WHAT IS A "PAID LOSS" FOR

INDEMNITY REINSURANCE PURPOSES?

By

Robert M. Hall

[*Mr. Hall is a former law firm partner, a former insurance and reinsurance executive and acts as an insurance consultant as well as an arbitrator and mediator of insurance and reinsurance disputes. The views expressed in this article are those of the author and do not reflect the views of his clients.* *Questions or comments may be addressed to the author at bob@robertmhall.com]*

I. Introduction

The reinsurer's obligation to pay a cedent under a reinsurance contract may be triggered by the liability of the cedent to pay losses or its actual payment of such losses, depending on how the contract is drafted.[1] In some cases, the cedent may be able to bargain for payment based on its liability.[2] However, the vast majority of such contracts today are of the latter variety *i.e.* the reinsurer indemnifies the cedent for its paid losses. The purpose of this article is to examine case law as to what constitutes a "paid loss" for purposes of reinsurance that indemnifies for paid losses.

II. Context

The case law below demonstrates that this issue often arises in a context in which the insured or cedent is in financial difficulty and lacks the wherewithal to front a large claim. Under these circumstances, the insured or cedent may issue a promissory note to the creditor and assign insurance or reinsurance proceeds, respectively, to the creditor. There is little question that reinsurance proceeds can be assigned.[3] However, the question remains as to what triggers the obligation to pay under the assignment.

III. Case Law Supporting a Note as a Paid Loss

The insurer agreed to indemnify the insured for its paid losses in Kennedy v. Fidelity and Cas. Co. of N.Y., 110 N.W. 97 (Minn. 1907). A judgment was obtained against the insured which the insured paid with promissory notes and then sought reimbursement from the insurer. The insurer claimed that no loss had been sustained by the insured since it might become insolvent before the notes became due. The court ruled that the insured had met the "paid loss" obligation:

> Of what consequence is it to the company whether respondent has on hand immediate cash to pay the judgment, or whether the judgment debtor is compelled to borrow that amount on the most favorable terms, or whether he makes the payment and secures the satisfaction by the execution of promissory notes running direct to the judgment creditor? Logically, there is no difference in the method, and in either case it amounts to a payment and satisfaction of the judgment.[4]

Residential Marketing Group, Inc. v. Granite Investment Group, 933 F.2d 546 (7th Cir. 1991) concerned the value of a non-recourse promissory note. The owner of a property heavily indebted to the FSLIC hired a building manager. The building manager contracted to receive a percentage of the proceeds from the sale of the property. The property was purchased with a non-recourse promissory note such that the seller's recourse was to take back the property if the buyer defaulted on the installments. The property owner contended that the basis for the building manager's fee was $0 since the non-recourse promissory note was illusory and worthless given its non-recourse nature and the amount owed to the FSLIC. The court rejected the property owner's argument that the non-recourse note was worthless.

The insured received a liability policy indemnifying it for paid losses, subject to a $1000 deductible, in Liman v. American Steamship Owners Mutual Protection and Ind. Assoc., 299 F.Supp. 106 (S.D.N.Y. 1969) *aff'd* 417 F.2d 627 (2nd Cir. 1969). The insured declared bankruptcy with many personal injury claims outstanding. The trustee proposed to defend and pay appropriate claims out of the remaining assets of the estate but with the $1000 deductible being contributed back to the estate with the claimants assuming general creditor status for such amount in order to avoid an illegal preference. The insurer denied liability under such a scheme arguing that the insured must show that it absorbed the entire loss, including the deductible, for the insurer's indemnity obligations to be triggered.

The Linman court rejected the insurer's arguments. It noted, initially, that there was no evidence of bad faith in the trustee's defense and payment of claims and that the insurer was seeking to benefit itself due to the financial difficulties of its insured. The purpose of the deductible is not to create a condition precedent to reimbursement but to allow the insurer to avoid small claims. Finally, the court stated the manner in which the estate dealt with the deductible is irrelevant to the insurer since the insurer does not pay it.

IV. Cases That Do Not Support a Note as a Paid Loss

Other cases from the second circuit help explain the import of the Liman decision. The first is Oberton v. American Steamship Owners Mutual Protection and Ind. Assoc., 1992 U.S. Dist. Lexis 2183 (S.D.N.Y.). The insured was in bankruptcy. The claimant loaned the insured certain funds and the insured paid such funds

back to the claimant in settlement of the claim. The policy indemnified the insured for paid losses and the insurer contended that no loss was sustained by the insured. The court ruled for the insurer stating:

> Moreover, the procedure adopted in Liman sought only to avoid the payment of a deductible written into the policy. Under the procedure approved by the Liman court, the insured would sustain the requisite good faith loss because all of the claimants would become general creditors of the insured's bankruptcy estate in the amount of the deductible. In contrast, (the insured in this case) sustained no loss at all when it returned to (the claimant), in slightly modified form, the money that it had borrowed from him days before. Accordingly, the arrangement in this action is not the type approved in Liman.[5]

Liman was again distinguished in Prudential Lines, Inc. v. American Steamship Owners Mutual Protection and Ind. Assoc., 158 F.3rd 65 (2nd Cir. 1998). A bankrupt was insured under a policy that indemnified against paid losses. The reorganization plan set aside $300,000 to pay asbestos claimants pursuant to a recycling plan. The $300,000 would be paid to one claimant, which would loan it back to the estate on a non-recourse basis, and then the process would be repeated with all other claimants. The insurer claimed that there no loss was sustained by the insured under such a scheme and the court agreed:

> As Liman notes, "the test in New York is whether the assured has actually in good faith sustained the loss for which reimbursement is sought." (citation omitted) The only detriment assumed by (the insured) vis-à-vis each Claimant is a wholly non-recourse debt, which in financial terms is – and is intended to be – nothing.[6]

Several cases in the fifth circuit examined this issue as well. The first is Stuyvesant Ins. Co. of N.Y. v. Nardelli, 286 F.2d 600 (5th Cir. 1961). The issue in the lower court was whether or not Nardelli, the charterer of a vessel, was an insured under a policy that indemnified for paid loss. The lower court granted summary judgment in favor of Nardelli on this issue but also granted Nardelli a policy limits recovery. The insurer appealed on the basis that the language of the policy required a demonstration of actual losses sustained by the insured. The court agreed with the insurer ruling:

> The language clearly provides that the insurer will not become liable under this section until Nardelli, as charterer, has made some payment and that the insurer is only liable to the extent those payments are made. Before Nardelli can recover under the policy for "damages to any other person nor (sic) persons" it must prove payment in the amount of its recovery. In the proceedings on remand, Nardelli made no proof of payment on the libel judgment.

> Absent such proof, it was error for the district court to enter judgment in its favor for the full face amount of the policy.[7]

In Conoco, Inc. v. Republic Ins. Co., 819 F.2d 120 (5th Cir. 1987) the insured was insolvent and, apparently, completely without assets. The insured, Bonzana, issued a note in favor of a claimant and assigned to the claimant insurance proceeds under a policy that indemnified for paid losses. The insurer argued that Bonzana had sustained no loss and the court agreed:

> The issue is thus distilled to the question of whether Bonzana's execution of the promissory note was an actual expense. . . Liman does not stand for the proposition that "payment" can be made by the use of a promissory note worthless from the day it was executed. By contrast, the Liman court declared that the test "is whether the assured has actually in good faith sustained the loss for which reimbursement is sought." (citation omitted)
> Since the bankrupt assured in Liman was not completely bereft of assets, the Liman court was not faced with the situation we face in this case, where Bonzana is literally incapable of sustaining a loss. At the time the note was executed, Bonzana was not merely insolvent, it had no assets whatsoever.[8]

V. Summary

The case law described above is consistent in ruling that a worthless promissory note paid to a claimant or a ceding company, particularly a non-recourse note, is not a paid loss for purposes of a reinsurance contract or policy indemnifying for paid losses. As noted in the quote from Stuyvesant, *supra*, it would follow that there would be indemnification only to the extent a loss has been paid. Despite some superficial similarities, the Kennedy and Liman cases, *supra*, are factually distinguishable in that the insureds incurred real losses for which they claimed indemnity.

ENDNOTES

1 *Compare* Allemannia Fire Ins. Co. of Pittsburgh v. Firemen's Ins. Co. of Baltimore, 209 U.S. 326 (1908) at 332 *with* Fidelity & Deposit Co. v. Pink, 302 U.S. 224 (1937) at 229.

2 For instance, a member of a reinsurance pool may be induced to issue its paper to front for the pool for licensing or other reasons. Under these circumstances, the fronting reinsurer may argue with some justification that payment by other members of the pool should be functionally simultaneous with that of the fronting reinsurer.

3 *See e.g.* Pine Top Ins. Co. v. Bank of America, 969 F.2d 321 (7th Cir. 1992); Hume v. Nat. Life Ins. Co., 245 S.W. 19 (Ark. 1922).

4 110 N.W. 97 at 98.

5 1992 U.S. Dist. Lexis 2183 *9.

6 158 F.3d 65 at 73.

7 286 F.2d 600 at 603.

8 819 F.2d 120 at 122.