Law and Practice of Insurance Company Insolvency Revisited

Edited by Francine L. Semaya

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William J. Branum, Assistant General Counsel
and Assistant Secretary
Robert M. Hall, General Counsel
and Secretary
Robin H. Willcox, Counsel and
Assistant Secretary
American Re-Insurance Company
555 College Road East
P.O. Box 5241
Princeton, NJ 08543

Setoffs, Recoupments, & Voidable Preferences - In the Insolvency Process

Introduction

Setoff, recoupment, and voidable preference are venerable legal doctrines which have received fresh scrutiny in light of the 238 ongoing insurance company liquidations as listed in the records of the National Association of Insurance Commissioners as of June, 1989. At present, these doctrines are governed by a patchwork of individual state statutes and case law. Liquidations produce intense political and economic pressure for interested parties to interpret or change existing law to achieve a desired end. In an era of complex multi-state insurer insolvencies, this can result in multiple litigation and inconsistent results from state to state. In addition, the costs of remaking the law on a case by case depletes the funds available to insureds and claimants.

The purpose of this paper is to clarify the doctrines of setoff, recoupment, and voidable preference in the ordinary course of business and in the extraordinary circumstances of insurance insolvency proceedings. It suggests a consensus as to the fair and neutral legal rules by which the difficult liquidation process may be governed.

Part 1 Setoff

A. Legal Analysis

1. Origins of Setoff

Setoff is the process by which two contracting parties reduce mutual debts and credits to arrive at a net balance. It is a common law doctrine, with its roots in principles of equity originating in British common law and thereafter embodied in British and American bankruptcy law.[1]

The rule of setoff was first recognized by the United States Supreme Court in Scott v. Armstrong wherein the Court stated that "liens, equities or rights arising by express agreement, or implied from the nature of the dealings between the parties, or by operation of law, prior to insolvency and not in contemplation thereof, are not invalidated."[2] Similarly, the Court, in Willing v. Binenstock, cited Scott for the proposition that "only the balance, after deduction of setoff, constitutes part of the assets of the insolvent."[3]

Current bankruptcy law relating to setoff is derived from earlier American and English bankruptcy acts.[4] Every federal

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1 The earliest British setoff provisions were enacted to recognize the judicially created equitable doctrine. Scott v. Armstrong, 146 U.S. 499 (1892).

2 Id. at 510.

3 Willing v. Binenstock, 302 U.S. 272, 276 (1937).

4 4 Collier on Bankruptcy at 68.01 [(1)] (14th ed. 1978).

bankruptcy statute has incorporated the right of setoff.[5]

In accordance with the concept of the primacy of state regulation of insurance, the federal bankruptcy statutes do not directly apply to the liquidation of insurance companies. Rather, the individual state liquidation laws are controlling. Nevertheless, state insurer liquidation statutes are based on the federal bankruptcy code, and the large majority specifically recognize and codify the right of setoff.[6] Consequently, setoff in the insurance context should be governed by the same principles which apply to banks, business corporations and similar entities. This proposition takes into account both practical business realities as well as fundamental constitutional considerations.

In the context of non-insurance bankruptcy proceedings, Congress has recognized setoff as a security interest. The Federal Bankruptcy Act accords setoff claims the status of secured claims.[7] Inasmuch as secured claims receive priority over all other claims to the extent of the security, setoff claims are not considered preferential. In essence, setoff simply permits two parties to arrive at an

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5 For example, Section 42 of the Bankruptcy Act of 1800 provided: "That where it shall appear to the said commissioners that there hath been mutual credit given by the bankrupt, and any other person, at any time before such person became bankrupt, the assignee or assignees of the estate shall state the account between them, and one debt may be setoff against the other, and what shall appear to be due on either side on the balance of such account after such setoff, and no more, shall be claimed or paid on either side respectively."

6 Banks and Bizzini, "A Reinsurer's Right of Setoff in Liquidation Proceedings," 2 Journal of Insurance Regulation (December 6, 1987) 207-224.

7 See 11 U.S.C. §506(a).

accurate statement of their accounts.[8] Funds subject to setoff are not considered a part of the general assets of the bankrupt's estate.[9] Because the only amount owed to the insolvent debtor is the net amount over and above the creditor's setoff rights, exercising the right of setoff does not work a preference. This treatment is consistent with the United States Supreme Court's recognition of the fundamental fairness of setoff[10] and the "absurdity of making A pay when B owes A."[11]

This concept of the inherent fairness of setoff has been afforded constitutional protection under the Fifth and Fourteenth Amendments to the United States Constitution by some courts. For example, attempts to restrict the right of setoff may be subject to the Fifth Amendment's prohibition against taking private property without just compensation, applied to the states by the Due Process Clause of the Fourteenth Amendment.[12] Furthermore, they may also

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8 The United States Supreme Court, in interpreting the 1898 Bankruptcy Act provision allowing setoff, stated: "The object of this provision is to permit, as its terms declare, the statement of the account between the bankrupt and the creditor, with a view to the application of the doctrine of set-off between mutual debits and credits." Cumberland Glass Mfg. Co. v. DeWitt and Co., 237 U.S. 447, 454-55 (1915).

9 Scott v. Armstrong, note 1, supra. See also, Bank & Bizzini, note 6, supra.

10 "Natural justice and equity would seem to dictate that the demands of parties mutually indebted should be set off against each other, and that the balance only should be considered as due." Carr v. Hamilton, 129 U.S. 252, 255 (1889).

11 Studley v. Boylston National Bank of Boston, 229 U.S. 523, 528 (1913).

12 Hager v. Anderson-Hutchinson Insurance Agency, et al., U.S. Dist. Ct., S.D. Iowa, CV86-841-E, decided July 14, 1989; United States v. Security Industrial Bank et al., 459 U.S. 70 (1982).

run afoul of the Equal Protection and Due Process Clauses of the Fourteenth Amendment,[13] inasmuch as they impose significant economic disadvantages on insurance company creditors but do not impose these hurdles on other similarly situated business creditors such as banks. And finally, abrogation of the right of setoff may work an unconstitutional impairment of contracts, under the Contract Clause of the Constitution.[14]

2. Mutuality

The equitable and constitutional underpinnings of the right of setoff must be considered during any examination of the current status of setoff in the context of insurer insolvencies. Such an analysis begins with the legal concept of mutuality and its codification in current insurer insolvency statutes.

The definition of setoff refers to the reduction of mutual debits and credits to a net balance. The essential element of mutuality arises in two factors: capacity and time.

Setoff by definition involves multiple contracts.[15] However, under the doctrine of mutuality, setoff is not allowed unless debts are owing to and from the same parties in the same capacities.[16] Two rules have been held to flow from this. First, the capacity (not number or type of contract) in which each party asserts its claim must be the same. In a reinsurance context, if reinsurer A has

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13 Hager v. Anderson-Hutchinson, id.

14 U.S. Const., Art. I, §10; Allied Structural Steel v. Spannaus, 438 U.S. 234 (1978).

15 Scammon v. Kimball, 92 U.S. 362, 367 (1876).

16 Harnett v. Nat'l Motorcycle Plan, Inc., 59 A.D. 2d 870, 399 N.Y.S.d 242, 244 (1977).

several reinsurance contracts with ceding company B, the outstanding balances on each contract may be setoff against each other. Generally, setoff is appropriate even if the multiple contracts between A and B provide for the companies to act as both reinsurers and cedants of each other under the separate contracts.

However, under normal circumstances, mutuality in capacity does not exist among affiliate debtors and the insolvent. Thus, affiliate debtor A cannot setoff or reduce its debt to the insolvent based on the existence of a credit due to affiliate B from the insolvent (regardless of whether A and B are cedants or reinsurers). This result does not change even if the affiliates' debts and credits arise under a joint contract because the parties' capacity, and not the nature or number of contracts, is the determinative factor.[17]

There is no mutuality in capacity when one of the parties is acting in a representative capacity. For example, if one party owes monies as a debtor and the other as a trustee, mutuality of capacity does not exist and setoff will not be allowed.[18] In effect, the

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17 Mutuality in capacity, however, may exist when affiliates have ceded business under a single contract to the insolvent reinsurer, and either through course of dealing or in the reinsurance agreement, the ceding insurers are treated as a single entity. Similarly, if multiple affiliates or non affiliated insurers have formed a pool to act as a single entity, and premiums and losses have been aggregated through a course of dealing, mutuality of capacity may be found to exist. In both cases the parties have treated the group affiliates or pool as a single entity and that relationship should continue to be recognized after insolvency.

18 Garrison v. Edward Brown & Sons, 25 Cal. 2d 473, 154 P.2d 377, 379 (1944); Downey v. Humphreys, 102 Cal. App. 2nd 323, 227 P.2d 484, 490 (1951). In re Consolidated Indemnity & Ins. Co., 287 N.Y. 34, 38 N.E. 2d 119, 120-21 (1941).

funds held in trust belong not to the trustee, but to the beneficiaries. In the insurer liquidation context, these beneficiaries are the general creditors, i.e., the policyholders. Thus, the mutuality requirement prevents a trustee from using funds equitably belonging to the policyholders to obtain a preference at their expense.

The second requirement of mutuality - mutuality in time - similarly protects the policyholders against preferential transfers. It provides that preliquidation obligations can be set off only against other preliquidation obligations, and post-liquidation obligations can be setoff only against other post-liquidation obligations.[19] Without this mutuality of time requirement, a person who owed money to the insolvent before the insolvency could purchase claims against the estate thereafter at a reduced rate and use those claims as setoff against the more expensive preliquidation claim.[20] When this occurs, the courts hold that mutuality does not exist.[21]

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19 O'Connor v. Insurance Co. of North America, 622 F. Supp. 611, 618 (N.D. Ill. 1985); Gambrell v. Cox, 250 S.C. 228, 157 S.E.2d 233, 236 (1967); Wisconsin Mutual Ins. Co. v. Manson, 24 Wis. 2d 673, 130 N.W. 2d 182 (1964); In re N.Y. Title & Mortgage Co. (Series Q-1), 260 A.D. 729, 23 N.Y.S.2d 303, 306 (1940); New York Title & Mortgage Co. v. Friedman, 153 Misc. 697, 276 N.Y.S. 72 (1934).

20 See, e.g., Sawyer v. Hoag, 84 U.S. 610 (1873).

21 The mutuality requirement for setoff may be distinguished from the equitable principle of recoupment where mutuality is irrelevant. See M. Wolke, Jr., Voidable Preferences, Fraudulent Conveyances, Offsets and Recoupment, 1986 Nat'l Inst. on Insurer Insolvency 349, 366-8 and Part II, infra.

When both requirements of mutuality are met, there is no preference,[22] because mutual debts and credits arise and are cancelled contemporaneously.[23]

Judicial decisions determining when setoff is proper in the insurer liquidation context fall into five distinct categories. In the first four situations, the courts will not allow setoff, because funds owed the estate are deemed held in trust for all creditors. In the fifth situation, however, no fiduciary relationship exists. The companies are deemed mutual debtors and creditors and setoff is permitted.

(a) Mutuality of Capacity

Unpaid Capital Due Undercapitalized Insurer

In Sawyer v. Hoag, supra, the Supreme Court would not allow the defendant to setoff an unpaid stock subscription against a claim against the company he purchased after the company became insolvent. The Court ruled that unpaid stock subscriptions are trust funds and held that "mutuality did not exist because the defendant's debt was owed in his capacity as trustee, whereas the insurer's debt was

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22 Under the National Association of Insurance Commissioners ("NAIC") Insurance Supervision, Rehabilitation and Liquidation Model Act ("Model Act") a preference cannot occur unless a transfer is made on account of "antecedent debt." See Model Act Section 28 (A)(1). Nor could a setoff result in a fraudulent transfer. Fraudulent transfers must be "without fair consideration." See Model Act Section 26(A) and 27(A). Since amounts setoff against each other are always equal, there is fair consideration.

For a discussion of the compatibility of Section 30B of the Model Act (exceptions to the rule of setoff) with common law principles, see the Report of the Working Group on Reinsurance Setoff described in the text accompany note 72, infra and I 1989 NAIC Proceedings 476, 483-487.

23 Scott v. Armstrong, 146 U.S. at 510; O'Connor, 622 F. Supp. at 620-22; Downey, 227 P.2d at 493.

owed in its capacity as debtor."[24]

Assessments Due Mutual Insurer

In cases where policyholders of mutual assessment companies have attempted to setoff claims for losses and unearned premium against their own obligations to pay assessments, the courts have held that mutuality does not exist, because the assessments constitute a trust fund for the benefit of all creditors.[25]

Reinsured's Salvage and Subrogation Funds

Salvage and subrogation recoveries by a ceding company are held in trust for the reinsurer. The reinsured's fiduciary obligation to pay the reinsurer its proportionate share of the salvage or subrogation proceeds may not be setoff by claims against the reinsurer for losses.[26] In effect, the subrogation and salvage rights are assigned.[27] The same rights accrue to a reinsurer as to an insurer.[28] Once a primary company makes a subrogation or salvage recovery, such funds are "impressed with a trust for the

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24 84 U.S. at 620. Although the court found it unnecessary to extend its inquiry any further, id. at 623, it should be noted that defendant's claim to setoff may also have been invalid for want of mutuality of time, as defendant purchased the loss claim after learning of the insolvency. Id. at 612.

25 Lloyd v. Cincinnati Checker Cab Co., 67 Ohio App. 89, 36 N.E.2d 67, 70 (1941) (attempt to setoff loss claim); see also Tuttle v. State Mutual Liability Ins. Co., 2 N.J. Misc. 973, 127 A. 682 (1924) (attempt to setoff claim for unearned premiums).

26 American Ins. Group v. McCowin, 7 Ohio App.2d 62, 218 N.E. 2d 746 (Ohio App.1966)

27 Maryland Cas. Co. v. Brown, 321 F. Supp. 309 (N.D. Ga. 1971)

28 Universal Ins. Co. v. Old Times Molasses Co., 46 F.2d 925, 927 (5th Cir. 1931); Maryland Cas. Co. v. Cincinnati, 291 F. 825 (D.C. Ohio 1923); 16 Couch on Insurance 2nd Sec. 61:5; 19 Couch on Insurance 2nd Sec. 80.12; Appleman, Insurance Law and Practice Sec. 7703

reinsurers in the amounts they are entitled to receive...."[29]

In two salvage cases involving reinsurance, setoff was disallowed because the court determined that the reinsured held monies in trust, rather than as a principal, so that the mutuality requirement could not be met.[30]

Agent's Claims for Unearned Premiums

Where an agent attempts to setoff its obligation to remit earned premiums to the insurer by claims for unearned premiums or contract damages, courts have disallowed this setoff. The agent holds earned premiums in trust for the benefit of the insurer, and, in the case of insolvency, holds unearned premium for the policyholders. To allow one agent to withhold earned premiums from the estate would grant that agent (and its customers) a preference to the detriment of

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29 Glacier General Assurance Co. v. G. Gordon Symons Co., Ltd., 631 F.2d 131, 134 (9th Cir. 1980). See also, In re Consolidated Indemnity & Ins. Co., 287 N.Y. 34, 38N.E.2d 119 (1941); Pink v. American Surety Co. of N.Y., 28 N.E.2d 842 (1940).

30 Pink v. American Surety Co., 28 N.E. 2d 842; Consolidated Indemnity, note 18, supra. A detailed discussion of these cases is contained in the Report of the Study Group on Reinsurance Setoff, I 1989 NAIC Proceedings 475 at 484.

the other general creditors.[31] These cases are to be distinguished from those involving insureds or reinsureds setting off sums owed as a principle in a debtor/creditor relationship.

These same principles should apply to the relationship between reinsurance intermediaries and assuming and ceding companies. In order to allow credit for reinsurance, however, regulators now require an "Intermediary Clause" to place the risk of defalcation on the reinsurers. By making the intermediary the agent of the reinsurer, regulators may have rearranged mutuality principles in

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31 Sheeran v. Sitren, 168 N.J. Super. 402, 403 A.2d 53, 61 (1979); See e.g., Malone v. Robertson, 88 F. Supp. 749, 751 (N.D. Fla. 1950); Garrison v. Edward Brown & Sons, 28 Cal. 2d 28, 168 P.2d 153, 155 (1946); Harnett, 399 N.Y.S.2d at 244; O'Neil v. Burnett, 263 Pa. 216, 106 A. 246, 247 (1919).

In Bohlinger v. Ward & Co., 20 N.J. 331, 120 A.2d 1 (1956), the agent learned that the insurer was about to become insolvent, and proceeded to collect unearned premiums owed its customers during the period immediately preceding entry of the liquidation order. After using the funds to purchase replacement coverage for its customers, the agent attempted to setoff the unearned premium amount against the insurer's claims for earned premium remittances. The court found that the agent collected premiums in a fiduciary capacity and that the insurer and agent stood in a principal-agent, as opposed to a debtor-creditor, relationship. To allow the agent credit for the unearned premiums of its own customers "would in actuality sanction a preference at the expense of other policyholders and creditors--and indeed what defendant did was done for the precise purpose of making its customers whole." 120 A.2d at 4. (Emphasis added).

favor of reinsurers.[32]

Insured's or Reinsured's Claims for Losses and Unearned Premiums

Caselaw demonstrates that mutuality exists when an insured or reinsured asserts claims for losses or remittance of unearned premiums as a setoff to the insurer's or reinsurer's claims for premiums. The claims need not arise from the same contract as long as the parties stand in a debtor-creditor relationship (i.e., as long as no fiduciary relationship is found). Thus, in Newman v. Hatfield Wire & Cable Co.,[33] the court allowed the insured to setoff unearned premiums paid on policies cancelled due to the insurer's

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32 Under this clause, the intermediary is the agent of the reinsurer for purposes of receipt of funds. Payment of premiums by the ceding company to the intermediary constitutes payment to the reinsurer. Payment of losses by the reinsurer to the intermediary does not reduce the reinsurer's obligations unless the intermediary actually pays the losses to the ceding company.

If a ceding or assuming company is placed in liquidation while funds are in transit through the intermediary, some consider setoff rights to be uncertain because questions are raised as to whether a ceding company can setoff premiums in the possession of the intermediary against recoverables from an insolvent reinsurer, and whether a reinsurer can setoff loss payments in the possession of the intermediary against premium due from an insolvent ceding company.

The Intermediary Clause appears to rearrange the trust principles applicable to agents and brokers, but if the principle of mutuality of capacity is applied to the relationship established by the Intermediary Clause, the ceding company should lose its right to setoff premiums paid to the intermediary. The reinsurer, however, should retain the right to setoff reinsurance recoverables in the possession of the intermediary (the agent of reinsurer) against premiums due from the ceding company.

33 113 N.J.L. 484, 174 A. 491 (1934).

insolvency to be applied as a setoff against premiums owed to the insurer on other policies.[34]

The Supreme Court has recognized that setoff is allowed among claims arising from different contracts or transactions.[35] In Scammon v. Kimball,[36] where a bank was allowed to setoff the amount of a property damage claim against funds the insurer had deposited with the bank, the Court defined setoff as "that right which exists between two parties, each of whom, under an independent contract, owes an ascertained amount to the other to setoff their respective debts by way of mutual deduction."[37] Similarly, in Forsythe v. Kimball,[38] an insured was held entitled to setoff his proportionate share of debt under a loan by the amount the insolvent insurer owed for losses under a policy. The Court in Carr v. Hamilton[39] held that a policyholder could reduce his debt to the insurer under a mortgage deed by the insurer's debt under an endowment policy.

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34 Id.

35 It is this right to net the debts and credits among different contracts which distinguishes setoff from recoupment. See note 21, supra.

36 92 U.S. 362 (1875).

37 Id. at 367.

38 91 U.S. 291 (1875).

39 129 U.S. 252 (1889).

(b) Mutuality of Time

The rights of a party having a contractual relationship with an insolvent insurer become fixed on the effective date of liquidation. The liquidator stands in the shoes of the insolvent insurer with respect to contractual rights and obligations which were fixed as of that date.[40] In order to satisfy the mutuality in time requirement, preliquidation debts may be setoff (as distinguished from recoupment) only against other preliquidation debts.[41]

Setoff of claims "susceptible of liquidation"[42] may be compared with setoff of contingent claims as it is allowed in a federal bankruptcy proceeding. The Bankruptcy Code allows a party to claim (and therefore setoff) contingent claims (those which have not been asserted), immature claims (those which are not yet due) and

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40 See e.g. K.R.S. Section 304.33-200(2); Bohlinger v. Zanger, 306 N.Y. 228, 117 N.E.2d 338, 341, reh'g den., 306 N.Y. 851, 118 N.E.2d 908 (1954)

41 O'Connor, 622 F. Supp. at 618; O'Hern v. DeLong, 298 Ill. App. 375, 19 N.E.2d 214, 215-16 (1939) (disallowed agent's attempt to setoff its debt under a mortgage held by an insolvent insurer by the agent's claims for commissions and renewal premiums it would have received had the insurer not failed); Manchester Ins. & Indemnity Co. v. Manchester Premium Budget Corp., 469 F. Supp. 126, 129 (E.D. Mo. 1979) aff'd 612 F. 2d 389 (8th Cir. 1980) (premium finance company which had obtained rights to unearned premiums by means of post-liquidation assignment held not entitled to setoff); Wisconsin Mutual Insurance Co. v. Manson, 24 Wis. 2d 673, 130 N.W. 2d 182 (1964) (interest due to insolvent insurer prior to liquidation could not be setoff against debt on surplus note that became due after liquidation); New York Title & Mortgage Co. v. Friedman, 153 Misc. 697, 276 N.Y. Supp. 72 (1934) (liability to insurer based on mistaken payment made to bond holder could not be setoff against insurer liability on guarantee of a preliquidation bond that did not become due until after liquidation date).

42 O'Connor, supra at 619.

unliquidated claims (those which are uncertain in amount).[43] Under 11 U.S.C. section 502(c), the Bankruptcy Court has the authority to estimate the value of contingent, immature or unliquidated claims if to do otherwise would unduly delay administration of the estate. The pre-petition and post-petition entities are treated as separate and distinct.[44]

In an insurance context, preliquidation claims would include those based on facts or occurrences in existence prior to the entry of an order of liquidation. For example, these could include losses which occur prior to such entry but which are reported afterwards.[45] Workers compensation and general liability classes have very long reporting and development periods. It is not practical for a liquidator to delay the winding up of an estate until all losses are liquidated and premium adjustments are finalized. Nonetheless, contingent, immature and unliquidated claims have a real value which should be recognized in liquidation proceeding.

Section 37 of the NAIC Model Act gives the liquidator the

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43 See 4 Collier on Bankruptcy 15th Ed. Par. 502.03, 553.08, and 553.11.

44 In re T&B Gen. Contracting Inc., 12 B.R. 234 (B. Ct., M.D. Fla. 1981).

45 O'Connor, supra, 622 F. Supp. at 619. This analysis focuses on a context where all policies can be cancelled by a liquidation order. There is some debate as to whether bonds can be cancelled. Some life and accident and health products are structured as "noncancellable." Whatever the limitations on their authority, some liquidators continue such noncancellable products after liquidation and try to sell the business to generate income. This paper does not address the preliquidation - post-liquidation issues arising out of this situation.

authority to allow in the proceeding:

(a) Unliquidated claims;

(b) Contingent claims to the extent they do not prejudice the orderly administration of the estate; and

(c) Immature claims discounted to present value.

A similar approach should be taken with setoff. The authors are aware that a variety of commutation and collateralization devices have been used for this purpose in a number of recent liquidations.

Claims for reinsurance proceeds and unearned premiums resulting from the cancellation of policies upon insolvency are preliquidation debts, because they are "liabilities of the bankrupt founded on contract . . . which existed at the time of the bankruptcy and either were fixed in amount or susceptible of liquidation."[46] When contracts are cancelled by the order of liquidation, no premium should be considered post-liquidation premium. Premiums which are adjusted after liquidation, pursuant to the terms of the contract, should be setoff against indebtedness under other contracts, since these adjustments are based on the preliquidation losses and, therefore, are "susceptible of liquidation".

It should be noted, however, that a contrary result occurred in Melco Systems v. Receiver of Trans-America Inc. Co.[47] This case is

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46 O'Connor 622 F. Supp. at 619 (citing Cunningham v. Comm'r of Banks, 249 Mass. 401, 144 N.E. 447, 459 (1924) (emphasis added)).

47 268 Ala. 152, 105 So. 2d 43 (1958).

distinguishable on its facts,[48] is inconsistent with analogous bankruptcy law and has not been followed by other jurisdictions.

In O'Connor v. Insurance Company of North America,[49] the Court reviewed Melco Systems and concluded that "it seems to ignore the established policy in an area of bankruptcy law quite analogous to the situation with which we are now faced. Defendant's debts are

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48 Melco Systems involved a reinsurer that settled its liabilities to the Receiver for $130,000 and then tried to assert a $8,928.11 setoff for earned premiums. A review of the record reveals that the reinsurance contract at issue contained neither an insolvency clause nor a setoff clause. Without an insolvency clause, a reinsurance contract is a contract of indemnity requiring the estate to pay a claim before it can be reimbursed by the reinsurer. The parties entered into a separate Insolvency Agreement which became operative upon liquidation and called for the reinsurer to pay claims to the Receiver without diminution because of the insolvency of the ceding company.

The ceding company was not able to pay the claim without reinsurance support and, therefore, could not claim reimbursement under the reinsurance agreement. The Receiver could claim reimbursement under the Insolvency Agreement but since this become operative upon liquidation, the court held that the $130,000 reinsurance recoverable was a post liquidation debt which could not be setoff against earned premium which was a preliquidation debt.

It is possible to distinguish the Melco Systems fact situation from that involving a reinsurance agreement with an integrated insolvency clause since in the latter situation, no new contract incepts on liquidation.

49 622 F. Supp. 611, 619 (N.D. Ill. 1985).

preliquidation debts, mutuality exists, and a set-off permissible."[50] With respect to the preference issue, the O'Connor court stated:

> It is true that the reinsurers would be paid in full if a set-off is permitted, but, of course, this is the case anytime a setoff is permitted. The whole point of the statutory setoff section is to make clear that such actions are permissible, even though one creditor may be getting paid more than other creditors.[51]

The reasoning of the O'Connor court is consistent with the bankruptcy analogy discussed above and common law precedents. Moreover it provides liquidators with a clear, consistent and readily applied rule: losses occurring and premiums earned prior to the entry of an order of liquidation are preliquidation debits.

3. Legislative History of Section 30 of the Model Act

Having reviewed the common law and equitable foundation of the right of setoff, it is appropriate to explore its statutory evolution.

In 1965 the Wisconsin legislature enacted the Wisconsin Liquidation Act. Section 34 of this statute, now codified in Section 645.56 of the Wisconsin Insurance Code, governed the application of setoff in insolvency proceedings. This statute formed the basis of

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50 Id.

51 612 F. Supp. at 618.

Section 30 of the NAIC Model Act.[52] In turn, Section 30 of the Model Act, serves as the basis for most state laws on setoff.[53]

An examination of the legislative history of the Wisconsin provision reveals that its drafters originally attempted to deny reinsurers setoff rights which existed at common law.[54] The original draft of the Wisconsin provision disallowed setoff where "the obligation of the insurer is to a reinsurer for premiums."[55] However, this subsection was deleted from the statute as it was

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52 Section 30 states:

(A) Mutual debts or mutual credits between the insurer and another person in connection with any action or proceeding under this subtitle shall be setoff and the balance only shall be allowed or paid, except as provided in Subsection (B) and Section 33.

(B) No setoff or counter-claim shall be allowed in favor of any person where:

(1) The obligation of the insurer to the person would not at the date of the filing of a petition for liquidation entitle him to share as a claimant in the assets of the insurer;

(2) The obligation of the insurer to the person was purchased by or transferred to the person with a view to its being used as a setoff;

(3) The obligation of the person is to pay an assessment levied against the members or subscribers of the insurer, or is to pay a balance upon a subscription to the capital stock of the insurer, or is in any other way in the nature of a capital contribution; or

(4) The obligation of the person is to pay premiums, whether earned or unearned, to the insurer.

53 See Banks and Bizzini, note 6, supra. I 1989 NAIC Proceedings 480-1.

54 S. Kimball, H. Denenberg & R. Bertrand, Delinquency Proceedings in Insurance, Second Draft, State of Wisconsin, Legislative Council, Insurance Laws Revision Committee. (October 26, 1966) at 128-9

55 Ibid.

ultimately enacted. Nevertheless, the Wisconsin provision did depart from the common law rule in subsection (2)(e), which denies setoff where the obligation of the creditor is to pay premiums, whether earned or unearned, to the insurer. A strict application of the mutuality doctrine would allow setoff where premiums and losses are owed in the same capacity, i.e., contracting principals. Thus, the Wisconsin legislature chose to deny setoff to policyholders, but preserved the common law entitlement of reinsurers to premium setoff.

On December 2, 1968, an NAIC subcommittee recommended the Wisconsin Act as the basis for model legislation on insurer insolvencies.[56] The resolution was adopted by the parent committee on December 4, and by the NAIC plenary session on December 5.[57] On December 6, 1977 the NAIC adopted the Model Act with Section 30 in virtually identical form to the corresponding provision of the Wisconsin Act.[58]

4. Other NAIC Consideration

(a) Earlier Debate

In 1970 the issue of reinsurer setoff was raised at the NAIC. The ensuing debate continued for two years, and ended with the adoption of a model regulation governing abusive surplus aid

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56 I 1969 NAIC Proceedings, at 241 and 271.

57 Actually, no clear record exists of adoption by the plenary session. However, it is not disputed that the Wisconsin Act was so adopted. See S. Kimball, "History and Development of the Law of State Insurer Delinquency Proceedings: Another Look After 20 Years," 5 Journal of Insurance Regulation 6, 28, n. 91 ("[i]f there never was proper formal action perhaps it can be analogized to the common law marriage"); see also II 1971 NAIC Proceedings 380.

58 I 1978 NAIC Proceedings 238-275.

reinsurance contracts. The issue was first joined on December 16, 1970, when Zone 4 recommended that the Laws, Legislation & Regulation Committee (B) ("the Parent Committee") consider amending the Model Act to eliminate the reinsurers' right of setoff.[59] A "Subcommittee to Consider Elimination of Reinsurance Setoff in Model Rehabilitation & Liquidation Act" ("the Subcommittee") comprising the insurance departments of Michigan, Wisconsin, Delaware and California was appointed to consider a compromise between the Zone 4 proposal (total elimination of reinsurer setoff) and objections thereto by the reinsurance industry.[60] After receiving briefs on the merits,[61] the Subcommittee failed to take any action eliminating the reinsurers' right of setoff. Instead, in September of 1971 Michigan proposed that the NAIC address the narrower problem of abusive surplus aid reinsurance contracts. In November of that year, the Subcommittee met and similarly set resolution of the surplus aid issue as its goal.[62] In December, the Parent Committee received and considered the Subcommittee report on the matter,[63] and the next day resolved that the Michigan proposal be adopted as the basis for future action.[64]

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59 This development in and of itself indicates that the regulators recognized that reinsurers retained their common law setoff rights under the Wisconsin and NAIC statutes, and that express revision would be necessary in order to deny that right.

60 I 1971 NAIC Proceedings 134.

61 II 1971 NAIC Proceedings 380-403.

62 I 1972 NAIC Proceedings 518.

63 I 1972 NAIC Proceedings 443.

64 I 1972 NAIC Proceedings 22.

At the June 1972 NAIC meeting a model surplus aid regulation was considered,[65] and in December of that year regulations for property/liability and life/health companies were adopted and referred to the Blanks Committee. The Subcommittee then dissolved itself.[66]

Finally, the Blanks Committee incorporated a "ceded reinsurance report" into Schedule S of the NAIC annual statement to enable regulators to detect abusive surplus aid reinsurance contracts.[67] After two full years of consideration on the merits, the original Zone 4 proposal to eliminate the reinsurers' right of setoff was rejected by the NAIC.

(b) Current Debate

At present, there are ongoing discussions within several committees of the NAIC concerning setoff. No final action had taken place as of the time this paper was finalized.

At the March 1986 NAIC meeting, the issue of reinsurance setoff was raised by James Dickinson, Assistant to the Special Deputy Liquidator of Delta American Reinsurance Company.[68] It eventually became a charge to the Rehabilitators and Liquidators Task Force. Relatively little was done on this topic in 1986 and it was carried over as a charge to the Task Force for 1987. In June of 1987 a

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65 II 1972 NAIC Proceedings 19, 391-393.

66 I 1973 NAIC Proceedings 42, 140-41.

67 II 1973 NAIC Proceedings 265-70; see also Kimball note 57, supra, at 30.

68 II 1986 NAIC Proceedings 496.

subgroup was formed to study setoff.[69] The charge to the subgroup was:

> Review applicability of the setoff provision in Section 30 of the Insurers Supervision, Rehabilitation and Liquidation Model Act as that provision affects reinsurers.

At the December 1987 NAIC meeting the subgroup presented a legislative history of Section 30 which concluded that Section 30 is consistent with reinsurance setoff.[70] In addition, the subgroup provided a framework for further examination of the topic including modern caselaw and business and regulatory considerations. No action was taken on this report by the Task Force.

The charge was carried over into 1988 and the subgroup, renamed the Setoff Working Group, continued its efforts.[71] At the September 1988 NAIC meeting, the Working Group presented its report and recommendations for alteration of Section 30.[72] The report found Section 30 to be compatible with legislative history, legal precedents and business and regulatory considerations and suggested certain clarifications of the limitations on setoff. This report was received and exposed for comment. (Receipt and exposure does not constitute acceptance by the NAIC.)

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69 II 1987 NAIC Proceedings 402.

70 I 1988 NAIC Proceedings 367-374.

71 II 1988 NAIC Proceedings 367.

72 I 1989 NAIC Proceedings 462, 475-512.

A dissent from the report also was received and exposed. The dissent took exception to the reasoning and conclusions of the Report but suggested no alternative language to Section 30 apparently because the dissenters believed that this was not the role of a Working Group.[73] Prior to the December 1988 NAIC meeting the dissenters reversed their position and submitted a proposed Section 30 which would severely restrict setoff rights. This was an attachment to a report to the Task Force at the December 1988 NAIC meeting.[74] At that meeting the Task Force requested a workshop on setoff in February of 1989 to further explore the issue. The workshop was held as requested with proponents of various views presenting their arguments.

Subsequent to the workshop a subgroup of regulators voted on various aspects of the issue and reached a conclusion which, among other things, would allow multiple contract setoff but require that it be done on a "cash for cash" basis. At the March 1989 NAIC Meeting this approach was altered somewhat to preclude setoff when one party both assumes business from a carrier and cedes business to that same carrier. A drafting group was appointed to prepare the

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73 I 1989 NAIC Proceedings 462, 513-536.

74 I 1989 NAIC Proceedings 376, 383, 414-15.

regulatory subgroup proposal.[75]

In response to the regulatory subgroup proposal, the Illinois Insurance Department composed a fourth alternative which, among other things, would require the collateralization of balances setoff against reserves and would recognize setoff when one party both assumes business from a carrier and cedes business to the same carrier. The regulatory subgroup proposal, the Illinois proposal and the two earlier proposals were considered by the Task Force at the June 1989 NAIC meeting. For purposes of further study of the capacity and solvency implications of the various proposals, all four proposals were referred to the Accounting Practices and Procedures Task Force for review and comment.[76] When this paper was finalized, Accounting Practices had not made its report.

B. Commercial Considerations

Setoff is the legal extension of the common commercial practice known as net balance accounting. This practice enables parties engaging in numerous commercial transactions to reduce efficiently credits and debits due to each other to a net balance. In the insurance industry, where the spreading of risk causes premiums and losses to pass through numerous entities, net balance accounting is employed at every level of the insurance and reinsurance relationship. For example, an agent will reduce premium due a company against return premium due from a company to calculate and pay a monthly account current.

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75 II 1989 NAIC Proceedings _____ .

76 II 1989 NAIC Proceedings _____ .

In like fashion, insurance companies net premiums due a reinsurer against credits for unearned premiums, losses and loss adjustment expenses and simply pay the balance.

Setoff, as regularly and routinely employed in net balance accounting, is recognized and accepted as an efficient and neutral means of reconciling premiums and losses between the parties to insurance and reinsurance transactions. It provides rapid resolution of balances, reduces paperwork and avoids both unnecessary liquidation of assets, and unnecessary cash flow among the various parties. As a result, setoff is an integral part of the routine accounting practices which form the basis for insurance company financial reporting and analysis. It is also an integral part of everyday reinsurance programs which enhance capacity and competition in the marketplace.

The use of setoff is unquestioned in the course of ongoing relationships between solvent insurers and reinsurers. Therefore, efforts to restrict the right of setoff where one party is insolvent must be evaluated in light of these business considerations. While other industries rely upon secured transactions to protect against nonperformance by a party, this technique is not well suited to insurance and reinsurance transactions, where creditor and debtor often change roles and balances vary almost daily. Instead, insurers and reinsurers rely on the right of setoff, a simple self-help mechanism, when entering into many traditional reinsurance arrangements. For example, sliding scale commissions used in pro rata reinsurance contracts and retrospective rating plans used in excess of loss reinsurance agreements allow for predictable

adjustments in premiums between fixed minimum and maximum amounts, based on actual underwriting experience.[77]

Sliding scale commissions and retrospectively rated programs enhance the availability and affordability of reinsurance, and setoff is required to assure payment based on ultimate experience. Here, reinsurers rely upon the security of setoff to counterbalance the considerable flexibility in the initial rate. If setoff were not available, reinsurers might require maximum premium at the outset of the program rather than a lower initial payment. The reinsurers, rather than the primary companies, would retain the investment income during the period of time before premium adjustments are made based on loss experience.

Furthermore, for lines of business which are hard to place (i.e. municipal liability), the flexibility of loss sensitive rates is important to close transactions. Where business historically is unpredictable or unprofitable, where the ceding company is small or non-traditional, or in new lines of business, capacity often is lacking. The availability of setoff to support the flexible, experience rated programs contributes to increased capacity for these lines of business.

Furthermore, the use of setoff, sliding scale commissions and retrospective rates often allow reinsurers to continue to support

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77 For sliding scale commissions, the actual commission on earned premiums varies inversely with the loss ratio.

Retrospectively rated programs adjust commissions or rates upward or downward from a provisional figure (which generally reflects the parties' best estimate of expected loss activity). As actual experience becomes known, adjustments are made at agreed-upon intervals.

insurers during periods of financial difficulty. Retrospectively rated excess programs can offer needed protection at the lowest possible cost, and commissions on pro-rata treaties can be responsive to a company's troubled condition. Without the security provided by setoff, these programs would not be readily available to troubled companies.

It is apparent that the insurance and reinsurance marketplace routinely operates in reliance upon net balance accounting and setoff. If these techniques were no longer available, other security methods might be adopted, with undesirable results. For example, agents, brokers, insurance companies, reinsurers and retrocessionaires could all remit gross balances. In light of the number and complexity of the transactions involved as well as the constant variation in the rates and terms, this would produce an accounting morass. Both the public and the industry would suffer from prolonged delays in receipt of return premiums and commissions.

Since setoff provides necessary security to the insurance marketplace, other security techniques will be devised if setoff is prohibited. These may increase the costs of insurance and have undesirable impact on competition and capacity. A "solution" which prohibits setoff can generate larger problems.[78]

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78 See I 1989 NAIC Proceedings 488-490. Alternatives could include general increase in rates due to increased credit risk, setting retrospective rates initially at their maximum or collateralizing the exposure through funds in trust or letters of credit. Payment of premiums could be made a condition precedent to payment of losses or the event of liquidation could be made a basis for recision of the reinsurance agreement. No doubt, other techniques can be devised to attain the same security goal as setoff.

C. Regulatory Considerations

One of the stated objectives in the Constitution of the NAIC is to serve the public by ensuring the "reliability of the insurance institution as to financial solidity and guaranty against loss".[79]

Elimination of the right of setoff might serve a short term goal of maximizing the assets of particular insolvent companies;[80] however this is not necessarily among the long range goals of insurance regulators. Without setoff, the above quoted objective of regulation may be undermined. For example, a primary company could be obligated to continue to pay premium adjustments to an insolvent reinsurer which had ceased paying losses. A reinsurer could be required to pay losses to an insolvent primary company without having collected corresponding premium, and to pay premiums to an insolvent retrocessionaire without collecting losses. The potential for a chain reaction of insolvencies is obvious; particularly for reinsurers.[81]

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79 I 1981 NAIC Proceedings, xxiii.

80 Even in the short term, a setoff prohibition may not be beneficial to regulators. To have a consistent rule, the liquidator would be prohibited from setting off distributions from the estate against those who are debtors of the estate. A consistent regulator would prohibit setoff even when this position puts a company in his or her state into financial jeopardy. Regulators must adopt a position which is consistent and can be supported in the long term since short term fact situations can vary a great deal.

81 For a financial model of the impact of lack of setoff, see I 1989 NAIC Proceedings, 495-512.

If offset were not available, reinsurers would have to protect themselves from this potential "domino effect" by avoiding difficult lines of business and small, start-up, non-traditional or troubled companies which are most in need of reinsurance capacity. Instead, capacity would gravitate to larger, traditional companies which may be seen as stronger credit risks. The result would be to decrease capacity and competition.

The effect of lack of setoff on insurance and reinsurance capacity can also be demonstrated in another way. The financial statements of insurance and reinsurance companies assumes the use of setoff. The statutory statement is prepared on a "liquidating" basis, largely reflecting the value of the company should it have to be liquidated. Inherent in this accounting methodology is the netting of debits and credits between ceding and assuming carriers.[82] To consider the potential implications for fundamental insurance and reinsurance reporting of denial of the right of setoff, the NAIC has referred the issue to its Accounting Practices and

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82 For example, for reinsurance assumed, non-admitted agents' balances (company balances for reinsurers) are permitted to be reduced by outstanding loss and unearned premium reserve liabilities maintained by the assuming reinsurer. See also, 27 McKinney's Section 1301(a)(II)(iii). In addition, the penalty for unauthorized reinsurance may be reduced by any and all liabilities owed to the reinsurer by the ceding company for reinsurance ceded.

Procedures Task Force.[83]

In addition, state laws on credit for reinsurance rely on the principle of setoff. Generally, these laws require unlicensed reinsurers to collateralize their reserves.[84] If proper collateral is provided, the ceding company is permitted to take a credit on its financial statement which counterbalances the debit for reinsurance ceded to an unlicensed reinsurer. The denial of setoff in the event of the reinsurer's insolvency would prevent a ceding company from utilizing the collateral in precisely the way in which the credit for reinsurance statute intended. This could have an enormous effect on capacity.[85]

D. Conclusion

Setoff lies squarely within principles of equity, the common law and bankruptcy law which allow two principles to setoff mutual debits and credits on multiple contracts. Consistently applied, it is a neutral doctrine that treats ceding and assuming companies equally. It serves legitimate security interests and is part of the normal course of insurance and other business enterprises.

The mutuality doctrine provides both a limitation on setoff and a clear line or demarcation for liquidators as to which claims are

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83 II 1989 NAIC Proceedings _____ .; See text accompanying note 76, supra.

84 See e.g. 18 §910(c) of the Delaware Insurance Code.

85 A study performed for the setoff workshop in February of 1989 (see text accompanying notes 74-75, supra.) found that if setoff of collateral posted by unauthorized reinsurers were eliminated, the 1987 reinsurance market surplus of $9.1 billion (as reported by the Reinsurance Association of America) would be reduced by $715.7 million. If total potential offsets between licensed companies are included, the figure increases to $1.53 billion.

preliquidation. While unliquidated preliquidation claims may be difficult to value, techniques are developing to address this issue and to secure the rights of all parties in the process. The venerable rule of setoff should not be set aside for an industry simply because it is inconvenient in certain situations.

Part II. Recoupment

Recoupment is another means by which a debtor, through the assertion of some demand of his own, may attempt to limit the net amount of the creditor's recovery. As Collier defines it, recoupment is:

> the setting up of a demand arising from the same transaction as the plaintiff's claims or cause of action, strictly for the purpose of abatement or reduction of such claim....[86]

Although a recoupment plea is sometimes raised by way of counterclaim instead of an affirmative defense,[87] it is strictly defensive in nature, and will not support an affirmative recovery from the plaintiff.[88]

The equitable basis for recoupment is that the defendant, as a matter of fundamental fairness,[89] ought to be entitled to show that "because of matters arising out of the transaction sued on, he is not

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86 4 Collier on Bankruptcy §553.03, at 553-12 (15th ed. 1983)

87 See, e.g., Midlantic National Bank v. Georgian, Ltd., 559A.2d 872 (NJ Super. 1989)

88 Beneficial Finance Co. of Atlantic City v. Swaggerty, 432.A.2d 512 (N.J. 1981)(whereas "setoff may be awarded for any amount to which the defendant is entitled," recoupment "may be utilized only to reduce or extinguish the plaintiff's recovery.")

89 In Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 299 (1946), Mr. Justice Jackson stressed the element of fairness in defining the underlying policy of recoupment as to permit the transaction sued upon "to be examined in all its aspects, and judgment to be rendered that does justice in view of the one transaction as a whole."

liable in full for the plaintiff's claim."[90] Unlike setoff, recoupment requires no showing of mutuality. The sole technical prerequisite for a recoupment plea is that the defendant's reduction claim arise from the same transaction which forms the basis of the plaintiff's demand.[91]

Another important difference between recoupment and setoff is that recoupment has never found its way into the Federal Bankruptcy Code or the state insurance insolvency statutes. It remains purely an equitable common law tool with no statutory restrictions concerning its application. The attempts of bankruptcy trustees to equate recoupment with setoff, so as to subject recoupment to the mutuality requirements of federal bankruptcy law, have consistently failed.[92]

In Waldschmidt v. CBS, for example, the court rebuffed the trustee's argument that the defendant recording company's right to receive credit for amounts advanced to a bankrupt recording artist is limited by "the restrictive setoff provisions of Section 68 of the Bankruptcy Act."[93] The court found no authority to support the

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90 Collier, supra, at n.1 ("There is no element of preference here or of an independent claim to be setoff, but merely an arrival at a just and proper liability on the main issue....").

91 Waldschmidt v. CBS, 14 B.R. 309, 314 (M.D. Tenn. 1981).

92 See, e.g., Lee v. Schwieker, 739 F.2d. 870, 875-876 (3d Cir. 1984); Quittner v. Los Angeles Steel Casting Co., 202 F.2d 814, 816, n.3 (9th Cir. 1953); Stanley v. Clark, 159 F. Supp. 65, 66-67 (D.N.H. 1957) ("...recoupment is allowed regardless of setoff statutes...."); In re Pennsylvania Fire Co., 26 B.R. 663, 675 (Banker N.D. Ohio 1982); Waldschmidt v. CBS, 14 B.R. 309, 314 (M.D. Tenn. 1981).

93 14 B.R. 309, 314 (M.D. Tenn. 1981)("recoupment is entirely separate from the restrictive provisions of Section 68" of the Federal Bankruptcy Act).

proposition that recoupment falls within the ambit of Section 68. Since the mutuality requirements associated with setoff were held not to apply, it mattered not that the creditor's claim was for pre-petition advances while the trustee's claim was for post-petition royalties.[94]

In bankruptcy cases such as Waldschmidt, the courts have displayed no lack of willingness to maintain the distinction between recoupment and setoff and thus to preserve both the availability and the uncomplicated character of the recoupment defense. Recoupment has met with similar success in tax cases[95] and cases involving the Federal Truth in Lending Act ("TILA").[96] Indeed, in the tax and TILA arenas, the courts have repeatedly allowed the assertion of claims in recoupment which would have been barred by statutes of limitations if brought as independent actions. The rule commonly recited in these cases is that "recoupment is never barred as a defense by the statute of limitations so long as the main action is timely."[97]

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94 Id. Since the post-petition royalties related to recordings made prior to the bankruptcy filing, it can be argued that the mutuality of time test would have been met if held to apply.

95 See, e.g., Bull v. United States, 295 U.S. 247 (1935); Stone v. White, 301 U.S. 532 (1937).

96 See Beneficial Finance Co. of Atlantic City v. Swaggerty, note 88 supra, and cases cited therein.

97 Midlantic Nat'l Bank v. Georgian, note 87 supra. See also Bull v. United States, 295 U.S. 247 (1935); Smith v. United States, 373 F.2d 419, 422 (4th Cir. 1966); Beneficial Finance Co. of Atlantic City v. Swaggerty, 432 A.2d 512 (N.J. 1981).

If recoupment is sanctioned for use in such diverse, statutorily governed contexts as bankruptcy, tax and TILA, it might be supposed that recoupment is also routinely recognized as a defense in the insurance insolvency context. At first glance, the interest of a liquidator in enhancing the estate of an insolvent insurer would appear to be no greater than the corresponding interest of a bankruptcy trustee or the interest of the Sovereign in protecting tax receivables from diminution. But in O'Connor v. Insurance Company of North American,[98] a federal district court seized upon the liquidator's role in protecting the interest of third party claimants in the estate of the insolvent Reserve Insurance Company as partial grounds for rejecting the recoupment arguments advanced by Reserve's reinsurers. The court concluded:

> while the concept of recoupment makes sense in the context of ordinary contract disputes, it is not applicable in the context of an insolvency, where we must consider the concerns of persons who are not necessarily parties to a contract, but who nevertheless also have claims against assets of the insolvent's estate.[99]

Beyond identifying this additional public interest dimension to the liquidator's role, the O'Connor court also reasoned from the comprehensive scope of the Illinois Insurance Code and the absence of express statutory recognition of the recoupment defense, that the code's setoff provision was intended to be exclusive:

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98 622 F.Supp. 611 (N.D. Ill. 1985)(dictum).

99 Id. at 615, n.2.

> [T]he Illinois Insurance Code provides a comprehensive scheme by which insurance companies are to be liquidated, and no provision in the Insurance Code permits a reduction in debt under the recoupment doctrine. Indeed, the careful limitations set forth in the [setoff] statute would be completely subsumed by the more expansive reach of the recoupment doctrine.[100]

Apart from the fact that the unitary transaction test makes recoupment easier to apply than setoff, with its vexatious mutuality tests, it is not readily apparent how recoupment is more expansive than setoff. After all, setoff may apply to multiple contracts or transactions entered into over a prolonged course of dealing. Nor is it by any means clear why statutory silence on the matter should be taken as an implicit legislative preemption of a common law defense which has survived successive codifications of bankruptcy law without express recognition. As the bankruptcy cases attest, recoupment is not incompatible with a comprehensive statutory scheme which makes specific allowance for setoff, but is silent on the issue of recoupment. Properly viewed, recoupment is merely a means to enable the court to arrive at a more just and accurate assessment of liability on the main demand.[101] It bears only superficial resemblance to setoff, and as will be seen, has nothing in common with avoidable preferences.

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100 Id.

101 See Collier, note 1 supra.

Part III. Voidable Preferences

A. Introduction

To date, this topic has received much less emphasis in liquidation proceedings than has setoff,[102] however, there are indications that this may become an important technique in the effort to maximize the assets of insolvent estates. The ability to avoid preferential transfers is essential to marshalling and distributing assets in the statutorily described fashion.[103] The effort to expand assets in the estate has created an historical tendency of preference law to oscillate "between formal mechanical rules and open-ended normative standards."[104]

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102 A lengthy and erudite study of voidable preferences was presented in the original Institute on Insurer Insolvency. M. Wolke, Jr. Voidable Preferences, Fraudulent Conveyances, Offsets and Recoupment, 1986 National Institute on Insurer Insolvency 349, 351-61. This paper will not recover old ground, but will summarize the issues, intervening case law and suggest future trends.

103 This assumption is critically examined in Jackson, Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain, 91 Yale L.J. 857 (1982). See Jackson, Avoiding Powers in Bankruptcy, 36 Stan. L. Rev. 725, 756-68 (1984).

104 Weisberg, Commercial Morality, the Merchant Character and the History of the Voidable Preference, 31 Stand. L. Rev. 3 at 5 (1986). "Bankruptcy law has been playing out a ritualized dance between formal legislative rules and normative commercial and moral standards for 500 years." Id. at 4. Professor Weisberg concludes that in no area of bankruptcy law is this more evident than in preference law, "one of the most unstable categories of bankruptcy jurisprudence." Id.

> The one dominant historical ritual in twentieth century American preference law has been for Congress to enact a new and supposedly clear and broad preference rule, and for judges then to ignore or shamelessly manipulate statutory rules to preserve transactions against preference attack. In short, judges transform rigid statutory rules into flexible discretionary norms, and turn preference law into a matter of "I know it when I see it."

Id. at 11.

B. Preferences

§28 of the Model Act is typical of many voidable preference statutes in that it breaks the issue into two parts: (a) a definition of preferences followed by; (b) a definition of these preferences which are voidable. In general, these statutes describe a preference as a transfer to or for the benefit of a creditor within a specified time period prior to the liquidation on account of an antecedent debt.[105]

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105 §28 (A)(1) of the Model Act reads as follows:

> A preference is a transfer of any of the property of an insurer to or for the benefit of a creditor, for or on account of an antecedent debt, made or suffered by the insurer within one year before the filing of a successful petition for liquidation under this Act, the effect of which transfer may be to enable the creditor to obtain a greater percentage of this debt than another creditor of the same class would receive. If a liquidation order is entered while the insurer is already subject to a rehabilitation order, then such transfers shall be deemed preferences if made or suffered within one year before the filing of the successful petition for rehabilitation, or within two years before the filing of the successful petition for liquidation, whichever time is shorter.

The terms used in these statutes raise a number of issues to which there are no clear answers under existing case law. For instance, a contemporaneous exchange of funds and/or property would not be a preference. However, it is not clear whether payment by an insurer of a retrospective premium adjustment extinguishes a debt incurred when the policy was issued or when the calculation was made.[106] Is the issuance of a letter of credit for the benefit of the ceding company a transfer for the benefit of the creditor?[107] Is the payment of unearned premium resulting from a policy cancellation a contemporaneous exchange?[108] These and similar questions must be explored by future case law.

C. Voidable Preferences

The Model Act is typical of insurer insolvency statutes which describe a voidable preference as one where:

(1) the insurer was insolvent at the time of the transfer;

(2) the transfer was made within a specified time period prior to the liquidation;

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106 See generally, Wolke, supra at note 102, 352-61.

107 Pine Top Ins. Co. v. Century Indemnity Co., No. 88L 4330 (N.D. Ill. 1989). See subsection D. infra.

108 O'Connor v. Ins. Co. of North America, 622 F. Supp. 611 (N.D. Ill. 1985)(app. pending). See subsection D. infra.

(3) the beneficiary of the transfer had reasonable cause to believe the insurer was insolvent or about to become insolvent, or

(4) the beneficiary was an officer, director, shareholder or other person not operating at arm's length with the insurer.[109]

The most significant problem under such a statute is to determine whether the creditor believed the insurer to be insolvent at the time of the transfer. In the Bankruptcy

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109 §28(A)(2) of the Model Act reads as follows:

Any preference may be avoided by the liquidator if:

(a) the insurer was insolvent at the time of the transfer;

(b) the transfer was made within four months before the filing of the petition;

(c) the creditor receiving it or to be benefited thereby or his agent acting with reference thereto had, at the time when the transfer was made, reasonable cause to believe that the insurer was insolvent or was about to become insolvent; or

(d) The creditor receiving it was an officer, or any employee or attorney or other person who was in fact in a position of comparable influence in the insurer to an officer whether or not he held such position, or any shareholder holding directly or indirectly more than five per centum of any class of any equity security issued by the insurer, or any other person, firm, corporation, association, or aggregation of persons with whom the insurer did not deal at arm's length.

Reform Act of 1978, Congress eliminated a similar requirement in the Federal Bankruptcy Act for transfers made within a 90 day period preceding bankruptcy and created a presumption of insolvency during that period.[110]

Insurance company liquidators have encountered similar problems in determining the knowledge or beliefs of creditors of insolvent insurance companies. Some have observed that the state of mind of the creditor is irrelevant as long as the transaction is in the ordinary course of business and for fair value. This "reasonable belief" language is under review

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[110] See H.R. Rep. No. 595, 95th Cong., 1st Sess. 177-79 (1977), cited at length in Countryman, The Concept of a Voidable Preference in Bankruptcy, 38 Vand. L. Rev. 713, 728 (1985).

As explained by the House Committee Report, the purpose of this change was to correct what were seen as two significant defects in the law. First, the requirement to prove reasonable cause to believe on the part of the creditor had been "nearly insurmountable," resulting in the defeat of many preference actions. Thus the previous preference section required the trustee "to prove a fact that nearly always exists but never can be proved with certainty." H.R. Rep. No. 595, 95th Cong., 1st Sess. 177-79 (1977). Second, the House Committee found that by attaching such importance to what was in the mind of the creditor, the former preference provision had ignored equality of distribution as the overriding objective of bankruptcy law. Furthermore, the reasonable cause requirement was said to have "generated immense amounts of litigation," put "a premium on lying" and, more than any other factor, to have rendered ineffective the preference section of the former Act. See Countryman at 727-28.

by an NAIC subcommittee but no action has been taken to date.[111]

D. Recent Case Law

Several cases from Illinois have signalled the beginning of the judicial exploration of voidable preferences in insurance company insolvencies. One of the issues in O'Connor v. Ins. Co. of North America[112] was whether or not a mass cancellation of policies just prior to the liquidation constituted a preference with respect to the refund of unearned premium. The court held that there was no preferential transfer since the debt arose contemporaneously with its payment.[113]

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111 See I 1989 NAIC Proceedings 453. A subcommittee of the Rehabilitators and Liquidators Task Force has discussed substituting an "ordinary course of business" exception for the "reasonable belief" language of the current Model Act. No final action has been taken to date.

112 622 F. Supp. 611 (N.D. Ill. 1985) (app pending).

113 The court stated:

> The language [of the Illinois voidable preference statute] clearly implies that a past debt must exist, which is reduced when the unearned premium is transferred to the policyholder. We simply do not see how this transaction can be construed as a payment of a past debt owed to the policyholder. If any debt arises at all, it arises when the policy is cancelled. If, at that time, the portion of unearned premium is returned to the policyholder, that is a contemporaneous transfer--the policyholder cancelled the policy and released Reserve from any further liability, and Reserve paid over the money it had collected in advance but did not earn because of the early cancellation--not a transfer on account of an antecedent debt.

622 F. Supp. at 622.

A more difficult case to reconcile is Pine Top Ins. Co. v. Century Indemnity Co.[114] wherein the court denied motions to dismiss a liquidator's action to recover allegedly voidable preferential transfers in connection with a letter of credit issued on the account of Pine Top Insurance Company as reinsurer of the beneficiary, Century Indemnity Company. The court acknowledged that the bank's obligation to Century was distinct from that of Pine Top, was not the property of Pine Top and was separate from any collateralization arrangements between Pine Top and the bank.[115] The court noted that the transfer of collateral from Pine Top to the bank, viewed in isolation, "cannot be a direct voidable transfer" as to the beneficiary, since there is no transfer of property to the beneficiary.

Nonetheless, the Pine Top court found that "the promised transfer of pledged collateral induced the bank to issue the letter of credit in favor of the creditor" to secure payment of an unsecured antecedent debt. Applying an "indirect transfer" concept, the court collapsed the issuance of the letter and the giving of the promised collateral into one event, indivisible in terms of its intended effect, which was to provide security, at a time of known, de facto insolvency, to a previously unsecured

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114 No. 88 C 7330 (N.D. Ill. 1989).

115 See In re Page, 18 B.R. 713 (Bankr. D.D.C. 1982), In re Pine Tree Electric Co., 34 B.R. 119, 201 (Bankr, D.Me, 1983). In re Planes, Inc., 29 B.R. 370, 371 (Bankr. N.D. Ga. 1983);

creditor. The court made it clear that the existence of an antecedent debt was the key to its decision, "not the relative timing of the issuance and collateralization of the LOC."[116]

The Pine Top ruling undercuts credit for reinsurance statutes which allow a deduction from liability for reserves ceded to an unlicensed reinsurer when such reserves are secured by a letter of credit.[117] If the ceding company cannot collect on the letter of credit, there is little purpose in allowing the ceding company to take a deduction from liabilities.

E. Conclusion

Given the economic and political pressures brought to bear in insurance company liquidations, it is not difficult to predict that voidable preferences will be a battlefield upon which the assets of estate will be determined. It remains to be seen whether traditional doctrines will be pulled out of shape or rejected in the effort to maximize assets.

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116 No. 88 C. 7330 (N.D. Ill. 1989). See also In re Air Conditioning, Inc. of Stuart, 72 B.R. 657 (S.D. Fla. 1987) aff'd 845 F.2d 293 (11th Cir. 1988); Wolke, supra at note 102, 352.

117 See e.g. §2 of the NAIC Model Law on Credit for Reinsurance.