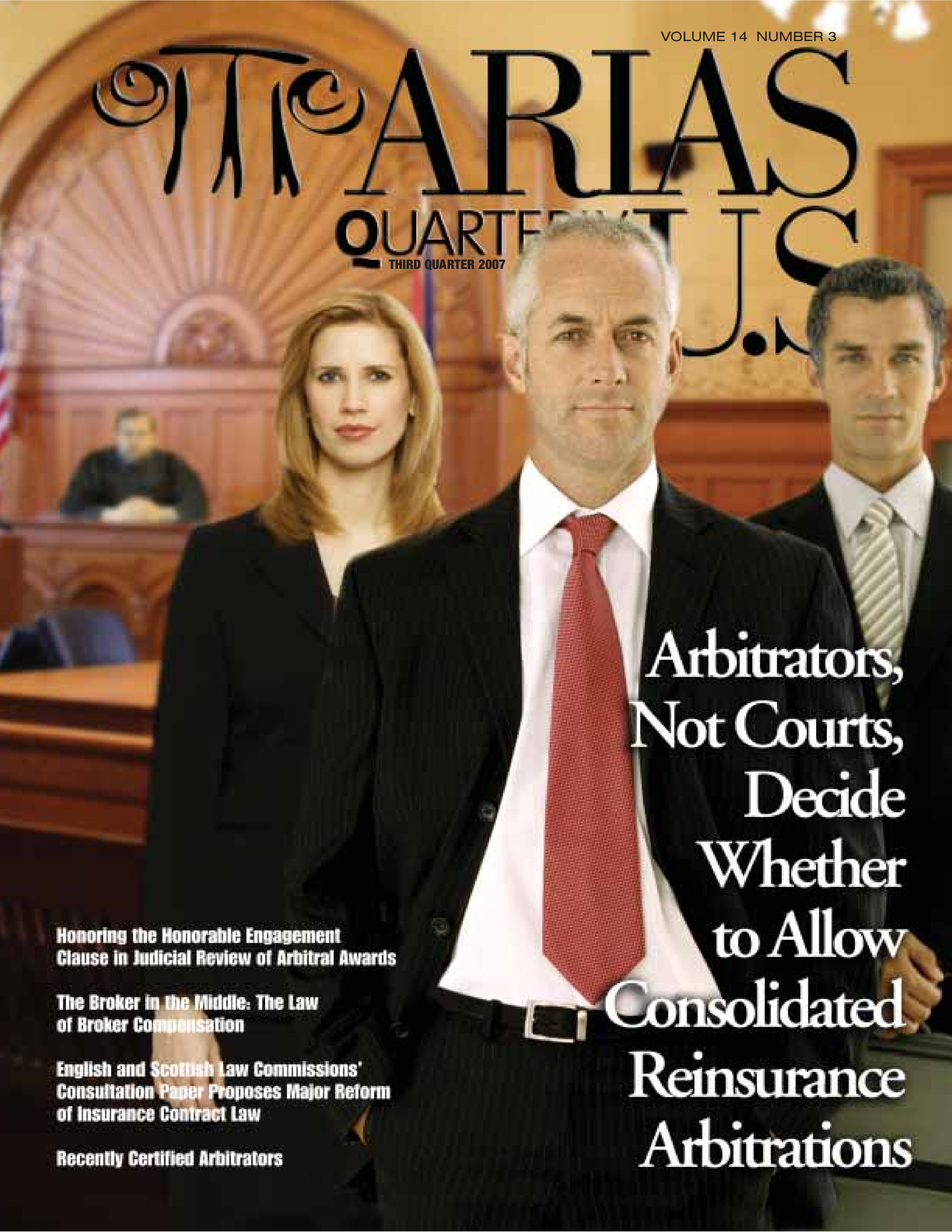
VOLUME 14 NUMBER 3

ARIAS U.S. QUARTERLY

THIRD QUARTER 2007



Arbitrators, Not Courts, Decide Whether to Allow Consolidated Reinsurance Arbitrations

Honoring the Honorable Engagement Clause in Judicial Review of Arbitral Awards

The Broker in the Middle: The Law of Broker Compensation

English and Scottish Law Commissions' Consultation Paper Proposes Major Reform of Insurance Contract Law

Recently Certified Arbitrators

editor's comments

T. Richard Kennedy

It is with special sorrow that we note the passing of our good friend and colleague, Ronald Jacks, who died at his home in New Zealand in July, 2007, after a courageous struggle with cancer. Ron in the early 1990's worked with us as a member of the group that conceptualized and developed the form of organization of ARIAS•US, and went on to serve on the Founding Board of Directors. With his sense of commitment, intellect, and wit, he was an inspiration to us all. We will sorely miss Ron's presence.

A lead article in this issue by Daniel Neppl reviews the dramatic shift in court decisions on who decides questions of arbitration procedure and how this change has affected consolidation questions in reinsurance arbitrations. Any party, counsel, or arbitrator faced with such questions will find excellent guidance in the article, *Arbitrators, Not Courts, Decide Whether to Allow Consolidated Reinsurance Arbitrations*.

"Manifest disregard of the law" is often an argument employed by counsel seeking to set aside an arbitral award. Natasha Lisman, in *Honoring the Honorable Engagement Clause in Judicial Review of Arbitral Awards*, raises the very interesting question of whether an honorable engagement clause may not expressly waive judicial scrutiny for manifest disregard of the law. It is to be hoped the courts may clarify the question, as the author suggests.

The Broker in the Middle: the Law of Broker Compensation, by Louis Aurichio and Amy Kelley, discusses recent court decisions that provide new guidance with respect to important issues surrounding broker retention and compensation.

Two English lawyers, Ali Sallaway and Paul Wortley, inform us of proposed significant changes in insurance contract law in *English and Scottish Law Commissions' Consultation Paper Proposes Major Reform of Insurance Contract Law*. The reforms, if adopted, likely will have a substantial effect not only on English and Scottish insurance transactions but also on international insurance and reinsurance disputes.

Program Co-chairs David Robb, Deirdre Johnson, and Steven Schwartz are hard at work planning an interesting and engaging session for us all at the Fall Annual Meeting. I look forward to seeing each of you at the New York Hilton on November 1st and 2nd.

contents

VOLUME 14 NUMBER 3

Editorial Policy

ARIAS•U.S. welcomes manuscripts of original articles, book reviews, comments, and case notes from our members dealing with current and emerging issues in the field of insurance and reinsurance arbitration and dispute resolution.

All contributions must be double-spaced electronic files in Microsoft Word or rich text format, with all references and footnotes numbered consecutively. The text supplied must contain all editorial revisions. Please include also a brief biographical statement and a portrait-style photograph in electronic form.

Manuscripts should be submitted as email attachments to trk@trichardkennedy.com .

Manuscripts are submitted at the sender's risk, and no responsibility is assumed for the return of the material. Material accepted for publication becomes the property of ARIAS•U.S. No compensation is paid for published articles.

Opinions and views expressed by the authors are not those of ARIAS•U.S., its Board of Directors, or its Editorial Board, nor should publication be deemed an endorsement of any views or positions contained therein.

feature

Arbitrators, Not Courts, Decide Whether To Allow Consolidated Reinsurance Arbitrations

Daniel J. Neppl

Daniel J. Neppl

Arbitration is a creature of contract, and only disputes that parties agreed to arbitrate are subject to arbitration. For more than 20 years, parties to contracts containing arbitration provisions have argued from this premise that they cannot be forced to participate in a consolidated arbitration absent their consent. Consequently, if one party initiated a consolidated arbitration, the opposing party typically filed a lawsuit and asked the court to declare that a consolidated arbitration was unavailable absent the consent of both parties.

Courts routinely agreed, and the decided weight of authority held that courts lacked the power under the Federal Arbitration Act ("FAA") to order consolidation unless the parties' agreement expressly so provided. These cases involved (1) arbitrations between the same parties under different contracts, (2) arbitrations between different parties under similar/identical contracts, and (3) arbitrations between different parties under different contracts. The courts themselves decided the number-of-arbitrations question and did not refer the question to the arbitrators to decide. *See, e.g., American Centennial Ins. Co. v. National Cas. Co.*, 951 F.2d 107 (6th Cir. 1991); *Protective Life Ins. Corp. v. Lincoln Nat'l Life Ins. Corp.*, 873 F.2d 281 (11th Cir. 1989); *Del E. Webb Constr. v. Richardson Hosp. Auth.*, 823 F.2d 145 (5th Cir. 1987), overruled by *Pedcor Management Co. v. Nations Personnel of Texas, Inc.*, 343 F.3d 355 (5th Cir. 2003); *Clarendon Nat'l Ins. Co. v. John Hancock Life Ins. Co.*, No. 00 Civ. 9222 (LMM), 2001 U.S. Dist. LEXIS 13736 (S.D.N.Y. 2001); *Home Ins. Co. v. New England Reinsurance Corp.*, No. 98 Civ. 9772 (JFK), 1999 U.S. Dist. LEXIS 13421 (S.D.N.Y. 1999); see also MANUAL FOR THE RESOLUTION OF REINSURANCE DISPUTES § IV(G) (R.A.A. Oct. 2006).

Beginning in 2002, however, the landscape fundamentally changed with two United States Supreme Court decisions considering arbitration issues, *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79 (2002) ("*Howsam*"); and *Green Tree Fin. Corp. v. Bazzle*, 539 U.S. 444 (2003) ("*Green Tree*"). In these decisions, the Court held that questions of arbitration procedure are strictly for arbitrators to decide in the first instance and that only certain "gateway" arbitrability questions are reserved for the courts. Changing the old rule of no consolidation absent consent of the parties, these decisions provided the foundation for recent developments in the law of arbitration. This article addresses how these two decisions have been applied to change the landscape in the reinsurance arbitration context.

In these decisions, the Court held that questions of arbitration procedure are strictly for arbitrators to decide in the first instance and that only certain "gateway" arbitrability questions are reserved for the courts

Howsam and *Green Tree*

In *Howsam*, an investor claimed that a brokerage firm had made misrepresentations concerning certain investment vehicles. The brokerage agreement between the investor and brokerage firm contained an arbitration clause that allowed the investor to choose the arbitration forum. She chose arbitration before the National Association of Securities Dealers ("NASD"), whose Code of Arbitration Procedure required any claims to be brought within six years. 537 U.S. at 81-82.

The brokerage firm brought an action in federal court, seeking a declaration that the investor's claim was time-barred because more than six years had passed. Determining that the NASD should interpret and determine applicability of the six-year limitations period, the district court dismissed the brokerage firm's complaint. The United States Court of Appeals for the Tenth Circuit reversed, concluding that the district court should determine whether the arbitration should proceed at all, in light of the time-bar, because applicability of the time-bar was a matter of substantive arbitrability for the court to decide. After granting *certiorari*, the U.S. Supreme Court reversed the Tenth Circuit's decision.

Daniel J. Neppl is a partner in the Chicago office of Sidley Austin LLP, where he arbitrates and litigates reinsurance disputes on behalf of ceding companies and reinsurers.

Emphasizing the liberal federal policy favoring arbitration, the Supreme Court held that "procedural questions" that grow out of an arbitrable dispute are "presumptively not for the judge, but for an arbitrator, to decide." Id. at 84 (emphasis in original). The Court explained:

> Linguistically speaking, one might call any potentially dispositive gateway question a "question of arbitrability," for its answer will determine whether the underlying controversy will proceed to arbitration on the merits. The Court's case law, however, makes clear that, for purposes of applying the interpretive rule, the phrase "question of arbitrability" has far more limited scope. The Court has found the phrase applicable in the kind of narrow circumstance where contracting parties would likely have expected a court to have decided the gateway matter, where they are not likely to have expected a court to have decided the gateway matter, where they are not likely to have thought that they had agreed that an arbitrator would do so, and, consequently, where reference of the gateway dispute to the court avoids the risk of forcing parties to arbitrate a matter that they may well have not agreed to arbitrate.

537 U.S. at 83-84.

In determining that the time-bar issue was for the arbitrators to address, the Court noted that the result aligned the decisionmaker with its comparative expertise in order to secure a fair and expeditious resolution of the underlying dispute - a fundamental goal of arbitration. *Id*. at 85. Accordingly, under *Howsam*, "procedural disputes," even those that would be outcome-determinative regarding an arbitration, are to be resolved by the arbitrators, and not by a court. Id.

One year after deciding *Howsam*, the Court ruled in *Green Tree* that whether an arbitration could be conducted as a class action was a matter of arbitration procedure for the arbitrator to decide. There were two lawsuits filed in South Carolina state courts, each seeking to be certified as class actions. Each of the contracts at issue in Green Tree - loan agreements between consumers and a finance company - called for arbitration before an arbitrator appointed by the finance company and consented to by the consumers. The contracts were silent regarding the availability of class arbitration. The consumers sued the finance company for failing to provide the disclosures and loan contract provisions mandated under South Carolina lending laws. They asked the South Carolina court to certify their lawsuits against the finance company as a class action, and the finance company moved to compel arbitration based on the arbitration clause in the loan agreements. The South Carolina court granted both requests, and then the arbitrator proceeded with the arbitration on a class basis because of the state court's certification order. In the class arbitration that ensued, the arbitrator issued an award against the finance company. The finance company challenged the award in the South Carolina state courts, arguing that the class-based arbitration not only was not provided for in the arbitration clauses, but also that those contracts precluded class arbitration. The South Carolina courts confirmed the award.

On *certiorari*, the Supreme Court vacated the lower court decisions, determining in a plurality decision that the availability of class arbitration was a question of contract interpretation and arbitration procedure that the arbitrator had to decide in the first instance. Id. at 454. Referring to its decision in *Howsam*, the Court stressed that only a narrow set of gateway arbitrability questions are reserved for a court, and the narrow set did not include the availability of class arbitration:

> The question here - whether the contracts forbid class arbitration - does not fall into this narrow exception. It concerns neither the validity of the arbitration clause nor its applicability to the underlying dispute between the parties. Unlike First Options [of Chicago, Inc. v. Kaplan, 514 U.S. 938 (1995)], the question is not whether the parties wanted a judge or an arbitrator to decide whether they agreed to arbitrate a matter. 514 U.S. at 942-45, 115 S. Ct. 1920. Rather the relevant question is what kind of arbitration proceeding the parties agreed to. That question does not concern a state statute or judicial procedures. ... It concerns contract interpretation and arbitration procedures.

Id. at 452-53 (emphasis in original). Further finding that "[a]rbitrators are well situated to answer that question" of contract interpretation and arbitration procedure, *id*. at 453, the Court vacated the South Carolina Supreme Court's judgment and remanded the case so that the arbitrator could decide whether to allow a class arbitration.

The plurality nature of the decision has been discussed by lower courts and litigants attempting to implement the Supreme Court's ruling in *Green Tree*. *Compare Employers Ins. Co. v. Century Indem. Co*., 443 F.3d 573, 578-579 (7th Cir. 2006), *with Pedcor Management Co. v. Nations Personnel of Texas, Inc*., 343 F.3d 355, 358 (5th Cir. 2003). A plurality decision is one in which the majority of Justices cannot agree on a single rationale for the Court's decision. In applying a plurality decision, lower courts look to the narrowest grounds taken by the separate Justices concurring in the judgment. *Marks v. United States*, 430 U.S. 188, 193 (1977).

The Legal Landscape Prior to *Howsam* and Green Tree

Prior to *Howsam* and *Green Tree*, courts themselves decided how many arbitrations would be conducted. This was true for numerous types of arbitral disputes, including reinsurance disputes. For example, in *American Centennial Ins. Co. v. National Cas. Co*., 951 F.2d 107 (6th

CONTINUED ON PAGE 4

After Howsam, the only issues remaining for the courts to decide were (a) whether an arbitration clause is binding and (b) whether an arbitration clause applies to the particular type of dispute between the parties.

CONTINUED FROM PAGE 3

Cir. 1991), American Centennial was reinsured under eight separate reinsurance contracts by National Casualty Company and Scottsdale Insurance Company. Refusing to order consolidation of disputes arising out of all eight contracts "when the agreement is silent regarding consolidation," the court itself resolved the number-of-arbitrations issue. 951 F.2d at 108.

In *Home Ins. Co. v. New England Reinsurance Corp.*, No. 98 Civ. 9772 (JFK), 1999 U.S. Dist. LEXIS 13421 (S.D.N.Y. 1999), the court likewise resolved the number-of-arbitrations issue in the first instance. After entertaining arguments in favor of and against consolidation, the court refused to order consolidation of arbitrations under four reinsurance treaties because the court found no evidence that the "individual agreements entered into as part of an overall plan should be treated as one agreement." *Id*. at *5.

A different judge in the same federal district court reached the same conclusion in *Clarendon Nat'l Ins. Co. v. John Hancock Life Ins. Co.*, No. 00 Civ. 9222 (LMM), 2001 U.S. Dist. LEXIS 13736 (S.D.N.Y. 2001). In that case, Clarendon demanded three arbitrations arising out of ten reinsurance contracts that involved three different types of reinsurance programs. Hancock objected and sought consolidation of all disputes arising out of all ten contracts and all three programs because "separate arbitrations would be wasteful, inefficient and repetitive." *Id.* at *3. Deciding the number-of-arbitrations issue itself, the court held that (absent an agreement by both sides to consolidate) ten separate arbitrations would be required, one under each contract. *Id*. at pp. *11-12.

Finally, in *Connecticut General Life Ins. Co. v. Sun Life Assurance Co.*, 210 F.3d 771 (7th Cir. 2000), seven retrocessionaires sought to compel two retrocedents to participate in a single arbitration. (The retrocedents were members of the same pool.) Although the court decided the number-of-arbitrations question itself, it noted that "[n]one of the parties contends that the issue of one versus many arbitrations is for the arbitrators rather than the court to decide." 210 F.3d at 773. Resolving the number-of-arbitrations issue, the Seventh Circuit distinguished the cases not ordering consolidation and stated that the proper analysis should focus on whether the contract allows consolidation, which is a matter of contract construction. The court stated that consolidation should not be disfavored, and it ultimately concluded that a number of provisions in the reinsurance contract, as well as practical considerations, favored ordering a single arbitration to resolve the parties' disputes. *Id*. at 776.

The Impact of *Howsam* and *Green Tree*

After the Supreme Court's decisions in *Howsam* and *Green Tree*, the lower courts' approaches profoundly changed. By holding that a seemingly substantive, outcome-determinative rule (a time-bar) was a procedural question for arbitrators to decide, the Court in *Howsam* expanded what issues were considered "procedural" for presentation to arbitrators. After *Howsam*, the only issues remaining for the courts to decide were (a) whether an arbitration clause is binding and (b) whether an arbitration clause applies to the particular type of dispute between the parties.

Evidencing its preference for sending to arbitration all but the most basic threshold issues, the Court in *Green Tree sua sponte* determined who should decide whether a contract allowed a class arbitration (none of the parties had briefed or argued the issue). Although the decision garnered only a plurality of the Justices, the end result was that the case was remanded with instructions to have the arbitrator decide whether the contract allowed for a class arbitration. Coupled with the decision in *Howsam* a year earlier, *Green Tree* paved the way for the argument to be made that the number-of-arbitrations issue presented a question of arbitration procedure for the arbitrators to decide.

Lower federal appeals courts have largely been receptive to this argument.[1] The First Circuit adopted this approach in *Shaw's Supermarkets, Inc. v. United Food and Commercial Workers Union*, 321 F.3d 251 (1st Cir. 2003), holding that a single arbitrator should decide how many arbitrations should be conducted in multiple labor grievances presented under multiple collective bargaining agreements between the same employer and same union. The Fifth Circuit also adopted this approach in *Pedcor Management Co. v. Nations Personnel of Texas, Inc.*, 343 F.3d 355 (5th Cir. 2003), holding that whether to hold a class arbitration under more than 400 reinsurance contracts should be decided by the arbitrator in the first instance. Finally, the Fourth Circuit reached a similar conclusion in an analogous situation; in *Dockser v. Schwartzberg*, 433 F.3d 421 (4th Cir. 2006), the court held that whether the parties' dispute should be presented to one arbitrator or three arbitrators under the American Arbitration Association's rules governing complex commercial arbitrations was a procedural question for the arbitral body to decide in the first instance.

Relying principally on *Howsam* and *Green Tree*, parties seeking to consolidate multiple contracts in a single arbitration have argued that whether consolidation is permissible presents a question of arbitration procedure to be decided by arbitrators, not courts, in the first instance. Lower federal courts grappling with the impact of Howsam and Green Tree have largely accepted this argument. In 2006 and 2007, federal appeals courts in three reinsurance disputes agreed with parties who made this argument, sending the number-of-arbitrations question to the arbitrators.

1. *Employers v. Century*

The first federal appellate decision to address whether courts or arbitration panels decide consolidation questions in the reinsurance context was the United States Court of Appeals for the Seventh Circuit's decision in *Employers Ins. Co. v. Century Indem. Co.*, 443 F.3d 573 (7th Cir. 2006) ("*Employers v. Century*").[2] The case concerned the number of arbitrations to be held between the cedent and reinsurer regarding asbestos losses presented under two layers of a reinsurance treaty program. The particular issue that divided the cedent ("Century") and reinsurer ("Wausau") was who would decide whether the parties would arbitrate their dispute in one or two arbitrations - a court or an arbitration panel?

Century had billed asbestos losses to Wausau under a reinsurance program consisting of two layers: a First Excess Agreement and a Second Excess Agreement. After Wausau failed to pay, Century demanded a single arbitration against Wausau under both layers, each of which called for tri-partite arbitration to resolve disputes arising out of the agreement. Wausau refused to participate in a single arbitration, arguing that the First Excess Agreement and Second Excess Agreements were separate contracts and contained no language expressing Wausau's consent to participate in a single arbitration involving both contracts.

Relying on cases holding that arbitrations could not be consolidated absent the parties' consent, Wausau filed an action in federal court in Wisconsin and asked the court to declare that Century's arbitration demand must result in multiple arbitrations, one under each layer. Century responded that the court decisions relied on by Wausau no longer controlled because the Supreme Court's decisions in *Howsam* and *Green Tree* required the district court to send the number-of-arbitrations question to the arbitrators to decide in the first instance. The district court accepted Century's argument, directed Wausau to appoint a single arbitrator in response to Century's demand, and ordered Wausau to raise its number-of-arbitrations issue with the arbitrators appointed in response to the demand.[3] Wausau appealed.

While conceding that the disputes were arbitrable, Wausau offered two principal arguments on appeal. First, Wausau argued that because federal courts had been deciding consolidation questions for more than 20 years, this created a presumption that consolidation is a gateway question of arbitrability for courts to decide in the first instance, not a procedural question for the arbitrators to decide. Second, Wausau argued that even if consolidation is a procedural question for the arbitrators, the district court was obliged to order the formation of two arbitration panels in the first instance - one under each contract - and then have the parties present their consolidation arguments to those two panels. Rejecting both arguments, the Seventh Circuit affirmed the district court's decision.

Relying on the *Howsam* rule that procedural questions regarding how an arbitration is to proceed are for the arbitrators, the court held "that the question of whether an arbitration agreement forbids consolidated arbitration is a procedural one which the arbitrator should resolve." 443 F.3d at 577.[4] The Seventh Circuit reached this conclusion because "the consolidation question concerns grievance procedures - i.e., whether [the parties] can be required to participate in one arbitration covering both Agreements, or in an arbitration with other reinsurers." 443 F.3d at 577. The Seventh Circuit concluded that the question of consolidation must be sent to the arbitrators in the first instance because "the only question is the kind of arbitration proceeding the[] Agreements allow." *Id*. at 578.

As for Wausau's argument that two separate arbitration panels should be formed in the first instance, the court disagreed:

> Wausau argues that ordering it to arbitrate both Agreements in one arbitration would conflict with the terms of the arbitration clauses, for example by not allowing "each party to appoint its arbitrator." We should not and will not consider this argument. The question before us is whether the parties' Agreements specify *who* is to decide whether consolidated arbitration is allowed - the court or the arbitrator. We have determined that the Agreements do not specify and that questions regarding consolidation are presumptively for the arbitrator. Wausau is free to argue at the arbitration that separate arbitrations for the First Excess Agreement and Second Excess Agreement are required under the contracts' terms. If the arbitration panel agrees, it can require the parties to proceed as it deems appropriate.

443 F.3d at 581-582 (emphasis in original).

CONTINUED ON PAGE 6

In a concurring opinion, Judge Gould...questioned whether all Underwriters could be "bound initially to arbitrate together" and ordered to appoint a single arbitrator to whom to present the number-of-arbitrations issue, in the first instance.

CONTINUED FROM PAGE 5

2. *Certain Underwriters at Lloyd's v. Cravens Dargan*

Four months after the Seventh Circuit's decision, the United States Court of Appeals for the Ninth Circuit issued a decision in a case that in many ways began as a mirror image of *Employers v. Century*. In *Certain Underwriters at Lloyd's v. Cravens Dargan & Co.*, Pacific Coast, No. 05-56154 consolidated with No. 05-56269, 2006 U.S. App. LEXIS 20853 (9th Cir., Aug. 14, 2006) ("*Cravens Dargan*"), the cedent ("Cravens Dargan") had billed asbestos losses to its reinsurers ("Underwriters at Lloyd's") under a reinsurance program consisting of multiple layers. After Underwriters at Lloyd's failed to pay, Cravens Dargan demanded a single arbitration under all layers and years of the reinsurance treaty program at issue, each of which called for tripartite arbitration to resolve disputes. Underwriters refused to participate in the single arbitration demanded by Cravens Dargan, arguing that each layer and each wording of the treaty was a separate contract requiring a separate arbitration.

Relying on the same cases that Wausau had relied on in *Employers v. Century*, Underwriters filed an action in federal court in California and asked the court to declare that Cravens Dargan's arbitration demand must be divided into five proceedings, one for each layer and each wording. Cravens Dargan responded that the authority relied on by Underwriters no longer controlled because *Howsam* and *Green Tree* required the district court to defer on the issue and to send the number-of-arbitrations question to the arbitrators. Accepting Cravens Dargan's argument, the district court directed Underwriters to appoint a single arbitrator in response to Cravens Dargan's demand and ordered Underwriters to raise their number-of-arbitrations issue with the arbitrators appointed in response to the demand. The court stated:

> There has been no showing that Respondent Cravens Dargan & Company, Pacific Coast has defaulted on its contractual duty to arbitrate. Respondent has initiated arbitration proceedings and the Court declines to set the terms of that arbitration.

Underwriters appealed.

Underwriters did not challenge the precedential value of *Green Tree*. They argued that *Green Tree* reinforced the rule that, absent the parties' consent, each contract required a separate arbitration. They further argued that *Green Tree* required the Ninth Circuit to reverse the district court and order the formation of five separate arbitration panels. Rejecting this argument, the Ninth Circuit stated that there was "no error in [the] determination [that Underwriters be ordered to appoint a single arbitrator in response to Cravens Dargan's single arbitration demand], which is consistent with *Howsam's* instruction that courts decide gateway issues, but leave procedural issues to the arbitrator." The Ninth Circuit affirmed the district court's decision.

In a concurring opinion, Judge Gould stated that he might have reached a different result if he were writing "on a clean slate." *Id*. at *2. Judge Gould questioned whether all Underwriters could be "bound initially to arbitrate together" and ordered to appoint a single arbitrator to whom to present the number-of-arbitrations issue, in the first instance. *Id*. Concluding that *Howsam, Green Tree, and Employers v. Century* all provided guidance on this issue, however, Judge Gould ultimately agreed with the majority's decision to affirm the district court.

3. Certain Underwriters at *Lloyd's v. Westchester Fire*

In June 2007, the United States Court of Appeals for the Third Circuit reached a conclusion similar to the conclusions reached by the Seventh and Ninth Circuits. In *Certain Underwriters at Lloyd's v. Westchester Fire Ins. Co.*, 489 F.3d 580 (3d Cir. 2007) ("*Westchester Fire*"), the cedent ("Westchester Fire") demanded a single arbitration under each of two separate reinsurance programs (the Comprehensive Catastrophe Treaty program and the Special Contingency Treaty program) to which its reinsurers ("Underwriters at Lloyd's") subscribed. Each program consisted of multiple layers of reinsurance protection, which were set forth in separate treaty wordings, and several of the treaty wordings were re-written at various points in time during the life of the respective program.[5]

Filed by Underwriters at Lloyd's in the federal district court in New Jersey on the same day they filed their petition in California in *Cravens Dargan*, this case was virtually identical to the dispute at issue in *Cravens*

Dargan*. Advancing the same arguments and relying on the same cases they relied on in *Cravens Dargan*, Underwriters sought six separate arbitrations proceedings under one program and two separate arbitration proceedings under the other program. For its part, Westchester Fire made the same arguments and relied on the same cases that Cravens Dargan had relied on in the California action. However, in addition to presenting essentially the same arguments to the district court that Cravens Dargan presented to the district court in California, Westchester Fire also relied on a New Jersey statute addressing consolidation of multiple arbitration proceedings.[6]

The district court in New Jersey reached a result similar to the result reached by the district court in California, ordering Underwriters to (a) "appoint a single arbitrator in response" to Westchester Fire's demand and (b) "proceed promptly with Westchester Fire ... to identify a single umpire in response to" Westchester Fire's arbitration demand. *Certain Underwriters at Lloyd's v. Westchester Fire Ins. Co.*, No. 05-CIV-3024 (WHW) at p. 2 (D.N.J. filed Jan. 5, 2006) (unpublished order) (available at www.dnj.uscourts.gov). The district court's order further provided: "The relief granted herein shall not, in any manner, preclude Petitioners Certain Underwriters at Lloyd's, London, from applying to the Panel for the same or similar relief sought in this proceeding nor in any way limit the Panel's authority to grant such relief." *Id*.

Underwriters appealed. Before the Third Circuit, Underwriters did not challenge the precedential value of *Green Tree*. Underwriters argued that the district court lacked authority to order the parties to participate in a "unified threshold proceeding" to determine the number of arbitrations. *Westchester Fire*, 489 F.3d at 584. Underwriters argued that each reinsurance treaty wording contained its own arbitration clause calling for the formation of an "individually convened" arbitration panel, and Westchester Fire then could present its consolidation arguments to each of the individually convened arbitration panels. *Id*.

Westchester Fire countered by arguing that the question of whether multiple reinsurance contracts "should be arbitrated collectively or individually is itself a determination that must be made" by the arbitrators. *Westchester Fire*, 489 F.3d at 584. Westchester Fire also argued that a New Jersey statutory provision, N.J. Stat. § 2A:23B-10, authorized the district court to order a consolidation proceeding. Finally, Westchester Fire argued that continuity clauses in the treaty wordings - which provided that each subsequent wording replaced and continued the preceding wording and did not alter or affect the preceding wording - rendered each subsequent wording to part of the prior wording, resulting in a single, continuous contract.

Accepting Westchester Fire's argument that the question of the number of arbitrations is a question of arbitration procedure to be decided by the arbitrators and not the courts in the first instance, the Third Circuit affirmed the district court. Relying on *Howsam* and *Green Tree*, the Third Circuit stated that, taken together, these two decisions establish the rule of law that the question of how many arbitrations should be held is not a "question of arbitrability" to be decided by the courts.[7] *Westchester Fire*, 489 F.3d at 586-587 (quoting Howsam). Rather, the question of how many arbitrations should be conducted is a question of arbitration procedure as to "what *kind of arbitration proceeding* the parties agreed to." *Id*. at 587 (quoting *Green Tree*) (emphasis in the original). The Third Circuit stated:

> Whether requiring the Underwriters to select an arbitrator for each program is consistent with the contractual language will be appropriately resolved by the arbitrators once the panels are convened. Such disputes on arbitral procedure are "[i]ncluded within the scope of [the] default rule" in favor of arbitral resolution, along with "the merits of the underlying dispute."

Id. (quoting *Dockser*, 433 F.3d at 425, 427).

The Third Circuit expressly rejected Underwriters' argument that forming one arbitration panel in response to Westchester's single arbitration demand would conflict with the separate arbitration clauses in the separate reinsurance contract wordings, each of which called for the formation of a tripartite panel. *Westchester Fire*, 489 F.3d at 588-589. Relying on *Dockser*

CONTINUED ON PAGE 8

Accepting Westchester Fire's argument that the question of the number of arbitrations is a question of arbitration procedure to be decided by the arbitrators and not the courts in the first instance, the Third Circuit affirmed the district court.

Finally, the Third Circuit followed the lead of the Seventh Circuit and squarely placed the burden of splintering a single arbitration demand on the responding party. The Third Circuit stated that the "[responding party] is free to argue at the arbitration that separate arbitrations for [multiple] Agreement[s] are required under the contracts' terms.

CONTINUED FROM PAGE 7

to conclude that sending the number-of-arbitrations question to a single arbitral panel would not violate the separate arbitration clause contained within each contract wording, the Third Circuit stated:

> Plaintiffs ... [raise] the novel argument that arbitrating the question here would present an "absurd 'chicken and egg' problem." They claim that if x number of arbitrators decide that there ought to be y number of arbitrators, the decision becomes ipso facto invalid. But many procedural questions exhibit this supposed bootstrapping problem, and accepting plaintiffs' argument would nullify the rule that these questions are arbitrable. ... *A similar conundrum would arise regarding whether the permissibility of consolidating separate arbitration proceedings is an issue for a single arbitrator or a host of different ones*. We need not countenance such a result, which would defy both the Supreme Court and the congressional policy favoring arbitration. By presumptively remitting procedural questions to the arbitral body, the FAA necessarily recognizes that decisionmaker's authority to answer them.

Westchester Fire, 489 F.3d at 589 (quoting Dockser, 433 F.3d at 427 (emphasis added by the Third Circuit) (internal quotation marks and citations omitted)).

Finally, the Third Circuit followed the lead of the Seventh Circuit and squarely placed the burden of splintering a single arbitration demand on the responding party. The Third Circuit stated that the "[responding party] is free to argue at the arbitration that separate arbitrations for [multiple] Agreement[s] are required under the contracts' terms. If the arbitration panel agrees, it can require the parties to proceed as it deems appropriate." Westchester Fire, 489 F.3d at 588 (quoting *Century v. Wausau*, 443 F.3d at 582).[8]

The Significance of These Cases on Reinsurance Arbitrations

The main significance of these cases lies in unequivocally and unanimously holding that reinsurance arbitrators, and not the federal courts, have the power to decide the number-of-arbitrations issue in the first instance. Historically, parties to reinsurance contracts who opposed consolidation would file a petition in court to compel separate arbitrations, one under each contract. By and large, such petitions were granted, and the courts would order the parties to proceed with separate arbitrations, one under each contract.

Although additional questions of law remain to be settled, such as how consolidation disputes involving three or more parties will be resolved or how inconsistent consolidation orders will be handled, the process has changed 180 degrees. A party to a reinsurance contract now can demand a consolidated arbitration, and the party opposing it will have to present its number-of-arbitrations arguments to reinsurance arbitrators, not to a court. Consequently, the courts have handed arbitrators significantly more power to control the format of arbitrations and whether those arbitrations can and should include one or more contracts. Long an issue decided by the courts themselves as a prelude to arbitration, the arbitrators now have this authority. And, in particular, under *Employers v. Century*, *Cravens Dargan*, and *Westchester Fire*, reinsurance arbitrators have been given this power.

Arbitrators will now have to grapple with the arguments to be advanced by parties resisting consolidation and seeking to splinter a single arbitration demand (*e.g.*, the parties bargained for separate arbitrations as evidenced by the fact that they have separate contracts) with arguments to be advanced by parties seeking a single arbitration (*e.g.*, efficiency, economy, consistency, *etc.*). Whether arbitrators will grant or deny motions for consolidated arbitrations likely will depend on the facts of each particular matter presented to them for consideration. But this result of having industry arbitrators decide procedural questions makes eminent sense because, as the courts have observed, it "aligns (1) decisionmaker with (2) comparative expertise [and] will help better to secure a fair and expeditious resolution of the underlying controversy - a goal of arbitration systems and judicial systems alike." *Howsam*, 537 U.S. at 85.

Conclusion

Disputes between cedents and reinsurers regarding how many arbitration proceedings should be held to resolve those substantive disputes will likely continue. The courts, however, are extricating themselves from deciding the number-of-arbitrations questions. Reflecting a fundamental change from only five years ago, cedents and reinsurers will now be expected to present their arguments regarding the number of arbitrations to reinsurance arbitrators, not the courts.▼

1 In addition to federal appeals courts, federal district courts also have largely been receptive to this argument. See, e.g., Blimpie Int'l, Inc. v. Blimpie of the Keys, 371 F. Supp. 2d 469 (S.D.N.Y. 2005); Clearwater Ins. Co. v. Granite State Ins. Co., No. C 06-4472, 2006 U.S. Dist. LEXIS 74771 (N.D. Calif. Oct. 2, 2006); Allstate Ins. Co. v. Global Reinsurance Corp., No. 06 Civ. 4419 (DAB), 2006 U.S. Dist. LEXIS 56701 (S.D.N.Y. Aug. 8, 2006). However, in ReliaStar Life Ins. Co. v. Canada Life Assur. Co., Civ. No. 04-74 (JNE/JGL), 2005 U.S. Dist. LEXIS 4045 (D. Minn. Mar. 14, 2005), the district court decided the number-of-arbitrations question itself. The court in ReliaStar did not cite Howsam or Green Tree, and none of the parties cited either of these cases in their briefs. Finally, in Certain Underwriters at Lloyd's v. Century Indem. Co., No. 05-2809, U.S. Dist. LEXIS 16675 (E.D. Pa. 2005), the district court ordered the formation of multiple arbitration panels in the first instance; however, the court did not discuss Howsam or Green Tree, and its decision predated Employers Ins. Co. v. Century Indem. Co., 443 F.3d 573 (7th Cir. 2006).

2 Sidley Austin LLP was counsel of record for Century Indemnity Company, Cravens Dargan & Company, and Westchester Fire Insurance Company in the three federal appeals described in this article.

3 In addition to seeking a single arbitration against Wausau under both layers of the particular treaty at issue, Century also sought to include another reinsurer ("Allstate") in the single arbitration. Allstate also subscribed to the first layer of the Treaty, but not the second layer. The district court did not accept Century's argument that Wausau and Allstate should be required to appoint a single arbitrator, in order to form a single arbitration panel, to whom the parties could present their consolidation arguments. After the district court issued its decision, Century and Allstate settled their dispute. Accordingly, this latter issue was not appealed.

4 In its decision, the Seventh Circuit stated that reliance on Green Tree was unnecessary in light of the Supreme Court's clear mandate in Howsam. The Seventh Circuit chose not to rely on Green Tree because of the plurality nature of the Green Tree decision. Wausau and Century disagreed about what the narrowest grounds were and, consequently, disagreed about whether Green Tree created any binding precedent. Even though it was unable to identify a single rationale endorsed by a majority of the Supreme Court in Green Tree, the Seventh Circuit acknowledged that the Fifth Circuit had reached a different conclusion in Pedcor, in which the Fifth Circuit determined that the narrowest ground was that arbitrators decide questions of contract interpretation in the first instance. See Employers v. Century, 443 F.3d at 580-581.

5 The district court consolidated the two actions commenced by Underwriters, one for the Comprehensive Catastrophe Treaty program and the other for the Special Contingency Treaty program.

6 The New Jersey statute provided:

> Consolidation of separate arbitration proceedings:
>
> a. Except as otherwise provided in subsection c. of this section, upon application of a party to an agreement to arbitrate or to an arbitration proceeding, the court may order consolidation of separate arbitration proceedings as to all or some of the claims if:
>
> (1) there are separate agreements to arbitrate or separate arbitration proceedings between the same persons or one of them is a party to a separate agreement to arbitrate or a separate arbitration agreement with a third person;
>
> (2) the claims subject to the agreements to arbitrate arise in substantial part from the same transaction or series of related transactions;
>
> (3) the existence of a common issue of law or fact creates the possibility of conflicting decisions in the separate arbitration proceedings; and
>
> (4) prejudice resulting from a failure to consolidate is not outweighed by the risk of undue delay or prejudice to the rights of or hardship to parties opposing consolidation.

N.J. Stat. § 2A:23B-10.

7 The Third Circuit concluded that, even though Green Tree was a plurality decision, it created a binding precedent on the issue of who is the proper decision-maker for the number of arbitrations, establishing that the number of arbitrations is a question of contract interpretation to be determined by the arbitrators in the first instance, rather than by the courts. Westchester Fire, 489 F.3d at 586 n.2 (quotations and citations omitted). Accordingly, the Third Circuit agreed with the Fifth Circuit's conclusion in Pedcor on this point while disagreeing with the Seventh Circuit's conclusion in Employers v. Century. Id.

8 The Third Circuit did not address Westchester Fire's arguments that the New Jersey statute and the continuity clauses compelled a single arbitration. Westchester Fire, 489 F.3d at 584, 590.

But this result of having industry arbitrators decide procedural questions makes eminent sense because, as the courts have observed, it "aligns (1) decisionmaker with (2) comparative expertise [and] will help better to secure a fair and expeditious resolution of the underlying controversy - a goal of arbitration systems and judicial systems alike." Howsam, 537 U.S. at 85.

news and notices

Elaine Caprio Brady Featured as Woman to Watch

ARIAS•U.S. Board of Directors member Elaine Caprio Brady is included in the July 30, 2007 issue of *Business Insurance*. She is one of fifty women selected as "Women to Watch."

The "2007 Women to Watch" feature is intended to highlight the fifty women in commercial lines insurance, reinsurance, risk management and employee benefits who are doing outstanding work that is drawing notice not only within but also outside their organizations. Ms. Caprio Brady was identified as a person belonging to this elite group of leaders in the category of insurers and reinsurers.

Business Insurance invited readers and experienced staff to submit nominations, and a group of *BI* editors evaluated candidates to determine the final list. According to *BI*, choosing candidates was difficult, as it received many strong nominations. Ms. Caprio Brady was selected on the basis of her leadership, achievements and impact on the buyers of insurance and benefits.

Elaine Caprio Brady has been a member of the ARIAS Board since 2005. ▼

Board Certifies Eight New Arbitrators

At its meeting in New York on June 12, the Board of Directors approved certification of eight new arbitrators, bringing that total to 334. The following members were certified; their respective sponsors are indicated in parentheses.

Paul Braithwaite (Roger Moak, Timothy Rivers, James MacGinnitie)

Carolyn Cunniff Corcoran (Roger Moak, Keith Kaplan, Donald DeCarlo)

Michael Gabriele (Stephen McCarthy, Gregg Frederick, Brian O'Donnell)

George P. Lagos (Robert Mangino, Nick DiGiovanni, James Rubin)

Stephen E. McCarthy (Daniel Hargraves, Thomas Tobin, James McConnell)

Allan E. Reznick (Roger Moak, John Diaconis, Fredric Marro)

Peter Suranyi (Mark Gurevitz, Jonathan Rosen, James Cameron)

James E. Tait (William Wall, Richard Bakka, Ronald Jacks) ▼

Checklist for Reasoned Awards Posted on ARIAS Website

The Forms and Procedures Committee has developed a list to provide guidance to arbitrators for issuing reasoned awards.

In the introduction, the committee advises that the "checklist" is intended to be helpful, not to define all of the necessary components of a reasoned award for any particular case. Thus, the list is neither exhaustive nor prescriptive.

The checklist is now available in the Forms section of the website. ▼

Ronald A. Jacks

One of the visionaries in the formation of ARIAS, Ronald Jacks died on July 6 in Auckland, New Zealand. Ron had been a significant presence in international and domestic insurance law for many years. He had been President of the U.S. Chapter of AIDA and President of the Reinsurance Association of America, and was a Founding Director of ARIAS-U.S., among many other activities. Ron served as an arbitrator or umpire in over 170 arbitrations. ▼

Robert M. Huggins

Veteran arbitrator Robert Huggins passed away on August 14. Bob was an early member of ARIAS who served on more than 100 arbitration panels. He was a former President and CEO of Belvedere Corporation. Bob lived for many years in Basking Ridge, New Jersey. ▼

ARIAS CLE Attendance Verification Procedures Expanded (Repeat)

At the request of the New York State CLE Board, ARIAS has changed its procedures for verifying attendance at the Spring and Fall Conferences.

Previously, participation in the conference sessions had relied on an honor system. If someone had specified the workshop he/she wished to attend, it was assumed that they did attend. Also, when everyone went to lunch, it was assumed that they all came back and attended the afternoon session, rather than just coming back later to sign out. Such assumptions are no longer allowed.

As part of the process of re-accrediting ARIAS as a provider of CLE training, the CLE Board required that, in the future, **everyone seeking CLE credit must sign in and out at each workshop** or breakout session. Also, **at lunchtime on the full day of the Fall Conference, everyone must sign out upon leaving the morning session and sign in again when returning for the afternoon session.**

The ARIAS staff will monitor the process to ensure that credit is only given to those who are attending for the full time of respective sessions. Certificates of attendance will be based on the sign-in sheets and will be sent to attendees after the conference. Credit will not be given for partial attendance at any session, in accordance with CLE rules. Anyone who does not sign out at the end of the day will not receive credit.

Executive Director Bill Yankus asks attorneys to help facilitate this process by taking responsibility for remembering and observing these rules. ▼

feature

Honoring the Honorable Engagement Clause in Judicial Review of Arbitral Awards:

Should The Honorable Engagement Clause Preclude Any Scrutiny for Manifest Disregard of the Law?

Natasha C. Lisman

Natasha C. Lisman

Introduction

> There appears to be no good reason to prevent parties from agreeing to equity clauses [in arbitration agreements]. However, it is to be noted that in agreeing that a dispute shall be resolved in this way, the parties are in effect excluding any right to appeal to the Court (there being no "question of law" to appeal).[1]

At first glance, this comment on Section 46 of the English Arbitration Act of 1996[2] in the Saville Report[3] - the report that accompanied the Act and serves as "a quasi-statutory guide" to its interpretation[4] - would seem to have no relevance to the American arbitration system. The comment concerns two aspects of the Act's fundamental reform of the English arbitration system. The first was to "validate 'honourable engagement' and similar clauses,"[5] thus legislatively overruling decades of hostility among English judges toward provisions in arbitration agreements authorizing arbitrators to resolve disputes on the basis of fairness and equity rather than strict rules of law.[6] The second was to make judicial review of arbitral awards for errors of law no longer mandatory, but, rather, subject to the parties' right to opt out of such review either by express, or, as the above-quoted comment on Section 46 recognized, implied agreement.[7]

Neither of these concerns is directly at issue in the American arbitration system. In the United States, equity clauses are encountered primarily in reinsurance treaties, in the form of the "honorable engagement" clause. As typically worded, such a clause provides that

> [t]he Arbitrators shall interpret this Agreement as an honorable engagement and not merely a legal obligation. They are relieved of all judicial formalities and *may abstain* from following the strict rules of law.[8]

In contrast to their English counterparts, American judges have never questioned the validity of such clauses,[9] giving rise to the continuing perception that the "U.S. legal framework governing arbitrations, principally the Federal Arbitration Act ('FAA'), has given teeth to the honorable engagement clause, thereby giving it much broader importance than English law provides."[10] Moreover, substantive judicial review of arbitral awards is far more limited in the United States than it remains, when available, in England, allowing our courts to scrutinize and vacate awards only for "manifest disregard of the law," but not for error in the arbitrators' interpretation or application of legal principles.[11]

However, in spite of these differences, a closer examination of the relevant U.S. case law reveals that there is an important lesson for our courts in the Saville Report's comment on the effect of equity clauses on judicial review of arbitral awards. As this article will show, American courts have failed to recognize a logical implication of the honorable engagement clause analogous to that drawn by the Saville Committee from equity clauses. Just as in England, the parties' choice to include an equity clause means "in effect excluding any right to

CONTINUED ON PAGE 12

...closer examination of the relevant U.S. case law reveals that there is an important lesson for our courts in the Saville Report's comment on the effect of equity clauses on judicial review of arbitral awards.

Natasha C. Lisman is a partner in the Boston litigation firm Sugarman, Rogers, Barshak & Cohen, P.C. She represents parties and serves as an arbitrator in commercial, intellectual property, insurance, and reinsurance disputes. The views expressed in this article are strictly her own and should not be attributed to her law firm or clients.

As articulated by Justice Story in an 1816 decision, according to that tradition, arbitrators "are not bound to award upon the mere dry principles of law applicable to the case before them. They may decide upon principles of equity and good conscience, and may make their award *ex aequo et bono*."

CONTINUED FROM PAGE 11

appeal to the Court (there being no 'question of law' to appeal)," so in the United States, the inclusion of an "honorable engagement" clause should mean, in effect, excluding any right to seek judicial review for manifest disregard of the law, there being no law that the arbitrators were required to have "regarded." Yet, though presented with opportunities to draw and implement this conclusion, U.S. courts have failed, or, without explanation, refused to do so. In case after case presenting a manifest-disregard-of-the-law challenge to an arbitral award rendered under an arbitration agreement containing the honorable engagement clause, instead of dismissing the challenge as waived, courts proceed with the determination of whether the arbitrators did manifestly disregard the law, as if the honorable engagement clause authorizing them to do precisely that made no difference. As a result, when it comes to judicial review of arbitral awards in the United States, the honorable engagement clause's teeth are not as sharp as they should be.

A caveat is in order before further discussion: This article assumes an arbitration agreement free of ambiguity as to the parties' intent to permit arbitrators to abstain from strict rules of law. However, such ambiguity can be created by, for example, including both an honorable engagement clause and a governing law provision in a contract, in which case the resolution of the ambiguity might well prevent the effectuation of the honorable engagement clause. In addition, the article assumes arbitration of garden-variety contract claims, or contract-based tort claims, rather than claims based on enactments in the nature of mandatory law, such as securities regulation or anti-discrimination statutes. While such claims are arbitrable under a broad arbitration clause, judicial review of the resulting awards presents complex issues that are beyond the scope of this article.[12]

The Manifest Disregard Doctrine

The doctrine that arbitral awards are subject to judicial review not only under the largely procedural standards for judicial review specified in the FAA, but also for "manifest disregard of the law," was first suggested in 1953 in a Supreme Court dictum.[13] Since then, it has become established in all federal circuits,[14] and all but one apply a variant of the following "two-part test in determining whether an award should be vacated for manifest disregard of the law: (1) Did the arbitrator know of the governing legal principle yet refused to apply it or ignored it altogether? and (2) Was the law ignored by the arbitrators well defined, explicit and clearly applicable to the case?"[15] The exception is the Seventh Circuit, which initially adopted the same standard[16] but subsequently redefined manifest disregard to mean only that "the arbitrator's award actually orders the parties to violate the law."[17] This extremely narrow formulation arguably eviscerates the manifest disregard doctrine altogether and probably does not pose the problem addressed in this article. At any rate, since the Seventh Circuit's shift to the new standard of manifest disregard has not found following in any other circuit, it is the effect of the doctrine under the prevailing broader standard that will be discussed here.

Even under that standard, mere error in interpreting or applying the law falls short of manifest disregard.[18] In essence, then, the doctrine allows arbitrators to get the law wrong but not consciously to ignore it. Moreover, because even in the broader formulation, the doctrine has been strictly applied, vacatur of arbitral awards for manifest disregard of the law is very rare. Nonetheless, the doctrine is far from inconsequential.

To begin with, it runs counter to a centuries' old American tradition concerning the role of the law in arbitral dispute resolution. As articulated by Justice Story in an 1816 decision, according to that tradition, arbitrators "are not bound to award upon the mere dry principles of law applicable to the case before them. They may decide upon principles of equity and good conscience, and may make their award *ex aequo et bono*."[19] In more contemporary formulations, arbitrators are free to "interpret the contract without regard to substantive law,"[20] "adjust the law to changing social and commercial conditions,"[21] and "reach a result that conforms to industry norms and to the arbitrator's notions of fairness."[22]

By contrast, the norm underlying the manifest disregard doctrine is that substantive law must be the basis on which disputes should be argued and resolved in arbitration. Thus, even while declining to vacate awards for manifest disregard, courts have warned that "counsel forego their *obligation* to educate arbitral panels as to governing legal principles at their great peril,"[23] and that, at least when so educated, "arbitrators, *of course*, cannot intentionally flout the law."[24] And, indeed, awards have been vacated where arbitrators were found to have "explicitly rejected" binding authority in favor of alternative non-binding authority,[25] or to have expressly applied a legal rule contrary to the law chosen in the parties' contract,[26] and, even in the absence of an explanation of the award, out of mere concern that the arbitrators may have heeded a party's plea "flagrantly and blatantly urg[ing]" them to ignore the case law precedent and instead "do what's fair and just and equitable."[27] In the face of such admonitions and occasional sobering results, diligent counsel can ill afford to ignore the law in their advocacy and conscientious arbitrators - in their decisions. Anecdotally, reports of growing pressure on arbitrators to understand and apply the law are commonly heard at arbitrator gatherings, even in industries such as reinsurance, where arbitrators are frequently non-lawyers.

Furthermore, beyond its effect on the conduct of arbitral proceedings, the doctrine has been a substantial contributing factor in the proliferation of complex, protracted and expensive post-award litigation, as evidenced by the continuing flow of lower court and appellate decisions dealing with challenges to arbitral awards for manifest disregard of the law.[28] Even if the outcome in most cases is "a happy ending for the arbitration's prevailing party,"[29] the process delays the happy ending and entails the expense of full-scale briefing, arguments, and consideration of substantive legal issues, from choice of law to the interpretation and application of the governing legal principles to the facts, in addition to whether the arbitrator, who may or may not have disclosed the legal basis of his award,[30] was aware of these principles and deliberately disregarded them. As one judge has lamented, the scrutiny of an award for manifest disregard of the law can be "even more complex than a search for simple error."[31]

Yet, for all the criticism it has engendered, as even one of its staunchest critics has conceded, the doctrine "appears to be so settled a part of federal arbitration law that it may appear quixotic to plead for its internment."[32] Indeed, the Second Circuit has declared manifest disregard to be a mandatory standard from which parties cannot opt out by agreement. In *Hoeft v. MVL Group, Inc.*, the winner of the arbitration urged that in view of the provision in the arbitration agreement that the arbitrator's decision "shall not be subject to any type of review or appeal whatsoever," the judge below "erred in even considering whether the arbitrator had manifestly disregarded the law."[33] In language strongly reminiscent of the pre-1996 English decisions decrying arbitration terms attempting to oust the jurisdiction of the courts, the Second Circuit rejected the contention:

> The manifest disregard standard together with [the FAA standards] represent a floor for judicial review of arbitration awards below which parties cannot require courts to go, no matter how clear the parties' intentions. ... The fact that the manifest disregard standard is a product of common law, rather than statute, makes it no less essential to the judicial review of arbitration awards. .... Judicial standards of review, like judicial precedents, are not the property of private litigants.[34]

While no other court has yet expressly articulated this view, the Second Circuit's underlying mindset may well be shared by other courts and explain their handling of petitions to vacate for manifest disregard by parties whose arbitration agreements permitted arbitrators to abstain from strict rules of law in their decisions.

Application of the Manifest Disregard Standard In Cases Involving the Honorable Engagement Clause

On the one hand, decisions in cases arising out of arbitrations involving the honorable engagement clause are replete with expressions of broad approval. The courts "read such clauses generously," agreeing that the language permitting the arbitrators to abstain from following the strict rules of law "confers a wide spectrum of powers on

CONTINUED ON PAGE 14

Anecdotally, reports of growing pressure on arbitrators to understand and apply the law are commonly heard at arbitrator gatherings, even in industries such as reinsurance, where arbitrators are frequently non-lawyers.

Surely, therefore, it would be better for all if the courts simply borrowed from the Saville Report and declared that when parties have agreed to authorize the arbitrators to abstain from following the strict rules of law, they effectively exclude the right to complain in court that the arbitrators manifestly exercised that authority.

CONTINUED FROM PAGE 13

arbitral panels," both procedural and substantive.[35] Most notably, the phrase has been construed "to operate, in effect, as an express 'choice of *no* law' provision,"[36] and to empower arbitrators to "*disregard*" what might otherwise be controlling law.[37]

On the other hand, while there are no reported decisions granting a motion to vacate an award for manifest disregard where the arbitration agreement included the honorable engagement clause, there is likewise no reported decision in which a court has even considered, much less ruled, that the consequence of authorizing the arbitrators to disregard the governing law is to preclude any inquiry into whether the arbitrators did in fact manifestly exercise the authority conferred on them. Instead, the courts simply proceed with the manifest disregard analysis on the merits, either without any reference to the honorable engagement clause in that context,[38] or with bare parenthetical reference at the conclusion of their analysis, as merely an additional consideration reinforcing the result they had already reached on other grounds.[39]

The Second Circuit's opinion in *Banco Seguros del Estado v. Mutual Marine Office, Inc.*[40] offers a particularly striking illustration of the first pattern, because there, the court gave the honorable engagement clause considerable weight with respect to one set of issues, only to completely ignore it when it reached the manifest disregard issue. The case was before the court on a consolidated appeal from lower court rulings denying a foreign government-owned reinsurer's motions to vacate interim orders in two arbitrations requiring it to post pre-hearing security. Each of the arbitration agreements contained the typical honorable engagement clause providing that the arbitrators "were relieved of all judicial formalities and may abstain from following the strict rules of law." The reinsurer argued, among other things, that in awarding pre-hearing security, the arbitration panels exceeded their authority and acted in manifest disregard of the law because, as an instrumentality of a foreign state, it was immune from such interim remedies under the Foreign Sovereign Immunities Act ("FSIA").[41]

Starting with the reinsurer's predicate, the Second Circuit expressed doubt that the FSIA applied to private commercial arbitration, but ultimately ruled that even if it did, the statutory immunity was subject to explicit waiver and the record demonstrated such waiver by the reinsurer. The court found evidence of the waiver primarily in the honorable engagement clause, joining other courts that have held that the "wide spectrum of powers" conferred by the honorable engagement clause encompassed "the power to award pre-hearing security."[42] The court cited this language again as part of the evidence showing that, contrary to the reinsurer's contention, the parties did place the issue of pre-hearing security within the scope of the arbitration.[43]

Yet, when the court turned to the manifest disregard claim, the honorable engagement clause vanished from its analysis. It subjected the claim to an extensive consideration on the merits - setting forth the manifest disregard standard, analyzing and distinguishing the case law alleged to have been disregarded as well as cases supporting the challenged arbitral orders, and finally concluding that, since "[i]n any event, it can hardly be said that the FSIA clearly prohibits the relief ordered by the Panels, [they] did not ignore or refuse to apply 'well defined, explicit, and clearly applicable law,' ... and, as such, did not act in manifest disregard of the law" - all without a single mention of fact that it would have been well within the Panel's discretion to do so.[44]

The Ninth Circuit's opinion in *U.S. Life Ins. Co. v. Ins. Comm'r of the State of California*,[45] illustrates the use of the honorable engagement clause as a mere afterthought. There, the reinsurer argued that the arbitrators' refusal to order rescission was in manifest disregard of the law because one of the panel's comments constituted a finding of fact that compelled the remedy under the California rescission statute. The court examined the statutory standard for rescission and the arbitrators' statement, and concluded that the statement did not amount to the requisite finding. Only after reaching this conclusion did the court mention the honorable engagement clause as an additional factor that, when combined with the narrow scope of judicial review of arbitral awards, buttressed its conclusion that the arbitrators did not exhibit a manifest disregard of law.[46]

Similarly, in *Insurance of Wausau v. Certain Underwriters at Lloyd's*, in response to the contention that the arbitration panel had disregarded the governing Wisconsin pre-judgment interest law, the Court of Appeals first established that Wisconsin recognizes the manifest disregard doctrine and then performed a careful "grouping of contracts" choice of law analysis to conclude that, because Wisconsin's prejudgment interest law was not necessarily the governing law, the arbitration panel's failure to apply it was not in manifest disregard.[47] Only in a footnote did the court make a note of the arbitration agreement's honorable engagement clause and suggested that "[e]ven if Wisconsin law were applied, an argument could be made that [Wisconsin's interest rules] fall within the panel's right to 'abstain from following the strict rules of law.'"[48]

In sum, while generally voicing a favorable attitude toward the honorable engagement clause and giving it effect for some purposes, with respect to the availability of judicial review of arbitral awards for manifest disregard of the law, U.S. courts have either disregarded it, or, at best, treated it as a make-weight.

Conclusion:

The Courts Need to Manifest the Scope of their Regard for the Honorable Engagement Clause

The result of the courts' willingness to put themselves and the parties through the exercise of determining whether the arbitrators manifestly disregarded the law, notwithstanding the fact that the arbitration clause expressly gave them the discretion to do so, is uncertainty for the participants in the arbitration process and/or wasteful litigation. While in no reported case has the exercise been fruitful for the party challenging the award, the very fact of the exercise being held at all leaves open the possibility - and no court has it ruled out - that the courts are not in fact prepared to honor honorable engagement clauses to the point of allowing arbitrators knowingly and deliberately to abstain from applying legal principles that are clear and directly applicable and, therefore, wish to reserve the power to vacate in those circumstances.[49] In other words, without acknowledging it, the courts may be putting a manifest disregard limit on the enforceability of the honorable engagement clause akin to that applied in *Hoeft* to a clause expressly waiving judicial review altogether.[50]

If that is the case, the courts surely owe it to the parties and arbitrators to spell out and justify that limit instead of leaving them to guess and run the risk of vacatur. To be sure, savvy arbitrators know how to "spin" a result so as to avoid the appearance of manifest disregard, but not all good arbitrators are able, or willing, to exercise such skills and a system of judicial oversight that discourages and penalizes transparent and candid arbitral decision-making is hardly fair and effective.

If, on the other hand, the courts' record of failing to find all the elements of manifest disregard in the presence of the honorable engagement clause reflects unreserved acceptance of the clause, their insistence on burdening themselves and the parties with consideration of manifest disregard claims on their merits, only invariably to reject them, is inexplicable and unjustifiably wasteful. Surely, therefore, it would be better for all if the courts simply borrowed from the Saville Report and declared that when parties have agreed to authorize the arbitrators to abstain from following the strict rules of law, they effectively exclude the right to complain in court that the arbitrators manifestly exercised that authority. ▼

Notes

1 Report of the Departmental Advisory Committee, Comment 223 at p. 49.

2 Section 46 requires arbitrators to "decide the dispute ... in accordance with the law chosen by the parties ... or ... *if the parties so agree*, in accordance with such other considerations as are agreed by them or determined by the tribunal." The Act is available at www.legislation.hmso.gov.uk/acts1996/1996023.htm.

3 So named after Lord Saville, who chaired the Departmental Advisory Committee (DAC) that helped draft the 1996 Act and prepared the report, which is also known as "DAC Report." Castle, *The UK Arbitration Regime: Jurisdictional Considerations*, 2005 ABA Annual Meeting, Section of Litigation, August 4-7 (2005); Netherway, *The Arbitration Act of 1996 and its Potential Impact on Insurance and Reinsurance Dispute Resolution*, Int. I.L.R. 1997, 5(9), p. 276-277. The Saville Report notes that equity clauses are also known as "*ex aequo et bono*," "*amiable composition*," and, in reinsurance treaties, "honourable engagement" clauses. Saville Report, Comment 223 at p. 49, and Supplement, Comment 30 at p. 11.

4 Netherway, supra n. 4, at p. 277.

5 *XI Insurance Ltd. v. Owens Corning*, [2000] 2 Lloyd's Rep. 500, 508. See generally, Bell, *Appeal of Arbitration, A Boost for "Honourable Engagement*," 1997-JAN ANIRDR 3; Netherway, supra, at p. 280.

6 See, e.g., *Home & Overseas Ins. Co. Ltd. v. Mentor Ins. Co.* (U.K.) Ltd. [1989] 1 L1.L.R. 473 ("a clause which purported to free arbitrators to decide without regard to the law and according, for example, to their own notions of what would be fair would not be a valid arbitration clause."); *Orion Compania Espanola de Seguros v. Belfort Maatschappij Voor Algemene Verzekgringeen* [1962] 2 Ll.L.R. 257 ("If the parties choose to provide in their contract that the rights and obligations shall not be decided in accordance with law but in accordance with some other criteria, such as what the arbitrators consider to be fair and reasonable, whether or not in accordance with law, then ... there would be no contract, because the parties did not intend the contract to have legal effect ... and an 'award' would not be an award which the law would recognize.") See generally, Lake, *The Arbitration Act 1996: Relevance to the Reinsurance Market*, Int. I.L.R. 1997, 5(1), 23-24 at p. 24.

7 Under Section 69 of the Act, ":*[u]nless otherwise agreed by the parties*, a party to arbitral proceedings may ... appeal to the court on a question of law arising out of an award made in the proceedings."

8 Schiffer, *The Honorable Engagement Clause (But I Thought I Had a Legal Contract)*, International Risk Management Institute (March 2007), www.imi.com (quoting from sample reinsurance arbitration provisions on Brokers & Reinsurance Mark Association (BRMA) website).

9 See generally, Barry R. Ostrager & Mary Kay Vyskocil, Modern Reinsurance Practice 5:01 (2d Ed Glasser Legalworks 2000); Graydon S. Staring, Law of Reinsurance, § 22:5 (1993).

10 Dunn, Corey, and Quadrino, *A Gentlemen's Agreement: The Impact of Honorable Engagement Clauses In U.S. and English Reinsurance Agreements and Arbitration Today*, 16-23 Mealey's Litig. Rep. Reinsurance 15 (2006); Milligan-Whyte, *Bermudian, English and American Law and Practice and Alternative Dispute Resolution Methods*, 28 Tort & Ins. L. J. 120, 133 (1989).

11 See text accompanying notes 13-16, infra.

12 For the position that substantive judicial review should be limited to arbitral disregard of mandatory statutory law that rises to violation of public policy, see Smit, *Manifest Disregard of the Law*, 15 Am. Rev. Int'l Arb. 111, 129-130 (2004).

13 The dictum was that "interpretations of law by arbitrators *in contrast to manifest disregard* are not subject, in the federal courts, to judicial

CONTINUED ON PAGE 16

CONTINUED FROM PAGE 15

review for error in interpretation." *Wilko v. Swan*, 346 U.S. 427, 436 (1953) (emphasis supplied). While *Wilko's* holding was subsequently overruled in *Rodriguez de Quijas v. Shearson/Am. Express, Inc*., 490 U.S. 477 (1989), the manifest disregard dictum survived and was reaffirmed in *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 942 (1995).

14 See generally, Hall, *Manifest Disregard of Law or Facts or Both*, 15-3 Mealey's Litig. Rep. Reinsurance 13 (2004); Binning and Nefsky, *Manifest Disregard, Vacating Arbitral Awards: A Circuit by Circuit Review*, ARIAS•US *Quarterly* Magazine (2d Quarter, 2002), pp. 18-23, available at www.arias-us.org. Courts are divided over the applicability of the manifest disregard doctrine under the New York Convention for the Recognition and Enforcement of Foreign Arbitral Awards. See 2 International Business Transactions § 35.12.

15 1 Domke on Com. Arb. § 38:9 (Westlaw database, updated April 2007).

16 *Health Services Management Corp. v. Hughes*, 975 F.2d 1253, 1267 (7th Cir. (Ill.) 1992).

17 *Butler Mfg. Co. v. United Steel Workers of America*, AFL-CIO-CLC 336 F.3d 629, 636 (7th Cir. 2003) (citing *George Watts & Son, Inc. v. Tiffany*, 248 F.3d 577, 579 (7th Cir. 2001)).

18 Domke, id.

19 *Kleine v. Catara*, 2 Gall. 61, 14 F. Cas. 732, 735 (C.C. D. Mass. May Term 1814); see also, *Detroit Automobile Inter-Insurance Exchange v. Gavin*, 331 N.W.2d. 418, 431 (Mich. 1982) (arbitrators are "generally expected to frame their decisions on broad views of justice, which may sometimes deviate from the strict rules of law").

20 21 Williston on Contracts § 57:137 (4th ed.)

21 Smit, supra n. 12, at fn. 40.

22 *Duferco Int. Steel Trading v. T. Klaveness* Shipping A/S, 333 F.3d 383, 389 (2d Cir. 2003).

23 *Nutrition 21, Inc. v. Wertheim*, 150 Fed. Appx. 108, 2005 WL 2574140, **2 (2d Cir. 2005); *Wallace v. Buttar*, 378 F3d 182, 190 (2d Cir. 2004); *Stark v. Sandberg, Phoenix & von Gontard, P.C*., 381 F.3d 793, 803 (8th Cir. 2004); *Citigroup Global Markets, Inc. v. Salerno*, 445 F. Supp. 2d 124, 128 (D. Mass. 2006); *Success Sys., Inc. v. Maddy Petroleum Equip., Inc*., 316 F. Supp.2d 93, 100 (D. Conn. 2004).

24 *Cytyc Corp. v. Deka Products Ltd. Partnership*, 439 F.3d 27, 35 (1st Cir. 2006); *Halligan v. Piper Jaffrey, Inc*., 148 F.3d 197, 204 (2d Cir. 1998).

25 *New York Telephone Co. v. Communications Workers of America Local 1100, AFL-CIO District One*, 256 F.3d 89, 93 (2d Cir. 2001).

26 *Patten v. Signator Ins. Agency, Inc*., 441 F.3d 230, 236 (4th Cir. 2006).

27 *Montes v. Shearson Lehman Bros., Inc*., 128 F.3d 1456, 1459, 1461 (11th Cir. 1997) (vacating and remanding for further arbitration).

28 See, e.g., *Apache Bohai Corp. LDC v. Texaco China BV*, 480 F.3d 397, 2007 WL 587233 (5th Cir. 2007); *Lessin v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, —- F.3d ——, 2007 WL 776864 (C.A.D.C. 2007); *McCarthy v. Citigroup Global Markets Inc.*, 463 F.3d 87 (1st Cir. 2006); *Patten v. Signator Ins. Agency, Inc.*, 441 F.3d 230 (4th Cir. 2006); *Parsons v. Polen*, 177 Fed.Appx. 728 (9th Cir. 2006); *Benson v. Bridgestone/Firestone, Inc*., 2006 WL 984926 (10th Cir. 2006); *B.L. Harbert Int'l, LLC v. Hercules Steel Co*., 441 F.3d 905, 910 (11th Cir. 2006); *Wizard v. Clipper Cruise Lines Slip Copy,* 2007 WL 29232 (S.D.N.Y. 2007); *Sherrock Broth., Inc. v. Daimler-Chrysler Motors Co., LLC* 465 F.Supp.2d 384 M.D.Pa. 2006). For particularly egregious examples of protracted post-award litigation, see *Wien & Malkin, LLP v. Helmsley-Spear, Inc.*, 6 N.Y.3d 471 (N.Y. 2006)(state court confirmed the award over a manifest disregard challenge, intermediate appellate court affirmed and the highest appellate court denied review; US Supreme Curt granted certiorari on a federal law issue, vacated judgment and remanded for reconsideration; on remand, intermediate state appellate court vacated the award, but the highest court reversed and reinstated the original trial court judgment confirming the award); *McCarthy v. Citigroup Global Markets, Inc*., 463 F.3d 87 (1st Cir. 2006) (District Court vacated award for manifest disregard and remanded for further arbitration, new panel rendered second award, District Court vacated second award for possible manifest disregard and remanded for a third arbitration proceeding, but the First Circuit reversed and ordered confirmation of second award).

29 Park, Saving the FAA, 4 International Arbitration News 10 (ABA, Summer 2004).

30 Generally, even under the manifest disregard doctrine, "[a]rbitrators are not required to disclose or explain reasons for their award," Domke, supra n. 16, but failure to do so "can be taken into account" in determining whether they disregarded the law. Halligan, supra, 148 F.3d at 204.

31 *George Watts*, supra, 248 F.3d 577, 579 (2001).

32 Smit, supra n. 12, at 122.

33 343 F.3d 57, 60, 62-63 (2d Cir. 2003).

34 343 F.3d at 64-65 (2d Cir. 2003).

35 *Banco de Seguros del Estado v. Mutual Marine Office, Inc.,* 344 F.3d 255, 251 (2d Cir. 2003) (and authorities collected therein) (emphasis supplied); *National Casualty Co. v. First State Ins. Group*, 430 F.3d 492, 497-98 (1st Cir. 2005).

36 *Continental Casualty Co. v. Lloyd's*, 1998 U.S. Dist. LEXIS 23547, *14 -19; see also, *Hartford Fire Ins. Co. v. Lloyd's Syndicate 0056 ASH*, 1997 WL 33491787, *5 (D. Conn. 1997) (in view of the provision allowing arbitrators to abstain from following the strict rules of law, the parties cannot be deemed to have contracted to apply a particular state law so as to preempt the New York Convention).

37 *St. Paul Fire and Marine Ins. Co. v. Eliahu Ins. Co., Ltd.*, 1997 WL 357989, *7 (S.D.N.Y. 1997) ("even if ... New York law governed, [since] the arbitrators would be free to disregard New York substantive law" under the honorable engagement clause, the defendant had not availed itself of New York law so as to submit itself to personal jurisdiction there); *Employers Ins. of Wausau v. Lloyd's*, 552 N.W.2d 420, 427 (Wis. App. 1996) ("The arbitration clause does not require the panel to apply Wisconsin law," but "[e]ven if Wisconsin law were applied, an argument could be made that [its provisions] fall within the panel's right to "abstain from following the strict rules of law.")

38 See, e.g. *Banco Seguros del Estado v. Mutual Marine Office, Inc.* 344 F.3d 255 (2d Cir. 2003); *Executive Life Ins. Co. v. Alexander Ins. Ltd*., 999 F2d 318 (8th Cir. 1993) (acknowledging that "contracts broadly empowered the arbitrators to use equity and customary industry practices to decide all question and issues," but entertaining a challenge to award based on manifest disregard); *Pacific Reins. Mgmt. Corp. v. Ohio Reins. Corp*., 935 F.2d 1019 (9th Cir. 1991) (referencing the honorable engagement clause in connection with the scope of the arbitration panel's mandate, but omitting any mention of it in the discussion of whether the panel's interim final order was in manifest disregard of the law); *Ludgate Ins. Co. Ltd. v. Banco Seguros del Estado* 2003 WL 443584 (S.D.N.Y. 2003) (quoting the honorable engagement clause in the background portion of the opinion, never to mention it again in a lengthy discussion of whether an award of arbitration costs to the prevailing party was in manifest disregard of the law); *Northwestern Nat'l Ins. Co. v. Generali Mexico Compania Seguros*, S.A.,2000 WL 520638, *9-10 S.D.N.Y. 2000) (reading an honorable engagement clause as "eschewing 'strict rules of law,'" but nonetheless endeavoring to find in the parties' submissions a colorable basis for the award that satisfied the manifest disregard standard); *Republic Western Ins. Co. v. Legion Ins. Co*., 2001 WL 1807913, *15-17 (Pa. Com.Pl. 2001).

39 See, e.g., *U.S. Life Ins. Co. v. Ins. Comm'r of the State of California*, 2005 WL 3150272 (9th Cir. 2005); *Insurance of Wausau v. Certain Underwriters at Lloyd's*, 552 N.W.2d 420 (1996); *Lancer Ins. Co. v. Tooling Mfg. Ins. Co*., Ltd, 1990 WL 124344 (S.D. N.Y. 1990).

40 344 F.3d 255 (2d Cir. 2003).

41 28 U.S.C. §§ 1330(a), 1441(d), 1602-1611. The reinsurer also argued that the panels offended public policy and violated fundamental fairness, but the Second Circuit gave these issues short shrift, ruling that the public policy argument was the same as the manifest disregard claim and that the fairness argument was precluded by the reinsurer's failure to raise it below. 344 F.3d at 264.

42 Id. at 260-262.

43 Id. at 262-263.

44 Id. at 263-264.

45 2005 WL 3150272 (9th Cir. 2005).

46 Id at *2-3.

47 552 N.W.2d 420 (1996).

48 Id at 426-429.

49 In considerably broader and stronger terms, one critic has attributed the entire manifest disregard doctrine to "the pursuit of the perpetual judicial inclination to substitute the judicial view for that of the arbitrators." Smit, *The Time Is Ripe for the U.S. Supreme Court to Bury The Misconceived Doctrine of Manifest Disregard of the Law*, 16 Am. Rev. Int'l Arb. 211 (2005).

50 *Hoeft v. MVL Group, Inc*., 343 F.3d 57, 63-65 (2d Cir. 2003).

members on the move

In each issue of the Quarterly, this column lists member announcements, employment changes, re-locations, and address changes, both postal and email, that have come in during the last quarter, so that members can adjust their address directories and PDAs.

Do not forget to notify us when *your* address changes. Also, **if we missed your change below, please let us know** at info@arias-us.org, so that it can be included in the next Quarterly.

Recent Moves and Announcements

LeBoeuf, Lamb, Greene & MacRae LLP moved its offices in DC after the directory closed. The new address is 1101 New York Avenue, N.W., Suite 1100, Washington, D.C. 20005. **Deirdre Johnson's** numbers are now phone 202-986-8041, fax 202-956-3233, cell 703-598-6140. **Fred Reinke** can be reached at phone 303-442-2900, fax 303-442-0026, cell 301-693-5180. Email addresses are unchanged.

Christopher Ash has relocated his law firm to 1221 Pearl Street, Suite 4, Boulder, CO 80302. All other information remains the same.

Maureen O'Connor has moved to St. Paul Travelers Companies, Inc., where she can be found at One Tower Square, Hartford, CT 06183, phone 860-277-6549, fax 860-277-3292, email moconno2@travelers.com .

Edward K. Lenci can be now reached at lencilaw@aol.com or at 914-939-8989.

Joseph A. Gervasi is now located at 9 Mackenzie Lane North, Denville, NJ 07834, phone 973-784-3454.

Michael S. Olsan has rejoined White and Williams LLP. He can be contacted at 1800 One Liberty Place, Philadelphia, PA 19103, phone 215-864-6278, fax 215-789-7508, email olsanm@whiteandwilliams.com .

P. Jay Wilker has formed a new firm with Robert McKay. His address is now Wilker & McKay, 645 Fifth Avenue, Suite 703, New York, New York 10022, email jaywilker@wilkerandmckay.com . All other information is unchanged.

Andreas Stahl's address of record is now Inter Hannover, 60 Fenchurch Street, London EC3M 4AD, UK. Other information remains unchanged.

Elizabeth M. Thompson has moved a little higher in the mountains of Colorado, (to be closer to her favorite ski trails?). She is now at P.O. Box 2228, 300 Black Bear, Gypsum, CO 81637, fax 970-524-1485. Other information is unchanged.

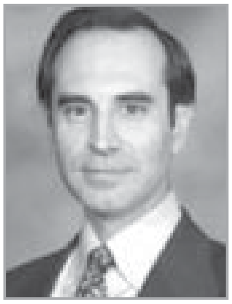
John D. Sullivan has retired from The Hartford's Horizon Management Company. He has set up shop for arbitration, expert witness and consulting services. He has also moved to Massachusetts and can be reached through P.O. Box 2149, Brewster, MA 02631, phone 508-896-5181, fax 508-896-5181, email johndennissullivan@verizon.net .

On August 1, **David D. Knoll** relocated his practice to Thompson, Coe, Cousins & Irons, LLP, One Riverway, Suite 1600, Houston, Texas 77056, phone†713-403-8376, fax 713-403-8299, email, dknoll@thompsoncoe.com .

feature

The Broker in the Middle: The Law of Broker Compensation

Louis J. Aurichio
Amy B. Kelley



Louis J. Aurichio

Amy B. Kelley

Reinsurance brokers have always walked a difficult line - hired by insurance companies to develop and place reinsurance programs but traditionally negotiating their compensation with the reinsurance companies with whom they place the business. This relationship can get even more complicated when a reinsurance broker is terminated mid-term, that is, when the insurance company terminates the broker's services before the expiration of the reinsurance placed by that broker. In such a situation, questions may arise with respect to which entity is actually paying the broker, whether the broker's commission was fully earned at placement, and the obligations the broker owes, if any, to the respective parties.

Until recently, case law in this area was very limited. In two recent decisions, however, courts in Minnesota and Connecticut have provided new guidance with respect to the issue of broker compensation. The courts have held that (i) reinsurance brokers are paid by the reinsurers for whom they produce the underwriting opportunity; (ii) the brokerage commission is earned upon placement notwithstanding the broker's ongoing servicing obligations; and (iii) while the broker is the fiduciary of the ceding company, there are at least some limits on the extent of the broker's fiduciary obligations to the ceding company in the context of the broker's negotiation of its compensation with the reinsurers. Each of these holdings is discussed in greater detail below.

The Broker Market

To put our discussion in context, we start with a brief review of the role of a reinsurance broker. As the reader surely understands, there are two distinct markets in which reinsurance is bought and sold: the direct market and the broker market. In the direct market, reinsurers solicit underwriting opportunities directly from the ceding companies via their own in-house marketing departments. In the broker market, reinsurers use a reinsurance broker as their external marketing arm - relying almost entirely on the broker to bring them underwriting opportunities.

As a result, an insurance company wanting to access the broker market generally needs to retain a reinsurance broker to implement its reinsurance program. The ceding company and the broker will typically enter into a broker of record letter at the outset of their relationship, specifying that the broker is the agent of the ceding company for purposes of implementing the client's reinsurance program. The NAIC Model Reinsurance Intermediary Act (and the various state statutes that have adopted the Model Act) also sets forth certain provisions which must be included in the written agreement between the ceding company and the broker. Significantly, for purposes of this discussion, the NAIC Model Act does not address the terms of the broker's compensation. Thus, broker of record letters are frequently silent on this issue.

Absent any special agreement in the broker of record letter or otherwise, the broker typically negotiates its compensation with the reinsurers with whom it ultimately places the reinsurance on behalf of the ceding company. The terms of the broker's compensation as agreed between the broker and the reinsurers are generally set forth in the placement slip. Reinsurance brokers typically receive a brokerage commission that is based on a specified percentage of the reinsurance premiums to be paid to the reinsurers by the ceding company. In such a situation, the broker deducts its commission upon receipt of the premium payments from the ceding company and then forwards the

...courts in Minnesota and Connecticut have provided new guidance with respect to the issue of broker compensation.

* Lou Aurichio and Amy Kelley are partners at Butler Rubin Saltarelli & Boyd LLP. They both concentrate their practice on arbitration and litigation of reinsurance disputes, as well as other areas of complex commercial litigation. Lou and Amy, along with Jim Rubin, represented Carvill in the *XL Specialty v. Carvill* case discussed in this article. The views expressed in this paper do not necessarily reflect the views of Butler Rubin Saltarelli & Boyd LLP, any of its attorneys, or those of its clients.

net premium payments to the reinsurers.

Not surprisingly, this practice becomes more complicated when the broker that placed the reinsurance program is terminated before the end of the contract term. If the ceding company shifts the servicing of the reinsurance program to a new broker, then the placing broker is no longer in a position to simply deduct its commission before making the net premium payments to the reinsurers. As a result, questions may arise with respect to the placing broker's entitlement to the remaining commission payments.

The Recent Decisions

Benfield v. Moline

The United States District Court for the District of Minnesota was the first court in the United States to directly address this issue. In *Benfield, Inc. et al. v. David Moline et al.*, Civil File No. 04-3513, 2006 WL 452903 (D. Minn. Feb. 22, 2006), the court granted summary judgment on Benfield's claim that another broker, John B. Collins Associates, Inc., had committed the tort of conversion when it retained brokerage commissions on reinsurance contracts that had been placed by Benfield. The court held that, as the placing broker, Benfield was entitled to the brokerage commissions until the end of the treaty term despite the fact that the servicing of the treaties had been transferred to Collins. The court also held, however, that Collins could introduce evidence with respect to the cost of servicing that had been avoided by Benfield prior to a determination of the actual damages to be awarded to Benfield.

Looking at the *Benfield* case in further detail, the dispute arose in the context of the departure of two employees, David Moline and Mark Hagan, from Benfield to Collins. Following the departure of Moline and Hagan, Benfield filed suit against the two brokers, as well as their new employer, Collins, alleging a variety of claims arising out of their employment contracts with Benfield, which included certain restrictive covenants and confidentiality agreements. Benfield also brought a claim against Collins for conversion, alleging that Collins had wrongfully converted Benfield's money by inducing several clients to transfer their accounts to Collins before the terms of their reinsurance treaties, placed by Benfield, expired. Benfield further alleged that following the transfer of the accounts, Collins had retained for its own benefit all of the commissions payable on the premium payments due under the reinsurance placed by Benfield.

Benfield thereafter moved for partial summary judgment on its claim of conversion, as well as a declaratory judgment claim seeking a declaration as to the ownership of the brokerage commissions. In considering Benfield's motion, the court first made several findings with respect to the relevant custom and practice in the industry, including the fact that (i) Benfield is generally compensated for its brokerage work by an up-front commission or by a periodic payment through a percentage deduction from the reinsurance premiums submitted to the reinsurers through Benfield; (ii) the reinsurer pays the commission; and (iii) reinsurance clients generally do not move their accounts before treaty renewal period, although they are free to change brokers at any time.

The court then held that because Collins did not deny collecting the commissions paid on reinsurance treaties placed by Benfield and transferred to Collins, "the only issue before the Court is which party owns the commissions." *Id*. at *14. In addressing this question, the court noted that neither party had provided the court with any contracts relating to the commissions and that it was not clear to the court whether there was, in fact, "any written agreement between the reinsurer and the placing broker." *Id*.[i] The court was therefore left to determine the question of "which party owns the commissions" without reference to any of the relevant contractual documents.

To advance its argument that it owned the commissions, Benfield contended that it is a well-accepted rule that "a reinsurance broker earns its commission upon the placement of the reinsurance contracts request[ed] by the insurance company client." *Id*. at *15. In support of this argument, Benfield relied on cases arising in the primary insurance context in which the courts have repeatedly held that, absent an agreement to the contrary, an insurance broker earns its commission when it brings about the relationship of insurer and insured.[ii] Benfield

CONTINUED ON PAGE 20

The Court concludes that the general rule for insurance brokerage commissions applies to the reinsurance industry: generally, reinsurance brokerage commissions are earned at placement; if the client switches brokers partway through the insurance contract year, the initial broker is still entitled to those commissions until the treaty renewal period.

The court further held that XL Specialty tortiously interfered with Carvill's business relationship with the reinsurers by taking certain deliberate actions after terminating Carvill that prevent-ed the reinsurers from paying Carvill the commission specified in the placement slips.

CONTINUED FROM PAGE 19

argued that "[l]ike reinsurance brokers, primary insurance brokers assess their clients' needs, assist them with claims submissions, and facilitate communications between the insurer and the insured." *Id*. Benfield further argued that "the reinsurance brokerage commission is based on the reinsurance treaty's premium; thus, the client's need for services after the treaty is secured has no effect on the amount of the brokerage commission." *Id*.

The court was persuaded by Benfield's arguments - at least in part. The court held as follows:

> The Court concludes that the general rule for insurance brokerage commissions applies to the reinsurance industry: generally, reinsurance brokerage commissions are earned at placement; if the client switches brokers partway through the insurance contract year, the initial broker is still entitled to those commissions until the treaty renewal period. Because neither party has submitted any evidence regarding the existence and terms of any contracts governing brokerage commissions, the general presumption applies. As the placing broker, Benfield is entitled to the brokerage commissions until the end of a treaty term.

Id. The Court thus granted Benfield's motion for summary judgment on liability on Benfield's conversion claim. The question of Benfield's damages was left for trial.

Consistent with its claim that "the client's need for services after the treaty is secured has no effect on the amount of the brokerage commission," Benfield subsequently brought a motion in limine to exclude evidence of servicing costs at trial. Noting that the goal of the law of torts is to place an injured party in the position they would otherwise have been in were it not for the tortious behavior, the court concluded that evidence of the servicing costs would be admissible at trial to address the issue of damages for the conversion claim. The court reasoned that "[a]lthough Collins committed a tort by converting commissions that rightfully belonged to Benfield, its tortious actions may have also benefited Benfield by relieving it of the costs associated with servicing those clients." *Benfield v. Molline*, 2006 WL 1662759, *2 (D. Minn. June 12, 2006). The court therefore held that "[a]llowing Benfield to recover the entire commissions while at the same time allowing it to reap the benefit of saving substantial servicing costs would grant Benfield a windfall." *Id*. The court thus denied Benfield's motion in limine to exclude evidence of servicing costs at trial.

The case was, however, never tried. According to the case docket, Benfield filed a stipulation of dismissal with prejudice on October 30, 2006.

XL Specialty v. Carvill

At the same time that the *Benfield v. Moline* case was being decided in Minnesota, there was another case pending in Connecticut in which the court was about to consider the same issues, albeit in a slightly different context. On May 31, 2007, following a five-week bench trial, the Connecticut Superior Court issued a decision in *XL Specialty Insurance Company v. Carvill America, Inc. et al.,* Case No. X04-CV-04-4000148-S, 2007 WL 1748157 (Conn. Super. May 31, 2007). Like *Benfield*, the *XL Specialty* dispute presented the question of whether a reinsurance broker is entitled to receive full brokerage commission on treaties it placed even though the cedent terminated its relationship with the broker before the end of the treaty periods. Here again, the court answered this question in the affirmative, holding that XL Specialty's termination of Carvill as broker of record for the subject reinsurance placements did not terminate the participating reinsurers' independent contractual obligation to pay Carvill the brokerage set forth on the slips. The court further held that XL Specialty tortiously interfered with Carvill's business relationship with the reinsurers by taking certain deliberate actions after terminating Carvill that prevented the reinsurers from paying Carvill the commission specified in the placement slips. *XL Specialty* at *11-12.

Carvill served as XL Specialty's broker of record from 1999 to mid-2003 during which time Carvill assisted XL Specialty in placing six treaties reinsuring professional liability policies written by XL Specialty. *Id*. at *3. The court found that the contractual relationship among the parties to the reinsurance placements was embodied in three separate agreements, which the court likened to a three-legged contractual stool. The first contractual relationship, between Carvill and XL Specialty, was memorialized in a Broker of Record Appointment Letter ("BOR") signed by Carvill and XL Specialty. *Id* at *5. As is typical, the BOR did not set the terms of Carvill's compensation. The BOR did, however, state explicitly that no fees or other remuneration were to be paid by XL Specialty to Carvill; rather, "remuneration earned by Carvill is to be received from the reinsurer(s) to which [XL Specialty's] premium is ceded as is customary in the industry." *Id*.

The second contractual relationship found by the court is the one between the broker and the reinsurers, as defined in the placement slips. *Id*. Consistent with the BOR provisions, which stated that XL Specialty paid no remuneration to Carvill, Carvill's brokerage commission (a percentage of the premiums paid to the reinsurers) was set forth in the placement slips prepared by Carvill and executed by the reinsurers. *Id*.

The court found that the "third leg of the contractual stool" is the one between the reinsured and the reinsurers, which is ultimately embodied in the treaties. *Id*. The treaties did not include reference to Carvill's commission, but the intermediary clause did require that the premiums be paid to the reinsurers through the broker who, by custom, deducts its commission and forwards the balance of the premium to the reinsurers. *Id*.

In August 2003, before the expiration of the most recently placed treaties, XL Specialty terminated Carvill's appointment as its broker of record. *Id*. at *4. In early 2004, XL Specialty sued Carvill, alleging that the reinsurance broker engaged in misconduct in the execution of its duties as XL Specialty's broker. XL Specialty claimed that Carvill was not entitled to any further brokerage following its termination, and that Carvill's alleged malfeasance required it to pay XL Specialty part of the brokerage it had already earned during the period in which it represented XL Specialty. Carvill brought a counterclaim for tortious interference with business expectancy and breach of contract.

In a 99-page decision, the Connecticut court first addressed Carvill's counterclaim. The evidence established that following Carvill's termination, XL Specialty instructed the replacing broker, Benfield, not to forward to the reinsurers that portion of the premium which would be paid to Carvill as commission pursuant to the slips. *Id* at *8. Rather, XL Specialty directed Benfield to withhold that sum and place it in a segregated account held to XL Specialty's order pending the outcome of the dispute. *Id*. Based upon these facts, the court held that XL Specialty tortiously interfered with Carvill's business relationships with the reinsurers. The court reasoned that "the termination of the reinsured-broker contract did not have the effect of terminating the contract between the reinsurers and Carvill." *Id*. at *11. To the contrary, there was a "cognizable business relationship between Carvill and the reinsurers that survived the appointment of Benfield as the new intermediary." *Id*. By directing Benfield to withhold from the reinsurers the portion of the premium that would ordinarily be paid to the placing broker, XL intended to prevent the reinsurers from paying Carvill its commission. The court emphasized that there was no "discernable justification" for XL Specialty's conduct: "even if Carvill had breached the contract between it and XL, such breach would not justify interference with the contracts between Carvill and the reinsurers." *Id*. at *12.

The court found that the proper measure of damages is the money that Carvill would have received had there been no interference. *Id*. at *37. Accordingly, the court awarded Carvill the full amount of commissions earned on premium ceded by XL Specialty after Carvill's termination pursuant to the treaties placed by Carvill, less "the expense Carvill saved by not having to service the treaty after termination." *Id*. Because there was no direct evidence of the cost of servicing in evidence, the court deducted 10% from the award, which is the percentage of the withheld commissions that XL Specialty had agreed to pay Benfield for servicing the treaties Carvill had placed. After that deduction, the court awarded compensatory damages to Carvill in the amount of $4,037,066.21 - 90% of the unpaid commissions. *Id*. With the application of prejudgment interest and offer of judgment interest to which Carvill was entitled, the court entered judgment in favor of Carvill in the amount of $5,068,583.97.

The court then went on to consider XL

CONTINUED ON PAGE 22

> The court reasoned that "the termination of the reinsured-broker contract did not have the effect of terminating the contract between the reinsurers and Carvill." Id. at *11. To the contrary, there was a "cognizable business relationship between Carvill and the reinsurers that survived the appointment of Benfield as the new intermediary."

The scope of Carvill's fiduciary duty was limited to acting on behalf of XL in the procurement and execution of the reinsurance program, and in that responsibility Carvill owed a fiduciary duty, both contractually and historically. Communications between the parties regarding the contractual responsibilities does not fall into the ambit of the fiduciary responsibilities of Carvill.

CONTINUED FROM PAGE 21

Specialty's 11-count complaint, which alleged that Carvill had engaged in various forms of misconduct. The *XL Specialty* court ultimately rejected the vast majority of XL Specialty's claims. Some of the court's rulings on XL Specialty's claims are instructive as to the scope of a broker's duties in a post-termination context. For example, XL Specialty alleged that Carvill, after its termination as broker of record, breached its fiduciary duties by asserting in a letter to reinsurers that it was still legally entitled to brokerage commissions. The court held that Carvill's assertion of its perceived right to brokerage did not qualify as a breach of fiduciary duty. *Id*. at *25. The court found nothing untoward about Carvill placing reinsurers on notice that Carvill intended to enforce the agreements with the reinsurers as reflected on the slips. *Id*. at *25-26. As the court put it: "In the context of commercial reinsurance, asserting a right is certainly a fair practice, especially if the assertion is correct." *Id*. at *26.

After it was terminated, Carvill's counsel wrote to Benfield stating that any attempt by Benfield to deliver premium, collect brokerage or otherwise represent itself as being the intermediary of treaties placed by Carvill, without proper legal authorization, would constitute intentional interference with contract. Again, XL Specialty alleged that Carvill breached its fiduciary duties by this post-termination communication. *Id*. The court disagreed with XL Specialty, finding that XL Specialty and the reinsurers "had the obligation to change the intermediary clauses in the treaties if they were technically to act according to the contracted framework." *Id*. Viewing Carvill's letter to Benfield as "Carvill's attempt to avoid being cut out of the process," the court concluded that there was "nothing unfair about reminding the others about the advisability of amending the contractual provisions to reflect the new reality." *Id*. Later, in its opinion, the court also rejected XL Specialty's claim that Carvill's letter to Benfield amounted to tortious interference with XL Specialty's contractual relations. *Id*. at *32.

These particular rulings are somewhat fact-specific, but in rejecting yet another XL Specialty claim, the court reached a more broad-based conclusion about post-termination communications between reinsurance brokers and their former clients. Again in support of its breach of fiduciary duty claim, XL Specialty complained about statements made in a letter from Carvill to one of XL Specialty's executives concerning Carvill's views on its contractual right to brokerage. *Id*. at *62. In rejecting XL Specialty's claim, the court observed:

> The scope of Carvill's fiduciary duty was limited to acting on behalf of XL in the procurement and execution of the reinsurance program, and in that responsibility Carvill owed a fiduciary duty, both contractually and historically. Communications between the parties regarding the contractual responsibilities does not fall into the ambit of the fiduciary responsibilities of Carvill.

Id.

The XL Specialty court did not reject all of XL Specialty's claims; it found two technical breaches. First, the court found that Carvill breached the BOR by failing to provide a periodic accounting of brokerage commission paid to Carvill, notwithstanding the custom in the industry that intermediaries do not report commissions unless specifically requested. *Id*. at *16-21. Second, the court found that after its termination, Carvill breached its fiduciary duty by its tardy transfer of XL Specialty account information to the replacing broker. *Id*. at *27.

Turning to damages arising from these breaches, the court found that XL Specialty was not harmed by Carvill's failure to provide the periodic accounting required pursuant to the BOR because it had been otherwise entirely satisfied with Carvill's services until immediately prior to the termination.[iii] *Id*. at *39. "Where there are no discernable damages, there can be no recovery of anything but nominal damages," which the court awarded to XL Specialty in the amount of one dollar. *Id*. Similarly, with respect to "the sluggish transfer of documents" to the replacing broker, the court found no credible evidence of pecuniary damages. *Id*. Because the court found that the "defalcation was not serious, caused no specific harm and was not performed to benefit Carvill at the expense of XL Specialty," the court again awarded nominal damages to XL Specialty. *Id*. at *41.

The State of the Law

Following the decisions in *Benfield v. Moline* and *XL Specialty v. Carvill*, there is now at least some guidance for reinsurance brokers with respect to their rights and obligations with respect to compensation for their services.

Brokers Are Paid by Reinsurers

The *Benfield* and *XL Specialty* courts both confirmed that reinsurance brokers are paid by the reinsurers. The Benfield Court came to this conclusion based on custom in the industry, while the XL Specialty Court reached this conclusion based on the contract between the brokers and reinsurers embodied in the slip.

Throughout the course of the *XL v. Carvill case*, XL argued that because Carvill's brokerage commission was deducted from reinsurance premiums paid by XL, it was XL that "really" paid the commissions. The court found that the superficial appeal of this position "does not change the nature of the commission as being directly paid by the reinsurers, as reflected in the fundamental contracts and the accounting procedures." *Id.* at *34 fn.34; *see also* *36. The court's reference to accounting procedures relates to evidence introduced at trial which established that, under the general accounting principles and procedures promulgated by the National Association of Insurance Commissioners ("NAIC"), reinsurers are required to report reinsurance brokerage as an expense on their statutory financial statements. Carvill argued that the NAIC rule reflected the industry's recognition that reinsurers bear the financial burden of paying brokerage commissions. The court agreed. *Id.* at *34 fn. 34.

Brokerage Is Earned on Placement

The *Benfield* and *XL Specialty* courts both held that brokerage is earned on placement notwithstanding the fact that the broker is committed to service the business until the last loss is paid.

In *Benfield*, the court concluded that "the general rule for insurance brokerage commissions applies to the reinsurance industry: generally, reinsurance brokerage commissions are earned at placement; if the client switches brokers partway through the insurance contract year, the initial broker is still entitled to those commissions until the treaty renewal period." Because the court had not been provided with the relevant contractual documents, the *Benfield* court's decision in this regard was based on (i) the evidence of custom and practice that had been presented to the court in the form of affidavits submitted in support of and in opposition to Benfield's motion for summary judgment and (ii) the line of cases holding the same in the primary insurance context.

In *XL v. Carvill*, the court reached the same conclusion although with the benefit of the relevant contractual documents. The court rejected XL Specialty's argument that brokerage is earned over the course of the broker-client relationship, such that XL Specialty's termination of Carvill partway through the contract term would cut off Carvill's right to a commission on premiums paid after the date of termination. In so holding, the court emphasized that "there is nothing in the language of the contracts to compel the conclusion that termination of the contract between XL and Carvill perforce terminates the contracts between Carvill and the reinsurers." *Id.* at *10.

Although the *XL Specialty* court took note of the primary insurance cases and the *Benfield v. Moline* decision in reaching its decision that the reinsurance brokerage commission is fully earned upon placement, the court placed the greatest weight on the language of the three contracts at issue, as well as expert testimony that the commission was paid by reinsurers as consideration for receiving the business from the broker. *Id.* at *9-10. "I credit the evidence suggesting that the reinsurers paid the commission for providing the business; so long as the reinsurers received premium payments, a percentage of that premium was owed to Carvill by the clear and unequivocal language of the slip. *Id.* at *10.

By this holding, the court also affirmed the proposition, advocated by Carvill, that reinsurers pay brokerage for the production of business to them by the placing broker. *Id.* at *9-10.

CONTINUED ON PAGE 24

The *Benfield* and *XL Specialty* courts both held that brokerage is earned on placement notwithstanding the fact that the broker is committed to service the business until the last loss is paid.

It therefore remains to be seen whether a clear trend will emerge among the courts - providing further clarity to reinsurance brokers as they attempt to balance the work that they do for their clients with their right to be compensated by the reinsurers with whom they place the business.

CONTINUED FROM PAGE 23

The Scope of the Fiduciary Relationship

It is generally accepted that reinsurance brokers act as the agent of the reinsured company and are therefore subject to the law governing the responsibilities of an agent to its principal.[iv] One of the arguments that XL Specialty made in the *XL Specialty v. Carvill* case was that Carvill owed XL Specialty certain fiduciary duties with respect to its negotiation of the terms of its compensation by reinsurers. In response, Carvill argued that the negotiation of its compensation was outside of the scope of the duties it owed to XL, as evidenced by the explicit language in the BOR, which provided that Carvill's remuneration was to be paid by reinsurers and not XL.

While the *XL Specialty* court dealt factually with (and rejected) XL Specialty's contention that Carvill's "commission structure" adversely affected XL Specialty's reinsurance program, the court never addressed whether a reinsurance broker's fiduciary duties extend to the broker's negotiation of its compensation with reinsurers. *Id*. at *28-29.[v] The court clearly held, however, that the fiduciary duties owed by a reinsurance intermediary to its client are not boundless:

> The fiduciary duty in the reinsurance broker context cannot require that the broker 'put the interests' of the ceding client ahead of its own in every conceivable way. To take the position to its logical absurdity - that a broker has the legally enforceable obligation to charge the least amount that a hired expert in hindsight thinks is fair - is to ignore the practical realities . . . and to substitute the subjective view of the reviewing court for the contractual realities.

Id. at *29. Thus, the court made it clear that, in its view, the broker has at least some right to look out for its own interest in the course of negotiating the terms of its compensation by reinsurers - the true extent of that right remains to be determined.

Conclusion

The *Benfield v. Moline* and *XL Specialty v. Carvill* cases are the first decisions to provide any real guidance to reinsurance brokers as they seek to negotiate the terms of their compensation or to enforce their right to compensation following termination by the ceding company. These decisions are significant in that they are the only reported decisions in the United States directly addressing these important issues. The decision in the *XL Specialty* case is particularly noteworthy as it was the culmination of a five week trial in which all of the relevant contracts and customs and practices were carefully considered by the court. There are, however, several other cases pending at the moment in which some of these same issues are being considered by other courts. It therefore remains to be seen whether a clear trend will emerge among the courts - providing further clarity to reinsurance brokers as they attempt to balance the work that they do for their clients with their right to be compensated by the reinsurers with whom they place the business. ▼

i Subsequent to the court's decision, Collins filed a motion for reconsideration seeking to introduce certain contract provisions that it claimed "address[ed] ownership of the brokerage commissions." *Benfield v. Moline*, 2006 WL 680591 (D. Minn. March 16, 2006). The court denied Collins' motion.

ii In the insurance context, there are numerous cases which hold that an insurance broker earns his commission upon placement of the insurance. *See, e.g., Underwriters Service, Inc. v. Aetna Casualty and Surety Co.*, No. 90C-MR-62, 1992 WL 9347, *1 (Del. Super. 1992); *Cockrell v. Grimes*, 740 P.2d 746 (Okla. 1987); *Commonwealth Ins. Dept. v. Safeguard Mutual Ins. Co.*, 336 A.2d 674, 685 (Pa. 1975); *Arizona Ins. Guaranty Ass'n v. Humphrey*, 508 P.2d 1146, 286 (Ariz. 1973); *Boro Hall Agency v. Citron*, 329 N.Y.2d 269, 270 (NY 1972).

iii The Court found that XL terminated Carvill because it refused to share its commissions with XL. (*Id.* at 20, 24-25.)

iv *See* Gordon S. Staring, Law of Reinsurance §7:2 (2005).

v In its negligence count, *XL Specialty* repeated its allegations about the adverse affect on XL Specialty of Carvill's "commission structure." XL Specialty at *33. The court observed that "not all of the actions of Carvill took place in its role as a fiduciary." *Id*. The court continued: "To the extent that its setting of its own fees and commission may be considered to be outside the fiduciary context, I nonetheless find that XL has not proved that, even if there was a duty to XL regarding the size of the fees, any duty was breached . . ." *Id.* These comments confirm that the court did not decide whether a reinsurance broker's fiduciary duty to its client extends to the arrangement of its compensation.

feature

English and Scottish Law Commissions' Consultation Paper Proposes Major Reform of Insurance Contract Law

Ali Sallaway
Paul Wortley

On 17 July 2007, the English and Scottish Law Commissions published a joint consultation paper on insurance contract law. The paper sets out wide-ranging proposals for the reform of the current law, which if enacted will have significant repercussions for both insurers and policyholders. The proposed reforms shift the balance in favour of policyholders, and insurers will want carefully to consider whether the proposals sufficiently respect their own legitimate interests.

The Commissions' proposals concentrate on three areas:

- misrepresentation and non-disclosure by the insured prior to inception of the contract;
- warranties and similar terms; and
- the position of insurance intermediaries.

The consultation paper is almost 400 pages in length. This article summarises some of the Commissions' more significant proposals, and discusses their likely practical effect.

Background to the current proposals

The Commissions first announced their intended review of insurance contract law in January 2006 and this has been followed by the publication of three issues papers setting out provisional proposals for reform. Following industry responses to those papers, the Commissions have modified a number of proposals for inclusion in their consultation paper.

The Commissions believe that statutory reform is necessary for three principal reasons:

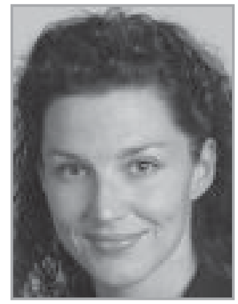
- The current law does not produce results that are in line with the reasonable expectations of policyholders. The Commissions believe that principles embodied in the Marine Insurance Act 1906 are "*no longer appropriate to a modern insurance market*", and that some aspects of the current law are "unjust" and "defy logic".
- Over the past 20 years, the current law, particularly in relation to consumer insurance, has been tempered by the introduction of non-binding Statements of Practice, the FSA Rules, and the creation of the Financial Ombudsman Service (the "FOS"), which has applied a "fair and reasonable" approach to consumer related insurance disputes. The result is a patchwork of rules and guidelines which are "*incoherent, unclear, and inaccessible*", and in need of reformulation.
- Many other common law countries have already reformed their insurance law provisions along the lines of the Commissions' proposals, serving to re-emphasise the possibility that English (and Scottish) law may be out of step with market practice.

The Commissions intend their proposals to apply to all classes of insurance and reinsurance.

Misrepresentation and non-disclosure

Current insurance law imposes strict duties on the insured to disclose all material facts to the insurer, and to avoid making any material misrepresentations. Any breach of these duties enables the insurer to avoid the policy *ab initio* - in practice this means that the policy is treated as if it never existed, and

CONTINUED ON PAGE 26



Ali Sallaway

Paul Wortley

The proposed reforms shift the balance in favour of policyholders, and insurers will want carefully to consider whether the proposals sufficiently respect their own legitimate interests.

Ali Sallaway is a partner and Paul Wortley an associate in Freshfields Bruckhaus Deringer's financial institutions disputes group in London. Both specialise in insurance and reinsurance law.

CONTINUED FROM PAGE 25

the insured will usually only be entitled to the return of his premium.

There are several reasons why it is commonly argued that the law as it stands operates harshly on insureds:

- A fact is considered material if it would influence the judgement of the hypothetical "prudent insurer" in assessing the risk. However, the fact need not have had a decisive effect on the mind of that insurer. Despite this, the insurer is entitled to avoid the policy, and therefore refuse to pay claims that it arguably would have paid had the fact been disclosed.
- Many policyholders, particularly consumers, may not realise that they have a duty to disclose information about which the insurer has not asked them any questions. They may also not appreciate what would influence the judgement of a prudent insurer.
- There is no differentiation between a misrepresentation that is fraudulent, negligent, or entirely innocent. The Commissions believe that a policyholder may be denied claims even when they have acted honestly and reasonably.

To address these issues, the Commissions propose to alter the test for materiality, and introduce the concept of proportionality to determine the remedies available to the insurer. There are separate proposals for consumer and business insurance, but both are based on the general principle that an insured who was honest and careful in giving pre-contract information should not have his claim refused.

Proposals for consumer insureds

For consumer insurance, the Commissions propose a mandatory regime based principally on existing FOS guidelines. The main features of this would be as follows.

- The consumer's duty to volunteer information would be abolished. The onus would be on the insurer to ask questions covering the information it required. The insurer would have no remedy in respect of information about which it had not asked a question.
- The consumer's duty would be to act honestly, and to take reasonable care to answer questions accurately and completely. Breach of that duty would only give rise to a remedy if the insurer could show that:
  - it would not have entered into the contract on the same terms (or at all) had it been aware of the full facts (this restates the existing requirement for inducement); and
  - a reasonable insured in the circumstances would have appreciated that the fact in question was one which the insurer would have wanted to know about (or, alternatively, that this particular insured did actually know that the insurer wanted to know the fact). This is the new test of materiality, and would represent the end for the hypothetical "prudent insurer".
- The insurer's remedy for breach of the duty would depend on the consumer's degree of fault, which the Commissions define by reference to three categories of misrepresentation:
  - If the consumer acted dishonestly and made a "deliberate or reckless" misrepresentation, then the insurer would be entitled to avoid the policy.
  - If the consumer made a negligent misrepresentation, then the insurer would be granted a compensatory remedy - i.e. one that aims to put the insurer in the position it would have been in had it known the true facts. For example, if the insurer would have increased the price of cover, then the claim should be reduced in proportion to the under-payment of premium. If the insurer would have refused to write the cover at all, it should be entitled to avoid the policy.
  - If the consumer made a misrepresentation that was neither dishonest nor negligent (which the Commissions refer to as a "reasonable misrepresentation") then the insurer would have no remedy, and would be obligated to pay the claim in full.

Proposals for business insureds

For business insurance, the Commissions propose a regime based on current accepted good practice. Unlike in consumer insurance, however, it is important to note that the parties would be free to contract out of the regime by express agreement in the policy. The main features of the regime would be as follows.

- The insured's duty of disclosure should be retained, but the current test of materiality should be narrowed. The duty would be limited to those facts that a reasonable insured in the circumstances would have appreciated the insurer would want to know about.
- For misrepresentations, the materiality test would be the same as that for consumers. An insurer would need to demonstrate that a misrepresentation had been made which had induced the insurer to enter into the contract and that a reasonable insured in the circumstances would not have made it.

In terms of remedies for the insurer, the Commissions seek views on whether it is appropriate to distinguish between dishonest and negligent conduct in a business context. They ask whether the remedy of avoidance should be reserved for dishonest conduct, with only a compensatory remedy available for negligent misrepresentation or non-disclosure. However, as there are concerns that it might be difficult to prove that a corporate organisation acted dishonestly, it has been argued that avoidance should be retained as the default remedy for negligent misrepresentation and non-disclosures.

Although it has been argued that the current law in this area is capable of producing harsh results, particularly on consumer insureds, it does have the advantage of being certain. Critics of the introduction of a "reasonable insured" test point to the inherent uncertainty in that formulation. Who is the reasonable insured? How can this be determined when insureds vary so dramatically in size, sophistication, and familiarity with the insurance market? By including reference to the circumstances of the insured, the Commissions are suggesting a hybrid objective/subjective test, of the kind used in Australia. A court would therefore be able to take into account matters such as, for example, whether that particular insured had access to independent professional advice. There is a risk therefore that the proposals exchange one set of uncertainties for another.

In relation to the compensatory remedy for negligent misrepresentation, insurers should note that the Commissions seek views on whether the courts should be afforded an overriding discretion to refuse the remedy of avoidance in certain circumstances. They suggest this may be appropriate where the policyholder's fault was "minor," and the insurer could be "adequately compensated by a reduction in the claim". In circumstances where the insurer has shown that it would have declined the risk had it known the true facts, it is questionable whether the existence of such a discretion would be consistent with the principle of proportionality.

In addition, the proposals do not expressly deal with circumstances in which the insurer would have covered the risk, but its premium would have been so high that the cover would be rendered uncompetitive, and the insured would likely not have taken it up. The outcome of such an argument by insurers may depend on the precise proportionality wording that is chosen for any statute.

Warranties

Certain statements in insurance contracts as to past, present, or future fact are known as "warranties." Under the existing law, an insurer can refuse to pay any claims that arise after the date of a breach of warranty, regardless of whether that breach is subsequently remedied or had any connection to the loss in question. In contrast to the position in respect of misrepresentation, there is no requirement that the warranted statement be material to the risk or that it induced the insurer to enter into the contract. A statement on a proposal form that the answers given form the "basis of the contract" has the effect of converting all of the insured's answers into warranties.

The Commissions believe that reform is needed in this area primarily to prevent insurers from relying on technical breaches that have no connection with the claim. Their principal proposals in respect of warranties as to future conduct are as follows.

- There should be a causal connection test to link the breach of warranty to a particular loss. The insurer must pay the claim if the insured can demonstrate on the balance of probabilities that the breach did not contribute to the loss.
- The causal connection rule would be mandatory for consumer insurance. For business insurance, the parties would be able to agree other consequences for breach of warranty if they wished, subject to special controls where the parties contract on the insurer's standard terms. The Commissions propose that the insurer would not be able to rely on a warranty contained in the standard terms if it would render the cover substantially different from what the insured "reasonably expected" in the circumstances.
- A breach of warranty would not automatically discharge the insurer from all future liability under the policy. It would instead give it the right to terminate the contract, but only if the breach has sufficiently serious consequences.
- Warranties should be set out in writing, and in consumer cases the insurer should take specific steps to bring the warranty to the insured's attention.

CONTINUED ON PAGE 28

For business insurance, the Commissions propose a regime based on current accepted good practice. Unlike in consumer insurance, however, it is important to note that the parties would be free to contract out of the regime by express agreement in the policy.

The Commissions recognise that their proposed intermediary reforms, whilst significant for consumers, are likely to have less effect on business insurance, where the intermediary is likely to continue to be regarded as agent of the insured.

CONTINUED FROM PAGE 27

In respect of warranties of past or present fact, the Commissions propose that:

- In consumer insurance, all statements of past or present fact would be treated as representations rather than warranties.
- In business insurance, specific warranties of past or present fact would be permitted, but the insurer could only refuse to pay a claim if the breach of warranty was material, and had some connection to the loss.
- For all types of insurance, "basis of the contract" clauses be abolished. The Commissions describe them as "*using obscure words that most policyholders will not understand*." Any warranty must be specifically identified.

Intermediaries and the law of agency

Under the present law, an insurance intermediary such as a broker is usually regarded as acting on behalf of the insured, rather than the insurer. There has long been debate, both academically and in the insurance market, as to whether this is appropriate. The question is one of real practical significance.

Legally, the actions of an agent are attributed to those for whom they act. In practice, this means that if the intermediary is at fault in providing the insurer with incorrect information prior to or at inception (whether negligently or deliberately) then that fault is imputed to the insured. This enables the insurer to avoid the cover, regardless of whether the insured provided correct information to the intermediary, against whom the insured is then left to pursue a remedy.

The Commissions believe that insureds may reasonably expect not to be held responsible for an intermediary's errors. The issue is complicated by the fact that the intermediary may potentially be regarded as agent of the insurer in certain circumstances e.g. an appointed representative of one insurance company. This may not be clear to prospective insureds (particularly consumers), and adds to the complexity of disputes involving alleged fault by intermediaries.

To address these issues, the Commissions:

- Propose that an intermediary should be regarded as acting for the insurer unless they are clearly independent and acting on the insured's behalf.
- Seek views on whether the independence of an intermediary should be determined by reference to whether he conducts "a fair analysis" of the market, as defined in the Insurance Mediation Directive.
- Propose to abolish the rule that an insurer's agent may temporarily become agent of the insured when completing the proposal form (originating from the much-criticised *Newsholme v. RTG Insurance case*).

In business insurance, the agency question has tended to raise separate issues, centred around whether the current law of agency is consistent with the commission payments received by brokers. The Commissions recognise that their proposed intermediary reforms, whilst significant for consumers, are likely to have less effect on business insurance, where the intermediary is likely to continue to be regarded as agent of the insured. This recognition will be welcomed by business policyholders, for whom the broker often fulfills a vital role in negotiating the best terms of cover on their behalf. It will not, however, address criticisms of the practice whereby brokers who are supposedly the agent of the insured, are in fact remunerated by the insurer.

The future of the proposals

The Commissions seek responses to their proposals by 16 November 2007. A separate consultation paper will be published in 2008 dealing with post-contractual good faith, insurable interest and damages for the late payment of claims.

Given the complex patchwork of law, regulation, and guidelines that presently govern an insured's rights and obligations, it seems likely that these proposals will result in reform (in contrast to the proposals of the English Law Commission in 1980, and its predecessor in 1954). Insurers now need to engage fully in the consultation process to ensure that their interests are sufficiently reflected. ▼

Recently Certified Arbitrators

Paul Aiudi

Paul Aiudi

Paul Aiudi recently joined American International Group, Inc. as an Assistant General Counsel in its Corporate Law Department, where he works within that department's group responsible for the resolution of reinsurance disputes.

Prior to joining AIG, Mr. Aiudi was a 2nd Vice President and Senior Counsel in the Travelers Companies' Reinsurance Legal Group. In this capacity, Mr. Aiudi had in-house legal management responsibility over numerous ceded and assumed reinsurance disputes and provided legal counsel to Travelers' various reinsurance groups. He has also been an Assistant Vice President and Assistant General Counsel in the Law Department of The Hartford Financial Services Group, Inc., where he served as legal counsel to The Hartford's assumed reinsurance operations. Prior to his in-house legal career Mr. Aiudi was in private practice, serving as an associate at Day, Berry & Howard (now Day Pitney LLP) in Hartford, Connecticut.

Mr. Aiudi received a Bachelor of Arts degree from Marist College in 1987 and his Juris Doctor from The University of Notre Dame in 1991. He has been a speaker at several reinsurance industry seminars, including those sponsored by ARIAS and Mealey's. He has also been an Instructor at The University of Connecticut School of Law where he taught an LLM course entitled "Principles of Reinsurance." ▼

John T. Andrews, Jr.

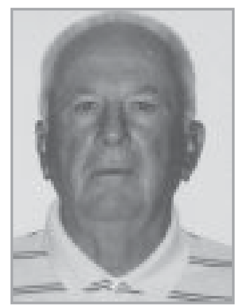
John T. Andrews, Jr.

John Andrews has served as Senior Vice President and General Counsel of SCOR U.S. Corporation and its subsidiaries since 1989. His prior experience in the reinsurance business was as Vice President and General Counsel of Prudential Reinsurance Company from 1977 to 1985. From 1982 to 1985, he was also in charge of the Claims Department at Prudential Re.

Mr. Andrews was with the Primerica Corporation group from 1985 to 1988 and served as Senior Vice President and General Counsel of Primerica Corporation from 1987 to 1988. He also was an Assistant General Counsel with The Prudential Insurance Company of America from 1970 to 1977 and an Associate at Dewey, Ballantine, Bushby, Palmer & Wood from 1966 to 1970.

Mr. Andrews graduated from Syracuse College of Law in 1966 and Holy Cross college in 1963. He is admitted to the Bar in New York City and is a member of the American Bar Association, Association of the Bar of the City of New York, Federation of Insurance and Corporate Counsel and ARIAS. ▼

Ralph C. Hemp



Ralph C. Hemp

Ralph Hemp began his insurance and reinsurance career in 1961, as an adjuster for Crawford & Company and left in 1967 as an Office Manager. He then became Home Office Claims Examiner for Olympic Insurance Company. In 1968, he joined Leatherby Insurance as Claims Manager. While at Leatherby, Mr. Hemp was involved not only in setting up a claims department, but also in setting up and managing an in-house legal department, all worker's comp statistical reporting, monitoring and supervising of MGAs. By the time he left Leatherby Insurance Company, he was Sr. VP, responsible for an eight-western-state region.

In 1976, Mr. Hemp joined North American Insurance Company for Property & Casualty as VP, responsible for all activities of this P&C company, reporting to the President. Shortly after arriving at NACPAC, he undertook a complete evaluation of the company and its operation, and laid out a plan for future operations. This plan was accepted by the President and senior officers of CIT, the parent of NACPAC.

Mr. Hemp set up offices in NYC and Connecticut, and took over the operations of several large MGA books of business. He worked with foreign and domestic brokers and agents, insurance departments, outside and in-house counsel, to manage the run off of this large volume of reinsurance and insurance business. He also was able to

CONTINUED ON PAGE 30

in focus


George P. Lagos


Allan E. Reznick


Leonard Ian Sleave

Profiles of all certified arbitrators are on the web site at www.arias-us.org

CONTINUED FROM PAGE 29

maintain licenses in all 50 states and Canada, and a satisfactory AM Best rating. At his direction, NACPAC was one of the first companies to set up a claims, underwriting and accounting audit department.

Mr. Hemp was promoted to President and, as the run-off came under control, he started to write reinsurance assured treaty business.

At about this time, the parent company of CIT was sold to RCA. Mr. Hemp and a group of investors approached RCA Corporation and were successful in buying NACPAC. NACPAC was operated as a private company for approximately one year and then went public. He retired in 1986 as CEO of NACPAC and Vice Chairman of NAC Re, the parent company.

Since 1986, Mr. Hemp has provided consulting services to insurance companies and reinsurance companies, and has been an active arbitrator serving on over 100 panels. He has also served as an umpire in arbitrations and has testified as an expert witness on approximately five occasions.

Mr. Hemp received his Bachelor of Arts degree from San Diego State University in 1961 and an LLB and JD in 1971. ▼

George P. Lagos

George Lagos is an attorney with twenty five years of diverse legal and business experience in the property-casualty insurance business. Mr. Lagos started his career as a staff attorney with New Hampshire Insurance Company, and was Vice President and General Counsel of this AIG subsidiary which was focused on independent agency business. During that time, Mr. Lagos was responsible for all legal and regulatory matters country wide, including oversight of the company's bad faith and extra-contractual claims litigation.

After consolidation of AIG's agency business into its domestic brokerage operation, Mr. Lagos became Senior Vice President and General Counsel to North American Specialty ("NAS"), a Swiss Re subsidiary that specialized in commercial program business. In addition to Mr. Lagos' legal responsibilities, he was also senior claims officer and a member of a tripartite office of the President.

In 1994 Mr. Lagos left NAS to take the position of President and CEO of Syndicated Services Company, an RK Carvill Subsidiary which managed and administered a portfolio of specialty commercial and professional liability business produced by program managers and reinsured with certain underwriters at Lloyds. He has had significant experience in the area of fronted program business and delegated underwriting authorities. Prior to retiring in 2006, Mr. Lagos had also assumed responsibilities as General Counsel to RK Carvill (International) Holdings, the Group's Bermuda based holding company, and was named as Chairman of Carvill America, Carvill's U.S. based reinsurance broking operation.

Mr. Lagos has held a number of industry related positions throughout his career. He is a past President of the NH Domestic Insurance Association and a former director of the NH Med Mal JUA, NH Guaranty Association and Maine Workers' Compensation Pool. ▼

Allan E. Reznick

Allan Reznick, a partner in the firm of Kramer Levin Naftalis & Frankel LLP, has over 26 years experience as an attorney and over 15 years experience in insurance and reinsurance. He has expertise in the following areas of practice: Mergers and Acquisitions, Insurance Holding Companies, Off-Shore Reinsurance, Protected Cell Companies, Retrocessions, Reinsurance Receivables, Commutation, Insolvency, Rehabilitation and Liquidation, Manufacturing, Oil and Gas, Professional Liability, Long Term Care, Workers' Compensation, Captives, Alternative Risk Transfer, Senior Settlements, Premium Finance, and Securitization of Insurance Assets. Mr. Reznick has been appointed to the New York City Bar Association Committee on Insurance and is the past Chair of its Life and Health Subcommittee. He has lectured on financing alternatives for insurance companies as well as on restructuring techniques for troubled insurance businesses.

Mr. Reznick received his J.D. at Rutgers University School of Law; his Ph.D. at the University of Wisconsin-Madison; his M.A. at University of Toronto and his B.A., cum laude, at Concordia University in Montreal.

Mr. Reznick was certified as an ARIAS-U.S. arbitrator on June 12, 2007. He believes the arbitration process can efficiently serve the needs of all parties and result in fair and equitable determinations. Mr. Reznick looks forward to applying his experience and background to the dispute resolution process. ▼

Leonard Ian Sleave

Ian Sleave retired as Managing Director of KWELM Management Services Limited in December 2006, after spending 18 years working in the Insurance and Reinsurance industries in the UK.

After graduating with a B.Sc. degree in Mathematics, Mr. Sleave trained as a Chartered Accountant and having spent a number of years with Peat Marwick Mitchell & Co (now KPMG), some of which were overseas, he returned to the UK. He spent the next ten years in international banking and stock-broking and undertook a number of roles & functions internationally with a large US Broking House including Vice President - International Internal Audit and Financial Controller - Banking, and eventually as Executive Director - Finance with Merrill Lynch Europe Limited.

In 1990, Mr. Sleave joined a recently formed UK insurance company and was responsible for establishing all the systems and procedures after the failure of its managing agent. He then moved to this managing agent to assist in the orderly transfer of part of its business to third parties and closing down of the company. For the past 16 years, work has involved the day-to-day management of the run off of the world's largest insurance liquidation/Scheme of Arrangement. Day-to-day work included involvement in initiating & resolving major international insurance/reinsurance disputes often involving arbitration/litigation proceedings and mediation which entailed dealing mainly with insurance & reinsurance companies worldwide. Mr. Sleave also dealt with major policyholders, over 90% of whom were based in the USA and included Fortune 500 companies, and settling a number of large direct claims. His work also included working with professional liquidators (both in the UK & US), international law firms and various Regulatory Authorities (predominantly UK and US). ▼

In Memorium…

Ronald Adair Jacks

September 4, 1935 – July 6, 2007

case notes corner

New York Appellate Division Rejects Cedent's Post-Settlement Reinsurance Allocations as Unreasonable

Case Notes Corner is a periodic feature on significant court decisions related to arbitration

Ronald S. Gass

Ronald S. Gass

Follow-the-settlements (loosely referred to by some courts as follow-the-fortunes) is a critical element of every reinsurance relationship and a doctrine that courts rarely fail to enforce to avoid disruptive second-guessing by reinsurers of cedents' reasonable, good faith settlements. However, this doctrine does have its limits as aptly demonstrated in a recent unanimous Supreme Court of New York, Appellate Division, First Department decision. That court rejected, as a matter of law, the cession of certain multi-site, multi-occurrence environmental losses to a facultative reinsurer primarily because the cedent's number of occurrences analysis underlying its global settlement with an insured was inconsistent with its post-settlement reinsurance allocation and would have required that "courts turn a blind eye to such manifest manipulation of the allocation process in total disregard of the reinsured's obligation to act in good faith."

In this case, the cedent insured United Technologies Corp. ("UTC") under two three-year property insurance policies, one with $6 million limits for the 1975-1978 period and the other with $10 million limits for the 1978-1981 period. UTC's self-insured retention under both policies was $200,000 for "any one occurrence." The cedent facultatively reinsured both policies, with the reinsurer's participation being 22% of $5 million excess $1 million on the 1975 policy and 25% of the same layer on the 1978 policy. Both certs had typical follow-the-settlements wordings. The 1975 cert provided, "This Certificate . . . is subject to the same . . . mode of settlement, as are, or were, or may be assumed or adopted by the Reinsured," and the 1978 cert provided, "The liability of Allstate shall follow that of the Company . . . ."

In 1992, UTC filed a federal district court action against its insurer seeking indemnification under the two policies for physical loss and damage allegedly due to environmental pollution at 17 sites. Throughout the litigation, both UTC and the insurer "consistently argued" that there were multiple occurrences at each site, and neither ever took the position that each one constituted just one occurrence. The trial proceeded in two phases, with one of the several UTC plants the subject of the first jury trial. The jury verdict was that there were seven separate areas at which loss or damage occurred during the relevant policy periods. The trial court subsequently found seven occurrences at this site for the purpose of calculating the number of UTC's SIRs (UTC had claimed seven occurrences, and the insurer claimed at least 18). Although the insurer sought a new trial and petitioned for an interlocutory appeal, the case was settled with neither party conceding its position regarding the number of occurrences at the first site.

During the second phase of the trial concerning the remaining 16 sites, the insurer's exposure analysis found multiple occurrences at each site and assigned an estimated cost of each occurrence. Two months prior to the scheduled 2002 trial, the parties settled, with the insurer agreeing to pay a lump sum of $112 million for all the remaining sites. During their settlement negotiations, the insurer claimed 95 occurrences at the 16 sites, and UTC claimed only 44.

Following the UTC global settlement, the cedent's lead counsel in the underlying UTC litigation prepared a complex reinsurance allocation analysis that was, according to the Appellate Division, "in stark contrast" to the cedent's position throughout the UTC litigation regarding the number of occurrences. It essentially resulted in a post-

Mr. Gass is an ARIAS•U.S. Certified Arbitrator and umpire. He may be reached via e-mail at rgass@gassco.com or through his Web site at www.gassco.com.

settlement one-occurrence-per-site-per-year allocation that enabled the cedent to pierce the fac certs' $1 million retentions and to bill the reinsurer $2,578,638 for its participations.

The reinsurer objected to this post-settlement allocation because it disregarded the cedent's multiple occurrence positions taken during the UTC litigation as well as its settlement allocation analysis, which had identified and allocated 21 occurrences for all the second phase sites. It also ignored the federal court's binding seven occurrences ruling in the first phase trial by assigning a single occurrence to that site. If this multiple occurrences per site analysis had been carried through to the reinsurance allocation, no single occurrence would have breached the cedent's $1 million retention per cert. Even if UTC's more conservative number of occurrences position had been adopted, there would still be no loss in excess of the retention.

The reinsurer subsequently filed a declaratory judgment action in the Supreme Court, New York County. On cross-motions for partial summary judgment, that court declared that the cedent's post-settlement allocation did *not* violate the terms of the parties' fac certs, was reasonable, and made in good faith. It relied on two U.S. Court of Appeals for the Second Circuit decisions, *North River Insurance Co. v. ACE American Reinsurance Co.*, 361 F.3d 134 (2d Cir. 2004), and *Travelers Casualty & Surety Co. v. Gerling Global Reinsurance Corp.*, 419 F.3d 181 (2d Cir. 2005), for the proposition that the follow-the-settlements doctrine was applicable regardless of any inconsistency between the reinsured's pre-settlement and post-settlement allocation positions.

Flatly rejecting the lower court's summary judgment ruling in favor of the cedent, the Appellate Division reversed, holding as a matter of law that the cedent was "playing by two sets of rules": one at the claim level to minimize the amount of the insured's exposure and loss, and another post-settlement to maximize its recovery against the reinsurer. It held:

> "The follow-the-fortunes doctrine was intended to foster consistency in the treatment of losses at both levels, insured and reinsured, not to allow an insurer to use a different set of rules at each level. *We soundly reject the notion that the follow-the-fortunes doctrine requires that courts turn a blind eye to such manifest manipulation of the allocation process in total disregard of the reinsured's obligation to act in good faith.*" [Emphasis added.]

The *Travelers* and *North River* decisions, according to the Appellate Division, do not require a reinsurer to accept its cedent's post-settlement loss allocation even if that allocation is contrary to its pre-allocation position and treatment of the loss allocation issue with its own insured. While the follow-the-settlements doctrine generally applies, it does so only as long as the allocation meets the usual follow-the-settlements requirements, i.e., it must be in good faith, reasonable, and within the applicable policies. As the court observed:

> "For [the cedent] to assert aggressively the maximum number of occurrences at each site to minimize its liability to its insured in the UTC litigation, and then completely change its position in allocating its loss to [the reinsurer] under the reinsurance certificates, is neither reasonable nor reflective of good faith. It is disingenuous."

The reinsurer was not bound by the cedent's post-settlement allocation of the $112 million lump sum payment, "where the reinsured's settlement allocation, at odds with its allocation of the loss with its insured, designed to minimize its loss, reflects an effort to maximize unreasonably the amount of collectible reinsurance." Moreover, its single occurrence allocation of the first phase site clearly diverged from the trial court's binding determination that there were seven occurrences. The Appellate Division found that the cedent had used a one-occurrence-per-site calculation in its post-settlement reinsurance allocation "to exaggerate its reinsurance claim against Allstate" as to that site.

As this rare follow-the-settlements decision favoring a reinsurer demonstrates, the doctrine definitely has its limits, particularly when there is such a stark difference between the cedent's pre-allocation positions and post-settlement reinsurance allocations. Such troubling allocation differences will be scrutinized by the court and subjected to the reasonableness and good faith tests. Any failing post-settlement allocations may then be struck down by the court as a matter of law.

Allstate Insurance Co. v. American Home Assurance Co., 837 N.Y.S.2d 138, 2007 N.Y. App. Div. LEXIS 7284, 2007 N.Y. Slip Op. 5170 (N.Y. App. Div. 1st Dep't June 12, 2007). ▼

As this rare follow-the-settlements decision favoring a reinsurer demonstrates, the doctrine definitely has its limits, particularly when there is such a stark difference between the cedent's pre-allocation positions and post-settlement reinsurance allocations.

ARIAS U.S.

Certified Arbitrators

as of September 2007

Therese A. Adams
Paul R. Aiudi
Hugh Alexander
John P. Allare
John T. Andrews
David Appel
David V. Axene
Richard S. Bakka
Michael V. Balzer
Christine E. Bancheri
Martha G. Bannerman
Nasri H. Barakat
Linda Martin Barber
Frank J. Barrett
Robert A. Bear
Clive A. R. Becker-Jones
David L. Beebe
Paul A. Bellone
Dennis A. Bentley
Peter H. Bickford
George J. Biehl
Katherine Lee Billingham
John W. Bing
John H. Binning
Edgar Ward Blanch Jr.
William K. Borland
Christian H. Bouckaert
Paul Braithwaite
Donald S. Breakstone
Daniel G. Brehm
Paul D. Brink
David S. Brodnan
Brian Z. Brown
Robert C. Bruno
D. Robert Buechel Jr.
Janet J. Burak
Robert K. Burgess
Mary Ellen Burns
W. Lockwood (Locke) Burt
Malcolm B. Burton
Frank T. Buziak
Cecil D. Bykerk
James I. Cameron
David L. Cargile
Bruce A. Carlson
Joseph E. Carney
Sheila J. Carpenter
Charles W. Carrigan
John R. Cashin
Marvin J. Cashion
R. Michael Cass
John F. Chaplin
Susan S. Claflin
Dewey P. Clark
Peter C. Clemente
Martin B. Cohen
John D. Cole
Robert L. Comeau
William P. Condon
Thomas F. Conneely
Charles F. Cook
Carolyn Cunniff Corcoran
James P. Corcoran
Carol K. Correia
John W. Cowley
Peter L. Craft
Dale C. Crawford
John J. Cuff
Patrick B. Cummings
Cathryn A. Curia
Bina T. Dagar
Thomas M. Daly
Paul Edward Dassenko
John W. Dattner
Michael S. Davis
Joelle de Lacroix
Donald T. DeCarlo
John B. Deiner
Howard D. Denbin
Joseph J. DeVito
John S. Diaconis
Theodor Dielmann
A.L. (Tony) DiPardo
Brian J. Donnelly
John A. Dore
Andrew Ian Douglass
James F. Dowd
John H. Drew
Allan H. Dunkle
John Dunn
Clement S. Dwyer Jr.
Charles G. Ehrlich
Michael W. Elgee
Charles S. Ernst
William F. Fawcett
Robert J. Federman
Paul Feldsher
Javier Fernandez-Cid
Ann L. Field
Mark J. Fisher
Paul R. Fleischacker
Charles M. Foss
Caleb L. Fowler
William W. Fox Jr.
James (Jay) H. Frank
Richard C. Franklin
Gregg C. Frederick
Kenneth H. French
Peter Frey
Michael P. Gabriele
Steven A. Gaines
James P. Galasso
Ronald S. Gass
Peter A. Gentile
Ernest G. Georgi
Joseph A. Gervasi
Colin L. Gray
Robert B. Green
Hugh W. Greene Jr.
Thomas A. Greene
David A. Grefe
George F. Grode
Susan E. Grondine
Mark S. Gurevitz
Martin D. Haber
Franklin D. Haftl
William D. Hager
Debra J. Hall
Robert F. Hall
Robert M. Hall
Lawrence F. Harr
George E. Hartz III
Cathy A. Hauck
William G. (Sandy) Hauserman
Charles W. Havens III
Paul D. Hawksworth
Alan R. Hayes
James S. Hazard
John Heath
Ralph Hemp
Robert D. Holland
Harold Horwich
John H. Howard
William H. Huff III
Ian A. Hunter
Fritz K. Huszagh
Louis F. Iacovelli
Wendell Oliver Ingraham
Bonnie B. Jones
Leo J. Jordan
Jens Juul
Lydia B. Kam Lyew
Sylvia Kaminsky
Keith E. Kaplan
Jerome Karter
James Ignatius Keenan Jr.
Cecelia (Sue) Kempler
T. Richard Kennedy
Robert Edwin (Pete) Kenyon III
Bernard A. Kesselman
James K. Killelea
William M. Kinney
Patricia M. Kirschling
Joel D. Klaassen
David D. Knoll
Floyd H. Knowlton
Eric S. Kobrick
Jack E. Koepke
Klaus H. Kunze
John M. Kwaak
George P. Lagos
Linda H. Lamel
Anthony M. Lanzone
Mitchell L. Lathrop
Frank A. Lattal
Soren N. S. Laursen
Jim Leatzow
Y. John Lee
Raymond J. Lester
Charles T. Locke
Joseph Loggia
Denis W. Loring
Douglas R. Maag
W. James MacGinnitie
Susan E. Mack
Lawrence C. Magnant
Peter F. Malloy
Richard Mancino
Andrew Maneval
Jennifer Mangino
Robert M. Mangino
Richard S. March
Merton E. Marks
Richard E. Marrs
Fred G. Marziano
Roderick (Rod) B. Mathews
Timothy T. McCaffrey
Stephen E. McCarthy
Paul J. McGee
Thomas J. McGeough
John McKenna
Edward J. McKinnon
Mark T. Megaw
Robert B. Miller
Edwin M. Millette
Christian M. Milton
Roger M. Moak
Lawrence O. Monin
Francis A. (Frank) Montemarano
Rodney D. Moore
Claudia Backlund Morehead

John A. Morgan
Jeffrey L. Morris
Patrick J. Murphy
Gerald F. Murray
William J. Murray
Raymond M. Neff
Diane M. Nergaard
Thomas R. Newman
David J. Nichols
Barbara Niehus
Gail P. Norstrom
Patrick J. O'Brien
Robert J. O'Hare Jr.
Constance D. O'Mara
Reinhard W. Obermueller
Elliot S. Orol
James M. Oskandy
Michael W. Pado
Herbert Palmberger
Stephen J. Paris
Griffith T. Parry
Glenn R. Partridge
James J. Phair
Edgar W. Phoebus Jr.
Joseph J. Pingatore
Andrew J. Pinkes
Thomas A. Player
James J. Powers
George C. Pratt
Michael D. Price
Raymond L. Prosser
Robert C. Quigley
Frank E. Raab
Joseph W. Rachinsky
Peter F. Reid
George M. Reider Jr.
Robert C. Reinarz
Allan E. Reznick
Steven J. Richardson
Kevin T. Riley
Timothy C. Rivers
David R. Robb
Eileen T. Robb
Debra J. Roberts
Robert L. Robinson
Edmond F. Rondepierre
Jonathan Rosen
Angus H. Ross
Brenda L. Ross-Mathes
Andrew N. Rothseid
Don A. Salyer
Molly P. Sanders
Peter A. Scarpato
Daniel E. Schmidt IV
Jack R. Scott
Savannah Sellman
James A. Shanman
Richard M. Shaw
Radley D. Sheldrick
Richard M. Shusterman
Frederick M. Simon
Paul M. Skrtich
L. Ian Sleave
David W. Smith
Richard D. Smith
Richard E. Smith
David Spiegler
Walter C. Squire
Timothy W. Stalker
J. Gilbert Stallings
Paul N. Steinlage
Richard E. Stewart
Michael H. Studley
C. David Sullivan
John D. Sullivan
Peter Suranyi
James E. Tait
David A. Thirkill
Elizabeth M. Thompson
N. David Thompson
Paul C. Thomson III
John J. Tickner
Kevin J. Tierney
Harry Tipper III
Thomas M. Tobin
Michael J. Toman
Daniel T. Torpey
William H. Tribou III
David W. Tritton
William J. Trutt
Jacobus J. Van de Graaf
James D. Veach
Theodore A. Verspyck
Richard L. Voelbel
Robert C. Walker
William J. Wall
Jeremy R. Wallis
Andrew S. Walsh
Michael T. Walsh
Paul Walther
Richard G. Waterman
Richard L. Watson
Barry Leigh Weissman
Alfred O. Weller
Emory L. White Jr.
Richard L. White
Charles J. Widder
William Wigmanich
W. Mark Wigmore
Michael S. Wilder
P. Jay Wilker
Eugene T. Wilkinson
William A. Wilson
W. Rodney Windham
Ronald L. Wobbeking
Eugene Wollan
Allan M. Zarcone
Michael C. Zeller
George G. Zimmerman

ARIAS·U.S. Umpire List

The ARIAS·U.S. Umpire List is comprised of ARIAS·U.S. Certified Arbitrators who have provided the Board of Directors with satisfactory evidence of having served on at least three completed (i.e., a final award was issued) insurance or reinsurance arbitrations. The ARIAS Umpire Selection Procedure selects at random from this list. Complete information about that procedure is available on the website at www.arias-us.org.

Therese A. Adams
Hugh Alexander
John T. Andrews
David Appel
Richard S. Bakka
Nasri H. Barakat
Frank J. Barrett
Paul A. Bellone
Peter H. Bickford
John W. Bing
John H. Binning
Janet J. Burak
Mary Ellen Burns
Bruce A. Carlson
R. Michael Cass
Dewey P. Clark
Peter C. Clemente
John D. Cole
Robert L. Comeau
Dale C. Crawford
Thomas M. Daly
Paul Edward Dassenko
Donald T. DeCarlo
John B. Deiner
A.L. (Tony) DiPardo
John A. Dore
James F. Dowd
Michael W. Elgee
Robert J. Federman
Charles M. Foss
Caleb L. Fowler
James (Jay) H. Frank
Peter Frey
Ronald S. Gass
Peter A. Gentile
Robert B. Green
Thomas A. Greene
Martin D. Haber
Franklin D. Haftl
Robert F. Hall
Robert M. Hall
Charles W. Havens III
Paul D. Hawksworth
Ian A. Hunter
Wendell Oliver Ingraham
Sylvia Kaminsky
T. Richard Kennedy
Floyd H. Knowlton
Klaus H. Kunze
Denis W. Loring
Peter F. Malloy
Andrew Maneval
Robert M. Mangino
Lawrence O. Monin
Rodney D. Moore
Diane M. Nergaard
Herbert Palmberger
James J. Phair
James J. Powers
George C. Pratt
Robert C. Reinarz
Debra J. Roberts
Edmond F. Rondepierre
Jonathan Rosen
Peter A. Scarpato
Daniel E. Schmidt IV
Richard D. Smith
David A. Thirkill
Elizabeth M. Thompson
N. David Thompson
Paul C. Thomson III
John J. Tickner
Kevin J. Tierney
Thomas M. Tobin
William J. Trutt
Jeremy R. Wallis
Andrew S. Walsh
Paul Walther
Richard G. Waterman
Emory L. White Jr.
Richard L. White
W. Mark Wigmore
Michael S. Wilder
Eugene T. Wilkinson
Ronald L. Wobbeking
Eugene Wollan

SAVE THE DATE May 7-9, 2008 SAVE THE DATE May 7-9, 2008

The ARIAS 2008 Spring Conference will be located at the beautiful Ritz-Carlton Hotel on Amelia Island. The island is located on the Atlantic Ocean in Florida, near the border with Georgia. All 444 rooms have balconies and an ocean view; it offers an 18-hole golf course, nine tennis courts, and a dramatic new 26,000 square-foot, state-of-the-art spa facility just completed in December 2006. The excellent conference facilities are perfectly sized for ARIAS sessions. **Details will be on the website calendar as they develop**.

You will not want to miss this event!

SAVE THE DATE May 7-9, 2008 SAVE THE DATE May 7-9, 2008

ARIAS U.S. Membership Application

AIDA Reinsurance & Insurance Arbitration Society
PO BOX 9001
MOUNT VERNON, NY 10552

Complete information about ARIAS•U.S. is available at www.arias-us.org. Included are current biographies of all certified arbitrators, a current calendar of upcoming events, online membership application, and online registration for meetings.

914-966-3180, ext. 116

Fax: 914-966-3264

Email: info@arias-us.org

Online membership application is available with a credit card through "Membership" at www.arias-us.org.

NAME & POSITION ______________________________

COMPANY or FIRM ______________________________

STREET ADDRESS ______________________________

CITY/STATE/ZIP ______________________________

PHONE ______________ CELL ______________

FAX ______________ E-MAIL ______________

Fees and Annual Dues: Effective 10/1/06

	INDIVIDUAL	CORPORATION & LAW FIRM
INITIATION FEE	$500	$1,500
ANNUAL DUES (CALENDAR YEAR)*	$275	$825
FIRST-YEAR DUES AS OF APRIL 1	$183	$550 (JOINING APRIL 1 - JUNE 30)
FIRST-YEAR DUES AS OF JULY 1	$92	$275 (JOINING JULY 1 - SEPT. 30)
TOTAL (ADD APPROPRIATE DUES TO INITIATION FEE)	$__________	$__________

* Member joining and paying the full annual dues after October 1 is considered paid through the following calendar year.

NOTE: Corporate memberships include up to five designated representatives. Additional representatives may be designated for an additional $150 per individual, per year. Names of designated corporate representatives must be submitted on corporation/organization letterhead or by email from the corporate key contact and include the following information for each: name, address, phone, cell, fax and e-mail.

Payment by check: Enclosed is my check in the amount of $__________
Please make checks payable to
ARIAS·U.S. (Fed. I.D. No. 13-3804860) and mail with
registration form to: ARIAS·U.S.
PO Box 9001, Mt. Vernon, NY 10552

Payment by credit card (fax or mail): Please charge my credit card:

☐ AmEx ☐ Visa ☐ MasterCard in the amount of $______________

Account no. ______________________________

Exp. _______/_______/_______ Security Code ______________________

Cardholder's name (please print) ______________________________

Cardholder's address ______________________________

Signature ______________________________

By signing below, I agree that I have read the By-Laws of ARIAS•U.S., and agree to abide and be bound by the By-Laws of ARIAS•U.S. The By-Laws are available at www.arias-us.org in the About ARIAS section.

____

Signature of Individual or Corporate Member Applicant

ARIAS U.S. Board of Directors

ARIAS U.S.
P.O. Box 9001
Mt. Vernon, NY 10552

FIRST CLASS
PRE-SORT
U.S. POSTAGE
PAID
MONSEY, NY
PERMIT NO. 9161