A Reinsurance Sidecar Checklist

Reinsurance sidecars are limited-life, special-purpose reinsurers that, during favorable pricing and underwriting conditions, provide investors exposure to reinsurance risk while allowing sponsor insurers and reinsurers an additional source of capacity and the opportunity to leverage their infrastructure by earning profit commissions. Sidecars emerged as an alternative to newco reinsurers during the hard market after Hurricane Katrina in 2005. Many industry observers are predicting that the series of tragic natural disasters over the past several months may trigger a renaissance of sidecars.

We have prepared the following checklist as a tool to assist in developing sidecars and similar vehicles. This checklist is not intended to be comprehensive; it is merely a tool to help identify some of the key issues that arise in developing a sidecar structure.

1. **Composition of the Target Business:** What insurance policies or reinsurance contracts will constitute "qualifying contracts" for inclusion in the ceded portfolio?
   - All policies or reinsurance contracts written in an entire "line of business," or only those covering specifically named perils?
   - Will the portfolio be a fixed portfolio of already-written contracts, or will it include contracts to be written over a specific time period (and if so, what time period)?
   - Will there be additional "filters" for the qualifying portfolio (e.g., a specific modeled return on equity)?
2. **Form of Risk Transfer to the Sidecar:**
   - Reinsurance or derivative?
   - Quota share or excess of loss reinsurance?
   - Will there be an additional trigger (e.g., industry loss threshold)?
3. **Retention, Inuring Reinsurance and Alignment of Interests:**
   - Will the ceding company be obligated to retain a specific portion of the risk in order to align interests with the Sidecar investors?
   - If so, what is a reasonable minimum retention amount that is sufficient to create alignment?
   - Will the ceding company be allowed to procure inuring reinsurance notwithstanding the retention?
   - Will the Sidecar be exposed to the credit and collection risk of the inuring reinsurance?

4. **Ceding and Profit Commissions:** While the ceding commission is designed to reimburse the ceding company for its expenses and overhead, the profit commission is central to the entire value proposition to the ceding company and also enhances alignment of interests.
    - What is the basis for the ceding commission (i.e., percentage of written premium or fixed amount)?
    - Will the commission be structured as a sliding scale incorporating both ceding and profit commission?
    - Will the profit commission be based purely on underwriting profit and if so, how is underwriting profit calculated?
    - What is the appropriate amount of profit commission?
    - Will there need to be a hurdle return on equity before profit commission is paid to the ceding company? If so, what is the appropriate hurdle rate?
    - Will there be tranched commissions based on varying hurdle return on equity rates?
5. **Other Key Terms and Conditions in the Reinsurance Contract:**
    - Which exclusions are market standard?
    - How to address follow-the-fortunes and the risk of *ex gratia* payments?
    - What are market standard representations & warranties, events of default, remedies?
    - What are appropriate automatic and voluntary termination features and what are appropriate termination payments (see also ramp-down and commutation below)?
6. **Capitalization During Ramp-Up:** Since premium does not come into vehicle until policies or reinsurance contracts are ceded, full funding at vehicle inception results in negative carry for investors. Therefore, at what point during the portfolio ramp-up will investors need to fund?
    - All funding upfront to give ceding company the certainty that capital is "in the box" as ceding company accepts risks into the portfolio?
    - Fixed schedule over time, with ceding company exposed to investor funding risk?
    - Capital calls that are contingent upon new business generation hurdles (also leaving ceding company with investor funding risk)?
7. **Amount of Capital and Retention of Tail Risk:** Sidecars have a finite amount of capital and are rarely capitalized to the full notional amount at risk; therefore the sponsoring cedent is exposed to the risk of loss in excess of the proceeds raised.
    - How much capital will be raised (e.g., to what modeled expected loss level?)
    - Will the premium paid to the Sidecar be reduced to pay the ceding company for retaining the "tail risk" (the risk that aggregate losses exceed the capital raised)?
    - How will the "price" for the tail risk retention be calculated?
    - Will premiums be included in the collateral available to pay reinsurance obligations to give investors some added leverage?
8. **Capital Structure:**
    - Will the Sidecar capital structure be tranched into equity and debt?
    - What is the dividing line between equity and debt?
    - What coupon will be paid to the debt investors?

9. **Collateral Structure and Permissible Investments:**
    - Will the proceeds raised from investors be lodged in a credit for reinsurance trust (a/k/a, "Regulation 114 Trust") at the outset or a different collateral arrangement?
    - How will the Sidecar investor's interest in the collateral be secured and perfected, in view of the ceding company's senior interest?
    - What will be the permitted investments for the collateral?
    - Will investment be limited to treasuries and government-backed instruments, riskier investments, or will a swap or tri-party repo be employed? If the latter, there are host of issues that need to be considered including amount of haircuts, frequency of marks and top-up, etc.
    - Will investments be chosen by the sponsor cedent or an independent investment manager?
10. **Ramp-Down; Reserves, Commutation and Return of Capital:**
    - Once the exposure period has ended on certain of the portfolio contracts, how and when will the capital be distributed to the Sidecar investors?
    - If there have been triggering events and the establishment of reserves, is all capital excess of the reserves distributed? If so, how is the ceding company protected against adverse development excess of the capital held back?
    - How are reserves established?
    - Can the ceding company or the Sidecar force a commutation? If so, what is the agreed methodology for valuing reserves and how are disagreements over the commutation amount resolved?
    - Will there be a roll-over option for investors to reinvest in next vehicle?
11. **US Securities Law Considerations:**
    - Will the offering include US investors?
    - Will the Sidecar investments be tradable?
    - There are multiple issues to consider in connection with disclosure and related potential liability issues.
12. **US Tax Considerations:** Investors need to be careful regarding structure to minimize tax exposure, including:
    - "Controlled foreign corporation" (CFC) rules.
    - "Passive foreign investment company" (PFIC) rules.
    - Excise and premium taxes.
13. **Domicile and Type of Legal Entity:**
    - How and where will the sidecar be licensed to write insurance or reinsurance, and will there be an intermediate or other holding company?
    - If Bermuda is chosen, will the Sidecar qualify as a special-purpose insurer?
    - Does another jurisdiction provide other benefits?

14. **Management and Service Providers:**

- Will the Sidecar be managed by an affiliate of sponsor or independent manager?
- If independent manager, will it perform additional "watchdog" services in vetting the portfolio, scrutinizing claims, etc.?

For assistance with this checklist, or for further information about reinsurance sidecars or similar structured reinsurance vehicles, please consult one of the following Mayer Brown lawyers.

Kenneth R. Pierce
Partner and Global Coordinating Leader
Insurance Industry Group
+1 212 506 2210
kpierce@mayerbrown.com

Keith M. Andruschak
Partner
+1 212 506 2658
KAndruschak@mayerbrown.com

Stephen G. Rooney
Partner
+1 212 506 2567
srooney@mayerbrown.com

Ricky B. Spitzer
Partner
+1 212 506 2309
rspitzer@mayerbrown.com

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