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Caught Between Rocks and Hard Places: The Plight of Reinsurance Intermediaries Under U.S. and English Law

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INTRODUCTION

Insurance is transacted in international commerce, and reinsurance is an indispensable component of the business of insurance.[1] The persons and business firms that place and service reinsurance are commonly known as intermediaries.[2] Because insurance companies are quasi-public financial institutions whose regulation is essential to the stability of

1. Insurance is a means to transfer the financial risk of a loss from the insured to the insurer. Reinsurance provides the insurance company with the opportunity to spread its risks and to increase its financial ability to write more new business by transferring a portion of its financial obligations to the reinsurer(s), who in turn may transfer a portion of the risk to other reinsurers. This process of reinsuring is referred to in the insurance business as *ceding* and *retrocession*, respectively. The reinsured (or "cedent") cedes the business to the reinsurer who *assumes* the financial consequences of the ceded business. A reinsurer of a reinsurer is a "retrocessionnaire." *See generally* ROBERT C. REINARZ ET AL., REINSURANCE PRACTICES 17 (1st ed. 1990).

2. The term "intermediary" is derived from the French — intermédiaire — meaning one that is intermediate, a mediator, an inter-agent, a go-between. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1180 (Philip Babcock Gove ed., 1986); OXFORD ENGLISH DICTIONARY 405 (J.A. Simpson & E.S.C. Weiner, eds., 13th ed. 1989). For purposes of this article, we use the generic term "intermediary" to identify all those who serve as agent or broker in a reinsurance transaction. In common insurance parlance, a broker represents the reinsured, while an agent represents the reinsurer. 1 BERNARD L. WEBB ET AL., PRINCIPLES OF REINSURANCE 45 (1st ed. 1990); Capitol Indem. Corp. v. Stewart Smith Intermediaries, Inc., 593 N.E.2d 872, 876 (Ill. Ct. App. 1992). Of course, both are "agents" within the meaning of agency law. 1 WEBB, *supra*, at 45.

domestic and foreign markets,[3] the regulation of reinsurance intermediaries, both in the United States and abroad, is regarded as essential to the preservation of insurance company solvency and the protection of a failed insurer's creditors.

Although the fundamental rights, duties, and obligations of reinsurance intermediaries in the United States have remained unchanged for many years, recent regulatory, judicial, and industry pressures have subjected them to unprecedented scrutiny.[4] The greatest change has been the enactment of comprehensive statutes regulating the licensure and professional conduct of reinsurance intermediaries. These statutes, and the regulations promulgated under them, seek to codify many of the intermediary's traditional responsibilities. They have brought with them, however, a new focus from start to finish on the relationships between cedents, intermediaries, and reinsurers. Led by the State of New York and the National Association of Insurance Commissioners (NAIC), a number of states have passed comprehensive intermediary legislation over the last four years.

Much has been written about the relative rights and duties of cedents and reinsurers when an intermediary is bankrupt and about the legal and financial consequences when an intermediary has placed business with a reinsurer that fails financially.[5] Until recently, intermediary legislation and regulation focused on the problems presented by bankrupt *intermediaries*. The current round of legislative and regulatory reform, however, addresses intermediaries' rights and duties when a *cedent or reinsurer* becomes insolvent. Perhaps because the law in this area is new and developing, little has been written of intermediary obligations in such circumstances.[6] The purpose of this article is to advance that discourse by discussing intermediary rights and duties

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3. Edward B. Rappaport, Congressional Research Service, *CRS Report to Congress: Insurance Company Solvency* 1 (1989).

4. *See, e.g.*, 1977-2 NAT'L ASS'N INS. COMMISSIONERS PROC. 416–21.

5. *See* John M. Sheffey, *Reinsurance Intermediaries: Their Relationship to Reinsured and Reinsurer*, 16 FORUM 922 (1981); Harold M. Tract, *Regulation 98: Muted Impact on Liability*, BEST'S REVIEW, Apr. 1984, at 48; Stacy Adler, *Courts Differ on Intermediaries' Status*, BUS. INS., Oct. 31, 1988, at 74; Diane E. Burkley & Carol Ann Bischoff, *Liability of Agents, Brokers, and Intermediaries for Insurance Insolvency*, *in* LAW AND PRACTICE OF INSURANCE COMPANY INSOLVENCY REVISITED 341 (Francine L. Semaya ed., 1989); Diane M. Nash, *Special Problems for Agents/Brokers Resulting from Insurance Company Insolvency*, *in* LAW AND PRACTICE OF INSURANCE COMPANY INSOLVENCY REVISITED, *supra*, at 783.

6. A recent article has provided part of the foundation of that discourse by summarizing current legislative and regulatory initiatives undertaken to regulate the business of intermediaries. *See* Debra J. Hall, *The Emerging Regulation of Reinsurance Intermediaries*, 42 DRAKE L. REV. 859 (1993).

under English and U.S. law. This article focuses on English and U.S. law because of the comparatively large volume of reinsurance transactions between the United States and the United Kingdom. As will be seen, reinsurance is negotiated in an international market, with most dollars passing between the United States and London. Each of those jurisdictions has enacted legislation and promulgated regulations governing an intermediary's conduct of its business. These laws can and do conflict. When a cedent or reinsurer fails in either country, the intermediary may find itself caught between conflicting laws in the two jurisdictions — between rocks and hard places.

Accordingly, Part I of this article provides a review of the role intermediaries have played in the recent spate of insurance company insolvencies and an overview of intermediary rights and duties. Part II then progresses to a discussion of English intermediary law, analyzing how the general English rules apply to intermediaries when a cedent or reinsurer becomes insolvent. Part III addresses the same issues under U.S. law, tracing the most recent statutory developments from their cause and considering their effect on reinsurance transactions. This article concludes with a discussion of how English and U.S. law interact in reinsurance transactions, pointing out how recent developments in each jurisdiction necessarily affect the other.

I. BACKGROUND

A. *Intermediaries Caught in the Middle of Insurer Insolvencies*

Insurance companies around the world have been failing at what many still regard to be an alarming rate. While this was perceived to be a U.S. phenomenon in the 1980s, recent failures in London, Bermuda, and Canada have highlighted what now is recognized to be a global dilemma. Legislators and insurance regulators have conducted both "macro" and "micro" studies of the problem and have proposed a flurry of legislative initiatives and regulatory pronouncements designed to prevent insurer insolvencies and lessen the impact of companies that inevitably fail.[7]

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7. *See, e.g.*, STAFF OF SUBCOMMITTEE ON OVERSIGHT & INVESTIGATIONS, HOUSE COMM. ON ENERGY AND COMMERCE, 101ST CONG., 2D SESS., FAILED PROMISES: INSURANCE COMPANY INSOLVENCIES 2 (Comm. Print 1990) [hereinafter FAILED PROMISES]; S.B. 1091, Cal. 1995–96 Regular Sess., 1995 Cal. Laws (proposing an interstate compact for administering insurer insolvencies); S.B. 534, 109th Regular Sess., 1995 Ind. Laws (same); S.B. 466, 88th Gen. Assembly, 1995 Mo. Laws (same); L.B. 178, 94th Legis., First Sess., 1995 Neb. Laws (same); S.B. 137, 1995 Regular Sess., 1995 N.H. Laws (same); H.B. 914, 74th Regular Sess., 1995 Tex. Laws (same).

Fearing another solvency crisis in U.S. financial institutions, a number of congressional committees initiated investigations, convened public hearings, and issued reports, addressing, among others, the issue of whether the federal government should assume regulation of the insurance industry.[8] The most controversial investigations have been conducted by the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, chaired by Congressman John D. Dingell (D. Mich.). In its 1990 report, *Failed Promises: Insurance Company Insolvencies* (*Failed Promises*), the House Subcommittee set forth its findings following a lengthy investigation of insurer insolvencies. Focusing primarily on the failures of four property and casualty insurers,[9] the House Subcommittee found the following to be common elements of financial failure: "rapid expansion, over-reliance on managing general agents, extensive and complex reinsurance arrangements, excessive underpricing, reserve problems, false reports, reckless management, gross incompetence, fraudulent activity, greed, and self dealing."[10] Recognizing the vital role that reinsurance plays in the solvency of insurance companies, the House Subcommittee was troubled by insurance company managers' "excessive reliance on the judgment" of, and delegation of "their most fundamental responsibilities" to, brokers and other third parties who may have conflicting interests.[11] The Subcommittee was especially critical of state officials whose regulatory efforts suffered from inadequate resources, lack of coordination, infrequent regulatory examinations, poor information and communications, and uneven implementation.[12]

Failed Promises closed with a series of questions about whether the federal government should assume regulatory responsibility for the business of insurance.[13] Four years later, the House Subcommittee issued

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8. Since Congress passed the McCarran-Ferguson Act in 1945, the states have had the virtually preemptive right to regulate the "business of insurance." *See* 15 U.S.C. §§ 1011-15 (1988).

9. Mission Insurance Company, Integrity Insurance Company, Transit Casualty Company, and Anglo-American Insurance Company.

10. FAILED PROMISES, *supra* note 7, at 2; *accord* STAFF OF PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, SENATE COMM. ON GOVERNMENTAL AFFAIRS, 102D CONG., 2D SESS., SECOND INTERIM REPORT ON U.S. GOVERNMENT EFFORTS TO COMBAT FRAUD AND ABUSE IN THE INSURANCE INDUSTRY: PROBLEMS WITH THE REGULATION OF THE INSURANCE AND REINSURANCE INDUSTRY 16, 18 (Comm. Print 1992) [hereinafter SECOND INTERIM SENATE FRAUD REPORT].

11. FAILED PROMISES, *supra* note 7, at 3. The conflict lies in an agents' fiduciary obligation to its principal and its own selfish desire for commissions generated by increased business. *Id.* at 10.

12. *Id.* at 4; SECOND INTERIM SENATE FRAUD REPORT, *supra* note 10, at 27.

13. FAILED PROMISES, *supra* note 7, at 75–76.

its sequel to *Failed Promises*, titled *Wishful Thinking: A World View of Insurance Solvency Regulation.*[14] The majority of the House Subcommittee concluded that federal intervention is both necessary and inevitable. Recognizing that preserving solvency is both the original purpose and first priority of insurer regulation, the Subcommittee articulated the following "realistic formula for solvency regulation:" a focus on prevention of insolvency, a commitment to bear the related costs, and implementation of appropriate regulatory systems to accomplish the prevention of insolvency, i.e., national solvency standards, meaningful enforcement, and control of alien[15] insurers and reinsurers. The Subcommittee also considered the role of insurance intermediaries and recommended that state regulators:

> closely inspect the qualifications and activities of independent brokers and agents, especially those handling reinsurance and surplus lines coverage.[[16]] Every significant property/casualty company failure has involved extensive participation by such intermediaries working on commissions, and they have been the chief conduit for transferring policyholder funds to unsound and unscrupulous destinations around the globe.[17]

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14. STAFF OF SUBCOMMITTEE ON OVERSIGHT & INVESTIGATIONS, HOUSE COMM. ON ENERGY & COMMERCE, 103D CONG., 2D SESS., WISHFUL THINKING: A WORLD VIEW OF INSURANCE SOLVENCY REGULATION (Comm. Print 1994) [hereinafter WISHFUL THINKING].

15. Most regulators and members of the United States insurance industry distinguish between insurers on the basis of: (i) their legal form of ownership (e.g., proprietary, cooperative, pools and associations, governmental, and "other"); (ii) their place of incorporation (i.e., domestic, foreign, and alien); (iii) their licensing status (i.e., licensed/admitted vs. unlicensed/nonadmitted); and (iv) the type of their product and service distribution systems (i.e., independent agency, exclusive agency, direct writer, and mail order). *See generally* 1 WEBB, *supra* note 2. A *domestic* insurer within any given state is an insurer that is incorporated within, or formed under the laws of, that state. A *foreign* insurer is one incorporated in, or formed under the laws of, another state. An *alien* insurer is one incorporated in or formed under the laws of another country. *Id.* at 12.

16. A surplus lines company is not licensed to do business in the state. It is permitted to operate in an unlicensed capacity on the assumption that it is providing coverage for exposures that cannot be readily obtained in the market provided by admitted insurance companies. Regulation is accomplished by regulating the in-state broker who places the business with the nonadmitted surplus lines company. Most state regulations provide that a surplus lines broker placing business with an unlicensed surplus lines company must have a special license, *see, e.g.*, ILL. ANN. STAT. ch. 215, para. 5/445 (1992), and that the company with which the business is placed, although unlicensed, be on a list of companies approved to do surplus lines business in the state (called a "white list"). Surplus lines brokers are also generally required to file information with the state insurance department every time business is placed with an unlicensed company. *Id.* para. 5/445(5). In order for a surplus lines company to remain on the approved list, the surplus lines broker sponsoring such a company may be required to provide financial information about the insurer to the insurance department. Some states do not have an approved list of surplus lines insurers. In these states, the broker is responsible to exercise care in selecting the insurer. 2 Webb, *supra* note 2, at 167–68.

17. WISHFUL THINKING, *supra* note 14, at 14.

Since *Failed Promises* was published, state regulators have worked in earnest to forestall execution on congressional threats of federal regulatory preemption by implementing state regulatory systems designed to preserve the solvency of domestic insurers and reinsurers. State insurance regulators have examined the events and persons identified by the federal government as causes of the "insolvency crisis" and have focused particularly on reinsurance intermediaries. Accepting the federal government's criticism that reinsurance is largely unregulated, state regulators have responded by proposing increased legislation and promulgating regulations to ensure that the people who place reinsurance and administer claims — the intermediaries — are sufficiently monitored to ensure the solvency of both cedents and reinsurers.

B. *Overview of the Rights and Duties of Reinsurance Intermediaries*

1. Business Practices

Intermediaries are the "middlemen" in reinsurance transactions.[18] Heifetz aptly describes the intermediary's role:

> [Intermediaries] bring buyer and seller together. Within this framework, the intermediary assumes many roles, at times the inquisitor, the devil's advocate, the diplomat, the referee, the accounting expert, the tax expert, the industry bellwether, the broad shoulder, the father confessor and, every once in a while, the fall guy.
>
> An intermediary's function in the reinsurance transaction process can be divided chronologically into six different parts — contact, survey, conceptualization, authorization, placement and service.[19]

"Contact" refers to the first step in any brokered business transaction: the identification (through research) of a business opportunity and the business broker's initial communication with one of the parties. "Survey" describes the intermediary's identification of the client's reinsurance needs. In a reinsurance transaction, it begins with a "limits

18. Leo T. Heifetz, *The Role of the Intermediary*, *in* INSURANCE INFORMATION INSTITUTE, REINSURANCE: FUNDAMENTALS AND NEW CHALLENGES 31 (2d ed. 1989).

19. *Id.*; *see also* 1 WEBB, *supra* note 2, at 22. The intermediary brings together a primary insurer and a reinsurer and assists them in negotiating one or more reinsurance agreements. The intermediary then acts as a conduit between reinsured and reinsurer for transmitting money and information. Intermediaries often provide other services, such as underwriting advice, suggestions for claims administration or reserving, and setting reinsurance retentions and limits. *Id.* at 22, 29; *accord* Calvert Fire Ins. Co., 526 F. Supp. 623, 625 n.2 (D. Neb. 1980); *Capital Indem. Corp.*, 593 N.E.2d at 876.

profile," typically including a description of the principal's underwriting practices; premium rate filings; claims administration; distribution of business (by line of business,[20] territory, and limits); expenses; financial data; existing reinsurance and management's attitude toward assumption of risk; analysis of the company's risk-bearing capabilities; and future business plans. "Conceptualization" refers to the broker's identification of the client's needs and recommendations on how they may be filled. "Authorization" is the client's agreement that the broker may act for it. "Placement" describes the broker's search for an appropriate reinsurer. "Service" encompasses the full execution of the contract, from signature through performance.[21]

2. Legal Duties

As a matter of law, a reinsurance intermediary's principal right is to receive compensation, usually through brokerage commissions and investments on funds held, for efforts expended on behalf of the principal. In return, the intermediary traditionally has owed the following duties to the principal:

1. to make reasonable *inquiry* about the financial strength of the proposed reinsurer;
2. to *effect* the desired *cession*;
3. to *transmit* promptly funds and communications between the cedent and reinsurer; and
4. to *account* properly for all funds received or transmitted.[22]

In other words, there are three broad categories of financial duties owed by reinsurance intermediaries: security, care and loyalty, and accounting. These legal duties generally fall in Heifetz's descriptions of the "placement" and "service" functions.

Before an intermediary is engaged to transact reinsurance business, he must provide security for his performance. Such security is provided by licensure, a contract or letter of engagement, fidelity bonds, and errors and omissions coverage.

Engagement triggers an intermediary's second duty, care and loyalty. This duty requires the intermediary to determine which reinsurers are capable of meeting financial obligations owed to the cedent, and which

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20. A "line of business" is a type of insurance written, e.g., burglary and theft, glass, etc. *See generally* 1 WEBB, *supra* note 2, at 64-65.

21. Heifetz, *supra* note 18, at 31-36.

22. *See generally* Sheffey, *supra* note 5, at 923–24; *see also* 1 WEBB, *supra* note 2, at 25.

cedents have underwritten risks compatible with the assuming reinsurer's program. On the one hand, this entails an obligation by the intermediary to analyze the financial security of unauthorized reinsurers. This frequently has been termed the duty of inquiry. Although new regulations still do not go so far as to make an intermediary a guarantor of a reinsurer's solvency, they do impose obligations to investigate the financial health of unauthorized reinsurers. Moreover, it has been suggested that intermediaries will be expected to monitor the performance of assuming reinsurers.[23] Increasing liability for failure to ascertain a reinsurer's ability to perform[24] provides an incentive for intermediaries to dedicate resources to analyzing the relative strength of reinsurers.

Equally important is an intermediary's duty to provide clear communication, sometimes labelled the duty to disclose. Intermediaries must understand both the nature of a cedent's reinsurance needs and a reinsurer's requirements in order to be able to formulate and communicate clearly the terms of the proposed cession. Failure to perform this function properly may lead to rescission[25] of the reinsurance treaty or facultative certificate (collectively, the "reinsurance contract").[26] Once the proposed cession has been approved in principle, the intermediary has a related duty to document the transaction. This obligation frequently includes the drafting, circulation, and execution of reinsurance contracts, as well as the maintenance of complete records even after the relationship is terminated.

Execution of the reinsurance contract triggers an intermediary's third duty, to account. In general, the intermediary has a duty to handle funds received in a fiduciary capacity on the principal's behalf. State regulators have begun demanding strict adherence to requirements for the maintenance and payment of reinsurance funds. The industry is demanding increasingly that intermediaries provide sophisticated administrative services to ensure that collections can be effected promptly. Because an intermediary is the conduit through whom claims information flows, he

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23. *See, e.g.*, Thomas J. Kennedy, *Intermediaries Under Siege*, BEST'S REVIEW, Mar. 1992, at 45.

24. *See generally* Burkley & Bischoff, *supra* note 5.

25. *See, e.g.*, Calvert Fire Ins. Co. v. Unigard Mut. Ins. Co., 526 F. Supp. 623 (D. Neb. 1980).

26. Reinsurance transactions are usually classified, by the method of underwriting, into two types: facultative and treaty. In *facultative* reinsurance, each risk is usually underwritten individually. The primary insurer has no obligation to submit any risks to the reinsurer, and the reinsurer is free to accept or reject any risks submitted. Under *treaty* reinsurance, the reinsurer generally underwrites an entire class or portfolio of risks. Individual risks of the primary insurer that come within the treaty contract conditions are automatically reinsured. 1 WEBB, *supra* note 2, at 147; *Calvert Fire Ins. Co.*, 526 F. Supp. at 626 n.5, 628 n.8.

also is expected to develop and maintain claims departments capable of securing such collection.[27] This frequently means that intermediaries must retain experts to resolve complex reinsurance claims and disputes.

The three duties of intermediaries — security, care and loyalty, and accounting — arise at different times, but are cumulative in nature and effect. For example, the duty to provide security is the intermediary's initial duty, but it is one that increases over time, as do each of the other duties. As demonstrated below, it has become increasingly difficult in today's marketplace for intermediaries to perform their duties. The most recently implemented statutory and regulatory controls of their performance are founded upon common law agency principles and designed to alleviate the difficulties encountered in many insurer receiverships.

II. English Law Governing Reinsurance Intermediaries

English law governing the relationships between cedents, intermediaries, and reinsurers derives from the common law of agency and contract, as well as from statute.

A. *Agency*

The general rule is that a reinsurance intermediary serves as the cedent's agent.[28] However, in certain circumstances (e.g., in connection with the adjustment and settlement of claims), an intermediary may act as the reinsurer's agent or as agent of both the cedent and reinsurer.[29] An intermediary is prohibited from acting on behalf of both the cedent and reinsurer, however, unless he obtains the prior, informed consent of both parties after disclosure of all material facts.[30]

Like other agents, reinsurance intermediaries owe their principals the duty to exercise reasonable care and skill and the duty of loyalty. As

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27. *See* 1 Webb, *supra* note 2, at 22, 29.

28. Rozanes v. Bowen, 32 Lloyd's List L. Rep. 98 (C.A. 1928).

29. Equitable Life Assurance Soc'y v. General Accident Assurance Corp., 12 S.L.T. 348 (1904) (where reinsurer exercises sufficient control over intermediary, intermediary is reinsurer's agent); Forsikringsaktieselskapet Vesta v. Butcher (No. 1), [1989] 1 All. E.R. 402 (H.L.) (broker acting in dual agency capacity is authorized to receive communications on reinsurer's behalf). *But see* Pryke v. Gibbs Hartley Cooper Ltd., [1991] 1 Lloyd's Rep. 602, 615 ("It may be possible for an agent by express agreement to place himself in the position in which he does act for two parties, but a custom to the effect that he is compelled to act in conflict or for two masters is not enforceable in law.") (citing Anglo African Merchants Ltd. v. Bayley, [1969] 1 Lloyd's Rep. 268, [1970] 1 Q.B. 311; North and South Trust Co. v. Berkeley, [1970] 2 Lloyd's Rep. 467, [1971] 1 W.L.R. 470).

30. *Pryke*, [1991] 1 Lloyd's Rep. at 615; *see also* John S. Butler & Robert M. Merkin, Reinsurance Law D.3.1-07 (15th ed. 1992) [hereinafter Butler & Merkin].

part of the duty to exercise care and skill, intermediaries are bound to investigate the financial health of a reinsurance company before ceding risk to that company.[31] As part of the duty of loyalty, intermediaries are not permitted to make a secret profit from transactions involving the cedent, although they are entitled to be compensated for their services.[32] This compensation typically is obtained by deducting a commission from premium payments.

An intermediary's duty to account is fairly settled in English law. In the reinsurance context, the intermediary receives premiums and claims for transmission to cedents and reinsurers. In handling those funds, the intermediary must:

> 1. act with due diligence in collecting amounts and . . . pay over any sum received in his employment in accordance with the arrangements agreed with his principal.
>
> 2. render an account when required.
>
> 3. keep his principal's property distinct from his own.
>
> 4. not . . . make any profit beyond the commission or remuneration paid by his principal.[33]

In most cases, the intermediary/cedent relationship is not governed directly by the terms of a reinsurance contract between the cedent and reinsurer; rather, the intermediary and his principal have a separate and distinct agreement. Moreover, since the intermediary is not bound by the reinsurance contract, he cannot sue in his own name to enforce it.[34] Similarly, third parties cannot sue an intermediary on a reinsurance contract made on behalf of a cedent or reinsurer.[35] However, an intermediary who effects reinsurance in his own name without disclosing the existence or identity of the cedent may sue for and recover in his own name the full amount of the cedent's loss under the reinsurance contract and eventually may be liable to transfer any funds recovered to the

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31. Osman v. J. Ralph Moss Ltd., [1970] 1 Lloyd's Rep. 313 (C.A.).

32. R.W. Hodgin, Insurance Intermediaries: Law and Regulation ¶¶ 2.27–2.35 (1992).

33. R.L. Carter, Reinsurance 153 (2d ed. 1983). Also, intermediaries typically earn investment income on premiums and claim payments held before distribution to reinsurers and cedents.

34. F.M.B. Reynolds, Bowstead on Agency art. 104 (15th ed. 1985) [hereinafter Bowstead].

35. *Id.*

cedent.[36] Furthermore, a reinsurer sued by an intermediary in his own name may be able to defend against the suit on the basis that it has paid the cedent, that the cedent has intervened and demanded payment or sued, or that the intermediary's authority to sue was terminated.[37]

An intermediary's authority to act on a cedent's behalf terminates under certain circumstances.[38] For example, subject to a contrary agreement, an intermediary's authority is to a considerable extent revoked if the cedent becomes insolvent, unless the intermediary is unaware of the insolvency.[39] Thus, an intermediary who is unaware of a cedent's insolvency may continue to pay a reinsurer; if the intermediary is aware of the insolvency, he has no authority to do so. Similarly, a reinsurer's payments of losses or return premiums to an intermediary who knows of the cedent's insolvency do not constitute payment to the cedent unless the reinsurer is unaware of the insolvency.[40] An intermediary's bankruptcy will not affect his ability to act on a cedent's behalf unless the agency agreement provides otherwise.[41]

An intermediary's authority to act on a cedent's behalf may be expressed in an agency agreement or implied under common law. To determine the scope of an intermediary's express authority, reference should be made to the terms of his agency agreement, as well as to other facts and circumstances surrounding the relationship. The implied authority of an intermediary to act on a cedent's behalf is determined principally by reference to the customs and usages of the reinsurance marketplace.

1. Custom and Usage

An intermediary has implied authority to act on a cedent's behalf according to reasonable customs and usages of the reinsurance market, or other customs and usages of which the cedent has notice and that the cedent adopts at the time the agent's authority is conferred.[42] The theory underlying this proposition is that if a practice becomes uniform and accepted, then conformity with that practice becomes an implied term of the agency agreement.[43] Many customs in the English reinsurance mar-

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36. *Id.* art. 105.
37. *Id.*
38. *See generally id.* arts. 124–128.
39. *Id.* art. 127.
40. *Id.*
41. *Id.*
42. *Id.* art. 31.
43. BUTLER & MERKIN, *supra* note 30, D.3.4-05; *see also* BOWSTEAD, *supra* note 34, art.

ket have been evolving over two centuries, particularly in relation to a cedent's obligation to pay premiums and the netting of accounts.

a. Premiums

As a matter of custom, reinsurance contracts covering marine risks are viewed differently than reinsurance contracts covering other risks. Under the former, the intermediary — not the cedent — is personally liable to the reinsurer for premiums. This obligation has existed for almost two hundred years.[44] *Universo Ins. Co. of Milan v. Merchants Marine Ins. Co.*[45] is a case in point. There, an intermediary became bankrupt after receiving from the cedent premium funds under a marine reinsurance contract before they were paid to the reinsurer. The reinsurer sued the cedent to recover the funds. Relying upon the custom prevailing in the marine reinsurance market, the court held that the reinsurer's action must fail. Mr. Justice Parke explained the theory underlying the custom sixty-eight years earlier:

> By the course of dealing, the broker has an account with the underwriter [i.e., the reinsurer]; in that account the broker gives the underwriter credit for the premium when the policy is effected, and he, as the agent of both the assured and the underwriter, is considered as having paid the premium to the underwriter, and the latter as having lent it to the broker again, and so becoming his creditor.[46]

Ten years after *Milan*, the custom was codified as Section 53(1) of the Marine Insurance Act of 1906 — "[u]nless otherwise agreed, where a marine policy is effected on behalf of the assured by a broker, the broker is directly responsible to the insurer for the premium."

Like the marine reinsurance market, Lloyd's custom obligates the intermediary — not the cedent — to pay premiums under reinsurance contracts underwritten by Lloyd's syndicates.[47] In other words, the intermediary stands in the shoes of, and is treated as though he were, the cedent. The custom has been justified because the intermediary (i.e.,

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40. It is not unusual for established practices in the marketplace to be pleaded as trade custom and usage by parties to legal actions.

44. Edgar v. Bumstead, 1 Camp. 411 (C.P. 1808).

45. [1897] 2 Q.B. 93.

46. Power v. Butcher, 10 B. & C. 329, 347 (K.B. 1829).

47. Julien Praet et Cie., S/A v. H.G. Poland Ltd., [1960] 1 Lloyd's Rep. 420, 433 ("It is an integral part of the Lloyd's system that where a firm of Lloyd's Brokers present a risk and have it accepted by an Underwriter, they make themselves responsible for the payment of the premium, whether or not they receive it from their client.").

Lloyd's broker) is known to the reinsurer, while the reinsurer usually does not know the cedent.[48]

Litigants unsuccessfully have tried to persuade courts to extend the Lloyd's custom to nonmarine reinsurance contracts underwritten outside of Lloyd's.[49] In *Wilson v. Avec Audio-Visual Equip. Ltd.*,[50] an insurer failed and its liquidator demanded payment of earned premiums arising under a nonmarine insurance policy underwritten outside of Lloyds. The intermediary paid the earned premiums to the liquidator and then sought indemnification from the insured. The insured refused, however, to indemnify the intermediary for premiums earned post-insolvency. The intermediary argued that custom required him to pay the premiums to the insurer's estate and that he had a right to be indemnified by his principal, the insured. The court rejected the intermediary's argument, applying the general rule that intermediaries are not personally liable under contracts made on behalf of their principals and held in the insured's favor. The court also relied upon a letter written by the insured withdrawing the intermediary's authority to pay the premiums.

The breadth of *Wilson*'s application is unknown. The case could be distinguished easily if the intermediary's authority were never revoked. In fact, the court stated that the custom may apply to non-Lloyd's, nonmarine policies if "clear and precise evidence of a very special relationship before an agent can be rendered personally liable in respect of a contract entered into on behalf of his principal" is presented.[51] Moreover, *Wilson* may not apply to reinsurance contracts. Thus, the custom could apply in the reinsurance context if it were established that the intermediary's obligation to pay premiums met requirements of reasonableness, certainty, and universal acceptance.[52]

b. Net Accounting

Absent a usage or custom, an intermediary has implied authority to receive payments only in cash.[53] To the extent a reinsurer pays an intermediary cash and the intermediary fails to pass on the money to the cedent, the cedent is not entitled to recover the cash from the reinsurer, because cash payment to the intermediary constitutes payment to the cedent.[54]

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48. Universo Ins. Co. of Milan v. Merchants Marine Ins. Co., [1897] 2 Q.B. 93, 99.

49. Wilson v. Avec Audio-Visual Equip. Ltd., [1974] 1 Lloyd's Rep. 81.

50. *Id.*

51. *Id.* at 83.

52. BOWSTEAD, *supra* note 34, art. 40 ("In order to establish the existence of a custom or usage [it must be shown] that the alleged custom is (i) reasonable, (ii) universally accepted by the trade or profession . . ., (iii) certain and (iv) not unlawful." (footnotes omitted)).

53. *Id.* art. 28.

54. Scott v. Irving, 1 B. & Ad. 605 (K.B. 1830); *see also* Trading & Gen. Inv. Corp. v.

Lloyd's intermediaries and underwriters typically enter into net accounting agreements under which they offset premiums and losses under multiple contracts on a regular basis and account to one another for the balance.[55] This practice has developed into a Lloyd's custom.[56] However, the practice of net accounting under multiple contracts has not yet risen to the level of a custom for policies underwritten outside of Lloyd's.[57]

Although net accounting is a Lloyd's custom, a cedent is not bound by the consequences that flow from it unless the cedent knows of and adopts its use. *Scott v. Irving* is a case in point.[58] In *Scott*, a Lloyd's broker and Lloyd's underwriter had a net accounting agreement. The underwriter owed the policyholder £100 in losses and the broker owed the underwriter £46 in premiums. In accordance with their net accounting agreement, the underwriter paid £54 to the broker, deducting the £46 owed to it. The broker became bankrupt before paying the policyholder. The underwriter argued that its obligation to the policyholder was discharged upon the payment of £54 to the broker in view of the set-off against premiums due from the broker. The court disagreed, however, holding that a policyholder is not bound by a net accounting agreement of which he is unaware. The court required the underwriter to pay the policyholder £46, reasoning that payment to the broker of the £54 in cash constituted payment to the policyholder. The court noted, however, that the result would be different where the policyholder "knows there is a certain accustomed course of dealing between the broker and the underwriter, and is willing to adopt it, whatever it may be."[59] The same principles also apply to the reinsurance market.[60]

Gault Armstrong & Kemble Ltd., [1986] 1 Lloyd's Rep. 195, 200 ("The cases [hold] that if an agent authorized to receive cash from a third party chooses not to receive cash but to give the third party credit, then the agent may be estopped from denying that he has received the cash or may . . . be treated as having received the money and lent it to the third party.").

55. *See generally* BUTLER & MERKIN, *supra* note 30, D.3.4-11.

56. *Scott*, 1 B. & Ad. at 605.

57. Sweeting v. Pearce, 9 C.B. (N.S.) 534, 535 (Ex. Ch. 1861) ("a usage of Lloyd's could not be taken to be a general usage of the trade of London, but only the usage of one house. . . .") (citing Gabay v. Lloyd, 3 B. & C. 793).

58. 1 B. & Ad. 605 (K.B. 1830).

59. *Id.* at 611; *see also* Matvieff v. Crosfield, 8 Com. Cas. 120 (1903) (court refused to bind insured to net accounting agreement between broker and insurer, despite fact that insured had considerable insurance knowledge and became a Lloyd's member before trial); *Sweeting*, 9 C.B. (N.S.) at 534 (ship-builder, insured, not bound by net accounting agreement between Lloyd's broker and Lloyd's underwriter, despite fact that jury found usage to be generally known to merchants and policy was effected in broker's name, where ship-builder was unaware of usage); Stewart v. Aberdein, 4 M. & W. 211 (Ex. Ch. 1903) (assured was cognizant of and authorized net accounting agreement and thus was bound by it).

60. *See* Provincial Ins. Co. Ltd. v. Crowder, 27 Lloyd's List L. Rep. 28, 30–31 (1927) (cedent not bound by net accounting practice between Lloyd's intermediary and Lloyd's underwriter).

2. Sub-agency

Sub-agency involves the delegation of an intermediary's authority or the appointment of a third party to act on the cedent's behalf. Sub-agency is becoming more common in the London reinsurance market because Lloyd's has recognized the need to permit intermediaries not registered with Lloyd's to have access to its underwriters. As one commentator noted, "[w]ith the growth of the Lloyd's market into areas other than marine, aviation and other large commercial risks, the market practice has had to adapt. . . ."[61] In the last few years, Lloyd's has opened its doors to non-Lloyd's intermediaries, permitting underwriters to accept business introduced to them by sources from all over the world.[62] Thus, the increasingly competitive nature of reinsurance likely will result in English courts having to resolve complex issues that arise in transactions involving more than one intermediary.

As a general rule, an intermediary may not delegate his authority or appoint a sub-intermediary to do any act on the cedent's behalf, except with the cedent's express or implied authority.[63] The reason is obvious: "the risks of agency are substantial, and a person has a right not to be represented, save at his own election and by an intermediary of his own choice."[64] Several consequences follow from the general rule: (i) actions of a sub-intermediary appointed without the cedent's permission are invalid; (ii) payments by a third party to the sub-intermediary do not bind the cedent; (iii) the cedent is not liable to the putative sub-intermediary for commission; (iv) the sub-intermediary does not have any lien against the cedent's property; and (v) the intermediary may be liable to the cedent for money received by the sub-intermediary.[65]

In addition, the intermediary may be liable to the cedent for the sub-intermediary's defaults resulting from the sub-intermediary's own negligence:

> The broker will thus face liability if his selection of the sub-broker was negligent, if he has failed to monitor the activities of the sub-broker or if he has participated in the sub-broker's negligent con-

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61. HODGIN, *supra* note 32, ¶ 5.16(ii).

62. *See, e.g.*, Lloyd's Byelaw No. 6 of 1988: Umbrella Arrangements, *as amended*; Lloyd's Byelaw No. 8 of 1990: Insurance Intermediaries Byelaw, *as amended*; Lloyd's Regulation No. 3 of 1990: Insurance Intermediaries Regulation, *as amended*; Lloyd's Regulation No. 4 of 1990: Approval of Correspondents.

63. *See generally* BOWSTEAD, *supra* note 34, art. 35.

64. *Id.* (quoting PHILIP MECHEM, OUTLINES OF AGENCY 50 (4th ed. 1952)).

65. *See id.*

> duct. The sub-broker is not, however, the employee of the broker so that the broker does not bear general vicarious liability for the misconduct of the sub-broker.[66]

The Civil Liability (Contribution) Act 1978 ensures that an intermediary who is liable to a cedent for a sub-intermediary's default has a right of contribution from the sub-intermediary.[67]

As a general rule, a sub-intermediary has no duty to account to a cedent, and the cedent cannot sue the sub-intermediary in contract or for money had and received because there is no privity of contract.[68] However, "[t]he present position as to the rules of law affecting the sub-agent in England is not . . . as firmly fixed as might appear."[69] There is some authority for the general proposition that a sub-intermediary may be a fiduciary of the cedent, and in appropriate cases the sub-intermediary may be ordered to account to the cedent.[70] For example, a sub-intermediary's failure to pay funds he has promised to the cedent may create a right of action in the cedent's favor against the sub-intermediary. Thus, if a cedent, *A*, is owed money by an intermediary, *B*, and *B* is owed money by a sub-intermediary, *C*, *A* will have a right of action against *C* for funds held by *C* if *B* has informed *A* that *C* will pay those funds to *A* and *C* also has promised to make that payment.[71]

In any event, a sub-intermediary may be liable in tort to a cedent. *Junior Books Ltd. v. Veitchi Co. Ltd.*[72] supports the proposition that a sub-intermediary's negligence which causes the cedent to suffer foreseeable loss may give rise to a cause of action in the cedent's favor.[73]

B. *Contract*

In addition to common law agency principles, relationships between intermediaries, cedents, and reinsurers are governed by common law contract principles. Thus, an intermediary must perform the duties set forth in his agency agreement with the cedent. In addition, the intermediary, although not a party to it, should be aware of provisions of the reinsurance contract between the cedent and reinsurer because he is the

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66. BUTLER & MERKIN, *supra* note 30, D.3.1–10.

67. *Id.*

68. BOWSTEAD, *supra* note 34, art. 36.

69. *Id.*

70. *Id.*

71. Griffin v. Weatherby, L.R. 3 Q.B. 753, 758 (action for money had and received); *see also* Shamia v. Joory, [1958] 1 Q.B. 448, 457 (same).

72. [1983] 1 A.C. 520.

73. BUTLER & MERKIN, *supra* note 30, D.3.4-22.

conduit for information and payments. English reinsurance contracts typically include an "intermediary clause," which provides that all communications and all premiums, losses, and return premiums must be made by the parties through the intermediary.[74] Unlike the U.S. version of the "intermediary clause,"[75] this clause does not place the risk of the intermediary's insolvency on the reinsurer.

English reinsurance contracts typically differ from U.S. contracts in at least one other material respect. In the United States, reinsurance contracts include an "insolvency clause,"[76] which requires that a reinsurer's liability to a cedent is not diminished in the event of the cedent's insolvency.[77] No such provision is to be found in most English reinsurance contracts, although there is little practical difference in how English law views a reinsurer's obligations. A reinsurer's obligation to pay losses does not diminish despite the fact that the cedent is insolvent and unable to meet its policyholder obligations in full.[78] However, a reinsurer's obligations may be diminished if the reinsurance contract provides that the reinsurer's liability to the cedent will be no greater than the losses actually paid by the cedent to its policyholders.[79]

C. *Insolvency*

The distinction between the obligations owed by intermediaries in marine and Lloyd's business and the obligations owed for other business[80] is acute when either the cedent, intermediary, or reinsurer is insolvent.[81] In addition, problems presented by premium payment obligations, net accounting between an intermediary and a reinsurer, set-offs, and intermediary funding become apparent in the event of an insolvency.[82] This article considers each in turn below.

In England, the laws relating to company insolvency have been consolidated by the Insolvency Act 1986, the Insolvency Rules 1986,

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74. *Id.* D.3.4-13.

75. *See infra* part III.B.

76. *See infra* part III.C.

77. *Id.*

78. Home & Overseas Ins. Co. Ltd. v. Mentor Ins. Co. (U.K.) Ltd. (1988) (unpublished, on file with the author); In re Eddystone Marine Ins. Co. (Ltd.), [1892] 2 Ch. 423; Re Law Guarantee Trust & Acc. Soc'y Ltd. v. Liverpool Mortgage Ins. Co., [1914] 2 Ch. 617; In re a Company (No. 0013734 of 1991), *cited in Liability of the Reinsurer to Pay Reinsured After Its Solvency*, THE TIMES (London), May 8, 1992, *available in* LEXIS, News Library, Times File.

79. Nepean v. Marten, 11 T.L.R. 256 (1895).

80. *See supra* part II.A.1.

81. *See generally* BUTLER & MERKIN, *supra* note 30, D.3.4-06 to 07.

82. *See infra* part II.C.

and the Companies Act 1985. These statutes and rules set forth several insolvency procedures for companies, such as administration, administrative receivership, voluntary arrangements, schemes of arrangement, and liquidation.[83] In addition, in England there is specific legislation relating to insurer insolvency, including the Insurance Companies Act 1982, Insurance Companies Winding-Up Rules 1985, and Policyholders Protection Act 1975.[84] This comprehensive legislative scheme solves many legal problems that arise in the context of insurer/reinsurer insolvencies. However, the issues discussed below for the most part may be resolved only by reference to the common law principles articulated in Parts II.A and II.B. *supra.*

1. Premiums

An analysis of the relative rights and duties of parties to a reinsurance transaction upon the insolvency or bankruptcy of one of those parties illustrates the significance of the customs and usages discussed in Part II.A.1 *supra*. The reinsurance intermediary often will find himself at a financial disadvantage when one of the parties to a marine or Lloyd's reinsurance transaction becomes insolvent. This is not necessarily the case when a party to any other type of reinsurance transaction becomes insolvent.

The consequences of parties entering into net accounting agreements affects who must bear the risk of another's insolvency. For example, if a Lloyd's intermediary and Lloyd's reinsurer engage in net accounting, and the reinsurer owes the cedent £1000 in treaty losses, and the intermediary owes the reinsurer £500 in premiums under the same treaty, then the reinsurer would net those amounts and pay the intermediary only £500. The intermediary, in turn, would send the £500 to the cedent. These facts should not present a problem when all of the parties are solvent. Questions arise, however, when one of them becomes insolvent.

First, assume that a cedent becomes insolvent before it pays its intermediary premiums under a reinsurance contract. If the reinsurance covers marine risks or is underwritten in Lloyd's, it follows from the

83. See Debra J. Anderson, et al., *Amreco: A Step Towards International Rehabilitations*, 7 J. INS. REG. 388 (1989) [hereinafter *Amreco*], for a general discussion of the English statutes applicable to reinsurance insolvency. The detailed aspects of English insolvency proceedings are governed by the rules promulgated under the Insolvency Act 1986. Insolvency Rules 1986, S.I. 1986, No. 1925, *as amended by* the Insolvency (Amendment) Rules 1987, S.I. 1987, No. 1919 and S.I. 1989, No. 397; *see generally Amreco, supra,* at 407 n.75.

84. See Stephen W. Schwab, et al., *Cross-Border Insurance Insolvencies: The Search for a Forum Concursus*, 12 U. PA. J. INT'L BUS. L. 303, 341 (1991), for a discussion of the applicability of those statutes to reinsurance.

general rules articulated above[85] that the intermediary is liable to the reinsurer for the premiums and the reinsurer is liable to the insolvent for losses. The intermediary's only remedy is to claim against the insolvent's estate for indemnification.[86] However, if the reinsurer pays losses to the intermediary, to be passed on to the insolvent's estate, the intermediary may be able to reduce his claim by the amount of those losses. If the intermediary has paid the premiums to the reinsurer, then it may be argued that the intermediary is subrogated to the rights of the reinsurer and may deduct the amount of premiums owed to him before transmitting the balance of the losses to the cedent's receiver. Thus, in *Orakpo v. Manson Inv. Ltd.*,[87] Lord Salmon held that:

> The test as to whether the courts will apply the doctrine of subrogation to the facts of any particular case is entirely empirical. It is . . . impossible to formulate any narrower principle than that the doctrine will be applied only when the courts are satisfied that reason and justice demand that it should be.

If, however, the reinsurance does not cover marine risks and is not underwritten in Lloyd's, the reinsurer will be able to reduce loss payments by the amount of premiums owed to it, before the reinsurer pays, or files a claim against the insolvent estate for, the balance.[88]

Second, assume that an intermediary becomes bankrupt after receiving premiums from the cedent under reinsurance covering marine risks or underwritten in Lloyd's and before transmitting those funds to the reinsurer. The cedent is not liable to the reinsurer for the premiums, and the reinsurer's only recourse is to file an unsecured creditor's claim against the intermediary's estate.[89] However, if the reinsurance does not cover marine risks and is underwritten outside of Lloyd's, the cedent remains liable to the reinsurer for the premiums and the cedent should seek to recover the previously paid funds from the bankrupt estate. In this respect, the cedent will be aided by the proprietary remedy of tracing, but only to the extent that the previously paid funds are readily identifiable.[90]

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85. *See supra* part II.A.1.

86. *See infra* part II.C.2.

87. [1978] A.C. 95, 110.

88. BUTLER & MERKIN, *supra* note 30, D.3.4-09.

89. *Id.* D.3.4-06.

90. *See* BOWSTEAD, *supra* note 34, art. 94(1) ("On the bankruptcy of the agent, the principal is entitled, as against the trustee in bankruptcy and creditors of the bankrupt, to all outstanding debts due to the bankrupt as his agent, and to recover and trace all money and property held by the bankrupt as his agent. . . ."). Tracing has been defined as involving "the

Finally, assume that the reinsurer becomes insolvent before the intermediary has paid premiums in his possession to the reinsurer. If the reinsurance covers marine risks or is underwritten at Lloyd's, the intermediary is liable to pay the premiums to the reinsurer's receiver and the intermediary must seek indemnification from the cedent. The cedent, in turn, may recover losses owed to it by filing an unsecured creditor's claim against the reinsurer's estate.[91] However, if the reinsurance does not cover marine risks and is not underwritten in Lloyd's, the cedent may apply the premiums to reduce the loss payments owed by the reinsurer. If the loss payments are greater in value than the premiums, the cedent must file an unsecured creditor's claim against the reinsurer's estate for the balance.[92] Finally, if the premiums exceed the losses, the cedent must pay the balance into the reinsurer's estate.[93]

2. Set-Offs

Despite the prevalent involvement of intermediaries in reinsurance transactions, little attention has been paid to the issue of whether and to what extent set-offs may be asserted between an insurer and a reinsurer — one of whom is insolvent — when one or both of them was represented by an intermediary. This lack of attention is surprising in view of the magnitude of the financial consequences that may attend the assertion of set-off rights. It is not difficult to see that the intervention of intermediaries may drastically alter the economic positions of the respective principals. The complexity of the issue and its relevance in assessing the financial health of parties to reinsurance transactions is a subject of great interest to international insurance regulators and consumers of insurance and reinsurance products.

In its simplest form, set-off is "the right which exists between two parties to net their respective debts where each party, as a result of unrelated transactions, owes the other an obligation."[94] The right to assert set-offs in the insolvency context is a statutory guarantee; thus, it may be viewed as a specie of lawful preference, avoiding the fundamen-

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following of money through its various permutations and is a process of tracking the genealogical descent of the money into its ultimate product." PHILIP R. WOOD, ENGLISH AND INTERNATIONAL SET-OFF 476 (1989). For a general discussion of the common law and equitable rights to trace, see BOWSTEAD, *supra* note 34, art. 93.

91. BUTLER & MERKIN, *supra* note 30, D.3.4-06.

92. *Id.*

93. *Id.*

94. Ralph R. Mabey, Setoff in a Non-Insurance Commercial Setting 1 (1989) (unpublished manuscript, on file with the *Michigan Journal of International Law*).

tal insolvency policy that unsecured creditors shall be paid *pari passu*, by allowing them to set off amounts owed to, against liabilities of, the insolvent. It also may be viewed in economic terms as a form of security.[95]

The Insolvency Rules 1986 contain specific provisions governing the application of set-offs as follows:

> (1) This Rule applies where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation.
>
> (2) An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other.
>
> (3) Sums due from the company to another party shall not be included in the account taken under paragraph (2) if that other party had notice at the time they became due that a meeting of creditors had been summoned under Section 98 or (as the case may be) a petition for the winding up[[96]] of the company was pending.
>
> (4) Only the balance (if any) of the account is provable in the liquidation. Alternatively (as the case may be) the amount shall be paid to the liquidator as part of the assets.[97]

Because of the requirement of "mutuality," it is important to determine the capacity of an intermediary before the respective set-off rights of parties to reinsurance transactions may be assessed. As discussed above, the general rule is that at the time a reinsurance contract is effected, an intermediary is agent of the cedent, not the reinsurer.[98] Assuming this general rule applies, we now apply general agency law principles to clarify the set-off rights of cedents, reinsurers, and intermediaries.

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95. See Stephen W. Schwab et al., *Onset of an Offset Revolution: The Application of Set-Offs in Insurance Insolvencies*, 95 DICK. L. REV. 449 (1991), for a general discussion of English set-off law and its historical development.

96. That is, the liquidation of the company. *See* Insolvency Act 1986, § 98 (Eng.).

97. Insolvency Rules 1986, S.I. 1986, No. 1925, ¶ 4.90.

98. *See supra* note 28 and accompanying text.

Every agent has a right against his principal to be reimbursed all expenses and to be indemnified against all losses and liabilities incurred by him in the execution of his authority.[99] When an agent is sued by his principal for money due, he has a right to set off the amount of any such expenses, losses, or liabilities, unless the money due is held in trust.[100] Such expenses, losses, and liabilities would include payments that the agent is legally bound to make, even though the principal may not be liable for them.[101] Thus, an intermediary's personal obligation to pay premiums under a reinsurance contract which covers marine risks or is underwritten in Lloyd's constitutes a liability with respect to which the intermediary has a right of set-off against money due to the cedent.[102]

Regardless of whether the insurance is marine or underwritten in Lloyd's, a reinsurer has no right to set off any claim the reinsurer may have against the intermediary personally.[103] Moreover, a reinsurer who reasonably believes that an intermediary is, in fact, the reinsured (i.e., the "true" reinsured is an undisclosed principal) is discharged from liability by payment to or settlement with the intermediary in any manner which would have operated as a discharge if the intermediary had been the principal; provided, however, that the reinsurer had not, at the time when the payment to or settlement took place or the set-off accrued, received notice that the intermediary was not in fact the true principal.[104] Finally, a reinsured may plead defenses arising out of a transaction that are personal to it, but not defenses personal to the intermediary such as set-off, which only the agent can plead.[105]

3. Funding

The pervasive and controversial practice of funding employed by intermediaries illustrates the complexity of the set-off question. Funding occurs, for example, when an intermediary receives a claim by a cedent for payment of loss, notifies the reinsurer of the loss, and pays the loss

99. BOWSTEAD, *supra* note 34, art. 64.

100. *Id.*

101. *Id.* at 247 n.57 (citing Adams v. Morgan & Co., Ltd., [1924] 1 K.B. 751 (Eng. C.A.)).

102. *See id.* at 249 n.73 (citing Cropper v. Cook, [1868] 3 L.R. C.P. 194 (broker, in accordance with reasonable custom of the particular market in which he was employed, rendered himself personally responsible for the price of goods bought on his principal's behalf and duly paid for them; court held that he was entitled to set off the amounts paid in an action by the principal's receiver for money due to the principal)).

103. *See id.* art. 85.

104. *Id.*

105. *See id.* art. 83.

before the reinsurer acknowledges the claim. In effect, the intermediary "funds" the reinsurer's obligations. In the context of reinsurance, funding may be described as "voluntary" or "involuntary."[106] Voluntary funding occurs when an intermediary pays premiums or claims before the cedent or reinsurer has paid those funds to him.[107] Involuntary funding arises where a cedent or reinsurer informs the intermediary that it intends to deduct the amount of a claim from the premium which is due and payable, or vice versa.[108] In other words, involuntary funding occurs in situations where a cedent or reinsurer engage in net accounting without the consent of the other party.

As a general rule, intermediaries have no obligation to fund payments. There are, however, exceptions to this rule. As stated above, Section 53 of the Marine Insurance Act 1906 provides that the intermediary — not the cedent — is directly responsible to the insurer for the premium.[109] Moreover, a Lloyd's custom renders a Lloyd's intermediary liable to a Lloyd's underwriter for premiums.[110] If, however, the intermediary does fund, parties to a reinsurance contract may become indebted to each other for more or less than the amounts reflected in their books of account. In order to calculate the precise amounts of such indebtedness, it is essential to determine on whose behalf the intermediary acted at the time he funded an obligation.

To date, few courts have addressed set-off issues in the funding context. Moreover, there are few statutory provisions, rules, and regulations governing set-off rights among parties to a reinsurance contract and intermediaries. Nonetheless, certain parameters may be gleaned from basic principles of agency and insurance law. This article serves only to highlight some of the difficulties which may arise when a party to a reinsurance transaction is bankrupt, although any determination of set-off rights in any given situation is very much dependent upon the facts and circumstances.

For example, if prior to an intermediary becoming bankrupt, a reinsurer pays losses in cash to him, the cedent must bear the risk of that bankruptcy. The cedent, as principal, is treated as having been paid by the reinsurer because the intermediary is authorized to receive pay-

106. *See* Clive Brown, *Status and Obligations of Reinsurance Brokers and Intermediaries: In the United Kingdom*, *in* LAW AND PRACTICE OF INTERNATIONAL REINSURANCE COLLECTIONS AND INSOLVENCY 294, 304 (A.B.A. Sec. Tort & Ins. Practice ed., 1988).

107. *Id.*

108. *Id.* at 304–05.

109. *See supra* part II.A.1.

110. *Id.*

ment in cash.[111] However, the cedent is aided by the proprietary remedy of tracing because of its agency relationship with the intermediary.[112] The cedent's risk thus is limited to the extent to which those funds cannot be traced. Similarly, if an intermediary's bankruptcy occurs after the cedent pays premiums to the intermediary, but before they are passed on to the reinsurer, the cedent remains liable to the reinsurer for those premiums, unless the intermediary is personally liable to the reinsurer for payment thereof (i.e., under marine or Lloyd's reinsurance contracts).[113] The situation is somewhat reversed in the event that the cedent becomes insolvent; intermediaries bear some of the risk of a cedent's insolvency, although they may take steps to protect their interests in limited circumstances. If, before a cedent becomes insolvent, an intermediary who is not personally liable for payment of premiums nevertheless funds premiums to a reinsurer and the reinsurer pays losses to the intermediary for transmission to the cedent, then, at least at first blush, it appears that the intermediary is liable to account to the cedent for the loss payments and must prove in the cedent's insolvency for the premiums due to him. However, it is arguable that the intermediary is subrogated to the reinsurer's rights and that he may set off the losses and premiums and pay only the balance, if any, to the cedent's estate.[114]

A cedent's receiver is better placed if an intermediary funds loss payments to the cedent prior to the cedent's insolvency. In that situation, the receiver may sue the reinsurer and recover the full amount of the losses owed to the cedent, notwithstanding the funded amounts.[115] However, the receiver would be obligated to reimburse the intermediary to insure that the cedent's estate is not overcompensated.[116] If the cedent's receiver chooses not to pursue an action against the reinsurer, the intermediary may find himself in the unenviable position of having to recover the funded losses from the cedent's estate. Any recovery by the intermediary would be subject to other general creditors' rights to receive a proportionate share of any asset distribution.[117]

The situation where the reinsurer is insolvent requires a similar analysis. If an intermediary who is not personally obligated to pay premiums to the reinsurer (i.e., under nonmarine, non-Lloyd's reinsur-

111. *See supra* note 53 and accompanying text.

112. *See supra* note 90.

113. *See supra* part II.A.1.

114. *See supra* part II.C.1.

115. Merrett v. Capitol Indem. Corp., [1991] 1 Lloyd's Rep. 169 (Q.B. 1990).

116. *Id.*

117. Insolvency Rules 1986, S.I. 1986, No. 1925, ¶ 4.181.

ance contracts) nonetheless funds premiums to the reinsurer before its insolvency, then the intermediary may seek indemnification from the cedent for the amount of those premiums.[118] Also, the reinsurer's receiver may rely on *Merrett* for recovery of those premiums directly from the cedent, subject however to the obligation to reimburse the intermediary to prevent overcompensation of the reinsurer's estate. It should be noted that *Merrett* may not apply in those circumstances because the intermediary and reinsurer probably will not have established an agency relationship and because payment of the premiums by the intermediary constitutes payment by the cedent. Finally, if an intermediary funds loss payments to the cedent and the reinsurer subsequently becomes insolvent, the only party who stands to lose is the intermediary, unless he recovers those funds from the cedent. In any event, the cedent may prove its claim against the reinsurer's estate like any other unsecured creditor.[119]

III. U.S. Law Governing Reinsurance Intermediaries

As demonstrated in the Introduction and in Part I of this article, reinsurance intermediaries in the U.S. are being subjected to an unprecedented level of scrutiny. Some of this attention resulted from a 1980 bankruptcy court[120] decision stemming from the failure of a large reinsurance intermediary, Pritchard and Baird, Inc. (P&B).[121] Until then, intermediaries largely were unregulated, since reinsurance was viewed as a business transacted among sophisticated equals who needed flexibility to operate in the marketplace.[122] As in England, U.S. intermediary law is a product of common law agency principles[123] and contract.

118. *See supra* part II.C.2.

119. *See Merrett*, [1991] 1 Lloyd's Rep. at 170.

120. Domestic and foreign insurance companies may not be bankruptcy debtors, *see* 11 U.S.C.A. §§ 109(b)(2), (d) (West 1993), but reinsurance intermediaries are not insurance companies and so may be bankruptcy debtors.

121. In re Pritchard & Baird, Inc., 8 B.R. 265 (D.N.J. 1980); *aff'd without op.* Hartford Fire Ins. Co. v. Francis, 673 F.2d 1299 (3d Cir. 1981); *aff'd without op.* In re Pritchard & Baird, Inc., 673 F.2d 1301 (3d Cir. 1981).

122. Robert W. Strain, Reinsurance 616 (1980).

123. *But see* Sheffey, *supra* note 5, at 930–34 (criticizing application of agency principles in context of reinsurance intermediaries).

A. *Agency and Sub-Agency*

1. Agency in General

Agency is a fiduciary relationship whereby one party, the *agent*, acts on behalf of another party, the *principal*, in dealing with third parties.[124] An agency is created when both parties agree that the agent will act on the principal's behalf, and subject to the principal's control, for the accomplishment of some purpose.[125] Agency can be created by appointment, estoppel, or ratification. An agency by appointment is created when a principal and agent enter into an oral or written contract for a purpose. Agency by estoppel is created when the principal's actions lead a third party to believe the agent has authority to act on the principals' behalf. Agency by ratification results when the principal subsequently approves an unauthorized act of the agent.[126] Whether an agency exists is viewed alternatively as a question of fact or law.[127]

An agency grants the agent such legal authority as is necessary to fulfill the purpose of the agency. As between principal and agent, an agent's authority is limited to express and implied powers. *Express authority* is specifically granted in the agency contract. *Implied authority* is that necessary to accomplish the purpose of the agency but not expressly granted in the contract.[128] For innocent third parties unaware of the extent of an agent's express and implied powers, an agent's authority may be extended by apparent authority, which is derived from the customs of the business in which the principal and agent are engaged.[129]

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124. 1 WEBB, *supra* note 2, at 33; Capitol Indem. Corp. v. Stewart Smith Intermediaries, Inc., 593 N.E.2d 872, 876 (Ill. App. Ct. 1992). In some circumstances, an agent also may serve in a dual agency, representing both the principal and the third party. 1 WEBB, *supra* note 2, at 42; *see, also*, Turner & Boisseau, Chtd. v. Marshall Adjusting Corp., 775 F. Supp. 372 (D. Kan. 1991) (attorney was agent of both reinsured and reinsurer) (citing Inland Mut. Ins. Co. v. Peerless Ins. Co., 152 F. Supp. 506 (S.D. W.Va. 1957), *aff'd* 251 F.2d 696 (4th Cir. 1958)); Monarch Ins. Co. of Ohio v. Ins. Corp. of Ireland, Ltd., 835 F.2d 32 (2d Cir. 1987) (intermediary held not to be dual agent of reinsured and reinsurer).

125. 1 WEBB, *supra* note 2, at 33; Aetna Ins. Co. v. Glens Falls Ins. Co., 453 F.2d 687 (5th Cir. 1972).

126. 1 WEBB, *supra* note 2, at 34; *Aetna Ins. Co.*, 453 F.2d at 687; *see also* Transcontinental Underw. Agency, S.R.L. v. American Agency Underw., 680 F.2d 298 (3d Cir. 1982) (unauthorized reinsurer estopped to deny liability for reinsurance commissions owed to intermediary); Northwestern Nat'l Ins. Co. v. Marsh & McLennan, Inc., 817 F. Supp. 1424 (E.D. Wis. 1993).

127. *Capitol Indem. Corp.*, 593 N.E.2d at 877 (question of fact); *Turner & Boisseau*, 775 F. Supp. at 372 (question of law).

128. 1 WEBB, *supra* note 2, at 36; *Aetna Ins. Co.*, 453 F.2d at 687.

129. 1 WEBB, *supra* note 2, at 36.

2. *Pritchard & Baird* Decision

As a matter of legal theory, *In re Pritchard & Baird, Inc.* did not yield any new rule of agency law, but merely represented application of well established principles.[130] The failure of P&B appears to have been the product of avarice. P&B's principal owners withdrew large amounts of money from the firm as advances on future earnings. The firm subsequently slowed payments to its insurers and reinsurers. By the time of its bankruptcy, several cedents had paid P&B reinsurance premiums, but P&B had failed to transmit the premiums to the reinsurers. The shortfall was projected to be in the millions.

The issue was who should bear the ultimate cost of P&B's failure. The reinsurers argued that P&B acted as agent for the cedents, so that payments by reinsurers to P&B constituted payment to the cedents. Seeking to avoid responsibility for the loss, the cedents asserted that P&B acted as agent for the reinsurers, so that cedent payments to P&B constituted payment to the reinsurers. Neither side was willing to concede that P&B was their agent, for fear of being forced to absorb the resulting loss.

After reviewing P&B's operating practices, the bankruptcy court found that the cedents controlled P&B and, therefore, held that P&B was their agent.[131] Thus was established in the United States the general English rule — absent facts demonstrating otherwise, reinsurance intermediaries are deemed to be agents of the cedent. Before considering the far-reaching effects of the decision, this article will survey the general principles of sub-agency which follow naturally from *Pritchard & Baird.*

3. Sub-Agency

An agent may be authorized to appoint sub-agents. Under U.S. law, a sub-agent performing acts authorized by an assigning agent pursuant to a reciprocal authorization from the principal is deemed to be an agent of the principal. The sub-agent can bind the principal for his actions as fully as if the appointing agent had done such acts.[132] The sub-agent

130. *See, e.g.*, Great American Ins. Co. v. Fireman's Fund Ins. Co., 481 F.2d 948 (2d Cir. 1973) (notice of cancellation given to intermediary was deemed given to reinsured); *see also* Calvert Fire Ins. Co. v. Unigard Mut. Ins. Co., 526 F. Supp. 623, 638–39 (D. Neb. 1980) (adopting the rationale of *In re Pritchard & Baird*, 8 B.R. at 265.

131. *In re Pritchard & Baird*, 8 B.R. at 269–70.

132. 1 WEBB, *supra* note 2, at 37; *see also*, Blanchette v. Cataldo, 734 F.2d 869, 875

owes a disclosed principal the same duties as an agent.[133] Thus, the sub-agent owes fiduciary duties to the principal and is subject to all of the liabilities owed by an agent to the principal, except as modified by a contract between the parties.[134]

Unless otherwise agreed, the assigning agent is liable to the principal for the conduct of a sub-agent within the scope of authority delegated to the sub-agent.[135] However, the principal must seek a remedy directly against the sub-agent for any negligence or misconduct on his part.[136]

U.S. courts disagree over the agent's liability for the sub-agent's negligence or default in collecting a fee for the principal where the sub-agent's appointment is necessitated by usages of business or the fact that the debtor resides in a distant place. One line of cases holds that the agent is an independent contractor for collection purposes and is responsible to the principal for the acts of any sub-agent he retains for the collection.[137] Other courts hold that if implied authority for the sub-agent's appointment exists and the agent exercises reasonable care in selecting the sub-agent, the agent is not liable to the principal for the sub-agent's neglect or default.[138] However, even in those jurisdictions where the agent may be held liable to the principal for the sub-agent's default, he may relieve himself of such liability by contract with the principal.[139]

An agent who pays funds or becomes liable to third persons because of the authorized conduct of a sub-agent in the performance of the principal's business has the same right to be indemnified by the principal as if the agent himself had acted. Thus, an agent who is required to indemnify a sub-agent because of payments made or losses suffered by the sub-agent when acting rightfully for the principal, has a right to indemnity under the same circumstances as if he had acted in person.[140]

(1st Cir. 1984); Stortroen v. Beneficial Fin. Co. of Colo., 736 P.2d 391, 395 (Colo. 1987). Agents also may be substituted. *See, e.g.*, *Turner & Boisseau*, 775 F. Supp. at 372.

133. RESTATEMENT (SECOND) OF AGENCY § 428(1) (1958).

134. *Id.* § 5.

135. Phillips v. JCM Dev. Corp., 666 F.2d 876, 882 (Utah 1983).

136. Thomas, Wilson & Co. v. Smith, 44 U.S. 763, 769 (1845).

137. Exchange Nat'l Bank v. Third Nat'l Bank, 112 U.S. 276, 281 (1884).

138. Wilson v. Carlinville Nat'l Bank, 58 N.E. 250, 251–52 (Ill. 1900).

139. Sanger v. Dun, 3 N.W. 388, 389 (Wis. 1879).

140. RESTATEMENT (SECOND) OF AGENCY, *supra* note 133, § 438.

B. Regulatory Control of Intermediaries

In the wake of *Pritchard & Baird*, states no longer were willing to rely on the common law to define the rights and responsibilities of reinsurance intermediaries. Instead, some states began affirmatively regulating their activities. The focus of this regulation was the preservation of cedent and reinsurer solvency. The size and number of insurance insolvencies quickened the pace of regulatory reform. Viewed as a whole, the regulations have provided strong incentives for intermediaries to transact business only with licensed, well capitalized, and prompt-paying reinsurers. They also are designed to ensure the proper reporting of reinsurance transactions so that regulators can accurately assess a cedent's financial condition.

1. New York

New York was the first state to enact legislation governing reinsurance intermediaries. In 1976, the New York legislature enacted Section 122-a of the New York Insurance Code,[141] compelling intermediaries to become licensed.[142] Six years later, the New York Insurance Department promulgated Regulation 98[143] to implement the reforms contemplated by Section 122-a.

Regulation 98 mandated several significant changes in intermediary conduct. First, it obligates licensed reinsurance intermediaries to have written authorization from a cedent before negotiating or accepting a reinsurance agreement on the cedent's behalf, which includes the cedent's name, kinds of business to be reinsured, kinds of reinsurance to be negotiated, coverage limits, and effective dates of the agent's authority. Second, Regulation 98 obligates the intermediary to notify the cedent promptly of a negotiated agreement and provide written evidence that the reinsurer has agreed to the assumption. Third, the regulation guards against financially troubled reinsurers by requiring intermediaries to inquire into the financial condition of unauthorized reinsurers and to provide cedents with a copy of the reinsurer's most recent financial statement.[144] Fourth, the intermediary must disclose to the cedent any conflicts of interest it may have (e.g., an ownership interest in the

141. N.Y. INS. LAW § 122-a (McKinney Supp. 1984–85), *as amended by* N.Y. INS. LAW § 2106 (McKinney 1984). For the text of Section 2106, see Appendix A *infra*.

142. *Id.*

143. N.Y. COMP. CODES R. & REGS., tit. 11, § 32 (1983).

144. *See* Appendix B *infra*.

reinsurer). Fifth, the intermediary must maintain books and records sufficient to permit an audit of its activities, and sixth, the intermediary must deposit all funds in one or more separate bank accounts (unless expressly authorized to commingle funds) and be responsible for them in a fiduciary capacity. Regulation 98 thus was the first significant attempt to regulate reinsurance intermediaries in the United States.

2. National Association of Insurance Commissioners

In the 1980s, the National Association of Insurance Commissioners (NAIC) built upon the foundation New York had layed in Regulation 98 by changing the rules insurers must follow in accounting for reinsurance ceded. This change gave rise to the incorporation into reinsurance agreements of "intermediary clauses." The NAIC later adopted its own version of Regulation 98, known as the Reinsurance Intermediary Model Act.[145] Both of these changes have profoundly affected the business of reinsurance intermediaries.

a. Intermediary Clauses

In 1982, the NAIC inserted into its Examiner's Handbook a provision that clarified the liability of intermediaries to cedents in the event the reinsurer becomes insolvent:

> Credit will not be granted to a ceding company for reinsurance . . . where payments are made to an intermediary unless the reinsurance agreement includes a provision whereby the reinsurer assumes all credit risks of the intermediary related to payments to the intermediary.[146]

This provision changed the face of reinsurance contracts by causing cedents to lose statutory credit for reinsurance unless the contract contains a clause placing the intermediary's credit risk on the reinsurer. In this way, the NAIC carved out an exception to the general *Pritchard & Baird* rule that the reinsurance intermediary is the ceding company's agent.[147]

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145. REINSURANCE INTERMEDIARY MODEL ACT (NAIC 1993).

146. 1 NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS EXAMINERS HANDBOOK 5-9 (1994). The EXAMINERS HANDBOOK guides state insurance departments in establishing and operating an effective examination system for (1) detecting, as early as possible, insurers in financial trouble and/or engaging in unlawful and improper activities (e.g., reviewing annual statements which all insurers must file with state regulators); and (2) developing the information needed for timely and appropriate regulatory action.

147. Even though this clause places the burden of the reinsurer's insolvency on the intermediary, it likely does not increase an intermediary's exposure to liability beyond levels

To obtain statutory reinsurance credit, most reinsurers using intermediaries now include intermediary clauses in their reinsurance contracts. These clauses mandate: (i) that all communications between the contracting parties flow through the intermediary; and (ii) that the reinsurer assumes the risk of the intermediary's insolvency. A typical reinsurance intermediary clause provides:

> [Intermediary] is hereby recognized as the intermediary negotiating this contract. All communications (including but not limited to notices, statements, premiums, return premiums, commissions, taxes, losses, loss adjustment expenses, salvages and loss settlements) relating thereto shall be transmitted to the ceding company or the reinsurers through [intermediary]. Payments by the ceding company to the Intermediary shall be deemed to constitute payment to the reinsurers. Payments by the reinsurers to the Intermediary shall be deemed to constitute payment to the ceding company only to the extent that such payments are actually received by the ceding company.[148]

In effect, the intermediary clause treats the intermediary as though he were the reinsurer's agent for payment purposes. The significance of the clause in the context of an insolvent intermediary is readily apparent: the reinsurer bears the risk of nonpayment.[149]

b. The Reinsurance Intermediary Model Act

The most comprehensive attempt to regulate intermediaries is the NAIC's Reinsurance Intermediary Model Act (Intermediary Model Act).[150] Adopted in December 1989, the Intermediary Model Act is designed to establish minimum standards for licensed intermediaries in states adopting it.[151]

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imposed by the common law. *See, e.g.*, Master Plumbers Ltd. Mut. Liab. Co. v. Cormany & Bird, Inc., 255 N.W.2d 533, 535 (Wis. 1977) (intermediary not liable for insolvent reinsurance company's debt to insured because reinsurer was solvent and authorized to do business when reinsurance contract issued, and no evidence intermediary knew or should have known of reinsurer's financial problems); *see generally* 1 WEBB, *supra* note 2, at 48–49. As one commentator indicates, Regulation 98 is more of a reminder, rather than a dramatic revision, of preexisting legal duties. Tract, *supra* note 5, at 48.

148. STRAIN, *supra* note 122, at 424–25; *see also* 1 WEBB, *supra* note 2, at 26. It is important to note that Webb, et al., erroneously ascribe to Regulation 98 the shift of credit risk and consequent statutory accounting limitation that are mandated by the NAIC. *See* 1 WEBB, *supra* note 2, at 27–28. The shift and limitation are not contained in Regulation 98, but rather in Regulation 125. *See* N.Y. COMP. CODES R. & REGS. tit. 11, § 34 (1982).

149. See Sheffey, *supra* note 5, at 930–34 for a general discussion of the significance of the intermediary clause.

150. INTERMEDIARY MODEL ACT, *supra* note 145.

151. Most states have enacted legislation based upon the Intermediary Model Act: ALA.

The Intermediary Model Act is a natural outgrowth of the NAIC's adoption of the standard intermediary clause. Codifying common law agency principles, the Intermediary Model Act identifies two types of reinsurance intermediaries: the reinsurance intermediary-broker (intermediary-broker) and the reinsurance intermediary-manager (intermediary-manager). An intermediary-broker is defined as any person, firm, association, or corporation who "solicits, negotiates or places reinsurance cessions or retrocessions *on behalf of a ceding insurer without* having the *authority* or power *to bind* reinsurance on behalf of such insurer."[152] Section two refers to the intermediary-broker as the cedent's agent. An intermediary-manager is defined as a person, firm, association or corporation who "*has authority to bind or manages* all or part of *the assumed reinsurance* business *of a reinsurer* (including the management of a separate division, department or underwriting office) and *acts as an agent for such reinsurer. . . .*"[153] Significantly, U.S. managers of U.S.

CODE §§ 27-5A-1 to 27-5A-13 (Supp. 1994); ALASKA STAT. §§ 21.27.670 to 21.27.770 (1993); ARIZ. REV. STAT. ANN. § 20-486 (Supp. 1994); ARK. CODE ANN. §§ 23-62-401 to 23-62-413 (Michie 1987); CAL. INS. CODE §§ 1781.1 to 1781.13 (West 1993); COL. REV. STAT. §§ 10-2-301 to 10-2-312 (1988); CONN. GEN. STAT. ANN. § 38a-760 (West Supp. 1994); DEL. CODE ANN. tit. 18, §§ 1601 to 1613 (Supp. 1994); D.C. CODE ANN. §§ 35-3101 to 35-3110 (Supp. 1994); FLA. STAT. ANN. ch. 626.7492 (Harrison 1994); GA. CODE ANN. §§ 33-49 (Harrison Supp. 1994); HAWAII REV. STAT. § 431:9B (Supp. 1993); IDAHO CODE §§ 41-5101 to 41-5111 (Supp. 1994); ILL. ANN. STATS. ch. 215, para. 100/1–60 (Smith-Hurd 1992); IND. CODE ANN. §§ 27-6-9-1 to 27-6-9-26 (West 1993); IOWA CODE ANN. §§ 521C.1 to 521C.12 (West Supp. 1994); KAN. STAT. ANN. §§ 40-4501 to 40-4513 (1993); KY. REV. STAT. ANN. §§ 304.9-700 to 304.9-759 (Michie/Bobbs-Merrill Supp. 1994); LA. REV. STAT. ANN. §§ 22:1210.20 to 22:1210.31 (West Supp. 1995); ME. REV. STAT. ANN. tit. 24-A, §§ 741 to 754 (West Supp. 1994); MD. ANN. CODE art. 48A §§ 698 to 717 (1994); MASS. ANN. LAWS ch. 175 §§ 177M to 177W (Law. Co-op. Supp. 1994); MI. COMP. LAWS ANN. §§ 500.1151 to 500.1171 (West 1993); MINN. STAT. ANN. §§ 60A.70 to 60A.756 (West Supp. 1995); MISS. CODE ANN. §§ 83-19-201 to 83-19-221 (Supp. 1994); MO. REV. STAT. § 375.1152 (Vernon Supp. 1994); MONT. CODE ANN. §§ 33-2-1701 to 33-2-1709 (1993); NEB. REV. STAT. §§ 44-5601 to 44-5613 (1993); N.H. REV. STAT. ANN. §§ 402-F:1 to 402-F:11 (Supp. 1994); N.J. STAT. ANN. §§ 17:22E-1 to 17:22E-23 (West 1994); N.M. STAT. ANN. §§ 59A-12D-1 to 59A-12D-12 (Michie Supp. 1994); N.Y. INS. LAW § 2106 (McKinney 1985 & Supp. 1995) AB 5740, SB 2601; N.C. GEN. STAT. §§ 58-9-2 to 58-9-26 (1994); N.D. CENT. CODE §§ 26.1-31.1-01 to 26.1-31.1-12 (Supp. 1993); OHIO REV. CODE ANN. § 3905.86; OKLA. STAT. tit. 36, §§ 5101-5113 (Supp. 1994); OR. REV. STAT. §§ 744.800-820 (1993); PA. CONS. STAT. tit. 40 §§ 321.1-.10 (Supp. 1994); R.I. GEN. LAWS §§ 27-52-1 to 27-52-13 (1994); S.C. CODE ANN. §§ 38-46-10 to 38-46-120 (Law Co-op. Supp. 1993); S.D. CODIFIED LAWS ANN. §§ 58-14-24 to 58-14-42 (Supp. 1994); TENN. CODE ANN. §§ 56-6-801 to 56-6-812 (1994); TEX. REV. CIV. STAT. ANN. § 21.07-7 (Supp. 1995); UTAH CODE ANN. §§ 31A-23-701 to 31A-23-709 (1994); VT. STAT. ANN. tit. 8 §§ 4815–4824 (1993 & Supp. 1994); VA. CODE ANN. §§ 38.2-1846 to 38.2-1857 (Michie 1994); WASH. REV. CODE ANN. §§ 48.94.005 to 48.94.901 (West Supp. 1994–95); W. VA. CODE §§ 33-38-1 to 33-38-13 (Supp. 1994); WISC. STAT. ANN. § 628.49 (Supp. 1994); WYO. STAT. §§ 26-47-101 to 26-47-113 (Supp. 1994).

152. INTERMEDIARY MODEL ACT, *supra* note 145, § 2(F) (emphasis added).

153. *Id.* § 2(G) (emphasis added). Two states also permit the reinsurance intermediary-broker or manager to act as an adjuster on the cedent's or reinsurer's behalf. *See* ALA. CODE

branches of alien reinsurers and managers of groups, associations, pools, or organizations of insurers that engage in joint underwriting of reinsurance are specifically excluded from the definition of intermediary-manager.[154]

The Intermediary Model Act regulates the content of contracts entered into between reinsurance intermediaries and their cedents and reinsurers. It requires that transactions between an intermediary-broker and a cedent be entered only with written authorization, specifying the respective responsibilities of each. At a minimum, the written authorization must provide, *inter alia*, that:

1. the insurer may terminate the intermediary-broker's authority at any time;

2. the intermediary-broker will render accounts to the ceding insurer adequately detailing all material transactions, including information necessary to support all commissions, charges and other fees received by, or owing to, the intermediary-broker; and

3. the intermediary-broker shall remit all funds due to the ceding insurer within thirty (30) days of receipt.[155]

The Intermediary Model Act also obligates the intermediary-broker to keep a complete record — for ten years after termination of the relationship — of all transactions entered into on behalf of the cedent. A "complete" record includes: (i) detailed information relating to the terms of all contracts; (ii) the identity of all parties to each contract; (iii) related correspondence and memoranda; and (iv) financial records.[156] During the ten year period, the cedent is entitled to access to review and copy all such records.[157]

Similarly, the Intermediary Model Act requires that all transactions between an intermediary-manager and a reinsurer be made pursuant to a written contract.[158] Each contract is subject to the state insurance commissioner's approval, and must be filed with the commissioner at least thirty days before the reinsurer assumes or cedes business through the

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§ 27-5A-3, 27-5A-7 (Supp. 1994) and VT. STAT. ANN. tit. 8, § 4800 (1993).

154. INTERMEDIARY MODEL ACT, *supra* note 145, §§ 2G(2), 2(G)(4).

155. *Id.* § 4.

156. *Id.* § 5.

157. *Id.* § 5(B).

158. *Id.* § 7.

intermediary-manager.[159] At a minimum, the written contract must provide that:

1. the reinsurer may terminate the contract for cause upon written notice to the intermediary-manager, and may immediately suspend the intermediary-manager's authority during the pendency of any dispute regarding the cause for termination;

2. the intermediary-manager will render accounts to the reinsurer accurately detailing all material transactions, including information necessary to support all commissions, charges and other fees received by, or owing to, the intermediary-manager;

3. the intermediary-manager shall remit all funds due to the ceding insurer on a monthly basis;

4. the intermediary-manager shall keep a complete record of each transaction with the reinsurer for a period of ten years after expiration of each contract;

5. the acts of the intermediary-manager within the scope of its actual or apparent authority shall be deemed the acts of the reinsurer.[160]

The Intermediary Model Act also imposes certain duties on cedents who utilize the services of an intermediary-broker.[161] For example, it: (i) prohibits cedents from engaging the services of any person or entity employed by an intermediary-broker with which the cedent transacts business (in other words, the cedent cannot employ the intermediary's sub-agent); (ii) requires cedents to engage only licensed intermediaries; and (iii) requires cedents to obtain annually copies of each of its intermediary-broker's financial statements.[162]

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159. *Id.* The Wyoming statute requires the contract to be filed within 45 days, rather than 30. *See* WYO. STAT. § 26-27-107 (1992).

160. INTERMEDIARY MODEL ACT, *supra* note 145, § 7.

161. *Id.* § 6.

162. *Id.* Some states impose experience requirements for licensure. *See, e.g.*, ALASKA STAT. § 21.27.270 (1993) (intermediary must have three years active experience within the previous ten); WYO. STAT. § 26-47-103 (Supp. 1994) (requiring reinsurance intermediary broker or manager must already be a licensed producer). Others require dual licensure as a primary insurance agent/broker. *See, e.g.*, ME. REV. STAT. ANN. tit. 24-A, § 742(4) (West Supp. 1994).

The initial licensing and renewal fee vary between states. For example, Missouri and Rhode Island have a $100 fee and annual renewal. *See* MO. REV. STAT. § 375.1137 (Supp. 1994); R.I. GEN. LAWS § 27-52-3(d)(3) (1994). Nebraska has a fee "not to exceed $250" and

The conduct of reinsurers utilizing the services of intermediary-managers is similarly regulated. For example, a reinsurer may not engage the services of any person or entity as an intermediary-manager unless such person is duly licensed.[163] Additionally, a reinsurer must annually obtain a copy of statements of the financial condition of each intermediary-manager the reinsurer has engaged.[164] If an intermediary-manager establishes loss reserves, the reinsurer must obtain annually the opinion of an actuary attesting to the adequacy of the reserves established for losses incurred and outstanding on business produced by the intermediary-manager.[165]

The Intermediary Model Act also enumerates certain acts which intermediary-managers are prohibited from completing. Thus, an intermediary-manager may not:

1. "[w]ithout prior approval of the reinsurer, pay or commit the reinsurer to pay a claim, net of retrocessions, that exceeds the lesser of an amount specified by the reinsurer or one percent of the reinsurer's policyholder's surplus as of December 31 of the past complete calendar year";

2. "[c]ollect any payment from a retrocessionnaire or commit the reinsurer to any claim settlement with a retrocessionnaire, without the prior approval of the reinsurer"; or

3. appoint a sub-agent.[166]

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an annual renewal. NEB. REV. STAT. § 44-5610(6) (1993); Virginia has a fee between $500 and $1,000 annually. VA. CODE ANN. § 38.2-1847 (Michie 1994). Texas provides for renewal every two years. TEX. INS. CODE ANN. art. 1.14-2 (Supp. 1995).

Transacting business without a license subjects the intermediary to imposition of various penalties. The Intermediary Model Act provides for a $5,000 or less fine for each occurrence. *See* INTERMEDIARY MODEL ACT, *supra* note 145, § 11(A)(1). Most states have followed this provision; however, a few have not. For example, Georgia and Iowa have raised the penalty to a maximum $10,000 fine. GA. CODE ANN. § 33-49-11 (Harrison Supp. 1994); IOWA CODE ANN. § 521C.11 (West Supp. 1994). Delaware raised its penalty to a maximum $15,000. DEL. CODE ANN. tit. 18, § 1611 (Supp. 1994); Vermont to a $25,000 maximum per occurrence. VT. STAT. ANN. tit. 8, § 4822(1) (1993). Maine gives a range for penalties between $5,000 and $100,000. *See* ME. REV. STAT. ANN. tit. 24-A, § 752 (West Supp. 1994). Kentucky allows for the amount applicable to agents. *See* KY. REV. STAT. ANN. § 304.9-745 (Michie/Bobbs-Merrill Supp. 1994). Texas allows any sanction authorized by law. *See* TEX. INS. CODE ANN. art. 1.10 (Supp. 1995). In contrast, Mississippi does not have a penalty section in its statute. *See* MISS. CODE ANN. §§ 83-19-201 to 83-19-221 (1993).

163. INTERMEDIARY MODEL ACT, *supra* note 145, § 9(A).

164. *Id.* § 9(B).

165. *Id.* § 9(C). Incurred losses are the sum of actual claim payments and outstanding reserves for a given book of business in a given year. 1 WEBB, *supra* note 2, at 205.

166. INTERMEDIARY MODEL ACT, *supra* note 145, § 8.

The Intermediary Model Act establishes certain rules that clearly provide protection in the event of insolvency, not only of the intermediary, but also the cedent or reinsurer. For example, the power given to the insurance commissioner to require fidelity bonds[167] and errors and omissions policies[168] for reinsurance intermediary-managers provides some protection not only to the reinsurer, but also to the cedent, in the event of the insolvency of the other. In addition, funds held either by a reinsurance intermediary-broker or by a reinsurance intermediary-manager are required to be held in a fiduciary capacity at a qualified financial institution.[169] Funds held by a reinsurance intermediary-manager must be held in separate accounts for each reinsurer represented.[170] California's Reinsurance Intermediary Act[171] requires separate bank accounts for reinsurers that are in receivership or deemed impaired by the Commissioner.[172] These requirements address the commingling defalcation problem seen in *Pritchard & Baird* and in *Wishful Thinking* and enhance the chances that a receiver actually will recover funds held by an intermediary that the estate is entitled to receive under its reinsurance contracts.

Similarly, both intermediary-brokers and intermediary-managers are required to render detailed periodic accounts to their principals,[173] and to retain and provide their principals access to detailed records for at least ten years after the expiration of the relevant contracts.[174] A drafting note to the Intermediary Model Act suggests that some states may wish to bifurcate this requirement, lengthening the records retention period for certain third-party liability coverages and shortening the retention period for contracts limited to first-party property coverages. Under Section 7(I)(3), claim files are the joint property of the reinsurer and the intermediary-manager, except that they become the sole property of the reinsurer's estate if the reinsurer is the subject of a liquidation order. Again, the preparation and retention of such records are invaluable to a receiver.

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167. *Id.* § 3(C)(1).

168. *Id.* § 3(C)(2).

169. *Id.* §§ 4(C), 7(C).

170. *Id.* § 7(C).

171. CAL. INS. CODE ANN. §§ 1781.1 to 1781.13 (West 1993).

172. *Id.* § 1781.7(c).

173. INTERMEDIARY MODEL ACT, *supra* note 145, §§ 4(B), 7(B).

174. *Id.* §§ 5(A), 7(D). Thus, the Missouri statute requires that records be maintained at least 23 years after each contract expires for medical malpractice insurance transacted by an intermediary-broker. *See* MO. REV. STAT. § 375.1120 (1993).

As is apparent, the Intermediary Model Act provides for extensive regulation of intermediaries.[175] Its provisions are intended to protect all parties to a reinsurance contract from risks of insolvency. To the extent that a cedent becomes insolvent, however, protection is afforded to its policyholders and creditors by virtue of the "insolvency clause."

C. *Insolvency*

Because reinsurance is a contract of indemnity, not liability,[176] a cedent generally may recover from its reinsurer only for claims and expenses actually paid by the cedent.[177] Thus, a reinsurer could reap a windfall in the event of a cedent's insolvency, at the expense of the cedent's creditors; i.e., the reinsurer could deny payment of otherwise valid claims from the insolvent cedent because the cedent did not have funds with which to pay its own insureds' valid claims.[178]

This result has been avoided by legislation and regulatory policy in the United States. The rule has been established that a reinsurer is liable to the insolvent cedent's estate to the extent of the cedent's liability to its policyholders, without diminution because of insolvency. In the United States, the rule has been implemented through statutes and regulations denying cedents statutory credit for reinsurance except where the reinsurance contract contains an "insolvency clause." A typical statute having the stated effect provides:

> No credit shall be allowed as an admitted asset or as a deduction from liability, to any ceding company for reinsurance unless the reinsurance is payable by the assuming company on the basis of the liability of the ceding company under the contract or contracts reinsured without diminution because of the insolvency of the ceding company.
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> . . . .

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175. Several other NAIC model acts are potentially applicable to reinsurance intermediaries to the extent that they impose requirements on reinsurance intermediaries beyond the ones already discussed. Some of these requirements are general, such as broker and agent licensing, while others are specific, as in the case of liquidation. *See, e.g.*, THE AGENTS AND BROKERS LICENSING MODEL ACT (NAIC 1969); THE SINGLE LICENSE PROCEDURE MODEL ACT (NAIC 1987); THE BUSINESS TRANSACTED WITH PRODUCER CONTROLLED PROPERTY/CASUALTY INSURER ACT (NAIC 1989); and THE MANAGING GENERAL AGENTS MODEL ACT (NAIC 1992). A discussion of the overlap and inconsistencies between these model acts is beyond the scope of this article.

176. *See generally* Henry T. Kramer, *The Nature of Reinsurance*, *in* REINSURANCE 3 (Robert W. Strain ed., 1980).

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

178. *See* Kramer, *supra* note 176, at 3.

> No such credit shall be allowed for reinsurance unless the reinsurance agreement provides that payments by the assuming company shall be made directly to the ceding company or to its liquidator, receiver, or statutory successor, except where the contract specifically provides another payee of such reinsurance in the event of the insolvency of the ceding company. . . .[179]

Similarly, the NAIC has codified the reinsurer's obligation to pay an insolvent insurer's receiver in its Insurers Rehabilitation and Liquidation Model Act.[180] Section 36.A. provides that "[t]he amount recoverable from the liquidator for reinsurers shall not be reduced as a result of the delinquency proceedings, regardless of any provision in the reinsurance contract or other agreement.[181] To the extent that a reinsurance agree-

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179. ILL. ANN. STAT. ch. 215, paras. 5/173.2 & 5/173.3 (Smith-Hurd 1992). New York conditions the availability of reinsurance credit on similar terms:

> (2)(a) No credit shall be allowed, as an admitted asset or deduction from liability, to any ceding insurer for reinsurance ceded, renewed, or otherwise becoming effective after January first, nineteen hundred forty, unless:
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> (i) the reinsurance shall be payable by the assuming insurer on the basis of the liability of the ceding insurer under the contracts reinsured without diminution because of the insolvency of the ceding insurer, and
>
> (ii) under the reinsurance agreement the liability for such reinsurance is assumed by the assuming insurer as of the same effective date.
>
> . . . reinsurance agreement may provide that the liquidator, receiver or statutory successor of an insolvent ceding insurer shall give written notice of the pendency of a claim against such insurer on the contract reinsured within a reasonable time after such claim is filed in the insolvency proceeding and that during the pendency of such claim any assuming insurer may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defenses which it deems available to the ceding company, its liquidator, receiver or statutory successor. Such expense shall be chargeable subject to court approval against the insolvent ceding insurer as part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to the ceding insurer solely as a result of the defense undertaken by the assuming insurer. Where two or more assuming insurers are involved in the same claim and a majority in interest elect to interpose defense to such claim, the expense shall be apportioned in accordance with the terms of the reinsurance agreement as though such expense had been incurred by the ceding company.

N.Y. INS. LAW § 1308 (McKinney 1984).

180. INSURERS REHABILITATION AND LIQUIDATION MODEL ACT (NAIC 1995) [hereinafter LIQUIDATION MODEL ACT]. As model legislation, however, this act is not binding on any reinsurer unless the state in which a receivership is pending has adopted its provisions.

181. *See id.* § 36. Thus, at least implicitly, the NAIC has recognized that a reinsurer's obligation to pay without diminution because of the reinsured's insolvency is not triggered by rehabilitation of the reinsured.

There generally are three stages of insurance receivership: conservation (or supervision), rehabilitation, and liquidation. In conservation, the receiver takes possession of an insurer's ment does not contain an insolvency clause, the Liquidation Model Act would provide it.[182] The NAIC also has ensured that a reinsurer does not frustrate the purpose of the insolvency clause by paying the reinsured's policyholder directly, unless the reinsurance agreement specifically permits such a payment.[183] The interplay between the intermediary clause and insolvency clause is significant in respect of reinsurance information, premiums, set-offs, and funding.

1. Reinsurance Information and Premiums

An intermediary's duties to promptly transmit funds and communications between the cedent and reinsurer, and to account for all funds received or transmitted, continues in receivership. By its terms, the Intermediary Model Act is not restricted in its application to events that

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assets, business, and affairs to conserve them for the benefit of the company's creditors. *See, e.g.*, ILL. ANN. STAT. ch. 215, para. 5/188.1 (1922). This procedure is most often used to preserve the status quo while the receiver evaluates the company's financial status; e.g., when the company's surplus has fallen below minimum statutory requirements, but could be raised to the required amount by an infusion of capital. *See* LIQUIDATION MODEL ACT, *supra* note 180, § 10.

"Rehabilitation" has been defined as the "preservation, whenever possible, of the business of an insurance company threatened with insolvency." People ex rel. Schacht v. Main Ins. Co., 448 N.E.2d 950, 952 (Ill. App. Ct. 1983); *accord* Smalls v. Weed, 360 S.E.2d 531 (Ct. App. 1987); New York Title & Mortgage Co. v. Friedman, 276 N.Y.S. 72 (N.Y. Mun. Ct. 1934).

"Liquidation" precludes the transaction of further business by the company and results in a final distribution of its assets. *See generally* ILL. ANN. STAT. ch. 215, para 5/187–221 (liquid provisions); *see also* LIQUIDATION MODEL ACT, *supra* note 180, § 20.46.

182. *See* LIQUIDATION MODEL ACT, *supra* note 180, § 36.B.:

> All reinsurance contracts to which an insurer domiciled in this state is a party that do not contain the provisions required with respect to the obligations of reinsureres in the event of insolvency of the reinsured in order to obtain credit for reinsurance or other applicable statutes, shall be construed to contain the following provisions:
>
>> (1) In the event of insolvency and the appointment of a receiver, the reinsurance obligation shall be payable to the receiver upon demand, with reasonable provision for verification, on the basis of claims allowed pursuant to Section 47 of this Act, without diminution because of the insolvency or because the receiver has failed to pay all or a portion of any claims. Payments by the reinsurer as set forth above shall be made directly to the ceding insurer or to its receiver . . . .

183. *See id.* § 36.C.:

> Payments by the reinsure as set forth shall be made directly to the ceding insurer or its receiver, except where the contract of insurance or reinsurance specifically provides for another payee in the event of insolvency of the ceding insurer in accordance with any applicable requirements of statutes, rules, or order of the domiciliary state of the ceding insurer.

occur pre-receivership of a reinsured or reinsurer. Nevertheless, the NAIC has modified another of its model acts to ensure that the receiver of a reinsured or reinsurer is entitled to enforce the insolvent's rights against reinsurance intermediaries. Adopted by the NAIC in 1977,[184] the Liquidation Model Act is designed to serve as a model for state insolvency statutes, in the hope that state insurer receivership statutes will become more uniform in their provisions governing the rights and obligations of an insolvent insurer, its receiver, debtors, creditors, and owners or members.

The Liquidation Model Act empowers receivers to obtain, and obligates intermediaries[185] to provide, information. Section 24.A. provides that a "liquidator shall have the power . . . (7) To audit the books and records of all agents of the insurer insofar as those records relate to the business activities of the insurer."[186] For their parts, intermediaries are entitled to receive notice of an insurer's receivership, and of coverage provided by any guaranty association, by first class mail "as soon as possible."[187] Every agent receiving such notice must, within 30 days, provide the liquidator with "the information in the agent's records related to any policy issued by the insurer through the agent (or sub-agent)."[188] Agents failing to provide such information are subject to fine and suspension of their license.[189]

The Liquidation Model Act also obligates intermediaries to transmit funds to the receiver. Section 37, entitled "Recovery of Premiums Owed," addresses the issues of what premiums are owed to a receiver, by whom, and when. Recognizing the distinction between earned and unearned premiums,[190] Section 37 attempts to resolve the constitutional issue of whether an agent can be compelled to pay unearned premium to

184. 1978-1 NAT'L ASS'N INS. COMMISSIONERS 238–75.

185. Although the Liquidation Model Act speaks of the rights and obligations of "agents of the insurer," *see, e.g.*, LIQUIDATION MODEL ACT, *supra* note 180, § 24.A.(7), the Act's definition of "insurer" and the use of the term "agent" are sufficiently broad to encompass reinsurance intermediaries. *See id.*

186. *Id.* § 24.A.(7).

187. *Id.* §§ 25.A.(3), D.

188. *Id.* § 26.A.

189. *Id.* § 26.B.

190. "Earned" premium means the "portion of a premium which is the property of an insurance company, based on the expired portion of the policy period." RUTH GASTEL & SEAN MOONEY, REINSURANCE: FUNDAMENTALS AND NEW CHALLENGES 101 (1989). "Unearned" premium thus means the balance of the premium, representing the unexpired portion of the policy period. *See id.* at 107.

a receiver,[191] by compelling intermediaries (not including premium finance companies) to pay only unearned premium to the receiver that is in the intermediary's possession, as well as unearned commissions.[192] Thus, intermediaries are not obligated to transmit funds they do not have or have not already received. Failure to transmit such funds may subject the intermediary to sanctions, including fines and suspensions, revocation, or non-renewal of licensure.[193] Agents and intermediaries are entitled to file claims to recover commissions and other monies owed to them, but they are assigned a sixth level priority for receipt of assets distributed from the insurer's estate.[194]

2. Set-Offs

Traditionally, set-offs between agents and insolvents have been denied on mutuality of capacity grounds, as the agent's role has been viewed not as that of a contracting principal, but as a representative or fiduciary.[195] Obligations which are fiduciary in nature, such as the holding of an insurer's earned premiums in trust by an agent,[196] cannot be set off against obligations arising out of the insolvent's contracts with the agent.[197] Similarly, an agent cannot set off claims arising in a per-

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191. *See* Hager v. Anderson-Hutchinson Ins. Agency, et al., Civil No. 86-841-E, 1989 U.S. Dist. LEXIS 13614 (S.D. Iowa July 14, 1989) (holding unconstitutional a statute imposing unpaid premium payment obligations on agents).

192. LIQUIDATION MODEL ACT, *supra* note 180, §§ 37.A.(2), (3), (4).

193. *Id.* § 37.B.

194. *Id.* § 46.F.

195. *See generally* 4 COLLIER ON BANKRUPTCY ¶ 553.04[2] (Lawrence P. King ed., 15th ed. 1991).

196. Accordingly, § 37.A.(4) of the Liquidation Model Act provides that "[P]ersons that collect premium . . . that is due the insurer in liquidation are deemed to hold that premium in trust as a fiduciary for the benefit of the insurer and to have availed themselves of the laws of this state. . . ." LIQUIDATION MODEL ACT, *supra*, note 180, § 37.A.(4).

The latter provision in § 37.A.(4) is designed to avoid the jurisdictional challenges that receivers frequently face when pursuing intermediaries and reinsurers to recover premiums owed to the insolvent insurer. *See, e.g.*, Melahn v. Pennock Ins., Inc., 965 F.2d 1497 (8th Cir. 1992) (Missouri receiver sued Pennsylvania intermediary in Missouri state court under state's long arm statute and intermediary challenged court's *in personam* jurisdiction); *see also* Birmingham Fire Ins. Co. of Penn. v. KOA Fire & Marine Ins. Co., 572 F. Supp. 962, 969 (S.D.N.Y. 1983). This provision does not prevent, however, an intermediary from removing the case from state to federal court under 28 U.S.C. § 1441(d). *See, e.g.* Fabe v. Aneco Reins. Underw. Ltd., 784 F. Supp. 448 (S.D. Ohio 1991). Nevertheless, receivers retain their rights to seek a remand of the case to state court by arguing that the federal court should abstain from exercising its jurisdiction, unless the receiver brought the suit in federal court or in the court of a state other than that in which the receivership is pending. *See, e.g.*, Stamp v. Insurance Co. of N. Am., 908 F.2d 1375 (7th Cir. 1990); *Melahn*, 965 F.2d at 1497.

197. *See, e.g.*, In re New York Title & Mortgage Co., 23 N.Y.S.2d 303 (N.Y. App. Div. 1940) (set-off denied because relationship between trustees, holders of first mortgage participation certificates, and liquidator of insurance company was one of trustee and *cestui que trust*).

sonal capacity (such as commissions) against obligations assumed in a fiduciary capacity.[198]

Disputes over set-offs often arise in insurer insolvencies involving set-off of earned and unearned premiums held by an agent or a broker.[199] In most cases, the courts have prohibited an agent from setting off its obligation to remit earned premiums to an insurer against claims for unearned premiums or other damages.[200] Even if a company agrees to set-offs by an agent, such an agreement likely is voided by the insolvency proceeding.[201]

Some states have statutes governing the rights of agents to set off premium owing to an insolvent insurer or reinsurer. Florida, for example, allows set-offs in favor of an agent who has paid the unearned portion of a premium to a policyholder.[202] Illinois and most other states do not allow such a set-off:

> No set-off shall be allowed in favor of an insurance agent or broker against his account with the company, for the unearned portion of the premium on any cancelled policy, unless that policy was cancelled prior to the entry of the Order of Liquidation or Rehabilitation, and unless the unearned portion of the premium on that cancelled policy was refunded or credited to the assured or his representative prior to the entry of the Order of Liquidation or Rehabilitation.[203]

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198. Garrison v. Edward Brown & Sons, 154 P.2d 377, 379 (Cal. 1944) (noting that no set-off would be allowed for personal claims against fiduciary obligations); Harnett v. Nat'l Motorcycle Plan, Inc., 399 N.Y.S.2d 242, 244 (N.Y. App. Div. 1977) (no set-off for breach of contract damages against fiduciary obligations).

199. *See, e.g.*, Bohlinger v. Ward & Co., 113 A.2d 38 (N.J. Super. Ct. App. Div. 1955), *aff'd*, 120 A.2d 1 (N.J. 1956).

200. Bohlinger v. Ward & Co., 120 A.2d 1 (N.J. 1956) (court denied set-off of premiums and rejected agent's argument that the principal-agent relationship between the parties had been changed into a debtor-creditor relationship through a course of business between the parties); *see, e.g.*, Sheeran v. Sitren, 403 A.2d 53 (N.J. Super. Ct. Law Div. 1979) (agent was not a debtor or creditor of insolvent, but merely an agent and conduit for premium payments and refunds, and therefore was not entitled to set off unearned premiums against earned but not yet paid premiums). *But see* Downey v. Humphreys, 227 P.2d 484, 490–92 (Cal. Dist. Ct. App. 1951) (agent allowed to set off unearned premiums against his obligations to the insurer where the court found the relationship between the insolvent insurer and general agent to be that of debtor and creditor, not trustee and beneficiary).

201. O'Neil v. Burnett, 106 A. 246 (Pa. 1919).

202. FLA. STAT. ANN. § 631.281(3) (Harrison 1983). For an extensive overall discussion of agents and their statutory duties to pay premiums to a liquidator, see Hager v. Anderson-Hutchinson Ins. Agency, Civil No. 86-841-E, 1989 U.S. Dist. LEXIS 13614 (S.D. Iowa July 14, 1989) (holding unconstitutional a statute imposing premium payment obligations on agents).

203. ILL. ANN. STAT. ch. 215, para 5/206(b) (1992). The same prohibition is contained in § 37.A.(3) of the Liquidation Model Act:

The law on set-off as related to agents, brokers, and other intermediaries in the reinsurance context is far from settled, however, and courts and commentators recently have refocused their sights on the roles such entities play in the relationship between insureds, cedents, and insolvents.[204] One interesting set-off issue involving intermediaries arises out of the situation where an insurance company, either cedent or reinsurer, becomes insolvent while funds paid by the cedent or reinsurer are still in the possession of the intermediary.[205] The question becomes whether the monies held by the intermediary can be set off against other obligations due to or from the insolvent company. The intermediary clause makes the intermediary the agent of the reinsurer for purposes of receipt of funds. Therefore, while payment of premiums by the cedent to the intermediary is deemed payment to the reinsurer, payment of losses by the reinsurer to the intermediary is not considered payment to the cedent until the cedent is actually paid.

3. Funding

Broker prefunding is another interesting issue beginning to arise in the context of insurer/reinsurer insolvencies in the United States. If the reinsurer becomes insolvent before sending payment on the prefunded claim to the intermediary, what are the set-off rights of the various parties? May the intermediary set off the prefunded amount against any claim of the insolvent against the intermediary? Receivers are particularly concerned about the practice of prefunding, as it can effectively mask a company's financial troubles from both regulators and other companies.

Case law on prefunding issues is sparse, but one U.S. court has

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> Credits or setoffs or both shall not be allowed to an agent, broker, premium finance company, or any other person against unpaid premium due the insurer for any amounts advanced to the insurer by such person on behalf of, but in the absence of payment by, the insured, or for any other amount paid by such person to any other person after the entry of the order of liquidation.

LIQUIDATION MODEL ACT, *supra* note 180, § 37.A.(3). It is important to note, however, that these limitations possibly may apply to an intermediary only in a liquidation, not a rehabilitation, proceeding. *See id.* §§ 37.A.(6), E. The reason for this distinction follows from the differences between the two types of receivership. *See supra* note 181.

204. *See, e.g.*, In re Pritchard & Baird, Inc., 8 B.R. 265 (Bankr. D. N.J. 1980), *aff'd*, 673 F.2d 1301 (3rd Cir. 1981); Vincent Vitkowsky, *Status and Obligations of Reinsurance Brokers and Intermediaries in the United States*, *in* LAW AND PRACTICE OF INTERNATIONAL REINSURANCE COLLECTIONS AND INSOLVENCY, *supra* note 106, at 264; Sheffey, *supra* note 5, at 922; Wollan, *Caught in the Middle*, BEST'S REVIEW, (Property/Casualty Insurance Edition) Apr. 1986, at 40.

205. *See, e.g.*, Bent v. Alexander, 15 Mo. App. 181 (1884) (agent held $100,000 given from one insurer to promote the transfer of assets to it of another insurer in return for reinsurance. Both insurers were placed in liquidation and both claimed the $100,000).

addressed intermediary prefunding in the reinsurance context. In *Ideal Mutual Ins. Co v. Korean Reins. Corp.*,[206] a cedent in liquidation (Ideal) sued its reinsurer, Korean Reinsurance Corp (KRC), a South Korean corporation, for amounts due under a reinsurance contract. Ideal had obtained an *ex parte* order of attachment of KRC's account to secure the damages Ideal claimed in its original complaint, and KRC posted a bond in lieu of attachment. Ideal then amended its complaint to plead higher damages and reflect sums that Ideal's London reinsurance intermediary, Hogg Robinson & Gardner Mountain International, Ltd (Hogg), had advanced to Ideal when KRC refused to pay the amount it allegedly owed under the reinsurance contract. Ideal sought a court order of attachment to secure the difference between the bond that KRC had previously posted and the amount sought in the amended complaint.

KRC contended that Hogg's payments to Ideal were gratuitous and thus irrecoverable. The court rejected KRC's argument, finding that the relationship between Ideal and Hogg was strictly commercial and that the evidence indicated Hogg's payments to Ideal were not gifts but were more akin to advances, which would have to be repaid as soon as Ideal received payment from KRC. As evidence of the manner in which Hogg viewed the payments, the court cited the fact that Hogg had filed a claim with Ideal's liquidator to recoup the advances.

KRC also argued that since Hogg had filed an action against it in Great Britain to recover directly from KRC the amount that Hogg had advanced to Ideal, KRC could be subjected to double liability for the payments. The court rejected this argument as well, citing Ideal's pledge not to extract a double recovery and an affidavit of Hogg's British solicitor indicating that the British action would be dismissed voluntarily.

The court specifically noted Ideal's contention that it is "common industry practice for brokers to pay their clients amounts that are left unpaid under reinsurance contracts . . . ."[207] While the court declined to make an express finding to that effect, it pointed out in *dictum* that, assuming it were so, "a rule of law that would allow KRC to escape payment in this case solely because of the brokers' payments would provide incentive for other reinsurance companies to renege on similar contracts in the hope that brokers would likewise, in effect, pay the reinsurance companies' debts for them."[208] The court's view seems to be extreme if one assumes that under the scenario the court posited, the

206. 657 F. Supp. 1174 (S.D.N.Y. 1987).
207. *Id.* at 1176.
208. *Id.*

intermediary would be subrogated to the cedent's claims against the reinsurer, and thus the reinsurer still would be liable for the disputed sums.

IV. Cross-Border Implications

Reinsurance transactions frequently involve insurance companies and intermediaries located in different countries.[209] United States insurance companies often obtain reinsurance in the London market through their U.S. intermediaries and "correspondent" intermediaries in England. These transactions give rise to complex legal issues, many of which have yet to be considered by English or U.S. courts.

A. *Choice of Law*

One of the first issues — which jurisdiction's law governs the dispute — becomes apparent upon an examination of the contractual relationships that exist between a U.S. ceding company, its U.S. intermediary, the English correspondent intermediary, and the English reinsurer. Typically, three agreements will govern the rights and obligations of the parties under a single reinsurance treaty. First, an agency agreement will govern the cedent's relationship with its intermediary. In all likelihood, unless the agreement provided otherwise, the applicable law of that agreement would be U.S. law, because both parties reside, and the agreement was completed, in the U.S.[210]

Second, a sub-agency agreement will control the relationship between the cedent's intermediary and the English correspondent intermediary. Determination of the applicable law of that agreement, in the absence of an express choice of law provision, may be uncertain. Determination of the applicable law of the sub-agency agreement, however, is essential to understand the various duties of the parties involved. As discussed above,[211] under English law, the U.S. cedent's rights of recovery against a sub-intermediary — in this case, the English correspondent

209. *See, e.g.*, Trading & Gen. Inv. Corp. v. Gault Armstrong & Kemble, Ltd., [1986] 1 Lloyd's Rep. 195 (Q.B. 1985); In re Ins. Antitrust Litig., 723 F. Supp. 464 (N.D. Cal. 1989), *rev'd*, 938 F. 2d 919 (9th Cir. 1991), *aff'd in part, rev'd in part sub nom*, Hartford Fire Ins. Co. v. Cal., 113 S.Ct. 2891 (1993).

210. Choice of law remains a vexing problem for courts presented with disputes involving reinsurance intermediaries. *See e.g.*, Arkwright-Boston Mfrs. Mut. Ins. Co. v. Calvert Fire Ins. Co., 887 F.2d 437 (2d Cir. 1989); Monarch Ins. Co. of Ohio v. Ins. Corp of Ireland, 835 F.2d 32 (2d Cir. 1987); Meadows Indem. Co. Ltd. v. Baccala & Shoop Ins. Services, 760 F. Supp. 1036 (1991); J.M.P.H. Wetherell v. Sentry Reins., Inc., 743 F. Supp. 1157 (E.D. Pa. 1990).

211. *See supra* part II.A.

intermediary — are probably limited to foreseeable loss caused by the sub-intermediary's negligence, which may be pursued in an action for money had and received. In contrast, U.S. law imposes more onerous obligations on sub-intermediaries, rendering them liable to cedents for negligent actions or omissions and imposing fiduciary duties on them with respect to funds held for the cedents' use. Admittedly, a sub-intermediary's obligations to the cedent likely will be of significance only in circumstances in which the cedent does not or cannot successfully pursue a claim against the intermediary.

As a general rule, English law provides that the applicable law of a contract is determined by reference to the Rome Convention on the Law Applicable to Contractual Applications (Rome Convention), which became effective in the U.K. on April 1, 1991, as a result of the passage of the Contracts (Applicable Law) Act 1990.[212] Although the provisions of the Rome Convention are fairly complicated, the underlying general principles are that, in the absence of an express choice of law provision and in the absence of a demonstration of the parties' choice of applicable law with reasonable certainty by the terms of the contract or the circumstances of the case, a contract is governed by the law of the country with which it is most closely connected.[213] A comprehensive discussion on this topic is not within the scope of this paper.[214]

212. See Tim Burton, *Caught in the Act*, INS. INT'L, 1st Quarter 1992 at 28, for a general discussion of the Act.

Choice of a forum for resolution of disputes is another difficult issue, depending upon whether the reinsurance agreement and intermediary contract contain forum provisions. *See, e.g.*, Fabe v. Aneco Reins. Underw. Ltd., 784 F. Supp. 448 (S.D. Ohio 1991) (choice of forum clause did not eliminate Bermudan liquidator's right to remove case to federal court pursuant to the Foreign Sovereign Immunities Act, 28 U.S.C. § 1603(a), (b)). Related to the issue of forum choice is the availability of arbitration to resolve the parties' dispute. Many reinsurance agreements contain arbitration clauses entitling the parties to a nonjudicial resolution of their dispute. *See* REINARZ, *supra* note 1, at 17, 59. In the absence of an arbitration clause in an intermediary's contract, the right of the intermediary to compel arbitration of a dispute with a cedent, a reinsurer, or their receiver is far from clear. *Compare* Mutual Ben. Life Ins. Co. v. Zimmerman, 783 F. Supp. 853 (D. N.J. 1992) (intermediaries had no standing to compel arbitration of disputes arising under reinsurance pool management agreement) *and* Pacific Reins. Managmt. Corp. v. Ohio Reins. Corp., 935 F.2d 1019 (9th Cir. 1991) (intermediary's right to collect from reinsurance pool members was arbitrable where intermediary served as pool manager). But when an intermediary has not participated in a reinsurance arbitration, it nonetheless may be collaterally estopped from relitigating issues decided there. *See, e.g.*, Commonwealth Ins. Co. v. Thomas A. Greene & Co., 709 F. Supp. 86 (S.D.N.Y. 1989).

213. Convention on the Law Applicable to Contractual Obligations, *opened for signature* June 19, 1980, arts. 3.1, 4.1, 1980 O.J. (L 266) 1.

214. However, an extensive treatment of this subject appears in BUTLER & MERKIN, *supra* note 30, D.4.2-01 to 39, suggesting that a sub-agency agreement between a U.S. intermediary and a U.K. correspondent intermediary is governed by English law because the agreement likely will be concluded, and the U.K. correspondent intermediary's duties likely will be performed, in England. *But see* Prager v. Blatspiel, Stamp & Heacock, Ltd., [1924] 1 K.B. 566 (location of the agent's residence may provide the applicable law); R. v. Doutre,

Unlike English law, little "black-letter" authority exists in the United States regarding conflict of law rules for reinsurance generally, let alone reinsurance intermediaries. As a general principle, a governing law provision in a contract should be respected if the law of the chosen state bears a substantial relationship to the contract, or if application of that state's law would not offend the fundamental policy of a state that has a materially greater interest than the chosen state in the determination of the issue before the court.[215] In practice, governing law provisions in primary policies of insurance are frequently disregarded by U.S. state courts.[216] Although governing law provisions of reinsurance contracts have fared somewhat better in U.S. courts than similar provisions of primary policies, courts nonetheless frequently have chosen to disregard such clauses.[217]

In the absence of an effective contractual governing law provision, the rights of the parties with respect to an issue are determined by the local law of the state that, with respect to that issue, has the most significant relationship to the transaction and the parties. In determining that state, most courts employ a "governmental interest" analysis that considers five "contacts:" (i) the place of contracting; (ii) the place where the contract was negotiated; (iii) the place of performance; (iv) the location of the contractual subject matter; and (v) the domicile, residence, nationality, place of incorporation, and place of business of the parties.[218] The test has proven much easier to state than to apply. In particular, some courts have had difficulty recognizing the various interests of potential forum states in protecting the interests of parties to a reinsurance contract.[219] Other courts have managed to recognize the risks of each of the parties to a reinsurance relationship.[220]

The third agreement governing the rights of the parties is the reinsurance treaty. Butler & Merkin suggest that the applicable law of the reinsurance agreement — in the absence of an express choice of law provision or failure by the parties to demonstrate their choice of appli-

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[1884] 9 App. Cas. 745 (agency agreement limited in operation to single market located at place where specialist agent carries on business takes its applicable law from that place).

215. RESTATEMENT (SECOND) OF CONFL. OF LAWS § 187(2) (1988).

216. *See generally* Pedro J. Martinez-Fraga, *Reinsurance Conflict: Choosing a Forum Without Losing a Contract*, 55 DEF. COUNS. J., 184, 188 (Apr. 1988).

217. *Id.*

218. RESTATEMENT (SECOND) OF CONFL. OF LAWS, *supra* note 215, § 188.

219. *See, e.g.*, Jefferson Ins. Co. of N.Y. v. Fortress Re Inc., 616 F. Supp. 874 (S.D.N.Y. 1984); *see also* Martinez-Fraga, *supra* note 216, at 191.

220. *See, e.g.*, American-Reins. Co. v. Ins. Comm'n of Cal., 527 F. Supp. 444 (C.D. Cal. 1981); *see also* Martinez-Fraga, *supra* note 216, at 192–3.

cable law with reasonably certainty by the terms of the contract or the circumstances of the case — likely would be English law.[221] However, English courts have raised a strong presumption that the laws of the country in which the venue for arbitration of disputes arising out of an agreement is located govern that agreement.[222] Many reinsurance contracts between U.S. cedents and U.K. reinsurers provide that arbitration proceedings are to be conducted in the United States. Thus, the law applicable to those agreements typically will be U.S. law.[223] However, there is some authority supporting the proposition that the applicable law of a sub-agency agreement governs some aspects of agreements arranged by the sub-agent.[224] This proposition has been challenged.[225]

If we assume that the applicable law of both the reinsurance contract (which we will assume contains a U.S. version of the intermediary clause) and agency agreements is U.S. law, and that of the sub-agency agreement is English law, then the legal boundaries within which claims for funds transmitted between the parties may be settled have been determined; only the result is open to debate.

B. *Effect of the Intermediary Clause*

If insolvency proceedings are commenced against the U.S. cedent, the effect of the intermediary clause also must be considered. Under the provisions of the intermediary clause discussed in this article,[226] any premiums the cedent paid to the U.S. intermediary prior to the commencement of those proceedings are deemed paid to the English reinsurer, whether or not the funds were received by the English reinsurer. The English reinsurer will not have a right of recovery against the U.S. intermediary, but if the reinsurance covers a marine risk or is placed at Lloyd's, then the English reinsurer will have a direct right of recovery against the English intermediary. In addition, application of the intermediary clause means that loss payments made by the English reinsurer to

221. *See* BUTLER & MERKIN, *supra* note 30, D.4.3-10.

222. Pena Copper Mines Ltd. v. Rio Tinto Zinc Co. Ltd., 105 L.T.R. 846 (1911) (strong presumption that venue chosen for arbitration provides governing law).

223. BUTLER & MERKIN, *supra* note 30, D.3.4-24; *see also* Deutsche Schachtbau-und Tiefbohrgesellschaft mbH v. Ras Al Khaimah Nat'l Oil Co., [1987] 2 All E.R. 769 (venue chosen in reinsurance agreement for arbitration shall provide governing law, even where underlying contract itself is governed by other law); *see generally* BUTLER & MERKIN, *supra* note 30, D.3.4-23.

224. Ruby Steamship Corp. v. Commercial Union Assurance Co., 46 Lloyd's List L. Rep. 265 (1933).

225. *See* BUTLER & MERKIN, *supra* note 30, D.4.3-10.

226. *See* discussion *supra* part III.B.2a.

the English intermediary are not deemed paid to the cedent until received and must be repaid by the reinsurer to the U.S. cedent's estate. In that event, the English reinsurer must seek recovery of those funds from the English intermediary.

If insolvency proceedings are commenced against the English reinsurer, then premiums are deemed paid to the reinsurer by the U.S. cedent after they have been paid to the U.S. intermediary. Thus, the reinsurer's trustee must recover those funds, if applicable law permits, from that intermediary, or, alternatively, in the case of marine or Lloyd's reinsurance, directly from the English intermediary. If the English reinsurer has paid losses to its English intermediary before commencement of those proceedings, then that intermediary may be liable to the U.S. cedent for those funds, either under U.S. law because privity of contract between a principal and agent exists, or under English law because a negligence action may be pursued within the limits prescribed in *Junior Books Ltd. v. Veitchi Co. Ltd.*,[227] or in an action for money had and received. Alternatively, the intermediary clause permits the U.S. cedent to assert a claim against the English reinsurer's estate.

CONCLUSION

The specter of increasing failures among U.S. and U.K. parties to reinsurance transactions has focused increasing attention on the rights and obligations of reinsurance intermediaries. Initially perceived as facilitators of risk cessions, intermediaries are becoming, at least to a degree, responsible for ensuring the solvency of their cedents and reinsurers. New York's Section 122-a and Regulation 98, the NAIC's adoption of the intermediary clause and recent amendments to the Liquidation Model Act, and the states' enactment of the Intermediary Model Act each have addressed various solvency concerns where intermediaries are involved. The effect of these developments on the international reinsurance marketplace is readily discernable but not easily measured or quantified. Whether these initiatives will produce mirror image changes in the U.K. remains to be seen. Thus far, the U.S. insurer insolvency experience has proven to be an onerous harbinger of a global dilemma. It is hoped that the recent U.S. efforts to stem the insolvency tide will be successful. In any event, the practices of reinsurance intermediaries have been changed, and it is now just a question of time before the merits of the changes can be fully appreciated and evaluated.

227. [1983] 1 App. Cas. 520, [1982] 3 All E.R. 201, [1982] 3 W.L.R. 477.

APPENDIX A

N.Y. INS. LAW § 122-A (CONSOL. 1977), *amended by* N.Y. Ins. Law § 2106 (1984).

2106. REINSURANCE INTERMEDIARIES; LICENSING

(a)(1) The superintendent may issue a reinsurance intermediary's license to any person, firm, association or corporation who or which has complied with the requirements of this chapter.

(2) Any such license issued to a firm or association shall authorize all of the members of such firm or association and any designated employees to act as reinsurance intermediaries under the license, and all such persons shall be named in the application and supplements thereto.

(3) Any such license issued to a corporation shall authorize all of the officers and any designated employees and directors thereof to act as reinsurance intermediaries on behalf of such corporation, and all such persons shall be named in the application and supplements thereto.

(b)(1) Before a reinsurance intermediary's license shall be issued or renewed the prospective licensee shall properly file in the office of the superintendent a written application therefor in such form or forms and supplements thereto as the superintendent prescribes, and pay a fee of five hundred dollars.

(2) Every reinsurance intermediary's license shall expire on the thirty-first day of August next following the date of issue.

(c)(1) If an application for a renewal license shall have been filed with the superintendent before September first of the year of expiration, the license sought to be renewed shall continue in full force and effect either until the issuance by the superintendent of the renewal license applied for or until five days after the superintendent shall have refused to issue such renewal license and given notice of such refusal to the applicant.

(2) Before refusing to renew any such license the superintendent shall notify the applicant of his intention so to do and shall give such applicant a hearing.

(d)(1) The superintendent may refuse to issue a reinsurance intermediary's license if, in his judgment, the applicant or any member, principal, officer or director of such applicant, is not trustworthy and competent to act as a reinsurance intermediary, or that any controlling person of such applicant is not trustworthy to act as a reinsurance intermediary, or that any of the foregoing has given cause for revocation or suspension of such license, or has failed to comply with any prerequisite for the issuance of such license.

(2) For the purposes of this section a "controlling person" is any person who or which directly or indirectly has the power to direct or cause to be directed the management, control or activities of the reinsurance intermediary.

(e) Licensees under this section shall be subject to examination by the superintendent as often as he may deem it expedient. The superintendent may promulgate regulations establishing methods and procedures for facilitating and verifying compliance with the requirements of this section and sections two thousand one hundred two and two thousand one hundred twenty of this article.

(f)(1)(A) The provisions of this section and of section two thousand one hundred two, subsection (a) of section two thousand one hundred ten and section two thousand one hundred twenty of this article shall apply to resident and non-resident reinsurance intermediaries; provided, however, that the provisions of this subsection shall be specifically applicable with respect to non-resident reinsurance intermediaries.

(B) A "non-resident reinsurance intermediary" is a reinsurance intermediary who is a non-resident of this state and is licensed or permitted to act as a reinsurance intermediary in the state in which such reinsurance intermediary resides and in which such reinsurance intermediary maintains an office as a reinsurance intermediary; provided, however, that this subsection shall not apply to any non-resident of this state who maintains an office as a reinsurance intermediary in this state, or who is an officer, director, member or employee of a firm, association or corporation which maintains an office as a reinsurance intermediary in this state.

(2)(A) Before a non-resident reinsurance intermediary's license shall be issued, the prospective licensee shall properly file in the office of the superintendent a written application therefor in such form or forms and supplements as the superintendent prescribes, and pay a fee of one hundred dollars.

(B) Every non-resident reinsurance intermediary's license shall expire on the thirty-first day of August next following the date of issue.

(C) No such license shall be issued unless the prospective licensee designates the superintendent as agent for service of process in the manner, and with the same legal effect, provided in section one thousand two hundred thirty of this chapter for designation of service of process upon unauthorized insurers, and also furnishes the superintendent with the name and address of a resident of this state upon whom notices or orders of the superintendent or process affecting such non-resident reinsurance intermediary may be served. Such licensee shall promptly notify the superintendent in writing of every change in its designated agent for service of process, and such change shall not become effective until acknowledged by the superintendent.

(g) The superintendent may issue a replacement for a currently in force license which has been lost or destroyed. Before such replacement license shall be issued, there shall be on file in the office of the superintendent a written application for such replacement license, affirming under penalty of perjury that the original license has been lost or destroyed, together with a fee of fifteen dollars.

APPENDIX B

N.Y. COMP. CODES, R. & REGS. tit. 11, § 32

(REGULATION 98)
REINSURANCE INTERMEDIARIES

Section 32.0 INTRODUCTION.

(a) Section 122-a of the Insurance Law was added by 620 of the Laws of 1976, effective September 1, 1976 and was amended by chapter of the Laws of 1981, effective July 28, 1981. Subdivision 8 of section 122-a provides that licensed reinsurance intermediaries shall be subject to examination by the superintendent as often as he may deem it expedient and that the superintendent may promulgate regulations establishing methods and procedures for facilitating and verifying compliance with the requirements of section 122-a; subdivision 9 of section 122-a provides that every reinsurance intermediary acting as such in this State shall be responsible, in a fiduciary capacity, for all funds received or collected in such capacity, and shall not, without the express consent of his or its principal or principals, mingle any such funds with his or its own funds held by him or it in any other capacity.

(b) This Part is promulgated to implement the provisions of subdivisions 8 and 9 of section 122-a by establishing criteria, methods and procedures for facilitating and verifying compliance with said subdivisions.

32.1 VERIFICATION OF COVERAGE AND DISCLOSURE

(a)(1) Where the reinsurance intermediary acts in procuring reinsurance for a licensed ceding insurer or accepting reinsurance for a licensed assuming insurer, such intermediary shall have written evidence from such insurer of authority to procure or accept specified types of reinsurance, and the scope of such authority.

(2) The written evidence shall be executed by a responsible officer of the insurer granting the authority and shall include:

(i) the name of insurer(s);
(ii) the kinds of insurance;

(iii) the type of reinsurance or retrocessions;
(iv) the limits of coverage; and
(v) the effective date and expiration date of the authority.

(b) When a reinsurance intermediary procures a reinsurance contract on behalf of a licensed ceding insurer:

(1) directly from any assuming insurer or insurers, written evidence must be furnished to the ceding insurer, that the assuming insurer or insurers have agreed to assume the risk; or

(2) from a representative, other than an employee of the assuming insurer or insurers, he shall obtain written evidence from the assuming insurer or insurers of the fact that such insurer or insurers have given authority to the representative to bind risks in their name and the scope of such authority. The written evidence shall be submitted to the ceding insurer.

(c) If the reinsurance intermediary places reinsurance on behalf of a licensed ceding insurer with an unauthorized reinsurer, which is not an accredited reinsurer or which has not placed adequate funds with the ceding insurer pursuant to section 70.7 of the Insurance Law, he shall inquire into the financial condition of the assuming unauthorized reinsurer and in connection with such inquiry disclose such findings to the ceding insurer and make available to the ceding insurer a copy of the most recent financial statement. Notwithstanding the above, the ceding insurer may assume the obligation under this subdivision by releasing the intermediary in writing from his obligations under this subdivision.

(d) Where a reinsurance intermediary acts for a licensed assuming insurer in accepting a reinsurance contract, the reinsurance intermediary shall act only within the authority granted by such insurer and shall promptly notify the insurer in writing of any commitment made on its behalf. If on a bordereau basis, such notification shall be made at least quarterly.

(e) No reinsurance intermediary shall procure a reinsurance contract with one or more unauthorized reinsurers, unless there is provision in such agreement for the appointment by the reinsurer or reinsurers of an attorney in this State, as the true and lawful attorney of each such insurer, upon whom all lawful process may be served in any action, suit or proceeding instituted in this State by or on behalf of a licensed ceding insurer, arising out of the contract of reinsurance.

(f) Every reinsurance intermediary shall make full written disclosure, at the time of negotiations, to the parties to any reinsurance transactions, of:

(1) any control over such intermediary by, or any control by such intermediary over any of the parties to or any other reinsurance intermediary involved in said transaction and/or any retrocessions placed by the intermediary affecting said transaction. For purposes of this paragraph, control means the possession directly or indirectly of the power to direct or cause the direction of the management and policies of such party, whether through the ownership of voting securities, by contract other than commercial contract for goods or nonmanagement services, or otherwise. Control shall be presumed to exist if any person directly or indirectly owns, controls or holds with the power to vote 10 percent or more of the voting securities of any other person; provided that no person shall be deemed to control another person solely by reason of his being an officer of such other person;

(2) any retrocessions placed by the intermediary, directly or indirectly, in connection with said transaction including the identity of such retrocessionnaires; and

(3) the commissions earned or expected to be earned by the reinsurance intermediary, directly or indirectly, in connection with any retrocessions applicable to the original reinsurance transaction.

Such reinsurance intermediary shall amend the original disclosure to reflect any additions involving paragraph (1), (2) or (3) of this subdivision as they may occur.

32.2 BOOKS AND RECORDS OF REINSURANCE INTERMEDIARIES.

(a) For at least 10 years after expiration of each contract of reinsurance transacted by a reinsurance intermediary, such reinsurance intermediary shall keep a complete record for each transaction showing:

(1) the type of contract, limits, underwriting restrictions, classes of risks and territory;

(2) period of coverage, including effective and expiration dates, cancellation provisions and notice required of cancellation, and disposition of outstanding reserves on covered risks;

(3) reporting and settlement requirements of balances;

(4) rate used to compute the reinsurance premium;

(5) names and addresses of insurers;

(6) rates of all reinsurance commissions, including the commissions on any retrocessions handled by the intermediary;

(7) related correspondence and memos;

(8) proof of placement;

(9) details regarding retrocessions handled by the intermediary, including the identity of retrocessionnaires and their percentage of each contract assumed;

(10) financial records, including but not limited to premium and loss accounts; and

(11) copies of the evidence required under section 32.1(b)(1)-(2) of this Part.

32.3 FIDUCIARY RESPONSIBILITY OF REINSURANCE INTERMEDIARIES.

(a) Every person, firm, association or corporation acting as reinsurance intermediary in this State, is responsible as a fiduciary for funds received by such reinsurance intermediary, in such capacity. All such funds shall be held in accordance with the following rules:

(1) A reinsurance intermediary shall deposit funds received in one or more appropriately identified accounts in a bank or banks duly authorized to do business in this State, from which no withdrawals shall be made except as hereinafter specified (any such account is hereinafter referred to as "a premium and loss account"). A licensed nonresident reinsurance intermediary may use a bank not authorized to do business in this State, provided such bank is a member of the Federal Reserve System.

(2) Deposits in a premium and loss account in excess of aggregate funds received but not remitted may be made to maintain a minimum balance, to guarantee the adequacy of the account, or to pay funds due but uncollected (any deposit is hereinafter referred to as "a voluntary deposit").

(3) No withdrawals from a premium and loss account shall be permitted except as follows: for payment or return of premiums, commission due others, losses to insurers or other parties entitled thereto, interest, if the principals have consented thereto in writing, the intermediary's commissions, and voluntary deposits, provided that no withdrawal of voluntary deposits may be made if the balance remaining in the premium and loss account thereafter is less than aggregate net premiums, commissions due others and losses received but not remitted. In computing aggregate net premiums, offsets from different principals shall not be permitted.

(4) Deposit of a premium in a premium and loss account shall not be construed as a commingling of the net premium and of the commission portion of the premium.

(5) In the case of a reinsurance intermediary dealing with more than one insurer, maintenance at all times in one or more premium and loss accounts of at least the net balance of funds received but not remitted shall be construed as compliance with this Part, provided that the funds so held for each such principal are reasonably ascertainable from the books of accounts and records of such reinsurance intermediary.

(b) Except as hereinabove provided, a reinsurance intermediary shall not commingle any premium or loss funds received or collected in such capacity with its own funds or with funds held by it as insurance agent, insurance broker or in any other capacity.

32.4 GENERAL PROVISIONS.

(a) The term reinsurance as used in this Part shall apply to all forms of reinsurance coverage.

(b) Before a ceding insurer of its representative pays any premiums or fees to any reinsurance intermediary, such ceding insurer shall obtain evidence that the requirements of section 32.1 (a)–(c), (e)–(f) of this Part have been complied with.

(c) The provisions of this Part apply to any person, firm, association or corporation acting as a reinsurance intermediary in this State.

(d) In the case of an insurance agent or insurance broker acting as a reinsurance intermediary in this State, such insurance agent or insurance broker shall be required to maintain a premium and loss account(s) separate from its premium account(s), required pursuant to Regulation 29 (11 NYCRR Part 20)

(e) The provisions of this Part shall not apply to:

(1) the manager of a group, association or organization of insurers which engage in joint underwriting or joint reinsurance pursuant to the provisions of section 186-a of the Insurance Law, provided, such manager applies to and is granted an exemption by the superintendent; and

(2) underwriting managers designated by Underwriting Members of the New York Insurance Exchange, Inc., provided that:

(i) such designation shall have been filed with the New York Insurance Exchange, Inc. in its register of Approved Underwriting Managers;

(ii) the New York Insurance Exchange, Inc. adopts rules to accomplish the intent and purposes of this Part; and

(iii) this exemption shall not apply to any retrocessions handled by such underwriting manager of the New York Insurance Exchange, Inc.

(f) If any provision of this Part or the application thereof to any person or circumstances is held unauthorized by law, the remainder of this Part and the application of such provision to other persons or circumstances shall not be affected thereby.