. Facultative Reinsurance

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[20] *See* Hartford Fire Ins. Co. v. California, 509 U.S. 764, 806-07 (1993).

[21] *See* RAA (Reinsurance Association of America) Fundamentals of Property Casualty Reinsurance available at http://www.reinsurance.org.

The most discrete form of reinsurance, and likely the original form of reinsuring generally, is known as facultative reinsurance.[22] These are contracts which usually cover individual underlying policies and are written on a policy specific basis, though facultative "treaty" or book of business policies are not uncommon.[23] Facultative reinsurance policies are so named because these contracts allow for the reinsurance company to use its "faculties" or reason to choose to reinsure a specific risk, specific policy or specific group of policies. The ceding insurer and reinsurer agree to the terms and conditions of each individual contract. In these contracts, the reinsurer often does its own underwriting to determine the appropriate premium level. This is the method by which the unusual is frequently reinsured and where the reinsurer has the greatest specific effect on the cost of covering unusual or rarely insured risks. Likewise, with its ability to allow reinsurers to engage in significant underwriting opportunities, facultative reinsurance is often used to cover catastrophic or other low incidence- high loss risks. Individual risk facultative reinsurance may be used in tandem with the second varietal of reinsuring agreements, the treaty.

B. Treaty Reinsurance

Treaties are broad agreements that reinsure multiple contracts, often even contracts that have yet to be written by the direct insurer. Usually, treaties cover some portion or class of business of the direct insurer and historically may cover a long period of time, usually renewable on a fairly automatic basis unless one of the parties seeks a

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[22] Graydon S. Staring, The Law of Reinsurance at 1:4.

[23] *See* Unigard Sec. Is. Co. v. North River Is. Co., 4 F.3d 1049, 1054 (2d Cir. 1993). Even with facultative insurance there are automatic or semi-automatic forms that allow reinsurers to cancel all or parts of the risks assumed. *See* Compaignie de Reassurace d'ile de Farce v. New England Reinsurance Corp., 57 F.3d 56, 64-65 and 74-76 (1st Cir. 19 95).

new term. Treaties are particularly useful reinsuring mechanisms since they can be structured to reinsure losses on direct insurance which either were written during the term of the treaty but occur later or they can be structured to reinsure losses that occur during the term of treaty but were written earlier. Likewise, the premiums may be calculated in a variety of ways including structuring the reinsurance premium in some way directly related to the premiums on the underlying policies or assigning a single sum or some other variable amount as the parties wish and which reflect their business purposes. The treaty reinsurance contract is generally deemed to have formed when the original insurer cedes part of the premiums for its policies and the risk of losses on those policies to the reinsurer. Treaty reinsurance can and often does involve multiple reinsurers taking part of a book of business's risks with each agreeing to assume a portion of the risk in some pre-determined manner.

Importantly, reinsurance treaties cover all risks written by the reinsured that fall within their terms unless specifically excluded. For this reason, treaty reinsurers generally do not engage in any review of the individual risks underlying the treaty and do not engage in their own underwriting of those risks. Rather, they rely on the underwriting experience of the original insurer with a prudent reinsurer investigating the underwriting philosophy, loss experience, attitude towards claims management and other business practices. Facultative reinsurance can be combined with treaty reinsurance to cover exclusions in the treaty or for other business purposes, some of which we explore later.

C. The Vertical and Horizontals of Reinsurance: Pro-rata and Excess of Loss

Again, we recognize along with the United States Supreme Court that:

In indemnity reinsurance . . . [the reinsurer] agrees to indemnify, or reimburse, the ceding company for a specified percentage of the claims and expenses attributable to claims that have been reinsured.[24]

The indemnification of the insured by the reinsured need not be total or complete. In fact, the ability of reinsurers to take only a portion of a risk or book of risks is one of the particularly useful risk spreading elements of reinsurance. Though there is nothing to prevent a single reinsurer from taking all indemnity responsibility for a policy or group of policies, most reinsuring agreements seek to take responsibility for only a portion of those losses. Traditionally this is divided into two basic divisional structures most easily visualized as either a vertical or horizontal slicing up of the losses from particular risks assumed. Both facultative and treaty reinsurance can be written in either a pro-rata or excess of loss basis.[25]

i) Pro-Rata treaties

If a reinsurer is not willing to take on an entire risk classification of group of policies, it can structure the treaty to take on only a specific portion of each risk to which it applies. Using a pro-rata reinsurance contract, the reinsurer only agrees to indemnify the ceding insurer for a percentage of original risk losses in exchange for a corresponding portion of the premium.[26] Generally, pro-rata agreements obligate the reinsurer to indemnify an insurer without requiring any retention by the reinsured.[27] A common form of this type of pro-rata arrangement is call Quota Share Reinsurance, where the cedent

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[24] Colonial American Life Insurance Co. v. Commissioner, 491 U.S. at 247. *See* also Hartford Fire Ins. Co. v. California, 509 U.S. 764, 806-07 (1993).

[25] O&S at 15.03[a].

[26] O&S 15.02.

[27] *See* Ott v. All-Star Ins. Corp., 99 Wisc. 2d 635, 643; Central Nat'l Ins. Co. v, Devonshire Coverage Corp., 426 F. Supp. 7, 11 n. 5, 21 (D. Neb. 1976), aff''d in part and remanded, 565 F.2d 490 (8th Cir. 1977).

insurer is indemnified for a fixed percentage of loss on all policies of a defined risk type written by the ceding company. This easily visualized apportionment can become somewhat more complex in that a "pro-rata" treaty can also be horizontally segmented within each "slice" by requiring the ceding insurer to retain some portion of the loss with the reinsurer only responsible for the surplus. This type of pro-rata reinsuring up to the amount of insurance originally written, minus the ceding insurer's retention is commonly called Surplus Share Reinsurance. With the entrance of additional retrocessionaires there can be quite a bit of segmentation in this surplus line.

Another interesting aspect to pro-rata treaties are the extent to which the reinsured is obligated to automatically accept its portion of the risks insured. Pro-rata treaties come in a variety of broad types, knowledge of each of which is useful for our later discussion. First, the treaty can be pro-rata and obligatory. Through this structure, all risks in a specified category are shared automatically by some proportion agreed to. The second type, however, is more interesting in that it is only semi-automatic and has a facultative component to it. Best defined as a facultative obligatory treaty, the obligation stays with the reinsurer to accept the ceded business that it selected by its reinsured. Alternatively, there exists the truly facultative treaty in which neither the reinsured nor the reinsurer is obligated to cede or accept the risks, both are free to accept or decline.[28] Pro-rata treaties often allocate a portion of the original premium to the reinsurer. By this mechanism a reinsurer which may not have been nor sought to be directly interested in the original

[28] Likewise, pro-rata share treaties can be subdivide into quota share treaties and surplus share treaties. Quota share treaties allow the reinsurer to take a specified percentage of the premiums charged in proportion to its percentage of the risk assumed, all within agreed upon upper limits of liability. Surplus share treaties are distinct in that the reinsurer does not participate until the loss reaches a specific level, after which they are liable on a fixed percentage basis, within limits, and for a percentage of the premiums.

insurer's premium calculations now acquires a more direct interest in their reinsured's underwriting decisions.

iii) Excess of Loss Reinsurance

In the excess of loss reinsurance scenario, the reinsurer's obligation is defined in relation to the reinsured's retention. In this structure the reinsurer, subject to specific stated limits of coverage, indemnifies the reinsured for all or a stated portion of losses in excess of the agreed upon retention. [29] The agreements can be structured so that the reinsurance can be excess to the specific risk, specific occurrence, an aggregate dollar amount or specified loss ratio.

2. Purposes of Reinsurance

A comprehensive review of all the reasons an insurer may seek to reinsure is not possible or necessary for the purposes of this Essay. Suffice it to say that as reinsurance is a flexible medium and supports a variety of functions, the purpose of acquiring it will differ in accordance with the business interests of the insurer seeking it. Likewise, as reinsurance can serve a variety of purely financial and accounting purposes reinsurance can be sought for purposes slightly beyond the scope of this Essay's interest in its potential regulatory effects on insurance companies as insuring companies, rather than as financial institutions. Regardless, in accordance with our focus on reinsurance potential effects on insurers, it is useful to review the four main purposes for which reinsurance is generally sought in relation to the primary insurer's insurance function.

A. Risk Allocation

[29] *See* Compagnie de Reassurance d'Ile de Farce v. New Eglad Reins. Corp., 944 F. Supp. 986, 998 n.17 (D. Mass 1996).

For some purposes, reinsurance can be seen as occupying nearly the identical functional purpose for the insurance company reinsured as that of many other common commercial insurances. Thus, reinsurance's initial purpose can simply be seen as a basic reallocation of risk and as an additional way to spread risk. Just as any commercial entity might go to the insurance market to seek indemnity for certain specific types of loss, so too does the insurer seek a mechanism to transfer the risk it chose to underwrite to another party.[30] Through the use of reinsurance the risk acquired by the ceding insurer is layed-off onto the reinsurer to the extent and within the limits of the contract agreed to and to the extent that those risks are allocated among numerous reinsurers, the risk is even further spread.[31]

This risk transfer has amongst its primary benefits to the insurer the ability to allow the reinsured to act in ways that otherwise might not be available to it in the absence of reinsurance. For instance, through the medium of reinsurance, the ceding insurer acquires the ability to engage in underwriting business that might otherwise have been foreclosed to it for various reasons. Either the risk itself may simply be too large or the risk of loss might be in some other way unusual. By limiting their loss exposure through reinsurance, the reinsured can offer higher coverage limits than they could

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[30] *See* Kemper Reins. Co. v. Corcora (In re Midland Ins. Co.), 79 N.Y.2d 253, 258 (1992).

[31] Importantly, it must be remembered that reinsurance does not actually lessen total risk exposure:

> In any discussion of reinsurance, the limitations must be considered along with its advantages. Reinsurance does not change the nature of a risk being insured. It cannot make a bad risk insurable or an exposure more predictable or desirable. And while reinsurance may limit an insurance company's exposure to a risk, the total risk exposure is not altered through the use of reinsurance.

Reinsurance Association of America, a Fundamental on Property Casualty Reinsurance available at http://www.reinsurance.org/i4a/pages/index,cfm?pageid=3310 [hereinafter RAA webpage].

otherwise afford. Through this mechanism, smaller insurers have the capacity to compete with larger companies and offer their policyholders a broader array of coverage options.

Likewise, the insurer may be seeking to enter into business lines which propose the possibility of some future unexpected losses the insurer is unwilling to retain alone beyond a specific retention. Either the possibility of too great a number of small, unexpected losses or the possibility of a single, catastrophic loss which could overwhelm the insurer's balance sheet might cause a prudent insurer to acquire reinsurance for this reason.[32] This prudential risk transferring purpose of reinsurance appropriately causes reinsuring even though the insurer believes (as it must) that its underwriting decisions are prudent and the premium appropriate. After all, imprudent underwriting could well be a defense to reinsurance coverage. Still, even the most perspicacious of underwriters cannot foresee the unexpected, thus the prudential purpose of reinsurance.

B. Reserve Requirements

A second reinsurance purpose, one particularly importantly in the insurance regulatory context, is that of using reinsurance to reduce the amount of reserves that an insurer is required to maintain, thus freeing the insurer up to write more policies.[33] Through the purchase of reinsurance, the primary is seen to reduce the size of its potential losses, thereby allowing it to reduce its statutorily mandated reserves.[34] Hence, if a primary insurer was up against the minimum allowable level of reserves plus surplus that

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[32] Robert Jerry II, Understanding Insurance Law sec 141, 3rd edition (2002).

[33] *See* Kemper Reins. Co. v. Corcoran (In re Midland Ins. Co.), 79 N.Y.2d 255, 258 (1992) (reinsurance allows "a primary insurer to reduce the amount of legally required reserves held for the protection of policyholders, and to increase the company's ability to underwrite other policies or make other investments").

[34] Robert Jerry II, Understanding Insurance Law sec 141, 3rd edition (2002).

it is statutorily required to maintain, it would be restricted in the amount of new business open to it. By the mechanism of reinsurance, that insurer would still be able to write new policies, so long as it could transfer the risk to a reinsurer. In fact, since the reinsurer swaps the new risk in exchange for a commission, the primary insurer is frequently seen as acquiring no new liabilities, while its surplus is viewed as increasing by the amount of the reinsurer's commission. The majority of public regulation of reinsurers, such as it is, concerns itself with this aspect of the reinsuring relationship.[35]

C. Risk Exits and Fronting

A third commonly understood purpose of reinsurance is to allow the primary insurer to engage in the opposite of writing more policies. Through appropriate reinsurance an insurer which seeks to exit a certain risk stream can be relieved of the risks of loss from those policies and exit that insurance market. This allows a certain amount of flexibility to insurers by allowing them to shift direction in their future business choices.

A few caveats are necessary here. By reinsuring the entire loss, the primary insurer generally has not freed itself from its direct responsibilities to its policyholders, despite the 100% risk transfer to the reinsuring companies. In other words, though it may have successfully transferred the risks of loss, it did not transfer its servicing responsibilities to the reinsurer. Again, reinsurance is generally defined as a secondary indemnity agreement and the reinsurer does not usually assume a direct claims handling relationship with the policyholders of the reinsured. Though there is the capacity to

[35] Since reserves are the primary way public regulators attempt to reduce the risk of insurer insolvency and default, a great amount of activity has occurred amongst and between regulators to devise statutory schemes which allow for protection of the reserves. There has been some very interesting work on reinsurer chartering and on bonding requirements for foreign insurers reinsuring domestic primaries.

allow for “cut-out” provisions in the reinsuring agreements, so as to allow a direct action by the policyholders against the reinsurer, such provisions change the reinsuring relationship.

Part of the benefit of being a reinsurer rather that an insurer is that the reinsurer is generally free from this type of direct original policyholder action. For this reason, the standards of contract performance and the mutual obligations of the reinsured and reinsurer differ in type and structure from that of policyholder and insurer. Some of these relationships and the differences of obligations are described in Section III of this Essay. Too much direct interaction by the reinsurer and the original policyholder will force the reinsurer to be treated simply as a insurer as concerns of the policyholder, obviating some of the benefits and performance obligations commonly assumed to have been the operating standards of the reinsuring agreement, usually to the reinsurer’s detriment. Likewise, though there is nothing to prevent that kind of direct assumption of the primary insurer’s role, such a situation is really better understood as a novation of the original primary insurance policies, rather the type of reinsurance agreement for business agility that is the more common purpose of seeking reinsurance for indemnity purposes.

Another brief caveat is also useful here. Placing reinsurance for 100% of a certain type of underwriting business for the purpose of getting out of that business is likewise different from another type of 100% reinsuring agreement that does bare certain similar characteristics. In what is known as “fronting agreements”, an insurer will enter into a policy with the understanding that another party, a reinsurer, will be responsible for

the entire amount that it is required to pay under the policy.[36] One New York court described a fronting company as "an insurer that issued the policy on the risk and then reinsured 100% of that risk by placing portions of the coverage with various reinsurance carriers".[37] The purpose of these "fronting agreements" is to allow a reinsurer not qualified or licensed to do business in the state, the opportunity to profit from the sale of insurance transactions in that state.[38] Generally, the licensed insurer will receive a fee for its trouble in acting as the "front".[39] Despite the slightly pejorative terms used in this arrangement, there is nothing illegal in a domestic insurer acting as a front for the unlicensed insurer. In fact, so long as all other regulatory goals are met, these relationships can allow for a significant increase in insurance capacity for the state.

D. Loss Stability

Finally, and perhaps most importantly, reinsurance is a mechanism for insurers to stabilize their profits and expected losses. Insurance is and has always been about risk. Through the medium of reinsurance, the primary insurer can set a limit on its exposure by facultative insurance for any given risk, use a surplus treaty to create a ceiling on aggregate loss or determine its percentage of risk retained through a pro-rata arrangement. In this way, even cumulative losses can be restricted to designated limits. Through risk limitation the insurer proposes to use reinsurance as a form of stability

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[36] *See* Reliance is. Co. v. Shriver, Inc., 224 F.3d 641, 643 (7th Cir. 2000) (describing a fronting agreement as a "well established ad perfectly legal scheme" where policies are issued by state-licensed insurance companies and then immediately reinsured to 100 percent of face value).

[37] Allendale Mut. Ins. Co. v. Excess Ins. Co., 970 F. Supp. 265, 267 n.2 (SDNY 1997)

[38] *See* Union Sav. Am. Life Ins. Co. v. North Central Life Ins. Co., 813 F. Supp. 481 (S. D. Miss. 1993).

[39] *See* Venetsanos v. Zucker, Facher & Zucker, 271 N.J. Super. 459, 463-64 (1994).

control, thus, hopefully, enabling them to fulfill their obligations to their policyholders in an ongoing manner[40] while also assisting them in stabilizing their profits.

III. Reinsurance as Regulator?

Regulation is a word that commonly evokes governmental action and the concept of the regulatory state. For good or ill the notion of regulation has been in large part indelibly linked to state power. Yet such a restrictive conceptualization of regulation is simplistic and ignores the capacity of private institutions to likewise regulate the activities of large swaths of social actors. To be fair, the sophisticated politician or legislator is well aware of this capacity and much of the ideological discourse of the last few decades has in some fashion revolved around the question of private rather that public actors as best regulator.

Insurance has been a battleground issue for this regulatory debate, both as a subject to be regulated and in its capacity to act as a regulator. This duality of status is one of the reasons the regulation of insurance, be it health, property or liability is so frequently central to some of the greatest political debates of our time. Yet, the ability of insurance itself to act as a regulator is often not explicitly recognized or highlighted in these policy debates. Despite this, a fascinating body of literature on insurance exists to allow us to recognize the myriad of way private or quasi-private insurance can be used as a regulator of private behavior. With the conceptualization of power not limited to overt government action alone, insurance takes its place among regulators of social behaviors

[40] *See* Corcoran v. Universal Reins. Corp., 713 F. Supp. 77, 82 (SDNY 1989) ("Insurance companies depend upon reinsurance contracts for financial stability and hence their ability to fulfill their obligations to their policyholders").

with surprising force and scope. Indeed, it has been stated that "looking at twentieth century governance, it is tempting to see insurance as the sleeping giant of power." [41]

The identification of insurance as a form of regulation draws from the idea that insurance offers a mechanism for the setting of social standards. Much work exists on the concept of insurance as gatekeeper to many economic activities, from the buying of a house to the driving of a car to the execution of complex financial transactions. Some of this regulatory effect occurs as the result of direct delegation of state power, by, for instance, mandating the purchase of insurance as a prerequisite to operating a car or engaging in certain businesses. Even in the absence of compulsion, however, the acquisition of insurance itself can be seen as a form of "private legislation" within the regime of traditional notions of liberal governance. Particularly relevant to this discussion of reinsurance as regulator, is the body of work which identifies the capacity of contracting behavior to result in social control. The fascinating work by Tom Baker on the genealogy of moral hazard and the path breaking sociological studies of Carol Heimer on the capacity of insurers contractual "control" of behavior each greatly assist in identifying insurance as a source of regulatory control over private life.[42] Thus, the thesis of this Essay; as insurance can be seen as a mechanism of regulation of policyholder action, likewise reinsurance deserves to be considered as a source of regulation of insurer action.

1. Reinsurance and Industry Standards

Each industry has its own standards and practices. Most people, even people who interact daily with the various professions do not spend overmuch time in pondering how

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[41] *See* Tom Baker & Jonathan Simon, Embracing Risk at 12.
[42] Baker and Simon, Embracing Risk at 13.

it is than an industry came to act in the way it does. Yet, understanding why industries and organizations act in the way they do gives greater richness to any who choose to study them. In commercial transactions of all kinds, the governing doctrines of law with their judicial enforcement of, or release from, certain obligations to a very great extent likely have been responsible for enshrining certain processes, practices and extend to creating expectations on the parts of consumers who interact with those businesses, without their even being aware of the legal doctrines which spawned them. How many buyers are actually aware of the Uniform Commercial Codes' treatment of warranties of quality and exceptions thereto when purchasing a good? Yet, it is common practice to mark and common knowledge to understand the meaning of a sign scrawled on a television "As Is".

Reinsurance contracts are subject to specialized doctrines of law, with long traditions of application to reciprocal performance obligations. A review of these doctrines and the effect clauses common to the agreements have been interpreted by courts to require behavior or risk release from the reinsurer's obligation is useful to our understanding of the effects of reinsurance on insurance industry practices. Likewise, how these rules came about and, to a certain extent, are still required for the economic viability of reinsurance as we know it are also interesting.

A. Reinsurance and Underwriting Standards

One of the strangest aspects of reinsurance is the often overlooked question of how reinsurance could ever exist without becoming cost prohibitive. If one were to simply think about reinsurance in terms of risk assessment, there seems little way that the addition of multiple new players in the insuring process would not add and keep on

adding to the cost of insurance. After all, due diligence is an expensive proposition. How could all these different reinsurance institutions capably evaluate the true risks of all the policies which they are agreeing to reinsure, particularly in the treaty context, without accruing costs as large as, if not larger than, the original insurer? The answer is simply that in the reinsurance treaty context they simply do not engage in that kind of investigation, instead they rely on the underwriting skills of their reinsureds. Costs of investigation are limited to investigation of the potential reinsured's loss experiences, underwriting skills and claims handling competence.

How can that possibly be prudent? As we have seen to our great dismay in the sub-prime mortgage crisis, the implication of opaque risk acquisition can be remarkably severe. In reinsurance this problem has been to a very great extent obviated by virtue of the application of the doctrine of utmost good faith or uberrima fides. This duty requires, "the most abundant good faith; absolute and perfect candor or openness and honesty; [including] the absence of any concealment or deception, however slight". That even utmost good faith can be seen as sufficient to appropriately govern trillions of dollars of transactions is interesting in and of itself, yet, as the Second Circuit has noted, it is the core relationship that allows for reinsuring to profitably occur. As they explained:

> Historically, the reinsurance market has relied on a practice of the exercise of good faith to decrease monitoring costs and ex ante contracting costs. Reinsurance works only if the sums of reinsurance premiums are less than the original insurance premium. Otherwise, the ceding insurer will not reinsure. For the reinsurance premiums to be less reinsurers cannot duplicate the costly but necessary efforts of the primary insurer in evaluating risks and handling claims. . . . Reinsurers are protected, however, by a large area of common interest with ceding insurers and by the tradition of utmost good faith, particularly in the sharing of information.

In other words, in exchange for placing the reinsurance at a price less than the original premiums, the reinsurer is allowed to rely on the good faith of the reinsured. In order for treaty reinsurance to function economically, the reinsurer cannot duplicate the underwriting functions engaged in by insurers at the time they placed the original coverage.

That, however, does not mean that the reinsurer is not interested in the underwriting activities of its reinsureds. As explained by the Reinsurance Association of America:

> While treaty reinsurance does not require review of individual risks by the reinsurer, it demands careful review of the underwriting philosophy, practice and historical experience of the ceding insurer, including a thoughtful evaluation of the company's attitude toward claims management, engineering control, as well as the management's general background, expertise and planed objectives.[43]

With these criteria in mind, it is difficult to imagine that insurance companies would not create and institutionalize underwriting practices that are most likely to be attractive to reinsurers if they are interested in benefiting from reinsurance. Particularly for smaller insurance companies who are dependant on reinsurance to take on the larger risks, it would not be beneficial to engage in underwriting practices too far from the acceptable industry norm. Should such a company attempt it, undoubtedly the company would have to charge higher premiums in order to entice reinsurers to take on their risks. Likewise, those companies who require greater amounts of reinsurance to comport with their reserve requirements would also be inhibited from engaging in broader or unusual underwriting procedures.

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[43] *See* Fundamentals of Property and Casualty Reinsurance, Reinsurance Association of America available at http://www.reinsurance.org/i4a/pages/index,cfm?pageid=3310 [hereinafter RAA webpage].

On the one hand, the interest of reinsurers in the underwriting procedures of those they reinsure undoubtedly serves the pseudo-regulatory function of encouraging sound underwriting practices by rewarding those companies with greater access to reinsurance. On the other hand, such policies likely result in a certain inhibition of experimentation in underwriting practices. Obviously, should one company or group of companies be able to exhibit to the reinsurers that its underwriting practices result in a better loss history, over time this could result in greater reinsurer interest in that company. However, during the period of time where the practice could be deemed "unusual" the practice could be detrimental to reinsurance access. Ironically, this would likely lead to the larger insurance companies being the most willing to experiment with underwriting practices as they have the greatest capacity to mitigate any increased reinsurance costs associated with their efforts.

This phenomenon of the unusual risk likely costing more than the usual or more easily forecastable risk is borne out by industry practice in placing facultative reinsurance. Again, it is through facultative reinsurance that an insurer could acquire reinsurance for a specific risk, a specific policy or a specific group of policies. It is for this reason that facultative reinsurance "usually covers catastrophic or unusual risks".[44] Facultative reinsurance, however, will likely be more expensive per risk than broader treaty reinsurance since in the facultative context the reinsurer often employs "substantial personnel and technical resources" to underwrite those risks.[45] It is exactly this type of cost which is avoided in the treaty reinsurance context.

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[44] *See* Reinsurance Association of America

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As an initial matter, it is necessary that treaty reinsurance is simply not generally available for a variety of certain types of risks. Things like nuclear hazard are common, industry-wide exclusions to most treaty reinsurance. In those contexts, should an insurer for example wish to acquire reinsurance coverage for other common exclusions like long-haul trucking or munitions manufacturing, reinsurance coverage is usually only available facultatively. An individual arrangement can be made, although the cost of reinsuring that risk is greater than what would otherwise be available by treaty.

That insurers are price sensitive to reinsurance premiums on both a current and forward looking basis is further borne out by the common practice of combining treaty reinsurance with facultative reinsurance so as to protect an insurer's loss history with its treaty reinsurer. This practice of placing facultative insurance for certain risks to protect loss histories is undertaken even though reinsurance coverage for the facultative risk was covered under already placed treaty reinsurance agreements. It is a strategic decision on the part of the insurer to enter into the additional facultative agreement as a hedge against the unexpected losses on that risk triggering a renegotiation of the insurer's entire treaty.

As an example the Reinsurance Association of America describes a situation where, to accommodate a policyholder, an insurer may agree to provide commercial automobile insurance coverage – a higher risk activity. For this reason, facultative reinsurance would be appropriate even if the treaty reinsurance the insurer already had did not exclude commercial automobile coverage simply to "protect its losses under applicable treaty agreements". As they also point out, the facultative "rider" need not even be purchased from the treaty reinsurers, allowing those potential commercial automobile losses to be handled under a completely separate relationship. This suggests

that the overall cost of ongoing higher treaty premiums is sufficiently grave to encourage the additional cost of “double reinsuring” certain risks, even at the relatively higher specific cost of the facultative agreement.

In any event, this common choice to interplay facultative with treaty reinsurance to protect loss histories support the conclusion that reinsurers are actively monitoring loss histories. Such monitoring of underwriting practices and ensuing accrued losses would likewise result in the insurer incorporating underwriting practices in conformity with the reinsurance market’s interests and prevent them from making underwriting changes that may negatively effect their reinsurance opportunities. To an extent, this natural interplay of loss history with reinsurance costs can create a self-regulating and self-limiting tendency among certain insurers to create loss histories lower than similarly situated insurers.

The simplest way for insurers to lower loss histories is to restrict their business to lower risk policyholders or limit their dollar exposure to those risks. A “cherry picked” book of business, for example could attract more reinsurance interest, resulting in the cherry-picking insurer the capacity to charge lower premiums to gain an even bigger bowl of cherries. There would still be an interest in insuring and reinsuring lemons, of course, so long as they are able and willing to pay higher premiums that could be shared with the reinsurer, but the potential for reinsurance pricing to encourage cherry-picking can be somewhat troubling. The competitive advantage an insurer can obtain through reduced reinsurance premiums may militate against the traditional benefits acquired by the law of large numbers. The insurer could determine that their best option for profit lay in the reinsurance cost saving acquired by having the lower risks.

An insurer with a sufficiently broad market share and multi-line business, of course, could get what would amount to a “bulk discount” for placing most of its reinsurance business with one company. But, if smaller insurers took the “cherry” approach and were rewarded with sufficiently lower premiums to compete against even the “bulk” advantage the move towards segmentation would again be triggered as the big insurer slowly (or even quickly) began to loose enough of its cherries to effect its loss history in a significant enough way to offset its “bulk” appeal to its reinsurers. Remember, the reinsurance market is extremely broad, with at least 50% of domestic insurers, reinsured by foreign companies. There is likely always some reinsurer around with a taste for cherries.

Importantly, this reinsurance effect on cherry-picked risk premiums does not have to result in the company actually restricting their business to those “better” risks alone. There is no reason why reinsurance treaties have to be structured so as to take the entire book of business for a certain type of risk, though they often are structured that way. An insurer could reinsure with one company for their “better” risks at the lower prices, seek a competitive advantage on that market and move the worse risks into a different book charged higher premiums, sufficient to entice a different reinsurer. Though a different insurer could acquire better overall pricing by averaging the two pools, they could face a certain difficulty in getting those cherries away from the segmented insurer, moving the whole market towards segmentation.

Additionally, an insurer could try to move toward the best of both worlds with broadest policyholder pools which represent “better” opportunities for a variety of reasons. If, for example, the worse risks in one line were restricted to those who proved

to be more profitable for the company on some other business basis, such as those interested in multi-line policies or were loss leaders in some other sense, the higher reinsurance premiums could be offset for even those “worse” risks, likewise giving that book of business a competitive advantage. Undoubtedly, these considerations account in part for the insurance industries’ constant research and refinement of ways to most accurately reflect the underwriting risks and potential ancillary benefits of all types of policyholders using all types of identifying criteria. Best information is of obvious benefit to any insurer, but when leveraged by the potentially significant added value from reinsurance benefits, the value of the information is even greater and offers the potential for one company to gain significant advantage over another. Unfortunately, all these factors could lead to the identification of a certain class of generally unattractive risks with fewer insuring options other than higher premiums since restrictive underwriting has the capacity to self-support segmentation through beneficial reinsurance rates.

It would be extremely interesting to empirically identify whether certain state actions, such as prohibiting coverage refusals to certain classes of policyholders in their state results in an initial spike in the cost of reinsurance for those reinsureds who must extend their underwriting in conformity with those new mandates. Likewise, it would be very interesting to determine how long, if at all, such a spike continued to exist and whether if a new underwriting requirement became sufficiently common that the effect disappeared.

Additionally, the above hypothetical situations discount the likelihood that there are various liquidity cycles for reinsurers themselves. Issues completely exogenous to the underwriting choices of America’s domestic insurers can effect the reinsurance

market itself and competition among and between reinsurers for various reasons will implicate those reinsurers own decisions on whom to reinsure and at what price. This reinsurance market problem is addressed more completely in Section IV.

B. Reinsurance and Claims-Handling

The duty of uberrima fides or utmost good faith applicable to reinsurance relationships has implications beyond the requirement of simply making "reasonable" underwriting decisions; it creates duties owed to the reinsurer by the reinsured which implicate issues of claims handling. The duty of utmost good faith on the part of the reinsurer is generally held to create reciprocal obligations on the part of the reinsured in the claims handling process. Failure to appropriately comport with these obligations can offer the reinsurer a contractual defense and release the reinsurer from its indemnity obligation. These fall into three broad obligations: 1) the duty to disclose material facts about the ceded business during the placement process, 2) the duty to notify the reinsurer of potential claims that could impact reinsurance coverage and 3) the duty to handle the claim in a proper and "businesslike" manner.

Each of these duties has the capacity to create and maintain industry standards and practices. Particularly the duty to disclose material information and conduct "business like" claims handling will require, even in the absence of any formal underwriting or claims handling regulations, a certain industry determined level of investigation when placing coverage and has the capacity to encourage formalized claims handling processes so as to justify claims determinations. After all, an insurer is unlikely to grant a policyholder's claim, particularly a large claim, in a manner which could provide the reinsurer with a defense to its indemnity obligations. To a certain extent, this

obligation creates a natural or at least contractually created floor on the generosity of claims handlers when making decisions to cover. Or, at least, it creates the natural inclination of managers *aware* of claims handling obligations in reinsurance coverage disputes to lean towards formalizing claims handling decisions so as to prevent the reinsurer from having the capacity to use poor claims handling as a defense. Even though, as described below, the claims handling would have to be so poor as to constitute recklessness or gross negligence to likely succeed in a coverage dispute, the fact that claims handling processes are monitored as part of all decisions to reinsure, just as with underwriting, would also support reinsurers to engage in formalized claims handling processes.

The manner in which claims handling can implicate reinsurance coverage obligations in the performance of the reinsurance contract requires some explanation as to the nature of those obligations and how courts have harmonized reinsurer obligations to perform with the reciprocal obligations of utmost good faith. In the performance of reinsurance agreements a key point to be remembered is that the duty of utmost good faith is mutual.[46] In the reinsurance context, this is not some amorphous responsibility or the more frequently encountered lesser duty not to behave egregiously that is the underlying justification of policyholder "bad faith" actions. Rather, the reinsurance company's duty of utmost good faith acts as a powerful judicially supported standard of care when examining the reinsurer's performance of its two primary obligations. Those

[46] *See* Commercial Union Ins. Co. v. Seven Provinces Ins. Co., 9 F. Supp. 2d 49 (D. Mass. 1998) aff'd 217 F.3d 33 (1st Cir. 2000); Compagnie de Reassurance d'Ile de France v. New England Reins. Corp., 57 F.3d 56, 88 (1st cir.), cert denied, 515 U.S. 1009 (1995).

obligations are the responsibility of the reinsurer to "follow the fortunes" and "follow the settlements" of their reinsureds.[47]

Briefly, the "follow the fortunes" doctrine obligates a reinsurer to pay its share of a loss sustained by its reinsured, so long as the reinsured's claims handling was not reckless or grossly negligent and the loss is arguably covered by the original policy and the reinsurance agreement.[48] This clause obligates a reinsurer to indemnify its reinsured for its good faith payment of claims that arguably fall within the scope of the agreement – no "second guessing" allowed. Likewise, the "follow the settlements" obligation, requires indemnification of the reinsured for good faith settlement decisions.

One "follow the settlements" case is particularly illuminating of the capacity of purportedly "poor" claims handling to release the reinsurer from its indemnity obligation. In *Suter v. General Accident Ins. Co.*, the court focused on claims handling improprieties in its decision to release the reinsurer of its obligation arising from the reinsured's settlement. The case involved tort claims asserted against a manufacturer of allegedly defective heart-valves by patients who had received the potentially defective valves. The

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[47] These doctrines are often conjoined in court decisions leading to certain amount of confusion in their analysis. *See* eg., Litho Color, Inc. v. Pac Employers ins. Co., v. Home Ins. Co., 991 P.2d 638, 647 (Ct. App. 1999). This problem has been noted by both courts ad commentators. *See* Aetna cas. Sur. Co. v. Home Ins. Co., 882 F.Supp. 1328, 1346 n.9 (SDNY 1995) (noting that "[t]he term 'follow the fortunes" has bee used imprecisely to describe the reinsurer's duty to follow the claims adjustment decisions of the ceding company, thereby giving rise to some ambiguity as to its meaning. 'Follow the fortunes' more accurately describes the obligation to follow the reinsured's underwriting fortunes, whereas 'follow the settlements' refers to the duty to follow the actions of the cedent in adjusting and settling claims.").

[48] *See* Commercial Union Ins. Co. v. Swiss Reinsurance Am. Corp., 413 F.3d 121 (1st Cir. 2005). The reinsurer cannot, however, be found liable for an amount in excess of the reinsurance limit of liability stated in the agreement. *See* Unigard Sec. Ins. Co. v. North River Ins. Co., 4 F.3d 1049 (2d Cir. 1993). This includes the reinsurer's liability for "expenses" as well as for the amount of the actual loss. *See* Excess Ins. Co. v. Factory Mutual Ins. Co., No. 147, 2004 Lexis 3728 (NY Ct App. Dec. 2, 2004) (finding that a reinsurers obligation for expenses incurred while handling a loss is capped by the limit of liability in a facultative agreement regardless of the presence of a "follow the fortunes" clause).

manufacturer was the original insured which settled claims with the consent of the original insurer which sought indemnity from its reinsured.

Interestingly, the "claims handling" improprieties identified in this decision were all actually related to the insurer's legal acumen and choices made in evaluating and defending the claim. They primarily were issues involving the proper use of coverage counsel and appropriate pre-settlement litigation tactics. The court determined that failure to seek certain types of legal counsel and take certain investigatory steps could constitute "gross negligence". The court cited the insurer's reliance on another insurer's counsel for its appraisal of potential liability as inappropriate. Likewise, it cited failure of the insurer to hire its own medical expert (again it had relied on another insurer's expert) to advise on the heart-valves potential for bodily injury and a failure of the insurer to keep up to date on the laws of trigger of coverage as determinative factors. Relying on these litigation process failures, the court determined that the insurer had failed to make a reasonable investigation of whether the underlying claims were "reasonably within the scope of the original policy". As such, the reinsurer was freed from its presumptively applicable duty to follow the insurer's settlement. [49]

To those familiar with the tort litigation process, this reflects an awesome entrance of a privately assumed obligation to effect legal process and litigation costs. By focusing on the insurer's choice not to hire independent counsel or rely on other medical experts as grounds for release from reinsurance obligations, the court explicitly allows

[49] The interpretation of the utmost good faith standard condition precedent to reasonableness in claims handling as used in the *Suter* decisions is remarkable given that a finding of good faith has been held sufficient to require performance by a reinsurer to indemnify payments found to be reasonably within the terms of the original policy, even if not technically covered by it. *See* General Ins. Corp. v. Great America Insurance Company, 979 F.2d 268, 280 (2d Cir. 1992).

the reinsurance contract obligation of reasonable investigation to affect the insurer's business judgment to save the cost of its own counsel or experts. In effect, this type of decision requires the use of coverage counsel by each insurer implicated on a claim and institutionalizes the added cost of duplicative legal analysis and investigation of claims where reinsurance is implicated or risk being viewed as not acting in utmost good faith.[50]

Even in cases where there would likely be little disagreement as to the likely value of the claims or medical evidence of causation, how could an insurer not be expected to cover its assets with duplicative legal opinions? One way or another, the litigation costs will eventually be internalized by the obligated insurers and passed on to policyholders in the form of higher premiums. Moreover, since the decision in *Suter,* is grounded in the universally applicable good faith obligation of the insurer to reasonably investigate as a predicate to the reinsurer's performance under the reinsuring agreement, this duplicative effort would likely become simple industry practice. Even if there is no reinsurer obligated on the particular claim, as described above by the Reinsurance Association of America "claims handling philosophy" is one of the criteria investigated and monitored by reinsurers generally. An insurer thinking toward their future interest in reinsurance, will take steps to ensure that their claims handling evidences their willingness and history of operating in a non- grossly negligent manner.

One caveat, it is of course possible that this added duplicative cost could be so cost prohibitive that the insurer would prefer to simply avoid reinsurers and internalize this litigation savings. As described above, the benefits of reinsurance, particularly as

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[50] Good faith is a perquisite for application of a reinsurer's indemnity obligations. *See* ReliaStar Life Ins. Co. v. IOA Re, Inc., 303 F.3d 874, 878 (8th Cir. 2002) (finding that "doctrine posits that if the cedent has acted in good faith in handling the claims presented to it and in providing coverage of the claims 'the reinsurer may not second guess the coverage decisions of the cedent'").

regards the ability to stabilize profits and leverage reserves makes such a choice unlikely. For various reasons, an insurer will remain aware that there remains at least the potential that it will, in future, need reinsurance. If anything, knowing that they are engaging in largely duplicative legal work would simply lead to insurer pressure on their attorneys to reduce the cost of engaging in redundant legal services, if it cannot reduce the need to engage those services. Perhaps this accounts for some of the insurance industries interest in creating legal services compensation structures which offer opportunities for "bulk rate" services and long-term billing agreements.

Follow-the-settlements decisions are not the only instance where reinsurance has likely affected insurer litigation practices. Since the original policies reinsured often include the providing of a defense, these costs will likewise be covered under the reinsurance agreement, unless there is an exclusion specifically to the contrary.[51]

Another example lies in the now nearly ubiquitous use of the declaratory judgment action to determine coverage disputes. Many reinsurance agreements include a clause which states that the agreement covers "all expenses incurred in the investigation and settlements of claims or suits".[52] As described above, such a clause makes sense in relation to the reinsurer's interest in not indemnifying claims beyond the scope of the policy they are reinsuring. It also makes sense for the reinsured to seek to lay-off these costs to the reinsurer where much of the benefit of the coverage determination would accrue to the reinsurer on the risk. This clause has been interpreted to include costs incurred by the reinsured for bringing declaratory judgment actions to avoid coverage of

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[51] *See* Bellefonte Reinsurance Co. v. Aetna Cas. & Sur. Co., 903 F.2d 910, 912-14 (2d Cir. 1990). Unlike original insurance, however, defense costs will be included within the stated limit of liability of the reinsurance agreement. *Id.*

[52] See Couch on Insurance at 9:30.

the original policyholder's claim.[53] Moreover, in the absence of an exclusion, the "standard practice" of the industry to allow for such costs can create a sufficient question of fact to support an implied modification of the contract sufficient to defeat a motion for summary judgment.[54] Even in the absence of a clause, declaratory judgment costs have been upheld as part of the contract's as a result of the parties "custom and practice".[55] In this circumstance, the ability of insurers' to introduce extrinsic evidence to supplement an alleged ambiguity is particularly useful.

## III. Institutional Regulatory Effects of Reinsurance on Public Regulation of Insurance: The Forces of Silence

The underlying conceptualizations of regulation in the domestic financial services industries share a considerable amount of policy determinations in common and overlap among industries to a considerable degree.[56] The regulatory structures among industries, however, often vary considerably among the differing sectors [57] and in a not altogether

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[53] See Employers Ins. Co. v. American Reinsurance Co., 256 F. Supp.2d 923, 925-926 (W.D. Wis. 2003).

[54] See Premier Ins. Co. v. Hartford accident & Indemnity Co. 35 F.Supp. 2d 348, 351 (SDNY 1999).

[55] See Affiliated FM Insurance Co. v. Constitution Reinsurance Corp., 416 Mass. 839, (1994).

[56] *See* Howell E. Jackson, Regulation in a Multisectored Financial Services Industry: An Exploratory Essay, 77 Wash U. L. Q. 319, 332-339 (1999) (describing the public policies underlying the regulation of financial Institutions).

[57] A descriptive organization of regulatory approaches has been offered by Professor Howell to assist in identifying risk containment strategies on a continuum from least invasive to most intrusive. Id. at 340. This structure places the private ordering of risk allocation between private parties engaged in the transaction as the default and least intrusive regulatory scheme, with regulatory systems proceeding on a continuum of general categories through "disclosure strategies", "general standards of conduct", "portfolio shaping rules (both static and dynamic) and "boding mechanisms". Id. at 340. The choices of regulatory schemes differ greatly among the various industries engaged in activities commonly construed to come with the general umbrella description of financial services. Consider for example the primary reliance on disclosure rules established by the Securities act of 1933 and Securities and Exchange Act of 1934 as a regulatory method as compared with the capital and reserve requirements insurance companies must maintain to comply with statutory leverage requirements.

consistent fashion.[58] Though this Essay does not purport to review the various types of regulatory differences among the numerous sectors of industry devoted to financial transactions,[59] such observation does assist in the unsurprising recognition that a certain amount of variance likewise exists within the regulatory tools in any given sector of the financial services industries.

The subject of this Essay is the regulation of that particular and perhaps even peculiar area of financial services known as the insurance industry. Importantly, regulation of insurance companies is a topic fraught with considerations far beyond the mere regulation of individual risk inherent to all financial regulatory regimes. Many of these considerations include those which the contractual arrangement of reinsurance, as described above and the nature of the reinsurance market have the capacity to influence.

Particularly with insurance, the fiscal ramifications to the public as a result of a wide scale insurance failure typify a best avoided externality often identified as justification for proper insurance regulation. The concept of mass insurance defaults in the wake of catastrophe and its concomitant public cost is among the reasons why reevaluation of

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[58] For instance, mandatory disclosure is the primary regime of choice as regards mutual funds with disclosure rules applicable to all issuers of securities enhanced by supplemental layers of disclosure required by the Investment Company act of 1940 particular to investment pools. Howell at 345. There is nothing about pooled investments that per se require a disclosure based regime. Howell at . n. 54. Other financial products, such as common trust funds at banks ad defined contribution pension plans pool investment returns. Id. at n. 54. In those contexts, disclosure rules do not maintain the same priority of place; with bank trust funds and defined-contribution pension plans regulated primarily by fiduciary rules. Id. at n. 54. The investment activities are similar though the regulatory scheme differs. Id. at n. 54. For a judicial discussion of these similarities *See* also Investment Co. Inst. V. Camp, 401 US 617, 642 (1971) (Blackmun J. dissenting).

[59] Some of these distinctions are undoubtedly a result of the historic evolution of the various regulatory systems as the industries themselves evolved. For a very complete analysis of these historical developments *See* HOWELL E. JACKSON & EDWARD L. SYMONS JR., REGULATION OF FINANCIAL INSTITUTIONS. The level of intrusiveness in the regulatory scheme does seem to correlate somewhat to the complexity of the financial transaction and the opacity of the financial sector's balance sheets. *See* Howell E. Jackson, Regulation in a Multisectored Financial Services Industry: An Exploratory Essay, 77 Wash U. L. Q. 319, 340 (1999) ("As a general matter, as the financial arrangement become more complex and the balance sheets of intermediaries become more opaque, our regulatory strategies become more intrusive ad draconian.").

insurance regulation has gained such primacy in current years. Who would wish to contemplate a Gulf Coast where coverage was severely reduced as a result of insurer insolvency?

Though the issue of risk containment obviously has influenced the structural regulation of the insurance industry, elements of political interest in promulgating equitable access to insurance and other redistributive and equitable norms alongside the unique state regulatory system of insurance have all had their part in the development of the regulatory structure under which the industry now operates. Many of these interests are of the type reinsurance market practices and common contract terms have the capacity to either promote or prohibit.

1. Reinsurance and Liquidity

Reinsurance is a source of liquidity. As a result of the way income is calculated in the insurance industry, upon issuing an insurance policy, the administrative expenses are charged immediately. For this reason, broker's fees or taxes or other ancillary expenses will be immediately charged as income with a concomitant net loss of outstanding surplus. The premiums collected by the insurance company, on the other hand, must be set aside in an unearned premium reserve and will only be recognized over the term of the policy. The purpose of this accounting system is to encourage insurer solvency. However, the situation clearly results in the potential to decrease capacity. With every policy sold, the surplus is decreased and the company's ability to write more policies lessened.

Reinsurance is a way to solve the surplus problem, since the reinsurer can agree to share a portion of the expenses. A reinsurer will give the reinsured a "ceding credit" for a

share of the expenses, this can then be recredited to the reinsured's surplus, increasing capacity. Likewise, the reinsurance agreement can be credited against loss reserves to similarly increase capacity.

In order for this increased capacity not to jeopardize insurer solvency, the main focus of regulation of reinsurance companies is concerned with reinsurer solvency. This is no idle matter. The failure of Transit Casualty Company and Mission Insurance Company in the 1980's, were two of the largest insurance insolvencies in domestic insurance history.[60] Both these insurance insolvencies occurred in part because of their inability to collect from their reinsurers. To address this risk, the states all have various techniques in place to assure reinsurer solvency. If admitted or licensed in the state, the reinsurer must comport with certain reserve requirements of their own or, if foreign or unadmitted, the reinsurer is usually required to offer a bond sufficient to allay fears of an inability for the insurer to collect on their reinsurance agreements. If no bond is posted, the insurer will not have access to the credit granting and reserve expanding benefit of the reinsurance.

Still, the multi-state system leads to some fears of inadequacy and redundancy. To address these issues, along with the perennial problem of construing the appropriate way for the states to share in the taxation of these transactions, the House of Representatives in June 2007 passed HR 1065, the Nonadmitted and Reinsurance Reform Act.[61] The Senate companion bill, S 929, awaits consideration in the Senate.[62] That

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[60] *See* Insurance Regulation: State Reinsurance Oversight Increased But Problems Remain, GAO Report, May 1990 at 2. [Hereinafter 1990 GAO Report].

[61] See NAIC, Current Issues: Nonadmitted Insurance and Reinsurance available at http://www.naic.org/topics/topic_surplus_lines.htm.

[62] Id. That legislation would grant exclusive regulatory authority for multi-state surplus lines and to the insured's home state sp as to restrict each transaction to a single set of regulatory oversight, rules and taxation. Id.

legislation would grant a single state authority to determine the appropriateness of reinsurance credit and reinsurer solvency assessment.[63] The solvency assessment would be conducted by the reinsurer's home state and the credit determination would be made solely by the ceding insurer's domiciliary state.[64] It is unclear how this alters the current regulatory system other than to encourage reinsurers or insurers to change their domiciles in search of a state whose regulation best comports with their needs, though it likely will assist in clarifying taxation.

2. Consumer Protection

Since reinsurance is considered a business to business transaction, it is subject to significantly less regulatory oversight beyond issues of solvency. As described above, however, the capacity of reinsurance to indirectly affect the policyholder though inculcating and rewarding reinsurer focused underwriting decisions and claims handling processes exist and are not addressed by the current regulatory schemes.

There are some significant policy concerns implicated in other commonly available reinsurance coverage clauses such as those making reinsurance coverage available for bad faith judgments. Called "judgment in excess of policy limits" clauses these allow insurers to be indemnified for their own bad faith actions against their policy holders. As reported in Ostrager & Newman's HANDBOOK ON INSURANCE COVERAGE DISPUTES, these clauses generally provide "in word or substance"[65]:

> It is agreed that should the ceding insurer become legally obligated to pay a loss in excess of policy limits by reason of alleged or actual negligence, fraud or bad faith in rejecting an offer of settlement or in the defense or

[63] Id.
[64] Id.
[65] Ostrager & Newman's HANDBOOK ON INSURANCE COVERAGE DISPUTES, sec 16.06[a].

> trial of any action against an insured, the Reinsurer agrees to assume ____% of said loss [in excess of the ceding insurer's] $ _____ retention.[66]

These clauses are "relatively widely used and provide[] the reinsurer will participate in such excess verdicts but not to exceed the reinsurance contract limits".[67] Moreover, there are iterations of this clause which explicitly provide for coverage of "punitive damages".[68] Other courts have found reinsurer's liable for bad faith judgments even in the *absence* of such a clause, but where the reinsurance agreement does contain the early omnipresent "follow the fortunes" language.[69] The "excess of policy limits clause" has been applied in bad faith decisions based on both contractual and tortious theories of liability.[70]

Various state statutes, including those of primarily regulatory purpose and the common law, both authorize bad-faith actions against insurers as a way to deter bad faith activities. Thus, it is somewhat surprising to find them reinsurable as a matter of public policy. Considering that the reinsurance agreements are supported by the premiums charged the policyholders, it seems somewhat incongruous to allow the cost of insurer's own bad faith judgments to be charged directly back to policyholders in their premiums. In fact, it seems to mitigate the entire purpose of the statute, the legal action and the tort judgment, beyond the insurer's own retention. Since that retention may or may not be greater than the public cost of supporting the civil justice system to allow for the trial of these cases, one wonders if there is any public benefit at all. Clearly, this type of

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[66] Id.
[67] Id.
[68] Id.
[69] Id. citing Peerless Ins. Co. v. Inland Mut. Is. Co., 251 f.2d 696, 697 (4th Cir. 1958).
[70] Id. citing Ott. V. All Star Insurance Corp., 299 NW 2d 839, 840 (Wis. 1981).(holding that the reinsurer was liable for judgments against its ceding insurer for "tortuous failure to settle within [its] policy limits" under an unparticularized "excess of policy limits" endorsement to the original reinsurance certificate.).

indemnification reduces the deterrent value of these actions. There can be little deterrence through litigation and the award of damages, tortious or otherwise, if those judgments are indemnified by reinsurer's as a matter of course. Granted, reinsurers are sensitive to loss histories so too common a number of negligent or bad faith judgments could increase their costs to reinsure. Still, that market based result seems somewhat less than the affect contemplated by legislators who enact bad faith statutes.

## IV. Conclusion

Reinsurance agreements certainly have the capacity to influence insurer behavior. The effect of these agreements and the manner in which courts enforce their performance likely leads to the institutionalization of systems beyond and not necessarily congruent with many of the expectations and avowed purposes of some regulatory activity.

Insurance is often dubbed an industry affecting the public interest; if that is so, then reinsurance should acquire that denomination as well. Though silent, operating through private contract alone, it has the capacity to regulate insuring behavior. To be effective, this Essay suggests that regulatory discussions of the insurance industry be expanded to recognize the regulatory capacity of the reinsuring industry. To fail to do so is to ignore a fundamental financial influence on the entire insurance industry with the likely result that the silent regulator will continue to operate below even the notice of our sometimes raucous public one.