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ROLL NUMBER

DESCRIPTION

2194

2005 SENATE INDUSTRY, BUSINESS AND LABOR

SB 2194

2005 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. 2194

Senate Industry, Business and Labor Committee

☐ Conference Committee

Hearing Date 1-18-05

Tape Number	Side A	Side B	Meter #
1	xxx		5730-end
1		xxx	0-3470
Committee Clerk Signature	Lisa VanBerkom		

Minutes: **Chairman Mutch opened the hearing on SB 2194. All Senators were present.**

SB 2194 relates to treatment of reinsurance upon insolvency, liquidation, or dissolution and reinsurer's liability in delinquency proceedings.

Constance Hofland, Attorney with Zuger, Kirmis, & Smith, representing Reinsurance Association of America, introduced the bill. See attached testimony.

Senator Espegard : Reinsurance then, would be required to have a cut through?

Constance: No, it's not required, but if they do have it in the agreement, then we want to make sure it's valid.

Senator Espegard : Explain to me how the reinsurer could pay twice.

Constance: There have been some isolated cases, when it goes into receivership that the reinsurer has the agreement with the beneficiary and the middle insurer is paying the beneficiary directly. But also when it goes to receivership because the language in the bill has been interpreted to the receiver that they also are on the hook to them.

Chairman Mutch : In other words, the primary carrier is the solvent, then the reinsurer would have to pay the whole claim.

Constance: Yes, if that is in the original agreement. It's not mandated.

Senator Klein : The original agreement with....?

Constance: With the original reinsurer and the insured.

Senator Klein : So as a policy holder, how would I know how to get to the reinsured? When he goes belly up and I have $4,000 damage on my roof from hail. He's gone, how do I get to the reinsurer?

Constance: There are provisions in the statute that require notice.

Senator Espegard: It seems to me that the benefit of the cut-through is if the agency goes broke, that the reinsurer would pay the entire claim.

Constance: That is my understanding.

Senator Espegard: When you talk middle insurer, who are you talking about?

Constance: The ceding insurer.

Senator Espegard : We have the cut-through, the insurance company and the reinsurer. Who is the middle person there?

Constance: The insurance company.

Senator Fairfield: It doesn't look like there is any ambiguity it this. Is it in the law or in the contract between the insurer and the reinsurer that is causing these isolated...What has happened, was there litigation?

Constance: It is in the statute itself. Alaska statute has almost the same language.

Senator Espegard: To your knowledge, do any of these companies use cut-through coverage?

Constance: As I understand, it's like a home owners situation. The mortgage company is requiring that cut-through.

Senator Heitkamp : Nothing in this bill changes the scenario that Senator Espegard laid out?

Constance: Right.

Senator Heitkamp : Really what we are talking about in this bill is the difference of if you have an insurance company and then you have a home owner working back up the ladder, making sure both of them don't get paid, right?

Constance: That's correct.

Senator Heitkamp : So let me take that a step further. Let's say you are the reinsurer and now you have the insurance company which has gone insolvent but the reinsurer pays that company?

Constance: That's correct.

Senator Heitkamp : This bill would allow the home owner, that the reinsurer pays the insurance company that went insolvent. The home owner is on the hook.

Constance: This doesn't change that. It does eliminate that private solvent companies, still in receivership, but they will say that the reinsurer is still on the hook to them. Even though the reinsurer has already paid the beneficiary.

Senator Espegard : Wouldn't the opposite be true? The reinsurer never issues a check to a policy holder as a general rule. The reinsurer issues the check to the insurance company. So if the reinsurance company has paid the insurance company, the insurance company goes broke. The policy holder is out, because they haven't paid him yet. So in that case, the policy holder had two kinds of insurance, so in that case I can see where the court would say that the reinsurance company really owes the policy holder some money.

Senator Heitkamp : Not if we pass this law.

Constance: I don't think that that's the way it works because if that situation, if there really was a cut through in the provision that they insured, the agreement that they have with the reinsurer will pay directly to the beneficiary.

Senator Heitkamp : That's the law right now. What this changes, is it takes the reinsurer off the hook for paying twice, even though they may have been foolish and paid the wrong person.

Constance: It doesn't take them off of the hook for paying the beneficiary, it takes them off of the hook for paying the receivership, if they have already paid the beneficiary.

Senator Fairfield : The scenario would only happen if there was no cut-through?

Constance: Right.

Senator Espegard : Normally when you have a loss, you don't get a check from the reinsurance company, you get a check from the one you bought the insurance from.

Senator Espegard : If my policy doesn't have a cut-through provision and my insurer goes broke, the receiver goes after the reinsurer to pay?

Constance: Correct.

Senator Espegard : If it has a cut-through provision, you don't have to go through the receiver, you could go directly to the policy holder?

Constance: That's right.

Senator Fairfield : So what happens if the insurance company becomes insolvent after the claim has already been made?

Constance: I'm not sure why the insurer would pay the middle insurer before they go insolvent. The customer agreement would only kick in in the case of insolvency.

Senator Krebsbach: Is there ever a time and a case where the reinsurance company pays the ceding insurance company?

Constance: If they had a different kind of reinsurance, but we aren't talking about that.

Senator Krebsbach: What role does the state health insurance department play?

Senator Espegard : As the insured, I don't even know about reinsurance, nor do I care. I deal with a company, I have a loss, they are going to pay me.

Senator Klein: To a degree, you do care because you want the insurance company to be strong as well the reinsurance company because that will reflect on good rates.

Carole Kessel, North Dakota Insurance Department, spoke neither for nor against the bill. Cut throughs are not going to be common to individual property and casualty insurance policies. That is not a typical scenario. You will see them in mortgage insurance.

Senator Espegard : What instance, would there be a claim then that they could pay twice?

Carole: In the event of an insolvency as a primary carrier, there is a coverage.

Senator Fairfield : The policy holders in the majority of cases are either banks or mortgage companies or large corporations.

Carole: That's correct.

Senator Klein : The department is good with this?

Carole: The department is fine with this.

The hearing was closed. No action was taken.

Chairman Mutch re-opened discussion on SB 2194 during committe work after hearings that day.

Senator Klein moved a DO PASS. Senator Espegard seconded.

Roll Call Vote: 6 yes. 1 no. 0 absent.

Carrier: Senator Klein

2005 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. 2194

Senate Industry, Business and Labor Committee

☐ Conference Committee

Hearing Date 1-18-05

Tape Number	Side A	Side B	Meter #
no tape			
Committee Clerk Signature	Lisa VanBerkom		

Minutes: **Chairman Mutch opened discussion on SB 2194. All Senators were present.**

SB 2194 relates to treatment of reinsurance upon insolvency, liquidation, or dissolution and reinsurer's liability in delinquency proceedings.

Senator Krebsbach: With this bill, the reinsurer is responsible to the insured directly. The liability ends there.

Senator Klein moved a DO PASS. Senator Heitkamp seconded.

Roll Call Vote: 6 yes. 1 no. 0 absent.

Carrier: Senator Klein

Date: 1-18-05
Roll Call Vote #: 1

2005 SENATE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO.

Senate Industry, Business and Labor Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number 2194

Action Taken Do Pass

Motion Made By Klein Seconded By Espegaard

Senators	Yes	No	Senators	Yes	No
Senator Mutch, Chairman	X		**Senator Fairfield**	X	
Senator Klein , Vice Chairman	X		**Senator Heitkamp**		X
Senator Krebsbach	X				
Senator Nething	X				
Senator Espegard	X				

Total (Yes) 6 No 1

Absent 0

Floor Assignment Klein

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

SB 2194: Industry, Business and Labor Committee (Sen. Mutch, Chairman) recommends **DO PASS** (6 YEAS, 1 NAY, 0 ABSENT AND NOT VOTING). SB 2194 was placed on the Eleventh order on the calendar.

2005 HOUSE INDUSTRY, BUSINESS AND LABOR

SB 2194

2005 HOUSE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. SB 2194

House Industry, Business and Labor Committee

❑ Conference Committee

Hearing Date 3-1-05

Tape Number	Side A	Side B	Meter #
1		x	26.-end
2	x		0-4.5
Committee Clerk Signature	Judy Brike		

Minutes:

Chairman Keiser: Opened the hearing on SB 2194.

Senator Jerry Klein: Appeared in support of bill and also was a sponsor. Provided a written statement (SEE ATTACHED TESTIMONY).

Constance Hofland, Attorney, Zuger, Kirmis & Smith Law Firm, Bismarck, ND: We are here representing the Reinsurance Association of America, and are in support of the bill and providing a written statement with amendments (SEE ATTACHED TESTIMONY).

Pat Ward, Attorney, Zuger, Kirmis & Smith Law Firm, Bismarck, ND: Appeared in support of bill and also provided a written statement (SEE ATTACHED TESTIMONY).

Representative Froseth: I move to **ADOPT** amendments.

Representative Vigesaa: **SECOND** the motion to **ADOPT** amendments.

Motion carried.

RepresentativeDosch: I move a **DO PASS AS AMENDED** on SB 2194.

Representative Thorpe: **SECOND** the **DO PASS** motion **AS AMENDED**.

Motion carried **VOTE: 13-YES 0-NO 1-Absent (BOE)**

Representative Dosch will carry the bill on the floor.

Hearing adjourned.

Date: 3-1-05

Roll Call Vote #: 1

2005 HOUSE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. SB 2194

House **INDUSTRY, BUSINESS AND LABOR** Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number _____

Action Taken Adopt Amendments

Motion Made By Rep. Froseth Seconded By Rep. Vigesaa

Representatives	Yes	No	Representatives	Yes	No
G. Keiser-Chairman	X		Rep. B. Amerman	X	
N. Johnson-Vice Chairman	X		Rep. T. Boe	A	
Rep. D. Clark	X		Rep. M. Ekstrom	X	
Rep. D. Dietrich	X		Rep. E. Thorpe	X	
Rep. M. Dosch	X				
Rep. G. Froseth	X				
Rep. J. Kasper	X				
Rep. D. Nottestad	X				
Rep. D. Ruby	X				
Rep. D. Vigesaa	X				

Total (Yes) 13 No 0

Absent (1) Rep. Boe

Floor Assignment _____

If the vote is on an amendment, briefly indicate intent:

Date: 3-1-05

Roll Call Vote #: 2

2005 HOUSE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. SB 2194

House **INDUSTRY, BUSINESS AND LABOR** Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number 50578.0101 .0200

Action Taken Do Pass As Amended

Motion Made By Rep. Dosch Seconded By Rep. Thorpe

Representatives	Yes	No	Representatives	Yes	No
G. Keiser-Chairman	X		Rep. B. Amerman	X	
N. Johnson-Vice Chairman	X		Rep. T. Boe	A	
Rep. D. Clark	X		Rep. M. Ekstrom	X	
Rep. D. Dietrich	X		Rep. E. Thorpe	X	
Rep. M. Dosch	X				
Rep. G. Froseth	X				
Rep. J. Kasper	X				
Rep. D. Nottestad	X				
Rep. D. Ruby	X				
Rep. D. Vigesaa	X				

Total (Yes) 13 No 0

Absent (1) Rep. Boe

Floor Assignment Rep. Dosch

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

SB 2194: Industry, Business and Labor Committee (Rep. Keiser, Chairman) recommends **AMENDMENTS AS FOLLOWS** and when so amended, recommends **DO PASS** (13 YEAS, 0 NAYS, 1 ABSENT AND NOT VOTING). SB 2194 was placed on the Sixth order on the calendar.

Page 1, line 14, after "court" insert "or proof of payment of the claim by a guaranty association"

Page 2, line 11, replace "and" with "an"

Page 2, line 19, after "insurer" insert "as a class 7 claim under section 26.1-06.1-41"

Page 3, line 7, after "court" insert "or proof of payment of the claim by a guaranty association"

Renumber accordingly

2005 TESTIMONY

SB 2194

Testimony of Constance Hofland in Support of SB 2194 with proposed amendment

My name is Constance Hofland. I am an attorney with the law firm of Zuger Kirmis & Smith of Bismarck. Pat Ward and I represent the Reinsurance Association of America in support of SB 2194 with the requested amendment.

The Reinsurance Association of America ("RAA") is a national trade association representing property and casualty organizations that specialize in reinsurance. The RAA's membership is diverse, including large and small, broker and direct. Together, RAA members write approximately two-thirds of the gross reinsurance coverage provided by the U.S. property and casualty reinsurers.

This proposed bill and amendment is a technical correction and clarification. It changes the language of two existing statutes on reinsurance to eliminate a possible ambiguity that could result in double payment by the reinsurer if the ceding insurer is insolvent. There have been some isolated cases in which the reinsurer has been compelled to pay twice, once to the beneficiary and once to the receiver. If this becomes more common, it is inequitable outcome that will chill the marketplace use of cut throughs.

What this bill does is improve the language concerning cut through provisions in the event of insolvency. This bill (1) ensures domestic ceding companies, their reinsurers and their beneficiaries can rely on valid cut through and assumption liability agreements; (2) ensures appropriate credit for reinsurance is provided; and (3) codifies standard insolvency requirements.

Background

Simply stated, **reinsurance** is an arrangement in which an insurance company buys insurance from another company to assume some of its risks. This way, the insurer shifts or **"cedes"** some of the risk and a share of the premiums to the reinsurer. Reinsurance is intended to benefit the insurance companies and the public interest, by increasing a company's capacity to accept new risks, allowing it to write risks that might otherwise be beyond its capacity, decreasing capital requirements, and enabling it to spread the risk of catastrophic losses, among other things.

A **cut through provision** is an agreement between the reinsurer and the ceding insurer, as a part of the reinsurance contract, that the reinsurer will be responsible to the insured directly for the insured risk, if the ceding insurer is insolvent.

The origin of the cut through endorsement stems from the post-World War II housing boom and the efforts to provide financing for the housing industry. The most common user of cut throughs remains the small homeowners insurance company. Cut throughs act as the exception to the rule that policyholders have no direct ability to make a claim with a reinsurer. This exception kicks in if the insurer is insolvent, allowing the beneficiary to make a claim directly against the insurer.

The common market effect of the existence of cut throughs is to encourage competition among insurers by ensuring that more insurers can compete for business.

The existing language in several states provides for cut through payment, but the statutes are not clear and, on some occasions, have been interpreted to require the reinsurer to pay the insured directly and also be liable to the receiver of the ceding insurer – resulting in double payment. This bill clarifies that the reinsurer's obligation is to pay the claim only once.

Why do we need SB 2194?

SB 2194 clarifies effect of a cut through provision if the ceding insurer is insolvent. This clarification is to clarify the intent of the current statute is met with regard to utilization of cut through and assumption liability agreements. There have been adverse court decisions in some jurisdictions. This bill will ensure our current law is not similarly misinterpreted and will eliminate possible double payment.

Not all reinsurance contracts have cut though provisions, in fact, reinsurers usually only provide cut throughs if an underlying insured and insurer request one. If a cut through provision is in place, it is because the reinsurer, the ceding insurer and the insured have agreed the reinsurer will step in and pay the insured directly if the ceding insurer is insolvent. This clarification of the statutory language is to make sure a contractual cut through agreement is recognized.

The RAA has been working to enact this clarification in various states across the country over the last 7-8 years. Currently, 34 states have improved cut through and /or insolvency clause provisions. The states that have already passed these improvements are shown in the attached U.S. map.

Because this improvement is being made in many states across the nation, we also need this amendment to remain uniform by conforming our law to the laws of the majority of the states. Plus, this clarification enhances market competition because cut throughs allow some insurers to compete for business that otherwise would be beyond their reach. In other words, this bill creates certainty that underlying insurance agreements will be honored in the event the insurance company becomes insolvent.

What are the changes proposed by SB 2194?

Subsection 1 of 26.1-02-21 clarifies that cut through agreements will be recognized. The intent is to clarify the language so the original intent is met. Subsection 1 of 26.1-02-31 makes the same clarification.

Breaking it down, clarity is provided as to the intent of the two exceptions to the general rule that the receiver is entitled to the reinsurance proceeds. Exception (a) is the reference to cut throughs and exception (b) is the reference to assumption transactions -- normally the replacement of one insurer in a direct policyholder relationship with another insurer. This amendment is a technical or clean-up amendment.

The other language changes to Subsection 1 are to standardize the insolvency clause provision requirements.

Subsection 2 of both 26.1-02-21 and 26.1-02-31 is a specific provision for when a life and health insurance guaranty association has stepped in as a successor, saying payment for the reinsurance claims will be made under the direction of the guaranty association. This does not alter the receivership proceeding, but merely clarifies the reinsurer's liability section to properly match the receivership code regarding allowed claims.

Subsection 3 of 26.1-02-21 provides for notice provisions, investigation rights of the reinsurer and treatment of expenses of the investigation and defense. We propose two minor amendments to this subsection. The first is a typographical correction on page 2, line 11, changing an "and" to an "an." The second is the specification of the priority of the reinsurer's expenses of investigation and defense. The priority proposed is class 7, out of 9 classes, therefore a low priority claim.

Conclusion

We urge a do pass vote SB2194 as amended, to clarify the intent of these statutes recognizing cut throughs and provide uniformity with the majority of other states.

Proposed Amendments of Reinsurance Association of America
to SB 2194, Draft 50578.0100

Page 2, line 11, replace "and" with "an"

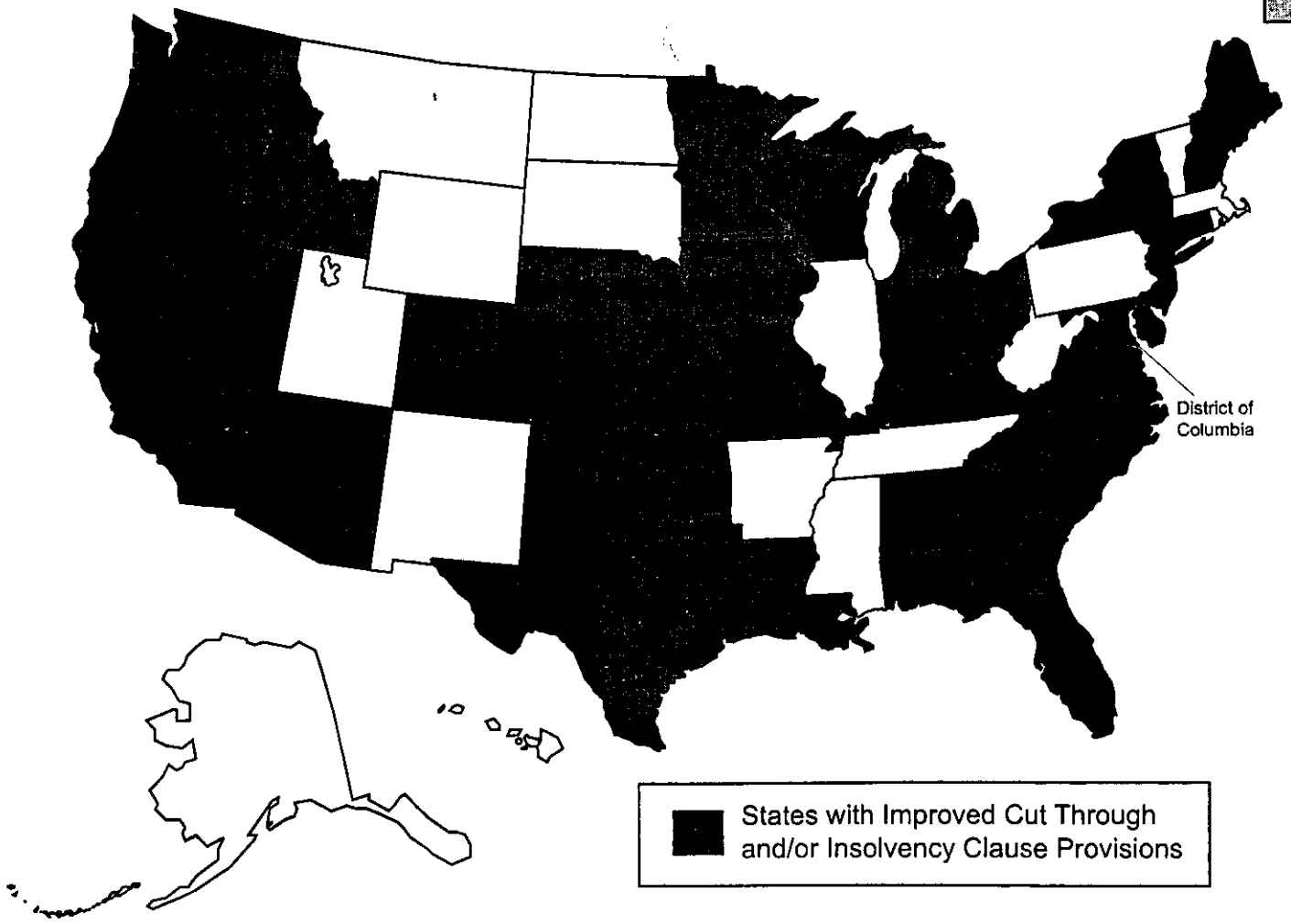
Page 2, line 19, after "insurer" insert "as a class 7 claim under Section 26.1-06.1-41"

34 States with Improved Cut Through and/or Insolvency Clause Provisions

Alabama	Delaware	Indiana	Maryland	New Jersey	Oregon
Arizona	District of Columbia	Iowa	Michigan	New Hampshire	South Carolina
California	Florida	Kansas	Minnesota	New York	Virginia
Colorado	Georgia	Kentucky	Missouri	North Carolina	Texas
Connecticut	Idaho	Louisiana	Nebraska	Ohio	Washington
		Maine	Nevada	Oklahoma	Wisconsin

2004 ENACTMENTS

Connecticut
Kentucky
Missouri



Prepared by RAA, August 2004

RAA
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October 14, 2004

The Honorable Jim Poolman
Commissioner of Insurance
Department of Insurance
State of North Dakota
600 East Boulevard Avenue, 5th Floor
Bismarck, ND 58505-0320

Re: **Proposed Amendments to North Dakota Insolvency Clause Provisions: § 26.1-02-21 (credit for reinsurance code) and § 26.1-06.1-31 (liquidation code)**

Dear Commissioner Poolman:

The Reinsurance Association of America (RAA) would like to meet with you and your staff to discuss measures to improve your state's insurance code. Specifically, we would like to exchange ideas with you on technical and corrective amendments to credit for reinsurance laws and liquidation code statutes relating to "insolvency clauses" in reinsurance contracts. We are interested in pursuing legislation in the 2005 session and have enclosed with this letter amendments to North Dakota's credit for reinsurance and liquidation codes. Please note that 34 states have acted to approve similar legislation in the last eight years (a map identifying these states is also enclosed).

The RAA is a national trade association representing property and casualty organizations that specialize in reinsurance. The RAA's membership is diverse, including large and small, broker and direct, U.S. companies, and subsidiaries of foreign companies. Together, RAA members write approximately two-thirds of the gross reinsurance coverage provided by U.S. property and casualty reinsurers and affiliates.

Background

In 1937, the U.S. Supreme Court rendered a decision in the case of *Fidelity Deposit of Maryland v. Pink*, holding that a reinsurance contract is a contract of indemnity. The case involved a dispute over reinsurance proceeds between the receiver of an insolvent insurer, i.e., the New York Insurance Commissioner, and one of the insolvent's reinsurers. The Court explained that, pursuant to such an agreement, the reinsurer had an obligation only to reimburse the insolvent insurer for amounts the insolvent had already paid to policyholders, not for payments that the insolvent insurer was liable to pay, but was unable to pay.

The Insurance Commissioner's first reaction to the decision came in the form of a legislative proposal to nullify the Court's holding in New York. As a result, in 1939 the New York Legislature passed a law requiring that all reinsurance contracts contain an "insolvency clause" if the cedent desired to receive credit for reinsurance. Under the law, the insolvency clause came into operation if

the ceding insurer became insolvent and, at that time, it obligated the reinsurer to pay money it owed under the reinsurance contract on the basis of the ceding company's actual claims payment obligations to its policyholders, not on the basis of whether the insolvent cedent had actually paid the money it owed its policyholders. The result was to circumvent the *Pink* decision, and turn a reinsurance contract into a contract of liability -- in this limited circumstance -- rather than one of indemnity. Thus, under the 1939 law in New York, a receiver had to simply show its reinsurer that a policyholder had made a valid claim under an insurance policy (the receiver no longer had to show it actually paid the loss), and that showing triggered the reinsurer's duty to pay its portion of the loss.

Despite this action, the 1939 law did not deprive a reinsurer of its rights in business dealings with clients, even with an insolvent client. The law guaranteed a reinsurer its rights to fully investigate claims reported by the insolvent, to have access to and to audit the insolvent's records, and to defend against claims. The inherent "bargain" in the insolvency clause requirement is broken if a reinsurer's rights are somehow limited or restricted by actions of a receiver.

Following the 1939 law, many states enacted a requirement similar to New York's insolvency clause. Subsequently, the NAIC required states to enforce an insolvency clause provision as part of credit for reinsurance laws in the NAIC's accreditation program for insurance departments.

Statutory and Regulatory Issues

Today, insurance regulators are likely to find references to the insolvency clause in statutes or regulations dealing with credit for reinsurance, and sometimes in liquidation law provisions defining a reinsurer's liability. After reviewing all states' laws (including yours), NAIC models, and relevant court opinions, the RAA believes it is time to look at these statutes and regulations, and to make technical or corrective amendments to them for the benefit of regulators, reinsurers and the insurance buying public. Generally speaking, we might review the following three main issues that arise in the statutes and regulations:

1. **What specific language is included in the credit for reinsurance statute and/or regulation?** Is it a requirement that an insolvency clause simply be "included" in a reinsurance agreement, but which does not explain or define the substance of an insolvency clause? Or is it a more detailed description of the content of the clause? Which is appropriate from both the state's solvency regulation perspective and the reinsurer's perspective? Does the requirement apply to all classes of reinsurers in the credit for reinsurance law?

2. **What language should be included in an insolvency clause provision?** Are the traditional reinsurer protections still in place? Is the insolvency clause language specific with regard to the reinsurer's rights on notice of claims, access to records, investigation of claims, asserting

defenses, and recovery of expenses? Is the insolvency clause language consistent with market practices? How specific is the definition of the reinsurer's obligation? Is the requirement appropriately linked to the claims approved by the liquidator? Are there provisions that inadvertently limit a reinsurer's rights? Is the language in the credit for reinsurance law consistent with language in the liquidation law?

3. **What are the exceptions to the requirement that reinsurance proceeds be paid directly to the ceding insurer's receiver?** Are "cut throughs" and assumption liability endorsements recognized? If they are not recognized, what would be the affect on small insurers that are dependent on such endorsements to qualify for homeowner's and surety business under secondary mortgage market rules and the U.S. Treasury Department's requirements for contractors?

Conclusion

Please let us know your interest in discussing these matters. The RAA believes such a dialogue will uncover opportunities to improve state insurance law for the benefit of the public and industry. We respectfully request the opportunity to meet with you and review your state statutes and regulations on these issues in anticipation of the need to seek corrective amendments. For your information, we have enclosed a binder of information on cut throughs and insolvency clauses.

Sincerely,

Bradley L. Kading, CPCU, ARe
Senior Vice President & Director
of State Relations

Marsha A. Cohen, CPCU, ARe
Senior Vice President, State Relations

BLK/MAC:prm

Enclosures

cc: FWN, DJH, MTW, PRM

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SB 2194
TESTIMONY
By Senator Jerry Klein

SB 2194 deals with reinsurance and hopes to clarify that law. There is a slight glitch in the law which could result in a double payment by the reinsurance companies.

There are a couple of definitions I might need to explain first.

Reinsurance is when an insurance company buys insurance from another company, to spread some of its risks. The insurer spreads his risk or cedes some of the risk with the reinsurer.

Reinsurance increases a company's capacity to accept new risks and allows it to write risks that could be beyond the company's capacity.

A cut through provision is an agreement between the reinsurer and the ceding insurer. It means that if the ceding insurer becomes insolvent, the insured can cut through directly to the reinsurer to cover the insured risks.

Not everyone has a cut through provision in their policy, but it is something that most likely large companies would seek when negotiating their insurance needs.

What we are doing here is improving the language concerning cut through provisions in the case of an insolvency. North Dakota currently provides for cut through provisions. But, the statutes are not clear and could be interpreted to pay the insured directly, which is the cut through and also be liable to the receiver of the ceding company – thus the double payment. The receiver in an insolvency would most likely be the insurance commissioner.

This bill clarifies that the reinsurer's agreement to pay the claim directly (or cut through) to the insured is honored by the receiver of the insolvent company.

Mr. Chairman, this provision would get us in line with the law as it stands in 34 other states. It will enhance market competition because cut throughs allow some insurers to compete for business that would otherwise be beyond their reach.

Testimony of Constance Hofland in Support of SB 2194 with proposed amendment

My name is Constance Hofland. I am an attorney with the law firm of Zuger Kirmis & Smith of Bismarck. I represent the Reinsurance Association of America in support of SB 2194 with the requested amendment.

The Reinsurance Association of America ("RAA") is a national trade association representing property and casualty organizations that specialize in reinsurance. The RAA's membership is diverse, including large and small, broker and direct. Together, RAA members write approximately two-thirds of the gross reinsurance coverage provided by the U.S. property and casualty reinsurers.

This proposed bill is a clarification. It changes the language of two existing statutes on reinsurance to eliminate a possible ambiguity that could result in double payment by the reinsurer if the ceding insurer is insolvent. There have been isolated cases in other jurisdictions in which the reinsurer, upon the insolvency of the primary insurer, has paid the beneficiary directly per the agreement. Then later, the receiver also required the reinsurer to

also pay to the liquidator. Clarifications of similar reinsurance bills have been passed in 34 states in the past few years.

This bill involves **reinsurance** and **cut through** agreements.

Reinsurance is an arrangement in which an insurance company buys insurance from another company to assume some of its risks. This way, the insurer shifts or **"cedes"** some of the risk and a share of the premiums to the reinsurer. Reinsurance is intended to benefit the insurance companies and the public interest, by increasing a company's capacity to accept new risks, allowing it to write risks that might otherwise be beyond its capacity, decreasing capital requirements, and enabling it to spread the risk of catastrophic losses.

A **cut through provision** is an agreement between the reinsurer and the ceding insurer, as a part of the reinsurance contract, that the reinsurer will be responsible to the insured directly for the insured risk, if the ceding insurer is insolvent.

What this bill does is improve the language concerning cut through provisions in the event of insolvency. This bill (1) ensures domestic ceding companies, their reinsurers and their beneficiaries can rely on valid cut through and assumption liability agreements; (2) ensures appropriate credit

for reinsurance is provided; and (3) codifies standard insolvency requirements.

Background

The origin of the cut through endorsement stems from the post-World War II housing boom and the efforts to provide financing for the housing industry. The most common user of cut throughs remains the small homeowners insurance company. These agreements enable the small insurers to meet the secondary mortgage market rules. Cut throughs act as the exception to the rule that policyholders have no direct ability to make a claim with a reinsurer. This exception kicks in only if the insurer is insolvent, allowing the beneficiary to make a claim directly against the insurer.

The common market effect of the existence of cut throughs is to encourage competition among insurers by ensuring that more insurers can compete for business.

The existing language in several states, including North Dakota, provides for cut through payment, but the statutes are not clear and, on some occasions, have been interpreted to require the reinsurer to pay the insured directly and also later be liable to the receiver of the ceding insurer – resulting in double payment. This bill clarifies that the reinsurer's

agreement to pay the claim directly to the beneficiary is honored by the receiver of the insolvent insurance company. SB 2194 is to make sure the intent of the current statute is met with regard to utilization of cut through and assumption liability agreements.

Not all reinsurance contracts have cut though provisions, in fact, reinsurers usually only provide cut throughs if an underlying insured and insurer request one. If a cut through provision is in place, it is because the reinsurer, the ceding insurer and the insured have agreed the reinsurer will step in and pay the insured directly if the ceding insurer is insolvent. This clarification of the statutory language is to make sure a contractual cut through agreement is recognized by the receiver.

The RAA has been working to enact this clarification in various states across the country over the last 7-8 years. Currently, 34 states have improved cut through and /or insolvency clause provisions.

Because this improvement is being made in many states across the nation, we also need this amendment to remain uniform with the majority of states. Plus, this clarification enhances market competition because cut throughs allow some insurers to compete for business that otherwise would be beyond their reach. In other words, this bill creates certainty that

underlying insurance agreements will be honored in the event the insurance company becomes insolvent.

PROPOSED AMENDMENTS

We propose amendments to four lines.

The first and fourth relate to the same issue, and are requested by State Farm and approved by RAA . These two amendments are to eliminate the possibility of a delay of payment by reinsurers until the closing of the estate by the liquidation court, if the guaranty association has already paid the claim.

> **Background:** As required by law, state guaranty funds have been paying the claims of the insolvent carriers (and thus guaranty funds are the largest creditors in the estates of the insolvent carriers). Guaranty funds file claims with the estates for the claim payments made on behalf of the insolvent carrier. Liquidators must submit the claims against insolvent carrier's estates through a liquidation court. Liquidators may submit guaranty fund claims to the court at any time, and some liquidators wait to submit all guaranty fund claims at once, perhaps as they are preparing to close the estate (which generally takes several years). The court then will make a determination to "allow" the claims and permit the liquidator to make distributions from the insolvent carrier's estate.
>
> State liquidation laws often include discretionary provisions called "early access" laws that allow a liquidator to pay state guaranty funds "dividends" after the allowance of their claims by the liquidation court, but before the estate closes. These "early access" distributions may be used by the guaranty funds to make other claim payments.

Under SB2194 as proposed without the amendment, "credit" for reinsurance will be allowed if the reinsurance contract provides that the reinsurance is payable on the basis only "of reported claims allowed by the liquidation court."

The Problem: Because the language is dependent on "reported claims allowed by the liquidation court," it may delay reinsurance payments for claims paid by guaranty funds until after the guaranty fund claims have been "allowed" by the liquidation court.

According to the experts at NCIGF, no one anticipated at the time the "model" language was developed. One way to deal with the issue is to modify the proposed amendment to provide that reinsurers would pay claims they owe (pursuant to their contract) that have been paid by a guaranty fund. This would assure that the reinsurance payment would not be dependent upon the allowance of the claim by the liquidation court.

Both State Farm and RAA agreed to an amendment to deal with this, modifying the bill in two places to add the phrase "or proof of payment of the claim by a guaranty association," following the term "liquidation court." This amendment would allow credit for claims for which there is "proof of

payment of the claim by a guaranty association" eliminating this possibility of delay.

The second amendment is a typographical correction on page 2, line 11, changing an "and" to an "an."

The third amendment is the specification of the priority of the reinsurer's expenses of investigation and defense. The priority proposed is class 7, out of 9 classes, therefore it is a low priority claim.

Conclusion

We urge do pass vote on SB2194 as amended, to clarify the intent of these statutes recognizing cut throughs and provide uniformity with the majority of other states.

Proposed Amendments to SB 2194

Page 1, line 14, after "court" insert "or proof of payment of the claim by a guaranty association,"

Page 2, line 11, replace "and" with "an"

Page 2, line 19, after "insurer" insert "as a class 7 claim under Section 26.1-06.1-41"

Page 3, line 7, after "court" insert "or proof of payment of the claim by a guaranty association,"

3-1-05

Testimony of Patrick Ward in Support of SB 2194 with proposed amendment

Chairman Keiser and members of the House-IBL committee. My name is Patrick Ward. I am an attorney with the law firm of Zuger Kirmis & Smith of Bismarck. I represent the North Dakota Life and Health Insurance Guaranty Association and State Farm Insurance Companies in support of SB 2194 with the requested amendment.

The Reinsurance Association of America ("RAA") is a national trade association representing property and casualty organizations that specialize in reinsurance. The RAA's membership is diverse, including large and small, broker and direct. Together, RAA members write approximately two-thirds of the gross reinsurance coverage provided by the U.S. property and casualty reinsurers.

This proposed bill is a clarification. It changes the language of two existing statutes on reinsurance to eliminate a possible ambiguity that could result in double payment by the reinsurer if the ceding insurer is insolvent. There have been isolated cases in other jurisdictions in which the reinsurer, upon the insolvency of the primary insurer, has paid the beneficiary directly per the agreement. Then later, the receiver also required the reinsurer to also pay to the liquidator. Clarifications of similar reinsurance bills have been passed in 34 states in the past few years.

This bill involves **reinsurance** and **cut through** agreements.

Reinsurance is an arrangement in which an insurance company buys insurance from another company to assume some of its risks. This way, the insurer shifts or **"cedes"** some of the risk and a share of the premiums to the reinsurer. Reinsurance is intended to benefit the insurance companies and the public interest, by increasing a company's capacity to accept new risks, allowing it to write risks that might otherwise be beyond its capacity, decreasing capital requirements, and enabling it to spread the risk of catastrophic losses.

A **cut through provision** is an agreement between the reinsurer and the ceding insurer, as a part of the reinsurance contract, that the reinsurer will be responsible to the insured directly for the insured risk, if the ceding insurer is insolvent.

What this bill does is improve the language concerning cut through provisions in the event of insolvency. This bill (1) ensures domestic ceding companies, their reinsurers and their beneficiaries can rely on valid cut through and assumption liability agreements; (2) ensures appropriate credit for reinsurance is provided; and (3) codifies standard insolvency requirements.

We Were asked to put in this bill for RAA. After we did so, NDLHIGA and State Farm requested some minor modifications in the bill. We meant to get those in on the senate

side but did not do so in time so we need to fix it here. Connie has explained how the bill and the amendments would work.

The market effect of the existence of cut throughs is to encourage competition among insurers by ensuring that more insurers can compete for business.

The existing language in several states, including North Dakota, provides for cut through payment, but the statutes are not clear and, on some occasions, have been interpreted to require the reinsurer to pay the insured directly and also later be liable to the receiver of the ceding insurer – resulting in double payment. This bill clarifies that the reinsurer's agreement to pay the claim directly to the beneficiary is honored by the receiver of the insolvent insurance company. SB 2194 is to make sure the intent of the current statute is met with regard to utilization of cut through and assumption liability agreements.

Currently, 34 states have improved cut through and /or insolvency clause provisions.

Because this improvement is being made in many states across the nation, we also need this amendment to remain uniform with the majority of states. Plus, this clarification enhances competition because cut throughs allow some insurers to compete for business that otherwise would be beyond their reach. In other words, this bill creates certainty that underlying insurance agreements will be honored in the event the insurance company becomes insolvent.

State Farm, NDLHIGA and RAA agreed to an amendment to deal with this, modifying the bill in two places to add the phrase "or proof of payment of the claim by a guaranty association," following the term "liquidation court." This amendment would allow credit for claims for which there is "proof of payment of the claim by a guaranty association" eliminating this possibility of delay.

The third amendment is the specification of the priority of the reinsurer's expenses of investigation and defense. The priority proposed is class 7, out of 9 classes, therefore it is a low priority claim.

Conclusion

We urge you to make the requested amendments and a do pass vote on SB2194 as amended, to clarify the intent of these statutes recognizing cut throughs and provide uniformity with the majority of other states.