Feature Article

Drafting a Commutation Agreement

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By Mark Everiss & Chris Sage

This article addresses some of the legal and drafting issues that should be considered when preparing and negotiating a commutation agreement. While the article primarily focuses on commutations of reinsurances, many of the issues apply to commutations of direct business also.

Commutation agreement or commutation clause

The first step is to examine the relevant contract(s) to see if there is already a commutation clause in the contract(s). In circumstances where a single policy or treaty is being commuted, if there is a commutation clause included in the contract it may be possible to use it. When deciding whether to rely on an existing commutation clause, the following points will be relevant:

- Does the clause set out how the commutation will be valued? Is there a mediation or dispute resolution procedure if the valuation cannot be agreed? Many commutation clauses are, effectively, 'agreements to agree', that is they do no more than require the parties to discuss commutation terms, and under English law such clauses are not legally enforceable.
- What is the effect of commutation? Does the commutation cover the whole policy/treaty, or just part of it?
- What if there are future claims? Are all liabilities commuted?

If there is no commutation clause in the policy or the commutation clause does not meet the commercial agreement that has been reached then a separate commutation agreement will be required.

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Basic principles

Although they may seem rather simplistic, some of the fundamental questions which need to be addressed (and often are not resolved until the lawyers get involved) are:

Who are the parties?

The issue may be particularly complicated if the commutation relates to a book of business between the parties over a period of time. The results of any pre-commutation due diligence exercise will be of assistance in this regard, as that process should have identified each of the contracts that is being commuted and details of the original parties to them.

Consideration should be given to whether the original parties are still the appropriate parties to the commutation. Particular attention will need to be paid to this issue if there has been an insurance business transfer or if either party has merged with or acquired other (re)insurers.

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Complications arise where insurance or reinsurance cover was originally granted to a company and its affiliates but one or more of the affiliates has since been sold off. Even if the contract provides for that affiliate to be excluded from cover from the point of sale, can pre-existing long tail liabilities be commuted without the consent of that affiliate? The answer to that question may depend on the terms of the policy.

Similarly, any reinsurance contract which is stated to be for the benefit of the reinsured "and/or their quota share reinsurers" (or similar wording) will require further analysis to establish whether or not those quota share reinsurers are parties to the contract.

What is being commuted?

Whether the commutation relates to a single policy, a facultative reinsurance, a treaty or an entire book, it must be precise in identifying its subject. Again, the

continued on next page

results of the pre-commutation due diligence will be key. How can the business being commuted be accurately and comprehensively described? What is the policy number? Is there a complete list of treaty numbers? If an entire book of business is to be commuted there is risk at both ends: either of missing something so that some contracts remain outstanding, or of commuting something very valuable that one or both parties did not even know existed. For example, a commutation of "all business written by X Insurance Company prior to 1995" may inadvertently include the contracts written through an underwriting agent to whom X had given its pen.

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One exception to the general principle that the commutation should identify the contracts being commuted as precisely as possible is the concept, which a number of run-off managers have used over the years, of the 'accelerated' or 'global' commutation, which encompasses all the policies between the parties, whether identified or not and (if relevant) whether inwards or outwards. In certain circumstances this approach has the benefit of allowing the parties to close their books on a particular line of business or relationship without the expense of a full due diligence process, and therefore is particularly useful where there are large numbers of small value policies but records are incomplete or poorly maintained and where the risk that a policy may be commuted unknowingly is low value, even if high probability. Even in this situation, precision in the wording is essential to ensure that the correct group of contracts is included in the agreement.

Particular care should be taken where one or both parties are the product of a number of mergers – is it the policies written by all of the former companies that are to be commuted, or just one?

How much is being paid, and how?

Is the commutation payment a lump sum figure? If not, how is it to be calculated? If the reserves are backed by a trust fund or other collateral arrangement containing specific investments, consideration should be given to whether these will be transferred to the cedant, liquidated and the cash proceeds paid over, or valued with the equivalent amount being paid and, if the last of these options, who will value them?

If the consideration is to be calculated according to a complex formula, or on the basis of a valuation of assets, a clause providing for reference to an independent expert, to make any determination that cannot be agreed, can be included in the contract. The expert's decision will usually be binding in the absence of manifest error, meaning that there is a pre-agreed (and hopefully quicker and cheaper) alternative to going straight to the courts or an arbitration panel.

Ideally (for the cedant, and for contractual simplicity) the commutation balance should be settled in full on completion of the agreement. If this is not to be the case, there is a risk that a later payment may not be made. The ability to sue for the unpaid amount may have little value if the reinsurer is insolvent. Can the balance be secured somehow, for example does the reinsurer have a parent which can guarantee payment? Often a commutation agreement will provide that the reinsured has the option of treating the commuted reinsurances as reinstated if the reinsurer defaults on a payment, with the reinsured's alternative option being to sue on the agreement.

Some more technical issues to consider

The extent of the liabilities being commuted

Unless the commutation is in relation to a particular claim or claims, or is intended to preserve IBNR (perhaps because an agreement with a retrocessionaire has not yet been reached – as to which, see below), the commutation needs to be in respect of all liabilities, present or future, actual or contingent, known or unknown. It has been suggested that wording such as "all claims under the contract" without any qualification may only catch paid and outstanding claims.

Are there any unpaid balances due under any of the contracts? The wording suggested above settles or releases that liability as well, so any such amount should either be wrapped up in the commutation payment or specifically carved out of the wording.

Recoverability of commuted amounts

Ideally a reinsurer commuting an inwards policy will have agreed the commutation with its retrocessionaire before completing. If not, consideration will need to be given as to the extent to which commutation payments can be recovered from the retrocessionaire. In the UK, there is a notable absence of judicial guidance on recoverability issues. This is not, perhaps, unsurprising given the fact that most market participants have both inwards and outwards interests to consider and the huge commercial impact of a concrete decision.

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The law

The recent decision of *English and American Insurance Co. Ltd. (In a Scheme of Arrangement) v Axa Re SA [2006] EWHC 3323* will be of great interest to reinsurers seeking maximum recovery on their retrocessions and to retrocessionaires being asked to pay claims comprising more than just 'paids'. In that case, Mrs Justice Gloster addressed an application for summary judgment (on the basis that there was not even an arguable defence to the claim) in a claim by a reinsured against its reinsurer for recovery of sums paid pursuant to a single settlement relating to Dow Corning (Dow) losses, of both paid claims and IBNR. Although the Judge did not, in fact, grant judgment for the sums relating to payments for IBNR by the reinsured, English and American Insurance Co. Ltd (EAIC), it would appear from her comments that she would have felt able to do so.

The Judge found that there had been a settlement which satisfied the requirements for settling a claim falling within the risks covered by the reinsurance contracts. Against the background of the 'follow the settlements' clause, the claim fell within the coverage of the contracts and EAIC had acted honestly and taken proper and businesslike steps in reaching the settlement – both these requirements being fundamental necessities as laid out in *ICA v SCOR [1985] 1LLR 312*. The payment to Dow by EAIC was in recognition of the fact that EAIC had liabilities to Dow of at least that amount.

The Judge considered that AXA had advanced no plausible basis for asserting it had a realistic prospect of defending EAIC's claim for at least the paid claims but found it was "just about conceivable, although unlikely" that AXA might have a defence to the amounts paid in respect of IBNR. Therefore, not least as a result of EAIC's counsel having conceded on this point, she did not grant summary judgment for that part of the settlement and a full hearing will now be heard in relation to that issue.

Comments

It is difficult to draw definite conclusions from this decision – it is not a lengthy one and does not go into the detail of the evidence actually presented by the parties. However, although in the context of recoverability it does not lay down any firm principles, there is no doubt that the decision is an interesting and controversial one for market settlements and settlements containing an element of the recovery of IBNR.

Enhancing the prospects of recovery of commutation payments

For a reinsurer, it may be useful to include in the commutation agreement separate valuations in respect of admitted liabilities, outstanding claims and IBNR to support a claim against a retrocessionaire. In addition, an obligation could be included to require the cedant to continue to provide claims information following the commutation to support further claims against a retrocessionaire. There may be more technical solutions to the problem but these are more complex and would need to be explored with your lawyers, taking account of the specific facts of the case.

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

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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. ■