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How Voidable Preferences Can Kill The Perfect Deal

Law360, New York (May 05, 2009) -- There is no doubt that the current global financial crisis is taking its toll on nearly every industry. The insurance industry has not been spared from this crisis, and insurers are taking a hard look at their operations to identify strategies to preserve capital and minimize exposure.

As part of this risk assessment, many insurers are reviewing the credit risk presented by their reinsurance and considering the use of commutations and settlements to alleviate exposure to financially troubled counterparties.

Depending on the circumstances, however, such commutations run the risk of being voided as a preference if the reinsurer subsequently becomes insolvent and is put into liquidation.

Many state insurance statutes limit the ability of a financially impaired insurer to transfer or place a lien upon its assets for the benefit of a creditor if the effect would be to enable the creditor to receive a greater percentage of the insurer's assets in a liquidation proceeding.

In general, these statutes permit a receiver to recover assets transferred by an insurer on account of prior debts, which result in some creditors receiving a preference over other creditors similarly situated. Such transfers are generally referred to as voidable preferences or transfers.

Elements of a Voidable Preference

Voidable preference statutes require the presence of four elements (and in some states five elements) before a transfer may be voided as a preference. Generally speaking, it is the effect of the transaction, rather than the debtor's or creditor's intent, that is controlling.

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Thus, if all elements of a voidable preference are present, the preference can be unwound regardless of the intent of the parties. These elements are as follows:

1) The transfer must involve the property of the insolvent insurer.

2) The transfer must occur during the statutorily defined preference period.

3) The transfer must be made on account of an antecedent debt of the insolvent insurer. Although the "antecedent debt" requirement is not expressly stated in all voidable preference statutes, this requirement generally is implied under common law as an essential element of a voidable preference.

4) The transfer must result in a preference in which a creditor obtains payment of a greater percentage owed to that creditor than what another creditor of the same class would have received from the estate for a similar debt.

Transfers of property made to or for the benefit of an unsecured creditor within the preference period would be preferential if other unsecured creditors falling within the same class of creditors would not receive the same percentage of payment for debts owed to them in a liquidation proceeding as that received by the preferred creditor.

Transfers of property to fully secured creditors generally do not constitute preferences because secured creditors will ordinarily receive the value of the assets held as collateral even in the context of a receivership proceeding.

In addition to these elements, some state statutes require that a receiver establish that the transfer in question was made with an intent to create a preference.

If each of these elements can be established, then a receiver will be permitted to void such a transfer as a voidable preference, unless the transfer falls within one of the common law or statutory exceptions to the general voidable preference rule.

For example, transfers made as part of a contemporaneous exchange for new value or in the ordinary course of business are protected under common law (and in some cases, statutory law) from a preference attack.

A transfer lacking any of the elements of a voidable preference or falling within one of the "safe harbor" exceptions will be unassailable as a preference.

Recommended Course of Action

Although insurers can defend a preference attack on the grounds that a reinsurance commutation constitutes a contemporaneous exchange for new value to the reinsurer (i.e., the reinsurer is relieved of the uncertainty of future adverse loss development on the covered business in exchange for a fixed sum of assets), the strength of this

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defense hinges somewhat on whether the consideration provided to the ceding insurer under the commutation is considered fair and reasonable.

Regulators likely will assume that any transfer of assets under a commutation will diminish the amount of assets available to pay other creditors of the estate.

This is especially true if the commutation deprives assets that otherwise would be available to satisfy claims of creditors in higher claim priority classes such as policyholders.

Apart from the passage of time, there is no bulletproof defense to a preference attack. Nonetheless, certain measures can be taken to reduce the risk that assets received from an insolvent reinsurer will later be recovered as a voidable preference. A few of these measures are as follows:

- In certain states, insurers may be able to seek regulatory approval of a commutation if the reinsurer is deemed to be financially impaired or insolvent. If regulatory approval is granted, the commutation cannot be challenged as a preference.

- As an alternative to a commutation, ceding insurers can attempt to novate and transfer their business from a financially troubled reinsurer to another reinsurer.

- Ceding insurers should not allow large or aged receivables to accumulate with financially troubled reinsurers. Payment of a large or aged receivable by a financially distressed company, whether as part of a commutation or otherwise, can create an easy target for being challenged as a preference.

- Ceding insurers should bill all amounts owed to financially troubled reinsurers on a regular and timely basis. This will help to reduce the size and age of the receivable owed by such reinsurers.

- Ceding insurers should collect all amounts billed to financially troubled reinsurers on a regular and timely basis. Amounts paid by such reinsurers in the ordinary course of business are much more difficult to challenge as a preference.

- Ceding insurers should consider requesting a letter of credit from financially troubled reinsurers in lieu of, or in addition to, holding funds in a trust account.

While letters of credit can be attacked as an indirect preference, this risk is somewhat less than the transfer of assets into a trust account. A letter of credit secured with assets provided by a different entity (e.g., an affiliate of the financially troubled reinsurer) would be best.

- Ceding insurers should (if they cannot get a letter of credit) have financially troubled reinsurers deposit as much collateral as possible into a trust account.

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Although subject to a potential preference attack, collateral deposited into a trust account, to the extent possible, should be characterized as security for incurred but not reported (IBNR) reserves.

Transfers made on account of present or future obligations (i.e., IBNR reserves) are harder to challenge as a preference than transfers made on account of past debts.

- If possible, ceding insurers should characterize all deposits into trust accounts as ordinary transfers made in accordance with the terms and conditions of the underlying agreements.

This approach will help establish a position that such deposits are made in the ordinary course of dealings between the parties. This is a defense to a preference attack.

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