CPCU SOCIETY INSURING YOUR SUCCESS

Reinsurance Interest Group

Volume 27 • Number 1 • March 2009

Reinsurance Encounters

Message from the Chair — Where Are We Headed in 2009?

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.

To paraphrase an airline's commercial, "We know you have a choice in CPCU Society interest groups." But I truly believe that the Reinsurance Interest Group is among the very best in the CPCU Society. Take a look at our plans for 2009, and you will likely agree.

On Thursday, Feb. 5, 2009, the Reinsurance Interest Group sponsored a half-day workshop in Chicago. It included a panel discussion of reinsurance professionals representing reinsurance providers, buyers and brokers, and a presentation on resolving small reinsurance disputes. Reinsurance Education and Communications Hotline (REACH), a local reinsurance professional group, held its quarterly lunch and presentation immediately following this workshop. **Eric F. Hubicki, CPCU; Michael J. Lamplot, CPCU;** and **R. Michael Cass, CPCU, ARe, ARM,** put together an excellent program!

On March 26–27 in Philadelphia, the Reinsurance Interest Group will sponsor its always-popular and informative reinsurance symposium. The premier event of our interest group, the 2009 symposium will focus on personally and corporately surviving the current economic challenges. Also, we will host a conferment ceremony for Associate in Reinsurance (ARe) designation program completers at the symposium's March 26 luncheon. **Charles W. Haake, CPCU, ARe,** and the entire Reinsurance Interest Group Committee have worked doggedly to put this event together, and I greatly appreciate their effort. You can find additional information on this event elsewhere in this edition.

At the CPCU Society's Annual Meeting and Seminars in Denver, Colo., Aug. 29–Sept.1, the Reinsurance Interest

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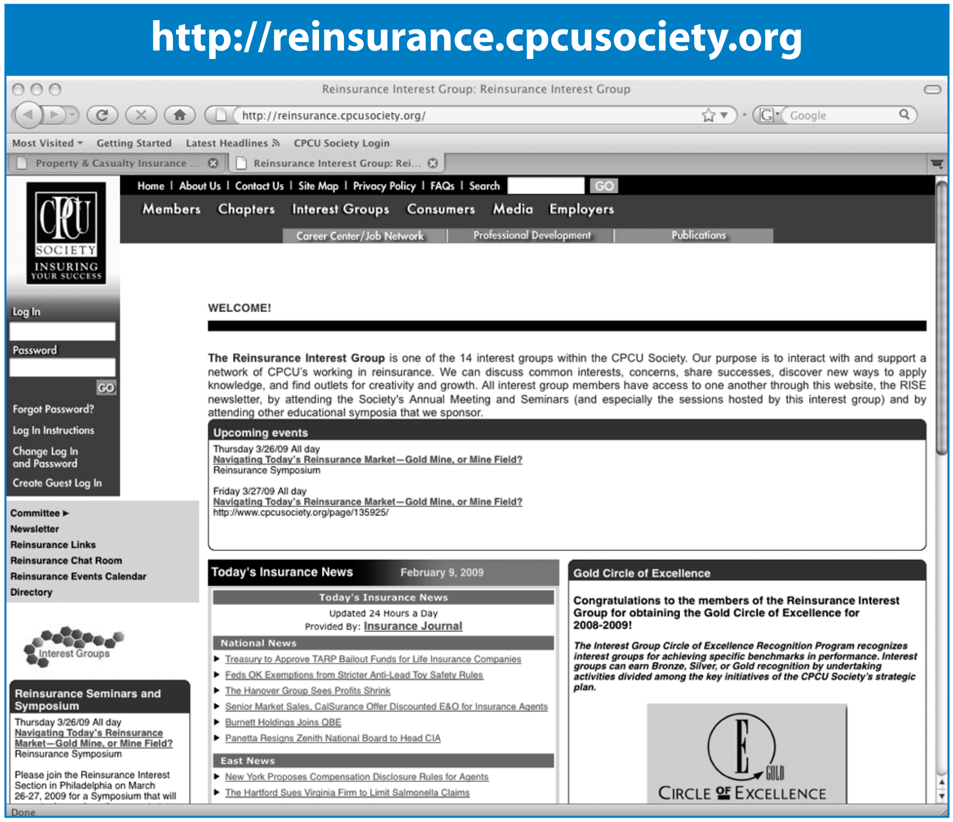
Group will conduct its "Reinsurance — State of the Art" seminar. This is a terrific opportunity to hear executive-level leaders from every facet of the reinsurance industry discuss current events, the state of the market and issues that keep them awake at night. We also intend to host a lunch at the Annual Meeting which will include a presentation on items of interest to our membership.

In addition to these events, the Reinsurance Interest Group regularly publishes this newsletter and hosts a Web site for the benefit of our membership. Newsletter editor **Richard G. Waterman, CPCU, ARe,** does a superb job securing and editing content. If you have ideas for future articles, or would like to write one yourself, please contact him at northwest_re@msn.com or (952) 857-2460.

■ ***This is a terrific opportunity to hear executive-level leaders from every facet of the reinsurance industry discuss current events, the state of the market and issues that keep them awake at night.***

Be sure to visit our Web site often. And please keep in mind that webmaster **Diane Houghton, CPCU, ARe,** is eager to receive your input on how the Web site can be enhanced to maximize its benefit. She may be reached at dianehoughton@att.net or (443) 353-2223.



The above is a screen shot of the Reinsurance Interest Group's Web site.

Also, as timely topics arise, the Reinsurance Interest Group is ready and willing to conduct webinars. The CPCU Society will provide you with detailed program information on webinars whenever they are scheduled.

I hope you will take part in all that the Reinsurance Interest Group has to offer. If you have additional ideas, or would like to help, please let me know at tpavelko@aaic.com or (847) 969-2947. ■

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.

The vase/profile illusion made famous in 1915 by Danish psychologist Edgar Rubin illustrates how difficult it is to perceive two possibilities simultaneously. This is because it can be perceived either as two black faces looking at each other in front of a white background, or as a white vase on a black background. The shape of the contour depends on your perception of which side of the line is regarded as part of the figure; the image fluctuates between the two possibilities.

Our lead article in this edition, "Is It a Vase or Are There Two Faces?" by **Rhonda D. Orin,** an attorney with Anderson Kill & Olick LLP, explains how policyholders perceive their coverage and how insurers and reinsurers sometimes see things differently. What we see, or the interpretation of what we see, can be biased by individual interests and hidden perceptual processes. Orin has graciously accepted an invitation to join our faculty on March 27 at the upcoming Reinsurance Interest Group symposium in Philadelphia, so we will have an opportunity to meet her and learn more about coverage disputes that can occur among policyholders, insurers and reinsurers.

Extra-contractual obligation (ECO) provisions in reinsurance contracts call for indemnification of payments made by a ceding insurer that do not arise out of the coverage of the original policy, such as punitive damages evolving out of the failure by the ceding company to settle within the policy limit, or by reason of alleged or actual negligence, fraud, or bad faith in rejecting an offer of settlement.

While the inclusion of ECO clauses in reinsurance contracts is common to address so-called bad faith allegations between a policyholder and an insurer, attorney **Andrew S. Boris, J.D.,** draws our attention to a rising number of bad faith and extra-contractual damage allegations between ceding companies and reinsurers in his article, "The Changing Landscape of Reinsurance — The Bad Faith Cause of Action." As a regular contributor to the Reinsurance Interest Group newsletter, Boris writes on a wide variety of recent court decisions affecting the reinsurance industry. He also has accepted an invitation to join our symposium faculty on March 27.

Continuing the theme of discovering hidden influences that shape our decisions, you will find the article "Finding Hidden Assets — Is Your Equipment Breakdown Reinsurance Program Broken?" by **Thomas N. Thompson, CPCU, ARe,** an enlightening commentary concerning equipment breakdown reinsurance programs. Thompson provides a brief history of equipment breakdown insurance coverage and identifies unique characteristics associated with this line of business that complicate administration and reinsurance loss recoveries.

Pundits often complain that voting behavior is "irrational." Studies indicate that voters are not particularly well informed in political knowledge and may be "swayed" by misperceived partisan ideologies. My contribution to this edition, "Dynamic Influences That Sway Our Decision Making," is a synopsis of a thought-provoking book titled, *Sway*, co-written by **Ori Brafman** and his brother **Rom Brafman.** The authors challenge your understanding of hidden forces that explain why people behave the way they do and how we can avoid succumbing to irrational decision making. Contrary to certain perceptions, it's possible that the decisions of voters are not irrational but simply don't conform to their critics' view of the world.

Also included in this issue are an article on the CPCU Society's new interest group member benefit and a listing of the 2008–2009 Reinsurance Interest Group Committee. ■

Is It a Vase or Are There Two Faces?

Policyholders See One Thing; Insurers Another

by Rhonda D. Orin, J.D.

Rhonda D. Orin, J.D., is the managing partner of the Washington, D.C., office of Anderson Kill & Olick LLP. She has secured insurance coverage for policyholders in connection with hurricane losses, environmental clean-ups, asbestos actions, the administration of ERISA plans and other circumstances. As trial counsel in 2002, Orin won one of the 10 largest jury verdicts of the year. She is the author of numerous articles and one book, *Making Them Pay: How To Get the Most from Health Insurance and Managed Care* (St. Martin's Press 2000).

Editor's note: This article originally appeared in the November/December 2007 issue of *Contingencies,* a publication of the American Academy of Actuaries. It is reprinted with permission. Copyright © 2007 *Contingencies*. This article also appeared in the October 2008 newsletter of the CPCU Society's Risk Management Interest Group. Orin gratefully acknowledges the invaluable assistance of Legal Assistant Brenda Bonazelli in the preparation of this article.

A Danish psychologist named Edgar Rubin became famous around the turn of the past century for designing a "vase/profile illusion," namely a picture that can be perceived as either a white vase against a black background or as two black faces against a white background. Since the picture's been around since 1915, you've probably seen it by now.

With apologies to Dr. Rubin, an analogy can be drawn between the vase/profile illusion and certain modern-day conflicts between policyholders and insurance companies. In short, these disparate groups can look at the same circumstance and come to completely opposite conclusions.

One of the clearest examples of these differing viewpoints can be seen in the 2005 hurricane season. To policyholders, when Hurricanes Katrina and Rita swept along the Gulf Coast, each one looked on television news like a cohesive whole. The swirling shape, with an eye in the center, was a single event — what most policyholders recognized as simply a hurricane.

But not so for the insurance industry. Insurance companies saw each hurricane as a series of wholly separate and unrelated events. One event was wind. Another was rain. Still others were high water, waves, storm surges, and so on.

The same is true for the consequences. To the "untrained" eye, the flooding of New Orleans, the power failures that rendered businesses inoperative, the evacuation orders that closed down entire communities, and the looting and thefts that followed the physical devastation all arose from single events: the hurricanes.

Here again, the insurance industry disagreed. It viewed each of the above as a separate event, rather than a collective consequence of the hurricanes.

There is a reason for the insurance industry to draw such distinctions. By parsing the hurricanes into separate parts, and especially by including "anti-concurrent causation" provisions that purport to justify the complete denial of coverage whenever there is a single uncovered part, insurance companies increase the likelihood of denying coverage for claims.

This entire system is confusing to policyholders. Often, when policyholders buy insurance policies that cover property damage and other losses that might follow in the wake of hurricanes, they think that they have purchased all the coverage that they need. They think that if a hurricane roars through their area and leaves physical and economic devastation in its wake, the damages that result from that hurricane will be covered.

Another problem is that the insurance policies are drafted by the insurance companies. The insurance companies define the key terms, such as "flood." The insurance companies draft the exclusions, even including draconian language that purports to exclude coverage whenever an excluded peril is among many causes of alleged harm. Finally, the insurance companies interpret the provisions that they drafted, leaving the policyholders with the relatively undesirable option of arguing against a *fait accompli*.

Certainly, there are checks and balances in this system. One of them is the role played by state insurance departments, which typically are empowered to review and approve the policy forms that the insurance companies propose to sell in their states. Another is the role played by state attorney generals and the courts in reviewing the insurance company denials. Still another is the role of the courts in reviewing policyholder challenges to denials of coverage, and in using state bad faith law to deter insurance companies from wrongful and bad faith denials.

Substantial activity in the courts following Hurricane Katrina should be immediately apparent to even the most casual observer.

A brief review of Westlaw shows that in Louisiana alone, approximately seventy decisions regarding Hurricane Katrina were handed down by the end of 2006. Mississippi ran a close second, with approximately 50 such decisions.

It should be no surprise that many of these early decisions have addressed the threshold issue of jurisdiction. To the extent that a pattern can be generalized, policyholders tend to file suit in the state courts, insurance companies tend to remove these actions to federal courts, and policyholders tend to respond with motions for remand. Whether or not those motions are granted often reflects a careful analysis of the specific allegations in the complaints. Policyholders who sue for insurance coverage under policies issued as part of the National Flood Insurance Program ("NFIP") should expect an uphill battle in seeking remand. Policyholders seeking recovery under state statutes, such as state Valued Policy Laws, or under state common law, such as negligence actions against the insurance agents who sold them their policies, should not expect the struggle to be as hard.

Only one post-Katrina case had been tried to completion by the end of 2006: *Leonard v Nationwide*, in the Southern District of Mississippi. That outcome, which is discussed in more detail below, clearly illustrates that Katrina litigation is proving to be fact-intensive, with policyholders facing a high burden of proof with regard to the cause of their damages and insurance companies facing a serious challenge to the enforceability of their coverage provisions.

State governments, state insurance departments and state attorney generals have been notably active in Katrina-related activities. In Louisiana, for example, Governor Blanco issued several Executive Orders that extended various legal deadlines that were deemed impossible to meet under the twin circumstances of physical devastation of property and displacement of citizens. Also, the Louisiana Legislature enacted Act Nos. 739 and 802, which extend the prescriptive period within which citizens may file certain claims under their insurance policies. The Louisiana Attorney General filed suit on behalf of the state on July 10, 2006, seeking a declaratory judgment as to the constitutionality of these acts. The action was removed to federal court and then remanded back to state court, where the attorney general filed a writ of certiorari with the Louisiana Supreme Court. Ultimately, that court found that the legislative acts at issue are constitutional.

The Texas Department of Insurance ("TDI") and the Texas attorney general have taken affirmative actions to prevent insurance companies from denying insurance coverage to Texas residents who have been deprived of access to their property due to power failures. They have sought and obtained a court order against Allstate Insurance Company, providing such relief.

The Mississippi Attorney General's office has been particularly aggressive in challenging anti-concurrent causation provisions as unenforceable. On September 15, 2005, Attorney General Jim Hood filed a lawsuit in Hinds County, Mississippi, First Judicial District, alleging that insurance companies are interpreting their policies in an overly restrictive manner; that they are taking advantage of policyholders who do not understand their rights; and also that they are selling insurance policies that are so difficult to understand as to be unconscionable and therefore void.

The insurance companies filed a Notice of Removal the very next day, removing the case to the Southern District of Mississippi on grounds that the complaint interprets not only private homeowners' policies, but also Standard Flood Insurance Policies (SFIPs) that are relegated to the administration and supervision of the Federal Emergency Management Agency (FEMA). Attorney General Hood responded with a Motion to Remand, which was granted on March 8, 2006. The federal court granted that motion, ruling that the Attorney General's complaint does not pertain to the SFIPs.

On December 19, 2006, the case was transferred to Judge L.T. Senter, Jr., who then remanded the action back to the Chancery Court of Hinds County, Mississippi, First Judicial District, on December 26, 2006. Ultimately, the case was resolved by settlement, yet there is an ongoing issue now regarding enforcement of the settlement's terms.

Anti-concurrent causation provisions have come under attack — albeit unsuccessfully, thus far — in the Louisiana legislature as well. In 2005, and again in 2006, State Sen. Julie Quinn (R-Metairie) and State Rep. Tim Burns (R-Mandeville) have proposed legislation precluding the enforcement of these clauses. Both times, the proposed legislation died during the session.

Policyholders and others, often acting through the vehicle of class actions, have turned to the courts for relief in a wide variety of situations. For example, in Louisiana on September 15, 2005, some 160,000 property and business owners filed a class action lawsuit against the Commissioner of Insurance, Robert Wooley, and a number of insurance companies, captioned *Gladys Chehardy, et al. v Louisiana Insurance Commissioner J. Robert Wooley, et al.* That lawsuit was one of the first class actions against the insurance industry as a result of Hurricane Katrina.

There, the plaintiffs were asking the court for an order requiring the insurance commissioner to nullify the exclusions for damage caused by rising water. They

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took the position that the flooding in New Orleans was caused by negligence in the construction and maintenance of the levees, rather than an excluded "Act of God." Accordingly, they alleged that the high water exclusions were not intended to apply to the flooding.

As with Attorney General Hood's lawsuit in Mississippi, the insurance companies immediately filed a Notice of Removal in *Chehardy*, removing the case to the U.S. District Court for the Middle District of Louisiana. The grounds were that the plaintiffs based their claims on "a construction of the National Flood Insurance Act (NFIA) and National Flood Insurance Program (NFIP)", and on the recently enacted Class Action Fairness Act (CAFA). In that case, the plaintiffs' remand motion was unsuccessful. That case was transferred to the Eastern District of Louisiana, where it has been consolidated with a class action, *In re Katrina Canal Breaches Consolidated Litigation*, *C.A. 05-4182*, which includes claims against the Orleans Levee District and its insurer for negligence in design, construction and maintenance of levees.

Against this backdrop of events, the following is a brief review of the standard policy language on wind, water and hurricanes, and the legal issues about causation under these policies.

Standard-Form Policy Language

Insurance for losses caused by hurricanes typically is provided under property policies, which are available to businesses as part of comprehensive or package policies, and to residents in such forms as homeowners' policies and renters' policies.

Commercial property insurance policies generally fall into two types. The first type covers losses caused by "all risks of direct physical loss or damage," except risks that are specifically excluded in the policy. In these broad policies, known as "all risk" policies, once an insured proves that it has suffered a loss, the insurance company has the burden of proving that the loss is not covered.

The other type of commercial property policy takes the opposite approach. It covers property damage or loss caused by listed perils, such as: fire, wind, hail or vandalism. Known as a "named perils" policy, it typically contains a wide variety of exclusions, including exclusions for many different types of weather conditions. The policyholder typically is found to have the burden of overcoming these exclusions, in accordance with basic principles of insurance law.

Both types of property insurance policies contain provisions insuring personal property. This coverage usually provides coverage for specified types of personal property contained within the covered premises. Often the coverage extends to property found within a certain distance from the covered premises.

Useful examples of this policy language can be found in the standard commercial policy of the Texas Windstorm Insurance Association ("T.W.I.A."). With regard to buildings, labeled "Coverage A," the policy expressly states that it covers:

> Building or structure, meaning everything which is legally part of the building or structure described in the Declarations. However, we do not cover machinery which is not used solely in the service of the building.
>
> Personal property owned by you that is used for the service of and located on the described location . . . .

Next, with regard to personal property, labeled "Coverage B," the policy expressly states that it covers:

> Business personal property located in or on the building described in the Declarations, or in the open on the described location, or in a vehicle or railroad car located within 100 feet of the described building. . . . .

These coverage agreements are followed by sections that delineate what types of personal property are and are not covered. Then comes a section called "Covered Causes of Loss," in which the policy specifies:

> We insure for direct physical loss to the covered property caused by windstorm or hail unless the loss is excluded in the Exclusions.

The next section – and the most important one, for purposes of this article – includes, but is not limited to, the following exclusions:

> The following exclusions apply to loss to covered property:
>
> Flood.
>
> We will not pay for loss or damage caused by or resulting from flood, surface water, waves, tidal water of tidal waves, overflow of streams or other bodies of water or spray from any of these whether or not driven by wind.
>
> Power Failure.
>
> We will not pay for loss or damage resulting from the failure of power or other utility service supplied to the described premises, if the failure occurs away from the described premises. However, we will pay for loss resulting from physical damage to power, heating or cooling equipment located on the described premises if caused by windstorm or hail.
>
> Rain.
>
> We will not pay for loss or damage caused by or resulting from rain, whether driven by wind or not unless wind or hail first makes an opening in the walls or roof of the described building. Then we will only pay for loss to the interior of the building, or the insured property within, caused immediately by rain entering through such openings.

The structure of this policy places causation directly into question. The problem is that, while some events are covered and others are not, damages often arise after a series of events take place. Hurricane Katrina is a perfect example. It involved a wide variety of perils, including wind, wind-driven water, flooding, levee breaches, sewage overflows, power failures, court-ordered evacuations, fire, looting, pollution and mold.

The courts have developed various tests for determining whether there is coverage when a covered peril and an excluded peril combine in some proportion to cause a loss. Most prominent among them is the doctrine of "efficient proximate cause." This doctrine provides for coverage if the covered cause is the efficient and dominant cause: the one that sets the loss into motion.

The highest courts of two of the states most affected by Hurricanes Katrina and Rita — Louisiana and Mississippi — have adopted the doctrine of efficient proximate cause. The Texas Supreme Court has no clear authority on this question.

The "efficient proximate cause" generally is defined as the "dominant" cause. If the dominant cause of the loss is a covered peril, there is coverage; if the dominant cause of the loss is an excluded peril, there is no coverage or, in some instances, reduced coverage. Although the "efficient proximate cause" doctrine most commonly has been applied where a loss was caused in part by a covered peril and in part by an excluded or non-covered peril, it is equally applicable where, as here, different limits of liability and may apply depending on what is determined to be the cause of the loss.

The "efficient proximate cause" doctrine sounds simple on paper. In practice, though, it is complicated to apply. One helpful explanation of "efficient proximate cause" offered in a respected treatise on insurance, and followed by many courts, is that it is the "risk [that] set[s] the other causes in motion which, in an unbroken sequence, produced the result for which recovery is sought."

This definition of "efficient proximate cause" may be helpful in arguing that the damages at issue with respect to Hurricanes Katrina and Rita were caused by wind, and not by flood, since it was the hurricanes that set in motion all the other events that led to the property damage at issue. Policyholders will argue (and insurance companies no doubt will disagree) that all subsequent events, including the breaches of the levees in New Orleans, were set in motion, in an unbroken sequence, by the hurricanes.

The insurance company's response to this coverage-friendly doctrine seems to be the addition of language designed to defeat coverage. Although not used by the T.W.I.A. in the sample policy highlighted above, many insurance policies contain a prefatory clause to the exclusions section, generally known as the "anti-concurrent causation" provision.

As published by the Insurance Services Offices ("ISO"), a typical anti-concurrent causation lead-in provision states as follows: "We will not pay for loss or damage caused directly or indirectly by any of the following. Such loss or damage is excluded regardless of any other cause or event that contributes concurrently or in any sequence to the loss."

This provision is significant because, if enforceable, it has the capacity to alter substantially the scope of coverage under a policy. Accordingly, many challenges have been raised to its enforceability. The lawsuit filed on September 15, 2005 by Mississippi's Attorney General is one example.

The most recent decisions in this area should be greatly encouraging to Mississippi business owners and homeowners (if they are not otherwise discouraged by certain holdings regarding the facts). In Leonard, Judge Senter found anti-concurrent causation clauses to be ambiguous and unenforceable as a matter of law in the context of hurricane damage. He ruled that enforcement of such language: "would mean that an insured whose dwelling lost its roof in high winds and at the same time suffered an incursion of even an inch of water could recover nothing under his Nationwide policy. Read literally, this provision would exclude all coverage when a windstorm did damage to both an insured dwelling (a covered loss) and adjacent 'screens, including their supports, around a pool patio or other areas.' (an excluded loss). I do not believe this is a reasonable interpretation of the policy."

Notably, there is no state law yet in Texas, Louisiana and Mississippi as to the enforceability of this provision, as the highest courts of these states have not had occasion to examine it. However, were the Mississippi Supreme Court to adopt Judge Senter's reasoning, if and when this important issue ultimately comes before it, that court would be in accord with the precedent of the highest courts of a number of other states.

The highest court in Washington State, for example, has held that as a matter of public policy, insurance companies may not use so-called anti-concurrent causation provisions to avoid the efficient proximate cause doctrine. West Virginia's highest court similarly has held that anti-concurrent causation clauses are ambiguous and that it offends the reasonable expectations of a policyholder to read them as precluding coverage for damage proximately caused by a covered peril.

On the other hand, this favorable response has not been universal. The highest court of Utah held that provisions like the anti-concurrent causation provision are enforceable, as insurance companies are entitled to contract around any applicable causation rule.

Applicable Doctrines and Statutes

Historically, the courts have considered a number of additional matters when called upon to decide insurance coverage disputes.

Principal among these is the doctrine of *contra proferentem*. This doctrine requires ambiguities in insurance policies

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to be interpreted against the insurance companies that drafted the policies, and in favor of coverage.

Courts typically agree that ambiguities are proved when courts adopt different interpretations of the same provision. Thus, the mere existence of a dispute over the meaning of the flood, rain and water exclusions, and the citation of supportive — yet contrary — authority by both policyholder and insurance company, should be sufficient to prove ambiguity, and tip the scales in favor of coverage.

Another important resource for the courts has been state statutes, which often are policyholder-friendly. For example, all three of the states being studied here — Texas, Louisiana and Mississippi — have statutes designed to protect policyholders against bad faith practices by insurance companies, particularly including unfair settlement practices and late payment practices. Also relevant are the Valued Policy Laws found in many states, which can lead to 100% recovery by policyholders in certain circumstances. Such statutes are likely to be studied carefully by both sides in the battlefields over hurricane coverage.

Conclusion

The principle of "buyer beware" extends all the way through the claims process for policyholders. As shown above, there are many possible reasons why policyholders may not receive the coverage they may believe that they purchased. But the inverse principle of "seller beware" applies to insurance companies. The developing precedent of Hurricane Katrina appears to be that ambiguous language in insurance policies will be "outed" by courts deciding hurricane cases. Insurance companies who sell ambiguous provisions may find themselves with serious legal problems, extending far beyond the particular framework of Katrina-related liabilities. ■

Photo by Jim McWilliams

2009 Reinsurance Symposium

"Navigating Today's Reinsurance Market — Gold Mine or Mine Field?"

March 26–27 • Philadelphia, Pa.

The 2009 edition of the always-popular Reinsurance Interest Group symposium, a program of unprecedented educational and networking value, will be held in Philadelphia on March 26 and 27. The 1 1/2-day program will feature leaders from various sectors of the industry sharing their expertise and knowledge.

Unique and critical insights of today's reinsurance market will be provided by leaders representing:

- Industry trade groups such as NAIC, RAA and NAMIC.
- Rating agency organizations such as S&P and AM Best.
- Insurance entities such as Nationwide, Zurich and Travelers,
- Reinsurance intermediaries such as Willis and Guy Carpenter.
- Off-shore entities such as Bermuda and Munich Re/German.
- Reinsurance carrier Transatlantic Reinsurance Company.

The luncheon on Thursday, March 26, will honor new and current Associate in Reinsurance (ARe) designees, and will provide all attendees with an opportunity to mingle with other reinsurance industry professionals attending the symposium.

Please clear your calendars and join us in Philadelphia, where you will come away with new concepts and ideas for our very dynamic and changing business!

The Changing Landscape of Reinsurance — The Bad Faith Cause of Action

by Andrew S. Boris, J.D.

Andrew S. Boris, J.D., is a partner in the Chicago office of Tressler, Soderstrom, Maloney & Priess LLP. His practice is focused on litigation and arbitration of reinsurance matters throughout the country. Questions and responses to this article are welcome at aboris@tsmp.com.

Complicating the already multifaceted area of reinsurance is the argument that an alleged "wronged" party in a reinsurance relationship is entitled to extra-contractual damages due to the "bad actor" behavior of the other party. Such extra-contractual damages can come in many forms, including: attorneys' fees, punitive damages, or multiplication of a damages award (i.e. double or treble damages). The list of possible fact scenarios that can serve as the foundation for a claim seeking extra-contractual damages is seemingly endless, but allegations in the reinsurance context come in many forms, including:

- The reinsurer is intentionally "slow-paying" claims to maximize the time value of money;
- The reinsurer's claims handling staff is unsophisticated and asks unnecessary questions that slows the payment of billings;
- The cedent provides inaccurate and potentially fraudulent billings; or
- One of the parties attempts to use information or funds as leverage in negotiations for new contract terms or a commutation.

Historically, the most pressing questions involving extra-contractual damages in the reinsurance arena involved whether reinsurance contracts covered such damages in direct cases. However, it has become more and more common to see allegations of bad faith between the ceding company and reinsurer. As bad faith and extra-contractual damages are injected into the reinsurance setting, more and more reinsurance professionals, attorneys, and arbitrators are confronted with concepts that have been traditionally associated with the handling of direct claims. In turn, new challenges involving scope of discovery, questions involving the attorney-client privilege, and the need for additional expert testimony are finding their way into reinsurance disputes as the result of a party raising allegations of bad faith or violations of an unfair claims practices statute.

For many, the rise in the number of reinsurance disputes involving a bad faith related cause of action is directly related to the decline in personal relationships in the industry. Regardless, many also believe that the increase in bad faith related actions can be tied to the publicity that some court decisions have been given wherein a party to the reinsurance relationship was held liable for extra-contractual damages. See e.g. *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 217 F.3d 33 (1st Cir. 2000). In addition to the fact-intensive nature of a bad faith claim and whether a party can actually prove that another acted in a particularly inappropriate way, a party's entitlement to pursue such a claim for extra-contractual damages is not always clear. In fact, two different courts have ruled within the past two years that the pursuit of bad faith or extra-contractual damages in the reinsurance context is inappropriate.

In *Gaffer Ins. Co. v. Discover Reinsurance Co.*, No. 3:07-CV-00580, slip op., 2007 WL 2972580 (M.D. Pa. Oct. 10, 2007), the court ruled that punitive damages were unavailable to the wronged party in a reinsurance relationship. Gaffer Insurance ("Gaffer") agreed to act as a reinsurer for policies insured by Discover Reinsurance Company ("Discover Re"). Under the arrangement, funds were placed in an account under Discover Re's control to pay losses within the reinsurance limits. Gaffer was obligated to forward additional funds to the account to ensure that all loss payments would be sufficiently covered. Gaffer was further obligated to provide Discover Re with collateral to secure Gaffer's reinsurance obligations. In connection with this requirement, Gaffer posted letters of credit. Gaffer terminated the relationship with Discover Re in May of 2003, and Gaffer's ultimate exposure to the insurance obligations was capped. Gaffer and Discover Re subsequently disputed the amount that should remain as part of the letters of credit. Although Discover Re agreed to release $300,000 from the letters of credit, no money was ever released to Gaffer. Gaffer filed suit alleging bad faith pursuant to 42 PA. CONS.STAT. ANN. Section 8371, breach of the covenant of good faith, breach of fiduciary duty, and negligence. Section 8371 provides in relevant part: "In an action arising under an insurance policy, if the court finds that the insurer has acted in bad faith toward the insured, the court may ... (1) Award interest ... , (2) Award punitive damages against the insurer ... [and/or] (3) Assess court costs and attorney fees against the insurer." Gaffer named Discover Re, United States Fidelity and Guaranty Company

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(Discover Re is a wholly owned subsidiary of United States Fidelity and Guaranty Company) and St. Paul Travelers (United States Fidelity and Guaranty Company is a wholly owned subsidiary of St. Paul Travelers) as defendants.

Notably, the reinsurance contract contained an arbitration agreement that stated any dispute relating to the agreement must be arbitrated unless otherwise agreed. Accordingly, Discover Re moved to compel arbitration and to dismiss the action filed by Gaffer. Meanwhile, Gaffer argued that the service of suit provision in the agreement should be construed to limit the effect of the arbitration agreement. The court granted Discover Re's motion to compel arbitration, finding the relevant arbitration agreement was very broad and the claims at issue fell within the scope of same.

The court also found that the bad faith statute was inapplicable to reinsurance agreements. The federal district court held that "Section 8371 is inapplicable in the context of reinsurance agreements" in part because "this statute was intended to protect a consumer from an insurance company, and not to protect two sophisticated, bargaining parties from one another." In addition, the court found no fiduciary relationship existed in the reinsurance context.

Similarly, a federal district court also recently found that punitive damages and other types of tort remedies are not available in a reinsurance dispute. See No. 08-00956, slip op., *Cal. Joint Powers Ins. Auth. v. Munich Reinsurance Am., Inc.*, 2008 WL 1885754 (C.D. Cal. April 21, 2008). Munich Reinsurance America, Inc. ("Munich") provided reinsurance under two agreements to California Joint Powers Insurance Authority ("Joint Powers"), a self-insured retention pool made up of various California public agencies. A suit was filed against a member of Joint Powers, and Joint Powers settled with the claimant for $4.25 million. However, Munich refused to indemnify Joint Powers for the settlement asserting, among other reasons, that the underlying claim was not covered by the Joint Powers policy. Subsequently, Joint Powers filed suit alleging Munich "tortiously breached the implied covenant of good faith and fair dealing," and sought punitive damages.

■ ***For many, the rise in the number of reinsurance disputes involving a bad faith related cause of action is directly related to the decline in personal relationships in the industry.***

Munich argued Joint Powers could not recover in tort for a breach of the implied covenant of good faith and fair dealing, and as such, the stated cause of action should be dismissed. As part of its analysis, the court noted that remedies based upon an implied covenant of good faith cause of action are limited to contract, but tort remedies have been awarded when social policy merits them. The court found that tort based remedies in the insurance context have been permitted because it reflects a recognition of the parties' unequal bargaining powers, the public interest, and the fiduciary responsibilities an insurer owes an insured. However, the court held that the cedents could not recover in tort because the reinsurance entities are largely equal in bargaining power, public policy concerns are limited, and reinsurers are not fiduciaries to their cedents. In the absence of any of the recognized rationales for allowing tort remedies in the reinsurance context, the court granted the defendant's motion to strike the prayer for punitive damages.

Despite these recent court decisions, allegations of bad faith conduct are commonly included in reinsurance disputes. In turn, many have turned their attention to drafting contract language that identifies potential limitations or parameters for available remedies in the event of a dispute. Nonetheless, those involved in reinsurance will need to be aware that the possibility of bad faith related causes of action cannot be ignored. ■

Finding Hidden Assets — Is Your Equipment Breakdown Reinsurance Program Broken?

by Thomas N. Thompson, CPCU, ARe

Thomas N. Thompson, CPCU, ARe, is the owner of Reinsurance Results Inc. (RRI), a company that specializes in the identification and recovery of hidden reinsurance assets through transactional reviews. Prior to forming RRI in 1998, Thompson was a reinsurance broker for 13 years with Sedgwick Re and E. W. Blanch Co.

Remember the thrill of finding coins between the cushions of the couch when you were a child? Insurers may experience a similar, albeit tamer, response to finding claims that have slipped through the cracks of their reinsurance reporting processes. Where do they look for these missed recoveries? Equipment breakdown reinsurance is a good start for a variety of reasons. This complex and ever-evolving line of business is one of the most difficult forms of insurance to process from a reinsurance perspective. A review of the historical equipment breakdown program may be just what is needed to uncover these hidden reinsurance assets.

Originally written in 1866 to cover boiler explosions, principally on steamboats, equipment breakdown insurance has expanded to cover loss resulting from the accidental breakdown of almost any type of equipment that operates under pressure or that controls, transmits or uses mechanical or electrical energy. Unfortunately, the expansion of the equipment covered has not come without added complexity. Today's equipment breakdown programs include numerous coverage nuances, exclusions and extensions that make them extremely challenging to administer.

Because of the unique characteristics associated with this line of business, most insurance companies cede 100 percent of their equipment breakdown insurance to reinsurers who specialize in this coverage. As a result, insurers are left with what would seem to be the relatively simple task of remitting premiums and reporting losses to its equipment breakdown reinsurance partners. While the payment of premium is typically straightforward, the cession of equipment breakdown loss is not.

For most insurers, the property claim adjusters are charged with identifying and reporting equipment breakdown claims to the reinsurer who then adjusts the claims on behalf of the insurer. Unfortunately, the recognition of equipment breakdown claims is not always easy, and there are many factors that complicate this task. Some are as follows:

- **Multiple perils involved in the same event** — assume a power surge short-circuits an electrical distribution panel which in turn starts a fire that destroys a building. In this type of scenario, the damage to the electrical panel from the surge may account for only a small portion of the overall cost of the claim. It is not uncommon for such a claim to be categorized or coded as a fire loss without any consideration given to ceding the electrical panel damage to the equipment breakdown reinsurer.
- **Overlapping coverage** — equipment breakdown coverage may duplicate the coverage being offered under other non-equipment breakdown lines. Damage caused by, or resulting from, water is just one example of overlapping coverage contained within, or between, forms. While each reinsurance arrangement differs from one company to the next, claims involving overlapping coverage are usually shared between the insurer and reinsurer on a joint-loss basis. However, too often insurers do not look to the equipment breakdown reinsurer for participation in the claim if its own coverage applies to the loss.
- **Power surges** — power surges stem from artificial and natural sources. Natural sources, such as lightning, are commonly retained by the insurer while surges produced from artificial sources, such as failure of a power supply, are the responsibility of the equipment breakdown reinsurer. Differentiating between the two types of surges is not always easy. This is especially true for lightning strikes that occur away from an insured's premises. The insurer and reinsurer should have a clear definition of what does and does not constitute damage from lightning as it relates to equipment. The absence of such an understanding may lead to more power surge claims being retained by the insurer.
- **Applying the cause of loss incorrectly** — equipment breakdown claims frequently require in-depth investigation in order to arrive at the correct cause of loss. Rushing to a conclusion regarding the cause of loss may limit an insurer's equipment breakdown recoveries. An example would be assuming the breakdown of a piece of equipment, say a pressure relief valve, was caused by wear and tear (not covered by equipment breakdown) when in fact, it was the result of faulty materials or workmanship (covered by equipment breakdown). If the reason why this

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relatively inexpensive valve failed is not correctly identified, it may lead to the unnecessary retention of thousands of dollars of water damage by the insurer.

- **Unique coverage extensions** — equipment breakdown insurance will often pay for business interruption or spoilage of perishable items caused by damage to equipment owned by a service provider, such as a utility or landlord. The insurer should be familiar with all the coverage extensions offered by the equipment breakdown reinsurer so that it may benefit from this additional coverage.
- **Numerous exclusions** — equipment breakdown insurance and reinsurance usually contain numerous exclusions relating to the type of equipment and causes of loss covered. These exclusions tend to frustrate and confuse claim adjusters attempting to apply the coverage. Over time, adjusters may develop the opinion the equipment breakdown coverage is rather narrow in scope, which in turn may lead to fewer claims being reported to the reinsurer.
- **Lack of exposure to claims and in-depth training** — contributing to challenges faced by adjusters in identifying and reporting equipment breakdown claims is the fact that they do not handle them on a daily basis. The exposure to these types of claims is simply too infrequent to allow the adjuster to become proficient at handling the more complex coverage issues. While equipment breakdown reinsurers attempt to remedy this problem with training, this training is usually limited to the coverage basics and does not delve into the many coverage nuances associated with this line of business.
- **Claim size** — many equipment breakdown claims that are left unreported are relatively small from a reinsurance perspective, usually less than $10,000. Smaller claims simply do not attract the same level of attention within an insurance company, and therefore are more susceptible to being overlooked. Surprisingly, smaller equipment breakdown claims are also sometimes intentionally retained by the adjusters because of the additional time and cost required to involve the reinsurer. When the business is ceded on a 100 percent first dollar quota-share basis, the retention of several smaller claims can add up to sizable missed recoveries.
- **Varying methods of attachment** — historically, equipment breakdown reinsurance was more commonly attached to a specific policy using an endorsement or separate coverage form. Over the past decade, equipment breakdown reinsurers have made a concerted effort to write this business on a portfolio-type basis by either embedding the coverage in the property form or endorsing the coverage on all commercial and business property forms issued by the insurer. Writing the reinsurance on a portfolio basis simplifies the reporting process. However, the transition from a policy-specific to a portfolio basis, or not having all the property business include equipment breakdown insurance, will contribute to missed reinsurance recoveries.

There are many more reasons why claims are not always reported to reinsurers. The more common issues for equipment breakdown claims have been presented here. A formal claim review will help to identify these and other types of unreported claims as well as weaknesses in the adjusting process. When contemplating such a review, an insurer should require the following of the individual or vendor being considered for this project:

(1) Extensive experience with equipment breakdown insurance and reinsurance claims.

(2) A proven track record of identifying and collecting unapplied reinsurance.

(3) No previous involvement in the program being reviewed. This is simply to avoid any potential conflicts of interest.

One final note: In general, equipment breakdown reinsurance was overpriced when it was being transitioned from a policy-specific to a portfolio basis around 2000 to 2005. Only in the last couple of years have insurers seen prices drop to more accurately reflect the exposures being ceded. A review of an insurer's historical equipment breakdown business will help to offset those excess premiums from earlier years while ensuring claims are not being left unreported in the future. ■

Dynamic Influences That Sway Our Decision Making

by Richard G. Waterman, CPCU, ARe

We generally believe that we act rationally in most situations, especially in making business decisions or in other areas of our personal lives that call for rational thinking. However, drawing on the latest research from social psychology, behavioral economics and organizational behavior, organizational thinker **Ori Brafman, MBA,** and his brother, psychologist **Rom Brafman, Ph.D.,** co-authors of *Sway*, present an introduction to the science of decision making and show the many ways in which logical thought can be subverted or "swayed." The thesis throughout *Sway* is that a growing body of research reveals that our behavior and decision making are influenced by an array of psychological undercurrents that are much more powerful and pervasive than most of us realize.

For a convincing example, *Sway* opens with a discussion concerning the take-off of KLM Flight 4805 from the Canary Islands in 1977, when a highly experienced pilot made a seemingly irrational decision that cost the lives of 584 people and caused the most deadly airline disaster in history. Why would a seasoned pilot — the head of safety at the airline — make such a rash and irresponsible decision? The authors make the argument that because the pilot was so focused on getting to his final destination after his flight had been diverted, he was swayed into making a wholly irrational decision which ended in tragedy.

You will find that *Sway* delves into the hidden psychological influences that derail our decision-making. Among the questions answered are: Why it is so difficult to end a doomed relationship? Why do we listen to advice from someone perceived to be important rather than relying on objective data? Why do we think we are behaving rationally when we are not? And why are we more likely to fall in love when there's danger involved?

Other deep-seated forces that skew our personal and business decision making revealed in *Sway* include:

- **Loss aversion** — our tendency to go to great lengths to avoid a possible loss regardless of the rational expected outcome. Rationally, we believe we are actually maximizing the gain.
- **Value attribution** — our inclination of giving someone or something certain qualities based on initial perceived assumptions instead of observing people or things for what they are, not just for what they initially appear to be.
- **Diagnosis bias** — our blindness to all evidence that contradicts our initial assessment of a person or situation, and our inability to reevaluate our initial diagnosis of a person or situation, including ignoring objective data and giving credence to irrelevant factors.
- **Group peer pressure** — how the reasonableness of our decision making can be distorted and compromised in a group setting, and our inclination to go along with group thinking unless someone else is willing to first break rank.
- **Chameleon effect** — our tendency to take on the positive characteristics that have been assigned to us by someone else, and also how we take on negative traits that have been arbitrarily ascribed to us.

Sway offers a lot of information to help us learn more about human behavior and the hidden psychological forces that influence a wide variety of decision making in our personal and business lives. Learning more about irrational sways in life enables us to recognize them when we encounter them in the future, and not be easily swayed in making irrational decisions. *Sway* will change the way you think about the way you think.

Disclaimer: If you decide to read this book to learn strategies to try and disarm the irresistible pull of irrational decision making, you have just been swayed. But you still should consider reading the book. I was swayed, and can highly recommend this fascinating book, which is full of techniques to help you avoid falling victim to ongoing dynamic forces that influence irrational behavior. ■

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New Interest Group Member Benefit

by CPCU Society Staff

Beginning Jan. 1, 2009, *every* Society member became entitled to benefits from every interest group for no extra fee beyond the regular annual dues, including access to their information and publications, and being able to participate in their educational programs and functions.

An Interest Group Selection Survey was e-mailed to members beginning mid-November. By responding to the survey, members could identify any of the existing 14 interest groups as being in their primary area of career interest or specialization. If you did not respond to the survey and want to take full advantage of this new member benefit, go to the newly designed interest group area of the Society's Web site to learn more about each of the interest groups and indicate your primary area of career interest. You will also see options to receive your interest group newsletters.

Currently, there are 14 interest groups: Agent & Broker; Claims; Consulting, Litigation & Expert Witness; Excess/Surplus/Specialty Lines; Information Technology; International Insurance; Leadership & Managerial Excellence (former Total Quality); Loss Control; Personal Lines; Regulatory & Legislative; Reinsurance; Risk Management; Senior Resource; and Underwriting.

As part of the Interest Group Selection Survey, members also were asked to express their interest in the following proposed new interest groups: Actuarial & Statistical; Administration & Operations; Client Services; Education, Training & Development; Finance & Accounting; Human Resources; Mergers & Acquisitions; New Designees/Young CPCUs; Nonprofits & Public Entities; Research; Sales & Marketing; and The Executive Suite.

Members who missed the survey may update their selections on the Society's Web site or by calling the Member Resource Center at (800) 832-CPCU, option 4. Members can also order printed newsletters for nonprimary interest groups at an additional charge. ■

The **Agent & Broker Interest Group** promotes discussion of agency/brokerage issues related to production, marketing, management and effective business practices.

The **Claims Interest Group** promotes discussion of enhancing skills, increasing consumer understanding and identifying best claims settlement tools.

The **Consulting, Litigation, & Expert Witness Interest Group** promotes discussion of professional practice guidelines and excellent practice management techniques.

The **Excess/Surplus/Specialty Lines Interest Group** promotes discussion of the changes and subtleties of the specialty and non-admitted insurance marketplace.

The **Information Technology Interest Group** promotes discussion of the insurance industry's increasing use of technology and what's new in the technology sector.

The **International Insurance Interest Group** promotes discussion of the emerging business practices of today's global risk management and insurance communities.

The **Leadership & Managerial Excellence Interest Group** promotes discussion of applying the practices of continuous improvement and total quality to insurance services.

The **Loss Control Interest Group** promotes discussion of innovative techniques, applications and legislation relating to loss control issues.

The **Personal Lines Interest Group** promotes discussion of personal risk management, underwriting and marketing tools and practices.

The **Regulatory & Legislative Interest Group** promotes discussion of the rapidly changing federal and state regulatory insurance arena.

The **Reinsurance Interest Group** promotes discussion of the critical issues facing reinsurers in today's challenging global marketplace.

The **Risk Management Interest Group** promotes discussion of risk management for all CPCUs, whether or not a risk manager.

The **Senior Resource Interest Group** promotes discussion of issues meaningful to CPCUs who are retired (or planning to retire) to encourage a spirit of fellowship and community.

The **Underwriting Interest Group** promotes discussion of improving the underwriting process via sound risk selection theory and practice.

Reinsurance Interest Group
Volume 27 • Number 1 • March 2009
Reinsurance Encounters

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The Reinsurance Interest Group newsletter is published by the Reinsurance Interest Group of the CPCU Society.

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