SETOFF IN ARBITRATION

WHEN ONE OF THE PARTIES IS IN RECEIVERSHIP

By

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I. Introduction

Setoff of credits and debits between a reinsurer and a cedent in a receivership setting became a controversial issue with a wave of insurer insolvencies in the 1980's.[1] However, treatment of this issue stabilized somewhat after a series of decisions confirming the right of a cedent or reinsurer to set off or net down credits and debits to the extent that there is mutuality in the capacity of the parties and mutuality in terms of the time the credits and debits arose.[2] Nonetheless, it remains a hot button with receivers who attempt to maximize the assets of estates through reinsurance receivables.

Setoff is a rare area of overlap between the language of the reinsurance treaty and the provisions of receivership law. Therefore, there is the potential for conflict between the rulings of an arbitration panel on multiple claims and a receiver's interpretation of the setoff provision of the applicable state receivership code.

An example of such conflict is Garamendi v. California Compensation Ins., et al., 2005 Cal. App. Lexis 11799. In this unpublished decision, the court reversed the confirmation of the order of an arbitration panel by the liquidation court and instructed the liquidation court to vacate the arbitration award and initiate a new arbitration proceeding. The basis of the court's ruling was that the panel exceeded its authority by an order which, the court found, implicitly required an improper setoff. As this article is written, the reinsurers, and other interested parties, are petitioning the California Supreme Court to hear an appeal of this decision since there is no appeal as of right in that state.

The purpose of this article is to examine whether this case was decided rightly or wrongly by the appellate division of the Superior Court and how arbitration panels might better express their rulings on multiple issues in a receivership context.

II. Background to and Summary of the Decision

A. Arbitration Decision

The relevant treaty contained an arbitration clause. It required the arbitration "of any dispute or difference of opinion hereafter arising with respect to this Contract . . . ."

When the cedents were placed in receivership, the liquidation court issued stays against setoff. Thereafter, the receiver served notice of his intent to seek collection of reinsurance recoverables through arbitration. The reinsurers moved to pursue claims against the cedent in the arbitration but the receiver opposed this motion. The receivership court, on July 17, 2001, lifted the stay and issued an order allowing the reinsurers to bring claims for rescission and related damages. The order prohibited the payment of any award against the insolvent cedents out of the assets of the estate of the cedents without the approval of the court. 2005 Cal. App. Lexis *7.

After 56 days of hearings, the arbitration panel issued its award:

> 1) The subject Contract is RESCINDED from inception as void *ab initio*; 2) In respect to all other demands of the parties to this arbitration, including the return of premium, interest thereon, and the costs and expenses incurred by the parties, [reinsurers] shall pay to [cedents] an aggregate amount of $2,500,000 . . . .

There was evidence in the record that the actual premium paid by the cedents to the reinsurers was between $7 and $7.5 million. 2005 Cal. App. Lexis 11799 *20. The difference between the premium paid to the reinsurers and the amount returned on rescission raised the issue of setoff.

B. Confirmation of the Liquidation Court

The reinsurers sought to confirm the award in the liquidation court. The receiver sought to have the award vacated on the basis that the panel exceeded its authority. The liquidation court confirmed the panel's award on the bases: (a) the July 17, 2001 order authorized the reinsurers to pursue affirmative claims to the extent there was no net amount due from the receiver; (b) Civil Code section 1692 allows the arbitration panel to adjust the recoveries on restitution to fit the equities of the situation; and (c) the panel award did not violate the California priority of distribution statute.

C. Appeal of Liquidation Court Confirmation

The appellate division found that: (a) Insurance Code section 481 (a)(1) requires the return of the entire premium on rescission and that this specific statute supercedes the general statute Civil Code section 1692 which would allow discretion restitution on rescission; (b) that the return premium was at least $7 million; (c) an order for

payment of $2.5 million to receiver indicated that the panel set off damages incurred by the reinsurers against the return premium; and (d) liquidation court orders preceding that of July 17, 2001 prohibited setoff.

Based on these findings, the court found that the arbitration panel exceeded its authority by failing to award the cedent the entire return premium in violation section 481 (a)(1). The panel also exceeded its authority since the orders preceding that of July 17, 2001 prohibited setoff.

Finally, the appellate court noted that Insurance Code section 1031 provides that "mutual debts . . . shall be set off and the balance only shall be allowed or paid." Case law interpreting this statute allows setoff of mutual debts which arise out of contracts in effect prior to the receivership. Prudential Reinsurance Co. v. Superior Court, 482 P.2d 48 (Cal. 1992). In this case, the return premium on rescission and the apparent set off of costs, attorneys' fees and fraud damages were not addressed in the treaty and, therefore, did not arise out of a pre-liquidation contract. Therefore, the debts were not mutual and the panel exceeded its authority in granting setoff under such circumstances.

III. Analysis of Appellate Court Decision on Setoff

A. Effectiveness of Court Orders Prohibiting Setoff?

The appellate court ruled that the arbitration panel exceeded its authority through setoff in violation of various court orders (preceding the July 17, 2001 order) that prohibited setoff. 2005 Cal. App. Lexis 11799 *27-9. Reading the preceding orders (properly) as stays, these stays were lifted by the liquidation court's July 17, 2001 order. Even reading the preceding orders as absolute prohibitions, one must question the effectiveness of orders which are facially violative of state law given the fact that setoff is allowed specifically by Insurance Code section 1031.

B. Conformity of Panel Order with July 17, 2001 Order?

Setoff is a netting down of the claim of A against B by the amount of B's claim against A. As such, it cannot produce a positive balance for B. At maximum, it can produce a zero balance due from B to A. Setoff is a defense. It is not an affirmative claim against the assets of the estate.[3]

In its July 17, 2001 order, the liquidation court allowed the reinsurers to arbitrate their claims against the cedents for "rescission . . . and related damages . . . . [provided that] no payment of any award or judgment obtained against [the companies in receivership] shall be paid in whole or part out of any assets of the estates . . . unless and until such payment is approved by order of this Court." 2005 Cal. App. Lexis 11799 *7. Obviously, this order contemplated setoff of the cedents' claim against the reinsurers by the reinsurers' claim against the cedents with the latter never reducing the cedent's claim below zero.

When the panel order came before the liquidation court, it was approved. Even if there was a setoff, therefore, it was approved in accordance with the liquidation court's order. Therefore, the panel order was within that contemplated by the liquidation court's July 17, 2001 order.

C. Must Mutual Debts be Pre-Liquidation Debts?

Because the appellate division found that the debts were post-liquidation it found that they failed the following test for setoff: "Thus, if the reinsurance debts arose from contracts executed prior to the date of liquidation, debts arising from these contracts are considered pre-liquidation debts subject to setoff." 2005 Cal. App. 11799 *23 quoting from Prudential Reins. Co. v. Superior Court, 842 P.2d 48 (Cal. 1992). However, it is not difficult to make an argument that the dispute "arose" out of the treaty. In fact, the issues disputed would not have been subject to arbitration if they did not. *See* the language of the arbitration clause in II. A. *supra.* Nonetheless, the debts need not be pre-liquidation debts to be set off.

Insurance Code section 1031 allows setoff of "mutual debts." This term has specific meaning in the insolvency context:

> In order for debts to be set off in an insurance insolvency, the debts must be mutual as to time as well as capacity. This requirement has often been stated in terms of a restriction that hinges upon the fixing date. That is, pre-liquidation debts may be set off only against other pre-liquidation debts, and post-liquidation debts only against other post-liquidation debts. In other words, a pre-liquidation debt cannot be set off against a post-liquidation debt. Put another way, the debts and credits to be set off must be owed contemporaneously. (citations omitted)[4]

The appellate division concluded that post-liquidation debts are not capable of setoff or, at least, are not mutual. However, this is not the law.

IV. Policy Issues with Respect to Arbitration in a Receivership Context

Receivers sometimes take the position that they are free to initiate arbitration against a reinsurer but that the reinsurer is barred by the anti-suit injunction from asserting a claim against the cedent. The receiver so argued in this case but the liquidation court ruled otherwise.

Dealing with the claims of both parties in the same proceeding provides judicial efficiency and an expert panel to decide the full panoply of issues arising out of a business dispute. The author is familiar with some receivers who willingly allow reinsurers pursue counterclaims that emanate from the reinsurance contract.

Arbitrators may be wise to recognize that their findings must be placed within a context of receivership law that structures the rights of creditor and debtors of the estate. For instance, a reinsurer's claim for damages may be valid under the treaty but be subject to priority of distribution laws that determine whether or not the claim actually will be paid out of the assets of the estate.

This being the case, there is logic to a panel order which specifies each basis of recovery on both sides and attributes a monitory value to each such basis. Such a practice makes it easier for the parties, and any reviewing court, should certain provisions of receivership law impact what portions of the order should be paid and/or in what priority. However, it is doubtful that such a practice was necessary with respect to the instant case since all the debts were mutual debts and the total sums credited to the reinsurers did not exceed the total sums credited to the cedent.

V. Conclusion

The appellate division of the Superior Court just got it wrong on setoff in this case. Even if the stays on setoff are interpreted as prohibitions, these orders were facially invalid under California law. The liquidation court clearly lifted its stays in allowing the reinsurers to bring their claims against the cedents in the arbitration proceeding. If the order of the arbitration panel worked a setoff, the liquidation court clearly approved it since it reduced merely the cedents' claim against the reinsurers. The panel order did not invade the assets of the estate. Finally, even if the debts set off were properly classified as post-liquidation debts, they were eligible for setoff under California law.

When receivers, or the liquidation court, agree to allow the solvent party to assert claims in an arbitration brought by the insolvent party, "best practices" suggests that the panel quantify its ruling on each claim. In some situations, this will be necessary for the subsequent application of certain provisions of the receivership law which are beyond the scope of the arbitration proceeding.

ENDNOTES

[1] Hall, Robert M., *Direct Actions and Setoff: The Next Generation*, Mealey's Reins. Rpt. No. 7 at 15 (1997) at section II A., (hereinafter "Hall") also available at the author's website: robertmhall.com.

[2] *Id.*

[3] Semple, T. Darrington, Jr., Hall, Robert M., *The Reinsurer's Liability in the Event of the Insolvency of a Ceding Property and Casualty Insurer*, Tort & Ins. Law Journal, Vol. XXI, No. 3 (Spring 1986) at 423. Anderson, Debra J., Mendelsohn, David E., Reed, Carolyn S., Schwab, Stephen W. *Onset of an Offset Revolution: The Application of Set-Offs in Insurance Insolvencies*, Dickinson Law Review, Vol. 95 No. 3 (Spring 1991) at 453-4 (hereinafter "Anderson"); Hall section II A.

[4] Anderson at 494-5.