Think Tank

Commutations – A Historical Perspective


Art Coleman

By Art Coleman (with a little help from his friends)

When the opportunity arose to put together an article for *AIRROC Matters* on the historical perspective of commutations, I agreed as long as: (a) it could be a bit irreverent to the sacred beliefs of our industry, and (b) I could seek collaboration. As you will see, they agreed to both points.

I decided to go back to 1986 when I was hired at Continental Insurance as the Director of Reclamations. You may ask, as I did, "what's a Reclamation?" (Imitate Groucho Marks "Viaduct? – Why not a Chicken?") While it was a fancy word for collections, settlements and disputes, it is where I experienced commutations for the first time.

My first commutation was a relatively small one, at the time being just under $600k. I recall that it was comprised of $100k in balances, $350k in undiscounted reserves and $250k of something called IBNR (which for awhile I believe meant I Bought No Reinsurance! – I have now come to know that IBNR is determined with a blindfold and a dartboard!). We had to do something called "discount the reserves for the time value of money". Not really knowing how to do this I found that one of the guys in the office had a piece of shareware software on a 5 ½ inch floppy disk (hey, remember – it was 1986) that allowed you to calculate mortgage rates and present value (the other side had Ms. Pacman). Well, we did it and got the deal done for $575k. We never looked back from there – well maybe a bit!

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So, to be fair to you, the reader, I reached out to some of my peers to divulge a few of their memorable commutations. Some of the responses were unprintable, while others expressed quite a bit of anger (so much for the "win-win" school of thought!). Others though, hit the mark right on the head.

The first entry comes from someone you all know, but has pleaded anonymity, as have the rest of the contributors.

> Some years ago, I was working for a ceding company that was engaged in a dispute with a number of its reinsurers on a particular treaty. An arbitration was pending, but in the spirit of good faith and reconciliation, the parties agreed to meet to consider commuting the treaty participations. The reinsurers had been acting callously and with considerable disregard for their obligations, I thought; I am sure that they thought our company had treated them poorly (or worse) in how the treaty was operated. Nevertheless, old bonds of friendship (and business-like pragmatism) prevailed, and we scheduled our meeting.
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> The meeting was to take place at the office of the reinsurers' lawyers. Twelve representatives of the reinsurers were to attend, plus two of their lawyers, ... and me. Clearly, the logistical planning had been unsound.
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> I was met in reception by the junior lawyer on the case. It seemed like a ten-minute walk through maze-like corridors to get to the conference room. As he was about to open the door, this lawyer looked me in the eye and said, "Ah, I am now bringing the lamb to the slaughter." I then entered the room where the twelve reinsurance men were all smiling broadly. They may

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continued on page 8

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Think Tank

Commutations – A Historical Perspective continued from page 6

have been pleased to see me, or optimistic of a conciliatory settlement, but I had no ability to recognize any of that. The two lawyers were also smiling, as if to suggest: "This dispute will put our children through college." The meeting lasted twenty minutes and was an absolute fiasco.

Approximately a month later, we met again. Lawyers were forbidden from any participation in the meeting, which was held in one of the reinsurers' offices. We commuted the treaty.

Early in my career I was told once that reinsurance was defined as an honorable engagement between two parties. I later heard reinsurance defined as an honorable engagement between two parties, their auditors, lawyers and external actuaries. I think the latter definition speaks to how our business really works.

Our next submission comes from a one of the great collection/commutation people in the industry.

In the 1980s, an alien pool closed down and sent a letter telling us we needed to go direct. We dutifully broke out the pool and started sending direct notices of loss and bills. One of the smaller players sent us a letter from their President saying he was going to be in Chicago and would like to meet us. When he arrived, he was accompanied by two other gentlemen who were there to translate for him.

We calculated the value of the deal, paid, case and IBNR at about $3,000. After the preliminaries and the revelation of the amount he asked his cohorts if they happen to have $3,000 on them so we could do the deal. My colleague who was also in the meeting had earlier pointed out that the President was sporting a rather nice Rolex Crown Ambassador watch.

We therefore proposed we would do the deal for his watch (which we figured we could fence on Van Buren Street for a least $5,000). The guy laughed and said he was serious about the deal and we said we were serious about taking his watch!

Many years later his cohorts were in our offices on another matter and I went in to say hello. We had a good laugh over the failed "watch deal" but I had to ask why the President wouldn't do it. They told me it was because the watch wasn't insured!!

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Another funny point; we submitted the deal to our central corporate HQ for approval … and it was REJECTED!!

Well, like they say, timing is everything! Knowing the two guys referenced in the story, they certainly would have received more than $5,000 for the watch.

Some deals have happy endings (for some) as can be seen in the next entry.

Back in the late 1980s I was in the rural UK doing an audit trying to support what we believed to be an exorbitant Commutation offer from the Cedant. We knew they were hurting but the price $55M they were asking was ridiculous! Unfortunately, our review of the claims was telling a story that supported their position. Then our fortunes changed!

It was Friday and after a quick (?) lunch at the nearby Pub, we were back at the office and attending to the after affects of the Pub in the "Gents". As we were doing our business, two fellows, who I later found out were from the Accounting Department, were talking and one said, "You know, I don't think we're going to be able to make payroll next week due to cash flow." A smile came across my face.

We walked into the MD's office and offered $20M by close of business the following Monday, $10M the following January 3rd and $10M the January 3rd after that.

continued on page 28

Think Tank

Commutations – A Historical Perspective continued from page 8

We did not mind the 8 hour flight home that evening!

They say that the doctrine of "caveat emptor" means, "let the buyer beware". Knowing the two parties involved, this was certainly a "win-win" scenario.

This next story was one of my favorites and shows that there really is a humane side to our industry (it's not frequently shown — but it is there nonetheless).

Late 1980s lower Manhattan, mid-afternoon and I had a 3 p.m. appointment with a gentleman from a German reinsurer that was in run-off. There is a monsoon of a thunderstorm going on and I realize that the meeting will probably be late.

I had been going over my financials and was thinking that I would have a hard time getting the $300K that was my wish list amount never mind my walk-away number of $250K from this reinsurer.

At 2:58 p.m. I receive a call from the front desk advising that my visitor has arrived. When he gets to my office there is a man that could not have been wetter if he stood for an hour under Niagara Falls without an umbrella. We tried to dry him off with paper towels but why bother!

This gentleman sits down in my now replaced chair and states that his company is in run-off and while appearing to be (and probably was) very uncomfortable he advises that he is only willing to pay $500K for the commutation.

This could have been the fastest commutation on record. We asked if he had reviewed the business and if he was sure of his price. He then advised that if pushed there was probably a bit more that could be had but he would have to go back to management for approval.

My associate and I stepped outside on the premise of getting him more towels and some coffee. We agreed that to take more than $400K from him would be in really bad form. We actually had to argue with him to get him to pay the lower amount!

It seems that today, we use phrases such as exit strategies, solvent and insolvent schemes and that the business seems like more of an exact science than it was *back in the day*. The best lesson we can probably learn from the past is that the best deal is not necessarily the one where the numbers are right – the lesson is that this is still a people business and relationships make for better deals.

Anyone who thinks that the business of run-off is boring just is not having enough fun! ■

Feature Article

Drafting a Commutation Agreement continued from page 15

Choice of law and dispute resolution

Finally, although by no means specific to commutations, a choice of law clause should be included in all contracts and a method for resolving disputes – either litigation in the courts or arbitration. If the latter, the parties should consider what form of arbitration will be used. ARIAS provides a standard clause which can be used if the ARIAS rules are being adopted. It is also becoming more common to include a clause requiring the parties to submit to mediation before commencing more formal proceedings. Usually these clauses do not provide for a binding resolution, but they provide some comfort that an effort will be made to avoid escalating a dispute unnecessarily.

Conclusions

While many companies have commutation agreements on their precedent system, many situations demand far more than merely an exercise in 'filling in the blanks'. As with all new contracts, from new policies to outsourcing services, careful due diligence at the pre-contract stage and precise drafting of the agreement will prevent potentially very expensive mistakes. ■