

A new deal for cedants

The New Hampshire Supreme Court has approved the proposed agreement



between the liquidator of the Home Insurance Co and the AFIA Cedants. **Nick Pearson** and **Brian J Green** of Edwards Angell Palmer & Dodge* explain the implications for reinsureds in future liquidations

In a development that is favourable to cedants of insolvent insurers, a recent decision by the New Hampshire Supreme Court gives a new twist to the meaning of administrative expenses in insurer insolvencies. Reinsureds, who fall into the 'bottom of the barrel' category of general creditors under the various States' insurance company liquidation laws, now have reason to hope for more generous treatment by liquidators, so long as retrocessional cover is valid and collectible. Whereas cedants used to be told, 'Don't bother calling,' they may now hear, 'Let's make a deal.'

Procedural background

The Home Insurance Company was ordered into liquidation in June 2003 in New Hampshire. Although the Home had substantial retrocessional protection in place, cedants were general creditors of the estate, and unlikely under the distribution scheme to receive any payment on their claims. This left them with little incentive to expend the time and costs to file claims with the liquidator.

A group of reinsureds, known as

the AFIA Cedants, threatened to directly approach ACE, the Home's retrocessionaire, to discuss foregoing a claim against the estate in return for a discounted payment on their claims. Such an arrangement would deprive the estate (and hence the higher priority creditors, such as policyholders) of reinsurance funds from ACE, which is obligated to pay the estate based upon the allowed value of cedants' claims, irrespective of whether cedants themselves ever realise any recovery from the estate.

The liquidator, faced with the likelihood that the AFIA Cedants would not submit their claims, entered into an agreement with the AFIA Cedants that required them to submit their claims to the liquidator. The liquidator would then seek recovery from ACE and distribute a portion of the reinsurance monies to the AFIA Cedants, using the remainder to pay the estate's higher priority creditors. The AFIA Cedants would receive distributions of approximately \$78 million, representing 50 per cent of the amount of claims submitted by the AFIA Cedants, less deductions for offsets and expenses.

The New Hampshire superior court approved the arrangement, stating that it was 'consistent with the goals and purpose' of the New Hampshire statutory distribution scheme to protect the interests of insureds and creditors. ACE and Benjamin Moore & Company (a policyholder creditor of the Home and a Berkshire Hathaway company) appealed this decision to the New Hampshire Supreme Court, which vacated the lower court's decision and sent the case back to the superior court for another determination.

The superior court ruled that :

- The payments to the AFIA Cedants are 'administration costs' because they are 'actual and necessary costs of preserving or recovering the assets of the insurer'.
- The court has an independent obligation to assess the fairness of the proposed agreement.
- The liquidator was authorised to enter into the proposed agreement and it was consistent with the broad purposes of the distribution statute to protect the interests of insureds and creditors.

In a subsequent proceeding, the superior court again approved the proposed agreement, holding that it was 'necessary to preserve access to and marshal the AFIA reinsurances' and 'fair and reasonable'. ACE and Benjamin Moore appealed this decision to the New Hampshire Supreme Court.

New Hampshire Supreme Court decision

On 5 December 2006, the New Hampshire Supreme Court affirmed the superior court's decision, citing three principal reasons. *In re Liquidation of Home Ins Co*, 2006 WL 3479902 (NH 5 Dec, 2006).

First, the court held that the liquidator has the authority to enter into the proposed agreement. The court cited New Hampshire's statutory distribution scheme, which states that a liquidator may 'collect all debts and moneys due and claims belonging to the insurer' and '*do such other acts as are necessary or expedient to collect, conserve or protect its assets or property.*' (Emphasis added.)

The court interpreted this to allow the liquidator 'broad authority to take all necessary and appropriate action in collecting the assets of an insolvent insurer.' The court also



tuted 'administration costs' under the New Hampshire distribution scheme. It cited to the New Hampshire statute that defined administration costs, as '*...the actual and necessary costs of preserving or recovering the assets of the insurer...*' (Emphasis added.)

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held that the statute does not prevent payment of administration costs to lower priority creditors in order to collect an asset for the estate. Further, the court rejected ACE's argument that approval of the proposed agreement would set a precedent for future violations of the distributory scheme, since a court oversees the entire process and any negotiated agreement requires court approval.

Second, the court held that payments to the AFIA Cedants consti-

The court rejected three arguments made by ACE and Benjamin Moore:

- That the proposed payments to the AFIA Cedants cannot be deemed administration costs because they arose from pre-liquidation contracts, and administration costs can only arise from post-liquidation transactions.
- That the proposed agreement creates an impermissible subclass by splitting the general creditors into two groups.

- That the payments to the AFIA Cedants are not 'necessary costs' to preserve the estate.

In rejecting the first argument, the court held that the proposed payments do not arise from the AFIA Cedants' claims 'but rather as an inducement for the AFIA Cedants to file claims in the liquidation in order to bring a net benefit to creditors of the estate.' Consequently, although the claims arose before the liquidation, the AFIA Cedants' right to payment under the proposed agreement is a post-liquidation creation.

The court then held that the proposed agreement did not create an impermissible subclass by splitting the general creditors into two groups because payment of 'administration costs, by definition, do not constitute a "distribution" to a lower priority class, and therefore do not create a subclass of lower priority creditors.' This aspect of the court's decision is extremely important, because it authorises payment to certain

reinsureds while other reinsureds, as general creditors, may not collect on their claims.

The court then affirmed the superior court's ruling that payments to AFIA Cedants are 'necessary costs.' It held that there was sufficient evidence that the AFIA Cedants would not file their claims without a financial incentive, citing to the possibility of cut-through agreements and the belief of the AFIA Cedants that there was no economic benefit to them to submit claims if not for the proposed agreement.

The court also stated that there are policy reasons for allowing the proposed agreement. The statutory



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scheme is to be 'liberally construed' and such a 'construction of the statutory language supports a finding that the proposed payments to the AFIA Cedants are necessary to collect and preserve assets of the Home's estate.' The court correctly pointed out that a decision otherwise would prevent collection of additional assets for the estate. Additionally, the court noted that ACE would 'reap a substantial windfall' if it did not approve of the agreement.

Finally, the court held that the proposed agreement is fair and reasonable. First, the New Hampshire Supreme Court found that the evidence demonstrated that the AFIA Cedants would not have filed claims of the Home estate without a financial incentive. Second, it held that the claims of the AFIA Cedants were significant, as they totaled approximately \$231 million, and the large dollar figure suggests that the collection proceedings would likely be 'lengthy, complex, and difficult.' And third, and most important, the proposed agreement benefits other creditors of the Home estate since it

increases the likelihood that their claims will be paid.

Currently pending before the New Hampshire Supreme Court are motions to reconsider and rehear the case. Such motions are generally denied, but there is a chance that the court could change its decision.

Ramifications

This decision may dramatically impact both present and future liquidations. Historically, cedants often chose not to submit liquidation claims because they had no expectation of recovery. This only benefited the retrocessionaires, who did not have to make payments to the insolvent insurer, but deprived the estate of assets.

Now, in light of the decision of the New Hampshire Supreme Court, a liquidator would be derelict in his statutory duty to attempt to maximize recoveries for the estate if he/she did not try to negotiate a structure similar to that created by the Home liquidator. Liquidators have incentive to say 'Let's make a deal' to cedants, and cedants have incentive to accept the deal.

We anticipate that in the coming months and years, courts in other jurisdictions will be faced with following the lead of the New Hampshire Supreme Court or denying liquidators and cedants the opportunity to make such agreements. The outcome of these cases will not only impact cedant creditors, but could lead cedants to choose reinsurers domiciled in jurisdictions that follow the New Hampshire lead. ●

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