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To: Members of The Home Insurance Company in Liquidation ("Home") UK Informal Creditors Committee

Re Priority Status of Claims Under Home's Assumed Reinsurance Contracts

As you know, we are special counsel to the Insurance Commissioner of the State of New Hampshire, in his capacity as Liquidator of Home ("Liquidator"). At the recent meeting of the UK Informal Creditors Committee in London, the Liquidator was asked where reinsurance creditors stood with respect to the creditor priorities applicable to the liquidation of a New Hampshire insurer.

Issue Presented and Conclusion

Home is a party to various reinsurance contracts pursuant to which it agreed to reinsure all or a portion of certain risks of the contracting ceding insurers. The New Hampshire insurer liquidation priority statute provides policy related claims with priority over other claims. RSA 402-C:44, II. The question has been asked whether the claims of cedants or reinsureds under Home's assumed reinsurance agreements are policy related claims or fall in a lower priority class. Based on the New Hampshire statutes and the consistent body of caselaw on the subject in other United States jurisdictions, we conclude that the claims of Home's cedants are general unsecured claims entitled to residual priority status only.

Discussion

1. The New Hampshire statutes. The New Hampshire insurer liquidation statutes provide for payment of claims in successive priority classes. RSA 402-C:44. As pertinent here, the statute accords second priority to "Policy Related Claims" and fifth priority to a "Residual Classification" of claims. RSA 402-C:44, II, V. The question presented is in which of these classes cedants' claims would fall. The second priority

class is defined as "[a]ll claims of policyholders, including claims for unearned premium in excess of $50, beneficiaries, and insureds arising from and within the coverage of and not in excess of the applicable limits of insurance policies and insurance contracts issued by [Home], and liability claims against insureds which claims are within the coverage of and not in excess of the applicable limits of insurance policies and insurance contracts issued by [Home] . . ." RSA 402-C:44, II. The fifth priority class is a residual class for "[a]ll other claims" that do not fit in other classes. RSA 404-C:44, V.

The policy related claims priority thus encompasses claims of "policyholders, . . . beneficiaries, and insureds" under "insurance policies and insurance contracts."[1] This language does not evidence any legislative intent to include claims of reinsureds-cedants under reinsurance contracts or treaties. Some reinsurer claimants have asserted that the statutory terms should be construed to cover their claims, noting that the New Hampshire insurer liquidation statute and other insurance statutes do not define the terms. However, other parts of the statute show that reinsurance contracts are distinct from insurance policies and that the parties to reinsurance contracts are not insureds.

First, the New Hampshire Legislature included a provision in the liquidation statute to mandate that the liquidation not reduce amounts due from reinsurers of the insolvent company. RSA 402-C:36, enacted by 1969 N.H. Laws 272:1. Section C:36 provided that the amount recoverable from a "reinsurer" by a liquidator shall not be reduced because of the delinquency proceeding, regardless of any provision in the "reinsurance contract or other agreement." It also specified that payment made directly to "an insured or other creditor" shall not diminish the reinsurer's obligation to the estate except when the "reinsurance contract" provided for "direct coverage of an individual named insured" and the payment was in discharge of that obligation. Id. This section shows that the Legislature used the term "insured" to refer to a direct insured and used "reinsurance contracts" and not "insurance policies" or "insurance contracts" when it intended to refer to reinsurance relationships.[2]

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[1] The "policyholders, beneficiaries and insureds" language was first enacted by 1977 N.H. Laws 499:1. The policy level priority class statute had originally provided priority for "Loss Claims": "[a]ll claims under policies for losses incurred, including third party claims, and all claims against the insurer for liability for bodily injury or for injury to or destruction of tangible property which are not under policies . . ." RSA 402-C:44, III, as enacted by 1969 N.H. Laws 272:1 The section was amended in 1975 to refer to "Policy Related Claims": "[a]ll claims under policies for losses incurred, including unearned premium claims, third party claims, and all claims against the insurer for liability for bodily injury, or for injury to or destruction of tangible property." RSA 402-C:44, III, as amended by 1975 N.H. Laws 348:14. Policy related claims were raised to second priority by 1998 N.H. Laws 99:1.

[2] Section C:36 was amended in ways not pertinent to this memorandum by 2003 N.H. Laws 218:3.

Second, the Legislature had previously recognized that reinsurance was different from insurance. Prior to 1986, it had restricted companies' ability to reinsure risks for property in New Hampshire. See RSA 405:45-52 (1968 ed.). While one section referred to a "policy of reinsurance," RSA 405:47 (1968 ed.), those statutes recognized that reinsurance is distinct from direct insurance and operates between insurance companies. See RSA 405:45, 46 (1968 ed.). This further demonstrates that the Legislature knew how to refer to reinsurance when it intended to and understood that reinsurance is a method of spreading risk among insurers.[3]

Third, shortly after enactment of the insurer liquidation statute by 1969 N.H. Laws 272:1, the Legislature enacted the New Hampshire Insurance Guaranty Association statute to further protect claimants or policyholders and chose to focus on direct insurance and entities outside the insurance industry. That statute provides that it applies to "all kinds of direct insurance," with specified exceptions. RSA 404-B:3, as enacted by 1970 N.H. Laws 37:3. It further specifies that the term "covered claim" "shall not include any amount due any reinsurer, insurer, insurance pool, or underwriting association." RSA 404-B:5, IV, as enacted by 1970 N.H. Laws 37:3 and amended by 1975 N.H. Laws 348:2, 3. These statutes reflect a legislature policy of protecting the interests of policyholders over the interests of those in the insurance industry. such as reinsurers.

The New Hampshire statutes should be construed as a consistent harmonious whole. E.g., In the Matter of Breault & Breault, 149 N.H. 359, 361 (2003) ("[W]e interpret statutes in the context of the overall statutory scheme and not in isolation."). These provisions demonstrate that the New Hampshire legislature knew how to refer to reinsurance contracts when it intended to do so. They also show that the term "insured" refers to a person insured under an insurance policy, not to ceding insurers under reinsurance contracts. Finally, the provisions evidence an intent to protect direct insureds, not members of the insurance industry. Accordingly, the claims of ceding insurers under reinsurance contracts should not be included within the priority for "policyholders, beneficiaries, and insureds" under "insurance policies and insurance contracts."

This interpretation furthers the purposes of the insurer liquidation statute to protect "the interests of insureds, creditors, and the public generally" through, among

[3] The Legislature replaced these sections with a credit for reinsurance statute in 1986. See RSA 405:45-52, as enacted by 1986 N.H. Laws 196:1. In the revised statutes, which remain in effect, the Legislature prescribed provisions for "reinsurance contracts" and referred to the parties to those contracts as the "ceding insurer" and "assuming insurer." E.g., RSA 405:49.

other things, the "[e]quitable apportionment of any unavoidable loss." RSA 402-C:1, IV(d). The priority statute represents the legislative determination of how loss should be allocated. The references to policyholders, beneficiaries and insureds in the priority statute reflect a legislative intent to prefer persons who have sought the protection provided by insurance over others. As recognized in the statutes cited above, reinsurance contracts are entered into by insurance companies, relatively sophisticated and large parties in the insurance business, and serve to spread risk within the insurance industry. If these entities were within the policy related priority class, the distributions to that class would be reduced, thus decreasing the protection afforded to the persons purchasing insurance. If the Legislature had intended this result, it would have expressly said so.

2. Uniform caselaw from other jurisdictions. The New Hampshire courts also "look[] for guidance to other States' interpretations of similar statutes." New Hampshire Ins. Guaranty Ass'n v. Pitco Frialator, Inc., 142 N.H. 573, 577-578 (1998). There is a significant body of caselaw from around the United States interpreting statutes like RSA 402-C:44 that provide priority for claims of policyholders, beneficiaries, and insureds under insurance policies or contracts. All of these cases have held that the claims of reinsureds under reinsurance contracts are not policyholder level claims entitled to priority status. They demonstrate "the widespread and longstanding policy of distinguishing direct insureds from reinsureds for the purpose of determining priorities of claims against insolvent insurance companies." In re Liquidation of Sussex Mutual Ins. Co., 301 N.J. Super. 595, 601, 694 A.2d 312 (N.J. Super. Ct., App. Div. 1997).

The cases construing priority statutes substantially identical to RSA 402-C:44, II, recognize that there is an essential difference between insurance policies and reinsurance contracts and that the purposes of the insurer liquidation statutes are not served by affording priority to cedants' claims. For example, in In re Liquidations of Reserve Ins. Co., 122 Ill. 2d 555, 561, 524 N.E.2d 538 (1988), the court held that a "reinsurance agreement is different from a policy of direct insurance in both form and substance" because it is entered between insurance companies and "the original policyholder – the entity whose loss is insured – is not a party to the reinsurance agreement." Further, as noted in Northwestern National Ins. Co. v. Kezer, 812 P.2d 688, 692 (Colo. Ct. App. 1990), cert. denied, 1991 Colo. LEXIS 449 (Colo. July 9, 1991), the courts have been "influenced by the underlying purpose of the liquidation statutes, in general, and the preference statutes in particular. That purpose is to provide preferred protection to individual policyholders and claims who, unlike a reinsured company, had little means of analyzing the risks involved in dealing with the now insolvent concern. Based on these considerations, the courts have uniformly agreed that a reinsurance contract does not constitute a policy of insurance under the preference statute." In light of this purpose, courts have concluded that "legislation intended to depart from that policy would be

likely to refer to reinsurance agreements explicitly." In re Liquidation of Sussex Mutual, 301 N.J. Super. at 601. Accord, Foremost Life Ins. Co. v. Department of Ins., 274 Ind. 181, 186-88, 409 N.E.2d 1092 (1980) (holding that reinsured is a general creditor not entitled to policyholder level priority status, based on the well recognized distinctions between a contract of reinsurance – an indemnity contract – and a direct insurance policy – a policy against loss or liability, and the fact that the purpose of the insurer insolvency statutes is to protect the public, not other insurance companies).

The courts have also consistently held that cedants' claims are not entitled to policyholder priority under similar statutes providing priority for "claims under policies for losses incurred" or claims "which arise out of and are within the coverage of insurance policies." See Covington v. Ohio General Ins. Co., 99 Ohio St. 3d 117, 118-20, 789 N.E.2d 213 (2003) (holding that reinsureds' claims under reinsurance contracts were general unsecured claims, not "claims under policies for losses incurred" and therefore were not entitled to policyholder-level priority status); State of North Carolina, ex rel. Long v. Beacon Ins. Co., 87 N.C. App. 72, 77, 359 S.E.2d 508 (N.C. Ct. App. 1987) (holding that claims arising out of contracts of reinsurance with the insolvent insurer are general creditor claims not entitled to policyholder level priority status); Neff v. Cherokee Ins. Co., 704 S.W.2d 1, 6-7 (Tenn. 1986) (holding that reinsureds are not entitled to policyholder-level priority status); Pioneer Annuity Life Ins. Co. v. National Equity Life Ins. Co., 159 Ariz. 148, 152, 765 P.2d 550 (Ariz. Ct. App. 1988) ("[G]enerally speaking a party to a reinsurance contract is not entitled to secured or priority creditor status under the [UILA].").

These cases illustrate the general understanding that due to the fundamental differences between contracts of reinsurance and contracts of insurance, and the relative bargaining power of the parties thereto, the level of protection afforded the rights under the former are less than the protection afforded the rights under the latter. See In re Liquidation of Reserve Ins. Co., 122 Ill. 2d at 561 ("A reinsurance agreement is different from a policy or contract of direct insurance in both form and substance . . . [and] the interest involved in a reinsurance agreement is different from that involved in a direct insurance agreement."); Beacon Ins. Co., 87 N.C. App. at 77 ("The public policy considerations favoring protection of policyholders are not applicable . . . to the business of reinsurance. Unlike transactions between insurers and consumers, insurers who negotiate and enter into reinsurance contracts do so from a substantially more equal bargaining position. Just as there is a reduced need for protection, there is a coextensive reduction in regulation."); Neff, 704 S.W.2d at 3, 6 ("The policy motivating the [insurer insolvency] regulatory scheme . . . [has been to] protect[] the little policy-holder. . . Clearly, the intention of the [Tennessee] Legislature has been to protect direct policyholders and not reinsurance promisees."); Pioneer Annuity Life Ins. Co., 159 Ariz.

at 152 ("The reason [why reinsureds are not entitled to priority status] is that these and similar laws were designed primarily for the protection of individual insurance consumers – individual insureds and their beneficiaries."). See also Prudential Reinsurance Co. v. Superior Court of Los Angeles County, 3 Cal. 4th 1118, 1158, 14 Cal. Rptr.2d 749, 842 P.2d 48 (1992) (dissent in an offset case noting that "[a]s the supreme courts of many states have noted, the relatively unregulated nature of the reinsurance business is one of the reasons the reinsurance obligations of an insolvent insurer are almost universally assigned a lower priority than an insolvent's obligations to policyholders under primary policies").

Commentators are in accord. See 1 Appleman on Insurance 2d, Eric Mills Holmes & Mark S. Rhodes, § 2.15, p. 320 (1996 West) ("[A] reinsurance contract or treaty is not considered to be an insurance policy for the determination of the priority of claims to assets of an insolvent insurer."); 19A Insurance Law and Practice, John A. Appleman & Jean Appleman, § 10726 (2003 Supp.) ("Claims arising out of reinsurance agreements are considered separate from and subordinate to claims of policyholders."); Couch on Insurance 3d, § 6:8, p. 6-22 (1995) ("In the absence of a statutory provision to the contrary, reinsured insurers are not entitled to priority over other general creditors of an insolvent reinsurance company, and the claims of reinsurers against the reserve and security of an insolvent insurer are claims of general creditors, as opposed to the claims of policyholders, beneficiaries or insureds of an insolvent company, because a contract of reinsurance is not one of insurance but simply one of indemnity.")

We are aware of no caselaw supporting the contention that a cedant's claims should be accorded policyholder priority. The courts have uniformly held to the contrary.

3. Model Act. Finally, there is a national regulatory consensus that cedants are not entitled to policyholder level priority as shown by the model statute promulgated by the National Association of Insurance Commissioners ("NAIC"). In December 1977, the NAIC promulgated the Insurers Rehabilitation and Liquidation Model Act ("Model Act"). III NAIC Model Laws Regulations and Guidelines at 555-101 (2000). The Model Act was revised in 1994 and one of the revisions clarified that reinsureds were not entitled to policyholder priority by explicitly excluding claims under reinsurance contracts from those claims provided policyholder level priority status. See Model Act, § 47(C) ("Class 3. All claims under policies . . . for losses incurred. . . . Notwithstanding the foregoing, the following claims shall be excluded from Class 3 priority: (1) Obligations of the insolvent insurer arising out of reinsurance contracts.").[4] This

[4] This language first appeared among the many proposed amendments suggested in the June 23, 1993 exposure draft. 1993 NAIC Proceedings 636, 670.

language merely clarified the Model Act so that it expressly reflected the universal views of the courts and insurance commissioners on the appropriate priority for cedants' claims.

It has been suggested that the express language in the Model Act somehow indicates that state statutes without that language provide reinsureds with policyholder priority. This is incorrect, as the language was only a clarification, and its enactment is therefore unnecessary. The suggestion is also inconsistent with the relevant chronology and the relationship between the New Hampshire priority statute and the Model Act, and contrary to the way in which legislative intent is expressed.

First, the priority language at issue was enacted by the New Hampshire Legislature in July 1977, see 1977 N.H. Laws 499:1, before the Model Act was promulgated by the NAIC in December 1977. Further, the language of the policyholder priority in the New Hampshire priority statute differs from that in the Model Act, which does not refer to "policyholders, beneficiaries and insureds." Compare RSA 402-C:44, II, with Model Act § 47(C). There was no legislative departure from the Model Act (much less the 1994 clarification), and the act thus sheds no light on the proper construction of the pre-existing New Hampshire statute.[5]

Second, the Model Act is advisory. See In the Matter of the Liquidation of American Mut. Liab. Ins. Co., 434 Mass. 272, 289 n.18 (2001) ("[U]niform acts, as such, are not binding on any State; they are adopted voluntarily, and often with substantial modifications."). While the Model Act serves to demonstrate the consensus views of the nation's insurance regulators, it is only a proposal for consideration by the States, and it is constantly under reconsideration and revision. See III NAIC Model Laws at 555-101 (noting 13 revisions to the Model Act between 1977 and 2000). It is unreasonable to suggest that the state legislatures are constantly monitoring the Model Act (and the many other model acts promulgated by the NAIC and the Commissioners on Uniform States Laws) so that a failure to enact a change to the model is indicative of a contrary legislative intent.

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[5] The New Hampshire priority statute was revised in 1998 to accord with the Supreme Court's decision in United States Dep't of Treasury v. Fabe, 508 U.S. 491 (1993). See 1998 N.H. Laws 99:1. The policy related claims priority was reenacted as priority class II and was otherwise unchanged (except for the ministerial substitution of "an" for "his" in the last sentence). Where the Legislature reenacts statutory language without change, it is presumed to have the same meaning as the original statute. See Appeal of Simplex Wire & Cable Co., 131 N.H. 40, 48 (1988)("reenactment of statutory text adopts prior statutory interpretation"), citing Tomson v. Ward, 1 N.H. 9, 12 (1816). If any inference were to be drawn from the 1998 reenactment, it is that the Legislature adopted the intervening caselaw from other states construing the statutory language not to include cedants' claims. See id.; Mann v. Carter, 74 N.H. 345, 347 (1907).

Third, and most fundamentally, legislative inaction is not a proper basis for construing a statute. "The Legislature expresses its will by enacting laws, not by failing to do so." Merrill v. Manchester, 114 N.H. 722, 728 (1974). That the Legislature did not update a statute by making a clarification (especially one consistent with the existing interpretation of the statute) to conform it to a model act (from which it already differs in some respects) does not somehow change the legislative intent underlying the existing statute.[6]

Very truly yours,

J. David Leslie

cc: Roger Sevigny
Gareth Hughes

[6] Indeed, the courts of other states have looked to post-enactment revisions of model or uniform laws to illuminate the meaning of existing state statutes. See, e.g., Clark Equip. Co. v. Massachusetts Insurers Insolvency Fund, 423 Mass. 165, 168 n.6 (1996); Carlson v. Giacchetti, 35 Mass. App. Ct. 57, 63 (1993).