CPCU SOCIETY INSURING YOUR SUCCESS

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 J.D. 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.

Ah … the songwriting team of George Gershwin and DuBose Heyward were right — "Summertime, and the livin' is easy."

Well, maybe not so much for the Reinsurance Interest Group Committee! It is proceeding at rocket pace to put together valuable content for CPCU Society members with an interest in reinsurance!

I look forward to the 2010 Annual Meeting and Seminars in Orlando, and Sunday, Sept. 26, 2010, in particular, when the Reinsurance Interest Group will be featured. From 11:45 a.m. to 12:45 p.m. that day, we will host the second annual Reinsurance Interest Group luncheon.

Our guest speaker will be **Joe Bouthillier,** director of underwriting for Citizens Property Insurance, the insurance company of last resort in the state of Florida. Citizens is a not-for-profit, tax-exempt government corporation whose public purpose is to provide insurance protection to Florida property owners throughout the state. Bouthillier has been with Citizens since its inception, and he will provide fascinating insights into the organization, its history and its evolution. Depending on catastrophic weather between now and then, he may also have some data to share on the 2010 Florida losses from hurricanes.

That afternoon at 2:45 p.m., the Reinsurance Interest Group will host the seminar entitled, "Reinsurance — State of the Art." **Tracey W. Laws, J.D.,** general counsel of the Reinsurance Association of America will moderate. Panelists will include **Bryan W. Barger, CPCU, ARM, ALCM,** vice president/client executive, Marsh USA Inc.; **Dan Hickey,** executive vice president, Standard Lines, PartnerRe U.S.; and **Stephan Hochburger, CPCU, ARe,** senior vice president and client manager, Munich Re America, Regional Client Division. I hope to see you all at both of these events.

In addition, we will celebrate the fact that the Reinsurance Interest Group has once again received Gold Circle of Excellence recognition, which confirms the terrific and active year that we have had.

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What's in This Issue

Message from the Chair

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The Reinsurance Interest Group Committee will also meet during the Annual Meeting to finalize plans for the 2010–2011 fiscal year. My term as chair will end after the 2011 Annual Meeting and Seminars in Las Vegas, so the first item on the agenda will be the official appointment of a vice chair/chair-elect. I am pleased to announce that my friend and fellow committee member, **Nick Franzi** of Munich Re, has agreed to step into that role. I look forward to working with him this coming year to ease his transition. We also have a full slate of events to plan.

For starters, we are working on two separate, but interconnected, webinars on the Deepwater Horizon catastrophe. The webinars are scheduled for Sept. 2 and Oct. 7.

Following the success of our symposia in Philadelphia and Chicago, we are planning to branch out in 2010! On Oct. 21, 2010, we will conduct a full-day reinsurance symposium in Dallas, Texas. Planned segments include the following:

- An executive panel of reinsurance buyers, providers and brokers on the state of the industry and what keeps them awake at night.
- A presentation from a representative of AM Best on the state of the marketplace.
- Analysis on the Deepwater Horizon catastrophe and its implications for the industry.
- Reinsurance IT trends.
- A cocktail reception and networking opportunity following the program.

Speaking of the Chicago and Philadelphia symposia, those are on the calendar for February and March 2011, respectively. After rave reviews for the 2010 location, the Philadelphia symposium will once again take place on March 30–31, 2011, at the Union League on South Broad Street in Philadelphia. The format will be the same as 2010. The symposium will begin on Wednesday evening with a networking reception and continue into a full day of program on Thursday. Watch our LinkedIn group page, our website, your e-mail inbox and future editions of this newsletter for further details.

Finally, you can look for tremendous content on topics of interest to everyone in the reinsurance industry from this newsletter. **Richard G. Waterman, CPCU, ARe,** is invaluable as the editor of *Reinsurance Encounters*. He compiles each issue masterfully, and I receive more compliments from members with each new edition.

I challenge each of you to commit to attend at least one of our planned events and to read each edition of *Reinsurance Encounters* this year! I truly believe that you will find our productions to be without peer in quality and content. ■

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 130 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.

With the lazy hazy days of summer winding down and fall commitments beginning to fill our calendars, it is reassuring to know, as reported in industry journals, that the insurance and reinsurance industry has withstood a tough economy and remains financially strong and capable of handling reasonably anticipated insured exposures.

To achieve those high levels of success in this business environment, people are working harder than ever, and in some cases, for less than they used to. You will notice when reading Chair **Tom Pavelko's** nearby column that the CPCU Reinsurance Interest Group Committee has also been commendably working hard on projects and seminars on behalf of our membership. We look forward to seeing you at the CPCU Society Annual Meeting and Seminars in Orlando.

In this issue, we feature three articles too loosely related to be grouped into one common theme, yet too closely connected to escape a collective identity. If I had to categorize them, I would call them "agents of change," for they deal with new developments affecting traditional concepts. A commitment to rebuild the New York Insurance Exchange is a contemporary topic of growing interest, which is followed by two others that address traditional underlying principles of the reinsurance industry that have become great sources of anxiety in recent years.

The lead article, "The Once and Future New York Insurance Exchange," is written by **Peter H. Bickford, LL.M.,** a long-standing business colleague. Back in 1980, the New York Insurance Exchange was established primarily as a reinsurance market. Financial woes resulting from a rapid growth in premium and large losses led to syndicate insolvencies and eventual suspension of all activity in November 1987.

Recently, New York's Superintendent of Insurance established working groups of interested members of the insurance and financial industries and regulators with the goal of developing a plan of action for the re-establishment of the New York Insurance Exchange. Since Mr. Bickford was the first general counsel to the original New York Insurance Exchange and has been appointed special advisor to the current Insurance Exchange Group and its various subgroups, he provides an especially well-informed perspective regarding resetting the future of the New York Insurance Exchange.

The next article, "Follow the Settlements — A House of Lords' Decision," written by **Richard J. Cohn, J.D.,** and **Jeffrey L. Kingsley, J.D.,** partners at Goldberg Segalla LLP, focuses on traditional reinsurance concepts of follow the settlements and back-to-back reinsurance in facultative reinsurance contracts. Follow the settlements is a widely recognized doctrine in the reinsurance industry. The doctrine of follow the settlements refers specifically to the duty of a reinsurer to follow the good faith claim adjusting and settlement decisions of its reinsured.

In the context of facultative reinsurance contracts, back-to-back reinsurance should cover the same risk as the underlying policy, often with some specific limitations. The House of Lords decision, governed by English law, upheld the principle that reinsurers were bound to follow the settlements of the reinsured while making it clear that the terms and conditions of a reinsurance contract are separate and distinct and must be analyzed independently when considering the principle of back-to-back coverage.

Andrew S. Boris, J.D., a reinsurance attorney with Tressler LLP in Chicago and a regular contributor of emerging and informative articles affecting the reinsurance industry, offers his thoughts related to replacing an arbitration panel member in his article, "My Arbitrator Resigned — What Happens Next?" Reinsurance contract provisions generally include an arbitration article establishing that in the event of a dispute each party chooses one arbitrator and the two arbitrators choose an umpire. Unfortunately, one of the party-appointed arbitrators or the umpire may become ill or may resign for other reasons during the pendency of the arbitration. In that event, how do the parties replace the panel member when the parties cannot agree? Most arbitration clauses in reinsurance contracts do not provide procedures to fill a vacancy on the panel. In his article, attorney Boris discusses a series of recent court decisions that provides some guidance.

Your continued support, contributions and feedback really help us plan future symposia and know the kind of articles you would like to see published in this newsletter. ■

The Once and Future New York Insurance Exchange

by Peter H. Bickford, LL.M.

Peter H. Bickford, LL.M., is an author, speaker and ARIAS-U.S. certified reinsurance arbitrator and umpire. In addition to having been a practicing attorney for more than 35 years, he has been an executive officer of both a life insurance company and a property-casualty insurance and reinsurance facility — the New York Insurance Exchange. Bickford was the first general counsel to the New York Insurance Exchange and served in that capacity from before the Exchange's opening in March 1980 until September 1985. In January 2010, New York Superintendent of Insurance James Wrynn appointed Bickford special advisor to the New York Insurance Exchange Working Group.

On March 31, 1980, the New York Insurance Exchange opened to great fanfare in Lower Manhattan. The Exchange was the culmination of several years of legislative, regulatory and industry effort to establish a Lloyd's-type insurance market in the U.S. — a market consisting of multiple syndicates, underwriting managers, brokers and intermediaries operating under a common set of rules on a common trading floor. The next day, April Fools' Day, started the longest transit strike in New York City history. Some say this was an omen of things to come for the fledgling Exchange. And after an initial period of spectacular growth and expansion, the Exchange ceased operations a short seven years after opening with a number of its syndicates having been declared insolvent and in various stages of receivership or run-off.

More than two decades later, Governor Paterson listed in his State-of-the-State Message a number of economic initiatives to be pursued by his administration. Among them was a commitment to "rebuild the New York Insurance Exchange," adding that: "By bringing together the buyers and sellers of complex commercial insurance, the Exchange will reaffirm our status as the focal point of international trade and finance. It will also curtail the types of transactions that were unregulated that decimated the global economy."

By including the rebuilding of the insurance Exchange in his remarks, the governor has placed the full weight of his administration behind the idea first raised by Insurance Superintendent Dinallo in 2007, and endorsed by his successor and current Superintendent James Wrynn. For his part, Superintendent Wrynn has moved the project from talk into action by establishing working groups of interested elements of the insurance and financial industries and the regulators, with the goal of developing a plan of action this year.

The idea of re-establishing the Exchange, however, has its skeptics and naysayers. What has changed in the past two decades to make a Lloyd's-style insurance exchange workable in the U.S. today when it did not seem to work before? Why do we need another market in the middle of a seemingly endless soft cycle? How can an exchange overcome the regulatory and tax disadvantages of operating in the U.S.? What assurances are there that a new exchange will not be as inefficient and costly as its predecessor? Why, indeed, even bother?

This article will look at the original Exchange experience, addressing some of the more common perceptions and misperceptions about its demise and the pros and cons of "rebuilding" the Insurance Exchange today. This effort can only scratch the surface in discussing the multiple and complex elements and history of the Exchange. By addressing some of the more common perceptions and issues, however, it is hoped that serious dialogue and consideration be given to the effort to re-establish the Insurance Exchange based on a solid factual understanding of the original Exchange — both its strengths and its weaknesses.

The Original Exchange — A Brief History[1]

The capacity crisis of the mid-70s was reflected in New York with the adoption in June 1978 of the "Free Trade Zone"[2] and insurance exchange legislation.[3] The insurance exchange legislation authorized the drafting of a constitution, which was adopted by statute in February 1979, leading to the opening of the Exchange a year later. The next several years witnessed extraordinary growth on the Exchange, primarily as a reinsurance market. By the end of 1984, it ranked in the aggregate as the eighth largest U.S. reinsurer by premium and fifth largest by policyholder surplus. The number of syndicates grew from 16 on opening day to 35 active syndicates by year-end 1984, and the number of participating brokers exceeded one hundred, including most of the major national brokers and reinsurance intermediaries. The optimistic predictions of the Exchange supporters appeared to be coming true. That optimism, however, proved to be misplaced.

The tight market that helped launch the Exchange legislation in the late 70s had disappeared by the time the Exchange opened in 1980. The rapid growth in premium volume coupled with the extreme soft market conditions of the early 1980s helped spark a growing impression in the industry that the Exchange was really the market of last resort; the "dumping ground" for the submissions from the bottom drawer that could not be placed anywhere else.[4]

As the premium volume grew, so did the losses, eventually leading several syndicates to stop underwriting new and renewal business, but these actions proved to be too little and too late. The seeds of financial trouble were present in the first few years of the Exchange. Finally, in August 1986, the Exchange Board of Governors declared five syndicates insolvent and petitioned the New York Superintendent of Insurance to liquidate four of them, and by fall 1987 the number of syndicates turned over for liquidation had grown to eight.

Although plagued by the adverse publicity of these insolvencies and the withdrawal of many of its major industry participants, as well as by a back-office operation that had not kept pace with its growth, the final straw appears to have been an action by the separate board of directors of the Exchange's security fund. In September 1987, the security fund's board of directors called down the $.5 million deposits of each of the underwriting members on the Exchange — a total of $25 million — to meet the potential claims against the security fund resulting from the declared syndicate insolvencies. This action took the Exchange members by surprise, and the resulting shockwave led to petitions to withdraw by all but 10 of the remaining syndicates. The Exchange board acted to "temporarily" suspend all activity on the Exchange in November 1987. The Exchange never opened its doors again.

A Failure?

It may be easy to conclude from this history, as many have, that the great U.S. exchange experiment was an abject failure. Such a conclusion would be wrong, however, and before there can be a reasoned discussion about restarting the exchange, this perception of total failure must be reexamined.

When the Exchange suspended operations in the fall of 1987, it had a number of syndicates that were solvent, well capitalized (for the business they were writing), well managed, profitable and — most importantly — willing and anxious to continue operating on the Exchange. A number of broker members had also developed successful exchange operations and were likewise willing and able to continue placing business with those exchange syndicates they had grown to trust and depend on as a market. These syndicates and brokers better than most understood the value of an exchange form of market and were successfully utilizing that knowledge and understanding to their advantage.

So why didn't they continue as an exchange? The simple answer is that after the Exchange's board of directors decided to close the facility, the rush was on not to be the last one standing on the sinking ship. That explanation, however, is overly simplistic and ignores some basic facts about the original makeup of the Exchange. It also ignores the role that fate often plays in history — even corporate history.

Loss of a Hero

Prior to the suspension of operations, the Exchange's most influential supporter was not on the Exchange board, Exchange staff or even a senior executive of a major insurance company or brokerage firm. He was the manager of the syndicate management subsidiary of one of the alphabet brokers, Johnson & Higgins (J&H). His name was **Roy Nelson,** and he tried in vain to convince the major powers on the Exchange board to find market solutions to the Exchange's problems and to give those willing participants the opportunity to continue. As the head of the J&H syndicate managers and with the full support of his parent company, an internationally savvy broker, he had four active and successful syndicates under management with plans to add at least a half-dozen more. Roy was also the head of the Syndicate Members Association, which attempted to rally the voices of those members looking to continue. He and his colleagues understood the concept of the exchange and knew that given time to develop the Exchange could become a strong and significant market. But cancer struck Roy down in the months before the Exchange board acted to discontinue operations and force the remaining members to withdraw.

It is impossible to know if Roy would have been successful in getting the Exchange board to support continuation of the market, but given his persistence and his understanding of an exchange market, it would have been hard to bet against him. And how could he have staved off the "inevitable"? Perhaps, by convincing the Exchange board and management to use the unique tools provided to it by statute, the Exchange constitution and by-laws, and the very nature of the exchange as a market.

Unused Toolbox

When the Exchange petitioned the New York Superintendent of Insurance to liquidate the first four syndicates in August 1986, many believed that it lost a golden opportunity to demonstrate to the industry that it could succeed as a self-regulated marketplace. Its constitution and by-laws, approved by the insurance department and the legislature, provided the Exchange with significant powers over its underwriting syndicates. These powers included the types of authority generally granted to insurance regulators over insurers, such as the authority to:

- Restrict writings.
- Require an increase in surplus or capital requirements.
- Issue cease and desist orders.
- Suspend authority.
- Place a syndicate under its supervision.
- Declare a syndicate insolvent and seek liquidation.

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The Once and Future New York Insurance Exchange

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In addition, however, the Exchange had certain advantages that the state regulators did not enjoy. In particular, because syndicates could only write business through the Exchange facility, and the Exchange processed all business written by the syndicates, in theory the Exchange should have had much more timely and accurate information about the extent and character of the writings of each syndicate member. However, the Exchange did not take advantage of this access to information, as evidenced by its failure to stop the insolvent syndicates from continuing to write business long after they had overextended their capital resources.

The reasons for this failure were complex, including the blurring of the line between the Exchange as promoter of the market as well as its regulator, processing backlogs at the Exchange facility, inconsistent submission and reporting requirements, and compliance issues that prevented it from having any significant control of the information that should have been available to it.

Many members, both syndicate and broker, urged that the Exchange find a market solution to the problem rather than simply turn the financially troubled syndicates over to the state for liquidation. They argued that for the Exchange to be accepted as a viable market, it had to deal with the adversity of financially troubled syndicates to show the industry that it had the ability and the resources to address difficult situations. The Exchange, it was argued, should use its unique self-regulatory authority to work with the syndicate managers, the broker community and the Exchange's security fund to find a way to resolve the syndicate financial problems and keep them out of the state's liquidation process.

For instance, one of the proposed market solutions was for the creation of a new syndicate that would be the reinsurer of, or assuming entity for, the insolvent syndicate liabilities. This new syndicate — which had the working name Syndicate 101 — would be capitalized by the existing members, take control of the remaining assets of the insolvent syndicates and look for additional financial support from the security fund. This proposal was presented long before the Lloyd's market "invented" Equitas.

For whatever reasons, however, the Exchange's board and management took no steps to attempt to prevent the liquidation of these syndicates. Instead, they simply turned them over to the state. In comparison, Lloyd's — faced with many of the same economic pressures and failures, only on a much greater scale — used all available resources and opportunities, including the establishment of Equitas to wall off old liabilities, to address its problems and in time restore its financial bearings and prestige as a market of choice. In other words, one could reasonably conclude that it was not a failure of the exchange market that resulted in the closing of the Exchange. Rather it was a failure of its management and leadership.

Why Now?

Before exploring the pros and cons of a new exchange enterprise today, it is helpful to consider how the world has changed in the 30 years since the original exchange opened in 1980. Consider the following list, which is by no means exhaustive:

- The first Vermont captive insurance company was licensed in 1981.
- The first liability excess facilities were established in Bermuda in 1986.
- The Liability Risk Retention Act that allowed for the creation of risk retention groups and risk purchasing groups was enacted in 1986.
- In the 1980s, a sidecar was an attachment to a motorcycle, a cat bond was getting to know your pet and securitization was protecting your home.
- E-mail and Internet access did not become widely available until the 1990s (remember TELEX?).
- IBM introduced the first PC in August 1981 (16k of memory expandable to 256k); Apple introduced the first Macintosh (128k of memory) in a famous commercial during the Super Bowl in January 1984.
- In 1980, it took from three to six minutes to fax one page via telephone.
- There were no laptops, cell phones, blackberries (other than the edible kind). SONY's Walkman, the grandfather of all portable electronic devices, had only been introduced in June 1979.
- The Exchange's modern idea of paperless recordkeeping was microfiche (try and find a readable copy of any of those records today!).

In other words, the explosion in alternative risk transfer vehicles and in data storage, access and retrieval had not begun when the Exchange was born. It is an entirely different universe today, and any consideration of the Exchange as a market needs to be viewed in light of these changes. That is not to say that the experience of the original exchange is not relevant. Quite the contrary! There are many lessons to be learned from that experience that still resonate today. The proof of this is Lloyd's itself.

The Lloyd's Experience

If an exchange form of market is irrelevant and wrong, then why is Lloyd's thriving? As stated, Lloyd's was faced with the same economic and business problems as the New York Exchange, but on a much greater scale. Many Lloyd's names (syndicate investors) were facing financial ruin from unlimited liability for a growing spiral of losses, and the market was facing a serious crisis of confidence. With persistence and determination, and with pressure and oversight of the regulators and lawmakers, Lloyd's managed to resolve those issues, including walling off the old liabilities through Equitas. In the process, Lloyd's was also able to restructure

itself for future success without destroying the basics of an exchange market.

When the New York Exchange first opened, many London critics scoffed at it allowing corporate syndicates and limited liability of syndicate members. In its own reinvention, of course, unlimited liability at Lloyd's has gone the way of the 10-cent cup of coffee (or 10-penny cup of tea). Equally important today, Lloyd's is a much more open facility than it was 20 years ago when business had to be placed through a relatively few number of Lloyd's brokers. While Lloyd's has always been an international market for insurance, it has not always been an internationally accessible place to do business for brokers, underwriting managers and investors. Many brokers and managers operating on Lloyd's today, however, are affiliated with international firms with widespread operations, and international insurers and investment groups participate through their own syndicates and managers. Yet with all this openness and competition, Lloyd's capacity continues to increase and the market thrives.

Which makes the argument often heard against a New York exchange — that it would result in unnecessary and unneeded competition for domestic companies — ring a little hollow! Many of these same critics have significant investments in the London and Lloyd's markets. In this changed world, the same international brokers, managers and investment groups operating at Lloyd's could actually welcome a vital, well-run exchange counterpart in the U.S. In other words, there is no reason that a U.S. exchange could not be a complementary market with the benefit of closer, less expensive access to the U.S. market, a more comfortable understanding of local business and insurance needs, and be a profit center rather than competition for many domestic companies.

What about Taxes?

There are also many critics that state that without significant tax breaks for on-shore investments, the New York exchange cannot possibly succeed as an alternative to offshore excess and reinsurance facilities. There is certainly a basis for this argument, which is well recognized by Superintendent Wrynn, who has made seeking some kind of tax "equalization" or leveling of the playing field a priority in his efforts for support. But focusing solely on the tax issues misses the mark regarding the potential benefits of an exchange form of market, and on the multitude of product and investment vehicles that can be developed for, and written competitively on, the exchange. It is these benefits and products that should be the focus today.

The legislative process is fickle at best, and reliance on some promise of relief down the road, while it should be pursued, should not be the determining factor in proceeding with or abandoning the exchange project. Simply put, re-establishing the New York Insurance Exchange should not hinge on obtaining tax relief.

Basic Principles for a New Exchange

With "past as prologue" in mind, there are a few basic principles that should be observed by the working groups established by Superintendent Wrynn in considering the form and structure of the new exchange. Among these are the following:

- The exchange should be industry driven and regulator supported. The regulators can provide the forum and support for the development of a plan, but the primary force needs to come from the insurance and financial services industries if there is to be any lasting success.
- The capital requirements for syndicates will need to be significantly stronger, not just in terms of the amount of capital, but, more importantly, through the application of risk to capital ratios that had not been developed or implemented in the 1980s.
- There will need to be a strong commitment on the part of both regulators and the industry to self-regulation and control of the market — with the regulators allowing the facility to develop rules controlling the operation and security of the market, and with the exchange leadership having the will to enforce its rules and its financial security requirements, a major failing of the old exchange.
- And a new exchange will need to take full advantage of the technical developments over the decades since the original exchange, including instant communications, virtual trading capabilities and real-time access to and use of transactional and other data.

Under Superintendent Wrynn's direction, a working group has been started to move the exchange project forward. This working group has been divided into a number of subgroups to focus on the following subjects: capitalization, tax, operations and technology, multistate issues, markets and government relations. The work product of these various subgroups will then form the basis for the development by the full working group of an overall plan of action for a revised exchange market. It is these initial working groups that will largely define the shape, look and feel of the new Exchange. Organizations that have a serious interest in the re-establishment of the insurance exchange, and helping with the process, should make sure they are involved now rather than complaining about a finished product later.

A New Beginning

Perhaps the most significant loss from the original exchange experience was the loss in time. If its board and management had found a way to allow the Exchange to continue operating so that the Roy Nelsons of the industry — who understood the risk spreading value of a syndicated exchange market — the New York Insurance Exchange might well

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have celebrated its 30th anniversary this March rather than the contemplation of its rebirth.

Those years cannot be recaptured, but we can learn from the experience of the original rather than dismiss the exchange concept as a waste of time and energy.

No market can or should be all things to all people! There are certainly many in the insurance and investment communities that will conclude that an insurance exchange makes no sense for them. There are many others, however, looking for new options and opportunities for which a viable, well-conceived exchange market makes sense. It is these people that need to step up and join the conversation. ■

Author's Update: Each of the various subgroups to the Insurance Exchange Working Group met and conferred over the months following the initial Working Group meeting in February 2010. These deliberations resulted in the presentation at the end of June 2010 of the preliminary recommendations of the subgroups. A copy of this presentation, prepared by the New York Insurance Department, can be accessed on my website at www.pbnylaw.com (on the Insurance Exchange page).

The next phase of this project is the preparation of an action/business plan to be presented for comment to the full Working Group. It is anticipated that an initial draft plan will be available by early fall 2010.

About the time my article was prepared, New York Superintendent of Insurance James Wrynn appointed me special advisor to the Insurance Exchange Working Group and its various subgroups. However, the views expressed by me in my article or elsewhere on this topic are solely mine, and do not necessarily reflect those of the New York Superintendent of Insurance, the New York Insurance Department, the Exchange Working Group or the various sub-groups.

Endnotes

(1) Some of the historical discussion in this article is excerpted from my 2004 article, "What Ever Happened to the New York Insurance Exchange (And Why do we Care)?" A PDF of that article can be obtained at www.pbnylaw.com, along with other articles and historical materials on the New York and other U.S. insurance exchanges.

(2) The Free Trade Zone (see New York Insurance Law Article 63, and Regulation 86 [NYCRR, Part 18B]) was New York's response to the perceived need for greater market flexibility by allowing licensed insurers in New York to write large or hard-to-place commercial risks free from rate and form restrictions.

(3) The insurance exchange legislation (see New York Insurance Law Article 62, and Regulations 89, 89A, 89B and 89C [NYCRR, Part 18]) — originally conceived and for the most part operated as a reinsurance exchange — was a direct result of the concern over shrinking capacity and the flow of premium dollars overseas. Neither the free zone nor the exchange concept was able to obtain the necessary legislative and regulatory backing on its own; together, however, they were able to muster the necessary acceptance.

(4) Under the original §6201(b) of the New York Insurance Law, the syndicates could write reinsurance, direct insurance on risks located outside the U.S., and risks rejected by Free Trade Zone insurers. In 1982, the section was amended to add the ability to write surplus lines from other states (where qualified). However, by the time the Exchange started gaining some traction with the expanded surplus lines authority, the Exchange market was already in decline, and it remained essentially a reinsurance market.

The Institutes™

Proven Knowledge. Powerful Results.

The Institutes Announce New Elective Component for CPCU Program

Working in close cooperation with industry professionals, designees, training experts and the CPCU Society, The Institutes announced on July 7 that they have modified the CPCU program to ensure that it continues to meet the industry's needs in an ever-changing and competitive marketplace.

Effective immediately, the CPCU program will include an elective component as a part of its education requirement, which consists of four foundation courses, one elective course and three concentration courses (personal or commercial).

Individuals pursuing the CPCU designation will select one elective course from among 10 options in seven functional areas. The elective choices are as follows:

- AAI 83 — Agency Operations and Sales Management.
- AIC 34 — Workers Compensation and Managing Bodily Injury Claims.
- AIC 35 — Property Loss Adjusting.
- AIC 36 — Liability Claim Practices.
- ARe 144 — Reinsurance Principles and Practices.
- ARM 56 — Risk Financing.
- AU 65 — Commercial Underwriting: Principles and Property.
- AU 66 — Commercial Underwriting: Liability and Advanced Techniques.
- CPCU 560 — Financial Services Institutions.
- ERM 57 — Enterprise-Wide Risk Management: Developing and Implementing.

Orlando Annual Meeting and Seminars —

First-Ever Interest Group Events

Agent & Broker Interest Group Breakfast Seminar

Saturday, Sept. 25 • 8:30–11:30 a.m.

Learn more about healthcare reform legislation at a complimentary breakfast seminar sponsored by the Agent & Broker Interest Group. Panelists will discuss "Healthcare Reform as It Stands Today" from the perspectives of the not-for-profit sector, the business community and the medical insurance industry. **Manus C. O'Donnell, CPCU, ARM, AMIM,** administrative vice president and director of corporate insurance for M&T Bank, will serve as moderator. Speakers include **Anne M. Buckley, Esq.,** vice president and general counsel, RMTS, LLC; **James P. Gelfand,** director of health policy, U.S. Chamber of Commerce; **Velma R. Hart, CAE,** national finance director/CFO, AMVETs; and **David P. Kalm, Esq.,** president and CEO, RMTS, LLC.

Register for this complimentary breakfast and seminar at http://www.zoomerang.com/Survey/WEB22ARTJ4KJZW.

International Insurance Interest Group Happy Hour

Saturday, Sept. 25 • 6:30–8 p.m.

All CPCUs and their families are invited to network with the CPCU "international" crowd at the International Insurance Interest Group Happy Hour, featuring a pay-as-you-go bar. The interest group will provide appetizers.

Agent & Broker/International Insurance/ Personal Lines Interest Groups "Meet Market"

Monday, Sept. 27 • 7:30–9 p.m.

Three interest groups — Agent & Broker, International Insurance and Personal Lines — are hosting a unique networking event that matches producers with markets to open a dialogue that paves the way for future business dealings. The networking activities will be facilitated by **Gregory G. Deimling, CPCU, ARM, AMIM,** a principal of Malecki Deimling Nielander & Associates, an insurance consultation and risk management firm. The format also encourages attendees to stop by insurance carrier tables, which will be staffed by company representatives.

Note: You must show your ticket to the Agent & Broker/ International Insurance/Personal Lines Interest Groups Dinner for admission to the "Meet Market."

CPCU: Your Bridge to the Future

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Follow the Settlements — A House of Lords' Decision

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Editor's note: Richard J. Cohen, J.D., and **Jeffrey L. Kingsley, J.D.,** of Goldberg Segalla LLP, presented the *Wasa* case at the CPCU Society's Reinsurance Interest Group's symposium in Philadelphia in March 2010. Goldberg Segalla, with 10 offices across New York, New Jersey, Pennsylvania and Connecticut, was ranked sixth (third among firms in the United States) in *Reinsurance* magazine's 2010 Top 10 Law Firms Power List.

On July 30, 2009, the House of Lords, in one of its last decisions as the United Kingdom's High Court, issued the much anticipated ruling in *Wasa v. Lexington* [2009] UKHL 40, in which it determined that the reinsurers, though agreeing to provide back-to-back cover through a facultative reinsurance agreement, were only responsible for a portion of the entire claim. While the House of Lords acknowledged that the reinsurance agreement contained the standard "follow the settlements" clause, it nevertheless limited the exposure to the three-year time of cover. Although reinsurers, particularly in the London market, rejoiced in what they deemed the prevention of a "monstrously unjust" ruling that was "plainly not the intention of the contract," cedents around the world began to examine their own policies to see if they could be saddled with a sizable under-reinsured claim.

The fundamental concept at the center of this decision is the scope of the "follow the settlements" clause in the reinsurance context. The seminal United Kingdom case regarding the scope of the "follow the settlements" is *Insurance Company of Africa v. Scor (UK) Reinsurance Co. Limited*, (1985) 1 Lloyd's Rep. 312, where the United Kingdom's Court of Appeal imposed the following requirements which would compel a reinsurer to pay their respective portion of the risk: (1) The claim falls as a matter of law within the risks covered by the reinsurance policy; (2) They have acted in good faith and without fraud or collusion; and (3) They have acted "in a proper and businesslike manner."

In the context of facultative reinsurance contracts, the reinsurance policy is presumed to provide "back to back" reinsurance coverage for the cedent. Simply stated, the reinsurance policy should cover the same risk as the underlying policy. While the *Scor* formula is well suited when the underlying policy and reinsurance policy are issued in the United Kingdom, issues and scope of a reinsurance policy are often discussed when the underlying policy is issued in a foreign jurisdiction different from the reinsurance policy.

The Key Ingredients in Making the *Wasa v. Lexington* Decision

Ingredient #1 — Alcoa

During the course of business over the years, the Aluminum Company of America ("Alcoa"), the world's leading producer of primary and fabricated aluminum, generated waste products that were stored in on-site disposal facilities, landfills and lagoons, and sometimes during the course of those operations, discharged into the property of others. In the early 1990s, the United States Environmental Protection Agency and various state environmental agencies required Alcoa to clean up the pollution and contamination of ground water, surface water and soil for at least 58 of its manufacturing sites in the United States and beyond, which resulted from more than 40 years of operation. Alcoa paid for the investigation and remediation of the environmental harm.

Ingredient #2 — The Lexington Policy to Alcoa

Lexington Insurance Company was one of many carriers that afforded coverage to Alcoa over the 40-plus years. The

Lexington policy carried an effective policy period of July 1, 1977, to July 1, 1980. The policy contained no express choice of law clause, but contained a standard service of suit clause. The policy had liability limits of $20 million per occurrence, and defined the term "occurrence" as "any one loss, disaster, or casualty arising out of one event or common cause." The policy's insuring agreement stated that:

> "Perils Insured: This policy insures against all physical loss of, damage to, the insured property as well as the interruption of business, except as hereinafter excluded or amended."

Ingredient #3 — The Reinsurance Contracts

On June 1, 1977, Sentry Underwriting Agencies Ltd. subscribed to a 2.5 percent line of the reinsurance contract. (Note: *Wasa* was the successor in title to 1 percent and AGF was, for all intents and purposes, successor in respect to 1.5 percent.) These dates were intended to coincide with the period of the underlying insurance. The subject matter of both the reinsurance and the insurance contracts was the risk of physical loss and damage occurring to property at Alcoa's worldwide sites. The period of reinsurance cover was 36 months from July 1, 1977, until July 1, 1980, subject to a limit of $20 million per occurrence.

Ingredient #4 — The State of Washington Decision in US, May 2000

In 1992, Alcoa brought litigation in the state of Washington against 167 insurance companies that had provided insurance to it during a period from 1956 to 1985. In the first of two actions, Alcoa sought a declaration of coverage with respect to the cleanup costs at 35 manufacturing sites scattered throughout the United States. Lexington was one of those defendants. A second action against first-party property carriers, which also included Lexington, was brought in 1996 regarding 23 other

Houses of Parliament, London

sites. The two actions were subsequently consolidated.

The Washington Superior Court selected three of the 58 manufacturing sites — one in Messina, N.Y., one in Vancouver, Wash., and one in Point Comfort, Texas, (referred to as the "Phase 1" test sites) to be the subject of an initial trial, with trials concerning the other sites to follow. At the conclusion of the evidence, the jury was provided with the verdict form, which contained several questions ranging from specific damages to allocation issues. The jury's verdict form was returned, only partially completed, in October 1996, following 60 days of deliberations. The jury had determined that there had been property damage at most of the three Phase 1 test sites and that the damage had occurred in each of the policy years, which contributed to the cost of repair. The jury provided monetary figures for the repair costs for some, but not all of the areas, the total of which was just less than $20 million. However, the jury did not answer Questions 12 and 13.

Following the jury's inability to reach a verdict, Lexington invited the trial judge to decide as a matter of law whether there was a "reasonable basis on which to allocate to each policy year the costs related to the property damage that occurred during that policy year." After a detailed analysis, she found that there were two occurrences. The court then concluded that Lexington was under no liability with respect to Point Comfort and Vancouver because the repair costs were within Alcoa's deductible. She determined that Lexington's liability with respect to the two occurrences at the Messina site was calculated to total $366,327.86, which was further reduced to zero.

Alcoa appealed the judge's rulings on fortuity, suit limitation and allocation. In May 2000, the Supreme Court of Washington reversed, holding that Lexington was not entitled to rely on the suit limitation provisions in its insurance contract and that the insurers were jointly and severally liable to Alcoa for all property damage, including damage which had occurred before the policies had incepted. The Washington Supreme Court determined that the trial court failed to closely examine the applicable policy language from the Lexington policy. It ascertained that the language was very broad and contained no limitation as to the time of the physical loss or the damage to the property itself. It also decided that there was no exclusion in the policy for physical loss or damage that might have started spreading before the policy had incepted. After concluding that Pennsylvania law was to be applied to this action, Lexington was found to be liable for $180 million. Lexington later settled the lawsuit for approximately $103 million.

Ingredient #5 — The UK Bench Division's Decision, April 2007

On Jan. 30, 2004, Lexington notified its reinsurers that it had settled for

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$103 million with $28 million in legal fees and requested contribution. The reinsurers refused and sought a declaration in court in the United Kingdom that they were not liable to indemnify Lexington under a contributing facultative reinsurance contract with respect to Lexington's settlement of a claim made under the underlying policy of insurance Lexington issued to Alcoa. Lexington counterclaimed for an indemnity or damages in respect to the settlement it had reached with Alcoa, as well as the legal costs it incurred in defending Alcoa's claim.

The court found that the principal issue in the litigation was whether the reinsurance contract required Wasa and AGF to indemnify Lexington with respect to the settlement with Alcoa. In particular, the question was whether the reinsurance contract provided for indemnity in respect to the remedial costs sustained in cleaning up the damages which occurred during the three-year period specified in the reinsurance contract; or did it also require the reinsurers to indemnify Lexington with respect to the remedial costs sustained in cleaning up the damage which occurred prior and subsequent to that three-year period.

Wasa's argument relied on the period of coverage clause. According to Wasa, the period of cover was fundamental to the scope of the bargain between the cedent and the reinsurer. Notwithstanding the existence of a "follow the settlement" provision, and the decision of the Washington Supreme Court as to the outcome of Lexington's insurance contract under Pennsylvania law, Wasa argued that it did not contract to indemnify Lexington against any liability that might be incurred under the insurance contract. In turn, Lexington's position was that the reinsurance policy was to be treated as "back-to-back" based on the intention of the parties.

Judge Simon noted this was a case where Lexington settled the underlying case on the basis it was liable for damage remedy costs outside of the period of cover. He determined that a reinsurance contract cannot be construed as if it provided cover in respect to the cost of damage remedy whenever the damage occurred solely on the basis that some of it occurred during the policy period. Therefore, by relying on the period of cover clause, Judge Simon ruled in favor of the reinsurer.

Ingredient #6 — The Court of Appeal Decision, February 2008

In February 2008, the Court of Appeal rendered its decision reversing Judge Simon's April 2007 decision in favor of the reinsurers. The Court of Appeal acknowledged that the "presumed intention" of the parties is the starting point of the inquiry. Relying on two prominent United Kingdom decisions, *Vesta* and *Groupama*, for the proposition that the language in the reinsurance policy must conform to the interpretation of the same language in the underlying policy so as to indemnify the reinsured, he determined that the prevailing factor was the fact that as a matter of construction the parties to the reinsurance contract intend the period clause to have the same meaning, "whatever that meaning may be." Simply stated, Lord Justice Longmore agreed with Professor Merken that "the arguments put forward by Lexington appear to have great cogency."

The "Controversial" House of Lords' Decision

On July 30, 2009, on its last day sitting as such, the House of Lords rendered its opinion reversing the Court of Appeal and reaffirming the decision of Judge Simon.

Lord Mance's opinion provided an articulate and detailed analysis of the issues, but it essentially boiled down to the basic premise that reinsurance is a separate contract, which may contain its own independent terms required to be satisfied before the reinsured can claim indemnity under it. Here, the reinsurance policy had an express period of cover clause of three years. As outlined in *Scor*, an insurer seeking indemnity under a reinsurance contract must establish both its liability under the terms of the insurance and its entitlement to indemnity under the terms of the reinsurance. Given that the reinsurance was placed expressly to cover the original insurance contract and that the relevant language of both the insurance and reinsurance was identical, as well as the fact that Lexington's intention in reinsuring was to cover itself in respect to the whole risk after the exhaustion of the retention, the two contracts must be treated as back-to-back. Furthermore, a contract has a meaning which is to be ascertained at the time the contract is executed, taking into consideration the surrounding circumstances within the parties' knowledge at that time.

Repercussions Following the *Wasa* Decision

The House of Lords' decision made it clear that reinsurance should not be seen as just an extension of the original insurance contract. The terms and conditions of a reinsurance policy, despite similarities with primary insurance, are separate and distinct and must be analyzed independently. In that regard, the House of Lords affirmatively held that the terms of a reinsurance contract is governed by English law, not the original insurance.

> "Therefore, the House of Lords made a point to distinguish this decision from the prevailing authority contained in the *Vesta* and *Groupama* in ruling in favor of the reinsurer."

In an attempt to characterize this decision as "exceptional," the House of Lords relied heavily on the fact that there was no identifiable system of law at the time the parties entered into the agreement. Due to this factual difference between the *Wasa* case and the *Vesta* and *Groupama* cases, Lord Justice Mance stated that it is "impossible to adopt [the Court of Appeal's views] in circumstances where Lexington's liability has been held to arise under a system of law which was applied to the insurance not by reason of the terms of the insurance or their operation but in the context of a choice of law on a blanket basis to cover a large number of other independent insurances and claims."

Further guiding the House of Lords' decision were the obvious practical implications of compelling reinsurers, with only a three-year period of cover, to be responsible for the entire amount of the settlement claim, which spanned more than 40 years. That said, the House of Lords attempted to avoid the stigma that this decision was a simple "technical" argument in which the reinsurers would escape liability.

The main concern for the House of Lords was that if the two policies were interpreted in the same way, the reinsurers would have been liable for the entire period of contamination even if the reinsurers covered less than a 10th of that time frame. In conclusion, the House of Lords stated that the *Wasa* decision was "exceptional" and traditional reinsurance principles such as the "follow the settlements"/"follow-the-fortunes" doctrines are still enforceable. That said, the implication of this decision is the notion that cedents, not reinsurers, are responsible for unexpected, unforeseen changes in governing law(s) the same as the United States court decision which applied "joint and several" liability to insurance carriers. ■

My Arbitrator Resigned — What Happens Next?©

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.

Although the claims professional has made a significant effort to develop a relationship with the reinsurance company, a dispute develops regarding a series of outstanding billings. The amount at issue is significant and neither party appears willing to concede any weakness. In turn, the claims are placed at issue in an arbitration demand, and the parties are set to have their respective arguments heard and addressed in an arbitration setting. Convinced that their respective positions are correct, the parties actively litigate the case in the arbitration, including significant discovery efforts and pre-hearing motion practice. Very little is accomplished in the arbitration by agreement, and the arbitration panel is called upon to address a variety of pre-hearing issues. Unfortunately, one of the party-appointed arbitrators becomes ill during the pendency of the arbitration and resigns in order to focus on getting medical care. What happens next?

So much time, money and effort have been invested into the process. In addition, one of the parties may have secured pre-hearing rulings that improved that party's likelihood of success at the arbitration hearing. No one can agree whether the arbitration should start over (essentially eliminating all of the prior rulings) or a replacement arbitrator should be put in place with the arbitration continuing to conclusion. A recent case from the United States Court of Appeals for the Second Circuit provides some guidance. See *INA v. Public Service Mutual Ins. Co.*, 2009 U.S. App. LEXIS 12853 (2d Cir. June 23, 2010).

In *INA*, the question presented was whether an arbitration needed to start anew when one of the arbitrators resigned due to illness prior to the arbitration hearing. The facts of the case are somewhat complicated. During the pendency of a reinsurance arbitration, INA's party-appointed arbitrator, **John Sullivan,** learned that he had cancer, requiring immediate and intensive medical treatment. In turn, he resigned from the arbitration panel. Of importance, there has never been a suggestion that the stated reasons for Mr. Sullivan's resignation were untrue. Nonetheless, a significant disagreement developed as to how to address Mr. Sullivan's resignation and whether the arbitration should continue with a replacement arbitrator.

Mr. Sullivan resigned after the panel rendered a unanimous decision effectively disposing of one of the chief defenses presented by INA as to why reinsurance was not being provided to Public Service Mutual Ins. Co. (PSMIC). Before Mr. Sullivan's resignation, the plan was for the parties to complete discovery for all remaining issues and present their respective cases at a full hearing. Mr. Sullivan resigned before any additional activities were completed. Of note, Mr. Sullivan resigned after INA filed a motion for reconsideration as to the panel's ruling on INA's primary legal defense but before the panel addressed the merits of the motion.

In the litigation that followed between the parties as to the effect of Mr. Sullivan's resignation, INA vigorously contended that the arbitration should begin anew. PSMIC opposed such an approach and advocated the continuation of the arbitration with a replacement arbitrator. By order of Dec. 10, 2008, the United States District Court for the Southern District of New York ruled that the arbitration should start anew. In finding that the arbitration needed to start over, the court relied upon case law finding that an arbitration needed to start anew in a analogous situation when a party-arbitrator dies during the pendency of an arbitration.

Recognizing that INA benefited from the decision (in essence, INA's prior summary judgment loss no longer existed), the court appeared to narrow its decision to the unique set of facts presented in the

case and was not necessarily trying to establish a general rule (the fact that a motion for consideration was pending at the time of Mr. Sullivan's resignation appeared to weigh heavily in the court's analysis. If the arbitration did not begin anew, a replacement arbitrator would be required to address the merits of a motion for reconsideration concerning a motion that the new arbitrator did not originally analyze).

In January 2009, PSMIC's counsel learned that Mr. Sullivan's health had improved to the point that he was actively seeking work as an arbitrator. Following the court's ruling that the arbitration was to start over, PSMIC's counsel sent correspondence to Mr. Sullivan inquiring whether he would be available to rejoin the arbitration panel from which he resigned. Before Mr. Sullivan responded to the inquiry, INA's counsel responded by stating that Mr. Sullivan's resignation was final, and it was not willing to allow him to join the "defunct" panel. In turn, Mr. Sullivan responded and denied the opportunity to rejoin the panel as he believed that he had no right to do so.

Based upon this long and tortured set of facts, PSMIC sought relief from the court's prior Dec. 10, 2008, order setting the arbitration to start anew since there was newly discovered evidence that Mr. Sullivan's health had improved to the point that he was an active arbitrator at the time of the court's order. The District Court concluded that PSMIC should be granted the relief it sought, and the arbitration should not start over. In turn, the District Court ordered Mr. Sullivan be reappointed to join the panel. In the event that Mr. Sullivan was unwilling or unable to serve as an arbitrator, the District Court directed INA to appoint a replacement arbitrator.

On appeal, the Second Circuit Court of Appeals was confronted with whether the District Court had erred in not ordering the arbitration to start over and directing INA to appoint a replacement arbitrator (or having Mr. Sullivan serve again). The Second Circuit specifically noted that established law requiring that an arbitration begin anew when a vacancy results from the death of an arbitrator does not apply to a situation involving a vacancy caused by a resignation. Of note, the Second Circuit recognized that there was the potential for manipulation if the rule required a "re-do" of an arbitration when a vacancy resulted for something other than the death of an arbitrator (i.e., a party receives an unfavorable interim ruling and has incentive to invite the party-appointed arbitrator to resign and delay an anticipated defeat). Ultimately, the Second Circuit affirmed all of the decisions made by the District Court.

Although it would appear that the facts of the *INA* case are somewhat unique, the general problems confronted in the case are not entirely uncommon. Arbitrators do resign from panels for a number of reasons, and it is never easy to get the parties to agree what happens following a resignation. The INA case provides some direction on the point, but it is only one case from the Second Circuit Court of Appeals.

Apart from the direction provided by the case, some companies have contemplated placing language in the arbitration clauses of their contracts specifically addressing the steps that need to be taken in the event of the death, resignation or other unavailability of an arbitrator. At a minimum, it would serve parties well to address such potential problems in advance of organizational meetings to potentially reduce litigation for issues tangential to the claims at issue. ■

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