Three Issues for Captives When Arbitrating Reinsurance Disputes

by Robert M. Horkovich and Peter A. Halprin

As companies increasingly look to captive insurance structures as an alternative to traditional insurance policies, they should be aware that a captive's resolution of its insurance disputes (which are disputes in the reinsurance forum) will involve reinsurance issues that may be new to those with only direct insurance experience.

There are three issues that captive insurance companies should be prepared to address in their reinsurance disputes with their captive's reinsurance companies:

1. *Follow the fortunes and collusion allegations.* The convention that a reinsurer will generally "follow the fortunes" of the primary insurance company's underwriting decisions is intended to limit disputes. Sometimes, however, reinsurers will argue that a captive's settlement with a policyholder was collusive and need not be covered.
2. *Selection of arbitrators.* For a captive, the requirement that arbitrators in reinsurance disputes be former or current reinsurance company executives can be troubling as such individuals may be used to traditional reinsurance that may not involve captive structures and may be biased as a result.
3. *Relief from judicial formalities.* As reinsurance arbitration provisions often relieve the arbitrators of following judicial formalities, captives may find their disputes are subject to equities rather than law.

FOLLOW THE FORTUNES AND COLLUSION ALLEGATIONS

In general, the "follow the fortunes" doctrine requires a reinsurer to follow its cedent's underwriting fortunes. Thus, where a "follow the fortunes" clause is present, a reinsurer generally must respect a cedent's decision to pay or contest underlying claims. According to commentators, the only proper inquiry under the doctrine is whether the cedent's determination was reasonable and in good faith. As set forth by the United States District Court for the Southern District of Ohio in *International Surplus Lines Ins. Co. v. Certain Underwriters & Underwriting Syndicates Lloyd's of London*, 868 F. Supp. 917, 921 (S.D.Ohio 1994):

"This standard is purposefully low. Were the court to conduct a de novo review of [the cedent's] decision-making process, the foundation of the cedent-reinsurer relationship would be forever damaged. The goals of maximum coverage and settlement that have been long established would give way to a proliferation of litigation. Cedents faced with de novo review of their claims determinations would ultimately litigate every coverage issue before making any attempt at settlement. Such a consequence this court will not abide."

Assuming a captive insurance company finds itself in a reinsurance dispute, the reinsurance company may seek to avoid payment by arguing that there was collusion between the policyholder and the captive insurance company. As noted above, one exception to "follow the fortunes" is bad faith, and this can take the form of collusion. In *Hartford Accident & Indem. Co. v. Columbia Cas. Co.*, the court found that bad faith was a possibility where the reinsured failed to follow its customary practice of retaining an environmental expert before settling an asbestos claim. (98 F. Supp. 2d 251 (D.Conn. 2000)). In *Mentor Ins. Co. (U.K.) Ltd. v. Norges Brannkasse*, however, the United States Court of Appeals for the Second Circuit rejected the notion that there should be greater scrutiny of settlements between captive insurance companies and their policyholders due to a greater likelihood of collusion. (996 F.2d 506, 515 (2d Cir. 1993)). The court ruled that the captive's settlement with its parent

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company was *not* "tainted...by inbred corporate relationships" as the reinsurers "were aware of those corporate relationships from the outset" and failed to provide evidence that the settlement was tainted, fraudulent, collusive, or made in bad faith.

Given the high bar required to prove collusion, captive administrators can take some comfort. Scrupulously following and documenting the captive's established procedures when handling claims should protect the captive from coverage defenses based on collusion.

ARBITRATOR SELECTION

While finding the right arbitrator for a dispute can present a challenge in the best of circumstances, provisions in some insurance and reinsurance policies setting forth the required qualifications for arbitrators can further tilt the playing field against a captive. In both the insurance and reinsurance context, for example, qualifications provisions may provide as follows:

"The arbitrators shall be active or retired executive officers of insurance or reinsurance companies."

Requiring all arbitrators to have served as executive officers of an insurance or reinsurance company can be challenging for captive insurance companies, as the arbitrators may be unfamiliar with captives or have some bias against them.

That said, given the abundance of captives, there should be directors or officers of captives who are willing to serve. Developing relationships within the industry and preparing a list of potential arbitrators in advance of any conflict can offset any inherent advantage that might otherwise fall to the reinsurance company.

RELIEF FROM JUDICIAL FORMALITIES

Some reinsurance policies contain a so-called "Honorable Engagement" clause permitting equitable rather than legal considerations, with language such as the following:

"The arbiters shall consider this agreement an honorable engagement rather than merely as a legal obligation and they are relieved of all judicial formalities and may abstain from following the strict rules of law."

It has been noted that such clauses "have [been] read generously [by courts], [with courts] consistently finding that arbitrators have wide discretion to order remedies they deem appropriate." (See *Banco de Seguros del Estado v. Mut. Marine Office, Inc.*, 344 F.3d 255, 261 (2d Cir. 2003).) Indeed, in the reinsurance industry, arbitrators often look to industry trade practices in reaching their decision.

Captive owners should regard the dispute resolution provisions in reinsurance contracts as negotiable, and be proactive about establishing procedures they are comfortable with in connection with the purchase of the reinsurance. Maintaining a list of pre-vetted arbitrators, as suggested above, may render proceedings less of a risk.

CONCLUSION

Captives involved in reinsurance disputes should be aware of the rarefied world that they are entering—and take proactive measures both to forestall disputes and to ensure that they take place on a level playing field. The deferential standard of "follow the fortunes" can limit the grounds upon which a reinsurance company can challenge the claims decisions of a captive insurance company. However, in a dispute, a captive insurance company may need to fend off the argument that a claim was resolved in a collusive matter—and should make sure that its claims-handling procedures will position them to do so, keeping in mind that the notion that a captive-policyholder relationship inherently is collusive has been rejected. In the advance of a dispute and in the event of a dispute, a captive insurance company will also need to find arbitrators who will give it a fair hearing—including, if necessary, in proceedings in which judicial formalities may be relaxed, and where a decision may be made in equity. ■

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