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

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This is the final part of this article which has been substantially revised and updated to take account of recent developments.

Recent set-off developments in the US

The application of set-offs in insurance insolvencies in the US is currently a controversial issue among both regulators and industry.[2] Industry advocates favour the broadest interpretation of set-offs, relying on the doctrine of mutuality and bankruptcy law.[3] However, many receivers contend that permitting reinsurance set-offs at all is contrary to the scheme of pro rata distribution under the priority of distribution established in the Model Act[4] and adopted in one form or another in the vast majority of states. The manifest intent of these priority distribution statutes is to favour claims of policyholders over those of general creditors, including reinsureds. Receivers take the position that set-offs strip policyholders of their favoured position under the priority statutes, as set-offs enable the party setting off to recover 100 per cent of his claim before policyholders can recover any portion of their unsecured claims.

These divergent views have resulted in intense debate among receivers themselves, and between receivers and industry. These debates have spurred attempts to both enlarge and restrict the right of set-off as set forth in the Model Act and the applicable statutes of many states. The combatants in this battle have not been content to wage war within the confines of their respective legislative and trade organisations, but have carried their causes to the courts, as evidenced by the recent *O'Connor* and *Mission* decisions. Whatever the end result of the current controversy, two things are clear: the doctrine of set-off in the US will change, and that change will not be the result of compromise.

The battle over reinsurance set-offs

Until the second half of this century, it was assumed that reinsurers of insolvent insurers could set off their reinsurance obligations against claims they might have against the insolvent for losses under primary policies or reinsurance treaties underwritten by the insolvent. In fact, it appears that no court addressed the precise issue until 1958.[5] Since that time, the assertion of set-offs by reinsurers has been a controversial issue, much debated in the legislatures and – as evinced above – litigated in the courts.

The first major legislative battle over reinsurance set-offs in insurance insolvency proceedings was waged in 1965, when the Wisconsin legislature created an Insurance Laws Revision Committee charged with rewriting the state's insurance code.[6] The first chapter of the insurance code reviewed by the Committee related to the rehabilitation and liquidation of insurers.[7] The Committee created a provision that would have denied reinsurers any set-off of an insolvent cedent's premium obligations. The purpose of the provision was to maximise the assets available for liquidation, encourage reinsurers to be more concerned with the financial condition of cedents, make reinsurance better perform its stabilising function, and frustrate fraudulent reinsurance transactions. However, the Committee's suggestion was rejected, and the restrictive provision was never enacted into law.[8]

The dissent over reinsurer set-off rights continued. In July 1970, the California Assembly considered a bill requiring that all payments due from a reinsurer be made without any set-off for premiums due from the insolvent insurer. By the time the bill passed in August of that year, however, the anti-set-off provision had been deleted.[9] In December 1970, a committee of the NAIC revisited the debate, creating a subcommittee to consider elimination of reinsurance set-offs.[10] The prevailing perception that surplus aid reinsurance was being abused and had become a serious problem provided impetus for the reconsideration.[11] After intense debate, both public and private, the matter was temporarily resolved in December 1972 by the addition of a 'ceded insurance report' to Schedule S of the annual report form that insurers are required to file with the various state departments of insurance.[12] The issue was revived briefly in 1983 when revision of the Utah insurance code was undertaken,[13] but this time the right of reinsurers to set-off was expressly preserved.[14]

In 1986, the NAIC again found itself hosting heated

debates over proposals to eliminate, or at least modify, the right to assert set-offs against reinsurance obligations owed to insolvent insurers and reinsurers. In September 1986, the Law/Legislation Study Group of the NAIC's Rehabilitators and Liquidators (Ex 4) Task Force ('Task Force') reported that it was considering 'the question of off-set for reinsurers'.[15] In June 1987, an Offset Issues Working Group ('Working Group') was established to review the applicability of section 30 (the predecessor of section 29) of the Model Act (the set-off provision) 'as it affects reinsurers'.[16] In 1988, this charge was delegated to a Reinsurance Setoff Study Group ('Study Group')[17] composed of industry representatives. A regulatory counterpart to the Study Group was created called the Regulatory Subgroup of the Offset Issues Working Group ('Regulatory Subgroup'), comprised of representatives from the insurance departments of various states.[18]

The Working Group, the Study Group, and the Regulatory Subgroup met on numerous occasions. They drafted or considered at least six separate proposed revisions of former section 30. They also created, distributed, collected, and tabulated the results of a questionnaire designed to elicit the views of the various state insurance departments and industry segments on certain set-off issues. Additionally, they produced written majority and minority reports, responses to those reports, and replies to the responses. They also conducted a workshop on the issue for regulators and their staff,[19] at which a majority of the regulators in attendance agreed on proposed changes to section 30.[20]

In August 1988, the Study Group concluded its deliberations on reinsurance set-offs, and reported its findings in September of that year to the Task Force.[21] The Study Group concluded that reinsurance set-offs were consistent with both English and American law, as well as equitable and business principles. Nevertheless, the Study Group recommended certain clarifications of former section 30, that is, deleting all reference to counterclaims, adding language denying set-offs when the obligation 'was not in existence upon entry of an order of liquidation', and adding language denying set-offs when the obligation sought to be set off is 'that of an insured to pay earned premium to the insurer' or that of a person to pay 'to an insurer sums held in a fiduciary capacity'.[22]

A dissent to the Study Group Report was submitted, rejecting the proposed clarifications, and arguing that section 30 was not in accordance with legal and equitable principles, thus leaving the law on set-offs unsettled.[23] One of the authors of the dissent, Henry Jernigan, also proffered changes to section 30 that would limit set-offs to mutual debits and credits 'arising from a single contract', provide that no contractual provision that increases the debts to be set-off will be enforceable, and prohibit set off of joint and several obligations.[24]

In April 1989, the Regulatory Subgroup proposed its own amendments to former section 30.[25] The Subgroup's amendments were the most comprehensive to date, including deletion of references to counterclaims, allowance of set-offs arising out of different contracts, and denial of set-offs between affiliates. The Subgroup also proposed that the receivers provide reinsurers with accountings of outstanding debts, and that only claims which a cedent had paid could be set off.[26] This proposal sparked intense debate and spawned numerous counterproposals, both from regulators and from the insurance industry.[27]

For example, the Illinois Department of Insurance proffered a proposal that would have amended section 30.A to expressly allow set-offs between different contracts, amend section 30.B.(1) to clarify the pre- and post-insolvency prohibitions, add a prohibition against set-offs by affiliates, and limit set-offs to mutual debts and credits 'which are currently due and payable'.[28] Under this proposal, if the party asserting the set-off determined that after set-off it owed the insolvent, then that party either could pay the net amount or delay payment of a portion of the net amount for future assertion as a set-off, provided it deposited that portion into an interest-bearing trust account for the insolvent's benefit.[29]

Priority distribution statutes and public policy

The *Prudential* and *Midland* decisions have intensified the debate over reinsurance set-offs. In both cases, industry representatives advocated a broad interpretation of statutory set-off provisions. Receivers contended that permitting any broad rights of set-off is fundamentally inconsistent with the statutory schemes of priority distribution established in the Model Act[30] and adopted in one form or another in the vast majority of states.[31] Both appellate courts reached the same results based on priority distribution statutes.[32]

Priority distribution statutes create and rank different classes of creditors in an insurance insolvency. Under these statutes, creditors in a particular class may be paid only after the insolvent's assets have been distributed pro rata to all other classes of creditors of a higher priority and those creditors have been paid in full. One of the central purposes of such priority distribution statutes is to favour claims of primary policyholders over those of general creditors, including reinsureds. Some receivers take the position that allowance of set-offs in an insurance insolvency strips policyholders of their favoured position under the priority statutes because set-offs enable the party setting off, that is, reinsurers with lower priority than policyholders, to recover 100 per cent of their claims before the higher priority policyholders can recover any portion of their unsecured claims.

The California Court of Appeals recently rejected the notion that reinsurance set-offs may be permitted only after all parties with higher priority under a statutory distribution scheme have been fully paid. In *Prudential Reinsurance Co. v Superior Court*,[33] Prudential sought to set off amounts owed by it to the insolvent Mission Insurance Group, Inc. ('Mission'), against amounts owed by Mission to Prudential under reciprocal reinsurance contracts.[34] That is, Prudential

sought to set off amounts owed by Prudential as a reinsurer of Mission against amounts owed by Mission as a reinsurer of Prudential.

The California liquidator denied the asserted set-offs for two reasons. First, the liquidator claimed that the language of California's insurance insolvency statute made payment of set-offs contingent upon the financial ability of the insolvent company to pay in full all claimants with a higher statutory priority than Prudential.[35] Second, the liquidator contended that strong public policy considerations favouring payment of policyholders rendered set-offs improper under the statute if such set-offs would result in diminution of payment to claimants with a higher statutory priority than Prudential.[36]

The trial court agreed with the liquidator's views on set-offs and denied Prudential's set-off claims.[37] Prudential appealed and the California appellate court reversed.[38] The appellate court determined that the priority distribution scheme of the California Insurance Code did not control the interpretation of the set-off provision therein.[39] Rejecting the liquidator's contention that set-off was impermissible until all higher-priority claimants had been paid, the court reasoned that such a construction of the set-off provision would create an irreconcilable conflict in the Code.[40] The court found the set-off provision to be 'a classic statement of the doctrine of equitable set-off, universally recognized to require payment of only the set-off balance into an insolvency estate'.[41]

The court also rejected the liquidator's contention because such a construction would render the set-off statute meaningless. As the court noted, 'If the legislature had meant to gear set-off entitlement to the estate's financial capacity, we presume it would have worded [the set-off statute] to make that intention sufficiently clear'.[42] Furthermore, the court found that when the set-off and priority provisions were adopted in 1935, the priority provision set forth only three classes of claimants, with primary policyholders and reinsurers sharing the same priority. The provision did not assign a higher class to policyholders until 1979.[43] Thus, the legislature could not have intended the 1979 amendment to the priority provision to control interpretation of the 1935 enactment of the set-off provisions. Also, observing that set-offs are not unlawful preferences, the court rejected the liquidator's contention that the set-off provision effected a 'double preference' in favour of reinsurers over both policyholders of a higher class and general creditors of the same class.[44]

In tandem with *Prudential* stands the *Midland* decision. In *Midland*,[45] the trial court relied on the dominant purpose of the statutory liquidation scheme – pro rata distribution of the insolvent's assets – to deny reinsurance set-offs. The court found that by withholding payment of its reinsurance obligation, Kemper sought to obtain a greater share of reinsurance proceeds that should have been contributed to Midland's assets for pro rata distribution to all of Midland's claimants.[46] This, the court said, 'is in fundamental opposition to the express policy behind the liquidation statute and will not be countenanced'.[47] The court held that set-off effects a preference that cannot be tolerated under the New York statutory scheme for liquidating the estates of insolvent insurers.[48]

Once again, the trial court's decision was reversed.[49] In fact, the appellate court quoted from the Seventh Circuit's decision in *Stamp v Insurance Company of North America*,[50] agreeing that reinsurer set-offs are in the interests of policyholders and the general public.[51]

Set-off of federal government claims

Federal claims are another type of claim in which the applicability of set-offs may depend upon a statutory priority of distribution scheme. In 1797, a federal statute was enacted to govern the priority of the federal government's claims in insolvencies.[52] Essentially unchanged today, this statute, known as the 'Superpriority Statute', provides that:

'(a)(1) A claim of the United States Government shall be paid first when –
(A) a person indebted to the Government is insolvent; and–
(i) the debtor without enough property to pay all debts makes a voluntary assignment of property;
(ii) property of the debtor, if absent, is attached; or
(iii) an act of bankruptcy is committed; or
(B) the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor.'[53]

This statute enables the federal government to be paid on its claims before any other claimants or creditors; thus the federal government has a 'superpriority' claim in an insolvency proceeding. The penalty for ignoring the statute is high: 'A representative of a person or an estate . . . paying any part of a debt of the person or estate before paying a claim of the Government is [personally] liable to the extent of the payment for unpaid claims of the Government.'[54]

Currently, there is great controversy as to whether the Superpriority Statute applies to insurance insolvencies. Some commentators argue that the exclusion of the business of insurance from federal regulation[55] precludes application of the Superpriority Statute in state insurance insolvency proceedings. Others argue that the statute is applicable, as insolvency proceedings do not fall within the 'business of insurance' excluded from federal regulation.[56]

This debate gives rise to an interesting question: are federal claims asserted in state insurance insolvency proceedings pursuant to the Superpriority Statute subject to rights of set-off? The Superpriority Statute is silent on the issue. As previously discussed, the existence of a prioritised distribution statute does not automatically negate the application of statutory set-off provisions before payment of priority claims. Thus, it would appear (at least under *Prudential*) that statutory set-offs could be applied before payment of government claims. In fact, at least one court has taken such a position.[57]

Another question arises regarding federal claims:

can an insolvent company take a set-off against government claims? The question would appear to be controlled by application of the two-part requirement for set offs: mutuality of capacity and mutuality of time. Thus, set-offs might be denied on mutuality of capacity grounds if the state receiver is deemed to be holding insolvency funds in *trust* for the federal government.[58] Complicating the analysis is the existence of the federal supremacy clause, dictating that the laws of the federal government are supreme to those of state government regulating the same subject. It could be argued that the Superpriority Statute overrides state set-off statutes to the extent they are deemed to conflict. Unfortunately, it does not appear that this issue will be resolved short of litigation.

Conclusion

American laws governing insurance insolvency proceedings have lagged behind the times. Originally created to resolve the financial difficulties of substandard primary carriers, these laws have not been adapted to respond to the myriad problems involved in the insolvencies of reinsurers. The business of reinsurance has changed and the insolvencies of reinsurers and primary carriers with reinsurance books of business have become increasingly complex. Receivers, however, have been given dated, ill-fitting tools with which to dismantle insolvent insurers. The effects of this morass have been visited on the insurance and reinsurance industry and ultimately the world community through restrictive approaches to the valuation of contingent claims and the applicability of set-offs.

The business of insurance and reinsurance is a global enterprise whose problems demand global solutions. The many conflicting and inconsistent statutory and regulatory provisions applicable to insolvencies evidence the need for reform. Contingent claims can and should be valued and allowed for payment or applied either through set-offs or the doctrine of recoupment. Models for reform can be found in the law of various jurisdictions read as a whole. The time is ripe for legislative reform. Unless receivers and industry work together to achieve needed change, drastic solutions may be forced upon them.

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.
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2. See, e.g. McCullough, *The Upset Over Offsets*, 6/89 ReActions 34 (1989).
3. See e.g. *O'Connor, supra* note 28.
4. Model Act §42.
5. *Melco System v Receivers of Trans-Am Ins Co*, 268 Ala 152, 105 So 2d 43 (1958). The *Melco* decision is discussed in detail above.
6. Kimball *History and Development of the Law of State Insurer Delinquency Proceedings: Another Look After 20 Years*, 5 J Ins Reg 6,14 (1986).
7. Ibid at 15–16.
8. Ibid at 28–29.
9. Assembly Bill 2194, as amended in Senate 27 July Briggs, Ca Leg Reg Sess, *1970 Assembly Final History*; Assembly Bill 2194, as amended in Assembly 14 August, Briggs, 1970 Ca Leg Reg Sess, *1970 Assembly Final History*. The issue was renewed in legislation in 1972, but the particular bill was never put to a vote. Assembly Bill 1390, as introduced 15 March 1972, Briggs, Ca Leg Reg Sess, *1970 Assembly Final History*; 5 J Assembly of Cal 8695 (1972).
10. NAIC Proceedings 1971, I: 134; see also NAIC Proceedings 1971, II: 38.
11. Kimball, at 28; NAIC Proceedings 1971, II: 377-403.
12. Kimball, 30 (citing NAIC Proceedings 1973, II: 265-70).
13. See Report of the Study Group on Reinsurance Offset, NAIC Proceedings 1989, I: 476, 481 (citing First Draft, s 96-45-56 (20(e))).
14. Kimball, 31 (citing Laws of 1985, ch 242, § 32, enacting Utah Ins Code, Utah Code Ann § 31A-27-323(2) (1986)).
15. NAIC Proceedings 1987, I: 474.
16. Report of the Working Group on Reinsurance Setoff, in NAIC Proceedings 1989, I: 476.
17. Ibid.
18. California, Delaware, Illinois, Indiana, Iowa, Kentucky, Missouri, New Jersey, New York, Ohio, Pennsylvania and Texas. NAIC Proceedings 1989, II: 384.
19. See NAIC Proceedings 1989, II: 337-54; NAIC Proceedings 1989 I: 378-446, 461-538; NAIC Proceedings 1988, II: 351-59.
20. NAIC Proceedings 1989, II: 384. Numerous arguments have been made as to the business, financial, and economic consequences of restricting set-offs beyond the limitations imposed by s 29 (and its predecessor, s 30) of the Model Act. A discussion of those arguments is beyond the purview of this article. For a detailed discussion of such arguments, see *Semple & Hall*; NAIC Proceedings 1989, I: 487-90, 495-512, 521-22.
21. NAIC Proceedings 1989, I: 475.
22. Ibid at I: 384.
23. Ibid at I: 513.
24. Ibid at I: 414.
25. Ibid at II: 345-46.
26. Proposed deletions are in brackets; proposed additions are underlined.
27. See, e.g., NAIC Proceedings 1989, II: 346 (proposal of National Reinsurance Corporation), 347 (proposal of Illinois), 351 (proposal of Henry Jernigan and his co-author of the 'minority report', Christopher Maisel), and 357 (proposal of The Alliance of American Insurers, The American Council of Life Insurance, The American Insurance Association, The National Association of Independent Insurers, and The Reinsurance Association of America ('Joint Industry Proposal').
28. NAIC Proceedings 1990, II: 530, 533.
29. Ibid.
30. Model Act § 42.

31. See, e.g., Illinois Insurance Code § 205, Ill Ann Stat ch 73, para 817 (Smith-Hurd Supp 1991).
32. *Prudential Reinsurance Co v Superior Court*, 216 Cal App 3d 1321, 227 Cal App 3d 293, 265 Cal Rptr 386 (1989), *review granted*, 268 Cal Rptr 542, 789 P 2d 342 (1990) (Opinion in 216 Cal App 3d 1321 omitted. Reprinted without change in 227 Cal App 3d 293, to permit tracking pending review by the supreme court); *In re* Liquidation of Midland Ins Co, 167 AD 2d 75, 569 NYS 2d 951, *aff'd* 1992 WL 55893 (NY 1992).
33. 216 Cal App 3d 1321, 277 Cal App 3d 293, 265 Cal Rptr 386 (1989), *review granted*, 268 Cal Rptr 542, 789 P 2d 342 (1990) (Opinion in 216 Cal App 3d 1321 omitted. Reprinted without change in 227 Cal App 3d 293, to permit tracking pending review by the supreme court).
34. 227 Cal App 3d at 299–300, 265 Cal Rptr at 388.
35. Ibid at 312-13, 265 Cal Rptr at 397-98.
36. Ibid at 315, 265 Cal Rptr at 399.
37. Ibid.
38. *Prudential Reinsurance Co v Superior Court*, 216 Cal App 3d 1321, 227 Cal App 3d 293, 316, 265 Cal Rptr 386, 400 (1989), *review granted*, 268 Cal Rptr 542, 789 P 2d 342 (1990) (Opinion in 216 Cal App 3d 1321 omitted. Reprinted in 227 Cal App 3d 293, to permit tracking pending review by the supreme court).
39. 227 Cal App 3d at 313, 265 Cal Rptr at 398.
40. Ibid.
41. Ibid.
42. Ibid.
43. *Prudential Reinsurance Co v Superior Court*, 216 Cal App 3d 1321, 227 Cal App 3d 293, 314, 265 Cal Rptr 386, 398 (1989) (Opinion in 216 Cal App 3d 1321 omitted. Reprinted in 227 Cal App 3d 293, to permit tracking pending review by the supreme court).
44. Ibid. The appellate court also found that permitting set-offs under cross reinsurance agreements between Prudential and the insolvent did not offend public policy. The court did not deem the interests of primary policyholders to be an overriding state policy interest sufficient to negate the application of set-offs. In reaching this result, the court noted that primary insureds have no interest in a contract of reinsurance, that the losses of primary insureds would be covered under the statute by a guaranty association, and that the state itself would not have to expend any funds for the policyholders' benefit as a result of the application of set-off rights. Ibid.
45. *In re* Liquidation of Midland Ins Co, 167 AD 2d 75, 569 NYS 2d 951, *aff'd* 1992 WL 55893 (NY 1992).
46. *In re* Liquidation of Midland Ins Co, Index No 41294/86, slip op 5–6 (NY Sup Ct 31 Jan 1990).
47. Ibid slip op at 5. *Accord Corcoran v Universal Reins Corp*, Index No 40924/86, slip op (NY Sup Ct Dec 1990). In view of the fact that the trial court's decision in *Midland* was reversed, it is doubtful that *Corcoran* has any validity.
48. Ibid slip op at 5–6. Some courts that have considered the issue have held that set-off does not effect a preference because only the balance owed the estate after assertion of the set-off is an asset of the estate. See, e.g., *Korlann v E-Z Pay Plan, Inc*, 247 Or 170, 428 P 2d 172 (1967). Others have held simply that the equity of equality among creditors is either found inapplicable to set-off or yields to their superior equity. See, e.g., *Scott v Armstrong*, 146 US 499 (1892).
49. *In re* Liquidation of Midland Ins Co, 167 AD 2d 75, 569 NYS 2d 951, *aff'd* 1992 WL 55893 (NY 1992).
50. 908 F 2d 1375, 1380 (7th Cir 1990).
51. *In re Midland Ins*, slip op at 10–11.
52. 31 USC § 3713 (1988).
53. 31 USC §§ 3713(a)(1)(A)(i), (iii), (B).
54. 31 USC § 3713(b).
55. Under the McCarran-Ferguson Act, 15 USC §§ 1011–15 (1988), the regulation of the 'business of insurance' is made exclusively a matter of the state, not federal law: 'No Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any state for the purpose of regulating the business of insurance . . .' 15 USC § 1–12(b).
56. Two courts have held that state insurance liquidation proceedings are not the 'business of insurance' and thus are not exempt under the McCarran-Ferguson Act. See *Gordon v United States Dept of Treasury*, 846 F 2d 272 (4th Cir 1988); State of Idaho *ex rel Soward v United States*, 858 F 2d 445 (9th Cir 1988). One court held, however, that the Superpriority Statute has no application in state insolvency proceedings. *Fabe v United States Dept of the Treasury,* 939 F 2d 341, 347 (6th CIR 1991), cert granted (1992); see *Grode v Mutual Fire, Marine & Inland Co*, 1990 WL 12253 at 9 (Pa Commw Ct 23 Jan 1990) ('McCarran Ferguson would appear to preclude the application of the Federal Priority Act' to state insurance insolvency proceedings). For a general discussion of the issue, see Howard, *Uncle Sam Versus the Insurance Commissioners: A Multi-Level Approach to Defining the 'Business of Insurance' Under the McCarran-Ferguson Act,* 25 Willamette L Rev I (1989); Kennedy, *The McCarran Act: A Limited 'Business of Insurance' Exemption Made Even Narrower – Three Decisions*, 18 Forum 528 (1983).
57. See *United States v Winnett*, 165 F 2d 149 (9th Cir 1947) (federal government entitled to enforce tax lien against insolvent only as to the unpaid balance on a note *after* the application of set-offs under state law).
58. See, e.g., *Lewis v United States*, 92 US 618 (1875); *United States v Duncan*, 25 F Cas 927 (7th Cir 1850) (No 15,003).

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