Second in a series of articles on the pros and cons of accelerated claim estimation

Think Tank

Bringing Claim Estimation into Perspective

By Jonathan Rosen

One can readily appreciate reinsurer resistance to attempts by liquidators of insolvent carriers or administrators of distressed entities to cede "bulk" or "pure" incurred but not reported ("IBNR") reserves carried on the cedent's books, but for which no actual liability has been established in relation to an underlying claimant. One can equally appreciate resistance, absent a contractual mandate, to forced commutations or crystallization of liabilities at the reinsurer level for the sole purpose of obtaining reinsurance "close out," either to achieve a successful solvent scheme for shareholder benefit or to merely accomplish cash realization for distressed or insolvent entities whose estates are a long way off from final maturity.

It is, however, difficult to come to grips with the wholesale denouncement of estimation by certain members of the reinsurance community, particularly within the realm of policy buy-backs, which have an element of contingency as a principal component. The cession of contingent or unliquidated liabilities determined in an estate in relation to known exposures identified by insureds or claimants is an issue of critical importance to liquidators, charged with the obligations of marshalling assets and obtaining expeditious and efficient estate closure, and administrators of distressed entities, whose primary objective is to secure a wind-up at maximum creditor value.

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There is, of course, nothing unique about the concept of a policy buy-back, which is endemic within the insurance arena where long tail liabilities exist and the reinsurance community has generally been receptive to the notion of loss curtailment through that mechanism. Indeed, courts have long imposed reinsurer liability for underlying settlements involving the resolution of future exposures (for example in relation to environmental impairment, where future clean-up obligations are resolved at net present value, or with respect to future asbestos liabilities which, because of their anticipated magnitude, would cause excess layer policy exhaustion as a matter of course), provided the settlements are reasonable, the settled exposures are arguably within the scope of coverage and there is nothing untoward in the settlement allocation.

So why does a mis-alignment emerge when a cedent becomes financially distressed? The answer is self-evident – cessation of ongoing underwriting relationships, whether through liquidation or run-off, changes everything. While this may be psychologically understandable, its impact is extremely deleterious.

Within the liquidation context, from a pure contractual perspective, traditional insolvency clauses require reinsurers to effect without diminution payment to the reinsured or its liquidator **on the basis of the liability** of the reinsured. In practice, the liability of the reinsured is ascertained through a claims determination process that, of necessity, includes within its ambit an evaluation of exposures having a future loss component, with a net present value ascribed to those future elements for determination purposes. Thus, while estimation is brought to bear in the liability determination process, there should be no perceived contractual impediment to reinsurer indemnity obligation in relation thereto.

At its recent Winter meeting, the National Association of Insurance Commissioners ("NAIC") unanimously adopted an Insurer Receivership Model Act ("IRMA"), a number of provisions of which will be required to be enacted by the various states as a means of obtaining or retaining NAIC accreditation. As a general proposition, the section of IRMA dedicated to reinsurer liability specifically mandates that nothing in the Act shall be

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construed to authorize a liquidator or any other entity to compel payment from a reinsurer on the basis of estimated IBNR losses or loss expenses and case reserves for unpaid losses and loss expenses.

However, in recognition of overriding public policy considerations embedded in the general purposes of IRMA, which have as their underpinnings early closure of an estate in conjunction with the ability of a liquidator to marshal assets and act in the best interests of estate creditors, the allowance of determined contingent and unliquidated claims arising from known exposures at underlying has been excepted from the general preclusion. The rationale for this exception lies in a recognition that while estate closure can only be attained once all proofs of claim filed in an estate have been determined, it is inconsistent with their cardinal charge to require receivers to wait for actual loss development of long tail liabilities as a precursor to effecting disposition of claims filed by identified claimants in relation to known exposures before having the right to secure reinsurance recoveries.

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Furthermore, consistent with its espoused purposes, and as an additional exception to the general preclusion relative to the scope of reinsurer liability, IRMA contains a specific provision that, subject to certain caveats, authorizes a liquidator to enter into voluntary commutations. Should the parties be unable to achieve voluntary commutation before an estate has reached a defined point of maturity, or if a reinsurer's risk based capital level falls below a defined threshold, IRMA also permits a liquidator to seek an order from the receivership court compelling the parties to submit commutation proposals for resolution by an arbitration panel.

To preserve contractual sanctity, however, in the event that either party declines commutation as resolved by the arbitration panel, IRMA obligates the reinsurer to create a reinsurance trust to the extent of such resolution, inclusive of its IBNR and case reserve components. The reinsurance trust remains subject to upwards or downwards adjustment depending on subsequent development, and as a means of ensuring harmony and symmetry between IRMA's provisions, the liquidator is specifically entitled to obtain release from the trust of the reinsurer's obligations with respect to ensuing claims determined at underlying and admitted in the estate, including claims determined on an unliquidated or contingent basis. As a result, even in the absence of commutation, estate closure can be occasioned following the determination of all filed proofs of claim without the risk of deprivation of reinsurance recoverables.

Certain reinsurer constituents, however, continue to balk at the exceptions in IRMA to the general preclusions circumscribing reinsurer liability. Such resistance, if acceded to, would potentially create a reinsurer windfall through a deprivation of reinsurance capacity with respect to contingent and unliquidated claim determinations, having the chilling effect of a liquidator being reluctant to determine claims on that basis and rather electing to wait for liability at underlying to become certain. Aside from detracting from the liquidator's statutory charge, this would certainly operate to the detriment of creditor interests by inordinately prolonging the life of an estate (thereby exponentially increasing administrative costs) as well as foreclosing on the liquidator's ability to obtain advantageous early settlements in relation to known long tail liabilities that history has confirmed only get worse over time.

On the flip side, by proceeding in the face of limitations creating incongruity between policyholder and reinsurer levels in relation to underlying determinations, a liquidator could be caught in the invidious position of achieving finality at the direct insurance level for actual identified exposure, albeit with a future loss component, while depriving an estate of valid future reinsurance recoveries because of the cessation of a continuing loss development relationship with the insured.

Accordingly, if the will of reinsurer detractors prevails not only will public policy considerations invariably be sacrificed, but the contractual obligation of reinsurers to pay **on the basis of the liability** of the cedent will be seriously undercut. These are surely untenable results.

Those resistant to estimation as a wholesale proposition argue that such endeavors subvert the

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notification requirements contained in the insolvency clause, deprive reinsurers of their contractual right to investigate claims and interpose defenses in relation thereto, and are, by their nature significantly infirm because of their reliance on inherently uncertain actuarial projections. As a normal everyday business practice in the industry, there is, of course, nothing novel in the reinsurance commutation concept and ceding companies and reinsurers routinely strike deals that are wholly founded on indefinite prognostication. That is not to say that forced commutation should be legally sanctioned, but the issue of contingent and unliquidated determinations, which are equally prognosticatory, is an entirely different matter.

Furthermore, following notification, a reinsurer is fully entitled to investigate the asserted claims and interpose coverage defenses if it so elects.

Because policy buy-backs are dependent on claims filed in an estate, for which there is a contractually mandated reporting obligation, it is difficult to conceive how the insolvency clause notification requirement can be subverted merely by virtue of the claims having an associated future loss component. Furthermore, following notification, a reinsurer is fully entitled to investigate the asserted claims and interpose coverage defenses if it so elects. Also, IRMA mandates the opportunity for reinsurer input as a precursor to underlying contingent and unliquidated claim determinations and reinsurers retain the right to challenge the reasonableness of such determinations before the receivership court at the time that the allowance is being considered for estate admission. Finally, the arbitration rights of reinsurers remain expressly preserved, so reinsurers are hard pressed to assert that their contractual and due process entitlements have been eviscerated because an estimation facet is incorporated into the claims determination process.

In sum, while not all forms of estimation are appropriate or desirable in the run-off and liquidation arenas, a blanket conclusion that estimations are the root of all evil is hardly compelling. It is rather incumbent on the industry to respond reasonably and responsibly to a change in financial circumstances that upsets traditional relationships but has the best interests of creditors as a fundamental objective. ■