

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

Part I Valuation of contingent claims and policies in the UK

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Overview

The statistics documenting the rise of insurance company insolvencies are all too familiar to those associated with the insurance industry.¹ The causes of those insolvencies have been the subject of much discussion, debate and analysis. Not surprisingly, the US federal government is conducting inquiries into the wisdom of continued state regulation of insurance,² and considering whether the federal government should assume responsibility for the regulation of insurance.

Amidst this fracas, insolvency practitioners³ and their staffs are faced with the administration of insolvent insurance and reinsurance companies or 'estates'. Today, they face enormous difficulties in ascertaining, estimating and valuing the liabilities of insolvent estates. Along with the dramatic increase in the number of insolvencies, the nature of insolvent estates also has changed, significantly impacting the administration of insolvency proceedings. Past US insolvencies affected 'small companies handling mostly automobile insurance and operating in one state or on a regional basis'.⁴ A review of more recent insolvencies, however, indicates that 'failing companies have become more diverse, and now reflect more fully the whole range of operating companies ...'.⁵

Unfortunately, many laws governing insurance insolvency are inadequate for dealing with the myriad complex issues arising in today's estates. Among other things, many US states' statutes fail to address the insolvency of reinsurers, or of primary carriers with reinsurance books of business. In particular, the statutes either fail to or inadequately address the valuation and liquidation of contingent claims and the application of set-offs as they relate to the prioritised distribution of assets to creditors.

The most time-consuming and complex aspects of administering a liquidation is the process of reconciling the companies' records and accounts.⁶ More often than not, the practitioner is faced with an insolvent's books that are, at best, in a state of disarray, and at worst are in need of complete reconstruction, a process that often takes several years to complete

before valuation can be attempted. United States practitioners administering the liquidation of companies whose demise occurred in the last five years are in many cases nearing completion of the reconciliation and reconstruction process, enabling them to value claims and render accounts to their reinsurers in the near future. Now they must make difficult decisions concerning the policies and procedures to be followed with respect to issues such as the liquidation of contingent claims, the valuation of reinsurance claims, and the extent to which claims can be set off in the insolvency proceeding. These issues are not susceptible of easy resolution, and their determination will have a significant impact upon the insurance industry and the way in which the business of insurance is conducted in the future. The purpose of this four part article is to examine two of the current problems in the light of American and English law: valuation of contingent claims and the application of set-offs.

What is a contingent claim?

In most instances the rights and obligations of creditors and the insolvent company are fixed as of the entry of a liquidation order. However, many claims will not be known or, even if known, their value either may not have been determined or may not be susceptible to valuation until a later time. As a general rule, creditors have the right to file claims against the insolvent's estate, and the law of many jurisdictions provides that this right exists whether the claim is contingent, non-contingent, absolute, unliquidated, liquidated, immature or mature.⁷

The term 'contingent claim' is often used to describe claims which remain questionable in terms of liability:

'[A contingent claim is] a claim which has not accrued and is dependent on the happening of some future event; ... one that depends for its effect on some future event, which may or may not happen'.⁸

In insolvency cases, a contingent claim is one as to which it remains uncertain whether the insolvent

party will ever become liable to pay. If liability is certain, then the claim is not contingent but merely unliquidated.⁹

A proper definition of contingent claim must take into account the fixing date provisions of statutes and existing case law of the jurisdiction. Thus, whether a claim is contingent depends upon whether the insolvent insurer's liability was established on the fixing date. If on that date the claim remained uncertain only as to amount, the claim is not contingent, it is simply unliquidated. Similarly, if on the fixing date the claim was absolute as to liability, certain as to amount, but not yet due, it is simply an immature claim.¹⁰ In contrast, a claim which was uncertain as to ultimate liability on the fixing date is a true contingent claim. Thus, contingency is a function of liability, liquidation is a function of valuation, and maturity is a function of time.¹¹ Unfortunately the term 'contingent claim' is often used to describe claims that are merely 'unliquidated' or 'immature'.¹²

The distinctions between contingent and non-contingent claims, and between liquidated and unliquidated claims are matters of substance, not form. Indeed, in some US jurisdictions these distinctions determine whether the claim will be allowed in the estate and whether the claimant will share in distributions of the estate's assets.

English insurance insolvency legislation

Generally, in England a reinsured may make a claim against the liquidator of an insolvent insurer for losses occurring prior to the date the insurer goes into liquidation, and for the value of his policy as of that date.¹³ To understand the rules to be applied when valuing claims and policies in the liquidation of an insurer, a brief overview of insurance company and insolvency statutes is necessary.

The Insurance Companies Act 1982 ('1982 Act') and the Insurance Companies (Winding-Up) Rules 1985 ('1985 Rules')¹⁴ regulate the activities (including insolvency) of insurance companies. English law as it relates to bankruptcy and insolvency has been revised and consolidated into the Insolvency Act 1986 ('1986 Act') and the rules promulgated under the 1986 Act ('1986 Rules').¹⁵ The principles contained in the 1986 Act are to be followed 'subject to the specific provisions of the [1982 Act] dealing with insolvency and liquidation in the insurance sector'.¹⁶ It should be noted that the 1982 Act and the 1985 Rules explicitly regulate matters only of insurance, not reinsurance.¹⁷ It is submitted, however, and for the purposes of this paper it shall be assumed, that the 1982 Act and 1985 Rules apply equally to matters of insurance and reinsurance.¹⁸

Before the presentation and allowance of contingent claims¹⁹ and the valuation of policies in the context of reinsurance can be discussed, two concepts must be understood: the distinction between long-term and general business must be appreciated, and the meaning of the term 'fixing date' understood. Long-term business²⁰ includes the

following classifications of insurance: life and annuity, marriage and birth, linked long-term, permanent health, tontines, capital redemption and pension fund management. General business²¹ includes accident, sickness, land vehicles, aircraft, ships, fire and natural forces, damage to property, motor vehicle liability and miscellaneous financial loss. All insurance companies must keep separate their long-term and general business.²² This distinction is a central theme in regulating the activities of insurance and reinsurance companies in England.²³ For example, an insurance company may not be wound up voluntarily if it carries on long-term business.²⁴

The fixing date

With respect to compulsory liquidations of insurance companies, the fixing date is defined as the date of the court's winding-up order.²⁵ There is, however, a notable exception to the 'fixing' date. Under the 1982 Act, unless the court issues a 'stop order', liquidators are required to carry on the long-term business of an insurer after the date of the winding-up order with a view to its being transferred as a going concern to another insurance company.²⁶ Thus, with respect to long-term business, the fixing date is the date of the stop order. The date has particular significance when determining the rights of creditors in liquidation proceedings. In a winding up, the court must ascertain all the liabilities of the insolvent for the purpose of effecting a proper distribution of its assets among its creditors. A date has to be fixed on which all debts and other liabilities are to be treated as definitely ascertained, both for the purpose of treating all creditors equally and for the purpose of properly conducting the winding up of the insolvent's affairs. One effect of the fixing date is to compel those creditors whose claims do not consist of debts or of liquidated demands ascertained and payable before that date to estimate and assess the amounts which they claim to be due to them on that date. Another effect of the fixing date is that when a claim is disputed, the court will decide the dispute as though it were being determined on the day when the winding-up order or stop order was made.

Proof and allowance of contingent claims

Debts²⁷ owed by an insolvent reinsurer to an insured are generally provable in liquidation proceedings at their valued amount.²⁸ An insured wishing to recover a debt must submit and prove his claim to the liquidator.²⁹ If the value of the claim is uncertain, the liquidator must estimate the amount which is provable in the liquidation:³⁰

'The liquidator shall estimate the value of any debt which, by reason of its being subject to any contingency or for any other reason, does not bear a certain value; and he may revise any estimate previously made, if he thinks fit by reference to any

change of circumstances or to information becoming available to him.³¹

As one renowned commentator has observed, 'there is clearly no one method of estimation applicable to all claims of whatsoever nature in every case ...'.³² The 1986 Act provides that a creditor unhappy with his estimate may appeal to the liquidation court. When the insolvent has a great number of creditors, the burden imposed on the liquidator and the estate assets by such appeals can be enormous. It is therefore essential that the liquidator find some way of making his estimation process binding on as many creditors as possible. This can be accomplished by way of representative action with representative respondents appearing before the court to argue the merits of a proposed method of estimation.³³ All represented creditor classes in such an action then would be bound by any court approved method of estimation.³⁴ The efficiency of such a course far outweighs the disadvantages of individual challenges to the liquidator's estimates of claims.

Naturally, the question arises – if the 'contingency' actually develops or occurs after the fixing date and submission of his claim, may a reinsured vary the claim to reflect the true value of the debt? The answer to that question would appear to be yes:

'[T]here is no doubt that a contingent claim for unliquidated damages is a provable debt and its amount has to be estimated as at the date of the ... order. That, however, does not mean that the effect of the ... order is to accelerate the happening of the contingency, so as to fix the amount of the defendant's claim on the basis of the contingency having happened on the day of the ... order ... The claim must be stated as on the day of the ... order; if, when the proof is lodged, the contingency has not happened, the amount of the claim must be estimated as accurately as possible; if the contingency happens before the proof is lodged, that fact is pro tanto evidence of the true value of the claim as at the date of the ... order, and there will, as a rule, be no difficulty in arriving at the amount of the claim; if the contingency happens after the proof is lodged and it appears that the amount at which the damages have been estimated is below the true value, the creditor will be allowed to amend his proof or lodge a fresh proof at any time during the continuance of the bankruptcy, but not so as to disturb prior dividends.'³⁵

If the liquidator rejects a creditor's claim, in whole or in part, he must prepare and send to the creditor a written statement of his reasons for doing so.³⁶ Thus, a liquidator may reject a whole claim if he disputes the liability of the insolvent reinsurer. If he considers the claimed amount to be excessive, the liquidator may reject that part of the claim representing the excess. If a creditor is dissatisfied with the liquidator's decision, he may apply to the court for the decision to be reversed or varied.³⁷ To a limited extent, the 1986 Rules recognize that claims based upon events which occurred prior to the fixing

date may arise after that date, and that some claims may be difficult to settle. Accordingly, creditors may prove for debts of which payment was not yet due as of the fixing date and, before declaring dividends to creditors, liquidators may make provision by retaining funds for unsettled claims.³⁸

Policy valuation

In addition to making claims for losses which have occurred prior to the fixing date in an insurer's liquidation, an insured will be admitted as a creditor without proof for an amount equal to the value of his policy as determined in accordance with the 1985 Rules.³⁹ The rules of valuation contained in the 1985 Rules apply both for the purpose of determining the excess of assets over liabilities in the long-term and general business of the insolvent insurer,⁴⁰ and for the purpose of proving the value of long-term and general business reinsurance policies.⁴¹

The rules of valuation may be summarised as follows:

General business policies:⁴²

- (a) In relation to periodic payments under a general business policy which fall due for payment after the fixing date, where the event giving rise to the liability to make the payments occurred before the fixing date, the value of such periodic payments shall be determined on such actuarial principles and assumptions in regard to all relevant factors as the court directs.⁴³
- (b) If the general business policy does not fall under paragraph (a) and provides for repayment of premium upon the early termination of the policy or that the policy is expressed to run from one definite date to another, or the policy may be terminated by any of the parties with effect from a definite date, the value of the liabilities under the policy shall be the greater of the amount (if any) which under the terms of the policy is repayable on early termination of the policy had the policy terminated on the fixing date, and where the policy is expressed to run from one definite date to another or may be terminated by any of the parties with effect from a definite date, the proportion of the last premium paid as is proportionate to the unexpired portion of the period in respect of which that premium was paid.⁴⁴
- (c) In any other case, the value to be attributed to the liabilities under a general business policy is to be a just estimate.

Non-linked life policies, non-linked deferred annuity policies, non-linked annuities in payment and capital redemption policies:⁴⁵

- (d) Generally, if no further fixed premiums fall due to be paid under the policy on or after the fixing date, the value of the policy shall be the aggregate of the present value of the ordinary benefits, the reserve for options, the reserve for

expenses and, if appropriate, the value of any additional benefits.

- (e) If further fixed premiums fall due to be paid on or after the fixing date, the value of the policy shall be the amount the aggregate amount calculated in paragraph (d) exceeds the modified⁴⁶ net premiums to be paid. If there is no excess, the policy has no value.

Life policies and deferred annuity policies which are linked policies:⁴⁷

The value of these policies is the aggregate of the value of the linked liabilities and the value of other than linked liabilities.⁴⁸

Other long-term business policies:⁴⁹

The value of such policies is determined on such actuarial principles and assumptions in regard to all relevant factors as the court shall determine.

Long-term policies where a stop order has been made:⁵⁰

Generally, the above principles which apply to long-term business policies apply to this category, except that values are determined as of the date of the stop order.

Conclusion

One of the liquidator's functions is to distribute the insolvent's assets promptly. Estimating the value of contingent claims and valuing policies as of the fixing date facilitates a prompt distribution of assets. However, before paying any dividend to any particular creditor, the liquidator should determine and then set off any claims the insolvent may have against the creditor. Set-off in the UK is the subject of Part II of this article, which will appear in the next issue.

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NOTES

1. In the United States alone, 59 of the 140 insolvencies of property and casualty companies from 1969 to 1986 occurred in the last three years of that period. US General Accounting Office, *Insurer Failures: Property/Casualty Insurer Insolvencies and State Guarantee Funds* 3 (1987) (hereinafter cited as '*Insurer Failures*'). The number of insolvencies increased from four in 1983 to 21 in 1985, then fell to 13 in 1987. Congressional Research Service, *Insurance Company Solvency* (1989). While the number of insolvencies was less in 1987 than in the two preceding years, the number was high by historical standards, which showed an average annual rate of six insolvencies between 1970 and 1983. *Ibid.*

2. With few exceptions, the regulation of insurance companies and their insolvencies in the United States is left to the several states. See 15 USC s. 1012 (regulation of the business of insurance excluded from the antitrust laws); 11 USC s. 109(b)(2), (3) (insurers exempted from being the target of bankruptcy proceedings, as domestic and foreign insurers may not be debtors in bankruptcy).
3. For purposes of this paper, the term 'insolvency practitioner' shall mean the individual or entity charged with the administration of insurance companies under supervision, conservation, rehabilitation or liquidation in the US, and administration, voluntary arrangements, schemes of arrangement or winding up in the UK.
4. *Insurer Failures* supra n. 1.
5. Congressional Research Service, *Insurance Company Solvency* 9 (1989).
6. Singer, *Some Considerations on the Admissibility and Valuation of Contingent Liabilities in an Insolvency*, Unpublished monograph, 1989 (hereinafter cited as 'Singer').
7. See for example, The Dominion Winding Up Act s. 71, ch. W-11; Australian Bankruptcy Act of 1966, s. 82; The Companies Act 1981 s. 234 (Bermuda law).
8. *In Re Lexington Surety & Indemnity Co.*, 272 NY 210, 5 NE 2d 204 (1936). Compare *Commissioner of Insurance v. Massachusetts Accident Co.*, 314 Mass. 558, 50 NE 2d 801 (1943) (claims of policyholders who have not yet suffered loss are not contingent within the meaning of insurance insolvency statute because they have lost coverage); *In Re Empire State Surety Co.*, 214 NY 553, 108 NE 825 (1915) (policyholders' claims against insolvent insurer were not contingent because liability became certain and fixed upon insurer's breach of policies).
9. *Hilgeman v. State ex rel. Payne*, 374 So. 2d 1327, 1329 (ala. 1979) (citing *In Re Munsie*, 32 F.2d 304 (D.Conn. 1929), *rev'd on other grounds*, 33 F.2d 79 (2d Cir. 1929)); *Ellis v. Burnham*, 263 Mass. 57, 160 NE 437 (1928)).
10. *Accord Pate v. Security Union Insurance Co.*, 54 SW 2d 355 (Tex. Ct App. 1932).
11. Those states having adopted the Model Act's contingent claims provision (Model Act § 37A), are consistent with this view. Those states' statutes and the Model Act provide that 'The claim of a third party which is contingent only on his first obtaining a judgment against the insured shall be considered and allowed as if there were no such contingency'. See, for example, Idaho Code s. 41-3337(1). Some states which have not adopted the Model Act provisions have confused the distinction between contingent, immature and liquidated claims. See, for example, Cal. Ins. Code s. 1025 (defining liquidation of claims in terms of whether liability has been determined); Fla. Stat. s. 631.281(2)(a) (requiring that claims be 'fully vested and mature' and 'in no way contingent upon any future event or condition precedent'). But see Wis. Stat. s. 645.63(4) (providing with respect to 'Immature claims' that 'claims that are due except for the passage of time shall be treated as absolute claims are treated...').
12. See Wolke, *Voidable Preferences, Fraudulent Conveyances, Offsets and Recoupment or How Can a Liquidator Use Your Money To Build Up the Estate?*, in 1986 ABA Sec. Tort & Ins. Practice, Law and Practice of Insurance Company Insolvency 349, 364 (hereinafter cited as '*Wolke*').

'To determine whether a claim existed at the time of the order, it is important to understand certain concepts: (1) contingent v. absolute claims; (2) immature v. mature claims; and (3) unliquidated v. liquidated claims. A contingent claim is one which is not absolutely owing at the time the insolvency occurs and the receiver or liquidator is appointed, but may ripen into an absolute claim later on. An insured, for example, would have a contingent claim under a fire policy before the fire occurs. An immature claim is one which may be an absolute debt at the time of the insolvency but may not then be due and payable. A Ceding insurer, for example, may be liable to a reinsurer for written premium, but the liability may not mature until the end of the quarterly accounting period when payment is due. An

- unliquidated claim is one where the holder of the claim has a right to recover against the estate, but the amount has not yet been determined. Unfortunately, liquidation statutes and courts have sometimes confused these entirely different concepts.' (footnote omitted). *Accord* Ky. Rev. Stat. Ann. §304.33-380(4) (providing that 'Immature claims' are 'Claims that are due except for the passage of time shall be treated as absolute claims ...').
- Compare Wis. Stat. §§.645.62(1), (2), (3) and *In the Matter of Liquidation of Wisconsin Surety Corp.*, 112 Wis. 2d 396, 332 N.W.2d 860 (1983) (distinguishing between 'technically' contingent claims, 'truly' contingent claims, and 'other' contingent claims, including 'technically' contingent claims of those not third parties).
13. 'The basic rule ... is that an assured ... is entitled to be admitted as a creditor for all amounts which have fallen due for payment before the making of the winding-up order, but thereafter the assured is to be admitted as a creditor only for the value of his policy', *J. Butler & R. Merkin, Reinsurance Law*, Part D.2 (1988) (hereinafter cited as '*Butler & Merkin*').
 14. SI 1985, No.95. Section 59 of the 1982 Act provides that rules may be made for determining the amount of the liabilities of an insurance company to policyholders for the purpose of proof in a winding up and generally for carrying into effect the provisions of the 1982 Act relating to the winding up of insurance companies.
 15. Under s.411 of the 1986 Act the Lord Chancellor, with the concurrence of the Secretary of State, is authorised to promulgate procedural rules relating to liquidation proceedings. See Insolvency Rules 1986. SI 1986, No.1925 (as amended by the Insolvency (Amendment) Rules 1987, SI 1987, No.1919).
 16. *Butler & Merkin*, supra n.13. See also, the Insurance Companies (Winding-up) (Amendment) Rules 1986, SI 1986, No.2002 (providing that in the event of a conflict between the 1985 Rules and the 1986 Rules or insolvency regulations, the 1985 Rules shall prevail).
 17. Singer, *The British Approach to Reinsurance Insolvency*, in 1988 ABA Sec. Tort & Ins. Practice, Law and Practice of International Reinsurance Collections and Insolvency, 623.
 18. But see infra n.22.
 19. As developed and used in this part of the article 'contingent' claims may be claims uncertain both as to liability and/or quantum.
 20. 1982 Act, sched.1.
 21. 1982 Act, sched.2, part I.
 22. 1982 Act, s.28.
 23. For example, insurance companies are required to maintain separate accounts for their long-term business and general business (*ibid.*). Also, r.5 of the 1985 Rules provides that in the case of an insurance company carrying on long-term business, the assets of the company available for meeting the liabilities of the company attributable to that business must be applied in discharge of those liabilities as though those assets and liabilities were the assets and liabilities of a separate company. Under the same rule, similar treatment must also be afforded to the assets and liabilities of the company attributable to its other business.
 24. 1982 Act, s.55(2). In England, a company may be wound up voluntarily by its members or creditors or compulsorily by the court (1986 Act, s.73). In a compulsory winding up, the court has power to wind up any company registered in England or Wales. If the court is satisfied that winding up is appropriate, it shall make a winding up order (1986 Act, s.125). 'In practical terms, then, the liquidation of most insurance and reinsurance companies will be compulsory rather than voluntary', *Butler & Merkin*, supra n.13 at D.2.1.-02.
 25. 1986 Act, s.247(2).
 26. 1982 Act, s.56(2). In so doing, the liquidator may agree to the variation of any contracts of insurance in existence as of the date of the winding-up order but must not effect any new contracts of insurance. *Ibid.*
 27. 'Debt' means any debt or liability to which the insolvent is subject at the fixing date or to which the insolvent may become subject after that date by reason of any obligation incurred before the date (1986 Rules, r.13.12). 'For the purposes of references in any provision of the [1986 Act] or the [1986 Rules] ... it is immaterial whether the debt or liability is present or future, whether it is certain or contingent, or whether its amount is fixed or liquidated, or is capable of being ascertained by fixed rules or as a matter of opinion ...' (1986 Rules, r.13.12(3)).
 28. *George Hardy and Another v. Richard Fothergill*, (1888) App. Cas. 351.
 29. 1986 Rules, r.4.73. A creditor who makes a claim whether or not in writing, is referred to as 'proving' for his debt; and a document by which he seeks to establish his claim is his 'proof' (1986 Rules, r.4.73(3)).
 30. 1986 Rules, r.4.82.
 31. 1986 Rules, r.4.86. Costs incurred by the liquidator in estimating the value of a debt are payable out of the assets of the insolvent as an expense of the liquidation (1986 Rules, r.4.78(2)).
 32. Singer, supra n.6 at 8.
 33. 1986 Act, ss.112(1), 168(3).
 34. For a more complete discussion of representative actions, see Singer, supra n.6.
 35. *Ellis and Company's Trustee v. Dixon-Johnson*, [1924] 1 Ch.342. This part of the trial court's decision was not commented upon in the House of Lords, the highest appellate court of England. But see the earlier decision in *In Re Law Car and General Insurance Corporation*, [1913] 2 Ch.103.
 36. 1986 Rules, r.4.82.
 37. 1986 Rules, r.4.83. The application must be made within 21 days of receipt of the liquidator's written statement of reasons for rejecting the claim in whole or part. 1986 Rules, r.4.83(1).
 38. 1986 Rules, rr.4.94, 11.6.
 39. 1985 Rules, rr.6, 7. It must be remembered that with respect to an insolvent's long-term business, the 1986 Rules, and not the 1985 Rules, shall apply to valuing claims for losses which have occurred after the fixing date, but before the date of the stop order.
 40. See supra n.23.
 41. Note that the application of the 1985 Rules in connection with valuing any insurance policy must depend upon the construction of that policy.
 42. See 1985 Rules, sched.1.
 43. This section addresses, for example, losses arising under a disability policy.
 44. This section provides for reinvestment of unearned premium.
 45. See 1985 Rules, sched.2. For purposes of the 1985 Rules, 'linked policy' means a policy which provides or provided for linked liabilities; 'linked liabilities' means liabilities under a long-term business policy, the amount of which is determined by reference to any of the value of property of any description, fluctuations in the value of such property, income from any such property, or fluctuations in an index of the value of such property (1985 Rules, r.2(1)).
 46. See 1985 Rules, sched.2, paras.6.
 47. *Ibid.*, sched.3.
 48. *Ibid.*, sched.3, paras.2, 4 and 5.
 49. *Ibid.*, sched.4.
 50. *Ibid.*, sched.5.