



Feature Article

A Roundtable Discussion: The Dynamics of the Commutation Process Examined through Multiple Lenses

Moderated by Special Editor Michael T. Walsh



Rudy Dimmling



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Howard Mills



Tom Ryan



Mike Walsh

Commutations necessarily tap human resources from various disciplines assigned not only with the responsibility to achieve the goal, but also to define, calculate, support, negotiate, consummate and document the goal.

Against this backdrop, we thought it would be interesting to convene a Roundtable discussion of experts from various disciplines to discuss the dynamics of the commutation process with the expectation that it would yield some lively discourse. We were not disappointed. The Special Editor, Michael T. Walsh of Boundas Skarzynski Walsh & Black, LLC, served in the John McLaughlin role, as moderator and host. Our panel of experts consisted of Howard Mills, the former Superintendent of Insurance for the State of New York, now with Deloitte as our regulatory authority, E. Paul Kanefsky of Edwards Angell Palmer & Dodge, LLP bringing a legal perspective, Rudy Dimmling, former Chief Administrative Officer of Centre, as our business expert and Tom Ryan of Milliman presenting an actuarial view.

Mike Walsh: Thank you all for making yourselves available today for a discussion of one of, if not the key issue in effective run-off operations — commutations. I thought I would start with a rather basic question: What are some of the key issues you would identify that are unique to run-off companies in approaching commutation?

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Rudy Dimmling: What is unique with commutations in a run-off environment is that you want to avoid having the original underwriters doing the commutations, which I have seen all too often. You really need to take it out of the hands of the underwriting unit because they usually have emotional ties to the deals that they originated. It is imperative to have a good commutation team bringing together the various disciplines within the company — actuarial, legal, accounting, tax, risk and investment management. In addition, good negotiators, which are essential to effectively executing commutations and having the right team in place, are crucial.

Paul Kanefsky: I agree with Rudy as to the effectiveness of commutation teams. As outside counsel, I have been part of such teams for companies in run-off, often where the commutation resolves a legal dispute but also when a company simply wants support for legal and drafting issues. Also, companies in run-off tend to seek global commutations to resolve all open matters with a given insurance company. A global commutation, which may include setoffs and other complications, usually involves more complex negotiations and drafting concerns, which is another reason for outside counsel to be part of the process.

Tom Ryan: As an actuary our goal is to put a number or

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value on the liabilities involved in the commutations in a run-off situation. A lot of the contracts were written a long time ago, the wording is ambiguous, and one of the challenges is to understand what was the intent of the coverage. You can read a reinsurance contract on its face but that necessarily is not the way it has been interpreted and operated by the parties. So it is helpful to have access to in-house knowledge, someone who is familiar with the contracts and sometimes that does not happen in a run-off situation.

Howard Mills: I think you put your finger on something that is a regulatory concern. When you talk about the absence of underwriters and absence of staff — from the regulators’ point of view, you are concerned about who is running the shop and who is there to do the work. The degree of interest on the part of the regulator is really a factor of whether or not there is a threat of insolvency. If it is a relatively healthy run-off where there are limited solvency concerns, the regulator is not likely to be that involved — obviously where there is a greater degree of financial peril and a possibility of reserves not being sufficient, then the regulatory involvement is much more intense.

Mike Walsh: What are the trends members of the panel have seen with respect to involvement or oversight of regulators with respect to commutations involving run-off companies that might have some solvency issues?

Howard Mills: I think the trend that we are seeing now is a greater willingness on the part of regulators to become involved and to be helpful in moving commutations along.

There are basically two things that no regulator wants to have happen on his or her watch: One is insolvency, and two is putting the company into liquidation. We are seeing a far greater willingness on the part of the regulators to get involved in very proactive and progressive approaches such as Regulation 141 type situations.

The regulator plays a very unique and important role as the referee in the commutation process, to impart the whole concept of equality and fairness whether it is a reinsurer or an insurer and whether to bring the retrocessionaires into this equation. I think that the regulator is also going to be looking at who is first in line and naturally they are always going to want to prioritize in favor of claimants versus reinsurers.

Paul Kanefsky: Clearly, where liquidation can be avoided through liquidator-approved commutations, as

in a successful New York Regulation 141 plan, everybody can win.

Tom Ryan: In terms of stepping back to the general point, when there is not an issue of financial insolvency or instability we usually do not see a lot of regulatory involvement, but when there is a situation of flirting with insolvency, the Regulation 141 setup in New York works pretty well. I think we would like to see things continue down that road.

Paul Kanefsky: Additionally, even when a company is already well into liquidation, a supportive liquidator can be a great facilitator of commutations that both help the insolvent company and are fair to the other party, especially in multifaceted relationships, as when the solvent company is both a creditor and a debtor of the company in liquidation. I have seen farsighted and cooperative liquidators who, recognizing the potential for mutually beneficial economic results, actively shepherd complex, multi-party commutations through to court approval.

Mike Walsh: Does the panel feel that there have been any new developments in the involvement of retrocessionaires in the commutation process?

The days when a retrocessionaire simply “followed the fortunes” of its reinsurer regarding a commutation without considerable due diligence are all but over. – Kanefsky

Paul Kanefsky: The days when a retrocessionaire simply “followed the fortunes” of its reinsurer regarding a commutation without considerable due diligence are all but over. A retrocessionaire wants to know how its reinsured’s commutation payment is being allocated: Is it all paid losses? How much is case reserves? How much, if any, is IBNR? Is the payment allocable to actual, identifiable claims as opposed to “notional claims” based on actuarial projections? Is the payment just a negotiated lump sum that a retrocessionaire may have a problem passing on to its own reinsurers?

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. U.S. law is much more liberal, but many defenses may still be available, ranging from treaty wording issues to the economic reasonableness and good faith basis of the transaction.

The commuting reinsurer wants to make sure that its retrocessionaires will support the deal and not raise

objections that could lead to a later dispute. We generally recommend notifying the retrocessionaires of a proposed commutation fairly early in the process, once you have agreed on the structure of the commutation and the approximate amount of the payment. More detailed discussions and provision of requested documentation will follow, and a draft commutation agreement may be provided to retros for comment and signoff.

I have been involved in situations where two sets of agreements were prepared — the commutation agreement itself and, not long after, a separate agreement between the reinsurers and their retrocessionaires, in which the retros agree to pay their proportionate shares of the reinsurers' commutation payments. The retrocessional agreement is contingent upon the commutation going through, and works almost in unison with it. In fact, the deal can be structured so that there is one pot, into which the reinsurers pay their retained portions of the commutation amount, and the retrocessionaires pay the amounts they have accepted.

Tom Ryan: I would agree with Paul. Retrocessionaires increasingly want to understand what their piece of the liability is and what documentation and modeling exists that supports their share. This can get pretty complex when talking about excess layers and allocating IBNR. It is definitely a trend that we are seeing that “follow the fortunes” is no longer a guiding principal but rather more emphasis is being placed on demonstrating why the reinsurer believes the retrocessionaire owes this money, with a demand for a higher degree of supporting documentation.

Retrocessionaires increasingly want to understand what their piece of the liability is and what documentation and modeling exists that supports their share. – Ryan

Rudy Dimmling: I want to echo what Paul said regarding timing. Timing is critical here. Bringing a retrocessionaire into the process too early does not work. It will just complicate matters, because commutations are by design one of negotiation, and commutation structures are always evolving. So if you bring them in too early it will be fruitless, because you end up negotiating a tri-party type settlement. Bringing retrocessionaires in too late could be disastrous as well. It could create problems down the road in which they could argue of not being involved in the process or that the commutation is unfavorable or unfair to them. So I think it is critical from a commutation team perspective for the person spearheading the commutation to have

the experience to know at precisely the right time to bring in a retrocessionaire within those discussions.

Mike Walsh: One of the areas of concerns faced by run-off companies is the potential for unwinding of pre-insolvency commutations as being preferential. What can be done to minimize this risk and/or to provide comfort to commuting partners?

Paul Kanefsky: You want to protect yourself as much as possible through language drafted into the agreement. As a matter of potential damage control, the lawyer for the party worried about another party's financial status wants to negotiate the strongest provisions possible to protect the client's interests and avoid ultimate exposure much greater than bargained for in the commutation. Of course, you do not want to commute with a company you expect to go under any week or month, because that may just be a preferential transfer waiting to happen, as opposed to the usual situation where a company may be seen as vulnerable to impairment but viable for the foreseeable future.

The basic problem for a cedent in a simple commutation is that the reinsurer becomes insolvent and the liquidator takes back the commutation payment as a preference or fraudulent transfer. Since the agreement itself might still stand, there will have been a release so that the cedent no longer has the right to recover against the reinsurer. This threshold issue is easily taken care of by a “reinstatement” clause providing that if a preference occurs and the payment is taken back, the agreement becomes null and void and the parties are returned to their original status as though the agreement did not exist. The rights of the cedent are revived so that it can file a valid proof of claim or otherwise seek to obtain at least partial reimbursement from the insolvent estate. In more complicated commutations, such as those including different levels of reinsurance — perhaps a quota share plus inuring protections — the parties can provide for indemnifications and other features to mitigate additional exposure triggered by a party's insolvency.

Rudy Dimmling: From a business perspective, what I have seen is that no matter how good your legal team is and how you go about crafting the legal document, you really cannot eliminate the risk of a preferential or fraudulent transfer. There is nothing you really can do to fully protect yourself. To go back to one of the previous questions we discussed earlier, you can try to utilize certain structures that are available to eliminate potential preference issues — Regulation 141 in New York is a case in point.

Tom Ryan: I would agree with Rudy, you can not eliminate the risk of these potential claw-backs. However, in terms of minimizing the risk from an actuarial perspective you can have strong documentation so that if there is a problem you can go back and show that you used the best practices, the right method, the correct data and a well documented plan to make your case that the final value of the commutation was fair.

Howard Mills: With regard to providing some comfort to commuting partners and facilitating the process moving forward, if you have an Insurance Department that is very proactive and engaged, a couple of advisory meetings with the regulator explaining this is where we are can avoid a more serious situation. It not only helps the process, but it can provide that comfort because it indicates that there is regulatory support which often I have found eases a lot of concern.

Mike Walsh: A question many of our readers may find interesting is what roles do you see outsourcing firms playing in commutations and how are these firms most effective?

Rudy Dimmling: Many run-off companies do not have the resources to fully execute a commutation strategy and an outsourcing firm can provide levels of expertise specifically needed such as actuarial, accounting, legal, IT and negotiating the commutation. Implementing a commutation strategy is as much art as science, it requires an effective deal manager to negotiate a favorable settlement.

Tom Ryan: Many of these outsourcing terms bring to the table a specialized knowledge or area of expertise. Sometimes where the company looking to commute is a foreign company, they might hire a US-based outsourcing firm to give them sort of boots on the ground here to understand the lay of the land and that can prove to be very effective. Also, some of these outsourcing firms specialize in certain types of claims. For example, I am aware of one firm that handles a lot of construction defect claims which are very different in terms of their life cycle, when they are reported, how they are closed and exposure trigger issues from other

types of claims. Because this firm does so much work with these types of claims, they have a much better understanding of how these claims are going to play out and what to expect in the future on these losses which translates into a real advantage going into any kind of commutation negotiations. That level of knowledge provides leverage and they were more effective in the commutation negotiations.

Paul Kanefsky: Where multiple companies are involved, as in run-off reinsurance facilities or pools, it is essential that you have a "clearinghouse." You need a professional run-off administrator to handle the accountings and the actuarial work for all of the companies involved, otherwise a commutation may never happen. Participating companies are not typically going to let a fellow pool or facility member run the show, and the necessary in-house expertise to handle all aspects of a multi-party commutation may not be available in any event.

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Rudy Dimmling: I think the industry is evolving and AIRROC and other organizations like that are growing. In my opinion there is a paradigm shift from run-off being perceived as a backwater type role. In years past senior management viewed run-off as expense management. Now boards and senior management realize the value that can be created for the firm and for shareholders by implementing a quality commutation team to extract value and return for shareholders. Companies are beginning to see that staffing their own teams on discontinued units makes sense because they know their business and know their deals. In essence the outsourcing firms are almost becoming a victim of their own success.

Mike Walsh: Thank you all very much for participating in what I think was a very lively and informative session. ■

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