Recovery of Commutation Payments


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By Ben Gonson

Much uncertainty exists surrounding the issue of whether commutation payments are recoverable. A commutation payment will typically comprise a mixture of unpaid claims (amounts notified by the reinsured as being due and payable), outstanding claims (estimates of future liabilities for known losses reported to the reinsurer) and incurred but not reported or IBNR (estimates of the value of possible future liabilities).

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In the December 2008 edition of AIRROC Matters, the panel on Ceding Policy Buy-backs and Commutations discussed whether commutation payments are recoverable under reinsurance and retrocessional contracts. There was consensus among the panel members that paid claims and outstanding claims (at least so long as the party seeking to recover has ascertained a loss) are generally recoverable. However, there was no clear answer as to whether commutation payments reflecting IBNR are, or should be, recoverable.

English Law

As noted in "Commutations Come Into The Spotlight" appearing in the July 12, 2005 edition of Insurance Day, commutations have been "long established in the UK and London Markets" and "are now beginning to snowball in other markets around the world, such as Europe and east Asia, and lately even in the US."

In the London Market, a protocol established at the end of 2003 by the Association of Run-Off Companies provided guidelines on how commutations should be recoverable. The protocol was not widely accepted in the London Market. During this time period many articles were written in the London Market concerning whether commutation proceeds should be recoverable. In Commutations – An English Law Guide (Sept. 2004), Richard Leedham noted that unpaid claims should be recoverable. Regarding outstanding claims, Mr. Leedham noted that "it is certainly arguable under English law that if outstandings relate to the settlement of known paid claims, and the decision to settle them has been made in an honest and business-like manner, then they should be recoverable." Regarding IBNR, Mr. Leedham noted that it was unlikely that IBNR was recoverable under English law from retrocessionaires because "IBNR cannot amount to a legal liability, and therefore is not a loss settlement of a relevant claim within the terms of the insurance and reinsurance policies."

In a roundtable discussion of the dynamics of the commutation process contained in the Summer 2007 Edition of AIRROC Matters, one of the panelists stated that with respect to London business with English choice of law or forum clauses, retrocessionaires are armed with court decisions supporting the view that they are not obligated to indemnify the retrocedent for portions of a commutation payment that do not represent "loss settlements" expressly covered by the treaty.

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In the article entitled "Drafting a Commutation Agreement" contained in the Summer 2007 Edition, the authors noted that there was a notable absence of judicial guidance under English law on the issue of whether commutation payments can be recovered from retrocessionaires. In both the December 2008 and Summer 2007 editions of AIRROC Matters, there is a reference to *English and American Ins. Co. Ltd. (In a Scheme of Arrangement) v. Axa Re SA* [2006] EWHC 3323 ("*Axa Re*"). In *Axa Re*, the insolvent ceding company, English and American Ins. Co. Ltd. ("E&A"), entered into a settlement with its insured and sought in turn to recover a proportion of that settlement

continued on next page

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from its 100% reinsurer, Axa. Axa refused to indemnify E&A, arguing that it was not required to follow the settlement because it was an interim good faith payment without admission of liability on a without prejudice basis, under a full reservation of rights, and that there was no identification of which claims E&A had settled and whether they fell within the terms of the reinsurance contracts (or were IBNR or ex-gratia payments). The settlement was part of a London Market settlement for all past, pending and future known or unknown claims by Dow Chemical against the London market insurers in respect of breast implant and associated costs. The judge concluded that the claims had been settled in a proper and businesslike manner since not only the London market, but also Axa's own willingness to settle in these amounts (which was communicated in an open letter to E&A which the Court admitted in evidence) indicated that payment was proper. As the Court concluded that there was no realistic prospect of Axa establishing that it did not have a liability to E&A for at least part of the claim, E&A was entitled to summary judgment in respect of claims which had been paid and which E&A could evidence. Regarding the future claims/IBNR component of the settlement, the judge stated, "it is just about conceivable, although unlikely, that Axa might have a defense in relation to settlement amounts paid in respect of IBNR, as opposed to paid claims, and I give Axa the benefit of the doubt in that respect."

American Law

There is no direct substantive law in the United States concerning whether commutation payments may be recovered from a retrocessionaire. In the United States, arbitration awards in 2007 between Global Re and Argonaut have resulted in a mixed bag of rulings concerning whether such proceeds are recoverable. In one ruling, the arbitration panel simply stated that the commutation payments Global sought to cede to Argonaut were not claims, losses or settlements within the terms of the excess of loss retrocessional agreements and were thus not recoverable. In another arbitration, the panel denied Global Re's claim against Argonaut for commutation balances but stated that, on a going forward basis, as claims that were the subject of the commutation were resolved by the original ceding company and reported to Global Re, Argonaut may be billed by Global Re for those claims. This type of ruling underscores the need to include, in a commutation agreement, a provision requiring the ceding company to provide claims information following the commutation to support recovery against a retrocessionaire.

In a third arbitration, the panel found that Global Re's commutation payment was covered under the excess of loss retrocessional contracts. The final award concluded that "[t]he evidence presented at the Hearing established that the ... claims comprising the commutation transaction [with Home] were covered by the original reinsurance contracts issued by [Global]." The question for the Panel was "whether a loss settlement, as used in these [Treaties], includes compromise of liability under all the

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[Original Reinsurance Contracts] as distinct from the liability of an individual loss settlement under a single [Original Reinsurance Contract]." Noting that "virtually all loss settlements, both in insurance and reinsurance, involve compromise and include a so-called contingent component ...." and that "the comprehensive nature of the commutation between [Home] and [Global] represents a distinction without a difference to the validity of a loss settlement under the [Treaties]" the Panel found the commutations were covered by the treaties.

Global Re then moved in the United States District Court for the Southern District to confirm the award. Argonaut cross-moved to vacate the portion of the award requiring it to indemnify Global Re for the commutation payments. In its cross-motion, Argonaut contended that the panel manifestly disregarded the law with respect to the commutations in three aspects. First, Argonaut contended that the panel ignored the unambiguous provision of the treaties requiring that Global provide notice of claims and an opportunity for Argonaut to associate itself with any claim before it must accept liability. Second, Argonaut contended that the panel ignored the unambiguous definition of "Loss Occurrence" in the treaties by finding that the contingent liabilities allocated to Argonaut based on actuarial studies were losses covered under the treaties. Finally, Argonaut contended that the Panel misapplied the "follow the fortunes" doctrine to expand the coverage of the treaties.

The Southern District first noted that for a panel to manifestly disregard the law, the law must be clearly applicable and be well-defined and explicit. The Southern District rejected Argonaut's first contention because there

continued on page 28

Recovery of Commutation Payments continued from page 27

was no evidence that Argonaut was prejudiced by any late notice. The Southern District rejected Argonaut's second contention by stating that "while a narrow reading of the 'Loss Occurrence' clause to particular losses that had already occurred might exclude contingent liabilities, the Treaties were interpreted by the Panel as 'honorable undertakings' not as strict legal documents. Because the Panel was given substantial freedom to interpret the Treaties and offered a colorable justification for their interpretation based on industry practices, this Court cannot conclude that they ignored the 'Loss Occurrence' definition." Finally, the Southern District rejected Argonaut's third contention by noting that "once the Panel interpreted the Treaties to include contingent claims as a loss covered under the Treaties, the Panel properly applied the "follow-the-fortunes" doctrine to preclude review of Global's decision to settle the contingent claims."

There has been one Privy Council decision applying New York law which found, in the context of an insolvency, that IBNR was recoverable pursuant to a loss settlement clause that required the reinsurer to pay based upon "the liability of the reinsured." *Bodden v. Delta American Reinsurance Co.* (Cayman Islands), 2001 citations - 1 BCLC 482, 2AC 328, 2WLR 1202, BPIR 438,UKPC 6; 2002 citation – Lloyd's Rep IR 167.

Follow the Settlements Applied Differently

There appears to be a difference between English and American law on the issue of how far the follow the settlements doctrine can be extended. This difference is exemplified in two cases where English and American courts reached opposite conclusions as to whether a reinsurer must a follow a settlement made pursuant to the Wellington Agreement, which was entered into between asbestos manufacturers ("producers") and their insurers in 1985. Pursuant to Wellington, each producer agreed to pay a share of every settled or adjudicated asbestos claim asserted against one or more Wellington signatory producers in accordance with the producer allocation formula, whether or not the claimant alleged exposure to its asbestos products. By agreeing to this allocation formula for all claims, the producers avoided the need to assert cross-claims against each other in the underlying asbestos suits.

In both cases reinsurers argued that payments made by insurers on behalf of producers under the producer allocation formula were not covered reinsurance losses absent proof that the underlying claimants were actually exposed to the insured's product. In *Unigard Security Ins. Co v. North River Ins. Co.*, 762 F. Supp. 566 (S.D.N.Y. 1991), *aff'd in part, rev'd in part on other grounds,* 624 F.3d 1049 (2nd Cir. 1993) ("*Unigard*"), the American court required the reinsurer to follow the settlement because the Wellington Agreement was a good faith settlement of claims and involved payments reasonably falling within the terms of the reinsured policies. The American Court noted that "while under the allocation formula [the insured] sometimes contributed to settlements of claims on which it might not legally have been liable, at the same time [the insured] benefited from the fixed percentage contributions that other producers made to claims on which [the insured] would have been chiefly liable." 762 F. Supp at 589. In *Hiscox v. Outhwaite,* 2 Lloyd's Rep. 524 (Q.B. Comm. Ct. 1991), the English Court found that the reinsurer was not obligated to follow the ceding companies settlement as "the disputed payments were in respect of non-insured claims, which by definition were not within the scope of the reinsurance contracts. They did not become insured, and therefore reinsured, claims, merely because [the signatory insurers] agreed to treat them as if they were." 2 Lloyd's Rep. At 531.

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Conclusion

Since loss settlements often involve contingent components, commutation payments representing IBNR arguably should be recoverable from retrocessionaires pursuant to the follow the settlements doctrine under certain circumstances. This doctrine has already been liberally extended in the United States for complicated settlements involving policy buybacks (*North River Insurance Company v. ACE Reinsurance Company*, 361 F.3d 134 (2d Cir. 2004) and for Wellington Agreement settlements that reflect payments for both covered and uncovered claims (*Unigard*). One American court has now ruled that an arbitration panel did not manifestly disregard the law by requiring the reinsurer to reimburse the ceding company for commutation payments that reflect contingent liabilities. ■