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Insurer Insolvency: Reinsurers' Right to Offset in Florida--A Comparative Analysis

Christopher M. Sacco

NOTES

INSURER INSOLVENCY: REINSURERS' RIGHT TO OFFSET IN FLORIDA—A COMPARATIVE ANALYSIS

Christopher M. Sacco[*] [**]

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* To my parents, Anne-Marie and Dennis Sacco, and my beautiful wife Sharon. Thank you for your love and support.

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I. INTRODUCTION

Insurance is such a common part of the American culture that we never contemplate it not being there when we need it most. Yet, since 1969, 640 insurance companies nationwide have disappeared as a result of insolvency.[1] Florida insurers experienced their fair share of insolvencies beginning in the late 1980s.[2] Upon insolvency, the Florida Department of Insurance (DOI) steps in as Receiver for the insurer while the insurer is liquidated.[3] The DOI has two objectives: 1) to protect the interests of those policyholders with claims against the insurer, and 2) to satisfy creditors to whom the insurer is indebted.[4] When creditors become aware of the insolvency, they will get in line to assert their rights to the insurer's assets.[5] Concurrently, the DOI attempts to recover any existing funds to which the insurance company is entitled in order to pay claims of policyholders and to satisfy the highest priority creditors.[6] One typical target of the DOI is funds owed to the insolvent insurer from its excess insurers, sometimes referred to as "reinsurers."[7] Reinsurance is defined as "[a] contract that one insurer makes with another to protect the latter from a risk already assumed."[8]

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1. *Insolvency: Will Historic Trends Return?*, BEST'S REVIEW—PROPERTY-CASUALTY INSURANCE EDITION, Mar. 1, 1999, at 59.

2. *Id.* at 65. One group of insurers, workers' compensation self-insurance funds, made up a large portion of Florida's insolvency problems. *Id.* at 65-66.

3. *See generally* FLA. STAT. ch. 631 (2000). This chapter addresses insurer insolvency and the duty of the DOI to function as a guarantor of payments in several areas of insurance. *See, e.g., id.* § 631.911 (governing the DOI's duties upon the insolvency of a workers' compensation insurance fund and creating a guaranty association that satisfies claims of the insolvent self-insurance fund).

4. *See id.* ch. 631; *see also id.* § 631.271 (establishing a priority of distribution of claims from the insurer's estate by which the receiver and creditors must abide).

5. *Id.* Section 631.271 was adopted to address this line of creditors.

6. *Id.* "[A]dequate funds shall be retrieved for such payment before the members of the next class receive any payment." *Id.*; *see also* Francine L. Semaya, *Insurance Insolvencies: 1999 and Beyond*, *in* REINSURANCE LAW AND PRACTICE 49 (PLI COM. L. PRACTICE Course Handbook Series No. 793, 1999). "A receiver . . . is empowered to do all acts necessary to . . . rehabilitate or liquidate the company's assets." *Id.*

7. *See generally* Semaya, *supra* note 6, at 80 (discussing collection of reinsurance receivables by the receiver).

8. BLACK'S LAW DICTIONARY 1287 (6th ed. 1990).

Difficulties arise when reinsurers are both debtors of the insurer (due to unpaid claims by the reinsurer) and creditors of the insurer (due to unpaid premium owed by the insurer).[9] Reinsurers in this situation will assert their alleged right to offset such obligations under a provision of the Florida Insurance Code that allows offset in certain circumstances.[10] The problem is that if offset is permitted, no one is left to pay the claims of policyholders. This issue is arising nationwide as a result of reinsurers marketing a type of policy that generates "payback premium."[11] In Florida, aggressive reinsurers sold these policies to insurers needing to satisfy DOI regulations.[12] The payback policy satisfied DOI regulations in form but not in function.

To illustrate: insurers are required by the DOI to insure their own reserves with two types of excess insurance, specific and aggregate.[13] This

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9. "The application of set-offs in insurance insolvencies in the U.S. has long been a controversial issue among both regulators and the insurance industry. In particular, regulators and the industry have waged a long, ongoing battle over the proper application of set-offs involving reinsurance." Steven W. Schwab et al.; *Onset of an Offset Revolution: The Application of Set-Offs in Insurance Insolvencies*, 95 DICK. L. REV. 449, 504 (1991).

10. *See* FLA. STAT. § 631.281. The statute permits offset of all mutual debts and credits between the insurer and another person, limited to a few exceptions, which are explored later in this Note. *Id.*

11. *See* H.R. CONF. REP. NO. 98-861, pt. 7 (1984) ("[A] contract may contain payback provisions to protect a reinsurer against termination of the reinsurance agreement after a large upfront ceding commission has been paid, but before the reinsurer has been able to enjoy the future profit stream. Such a provision may be a reasonable business practice.... On the other hand, a payback provision which allows a reinsurer to recover all its losses in any case, through adjustments in future premiums or specific termination provisions, would indicate that the transaction is merely a financing arrangement.").

12. *Failed Promises: Insurance Company Insolvencies, Report by the Subcommittee on Oversight and Investigation of the Committee on Energy and Commerce*, 101st Cong., 2d Sess., at 70 (Comm. Print 1990) ("The Subcommittee was told many times [during its nationwide investigation of insurer insolvency] that reinsurance is not being properly regulated . . . .") [hereinafter *Failed Promises*]. The Subcommittee found many similarities and common elements among the insolvent insurers, including "extensive and complex reinsurance arrangements." *Id.* at 2.

13. *See, e.g.*, FLA. ADMIN. CODE R. 38F-5.109 (2000) (stating that self-insurers "shall maintain specific excess insurance" unless their net worth exceeds $250,000,000); *see also* FLA. STAT. § 624.469(2). Section 624.469(2) requires self-insurance funds to carry aggregate excess of loss reinsurance that shall attach at a "point not greater than the loss ratio." FLA STAT. § 624.469(2). "As a minimum, the aggregate excess of loss reinsurance shall also provide coverage for 100 percent of the losses between the attachment point required by this section and a loss ratio of 100 percent." *Id.* The statute goes on to provide complex calculations regarding the proper levels of aggregate reinsurance based on earned premiums. *Id.* § 624.469(3)-(4).
The *Reinsurance Glossary* defines the two types of insurance as follows:

> Aggregate Excess of Loss Reinsurance—A form of excess of loss reinsurance which indemnifies the ceding company against the amount by which all of the

excess insurance is a safety valve to protect policyholders in case of insolvency of the insurer. Specific excess insurance is a policy that protects against high, individual claims.[14] For example, suppose a single insured experiences a catastrophic injury that results in a one million dollar claim settlement. Specific excess coverage will pay out on this high, single claim. Aggregate excess insurance is a policy that protects against a high number of claims over the course of a year.[15] For example, an insurer's actuary estimates five million dollars' worth of total claims over the year, and the insurer holds these dollars in reserve. At the end of the year, however, total claims exceed the reserves. The aggregate layer of reinsurance is "pierced" at this point and serves to cover the difference.[16]

Both types of excess insurance can be very expensive; hence this is a tough pill to swallow for those insurers that consider their reserves adequate to pay claims. Also, some aggregate policies can be poison pills if the insurer ever needs to utilize them. If the insurer has a year in which its aggregate claims exceed its reserves and the fund has to make a claim to the reinsurer, the reinsurer may agree to pay the claim but then require the insurer to pay back the entire amount or more. The payback is sometimes characterized by the reinsurer as "unpaid premium" on the aggregate policy.[17] Thus, the insurance policy was not insurance at all, but rather an expensive loan.

If the insurer has to draw on the excess policy in subsequent years, massive debt is generated with the reinsurer and may become one factor

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> ceding company's losses incurred during a specific period (usually 12 months) exceed either (1) a predetermined dollar amount or (2) a percentage of the company's subject premiums (loss ratio) for the specific period.
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> Specific Excess of Loss Reinsurance—A form of excess of loss reinsurance which, subject to a specified limit, indemnifies the ceding company against the amount of loss in excess of a specified retention for each risk involved in each occurrence.

Reinsurance Glossary, at http://www.reinsurance.org/aboutteraa/glossary.html.

14. *See id.* and accompanying text.

15. *See id.*

16. *See generally Fundamentals of Property Casualty Reinsurance at* http://www.reinsurance.org/reports/fundamentals/fundamentals.html. "Excess of loss contracts require the primary insurer to keep all losses up to a predetermined retention and the reinsurer to reimburse the company for any losses above that retention, up to the limits of the reinsurance contract." *Id.*

17. *See, e.g.*, Bluewater Ins. Ltd. v. Balzano, 823 P.2d 1365, 1372 (Colo. 1992). On facts similar to those described in the text, the reinsurer referred to the premiums due in advance, which exceeded the reinsurance receivables due under the reinsurance policy, as "unpaid premiums." *Id.*

in the insurer's insolvency.[18] Reinsurers allege that the need by the insurer automatically generates a payback debt. In the insolvency process, the reinsurance company may then claim that anything it owes in unpaid claims to the insurer is "offset" by the unpaid premium owed it.[19]

At the heart of the problem is the simple fact that DOI regulators often "rubber-stamp" these reinsurance policies. Regulators have a difficult time analyzing some of these policies as the language is shrouded in mystery and ambiguity.[20] Only when the insurer is insolvent and the DOI needs the reinsurer to pay on the claims does the reinsurer reveal the complex payback provisions. Florida does not have consistent regulations on the matter. Other states allow reinsurers to offset in all circumstances, without ever considering the nature of the insurance policy.[21] But a few states have taken progressive measures to stamp out these practices and explicitly require that DOI only approve reinsurance policies that accomplish a "meaningful transfer of risk."[22] Common law in these states has given teeth to the "transfer of risk" doctrine.[23]

This Note addresses whether a reinsurance company may offset what it owes unpaid claims against what the insolvent insurance company owes it in unpaid premiums. Part II of this Note addresses Florida's insurance code, regulations, and common law on the issue. Part III takes a comparative look at the problem, focusing on a sample of states and their approaches. Particular emphasis is placed on those states taking a progressive approach. Finally, Part IV hypothesizes how Florida law, as it stands today, may provide an adequate basis for courts to prohibit reinsurance offset and then introduces the author's "blueprint" of a legislative decree that would absolutely prohibit problematic reinsurance policies from the outset.

18. *See Failed Promises*, *supra* note 12, at 69 ("Reinsurance abuse has been a key factor in every insolvency studied by the Subcommittee."); *see also* Semaya, *supra* note 6, at 49 (indicating that the inability of the ceding company to collect reinsurance recoverables is one of the key factors common to insolvent companies).

19. *See, e.g., Balzano*, 823 P.2d at 1369.

20. *See Failed Promises*, *supra* note 12, at 4. "State regulators have not successfully resolved problems associated with regulating reinsurance." *Id.* at 60. "Reinsurance is the 'black hole' of solvency regulation." *Id.* Reinsurance is not regulated directly. *Id.*

21. *See infra* Part III.A.

22. *See infra* Part III.B.

23. *See infra* Part III.B.

II. FLORIDA LEGISLATION, REGULATIONS, AND COMMON LAW

A. *The Insurance Code: Is it Savvy Enough to Deal with Reinsurance Policies with Payback Provisions?*[24]

We do not know the answer to the question just posed in the subheading. Although the reinsurance statute acknowledges that to truly be "insurance" the policy should transfer risk to the insurer, Florida courts have not directly addressed this issue. But, it is worthwhile to discuss pertinent provisions as a means of comparison to states that have addressed the issue head-on. Such comparison will provide insight as to how Florida courts may decide the issue.

1. The Offset Provision and Pertinent Case Law

Section 631.281 of Florida Statutes is Florida's "offset" statute. Whether a party is entitled to offset what it owes an insolvent insurance company against what the insurance company owes to the party is guided by this statute.[25] The statute permits offset "[i]n all cases of mutual debts or mutual credits between the insurer and another person."[26] Exceptions to the rule are, among other things, obligations not mature as of the liquidation date and obligations specifically purchased by a person "with a view of its being used as an offset."[27]

The only mention of reinsurers within this statute is a mere restatement of the maturity requirement: "In the case of a reinsurance agreement, the insurer's obligation must be incurred as of the date of the order of liquidation to allow an offset."[28] Thus, the issue remains whether offsets apply to the reinsurer's unpaid claims. Are the mutuality requirements met? One argument is that "payback provisions" on reinsurance policies do not become effective until the reinsurer does its part, i.e., pays the

24. In reinsurance language, the term payback has two meanings:

> (1) A method of rating under which the underwriter sets the price based upon his view of how frequently the loss event might occur over a period of time. Thus, if the underwriter felt that the loss would occur only once in five years, the price would be set (without regard to expenses and profit margins) to be equal to the limit divided by five and the contract would thus be said to have a "five year payback. . . ." (2) Can also refer to premium charged in addition to the cost of an ongoing program for prior losses and, thus "payback" reinsurers.

Reinsurance Glossary, at http://www.reinsurance.org/abouttheraa/glossary.html.

25. FLA. STAT. § 631.281 (2000).

26. *Id.* § 631.281(1).

27. *Id.* § 631.281(2).

28. *Id.* § 631.281(2)(a).

original claims. But reinsurers argue that it is pointless to pay out on claims if ultimately the insurer owed more to the reinsurer than the reinsurer owed to it.

No Florida court has addressed the mutuality issue in this context. In 1958, the Alabama Supreme Court answered this exact question in *Melco System v. Receivers of Trans-America Insurance Co.*[29] The Alabama court held that reinsurance debts are not contemporaneous debts owed prior to insolvency.[30] The obligations could not be mutual; thus, the court denied the offset claims of the petitioner reinsurance company.[31] The reinsurance contract also contained provisions that would guide payments in the event of insolvency.[32] The court concluded that because the reinsurer did not pay claims prior to liquidation, the insurer did not yet owe proceeds to the reinsurer, and thus the debt was not "preliquidation."[33] Also, the court held that the insolvency clause would not take effect until *after* insolvency occurred; thus, it was impossible to characterize these debts as mutual.[34]

Does Alabama's interpretation of mutuality of obligations in the context of payback policies answer the question in Florida? Arguably, it is influential law for a Florida lawyer. But, is it enough to say that payback policies are not "mutual"? The problem with relying on this argument is that it is merely a reactionary fix, after the damage has been done. The real problem is that the reinsurance policy itself should not be labeled as insurance at all, and thus, should not have been allowed from the outset.[35] Requiring a payback of all or more than the payout does not insure the reserves; it drives insurance funds into insurmountable debt.

2. The Reinsurance Provision, the Administrative Code, and a Small Detour into Accounting Standards

Section 624.610 of Florida Statutes concerns the general duties and laws governing reinsurers.[36] Two subsections of the statute are particularly relevant to analysis of the issue raised in this Note: subsection 8 and subsection 13. Subsection 13 provides that "[n]o credit shall be allowed for

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29. 105 So. 2d 43 (Ala. 1958).

30. *Id.* at 53.

31. *Id.* The reinsurer did not become liable under the contract until the insurer actually paid the loss. "That was an absolute condition precedent to any liability on the part of [the reinsurers]." *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. The author submits that Florida's reinsurance statute, which is discussed *infra* note 36, should prohibit this type of policy because the reinsurer has assumed no risk of loss.

36. *See* FLA. STAT. § 624.610 (2000). The purpose of this section, according to the legislature, is to "protect the interests of insureds, claimants, ceding insurers, assuming insurers and the public." *Id.* § 624.610(1).

reinsurance with regard to which the reinsurance agreement does not create a meaningful transfer of risk of loss to the reinsurer."[37] The "credit" referred to in the statute refers to credit on the insurance company's financial statement, i.e., a reduction of the insurer's liabilities to the extent of reinsurance. Subsection 8 is the so-called "insolvency clause." An insurer may only recognize reserve credits if the reinsurance is payable "without diminution because of insolvency of the ceding insurer."[38] Essentially, reinsurance will not be given credit if it either fails to accomplish risk transfer or if it does not pay out when the insurer is insolvent.

In conjunction with the statutory provisions, the Florida Administrative Code adopts the provisions expounded by the National Association of Insurance Commissioners (NAIC) and the Federal Accounting Standards Board (FASB) section 113.[39] Auditors of insurers doing business in the State of Florida must adhere to the NAIC Model Law, as indicated in the NAIC Practice Manual.[40] Within the Practice Manual are the detailed instructions for accounting for reinsurance, including the necessary components of the reinsurance contract itself.[41] Specifically, the Manual indicates that the "essential ingredient of a reinsurance contract is the shifting of the risk."[42] Essentially, if a reinsurance contract fails to effectively transfer risk, the reinsurer is prohibited from taking advantage of the reserve credit. The reinsurance must be accounted for as a deposit in NAIC financial statements.[43] Evaluating whether a reinsurance contract transfers risk is a two-step process requiring satisfaction of both of the following elements:

1. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.

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37. *Id.* § 624.610(13).

38. *Id.* § 624.610(8).

39. *See* FLA. ADMIN. CODE R. 38F-5.101 (2000) (defining "excess insurance" as "[a] policy providing 'excess coverage' or 'reinsurance' which must provide an actual transfer of risk to the reinsurer or excess carrier as defined in Financial Accounting Standards Board Statement 113 (FASB 113)" and incorporating FASB 113 by reference); *see also id.* at R. 4-137.001(4) (incorporating by reference and adopting the NAIC manuals for property and casual insurance companies and life, accident and health insurance companies).

40. *See supra* note 39 and accompanying text.

41. *See* NAIC ACCOUNTING PRACTICES AND PROCEDURE (Statutory Issue Paper No. 75 1998). The general title of this section is "Relevant Statutory Accounting and GAAP Guidance." *Id.* Subsection 18 is entitled "Reinsurance Contracts Must Include Transfer of Risk." *Id.*

42. *Id.* "Unless the so-called reinsurance contract contains this essential element of risk transfer, no credit whatsoever shall be allowed on account thereof in any accounting or financial statement of the ceding insurer." *Id.*

43. *Id.* at 6.

2. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.[44]

How much influence does this have on Florida law? Apparently the DOI finds the NAIC standards fairly important. Indeed, the DOI adopted the Model Law into the Administrative Code.[45] However, it is difficult to discern how courts are influenced by NAIC standards, simply because there is no Florida case law addressing reinsurers and offsets. Therefore it is necessary to look to other sources of law for guidance.

B. *Peripheral Case Law: General Application of the Offset Provision*

1. The "Priority of Claims" Issue

Barnett Bank of Jacksonville v. Department of Insurance[46] is a useful case to understand how the offset provision is applied in peripheral circumstances. The case also indicates the interplay between the offset provision and section 631.271 of Florida Statutes, governing priority of claims.[47] In *Barnett*, the court allowed the bank, a creditor of the insolvent insurance company, to offset mutual debts.[48] Most importantly, the court indicated that the priority of claims provision and the offset provision do not conflict.[49] That is, even though allowing the bank to offset the mutual debt gives the bank a priority over creditors who might otherwise have priority under the statute, it was still permitted.[50]

Applying the logic of *Barnett* to reinsurers attempting to offset unpaid claims against unpaid premiums, it is relatively clear that, although a reinsurer probably falls into the "Class 6" category of "general creditors,"[51] the reinsurer will be permitted to offset. This notion is critical to offset analysis. *Barnett* indicates how Florida courts favor offset despite

44. *Id.* at 5. This Issue Paper also indicates that the ceding insurer's valuation of whether it is possible for a reinsurer to realize loss from the agreement "shall be based on the present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes . . . ." *Id.*

45. *See supra* note 39 and accompanying text.

46. 507 So. 2d 142 (Fla. 1st DCA 1987).

47. FLA. STAT. § 631.271 (2000). "The priority of distribution of claims from the insurer's estate shall be in accordance with the order in which each class of claims is set forth in this subsection." *Id.* § 631.271(1).

48. *Barnett*, 507 So. 2d at 144.

49. *Id.*

50. *Id.*

51. *See* FLA. STAT. § 631.271(2)(f); *see also* Bluewater Ins. Ltd. v. Balzano, 823 P.2d 1365, 1374 (Colo. 1992) (holding that reinsurers are "'other' general creditors who must get in line behind the policyholders").

the fact that offset may defeat other insolvency statutes.[52] The *Barnett* court reasoned that "offset . . . by its very nature, [is] a specie of preference."[53] Its purpose is to provide a preference to the limited extent that mutual obligations are netted out and only the balance is paid.[54]

2. An Analogy to Bankruptcy Offset

The concept of offset finds its roots in bankruptcy law. Rule 4001(a) of the Federal Bankruptcy Code allows creditors to effect a setoff of "mutual pre-petition obligations."[55] Courts have indicated that the right of setoff is "preserved, but not created, in the bankruptcy code."[56] Though bankruptcy courts are federal courts, it is state law that determines the validity of the right.[57]

The concept of offset first arose in *Studley v. Boylston National Bank*,[58] a 1913 United States Supreme Court decision. The Court in *Studley* indicated that the purpose of setoff is to avoid "the absurdity of making A pay B when B owes A."[59] In 1992, the Eleventh Circuit, the controlling jurisdiction for Florida bankruptcy courts, recognized setoff as an established creditor's right to cancel out mutual debts against one another in full or in part.[60] In *In re Patterson*,[61] the plaintiff credit union appealed a judgment of an Alabama federal district court entered in favor of debtors in a bankruptcy case involving an alleged violation of the automatic stay provisions of Chapter 11 of the Bankruptcy Code.[62]

The debtors in *Patterson*, husband and wife, filed for bankruptcy.[63] Husband was a member of the credit union.[64] The credit union proceeded to block any activity in the debtors' accounts because its loan to the debtors was secured by these accounts and the outstanding loan balance

52. *See Barnett*, 507 So. 2d at 144.

53. *Id.* The court, applying seemingly circular reasoning, indicated that "[t]his (holding) is consistent with 631.271 because that section, by creating priorities of claims, also prefers some creditors over others." *Id.*

54. *Id.*

55. 11 U.S.C. § 553 (2000). To maintain a right of setoff under this statute, a creditor must prove (1) that a debt exists and that the debt arose prior to the petition date, (2) that the creditor has a liquidated and non-contingent claim against the debtor that arose prior to the petition date, and (3) the debt and claim are mutual obligations. *Id.* § 553(a).

56. *In re* Patterson, 967 F.2d 505, 508 (11th Cir. 1992).

57. *Id.*

58. 229 U.S. 523 (1913).

59. *Id.* at 528.

60. *See Patterson*, 967 F.2d at 513.

61. 967 F.2d 505 (11th Cir. 1992).

62. *Id.* at 507.

63. *Id.*

64. *Id.*

exceeded the balance in the accounts.[65] Although recognizing the right to offset mutual debts, the *Patterson* court ultimately held that the plaintiff credit union did not have such a right because there was no mutuality of obligations.[66] The court seems to strictly interpret this concept, considering that the debtors' loan was secured by the same accounts that the credit union was attempting to block.[67] Therefore, the precedent case that established the right of offset in Florida bankruptcy law ironically denied offset on the facts of the particular case.[68]

Thus, although bankruptcy law permits offset, much weight is placed on the mutuality of obligations factor. The burden of proof lies with the party seeking offset to prove that the obligations are mutual.[69] As Part III will illustrate, other states that permit reinsurers to offset unpaid claims against an insolvent insurance company's unpaid premiums do so in part because the bankruptcy courts sitting in their states recognize the right of offset. Will a Florida court find this same analogy? Part IV will tackle that issue.

In light of the preceding discussions of the sparse law on the issue, how does a Florida lawyer protect an insurer from a payback policy? Does Florida legislation and administrative law, as it now stands, protect Florida insureds from questionable reinsurance practices? To answer these questions, and to develop a theory of proper legislation to combat this problem, it is necessary to compare Florida with other influential insurance states and their approach to the offset issue.

III. OFFSET—A COMPARATIVE PERSPECTIVE

A. *Influential States that Allow Offsets*

Two states influential in legal decision-making, California and New York, both allow offset in practically any circumstance. Subsection A will examine the statutes, regulations, and common law of each state, and note the similarities with Florida law. Doing so allows us to hypothesize as to how Florida *may* treat the payback policies of some reinsurers.

65. *Id.* The credit union referred to this action as an "administrative freeze." *Id.*

66. *Id.* at 509.

67. *See id.* at 511.

68. *See id.*; *see also In re* Bowden, 186 B.R. 523, 525 (Bankr. M.D. Fla. 1995) ("In determining whether the debts and claims arose pre-petition, the *key* test is whether 'all the transactions which gave rise to the mutual obligations occurred prior to the petition date.'") (emphasis added).

69. *Patterson*, 967 F.2d at 509.

1. New York's Statutory and Regulatory Authority

New York's offset provision, which is found in section 7427 of that state's insurance code,[70] is practically identical to the Florida provision. The main thrust of the New York statute is the mutuality of obligations requirement.[71] Unlike the Florida statute, reinsurers are not singled out in the New York provision.[72]

New York's reinsurance provision,[73] however, is markedly different from Florida's. Most notably, the statute does not address the "transfer of risk" issue, but instead contains complex, technical guidelines as to when reserve credits may be realized.[74] None of the provisions in the statute restrict reinsurance based on the type of policy; rather, most concern the effect of reinsurance on the ceding company's reserves (i.e., there is a presumption that the reinsurance policy itself is valid).[75] In fact, subsection (a)(1) indicates, "[n]o prohibition or limitation in this chapter shall invalidate any reinsurance agreement as between the parties thereto."[76]

New York does not explicitly adopt NAIC Model Law into its Administrative Code as Florida does.[77] Some specific NAIC rules are adopted into the code, but most concern life insurance valuations and other extraneous matters.[78] No recognition of the NAIC's emphasis on the validity of policies is contained in New York's code, yet some New York case law is very influential on the reinsurer offset issue.[79] This is somewhat problematic because, as this Note has illustrated, some reinsurance policies are dangerous to insurers that need to use them, and are a significant cause of insolvency.[80] Yet, applying New York common law allows these same reinsurers to offset their debt and inevitably take more from the insolvent insurers (or the DOI as Receiver).

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70. N.Y. INS. LAW § 7427 (McKinney 1999).

71. *Id.* § 7427(a) ("In all cases of mutual debts or mutual credits between the insurer and another person . . . .").

72. *Id.* § 7427.

73. *Id.* § 1308.

74. *See, e.g., id.* § 1308(a)(2). This paragraph indicates the characteristics that a reinsurance agreement must possess in order for the ceding insurer to recognize credit. *Id.* The first requirement is that the reinsurance obligation remain payable by the reinsurer if the insurer is insolvent. *Id.* § 1308(a)(2)(A)(i). The second requirement is that the liability for reinsurance be "assumed by the assuming insurer as of the same effective date." *Id.* § 1308(a)(2)(A)(ii). No part of this section indicates that the reinsurance agreement must transfer risk of loss to the reinsurer.

75. *See id.* § 1308.

76. *Id.* § 1308(a)(1).

77. *See* 11 N.Y. COMP. CODES R. & REGS. § 27.1 (2000); N.Y. INS. LAW § 95.9.

78. *See supra* note 77.

79. *See* Midland Ins. Co. v. Kemper Reinsurance Co., 590 N.E.2d 1186 (N.Y. 1992), a New York decision that has had much national influence.

80. *See supra* Part I.

2. New York Case Law

New York addressed the specific application of its offset statute to reinsurers in *Midland Insurance Co. v. Kemper Reinsurance Co.*[81] In that case, New York's highest court held that a reinsurer was authorized to offset money owed to an insolvent insurer under a reinsurance contract against amounts owed to it for premiums under a separate contract.[82] Even though the premiums owed were under a separate contract, the court determined that the two debts constituted "mutual obligations" and thus satisfied the offset provision.[83] This case serves as a broad interpretation of an offset statute's application to reinsurers.

In *Midland*, the reinsurer owed Midland, the insurer, $750,000 in reinsurance proceeds while Midland owed the reinsurer unpaid premiums that allegedly exceeded the amount owed under the reinsurance contract.[84] Under the contract, the reinsurer was obligated to pay reinsurance proceeds due notwithstanding Midland's subsequent insolvency.[85] The court's reasoning implicitly indicates that the "transfer of risk" issue did not factor into the analysis.[86] The court reasoned that "[t]he reinsurer does not assume liability for losses paid . . ., its only obligation is to *indemnify* the primary insurer."[87] The court also stressed the analogy to offset in bankruptcy law as an influential factor.[88]

Nationally, *Midland* is cited often.[89] States either take the New York approach or an opposite, more progressive approach that will be explored later in this subsection. The heart of *Midland* is the court's perspective on the general role of reinsurance as a policy of indemnification.[90] Does this

81. 590 N.E.2d 1186 (N.Y. 1992). This case arose when the reinsurance company, Kemper Reinsurance, sought a declaration that New York insurance law authorized it to offset money it owed Midland under a reinsurance agreement against amounts Midland owed it for premiums under a *separate* contract. *Id.* at 1187-88.

82. *Id.* at 1192.

83. *Id.* at 1193.

84. *Id.* at 1188.

85. *Id.*

86. *See id.*

87. *Id.* ("Typically, reinsurance permits a small insurer to minimize its exposure to catastrophic loss by the distribution of its risks to another insurer or group of insurers.").

88. *Id.* at 1189. With regard to the legislative history of the offset statute, "an explanatory memorandum to the Legislature . . . stated that section 420 (the predecessor to section 7427) was patterned after the conventional provisions commonly found in insolvency laws and the provisions of the Bankruptcy Act." *Id.*

89. *See* Bennett v. Liberty Nat'l Fire Ins. Co., 968 F.2d 969, 972 (9th Cir. 1992); Prudential Reinsurance Co. v. Superior Court, 842 P.2d 48, 53 (Cal. 1992); Sloan v. Kubitsky, No. 309810, 1996 Conn. Super. LEXIS 2520, at *10 (Conn. Super. Ct. Sept. 23, 1996).

90. *See Midland*, 590 N.E.2d at 1188.

mean that reinsurance does not have to be "insurance" per se? The court seems to indicate that reinsurance merely fills in the gap between the reserves and the excess, however necessary. An *explicit* insolvency clause, obligating the reinsurer to pay claims in the case of insolvency, did not even defeat the reinsurer's "right" to offset, and neither did policy considerations.[91] The court seemingly concluded that the reinsurer's rights abrogated all others; even the rights of New York's own Department of Insurance.[92]

3. California—The *Pru Re* Case and an Important Dissent

California's statutory offset provision is duplicative of both New York's and Florida's.[93] The reinsurance provision is like New York's in that it is a technical handbook dictating when a ceding insurer may take reserve credits.[94] California, also like New York, incorporated only a few NAIC rules into the insurance code.[95] It is not surprising then that the California Supreme Court followed the logic of *Midland*.[96]

In *Prudential Reinsurance Co. v. Superior Court*,[97] (*Pru Re*) the Insurance Commissioner brought suit against various reinsurers on behalf of a group of insolvent insurers to compel payment into the liquidation estate of all reinsurance proceeds owed, without any offset credit.[98] Again, the reinsurance contract was treated as primarily an indemnity contract—the reinsurer had no duty to the actual insured.[99] The court noted

91. *Id.* at 1192 ("[W]ere we to adopt defendant's construction of the insolvency clause the reinsurer's right to offset granted by section 7427, would be nullified in every liquidation proceeding where a ceding company elected to include the clause in its reinsurance contract.... Nothing in the language of section 1308(a)(2)(a) or its history... support the conclusion that the statute was enacted to destroy a reinsurer's right of offset....").

92. *See id.*

93. *See* CAL. INS. CODE § 1031 (West 1999). Section 1031 provides in pertinent part that: "In all cases of mutual debts or mutual credits between the person in liquidation under Section 1016 and any other person, such credits and debts shall be set off and the balance only shall be allowed or paid ...." *Id.; see also* Prudential Reinsurance Co. v. Superior Court, 842 P.2d 48, 57 (Cal. 1992) (acknowledging that the New York offset statute is identical).

94. *See* CAL. INS. CODE § 1031.

95. *See id.* § 922.4. The statute is an incredibly detailed guidebook regarding when credit for reinsurance shall be allowed. *Id.* But, despite over fifty subsections, the statute does not address risk transfer.

96. *See* Prudential Reinsurance Co. v. Superior Court, 842 P.2d 48, 63 (Cal. 1992).

97. 842 P.2d 48 (Cal. 1992).

98. *Id.* at 51-52.

99. *Id.* at 52. "Reinsurance contracts, as contracts of indemnity, operate to shift a part of the risk of loss under the insurance policy from the original insurer to the reinsurer." *Id.* (quoting 1 CALIFORNIA INSURANCE LAW AND PRACTICE, REINSURANCE § 11.01 (1991)).

that California's statutory offset provision is identical to that of New York and several other states.[100]

The reinsurance contracts at issue in *Pru Re*, like the contract in *Midland*, contained explicit insolvency clauses.[101] Citing *Midland*, the court held that the reinsurance contracts executed prior to the entry of order of liquidation were "preliquidation debts," against which the reinsurer was entitled to offset past-due premiums (premiums for future coverage based on past claims).[102] The court distinguished *Melco* because that case did not discuss the effect of an insolvency setoff statute on the issue.[103] Like the *Midland* court, this court relied on the analogy to bankruptcy law in its reasoning.[104]

In his dissent, Justice Kline criticized the majority for elevating the "economic interests of reinsurers over the . . . superior rights of policyholders . . . ."[105] Kline accused the majority of granting offset to the reinsurers simply because of the offset provision of the insurance code.[106] The flaw in the majority's reasoning, according to Kline, was that if you looked to "the whole system of law," the Code did not in fact grant such a right to reinsurers.[107] Reading the offset provision in conjunction with the priority of claims provision,[108] Kline concluded that the Legislature "expressed its specific intent to subordinate the rights of reinsurers to those of policyholders."[109] Finally, Kline emphasized strong public policy, and a general notion of fairness, to discredit the majority's conclusions. "Because the public interest is implicated in reinsurance contracts . . . such contracts may not be considered pure indemnity contracts . . . ."[110]

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100. *Id.* at 50.

101. *Id.* at 57. California's reinsurance provision explicitly requires all reinsurance agreements to contain an insolvency clause, "allowing the liquidator to collect from the reinsurer the amount that would have been due if the ceding company had not become insolvent." *Id.*

102. *Id.*

103. *Id.* at 58. The Insurance Commissioner relied on *Melco Sys. v. Receivers at Trans-American Ins. Co.*, 105 So. 2d 43 (Ala. 1988), contending that the insolvency clause "destroy[ed] contemporaneous mutuality and, hence, prevent[ed] setoff." *Id.*

104. *Prudential Reinsurance Co.*, 842 P.2d at 54 (citing Carr v. Hamilton, 129 U.S. 252 (1889), as the first case to draw the connection between offset in bankruptcy and insurer insolvency). "The *Carr* decision was based on the premise that any contractual creditor of the insurer in liquidation should be allowed to set off mutual debts created by contract before the insolvency occurred." *Id.*

105. *Id.* at 65 (Kline, J., dissenting).

106. *Id.* Judge Kline thinks that ultimately the court, and not the Legislature, "carries the day for the reinsurers." *Id.*

107. *Id.*

108. *Id.*

109. *Id.* at 67.

110. *Id.* at 72 (quoting Bluewater Ins. Ltd. v. Balzano, 823 P.2d 1365, 1368 (Colo. 1992)). Because policyholders have no direct right of action, Judge Kline advocated that the court should

B. Progressive Movements Away from Allowing Reinsurer Offset

A few states, consistent with explicit provisions in their insurance codes, do not allow reinsurers to offset unpaid claims. The central reason for denying offset lies in the "transfer of risk" doctrine. As the following cases will demonstrate, public policy discourages the respective courts from treating reinsurance policies as mere indemnity contracts.

1. Colorado and the *Balzano* Case

Section 10-3-529 of Colorado Statutes, governing setoffs, includes a provision that specifically prohibits setoff where "the person or the insurer has assumed risks and obligations from the other party and then has ceded back to that party substantially the same risks and obligations."[111] Thus Colorado, unlike other states explored so far, has a notion of risk transfer written into its offset statute.[112] Colorado's reinsurance provision, found in section 10-3-118 of Colorado Statutes, establishes that "[n]o credit shall be allowed . . . [w]here the reinsurance contract does not result in the *absolute* transfer to the reinsurer of risk or liability."[113] This section also contains an insolvency clause, worded similarly to the New York and California clauses. It requires that reinsurance must be payable "without diminution due to the insolvency of the ceding insurer."[114]

It was against this backdrop that the Colorado Supreme Court issued a landmark decision in 1992. In *Bluewater Insurance Ltd. v. Balzano*,[115] the court concluded that, reading the statutory provisions together, the Colorado Legislature *required* reinsurers to pay policy liabilities in full, "thus abrogating any right of the reinsurer to offset unpaid premiums from

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"enhance the power of the Commissioner of Insurance, as liquidator, to protect the public against overreaching reinsurers by enforcing section 922.2." *Id.*

111. COLO. REV. STAT. § 10-3-529(2)(f) (1999).

112. This is not necessarily the clearest notion, though. Subsection (2)(f) of the statute is *very* awkwardly worded. Subsection (2) indicates:

> No setoff shall be allowed in favor of any person where: . . . (f) The person ceded to the domestic insurer, whose capital and surplus was at the time of the cession less than twenty million dollars, and the obligations between the person and the insurer arise from business which is both ceded to and assumed from the insurer; except that the commissioner may, with regard to such business, allow certain setoffs if appropriate . . . .

Id. § 10-3-529(2)(f). Immediately following this language is the passage regarding risk transfer cited in the text accompanying this footnote. *Id.*

113. COLO. REV. STAT. § 10-3-118(3)(c) (1999) (emphasis added).

114. *Id.* § 10-3-118(3)(b).

115. 823 P.2d 1365 (Colo. 1992).

the reinsurance proceeds due."[116] The petitioners in *Balzano* were a group of reinsurance companies that provided reinsurance to a primary insurer licensed in Colorado.[117] The insurer agreed to pay a certain percentage of its premium to the reinsurers in advance installments.[118] In 1984, the Colorado Insurance Commissioner determined that the insurer was insolvent and began liquidation proceedings.[119] Petitioners immediately claimed that any claims owed to the insolvent insurer should be offset by unpaid premium.[120]

The court approved the trial court's finding that the reinsurer was not entitled to offset unpaid claims.[121] Authority for the court's conclusion was found in two concepts: 1) the insolvency clause in the reinsurance statute, and 2) the power of the commissioner to interpret the "absolute transfer" clause in the same statute.[122] If the reinsurers in this case were allowed to "offset Aspen's five quarters of unpaid premiums from the sums due on the reinsured policies, the transfer of risk would be less than absolute while the credit against reserves would be absolute."[123]

The commissioner's power to disallow offsets is derived from his or her authority under the absolute transfer clause, and disapproval of this particular reinsurer's claimed offset rights "gives sensible effect to the statute."[124] Permitting offset would, according to the court, defeat the main objectives of the statute, which is "namely, increasing the underwriting capacity of the ceding insurer while simultaneously protecting the insured public."[125] Diminishing the assets of the insolvent insurer would be contrary to the best interests of policyholders.[126]

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116. *Id.* at 1366. The court affirmed the trial court's decision, granting summary judgment to the Colorado Insurance Commissioner. *Id.* at 1376.

117. *Id.* at 1368.

118. *Id.* at 1368. Aspen, the insurer, issued primary coverage to Caterpillar dealerships, including Caterpillar's workers' compensation insurance. *Id.* Aspen expanded and started writing fire, property and casualty coverage in 1979, at which point they entered into this reinsurance agreement with the defendants. *Id.*

119. *Id.* at 1369.

120. Id.

121. *Id.* at 1376.

122. *Id.* at 1372, 1374.

123. *Id.* at 1372.

124. *Id.*; *see also* Farmers Group, Inc. v. Williams, 805 P.2d 419, 422 (Colo. 1991); Martinez v. Cont'l Enters., 730 P.2d 308, 315 (Colo. 1986) (holding that "[a] statute is to be construed as a whole to give a consistent, harmonious and sensible effect to all its parts"). "[E]ven assuming the insolvency clause standing alone is not the best basis for excluding the right to offset, the statutory requirement of an absolute transfer of risk and liability is effectuated by the exclusion." *Balzano*, 823 P.2d at 1372-73.

125. *Balzano*, 823 P.2d at 1372.

126. *Id.*

The court also discussed its view of the purpose of the insolvency clause, which is an integral part of most states' reinsurance statutes.[127] Before *Balzano*, the general notion was that the intent of the insolvency clause was not to abrogate the right to offset "but simply to overcome *Fidelity & Deposit Co. v. Pink*" and cases similar to it.[128] *Pink* was a 1937 United States Supreme Court decision wherein the Court held that a reinsurance contract was one of indemnity rather than liability.[129] Characterizing reinsurance in this way "resulted in windfalls for insurers in cases of insolvency," because reinsurers were only obligated to indemnify payments that were actually made by the insurer.[130] The Colorado court in *Balzano* concluded that the clause was not only meant to correct *Pink*, but also was intended to change the very nature of the reinsurance contract.[131] "The statutory requirement makes a reinsurance contract . . . less a contract of indemnity and more a contract of liability enforceable by the receiver."[132]

Balzano has proven to be an influential case on the offset issue nationwide.[133] It defines the other school of thought, diametrically opposed to New York's *Midland* decision. The next subsection will briefly examine two other western states, one of which has followed *Balzano* and the other of which created some of the notions that the *Balzano* court ultimately relied on.

2. Oklahoma and Missouri

In the 1998 case of *State ex rel. Crawford v. Guardian Life Insurance Co.*,[134] the Oklahoma Supreme Court held unequivocally that a reinsurer's right to offset obligations to pay claims against the right to receive premiums is eliminated where the reinsurance agreement does not truly transfer risk.[135] This was a reflection of Oklahoma's offset provision,

127. *Id.* at 1371.

128. *Id.* (citing Fidelity & Deposit Co. v. Pink, 302 U.S. 224 (1937)). In *Pink*, the Court held that a reinsurer must only indemnify a ceding insurer for payments that in fact were made by a ceding insurer to an insured for claimed losses. *Pink*, 302 U.S. at 229. Thus, any protection from the reinsurer to policyholders was easily defeated by the insolvency of the primary insurer; payments not made were not indemnified. *Id.*

129. *Pink*, 302 U.S. at 229.

130. *Balzano*, 823 P.2d at 1371.

131. *Id.* at 1371-72.

132. *Id.* at 1372.

133. *See* Stonewall Ins. Co. v. Argonaut Ins. Co., 75 F. Supp. 2d 893, 910 (N.D. Ill. 1999); First Am. Ins. Co. v. Commonwealth Gen. Ins. Co., 954 S.W.2d 460, 465 (Mo. Ct. App. 1997); Frontier Ins. Serv. v. State, 849 P.2d 328, 331 (Nev. 1993).

134. 954 P.2d 1235 (Okla. 1998).

135. *Id.* at 1237.

which is contained in the insurance code.[136] The statute was amended in 1988 in response to public pressure to protect policyholders.[137] The legislation was applied in lower court cases, but not until *Guardian Life* did the Oklahoma Supreme Court have an opportunity to interpret the application of the amended statute.[138]

In *Guardian Life*, the court concluded that a reinsurance agreement between the insurer and reinsurer was structured merely to mask the insurer's financial weakness.[139] The policy was a lending agreement, "structured to avoid reasonable risk transfer and indemnification criteria."[140] Thus, the Oklahoma offset statute specifically prevented Guardian from offsetting unpaid claims against unpaid premiums.[141]

After the *Guardian Life* decision, in 1999, the Oklahoma Legislature again amended the offset statute. In this amendment, all specific references to reinsurers were deleted.[142] The new provision prohibits offset by any "person" if the obligation to be offset arose from "business" with the insurer that failed to transfer risk.[143] Essentially, the legislature expanded the offset provision to cover all parties engaged in loaning security rather than truly insuring the insurer. This highlights the relative importance that Oklahoma places on the "meaningful transfer of risk" in offset analysis.[144]

The State of Missouri's insurance code contains one of the most prohibitive offset provisions in the country, as it applies to reinsurers.[145] The provision prohibits *all* offsets arising from "reinsurance relationships resulting in business which is both ceded to and assumed from the insurer."[146] For many years, no right of offset existed at all in the Missouri Insurance Code and proposed statutes were met with repeated rejection because of the strong public policy interest in protecting insureds.[147] The decision in *Allendale Mutual Insurance Co. v. Melahn*,[148] which arose prior to the enactment of Missouri's offset provision, indicates that the

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136. *See* OKLA. STAT. tit. 36, § 1928 (1997).

137. *Guardian Life*, 954 P.2d at 1237. "The parties agree that the purpose of § 1928.B.4 was to avoid granting a reinsurer a post-insolvency right to setoff where the true purpose of the reinsurance agreement had been to lend or rent surplus in order to allow an insurer to mask its financial weakness." *Id.*

138. *Id.* The ultimate issue the court faced was whether the statute applied retroactively. *Id.*

139. *Id.*

140. *Id.*

141. *Id.*

142. *See* OKLA. STAT. tit. 36, § 1928 (1999).

143. *Id.* § 1928(B)(6).

144. *See id.*

145. *See* MO. REV. STAT. § 375.1198 (1999).

146. *Id.* § 375.1198, at 2(6).

147. *See* Allendale Mut. Ins. Co. v. Melahn, 773 F. Supp. 1283, 1286-87 (W.D. Mo. 1991).

148. 773 F. Supp. 1283 (W.D. Mo. 1991).

current provision likely codified the common law approach with regard to reinsurers.[149]

In *Melahn*, which was cited by the Colorado Supreme Court in *Balzano*,[150] a construction worker was severely injured when a crane fell on him at a job site.[151] The injured worker began collecting payments from his workers' compensation insurer, Transit.[152] Six months later, Transit was declared insolvent and payments ceased.[153] The worker sued American Reinsurance (Am Re), who insured excess claims above Transit's reserves.[154] Am Re interpled the Receiver for Transit, who had also made a demand for those same reinsurance proceeds.[155] The District Court held that the reinsurance proceeds could not be paid to anyone but the Receiver.[156]

Am Re then amended its complaint, claiming that any reinsurance proceeds it must pay to the Receiver should be reduced by the amount of unpaid premiums by Transit.[157] The basis for offset, according to Am Re, was found in the policies themselves, which indicated that offset was allowed in accordance with New York insurance law.[158] The Receiver moved to dismiss the claim because Missouri did not have an offset provision in its insurance code, nor did it recognize a common law right to offset.[159]

The court concluded that no express provision existed in the Missouri code, nor did the cases cited by Am Re suggest that a common law right to offset existed.[160] In fact, Am Re failed to locate a single Missouri case that allowed offset.[161] Am Re finally requested that the court give effect to

149. *See id.* at 1287. "The cases cited by American Re are not persuasive on this issue because they either involve non-insurance insolvency situations, arose before the McCarran-Ferguson Insurance Regulation Act, . . . or are from states that have expressly enacted set-off statutes." *Id.* Essentially, the statute codified the Missouri court's interpretation that offset was not permitted, based on tertiary case law that did not "fit" into Missouri's current statutes.

150. Bluewater Ins. Ltd. v. Balzano, 823 P.2d 1365, 1373 (Colo. 1992).

151. *Melahn*, 773 F. Supp. at 1284-85.

152. *Id.* at 1285.

153. *Id.* "Transit was declared insolvent and placed in receivership by order of the Circuit Court of Cole County, Missouri." *Id.*

154. *Id.*

155. *Id.*

156. *Id.* Based on this conclusion, the trial court entered a permanent injunction against payment of the reinsurance proceeds to anyone but the Receiver. *Id.*

157. *Id.*

158. *Id.* The court then analyzed the choice of law issue in order to determine whether Missouri should apply New York statutory law. *Id.* at 1286. The court concluded that Missouri law controlled on this issue because Missouri is Transit's state of incorporation and domicile. *Id.*

159. *Id.* at 1285.

160. *Id.* at 1287.

161. *Id.* The court focuses on the important influence of the McCarran-Ferguson Insurance

the offset provision in the reinsurance contract itself.[162] The court refused to do so, holding that it would offend the Missouri public policy against offset and would give Am Re a superior priority to other creditors, contrary to explicit statutory provisions.[163]

This subsection has highlighted three states that adamantly oppose reinsurer offset for several reasons, including public policy, treatment of the reinsurance contract as one of liability rather than indemnity, and the resulting mis-prioritization of creditors' rights. Colorado, and those states that follow the *Balzano* decision, particularly oppose offset in the context of a reinsurance policy that fails to transfer risk.[164] Missouri opposed reinsurance offset to the point where it disallowed offset despite the total *silence* on the issue in its Insurance Code.[165]

IV. FLORIDA REVISITED—WHAT MIGHT BE DONE AND WHAT SHOULD BE DONE

This Part will hypothesize as to whether Florida law, as it currently stands, will permit or prohibit reinsurers to offset unpaid claims against unpaid premiums. Subsection A will present reasons why Florida courts will apply the *Midland* analysis and hence will permit practically all offsets. Subsection B will provide equally persuasive reasoning that the Florida judiciary will follow *Balzano* and prohibit offset when the underlying policy is of the payback variety addressed in this Note. Finally, Subsection C will present the author's proposed legislation for resolving this issue at the source, i.e., when the contract is made for reinsurance.

A. *Why Florida Courts Would Allow Reinsurers to Offset Unpaid Claims*

To predict that Florida courts will follow the path laid by *Midland*, one has to look no further than the similarities between the Florida, New York and California Insurance Codes. Offset provisions in all three states are practically identical. The key to these offset provisions is merely that the obligations to be offset were mutual. New York and California both discounted the "lack of mutuality" argument.[166] Both *Midland* and *Pru Re*

Regulation Act, 15 U.S.C. § 1011-15 (1976), which was a federal government act dictating that state law trumps federal law with regard to insurance. *Melahn*, 773 F. Supp. at 1287.

162. *Melahn*, 773 F. Supp. at 1288.

163. *Id.* at 1287. "To allow American Re to set-off the unpaid premiums against the reinsurance proceeds owed to Transit would conflict with the statutory priority of claims set forth in [section] 375.700 [of Missouri Revised Statutes]." *Id.*

164. *See supra* notes 111-33 and accompanying text.

165. *See supra* notes 145-63 and accompanying text.

166. *See* Midland Ins. Co. v. Kemper Reinsurance Co., 590 N.E.2d at 1186, 1191 (N.Y. 1992)

held that the debts to be offset were "preliquidation debts," despite the similarities between the reinsurance contracts in these cases and in the *Melco* case, where the Alabama Supreme Court classified such contracts as creating post-liquidation obligations.[167]

Midland focused almost exclusively on the legislative intent behind the offset provisions contained in the insurance code.[168] *Pru Re* explicitly distinguished *Melco* because Alabama did not have an offset statute at the time that decision was rendered.[169] In *Pru Re*, the offset statute even trumped an insolvency clause expressly written into the reinsurance contract.[170] Thus, since the Florida offset provision is essentially identical to New York's and California's, a persuasive argument can be made that Florida judges will simply allow any offsets because the statute expresses a desire by Florida citizens that judges do so.[171]

The analogy to bankruptcy offset is another factor that influenced both New York and California justices. Florida too has a right to offset in bankruptcy proceedings, as indicated in the *Patterson* case discussed in Part II.[172] Again the concept of mutuality guides offset in the bankruptcy context. Though the analogy may be more tenuous in Florida, because *Patterson* seems to strictly apply the mutuality requirement,[173] the mere fact that the right does exist may be an additional factor that weighs in favor of the argument that Florida courts will permit reinsurance offsets.

(concluding that the contractual obligations were mutual for purposes of offset despite the fact that they arose out of "two separate and distinct transactions"); Prudential Reinsurance Co. v. Superior Court, 842 P.2d 48, 63 (Cal. 1992) (holding that reciprocal reinsurance contracts are per se mutual credits and debts).

167. Melco Sys. v. Receivers at Trans-America Ins. Co., 105 So. 2d 43, 53 (Ala. 1958).

168. *Midland*, 590 N.E.2d at 1191. "[T]he Legislature has resolved the competing concerns and recognized offsets as a species of lawful preference." *Id.*

> Insurance Law § 1308 . . . was enacted in response to the Supreme Court's decision in Fidelity & Deposit Co. v. Pink. . . . [The section] was intended to overcome that decision by altering the indemnity nature of a reinsurance contract when the ceding company becomes insolvent. . . . Nothing in the language of § 1308 . . . or its [legislative] history, however, support[s] the conclusion that the statute was enacted to destroy a reinsurer's right of offset . . . .

Id. at 1191-92.

169. *Pru Re*, 842 P.2d at 58.

170. *Id.*

171. The key fault that Judge Kline found in the majority's opinion in *Pru Re* was that the court permitted offset solely because the offset statute generally permits it. *Id.* at 65 (Kline, J., dissenting). Judge Kline stressed the importance of analyzing the "whole system of law" to properly resolve this issue. *Id.*

172. *See In re* Patterson, 967 F.2d 505, 508-09 (11th Cir. 1992).

173. *Id.* at 507. The defendant debtors' loan was *secured* by the accounts that the plaintiff sought to offset. *Id.*

Finally, in *Barnett*, a Florida court indicated that the priority of claims issue and the offset provision do not conflict.[174] The *Barnett* court permitted the bank, a creditor of the insolvent insurance company, to offset mutual debts.[175] This holding suggests a pecking order within these two concepts, with the right to offset outweighing priority of claims. This too was the approach of both the *Midland* and *Pru Re* courts.[176] Although acknowledging that permitting reinsurers to offset mutual debts gave the reinsurers priority over creditors who, under the claims priority provision, ranked higher in priority, both New York and California concluded that such a conflict did not defeat the right to offset.[177] In light of Florida's *Barnett* decision, it seems likely that Florida courts would adopt the same reasoning.

But, a key element this hypothetical overlooks, one which the author hopes Florida courts will not overlook when they are faced with this issue, is that Florida's reinsurance provision differs markedly from both California's and New York's. In particular, Florida's provision acknowledges the notion of risk transfer.[178] Florida's Administrative Code adopts NAIC standards that also indicate, for accounting purposes, the necessity that insurance accomplish a transfer of risk if insurers are to benefit from reserve credits.[179] In light of this distinction, the question arises whether Florida would, like New York and California, treat reinsurance as merely a contract of indemnity or as a contract of liability.[180]

174. Barnett Bank at Jacksonville v. Dep't.of Ins., 507 So. 2d 142, 144 (Fla. 1st DCA 1987).

175. *Id.*

176. *See supra* Part III.A.

177. *See* Midland Ins. Co. v. Kemper Reinsurance Co., 590 N.E.2d 1186, 1191-92 (N.Y. 1992); *Pru Re*, 842 P.2d at 57.

178. *See* FLA. STAT. § 624.610(1) (2000).

179. *See supra* note 39 and accompanying text.

180. The author submits that after close analysis of all pertinent case law, an argument can be made that the indemnity/liability classification of reinsurance is the key issue in determining the right to offset. And, underlying the distinction between the two classifications is the underlying public policy of each state. For example, there seems to be strong policy pressure that Colorado's ultimate concern is to protect individual policyholders. *See* Bluewater Ins. Ltd. v. Balzano, 823 P.2d 1365, 1376 (Colo. 1992). Thus the Colorado courts characterize reinsurance as a contract of liability and prohibit offset. *Id.* at 1372-73. These same pressures may not weigh on the New York Insurance Commissioner, as many reinsurance companies have their principle places of business in New York. Thus, New York courts refer to reinsurance as a mere contract of indemnity, and allow offset. *See Midland*, 590 N.E.2d at 1193.

B. *Why Florida Courts Should Not Allow Reinsurers to Offset Unpaid Claims*

There are three persuasive arguments as to why Florida courts should follow *Balzano* and prohibit offset if the underlying reinsurance policy failed to transfer risk of loss to the reinsurer. First, the Florida reinsurance statute shares some characteristics with the Colorado statute: namely, it contains a risk transfer doctrine.[181] Next, the analogy to bankruptcy offset may actually weigh in favor of *disallowing* offset in the reinsurance context. Third, if the offset provision is read within the "whole system of law," as suggested by Judge Kline in his dissent in *Pru Re*,[182] it can be argued that the Florida Legislature expressed an implicit intent to subordinate the rights of reinsurers to the rights of policyholders. When these three arguments are taken together, Florida should not ignore the public policy interest of protecting policyholders, and should treat the reinsurance contract as one of liability, rather than one of indemnity.

Both the Florida and Colorado statutory reinsurance provisions prohibit credit for reinsurance if the agreement fails to create a meaningful transfer of risk of loss to the reinsurer.[183] Additionally, both provisions have an insolvency clause with identical language, indicating that an insurer may only recognize reserve credits if the reinsurance is payable "without diminution due to the insolvency of the ceding insurer."[184] Essentially, insolvency in no way defeats the obligation of the reinsurer to continue to pay claims. If the reinsurance agreement negates this obligation, then no reserve credit may be realized.[185]

The Colorado Supreme Court in *Balzano* concluded that the risk transfer provision empowered the insurance commissioner to prohibit offset of reinsurance payable in situations where the agreement failed to transfer risk.[186] The court also gave much weight to the insolvency clause, and its purpose of protecting the insured public.[187] Neither New York's nor California's reinsurance provisions contain risk transfer provisions, although they do both include an insolvency clause.[188] Although Colorado's offset provision also contains a risk transfer clause, the *Balzano* court focused on the reinsurance statute as the critical tool that the insurance commissioner could utilize to prohibit offset.[189] Therefore, since

181. *See* FLA. STAT. § 624.610(1).
182. *Pru Re*, 842 P.2d at 65 (Kline, J., dissenting).
183. *See* COLO. REV. STAT. § 10-3-529(2)(f) (1999); FLA. STAT. § 624.610(13).
184. COLO. REV. STAT. § 10-3-118(3)(b); FLA. STAT. § 624.610(8).
185. *See supra* note 184.
186. Bluewater Ins. Ltd. v. Balzano, 823 P.2d 1365, 1376 (Colo. 1992).
187. *Id.* at 1372-73.
188. *See supra* notes 70-79, 93-96 and accompanying text.
189. *Balzano*, 823 P.2d at 1372-73.

Florida's reinsurance provision contains practically identical language as Colorado's, Florida's Insurance Commissioner should also have the power to prohibit reinsurers from offsetting their obligation to pay claims.[190]

New York and California, in *Midland* and *Pru Re* respectively, gave much weight to the analogy to bankruptcy law, which permits offset of mutual obligations.[191] Florida law also recognizes such offset.[192] But, the Eleventh Circuit put its own gloss on the right to offset in the case in which it adopted that provision of the Bankruptcy Code.[193] In *Patterson*, the court strictly interpreted the mutuality obligation.[194] The defendant debtors' loan was *secured* by the accounts that the plaintiff sought to offset.[195] If a loan and an account serving as collateral to that loan are not mutual obligations, it is difficult to imagine what the Eleventh Circuit would consider "mutual." Implicit in the *Patterson* decision is the desire by the court to protect the party that has the lesser bargaining power.[196]

Looking at the insurer/reinsurer relationship through a wider lens, the reinsurance policy is essentially added protection for individual insureds. Although there is legally no privity between the insureds and the reinsurer,[197] there is an undeniable relationship. Insureds implicitly rely on reinsurers to step in and pay claims if the insurer is insolvent. Individual insureds have no way of protecting themselves[198] from unreasonable

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190. This notion was the ultimate ground for the decision in *Balzano* that the Insurance Commissioner had the power to permit or prohibit offset (although the court strongly suggested that the Commissioner should deny offset in all situations similar to the facts of *Balzano*). *Id.*

191. *See supra* Part III.A.

192. *See supra* notes 55-69 and accompanying text.

193. *See In re* Patterson, 967 F.2d 505, 514 (11th Cir. 1992).

194. *Id.* at 510-11.

195. *Id.* at 507. "The promissory note on that loan [at issue] provides that the Pattersons' checking and savings account serve as security for the loan." *Id.* The Credit Union froze these checking and savings accounts. *Id.*

196. *Id.* at 510. The court focuses on the fact that the creditor plaintiff unilaterally made the determination to freeze the defendant debtors' account. *Id.*

197. *See* Charles F. Corcoran, III, *Reinsurance Litigation: A Primer*, 16 W. NEW ENG. L. REV. 41, 43 (1994). "The original insured is not a party to the reinsurance agreement and there is no privity of contract between the original insured and the reinsurer." *Id.* at 42. The contractual exception to the privity rule is referred to as a "cut through" clause. *Id.* at 43. Some reinsurance contracts are drafted with such a clause, which "permits an original insured to bring an action directly against a reinsurer." *Id.* But not surprisingly, "reinsurers will be reluctant to incorporate a cut through clause into a reinsurance contract, unless substantial premiums are involved." *Id.*

198. Associate Professor Grace Giesel of the University of Louisville offers a novel solution to this problem. She proposes providing a tort remedy for insureds against reinsurers. Grace M. Giesel, *A Proposal for a Tort Remedy for Insureds of Insolvent Insurers Against Brokers, Excess Insurers, Reinsurers and the State*, 52 OHIO ST. L.J. 1075, 1079 (1991). "If . . . all parties to the insurer insolvency situation, with the exception of the insured, are potentially liable, the protection of the insured is maximized." *Id.* at 1117-18. But, no court has ever held that reinsurers owe a tort duty to owners of insurance policies. *Id.* at 1075.

reinsurance provisions, such as ones that generate excessive payback debt. Thus, in considering whether reinsurers are permitted to offset obligations with an insolvent insurer, Florida may recognize the analogy to offset in bankruptcy law.[199] But, Florida courts should recognize *Patterson* and its implicit protection of the party with unequal bargaining power.[200] If a reinsurance agreement generates an unreasonable payback premium and offsetting this premium against unpaid claims harms policyholders, courts should recognize the bankruptcy analogy as prohibiting such offset.

Finally, the offset provision should be read within the "whole system of law," as suggested by Judge Kline in his dissent in *Pru Re*.[201] Judge Kline suggested that the offset issue could not be resolved by focusing solely on the offset provision itself.[202] At the very least, the offset provision must be read in conjunction with the priority of claims provision.[203] Florida's reinsurance provision should also be read into this analysis. When the offset provision and the reinsurance provision are taken together, it is reasonable to perceive an intent by the Florida Legislature to prohibit offset where the reinsurance agreement fails to transfer risk. If a reinsurance agreement is not given credit if it fails to transfer risk, why would premiums generated by that same policy be permitted to be offset against unpaid claims? Also, if the whole system of law includes analogous case law, the *Patterson* case and possibly the Alabama *Melco* decision should factor into the analysis.[204] Payback premium is probably not a mutual obligation that can be set off against unpaid claims.

C. *Two Proposed Statutory Amendments*

Although there is a possibility that the current Florida law may be interpreted to prohibit reinsurer offset, this author submits that the ultimate solution lies in adding some minor provisions to the Florida statutes themselves. Adding a risk transfer provision to the offset statute, as the Colorado Legislature has done, would leave no question that reinsurance agreements requiring paybacks of most or more of the payout will prohibit reinsurers from offsetting unpaid obligations.[205] More importantly, adding a subsection to the transfer of risk provision of the reinsurance statute that specifically addresses payback policies will prohibit these policies from

199. *See supra* notes 55-69 and accompanying text.

200. *Patterson*, 967 F.2d at 510-11.

201. Prudential Reinsurance Co. v. Superior Court, 842 P.2d 48, 65 (Kline, J., dissenting).

202. *See id.*

203. *Id.* at 65.

204. *See generally Patterson*, 967 F.2d at 514; Melco Sys. v. Receivers at Trans-America Co., 105 So. 2d 43 (Ala. 1958).

205. *See* COLO. REV. STAT. § 10-3-529(2)(f) (1999).

the outset, and may ultimately serve to protect some insurers from insolvency.

1. Proposed Amendment to Section 631.281 of Florida Statutes, Governing Offsets

Under subsection (2), which states that "[n]o offset shall be allowed in favor of any such person where,"[206] the new subsection (d) should read: "the obligation of the insurer to such person is one in which the person or the insurer has assumed risks and obligations from the other party and then has ceded back to that party substantially the same risks and obligations." This proposed amendment borrows the language of the Colorado provision, which the court in *Balzano* interpreted as prohibiting offset of reinsurance obligations resulting from a reinsurance agreement that failed to transfer any risk.[207] Amending Florida's offset statute to read this way would unambiguously empower the Florida insurance commissioner to prohibit reinsurance offset.

2. Proposed Amendment to Section 624.610 of Florida Statutes, Governing Reinsurance

Subsection (13) of the reinsurance statute is the transfer of risk doctrine. It indicates simply that no credit shall be allowed for reinsurance that does not create a "meaningful transfer of risk of loss to the reinsurer."[208] The subsection also indicates that the NAIC Manual will be the tool to determine whether a transfer of risk has been accomplished.[209] Subsection (12) of the statute indicates that the DOI has the power to cancel any reinsurance agreement that creates a substantial risk of insolvency to the insurer.[210]

A subsection should be added immediately following subsection (13), which the author will refer to as subsection 13.5, that would read as follows:

> The department shall have the power to disallow any reinsurance agreement that requires additional premium upon payment of claims by the reinsurer if such additional premium is equal to or greater than 100% of the claims paid by the reinsurer. The department shall have the power to nullify any existing reinsurance agreements that create this

206. FLA. STAT. § 631.281(1) (2000).
207. Bluewater Ins. Ltd. v. Balzano, 823 P.2d 1365, 1372-73 (Colo. 1992).
208. FLA. STAT. § 624.610(13).
209. *Id.* § 624.610(14).
210. *Id.* § 624.610(12).

> type of payback. The legislature has determined that this type of reinsurance agreement violates subsection (13) of this statute because no risk of loss has been transferred to the reinsurer. The legislature has also determined that this type of reinsurance agreement may create a risk of insolvency to the insurer, in violation of subsection (12) of this statute.

New subsection 13.5 would prevent payback policies from the outset, and may help to protect against insurer insolvency. It would also serve as a warning to reinsurers that offer such policies that the state of Florida will not tolerate these arrangements. This subsection would be the most effective measure to protect Florida insureds. It would prevent Florida courts from having to determine in a litigation setting whether reinsurers have a right to offset. While the judicial process drags on, insureds suffer the ultimate consequence; their claims will not be paid.[211]

V. CONCLUSION

Whether Florida law, as it currently stands, will prohibit the offset of reinsurance premium generated from payback policies is debatable. There are some strong arguments that Florida courts will follow the logic of the Colorado Supreme Court and, in light of Florida's whole system of law, prohibit offset.[212] But, there is reason to believe that Florida will follow New York and California, which permit offset of unpaid claims under practically any circumstance.[213] This is a problem that the Florida Legislature needs to remedy, because reinsurance practices such as those discussed in this Note are occurring. The customers insolvent insurers pay the price when reinsurers attempt to avoid their obligations. The best solution is to legislate at the heart of issue, and amend the Florida reinsurance statute to empower the DOI to prohibit payback policies.

211. And this litigation drags on indeed. In the House of Representatives Subcommittee report, the Subcommittee found that *most* reinsurers do not pay claims when the insurer is insolvent. They instead file a suit seeking a declaration that they no longer have to pay, and then in the meantime search for a legal precedent that will justify the injunction. *See Failed Promises*, *supra* note 12, at 4. The Subcommittee recommended that the federal government get involved and legislate to correct the problem. *Id.* at 70.

212. *See supra* Part III.B.

213. *See supra* Part III.B.