<u>SHOULD ARBITRATORS FOLLOW LEGAL DECISIONS? – CASES IN POINT</u>

A critical question facing companies, counsel, and arbitrators is the weight arbitrators will (or should) give to case-law in deciding reinsurance disputes. The clearest argument in favor of relatively strict adherence, at least to court decisions that would affect the outcome on the merits, is that when insurers and reinsurers must make the business decisions that can ultimately lead to arbitration, court decisions provide a reference body against which they can evaluate how to proceed. In contrast, arbitration decisions are confidential and thus do not provide guidance—beyond whatever a party may have experienced in previous cases or heard about through industry talk.

Yet, it is frequently the case that the arbitration agreement itself frees the panel from strict adherence to law and instead directs it to the somewhat open-ended concepts of “custom and practice” and/or “an honorable engagement.” What is “custom and practice” is likely to be vigorously disputed between the parties, while “honorable” conduct can an even more variable test.

So, what are internal decision-makers to do? Should they rely upon seemingly on point or closely on point judicial decisions or should they endeavor to predict what an arbitration panel will find to be “custom and practice” and/or “honorable?” What should arbitrators do? The important New York Court of Appeals decision in <u>*U.S. Fid. & Guar. Co. v. Am. Re-Ins. Co.*</u>, 20 N.Y.3d 407 (2013) gives us food for thought.

In 2013, the New York Court of Appeals, the state’s highest court, decreed that reinsurers are bound to follow settlements (and allocations) that are “objectively reasonable”. According to the Court, a settlement is “objectively reasonable” if it is one “that the parties to the settlement would have agreed to in the absence of reinsurance." U.S. Fid. & Guar. Co. v. Am. Re-Ins. Co., 20 N.Y.3d 407, 420 (2013) ("USF&G"). In its discussion, the Court observed the practical reality that a cedent is likely to adopt an allocation that is financially rewarding. The Court also stated that a cedent is not required to adopt an allocation that is least favorable to it. In fact, the Court stated that, "the cedent's motive should generally be unimportant." *Id.* at 421.

All of this begs us to inquire, "Where did these rules come from?" Were they advocated by counsel in the briefing or during the argument? Was the Court relying upon expert witness testimony? Was there anything in prior follow the settlements cases suggesting that courts were trending in the direction of "objective reasonableness?" Or, was the Court simply attempting to fashion a standard that would make it easier for courts to summarily adjudicate reinsurance disputes? After all, if motive is generally "unimportant," does this render irrelevant a cedent's desire to create or to maximize a reinsurance recovery?

Litigants will live with the USF&G rules for the foreseeable future - - and probably beyond. As we have learned from the Bellefonte debate, which has literally lasted for almost 30 years, once an appellate court establishes relevant precedent, subsequent courts are bound by the rule of *stare decisis* to follow it. The recent decision in Global Reins. Corp. of Am. v. Century Indem. Co., 2017 N.Y. LEXIS 3723 (Dec. 14, 2017), in which the NY Court of Appeals was asked to clarify whether, in deciding Excess Insurance Co. Ltd. v. Factory Mutual Ins. Co., 3 N.Y.3d 577 (2004), it intended to establish a rule of contract construction or only to create a presumption that a facultative certificate's limit of liability includes expenses, reveals just how powerful the rule of stare decisis is. Even with the Global Re Court all but admitting that Bellefonte was decided incorrectly, it was reluctant to overturn that decision or those which had followed its premise. Time will tell whether the Second Circuit, which will now consider the issue in light of the NY Court of Appeals guidance, elects to overturn those decisions.

How Does USF&G Align With Industry Custom & Practice

As a general proposition, various prerequisites to application of follow the settlements have been expressed - - both in the context of the back and forth between insurers and reinsurers in respect of particular cessions and in the context of litigated disputes. These include arguable coverage, reasonableness, good faith, absence of collusion between insurer and insured, and acting in a businesslike manner. As a matter of custom and practice in the reinsurance industry, reasonableness and good faith appear to be the two most widely recognized and universally accepted elements to be established (or refuted, depending on whether a tribunal places the burden of proof on the party seeking to avoid application of follow the settlements).

Historically, and to this date, reinsurers have contended that 1) settlements must be reinsurance-blind, 2) a cedent must make its settlement decisions on the basis that it has 100% net responsibility for payment of the settlement, and 3) that cedents must treat the interests of the reinsurers as their own. To the extent that these arguments find their basis in accepted industry custom and practice, they are effectively gutted by USF&G. Specifically, USF&G invites cedents not to treat the interests of the reinsurers as their own. USF&G essentially portrays reinsurers as naïve to believe that cedents will not consider reinsurance implications when making their settlement and allocation decisions.[1] Indeed, if literally applied, USF&G arguably

[1] That said, a recent district court decision, denying summary judgment to a cedent on follow the settlements, found that the reinsurer submitted ample evidence of the cedent's "extreme efforts to ensure an allocation of the settlement to its umbrella policy reinsurers, proving it was impermissible and in bad faith. Drawing all inferences in [reinsurer's] favor, a rational trier of fact could conclude that [the cedent] included the stipulations in the Settlement Agreement…solely to ensure access to its reinsurance…Under this version of the facts, [the cedent's] allocation was improper and in bad faith and would not have

validates the targeting of reinsurers in allocating settlements, particularly if a court finds that motive is irrelevant and excludes evidence of bad faith. There is little doubt that USF&G does not comport completely with accepted industry practice.

What does USF&G instruct on a cedent's duty to act in good faith? That the Court did not question prior judicial decisions - - which it cited with seeming approval - - finding that application of follow the settlements required both reasonableness and good faith, it is fair to assume that evidence of bad faith is still a relevant consideration.[2] To what extent, however, remains to be seen.

The Potential Impact of USF&G Upon Accepted Industry Practice

Will the industry adopt the USF&G standard of objective reasonableness as the new test for application of follow the settlements? The answer to that question is, probably not. As the duty of good faith is so engrained in the reinsurance relationship, the expectation continues to be that the cedent will act in good faith. Contrary to USF&G, motive is singularly important, and a focal point in virtually every arbitration in which the application of follow the settlements is being challenged. The quid pro quo for accepting the obligation to follow settlements and granting deference to a reinsured's coverage determinations is the expectation that the cedent will act - - and has acted - - in good faith. While cedents will cite the "objective reasonableness" test in reinsurance arbitrations, arbitrators are as likely to cut off an inquiry into a cedent's

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resulted from arm's length negotiations if reinsurance did not exist, and [the reinsurer] would therefore not be required to follow the terms of the Settlement Agreement." Utica Mut. Ins. Co. v. Fireman's Fund Ins. Co., 238 F.Supp.3d 314, 346 (N.D.N.Y. Feb. 24, 2017)

[2] There is, however, at least one reported arbitration decision of which we are aware, chaired by a retired federal judge, in which the Panel declined to grant discovery on the issue of intent based upon the USF&G rationale regarding motive.

motivation as a cedent is likely to concede that it did consider the reinsurance implications of its decisions when making them. In other words, it is highly unlikely.

Things get a bit dicey when the issue is allocation. When it comes to allocation, the interests of the cedents and reinsurers are not necessarily aligned. In some circumstances the allocation decision determines whether the cedent or the reinsurer will bear the loss. And because of scenarios such as these, it is fair to ask whether follow the settlements should apply to allocation decisions at all. This leads us to the seminal judicial decision in Commercial Union v. Seven Provinces. In Seven Provinces, a Massachusetts federal district court found, after a trial, that follow the settlements applies to the allocation of the settlement. 9 F.Supp.2d 49 (D.Mass. 1998), aff'd by 217 F.3d 33 (1st Cir. 2000). Prior to Seven Provinces, there were no industry publications espousing that follow the settlements applies - - or should apply - - to the allocation process. Nor had we ever heard of anyone articulating that concept.

In Seven Provinces, Commercial Union's allocation was consistent with both the settlement and Commercial Union's assessment of the exposure that damages at the various environmental sites presented to its policies. It argued that because the allocation was consistent with the settlement and the exposures which drove it, the allocation should be judged by the same standards of reasonableness and good faith.

Courts define custom and practice as the universally accepted way that things are done in the industry. See, *e.g.*, Law Debenture Trust Co. of New York v. Maverick Tube Corp., 595 F.3d 458, 466 (2d Cir. 2010) (stating "custom must be established, and not casual, uniform and not varying, general and not personal, and known to the parties"); SR Int'l Bus. Co. v. World Trade Ctr. Props., LLC, 467 F.3d 107, 135 (2d Cir. 2006)(The "party seeking to establish [the] custom and usage must establish, by competent evidence, that the practice is fixed and invariable.") With such a high threshold - - *i.e.,* universal acceptance - - very few things in reinsurance would qualify. But those who have spent a lifetime in the business have an innate appreciation for acceptable market conduct.[3] In the twenty years since Seven Provinces, the reinsurance industry is still not in complete accord as to whether follow the settlements applies to the allocation process. While the industry understands that the courts will apply follow the settlements to allocation, the industry also recognizes that reinsurers are likely to push back on reinsurance presentations that deviate from the settlement or where there is a sense that the cedent and the insured negotiated an unfair or self-serving allocation in the settlement agreement.[4]

Seven Provinces and USF&G both involved challenges to allocation. Also common to both cases is that each appears to have expanded application of follow the settlements. Seven Provinces expansion of the concept was arguably inadvertent because Commercial Union did not advocate that follow the settlements applies to the allocation process; rather, Commercial Union argued only that because the settlement drove a consistent allocation, the propriety of the allocation should be assessed on the same basis. The reinsurance industry would universally accept application of follow the settlements to an allocation that is consistent with a settlement which itself is driven by the reinsured's assessment of the exposure that the losses presented to its policies. To the extent that the allocation deviates from the settlement, and is driven by other commercial considerations, not so much. The follow the settlements cases decided since Seven

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[3] In a very real sense, market participants set the boundaries for such conduct.

[4] USF&G recognized this possibility and stated that just because the insured and insurer agreed on an allocation does not make it binding on reinsures. The Court stated that, "far from being indifferent, [insureds] will enthusiastically support insurers' efforts to fund a settlement at reinsurers' expense."

Provinces make it clear that the Seven Provinces scenario - - an allocation consistent with the settlement driven by the insurer's perception of exposure to its policies - - is not the only reasonable allocation that can be sustained. It is only the most reasonable, and the one selected need to be the most reasonable.

It is too early to know whether USF&G will take root in accepted industry custom and practice. To the extent that USF&G is read to eliminate the requirement of good faith in assessing the propriety of an allocation, it is not likely to generate much traction. The creation or maximization of reinsurance recoveries is not objectionable if it is the byproduct of an otherwise reasonable allocation and performed in good faith. On the other hand, if the allocation is motivated by the desire to create or maximize a reinsurance recovery, it will not be accepted by the assuming reinsurance marketplace. The closer question is where the desire to create or maximize a reinsurance recovery is only a factor, but not the primary motivation, in a cedent deciding how to allocate the settlement. At the present time, USF&G has only been cited in a handful of cases. See, e.g., Utica v. Fireman's; Travelers Indem. Co. v. Excalibur Reins. Corp., 2013 U.S. Dist. LEXIS 50134 (D. Conn. Apr. 8, 2013) ("[Reinsurer] is entitled under the New York Court of Appeals cases to challenge the reasonableness of [cedent's] post-settlement allocation decision, and to argue that the economic consequence of that allocation violates or disregards provisions in the reinsurance contract"); New Hampshire Ins. Co. v. Clearwater Ins. Co., 129 A.D.3d 99 (1st Dep't 2015); Lexington Ins. Co. v. Sirius Am. Ins. Co., 2014 N.Y. Misc. LEXIS 4138 (NY. Sup. Ct. Sept. 15, 2014). None have expressly interpreted USF&G to eliminate good faith from the follow the settlements equation. As stated at the outset of this discussion, any standard that eliminates the duty to act in good faith is not likely to find support in the industry.

While the industry has come to accept Seven Provinces, it continues to struggle with cases that have gone beyond Seven Provinces and have sustained allocations that 1) do not comport with the cedent's pre-settlement assessment of its exposure, or 2) suggested that allocations which are inconsistent with the settlement may nonetheless be entitled to deference. The reason that the industry accepts Seven Provinces is because "follow the allocation" as applied there, was consistent with accepted application of follow the settlements. As far as USF&G is concerned, the industry may never be willing to remove good faith from the playing field.

Ignoring The Law

Industry arbitrators are sensitive to claims that their decisions ignore the law. Do any of us have experience in industry arbitrations where arbitrators made their ruling based upon a belief that they were bound to follow the law even if inconsistent with their own understanding of how things are generally done in the industry? If so, that is unfortunate.[5]

Manifest disregard of the law is one of the limited grounds recognized to vacate an arbitration award. However, there is little to no likelihood of an arbitration award being vacated because the arbitrators did not follow the letter and spirit of USF&G - - by failing to require the reinsurer to establish that the allocation was not objectively reasonable. At least three factors are responsible for this: first, case law has developed to the point where courts actually question whether there is a basis to vacate an award based on a claim that the arbitrators did not follow the

[5] We have been involved in an arbitration in which the arbitrators excused misrepresentations and concealment of information from the reinsurers at the time the reinsurance was placed as "common industry deceit" and declined to grant rescission.

law;[6] second, some arbitration clauses contain express language relieving arbitrators of the obligation to "follow the strict rules of law" and/or suggesting that they reach their decision based on industry practice or by treating the contract evidencing the reinsurance relationship as an "honorable undertaking"; third, arbitration awards, even if reasoned, are not likely to announce that the arbitrators have considered but have disregarded applicable law.[7] Consequently, even if the arbitration clause required that the arbitrators apply the law of a particular state, it would be impossible for a court to find that they did not do so.[8] As long as there is any basis at all in the record upon which the award can be sustained, a court will not disturb the award.

Conclusion

Today's disputes, in many instances, involve contracts written in the 1960's and 1970's. When follow the settlements evolved, the industry was dealing with occurrences or accidents with definitive dates of loss, and was not confronting asbestos, environmental and other toxic tort claims spanning multiple policy periods. Has the industry evolved to meet unanticipated challenges? When allocation became part of the insurance and reinsurance landscape, the

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[6] As a practical matter, it is an uphill battle to vacate an arbitration award, even if the challenge is based on one of the grounds stated in the federal statute as a basis to vacate. Manifest disregard of the law is not among the statutory grounds and is the least likely basis upon which to prevail. See Federal Arbitration Act, 9 U.S.C.A. § 10(a)(1)-(3). The Second Circuit has emphasized that awards are vacated on the judicially created grounds of manifest disregard "only in those exceedingly rare instances where some egregious impropriety on the part of the arbitrator is apparent." T.Co Metals, LLC v. Dempsey Pipe & Supply, Inc., 592 F.3d 329, 339 (2d Cir. 2010).

[7] There are a number of decisions standing for the proposition that an arbitration award will not be vacated merely because the law would have mandated a different outcome had the matter been litigated. An example of this is where a Panel supports a reinsurance billing even though the arbitration was commenced after expiration of an applicable statute of limitations.

[8] Misapplication of the law is not a ground to vacate an arbitration award.

industry found a way to deal with allocation. There were a number of arbitral disputes in which allocation was challenged. These disputes were resolved without it being necessary to state, one way or the other, whether the concept of follow the settlements required the reinsurer to defer to the cedent's allocation decisions. Despite the labelling provided by Seven Provinces, the industry continues to assess the propriety of allocations as it did before Seven Provinces.

It is probable that USF&G will play out in industry arbitrations the same way. Arbitrators will continue to focus on evidence of bad faith. And while USF&G stated that motive is generally unimportant, it also told us that an allocation is not objectively reasonable if it would not have been the result of arms-length negotiation in the absence of reinsurance. If the cedent has selected an allocation that would not have been selected in the absence of reinsurance, can it truly be said that USF&G instructs not to examine intent?

Reinsurance arbitration offers little in terms of its utility as a dispute resolution mechanism if arbitrators are expected or required to follow legal decisions. This is particularly true if the decisions to which they are referred were incorrectly decided or out of line with accepted industry custom and practice. While the law offers certainty, and in many cases, uniformity, do we really want our arbitrators to tell us what the law is? Are we not better off in court, where the courts are the messengers and can deliver the message directly? Reinsurance arbitrations can only offer a meaningful service to the industry if arbitrators are free to bring their sense of accepted - - and indeed, acceptable - - industry practice into the hearing room in reaching a fair and equitable result.

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