

The impact of different approaches to settlement credits

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Presentation outline

- Theme
 - Choice of law for settlement credits strongly affects settlement incentives and impacts non-settling insurers
- Outline
 - Describe a hypothetical environmental claim
 - Analyze two factors:
 - Choice of law—settlement credits based on policy limits or settlement amount
 - Solvency of insurers—completely solvent or insolvency risk

Hypothetical fact pattern for BusyMart's liability

- Liability
 - \$100 million environmental loss
 - \$10 million per year for ten years—2006 to 2015
 - Net present value of \$75 million
- Coverage
 - BusyMart has \$1 billion in total coverage
 - XYZ insurance has \$30 million of coverage

Coverage reimbursement under pay-as-you-go

- Without any settlement agreement, XYZ pays \$30 million over time
- These payments have a present value of \$20 million

	XYZ		All other insurers		Total	
	Nominal	Present value	Nominal	Present value	Nominal	Present value
Pay-as-you-go	\$30 M	\$20 M	\$70 M	\$55 M	\$100 M	\$75 M

BusyMart settles with XYZ for \$20 million in 2005

- XYZ is released from its policies
- The value of all other insurance coverage depends on the choice of law

	XYZ		All other insurers		Total	
	Nominal	Present value	Nominal	Present value	Nominal	Present value
Pay-as-you-go	\$30 M	\$20 M	\$70 M	\$55 M	\$100 M	\$75 M
XYZ settles for \$20 M	\$20 M	\$20 M	?	?	?	?

When settlement credit equals policy limits, non-settling insurers pay the same as under pay-as-you-go

- Other insurers receive a \$30 million offset from the XYZ settlement
- Other insurers still pay \$70 million nominal, \$55 million present value

		XYZ		All other insurers		Total	
		Nominal	Present value	Nominal	Present value	Nominal	Present value
Pay-as-you-go		\$30 M	\$20 M	\$70 M	\$55 M	\$100 M	\$75 M
XYZ settles for \$20 M	Policy limits	\$20 M	\$20 M	\$70 M	\$55 M	\$90 M	\$75 M

When settlement credit equals settlement amount (pro-tanto), non-settling insurers pay more than under pay-as-you-go

- Other insurers receive a \$20 million offset from the XYZ settlement
- Other insurers pay \$80 million nominal, \$63 million present value

		XYZ		All other insurers		Total	
		Nominal	Present value	Nominal	Present value	Nominal	Present value
Pay-as-you-go		\$30 M	\$20 M	\$70 M	\$55 M	\$100 M	\$75 M
XYZ settles for \$20 M	Policy limits	\$20 M	\$20 M	\$70 M	\$55 M	\$90 M	\$75 M
	Pro-tanto			\$80 M	\$63 M	\$100 M	\$83 M

Effects of varying settlement credits

- When settlement credit equals policy limit
 - Value of recovery = value of loss
 - Other insurers are unaffected by prior settlements
 - Present value of total recoveries is held constant
- When settlement credit equals settlement amount
 - Value of recovery $>$ value of loss
 - Other insurers are adversely affected by prior settlements
 - Present value of total recoveries increases
 - Total nominal recoveries are held constant

New scenario: same hypothetical fact pattern, but XYZ faces a 50 percent risk of insolvency

- Liability
 - \$100 million environmental clean-up site
 - \$10 million per year for ten years—2006 to 2015
- Coverage
 - BusyMart has \$1 billion in total coverage
 - XYZ has \$30 million of coverage
 - All other insurers cover remaining \$70 million
- Solvency risk
 - XYZ faces a 50 percent risk of insolvency
 - There is a 50 percent chance XYZ will be bankrupt and pay none of its coverage
 - There is a 50 percent chance XYZ will remain solvent and pay all of its coverage

Coverage reimbursement under pay-as-you-go with insolvency risk

- If XYZ stays solvent, it will pay \$30 million over time

		XYZ		All other insurers		Total	
		Nominal	Present value	Nominal	Present value	Nominal	Present value
Pay-as-you-go	Solvent	\$30 M	\$20 M	\$70 M	\$55 M	\$100 M	\$75 M

Coverage reimbursement under pay-as-you-go with insolvency risk

- If XYZ stays solvent, it will pay \$30 million over time
- If XYZ becomes insolvent, it will pay \$0

		XYZ		All other insurers		Total	
		Nominal	Present value	Nominal	Present value	Nominal	Present value
Pay-as-you-go	Solvent	\$30 M	\$20 M	\$70 M	\$55 M	\$100 M	\$75 M
	Insolvent	\$0 M	\$0 M	\$100 M	\$75 M	\$100 M	\$75 M

BusyMart settles with XYZ for the policy's expected present value

- Settlement is for \$10 million in 2005
- XYZ is released from all its policies

		XYZ		All other insurers		Total	
		Nominal	Present value	Nominal	Present value	Nominal	Present value
Pay-as-you-go	Solvent	\$30 M	\$20 M	\$70 M	\$55 M	\$100 M	\$75 M
	Insolvent	\$0 M	\$0 M	\$100 M	\$75 M	\$100 M	\$75 M
XYZ settles for \$10 M		\$10 M	\$10 M	?	?	?	?

Under policy limits, BusyMart assumes XYZ's insolvency risk and is not made whole

- Other insurers receive a \$30 million offset from the XYZ settlement
- Other insurers pay \$70 million nominal, \$55 million present value

		XYZ		All other insurers		Total	
		Nominal	Present value	Nominal	Present value	Nominal	Present value
Pay-as-you-go	Solvent	\$30 M	\$20 M	\$70 M	\$55 M	\$100 M	\$75 M
	Insolvent	\$0 M	\$0 M	\$100 M	\$75 M	\$100 M	\$75 M
XYZ settles for \$10 M	Policy limits			\$70 M	\$55 M	\$80 M	\$65 M
		\$10 M	\$10 M				

Under pro-tanto, other insurers assume XYZ's insolvency risk and BusyMart's recoveries exceed its losses

- Other insurers receive a \$10 million offset from the XYZ settlement
- Other insurers pay \$90 million nominal, \$70 million present value













		XYZ		All other insurers		Total	
		Nominal	Present value	Nominal	Present value	Nominal	Present value
Pay-as-you-go	Solvent	\$30 M	\$20 M	\$70 M	\$55 M	\$100 M	\$75 M
	Insolvent	\$0 M	\$0 M	\$100 M	\$75 M	\$100 M	\$75 M
XYZ settles for \$10 M	Policy limits	\$10 M	\$10 M	\$70 M	\$55 M	\$80 M	\$65 M
	Pro-tanto			\$90 M	\$70 M	\$100 M	\$80 M

Effects of varying settlement credits with insolvency risk

- When settlement credit equals policy limit
 - Value of recovery $<$ value of loss
 - Other insurers benefit from prior settlements
 - Present value of total recoveries decreases
- When settlement credit equals settlement amount
 - Value of recovery $>$ value of loss
 - Other insurers are adversely affected by prior settlements
 - Present value of total recoveries increases
 - Total nominal recoveries are held constant

Summary of incentives

- Pro-tanto unambiguously increases the incentive to settle
- This incentive is financed by increasing and accelerating the payments of non-settling insurers

	Policy limits			
	Solvent	Insolvent	Solvent	Insolvent
Incentive to settle				
Recovery for BusyMart				
Payment by other insurers				

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