

THE STATE OF NEW HAMPSHIRE

MERRIMACK, SS.

SUPERIOR COURT

BEFORE THE COURT-APPOINTED REFEREE  
IN RE THE LIQUIDATION OF THE HOME INSURANCE COMPANY  
DISPUTED CLAIMS DOCKET

In Re Liquidator Number: 2005-HICIL-11  
Proof of Claim Number: INTL700617  
Claimant Name: Century Indemnity Company

REFEREE'S RULING

Century Indemnity Company ("CIC") moves to assert and establish a right to setoff through filing a proof of claim. The Referee has given consideration to the use of this process to resolve a setoff issue, a matter briefly touched upon at the hearing on June 23, 2006. N.H. RSA 402-C:34 provides the statutory basis for the setoff of "mutual debts or mutual credits between the insurer and any other person in connection with any action or proceeding" under Chapter 402-C, but nothing within that provision directs a debtor to follow any particular procedure to preserve or exercise a right to setoff. Though setoff disputes would more commonly arise in the guise of an affirmative defense in a collection action initiated by the Liquidator, there appears to be no bar to resolving the matter here. Further, the parties indicate a joint interest in doing so.

**Background:**

The practical import of this disputed claim, and also of the disputes in 2005-HICIL-12 and 2005-HICIL-14, is reflected in the monthly setoff statements that CIC generates under Paragraph 3.3 of the claims protocol approved by the Court on November 12, 2004. These statements report the aggregate dollar value of Liquidator-submitted allowances received by CIC, and CIC's running account of its asserted setoff position. The latest statement carries a substantial setoff balance in CIC's favor upon which CIC relies to forestall the time when actual payments to the Home Insurance Company ("Home") in liquidation would be required. The Liquidator acknowledges the validity of some of the entries on the statements, but disputes others.

This dispute arises within the context of CIC's assumption of Home's exposures in the M.E. Ruddy Pool (the "Ruddy Pool"), and more specifically, the reinsurance relationship between Home and Nationwide Mutual Insurance Company ("Nationwide") under Contract R. In 1995, Nationwide sued Home in U.S. Federal District Court in the Southern District of Ohio for breach of Contract R. The district court referred the parties to arbitration. Pursuant to its obligation under the Insurance and Reinsurance Assumption Agreement (the "Assumption Agreement"), CIC engaged in the arbitration proceedings on Home's behalf. The proceedings were contentious and lengthy, encompassing a number of excursions back to district court before a final arbitration

award was confirmed by the U.S. Court of Appeals for the Sixth Circuit in 2005. See Nationwide Mut. Ins. Co. v. Home Ins. Co., 429 F.3d 640 (6th Cir. 2005).

Ultimately, an arbitration award favorable to Home was secured. It was favorable to Home in two important ways: it settled a dispute regarding the breadth of Home's Rutty Pool obligations, confining those obligations to a "duty to supervise Rutty's inward and outward claim handling in respect of Nationwide's fixed pool share...", and it awarded Home \$1.25 Million "in respect of its counterclaims for administrative costs and interest." Having no privity with Nationwide, CIC seeks to secure a claim in setoff against Home in an amount equal to the arbitration award's value to Home. CIC also seeks recognition of an ongoing right to setoff related amounts as they might arise.

### **The Disputed Claim / Positions of the Parties**

In support of its claim, CIC argues that under the terms of the Assumption Agreement and the related Services Agreement, it made payments to Nationwide "through and on behalf" of Home "and in its name." CIC also points out that under an express reservation of rights pending legal resolution of disputed matters under Contract R, it chose to make payments to Nationwide on the more generous fronted pool share basis, rather than expose Home to bad faith claims for failure to perform on Contract R obligations. It is within this context, CIC argues, that Home is immediately indebted to CIC for any payments CIC made to Nationwide in excess of Home's obligation.

While consistently acknowledging that CIC is positioned to claim a future entitlement to an "economic benefit" in the amount of \$1.25 Million, the Liquidator argues that Home is not a debtor to CIC on this claim, and that the arbitration award in favor of Home creates no present Home liability to CIC. The Liquidator takes the position that until such time as Nationwide's obligation to Home is satisfied by either a cash payment to Home, or Home's exercise of setoff rights against Nationwide claims, CIC is foreclosed from taking a related setoff. In the meantime, the Liquidator notes that Home has received no monies from Nationwide, nor has it affected any related setoff. The Liquidator adds that if either occurs, CIC's obligation to the estate will be appropriately credited. Because the Liquidator believes that CIC has failed to establish the liability he says is necessary to support the claim, he requests a dismissal of this disputed claim proceeding.

### **Analysis / Discussion**

To put this matter into context, it is important to recognize that insolvency clauses in reinsurance contracts require reinsurers to pay losses even though the insolvent company has not first made payments to the insureds. The practice of net balance accounting intrinsic in the relationship between cedents and reinsurers prior to an insolvency shifts to a debate over setoff in a liquidation proceeding. The right of reinsurers to use contractual and statutory setoff opportunities to adjust payments that may be due by taking credit against them for sums owed by the insolvent carrier to the reinsurer is well established. See, e.g., In the Matter of the Liquidation of Midland Ins. Co., 79 N.Y.2d 253, 258-59 (N.Y. App. 1992); Prudential Reins. Co. v. Superior Court, 3 Cal.4th 1118, 1125 (Cal.

1992). “Since reinsurance is often the largest asset in the insolvent estate, setoff [becomes] a high stakes issue for receivers and for insurers that ceded to or assumed reinsurance from the insurer in receivership.” Robert M. Hall, *Direct Actions and Setoff: The Next Generation*, VIII MEALEY’S REINS. REP., No. 7 at 15 (1997). So it is with the liquidation of Home.

The parties to this dispute share a significant history of mutual dealings. Beginning in 1995, ACE INA Services U.K. Limited (“AISUK”), CIC’s disclosed agent, administered Home’s Rutty Pool business, making required payments directly to Nationwide under the terms of the Assumption Agreement and the pertinent version of Contract R. This was apparently done with little involvement of Home. Had there been no liquidation of Home, the Nationwide overpayments at issue would have been recouped through attrition as claims payments continued in the normal course of business; however, the advent of the liquidation and the triggering of the insolvency clause in the Assumption Agreement foreclosed that opportunity.

Importantly, CIC continues to have substantial and direct involvement with settling AFIA related claims despite the advent of the liquidation. It does so under the post-liquidation protocol negotiated between the parties and approved by the Court in 2004. That protocol expressly anticipates the application of RSA 402-C:34 to the parties’ ongoing dealings. It requires that CIC provide the Liquidator with a monthly accounting of CIC’s claimed setoff position, and in anticipation of potential disputes on setoff, provides both parties with reservations of rights to preserve respective positions.

In this specific dispute, the Liquidator opposes CIC’s claim by asserting that CIC has failed to establish any liability running from Home to CIC, and therefore no setoff is available. While strongly resisting CIC’s assertion of setoff as inapposite, the Liquidator concedes, nonetheless, that CIC has a future entitlement to share in the economic benefit that Home receives from the arbitration award, likely to first occur when Home sets off the award’s value against Nationwide claims presented to the Home estate. As there seems to be little doubt expressed by the Liquidator that Home will at some point gain the full value of the award as Nationwide claims are processed, this disputed claim is really about *when* CIC is entitled to the economic benefit of the arbitration award, rather than *whether* CIC is so entitled.

The Referee has difficulty with the Liquidator’s position. In reviewing the parties’ protocol on AFIA related claims, it seems fair to conclude that the provisions addressing setoff were included to accommodate the necessary and usual practice of netting out credits and debits before CIC’s net debtor status would emerge with some clarity. However, instead of allowing a debit in this instance, the Liquidator takes the position that CIC’s remedy vis-à-vis the Nationwide overpayments is to await Nationwide claims allowances or enlist the Liquidator’s cooperation in a recoupment action under the terms of Paragraph 5 of the Assumption Agreement.

The Referee has been unable to rely on any case specifically on point with the factual circumstances in this dispute; however, the “O’Connor case,” cited by CIC at oral

argument<sup>1</sup>, is noteworthy. See: O'Connor v. Insurance Co. of North America, 622 F. Supp. 611 (N.D.Ill. 1985). There, the court was faced with a dispute between Reserve's liquidator and twenty-six of its reinsurers. Over a number of years prior to the liquidation, Reserve was a party to a number of reinsurance contracts insuring property risks in the petroleum and petrochemical industries. In that federal action, the liquidator presented a number of claims on behalf of Reserve arising out of these activities, and the reinsurers asserted setoffs on the basis of amounts Reserve owed them pursuant to the reinsurance contracts. The liquidator argued the setoffs could only be determined in the liquidation court, and important to the matter at issue here, that the reinsurers were not entitled to the claimed setoffs.

After a quick determination that matters at issue could be litigated before it, the court then embarked upon a discussion of the requirements for asserting setoff. Its analysis is relevant to the present dispute:

'The right of set-off may be asserted in the bankruptcy proceedings even though at the time the petition is filed one of the debts involved is absolutely owing but not presently due, or where a definite liability has accrued but is as yet unliquidated.' 4 Collier on Bankruptcy 68.10[2] (14th ed. 1978)...In Cunningham v. Commissioner of Banks, 249 Mass. 401, 144 N.E. 447, 459 (1924), the court stated '[p]rovable debts under the Bankruptcy Act include all liabilities of the bankrupt founded on contract express or implied which existed at the time of the bankruptcy and either were fixed in amount or susceptible of liquidation.' In this case, the reinsurance contract was in existence at the time of Reserve's insolvency. With respect to the reinsurance proceeds, all the claims giving rise to Defendants' liability were filed prior to Reserve's insolvency. Therefore, although the claims were not paid prior to Reserve's insolvency, they were susceptible of liquidation. The unearned premiums on policies still in existence on the date of insolvency became payable on that date, and the amounts were fixed. Accordingly, we find that Defendants' debts are pre-liquidation debts; therefore, mutuality of obligation exists and a set-off is permitted.

O'Connor, 622 F. Supp. 611 at 619. The court specifically rejected the holding in Melco System v. Receivers of Transamerica Ins. Co., 268 Ala. 152 (1958), in which the Supreme Court of Alabama held that the reinsurer incurred no debt to the reinsured until the reinsured had actually paid the losses.

The Liquidator's argument that here Home owes nothing directly to CIC gives pause, but the fact that Home presently holds a credit against Nationwide claims in the amount of \$1.25 Million cannot be ignored. While it may be true that the Liquidator and Nationwide have yet to fully "account" between them for the value of the arbitration award, the liquidation process will yield that accounting in time. Were the Liquidator in a position to

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<sup>1</sup> While CIC referenced the "O'Connor" case at argument, the case was not actually cited in CIC's pleadings.

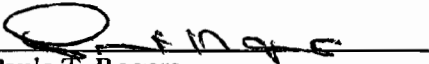
argue that Home would never use its setoff or otherwise receive the benefit from CIC's overpayments, the Referee would be inclined to give additional consideration to his posture on this matter; however, that is not the case here. While it is certainly necessary for the Liquidator to carefully evaluate any assertions of reinsurer setoff to assure that the reinsurance assets are fully collected, withholding setoff when a Home credit to CIC for overpayments to Nationwide is all but inevitable brushes against that often noted absurdity of "A paying B when B owes A." Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 18 (1995) ("The right of setoff (also called 'offset') allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'," quoting Studley v. Boylston Nat. Bank, 229 U.S. 523, 528 (1913)).

### Conclusion

Based on the foregoing, the Referee finds that CIC's claim to setoff relating specifically to the \$1.25 Million Nationwide arbitration award is reasonable and proper. Home has received a benefit in that it holds an enforceable final judgment in its favor with respect to the amount it is owed from Nationwide. However, the Referee agrees with the Liquidator that CIC has failed to establish any foundation for its contingency setoff claim. Therefore, that element of CIC's claim is dismissed.

So ruled:

Dated: August 15 2006

  
Paula T. Rogers  
Referee