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Inside:

Industry Custom and Practice Versus Judicial Fiat: Something's Gotta Give

Sing a Song of Reinsurance

By EUGENE WOLLAN, ESQ.

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There is a conflict in the reinsurance business, and neither side is budging. The dispute? Whether expenses are within or in addition to the limits of a facultative reinsurance contract. Industry custom and practice says "in addition"; the Second Circuit says "within." Players in the reinsurance business need to know which voice is louder.

When an irresistible force such as you
Meets an old immovable object like me,
You can bet, as sure as you live,
Something's gotta give,
Something's gotta give,
Something's gotta give.[1]

What happens when an irresistible force meets an immovable object? In the words of the immortal poet (and lyricist) Johnny Mercer, "Something's gotta give." But which something?

The reinsurance business has recently generated a less lyrical version of the question. One of the special characteristics of reinsurance has always been its heavy emphasis on tradition or, to tap a familiar phrase, "industry custom and practice." Call "industry custom and practice" the immovable object, and call directly contrary case law the irresistible force. Not even Johnny Mercer can tell us with certainty which of them will prevail in the long run. But if I were a betting man, I'd put about $75 on the irresistible force.

"Something's gotta give." But which something?

Within or In Addition

The current tension between industry practice and judicial fiat arises out of the debate over whether expenses are within or in addition to the limits of a facultative reinsurance contract. Every facultative certificate, for rather obvious reasons, sets forth a limit of the reinsurer's liability. Most certificates also embody language, in one form or another, requiring the reinsurer to pay its share of "expense," meaning loss adjustment expense, legal fees, and the like. (We will pass over the hot topic of whether it includes declaratory judgment expenses, as that subject calls for a column of its own and, no matter what view I hold, expressing it will make me enemies.) Finally, most certificates also incorporate some formulation of the follow-the-fortunes or follow-the-settlements principle, which would probably be read into the contract even if it is not articulated.

The understanding in the reinsurance world since time immemorial has been that the reinsurer's share of expense is not charged against its limit of liability — in other words, the expense is in addition to the limit. Then, along came Bellefonte Reinsurance Co. v. Aetna, 903 F.2d 910 (2d Cir. 1990).

Strike One

Bellefonte was decided in 1990 by the U.S. Court of Appeals for the Second Circuit. It held that expense was within — i.e., subject to — the limit. The cedent in that case relied heavily on the phrase in the certificate

Continued on page 4

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Arbitrated Commutations of Reinsurance Receivables in a Receivership:

The Uniform Receivership Law

By Robert M. Hall

[Robert M. Hall is "of counsel" in the Washington D.C. office of Rudnick & Wolfe. He is a former insurance and reinsurance company executive and acts as an arbitrator and mediator of reinsurance disputes. The views expressed in this article are those of the author and do not represent the views of Rudnick & Wolfe or its clients. Copyright 1999 by the author. This article first appeared in Mealey's Litigation Report: Insurance Insolvency.]

Introduction

Insolvent insurers with pollution, asbestos and other long-tailed liability exposures may require twenty, thirty or even more years to run off all losses. The costs and effort involved in such extended estates have caused receivers to examine methods for an earlier closing. Receivers generally have the power to shorten this period by providing a cutoff date for making and proving claims. However, this is sometimes characterized as prejudicing claimants with latent injuries and creating a windfall for reinsurers which would indemnify the estate for a portion of such latent injuries.

Receivers in California, Missouri and New Jersey have attempted to resolve this dilemma by estimating long-tailed claims and accelerating reinsurance recoverables related to such claims. Several states have enacted or attempted to enact legislation intended to allow some form of estimation and acceleration. Reinsurers have opposed these efforts[1] with growing success. Litigation in New Jersey over the receiver's statutory authority to estimate and accelerate claims is ongoing with no end in sight. Absent compromise or alternatives, extended litigation seems to be the pattern for the future.

The merits of the arguments for and against claims estimation and acceleration are detailed elsewhere and need not be recounted here. However, the debate has generated efforts to find alternatives which may serve as acceptable compromises for both receivers and reinsurers. One such compromise calls for arbitrated commutations of reinsurance recoverables.

The Interstate Receivership Compact

The concept of an interstate compact for insurance company receiverships originated in an effort to assure more consistency and quality to the receivership process without resorting to a federal system.[2] Three states (Illinois, Michigan and Nebraska) have formed the Interstate Receivership Compact (hereinafter "Compact") and others are considering joining. It remains to be seen how many states will ultimately joint the compact and what influence it will have generally over the administration of insurance company receiverships in the fifty states. Nonetheless, the first stage of the Compact's efforts, drafting a Uniform Liquidation Law (hereinafter "URL"), may have an impact far beyond the states which actually join the Compact.

The URL Effort

The URL was drafted over two years by receivers, regulators and representatives of guaranty funds, insurers and reinsurers. The drafting committee initially used existing state law as a model. However, the effort evolved into what was probably the most comprehensive effort at drafting state receivership law since the Wisconsin liquidation code was drafted in the mid-1960's. This Wisconsin code became the basis for the original Liquidation and Rehabilitation Model Act of the National Association of Insurance Commissioners (hereinafter "NAIC").

The URL is receiving very favorable reviews from veteran observers of U.S. receiverships. On November 21, 1998, the National Conference of Insurance Legislators adopted a resolution endorsing the "URL as an effective mechanism for handling insurance receiverships by establishing a uniform, fair and more efficient means of administering insurance insolvencies within the State-based system." On November 17, 1998, the International Association of Insurance Receivers adopted a resolution noting that "a uniform set of laws to govern insurer insolvencies is necessary for the efficient administration of those insolvencies" and that the URL "provides such a set of laws." In an analysis issued on January 20, 1999, the National Conference of Insurance Guaranty Funds commented that "[o]verall, the URL is superior to the NAIC Model Act and the Uniform Insurers Liquidation Act from the perspective of guaranty associations."[3] This year the Insolvency Subcommittee of the NAIC will study the URL with a final report to be submitted in December, 1999. Some trade associations and states are considering the URL as a complete substitute for current state receivership law.

... some courts have held that a party cannot seek judicial disqualification of an arbitrator before the arbitration is completed.

Chapter 8 of the URL

Some of the more innovative features of the URL are contained in Chapter Eight which, among other things, deals with the termination of estates. While this chapter prohibits mandatory acceleration of reinsurance based on estimated values,[4] it proves a variety of options, other than cut off or run off, by which a receiver may wind up the estate. The receiver may sell

continued on page 9

Sing a Song of Reinsurance

Continued from page 1

calling for the reinsurer to pay its proportion of the liability "in addition" to its share of expense. But the Second Circuit was not persuaded and held that the limit of liability applied overall, capping what the reinsurer must pay the cedent.

Industry practice continued undeterred, however.

Strike Two

Next came Unigard Security Ins. Co. v. North River Ins. Co., 4 F.3d 1049 (2d Cir. 1993), decided by the same court in 1993. The court reaffirmed the Bellefonte rule — and even displayed a bit of petulance that the lower court (which it reversed) had gone the other way, especially so soon after Bellefonte.

Still, the immovable object of custom and practice remained unaffected. In at least one unreported arbitration, involving precisely the same certificate form as in Bellefonte and Unigard, the panel unanimously went down the line for custom and practice — the Second Circuit be damned. How many more such situations there have been, this writer knoweth not.

Strike Three, You're ... Wrong

July 1997 brought us another court decision that not only relies on Bellefonte and Unigard, but seemingly expands their application beyond the specific form of the certificate. The case is Allendale Mutual Insurance Company v. Excess Insurance Company, Ltd., No. 95 CIV. 10970, 1997 WL 379683 (S.D.N.Y. July 8, 1997), and it was decided by Judge Scheindlein in the Southern District of New York (which, for the benefit of readers without a U.S. circuit court map, is in the Second Circuit and, therefore, is obliged to follow Second Circuit decisions).

Telescoping the facts: Allendale fronted a coverage that was reinsured in part by certain U.K. reinsurers for \$7,000,000 (the "limit"), part of the \$13,500,000 layer between \$25,000,000 and \$38,500,000. When the loss payment exhausted the limit, Allendale sought to recover from these reinsurers an additional \$5,000,000 for their share of loss adjustment expense and litigation costs.

Contract Basics

Judge Scheindlein saw her task as resolving an apparent, although not actual, conflict between the limit clause and the follow-the-settlements clause. She turned to basic principles of contract construction for guidance.

I begin the analysis of this question with a recitation of certain contract law fundamentals. "The cardinal principle for the construction and interpretation of insurance contracts — as with all contracts — is that the intentions of the parties should control." ... To determine the parties' intent, the contract must be read as a whole, and all its clauses must be considered together to determine if and to what extent one may modify, explain, or limit another. From this, it follows that a contract containing two clauses which may be in conflict should, if possible, be read to give meaning to both rather than to prefer one to the exclusion of the other. This is especially true when interpreting contracts drafted by sophisticated and experienced entities, for such are not likely to inadvertently write meaningless, contradictory, or vestigial language into a contract.

Judge Scheindlein went on to point out that, if the parties had intended a contrary result, they could easily have made that result clear. For example, the parties could have introduced the follow-the-settlements clause with such language as "notwithstanding any provision to the contrary in this contract." Without that language, the judge admonished:

> ... a straight-forward reading of the contract as a whole requires the opposite conclusion. The limitation clause comes before any other substantive provision of the reinsurance agreement, and the word "LIMIT" is both underlined and set apart physically from the following "CONDITIONS." The term "LIMIT" is not expressly conditioned by another term in any way. Given the absence of any indication that any clause in the contract modified the words "LIMIT: \$US 7,000,000," the most reasonable construction of the contract's language supports [the] defendants' position that the limit clause imposes an absolute cap on their liability at \$7,000,000 in toto.

Respecting Industry Practice

Judge Scheindlein also invoked industry practice, but with a different spin from the one that says expense should be paid in addition to limits:

This reading of the reinsurance agreement is buttressed by an understanding of the traditional role of follow-the-settlement clauses In the reinsurance industry. Such clauses generally reinforce what has been until recently the general practice in this industry — that is, for reinsurers to conduct their business with insurers on a handshake basis, without second-guessing the insurer's decision to pay a claim. ... Their purpose is to "preclude wasteful relitigation by a reinsurer of defenses to underlying policy coverage in cases where the ceding insurer has in good faith paid a settlement or judgment." ... Follow-the-settlement clauses have not traditionally served to modify or eliminate the limit of the reinsurer's exposure.

Respecting Precedent

By the time the judge's analysis turned to Bellefonte and Unigard, the cedant's cause was obviously lost:

Both cases rejected ceding insurers' claims that a follow-the-settlement clause required the reinsurers to pay for defense costs in addition to the reinsurers' express reinsurance limit. The primary ground for these holdings was the court's finding that the insurers' proposed interpretation effectively read the limit clauses out of the reinsurance contracts. Bellefonte explained:

"To read the reinsurance [contract] in this case as [the insurer] suggests — allowing the 'follow the fortunes' ... clause to override the limitation on liability — would strip the limitation clause and other conditions of all meaning; the reinsurer would be obliged merely to reimburse the insurer for any and all funds paid ... The 'follow the fortunes' clauses in the [contracts] are structured so that they co-exist with, rather than supplant, the liability cap."

Bellefonte, 903, F.2d at 913. In addition, Bellefonte relied on the excess language of the contract at issue in that case, pointing out that the insurer's suggested interpretation "would negate the phrase 'the reinsurer does hereby reinsure Aetna ... subject to the ... amount of the liability set forth herein' and concluding based on that language that '[t]he reinsurers are liable only to the extent of the risk they agreed to reinsure.'" Id. at 914.

... [T]he primary underpinning of both cases is the parties' assumed intent to give meaning to both the limit clause and the follow-the-fortunes clause. To fulfill this intent, the reinsurers' duty to follow the settlement must be understood to be capped by the limit clause. "To construe the [contracts] otherwise would effectively eliminate the limitation on the reinsurer's liability to the stated amounts."

Finally, Judge Scheindlein regarded the fact that Bellefonte and Unigard involved liability insurance and Allendale property insurance as a distinction without a difference:

These arguments rely on the kind of "idiosyncratic factors" that Unigard teaches should not be considered in determining whether a follow-the-settlement clause may extend a reinsurer's liability beyond the stated liability limit, see Unigard, 4 F.3d at 1071, and cannot allow Allendale to evade the clear holdings of Bellefonte and Unigard with regard [to] the effect of a standard follow-the-settlement clause on a limit clause in a reinsurance contract.

While the follow-the-settlement clause requires defendants to accept Allendale's good faith decisions to settle a case, and to pay their proportion of that settlement, it does not increase their potential liability in excess of the risk for which they bargained. As a matter of law, the limit clause must be interpreted to cap the reinsurers' liability to $7,000,000 including all of Allendale's costs and expenses. Hence, the terms of the reinsurance agreement preclude Allendale's claim for loss adjustment expenses in addition to its claim for $7,000,000 in unpaid reinsurance.

The Conflict That Lies Ahead

Many members of the reinsurance community were shocked by Bellefonte and Unigard, not because they were inherently horrifying decisions, but because they ran in the face of long-standing industry practice. What we see in Allendale is reaffirmation and expansion of the judicial position: The irresistible force continues to roll on. However, there is no clear indication that the immovable object has even begun to give way, and it may be some time before that starts to happen. Insurance and reinsurance folk can be awfully stubborn, but the Second Circuit in general and New York in particular are important insurance venues. I'm guessing the people in the long black robes will eventually succeed in laying down the law.

Endnotes

[1] SOMETHING'S GOTTA GIVE, by Johnny Mercer. @ 1954, 1955 (Renewed) WB Music Corp. All Rights Reserved. Used by Permission. WARNER BROS. PUBLICATIONS U.S. INC., Miami, FL 33014

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Continued from page 3

some or all of the business to another entity.[5] The receiver may sell the reinsurance recoverables to a third party[6] and/or transfer responsibility for claims handling to one or more guaranty funds or another qualified entity.[7] Some of the assets and liabilities of the estate may be transferred to a liquidating trust for long-tailed claims.[8]

The right of the receiver to enter into voluntary commutations is specifically recognized[9]. However, the URL also recognizes commutation provisions built into reinsurance contracts to the extent they were not entered into with reasonable cause to believe that the cedent was insolvent or about to become insolvent.[10]

One of the more creative aspects of Chapter 8 is its mandatory negotiation and arbitration provisions[11] which allows the receiver to force an arbitration of the value of outstanding and incurred but not reported (hereafter "IBNR") losses. Once the arbitration is complete, the reinsurer must pay or provide collateral for the value of their reinsurance payables as found by the arbitration panel.

The mandatory arbitration procedure may be invoked by the receiver via court order when: (1) reserves for outstanding claims and IBNR on casualty business is 25% or less of total estate liability; or (2) the reinsurer's total adjusted capital is at or below 200% of its authorized control level for risk-based capital purposes.[12] The first point is meant to assure a mature book of business which can be subject to relatively accurate actuarial estimation.[13] The second point allows an exception to such maturity requirement when the reinsurer is approaching unsound financial status.

Within 90 days of a court order authorizing arbitration, the receiver and the reinsurer will exchange their estimates of liability along with relevant documents and underlying data such as premiums, losses, projected payout patterns, discount factor and net present value of outstanding losses and IBNR.[14] If the parties cannot reach agreement 90 days thereafter, either party may demand arbitration of the proper commutation amount.[15]

Should arbitration ensue, the receiver and the reinsurer each select an arbitrator who shall be a "disinterested active or inactive officer, executive or other professional with no less than ten years experience in or serving the insurance industry."[16] In arbitration circles, "disinterested" generally is interpreted to mean not financially interested in the outcome of the dispute but not necessarily impartial. This is in keeping with the school of thought that party arbitrators have some advocacy role in typical reinsurance arbitrations. In addition, the quoted language differs from the qualifications commonly required for reinsurance arbitrators in that professionals other than officers or executives of insurers or reinsurers qualify. Given the nature of the financial deliberations involved, this language certainly allows the selection of those who have spent their careers in accounting or actuarial firms. However, the language might also allow the selection of members of law firms, regulators and receivers.

The umpire for the panel is selected by the party arbitrators. In contrast to the qualifications for arbitrators, the umpire must be "independent, impartial, disinterested" and be "an active or inactive officer or executive of an insurance or reinsurance company."[17] The "independent" and "disinterested" language suggests that the umpire must not be under the control of any relevant party and have no financial interest in the result of the arbitration. The "impartial" language suggests that the umpire must have no pre-disposition on the issue involved in the arbitration. The requirement of insurance or reinsurance company background suggests a desire for experience grounded in the manner in which insurers and reinsurers project, estimate and discount their loss reserves.

Once the arbitration panel is in place, the URL does not provide structure or procedures for the arbitration. The panel develops its own procedures, which dictates an umpire, ...

Should the party arbitrators be unable to agree on an umpire, they will each name three qualified individuals and strike two from the other's list. The umpire is chosen by drawing of lots.[18] In the reinsurance arbitration context, this often takes the form of guessing whether the Dow Jones Industrial Average for a future date will be odd or even.

Once the arbitration panel is in place, the URL does not provide structure or procedures for the arbitration. The panel develops its own procedures, which dictates an umpire, if not an entire panel, with significant arbitration experience. An award issued by the panel shall be approved by the court absent the limited statutory grounds for vacating an arbitration award under the Federal Arbitration Act.[19]

The URL allows a receiver or reinsurer who is dissatisfied with the result of the arbitration to hedge its bet. A reinsurer can either agree to pay the arbitrated value or disagree and place assets equal to such value into a trust patterned after a credit for reinsurance trust.[20] Should the losses run off in a lesser amount than that calculated by the arbitration panel, the excess is returned to the reinsurer.[21]

Should the reinsurer agree to pay the sum decided upon by the arbitration panel, the receiver may accept this

Continued on page 12

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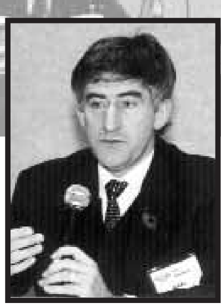

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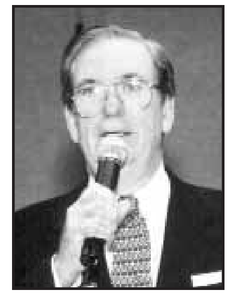

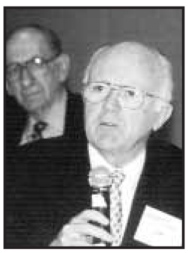

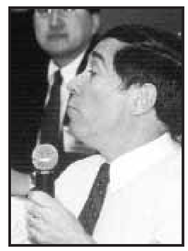

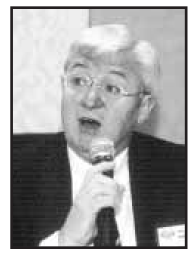

Continued from page 9

The effort to find a procedural middle ground offers the opportunity to wind up estates with long-tailed casualty business at earlier dates while respecting the contractual and legal rights of reinsurers.

tender and deliver a complete release to the reinsurer. The receiver may also decline to provide a release and require that the value of the arbitration panel's award be placed in trust to pay the reinsurer's claims. In this fashion both the reinsurer and receiver are protected against a rogue decision of an arbitration panel. In addition, the receiver has security against the future insolvency of the reinsurer.

Conclusion

The estimation of claims and acceleration of reinsurance recoverables has generated a great deal of controversy and litigation in receivership proceedings. The effort to find a procedural middle ground offers the opportunity to wind up estates with long-tailed casualty business at earlier dates while respecting the contractual and legal rights of reinsurers.

The Compact's URL is a ground breaking effort which allows receivers a menu of options to close estates. One such option is a mandatory arbitration procedure by which the value of reinsurance recoverables is determined and paid or secured. This procedure has the potential to act as the middle ground which can avoid the current litigation and bitterness associated with the acceleration of reinsurance recoverables.

Endnotes:

1. Reinsurers oppose acceleration of reinsurance recoverables on the basis that they are theoretical claims with theoretical values allocated in a theoretical fashion. Reinsurers assert that because reinsurance is a contract of indemnity, they cannot be required to pay losses, such as incurred by not reported losses, which are unidentified or unknown and which, as a result, have not been asserted or allowed in the receivership proceeding.

2. Compare James W. Schacht, Peter G. Gallanis, The Interstate Compact as an Effective Mechanism for Insurance Receivership Reform, J. of Ins. Reg. 188 (1993) with Debra J. Hall,

   Robert M. Hall, Insurance Company Insolvencies: Order Out of Chaos, id. at 145.

3. In the executive summary of its report the Conference stated:

   With provisions dealing with such matters as an automatic stay, standing and appeal rights of affected parties, a document depository maintained by the receiver and the requirement of the filing of a plan for the handling of the insolvency, the URL embodies a modernized, more businesslike approach to the handling of insolvencies. While it would be preferable for certain revisions to be made to sections that are important to guaranty associations, we believe that overall the URL gives proper consideration to guaranty association interests. The URL deals fairly and favorably with such topics as early access, distribution priority and intervention provisions. In considering the URL as replacement legislation, it is critically important to account for and preserve unique provisions in a state's existing liquidation act so that these provisions would not be lost by enactment of the URL.

4. ß 805 D.

5. ß 802 B. (2).

6. Id.

7. ß 802 B. (4). Such a transfer would be an arm's length transaction, wholly voluntary to a guaranty fund.

8. ß 806.

9. ß 808 A.

10. ß 808 B.

11. ß 809.

12. ß 809 A. (1).

13. Some unlucky estates have a wide variety of manuscript, high excess liability coverages written on a surplus lines or other unregulated basis with significantly varying retentions and severe exposure to asbestosis, pollution, tobacco and other latent injuries. Even for highly qualified actuaries, ultimate liabilities for such estates are extremely hard to predict early in the proceeding since losses may be impacted by a wide variety of economic, legislative and judicial factors.

14. ß 809 B. (1).

15. ß 809 B. (2).

16. ß 809 B. (3) (a).

17. Id.

18. Id.

19. ß 809 B. (3) (c). The Federal Arbitration Act, 9 U.S.C.A. ß 10 allows an award to be vacated for a variety of reasons including fraud, corruption, partiality or misconduct of the arbitrators. For a discussion of certain bases for overturning awards under the Federal Arbitration Act, see Robert M. Hall, Paige D. Waters, Partiality Among Arbitration Panelists, VII Mealey's Reins. Rep. 3 at 18 (1997).

20. The trust is placed with a qualified U.S. financial institution and the assets may not be withdrawn without the approval of the receiver. The assets will be placed in specified categories of investments and shall be maintained at a value of 102% of the required amount. See generally ß 810.

21. ß 810 F.

IN MEMORIAM

It is with deep regret

that we report

the passing of

Michael Isaacson,

an active

ARIAS•U.S. member

and Certified Arbitrator.

He will truly be missed.

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