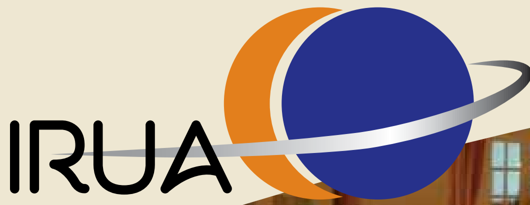

JOURNAL OF REINSURANCE

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INTRODUCTION

The last edition was a tough act to follow but we have compiled four more excellent and varied articles to educate and interest our readers.

Our first article is titled **Regulators, Reinsurers, and ILS: The Road Ahead** and was produced by three Deloitte executives. Andrew Mais is a former Director at the NY Insurance Department and now with the Deloitte Center for Financial Services. Edmond Hardy is a partner with Deloitte Advisory, and David Vacca was at the NAIC and is now a senior advisor at Deloitte. With the rapid growth in cat bonds, the inevitable calls for increased regulatory scrutiny makes this a very timely topic for the *Journal.*

Next up is the first prize winning essay submitted as part of our first-ever Scholars Essay Award Program. As previously advised in the Journal, we revamped our Internship program for 2015 with a change in emphasis away from IRUA sourcing interns for placement with member companies to one whereby member companies select their own interns and encouraged them to apply for this new program. Thanks to wonderful membership support, we raised $15,000 in scholarship funds for 2015 and Katie Martincic's excellent paper on **Drones and Their Impact on the Insurance and Reinsurance Industry** was selected by IRUA's Scholars Committee as the winner. As in past years, we are very pleased to publish the winning essay, submitted by college students interning at member companies. Ms. Martincic attends Temple University in Philadelphia and interned this past summer at Maiden Re in Mt. Laurel, NJ.

Veteran New York attorney, Jim Veach, then offers a not-entirely "tongue-in-cheek" paper entitled **Reinsurers and Receiverships: A Checklist.** Jim is a partner in the well-known and respected New York law firm of Mound, Cotton, Wollan & Greengrass LLP. This entertainingly written article examines a serious subject and attorney Veach offers many good, sensible, and practical tips while fitting his checklist into one page. No mean feat! We are very pleased to have his expertise serving the IRUA through his involvement in our Industry Advisory Panel, whose names appear on page two of this issue. Along with the Journal of Reinsurance Committee of IRUA, this hardworking Panel is responsible for many of the excellent articles we have been privileged to publish in the last few years.

Finally, we are pleased to welcome back another, and we regret, final, article in our popular series **"From the Reinsurance Claims Executive's Corner."**

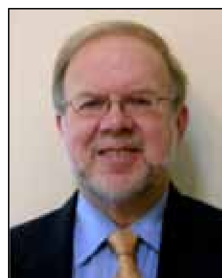
Appropriately, Susan Mack wraps up her series by examining the aptly named Sunset Clause and then the contractual termination of the reinsurance relationship through the Commutation clause. Susan is Special Counsel practicing law with the Jacksonville, Florida office of Adams and Reese LLP . Ms. Mack's "Reinsurance Claims Executive Corner" series will, we are sure, be much in demand as future reference tools and we are extremely grateful to her for the contribution of this series of articles and much appreciative of her ongoing commitment to the *Journal* through her role on our Industry Advisory Panel.

A quick word about IRUA's initial slate of Educational Events for 2016. Following the success of our **Reinsurance Networking Group** lunch, networking and learn meetings held about four times a year, we are now expanding our Education Committee events to include the same format. The first will be held on **February 3rd** and the topic will be **"Cat Bond Mechanics."** The international law firm Hogan Lovells LLP are kindly hosting us at their midtown NYC office. On **March 9th**, a full-day session titled: **"Claims and Underwriting Aspects of Emerging Risks"** will be held in Manhattan. Details of this and all the other great programs in the planning stage for 2016 may be found on our website.

Also on our agenda for 2016 is our **"Annual Members Meeting & Conference"** being held **April 17-19** at the Streamsong Resort, an easy drive from Tampa, Florida. The Program Committee has, as usual, done a superb job in selecting relevant and interesting topics matched with expert speakers. Our 2016 trademark Executive Roundtable will feature Reinsurance Buyers and is sure to be a scintillating and much anticipated session.

Online registration for all these events will be commencing about the time you receive this edition of the *Journal* so please check our website frequently for updates and status reports : **www.irua.com.**

As always, we welcome your comments. Contributions to the *Journal* are always welcome and if you have an article that you would like to be considered for publication, please contact us.



Thanks and Happy Holidays to all!

Best regards,

Jerry Wallis

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Mission Statement

Vision

To facilitate a vibrant forum that encourages professional and personal development of member company personnel through educational excellence, the exchange of knowledge among industry constituents within the insurance and reinsurance marketplace and recognition for academic excellence for the next generation of reinsurance professionals. We accomplish this vision through focused educational offerings, a robust Scholars program, the publication of the *Journal of Reinsurance,* and an annual Conference.

Mission

The IRUA is a not-for-profit corporation, organized for the purpose of providing high-quality insurance and reinsurance education, meaningful networking opportunities, and the dissemination of topical publications and information relevant to the reinsurance industry.

REGULATORS, REINSURERS, AND ILS: THE ROAD AHEAD

BY ANDREW N. MAIS, DAVID A. VACCA, & EDMOND HARDY, DELOITTE

About the Authors: Andrew N. Mais, a former Director at the NY Insurance Department now with the Deloitte Center for Financial Services, and Edmond Hardy, a Partner with Deloitte Advisory, have recently completed a whitepaper on Risk and Insurance-Linked Securities (ILS). David A. Vacca, formerly with the NAIC, is a Senior Advisor with Deloitte.

Abstract: ILS and other alternative capital will continue to increase in size and importance in the reinsurance market as both the risks being covered and the investor pool continue to grow. State insurance regulatory scrutiny on these securitizations should also increase, with a focus on clarity, standardization, and an understanding of the risk being assumed. Regulators' concerns may include transparency, the ability to maintain capacity after a series of triggering events, and the effect on the regulated market.

Two questions spring to mind as one looks at the ILS market. The first and most obvious is what happens to the traditional reinsurance market participants as the ILS market continues to grow. The second, and of growing importance to regulators, is what, if anything, insurance regulators should do as the ILS market grows and as the return on equity for reinsurers continues to fall under increasing pressure.

First, though, some perspective: the era of insurance linked securities, or cat bonds, as the most common ILS are most known, began in 1992 when Hurricane Andrew and numerous other natural catastrophes triggered a capacity shortage in the reinsurance industry. The first ILS was issued in 1994 as part of the industry search for additional capital after that event.

The appeal of cat bonds is so simple and straightforward one wonders why it took an Act of God to trigger their creation. In some sense, the insurance industry sits on two pillars: capital and expertise. In the go-go years of the 90s and at least up until the financial downturn of the first decade of this millennium, new financial instruments were all the rage, designed to take advantage of available capital.

ILS, in that sense, were no different. They brought into the reinsurance industry a pool of capital searching for return and thrilled to find it barely correlates to certain capital market risks. ILS are triggered by an event as specified, and while Wall Street might see itself as all-powerful, no investment bank has yet been able to trigger its own hurricane, earthquake, or tornado. ILS allows an investor a reasonable rate of return that is mostly delinked from the choppy motion of any stock index or federal bank interest rate change.

Expertise might be a different question, and one of which reinsurers and insurers may be justly proud. Nonetheless, with the exponentially increasing ability to use big data and the increasing availability of granular and macro data surrounding everything from earth movement to climate change, the traditional edge held by the insurance and reinsurance industry — underwriting — could be minimized to a great extent by new entrants into the reinsurance market from the capital markets.

Since that first issuance, the ongoing convergence of the reinsurance and capital markets has resulted in the creation of these nontraditional risk transfer products as alternatives to traditional reinsurance. In addition to catastrophe bonds, catastrophe funds and catastrophe contingent insurance linked notes are among the manifestations of this convergence. However the possibility of using ILS more frequently to transfer risks related to other property, life and accident and health lines of business appears plausible.

This convergence is due to an influx of capital from new investors who have the desire to provide cedents with additional markets for their reinsurance. These investors can include hedge funds, endowments, pension funds, money managers, and others.

Compared with the total market for securitization, the ILS market is almost barely noticeable. According to a recent

CONTINUED ON PAGE 4

REGULATORS, REINSURERS, AND ILS: THE ROAD AHEAD

CONTINUED FROM PAGE 3

International Monetary Fund (IMF) staff discussion note[i], in 2014 total securitization in the US and European markets was about $700 billion. That represents an increase from the previous year, but a substantial decline from the more than $2,200 billion issued in 2007, and less than half the levels issued all the way back in 2003. US securitization issuance was more than $400 billion in 2014, representing a steady climb since 2008, but still far below the approximately $1600 billion issued in each year in 2006 and 2007.

By contrast, Artemis reported that the total ILS issuance for 2014 was $8.72 billion.[ii]

But comparing ILS issuance to total securitizations really matters little in our corner of the world. What is more revealing is a comparison between alternative capital, which includes ILS, and traditional reinsurance capital.

In a recent report, Aon Benfield noted that alternative capital now constituted about 12% of global reinsurance capital. The report said that traditional capital was approximately $497 billion at the end of the first half of 2015, while alternative capital was $68 billion.[iii] Sidecars, Industry Loss Warranties (ILW) collateralized reinsurance grew to historical highs of $8.4 billion, $4.0 billion and $32.5 billion respectively. Catastrophe bond capital decreased slightly to $23.5 billion.[iv]

It is worth noting that the report expects total alternative capital to increase to between $120 billion and $150 billion by 2018.[v]

This would seem to indicate that the impact of alternative capital, including ILS, on the reinsurance industry can only be expected to rise over the next few years. To go back to our initial questions, what would this mean for reinsurers, and what would this mean for regulators?

For reinsurers, the picture thus far has been mixed. The relatively low level of natural catastrophes in the recent past and the influx of capital has led to a relatively soft market with corresponding ROE pressure on reinsurers and an increasing pace of mergers and acquisitions.

But the insurance industry is nothing if not adaptive, and reinsurers have already demonstrated their willingness to use the benefits provided by the availability of this capital pool. In our current low interest rate environment, this may reduce the cost of capital to reinsurers, reduce the cost of reinsurance to primary insurers, and allow traditional reinsurers to maintain their dominance in the space.

For reinsurers, this may be a necessary adaptation. ILS currently are primarily focused in the property space, with catastrophe bonds as the best known examples of ILS to laypeople. It may only be reasonable to expect continued growth in ILS, both as demand increases and as the sectors covered widen.

Certain risks within life, annuity, and accident and health products may be prime targets for ILS growth. Continuing low interest rates may preserve investor interest in ILS, even as their risk-adjusted return stabilizes at a lower level. Requested changes to RBC treatment for ILS by life companies may make them more attractive as an asset class to a major investor group that now is at best a very minor participant.[vi]

Reinsurers — though seemingly prime targets for disintermediation — may actually be best prepared to take advantage of this new capital structure by combining this low-cost capital with their underwriting and risk management knowledge and expertise.

What of the regulators? At least in the US, state insurance regulators are primarily concerned about policyholder protection. This means ensuring that in the event of a covered catastrophe, policyholders get paid. It also means looking ahead, past a series of catastrophes such as those that triggered the creation of the ILS market, and working now to ensure that no matter what, sufficient capacity will be available.

In the post financial downturn era, insurance regulators also have to be concerned about financial stability and systemic risk.

Existing coverage is probably easiest to deal with and least likely to keep regulators up at night. Typically, ILS are fully collateralized. However, there are still concerns. Triggers may vary and can include: parametric, indemnity, industry loss, modeled loss, and hybrid. Additionally, some regulators have raised concerns with non-indemnity trigger securities, possibly for fear it is a maneuver to help avoid regulatory scrutiny.

US state insurance regulators have been showing interest in monitoring ILS activity at both insurer and macro level. Some concerns include the lack of transparency of cedents engaging in the transactions within the statutory filings, as well as which lines of business.

Other concerns exist with regard to insurers potentially engaging in an "originate-to-distribute" model with little skin in the game. One may argue the risk is low because these securities are being sold to only the most sophisticated investors. That argument, however, may limit both the growth and stability of this market. As the IMF staffers note in the conclusion to their discussion on securitization in general, "Securitization markets could be strengthened in the future to the extent that they are underpinned by a diversified institutional investor base (beyond just banks) with long-term capital."[vii] That argues for clarity and standardization in order to attract the broadest possible base.

Indeed, even sophisticated investors may know very little about the products they are reinsuring or the market cycles, choosing instead to rely on third parties, such as rating agencies or modeling agencies, to evaluate the level of risk being assumed.

Interestingly, even the National Association of Insurance Commissioners (NAIC) may be getting into the arena of outsourcing some quality decisions to third parties such as rating agencies.

The NAIC's Center for Insurance Policy and Research (CIPR) noted, "Typically, insurers are not expected to invest in a cat bond if they are already exposed to the peril in question in their primary business. Insurers that do invest in cat bonds were in the past required to file them with the NAIC Capital Markets & Investment Analysis Office for determination, as they were not eligible for filing exemption under the NAIC rule which grants an exemption from filing for securities that have been assigned a current, monitored rating by an ARO (acceptable rating organization) as prescribed in the Purpose and Procedures Manual. At the 2014 NAIC Spring National Meeting, the VOS Task Force adopted a motion to make rated cat bonds filing exempt."[viii]

So does a security having being reviewed and rated by a credit

rating agency (CRA) mean we no longer have to worry about risk? The NAIC itself may beg to differ, having moved swiftly after the financial downturn to ensure certain securitized obligations are measured by its own criteria through its own contracted assessor.

IMF staffers also expressed concern. Their recommendations on the use of credit ratings include:

- "Statutory references to credit ratings for securitization need to be eliminated.
- Where not yet complete, regulators should finalize rules for CRAs to ensure transparency regarding the commercial relationship between the CRAs and issuers. Issuers should disclose the extent of any "ratings shopping" in which they may have engaged.
- The industry should embrace standardized definitions for the underlying characteristics of securitizations (i.e., simplicity, transparency, collateral features, track record of underlying asset quality, etc.) as opposed to a simple aggregate classification (like credit ratings), which can lead to investor 'shirking' of due diligence responsibilities and forced buying and selling."[ix]

This may open the way to an interesting new avenue for reinsurers. Who would be better equipped to evaluate the quality and risk of an ILS?

There are other issues that concern state insurance regulators. One is whether the mechanisms work appropriately, as disputes have reportedly arisen over triggers with certain ILS. Additionally, some rating agencies have higher capital charges on cedents' credit exposure to catastrophe bond reinsurance than for traditional reinsurance. This may suggest the perception of a certain level of additional risk.

State insurance regulators have also raised various concerns about possible issues with the trusts holding collateral. For example, are the assets in the trust liquid or investment grade? Are there potential substitution issues, or instances with the trust assets being released too early?

Eventually, one can predict that state insurance regulators will begin to discuss the range of insurance risks that can be packaged into ILS products. Longevity bonds, multi-peril bonds, health insurance ILS and extreme mortality bonds have already been witnessed. What types of risk will be next? Should certain types of risks and structures be prohibited as ILS products?

The ongoing evolution of the product itself in response to market demands may argue for continuing strict scrutiny. As mentioned earlier for example, the triggers have evolved from straight indemnity to parametric and others. This continuing evolution may be seen through the first three quarters of 2015, when $4.7 billion in traditional cat bonds were issued, down from the year before. However a new variant — "cat bond lite" structures — saw $490 million in new capital in 2015 compared to $242 million in 2014.[x] Cat bond lite structures are usually smaller placements, allowing lower entry points with reduced frictional costs.[xi]

And finally, though not completely identified, there are the macro prudential considerations. Though we have faith in the resiliency and expertise of reinsurers, there may be some who fear that ILS present a viable threat to the traditional reinsurer model. This model relies on pricing peaks to balance out active loss years and ensure continuing capacity. In addition, participants in this model are regulated and offer a level of transparency to regulators that may not yet be evident throughout the entire ILS market.

For regulators, this argues for an increased focus on the ILS market in the coming years. Participants may be well advised to prepare for such scrutiny. Fortunately for investors and other market participants, the most desirable end goal is a transparent market supporting but not supplanting the traditional reinsurance models, with the clear rules and fair and equitable capital treatment that will enhance growth for all participants while reducing costs and managing risk.

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i *Securitization: The Road Ahead*, Miguel Segoviano, Bradley Jones, Peter Lindner, and Johannes Blankenheim, International Monetary Fund, Washington DC, January 2015.

ii *2014 to end with record $8.718 billion ILS issuance, market at $25 billion,* Artemis www.artemis.bm, Dec. 23, 2014.

iii *Reinsurance Market Outlook: Supply Increase Pauses and Demand Set to Accelerate,* Aon Benfield, Sept. 2015.

iv *Ibid.*

v *Ibid.*

vi *Discussion of Life Insurer Capital Treatment for Catastrophe Bonds*, North American Chief Risk Officers Council, Nov. 17, 2014.

vii *Securitization: The Road Ahead,* Miguel Segoviano, Bradley Jones, Peter Lindner, and Johannes Blankenheim, International Monetary Fund, Washington DC, January 2015.

viii *Insurance-Linked Securities: Catastrophe Bonds, Sidecars and Life Insurance Securitization*, National Association of Insurance Commissioners Center for Insurance Policy and Research, updated Sept. 3, 2015.

ix *Securitization: The Road Ahead*, Miguel Segoviano, Bradley Jones, Peter Lindner, and Johannes Blankenheim, International Monetary Fund, Washington DC, January 2015.

x *ILS market looks to expand reach amid quiet Q3 for cat bonds*, Zaem Shoaib, SNL Financial, September 30, 2015.

xi *Insurance-linked securities sector grows with emergence of 'cat bonds lite'*, Matthew Lerner, Business Insurance, April 5, 2015.

DRONES AND THEIR IMPACT ON THE INSURANCE AND REINSURANCE INDUSTRY

BY KATIE MARTINCIC, TEMPLE UNIVERSITY

About the Author: Kathryn Martincic is a senior at Temple University majoring in Risk Management & Insurance and minoring in Management Information Systems and is IRUA's 2015 1st Place Internship Scholars Winner. For the past two summers, she has interned with Maiden Re on their Direct Treaty team. Katheryn will be graudating in May 2016 and plans to go on to work full-time for a broker, primary insurer or reinsurer. This spring, she spent a semester studying abroad in Tokyo, Japan and has also studied abroad for a short time in Saigon, Vietnam. Kathryn submitted her paper on Drones to the IRUA's Scholars Committee where it was selected as the 1st Place winner of it's new IRUA Scholars Program.

Abstract: This white paper provides general information on drones and their predicted effects on the insurance and reinsurance industry. The paper explores drones related legislation, an overview of drone technology, current and potential uses for drones across various industries and an analysis of changing public perception of drones. The paper then examines new coverage opportunities and challenges that the budding drone market will create for the insurance and reinsurance industry, as well as the potential loss exposure difficulties involved in the widespread use of drones.

INTRODUCTION

Within the next five years, the commercial use of unmanned aircrafts, or drones, could become common practice for nearly 40 percent of all U.S. businesses. In 2015 alone, more than 1 million commercial drones are expected to be in operation globally with spending on drones expected to reach $89.1 billion by 2025 (Marsh, 2015). While military use has historically been the leading catalyst for the development of drone technology, today, drones have increasingly endless applications. While drone technology in the insurance, agriculture, filmmaking, law enforcement, and disaster relief industries have recently been capturing headlines, drones have the potential to touch nearly every industry within the next decade. Advocates for drone technology assert a common theme of increased safety, cost savings and unmatched accessibility (Swiss Re, 2014).

This white paper seeks to provide information on drones, including current drone legislation, a summary of drone technology, current and potential uses for drones across industries and an analysis of public perception of drones. This paper then examines the new business opportunities and challenges that the budding drone market will create for the insurance and reinsurance industry as well as analyzes the potential loss exposure issues involved in the widespread use of commercial and personal drone use.

WHAT IS A DRONE?

What is commonly referred to as a drone, is technically referred to as an unmanned aircraft, unmanned aerial vehicle or unmanned aircraft system. The Federal Aviation Administration (FAA) defines unmanned aircrafts, unmanned aircraft systems and model aircrafts as the following:

- UA (Unmanned Aircraft) – A UA, which is sometimes referred to as an Unmanned Aerial Vehicle (UAV), is defined as "a device used for flight in the air that has no onboard pilot."
- UAS (Unmanned Aircraft System) – A UAS is defined as "an unmanned aircraft and its associated elements related to safe operations, which may include control stations (ground, ship, or air-based), control links, support equipment, payloads, flight termination systems, and launch/recovery equipment" (ISO, 2015).
- Model Aircraft – A model aircraft is an aircraft that is mechanically driven or launched into fight for recreational (not commercial) purposes and that is not designed to carry persons (Swiss Re, 2014).

A UA or UAS can be either a device piloted by an operator via a ground control system or an unpiloted device that uses sensing hardware and Global Positioning System (GPS) (Munich Re, 2015). While UAs, UAVs and UAS are commonly used interchangeably to refer broadly to a "drone," a model aircraft differs because it can only be used for recreational purposes. This distinction between drones and model aircrafts is important because the FAA does not enforce the same regulatory restrictions on model aircrafts as it does on drones (Swiss Re, 2014).

REGULATION

In 2012, the United States Congress passed the FAA Modernization and Reform Act, which directed the FAA to develop a plan for the safe integration of drones into U.S. airspace by September 2015. However, according to an audit performed by the federal government, the FAA will likely miss this deadline and may still be as far as two years away from permanent regulation (ISO, 2015). The delay is due in part to challenges in creating legislation that will effectively address issues involved in the widespread use of drones including increasing drone capacity, global operations, public safety, privacy concerns and controlling congestion in the airspace (Stone, January 2014).

In February 2015, the FAA announced proposed rules for small commercial drones weighing less than 55 pounds. Under these proposed regulations, drones must operate only during daylight hours, fly below 500 feet and remain in the sight of operators. Pilots also must pass a knowledge test to get a drone operator license and must be assessed by the Transportation Security Administration. Operators must take a recurrent test every two

years and be at least 17 years old (Lardinois, 2015). In months following, the FAA received over 4,000 comments on these proposed rules and predicted it would take another 18 months to two years to finalize the regulations. Until the FAA has permanent rules in place, it has been issuing case-by-case exemptions for the commercial use of drones at a rate of about 250 a month. Most of these exemptions grant permission to capture pictures or videos. Photography and videography was listed on 50 percent of requests, followed by 27 percent for inspections and 24 percent for mapping and surveying (Adams-Heard, 2015).

Since the FAA may still be up to two years away from finalizing drone regulations, businesses are not supposed to fly drones without an FAA-granted exemption. Despite this, commercial drones are being used across the country by businesses in various industries. These businesses are buying insurance coverage from insurers that are writing their own safety regulations to fill a void left by federal regulators (Levin, 2015). Although there are no final regulations, individual insurers' safety regulations often exceed the FAA's proposed rules for commercial drones mentioned above. For example, some insurers require clients to keep logs of drone flights and maintenance checks, which the FAA-proposed rules do not require. One Colorado-based insurance broker says it has already written 2,600 policies covering commercial drones and a San Francisco-based company says it has assembled a list of 1,000 trained operators that businesses can hire to fly the drones for them (Levin, 2015). Although operators flying drones without an FAA-granted exemption could make an operator subject to fining by the FAA, many commercial flyers are unconcerned, as these fines have rarely been imposed.

In addition to beginning to regulate commercial drone use, the FAA has also made adjustments to prepare for the changing landscape of U.S. airspace. The U.S. airspace has the busiest air traffic in the world and, therefore, mitigating congestion in airspace could pose a challenge. The FAA has allocated $63.4 billion to improve the country's air traffic control systems and expand air space to accommodate the increasing use of drones (Stone, January 2014).

LEGAL ENVIRONMENT

One of several topics of discussion regarding the evolving legal environment around drones has been the extent to which federal law overrides state law. Since the federal government has sovereignty of U.S. airspace, the FAA has the authority to establish air traffic regulations on the flight of any aircraft, including drones (FAA, 2015). While the FAA focuses on federal legislation that will safely integrate drones into the domestic airspace, regulation specific to commercial drone use is being left up to the states (Coe, 2014). Although states will regulate commercial drones, federal law could preempt state requirements for drones depending on the nature of those requirements. The Department of Transportation evaluates these laws individually to confirm that they do not conflict with FAA's authority (FAA, 2015).

Another legal issue making headlines has been whether or not a property owner can claim an operator is trespassing on their property by flying a drone over it. Placing privacy restrictions on drone use on private property has resulted in ever-changing legislation varying from state to state. As of May 2015, 15 states have passed bills pertaining to the use of drones and 11 states have bills pending (Munich Re, 2015). These laws generally aim to restrict commercial drone use. While some states restrict drones from flying over private property without the consent of the owner, others do not. In some cases of violation of these laws, the property owner may have a private cause of action to sue the drone operator for trespassing and, in other cases, the state might prosecute the drone operator for use of a drone in violation of state law (Swiss Re, 2014). Some states have also passed legislation that requires law enforcement agencies to obtain search warrants before using a drone to conduct surveillance on a suspect (Coe, 2014).

It will become important for insurers to identify what specific torts, state and federal laws could generate lawsuits or fines against drone users. Insurers may find that some types of lawsuits that could be brought against an insured are uninsurable risks. For example, a drone with a camera can be a basis for an invasion of privacy lawsuit virtually any time it flies regardless of the user's intent. Insurers may decide that losses arising from invasion of privacy lawsuits is an uninsurable loss (Swiss Re, 2014).

TECHNOLOGY AND DESIGN

Typical FAA-approved drones weigh less than 55 pounds, are about 4.5 feet long and are controlled by an offsite operator using an advanced control system and data link transmission (Stone, January 2014). However, the term "drone" is broadly used to identify a range of unmanned vehicles that can vary greatly in design, size and technological capabilities. Fixed-wing drones resemble small airplanes, while multirotor drones called "octo-copters" and "quad-rotors" resemble helicopters. Mini drones known as micro air vehicles (MAVs) sometimes measure only a couple inches in diameter and can be designed to mimic birds and insects in appearance and flight patterns (ISO, 2015).

The delay in FAA regulation will also allow for the integration of tethered drones. Tethered drones are UAs that are attached to a ground base by a cable, therefore allowing them to avoid current FAA regulation. One of the tethered drones being introduced into the commercial market is a quad-rotor copter. The quad-rotor copter is already used by the U.S. military and is similar to other small drones, but its tethering makes it more efficient (Keane, 2014). The drones tethering allows it to have longer flight durations and lower costs than with its non-tethered equivalents. The tethered drone also has better mobility, as it can be attached to a moving vehicle and programmed to follow the vehicle while it's moving and remain stable when the vehicle stops (Keane, 2014).

One significant barrier to the widespread commercial use of drones is the issue of developing sense-and-avoid technology. Drones must be able to avoid an unpredictable obstacle or event in order to safely be integrated into the air. Today, drones use visual-line-of-sight (VLOS) technology, which require user input to navigate a drone around obstacles. However, operator error or a gust of wind could still easily result in an accident. The largest growth area for insuring drones is expected to be for VLOS operations that can require up to $1 million in physical loss sums insured (Marsh, 2015).

USE OF DRONES

While some argue that drone use across industries will make many manual jobs obsolete, the Association for Unmanned Vehicle Systems International expects that commercial drones will actually create 70,000 new U.S. jobs in the first 3 years (Swiss Re, 2014). By 2025, it estimated this could reach 100,000 jobs (Marsh, 2015). In order to meet the expected demand for drone operators,

CONTINUED ON PAGE 8

DRONES AND THEIR IMPACT ON THE INSURANCE AND REINSURANCE INDUSTRY

CONTINUED FROM PAGE 8

some universities have begun to offer courses specific to drones – from drone piloting to becoming an aerial drone photographer or drone systems engineer. Law firms are already launching practice groups specializing in drones. For now, these firms defend those fined by the FAA, but once commercial drone use is allowed, this client base is expected to expand quickly (Swiss Re, 2014).

The common theme for drone advocates is that they allow for faster, safer operations at lower costs. From a risk management perspective, drones allow a way to protect workers by sending drones to do various dangerous jobs across industries. Although there are increasingly endless applications for commercial drone use, drones are expected to have an especially significant impact on the following industries: military and law enforcement, package delivery, public safety, agriculture and insurance.

MILITARY AND LAW ENFORCEMENT

Historically, the development of drone technology has been a result of military conflicts. The technology especially evolved following the 9/11 terrorist attacks and the resulting invasions of Afghanistan and Iraq. These conflicts drove a significant increase in the frequency of drone use and the growth of drone technology. Since then, the U.S. has deployed over 11,000 military drones, up from fewer than 200 in 2002 (Swiss Re, 2014).

Drones have been used for border control and intelligence gathering on Mexican drug cartels for several years (McNeal, 2012). Fixed-wing Predator drones are currently used by The Department of Homeland Security for border security but are gradually making their way into local law enforcement agencies across the country (Swiss Re, 2014). In the near future, small drones will likely be used on a large scale in the law enforcement capacity. Law enforcement drones are expected to carry sophisticated cameras, infrared sensors, license plate readers and facial-recognition technology (Stone, January 2014). However, as mentioned above, how law enforcement can or cannot use drones will vary by law from state to state.

PACKAGE DELIVERY

Package delivery is a huge industry eager to take advantage of commercial drone use. Drones capable of delivering packages to a customer's doorstep will allow for more deliveries with far fewer employees, significantly reducing costs for companies offering delivery services (Love 2013). Zookal, an Australian company that sells textbooks, is already using drones to deliver packages directly to customers. Zookal's drones do not land to deliver packages, but simply lowers the parcel for the customer to collect (Love, 2013). This commercial drone technology works best for lightweight packages delivered over relatively short distances. For large metropolitan areas, drone package delivery is expected to boom (Love, 2013).

Amazon.com Inc. has announced its vision of using commercial drones for deliveries and is working with the FAA to develop the technology necessary to permit deliveries (Adams-Heard, 2015). For home delivery drones to work safely, however, they must be able to decipher satellite maps for landing as well as be equipped with sense-and-avoid technology to ensure drones respond to unpredictable events.

PUBLIC SAFETY

Drone use is highly anticipated in the public safety field. Search-and-rescue, wildfire fighting, and disaster and emergency relief efforts will not only become safer with the use of drones, but will become substantially more effective as well. For Example, drones can fly lower than helicopters and can be used to scan areas for survivors trapped under debris after a natural disaster. Drones can provide aerial footage to inspect debris that could be dangerous for a person to walk on. The American Red Cross has expressed interest in using drones in disaster relief efforts and is waiting for FAA regulation to do so.

AGRICULTURE

Drones are widely used for agriculture in various countries around the world including Australia and Japan. These drones can be used for assessing crop yields, surveying property and tailoring the use of herbicides, pesticides and fertilizers (Swiss Re, 2014). This technology would help farmers obtain a much more detailed oversight of their crops while saving them money in the process. In the U.S., the FAA is expected to grant commercial farms an agricultural exemption for drone use. Grinnell Mutual is reportedly making available an endorsement that provides liability coverage on their Farm-guard Policy and their farm liability policy for drones used for "precision agricultural operations" (Anderson, 2015).

Drones can also help reduce insurance fraud claims in crop insurance policies, where there is a significant potential for fraudulent claims. They can be used to help determine the actual cultivatable land and to better understand the extent of a loss and the actual crop yield. Drones with cameras can help claims adjusters quickly understand the true health of crops by analyzing the color contrast of a field (Francis, 2014).

INSURANCE AND REINSURANCE

Drones are already beginning to change the way that insurers are handling claims, surveying properties, and assessing risks. On-site visits by underwriters and claims adjusters are being replaced by a drone dispatch to inspect a property or investigate a claim (Stephenson). Not only does this mean significant cost savings, but insurers will no longer need to send staff on potentially dangerous inspections. Insurers such as State Farm Mutual Automobile Insurance Co., Liberty Mutual Insurance Co. and Travelers Companies, have won exemptions to use drones to inspect and survey properties (Adams-Heard, 2015). Some estimates have shown that efficiency could increase up to 50 percent in the insurance industry alone as the ability to combine notes with pictures and videos collected by drones reduces the need for follow-up visits (Tuttle, 2015).

Drones can also help to improve insured satisfaction during catastrophes by speeding up claims adjudication. A drone's ability to quickly take high-resolution videos and photos and send the information back to adjusters to prepare estimates will save insurers a significant amount of time during a catastrophic event such as a hurricane or tornado, and allow for claims to be settled quickly (Francis, 2014).

Additionally, drones' ability to collect evolving meteorological

data could improve weather forecasts and lengthen lead-times for violent storm warnings. Such added weather data and lead-time could help protect people and properties in the event of a storm, potentially reducing the frequency and severity of catastrophic losses for insurers (Munich Re, 2015).

PUBLIC PERCEPTION

The word "drone" has a negative connotation for many, provoking images of military machinery used for bombing and aerial surveillance purposes. However, new drone applications, especially in the public safety fields, are improving public perception of drones. Until permanent FAA regulation is implemented, however, public confidence in drones is likely to remain low. Issues surrounding potential invasion of privacy and safety are on the forefront of public concern (Marsh, 2015). A survey conducted by Munich Re America shows that 69 percent of people surveyed believe invasion of privacy poses the greatest concern with the adoption of commercial drones. Numerous organizations have petitioned the FAA, citing these privacy concerns. The second greatest concern among surveyed Americans was inadequate insurance at 12 percent, followed by personal injury at 11 percent and property damage at 8 percent (Munich Re, 2015).

Public perception is one of the biggest hurdles for the budding drone industry with privacy concerns causing the most resistance. Although some invasion of privacy coverage is available under today's policies, the new exposures that could result from drones equipped with cameras will likely not fit the limitations of traditional personal injury endorsements (Tuttle, 2015). Some insurers, however, are not very concerned with privacy claims, claiming that smartphones equipped with picture and video capabilities have become an accepted part of society and that drones will eventually meet the same acceptance (Tuttle, 2015).

EXPOSURES

The insurance industry has been assessing risks and providing for physical loss and product liability involved with drones since the early 1980s. At this time, however, insurers had a limited understanding of drones and generally little interest in them altogether (Marsh, 2015). By 2013, Lloyd's markets and companies alike had begun writing drone risks around the world. Although a general lack of expertise and historical loss data remains, the insurance and reinsurance industry are quickly adapting so that they can take advantage of this new business opportunity and support the growing presence of drones across industries (Marsh, 2015).

While some insurers have explicitly said that they are not currently interested in insuring drones, primarily because of the invasion of privacy risks involved and the lack of historical data, many aviation and property/casualty insurers are eager to get involved in the evolving drones market. Aviation insurers are generally focused on underwriting larger drones that provide services to other entities, while property/casualty insurers are interested in providing coverage for entities that own and operate drones as a related part of their business operations (Munich Re, 2015).

Providing adequate insurance coverage for businesses utilizing drones will be challenging. Aside from the fact that drone technology is relatively new and therefore drone expertise and loss data is minimal, there are a variety of new insurance liability and coverage concerns. These coverage concerns range from personal injury and invasion of privacy, to fraud surveillance, to the more traditional bodily injury and property damage (Anderson, 2015).

Most operators of traditional manned aircrafts around the world are required by law to have adequate insurance coverage in order to cover liabilities in the event of an accident. However, as the FAA's regulation of drones remains unclear, so do the coverage requirements (Marsh, 2015). In a 2015 survey conducted by Munich Re, 76 percent of business owners who used drones in their operations said that it would invest in drone specific insurance coverage even if it were not required by the FAA (Munich Re, 2015).

Since there is little data in the unmanned aircraft class, some insurers are using experience in the manned aircraft class to assess the risk and limit their exposures by selecting against size, use, and value of the aircraft, and the type of coverages offered (Marsh, 2015). Insurers may decide to use the claims reported by the Academy of Model Aeronautics (AMA) as a source of data to underwrite drones due to the similarities between small drones and model aircrafts. However, this data is also limited. Only 400 claims have been reported to the AMA, and only 12 to 15 of those claims involved serious injuries. All of these injuries were the cause of the operator losing control of the model aircraft (Munich Re, 2015).

Insurers may want to ask whether current or prospective insureds are considering using drones in their routine operations. Insureds may not be aware of the unique risks associated with commercial drone use and may assume, probably incorrectly, that the needed coverage is already being provided under their current policies (Waller). In order to effectively underwrite these risks, insurers will need to collect information including but not limited to the drone's function, its take-off and landing location, its flying altitude and distance, and the population of the area it will be flying over (Stone, January 2014). Insurers may also ask what, if any security and safeguards are in place to protect against software or hardware failures and third-party hacking of the equipment (Munich Re, 2015).

As drones become more prevalent in our world, present policy wording in many general liability, business owners, commercial umbrella, personal umbrella, home owners and farm owners policies may lead to legal challenges. For example, umbrella policies typically provide coverage for personal injury or personal and advertising injury without any added endorsement (Swiss Re, 2014). However, drone operators with or without malicious intent may be exposed to lawsuits for trespass, nuisance and invasion of privacy. In the event of a lawsuit against them, these innocent insureds may expect to be covered under these circumstances. Adversely, a drone operator could also intentionally use a drone with an attached camera to stalk, harass or blackmail others. Insurers need to examine policy wordings to avoid covering intentionally illegal activity (Swiss Re, 2014).

LIABILITY EXPOSURES

In general, hull loss potential is not a huge concern for insurers and reinsurers since drones are currently relatively inexpensive. Liability loss exposures in drone coverages are expected to far outweigh the financial losses to the drones themselves. The unclear extent of liability exposures is the largest concern for many insurers interested in covering drone risks (A.M. Best, 2015). Although there are many new liability exposures insurers

CONTINUED ON PAGE 10

DRONES AND THEIR IMPACT ON THE INSURANCE AND REINSURANCE INDUSTRY
CONTINUED FROM PAGE 9

will need to consider, the areas that raise the most concerns are personal injury and invasion of privacy. There is a general concern that commercial drones equipped with cameras will be flying over people's personal property and peering into their windows and backyards. Overall, regulation that dictates what an entity can do with information collected by drones and how they must secure it is unclear and varies from state-to-state (Stone, March 2014).

As mentioned above, insurers will need to analyze policy wording in their current liability policies to avoid covering unintended losses. For example, an insured that uses a drone with a camera may post content on the Internet with or without malicious intent. Any suits filed against the insured would likely be covered because ISO's Commercial General Liability 00 01 04 13 policy defines "personal advertising injury" in part as: "Oral or written publication, in any manner, of material that violates a person's right of privacy" (Swiss Re, 2014). Since most companies use ISO policy language or a similar variant thereof, this offense would likely be covered. There is currently no aircraft exclusion that applies to covered personal and advertising injury offenses under ISO's commercial general liability policy (ISO, 2015).

In June 2015, ISO released new coverage and exclusion options for commercial drones to address these growing liability exposures. The options are designed to give insurers more flexibility when underwriting risks involving drones (Waller). The options modify coverage under ISO's Commercial General Liability and Commercial Liability Umbrella/Excess programs (Johnson, 2014). There are three optional exclusions and three limited-coverage endorsements available under each program that can be used to address bodily injury, property damage, and other liability exposures (Johnson, 2014). The options give insurers the tools to write coverage or exclude drone-related liability under Coverage A (bodily injury and property damage only), Coverage B (personal and advertising injury) only, or Coverages A and B together under a single endorsement. Each option allows for limited coverage for designated drones with respect to the insured's operations (Waller). ISO is also reviewing drone coverage as it relates to commercial property, businessowners, homeowners, farm, and commercial inland marine coverage.

Drone operators will likely want to purchase liability coverage to protect against losses stemming from bodily injury and property damage losses. This coverage would apply, for example, if a drone collided with a person, building or car, causing bodily injury and/or property damage (ISO, 2015). Drone manufacturers will also likely purchase liability coverage to protect against third-party bodily injury and property damage suits resulting from a defect in the design or manufacturing of a drone, collision with persons or property or an interruption in data-link transmission communication failure.Additionally, manufacturers may also want coverage in the event that customers accuse manufacturers of false advertising, unfair competition or deceptive trade claims if manufacturers promoted features that do not operate as advertised (Coe, 2014).

From a personal liability perspective, homeowners who fly drones as a hobby could face bodily injury and property damage exposures similar to those of a commercial operator. Additionally, if a child operates a drone, with or without parental permission, the parents could face vicarious liability or negligent entrustment from claims arising from property damage or bodily injury (ISO, 2015).

PROPERTY EXPOSURES

The most obvious property exposure is first-party exposures to drone equipment, hull or payload due to collision or internal malfunction. First-party marine or hull insurance policies are among the potential insurance products that could be used to cover a drone, including its various parts (ISO, 2015). Although there are many drone manufacturers, some may not be able to manage the constant development needed to sustain their market position in this ever-evolving industry. As a result, replacement parts for even slightly outdated drones may become difficult and expensive to find. This could further fuel the agreed value versus insured value issue because a relatively low damage drone accident could easily result in a total financial loss (Marsh, 2015).

Another property exposure could be business interruption, including business income and miscellaneous expenses exposure associated with damage from a drone-related accident to a commercial building (ISO, 2015). The damageability and availability of certain computer or electronic parts will likely affect business interruption exposure (Swiss Re, 2014).

THEFT EXPOSURES

Fraud and theft are significant exposures when insuring drones, especially in regard to small drones. Drones valued at less than $250,000 are currently the main growth area in commercial operations. Since these drones are often relatively small, portable and at the cutting-edge of technological development, they pose a significant exposure for theft. Furthermore, many drone airframes do not carry serial numbers and may have interchangeable airframe parts, which are untracked, unlike those of a traditional manned aircraft (Marsh, 2015).

PROFESSIONAL LIABILITY (E&O) EXPOSURES

The use of drones will likely also affect the professional liability (E&O) insurance market. Drone service providers and software developers will likely seek coverage for mistakes in their operations. For example, when using a drone for inspection purposes, an operator could accidentally program the drone to collect picture or video data on the wrong property. This type of error could open up arguments for a potential errors and omissions (E&O) claim resulting from invasion of privacy (ISO, 2015).

WORKERS COMPENSATION AND EMPLOYERS LIABILITY

As mentioned above, drones are expected to replace various dangerous jobs that only humans can perform today. From search-and-rescue teams to claims adjusters, As mentioned earlier, those jobs could include everything from search and rescue teams dispatched during a natural disaster to claims adjusters inspecting a damaged roof. This replacement could lead to a reduction in both worker's compensation and employer liability claims (ISO, 2015).

CYBER EXPOSURES

Many UAS platforms have safeguards and back-up systems that provide redundancy in the event of interference with navigation signals. However, significant cyber risks remain involved in insuring drones (Mahoney, 2015). Although The

The use of drones will likely also affect the professional liability (E&O) insurance market. Drone service providers and software developers will likely seek coverage for mistakes in their operations.

Association for Unmanned Vehicle Systems International has said that the group is not aware of any events where a drone has had its software hacked, many broadband/Wi-Fi devices use the same frequency as the 2.4 MHz banding commonly used by low-cost drones, and could be used to hack into the flight path of a drone (Marsh, 2015). In January 2015, security engineer, Rahul Sasi, developed malware that is able to trick the autonomous decision making unit of a UAS into giving control to a third-party, or hacker. Once this malware, nicknamed "Maldrone," has infected the drone, the hacker has the ability to do anything from change the landing destination of the drone to make it drop to the ground. Since Maldrone targets the autonomous decision making unit, it is designed to work with any type of software (Marsh, 2015).

In the event of an intangible peril, such as drone software being hacked, where there is economic loss but no bodily injury or tangible property damage, coverage issues arise. General liability typically is not intended to cover intangible perils (Mahoney, 2015).

TERRORISM EXPOSURES

While the FAA can monitor the commercial use of drones, private use poses more of a challenge. A recent story capturing headlines describing a hobbyist crashing a drone onto the front lawn of the White House grabbed the public's attention and heightened America's concern for the implicit security risk drones carry. To the surprise of many, the operator who crashed the drone did not violate any laws and was therefore not charged with a crime. The Secret Service is currently looking into developing laws to prevent security risks involving drones from happening again (Safety National, 2015).

CONCLUSION

The costs savings and unparalleled accessibility that drones allow for will drive the technology to continue expanding across numerous industries and markets. The insurance and reinsurance industry could benefit significantly from the growing presence of drones, both by improving the efficiency of its claims adjusting and inspection processes and by offering the industry countless new business opportunities. However, in taking advantage of these new opportunities, a variety of insurance liability and coverage issues must be addressed. Regulation concerning personal injury and invasion of privacy to aerial surveillance and data collection are unclear or non-existent in many states. Nevertheless, the lack of permanent regulation is not stopping businesses from beginning to add drones to their commercial operations. As drone technology evolves, it will become increasingly important for insurers and reinsurers to adapt to the technological advances or risk becoming uncompetitive to more forward-thinking companies (Francis, 2014).

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REINSURERS AND RECEIVERSHIPS: A CHECKLIST

BY JAMES VEACH, ESQ., MOUND COTTON WOLLAN & GREENGRASS LLP

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Abstract: Many professional persons recognize the "simplicity and power of using a checklist." ATUL GAWANDE, CHECKLIST MANIFESTO: HOW TO GET THINGS RIGHT 186 (2010). Reinsurers could also profit from devising checklists to deal with their cedants' (or retrocessionaires') insolvencies. Your author proposes a checklist designed to improve communication among accounting, claims, and underwriting departments, as well as outside or in-house counsel. This draft checklist would preserve corporate memory, avoid missing key receivership deadlines, and reduce the time spent revisiting accounts and files during the often long-lives of many insurance receiverships. Your author seeks your comments/suggestions with respect to how this draft checklist may be improved.

What follows is a not-entirely tongue-in-cheek proposal that reinsurers with insolvent cedants (or retrocessionaires) use a checklist to address the demands of these insolvent entities' receivers.[1] Already, I sense the seasoned reinsurance professional's resistance.

Nevertheless, I plunge on, inspired by the architects, engineers, physicians, construction managers, nuclear plant operators, airplane pilots, police officers, and, lawyers[2] who use checklists every day – and to great advantage.

OPERATING ROOM CHECKLISTS

Dr. Atul Gawande, a surgeon and an associate professor at the Harvard Medical School, recently wrote a book about a "Surgical Safety Checklist" that he and others designed for the World Health Organization(WHO).[3] In his book, Dr. Gawande describes the push-back he encountered when he introduced his checklist – just as I expect to hear objections and wails from my friends in reinsurance – but once implemented, the WHO checklist produced double-digit percentage reductions in surgical complications.[4]

According to Dr. Gawande, checklists work because they "help[] with memory recall and clearly set out the minimum necessary steps in a process."[5] Dr. Gawande found that checklists also "catch mental flaws inherent in all of us – flaws of memory and attention and thoroughness."[6]

But how do checklists work in a team context? The author found that by requiring surgical team members to call out and confirm that they had prepared, executed, or approved a given procedure before moving to the next step, team members communicated better and double-checked one another.

Dr. Gawande, however, acknowledged that his first surgical checklist failed its initial test.[7] An effective checklist, it appears, may need to pass through several iterations.[8] With that background, here's a first draft of a checklist to be used by reinsurers dealing with the receiver of a failed cedant (or retrocessionaire).

A CEDANT INSOLVENCY CHECKLIST

Our checklist team would have five members: a team leader or principal person (PP), an outside or in-house counsel (L) (because most issues arising in insurer insolvencies involve regulatory and statutory requirements and occur within court-supervised proceedings), and representatives from the reinsurer's accounting (ACC), claims (C), and underwriting(U) departments.

Our checklist fits on one sheet of paper.

Checklist for ________, in (Rehabilitation/Liquidation)

Principal Person (PP): ____________ Accounting (ACC): ____________ Claims (C): ____________

Underwriting (U): ____________ In-house/outside lawyer (L): ____________

Order Entered (do within first three months)	Receivership Underway (repeat every six months)	Resolving Disputes/ Commuting/Exiting the Estate (do as needed)
☐ Read/order and identify assets subject to it: PP, ACC, and L	☐ Determine Position of IGAs and related issues: PP, C, and L	☐ Identify and calendar statutes of limitations: PP, C, and L
☐ Summarize domiciliary insolvency law: PP and L	☐ Audit approved and undetermined claims: PP and C	☐ Confirm status of POC and determine Receiver's position on offset: PP and L
☐ Study CMO and sign up for all notices/ reports: PP, L, and ACC	☐ Update timely-filed POC: PP, ACC and L	☐ Monitor Receiver's offset policy (to extent publicly available) plus negotiate commutations/releases: PP, C, and L
☐ Review insolvency clauses PP, U, and L		☐ Celebrate estate closing: PP, L, C, ACC, and U
☐ File initial and timely proof of claim (POC): PP, ACC, C, U, and L Receivership Underway		

Now let's walk through our checklist.

READ THE RECEIVERSHIP ORDER

This first step seems obvious, but often the order that places an insurer in rehabilitation or liquidation gets passed along to in-house or outside counsel and is never closely examined by anyone in the claims or accounting departments. Comparing a few receivership orders will quickly reveal how their terms differ from state to state (and from estate to estate). A close reading of the receivership order at issue will also remind the checklist team of the powers conferred upon receivers and their agents, including the power to require that records or funds be returned by specific dates.[9]

Of course, under all receivership orders, the receiver becomes "entitled to the custody and control of all property and assets of the insurer."[10] This includes not only bank accounts and escrow funds, but also the failed insurer's real property, parts of attorneys' or intermediaries' or agents' files, as well as leases, deposits, copyrights, and even the art on the wall.[11]

The liquidation or rehabilitation order will certainly encompass the cedant's reinsurance receivables, usually the estate's single most valuable asset, but may also extend to premium lodged in an intermediary's account, undistributed subrogation recoveries, or funds withheld. The order may call for a response or report to the receiver by a given date. Failing to act promptly with respect to the order may lead to litigation that could otherwise have been avoided.[12] The appropriate team -member should summarize and circulate this asset-related information.

REVIEW DOMICILIARY LAW

Every state insurance code addresses insurer insolvency, and these specific statutes will trump most conflicting state law.[13] State insurance insolvency statutes may include parts of the 1939 Uniform Insurers Liquidation Act (UILA), the National Association of Insurance Commissioners' (NAIC) 1998 Insurers Rehabilitation and Liquidation Model Act, or the comprehensive Insurer Receivership Model Act (IRMA) adopted by the NAIC in 2007 but not enacted in many states. The point: from a distance, state insurance insolvency laws may look similar, but they actually differ in many respects. And it is the rule rather than the exception that most states have added their own unique insurance insolvency provisions, e.g., the 2004 New Jersey guaranty fund legislation discussed below.

In this area, it's best to apply an ounce of history vs. a pound of logic rule.[14] In other words, never, ever assume that state insurance insolvency rules and regulations are in any way "uniform" or that experience gained in one receivership can be transferred to another.

LOOK FOR THE RECEIVER'S CMO; SIGN UP FOR ALL NOTICES AND REPORTS

Most of the courts that oversee insurer insolvencies will adopt case management orders (CMOs) that establish procedures for filing claims, approving/disapproving claims, and addressing how parties may raise objections with the receivership court. Our checklist insolvency team, however, will soon discover that other states' laws (and other state's insolvency statutes) may quickly come into play.

For example, In the Matter of Midland Insurance Company[15] – and many years into the Midland liquidation – the receivership court formed two committees: a committee of major policyholders (MPH) and a committee composed of Midland's reinsurers. With

> It would be a good idea to have a checklist team member look at the insolvency clauses in each reinsurance agreement with the failed company…

the court's oversight and supervision, these two committees stipulated to a detailed CMO that the court approved. Pursuant to this new CMO, and with the aid of briefing from the MPH and reinsurer committees, the court ruled that asbestos, environmental pollution, product liability, and other toxic tort claims were to be reviewed by Midland's liquidator applying New York's conflict-of-law rules to determine which state's laws applied rather than automatically following New York substantive law to make coverage claim determinations.

In addition to demonstrating how quickly other states' laws will intrude on a receivership commenced in any given state, the Midland insolvency also exemplifies direct reinsurer involvement in a liquidation proceeding. Note, however, that it was the receiver's outside counsel – not Midland's reinsurers – that got the ball rolling in 2006 and encouraged the receivership court overseeing the Midland estate to appoint these committees.

This is not the place for an exhaustive list of items to look for while reviewing the domiciliary state's liquidation/rehabilitation statutes, but rather the place to suggest that someone on the team prepare and circulate a short summary of the insolvency-related rules and cases in the failed company's domicile. This summary would address issues relevant to the insolvency proceeding, including offset, the insolvency clause, cut-through clauses/agreements, priority of claims payments, steps required to perfect a proof of claim, and the dangers associated with a reinsurer's settling/dealing directly with an underlying policyholder.[16]

COMPARE THE INSOLVENCY CLAUSES

Immediately after the U.S. Supreme Court's decision in Fidelity Deposit Co. of Maryland v. Pink,[17] New York enacted legislation requiring that in order for reinsurance treaties/certificates to provide a reinsurance credit for the ceding company, these agreements had to include an insolvency clause that placed the liquidator in the shoes of an insolvent cedant.[18] Most U.S. states followed and adopted similar statutes, but some states chose language that differed from New York's statute or simply provided that a reinsurer's payments could not be diminished on the basis of its cedant's insolvency.[19]

It would be a good idea to have a checklist team member look at the insolvency clauses in each reinsurance agreement with the failed company, and the related statutes or regulations in the failed insurer's state of domicile, and then compare the statutory insolvency provisions with the insolvency clauses in the subject reinsurance agreements. While doing so, our checklist team member should be alert to:

CONTINUED ON PAGE 14

REINSURERS AND RECEIVERSHIPS: A CHECKLIST

CONTINUED FROM PAGE 13

- the danger of double payments;
- the receiver's obligation to provide reinsurers with timely notice of their rights to participate in or even assume the defense of claims; and
- the cost-sharing features of assuming the defense of a claim.

All of these efforts should be coordinated with the reinsurer's intermediaries, although that may be a challenge given the recent surge in intermediary mergers and acquisitions.

And the checklist team should be alert to the opportunity to comment on any proposed CMO at the very outset of a liquidation proceeding.[20] The team might see an opportunity to raise issues relating to the CMO before the receiver's claims procedures ossify.

DON'T OVERLOOK THE IGAS

Insurance guaranty associations (IGAs) pay policyholders of the insolvent for allowed claims in amounts up to $300,000 or $500,000 or $1,000,000, depending on which state's laws apply. But IGAs may play a bigger role to the extent that they influence regulators' decisions with respect to how an estate should be administered. Consider, for example, a relatively recent New Jersey Supreme Court decision: Farmers Mutual Insurance Company of Salem v. New Jersey Property-Liability Insurance Guaranty Association (as Administrator of Claims against Newark Insurance Company).[21] We spend a few extra words on Farmers because it not only illustrates the interplay between insurance regulation and the guaranty associations, but it also provides a new twist on the allocation of continuously-triggered long-tail claims under New Jersey law.

The Farmers case arose from leaking underground oil tanks located on two different residential properties. In both cases, Newark Insurance Company (Newark) had provided the homeowners with coverage for three or more years. Newark was then succeeded by Farmers Mutual Insurance Company of Salem (Farmers) on the risks. Newark failed and was placed in liquidation. The New Jersey Property-Liability Insurance Guaranty Association (PLIGA) began the administration of Newark's claims pursuant to its statutory obligations under the N.J. Property-Liability Insurance Guaranty Act.[22] Meanwhile, Farmers had paid both losses in full.

Farmers sued PLIGA for reimbursement for Newark's share of the allocated loss that Farmers had paid to the policyholders. Farmers claimed that under the allocation requirements set out by the New Jersey Supreme Court in an earlier case,[23] the policyholder/guaranty association was responsible for Newark's share of the loss. PLIGA refused to reimburse Farmers, insisting that pursuant to 2004 amendments of the legislation that established both the property/casualty and the surplus lines guaranty funds, Farmers had to "exhaust" its policy limits before applying to the IGA for reimbursement under the Act.

A little background is in order. The 2004 PLIGA Amendment defined the term "exhaust" to mean, in the context of a continuous-trigger long-tail claim, that "with respect to all other insurance, * * * exhaustion shall be deemed to have occurred only after a credit for the maximum limits under all other coverages, primary and excess, if applicable, issued in all other years, has been applied . . ." (emphasis added).[24] PLIGA maintained that the New Jersey Legislature intended its 2004 amendment "to modify 'the role of the Guaranty Association in the context of the Owens-Illinois allocation scheme' by effectively rendering the Association as a 'payor of last resort'" and, therefore, pay Newark's allocated share of the loss up to the limit of the Farmers' policy.[25] Only after Farmers had "exhausted" its policy limits, and it had been established that no other solvent coverage existed, would the policyholder and the policyholder's guaranty fund be required to pay Newark's allocated share of the loss.[26]

Where did this 2004 PLIGA amendment come from? In 1997, an intermediate New Jersey appellate court had addressed a similar action for reimbursement, although in the context of surplus lines policies, in a case captioned Sayre v. Insurance Co. of N. America.[27] The Sayre case involved the New Jersey Surplus Lines Guaranty Act, which established the only insurance guaranty fund in the U.S. that covers surplus lines.

In the Sayre case, the surplus lines guaranty association fund had also argued that the Owens-Illinois allocation method should be "employed first to exhaust all other insurance coverage provided by the solvent carriers on the risk . . . before seeking recovery from the fund . . . ."[28] The Appellate Division in the Sayre case, however, affirmed a trial court order holding that the purpose of the guaranty fund was to pay for losses that would have been paid by the insolvent surplus lines insurer.

The court in Sayre reasoned that if New Jersey courts were to hold that solvent insurers were compelled to step into the shoes of the insolvent insurer, then the courts would have, in effect, "create[d] a separate statutorily unauthorized 'fund' consisting of insurers who were not on the risk" during the failed surplus lines insurer's time on the risk."[29] The court in Sayre, therefore, assigned the insolvent insurer's allocated share of the loss to the policyholder (and the surplus lines guaranty fund).

After the Sayre decision, the New Jersey Banking and Insurance Department began drafting an amendment to New Jersey's guaranty fund statutes, with some drafting advice from the guaranty associations themselves. This legislation included the above-quoted passage defining the term "exhausted" and was enacted by the Legislature in 2004. In the Farmers case, the New Jersey Supreme Court, on the basis of this 2004 amendment, held that Farmers must "step into the shoes" of the insolvent carrier, Newark, and become – up to Farmers' policy limits – the "payor of last resort." As a result, neither the two policyholders nor PLIGA, the guaranty fund, had to pay for defense costs or indemnity until all of the policyholders' solvent insurers had "exhausted" their policy limits as that term was defined in the 2004 amendment.

The Supreme Court in Farmers concluded that the New Jersey Legislature intended in 2004 to overrule Sayre. "If the Legislature were content with the Sayre decision – a continuous-trigger case – in which the Guaranty Fund was required to step into the shoes of the insolvent carrier for proration purposes, there would have been little point to adding the 2004 amendments" and providing a new definition of the term "exhaustion."[30]

An audit/inspection might also generate discussions that could lead to commutations or even reconsideration of the claim.

The takeaway here: it pays to pay attention to proposed legislation affecting insurance generally – and insurance insolvency in particular. Note: so far, the ruling in Farmers is confined to New Jersey, but it has been suggested/urged that the Farmers reasoning be exported to other states and jurisdictions.[31]

CONSIDER AUDITING

Under the relevant insolvency clause or pursuant to a CMO, reinsurers may have the right to inspect or audit files on which claims are approved by the receiver, rights often not exercised by reinsurers. A review of reserves for the insolvent company's claims might be worth the investment. Of course, reserves set by liquidators and receivers for these claims may be difficult to decipher because: (1) reporting formats may have changed; (2) the failed insurer's records may not be in the best of order; and (3) ancillary receivers may have set their own reserve figures.

Nevertheless, an inspection and audit would allow the reinsurer, depending on the terms of the CMO, to object to the approval of yet-to-be approved claims. An audit/inspection might also generate discussions that could lead to commutations or even reconsideration of the claim.

IDENTIFY STATUTES OF LIMITATION

In a recent decision, the New York Supreme Court that oversees the liquidation of a failed New York provider of dental liability coverage granted a quota share reinsurer's motion to dismiss the Liquidator's complaint against the quota share reinsurer with respect to certain billings barred by New York's six-year statute of limitations.[32] In that case, Superintendent of Financial Services of the State of NY v. Guarantee Ins. Co.,[33] the quota share reinsurer and the cedant's Liquidator had been engaged in intermittent commutation discussions for almost two decades. The quota share reinsurer had also twice audited the Liquidator's claim files.

Despite the reinsurer's nearly thirty-year refusal to pay, the Liquidator argued that each of the Liquidator's revised billings superseded all prior billings and extended the life of the reinsurance claim, which did not, therefore, reach its "natural termination" until the quota share reinsurer finally rejected the Liquidator's most recent billing. The trial court dismissed the Liquidator's arguments and held that the first reinsurance billing, which dated back to 1994, established all the "conditions precedent for commencing a suit and began running New York's six-year statute of limitations."[34]

The trial court also specifically addressed the Liquidator's argument that "on-again-off-again commutation discussions extend the time to bring suit." As the trial court put it, "a contractual payment obligation is not breached solely by repudiation, but also (or primarily) by the simple failure to pay on time."[35] After the decision, the Liquidator in the Guarantee case subsequently commuted with the quota share reinsurer and withdrew his appeal of the Guarantee decision, perhaps unwilling to risk an appellate ruling.

The Guarantee decision should inspire the checklist team to calendar all relevant statutes of limitation and be prepared to pursue this issue either before the receivership court or in commutation discussions.

PERFECT PROOFS OF CLAIM/RIGHTS OF OFFSET

Most reinsurance claims in an insurance company receivership will not be paid or will paid in pennies on the dollar. Nevertheless, a timely filed and periodically updated POC may prove worth the effort with respect to rights of set-off.[36] And the mere filing of the POC will reinforce the need to pay attention to these rights (and encourage our accounting team members to stay focused).[37]

At this point, many of the major 50-state insolvencies – some of which began in the mid-1980s – are winding down and receivers are commuting with reinsurers in order to close these estates.[38] Approved payments or commutations/releases will be negotiated and settled pursuant to statutory and case law requirements for offset,[39] but by using the checklist at least the amounts that might be offset will have been tracked and calculated.

AGAIN, WHY A CHECKLIST?

One reinsurance veteran wrote that while a cedant's insolvency may give rise to "storm clouds," over time a reinsurer will discover that the insolvency has produced "a silver lining – paying less and paying it later."[40] Regardless of whether the insolvency reduces a reinsurer's ultimate claims exposure, a receivership checklist might reduce the time that must be devoted to dealing with a cedant's receiver. Receivers have remarkable staying power. Reinsurers might as well use a dedicated team and a simple checklist to follow these estates. A dedicated team would also build up expertise and corporate knowledge with respect to receiverships and reduce the learning curve needed to address future receiverships.

According to Dr. Gawande, "[e]ven the simplest [checklist] requires frequent revisitation and ongoing refinement."[41] This proposed draft may need a lot of work (and perhaps some sub-checklists), but at least we will have started the discussion. With that said, let's give Dr. Gawande the last word: other professions have "recognized the simplicity and power of using a checklist. * * * When we look closely, we recognize the same balls being dropped over and over, even by those of great ability and determination. We know the patterns. We see the costs. It's time to try something else. Try a checklist."[42]

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1 For our purposes, the term "receiver" includes special deputy receivers, liquidators, rehabilitators, conservators, and any other regulatory persons who oversee a failed insurer through the operation of state insurance insolvency laws.

2 *See* D. Siegel, M. Gilligan, and P. Myers, CHECKLISTS FOR LAWYERS (ABA 2014).

3 A. Gawande, THE CHECKLIST MANIFESTO: HOW TO GET THINGS RIGHT (Picador 2009)(CHECKLIST).

4 CHECKLIST at 155.

5 CHECKLIST at 39.

CONTINUED ON PAGE 16

REINSURERS AND RECEIVERSHIPS: A CHECKLIST
CONTINUED FROM PAGE 15

6 CHECKLIST at 48.

7 CHECKLIST at 112-13.

8 CHECKLIST at 136-37. Among other things, the revised checklist was shorter, clearer, and operated in a "DO-CONFIRM," rather than a "READ-CONFIRM," format.

9 For a general overview of the powers conferred on insurance company receivers, *see* REFERENCE HANDBOOK ON INSURANCE COMPANY INSOLVENCY 3rd ed. at 276-315 (ABA-TIPS 1993) (ABA HANDBOOK).

10 1 COUCH ON INSURANCE (3rd edition) § 5:13 (June 2015).

11 *See*, *Liquidator Asks Court Permission to Sell Insolvent Insurer's Art Collection*, Mealey's Litigation Reports: Insolvency (Mealey's Insolvency), Vol. 27, Issue No. 4 at 9 (August 2015). For a collection of cases identifying other types of assets that fall within receivership orders, see ABA HANDBOOK at 369-379.

12 *See* Stephens v. American International Insurance Company, 66 F. 3d 41 (2d Cir. 1995) (liquidator sued multiple cedants to recover unpaid future premiums that cedants claimed were subject to rights of offset or were held in an intermediary's account).

13 "The provisions of the insolvency statutes prevail over any general statutes or common law because the legislature has set forth the substantive law and the procedures to be followed." In re Transit Cas. Co., 900 S.W.2d 671, 676 (Mo.App.1995).

14 For a history of how state laws for insurance receivership evolved, see S. Kimball, *History and Development of the Law of State Insurer Insolvency Proceedings: An Overview* in ABA NATIONAL INSTITUTE OF INSURER INSOLVENCY (1986).

15 86 N.Y.S.2d 922 (Sup. Ct., NY County 2008) (Stallman, J.), *rev'd*, 893 N.Y.S.2d 31 (lst Dept 2010) , rev'd, 923 N.Y.S. 2d 396, 947 N.E. 2d 1174 (2011).

16 *See* Ainsworth v. General Reinsurance Corp., 751 F. 2d 962 (8th Cir. 1985) (reinsurer liable to receiver for reinsurance moneys paid directly to the underlying insured); American Cast Iron Pipe v. Statesman Ins. Co., 343 F. Supp. 860 (D. Minn. 1972) (insolvency clause bars direct settlement with underlying insured).

17 302 U.S. 224, 58 S. Ct. 162 (1937).

18 NYIL § 1308.

19 For a thorough, albeit dated, analysis of this insolvency clause legislation in 52 U.S. jurisdictions, *see* David Spector, *Rights and Obligations of Reinsurers of an Insolvent Ceding Company – a Consideration of Selected Issues* at 93, 106-08, 185-92 in INSURER INSOLVENCY (ABA-TIPS Satellite Seminar Materials for live broadcast on October 25, 1990).

20 *See, e.g., Justice Asks for Input Regarding Proposed Liquidation Claims Procedure*, Mealey's Insolvency, Vol. 27, Issue No. 4 at 8 (August 2015) (a Supreme Court Justice in New York County issued an order to show cause calling for policyholders, creditors, and "others interested in the affairs" of the failed company (Eveready Insurance Company) to comment on/object to the liquidator's proposed procedures for the adjudication and classification of claims."

21 74 A.3d 860 (2013).

22 74 A.3d at 863.

23 Owens-Illinois, Inc. v. United Insurance Co., 650 A.2d. 974 (1994) (New Jersey is a continuous trigger jurisdiction that uses a pro-rata and time-on-risk plus weighted limits allocation methodology for certain long-tail claims).

24 74 A.3d at 871.

25 74 A.3d at 867 quoting the Association's brief.

26 74 A3d at 875. J. Kich, *Who has to Pay for Periods of Insolvent Insurance in Long-Tail Coverage Claims? New Jersey High Court Changes the Game in Favor of Policyholders*, Environmental Claims Journal, Vol. 26, Issue 1 (March 2014).

27 701 A.2d 1311 (App. Div. 1997) (allocated losses for the period in which an insurer has become insolvent to be paid by the responsible guaranty fund and/or the policyholder).

28 701 A.2d at 1313.

29 701 A.2d at 1314.

30 74 A.3d at 872.

31 J. Waldon and S. Brown, *New Jersey Allocation Laws: How to Calculate Solvent and Insolvent Insurers' Pro-Rata Shares for Long-Tail Claims*, Tort Trial & Insurance Practice Law Journal, Vol. 50, Issue Nos. 3 & 4 at 747-779 (Spring/Summer 2015).

32 2013 N.Y. Misc. LEXIS 2442, 2013 N.Y. Slip op. 3123.

33 For a full discussion of this case and its ramifications, J. Veach, *New York's Six-year Statute of Limitations Bars Liquidator's Reinsurance Recovery,* Mealey's Litigation Reports: Reinsurance (Mealey's Reinsurance) , Vol. 24, Issue No. 16 at 14 (December 20, 2013) and Mealey's Insolvency Reports, Vol. 25, Issue No. 9 at 21 (January 2014).

34 Slip op. at 2-3.

35 Id.

36 *See, e.g., Liquidator Asks Court to Approve Reinsurance Allowance Amounts,* Mealey's: Insolvency, Vol. 27, Issue No. 6 at 18 (October 2015).

37 *See, e.g., Texas Judge Oks Insolvent Insurer's Payment to Reinsurer after Offset*, Mealey's Reinsurance, Vol. 26, Issue No. 1 at 11 (May 1, 2015).

38 *See, e.g., Liquidator Seeks Approval of $13 Million in Reinsurance Commutation Agreements,* Mealey's Reinsurance, Vol. 26, Issue No. 4 at 13(June 18, 2015); *Liquidator Asks Court to Approve Reinsurance Commutation Agreement*, Mealey's Reinsurance, Vol. 26, Issue No. 1 at 11 (May 1, 2015).

39 *See, e.g., Texas Judge Oks Insolvent Insurer's Payment to Reinsurer After Offset*, Mealey's Reinsurance, Vol. 26, Issue No. 1 at 11 (May 1, 2015).

40 J. Cuff, *Insurance Insolvencies: The Reinsurer's View,* Mealey's Litigation Report: Insurance, Vol. 11, Issue No. 6 (July 27, 2000) Among other things, the author suggested that over the life of the estate: (1) policyholders' claims might run afoul of claim bar dates; (2) policyholders may abandon their claims and cease following their proofs of claim; (3) guaranty funds and receivers themselves may play hardball and drive down claims; and (4) policyholders may turn their attention to solvent insurers. Mr. Cuff believed that these circumstances would eliminate some claims and, as a result, reduce amounts ceded to reinsurers.

And, to a degree, it appears that insurance receivers agree with Mr. Cuff. Consider this passage from a motion filed by the Liquidator of Reliance Insurance Company to establish a Bar Date for claims against the Reliance estate:

> Mass tort & CD (construction defect) claims can develop quite differently in a liquidation context involving an insolvent carrier. These claims are often covered by multiple insurers in multiple layers or a tower of insurance. Logically, the claimants first seek recovery from any solvent carriers which may mean that no claim is ultimately pursued against the Reliance Estate unless other coverage is exhausted.

Application of Michael F. Consedine, Pa. Insurance Commissioner, at 17, ¶ 26, submitted in In Re Reliance Insurance Company, in Liquidation, No. 1 REL 200 to the Pennsylvania Commonwealth Court on July14, 2014 by the Commissioner's counsel in support of the Commissioner's Application to Establish a Claims Bar Date.

41 CHECKLIST at 183.

42 CHECKLIST at 186.

THE SUNSET AND COMMUTATIONS CLAUSES

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Ms. Mack holds the distinction of being a certified ARIAS-US umpire and qualified ARIAS-US mediator. She is listed on the American Arbitration Association's list of commercial arbitrators.

Abstract: This is the fourth and last in a recurring series of articles focusing on reinsurance treaty clauses most useful to claims professionals. Authored by a member of the Journal of Reinsurance's Industry Advisory Board, this article addresses how best to interpret the Sunset and Commutations Clauses, and what elements, optimally, these clauses encompass. This article provides pragmatic advice as to how claims executives can avoid issues with application of either the Sunset Clause or the Commutations Clause.

The author is indebted to the research talents of James Floyd, an associate attorney at Adams and Reese LLP. Also, the author would like to thank her good friend and fellow arbitrator, Robert M. Hall, for his fine 2014 article "Loss Notice and Sunset Clauses in Reinsurance Treaties" on which she has relied.

1. INTRODUCTION TO SUNSET AND COMMUTATIONS CLAUSES

How fitting it is that this final installment in the Reinsurance Claims Executive Corner series of articles focuses on those clauses which finalize or terminate claims arising from a treaty; namely, the Sunset Clause and the Commutations Clause! Related but different, these clauses indicate which claims are subject to a final "cash call" and specify under what circumstances these terminal claim payments by reinsurers to cedents occur.

First, a few helpful definitions. A treaty's Sunset Clause limits the time after a treaty's inception or expiration that claims can be reported. After the "sunset" or bar date, the reinsurer is no longer liable for those claims.[1] A treaty's Commutations Clause is utilized by parties who wish to finally settle a subset or all of a treaty's claims based upon an agreed methodology.[2] Claims are commuted within a specified time of (a) the treaty's inception, (b) after one annual period has elapsed (as in the case of an automatically renewable treaty) or (c) at treaty expiration. The onset of the commutations process can be contractually mandated, can be "called" at one party's option or can be completely discretionary.

Sunset and Commutations Clauses result in certain similar benefits to the parties to a reinsurance treaty. From the reinsurer's point of view, either a Sunset or Commutations Clause caps future adverse experience by reducing volatility. Such variability in claim experience stems from unexpected future escalation of frequency or severity of covered losses or allocated loss adjustment expense. From the cedent's point of view, either clause results in getting cash from claim payments at a specified point and therefore reduces any credit risk due to the reinsurer's possible future insolvency.[3]

The Commutations Clause differs from and expands upon the Sunset Clause in that it specifies agreed terms as to claim valuation. Also, this clause contains a built in dispute mechanism for actuaries to a make a decision in the case of disagreement upon the results of that valuation methodology. While a Sunset Clause's terms serve as a final bar to all claims not reported before a particular date, a Commutations Clause may specify that only some claims will be capitalized.

Both the Sunset Clause and the Commutations Clause are employed across the insurance sectors- in both property/casualty insurance and life/health insurance. In property/casualty insurance, the types of treaties containing Sunset Clauses are usually specific to workers compensation, but may also include casualty excess of loss treaties and catastrophe excess of loss treaties from hard market periods.[4] Claims people having dealt with the fall-out from workers' compensation carve-out reinsurance coverages, wherein reinsurance attaches only to the medical and disability portions of workers' compensation policies, are all too familiar with the fact that Sunset Clauses are contained in these health reinsurance treaties. Commutations Clauses are contained in property-casualty treaties such as workers' compensation contracts, but are also contained in medical stop loss treaties and workers' compensation carve-out treaties on the health side.

CONTINUED ON PAGE 18

1 Robert W. Strain, Reinsurance (3rd ed., 1997) pp.187-88.

2 Robert W. Strain, Reinsurance Contract Wording, (3rd ed. 1998) p.83

3 Lynn Bloom, Commutation Contract Clauses – Risk Transfer and Accounting Consideration (September 15, 2014 PWC presentation) at p. 3).

4 Reinsurance Contract Wording at pp. 281-282 and 366; see also "Evaluating Variations in Contract Terms for Casualty Clash Reinsurance Treaties," Casualty Actuarial Society Forum (1997, White Paper).

THE SUNSET AND COMMUTATIONS CLAUSES

CONTINUED FROM PAGE 17

2. THE CONTEMPORARY SUNSET CLAUSE

Frequent readers of this column know that, for fine examples of well-drafted treaty clauses, a great resource is the Brokers and Reinsurance Market website containing clauses contributed by industry leaders (see www. brma.org). An example of a current Sunset Clause follows:

Notwithstanding Errors and Omissions provisions, if any, to the contrary, coverage hereunder shall apply only to losses for which the Company has provided the Reinsurer with written initial notification within xxx years from the expiration of this Contract. If a claim arising out of an occurrence is reported during this period, all subsequent claims arising out of the same occurrence will be deemed reported under this paragraph regardless of when notification of loss is provided. [BRMA 68C]

a. Key Elements of the Sunset Clause

This example addresses each of the key elements of a Sunset Clause; namely, (a) the absolute bar to claim payment if a claim is not reported to the reinsurer, (b) the method of reporting and (c) the time for reporting. In this particular instance, the contract wording applies to treaties with a definite term, written on an occurrence basis. As appropriate, it springboards off the typical treaty definition of occurrence, that being an accident or series of accidents arising from one event. So even though there is a bar date for claims, once a claim is reported, all other claims related to that occurrence are provided coverage.

This clause also makes an exception to the absolute claim bar in the event that the treaty contains an Errors and Omissions clause. Certainly, it is a difficult and necessarily incomplete exercise to recite all the possible circumstances under which a claim could be inadvertently omitted from reporting. But a prudent claims executive should advocate that the cedent and the reinsurer document those anticipated circumstances which they jointly envision as giving rise to an error or omission. Otherwise, what is optimally an orderly claim valuation process may decelerate into a less predictable arbitration process and award.

b. Key Elements of Sunset Clause Implementation

Both today's cedent and today's reinsurer should be keenly in tune to the two key issues regarding Sunset Clause implementation:

- Were the claims timely reported?
- Were the claims properly reported?

The recent case of Munich Reinsurance America, Inc. vs. American National Insurance Company[5] is a cautionary tale, melding timeliness and manner of reporting issues. The circumstances of the case specifically arose from a Sunset Clause, although the principles in dispute which the judgment resolved apply equally to issues arising from Commutations Clauses.

American National Insurance Company [ANICO] provided retrocessional excess of loss coverage to Munich Reassurance for workers' compensation carve-out insurance coverage. One of the many issues which ANICO disputed was whether Munich Re's reporting methodology sufficed to provide the retrocessionaire with timely and adequate notification of claims. While the treaty contained a detailed loss notice provision, it also contained a Sunset Clause providing:

Seven years after the expiry of this Agreement, the Company shall advise the Reinsurer of all claims for said annual period, not finally settled, which are likely to result in a claim under this Agreement. No liability shall attach hereunder for any claim or claims not reported to the Reinsurer within this seven year period.

Munich, as the retrocedent, attempted to notify ANICO of several claims prior to the bar date or sunset date of December 21, 2008 by providing a twenty-four page spreadsheet on August 8, 2008.[6] For all but one of the claims, the federal district court judge concluded that the spreadsheet was the only notification methodology employed for the claims prior to the applicable bar date.[7] While the spreadsheets provided such detailed information as both parties' claim numbers, underwriting years, dates of loss, paid amounts for both indemnity payments and allocated loss adjustment expense, ANICO argued that (a) spreadsheet or bordereau claim reporting was not appropriate for an excess of loss (as opposed to a quota share) treaty and (b) the spreadsheets did not provide enough detail to result in individual claim valuation. While the district court judge refused to opine whether the spreadsheet constituted bordereau reporting, she did opine that the specific descriptors of claims on the spreadsheet were not sufficient to allow ANICO to determine whether individual claims were likely to pierce the retroccessionaire's layer of coverage. Accordingly, ANICO was able to escape liability for most of these claims.

In the author's experience, from the 1990's onwards, large cedents and retrocedents complied with their Sunset Clause claim reporting obligations by notifying their reinsurance partners of claims via spreadsheet or bordereau. The fact-intensive ruling in the above-cited case did not purport to resolve the issue as to whether, for Sunset Clause reporting purposes under both excess of loss treaties and quota share treaties, a detailed claim bordereau is sufficient to notify claims. Rather, the court's reasoning stresses the importance of both the cedent and reinsurer resolving in writing what constitutes sufficient claim notification, well in advance of the Sunset Clause's bar date and certainly well in advance of any claims dispute.

The key question is, of course, whether individual claims can be identified and valued meaningfully; however, in light of

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5 990 F. Supp. 2d 690 (D. N. J., 2014); *see also* Robert M. Hall, Loss Notice and Sunset Clauses in Reinsurance Treaties. By way of full disclosure, the author of the present article was the retrocedent's claims expert in federal district court.

6 *Id.* at pp. 727-728

7 *Id.* at Footnotes 59, 64.

this case authority, the prudent claims professional should not rely on his or her understanding of what information seasoned claims professionals would typically find adequate. If a bordereau constitutes a mutually convenient reporting format, it should be so agreed. Similarly, the fields of information to be listed on that bordereau-together with a legend to make clear any referenced abbreviations- should also be agreed. Under no circumstances should the prudent cedent's claims executive notify the claims in summary fashion, and then later provide supplemental details by subsequent notice--without seeking the reinsurance partner's consent.

3. THE CONTEMPORARY COMMUTATIONS TREATY CLAUSE

A current version of a well-drafted Commutations Clause follows:

Not later than xxx months after the close of any one annual period, the Company shall advise the Reinsurer of all claims, both reported and unreported for said annual period not finally settled which are likely to result in a claim under this Contract. The Company and the Reinsurer or their respective representatives shall, by mutual agreement, determine and capitalize such claims. Payment by the Reinsurer of its proportion of the amount or-amounts, so mutually agreed, shall constitute a complete and final release of the Reinsurer of all claims, both reported and unreported.

If agreement cannot be reached, the Company and the Reinsurer shall mutually appoint an actuary or appraiser to investigate, determine and capitalize such claims. If both parties then agree, the yyy Reinsurer shall pay its proportion of the amount so determined to be the capitalized value of such claims.

If the parties fail to agree, then any difference shall be settled by a panel of three actuaries, one to be chosen by each party and the third by the two so chosen. If either party refuses or neglects to appoint an actuary within zzz days, the other party may appoint two actuaries. If the two actuaries fail to agree on the selection of a third actuary within aaa days of their appointment, each of them shall name two of whom the other shall decline one and the decision shall be made by drawing lots. All the actuaries shall be regularly engaged in the valuation of Workers' Compensation claims and shall be Fellows of the Casualty Actuarial Society or of the American Academy of Actuaries. None of the actuaries shall be under the control of either party to this Contract.

Each party shall submit its case to its actuary within bbb days of the appointment of the third actuary. The decision in writing of any two actuaries, when filed with the parties hereto, shall be final and binding on both parties. The expense of the actuaries and the commutation shall be equally divided between the two parties. Said commutation shall take place in specified city, specified state, unless some other place is mutually agreed upon by the Company and the Reinsurer. [BRMA Clause 11D].

a. Key Elements of the Commutations Clause: Mandatory vs Optional vs. Discretionary

The BRMA note to this example states that the commutation contemplated by the clause "is enforceable for all claims, rather than a subset of claims". This clause is also an excellent illustration of a "mandatory" clause, meaning that the parties must complete the commutations process as to claims existing after a given amount of time has elapsed since a given date (typically, treaty inception, expiration or, as here, after any one annual period has come to a close). In the event of the parties' disagreement as to the valuation of the involved claims, this clause also contains a dispute resolution mechanism by which three independent actuaries determine the valuation.

Contrast this with the optional clause, where the parties may, but need not, institute the commutations process. While either party may opt for commutation, typically this type of clause is triggered by the cedent in following situations; namely, where: (a) the book of business is very profitable, and the cedent wishes to discontinue reinsurance early and keep the profits; (b) there is a profit commission clause and there are nominal losses; or (c) simply there is motivation to receive money sooner.[8] The counterparty may refuse to accept commutation, but, in the event that the counterparty's concerns are limited to the amount of the valuation, this version of the clause also includes a dispute resolution mechanism by actuarial process. This clause has the decided drawback of potentially putting the parties through a time-consuming process without resulting in finality.

There also exists the totally discretionary Commutations Clause, which can best be typified as an agreement to agree. This clause's simple purpose is to set parameters in case a commutation does occur. While it is arguable that such a clause's parameters may turn out to be inappropriate due to changing circumstances, prudent claims executives prefer having such a clause to no clause at all. When emotions start running high about whether/how to value claims, a valuation framework proves very helpful.

b. Differences between Commutations Clause Implementation and One-Off Commutation Agreements

Why have a Commutations Clause in a treaty at all when a one-off commutation is possible? As seasoned claims executives know, an individual commutation agreements is "an agreement between a ceding insurer and a reinsurer that provides for the valuation, payment and complete discharge of all obligations between the parties under a particular reinsurance contract."[9] A commutations agreement is situational in nature, as opposed to a treaty's Commutations Clause which may be repetitive and is in ordinary course of business for ongoing treaties. In other words, particularly when the Commutations Clause triggers at the end of each annual period for an automatically renewable treaty, the treaty remains intact as opposed to being extinguished.

As opposed to a situational commutations agreement, having a Commutations Clause in a treaty eases any future administrative

CONTINUED ON PAGE 20

8 Bloom at pp. 6-7.

9 International Risk Management Institute Glossary at www.irmi.com/online/ insurance-glossary

THE SUNSET AND COMMUTATIONS CLAUSES

CONTINUED FROM PAGE 19

issues. In the case of a one-off commutation, the reinsurer's reinsurers, that is the retrocessionaires, may have to be convinced that the deal is appropriate and that the allocation among the layers of a retrocessional program is fairly implemented. A retrocessionaire cognizant of a treaty's Commutations Clause is less likely to contest administration conducted in accordance with the clause's terms.

c. Issues in Common for Cedents and Reinsurers-Effect on Paids, Reserves and IBNR.

Since the Commutations Clause specifies a cut-off for claims, the valuation specified by the commutation must include only paid claims but case reserves and incurred but not reported claims (IBNR). In addition, the valuation terms routinely include a discount factor, accounting for the present value of expected future paid losses given that the case reserves and IBNR have not yet matured.

Let's put the above explanation in different terms. Pricing of the commutation is an actuary's job, rather than that of a claims professional; however, claims professionals can and do acknowledge that the commutation calculations begin with a determination of the cost to the reinsurer of not commuting.[10] That cost is the present value of the tax benefit related to the unwinding of reserves subtracted from the present value of expected future losses (using the discount rate). Thereafter, the cost of the commutation is calculated by subtracting the value of the tax on the underwriting gain or loss generated by the transaction from the cost of not commuting.

d. Views From the Cedent's Side-The Balancing Act

Accelerating case reserves and IBNR enables a cedent to receive cash immediately. Obviously that provides a real benefit, and also minimizes any future credit risk on the part of the reinsurer. The real downside posed by any commutations process to the cedent is the fact that it now re-assumes the underwriting risk that was previously transferred to the reinsurer.[11] In essence, the Commutations Clause forces the cedent to take the bet that expected future paid losses will not exceed the valuation actuary's predictions.

e. Views from the Reinsurer's Side-Or Why the Barn Door Should be Shut

Conversely, triggering a commutations process can enable a reinsurer to minimize or eliminate ultimate liabilities on its books at an early date by making a present cash value payment. Particularly with respect to reinsured workers compensation coverages, the reinsurer's anticipated future costs may be increased due to escalation of indemnity payments, inflation in medical costs or increase in the original claimants' life expectancies. Accepting a commutation pursuant to a treaty clause minimizes those risks for the reinsurer.

Of course, finality – whether for a treaty period or for an entire treaty – also constitutes a real and substantial benefit to the reinsurer. A cautionary note: one-off commutations are typically concluded by an agreement releasing the reinsurer from all liability for the covered claims. At the very least, the well-drafted Commutations Clause must recite that the fact of the reinsurer's payment releases the reinsurer from any future liability for the reported claims. To be very careful, a detailed commutations agreement containing a well-crafted release should also be executed.

f. A Problem: The Commutations Clause's Effect on the Arbitration Clause

Unfortunately, today's claims executive is all too familiar with the process of arbitration. A treaty's Arbitration Clause typically provides for resolving disputes between the reinsurer and cedent by means of a three arbitrator panel's binding award. As noted, the Commutations Clause itself contains its own dispute resolution mechanism, utilized when the reinsurer and cedent cannot agree on the valuation of the involved claims. What happens when, after a Commutations Clause is triggered, issues arise both as to whether individual claims are covered by a particular reinsurance treaty and as to their potential valuation (assuming issues are ultimately resolved in favor of treaty coverage for the claims)? What dispute mechanism prevails?

A pragmatic solution exists to this quandary. Optimally, the parties could break the stalemate by opting to proceed according to the Arbitration Clause, but may then choose to bifurcate the involved issues. In the first phase of the arbitration, coverage for the disputed claims under the relevant treaty can be resolved. If coverage is proven for all or a subset of the claims subject to the Commutations Clause, the arbitration then moves to its second phase. For the covered claims, the Commutations Clause's three actuary valuation process is invoked and an appropriate valuation is provided to the parties.

4. CONCLUSION

We are at the end of the Reinsurance Claims Executive's series. Over the course of the past year, we have reviewed together drafting considerations and pragmatic claims concerns for the Subrogation and Salvage Clauses, the Excess of Policy Limits Clause, the Extra-Contractual Obligations Clause and the Commutations and Sunset Clauses. With these resources provided to you as claims executives, I wish you many happy future claims resolutions!

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10 Mark Jones, "A Commutations Overview: Effectively Managing Reinsurance Programs" Journal of Insurance Operations (2009) at p. 4.

11 *See* Scott E. Westra, "Reinsurance Oversight: Beware the Risks of Reinsurance: Here's What to Look for" AASCIF News (2009).

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