The Trouble with Securing Collateral

by Joshua Gold

Policyholders routinely post collateral in connection with their captive insurance operations, deductible reimbursement programs and workers compensation policies. At its most basic level, the collateral is used to secure obligations that the policyholder must perform. If the policyholder fulfills its obligations, the collateral should remain secure and untouched. That, however, is not always the case.

Some insurance companies have seized the policyholder's collateral improperly—often on the basis that claims reserves require greater capital infusions to secure pending claims or claims estimates. Policyholders have also fought with state regulators regarding the treatment and disposition of collateral they have posted with insurance companies that are later rendered insolvent, resulting in liquidation or rehabilitation. These perils all point to the need for carefully drafted agreements that define the handling and purpose of the policyholder's collateral.

Problem #1: Over-reserving and claims handling. Unfortunately, it is not uncommon for insurance companies to set reserves in a manner that the policyholder views as imprudent and unreasonable. The inflation of claim reserves may "coincidentally" arise at the very time the policyholder is considering using a new insurance company for its fronting needs or other business requirements. Setting inflated reserves can tie up existing collateral for several years or result in the need for an infusion of additional assets from the policyholder to collateralize its "obligations."

To guard against this risk, policyholders should seek some measure of protection in the underlying contracts that spells out the obligations and rights of the parties, the setting of reserves and the resolution of disputes, should the parties disagree on the reserving methodology. Many contracts drafted by insurance companies provide a one-sided formula for setting reserves and triggering collateral requirements. Policyholders should spend the time to balance contracts with fair and reasonable terms that delineate the formula to be used and the manner in which actuarial disagreements over reserve-setting and claims-handling will be resolved.

While scrutinizing the actual terms underpinning these obligations and rights at the point of purchase, the policyholder should, above all else, make sure that those terms provide the policyholder with some recourse if it believes that collateral is being locked-up improperly to secure inflated claim reserves or is otherwise being utilized and dissipated for the improper handling of claims.

Problem #2: The collateral should be identified as collateral. Another problem for policyholders is posed by some forms of collateral agreements that fail to identify that the funds or assets are collateral posted by the policyholder. Furthermore, some forms of agreements fail to define when and for what purpose the collateral may be used or drawn-down upon. Given that some arrangements involve a number of entities and contracts, the documentation must be written in a way that harmonizes the rights and obligations between the parties so that policyholders and their collateral are protected.

Within this documentation, there should be an explicit contractual provision identifying the assets posted as the collateral for the agreement. Otherwise, a policyholder may find the insurance company arguing that the assets are not necessarily collateralizing the relationship but instead may be drawn upon by the insurance company for any reason and in any sequence (i.e., before the policyholder fails to meet an obligation that required the collateral in the first place).

Problem #3: Protecting collateral from state regulators. If a policyholder posts collateral in favor of an insurance company that later enters liquidation or state insurance department rehabilitation, a state insurance department may seek to seize the collateral as part of the insurance company's estate general assets to satisfy other creditor claims. Clearly identifying collateral as such in written agreements with the insurance company decreases the likelihood of such a seizure. The key is making sure that the agreements are properly documented. ■