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Reinsurance: The Silent Regulator?

By Aviva Abramovsky¹

Abstract

This Essay suggests that a discussion on insurance regulation should include a consideration of the effect reinsurance may have on the behavior of insurers. The Essay reviews the traditional types of reinsurance, and considers the ability of private reinsurance contracts to produce insurer action. This essay suggests if reinsurance is not included in a holistic examination of the field, its realities have the capacity to misdirect insurance regulatory assumptions. Moreover, reinsurance works as a source of independent and often unexamined contractual influence on insurer activity, and as a potential source of interference with regulatory proposals. Even though reinsurance is initiated by private contract, those contracts have the potential for regulatory effect sufficient to provide a positive answer to this Essay's main query: may reinsurance correctly be termed a "silent regulator"?

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

I. Introduction

When evaluating the efficacy of insurance regulation, the nature and availability of reinsurance does not count among the general issues commonly discussed. Yet, as “the insurance of insurance companies”³, reinsurance should not be so quickly dismissed as irrelevant in the regulatory discussion.⁴ Just as insurance is often viewed as having a

¹ Associate Professor, Syracuse University College of Law. The author would like to thank the Searle Center for its generous support of this research and for the inclusion of the author in its symposium. The author would like to recognize the work of her research assistant, Jennifer Reimers, and the staff of the H. Douglas Barclay Law Library at the Syracuse University College of Law for their invaluable help in producing this work.

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

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

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

Much insurance regulatory policy focuses on capital reserves and issues of liquidity. An examination of reinsurance is helpful because one of reinsurance's primary uses is to expand an insurance company's liquidity, an attractive quality for many primary insurers.⁵ Likewise, the reinsurance relationship concerns issues of insurance availability, organic standards for underwriting and claims handling, and premium calculations.⁶ Insurance companies that use reinsurance may contract to gain a certain amount of foreseeable stability in their losses and is frequently used as a "stop gap" in the event of catastrophic losses.⁷ More generally, reinsurance, as a contract of indemnity with conditions for performance, has all the potential of regular insurance to influence the activity of reinsureds.

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

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

⁶ See RAA webpage, Fundamentals of Property Casualty Reinsurance, <http://www.reinsurance.org/i4a/pages/index.cfm?pageid=3310> ("Reinsurance provides protection against catastrophic loss in much the same way it helps stabilize an insurer's loss experience. Insurers use reinsurance to protect against catastrophes in two ways. First, reinsurance protects against catastrophic financial loss resulting from a single event, such as the total fire loss of a large manufacturing plant. Second, reinsurance also protects against the aggregation of many smaller claims resulting from a single event, such as an earthquake or major hurricane, that affects many policyholders simultaneously. While the insurer is able to cover losses individually, the aggregate may be more than the insurer wishes to retain.").

⁷ See Graydon S. Staring, The Law of Reinsurance, sec. 1:3, 4-5 ("For the individual insurer the purchase of reinsurance has any or all of a number of objectives. It will desire to limit the reserves it must maintain for losses on its ordinary business. Beyond that, it may occasionally desire to write policies too large for its own resources, although otherwise routine, and earn premiums and good will for them. It may desire to take a novel risk that its own experience does not permit it to rate, which can be assumed, however, with the support of a large amount of reinsurance. Finally, it will certainly wish to avoid wide fluctuations in its financial condition from year to year and assure its own continued solvency, in the face of possible extraordinary losses due to natural and economic catastrophes touching its lines of business; it will do so by reinsuring itself against extraordinarily high losses on its entire business any year.").

Reinsurance is of grave consequence to insurance loss handling, yet there has been little discussion of the way reinsurance interacts with other de jure and de facto efforts of insurance regulation. The utmost good faith obligation integral to reinsurance contract performance serves as the primary regulator of this relationship.⁸ These relationships concern reinsurance standards of performance and the potential effect on coverage availability; moreover, the relationships have a derivative effect on the cost and availability of various insurance lines. Yet, reinsurance, beyond the risk of defaults or insolvencies, is not generally discussed beyond a few sentences in most regulatory discussions. Nor is the regulatory capacity of reinsurance announced through statutory constructs. Rather, reinsurance's regulatory effect is accomplished through simple contractual relations, reliance on commercial standards in the performance of those contracts and, importantly, the courts' use of the concept of utmost good faith in the apportionment of contractual duties. In recognition of these effects, this Essay seeks to answer the question of whether reinsurance relationships can appropriately be considered a silent regulator of insurance industry.

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

At its most reductive, reinsurance is a relatively straightforward financial transaction by which an insurance company is indemnified for all or a portion of some risk by

⁸ See Robert H. Jerry, II, *Understanding Insurance Law*, sec. 142[c], 3rd edition (2002), 1059 (“In many respects, the relationship between primary insurer and reinsurer tracks that of the original insured and the primary insurer. The primary insurer and reinsurer have a duty to deal with each other in good faith, and the reinsurer will have available to it the defense of misrepresentation, breach of warranty, fraud, or concealment in circumstances where the primary insurer’s acts or neglect give rise to the defense.”). See also Couch on Insurance, 3rd edition (2007), sec. 9:17, 56-57 (“Duties of good faith and fair dealing run between the reinsurer and the reinsured much as they do between the initial insured and his or her insurer. This duty originates from the reinsurer’s need to rely upon and not duplicate the reinsured’s efforts in properly evaluating risks and handling claims, reducing costs for both parties to the reinsurance contract. Accordingly, this duty requires the reinsured to disclose to the reinsurer all material facts which may affect the subject risk. The extension of this duty of good faith is the related concept that reinsurers are generally bound by the reinsured’s good faith decision to pay a claim, commonly referred to as the ‘follow the settlements’ doctrine.”).

another insurer.⁹ This risk transfer, just as with common consumer or commercial insurance policies is effectuated by contract, with the reinsurance agreement subject to ordinary contract rules and doctrine.¹⁰ Some practices of reinsurance contract interpretation are distinct from the practices used in interpreting a more common insurance policy, but at this juncture, it is sufficient to recognize that reinsurance is a creature of contract.¹⁰

1. What is Reinsurance?

One of the hardships in understanding reinsurance is that the term is sometimes used over-broadly and applied to relationships which are best understood as something other than a commonly accepted definition of reinsurance.¹¹ Reinsurance is best understood as distinct from co-insurance, the proper term for the relationship which forms when separate insurers, either severally or jointly, assume direct shares of a given risk; in such cases where all the insurers have a direct relationship with the insured, the relationship is not within the traditional understanding of reinsurance.¹² Likewise, reinsurance should

⁹ Id at sec. 140[a], 1053 (“Reinsurance is essentially a form of insurance for insurance companies; insurance business is transferred from one insurer to another.”). Id.

¹⁰ See New Appleman Insurance Law Practice Guide, Vol. 3: Separate Lines of Insurance, sec. 40.01 (2007), 6 (“The reinsurance relationship is evidenced by a written contract reflecting the negotiated terms. Although reinsurance contracts between different cedents and reinsurers can include clauses with similar purposes, the wording of particular provisions varies significantly, depending on the parties’ specific needs, customs and practices.”).

¹⁰ See Couch on Insurance, 3rd edition (2007), sec. 9:6, 21 (“Although some rules of construction do not apply to contracts in the reinsurance context, the general rules of contract do apply to reinsurance contracts.”).

¹¹ See Robert H. Jerry, II, Understanding Insurance Law, sec. 140[a], 3rd edition (2002), 1053 (“Reinsurance should not be confused with the situation where one insured takes out two or more policies covering the same risk with two or more insurers. Also, reinsurance should not be confused with the situation where the insured cancels one policy and substitutes another for it. Reinsurance only exists where a primary insurer becomes a ‘reinsured’ by entering into a contract with another insurer, the ‘reinsured.’”).

be distinguished from banking even though it may assist in the reinsured's financing and allow for insurance loss amortization.¹³ Nor is reinsurance a security, since the risks assumed are generally fortuities distinct from the ordinary risks of business and finance.¹⁴

As a descriptive matter, reinsurance is inherently a contract of insurance, albeit a secondary one.¹⁵ Reinsurance is commonly defined as a contract “by which an insurer procures a third person to insure him against loss or liability by reason of such original insurance.”¹⁶ More generally, reinsurance includes all contractual arrangements where one insurance company transfers to another all or some portion of the risk it underwrites

¹² See Graydon S. Staring, *The Law of Reinsurance*, sec. 1:5, 9-10 (“Reinsurance is not coinsurance, which is the relationship that results when separate insurers, either severally or jointly, assume direct shares of a given risk; in that case, all the insurers have a direct contract with the insured. It also is not a partnership, co-venture, or syndication, even though the contract may contain clauses creating or permitting joint responsibilities or control, as well as joint loss, since true reinsurance lacks essential characteristics of those relationships.”).

¹³ Id. at 10 (“Neither is reinsurance banking, although it performs a function of banking by providing the amortization of insurance losses and may, in effect, finance the growth of the reinsured.”). Id.

¹⁴ Id. (noting reinsurance “is not a security as defined in the securities legislation, since the risk assumed are normally fortuities apart from the ordinary risks of business and finance.”). Id.

¹⁵ See Couch on Insurance, 3rd edition (2007), sec. 9:1, 3-4 (“Reinsurance is a contract whereby one insurer transfers or ‘cedes’ to another insurer all or part of the risk it has assumed under a separate or distinct policy or group of policies in exchange for a portion of the premium. While reinsurance technically qualifies as insurance, it is a contract for indemnity rather than liability.”).

¹⁶ Id. at 1:1 (**to what cite?**). Reinsurance discussions, however, commonly and appropriately also extend to cover discussions of contracts which are entered to reinsure in the future. In such circumstances, a contract *to be* reinsured is made between the parties to provide reinsurance on unidentified underlying policies yet to be written. Though these agreements might not actually reinsure specific risks or liabilities, their ubiquity in the industry appropriately places them within any reinsurance discussion.

This definition allows for the inclusion of both an existing policy or contract of reinsurance and assumes that the requirements of the contract are met. Staring at 1:1, 2. A “reinsurance policy” can therefore simply be understood as a “contract for indemnity one insurer makes with another to protect the insurer from risks already assumed.” Id. at 1:1. Likewise a treaty looking forward to reinsure would constitute reinsurance, though such agreement may be better understood as a contract for reinsurance, rather than a contract of reinsurance. Id. In either case, reinsurance policies, reinsurance treaties on specific classes of risk and reinsurance treaties entered into for future acquired risk would all come within the heading of reinsurance. See Ostrager & Newman, *Handbook on Insurance Coverage Disputes*, 12th edition at 15:01, 990.

to another insurer.¹⁷ Thus, the common refrain that reinsurance is insurance for insurance companies.¹⁸

Perhaps the most difficult aspect of the study of reinsurance stems from the particularly opaque and obscure language endemic to the industry.¹⁹ Some discussion of terms is necessary. As reinsurance involves a minimum of two insurance companies, different terms have developed to identify the various parties.²⁰ The original insurer who acquired the risk or liability is referred to by a variety of designations, including that of direct or initial insurer and sometimes, though less commonly, as the primitive insurer.²¹ However designated, once it has entered into an agreement with a new insurer for the purpose of reinsurance, the original insurer is thereafter most commonly referred to as the

¹⁷ See *Colonial America Life Ins. Co. v. Commissioner*, 491 U.S. 244 (1989); Ostrager & Newman, *Handbook on Insurance Coverage Disputes*, 12th edition at 15:01, 990.

¹⁸ See *Cont'l Cas v. Stronghold Ins. Co.*, 77 F.3d 16, 17, 20 (2d Cir 1995). In that case, the Second Circuit offered an additional colorful and intuitive explanation of reinsurance adopted in a New York Court of Appeals decision of the late 1930's. See *Cont'l Cas v. Stronghold Ins. Co.*, 77 F.3d 16, 17 (2d Cir 1995) quoting *People Ex. Rel. Sea Ins. Co. v. Graves*, 274 N.Y. 312, 15 (1937) (The concept of reinsurance "dates back to the time the first bookie, fearful that he could not cover all his bets in the event he were to lose, decided to spread his risk 'laying-off' the risk by getting other bookies to share his exposure.). Though colorful, that assessment is not entirely accurate. The earliest recordings of the use of reinsurance likely predated the iteration of the modern bookie and has been historically identified as predating the 17th century. See Graydon S. Staring, *The Law of Reinsurance* at 1:4, 5-6 ("The earliest recorded instance is said to have been a policy written on a voyage from Genoa to Sluys and reinsured for the more hazardous portion, from Cardiz to Sluys, the insurer retaining the Mediterranean portion of the risk."). The New York courts were not altogether mistaken as England likely recognized the relationship between insurance and speculation in the 18th Century and prohibited marine reinsurance by the Marine Act of 1745. Addressing that Parliamentary Act, Lord Mansfield noted that, "The statute doubtless was intended to prevent gambling. I suppose that the mischief was that policies were underwritten at one premium and reinsurance affected at another." In *Re Norwich Equitable Fire Assurance Soc'y* 57 LT Rep. 241, 243 (1887).

¹⁹ See Robert H. Jerry, II, *Understanding Insurance Law*, sec. 140[a], 3rd edition (2002), 1054 ("The business of reinsurance has developed some special terminology."). See also *New Appleman Insurance Law Practice Guide*, Vol. 3: *Separate Lines of Insurance*, sec. 40.01 (2007), 5 ("Reinsurance, like many areas of business law, has a language of its own.").

²⁰ See *Couch on Insurance*, 3rd edition (2007), sec. 9:2, 6 ("There are two parties to a reinsurance agreement, but these parties have been bestowed with multiple names which are used interchangeably and are all accurate.").

²¹ See Graydon S. Staring, *The Law of Reinsurance*, sec. 1:1, 3 ("The original insurer, sometimes called the direct, or initial, insurer, and occasionally the primitive insurer, is commonly called the reinsured or, especially in England, the reassured.").

reinsured.²² Though that seems clear enough, the original insurer is frequently referred to by another more exotic definition, that of cedent.²³ This designation stems from the idea that the function of reinsurance is for the original insurer to “cede” a certain amount of its business to the reinsurer, hence the term cedent.²⁴ Likewise, a reinsurer may itself seek reinsurance, called retrocessions, in the same forms and for the same purposes as any other insurers.²⁵ Hence, the reinsurer of a reinsurer is often called a retrocessionaire.²⁶

In a true reinsurance contract, the risk indemnified is the risk that the insurer will have to pay on the underlying insured risk.²⁷ Reinsurance is an aspect of insurance and is

²² See Ostranger & Newman, *Handbook on Insurance Coverage Disputes* at 15.01[c], 992 (noting a ceding insurer or reinsured is “the insurer that transfers all or a portion of the risk it underwrites to a reinsurer.”).

²³ See Graydon S. Staring, *The Law of Reinsurance*, sec. 1:1, 3 (“The reinsured is said to cede business to the reinsurer, or reassurer, and is therefore also referred to as the ceding company or the cedent (or cedant).”). See also New Appleman Insurance Law Practice Guide, Vol. 3: Separate Lines of Insurance, sec. 40.01 (2007), 5 (“The insurance company purchasing reinsurance is called the ‘ceding company’ (or the ‘cedent’ (or ‘cedant’), ‘reinsured’ or ‘ceding insurer’) because it ‘cedes’ or transfers part of the risk.”).

²⁴ See Robert H. Jerry, II, *Understanding Insurance Law*, sec. 140[a], 3rd edition (2002), 1054 (“The act of transferring the risk is called ‘ceding,’ and the portion of the risk passed to the reinsurer is called the ‘cession.’”).

²⁵ The retrocessional agreement, like any other reinsurance agreement, is a contract and will be effective according to its terms. These terms need not mirror the specific risks of the reinsurance agreement which it is reinsuring. As can quickly be deduced, with the expansion of the insuring scenario from one to three or more separate agreements, all of which may cover different risks and have different exclusions, the resolution of indemnity responsibility can easily become complex. See Couch on Insurance 9:3, 9-10.

²⁶ The preponderance of French terminology likely arises from the early statutory action by the French Courts in the reinsurance business. For instance, notice of the 1681 Ordonnance de la Marine of Louis XIV provided that:

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

Graydon S. Staring, *The Law of Reinsurance* at 1:4, 6 (providing translation of Article XX, Title Sixth of the 1681 Ordonnance).

²⁷ Risk is transferred by a variety of financial transactions, not all, or even most of which, constitute insurance. Though insurance itself remains a somewhat elusive definitional concept, the indemnity function, particularly when combined with some aspect of fortuity is often seen as core insurance principles. For an excellent discussion of the nature of various financial intermediaries and on the overlap

regulated as such. By entering into a contract to reinsure, the reinsurer agrees to indemnify the ceding insurer for any liability incurred by the insurer that is covered by the reinsurance agreement.²⁸ Importantly for our later discussions, the liabilities covered under a reinsuring agreement frequently extend beyond the cost of losses accrued by the cedent insurer's policyholder under the original policy.²⁹ Examples of other indemnified liabilities often include such things as the cost of bringing a declaratory judgment against their policyholder and other "expenses" inherent to the cedent insuring company's coverage defense.³⁰

The reinsurance industry also has traditions and structures unfamiliar to the regular cognesti of students of insurance, some of which are important to determining reinsurance's regulatory effect on insurers. For instance, primary insurance policies treat operative standards of interpretation and the financial interests of the parties in a somewhat different manner.³¹ Primarily, these different legal standards stem from the

in definitions for regulatory purpose *See* generally Howell E. Jackson, Regulation in a Multisectoral Financial Services Industry: An Exploratory Essay, 77 Wash U. L. Q. 319 (1999)

²⁸ Ostrager & Newman, Handbook on Insurance Coverage Disputes at 15.01, 990. *See* Travelers Indem. Co. v. Scor Reins. Co., 62 F.3d 74, 76 (2d Cir. 1995). Reinsurance is a contract for indemnity not one of liability. *See* Transcontinental Underwriters Agency v. American Agency Underwriters, 680 F.2d 298, 299 n.2 (3d Cir. 1982).

²⁹ *See* Couch on Insurance, 3rd edition (2007), sec. 9:24, 67 ("Because the reinsurance agreement is a contract of indemnity, the liability of the reinsurer is inextricably tied to the loss of the reinsured.").

³⁰ *Id.* at 67-68 ("It is the language of the reinsurance contract that will ultimately determine the extent of the reinsurer's liability to the reinsured. In other words, the sustaining of a loss by the original insured cannot create liability for the reinsurer extending beyond the terms of its contract."). *Id.* *See also* Graydon S. Staring, The Law of Reinsurance, sec. 15:1, 1 ("It does not necessarily follow that, where the first insurer is liable, the reinsurer is also liable. Whether or not the reinsurer is liable depends upon the terms of the contract of reinsurance.").

³¹ *See* Couch on Insurance, 3rd edition (2007), sec. 9:9, 33-34 ("The fundamental rules or principles governing the construction and interpretation of contracts generally apply equally to contracts of reinsurance. The form of the reinsurance contract, while distinctive in nature, is often similar to a contract of original insurance. It is the nature and heightened complexity or sophistication that sets the reinsurance contract apart and necessitates its own area of law within the broader context of insurance law.").

greater sophistication of the parties involved and the more complex purposes of reinsurance beyond issues of simple indemnity.³²

2. A Brief Taxonomy of Reinsurance

As reinsurance is a contractual arrangement, the nature, complexity and terms of many contracts stray from the standardization common among primary insurance policies.³³ In fact, because of reinsurance's remarkable flexibility and its capacity to take on a large variety of risk types and risk levels, the policies vary in their purposes and specifics.³⁴ The terms of the reinsurance contract and the terms of the policies reinsured determines the scope of the indemnity offered by the reinsurer.³⁵ The contracts reflect the business needs of sophisticated commercial entities and, as such, the terms, conditions and costs of a reinsurance contract are all negotiable.³⁶ However, likely as a result of historical development, these policies generally fall into a few recognized categories of reinsurance.³⁷

³² See Robert H. Jerry, II, *Understanding Insurance Law*, sec. 141, 3rd edition (2002), 1056-57 (“Reinsurance serves several purposes; first, reinsurance permits an insurer to transfer large risks that it is unable to manage or that are simply too risky to another insurer. Second, reinsurance increases an insurer’s capacity to write policies. Third, just as reinsurance enables an insurer to take on new business, reinsurance can also be used to enable an insurer to leave a particular kind of business quickly. A fourth purpose of reinsurance is to stabilize insurers’ profits and losses.”).

³³ See Ostranger & Newman, *Handbook on Insurance Coverage Disputes* at 15.03[b], 997 (“Reinsurance treaties and certificates vary considerably in their language and terms of coverage.”).

³⁴ *Id.* (“Reinsurance treaties may contain ‘follow the fortunes,’ ‘errors and omissions,’ ‘notice,’ ‘arbitration,’ ‘claims cooperation,’ ‘salvage and subrogation,’ ‘allocation of expenses,’ ‘extra contractual obligations,’ ‘punitive damages’ and/or ‘cut through clauses.’ The wording of these clauses in different reinsurance certificates and treaties can also vary substantially.”). *Id.*

³⁵ See *Hartford Fire Ins. Co. v. California*, 509 U.S. 764, 806-07 (1993).

³⁶ See RAA webpage, *Who We Are*, <http://www.reinsurance.org/i4a/pages/Index.cfm?pageID=3615> (“Headquartered in Washington, D.C., the RAA is a non-profit association committed to an activist agenda that represents the interests of reinsurance professionals in Congress and in state legislatures.”).

A. Facultative Reinsurance

Facultative reinsurance is the most discrete form of reinsurance, and generally accepted as the likely original form of reinsurance.³⁸ Facultative reinsurance contracts usually cover individual underlying policies written on a policy-specific basis, although facultative “treaties” or book of business policies are not uncommon.³⁹ Facultative reinsurance policies take their name because the contracts allow the reinsurance company to use its “faculties” or reason to choose to reinsure a specific risk, a specific policy, or a specific group of policies.⁴⁰ The ceding insurer and reinsurer agree to the terms and conditions of each individual contract.⁴¹ In these contracts, the reinsurer often conducts its own underwriting to determine the appropriate premium level.⁴² Facultative

³⁷ See Couch on Insurance, 3rd edition (2007), sec. 9:3, 8 (“There are two broad categories of reinsurance agreements: facultative reinsurance and treaty reinsurance.”).

³⁸ See Graydon S. Staring, *The Law of Reinsurance* at 1:4, 7-8 (“Facultative reinsurance of a single risk, which was undoubtedly the original type, continued dominant until the last half of the Nineteenth Century. A treaty, which is a long term contract covering more than one risk, is known to have existed as early as 1821. Treaties became common around the beginning of the Twentieth Century and one form, the excess of loss treaty, is said to have become widespread as a result of the San Francisco earthquake and fire of 1906”).

³⁹ See *Unigard Sec. Is. Co. v. North River Is. Co.*, 4 F.3d 1049, 1054 (2d Cir. 1993). Even with facultative insurance there are automatic or semi-automatic forms that allow reinsurers to cancel all or parts of the risks assumed. See *Compagnie de Reassurance d’île de Farce v. New England Reinsurance Corp.*, 57 F.3d 56, 64-65 and 74-76 (1st Cir. 1995).

⁴⁰ See Robert H. Jerry, II, *Understanding Insurance Law*, sec. 140[b], 3rd edition (2002), 1054 (“Facultative reinsurance involves the primary insurer entering into an agreement for the reinsurance of a particular risk. The reinsurance can be written on a pro rata or an excess basis; the root word “faculty” denotes that the reinsurer has a choice of accepting or rejecting any risk proposed and of demanding whatever premium it thinks appropriate.”).

⁴¹ See *New Appleman Insurance Law Practice Guide*, Vol. 3: Separate Lines of Insurance, sec. 40.04[1] (2007), 16 (“The reinsurer and cedent negotiate the terms for each facultative certificate.”). See also Graydon S. Staring, *Law of Reinsurance* at 2:2, 3 (“The prospective reinsured, either directly or through a broker, presents the direct policy terms, or a summary of them, and the proposal for reinsurance. If it is accepted at a satisfactory premium, a contract is made. Other terms are negotiated to the satisfaction of both parties.”).

⁴² See Graydon S. Staring, *Law of Reinsurance* at 2:6, 7 (“The reinsurer will always have at least a general, if not a particular, interest in the integrity of the reinsured’s underwriting and claims practices.”). See also *New Appleman Insurance Law Practice Guide*, Vol. 3: Separate Lines of Insurance, sec. 40.04[1] (2007),

reinsurance contracts provide reinsurance for the unusual; they also have the greatest specific effect on the cost of covering unusual or low-incidence risks.⁴³ Likewise, with its ability to allow reinsurers to engage in significant underwriting opportunities, facultative reinsurance is often used to cover catastrophic or other low incidence - high loss risks.⁴⁴ Individual risk facultative reinsurance may be used in tandem with the second variety of reinsuring agreements, the treaty.⁴⁵

B. Treaty Reinsurance

Treaties are broad agreements that reinsure multiple contracts, often contracts that have yet to be written by the direct insurer.⁴⁶ Usually, treaties cover some portion or

16 (“Facultative reinsurance is commonly purchased for large, unusual or catastrophic risks. Reinsurers thus must have the necessary resources to underwrite individual risks carefully.”).

⁴³ Id at sec. 2:3, 4 (“Once, no doubt, all reinsurance was facultative. With the rise of treaties, they account for great amounts of reinsurance but facultative reinsurance, which requires individual attention to underwriting, remains very important for businesses that fall outside the bounds of a treaty reinsurance program. The reinsured may want to meet competition and enter into new lines in which it has no expertise but can gain it through initially taking risks and obtaining facultative reinsurance from those who have experience. The reinsured may need facultative reinsurance where the risk falls under an exclusion in its treaties, either as to type or amount, or because the risk, although routine in nature, present a very high loss exposure. In the end, all these uses serve the general purpose of reinsurance to provide stability and promote growth.”). Id.

⁴⁴ See Ostranger & Newman, Handbook on Insurance Coverage Disputes at 15.01[b], 991 (“The availability of reinsurance enables an insurer to accept risks that would otherwise be beyond its underwriting capacity by allowing the ceding insurer to ‘lay-off’ on reinsurers a portion of the risk of loss. Thus, reinsurance enables insurers to spread the risk of catastrophic losses among a larger pool of insurers.”).

⁴⁵ See New Appleman Insurance Law Practice Guide, Vol. 3: Separate Lines of Insurance, sec. 40.04[1], (2007), 16 (“Insurers sometimes purchase both facultative and treaty reinsurance to cover the same risk. Unless there are contract terms to the contrary, the facultative reinsurance will perform first and completely before any of the treaty reinsurance performs. Sometimes the facultative reinsurance only applies to the ceding company’s net retention; other times facultative coverage also inures to the benefit of the treaty reinsurers. Ideally, the wording of the facultative certificate will make this clear.”).

⁴⁶ See Robert H. Jerry, II, Understanding Insurance Law, sec 140[b], 3rd edition (2002), 1054 (“The reinsurer is obligated to accept a portion of all of the risks that meet the requirements agreed to by the parties, as opposed to providing reinsurance directly for a particular risk. The primary insurer may or may not be obligated to cede risks. Provisions exist for renewing or terminating the reinsurance, but the distinguishing aspect of the treaty is that a commitment to reinsure exists, which is not the case when facultative arrangements are used. In a treaty reinsurance relationship, there is 1) no individual risk scrutiny by the reinsurer, 2) obligatory acceptance by the reinsurer of covered business, and 3) a long-term

class of business of the direct insurer and historically may cover a long period of time, usually renewable on a fairly automatic basis unless one of the parties seeks a new term.⁴⁷ Treaties are particularly useful reinsuring mechanisms since they can be structured to reinsure losses on direct insurance which either were written during the term of the treaty but occur later, or they can be structured to reinsure losses that occur during the term of treaty but were written earlier.⁴⁸ Likewise, the premiums may be calculated in a variety of ways including structuring the reinsurance premium in some way directly related to the premiums on the underlying policies or assigning a single sum or some other variable amount as the parties wish and which reflect their business purposes.⁴⁹ Generally speaking, the treaty reinsurance contract forms when the original insurer cedes part of the premiums for its policies and the risk of losses on those policies to the reinsurer.⁵⁰ Treaty reinsurance usually involves multiple reinsurers taking part of a book of business' risks, with each agreeing to assume a portion of the risk in some pre-determined manner.⁵¹

relationship in which the reinsurer's profitability is expected, but measured and adjusted over an extended period of time.").

⁴⁷ Id ("Most reinsurance is treaty reinsurance. The treaty arrangement, sometimes called "automatic reinsurance," involves a commitment of a reinsurer to assume part of the risk of the primary insurer, either on a pro rata or an excess basis, for a stated period."). Id.

⁴⁸ See Graydon S. Staring, *Law of Reinsurance* at 2:4, 4-5 ("Depending on its purpose and structure, a treaty may reinsure only losses on direct insurance written during its term, or it may reinsure losses occurring in that term, although under insurance written earlier. Depending on the purpose of the reinsured and the specialization or business interest of the reinsurer, it may be written on one or more particular classes of the reinsured's business, or parts of them, or on the results of its business as a whole.").

⁴⁹ Id at 5 ("Depending again on its structure and purpose, the premiums may be directly related to the premiums on the underlying insurance or may be lump sums, or variable amounts, not based on direct participation in the underlying premiums."). Id.

⁵⁰ See Ostrager & Newman, *Handbook on Insurance Coverage Disputes* at 15.03[a], 996 ("The reinsurer, under a single contract, agrees to indemnify the ceding insurer with respect to an entire 'book' of the ceding insurer's underwriting activities for designated lines of insurance. A treaty reinsurance contract is formed when the primary insurer cedes part of the premiums for its policies and the losses on those policies to a reinsurer.").

Importantly, reinsurance treaties cover all risks written by the reinsured that fall within their terms unless specifically excluded.⁵² For this reason, treaty reinsurers generally do not review the individual risks underlying the treaty and do not conduct their own underwriting of the risks.⁵³ Rather, they rely on the underwriting experience of the original insurer with a prudent reinsurer investigating the underwriting philosophy, loss experience, attitude towards claims management and other business practices.⁵⁴ Facultative reinsurance can be combined with treaty reinsurance to cover exclusions in the treaty or for other business purposes, some of which we explore later.⁵⁵

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

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

In indemnity reinsurance . . . [the reinsurer] agrees to indemnify, or reimburse, the ceding company for a specified percentage of the claims and expenses attributable to claims that have been reinsured.⁵⁶

⁵¹ Id (“Arrangements typically involve the participation of numerous reinsurers, each agreeing to assume a percentage of the total liability under a single treaty.”). Id.

⁵² See New Appleman Insurance Law Practice Guide, Vol. 3: Separate Lines of Insurance, sec. 40.04[1] (2007), 17 (“Reinsurance treaties cover all of the risks written by the ceding insurer that fall within their terms unless exposures are specifically excluded. Thus, in most cases, neither the cedent nor the reinsurer has the ‘faculty’ to exclude from a treaty a risk that fits within the treaty terms.”).

⁵³ Id (“Treaty reinsurers rely heavily on the cedent’s underwriting.”). Id.

⁵⁴ See RAA webpage, Fundamentals of Property Casualty Reinsurance (“While treaty reinsurance does not require review of individual risks by the reinsurer, it demands a careful review of the underwriting philosophy, practice and historical experience of the ceding insurer, including a thoughtful evaluation of the company’s attitude toward claims management, engineering control, as well as the management’s general background, expertise and planned objectives.”).

⁵⁵ See Footnote 46.

⁵⁶ Colonial American Life Insurance Co. v. Commissioner, 491 U.S. at 247. See also Hartford Fire Ins. Co. v. California, 509 U.S. 764, 806-07 (1993).

The insured's indemnification by the reinsured need not be total or complete.⁵⁷ In fact, the ability of reinsurers to take only a portion of a risk or book of risks is one of the particularly useful risk spreading-elements of reinsurance.⁵⁸ There is nothing to prevent a single reinsurer from taking all indemnity responsibility for a policy or group of policies, but most reinsuring agreements take responsibility for only a portion of those losses.⁵⁹ Traditionally, the responsibilities divide into two basic divisional structures most easily visualized as either a vertical or horizontal slicing up of the losses from particular risks assumed.⁶⁰ Both facultative and treaty reinsurance can be written in either a pro-rata or excess of loss basis.⁶¹

⁵⁷ See RAA webpage, Fundamentals of Property Casualty Reinsurance ("Reinsurance is a transaction in which one insurance company indemnifies, for a premium, another insurance company against all or part of the loss that it may sustain under its policy or policies of insurance.").

⁵⁸ Id ("The fundamental objective of insurance, to spread the risk so that no single entity finds itself saddled with a financial burden beyond its ability to pay, is enhanced by reinsurance."). Id. See also New Appleman Insurance Law Practice Guide, Vol. 3: Separate Lines of Insurance, sec.40.01 (2007), 6 ("Reinsurance relationships can be simple or complex. A cedent can cede certain loss exposures under one contract or purchase several contracts covering different aspects or portions of the same policy to achieve the desired degree of coverage. A layering process involving two or more reinsurance agreements is commonly employed to obtain sufficient monetary limits of reinsurance protection. When a claim is presented, the reinsurers respond in a predetermined order to cover the loss.").

⁵⁹ See Couch on Insurance, 3rd edition (2007), sec. 9:1, 3-4 ("Reinsurance is a contract whereby one insurer transfers or 'cedes' to another insurer all or part of the risk it has assumed under a separate or distinct policy or group of policies in exchange for a portion of the premium.").

⁶⁰ See RAA webpage, Fundamentals of Property Casualty Reinsurance ("Reinsurance may be written on either a proportional basis or excess of loss basis. A reinsurance contract written on a proportional basis simply prorates all premiums, losses and expenses between the insurer and the reinsurer on a pre-arranged basis. The proportional approach is used extensively in property reinsurance. Excess of loss contracts, on the other hand, require the primary insurer to keep all losses up to a predetermined level of retention, and the reinsurer to reimburse the company for any losses above that level of retention, up to the limits of the reinsurance contract. In simplest terms, a retention is analogous to the deductible a policyholder may have on a personal insurance policy, such as an automobile or homeowner's policy.").

⁶¹ See Ostrager & Newman, Handbook on Insurance Coverage Disputes at 15.03[a], 996 ("Both treaty reinsurance and facultative reinsurance can be written on either a pro-rata or excess-of-loss basis. Treaty reinsurance involves an ongoing agreement between two insurers, binding in advance one to cede and the other to accept specified business that is the subject of the treaty. Facultative reinsurance is negotiated with respect to a specific risk insured by a particular policy or policies."). See also RAA webpage, Fundamentals of Property Casualty Reinsurance.

i) Pro-Rata treaties

If a reinsurer does not want indemnification responsibility for an entire risk classification or group of policies, it can structure the treaty to take on only a specific portion of each risk to which it applies.⁶² Using a pro-rata reinsurance contract, the reinsurer agrees to indemnify the ceding insurer for a percentage of original risk losses in exchange for a corresponding portion of the premium.⁶³ Generally, pro-rata agreements obligate the reinsurer to indemnify an insurer without requiring any retention by the reinsured.⁶⁴ Commonly, this type of pro-rata arrangement is called Quota Share Reinsurance, where the ceding company indemnifies the cedent insurer for a fixed percentage of loss on all policies of a defined risk type.⁶⁵ This easily visualized apportionment can become somewhat more complex in that a “pro-rata” treaty can also be horizontally segmented within each “slice” by requiring the ceding insurer to retain some portion of the loss with the reinsurer only responsible for the surplus.⁶⁶ This type

⁶² See RAA webpage, Fundamentals of Property Casualty Reinsurance (“Under proportional reinsurance, the ceding insurer and the reinsurer automatically share all premiums and losses covered by the contract on a pre-agreed basis, thus there are no characteristics uniquely attributable to the risk associated with proportional reinsurance.”).

⁶³ See Ostrager & Newman, Handbook on Insurance Coverage Disputes at 15.02[a], 993 (“Pursuant to a pro-rata reinsurance contract, the reinsurer agrees to indemnify the ceding insurer for a percentage of any losses from the original risk in return for a corresponding portion of the premium for the original risk.”).

⁶⁴ See *Ott v. All-Star Ins. Corp.*, 99 Wisc. 2d 635, 643; *Central Nat’l Ins. Co. v. Devonshire Coverage Corp.*, 426 F. Supp. 7, 11 n. 5, 21 (D. Neb. 1976), *aff’d in part and remanded*, 565 F.2d 490 (8th Cir. 1977). See also Ostrager & Newman, Handbook on Insurance Coverage Disputes at 15.02[a], 993 (“Pro-rata reinsurance arrangements generally obligate the reinsurer to pay a proportion of any losses that occur with no retention by the reinsured.”).

⁶⁵ See Robert H. Jerry, II, Understanding Insurance Law at §140[b], 1054 (“Pro rata reinsurance, sometimes called ‘quota share’ reinsurance, means that losses, premiums, and expenses are divided pro rata by the primary insurer and the reinsurer. For example, the primary insurer may retain sixty percent of the risk and transfer forty percent. If any loss occurs, whether large or small, the primary insurer is liable for sixty percent of the loss and the reinsurer is liable for forty percent.”). See also Ostrager & Newman, Handbook on Insurance Coverage Disputes at 15.02[a], 993 (noting quota share reinsurance “indemnifies the ceding insurer for a fixed percentage of loss for all policies of a defined type written by the ceding company.”).

of pro-rata reinsuring up to the amount of insurance originally written, minus the ceding insurer's retention is commonly called Surplus Share Reinsurance.⁶⁷ With the entrance of additional retrocessionaires there can be quite a bit of segmentation in this surplus line.

Another interesting aspect of pro-rata treaties is the reinsured's obligation to automatically accept its portion of the risks insured.⁶⁸ Pro-rata treaties come in a variety of broad types, knowledge of each of which is useful for our later discussion. First, the treaty can be pro-rata and obligatory.⁶⁹ Through this structure, all risks in a specified category are shared automatically by some proportion agreed to.⁷⁰ The second type, however, is more interesting because it is only semi-automatic and contains a facultative component.⁷¹ Best defined as a facultative obligatory treaty, the obligation stays with the reinsurer to accept the ceded business that it selected by its reinsured.⁷² Alternatively,

⁶⁶ Id. at 1055 (“A special kind of pro rata reinsurance is ‘surplus reinsurance.’ Under surplus reinsurance, the reinsurer agrees to cover a share of the risk that varies with the size of the exposure. For example, the treaty might specify that losses under \$50,000 are covered in full by the primary insurer, that the first \$50,000 of losses between \$50,000 and \$250,000 is paid by the direct insurer and the rest by the reinsurer, and that losses exceeding \$250,000 are paid 20 percent by the direct insurer and 80 percent by the reinsurer.”). Id.

⁶⁷ See Ostrager and Newman, Handbook on Insurance Coverage Disputes at 15.02[a], 993 (noting surplus share reinsurance “indemnifies the ceding insurer for a fixed percentage of loss for all policies of a defined type written by the ceding company.”).

⁶⁸ See New Appleman Insurance Law Practice Guide, Vol. 3: Separate Lines of Insurance, sec.40.04[2] (2007), 18 (“Proportional or pro-rata reinsurance is characterized by a proportional division of liability and premium between the ceding company and the reinsurer.”).

⁶⁹ Id (“The cedent pays the reinsurer a predetermined share of the premium, and the reinsurer indemnifies the cedent for a like share of the loss and the expense incurred by the cedent in its defense and settlement of claims (the ‘allocated loss adjustment expense’ or ‘LAE’”). Id.

⁷⁰ Id (“According to the percentage agreed, the cedent and reinsurer share the premium and losses from the business reinsured.”). Id.

⁷¹ See Ostrager and Newman, Handbook on Insurance Coverage Disputes at 15.03[a], 997 (“Semi-automatic reinsurance, or ‘automatic facultative reinsurance,’ is a variation of facultative reinsurance which enables a ceding company to cede to the reinsurer specific risks, which are assumed by the reinsurer for a predetermined period, unless the insurer declines the risk within a stipulated time period.”).

there exists the truly facultative treaty in which neither the reinsured nor the reinsurer is obligated to cede or accept the risks, both are free to accept or decline.⁷³ Pro-rata treaties often allocate a portion of the original premium to the reinsurer.⁷⁴ By this mechanism a reinsurer which may not have been nor sought to be directly interested in the original insurer's premium calculations now acquires a more direct interest in their reinsured's underwriting decisions.⁷⁵

iii) Excess of Loss Reinsurance

In the excess of loss reinsurance scenario, the reinsurer's obligation is defined in relation to the reinsured's retention.⁷⁶ In this structure the reinsurer, subject to specific stated limits of coverage, indemnifies the reinsured for all or a stated portion of losses in excess of the agreed upon retention.⁷⁷ The agreements can be structured so that the

⁷² Id (“A ‘semi-automatic’ reinsurance facility differs from an ‘automatic’ one in that, under the former, the reinsurer has retained the right to cancel any individual risk it does not want to accept, while under the latter, the reinsurer has the right to cancel the entire facility.”). Id.

⁷³ Likewise, pro-rata share treaties can be subdivide into quota share treaties and surplus share treaties. Quota share treaties allow the reinsurer to take a specified percentage of the premiums charged in proportion to its percentage of the risk assumed, all within agreed upon upper limits of liability. Surplus share treaties are distinct in that the reinsurer does not participate until the loss reaches a specific level, after which they are liable on a fixed percentage basis, within limits, and for a percentage of the premiums.

⁷⁴ See Ostrager and Newman, Handbook on Insurance Coverage Disputes at 15.02[a], 993 (“Pursuant to a pro-rata reinsurance contract, the reinsurer agrees to indemnify the ceding insurer for a percentage of any losses from the original risk in return for a corresponding portion of the premium for the original risk. Pro-rata reinsurance arrangements generally obligate the reinsurer to pay a proportion of any losses that occur with no retention by the reinsured.”).

⁷⁵ See Graydon S. Staring, Law of Reinsurance at 2:2, 4 (“Whether the contract is pro rata or excess, the reinsured will...be expected ordinarily to retain a sufficient amount of the risk to give the reinsurer confidence that the policy will be well administered.”).

⁷⁶ See Ostrager and Newman, Handbook on Insurance Coverage Disputes at 15.02[b], 993 (“Excess of loss reinsurance indemnifies the ceding insurer, subject to specified limits, for all or a stated portion of loss in excess of a state retention.”).

⁷⁷ See *Compagnie de Reassurance d’Ile de Farce v. New England Reins. Corp.*, 944 F. Supp. 986, 998 n.17 (D. Mass 1996).

reinsurance can be excess to the specific risk, specific occurrence, an aggregate dollar amount or specified loss ratio.⁷⁸

2. Purposes of Reinsurance

A comprehensive review of all the reasons an insurer may seek to reinsure is not possible or necessary for the purposes of this Essay. Suffice it to say that as reinsurance is a flexible medium and supports a variety of functions, the purpose of acquiring it will differ in accordance with the business interests of the insurer seeking it.⁷⁹ Likewise, as reinsurance serves a variety of purely financial and accounting purposes, reinsurance may be employed for purposes slightly beyond the scope of this Essay's interest in its potential regulatory effects on insurance companies as insuring companies, rather than as financial institutions. Regardless, in accordance with our focus on the potential effects of reinsurance on primary insurers, it is useful to review the four main purposes for which reinsurance is generally sought in relation to the primary insurer's insurance function.⁸⁰

A. Risk Allocation

For some purposes, reinsurance serves the almost identical purpose for the reinsured insurance company as that of many other common commercial insurances.

Thus, reinsurance's initial purpose may be viewed as a basic reallocation of risk and as an

⁷⁸ See Ostrager & Newman, Handbook on Insurance Coverage Disputes at 15.02[b], 994 (noting per risk or specific excess reinsurance "indemnifies the ceding insurer, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to each risk covered by a reinsurance arrangement"; per occurrence reinsurance "indemnifies the ceding insurer, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to each occurrence"; aggregate excess of loss reinsurance "indemnifies the ceding insurer for the amount by which the ceding insurer's loss during a specified period exceeds either (a) a specific dollar amount or (b) a percentage of the company's subject premium"; and stop loss reinsurance "indemnifies the ceding insurer for losses in excess of a specified loss ratio up to a predetermined loss ratio limit.").

⁷⁹ See RAA webpage, Fundamentals of Property Casualty Reinsurance ("Depending on the ceding company's goals, different types of reinsurance contracts are available to bring about the desired result.").

⁸⁰ Id (Insurers purchase reinsurance for essentially four reasons: (1) to limit liability on specific risks; (2) to stabilize loss experience; (3) to protect against catastrophes; and (4) to increase capacity."). Id.

additional way to spread risk.⁸¹ Just as any commercial entity might enter the insurance market seeking indemnity for specific types of loss, so too does the insurer seek a mechanism to transfer the risk it chose to underwrite to another party.⁸² In a reinsurance situation, the risk acquired by the ceding insurer transfers to the reinsurer to the extent and within the limits of the negotiated contract; to the extent that those risks are allocated among numerous reinsurers, the risk is even further spread.⁸³

This risk transfer benefits the insurer by allowing the reinsured to take action that might otherwise be prohibited or disallowed sans reinsurance.⁸⁴ For instance, through the medium of reinsurance, the ceding insurer can underwrite business that it might otherwise could not have.⁸⁵ Either the risk itself may simply be too large or the risk of loss might be in some other way unusual.⁸⁶ By limiting their loss exposure through reinsurance, the reinsured can offer higher coverage limits than they could otherwise

⁸¹ Id (“By providing a mechanism through which insurers limit their loss exposure to levels commensurate with their net assets, reinsurance enables insurance companies to offer coverage limits considerably higher than they could otherwise provide.”). Id.

⁸² See *Kemper Reins. Co. v. Corcora (In re Midland Ins. Co.)*, 79 N.Y.2d 253, 258 (1992).

⁸³ See RAA webpage, *Fundamentals of Property Casualty Reinsurance*, Importantly, it must be remembered that reinsurance does not actually lessen total risk exposure:

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

⁸⁴ See Robert H. Jerry, II, *Understanding Insurance Law* at §141, 1056 (“Reinsurance permits an insurer to transfer large risks that it is unable to manage or that are simply too risky to another insurer.”).

⁸⁵ Id (“For example, an insurer that has a portfolio of coverage faces the risk that a large number of small losses or an unexpected, unexceptional nature may occur, thereby exceeding the insurer’s capacity to pay for them without suffering a loss. For...[this] risk, an insurer can seek reinsurance to protect against [this] contingency.”). Id.

⁸⁶ Id (“The insurer faces the risk that a single catastrophic event, the precise timing of which is uncertain (e.g., an earthquake) may occur with devastating consequences to the insurer’s balance sheet. For...[this] risk, an insurer can seek reinsurance to protect against [this] contingencies.”). Id.

afford.⁸⁷ Through this mechanism, smaller insurers have the capacity to compete with larger companies and offer their policyholders a broader array of coverage options.⁸⁸

Likewise, the insurer may want to enter business lines that present the possibility of some future unexpected losses the insurer is unwilling to retain beyond a specific retention.⁸⁹ Either the possibility of a very great a number of small, unexpected losses or the possibility of a single, catastrophic loss which could overwhelm the insurer's balance sheet might cause a prudent insurer to acquire reinsurance to offset the risk of loss.⁹⁰

This prudential risk-transferring purpose of reinsurance appropriately causes reinsuring even though the insurer believes (as it must) that its underwriting decisions are prudent

⁸⁷ See RAA webpage, Fundamentals of Property Casualty Reinsurance (“In calculating an appropriate level of reinsurance, a company takes into account the amounts of its own available surplus, and determines its level of retention based on the amount of loss it can absorb financially. Surplus, sometimes referred to as policyholders’ surplus, is the amount by which the assets of an insurer exceed its liabilities. A company’s retention may range anywhere from a few thousand dollars to one million dollars or more. The loss exposure above the retention, up to the policy limits of the reinsurance contract, is indemnified by the reinsurer. In this manner, reinsurance helps to stabilize loss experience on individual risks, as well as on accumulated losses under many policies occurring during a specified period.”).

⁸⁸ See RAA webpage, Fundamentals of Property Casualty Reinsurance (noting reinsurance’s goal of limiting liability “is crucial because it allows all companies, large and small, to offer coverage limits to meet their policyholders’ needs. In this manner, reinsurance provides an avenue for small-to-medium size companies to compete with industry giants.”).

⁸⁹ See Robert H. Jerry, II, Understanding Insurance Law at §141, 1056-57 (“Just as reinsurance enables an insurer to take on new business, reinsurance can also be used to enable an insurer to leave a particular kind of business quickly. An insurer that wants to rid itself of a particular kind of coverage can solicit reinsurance for all of the insurance the carrier has written, which effectively takes the insurer out of the business and makes the reinsurer the insurer for all of the risks.”).

⁹⁰ Id at 1056 (“When the primary insurer purchases reinsurance, it reduces the size of its potential losses, which reduces the size of the reserves it must maintain. Insurers, however, are not as interested in reducing reserves as they are in increasing their business. An insurer with the minimum allowable level of reserves and surplus (the amount an insurer is required to maintain in excess of reserves to meet unexpected losses) could not take on new business or enter new fields. However, reinsurance provides a solution: the insurer could write the coverage, transfer the risk to a reinsurer, and receive a commission from the reinsurer. The primary insurer adds no new liabilities, but its surplus increases by the amount of the commission. This increased surplus enables the primary insurer to write and retain additional coverage. Another way to view this transaction is that some of the excess capacity of the reinsurer is utilized by the business-garnering efforts of the primary insurer; in essence some excess capacity is transferred from the reinsurer to the primary insurer. For the small insurer who wants to grow, reinsurance is an important way to take on new business beyond its means and simultaneously increase its capacity.”). Id.

and the premium appropriate. After all, imprudent underwriting could well be a defense to reinsurance coverage.⁹¹ Still, even the most perspicacious of underwriters cannot foresee the unexpected; thus the prudential purpose of reinsurance.

B. Reserve Requirements

A second purpose for reinsurance, one particularly importantly in the insurance regulatory context, is using reinsurance to reduce the amount of reserves an insurer must maintain, thus freeing the insurer up to write more policies.⁹² In purchasing reinsurance, the primary reduces the size of its potential losses, which allows it to reduce its statutorily-mandated reserves.⁹³ Hence, if a primary insurer hit the threshold for the minimum allowable level of reserves plus surplus that it is statutorily required to maintain, it would be restricted in the amount of new business open to it. If the primary insurer purchased reinsurance, the primary would still be able to write new policies so long as it could transfer the risk to the reinsurer.⁹⁴ In fact, since the reinsurer swaps the

⁹¹ See Couch on Insurance, 3rd edition (2007), sec. 9:31, 80-81 (“The duty of good faith that runs between the parties to a reinsurance contract is essential to the reinsurance relationship. Stemming from the reinsurer’s need to rely upon and not duplicate the reinsured’s efforts in properly evaluating risks and handling claims, and reducing costs for both parties to the reinsurance contract. Due to these specific needs of the industry, the duty of utmost good faith in this context connotes a higher duty than the ordinary duty of good faith that is inherent in general contract law. Accordingly, it requires that the reinsured must disclose to the reinsurer all material facts which may affect the subject risk. The failure of a reinsured to disclose material facts to the reinsurer will warrant the rescission of a reinsurance contract.”).

⁹² See *Kemper Reins. Co. v. Corcoran (In re Midland Ins. Co.)*, 79 N.Y.2d 255, 258 (1992) (noting reinsurance allows “a primary insurer to reduce the amount of legally required reserves held for the protection of policyholders, and to increase the company’s ability to underwrite other policies or make other investments”).

⁹³ See footnote 91.

⁹⁴ See footnote 91. See also RAA webpage, Fundamentals of Property Casualty Reinsurance (“When an insurance company issues a policy, the expenses associated with issuing that policy, such as taxes, agent commissions, and administrative expenses, are charged immediately against the company’s income, resulting in a decrease in surplus. Meanwhile, the premium collected must be set aside in an unearned premium reserve to be recognized as income over a period of time. This accounting procedure allows for strong solvency regulation; however, it ultimately leads to decreased capacity. As an insurance company

new risk in exchange for a commission, the primary insurer is frequently seen as acquiring no new liabilities, while its surplus is viewed as increasing by the amount of the reinsurer's commission.⁹⁵ The majority of public regulation of reinsurers, such as it is, concerns itself with this aspect of the reinsuring relationship.⁹⁶

C. Risk Exits and Fronting

A third commonly accepted purpose of reinsurance allows the primary insurer to not write more policies.⁹⁷ An insurer which seeks to exit a certain risk stream can be relieved of the risks of loss from those policies and exit that insurance market via appropriate reinsurance.⁹⁸ This allows a certain amount of flexibility to insurers by allowing them to shift direction in their future business choices.⁹⁹

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

sells more policies, it must pay more expenses from its surplus. Therefore, the company's ability to write additional business is reduced.").

⁹⁵ See footnote 91.

⁹⁶ Since reserves are the primary way public regulators attempt to reduce the risk of insurer insolvency and default, a great amount of activity has occurred amongst and between regulators to devise statutory schemes which allow for protection of the reserves. There has been some very interesting work on reinsurer chartering and on bonding requirements for foreign insurers reinsuring domestic primaries.

⁹⁷ See footnote 90.

⁹⁸ See footnote 90.

⁹⁹ See footnote 90.

relationship with the policyholders of the reinsured.¹⁰⁰ Reinsuring agreements can include “cut-out” provisions, which allow a direct action by the policyholders against the reinsurer; provisions like these change the reinsuring relationship.¹⁰¹

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

Another brief caveat is also useful here. Placing reinsurance for 100% of a certain type of underwriting business for the purpose of exiting the business is likewise different from another type of 100% reinsuring agreement that displays certain similar

¹⁰⁰ See New Appleman Insurance Law Practice Guide, Vol. 3: Separate Lines of Insurance, sec.40.01 (2007), 5 (“In essence, reinsurance is insurance for insurance companies. It is a contractual arrangement under which an insurer secures coverage from a reinsurer for a potential loss to which it is exposed under insurance policies issued to original insureds. The risk indemnified against is the risk that the insurer will have to pay on the underlying insured risk. Because reinsurance is a contract of indemnity, absent specific cash-call provisions, the reinsurer is not required to pay under the contract until after the original insurer has paid a loss to its original insured.”).

¹⁰¹ See footnote 34.

characteristics. In “fronting agreements”, an insurer will enter into a policy with the understanding that another party, a reinsurer, will be responsible for the entire amount that it is required to pay under the policy.¹⁰² One New York court described a fronting company as “an insurer that issued the policy on the risk and then reinsured 100% of that risk by placing portions of the coverage with various reinsurance carriers”.¹⁰³ The purpose of these “fronting agreements” is to allow a reinsurer not qualified or licensed to do business in the state, the opportunity to profit from the sale of insurance transactions in that state.¹⁰⁴ Generally, the licensed insurer will receive a fee for acting as the “front”.¹⁰⁵ Despite the slightly pejorative terms used in this arrangement, there is nothing illegal in a domestic insurer acting as a front for the unlicensed insurer. In fact, so long as all other regulatory goals are met, these relationships can allow for a significant increase in insurance capacity for the state.¹⁰⁶

D. Loss Stability

Finally, and perhaps most importantly, reinsurance is a mechanism for insurers to stabilize their profits and expected losses.¹⁰⁷ Insurance does and always has concerned

¹⁰² See *Reliance Ins. Co. v. Shriver, Inc.*, 224 F.3d 641, 643 (7th Cir. 2000) (describing a fronting agreement as a “well established and perfectly legal scheme” where policies are issued by state-licensed insurance companies and then immediately reinsured to 100 percent of face value).

¹⁰³ *Allendale Mut. Ins. Co. v. Excess Ins. Co.*, 970 F. Supp. 265, 267 n.2 (SDNY 1997).

¹⁰⁴ See *Union Sav. Am. Life Ins. Co. v. North Central Life Ins. Co.*, 813 F. Supp. 481 (S. D. Miss. 1993).

¹⁰⁵ See *Venetsanos v. Zucker, Facher & Zucker*, 271 N.J. Super. 459, 463-64 (1994).

¹⁰⁶ See *New Appleman Insurance Law Practice Guide*, Vol. 3: Separate Lines of Insurance, sec. 40.04[5], 26 (2007) (“A licensed reinsurer can front for an unauthorized reinsurer or a reinsurance syndicate, to permit the ceding insurer to take credit for the reinsurance without need for security.”).

¹⁰⁷ See Robert H. Jerry, II, *Understanding Insurance Law* at §141, 1057 (“A fourth purpose of reinsurance is to stabilize insurers’ profits and losses.”).

risk.¹⁰⁸ Using reinsurance, the primary insurer can set a limit on its exposure by facultative insurance for any given risk, use a surplus treaty to create a ceiling on aggregate loss or determine its percentage of risk retained through a pro-rata arrangement.¹⁰⁹ In this way, even cumulative losses can be restricted to designated limits.¹¹⁰ The insurer uses reinsurance as a form of stability control, enabling them to fulfill their obligations to policyholders in a continuous manner¹¹¹ and assisting them stabilize their profits.¹¹²

III. Reinsurance as Regulator?

“Regulation” commonly evokes thoughts of governmental action and visions of the regulatory state. For good or ill, thoughts of regulation links with thoughts of state power. Yet such a restrictive vision of regulation is simplistic and ignores the capacity of private institutions to regulate the activities of large swaths of social actors. To be fair, the sophisticated politician or legislator is well aware of this capacity and much of the ideological discourse of the last few decades concerns the question of private, rather than public actors as best regulator.

¹⁰⁸ Id (“Through reinsurance, the maximum losses on policies can be kept to manageable levels, and cumulative losses over a period of time can be kept within a designated limit.”). Id.

¹⁰⁹ See RAA webpage, Fundamentals of Property Casualty Reinsurance (“Insurers often seeks to reduce the wide swings in profits and loss margins inherent to the insurance business. These fluctuations result, in part, from the unique nature of insurance, which involves pricing a product whose actual cost will not be known until sometime in the future. Through reinsurance, insurers can reduce these fluctuations in loss experience, and stabilize the company’s overall operating results.”).

¹¹⁰ See footnote 109.

¹¹¹ See *Corcoran v. Universal Reins. Corp.*, 713 F. Supp. 77, 82 (SDNY 1989) (“Insurance companies depend upon reinsurance contracts for financial stability and hence their ability to fulfill their obligations to their policyholders.”).

¹¹² See footnote 110.

Insurance has been a battleground issue for the regulatory debate, both as a subject for regulation and in its ability to regulate. Insurance's dual status is one of the reasons the insurance regulation, be it health, property or liability is so frequently central to some of the greatest political debates of our time. Yet, insurance's ability to regulate rarely receives recognition or discussion in policy debates. Despite this, a fascinating body of literature on insurance exists allowing us to examine the myriad ways private or quasi-private insurance can regulate private behavior. With the concept of power not limited to overt government action alone, insurance takes its place among regulators of social behaviors with surprising force and scope. Indeed, it has been stated that "looking at twentieth century governance, it is tempting to see insurance as the sleeping giant of power."¹¹³

Identifying insurance as a regulator stems from the idea that insurance works as a mechanism to set social standards.. Much scholarship exists on the concept of insurance as gatekeeper of many economic activities, from buying a home to driving a car to executing a complex financial transaction. For instance, some of this regulatory effect results from direct delegation of state power mandating the purchase of insurance as a prerequisite to operating a car or entering certain businesses. Even without compulsion, acquiring insurance may be viewed as a form of "private legislation" within the regime of traditional notions of liberal governance. Particularly relevant to the discussion of reinsurance as regulator is the body of work which highlights the capacity of contracting behavior which results in social control. The fascinating work by Tom Baker on the genealogy of moral hazard and the path-breaking sociological studies of Carol Heimer on the capacity of insurers' contractual "control" of behavior each greatly assist in

¹¹³ See Tom Baker & Jonathan Simon, *Embracing Risk* at 12.

identifying insurance as a source of regulatory control over private life.¹¹⁴ Thus, the thesis of this Essay; as insurance regulates of policyholder actions, reinsurance regulates insurer actions.

1. Reinsurance and Industry Standards

Each industry has its own standards and practices. Most people, even people who interact daily with the various professions do not spend too much time pondering how an industry came to act the way it does. Yet, understanding why industries and organizations act in a given manner provides any who choose to study them a rich, in-depth understanding of their topic. In all types of commercial transactions, the governing doctrines of law (with their judicial enforcement of, or release from, certain obligations) enshrined certain processes and practices. These governing doctrines of law also create expectations on the parts of consumers who interact with those businesses, without their even being aware of the legal doctrines which spawned them. How many buyers are actually aware of the Uniform Commercial Codes' treatment of warranties of quality and exceptions thereto when purchasing a good? Yet, it is common practice to mark and common knowledge to understand the meaning of a sign scrawled on a television "As Is".

Reinsurance contracts are subject to specialized doctrines of law, with long traditions of application to reciprocal performance obligations.¹¹⁵ Courts reviewing

¹¹⁴ Baker and Simon, *Embracing Risk* at 13.

¹¹⁵ See Graydon S. Staring, *Law of Reinsurance* at 12:1, 1-2 ("The long and well established tradition that reinsurance transactions are a matter of 'utmost good faith' between the parties has had a predictable effect on the preparation of reinsurance contracts...The typical reinsurance contract is a relatively short, concise document, noticeably lacking in the legalisms so characteristic of other types of contracts. This underlying assumption of utmost good faith allows the companies to draft a document that assumes both parties are so

these doctrines and their effect clauses interpret them to require behavior or risk release from the reinsurer's obligation; this information helps one understand reinsurance's effect on insurance industry practices. Also interesting is an examination of how the rules came about and the extent they inform reinsurance's economic viability.

A. Reinsurance and Underwriting Standards¹¹⁶

One of the strangest aspects of reinsurance is the often overlooked question of how reinsurance could ever exist without becoming cost prohibitive. If one were to simply think about reinsurance in terms of risk assessment, there seems little way that the addition of multiple new players in the insuring process would not add and continue adding to the cost of insurance. After all, due diligence is an expensive proposition. How could all these different reinsurance institutions capably evaluate the true risks of all the policies which they agree to reinsure, particularly in the treaty context, without accruing costs as large as, if not larger than, the original insurer?¹¹⁷ The answer is simply that in the reinsurance treaty context they simply do not engage in that kind of investigation, instead they rely on the underwriting skills of their reinsureds.¹¹⁸

knowledgeable on the subject matter to be dealt with and possess such a degree of sophistication as to preclude the necessity of long, expository declarations of intent and implementation.”).

¹¹⁶ See RAA webpage, Reinsurance Glossary, <http://www.reinsurance.org/i4a/pages/index.cfm?pageid=3309> (noting underwriting capacity is “the maximum amount of money an insurer or reinsurer is willing to risk in a single loss event on a single risk or in a given period. The limit of capacity for an insurer or reinsurer that may also be imposed by law or regulatory authority.”).

¹¹⁷ See Couch on Insurance, 3rd edition (2007), sec. 9:17, 56-57 (“Duties of good faith and fair dealing run between the reinsurer and the reinsured much as they do between the initial insured and his or her insurer. This duty originates from the reinsurer’s need to rely upon and not duplicate the reinsured’s efforts in properly evaluating risks and handling claims, reducing costs for both parties to the reinsurance contract.”).

¹¹⁸ See Graydon S. Staring, Law of Reinsurance at 2:6, 7 (“The reinsurer will always have at least a general, if not a particular, interest in the integrity of the reinsured’s underwriting and claims practices.”).

Investigation costs are limited to delving into the potential reinsured's loss experiences, underwriting skills and claims handling competence.¹¹⁹

How is action like that considered prudent? As we have seen to our great dismay in the sub-prime mortgage crisis, the consequences of opaque risk acquisition can be remarkably severe. In reinsurance, the doctrine of utmost good faith or *uberrima fides* obviates this problem.¹²⁰ This duty requires, “the most abundant good faith; absolute and perfect candor or openness and honesty; [including] the absence of any concealment or deception, however slight”.¹²¹ Viewing utmost good faith as appropriately sufficient to govern trillions of dollars of transactions is interesting in and of itself, yet, as the Second Circuit has noted, it is the core relationship that allows for reinsuring to profitably occur. As they explained:

Historically, the reinsurance market has relied on a practice of the exercise of good faith to decrease monitoring costs and *ex ante* contracting costs. Reinsurance works only if the sums of reinsurance premiums are less than

¹¹⁹ See footnote 116.

¹²⁰ See Couch on Insurance, 3rd edition (2007), sec. 9:17, 57-58 (“The duty [of utmost good faith] requires the reinsured to disclose to the reinsurer all material facts which may affect the subject risk. The extension of this duty of good faith is the related concept that reinsurers are generally bound by the reinsured’s good faith decision to pay a claim, commonly referred to as the ‘follow the settlements’ doctrine. The purpose for this rule is to prevent situations in which reinsurers, in attempt to deny coverage, use against the reinsured the same coverage arguments made by the reinsured against the original insured, essentially eroding the good faith relationship needed in the reinsurance context. The limiting factor, preventing the abuse of this doctrine, is the determination of whether the reinsured’s payment was made in good faith.”).

¹²¹ See Robert H. Jerry, II, Understanding Insurance Law at §142[c], 1060 (noting good faith “is the position of reinsurers that their contracts are those of ‘utmost good faith.’ Utmost good faith contracts of any kind are so delicate in character and so susceptible of abuse that unusual precautions must be observed by both parties in their implementation. The business of reinsurance often involves considerable oral exchange of information between primary insurer and reinsurer, and the reliability of this information is very important. The resemblance of the customary practices to how business used to be conducted at the Lloyd’s Coffee House of old is unmistakable. The strict law of warranty which applied to the old transactions at Lloyd’s probably has something in common with the duty of ‘utmost good faith’ which applies in reinsurance. Both doctrines have the effect of ratcheting up the expectations contracting parties can reasonably possess with regard to the accuracy of information shared by the other party.”).

the original insurance premium. Otherwise, the ceding insurer will not reinsure. For the reinsurance premiums to be less reinsurers cannot duplicate the costly but necessary efforts of the primary insurer in evaluating risks and handling claims. . . . Reinsurers are protected, however, by a large area of common interest with ceding insurers and by the tradition of utmost good faith, particularly in the sharing of information.¹²²

In other words, in exchange for placing the reinsurance at a price less than the original premiums, the reinsurer is allowed to rely on the good faith of the reinsured.¹²³

In order for treaty reinsurance to function economically, the reinsurer cannot duplicate the underwriting functions engaged in by insurers at the time they placed the original coverage.¹²⁴

However, that does not mean the reinsurer does not take an interest in the underwriting activities of its reinsureds. As explained by the Reinsurance Association of America:

While treaty reinsurance does not require review of individual risks by the reinsurer, it demands careful review of the underwriting philosophy, practice and historical experience of the ceding insurer, including a thoughtful evaluation of the company's attitude toward claims management, engineering control, as well as the management's general background, expertise and planed objectives.¹²⁵

¹²² *Unigard Sec. Ins. Co., Inc. v. North River Ins. Co.*, 4 F.3d 1049, 1054 (C.A.2 (N.Y.)), 1993.

¹²³ *See* Robert H. Jerry, II, *Understanding Insurance Law* at §142[c], 1060 (“Not all insurance law doctrines are ratcheted up when it comes to reinsurance arrangements, however. As one court explained, ‘reinsurance contracts, unlike primary insurance contracts, are not contracts of adhesion. Rather, reinsurance involves two sophisticated business entities familiar with the business of reinsurance who bargain at arms-length for the terms in their contract.’ Thus, a rule like the notice-prejudice rule, which is designed to equalize the relationship between insured and primary insurer, may be deemed irrelevant to the reinsurance setting, and an insurer that fails to give timely notice to a reinsurer may find itself unable to defeat the reinsurer’s late notice defense on the ground that the reinsure failed to show prejudice.”).

¹²⁴ *See* footnote 117.

¹²⁵ *See* *Fundamentals of Property and Casualty Reinsurance*.

Keeping these criteria in mind, it is difficult to imagine insurance companies would not create and institutionalize underwriting practices that are most likely to attract reinsurers if they want to benefit from reinsurance.¹²⁶ Particularly for smaller insurance companies dependant on reinsurance to take on the larger risks, it would not be beneficial to adopt underwriting practices which stray too far from the industry's accepted norm.¹²⁷ Should such a company attempt it, undoubtedly the company would have to charge higher premiums in order to entice reinsurers to take on their risks. Likewise, those companies which require greater amounts of reinsurance to adhere with their reserve requirements would also be prohibited from adopting broader or unusual underwriting procedures.

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

¹²⁶ See footnote 118.

¹²⁷ See footnote 89.

Facultative reinsurance mitigates the effect of the phenomena of the unusual risk costing more than the easily forecastable risk.¹²⁸ Again, it is through facultative reinsurance that an insurer could acquire reinsurance for a specific risk, a specific policy or a specific group of policies.¹²⁹ It is for this reason that facultative reinsurance “usually covers catastrophic or unusual risks”.¹³⁰ Facultative reinsurance, however, will likely be more expensive per risk than broader treaty reinsurance because with facultative reinsurance the reinsurer often employs “substantial personnel and technical resources” to underwrite those risks.¹³¹ Treaty reinsurance avoids this kind of cost.

As an initial matter, treaty reinsurance simply is not generally available for a variety of certain types of risks.¹³² Things like nuclear hazards are common, industry-wide exclusions to most treaty reinsurance.¹³³ Should an insurer wish to acquire reinsurance coverage for other common exclusions like long-haul trucking or munitions manufacturing, reinsurance coverage is usually only available facultatively.¹³⁴ An individual arrangement can be made, although the cost of reinsuring the risk is greater than what would otherwise be available by treaty.¹³⁵

¹²⁸ See footnote 41.

¹²⁹ See footnotes 42, 43, 45.

¹³⁰ See RAA webpage, Fundamentals of Property Casualty Reinsurance.

¹³¹ Id.

¹³² See footnote 47.

¹³³ See footnote 49.

¹³⁴ See footnote 41.

¹³⁵ See footnotes 48, 49.

The common practice of combining treaty and facultative reinsurance to protect an insurer's loss history with its treaty reinsurer provides further support to the contention that insurers are sensitive to the current and future price of reinsurance premiums.¹³⁶ Companies use facultative insurance to protect loss histories even though reinsurance coverage for the facultative risk already existed under treaty reinsurance agreements. It is the insurer's strategic decision to enter the additional facultative agreement as a hedge against the unexpected losses on the risk which would trigger a renegotiation of the insurer's entire treaty.

As an example, the Reinsurance Association of America¹³⁷ describes a situation where in order to accommodate a policyholder, an insurer may agree to provide commercial automobile insurance coverage – a higher risk activity. Facultative reinsurance¹³⁸ would be appropriate even if the treaty reinsurance¹³⁹ the insurer already acquired did not exclude commercial automobile coverage to “protect its losses under applicable treaty agreements”. As the RAA points out, the facultative “rider” need not even be purchased from the treaty reinsurers, allowing those potential commercial automobile losses to be handled under a completely separate relationship. This suggests the overall cost of ongoing higher treaty premiums is sufficiently grave to encourage the additional cost of “double reinsuring” certain risks, even at the relatively higher specific cost of the facultative agreement.

¹³⁶ See footnote 46.

¹³⁷ See footnote 37.

¹³⁸ See footnote 41.

¹³⁹ See footnote 47.

In any event, this common choice to pair facultative with treaty reinsurance to protect loss histories¹⁴⁰ supports the conclusion reinsurers actively monitor loss histories. Monitoring underwriting practices and ensuring accrued losses would likewise result in the insurer implementing practices that conform with the reinsurance market's interests and prevent them from making underwriting changes which may negatively effect their reinsurance opportunities. To an extent, this natural interplay of loss history with reinsurance costs can create a self-regulating and self-limiting tendency among certain insurers to produce loss histories lower than similarly situated insurers.

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

An insurer with a sufficiently broad market share and multi-line business, of course, could get what would amount to a “bulk discount” for placing most of its reinsurance business with one company. But, if smaller insurers took the “cherry”

¹⁴⁰ See footnote 46.

approach and were rewarded with sufficiently lower premiums to compete against even the “bulk” advantage, the move towards segmentation would start when the big insurer slowly (or even quickly) began to lose enough of its cherries to affect its loss history in a way significant enough to offset its “bulk” appeal to its reinsurers. Remember, the reinsurance market is extremely broad, with at least 50% of domestic insurers reinsured by foreign companies.¹⁴¹ There is likely always some reinsurer around with a taste for cherries.

Importantly, reinsurance’s effect on cherry-picked risk premiums does not always result in the company actually restricting their business to those “better” risks alone. There is no reason why reinsurance treaties must be structured so as to take the entire book of business for a certain type of risk, though they often are structured that way. An insurer could reinsure with one company for their “better” risks at the lower prices, seek a competitive advantage on the market, and move the worse risks into a different book charged higher premiums; premiums sufficient to entice a different reinsurer.¹⁴² A different insurer could acquire better overall pricing by averaging the two pools, but it could face difficulty getting those cherries away from the segmented insurer, moving the whole market towards segmentation.

Additionally, an insurer could try to create the best of both worlds by combining and aggregating individual policyholders into the broadest possible policyholder pool; broad policyholder pools represent “better” opportunities for a variety of reasons. If, for

¹⁴¹ See RAA webpage, Fundamentals of Property Casualty Reinsurance (“Reinsurance can be purchased from three distinct sources: reinsurance companies located in the United States, reinsurance departments of U.S. primary insurance companies, and alien reinsurers that are located outside the U.S. and not licensed here. The ceding insurer may purchase reinsurance directly from a reinsurer or through a broker or reinsurance intermediary.”).

¹⁴² See footnote 16.

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

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

Additionally, the hypothetical situations described above discount the likelihood that there are various liquidity cycles for reinsurers themselves. Issues completely

exogenous to the underwriting choices of America's domestic insurers may affect the reinsurance market and competition among and between reinsurers; for various reasons, these issues implicate those reinsurers' decisions about whom to reinsure and at what price. This reinsurance market problem is addressed more completely in Section IV.

B. Reinsurance and Claims-Handling

The duty of *uberrima fides* or utmost good faith¹⁴³ applicable to reinsurance relationships has implications beyond the requirement of simply making "reasonable" underwriting decisions; it creates duties the reinsured owes the reinsurer which involve issues of claims handling. The duty of utmost good faith on the part of the reinsurer is generally held to create reciprocal obligations on the part of the reinsured in the claims handling process.¹⁴⁴ Failure to appropriately comport with these obligations can offer the reinsurer a contractual defense and release the reinsurer from its indemnity obligation.¹⁴⁵ These fall into three broad obligations: 1) the duty to disclose material facts about the ceded business during the placement process, 2) the duty to notify the reinsurer of potential claims that could impact reinsurance coverage and 3) the duty to handle the claim in a proper and "businesslike" manner.¹⁴⁶

Each of these duties can, in the right circumstances, create and maintain industry standards and practices. Particularly the duty to disclose material information and conduct "business like" claims handling will require, even in the absence of any formal underwriting or claims handling regulations, a certain industry-determined level of

¹⁴³ See footnote 92.

¹⁴⁴ See footnote 92.

¹⁴⁵ See footnote 92.

¹⁴⁶ See footnote 92.

investigation when placing coverage and can encourage formalized claims handling processes so as to justify claims determinations.¹⁴⁷ After all, an insurer is unlikely to grant a policyholder's claim, particularly a large claim, in a manner which could provide the reinsurer with a defense to its indemnity obligations. To a certain extent, this obligation creates a natural, or at least a contractually-created floor on the generosity of claims handlers when making decisions to cover. Additionally, in the least, managers aware of claims handling obligations incline towards formalizing claims handling decisions to prohibit the reinsurer from invoking poor claims handling as a defense.¹⁴⁸ Even though, as described below, the claims handling would have to be so poor to constitute recklessness or gross negligence to have a chance of success in a coverage dispute, the fact that claims handling processes are monitored as part of all decisions to reinsure (just as with underwriting) would also encourage reinsurers to adopt formalized claims handling processes.

How claims handling implicates reinsurance coverage obligations performing reinsurance contracts requires some explanation about the nature of the obligations and how courts marry reinsurer obligations to perform with the reciprocal obligations of utmost good faith.¹⁴⁹ A key point to remember is that the duty of utmost good faith is mutual.¹⁵⁰ In the reinsurance context, this is not some amorphous responsibility or the

¹⁴⁷ See footnote 92.

¹⁴⁸ See footnote 92.

¹⁴⁹ See footnote 92.

¹⁵⁰ See *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F. Supp. 2d 49 (D. Mass. 1998) aff'd 217 F.3d 33 (1st Cir. 2000); *Compagnie de Reassurance d'Ile de France v. New England Reins. Corp.*, 57 F.3d 56, 88 (1st cir.), cert denied, 515 U.S. 1009 (1995).

more frequently encountered lesser duty not to behave egregiously that is the underlying justification of policyholder “bad faith” actions. Rather, the reinsurance company’s duty of utmost good faith acts as a powerful judicially-supported standard of care when examining the reinsurer’s performance of its two primary obligations.¹⁵¹ Those obligations are the responsibility of the reinsurer to “follow the fortunes” and “follow the settlements” of their reinsureds.¹⁵²

Briefly, the “follow the fortunes” doctrine obligates a reinsurer to pay its share of a loss sustained by its reinsured, so long as the reinsured’s claims handling did not constitute reckless or grossly negligent behavior, and the loss is arguably covered by the original policy and the reinsurance agreement.¹⁵³ This clause obligates a reinsurer to indemnify its reinsured for its good faith payment of claims that arguably fall within the scope of the agreement – no “second guessing” allowed.¹⁵⁴ Likewise, the “follow the

¹⁵¹ See footnote 92.

¹⁵² These doctrines are often conjoined in court decisions leading to certain amount of confusion in their analysis. See eg., *Litho Color, Inc. v. Pac Employers Ins. Co., v. Home Ins. Co.*, 991 P.2d 638, 647 (Ct. App. 1999). This problem has been noted by both courts and commentators. See *Aetna Cas. Sur. Co. v. Home Ins. Co.*, 882 F.Supp. 1328, 1346 n.9 (SDNY 1995) (noting that “[t]he term ‘follow the fortunes’ has been used imprecisely to describe the reinsurer’s duty to follow the claims adjustment decisions of the ceding company, thereby giving rise to some ambiguity as to its meaning. ‘Follow the fortunes’ more accurately describes the obligation to follow the reinsured’s underwriting fortunes, whereas ‘follow the settlements’ refers to the duty to follow the actions of the cedent in adjusting and settling claims.”).

¹⁵³ See *Commercial Union Ins. Co. v. Swiss Reinsurance Am. Corp.*, 413 F.3d 121 (1st Cir. 2005). The reinsurer cannot, however, be found liable for an amount in excess of the reinsurance limit of liability stated in the agreement. See *Unigard Sec. Ins. Co. v. North River Ins. Co.*, 4 F.3d 1049 (2d Cir. 1993). This includes the reinsurer’s liability for “expenses” as well as for the amount of the actual loss. See *Excess Ins. Co. v. Factory Mutual Ins. Co.*, No. 147, 2004 Lexis 3728 (NY Ct App. Dec. 2, 2004) (finding that a reinsurer’s obligation for expenses incurred while handling a loss is capped by the limit of liability in a facultative agreement regardless of the presence of a “follow the fortunes” clause).

¹⁵⁴ See Robert H. Jerry, II, *Understanding Insurance Law* at §142[e], 1061-62 (“The usual role of the reinsurer is to ‘follow the fortunes’ of the primary insurer as if the reinsurer were a party to the original insurance. Some courts insist that the reinsurance agreement have appropriate language placing this obligation on the reinsurer, while others presume that the reinsurer’s obligations follow the form (although in most certificates ‘follow the form’ language will be found). As the phrase suggests, the idea is that the reinsurer is to accept whatever settlements the primary insurer makes and participate and pay according to the reinsurance agreement the appropriate share of whatever judgments are entered that trigger the primary

settlements” obligation requires indemnification of the reinsured for good faith settlement decisions.¹⁵⁵

One “follow the settlements” case is particularly illuminating of the capacity of purportedly “poor” claims handling to release the reinsurer from its indemnity obligation. In *Suter v. General Accident Ins. Co.*, the court focused on claims handling improprieties in its decision to release the reinsurer of its obligation arising from the reinsured’s settlement.¹⁵⁶ The case involved tort claims asserted against a manufacturer of allegedly defective heart-valves by patients who had received the potentially defective valves.¹⁵⁷ The manufacturer was the original insured which settled claims with the consent of the original insurer which sought indemnity from its reinsured.¹⁵⁸

Interestingly, the “claims handling” improprieties identified in this decision were all actually related to the insurer’s legal acumen and choices made in evaluating and defending the claim.¹⁵⁹ They primarily were issues involving the proper use of coverage counsel and appropriate pre-settlement litigation tactics.¹⁶⁰ The court determined that failure to seek certain types of legal counsel and take certain investigatory steps could

insurer’s liability. Difficulties can arise in determining exactly what ‘fortunes’ the reinsurer agreed to ‘follow,’ in that the reinsurer’s obligation to participate in whatever payments the primary insurer makes is not unlimited.”).

¹⁵⁵ See Graydon S. Staring, *The Law of Reinsurance*, sec. 18:1, 2 (“Following the settlements’ is the expression properly used for a contractual obligation that the reinsurer accept the settlements of the reinsured, or judgments against it, and pay accordingly. The obligation arises by virtue of a clause best called a ‘loss settlement clause’ or ‘following settlement clause.’ Where it exists, it may be limited to the amount of a settlement where liability is not in dispute or extend to the acceptance of liability and amount.”).

¹⁵⁶ *Suter v. General Accident Ins. Co.*, 424 F.Supp 2d 781 (2006).

¹⁵⁷ *Id* at 781.

¹⁵⁸ *Id* at 784.

¹⁵⁹ *Id* at 784.

¹⁶⁰ *Id* at 784.

constitute “gross negligence”.¹⁶¹ The court cited the insurer’s reliance on another insurer’s counsel for its appraisal of potential liability as inappropriate.¹⁶² Likewise, it cited failure of the insurer to hire its own medical expert (again it had relied on another insurer’s expert) to advise on the heart-valves potential for bodily injury and a failure of the insurer to keep up to date on the laws of trigger of coverage as determinative factors.¹⁶³ Relying on these litigation process failures, the court determined that the insurer had failed to make a reasonable investigation of whether the underlying claims were “reasonably within the scope of the original policy”.¹⁶⁴ As such, the reinsurer was freed from its presumptively applicable duty to follow the insurer’s settlement.¹⁶⁵

To those familiar with the tort litigation process, this demonstrates a privately assumed obligation’s effect on the legal process and litigation costs. By focusing on the insurer’s choice not to hire independent counsel or rely on other medical experts as grounds for release from reinsurance obligations, the court explicitly allows the reinsurance contract obligation of reasonable investigation to affect the insurer’s business judgment to save the cost of its own counsel or experts.¹⁶⁶ In effect, this type of decision requires the use of coverage counsel by each insurer implicated on a claim and

¹⁶¹ Id at 785.

¹⁶² Id at 785.

¹⁶³ Id at 781.

¹⁶⁴ Id at 781.

¹⁶⁵ The interpretation of the utmost good faith standard condition precedent to reasonableness in claims handling as used in the *Suter* decisions is remarkable given that a finding of good faith has been held sufficient to require performance by a reinsurer to indemnify payments found to be reasonably within the terms of the original policy, even if not technically covered by it. *See General Ins. Corp. v. Great America Insurance Company*, 979 F.2d 268, 280 (2d Cir. 1992).

¹⁶⁶ Id at 785.

institutionalizes the added cost of duplicative legal analysis and investigation of claims where reinsurance is implicated or risk being viewed as not acting in utmost good faith.¹⁶⁷

Even in cases where there would probably be little disagreement as to the likely value of the claims or medical evidence of causation, how could an insurer not be expected to cover its assets with duplicative legal opinions? One way or another, the litigation costs will eventually be internalized by the obligated insurers and passed to policyholders in the form of higher premiums. Moreover, as the decision in *Suter* stems from the universally applicable good faith obligation of the insurer to reasonably investigate as a predicate to the reinsurer's performance under the reinsuring agreement, this duplicative effort would likely become simple industry practice.¹⁶⁸ Even if there is no reinsurer obligated on the particular claim, reinsurers investigate and monitor claims handling philosophy. An insurer thinking about their future interest in reinsurance will take steps to ensure their claims handling demonstrates their history of operating in a non- grossly negligent manner.

One caveat: it is of course possible that this added duplicative cost could be so cost prohibitive the insurer would prefer to simply avoid reinsurers and internalize the litigation savings. As described above, the benefits of reinsurance, particularly the ability to stabilize profits and leverage reserves makes such a choice unlikely.¹⁶⁹ For various

¹⁶⁷ Good faith is a prerequisite for application of a reinsurer's indemnity obligations. *See ReliaStar Life Ins. Co. v. IOA Re, Inc.*, 303 F.3d 874, 878 (8th Cir. 2002) (finding that "doctrine posits that if the cedent has acted in good faith in handling the claims presented to it and in providing coverage of the claims 'the reinsurer may not second guess the coverage decisions of the cedent'").

¹⁶⁸ *Suter v. General Accident Ins. Co.*, 424 F.Supp 2d 781 (2006).

¹⁶⁹ *See* footnote 7.

reasons, an insurer remains aware of the chance it will in future need reinsurance. If anything, knowingly producing largely duplicative legal work would simply lead insurers to pressure their attorneys to reduce the cost of redundant legal services, if it cannot reduce the need to complete the work in the first place. Perhaps this accounts for some of the insurance industry's interest in creating legal services compensation structures which offer opportunities for "bulk rate" services and long-term billing agreements.

Follow-the-settlements¹⁷⁰ decisions are not the only instance where reinsurance affects insurer litigation practices. As the original policies reinsured often provide for a defense, the costs will likewise be covered under the reinsurance agreement, unless a specific exclusion exists.¹⁷¹

Another example stems from using the declaratory judgment action to determine coverage disputes.¹⁷² Many reinsurance agreements include a clause which states that the agreement covers "all expenses incurred in the investigation and settlements of claims or suits".¹⁷³ As described above, such a clause makes sense in relation to the reinsurer's interest in not indemnifying claims beyond the scope of the policy they are reinsuring. It also makes sense for the reinsured to seek to lay-off these costs to the reinsurer where much of the benefit of the coverage determination would accrue to the reinsurer on the risk.¹⁷⁴ Some interpret this clause to include costs incurred by the reinsured for bringing

¹⁷⁰ See footnote 156.

¹⁷¹ See *Bellefonte Reinsurance Co. v. Aetna Cas. & Sur. Co.*, 903 F.2d 910, 912-14 (2d Cir. 1990). Unlike original insurance, however, defense costs will be included within the stated limit of liability of the reinsurance agreement. *Id.*

¹⁷² See footnote 35.

¹⁷³ See Couch on Insurance at 9:30.

¹⁷⁴ See footnote 33.

declaratory judgment actions to avoid coverage of the original policyholder's claim.¹⁷⁵ Moreover, in the absence of an exclusion, the "standard practice" of the industry to allow for such costs can create a sufficient question of fact to support an implied modification of the contract sufficient to defeat a motion for summary judgment.¹⁷⁶ Even in the absence of a clause, declaratory judgment costs have been upheld as part of the contract as a result of the parties "custom and practice".¹⁷⁷ In this circumstance, the ability of insurers to introduce extrinsic evidence to supplement an alleged ambiguity is particularly useful.

III. Institutional Regulatory Effects of Reinsurance on Public Regulation of Insurance: The Silent Force

The underlying concepts of regulation in the domestic financial services industries share in common a considerable amount of policy determinations and overlap among industries to a considerable degree.¹⁷⁸ The regulatory structures among industries, however, often vary considerably among the differing sectors¹⁷⁹ and in a not altogether

¹⁷⁵ See *Employers Ins. Co. v. American Reinsurance Co.*, 256 F. Supp.2d 923, 925-926 (W.D. Wis. 2003).

¹⁷⁶ See *Premier Ins. Co. v. Hartford accident & Indemnity Co.* 35 F.Supp. 2d 348, 351 (SDNY 1999).

¹⁷⁷ See *Affiliated FM Insurance Co. v. Constitution Reinsurance Corp.*, 416 Mass. 839, (1994).

¹⁷⁸ See Howell E. Jackson, *Regulation in a Multisectoral Financial Services Industry: An Exploratory Essay*, 77 Wash U. L. Q. 319, 332-339 (1999) (describing the public policies underlying the regulation of financial institutions).

¹⁷⁹ A descriptive organization of regulatory approaches has been offered by Professor Howell to assist in identifying risk containment strategies on a continuum from least invasive to most intrusive. *Id.* at 340. This structure places the private ordering of risk allocation between private parties engaged in the transaction as the default and least intrusive regulatory scheme, with regulatory systems proceeding on a continuum of general categories through "disclosure strategies", "general standards of conduct", "portfolio shaping rules (both static and dynamic) and "boding mechanisms". *Id.* at 340. The choices of regulatory schemes differ greatly among the various industries engaged in activities commonly construed to come with the general umbrella description of financial services. Consider for example the primary reliance on

consistent fashion.¹⁸⁰ This Essay does not have a goal to review the various types of regulatory differences among the numerous sectors of industry devoted to financial transactions,¹⁸¹ although such an observation assists in (not surprisingly) recognizing that a certain amount of variance exists within the regulatory tools in any given sector of the financial services industries.

The subject of this Essay is the regulation of the particular and perhaps even peculiar area of financial services known as the insurance industry.¹⁸² Importantly, insurance company regulation is a topic fraught with considerations far beyond regulation of individual risk inherent to all financial regulatory regimes. Considerations include

disclosure rules established by the Securities Act of 1933 and Securities and Exchange Act of 1934 as a regulatory method as compared with the capital and reserve requirements insurance companies must maintain to comply with statutory leverage requirements.

¹⁸⁰ For instance, mandatory disclosure is the primary regime of choice as regards mutual funds with disclosure rules applicable to all issuers of securities enhanced by supplemental layers of disclosure required by the Investment Company Act of 1940 particular to investment pools. Howell at 345. There is nothing about pooled investments that per se require a disclosure based regime. Howell at . n. 54. Other financial products, such as common trust funds at banks and defined contribution pension plans pool investment returns. Id. at n. 54. In those contexts, disclosure rules do not maintain the same priority of place; with bank trust funds and defined-contribution pension plans regulated primarily by fiduciary rules. Id. at n. 54. The investment activities are similar though the regulatory scheme differs. Id. at n. 54. For a judicial discussion of these similarities *See* also *Investment Co. Inst. V. Camp*, 401 US 617, 642 (1971) (Blackmun J. dissenting).

¹⁸¹ Some of these distinctions are undoubtedly a result of the historic evolution of the various regulatory systems as the industries themselves evolved. For a very complete analysis of these historical developments *See* HOWELL E. JACKSON & EDWARD L. SYMONS JR., *REGULATION OF FINANCIAL INSTITUTIONS*. The level of intrusiveness in the regulatory scheme does seem to correlate somewhat to the complexity of the financial transaction and the opacity of the financial sector's balance sheets. *See* Howell E. Jackson, *Regulation in a Multisector Financial Services Industry: An Exploratory Essay*, 77 Wash U. L. Q. 319, 340 (1999) ("As a general matter, as the financial arrangement become more complex and the balance sheets of intermediaries become more opaque, our regulatory strategies become more intrusive ad draconian.").

¹⁸² *See* RAA webpage, *Fundamentals of Property Casualty Reinsurance* ("Since reinsurance regulation focuses on solvency, it safeguards the validity of reinsurance policies and, at the same time, maintains flexibility in the business of reinsurance. By focusing on the reinsurer, rather than on the reinsurance contract, primary insurance companies are allowed to purchase reinsurance to suit their particular business needs. Of course, reinsurance contracts are entered into by two or more insurance companies – the reinsurer(s) and the insurer(s). Recognizing that there are always some exceptions to the rule, the two companies are generally expected to be knowledgeable about the insurance business. Therefore, the oversight necessary in primary insurance to protect consumer interests is not essential in the reinsurance business.").

those which the contractual arrangement of reinsurance and the nature of the reinsurance market can influence.

Particularly with insurance, the fiscal ramifications of wide scale insurance failure typify an externality often identified as justification for proper insurance regulation. Mass insurance defaults in the wake of catastrophe and its concomitant public cost counts among the reasons why reevaluation of insurance regulation gained such primacy in current years.¹⁸³ Who wants to contemplate a Gulf Coast where companies severely reduced coverage due to insurer insolvency?

The issue of risk containment obviously influences the structural regulation of the insurance industry; political interest championing equitable access to insurance and other redistributive and equitable norms alongside the unique state regulatory system of insurance all play their part in developing the regulatory structure in which the industry currently operates. Reinsurance market practices and common contract terms can alternately promote or prohibit many of these interests.

1. Reinsurance and Liquidity

Reinsurance is a source of liquidity. Due to the way the insurance industry calculates income, the administrative expenses are charged immediately upon issuing an insurance policy.¹⁸⁴ For this reason, broker's fees or taxes or other ancillary expenses will be charged immediately as income with a concomitant net loss of outstanding surplus.¹⁸⁵ The premiums collected by the insurance company, on the other hand, must

¹⁸³ See RAA webpage, Reinsurance Glossary (noting an insolvency clause is "a provision now appearing in most reinsurance contracts (because many states require it) stating that in the event the reinsured is insolvent the reinsurance is payable directly to the company or its liquidator without reduction because of its insolvency or because the company or its liquidator has failed to pay all or a portion of any claim.").

¹⁸⁴ See footnote 95.

be set aside in an unearned premium reserve and will only be recognized over the term of the policy.¹⁸⁶ The purpose of this accounting system is to encourage insurer solvency.¹⁸⁷ However, the situation clearly results in the potential to decrease capacity. With every policy sold, the surplus is decreased and the company's ability to write more policies lessened.

Reinsurance solves the surplus problem, since the reinsurer agrees to share a portion of the expenses. A reinsurer gives the reinsured a "ceding credit" for a share of the expenses, which can be recredited to the reinsured's surplus, increasing capacity. Likewise, the reinsurance agreement can be credited against loss reserves to similarly increase capacity.¹⁸⁸

In order for the increased capacity to not jeopardize insurer solvency¹⁸⁹, reinsurance company regulation focuses on reinsurer solvency. This is no idle matter. Both the Transit Casualty Company and Mission Insurance Company failed due to insurance insolvency in the 1980's.¹⁹⁰ The failure occurred in part because they could not collect from their reinsurers. To address this risk, the states all have various techniques in place to assure reinsurer solvency. If admitted or licensed in the state, the reinsurer must comport with certain reserve requirements of their own or, if foreign or

¹⁸⁵ See footnote 95.

¹⁸⁶ See footnote 95.

¹⁸⁷ See footnote 184.

¹⁸⁸ See RAA webpage, Reinsurance Glossary (noting capacity is "the largest amount of insurance or reinsurance available from a company or the market in general. Also refers to the maximum amount of business (premium volume) that a company or the total market could write based on financial strength.").

¹⁸⁹ See footnote 184.

¹⁹⁰ See Insurance Regulation: State Reinsurance Oversight Increased But Problems Remain, GAO Report, May 1990 at 2. [Hereinafter 1990 GAO Report].

unadmitted, states require the reinsurer to offer a bond sufficient to allay fears of not collecting on reinsurance agreements.¹⁹¹ If the company does not post a bond, the insurer cannot take advantage of reinsurance's ability to grant credit and expand reserves.¹⁹²

Still, the multi-state system leads to some fears of inadequacy and redundancy. To address these issues, along with the perennial problem of construing the appropriate way for the states to share in the taxation of these transactions, the House of Representatives in June 2007 passed HR 1065, the Nonadmitted and Reinsurance Reform Act.¹⁹³ The Senate companion bill, S 929, awaits consideration in the Senate.¹⁹⁴ That legislation would grant a single state authority to determine the appropriateness of reinsurance credit and reinsurer solvency assessment.¹⁹⁵ The solvency assessment would be conducted by the reinsurer's home state and the credit determination would be made solely by the ceding insurer's domiciliary state.¹⁹⁶ It is unclear how this alters the current regulatory system other than to encourage reinsurers or insurers to change their domiciles

¹⁹¹ See RAA webpage, Fundamentals of Property Casualty Reinsurance (“When overriding public policy concerns require regulatory involvement, however, nearly all states have adopted regulations affecting reinsurance contracts. An example of this type of regulatory involvement is the requirement of a standard insolvency clause, which allows the receiver of an insolvent insurer to collect on reinsurance contracts. While few states require the filing or approval of reinsurance contracts, indirect regulation of reinsurance contracts and rates does exist. For example, restrictions on insurance rates affect reinsurance rates. Generally, if the amount paid in the premium to the insurer is limited, the amount of premium paid under a quota share reinsurance contract may also be limited.”).

¹⁹² See footnote 33.

¹⁹³ See NAIC, Current Issues: Nonadmitted Insurance and Reinsurance available at http://www.naic.org/topics/topic_surplus_lines.htm.

¹⁹⁴ Id. That legislation would grant exclusive regulatory authority for multi-state surplus lines and to the insured's home state so as to restrict each transaction to a single set of regulatory oversight, rules and taxation.

¹⁹⁵ Id.

¹⁹⁶ Id.

in search of a state whose regulation best comports with their needs, though it likely will assist in clarifying taxation.

2. Consumer Protection

Since reinsurance is considered a business to business transaction, it is subject to significantly less regulatory oversight beyond issues of solvency. As described above, however, reinsurance's ability to indirectly affect the policyholder through inculcating and rewarding reinsurer-focused underwriting decisions and claims handling processes exist and current regulatory schemes do not address them.

There are some significant policy concerns implicated in other commonly available reinsurance coverage clauses such as those making reinsurance coverage available for bad faith judgments. Called "judgment in excess of policy limits" clauses these allow insurers to be indemnified for their own bad faith actions against their policy holders. As reported in Ostrager & Newman's Handbook on Insurance Coverage Disputes, these clauses generally provide "in word or substance"¹⁹⁷:

It is agreed that should the ceding insurer become legally obligated to pay a loss in excess of policy limits by reason of alleged or actual negligence, fraud or bad faith in rejecting an offer of settlement or in the defense or trial of any action against an insured, the Reinsurer agrees to assume _____% of said loss [in excess of the ceding insurer's] \$ _____ retention.¹⁹⁸

These clauses are "relatively widely used and provide[] the reinsurer will participate in such excess verdicts but not to exceed the reinsurance contract limits".¹⁹⁹ Moreover, there are iterations of this clause which explicitly provide for coverage of

¹⁹⁷ Ostrager & Newman's HANDBOOK ON INSURANCE COVERAGE DISPUTES, sec 16.06[a].

¹⁹⁸ Id.

¹⁹⁹ Id.

“punitive damages”.²⁰⁰ Other courts have found reinsurer’s liable for bad faith judgments even in the *absence* of such a clause, but where the reinsurance agreement does contain the early omnipresent “follow the fortunes” language.²⁰¹ The “excess of policy limits clause” has been applied in bad faith decisions based on both contractual and tortious theories of liability.²⁰²

Various state statutes, including those with primarily a regulatory purpose and the common law, both authorize bad-faith actions against insurers as a way to deter bad faith activities. Thus, it is somewhat surprising to find them reinsurable as a matter of public policy. Considering that the reinsurance agreements are supported by the premiums charged the policyholders, it seems somewhat incongruous to allow the cost of insurer’s own bad faith judgments to be charged directly back to policyholders in their premiums. In fact, it seems to mitigate the entire purpose of the statute, the legal action and the tort judgment, beyond the insurer’s own retention. Since that retention may or may not be greater than the public cost of supporting the civil justice system to allow for the trial of these cases, one wonders if there is any public benefit at all. Clearly, this type of indemnification reduces the deterrent value of these actions. There can be little deterrence through litigation and the award of damages, tortious or otherwise, if those judgments are indemnified by reinsurer’s as a matter of course. Granted, reinsurers are sensitive to loss histories so too common a number of negligent or bad faith judgments

²⁰⁰ Id.

²⁰¹ Id (citing *Peerless Ins. Co. v. Inland Mut. Is. Co.*, 251 f.2d 696, 697 (4th Cir. 1958)).

²⁰² Id (citing *Ott. v. All Star Insurance Corp.*, 299 NW 2d 839, 840 (Wis. 1981)) (holding that the reinsurer was liable for judgments against its ceding insurer for “tortuous failure to settle within [its] policy limits” under an unparticularized “excess of policy limits” endorsement to the original reinsurance certificate.).

could increase their costs to reinsure. Still, that market based result seems somewhat less than the affect contemplated by legislators who enact bad faith statutes.

IV. Conclusion

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

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