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Reinsurance Interest Group

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Reinsurance Encounters

Message from the Chair

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

Thomas M. Pavelko, CPCU, J.D., ARe, is assistant general counsel, contracts and regulatory, for American Agricultural Insurance Company (AAIC), where he has worked for 11 years. Previously, he ran an active law practice for 15 years. Pavelko earned his juris doctor degree from Washington University School of Law in St. Louis, Mo., and his bachelor's degree from Marquette University in Milwaukee, Wis. He is currently chair of the Reinsurance Interest Group Committee. In the past, he served on the board of the CPCU Society's Chicago-Northwest Suburban Chapter and was its president in 2006–2007.

Overwhelmed. It's a word with both negative and positive connotations. Both connotations apply to me right now.

Let's dispense with the negative ones first. Work has never been more hectic than it has been this spring. I am not complaining, mind you. Just making an observation. As I pound out this column on my keyboard, I am hopelessly past its deadline. At home, my wife is nursing a broken right leg. That is heaping a lot more family chores on my lap. I have gained a new appreciation for all that she does to make our household function, but I wish I could have learned it in an easier way. It is amazing how driving becomes a chore when the trips run by two of us are combined into the family's lone driver.

OK, I am finished with my rant. I really wanted to focus on the positive connotations anyway. That version of "overwhelmed" accurately describes my reaction to everything that I see my fellow reinsurance professionals doing to help and improve our profession and one another!

First, there are the very able members of the committee that I have the honor to chair. In February, the Chicago-area committee members (namely, **Eric F. Hubicki, CPCU, ARe, AU, AFIS; Michael J. Lamplot, CPCU;** and **Jon Wit, CPCU, ARe, ARM**) put together and executed a superb Chicago workshop. Eric compiled a synopsis of the event that is part of this edition of *Reinsurance Encounters*. The Chicago event was so well-received that one attendee from the Dallas/Fort Worth area is now working with our interest group committee to conduct a similar workshop in the Dallas/Fort Worth area.

As I finalize this article, our annual Reinsurance Symposium is heading toward its closing ceremonies. Although

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Message from the Chair

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I was not able to attend (because of those things discussed in the second paragraph above), I have already heard that the event was excellent in all respects. The Union League of Philadelphia was a great venue with perfect meeting facilities and terrific catering, and the presentations were first class!

The Reinsurance Interest Group held its 2010 Reinsurance Symposium, "Dawn of a New Reinsurance Horizon," at the historic Union League of Philadelphia.

There are a lot of committee members that helped on this project — **Richard T. Blaum, CPCU, ARe; Gordon J. Lahti, CPCU, ARe; Marsha A. Cohen, CPCU, ARe; Timothy D. Foy, CPCU;** and **Nicholas J. Franzi, CPCU, ARe,** helped to secure the first-class talent for the event. Tim Foy; **Susan J. Kearney, CPCU, ARM, AU, AAI; Connor M. Harrison, CPCU, ARe, AU, ARP, AAM, AIAF;** and **John J. Kelly, CPCU,** were our feet on the ground in Philadelphia and helped us find such a great facility as the Union League!

All of these and others on the committee, such as **Richard G. Waterman, CPCU, ARe; Charles W. Haake, CPCU, ARe;** and **Ralph K. Riemensperger, CPCU,** participated in numerous planning meetings, brainstorm sessions and conference calls to put together the many details that made this event great. Special commendations are due Rick Blaum and Susan Kearney, who stepped in at the last moment to co-emcee the event when I could not be there.

Even after such a great event, these dedicated volunteers don't rest. Plans continue for "Reinsurance — State of the Art," our executive panel discussion at the upcoming CPCU Annual Meeting and Seminars in Orlando. Gordon Lahti and Rick Blaum head the effort to find participants. At that same meeting, we will host the second annual Reinsurance Interest Group lunch. It provides a great opportunity for fellowship with other reinsurance professionals during the meeting. **Joe Bouthillier,** director of underwriting for Citizens Property Insurance Corporation, will speak on the impact of recent legislative changes and the latest hurricane losses on Citizens, a not-for-profit, tax-exempt government corporation whose public purpose is to provide insurance protection to Florida property owners throughout the state. Joe oversees a division that provides underwriting services for a commercial and personal lines property book of business exceeding $400 billion in exposure and over $1.2 billion in annual premium.

Richard Waterman, editor of this newsletter, also deserves special mention. Richard works endlessly to secure and edit articles for this newsletter. I don't thank him enough for what he does for this committee and for CPCU Society members. I am still receiving praises for the phenomenal edition of *Reinsurance Encounters* that Richard put together late last year. Looking at the advance pages, this edition, with its emphasis on "confidence" and "trust," will also be noteworthy and praiseworthy. Jon Wit, serving as webmaster for our interest group Web site similarly brings value to each Society member.

If you think about it, though, the interest group's committee is just the tip of the iceberg of the many talents who are involved! Without the contribution of our speakers, panelists, moderators and authors, there would be no events and newsletters for us to put together. In this category, our dear friends **Franklin W. Nutter, J.D.,** and **Tracey W. Laws, J.D.,** of the Reinsurance Association of America, deserve special mention. As far back as I can remember, one or the other has moderated the executive panel we have had at the annual meeting or at the Philadelphia symposium. They bring a level of professionalism to these events that are peerless.

I also have to thank all of you who choose the Reinsurance Interest Group as your primary interest group. It is you who read our newsletters, attend our workshops and our symposia, or join us on LinkedIn. I am so grateful for your input afterwards, telling us where we hit or missed the mark. Without that, it would be impossible to deliver and improve upon the quality of the products we present.

I hope that other interest group chairs are as blessed with generosity of time and talent that I have been. I doubt, however, that any of them are as overwhelmed by it as I am. ■

Editor's Comments

by Richard G. Waterman, CPCU, ARe

Richard G. Waterman, CPCU, ARe, is president of Northwest Reinsurance Inc., a Minnesota-based management consulting firm specializing in the fields of insurance, reinsurance and alternative dispute resolution. In addition to working with both ceding and assuming companies in his consulting practice, he has served as an arbitrator or umpire on more than 110 panels to resolve industry disputes as well as a neutral mediator, facilitator and fact-finder assisting parties to work out differences in a confidential setting. Waterman has been a member of the CPCU Society since 1978, and has served on the Reinsurance Interest Group Committee for more than 10 years.

Four articles in this edition of *Reinsurance Encounters*, written by **Steven A. Mestman, CPCU, Andrew S. Boris, J.D., William E. Cox, J.D.,** and **Eric F. Hubicki, CPCU, ARe, AU, AFIS,** nicely capture a theme of confidence and trust in long-term reinsurance relationships. The words "confidence" and "trust" are used carefully and purposefully. Similar to any long-term relationship, it is recognized that both parties in a reinsurance relationship have confidence and trust in each other's expertise, and the parties can rely on those good qualities.

Our lead article, "Treaty Reinsurance Portfolio Management — An Encounter with the Institution of Marriage," authored by Steven Mestman, is a delightful read, especially if you are somewhat of an underwriting wonk like me. Mestman begins by drawing a distinction between facultative reinsurance as similar to a casual dating relationship and long-term treaty reinsurance as having many similarities to the dynamics of a marriage relationship. However, as he also points out, sometimes trusted expectations of the parties in marriage and a reinsurance relationship encounter "bumps in the road," resulting in serious issues that are not easily resolved. Arbitration is the traditional and preferred manner to resolve reinsurance disputes, which leads to our next two articles.

"Resolving Reinsurance Disputes — A Question of Trust in the Decision Makers?©", by Andrew Boris, a highly regarded reinsurance attorney with Tressler LLP in Chicago as well as a regular *Reinsurance Encounters* author, continues the discussion about the long-term nature of treaty reinsurance relationships with the expectation that no significant coverage disputes will emerge. Despite those good intentions, if a disagreement does surface that cannot be resolved through negotiation, the difference of opinion is usually resolved in a confidential arbitration proceeding. Almost all reinsurance treaties have mandatory arbitration clauses as the exclusive means to settle unresolved disputes. And most importantly, each party is entitled to have confidence in the process and trust that they will receive a fair arbitration hearing. In his article, Boris summarizes two recent court decisions that challenge the decision-making ability of arbitration panels based on a perceived injustice or inequity in the composition of those panels.

Courts have long held that judicial review of arbitration awards is extremely limited. However, recently there has been an increase in litigation by the losing party asking a court to vacate an arbitration award. Notwithstanding the great deference courts give to arbitration decisions, legal fees to defend challenges to arbitration awards can be expensive and time consuming. This poses the question, "If the prevailing party in the arbitration proceeding is also successful in winning a related court challenge, can that party recover its litigation costs and attorney's fees?" Fortunately, William Cox, a prominent reinsurance attorney with Thorp Reed & Armstrong, provides a comprehensive analysis in response to that question in his article, "Recovering Attorney's Fees in Arbitration."

All of us recognize the reinsurance industry is undergoing rapid change energized by driving forces in risk identification and transferring developments in today's dynamic environment. A hint of future articles addressing some of the compelling developments in the reinsurance industry can be found near the end of this newsletter in a recap of the February workshop in Chicago presented by the CPCU Society's Reinsurance Interest Group and Chicago-area chapters, the Reinsurance Education And Communication Hotline (REACH) and the Association of Lloyd's Brokers (ALB).

The final article in this edition of *Reinsurance Encounters*, "Emerging Issues for Today's Insurance Professional," by **Laura M. Kelly, CPCU, AIC, AIS, ASQ, CQIA**, includes an interesting summary of a 2009 decision by a United Kingdom House of Lords panel in a pollution cleanup liability case regarding a reinsurance contract from the late 1970s.

Once again, we invite you to join the conversation by writing an article for publication, by sending me a Letter to the Editor to express your views in a less formal format, or inviting a colleague to submit an article that would likely be of interest to others in the reinsurance community. We welcome and encourage your active involvement to ensure that *Reinsurance Encounters* affords timely and informative articles related to reinsurance endeavors. ■

Treaty Reinsurance Portfolio Management — An Encounter with the Institution of Marriage

by Steven A. Mestman, CPCU

Steven A. Mestman, CPCU, is president of October Mountain Consulting LLC, which he formed in 2008. October Mountain focuses on reinsurance consulting that includes underwriting analysis, expert witness and arbitration services. He retired in July 2008 from Everest Reinsurance Company as executive vice president and chief underwriting officer, after more than 31 years of combined service with Everest and its predecessor company, Prudential Reinsurance Company. He has had extensive experience in underwriting and negotiating terms for virtually all classes of casualty and specialty insurance during his career. Mestman is a member of the Professional Liability Underwriters Society and a certified ARIAS-US reinsurance arbitrator.

The reader is about to have a reinsurance encounter with a portfolio management method that I have developed and utilized with success over the last 20 years. This method along with other more conventional tools helped me, as a treaty executive, to evaluate the viability of a treaty reinsurance relationship. It stemmed from a realization that there are many similarities in the dynamics of a marriage relationship and a treaty reinsurance relationship. By evaluating a treaty relationship in this context, I found it to be helpful in determining the present health of the relationship, and even more importantly, highly predictive of whether it would be sustainable and profitable in the future.

In order to understand how this evolved, the reader should know that I began my career in the industry as a multiline property-casualty street claims adjuster, and then transitioned into casualty insurance underwriting followed by facultative reinsurance underwriting. This spanned in successive order approximately the first 15 years of my career. My experiences in each of these areas were essentially transactional with the counterparty with which I was interacting — you evaluated the policy coverage(s), investigated and adjusted the claim, underwrote and priced the policy or reinsurance certificate, and then moved onto the next matter.

There was no implicit expectation of a long-term relationship, certainly not in claims nor in the insurance or facultative underwriting process. The latter two were essentially one-off transactions, usually for a one-year term. The underwriter's position with regard to renewal the following year was heavily dependent on the account loss experience combined with an updated evaluation of the perceived risk exposures. Certainly, if the underwriter's initial decision to cancel or nonrenew was rebutted by the agent, insured or reinsured, as the case may be, it was incumbent on the underwriter to give due consideration to the counterargument(s) for continuation; however, at the end of the day the focus on profitability and risk exposure won out.

During this time period, I eventually moved into various supervising underwriting and underwriting management positions. On several occasions I was called upon as a manager to re-underwrite problematic portfolios of insurance policies or facultative certificates. This process involved reviewing each particular policy or certificate in the portfolio, and deciding whether or not it was adequately underwritten and whether or not it was profitable or likely to be so going forward. The end result was that some were marked for continuance and some were marked for midterm cancellation or nonrenewal. Once again, there was no expectation of a long-term relationship present.

When I moved into treaty reinsurance underwriting, I found that my prior experiences were most helpful in preparing me for this transition. Something else had helped to prepare me for this transition that I was not aware of at that time — I had been through a marriage, divorced and about to remarry again.

Within a short time after I began treaty reinsurance underwriting, I realized that it required from the underwriter utilization of a broader array of analytical resources than did an individual facultative certificate. One's perspective on underwriting had to shift dramatically. Instead of making decisions risk-by-risk, exposure-by-exposure, an underwriter was required to make an assessment of the entire group of policies (sometimes thousands) destined to be ceded into the treaty and the multitude of exposures they constituted. It was a daunting task in my estimation, especially on those treaties that had business ceded from

various lines of business such as general liability, automobile liability, workers compensation, etc.

The conventional process in treaty underwriting is to undertake a certain amount of due diligence with respect to an evaluation of the historical underwriting results involving underwriting, claims and actuarial staff and to form an educated "guess" as to what would transpire on the treaty going forward. It became particularly difficult when it was a new treaty, and there were no historical results to evaluate. In those cases, more diligence was focused on the underwriting evaluation of the business plan, underwriting guidelines, underwriting staff competency, and the prevailing market conditions as well as other factors dependant on the particular fact set.

I was struck at some point that beyond the substantial differences in underwriting analysis required between treaty reinsurance and facultative reinsurance as previously mentioned, the treaty underwriter, as opposed to the facultative underwriter, had to recognize the existence of a treaty relationship and its importance. Somehow this had to be incorporated into the objective underwriting evaluative process in a holistic way in order to expect ultimate underwriting success.

The essence of the difference between a treaty and facultative relationship can best be contrasted by analogizing facultative to a casual dating relationship and treaty to a committed dating relationship based upon expectations by the couple that if everything goes well it will lead to a marriage. The basis for these analogies stems from the observation that ceding companies almost invariably purchase facultative reinsurance in order to protect themselves from perceived severity loss exposures on a particular risk. The company seeks to transfer a portion of the risk to the reinsurer in consideration of paying a portion of its policy premium. There is no understanding/expectation between the parties in this transaction that there is any relationship beyond that cession. Conversely, in a treaty it can be said there are invariably real elements of a relationship present. The ceding company is searching for a partnership arrangement with a reinsurer(s) to accept risk on a predetermined segment of its book of business. It usually represents a large financial commitment on the part of both parties, and the treaty represents a legally binding agreement outlining their mutual duties and obligations with respect to the block of policies being ceded. In many instances, the motivation to purchase a treaty is to allow the company to write amounts and/or types of business that its own financial and underwriting resources would not otherwise allow. Thus, it can be said that treaties are often necessary to sustain a ceding company's continued growth, profitability and viability.

In what follows, I would like to examine in what aspects the treaty reinsurance relationship and the venerable institution of marriage share many of the same psychological dynamics, and follow surprisingly similar paths as they evolve:

Courtship

The courtship process that takes place in a relationship leading to a marriage typically is a time when the couple gets to know one another, their families, determine if they share similar values, needs and expectations for the future. Similarly, with new treaty opportunities that both parties have an initial interest in, it is customary for the parties to arrange one or more meetings, often with some senior officers of each entity present. During these meetings, the parties familiarize each other with details of their respective business plans, underwriting approaches, knowledge of the marketplace, respective financial status and corporate structures. Often if these meetings go well, additional interactions take place in the form of underwriting, claims, accounting and actuarial reviews so that more detailed information can be obtained necessary to favorably consider reinsuring the treaty.

Engagement

An engagement is generally the next stage that follows a successful courtship in relationships on a marriage track and the couple decides that they want to marry. In a treaty relationship context, the engagement stage takes place when both parties are in substantial mutual agreement with the proposed terms and conditions set forth for the treaty contract, subject only to the issuance and bilateral execution of the final contract document.

Marriage

Marriage is signified by a legally binding ceremony in which the couple exchange vows and assume various obligations. The executed treaty contract between the parties is the equivalent ceremony. The contract confers lawful rights, duties and benefits as prescribed in its terms and conditions just as state laws ascribe enforceable rights and duties to the marital status.

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Treaty Reinsurance Portfolio Management — An Encounter with the Institution of Marriage

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Honeymoon

The comparable characteristics of this stage cover an undefined period of time after execution of the treaty when both parties are in a relatively happy and optimistic state with each party feeling it has gotten what it wanted out of the treaty, and both parties expect that they will continue to do so going forward.

Humdrum/Everyday Routine

This stage also occurs for an undefined period after the honeymoon and is characterized in the treaty relationship sense by the conducting of normal business transactions related to the treaty. This would include things such as remittance of monthly premium and claims reports, routine questions and interactions between the parties, contract wording questions, as well as routine meeting and audits that take place in the course of the year.

Bump(s) in the Road/ Problems/Failure to Meet Expectations

There comes a time in any marriage or treaty reinsurance relationship where there is a realization by one or both parties that one or more of the expectations they had of the relationship when originally entered into are not being fulfilled. In the marriage context this could arise for a whole host of reasons. Similarly, in the treaty context many different stimuli could cause this, such as excessive loss activity, changes in types and/or quantity of business ceded from what was anticipated, failure to pay claims promptly, coverage issues, change in management and/or key personnel, and last but not least deteriorating financial condition. The extent to which these "bumps" become only small potholes or gaping chasms, as in a marriage, usually depends on the amount of effort the parties are willing to devote toward finding mutually agreeable solutions. In many cases, these issues can be worked out and the relationship continues in a healthy, positive way. At times, however, when serious issues are not resolved, the relationship will continue to deteriorate. Often in this circumstance, the parties begin to recognize that their initial expectations no longer can be met, resulting in irreconcilable differences.

Divorce/Dissolution of the Relationship

When the parties end up having irreconcilable differences, inevitably this leads to cancellation or nonrenewal of the treaty relationship. Once ended, as in a marriage context, both parties are expected to fulfill the residual obligations as provided for in the treaty agreement. Reinsurers in most circumstances have the ongoing duty to indemnify the company for any claims otherwise recoverable after the termination date until all claims are settled. Likewise, in those circumstances, the ceding company must continue to pay all premiums due the reinsurer on policies ceded that remain in force after the termination date of the treaty. This, in my way of viewing it, is quite similar in concept to a joint custody and ongoing support/alimony arrangement. Further, almost all treaties have mandatory arbitration clauses, which provide for the appointment of disinterested nonaffiliated business professionals to resolve contractual disputes stemming from the treaty relationship much like divorce courts resolve residual disputes stemming from a marriage.

Applying the Method

Assuming that the reader agrees that there are these many similarities, how can recognition of these similarities be applied in practical terms by a reinsurer when evaluating the viability of the treaty relationship? In basic terms, the reinsurer needs to periodically take a hard look at the stages of the relationship as they develop and determine if they are evolving by continuing to meet the needs of the parties. Without a doubt, the most critical stage in the relationship is the "bump in the road." The nature of the problem(s) that surface in this stage may shine a light on the parties' real expectations prior to the problem(s) arising. As an example, a ceding company may profess in the courtship stage that the reinsurer should take the most optimistic view when pricing the treaty, recognizing its expectation to make the reinsurer whole in the event a deficit subsequently occurs. To the extent that the reinsurer has similar expectations and offers an optimistic pricing, this forms a bedrock foundation for the treaty relationship to proceed to subsequent stages. Should a deficit later occur and the ceding company by its actions does not try to make the reinsurer whole, it demonstrates it had no real expectation for payback and brings into question the whole premise upon which the relationship was built. Conversely, if the ceding company cooperates with the reinsurer going forward to allow additional rate increases to bring the treaty results back on track, this is a positive step that shows the parties want to maintain the relationship.

There can be and usually are a whole host of issues that arise in virtually all treaties over time. The reinsurer continually needs to evaluate these issues in terms of those that are material and those that aren't. With respect to those that are material, the reinsurer must evaluate them with an eye on the expectations of each party and whether the issues are consistent with those expectations. Oftentimes, as in a marriage, the purposes for which a treaty was originally purchased cease to exist

or otherwise change dramatically, and there remains no ongoing mutual need. The reinsurer needs to recognize these evolving changes and be prepared to take action in a timely manner when indicated.

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Conclusion

The foregoing is obviously a very subjective management tool for evaluating the viability of a treaty relationship. It should be used in concert with an objective quantitative analysis of the treaty so that a reasonably complete overview of the treaty can be formulated that will be representative of how the treaty has performed in the past and predictive of how it will perform in the next 12-month period. I have found from personal experience that at times the subjective analysis of the psychological aspects of a particular treaty relationship will track closely with the findings of the objective analysis. That is not always the case, however, nor should it be assumed that should they conflict one view is more predictive than the other. I have observed on numerous occasions where there are clear signs of trouble in the subjective analysis, but the quantitative view looks good. The reality is that it often takes awhile, especially on casualty business with a longish tail period, for the two views to come into synchronization. There is a natural incentive to favor the quantitative side, especially when it is favorable, and the subjective isn't. I can advise, based on personal experiences, that consistently ignoring serious warning signs on the subjective side can have long-term adverse financial consequences for a reinsurer.

Treaty reinsurance executives who utilize this subjective analytical method consistently will find that it will provide invaluable insight when evaluating a portfolio of treaties in terms of viability and also for budget planning. In order to get the input that is necessary to apply this method, it is necessary to maintain close contact with the underwriting account executive to obtain the necessary history and updated input relative to the psychological dynamics. In addition, the executive should review internal underwriting and claims audits as well as periodically interact with ceding company managements that make up the portfolio. No doubt it is an ongoing, labor-intensive process, but it provides a clear pathway to maintaining a healthy, profitable portfolio over all market cycles. ■

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Resolving Reinsurance Disputes — A Question of Trust in the Decision-Makers?©

by Andrew S. Boris, J.D.

Andrew S. Boris, J.D., is a partner in the Chicago office of Tressler LLP. His practice is focused on litigation and arbitration of insurance coverage and reinsurance matters throughout the country, including general coverage, professional liability, environmental and asbestos cases. Questions and responses to this article are welcome at aboris@tresslerllp.com.

When parties enter into a reinsurance relationship, the hope and expectation are that there will be no significant disputes concerning the coverage being provided by the reinsurance contracts (or if there are any disputes, they will be quickly resolved in a business-like fashion). Despite those hopes and expectations, disputes do develop and the parties commonly have to address them in the context of a confidential arbitration. An important facet of the arbitration process is that each party has trust that it will receive a fair hearing to address the merits of the dispute.

Two recent decisions from the United States District Court for the Northern District of Illinois highlight some of the challenges associated with the question of trust in the arbitrators assigned to address reinsurance disputes. See *Trustmark Insurance Company v. John Hancock Life Insurance Company*, — F.Supp.2d —, 2010 U.S. Dist. Lexis 4698 (N.D. Ill. Jan. 21, 2010); *Trustmark Insurance Company v. Clarendon National Insurance Company, et al.*, — F.Supp.2d —, 2010 U.S. Dist. Lexis 8078 (N.D. Ill. Feb. 1, 2010).

In *John Hancock*, there was a question as to whether the parties agreed to include retrocessional business (in addition to direct business) within the scope of the reinsurance contracts at issue. In 2002, the cedent initiated an arbitration, pursuant to the terms of the reinsurance contracts, when the reinsurer refused to indemnify it for retrocession related billings.

The relevant arbitration clauses required that the arbitrators be "disinterested" in the outcome of the arbitration. After execution of a confidentiality agreement among the parties and the arbitration panel, the parties participated in significant discovery and a hearing on the merits. Ultimately, the arbitration panel determined that the retrocession business was covered by the reinsurance contracts.

In 2005, the cedent initiated a second arbitration with the same reinsurer. In connection with the second arbitration, the cedent appointed the same arbitrator to serve on the arbitration panel that the cedent had appointed to serve on the panel in the first arbitration.

At the organizational meeting for the second arbitration, the cedent's appointed arbitrator was questioned about his ability to honor the confidentiality agreement from the first arbitration. The arbitrator stated that he might find it difficult to deal with the knowledge he had from the first arbitration that the other panelists in the new arbitration did not have, but he would honor the confidentiality agreement.

During the course of the second arbitration, the panel rendered several interim decisions regarding the use of materials from the first arbitration and the potential litigation of issues previously addressed in the first arbitration. Although a signatory to the confidentiality agreement in the first arbitration, the cedent's arbitrator did not recuse himself from the deliberations on these issues.

In turn, the reinsurer filed a motion for a preliminary injunction seeking to: (1) prevent the second panel from resolving disputes about the confidentiality agreement from the first arbitration, as it was not properly at issue in the second arbitration; and (2) end the participation of the cedent's arbitrator in the arbitration as he was not "disinterested," as required by the reinsurance contracts.

The district court determined that the cedent's arbitrator was not "disinterested" because the arbitrator had violated the confidentiality agreement from the first arbitration, which rendered him an interested party in the outcome of the second arbitration. The court was persuaded that the arbitrator's actions

during the second arbitration evidenced a breach of the confidentiality agreement when, among other issues, he openly commented on and tried to clarify counsel's characterizations of the claims at issue in the first arbitration.

Although the court opined that an arbitrator was presumed able to disregard his prior knowledge when addressing a dispute, the cedent's arbitrator (in the opinion of the district court) had shown that he was unable to do that in the instant case. Finally, the court also determined that the parties had not contractually agreed to arbitrate any issues involving the confidentiality agreement from the first arbitration. Thus, the reinsurer's motion was granted.

In *Clarendon*, the same court that rendered a decision in the *John Hancock* case less than two weeks earlier, addressed the question of an arbitrator's disqualification in very similar circumstances. In *Clarendon*, the court was once again confronted with: (1) different reinsurance arbitrations between the same parties; (2) one of the parties having appointed the same arbitrator for the different arbitrations; (3) the execution of a confidentiality agreement in the first arbitration involving the arbitrator who was being asked to serve on the panel in the second arbitration; and (4) questions whether the arbitrator's service in the first arbitration required court intervention with respect to the second arbitration's proceedings. In fact, the cedent asked the court to disqualify the arbitrator, find that the reinsurer in breach of the confidentiality agreement for appointing the same arbitrator, and enjoin the reinsurers from participating in an arbitration with the same arbitrator.

In *Clarendon*, the court determined that the cedent's challenge to the arbitrator's qualifications was premature. The court ruled that any such challenge should be raised after the conclusion of the arbitration. Of note, the court relied upon the strong presumption that arbitrators can disregard the knowledge they already possess and address the merits of an individual case as it is presented to them.

In turn, the court distinguished the finding in the *John Hancock* case because the arbitrator in the *John Hancock* case had already breached a confidentiality agreement and there was no such evidence in the instant case. Thus, the court refused to grant the cedent's requested relief.

These recent cases are instructive on a number of points. First, the *John Hancock* case sends a message to parties (and arbitrators) regarding how courts will analyze situations where arbitrators are appointed to arbitrations involving the same parties. The *John Hancock* court was very specific in its analysis of whether the arbitrator in question had adhered to the obligations of a confidentiality agreement.

Undoubtedly, counsel involved in situations where arbitrators are appointed to numerous arbitrations involving the same parties will be particularly interested in facts that might support a motion to disqualify an arbitrator and/or a challenge to the arbitration panel's decision, and the *John Hancock* case gives some direction on those issues.

Finally, although the cases reach different conclusions (based upon the facts of each case), they teach that parties are very willing to question the decision-making ability of an arbitration panel based upon a perceived injustice or inequity in the composition of an arbitration panel. ■

Recovering Attorney's Fees in Arbitration

by William E. Cox, J.D.

William E. Cox, J.D., is senior counsel in the Philadelphia office of Thorp Reed & Armstrong LLP. His practice is focused on litigation and arbitration of reinsurance disputes on behalf of domestic and foreign insurers and reinsurers in matters involving asbestos, environmental, toxic tort, mold, medical malpractice, sexual abuse, construction defect, long-term exposure, private mortgage insurance, workers compensation and other claims. These matters have included issues involving policy and contract coverage and interpretation, rescission, fraud, misrepresentation, late notice, follow the fortunes/settlements, declaratory judgment, underwriting practices, claims management, allocation, fronting arrangements, allegations of broker misconduct, and sunset and commutation clauses.

Editor's note: This article is reprinted with permission from Thorp Reed & Armstrong LLP

Costs of collecting reinsurance are a regular source of concern for reinsureds. Ideally, a reinsurer will pay a reinsurance claim on a timely basis after raising few, if any, inquiries about the claim. Or the reinsurer may raise questions or request documents to enable the reinsurer to understand the basis on which the underlying claim was settled or ceded to the reinsurance contract.

Oftentimes, however, a ceding company finds it necessary to initiate arbitration to collect its reinsurance. The general rule is that a reinsured must bear its own legal fees in arbitration. While arbitrators have the power in limited circumstances to award attorney's fees, in most cases they do not do so. Thus, attorney's fees and other costs of collection inevitably eat away at the principal amount of the reinsurance claim, reducing the reinsured's net recovery.

If a reinsured prevails in an arbitration, in most instances the reinsurer will voluntarily pay the award. It is not uncommon, however, for a disappointed reinsurer to bring an action in court seeking to have the award vacated. If that happens, the reinsured faces the prospect of incurring still more legal fees before its reinsurance claim is paid.

In recent years, courts have begun to recognize that a litigant who continues to drag a dispute through the courts after losing in arbitration should face the prospect of sanctions in the form of attorney's fees if its petition to vacate an arbitral award is without any real legal basis. See *B.L. Harbert International, LLC v. Hercules Steel Company*, 441 F.3d 905 (11th Cir. 2006).

In an action in federal court, 28 U.S.C. § 1927 provides that an attorney may be personally liable for attorney's fees and costs incurred by the prevailing party if the attorney has brought a legal proceeding "unreasonably and vexatiously." This provision has been used by federal courts to award attorney's fees to a party that successfully defended a favorable arbitration award in court. See *DMA International, Inc. v. Qwest Communications International, Inc.*, 585 F.3d 1341 (10th Cir. 2009).

In *DMA*, the arbitrator adopted one party's interpretation of a contract and rejected the other's. The trial court upheld the arbitrator's decision as did the appeals court. But the Tenth Circuit went further and awarded attorney's fees to the prevailing party under 28 U.S.C. § 1927 on the grounds that, given the extreme deference courts accord arbitral awards, it was frivolous for the losing party to seek to overturn the arbitrator's decision. Although *DMA* was decided by a federal appeals court, 28 U.S.C. § 1927 applies as well to actions in federal trial courts.

In awarding attorney's fees, the court in *DMA* also relied upon Rule 38 of the Federal Rules of Appellate Procedure, which provides that a court may award damages (including attorney's fees) if it determines an appeal is frivolous. Federal trial courts may similarly award attorney's fees under Federal Rule of Civil Procedure 11 against a party that has filed a pleading advancing a frivolous claim or argument.

Similar provisions exist in state courts. For example, Pennsylvania Rule of Appellate Procedure 2744 provides that an appellate court may award attorney's fees if it determines an appeal is frivolous. In *Gargano v. Terminix International Co.*, 2001 PA Super 282 (2001), the Pennsylvania Superior Court held that an appeal of an adverse arbitration decision was frivolous under Rule 2744 and remanded the case to the trial court for the imposition of attorney's fees. In California, Code of Civil Procedure § 907 and California Rule of Court 8.276(a) (1) provide that an appeals court may award costs (including attorney's fees) if an appeal is frivolous. In *Evans v. Centerstone Development Company*, 134 Cal. App. 4th 151 (2005), the California Court of Appeal awarded attorney's fees to the party that prevailed

in an arbitration, stating that: "[w]e also publish this opinion to discourage parties to arbitration agreements from frivolously seeking judicial review of matters not cognizable in our courts."

Courts have long held that judicial review of arbitration decisions is extremely limited. By agreeing to arbitrate their disputes, parties intend the award to be final and binding. Courts will not review the merits of an arbitrated controversy or the correctness of an arbitrator's decision which generally will not be overturned even if based on an erroneous conclusion of fact or law. A party that loses an arbitration but then continues to litigate its claim in court defeats the key goals of arbitration, which are to provide a less costly and quicker alternative to litigation. Courts are increasingly willing to penalize such a party for needlessly protracting litigation.

Reinsureds forced to defend arbitration awards in court should consider seeking attorney's fees. In many cases, the losing party in arbitration makes the same arguments to a court that it made to the arbitrator. Although those arguments may have been perfectly reasonable in arbitration, once they have been rejected by the arbitrator, given the great deference courts give to arbitrators' decisions, those same arguments may become unreasonable, even frivolous and sanctionable, if made to a court in support of an application to vacate an award. ■

Your Reinsurance Interest Group presents …

Reinsurance Interest Group Luncheon

Sunday, Sept. 26, 2010 • 11:45 a.m.–12:45 p.m.

Joe Bouthillier, director of underwriting for Citizens Property Insurance Corporation, will speak on the impact of recent legislative changes and the latest hurricane losses on Citizens, a not-for-profit, tax-exempt government corporation whose public purpose is to provide insurance protection to Florida property owners throughout the state. ***Tickets are required.***

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Reinsurance — State of the Art

Sunday, Sept. 26, 2010 • 2:45–4:45 p.m.

The 2010 edition of this perennial Annual Meeting favorite will feature a panel discussion of executive–level talent from reinsurance providers, a reinsurance broker and reinsurance customers. Attendees will leave with up–to–the–minute information on critical issues pertaining to reinsurance and its industry. Reinsurance, insurance and other professionals interested in learning or learning more about reinsurance and its place in the insurance world will gain insight and knowledge into today's issues, activities and events.

Moderator: Tracey W. Laws, J.D., Reinsurance Association of America (RAA)

Presenters: To be announced.

Visit www.cpcusociety.org for more information.

REACH and CPCU Society Reinsurance Interest Group February Workshop Recap

by Eric F. Hubicki, CPCU, ARe, AU, AFIS

Eric F. Hubicki, CPCU, ARe, AU, AFIS, is vice president at BMS Intermediaries, Inc. in Barrington, Ill., and is a valued Reinsurance Interest Group leader.

The CPCU Society Reinsurance Interest Group, in conjunction with the Reinsurance Education And Communication Hotline (REACH) and the Association of Lloyd's Brokers, gathered industry experts for an in-depth workshop on the state of the reinsurance market. Held at the DLA Piper law offices in downtown Chicago, the workshop drew approximately 50 attendees from the insurance market.

The event was chaired by **Thomas M. Pavelko, CPCU, J.D., ARe,** American Agricultural Insurance Company; **Michael J. Lamplot, CPCU,** Chiltington USA; **R. Michael Cass, CPCU, ARe, ARM,** R. M. Cass Associates; and me. Also involved in the planning process was **Al Moy,** president of REACH.

Thomas M. Pavelko, CPCU, J.D., ARe, served as chair for the Reinsurance Interest Group's February Workshop held in Chicago, Ill.

Regulatory Issues

Attorneys **Holly M. Spurlock, J.D.,** and **Kevin O'Scannlain, J.D.** from DLA Piper law offices presented on legislation affecting the insurance and reinsurance industry. Discussion focused on financial regulatory reform key players in Washington, systemic oversight, capital requirements, proposed Consumer Financial Protection Agency (CFPA) and credit agency reform.

Holly M. Spurlock, J.D., and Kevin O'Scannlain, J.D., presented on legislation affecting the insurance and reinsurance industry.

Spurlock and O'Scannlain discussed Washington legislators' varied understanding of insurance business practices and how efforts should be made to better educate and inform them. However, they believe that since the property-casualty industry has fared well in these difficult economic times, it is not tainted with the same brush as other financial institutions.

Market Conditions

I moderated a panel of experts including **James Wilcox,** Swiss Reinsurance Company; **Susan Kelly,** CNA Reinsurance Operations; **Bruce Kukowski,** Maiden Reinsurance Company; and **Charles Desmond,** BMS Intermediaries Inc.

The panel discussed general impressions of the 2010 treaty year, the 2010/2011 outlook, the perception of buyers, brokers, reinsurers during this time of economic turmoil, cause/impact of soft casualty pricing, and the impact of consolidation in the market.

Driving factors in the discussion were the absence of nationwide catastrophe activity, continued abundance of capital in the marketplace and difficulty of managing an industry that could demand short-term returns on products that can have long-term implications.

From left: James Wilcox, Charles Desmond, Susan Kelly, and Bruce Kukowski comprised a panel at the February reinsurance workshop in Chicago that discussed reinsurance market conditions and outlook.

The group reported the recent renewal cycle was relatively calm and the overriding view that, barring some catastrophic event, this would continue through the rest of 2010.

On the topic of soft casualty pricing, participants hopefully predicted the market may eventually see the wisdom of building enough reserves to account for events billed as casualty catastrophe losses. such as the next mold, asbestos or silica crisis.

The panelists also conveyed that industry consolidation and reorganization continue to impact the market. From various perspectives, there was a view that too few players could lead to leveraged situations that could stifle creativity and innovation. In addition, the loss and/or shifting of valuable human intellectual capital that comes with such activities could prove detrimental in the next few years.

Looking Forward

During his luncheon presentation, **Kevin Williams,** of General Reinsurance Corporation, provided both a historical and forward-looking view. His presentation covered key drivers of the reinsurance market: historical property-casualty underwriting results, return on invested assets and industry net income/return on equity. Williams said that while the environment is relatively benign today, the industry may be facing the prospects of inflation in the near future brought about, in part, by the $787 billion stimulus funds. He stressed that buyers of long-tailed lines of coverage need to consider the prospect of inflationary pressures in their business plans.

Overall, event participants looked favorably on the reinsurance industry's ability to reload capital in a tough economic environment and a relatively catastrophe-free 2009. However, challenges lie ahead in rate adequacy and inflation. If capital is lost due to a major event, will companies find it easy to shore up balance sheets in these trying economic times? Time will tell how 2010 plays out. ■

Emerging Issues for Today's Insurance Professional

by Laura M. Kelly, CPCU, AIC, AIS, ASQ, CQIA

Laura M. Kelly, CPCU, AIC, AIS, ASQ, CQIA, is director of best practice compliance/ insurance industry liaison for Goldberg Segalla LLP, overseeing the firm's compliance and quality department. Kelly's past experience includes 16 years in the insurance industry in roles as a claims adjuster, claims supervisor and litigation manager. She is chair-elect of the CPCU Society's Leadership & Managerial Excellence Interest Group Committee and secretary of the CPCU Society's Northeastern New York Chapter, among other leadership roles. Kelly is also an active member of the American Society for Quality.

Editor's note: This article first appeared in the January 2010 issue of the CPCU Society's Leadership & Managerial Excellence Interest Group newsletter.

In today's rapidly changing world, it is critical that insurance professionals stay abreast of new developments, understand the effect those developments have on the insurance industry, and remain prepared to respond to those issues when they arise in their day-to-day activities at the office. The Leadership & Managerial Excellence Interest Group was proud to sponsor "Emerging Issues for Today's Insurance Professional" at the 2009 Annual Meeting and Seminars in Denver. The program was well attended, with an audience that filled the room to capacity.

Richard J. Cohen, J.D., managing partner of Goldberg Segalla LLP and co-chair of its Global Insurance Services Group, discussed several of the most current and significant issues affecting the insurance industry — most notably in the areas of green construction, Chinese drywall and reinsurance. This article will highlight those topics, as discussed in Denver.

The Issues and Their Significance

Green Construction

The industry for green construction has increased significantly over the past several years. In 2005, there was approximately $7.4 billion invested in green construction, and that is estimated to increase to $19–38 billion by 2010. The benefits to going green include an increase in the efficiency with which buildings and their sites use energy, water and materials, and reduce building impacts on human health and the environment. However, along with the advantages to green construction, a number of claims have resulted.

Cohen addressed a number of questions that might result in litigation when going green goes wrong. What happens if a building does not achieve green certification or the building is not certified at the level that was requested? What if, for example, subsequent to completion, the building is not certified as green? What if the building does not obtain a platinum-level certification? Who is responsible for maintaining the building's green status if standards change? Is the architect or engineer responsible for maintaining the designation for an undisclosed period of time, and does the failure to do so create a cause of action for negligence?

Given the nature of this expanding marketplace, there are two general issues insurers must anticipate. First, consideration must be given to the inevitability of malpractice claims arising out of green construction, or more likely, failed green construction. Second, current professional liability policies, as written, must be examined to assess whether they provide proper coverage and/or limit an insurer's exposure for potential green build claims. Cohen walked the audience through a very interesting hypothetical that addressed the expected insurance coverage issues arising out of these very questions.

Chinese Drywall

Chinese drywall was imported to the United States primarily between 2004 and 2006. In 2006, there was a significant demand for imported drywall manufactured in China for post-Hurricane Katrina reconstruction. More than 500 million pounds of drywall imported from China have been used in

construction — most notably in Florida and the Gulf states, but elsewhere as well.

The lawsuits being filed against manufacturers, distributors and home-builders for the alleged production, sale or use of purportedly defective Chinese-imported drywall will result in numerous claims being filed with insurers by policyholders seeking defense and indemnification for alleged damages resulting from such production, sale or use. Furthermore, it is anticipated that there will be numerous claims under homeowners' policies for the alleged damage to homes.

Insurers are currently attempting to address the various coverage issues pertinent to these product-liability-type claims. Cohen discussed the fact that suits between insurers and their insureds are beginning to dot the landscape, and discussed the issues that he believes we are most likely to see as these cases get litigated.

Reinsurance

Cohen brought to the audience's attention a recent and highly anticipated decision by the House of Lords — *Lexington Insurance Co. v. AGF Insurance Limited et al* [2009] UKHL 40 (July 30, 2009) — that will no doubt have wide-ranging implications for reinsurers and cedents alike. By way of background, Lexington Insurance Co. ("Lexington") issued a property damage and business interruption policy to Alcoa. The policy had a three-year period, from July 1, 1977, until July 1, 1980. The policy did not have an express choice of law provision; however, it contained a United States Service of Suit clause. Lexington, in turn, obtained facultative reinsurance based on the same terms and conditions as the underlying policy. The reinsurance policy, similar to the underlying policy, did not have a choice of law provision but contained the same United States Service of Suit clause. The policy also contained a follow-the-fortunes/follow-the-settlement clause.

In the underlying action, the U.S. Environmental Protection Agency (EPA) demanded that Alcoa clean up several of its properties. Given that the pollution was over a course of more than 30 years, a declaratory action was initiated against Lexington and other insurance carriers regarding their respective coverage obligations pertaining to the cleanup. The Supreme Court of the State of Washington, applying Pennsylvania law by reason of the Service of Suit provision, concluded that each of the insurers was "joint and severally" liable for the all cleanup costs of the polluted sites "regardless of whether or not that pollution damage actually occurred during the policy period." Given that some of the other insurance carriers absolved themselves of liability due to applicable exclusions, Lexington was potentially responsible for the entire $103 million in cleanup costs. In other words, Lexington was responsible for all damage that occurred before and after the policy was in effect. The reinsurer declined to pay the amount and commenced this action in the U.K. to determine its respective reinsurance obligations.

In deciding the reinsurer's obligations, the House of Lords explored whether United States law or English law applied. While conceding that U.S. law was referred to in the underlying and reinsurance policies, the court determined that English law applied to the construction of the reinsurance policy. As a result, the House of Lords explained that under traditional English law, the time period in which the policy was in effect is a binding provision, which should be enforced by the parties. Therefore, under customary reinsurance principles, the risk the reinsurers accepted was for the time specified in the policy, not the entire risk itself. Additionally, the House of Lords looked at whether having a follow-the-fortunes/follow-the-settlement provision in the reinsurance policy would expose the reinsurer to a risk beyond the policy period. The House of Lords declared that simply containing a follow-the-settlement provision did not expand the scope of the risk beyond the policy period. As a result, the House of Lords rejected the Supreme Court of Washington's decision and declared that the reinsurer's exposure was limited to the time period of the policy.

If you are interested in a copy of the handout and PowerPoint for this session, please contact me at lkelly@goldbergsegalla.com. ■

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