Valuation of contingent claims and the application of set-offs in reinsurance insolvencies[1]

Part III Valuation of contingent claims and policies in the US

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Overview

The first two parts of this article have appeared in earlier issues of the journal, and have dealt with the relevant parts of English law. It remains to deal with US law, and this part will explain and examine the rules on contingent claims in the United States.

The fixing of rights and liabilities

One of the first steps in any liquidation is the establishment of an exact date upon which all rights, obligations and liabilities of the insolvent company and its creditors can be determined or fixed. The National Association of Insurance Commissioners Insurers Supervision, Rehabilitation and Liquidation Model Act ('Model Act') provides for the fixing of rights and liabilities:

'Upon issuance of the order [of liquidation or rehabilitation],[2] the rights and liabilities of any such insurer and of its creditors, policyholders, shareholders, members and all other persons interested in its estate shall become fixed as of the date of entry of the order.'[3]

Consistent with the Model Act, the insurance statutes of most states provide that the rights and liabilities of the company and its creditors are fixed as of the date of the entry of an order of liquidation or rehabilitation.[4] The effect of this 'fixing date' is significant, in that it provides a date at which coverage is terminated, such that a creditor who suffers a loss prior to the fixing date will share in the ultimate distribution of assets, but will not do so for any loss occurring after the fixing date. It also is a date certain at which the liability of the insolvent company is determined, resulting in the classification of claims in the estate as contingent or non-contingent. This determination of contingency, in turn, controls whether the claimant will share in distributions of the estate's assets, and governs the availability of set-offs with respect to those claims.[5]

Statutes governing the filing and proof of contingent claims

The Model Act provides for the filing and allowance of contingent claims:

(a) The claim of a third party which is contingent only on his first obtaining a judgment against the insured shall be considered and allowed as if there were no such contingency.
(b) A claim may be allowed even if contingent, if it is filed in accordance with section 35. It may be allowed and may participate in all distributions declared after it is filed to the extent that it does not prejudice the orderly administration of the liquidation.[6]

A review of the law of various states, however, reveals that not all states follow the Model Act. In fact, it appears that twelve states do not have any statutory recognition of contingent claims per se.[7]

Approximately 23 states and two territories explicitly provide for the filing and allowance of contingent claims.[8] For example, the Illinois Insurance Code provides that both insureds and those with claims against insureds may file contingent claims:

'Where a Liquidation ... Order has been entered in a proceeding against an insurer under this Code, any insured under a liability insurance policy shall have the right to file a contingent claim ... Where a liquidation ... order has been entered in a proceeding against an insurer under this Code, any person who has a cause of action against an insured of such insurer under a liability insurance policy issued by such insurer, shall have the right to file a claim in the proceeding, regardless of the fact that such claim may be contingent ...'[9]

A review of the statutory provisions of the fifty states, Puerto Rico and the Virgin Islands indicates that approximately eighteen other states have virtually the same statutory language as Illinois.[10] Two other states have a slightly modified version of the Illinois statute, the main difference being the omission of any reference to 'liability insurance policy'.[11]

Proof and allowance of claims

Reinsurance claims are not specifically defined or allowed as contingent under the statutory law of any state, even though they are subject to the same process of valuation. All states, however, provide for the proof and allowance of claims by insureds and third parties, although the proof requirements may differ. On the one hand, the Model Act requires that proof of claim shall consist of a statement signed by the claimant that includes all of the following that are applicable:

(a) the particulars of the claim including the consideration given for it;
(b) the identity and amount of the security on the claim;
(c) the payments made on the debt, if any;
(d) that the sum claimed is justly owing and that there is no set-off, counterclaim or defense to the claim;
(e) any right of priority of payment or other specific right asserted by the claimants;
(f) a copy of the written instrument which is the foundation of the claim; and
(g) the name and address of the claimant and the attorney who represents him, if any.[12]

On the other hand, Illinois requires a sworn statement made in writing and signed under oath demonstrating the following:

(i) the claim (i.e. that a loss was suffered, and its amount);
(ii) the consideration for the claim (i.e. that the loss was a covered claim within the terms of the policy issued to the insured);
(iii) what security is held by the claimant, and, if so, what payments have been made thereon; and
(iv) that the claim is justly owing by the company to the claimant.[13]

Unlike the Model Act, the statutes of many states distinguish between contingent claims filed by insureds and those filed by third parties. For example, the Illinois Insurance Code provides that contingent claims of insureds shall not be allowed 'unless such claim is liquidated and the insured claimant presents evidence of payment of such claim to the Director on or before the last day fixed by the Court' for the final date of liquidation of contingent claims (i.e. not more than three years after the date fixed for filing claims).[14] Contingent claims of third parties, however, may be allowed:

(a) if it may be reasonably inferred from the proof presented upon such claim that such person would be able to obtain a judgment upon such cause of action against such insured; and
(b) if such person shall furnish suitable proof, unless the court for good cause shown shall otherwise direct, that no further valid claims against such insurer arising out of this cause of action other than those already presented can be made; and
(c) if the total liability of such insurer to all claimants arising out of the same act of its insured shall be no greater than its total liability of such insurer to all claimants arising out of the same act of its insured shall be no greater than its total liability would be were it not in liquidation, rehabilitation or conservation. No judgment against such an insured or an insurer taken after the date of the entry of the liquidation, rehabilitation or conservation order shall be considered in the proceedings as evidence of liability, or of the amount of damages, and no judgment against an insured or an insurer taken by default, or by collusion prior to the entry of the liquidation order shall be considered as conclusive evidence in the proceeding either of the liability of such insured to such person upon such cause of action or of the amount of damages to which such person is therein entitled.[15]

Against the backdrop of these rules, a receiver essentially has three choices in deciding the overall scheme by which the estate will be administered and reinsurance claims will be valued.[16] The receiver may:

(1) Recommend to the Court a date before which all claims, both contingent and non-contingent, must be liquidated, thereby cutting off the insolvent's liability at an arbitrary date;
(2) Recommend to the Court a run-off of the estate over time;
(3) Recommend to the Court a method by which the ultimate claims of creditors can be fairly determined and allowed against the estate.

The first approach has the effect of penalising creditors who placed long-tail business with the insolvent or did business with the insolvent shortly before its demise. Under this approach, only claims that have become absolute, liquidated claims as of the cut-off or 'bar' date will be paid. Those creditors whose claims have developed as of the bar date will be paid a full share of the estate distribution, while those whose claims have not developed will be paid nothing.

The second approach, in most instances, keeps the estate open for an inordinate length of time, often decades. While this approach affords all creditors equal opportunity for payment, the estate's assets are depleted by ongoing administrative costs and expenses.

The last approach – advanced in this paper – is the most preferable. Under this approach, all claims, whether contingent, absolute, unliquidated, immature, or liquidated and mature, can be paid. Liquidated claims would be allowed through the usual proof of claim procedures. Contingent claims would be estimated and valued and submitted for payment. Thus, this approach strikes a balance between the first two approaches; it treats all creditors equally regardless of the type of business they transacted with the insolvent, allowing all creditors an opportunity to be paid, and provides for a much earlier distribution of funds, which benefits the estate's creditors and facilitates a prompt return of funds to the market place.

Unfortunately, existing statutes do not provide for

the implementation of this type of approach in the reinsurance context. For example, in some states the claims of reinsureds are treated as those of general creditors.[17] Claims of reinsureds are not deemed claims of insureds or policyholders for purposes of asset distribution, because reinsurance contracts are not insurance policies, but rather are contracts of indemnity.[18]

A reinsured's claim has two components. The first component is paid losses. Paid losses are a contractual liability of the reinsurer which are determined as of, or prior to, the date of liquidation. The insolvent company's liability to indemnify the reinsured for paid losses is clearly established and fixed under most statutes as of the entry of the liquidation order. The second component of a reinsured's claim consists of contractual liability for outstanding reserves and incurred but not reported losses ('IBNR'). The liability of a reinsurer to pay its reinsured for outstanding reserves and IBNR can be fixed as of the date of entry of an order of liquidation, albeit not liquidated.

Reinsurance claims, whether for paid losses, outstanding reserves or IBNR are not specifically addressed in the contingent claims provisions of the insurance codes of some states. Depending upon the wording and interpretation of such provisions, reinsurance claims for outstanding reserves and IBNR as of the fixing date might not be recognised as allowable contingent claims. Unfortunately, current insurance insolvency statutes give no clue as to how such claims could be estimated or valued.

This should not, however, end this discussion. Although there are no statutory mechanisms in place for valuation of contingent reinsurance claims, there are legal mechanisms for the valuation and allowance of contingent claims in other contexts and jurisdictions, whose principles may shed light on the suggested approach to valuation of reinsurance claims in insurance insolvencies. In 1978, the US Congress enacted the Bankruptcy Reform Act of 1978 ('the Bankruptcy Code').[19] Although it does not apply to liquidation of insurance or reinsurance companies, it does deal with the filing and payment of contingent claims in US law.[20] The Bankruptcy Code significantly changed the treatment of contingent and unliquidated claims in bankruptcies, requiring estimation and discharge of all contingent claims. As one commentator noted:

'Enactment of the 1978 Bankruptcy Code significantly alters the treatment of contingent and unliquidated claims in bankruptcy. Whereas in the past, few contingent or unliquidated claims were estimated and discharged in bankruptcy, under the new Code all contingent claims and unliquidated claims must be estimated and discharged. Due to this change, and because legislative guidance is lacking, courts will need to develop procedures to be used in claims estimation. To achieve the objectives of the new Code, these procedures will have to allow prompt estimation of contingent claims and unliquidated claims to be constitutional, [and] they will have to comply with the requirements of due process . . . Because of the diverse factual and legal issues that contingent or unliquidated claims raise, bankruptcy courts will have to balance the need for expedience and the need for procedural protections on a case-by-case basis. In some cases – those involving many claims or complicated claims – the interest in avoiding delay may warrant using abbreviated procedures. Where possible, however, the threat of delay should be minimised without resorting to the use of abbreviated procedures: Class actions, consolidations, and special masters may be valuable means of expediting contingent claims and unliquidated claim estimations, while still avoiding reductions in traditional due process protection.'[21]

Thus, despite the inherent difficulty of valuing contingent claims, the US Congress chose the 'imprecise estimation' process for such claims rather than continued application of doctrines that rendered contingent claims worthless.

One of the problems inherent in valuing contingent claims, whether in insurance insolvencies or other commercial bankruptcies, is that the process is slow and may be expensive, and creditors lose the time value of money while administrative costs diminish the assets of the estate. As the Second Circuit Court of Appeals commented generally with respect to the provability of claims in a bankruptcy proceeding:

'Equitable considerations must govern and the underlying ones are these: The assets of an insolvent corporation belong to its creditors. Although not, strictly speaking, a trust fund, they partake of the nature of one. The administration of the estate is for their benefit. Its purpose is to make an equitable distribution. Equality is equity. Debts and liabilities, present and future, certain and contingent, stand upon the same equitable basis. If delays were unimportant, the settlement of estates would be kept open until contingencies should become certainties. If courts were omniscient, distribution would always be through the resolving of all contingencies and the ascertainment of the present worth of all demands. But courts cannot look with certainty into the future. Delays are important. The settlement of estates cannot be held open to await contingencies. Orderly administration requires that at some reasonable speedy time all claims should be so liquidated as to afford a basis for distribution.

A court of equity, then in prescribing what claims shall take in the distribution of the estate of a corporation must regard, on the one hand, the substantial right of all creditors to share in their debtor's property, and, on the other, the necessity for expeditious administration and, giving due consideration to both, must make rules which are practicable as well as equitable.'[22]

The time is ripe for change. As demonstrated above, state law has not kept pace with changes in the nature of insolvencies currently facing receivers. US law applicable to insolvencies of entities other than insurers (i.e. US bankruptcy law) has kept pace with such changes and jurisdictions outside the United

States have adopted procedures for the valuation and allowance of contingent claims. For example, in his thought-provoking article, 'Liquidation of Insolvent Reinsurers – The Actuarial Estimation of Contingent Liabilities – A Bermuda Initiative',[23] Bermuda's John Milligan-Whyte describes proposed procedures for the actuarial estimation of contingent liabilities that may well form part of the solution to the problems currently facing receivers of insolvent reinsurers, their creditors and the reinsurance industry. Other steps are being taken in the United Kingdom to resolve some of those problems. These were discussed in the first part of this article.

NOTES

1. The views expressed herein are those of the authors alone, and do not represent the express or implied opinions of the Illinois Department of Insurance, the Office of the Special Deputy Receiver, Rudnick & Wolfe, or any of their clients. The authors are:

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2. The insurance statutes of most states grant the Director or Superintendent of Insurance broad regulatory power to monitor insurance companies organised or operating within the state. In Illinois, if the Director determines that a company is 'operating in a manner that could lead to, or is in, a financial condition, which if continued would make it hazardous to the public, and its policyholders', the Director may issue a corrective order requiring or prohibiting action to correct the company's deficiencies. Illinois Insurance Code §186.1, Ill Rev Stat ch 73, para 798.1. When an insurer's financial difficulties are not resolved under a corrective order, the remaining alternatives are conservation, rehabilitation, and liquidation.

   'Conservation' refers to the procedure whereby the Director may file a complaint for an order empowering him to take possession of an insurer or reinsurer's assets, business and affairs and conserve them for the benefit of the company's creditors. Illinois Insurance Code §197, Ill Rev Stat ch 73, para 809. This procedure is most often used to preserve the status quo while the Director evaluates the company's financial status; e.g., where the company's surplus has fallen below minimum statutory requirements, but could be raised to the required amount by an infusion of capital. Compare National Association of Insurance Commissioners Insurers Supervision, Rehabilitation and Liquidation Model Act 1987 ('Model Act') §9 (supervision proceedings).

   'Rehabilitation' has been defined as the 'preservation, whenever possible, of the business of an insurance company threatened with insolvency'. *People ex rel Schacht v Main Insurance Co*, 114 Ill App 3d 334, 336–37, 448 NE 2d 950, 952 (1st Dist 1983); accord *New York Title & Mortgage Co v Friedman*, 153 Misc 697, 276 NYS 72 (Mun Ct 1934).

   'Liquidation' precludes the transaction of further business by the company and results in a final distribution of its assets. See generally Illinois Insurance Code §§187–221.13, Ill Rev Stat ch 73, paras 799–833.13 (rehabilitation and liquidation provisions); see also Model Act §12 *et seq* (rehabilitation and liquidation provisions).
3. Model Act §18.B.
4. See, e.g. Illinois Insurance Code §194, Ill Rev Stat ch 73, para 806.
5. The fixing date also may be important to the receiver in determining the rate of exchange to be used when valuing a creditor's claim. Because claims are fixed as of the liquidation date, the value of a claim may be the value it held at the exchange rate applicable on that date, although the claim will not be submitted or paid until a later date, and the creditor may receive an advantage or disadvantage based on subsequent adjustments of the exchange rate. Singer, *The British Approach to Reinsurance Insolvency*, in 1988 ABA Sec Tort & Ins Practice, Law and Practice of International Reinsurance Collections and Insolvency 623, 638 (hereinafter cited as '*The British Approach*').
6. Model Act §37.
7. See Appendix A, in which those states with statutory language identical to the Illinois statute are designated 'IL', and those states with a modified form of the Illinois statute are referenced as 'MIL'. The remaining states either have no statute addressing contingent claims, or have statutes following or slightly modifying the Model Act (designated 'MA' or 'MMA'). Four states have adopted statutes unlike either the Model Act or that of Illinois: California, Massachusetts, Nebraska and Oregon.
8. See, e.g. Cal Ins Code §1025 (claims founded upon unliquidated or undetermined demands (i.e. those upon which liability has not been determined) must be timely filed, but not paid until definitely determined, proved and allowed); Mass Gen L ch 175, §180H (a contingent claim may be paid if it becomes absolute on or before the last day for filing proofs, or if there is a surplus and the insurer is decreed solvent); Neb Rev Stat §44-127.05 (requiring filing of unliquidated claims, but prohibiting payment 'until such claims have been definitely determined, proved and allowed').
9. Illinois Insurance Code §209(3), (4), Ill Rev Stat ch 73, para 821(3), (4).
10. See Appendix A.
11. See Me Rev Stat Ann tit 24A, §4378; NJ Rev Stat §17:30C-28.
12. Model Act §36.
13. Illinois Insurance Code §209(1), Ill Rev Stat ch 73, para 821(1).
14. Illinois Insurance Code §209(3), Ill Rev Stat ch 73, para 821(3).
15. Illinois Insurance Code §209(4), Ill Rev Stat ch 73, para 821(4). Whether the prohibition against allowing proof of judgments entered during rehabilitation or liquidation, or by default, is enforceable or constitutional remains to be seen. See, e.g. *Morris v Jones*, 329, US 545 (1947) (Missouri judgment against Illinois insurer entered after insurer was placed in liquidation could not be disallowed by Illinois liquidator).
16. The process of claim valuation, of course, is a complex actuarial procedure, the specifics of which are beyond the scope of this paper. See generally Simon, *Liquidation of Insolvent Reinsurers: The Actuarial Estimation of Contingent Liabilities*, in 1988 ABA Sec Tort & Ins Practice, Law and Practice of International Reinsurance Collections and Insolvency 813.
17. See, e.g. *In Re Liquidation of Reserve Insurance Co*, 122 Ill 2d 555, 524 NE 2d 538 (1988).
18. *Id*, 122 Ill 2d at 564, 524 NE 2d at 542 (citing *People ex rel Baylor v Highway Insurance Co*, 57 Ill 2d 590, 594–95, 316 NE 2d 633, 635 (1974)); *Union Central Life Insurance Co v Lowe*, 349 Ill 464, 469, 182 NE 611, 613 (1932); *Baltica Insurance Co v Carr*, 330 Ill 608, 613, 162 NE 178, 180 (1928); *Vial v Norwich Union Fire Insurance Society*, 257 Ill 355, 358, 100 NE 929, 932 (1913)).
19. 11 USC §109(b)(2), (3).
20. 11 USC §502(b)(1), (c).
21. Kauffman, *Procedure for Estimating Contingent or Unliquidated Claims in Bankruptcy*, 35 Stan L Rev 153, 173–174 (1982).
22. *Pennsylvania Steel Co v New York City Railway Co*, 198 F 721 (CANY 1912), aff'd, 204 F 513 (1939).
23. 1988 ABA Sec Tort & Insurance Practice, Law and Practice of International Reinsurance Collections and Insolvency 673.

APPENDIX A

INSURANCE INSOLVENCY STATUTES: CONTINGENT CLAIMS

(United States and Territories)

STATE	STATUTORY CITATION	STATUTE TYPE: MODEL ACT (MA), MODIFIED MODEL ACT (MMA), ILLINOIS-TYPE (IL), MODIFIED ILLINOIS-TYPE (MIL)	STATUTORY PROVISION REGARDING CONTINGENT CLAIMS?	STATUTORY PROVISION FOR VALUATION/ LIQUIDATION OF CONTINGENT CLAIMS?	STATUTORY PROVISION FOR VALUATION OF REINSURANCE CLAIMS?
ALABAMA	ALA CODE §27–32–30	IL	YES	YES	NO
ALASKA	ALASKA STAT §21 78 280	IL	YES	YES	NO
ARIZONA	ARIZ REV STAT ANN §20–639	IL	YES	YES	NO
ARKANSAS	ARK STAT ANN §23–68–12	IL	YES	YES	NO
CALIFORNIA	CAL INS CODE §§1025 §1027	OTHER	YES	NO	NO
COLORADO	–	–	NO	–	NO
CONNECTICUT	CONN GEN STAT §38–457	MA	YES	NO	NO
DELAWARE	DEL CODE ANN tit 18 §5928	IL	YES	YES	NO
DISTRICT OF COLUMBIA	–	–	NO	–	NO
FLORIDA	FLA STAT §631 192	MIL	YES	YES	NO
GEORGIA	GA CODE ANN §33–37–22	IL	YES	YES	NO
HAWAII	HAW REV STAT §431:15–327	MMA	YES	NO	NO
IDAHO	IDAHO CODE §41–3337	MA	YES	NO	NO
ILLINOIS	ILL REV STAT Ch 73, para 209	IL	YES	YES	NO
INDIANA	IND CODE §27–9–3–35	MA	YES	NO	NO
IOWA	IOWA CODE §507C.37	MA	YES	NO	NO
KANSAS	–	–	NO	–	NO
KENTUCKY	KY REV STAT ANN §304.33–390	MMA	YES	NO	NO
LOUISIANA	LA REV STAT ANN §22:749	MIL	YES	YES	NO
MAINE	ME REV STAT ANN tit 24A. §4378	MIL	YES	YES	NO
MARYLAND	MD INS CODE ANN §160	IL	YES	YES	NO
MASSACHUSETTS	MASS GEN L ch C 175, §180 G, H	OTHER	YES	YES	NO
MICHIGAN	–	–	NO	–	NO
MINNESOTA	MINN STAT §60B.39	MMA	YES	NO	NO
MISSISSIPPI	–	–	NO	–	NO
MISSOURI	–	–	NO	–	NO
MONTANA	MONT CODE ANN §33–2–1366	MA	YES	NO	NO

STATE	STATUTORY CITATION	STATUTE TYPE: MODEL ACT (MA), MODIFIED MODEL ACT (MMA), ILLINOIS-TYPE (IL), MODIFIED ILLINOIS-TYPE (MIL)	STATUTORY PROVISION REGARDING CONTINGENT CLAIMS?	STATUTORY PROVISION FOR VALUATION/ LIQUIDATION OF CONTINGENT CLAIMS?	STATUTORY PROVISION FOR VALUATION OF REINSURANCE CLAIMS?
NEBRASKA	NEB REV STAT §44–127.05	OTHER	YES	NO	NO
NEVADA	NEV REV STAT §696B.450	IL	YES	YES	NO
NEW HAMPSHIRE	NH REV STAT ANN §402–C:39	MMA	YES	NO	NO
NEW JERSEY	NJ REV STAT §17:30C–28	MIL	YES	YES	NO
NEW MEXICO	–	–	NO	–	NO
NEW YORK	NY INS LAW §7433	IL	YES	YES	NO
NORTH CAROLINA	NC GEN STAT §58–155.29	IL	YES	YES	NO
NORTH DAKOTA	–	–	NO	–	NO
OHIO	OHIO REV CODE ANN §3903.37	MA	YES	NO	NO
OKLAHOMA	OKLA STAT tit 36, §1929	IL	YES	YES	NO
OREGON	OR REV STAT §734.380	OTHER	YES	YES	NO
PENNSYLVANIA	PA CONS STAT §40–11–421	MMA	YES	NO	NO
RHODE ISLAND	–	–	NO	–	NO
SOUTH CAROLINA	SC CODE ANN §38–27–560	MA	YES	NO	NO
SOUTH DAKOTA	–	–	NO	–	NO
TENNESSEE	TENN CODE ANN §56–9–129	IL	YES	YES	NO
TEXAS	TEXAS INS CODE ANN §21.28	MIL	YES	YES	NO
UTAH	UTAH CODE ANN §31A–27–330	MMA	YES	NO	NO
VERMONT	–	–	NO	–	NO
VIRGINIA	–	–	NO	–	NO
WASHINGTON	WASH REV CODE §48.31.300	IL	YES	YES	NO
WEST VIRGINIA	W VA CODE §33–10–29	IL	YES	YES	NO
WISCONSIN	WIS STAT §645.63	MMA	YES	NO	NO
WYOMING	WYO STAT §26–28–127	IL	YES	YES	NO
PUERTO RICO	PR LAWS ANN tit 26, §4018	IL	YES	YES	NO
VIRGIN ISLANDS	VI CODE ANN tit 22, §1278	IL	YES	YES	NO