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Reinsurance Section Encounter

RISE

Volume 22 Number 2 July 2004

As the Market Turns—Which Way Reinsurance?

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

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One of the featured articles of this edition of the *Reinsurance Section Encounter* is a summary of our Reinsurance Symposium that took place in Philadelphia on May 13 and 14. The returns are in and those attending believed the program provided a very good overview of important issues facing reinsurance professionals in today's ever-changing marketplace. The symposium emphasized the fundamental practices that are required to ensure continued success in our business.

> *Will the relatively more financially secure reinsurers "hold the line" and demand adequate prices and terms for their products or will competition force a renewed aggressiveness?*

The much improved industry results being reported for insurers and reinsurers are needed good news. But, will they lead to complacency and compromise or will they pave the way to a stronger and more responsible reinsurance industry? Typically in the industry, improved results invite increased and sometimes new competition. Such competition in the past has often led to compromises in sound underwriting and claims practices. These compromises can ultimately produce a downward spiral of unfavorable results often unchecked until a catastrophic event such as Hurricane Andrew or 9/11.

The "View from the Top" panel of industry executives at the recent symposium addressed the issue of reinsurance security and the continued "flight to quality." Will the relatively more financially secure reinsurers "hold the line" and demand adequate prices and terms for their products or will competition force a renewed aggressiveness? If less financially sound companies are forced to chase inadequate prices, it can place extraordinary market pressure on all players.

And now for some good news! As demonstrated at the recent symposium, underwriting tools such as catastrophe modeling have become more available and sophisticated. Such devices can enable insurers and reinsurers to keep track of aggregate exposures in specific lines of business. Such knowledge facilitates the development of strategies for risk accumulation and, to the extent necessary, the transfer of risk through reinsurance or retrocessional protections.

During the symposium luncheon and ARe Diploma Presentation Ceremony, Connor M. Harrison, CPCU, of the AICPCU and Insurance Institute of America, discussed developing changes in the ARe curriculum. Effective in 2005,

Continued on page 2

What's in this Issue?

As the Market Turns—
Which Way Reinsurance? 1

The Discovery Battlegrounds
of Reinsurance Litigation
and Arbitration 3

"Back to Basics" in the
Reinsurance Industry 5

As the Market Turns—Which Way Reinsurance?

Continued from page 1

a revised five-part program will include a web-based course of current reinsurance readings. ARe participants may access readings and be tested on their own time. These revisions will be reviewed in more detail in future issues of the section newsletter.

With our year 2004 symposium now complete, next year's focus may well be international issues that are receiving more attention in reinsurance. Several sessions of the recent symposium included comment on offshore capacity. Discussions included the evaluation of foreign security and how regulators are addressing competition from outside the United States. Your section committee is considering programs and articles that will provide members more insight and knowledge about international reinsurance issues whose importance will increase in a growing global economy.

As always, I invite comment and contributions from all of our members. Your section committee is already planning content for next year's symposium. We would greatly appreciate any thoughts members might have in connection with the conduct and content of next year's program. If you would like to participate in the 2005 symposium planning, administration, or presentation, please do not hesitate to contact me or any section committee member regarding your possible involvement.

Finally, I would encourage all members to contribute articles on current reinsurance issues to your section newsletter. As I mentioned, the new ARe program will contain a web-based course of approximately 50 articles on current reinsurance issues. An article for your section newsletter may become the basis for an article contained in the new ARe curriculum, and all section members would benefit from this contribution. Please contact Bruce D. Evans, CPCU, ARe, our *RISE* editor with your ideas. ■

The Discovery Battlegrounds of Reinsurance Litigation and Arbitration

by Andrew S. Boris, Esq.

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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.

Reinsurance professionals of years past could never have anticipated the number and complexity of reinsurance disputes that exist today. Historically, parties to a reinsurance agreement worked under the assumption that any subsequent disagreements would be handled differently than disputes in other contexts because reinsurers and insurers were expected to resolve any differences within a duty of good faith. Thus, reinsurance disputes were often confined to private arbitration.

■ *. . . the arbitration process itself is not the confidential and systematic process envisioned by the drafters of typical arbitration clauses.*

However, parties no longer confine themselves to the arbitration process, and the arbitration process itself is not the confidential and systematic process envisioned by the drafters of typical arbitration clauses. Reinsurance litigation can involve significant sums and more closely resemble the protracted proceedings common to other segments of society. Thus, courts and arbitration panels are typically confronted with significant legal arguments addressing the scope and extent of discovery that the parties may seek in order to clarify their respective arguments. Four decisions from the recent past highlight issues that are commonly being addressed by the courts and arbitration panels presented with reinsurance disputes: the assertion of privilege, the use of third-party subpoenas as part of the arbitration process, the ability to seek discovery of unrelated claims, and the pursuit of depositions of corporate executives.

Privilege

In *Travelers Casualty & Surety Co. v Constitution Reinsurance Corp.*, No. 01-17057 (E.D. Mich. June 13, 2003), a Michigan federal court was confronted with the question of how much discovery a reinsurer may seek concerning a cedent's allocation among various reinsurers of the same underlying policies. The cedent refused to produce some of the information, contending that the materials were protected by the attorney-client privilege and work-product doctrine. The reinsurer challenged the cedent's assertion of privilege and contended that the reinsurer was entitled to review the materials based upon the common interest doctrine.

The reinsurer argued that the legal services provided by the cedent's attorneys were arguably at least partially performed in the interest of the cedent's reinsurers. Rather than address the merits of the privilege argument, the court ordered production of the materials after finding the cedent's privilege log to be inadequate and that the materials would be protected by the confidentiality order in the case. The privilege issue frequently arises in reinsurance litigation and, although the court did not directly address the arguments, this case provides a helpful road map of the privilege issue and the arguments made in connection to same.

Third-Party Subpoenas and Arbitrations

As the scope of discovery in arbitration proceedings continues to expand, panels are increasingly called upon to allow the parties wide latitude in their efforts to find evidence to support their positions. As parties to reinsurance disputes seek additional information from parties other than those involved in the arbitration, the power of arbitration panels to grant (and enforce) non-party discovery has

Continued on page 4

The Discovery Battlegrounds of Reinsurance Litigation and Arbitration

Continued from page 3

come under considerable scrutiny. In *Hay Group, Inc. v E.B.S. Acquisition Corp.*, 360 F.3d 404 (3rd Cir. 2004), the question presented was whether an arbitration panel had the power to require a non-party to produce documents in advance of the hearing.

At the request of one of the parties, the arbitration panel issued a subpoena requiring a third party to produce documents in advance of the arbitration hearing. The federal district court issued an order enforcing the subpoena when the recipient of the subpoena refused to produce the requested documents. The Third Circuit reversed, finding that the Federal Arbitration Act granted arbitration panels limited powers with respect to third-party subpoenas (i.e. only allowed to subpoena witnesses to bring documents with them to a hearing and not in advance). As many maintain the legal complexity of arbitrations has gone too far, this case provides some support for those who argue that the process should be streamlined.

Discovery of Unrelated Claims

A New York court in *Excess Insurance Co. v Factory Mutual Insurance Co.*, No. 605759/1999 (N.Y. Sup.Ct. April 24, 2003) denied a cedent's request to have the reinsurer respond to interrogatories and document requests related to the reinsurer's handling of unrelated claims. Although the cedent maintained that the information requested was important to its development of a defense in the case, the court ruled the information was irrelevant and not likely to lead to the discovery of admissible evidence. Notably, the court also ruled that the discovery was irrelevant because a determination by a reinsurer on prior business was a matter of objective judgment. Frequently, cedents and reinsurers seek broad discovery addressing matters not in dispute in order to show a pattern or particular business practice. This case provides some guidance for those who seek to thwart such discovery attempts.

Depositions of Executives

A significant part of discovery in all cases involves the strategy of placing pressure on the opposing party. Whether it is seeking confidential information, the production of a voluminous set of documents, or the depositions of high-level executives, parties are pursuing ways to bring the opposing party to the bargaining table in a weakened position. In *Gen. Star. Indem. Co. v Platinum Indem. Ltd.*, 210 F.R.D. 80 (S.D.N.Y. 2002), the court was confronted with a motion for a protective order concerning the request for depositions of certain high-level General Reinsurance executives. The dispute in the case centered on whether an individual had the authority to act as a managing general agent (MGA) of the reinsurer when the reinsurance contracts were issued. During the case, the defendants sought the depositions of high-level executives of the reinsurer in an effort to support the argument that the MGA had the requisite authority. The court denied the reinsurer's motion for a protective order, finding that the reinsurer: (i) had failed to provide affidavits from the reinsurance executives and deprived the defendants of basic information necessary to develop their case; (ii) had failed to provide any information to negate testimony from a corporate designee for the reinsurer that the executives were responsible for corporate guidelines; and (iii) had failed to convince the court that the reinsurer's oversight of the MGA by the corporate executives was not relevant in the case. Again, this case provides an excellent road map for those who are confronted with (or wish to pursue) deposition requests for high-level executives.

> ■ *The days of efficient, amicable resolutions have been replaced with issue-specific litigation.*

As with all facts of life, the reinsurance dispute process has changed. The days of efficient, amicable resolutions have been replaced with issue-specific litigation. Thus, the costs attendant to the disputes involving fees from attorneys, arbitrators, and umpires are significant and should be considered when determining whether a particular disagreement can be compromised without turning to an outside arbitration or litigation process. ■

"Back to Basics" in the Reinsurance Industry

by Robert Lauterbach Jr., CPCU, CLU

CPCU Society Reinsurance Section Symposium

"Back to Basics"

Marriott Philadelphia Downtown

May 13–14, 2004

The 2004 edition of the CPCU Society Reinsurance Section Symposium—which featured a luncheon ceremony honoring new Associate in Reinsurance (ARe) designees—again received high accolades for bringing critical and timely information to reinsurance professionals. This great networking event drew 85 attendees/participants to our section's symposium.

Cochairmen for the symposium were current Reinsurance Section Chairman R. Michael Cass, CPCU, and past Reinsurance Section Chairman Gordon J. Lahti, CPCU. Cass is president and principal consultant for R.M. Cass Associates, an independent consulting firm located in Chicago. Lahti is an account executive with Swiss Re.

Cass served as moderator for the first panel, which included James T. Buysse, executive vice president in the Client Development Group of Benfield, Inc.; David B. Grant, vice president, Reinsurance Assumed at American Agricultural Insurance Company; Rupert C. Hall, president and chief executive officer of Golden Bear Insurance Company, and Eric Simpson, vice president of corporate marketing with American Re-Insurance.

There was a general consensus from this group that financially, the industry was in good shape. Those companies with "fresh capital" are in a little better shape. The relative collapse of the stock market after 9/11 was significant. The real industry disaster arose from lowered investment income since the WTC only impacted a few reinsurers.

The "flight to quality" theme is a market reality. Primary companies are reaching for reinsurers who understand and know the client. Selling practices have changed more than buying practices. From the buying side, larger buyers are now seeking much higher retentions in order to adapt to current market pricing.

Reinsurers are taking a closer look at what they are reinsuring. They are more carefully analyzing exposures, correlation of risk, convergence of risk, distribution of risk, multi-line accumulations, contract language, and enterprise risk management. With respect to terrorism, it was mentioned that reinsurers did not have the appetite for risk—and, hence, a significant market void.

> *In the last few years, the amount of run-off business has increased significantly . . . there is a breakdown in the positive relationships between insurer and reinsurer.*

In the last few years, the amount of run-off business has increased significantly. With this development, there is a breakdown in the positive relationships between the insurer and reinsurer.

There was also a consensus among the group that asbestos and environmental reserve increases will be significant.

There was an intensive discussion concerning Bermuda—new capital without past debt. Bermuda has added significant capacity. Post-9/11 Bermuda business is more diversified. The feeling was that there will be more roll offs and mergers among the players—probably not any totally new players.

The second panel discussed catastrophe modeling for the reinsurance process. The two presenters were Scott Quiana, a principal with Risk Management Solutions, and Craig Tillman, a senior vice president with Wyndham Partners Consulting, Ltd. (an affiliate of the Glencoe Group and part of RenaissanceRe Holdings, Bermuda).

> *Post 9/11 has led to new model development, which requires viewing catastrophe risk differently.*

The discussion in the second panel included the evolution of catastrophe risk management. The presentation applied CAT models to underwriting and portfolio management, internalizing varied loss estimates, integrating modeling into the underwriting process, and evaluating frequency assumptions and clustering. The utilization of CAT models after the event, with respect to managing claims and anticipating change, was also covered.

Natural catastrophes, such as hurricanes, earthquakes, and tornadoes have been modeled for some time. Man-made catastrophe modeling became more significant after 9/11. Post 9/11 has led to new model development, which requires viewing catastrophe risk differently. Higher resolution models are necessary to the understanding of

Continued on page 6

"Back to Basics" in the Reinsurance Industry

Continued from page 5

accumulations, which is further magnified within programs that build across multiple lines. More scrutiny is also required on the submission data.

There was a good discussion on reasons why models vary. For instance, there is different science behind models. The hazard depiction varies. There are vulnerability differences in inventory classification systems and uncertainty estimates. Financial models vary in application of deductibles, loss to excess layers, etc. The concept of "modeling malpractice" was introduced. A good model might be used for the wrong purpose. A small change in assumptions may drive a large change in projection. The presenters also reviewed internalizing varied loss estimates, integration, and how the methods yield different portfolio outcomes.

Differences in models and model bias were discussed. A blended model approach was suggested. Model differences in frequency assumptions was also addressed—as was the concept of clustering. Proactive usage of CAT models seeks to understand risk by examining similarities and differences between credible models. The session concluded with a discussion of post-event model revisions.

The third session addressed coverage issues in insurance and reinsurance—"Asbestos and Beyond." The two presenters were Randy J. Maniloff, chair of the Insurance Coverage Group at Philadelphia's Christie, Pabarue, Mortensen and Young, P.C., and Bruce Engel, a partner at Tressler, Soderstrom, Maloney and Priess in Chicago.

Maniloff provided the symposium participants an excellent accumulation of handout material dealing with insurance coverage developments. For each of the past few years, he has authored *The Year's Ten Most Significant Insurance Coverage Decisions*. He also authored an excellent article comparing the mold litigation exposure to asbestos litigation.

In his presentation, Maniloff described the changing asbestos landscape. He cited examples where policyholders that have been "products" defendants in the past are now seeing cases filed against them for "premises" liability. "Insurers face additional exposure for these 'premises' cases on the basis that they constitute a different 'occurrence,' and one that is not subject to the 'products' aggregate." He provided the participants with excellent examples and thought-provoking scenarios on coverage disputes.

Engel also provided excellent handouts with his "Significant Reinsurance Cases of 2003" and "The Party-Appointed Arbitrator: When Is Neutral Really Neutral?" Engel led a revealing discussion on allocation and good faith. He distinguished cases involving positions on single versus multiple occurrences as well as operations versus product losses. An interesting scenario was presented with respect to Owens-Corning and the different positions taken in three different payment demands by different reinsurers.

Maniloff and Engel also commented on concepts such as limits, allocation, follow the fortunes, late notice/prejudice, premises/products liability, single/multiple occurrences, contract language, declaratory judgment, arbitration, and discovery.

The fourth session was presented by Laline Carvalho, director of the Financial Services Department at Standard and Poor's. Carvalho stated that insurance companies have underperformed other industries, which can be attributed to the "uncertainty and volatility" of the insurance business.

Carvalho acknowledged that over the last few years, the ratio of downgrades to upgrades has increased significantly. Most of these occurred in late 2002—not immediately after September 11, 2001. Carvalho identified additional concerns that may add to the number of downgrades: asbestos, workers compensation, D&O, E&O, financial reinsurance, and the terrorism risk (what will be renewed?).

Some observations Carvalho made:

- Lower interest rates require a stronger underwriting profit. Pricing has already peaked in property lines. Pricing improvement is still needed in casualty lines. Will price improvements outpace loss costs?
- More than 50 percent of insolvencies in the past few years were due to inadequate reserves.
- In addition to asbestos/environmental, there is probably an industry reserve deficiency of $45 billion. Both run-off and reserve additions are now becoming significant for reinsurers.
- The amount of reinsurance recoverables has become more important to the surplus of primary companies.
- Relationships with primary companies/reinsurers are becoming more transactional. There is little room for the old idea of a primary company having a "bank" with a reinsurer.
- Increased focus on financial strength of reinsurers—"flight to quality."

The fifth presentation was titled "Presenting Claims to Reinsurers—It's Not Your Father's Allocation." The presenters were Thomas A. Allen, a partner in the Philadelphia law firm of White and Williams LLP.; Richard T. Blaum, supervising claim consultant for Swiss Re America; and Anne M. Quinn, vice president and assistant general counsel with GenRe.

Blaum utilized three vignettes from the motion picture industry to demonstrate "It's Not Your Father's Allocation." He also addressed late notice and the difficulty in demonstrating prejudice. Blaum offered some insight on the importance of claim audits. He suggested that reinsurers visit with insurers and review all precautionaries and non-reported claims to reinsurers. He emphasized that reinsurers need to be more proactive with cedent companies to "find out what is out there."

Quinn stated that reinsurance is not a "guarantee" or "backstop." She stated that GenRe had been sued by regulators for not guaranteeing payment by primary companies. Reinsurance was never intended to take on risk that was not included in the contract. There are reserve deficiencies. If there is a cedent "asset" such as reinsurance, there is going to be maximum utilization of this "asset."

Quinn described current arbitrations as no longer orderly, but a brawl for the following reasons: number of qualified "good" arbitrators is limited, decisions are not reasoned, appearance of a judge and "two hired guns," and because of governing law, the outcome may be extremely different than ever imagined.

Allen cited that reinsurance disputes and arbitrations are growing substantially. He gave the following reasons:

- Bad relationships—the number of run offs is increasing. No long-term relationships. Reinsurers who are insolvent, or in run off, have less incentive to pay claims than if the reinsurers were in strong, current commercial relationships with their ceding companies. Cedents that are insolvent, or in run off, may have little to lose by taking aggressive positions and being willing to litigate or arbitrate those positions.
- Unexplicit contracts—Many reinsurance contracts are simply not explicit about issues that arise.
- Disparity in reserves—Responsible concern has been expressed that there are striking disparities in reserves, posted by insurers and reinsurers, for their respective shares of the same losses.
- Disagreements regarding "follow the fortunes" and "follow the settlements" concepts.
- Disagreements in the utilization of aggregates and defining "occurrence."
- Allocation, commutations, and coverage expense.

The sixth and final panel was moderated by George M. Gottheimer Jr., Ph.D., CPCU, CLU, president and CEO of Kernan Associates, Inc., an insurance and reinsurance management consulting firm. The subject was "Reserving Practices of Reinsurers—The Devil Is in the Details." Presenters were Sheldon Rosenberg, senior vice president in the Actuarial Department at Converium Reinsurance (North America) and John J. Swanick, managing partner of the Smart and Associates, LLP Insurance and Regulatory Services Practice. Rosenberg's presentation was "Reserves: An Uncertain Estimate." He began by explaining the significance of reserves—with actuarial trying to gain certainty. "Actuarial Estimates Are Inherently Uncertain Because They Are Dependent on Future Contingent Events"—ASOP 36. Rosenberg cited (with explanation) the following reasons for sources of uncertainty: random chance; erratic historical development data; past and present change in operations; changes in the external environment, changes in data, trends, development, and patterns; emergence of unusual claims—in both types and sizes; and changes in frequency and/or severity.

Rosenberg felt that reinsurers faced even greater uncertainty because of the following: information gap, varied claims-handling practices of reinsureds, the reinsurance reserving lag, unusual claims, catastrophe exposures, excess position, leveraged trend, and changes in terms and conditions.

Rosenberg also shared reinsurance results, actuarial reports, and significant actuarial changes for 2004 (handout).

Swanick's presentation was "The Role of Reinsurance Recoverables in the Asset Valuation of Insurance Companies." He began by sharing information substantiating that the most significant cedent asset will generally be the reinsurance recoverables. The type of insolvency will influence the valuation of reinsurance recoverables. One must determine if it is a balance sheet insolvency or a cash flow insolvency. Most contested receiverships involve the latter version. The debate centers on whether the cash flow insolvency be corrected through rehabilitation. He presented the positions of both the proponents and the opponents; and shared with the group factors to consider in valuing reinsurance recoverables. Swanick described what to look for in determining the integrity of the supporting data—and what may be the hidden issues. He also shared with the participants financial ratings of reinsurers, rating changes for the top 10 reinsurers since September 11, 2001, and the principal reinsurance restructuring that took place in 2002.

At lunch, on Thursday, May 13, 15 new AREs were recognized for attaining the Associate in Reinsurance designation. The following ARe completers were recognized:

- Richard T. Blaum, CPCU, ARe
- James Cheatle, ARe
- Gerald V. Beher, CPCU, ARe
- Christopher Donahue, CPCU, ARe
- Daniel Duesterhaus, ARe
- Joseph F. Grant, CPCU, ARe
- Steven P. Larzelere, CPCU, ARe
- Terri Meredith, ARe
- Stephen Allen Moyer, CPCU, ARe
- Mara C. Pellish, ARe
- George Rabb Jr., CPCU, ARe
- Katarina Scamborova, ARe
- Noreen Sharkey, ARe
- Ruth A. Wisler, ARe

The luncheon speaker was John Quincy Brown III (of the law firm Hardy Erich, Brown & Wilson). Connor M. Harrison, CPCU, made the ARe Ceremony presentation. ■

Visit http://reinsurance.cpcusociety.org to view photos from the Reinsurance Section Symposium.

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Reinsurance Section Encounter
is published four times a year by and for the members of the Reinsurance Section of the CPCU Society.

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Reinsurance Section Encounter
RISE
Volume 22 Number 2 July 2004

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