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Strings Attached

Insurance liquidators can use 'preference statutes' to recall already settled claims.

The difficulties that many insurers continue to face make this a good time to remind risk managers and reinsureds of one of the dangers of transacting business with a financially weak insurer.

When an insurer's financial condition is deteriorating, its creditors, including policyholders and cedents, face the risk that payments from the insurer for legitimate claims, or pursuant to arms-length commutations and policy buybacks, may have to be paid back if the insurer later goes into liquidation.

Almost all states have preference statutes that give the insurer's liquidator the right to recover payments and other transfers made to a creditor for past debt, subject to certain conditions. A creditor who returns a preferential payment is entitled to reassert its claim for payment against the estate, but will only be paid its pro rata share based on statutory priorities. Most states allow a liquidator to reach back and recover transfers made up to a year before the commencement of rehabilitation or liquidation proceedings. At least two states have a two-year look-back period.

Payments of insurance and reinsurance claims can be characterized as payments for past debt since they are made under a pre-existing contract and are for losses after the losses occur. Reinsureds are generally at greater risk than policyholders, since reinsureds are more likely to receive less than the full amount of their claim in a liquidation; often, they receive no payment. Therefore, even reduced payments of reinsurance claims often will be subject to recovery by the liquidator unless the reinsurance obligation is fully secured or a defense to the preference claim is available. In some states, payments made in the ordinary course of business are protected from recovery as preferences. A few states statutorily provide that payments made in the ordinary course of business cannot be set aside as preferences. In some states without such a provision, the courts have exempted payments made in the ordinary course of business.

For example, we were involved in preference actions brought by a liquidator against policyholders. In that case, the Pennsylvania Supreme Court read an ordinary-course-of-business defense into the state preference statute; therefore, the claim payments were not recoverable. Yet at least one state, Nebraska, has held that ordinary-course-of-business is not a defense to a preference action.

Even payments made a year ago can be subject to recovery.

Reinsurance commutations and policy buybacks, however, are not ordinary-course transactions, nor are most payments made after the parties have begun arbitration or litigation.

Two states have statutes that can protect certain transactions approved by the insurance regulator from being set aside. Illinois law provides that approval by the director of insurance can protect a transfer by an insurer subject to a corrective action order from being voided as a preference. New York has a law that, in limited circumstances, protects reinsurance commutations if approved by the superintendent of insurance.

Given these limits, the best protection for a creditor is to be fully secured with an insurer at least prior to the beginning of the preference look-back period. Other ways to mitigate the preference risk include dealing only with financially sound companies, and disengaging from them at the earliest sign of financial trouble. It has become common for policyholders and cedents to negotiate disengagement or security rights at the inception of a relationship. And promptly submitting claims and obtaining timely payments reduce the likelihood that a payment could be subsequently avoided. BR

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