

# Valuation of contingent claims and the application of set-offs in reinsurance insolvencies

## Part II English law of set-off

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### Overview

In the first part of this four-part article, we addressed the topic of contingent claims in insurance insolvency proceedings. Another issue of importance to receivers and the insurance industry alike is that of set-offs. The issue is important to receivers because set-offs deprive the estate of funds that otherwise would be used for payment of administrative costs and expenses and for the benefit of the insolvent's creditors as a whole. The issue is equally important to reinsurers eager to minimize losses sustained as a result of the insolvency of reinsureds because it enhances their ability to retain funds that, but for set-offs, would have to be paid to the insolvent's receiver.

### What is a set-off?

The right to assert set-offs in the insolvency context is a statutory guarantee in England and the United States. In its simplest form, set-off is 'the right which exists between two parties to net their respective debts where each party, as a result of unrelated transactions, owes the other an obligation'.<sup>51</sup> Under the set-off doctrine, mutual debts and credits<sup>52</sup> may be set off, even though they arise from different transactions. Set-off thus is distinct from the similar doctrines of abatement or recoupment, which contemplate reduction of one party's debt to the other by the netting of mutual obligations arising in the same transaction, to the extent sufficient to satisfy the plaintiff's claim.<sup>58</sup> This distinction is important to receivers, reinsureds and reinsurers because adherence to the abatement doctrine may deprive parties of all but a few set-offs; abatement does not permit a reduction of mutual obligations arising under different contracts, thus denying a reinsured the opportunity to reduce its obligations owed the insolvent reinsurer as retrocessionnaire, while set-off would allow such an accounting. Unfortunately, the distinction between set-off and abatement has not always been observed.<sup>54</sup>

Set-off may be viewed as a specie of lawful preference.<sup>55</sup> It also may be viewed in economic terms as a form of security.<sup>56</sup> It has been observed that 'two

policies justify the recognition of set-off in bankruptcy; fairness and commercial necessity. Set-off may also involve [U.S. federal] constitutionally guaranteed property rights, the taking of which is restricted, or contract rights, which the [American] states are restricted from impairing.'<sup>57</sup> These same policy considerations apply with equal force to set-off in the context of insurance and reinsurance company insolvencies.

### Historical development

The right of set-off was created in Roman law, developed in courts of common law and equity,<sup>58</sup> and later codified in England and thereafter the United States. An often cited, early recognition of the right at common law is found in *Anonymous*,<sup>59</sup> where Chief Justice North stated that:

'If there are accounts between two merchants, and one of them become bankrupt, the court is not to make the other, who perhaps upon stating the accounts is found indebted to the bankrupt, to pay the whole that was originally entrusted to him, and to put him for the recovery of what the bankrupt owes him, into the same condition with the rest of the creditors; but to make him pay that only which appears due to the bankruptcy on the foot of the account; otherwise it will be for accounts betwixt them after the time of the other's becoming bankrupt, if any such were.'

At the time of *Anonymous*, the existing English bankruptcy statute<sup>60</sup> contained no set-off provision. Two other decisions followed *Anonymous* – *Curson v. African Co.*<sup>61</sup> and *Chapman v. Derby*,<sup>62</sup> both of which allowed set-offs – before the bankruptcy statute was amended to provide a right of set-off.<sup>63</sup>

### UK law of set-offs

Under current English rules of civil procedure, a defendant may deduct or 'set off' a claim to a sum of money against the whole or part of a plaintiff's claim.<sup>64</sup> Set-off must be distinguished from the similar but distinct concepts of counterclaims and cross-actions.<sup>65</sup> The object of set-off is to prevent cross-

actions, and 'prevent the injustice of a man who has had mutual dealings with a bankruptcy from having to pay in full what he owes to the bankrupt while having to rest content with a dividend on what the bankrupt owes him'.<sup>66</sup>

The rules of civil procedure do not define or describe what type of claim may be pleaded as a set-off; they merely provide that where a defendant relies upon a claim to a sum of money as a defense, it may be pleaded as such.<sup>67</sup> What then, is the nature of set-off? In England, the modern law of set-off is an amalgamation of common law and equitable set-off.<sup>68</sup> The nature of the equitable right of set-off has been described as:

'[w]here a cross-complaint for a sum of money is so closely connected with the claim that it goes to impeach the plaintiff's title to be paid and raises an equity in the defendant, making it unfair that he should pay the plaintiff without deduction, the general rule is that the defendant may deduct with impunity the amount of the cross-complaint, or raise it by way of equitable defence when sued.'<sup>69</sup>

In addition to the equitable standard, the set-off may be for a sum of money whether ascertainable or not. As a general rule, however, set-off may be raised as a defence only to money claims,<sup>70</sup> and both the defendant's and the plaintiff's claims must exist between the same parties, in the same right.<sup>71</sup>

A right of set-off may be created by express or implied agreement. If there is an agreement, a debt may be set off which otherwise could not be so pleaded, provided the agreement is supported by consideration. Prior dealings of parties which have permitted mutual debts to be set off is sufficient evidence from which to imply an agreement.<sup>72</sup> However, a set-off by agreement will not be implied from a custom of which the plaintiff was not aware.<sup>73</sup>

### **Set-offs in the context of insolvent insurance companies**

In England, the laws relating to both individual and company insolvency have been consolidated by the 1986 Insolvency Act ('1986 Act').<sup>74</sup> The detailed, procedural aspects of insolvency proceedings in England are governed by the rules promulgated under the 1986 Act (the '1986 Rules').<sup>75</sup> The Rules, in part,<sup>76</sup> provide:

(1) This Rule applies where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation.

(2) An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sum due from the other.

(3) Sums due from the company to another party shall not be included in the account taken under paragraph (2) if that other party had notice at the time

they became due that a meeting of creditors had been summoned [to vote on a resolution for winding-up<sup>77</sup> the company] or (as the case may be) a petition for the winding-up of the company was pending.

(4) Only the balance (if any) of the account is provable in the liquidation. Alternatively (as the case may be) the amount shall be paid to the liquidator as part of the assets.

In *Re City Equitable Fire Insurance Co. Ltd. (No. 2)*,<sup>78</sup> the court considered the expression 'mutual dealings' in a reinsurance context. The court determined that money retained by the reinsured in a premium deposit account may be set off against debts owing to the reinsured under the treaty of reinsurance creating that account. The court further held that the interest earned on the premium deposit account may be set off against debts owed by the reinsurer to the reinsured arising under other treaties of insurance and reinsurance between the parties. However, the principal monies collected in the premium deposit account could not be set off against debts owing to the reinsured under other treaties of insurance and reinsurance. As one commentator observed, this decision implies that 'sums owing between a reinsurer and a reinsured may be set off against each other under r.4.90 of the Insolvency Rules 1986 even if arising under different treaties.'<sup>79</sup>

The question arises whether all provable debts resulting from mutual dealings, in particular contingent liabilities, are capable of being set off. Until recently, creditors of an insolvent reinsurance company could not set off claims for payment made by them to policyholders after the fixing date.<sup>80</sup> It is now settled that:

'to disallow the set-off of a provable debt merely because it was still contingent at the [fixing date] ... where the contingency has since occurred and the liability which has arisen is exclusively referable to and has resulted in the natural course of events from a transaction between the same parties entered into before the [fixing date], would ... be productive of the very injustice [set-off is] designed to prevent.'<sup>81</sup>

Thus, once the contingency has been valued and is provable in the liquidation, the valued amount is capable of being set off.<sup>82</sup> Nevertheless, a reinsured is not permitted to gain an advantage after the fixing date by buying up the insolvent reinsurer's liabilities in order to obtain the benefit of a set-off.<sup>83</sup>

### **Set-offs involving reinsurance intermediaries**

Despite the prevalent involvement of intermediate parties in reinsurance transactions, little attention has been paid to the issue of whether and to what extent set-offs may be asserted between an insurer and a reinsurer – one of whom is insolvent – when one of them was represented by an intermediate party (usually referred to as brokers, agents and intermediaries<sup>84</sup>). This lack of attention is surprising in

view of the magnitude of the financial consequences that may attend the assertion of set-off rights. It is not difficult to see that the intervention of intermediate parties may drastically alter the economic positions of the respective principals. The following brief discussion will illustrate the complexity of the issue and its relevance in assessing the financial health of parties to reinsurance transactions – a subject of great interest to international insurance regulators and consumers of insurance and reinsurance products.

It is important to determine the capacity of the intermediate party before the parties' respective set-off rights may be assessed. The general rule is that at the time a reinsurance treaty is effected, an intermediate party is an 'agent' of the reinsured, and not the reinsurer.<sup>85</sup> In certain circumstances, however, an intermediate party may be an 'intermediary' (i.e., agent of both the reinsured and reinsurer), or agent of the reinsurer alone.

The pervasive and controversial practice of funding employed by intermediate parties evinces the complexity of the set-off question. Funding occurs when an intermediary receives a claim by a reinsured for payment of losses, notifies the reinsurer of the loss, and pays the loss before the reinsurer acknowledges the claim. In effect, the intermediary 'funds' the reinsurer's obligation. In the context of reinsurance, funding may be described as 'voluntary' or 'involuntary'. Voluntary funding occurs when an intermediate party makes payment of premiums or claims when he is not obligated to do so. Involuntary funding arises where a reinsured or reinsurer informs the intermediate party that it intends to deduct the amount of a claim from the premium which is due and payable, or vice versa. In other words, involuntary funding occurs in situations where reinsureds, reinsurers and intermediate parties force a set-off of sums of money owed without the consent of the creditor.

As a general rule, intermediate parties have no obligation to fund payments.<sup>86</sup> If, however, the intermediate party does fund, parties to a reinsurance treaty may become indebted to each other for more or less than the amounts reflected in their respective books of account. In order to calculate the precise amounts of such indebtedness, it is essential to determine on whose behalf the intermediate party acted as of the time he or she funded an obligation.

To date, few courts have addressed set-off issues in the context of funding. Moreover, general rules governing set-off rights among all parties to a reinsurance treaty and intermediate parties have not been formulated. Nonetheless, certain parameters of set-off in situations involving intermediate parties may be gleaned from basic principles of agency and insurance law.<sup>87</sup>

First, an intermediate party has implied authority to act only according to reasonable usages and customs of the market in which he is employed, unless the principal (i.e., reinsured or reinsurer) has notice of such usage or custom at the time when the authority was conferred.<sup>88</sup> The Lloyd's custom that a broker may set off his account with his underwriter

(i.e., insurer) has been held unreasonable, and thus the reinsured is not bound by the settlement unless he was aware of the custom when he authorized the broker to receive payment.<sup>89</sup>

Second, an intermediate party who effects insurance or reinsurance in his own name without disclosing his principal may sue for and recover in his own name the full amount of his principal's loss under the policy or treaty, holding the same thereafter in a fiduciary capacity for his principal.<sup>90</sup> Thus, it has been suggested that set-offs in account by the reinsurer that are available against the undisclosed reinsured may be asserted in litigation with the broker.<sup>91</sup> It follows that a reinsurer sued by a broker in his own name may defend on the basis that he has paid the reinsured, or that the reinsured has intervened and demanded payment or sued, or that the broker's authority to sue was otherwise terminated.

Third, an intermediate party authorized to receive payment may receive it only in cash, unless it is usual or customary in his particular business to do so, and such usage or custom is reasonable or known to the principal at the time he confers the authority.<sup>92</sup> Thus, if a reinsurer sets off his obligation to a reinsured against an account owed by a broker, the reinsured is entitled to recover cash from the reinsurer because the broker exceeded his authority. However, to the extent the reinsurer pays the broker cash and the broker fails to pass on the money to the reinsured, the reinsured is not entitled to recover the cash from the reinsurer.<sup>93</sup>

The importance of these principles is appreciated when applied to circumstances in which one party has become insolvent. For example, if prior to its becoming insolvent, a reinsurer pays cash to a broker, the reinsured must bear the risk of that insolvency. The reinsured, as principal, is treated as having been paid by the reinsurer because the broker is authorized to receive payment in cash. Similarly, the reinsured would bear the risk of a broker's insolvency with respect to premiums paid by the reinsured to its insolvent broker, unless the intermediate party is personally liable to the reinsurer for payment thereof.<sup>94</sup>

## Conclusion

The foregoing is but a brief introduction to the complicated nature of set-offs in insurance and reinsurance insolvencies. As the funding discussion demonstrates, resolution of set-off issues requires both a fact-intensive investigation of the capacities and obligations of the respective parties, as well as knowledge of the applicable rules of the market place. The set-off issue is one of great importance, and doubtless will remain the subject of litigation and debate.

## Preview

When a multinational insurance or reinsurance company becomes insolvent, an English liquidator is responsible for ensuring that the insolvent's English

assets are distributed in accordance with English law. The task of distributing US assets, however, often will be governed by American laws. Parts III and IV of this article address the subject of contingent claims and set-offs in the USA.

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#### NOTES

51. Mabe, *Setoff in a Non-Insurance Commercial Setting*, 1 (unpublished manuscript 1989) (hereinafter cited as 'Mabe').
52. The concept of mutuality is addressed infra, and will be addressed in detail in Part IV of this article.
53. Mabe, supra note 51; *In re Klingberg Schools*, 68 Bankr 173, 178-179 (ND Ill 1986); *aff'd*, 837 F.2d 763 (1988). As Mabe points out, the distinction between set-off and recoupment is not limited to a conceptual difference:

'In the context of bankruptcy, there are important procedural distinctions between recoupment and set-off as well. For example ... set-off, except in certain commodities contracts, is clearly restrained by the automatic stay of 11 U.S.C. §362(a). According to some commentators and courts, recoupment is not restrained by the automatic stay and may be exercised after a bankruptcy petition is filed without court intervention.'

Id., at note 2 (citing 4 *Collier on Bankruptcy*, ¶553.03 (15th ed. 1988); *In re B&L Oil Co.*, 783 F.2d 155 (10th Cir. 1986)).

Recoupment is the business term for the English concept of abatement: where 'A' has a claim for a sum of money against 'B' for the price of goods or services, and 'B' has a cross-complaint for a sum of money against 'A' arising out of deficiencies in those goods or services, 'B' is entitled to deduct the amount of his cross-complaint and set it off as a true defense by way of abatement in an action by 'A' because the rights of 'A' and 'B' arise out of the same transaction. As developed above, this is not necessarily the case with set-off.

54. The extent to which American courts have employed the doctrine of recoupment to limit the application of set-offs in insurance insolvencies will be explored fully in Part IV of this Article.
55. *Barnett Bank of Jacksonville, N.A. v. State of Florida ex rel. the Department of Insurance*, 507 So. 2d 142 (Fla. Dist. Ct. App. 1987) (set-off is a preference). But see *Scott v. Armstrong*, 146 US 499, 510 (1892) ('Where a set off is otherwise valid, it is not perceived how its allowance can be considered a preference').
56. *In the Matter of Elcona Homes Corp*, 863 F.2d 483, 485 (7th Cir. 1988). But see Fla Stat §631,281(4) ('No claim of offset shall operate to create a secured claim').
57. Mabe, supra note 51, at 1-2; United States Constitution, art. 1, §10.
58. Mabe, supra note 51, at 1, n.3.
59. 86 Eng. Rep. 837.
60. 13 Eliz. c. 7.
61. 23 Eng. Rep 358 (Ch 1682).
62. 23 Eng. Rep 684 (Ch 1689).
63. 4 Ann. c. 17, §22, and 5 Geo 2, c.30, §28.
64. Rules of the Supreme Court ('RSC') Ord. 18, r. 17.
65. *Counterclaims*: If in an action brought by 'A' against 'B', 'B' has a claim against 'A' which he might have asserted by bringing a separate action (whether or not a claim for a sum of money) against 'A', he may raise it in the existing action by

adding to his statement of defense a statement of the facts upon which he bases his claim, and of the relief which he claims against 'A' (RSC, Ord. 15, r. 2). The claim brought by 'B' against 'A' is called a counterclaim. Unlike a counterclaim, set-off is limited to money claims and may only be raised as a defense. A counterclaim affords no defense to 'A's' claim.

*Cross-actions*: When 'A' brings an action against 'B' and 'B', before final judgment is given, brings an action against 'A' arising out of the same subject matter, 'B' is said to have brought a cross-action. *Davies v. Hedges* (1871) LRQB 687.

66. *In re Charge Card Services Ltd.*, [1988] 3 All ER 702. See also *Anonymous*, 86 ER 837 (KB 1675). Thus, the fundamental policy of insolvency that unsecured creditors shall be paid *pari passu* is, to a limited extent, avoided by allowing them to set off amounts owed to, against liabilities of, the insolvent.
67. 'The question as to what is a set-off is to be determined as a matter of law and is not in any way governed by the language used by the parties in their pleadings' (*Hanak v. Green*, [1958] 2 QB 9, at 26).
68. '[T]he streams of common law and equity have flown together and combined so as to be indistinguishable ... we have to ask ourselves: what should we do now so as to ensure fair dealing between the parties?' (Lord Denning MR in *Federal Commerce and Navigation Co. Ltd. v. Molena Alpha Inc.* [1978] QB 927 at 974).
69. 42 *Halsbury's Laws of England*, Set-off and Counterclaim at 248. See e.g., *Aries Tanker Corporation v. Total Transport Ltd.*, [1977] 1 All ER 398 ('the mere existence of cross-claims per se did not give rise to equitable intervention: it was not enough that they arose from the same contract; the equity ... had to impeach the title to the legal demand').
70. *Halsbury's* supra note 69, at 248. It is 'uncertain whether it may be raised only in defense to a liquidated money claim. It is ... submitted that in general a defendant should be permitted an equitable set-off against an unliquidated money claim.' Id.
71. See e.g., *Pedder v. Preston Corp.* (1862), 12 CBNS 533. There are, however, exceptions to this rule. For example, if a defendant is sued by an agent (e.g., a broker), the defendant cannot set off a debt due from the principal unless it can be shown that the agent has assented to such a set-off. *Jarvis v. Chapple*, (1815) 2 Chit 387.
72. *Jeffer v. Wood* (1723) 2 P Wms 128.
73. *Blackburn v. Mason* (1893) 68 LT 510 CA.
74. For a general discussion of the English statutes applicable to insurance insolvency, see Anderson et al. *Amreco: A Step Towards International Rehabilitations* (hereinafter cited as *Amreco*), 7 J Ins Reg 388 (1989).
75. Insolvency Rules 1986, SI 1986, No.1925. See generally *Amreco*, supra, note 74, at 407, note 75.
76. 1986 Rules 4.90.
77. That is, liquidation of the company. See 1986 Act, §98.
78. [1930] 2 Ch 293.
79. *Bulter & Merkin*, supra note 13, at D.2.2-22 (1988).
80. See *The British Approach*, supra note 17; see also notes 25-26 and accompanying text, supra.
81. *In re Charge Card Services Ltd.*, supra note 66.
82. It remains an open question whether, in view of the separation of long-term business and general business, a claim (whether or not contingent) attributable to long-term business could be set off against a liability attributable to general business and vice versa.
83. *In re Charge Card Services Ltd.*, supra note 66.
84. There is no comprehensive legal definition of these terms in English law. For purposes of this article, the term 'broker' shall be used with respect to an intermediate party who is an agent only of the reinsured. The term 'agent of the reinsurer' shall be used in circumstances where the intermediate party is agent only of the reinsurer. In circumstances where the intermediate party is agent for both the reinsured and reinsurer, the term 'intermediary' shall be used. See generally R. Hodgin, *Insurance Intermediaries and the Law* (1987).
85. *Rozanes v. Bowen* (1928) 32 LI LR 98.
86. There are, however, exceptions to this rule. For example, §53 of the Marine Insurance Act 1906 provides that '[u]nless otherwise agreed, where a marine policy is effected on behalf