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Reinsurance Section Encounter

RISE

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Reaching Out to Reinsurance Section Members

by R. Michael Cass, J.D., CPCU

R. Michael Cass, J.D., CPCU, is president and principal consultant for R.M. Cass Associates, an independent consulting firm located in Chicago. Formed in 1987, the practice emphasizes reinsurance and related matters. A graduate of Penn State University and Temple University School of Law, Cass is a member of the New York Bar; the American Arbitration Association's Panel of Neutrals; and a certified arbitrator for ARIAS—U.S. He is past chairman of the CPCU Society's Risk Management Section Committee; a former member of the Excess, Surplus, & Specialty Lines Section Committee; and recently began a three-year term as chairman of the Reinsurance Section Committee.

At the close of the CPCU Society's Annual Meeting held in New Orleans in October 2003, I was privileged to begin serving as chairman of the Reinsurance Section Committee. There are many important issues confronting the reinsurance industry and I know your section committee will again be able to offer valuable comment on industry developments to section members as well as other interested individuals.

On behalf of all section members, I would like to thank Gordon Lahti, CPCU, for his excellent leadership as chairman of the Reinsurance Section Committee. Gordon's efforts over the past three years have enabled your section to continue as one of the most active and effective sections within the CPCU Society. We are fortunate that Gordon will remain on the committee and that we will benefit from his counsel and contributions.

This edition of *RISE* includes a roster of the current Reinsurance Section Committee members. I think your first impression will be that the committee represents a broad spectrum of backgrounds and industry focus. One of the key reasons I accepted the chairman position was that this committee has worked diligently in the past to best represent the interests of members and the industry.

The major emphasis of the section will be to again present programs and articles of current importance to all those with an interest in reinsurance. Our annual Reinsurance Section symposium is scheduled to be held in Philadelphia on March 25 and 26, 2004. We will also be presenting programs at the CPCU Society's Annual Meeting and Seminars to be held next year in Los Angeles on October 23-26. A review of our just completed traditional state-of-the-art seminar in New Orleans is included in this edition of *RISE*.

Regarding *RISE*, we are fortunate to again have as our editor, Bruce D. Evans, CPCU, ARe, professor at the University of Dallas. Your Reinsurance Section Committee believes that *RISE* has been the most informative and consistently produced of all of the section newsletters. This contribution is all due to Bruce's unfailing efforts to offer new and current articles in each edition. I personally encourage each and every member to consider contributing to *RISE*. If you have a topic for an article, contact Bruce and he will assist you in bringing your important ideas before our members.

Finally, I would suggest that our section can be even more effective if it addresses all the collective interests of our individual members. To this end, I ask each section member to consider contacting me or any committee member regarding suggestions for programs or articles. In connection with programs, the section committee may be able to assist with presenting local or regional seminars regarding general or specific reinsurance topics. We look forward to hearing from you! ■

Reinsurance Challenges and Opportunities in a Post-9/11 World

by Thomas M. Pavelko, J.D., CPCU, ARe

Thomas M. Pavelko, J.D., CPCU, ARe, is the contracts and regulatory attorney for American Agricultural Insurance Company. Pavelko has more than 20 years of legal experience, primarily working in the field of insurance defense litigation in Missouri and Illinois prior to taking an in-house position in reinsurance in 1998. Pavelko is a member of the CPCU Society's Reinsurance Section Committee, having been appointed to the position in 2001.

Industry observers agree that September 11, 2001, dramatically and forever changed the reinsurance market—where it is today and what its future holds. At this year's CPCU Society Annual Meeting and Seminars, the Reinsurance Section developed and presented a panel discussion, "Reinsurance Challenges and Opportunities in a Post-9/11 World" to consider these issues. Sandy LaFevre, CPCU, CPIW, vice president of the Reinsurance Association of America, moderated the discussion. The panel consisted of Robert T. Kingsley, president and CEO, Financial Pacific Insurance Company; Mark Lescault, head of the divisional underwriting office and member of the Americas division management board for Swiss Re America; Wayne C. Paglieri, chief underwriting officer for Chubb Re, Inc.; João W. Santos, CPCU, CLU, vice president, personal lines division and reinsurance manager for Island Insurance Companies; and Michael D. Schnur, CPA, managing director of the mid-America region and a member of the executive management board for Guy Carpenter & Company.

LaFevre opened the discussion by asking each panelist to discuss the state of the industry. Paglieri commented that it is an improving picture, but that the big wrinkle is whether reserves are adequate. Lescault stated that 9/11 awoke the industry to loss potential and we now know that the required loss reserves are larger than we had assumed and larger than we have modeled. This has led, Lescault continued, to a willingness to say no to potential business, a willingness to return to disciplined underwriting. Schnur said that from a broker's perspective, a rosy outlook for the industry continues. That is because rates, especially for casualty lines, are going up, we're seeing positive accident-year numbers, and there is much more back-to-basics underwriting.

Kingsley noted that from a buyer's perspective, it is a confusing time. "We're seeing a lot of adjustments in reinsurer results," Kingsley said. "The big question is why they are not making money in this environment." In addition, Kingsley expressed frustration about it being more difficult to gauge the quality of a reinsurer today. Santos thought that rating agencies, such as Moody's and A.M. Best, are giving the reinsurance industry a hard look, and it is not a rosy view. This causes him to be concerned as a buyer, especially with regard to placing long-tail business, where you want to know that your reinsurer will exist for the long term.

The panel also looked at the various segments of the reinsurance market today—reinsurer, reinsured, and intermediary. When asked what buyers are doing today regarding reinsurance, Santos said that they are placing more emphasis on financial stability. He also thought that buyers were heading toward higher retentions, either by choice or to handle a reinsurance price increase. Kingsley said buyers are being selective, and they don't want to deal with reinsurers rated lower than they are. In some cases, that has meant that many have had to turn to the London markets and to financial markets as alternatives to the domestic reinsurance market.

When it comes to reinsurers today, Schnur commented that they are not being effective in the area of recruiting. "There is a dearth of young people in the business," he said, and reinsurers are not doing a good job getting new talent to start reinsurance careers out of college. Schnur also expressed concern that reinsurance decisions are being made too often by actuaries and not by underwriters. Lescault concurred, adding that training is also an issue. "In the soft market, underwriters were order takers." Now, reinsurers need to get back to assessing risks properly.

On the issue of assessing the reinsured's business, Kingsley thought that reinsurers were doing much better in performing their due diligence. As an

Sandra L. LaFevre, CPCU, CPIW, moderated the panel discussion.

example, his company was undergoing seven reinsurance audits in the month of November, contrasted to six typical audits in an entire year.

When asked about what has changed for reinsurance intermediaries in today's market, Schnur said that it used to be that brokers just secured the business and then found reinsurers to place it. Now, however, brokers have to provide much more—they are consultants on modeling, they offer merger and acquisition help, and they provide advice on non-reinsurance issues. Most significantly, however, the reinsurance transaction has become more detailed.

■ *This is an exposure that had been vastly underrated beforehand . . . we need to be bottom-line focused.*

Regarding terrorism and the effect of 9/11, LaFevre asked each panelist what changes his company has seen after 9/11. Most thought that it caused the industry to wake up to how devastating the exposure was. "This is an exposure that had been vastly underrated beforehand," Lescault said. It caused reinsurers to think more carefully about pricing/managing accumulations. "We need to be bottom-line focused," Lescault said. Santos said that even though his company only writes in Hawaii, 9/11 caused them to think more about managing their aggregates and the process by which they would do that.

■ *Panelists João W. Santos, CPCU, CLU, and Michael D. Schnur, CPA, discussed managing aggregates and broker implications, respectively, in a post-9/11 world.*

"Before 9/11, we never had to consider the unlimited vertical loss, especially in workers compensation." Now, Santos said, data has become key, and his company looks very carefully at things like payroll by street address. The effect of 9/11 was the most direct and dramatic for Schnur's company. "We had personnel there. Now, we have moved everything into a non-descript, low-rise building, and operations have been spread out to various buildings."

On the government's response to terrorism—the Terrorism Risk Insurance Act—opinions were mixed. Some of the panelists thought that the federal government missed the boat. This is an exposure that can't be underwritten, they said, so we need the federal government to step in. The critical problem they saw with TRIA is that it is a limited-term response that may expire without being used. All agreed that some government response is necessary because the industry does not have unlimited capital.

What did the panelists think the future holds for the reinsurance industry? Regarding the underwriting cycle, Lescault said, "Is the hard market going to change? Hopefully not for a long time if the term means strong price adequacies." Lescault believes the industry can no longer rely on investments to offset poor underwriting results. Paglieri cautiously agreed. "Right now, everyone is saying the right things about price—we'll walk away from underpriced business. It'll be interesting to see if that disciplined focus continues." Because there is new capital available that wants a good return, Paglieri wondered whether they will need to start seeking opportunities that they are currently avoiding.

To conclude the panel discussion, LaFevre asked the panelists to share what keeps them awake at night. Their answers: terrorism; an aging talent pool; the perfect storm; past long-tail liabilities, such as asbestos; and concern for whether the industry has learned discipline from its past underwriting mistakes. ■

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A New Curve on the Road for "Follow the Settlements"

by Andrew S. Boris, Esq.

Andrew S. Boris, Esq., is a partner in the Chicago office of Tressler, Soderstrom, Maloney & Priess. His practice is focused on litigation of complex insurance coverage matters throughout the country, including general coverage, reinsurance, and bad-faith cases.

Before attending law school, Boris worked for a major insurance company. He remains licensed as an insurance provider and has extensive experience in interpreting insurance policies and the coverage they provide. In addition, he has authored and spoken on a variety of topics including general insurance coverage, reinsurance, bad faith, and general litigation issues. Boris has served as an adjunct professor at the DePaul University College of Law having taught both litigation and legal writing classes.

Boris received his undergraduate degree from Boston College and his law degree, with honors, from DePaul University College of Law where he served on the law review and was a member of the Order of the Coif.

Editor's note: The opinions expressed herein are those of the author and do not reflect the views of Tressler, Soderstrom, Maloney & Priess or any of its clients.

A quick review of any reinsurance hornbook will provide the reader with a straightforward explanation for the "follow the fortunes" and "follow the settlements" clauses found in many reinsurance contracts. "The purpose of the [clauses] is to prevent the reinsurer from 'second-guessing' the settlement decisions of the ceding company. Absent such a rule, an insurer would be obliged to litigate coverage disputes with its insured before paying any claims, lest it first settle and pay a claim, only to risk losing the benefit of reinsurance coverage when the reinsurer raises in court the same policy defenses that the original insurer might have raised against its insured." *Aetna Cas. and Sur. Co. v Home Ins. Co.*, 882 F.Supp. 1328, 1346 (S.D.N.Y. 1995). Some courts have described a reinsurer's obligation by stating that a reinsurer must pay a cedent's loss recoverable statement provided that it is not fraudulent, collusive, or otherwise made in bad faith, and provided further that the settlement is not an *ex gratia* payment. *Id.* at 1346. Nonetheless, other courts have described the boundaries of a reinsurer's obligations, holding a reinsurer is not obligated to indemnify for payments clearly beyond the scope of the original policy or in excess of its agreed exposure. See, *Bellefonte Reinsurance Co. v Aetna Cas. and Sur. Co.*, 903 F.2d 910 (2d Cir. 1990).

A recent decision provides support for a cedent's challenge to the invocation of the follow-the-settlements clause in a case involving an underlying long-tail asbestos exposure. *Travelers Cas. & Sur. Co. v Gerling Global Reinsurance Corporation of America*, 2003 WL 22273321 (D. Conn. September 30, 2003).

In *Gerling*, the question presented was whether the money paid by Travelers to Owens-Corning Fiberglass in settlement of underlying asbestos bodily injury claims required a multiple occurrence allocation as a matter of law or whether Gerling was obligated to follow Travelers' single-occurrence allocation model pursuant to applying the follow-the-settlements clause.

As was common during the relevant time period, the Travelers' primary and excess policies had both per occurrence and aggregate limits for products coverage . . .

Between 1952 and 1979, Travelers provided Owens-Corning Fiberglass with both primary and excess general liability coverage. As was common during the relevant time period, the Travelers' primary and excess policies had both per occurrence and aggregate limits for products coverage, but only occurrence limits [with no corresponding aggregates] for non-products coverage. Gerling agreed to reinsure Travelers for losses paid by Travelers to or on behalf of Owens-Corning under specified portions of excess liability insurance policies covering the period of 1975 to 1977. The reinsurance certificates included a "follow-the-settlements" clause.

After paying hundreds of millions of dollars to Owens-Corning for defense and indemnity costs in connection with asbestos bodily injury lawsuits, the Travelers' products coverage limits were exhausted by the early 1990s. Shortly thereafter, Owens-Corning began submitting the asbestos claims under the non-products coverage provisions of the Travelers policies. When the parties were unable to agree on the appropriate payment of the claims, they agreed to participate in an arbitration proceeding to

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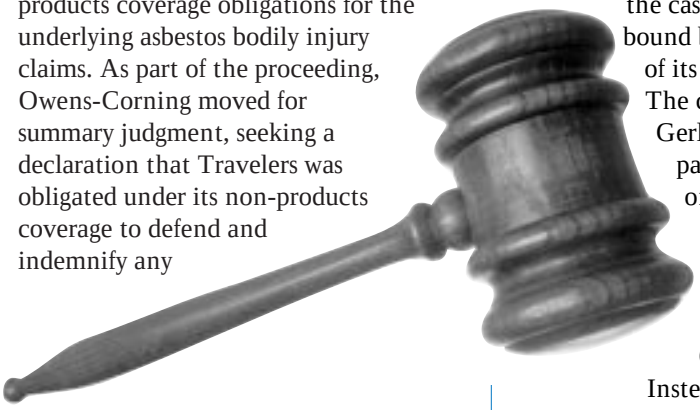
determine Travelers' potential non-products coverage obligations for the underlying asbestos bodily injury claims. As part of the proceeding, Owens-Corning moved for summary judgment, seeking a declaration that Travelers was obligated under its non-products coverage to defend and indemnify any asbestos claim that arose out of an exposure to asbestos, and that each asbestos exposure claim was a separate occurrence triggering a full set of occurrence limits. Travelers vigorously opposed the Owens-Corning motion, contending that all of the asbestos claims arose from a single occurrence. Travelers and Owens-Corning ultimately settled their dispute before the arbitration panel rendered a ruling on the Owens-Corning summary judgment motion. Notably, the settlement agreement espoused no particular allocation method, but Travelers ultimately allocated the vast majority of its cash payments to Owens-Corning as a single occurrence.



During the pendency of the arbitration and upon Travelers' loss-recovery request, Gerling consistently objected to the use of a single-occurrence allocation model. As part of the reinsurance dispute, Travelers maintained that the follow-the-fortunes clause controlled, and Gerling was obligated to accept the single-occurrence allocation model as long as it was reasonable and not executed in bad faith. In opposition, Gerling contended that the single-occurrence model was a unilateral decision made in the context of negotiating a settlement of the underlying arbitration. Gerling pointed to the deposition testimony of Travelers' witnesses and internal Travelers documents to support the contention that Travelers' focus in settling the underlying matter was based upon a bottom-line monetary analysis with little mention of the occurrence issue.

The court ruled that under the facts of the case, Gerling was not bound by Travelers' allocation of its settlement payments. The court reasoned that Gerling's challenge to payment was not premised on the concept that Travelers failed to present a specific coverage defense in the arbitration with Owens-Corning. Instead, Gerling adopted a position advocated by Owens-Corning which, in the court's view, had no effect on Travelers' ability to settle with Owens-Corning. The court summarized its position as follows: "Put simply, by refusing reinsurance coverage on the basis of Travelers' single occurrence allocation, Gerling is not punishing Travelers for not going to the mat with OCF on the single-occurrence position it advanced—a situation which the follow-the-fortunes clause was promulgated to prevent."

Undoubtedly, cedents will rely upon this case in their attempts to limit the application of the follow-the-fortunes clause. Notably, the facts that appear to have been the basis for the court's decision may not be found in every case. First, the reinsurer was advocating a position exactly similar to the position advanced by the insured. Second, deposition testimony and documentary evidence failed to demonstrate that the allocation model being advocated by the cedent was a significant consideration in the underlying settlement. Third, the make-up of the settlement (payment amount) and failure to advocate a specific position in the settlement documents supported the concept that the allocation model was not a driving influence in the settlement. To what extent this case becomes heavily relied upon remains to be determined, but the case does provide an excellent teaching tool for how some courts analyze the follow-the-fortunes clause. ■

Save the Date!

Plan now to attend the 60th Annual Meeting and Seminars **October 23-26, 2004,** in Los Angeles, CA.

Look for future issues of *RISE* for more information about Reinsurance Section-sponsored seminars.

Finding the Real Meaning of the Errors and Omissions Clause

by David G. Newkirk, J.D.

Editor's note: My reinsurance seminars always include a legal contract segment, and one of the most elusive to understand components is the errors and omissions clause. David Newkirk's classic article on this subject, which originally appeared in the Summer 1992 issue of *RISE*, is surely worth repeating for our current *RISE* readers.

The typical reinsurance treaty contains a clause similar to the following: *No error or inadvertent omission on the part of the company shall relieve the reinsurer of liability in respect of losses hereunder provided that such errors and omissions are rectified as soon after discovery as possible*.

The meaning of this clause has seldom been litigated. However, disputes over the interpretation of the clause occasionally arise in the context of reinsurance claims or treaty negotiations. By reviewing reinsurance authorities, cases, and the history of the clause, this article attempts to provide a framework for the resolution or prevention of these disputes.

Background

Like other forms of insurance, reinsurance is the transfer for consideration of a defined risk from one party to another. However, historically, the reinsurance treaty has been at least partially removed from the otherwise applicable body of contract law. This removal was accomplished by several clauses in reinsurance treaties. These clauses include:

- errors and omissions,
- follow the fortunes (or settlements), and
- "honorable obligation" or "utmost good faith."

Each clause operates to eliminate specific defenses otherwise available to the reinsured or reinsurer. The *combined* operation of these clauses has been to stress the "partnership" aspect of reinsurance. In fact, some early treaties went so far as to declare that "the company and the reinsurer shall, so to speak, form one company." Let's remember that the business of reinsurance has evolved from the days of English gentlemen sharing tea and shipping risks at Lloyd's coffee house. As is the case with modem insurers, parties to reinsurance transactions must now confront the threats of adverse selection, moral and morale hazards, and insolvency. Further, the growth of bad-faith tort jurisprudence has created new potential liabilities that were not present in traditional reinsurance contracts. These changing circumstances have led to the revision of many treaties. The "follow-the-fortunes" clause and "honorable-engagement" language are becoming increasingly uncommon. These eliminations have the effect of preventing reinsurer liability for tort loss arising due to the claims handling of the primary company. In addition, the reinsurer is not liable for defense costs or loss paid for items that are outside the scope of the treaty. In summary, the modern reinsurance contract stresses the cession of a defined risk, rather than the effective creation of "one company," which shares in all losses regardless of the source.

The Focus on the E&O Clause

In spite of these revisions, the errors and omissions clause is frequently retained in modern treaties. Proper interpretation of this clause requires that it be freed from the historical "baggage" of the follow-the-fortunes clause. One authority states that:

> The errors and omissions clause is often misunderstood by members of the insurance industry. It does not affect the usual provisions regarding limitations and conditions found in the contract of reinsurance. The purpose of the clause in reinsurance practice is to correct internal communication errors of the reinsured in reinsuring risks. It does not relieve the reinsured from the duty to comply with all terms of the contract, including notice of loss and cooperation provisions.[1]

Another authority stresses the fact that the function of the modern clause is to prevent defenses based on accounting inaccuracies in the bordereaux:

> The reasons why an "errors and omissions" clause should be included in a treaty which calls for a company to enter all cessions, revisions, cancellations and renewals in a reinsurance register and to advise the same to the reinsurer by quarterly bordereaux, are fairly clear. The reinsured would otherwise be in breach of contract by failure in any one of these regards . . . it might be possible to regard correct register and bordereaux entries as conditions precedent to the liability of the reinsurer in relation to a claim by the reinsured.[2]

Dr. Klaus Gerathewohl, in his landmark work on reinsurance, discusses five situations where the application of the clause has come into dispute:

1. A reinsured who ceded a tanker under a facultative/obligatory treaty in 1970, but who failed to cede the same risk in 1971, with loss occurring in 1971.
2. A direct insurer of a fire risk of 1,000,000,[3] who ceded 100,000 to the reinsurer based on a 100,000 retention and a 20 percent PML (probable maximum loss) estimate. After a total loss, the reinsured claimed that the 20 percent PML was an error and a 100 percent PML should be substituted.
3. A reinsured under an obligatory proportional treaty with a reinsurer from 1930 to 1960, who in 1961 attempted to debit the reinsurer for cancellation premium from 1935 to 1940.

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4. A direct insurer with a retention of 50,000 on an excess-of-loss treaty who forgot to cede premium for a 200,000 policy, where a total loss occurred.[4]
5. A direct insured who reinsured all risks exceeding 50,000 in reinsurance category A, but who incorrectly reported that the policy is a 200,000 retention in reinsurance category E.[5]

Dr. Gerathewohl concludes that the clause is properly applicable only in the last two situations. In the first case, coverage does not commence until the reinsured decides to cede the risk. "Only such communication errors shall qualify for rectification which pertain to rights and obligations already existing at the time of the error."[6] The clause cannot be used to create facultative coverage where none was elected. In the second case, the reinsured has made an error of judgment, not a communication error. In the third case, the reinsured has failed to rectify the error "without delay," or "as soon as possible." The limited American and English case law that exists supports this interpretation. In an American case where inland marine risks were excluded, the errors and omissions did not require that the reinsurer pay its share of an inland marine risk for which premium was erroneously ceded.[7] Similarly, in an English case, the clause was held to have nothing to do with whether the reinsurer was bound by an arbitration award entered against the reinsured.[8] Two English cases have not questioned the application of the clause where a risk is ceded at an erroneous percentage,[9] and where an accounting error led to submission of an incorrect billing.[10]

In summary, the modern errors and omissions clause is not a "cure all" for any deficiency. The clause is entirely different from the follow-the-fortunes clause, and does not obligate the reinsurer to participate in a claims handling, rather than underwriting, risk. The clause does not serve to excuse late notice, or to waive other treaty provisions. Rather, the clause is designed to allow correction of internal accounting errors made by the reinsured. In the structure of a complicated bordereaux reporting system, this limited function is valuable to both the reinsured and reinsurer, and serves both interests well. ■

Endnotes

1. Robert F. Hall, Reinsurance Claims, in Insurance, Excess and Reinsurance Coverage Disputes 1989, B. Ostrager & T. Newman, ads. (1989).
2. John S. Butler & Robert M. Markin, *Reinsurance Law C.*, 1.4-01 to 02, Vol. 1 (1980).
3. Currency designations are omitted in Dr. Gerathewohl's original work to stress the universality of these observations.
4. Klaus Gerathewohl, at al., *Reinsurance Principles and Practice,* 739-40, Vol. 1 (1980).
5. *Id.* at 667.
6. *Id.* at 741.
7. *Aetna Ins. Co. v Glen Falls Ins. Co.*, 327 F. Supp. 11, 15 (N.D. Ga. 1971).
8. *Hayter v Nelson & Home Ins. Co.*, [1990] 2 Lloyd's Rep. 165 (Queen's Bench 1990).
9. *Fenton Ins. Co. Ltd. v Gothaer Versicherungsbank Vyag.* [1991] 1 Lloyd's Rep. 172 (Queens Bench 1990).
10. *River Thames Ins. Co. v Al Ahleia Ins. Co.*, [1972] Lloyd's Rep. 2 (1972).

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