FDCC REINSURANCE, EXCESS AND SURPLUS LINES SECTION
NEWSLETTER

Winter 2012/13

Greetings from Chair – Stephen Carter

Happy New Year to all.

This is my first newsletter as Reinsurance Section Chair, so by way of introduction to those who may not already know me, I am a partner in the London law firm of Carter Perry Bailey LLP, a niche firm which specialises in insurance and reinsurance law. The focus of my own work is on reinsurance and coverage work, largely international, in both litigation and arbitration. I am greatly indebted to the Section Vice Chairs for their support, assistance and hard work, without which it would be a far greater challenge to chair the section from England, especially in stepping into my shoes when they have been the wrong side of the pond!

Vice Chairs of the Section:

Michael Aylward (Boston, MA)
Russell Allison (Birmingham, AL)
Charles D Henderson (Philadelphia, PA)
Barbara O'Donnell (Boston, MA)
Ex officio Meloney Perry (Dallas, TX)

2013 Meetings - a proposed new approach

We are looking forward to a great winter meeting at the San Antonio Westin (think cowboy boots, margaritas, great golf and very small hills). The reinsurance section is joining with Insurance Coverage for a session on the new exposures and coverages arising from cyber risk. This should be fascinating and cutting edge stuff.

For the annual meeting, we propose, with section members' approval, something different. Over a number of years we have seen section meetings increasingly adopt a more formulaic approach commensurate with the requirements for obtaining CPE points. This has necessarily involved teaming up with other sections in larger more formal presentations involving topics which, while relevant to reinsurance excess and surplus lines, are often not central to the issues that concern us. We are a relatively small section, who share specialist interests and expertise. There are plenty of other CPE points to go around at FDCC meetings, if that is what members require, so we looked at what might be achieved if we freed our section meeting from the constraints of CPE requirements. The result is our proposal to have a separate section meeting in San Antonio, at which a panel-led discussion of current issues will be held, followed by section business. In this respect, we would invite you as section members to email to me any matters that you would like to see included in this discussion. In this way, we hope to achieve a proactive, participatory discussion in a more informal environment, which we also hope will prove enjoyable, illuminating and beneficial.

I need finally to confirm this proposal to Walter Jukes and those involved in the organisation of the annual meeting in the summer, within the next couple of weeks. Accordingly, if you have any views on this proposal (positive or negative!) please let me know as soon as possible. It is not too late to revert to the shared CPE session format if that is really what most people want! Similarly, if you have any comments on

the scheduling of the meeting, preferences for times at which it should take place and clashes to be avoided, please let me know.

Report - 2012 Annual Meeting – Whistler, B.C. (by Michael Aylward, Vice-Chair)

What a meeting it was! Moonlit evenings combined with zip lining, outstanding CLE and very cold beer to make for one of most memorable and enjoyable gatherings ever.

Our Section co-sponsored an excellent CLE presentation on Wednesday morning discussing the problem of bad faith set ups and time-limited demands for policy limits. Lewis Collins, Jim Crandall and Paul White did an excellent job walking through the knotty problems that these claims present and possible strategies that carriers and defense counsel can employ to contest them.

Another presentation of interest discussed a recent conspiracy in Las Vegas between plaintiff's lawyers and homeowner's associations to gin up construction defect claims. Andy Downs led a provocative discussion of the coverage implications of such claims, both for CD insurers and the E&O carriers of the perpetrators. All of the CLE papers from the meeting are posted on the FDCC web site (look under "Site Map" and search for "CLE 2012 Annual").

….and Keep in Mind

….that our Section needs to submit an article to the FDCC Quarterly as well as nominate two new FDCC members each year.

Recently there have been a number of important and interesting cases in England and USA relevant to our practice group. I commend to you the following, with thanks to Mike Aylward and Russ Allison for the US case summaries.

FEATURED ANALYSIS

FOURTH CIRCUIT SUSTAINS PRIMACY OF INTERNATIONAL ARBITRAL PROTECTION OVER STATE ROLE IN REGULATING INSURANCE

A recent ruling of the U.S. Court of Appeals for the Fourth Circuit addresses the complex question of how federal preemption principles work where federal statutes, international treaties and principles of public policy collide. At issue in *ESAB Group, Inc. v. Zurich Ins. PLC, No. 11-1243 (4th Cir. July 9, 2012)* was whether a South Carolina statutes that bars the enforcement of arbitration clauses in insurance agreements and which have been held to "reverse preempt" the application of Chapter 1 of the Federal Arbitration Act have similar preemptive effect with respect to foreign arbitral agreements subject to Chapter 2 of the Act.

In ESAB Group, the Fourth Circuit has joined the Fifth Circuit in holding that the role of state regulation protected by the McCarran-Ferguson Act is limited to domestic insurance arrangements and does not extend to foreign insurance undertakings containing arbitration requires subject to international arbitral protection. In upholding the primacy of the international treaty in this case, the Fourth Circuit has reaffirmed the importance of America speaking with one voice when it comes to regulating foreign commerce, including insurance agreements, and the troubling implications of allowing the views of individual states to interference with the international agreements.

In 1944, the U.S. Supreme Court had surprised many by holding that insurance was subject to regulation under the Commerce Clause. See *U.S. v. South-Eastern Underwriters Assoc., 323 U.S. 533 (1944).* Alarmed

by the antitrust implications of this ruling, the Congress passed the McCarran-Ferguson Act (15 U.S.C. §1101, et seq) the following year, declaring that only the individual states had jurisdiction to regulation the insurance industry. McCarran-Ferguson is unusual in that the Supremacy Clause to the U.S. Constitution ordinarily gives predominant effect to federal law.

In 1958, a conference of the United Nations produced an international Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "Convention"). The United States did not ratify the Convention for many years due to domestic concerns, however, notably the potential conflict between this new international treaty and the lack of any provision in the Federal Arbitration Act (9 U.S.C. §1 et seq) for international arbitral terms. Only after the FAA was amended to include Chapter 2 dealing with foreign arbitrations did the U.S. become a signatory in 1970.

ESAB Group is a South Carolina-based manufacturer of welding equipment that was acquired by foreign entities in the late 1980s. Between 1989 and 1996, it was insured under seven global liability policies issued by Trygg-Hansa a Swedish insurer. Five of these policies contain clauses mandating that any disputes be resolved through binding arbitration in Sweden in accordance with Swedish law. The other two policies include Swedish choice of law provisions but omit arbitration clauses.

The obligations of ESAB's original insurers were transferred to Zurich in 1998 through a Loss Portfolio Transfer Agreement. In 2005, these obligations were thereafter transferred by Zurich to ZIP, an Irish insurer.

After ESAB became ensnared in the surge of welding fume toxic tort litigation during the past decade, disputes arose between ESAB and its liability insurers concerning the coverage available for these claims. By mid-2009, ESAB has spent over $54 million to defend these cases and another $25 million for judgments and settlements.

After ZIP declined to provide a defense to the underlying welding fume suits, ESAB sued it and other carriers in South Carolina. ZIP removed the case to federal court and sought to invoke the protection of the Convention and the Convention Act's grant of removal jurisdiction. ESAB disputed ZIP's right to removal, contending that the policies did not contain valid arbitration agreements and therefore did not fall under the Convention. The South Carolina district court ruled, however, that the arbitration clauses in the 1989-93 policies were subject to arbitration. However, the court remanded to state court the insured's dispute with respect to those policies lacking such clauses.

Although South Carolina law favours arbitration in general, S.C. Code Ann. § 15-48-10(b)(4) makes plain that this does not apply to claims by insureds or beneficiaries under any insurance policy. As a result, South Carolina courts have ruled that the McCarran-Ferguson Act preempts the application of Chapter 1 of the Federal Arbitration Act to arbitration agreements in insurance policies. Relying on this law, ESAB argued that the South Carolina statute "reverse preempted" the application of Chapter 2 to the ZIP arbitration clauses.

Nevertheless, the South Carolina District Court adopted the view pioneered by the Fifth Circuit in *Safety National Cas. Corp. v. Certain Underwriters at Lloyd's, London, 587 F.3d 714 (5th Cir. 2009), cert. denied, 131 S. Ct. 65 (2010)* concluding that, "[t]he Convention, not the Convention Act directs courts to enforce international arbitration agreements." Accordingly, because the McCarran-Ferguson Act text limits its scope to federal statutes, the Act may not disrupt the application of traditional preemption rules with respect to this international treaty.

On appeal to the Fourth Circuit, ESAB argued that the Convention is a non-self-executing treaty, that is to say one that requires implementing legislation to be given effect in domestic courts. It followed, therefore,

that the Convention only has legal effect insofar as it is incorporated into its implementing legislation, that is to say the Convention Act. ESAB concluded, therefore, that because the Convention Act is a federal statute that does not speak directly to insurance it is subject to reverse preemption under the McCarran-Ferguson Act and may therefore not be given effect in light of South Carolina's public policy against arbitration clauses in insurance agreements.

The Fourth Circuit disagreed, adopting the view of the Fifth Circuit in *Safety National, 587 F.3d at 722*, that even assuming the Convention was not self-executing and therefore did not have legal effect in domestic courts absent implementing legislation, reverse preemption did not apply. In Safety National, a majority of the Fifth Circuit sitting en banc had concluded that the McCarran-Ferguson Act applied only to statutes, not treaties. It then concluded that despite the presence of implementing legislation, the Convention, not the Convention Act, was being construed to supersede state law. Because the McCarran-Ferguson Act did not apply to treaties, the Act could not cause state law to preempt the Convention.

The Fourth Circuit ruled that even assuming that Chapter 2 of the Convention is non-self-executing, the Convention Act, as implementing legislation of a treaty, does not fall within the scope of the McCarran-Ferguson Act. In keeping with U.S. Supreme Court precedent and the view of other federal courts, it concluded that the scope of the Act should be read narrowly. In particular, "Where a statute touches upon foreign relations and the United States' treaty obligations, we must proceed with particular care in undertaking this interpretative task."

The Fourth Circuit noted that Congress might in the future opt to exclude insurance disputes from the Convention but has not done so with the McCarran-Ferguson Act. Nor is there anything in the statute suggesting that, by enacting McCarran-Ferguson, Congress intended to delegate to the states the authority to abrogate international agreements that the United States has entered into and rendered judicially enforceable.

The Fourth Circuit concluded, therefore, that "Because the Supreme Court has made clear that McCarran-Ferguson is limited to domestic affairs, we hold that the Convention Act falls outside of its scope." It concluded, therefore, that the South Carolina District Court had properly assumed jurisdiction and compelled arbitration in Sweden with respect to the ESAB Group's claims under these ZIP policies.

A concurring opinion by Judge Wilkinson observed that holding the McCarran-Ferguson Act empowered states to displace the Convention on the recognition and enforcement of foreign arbitral awards would ignore the Convention's express statement that contracting states "shall recognize an agreement in writing under which the parties undertake to submit to arbitration" as well as its direction that "The court of a Contracting State shall, at the request of one of the parties, refer the parties to arbitration. . . ."

NEWS FROM THE COURTS!

--**EXCESS DECISIONS**

--Comity – there follows two decisions of the English Court of Appeal, involving concurrent actions in England and USA, which emphasize the importance of expedition in establishing jurisdiction in the English Courts.

--Comity (1)

On appeal from the Queen's Bench, the U.K. Court of Appeal has ruled on July 20 in Faraday Reinsurance Co. v. Howden North America that certain excess liability policies that General Star issued to Howden were subject to English law and the jurisdiction of the English courts and therefore could not be adjudicated in

the large asbestos coverage proceeding that Howden has been pursuing against its other carriers in Pittsburgh. The court observed:

It would be idle to pretend that the English courts and the American (including the Pennsylvania) courts see eye to on the question of the liability of insurers to respond to asbestos claims. The English courts do not accept the triple trigger of liability, nor do they accept that insurers are liable if the relevant trigger does not occur within the strict time limits of the policy. In Wasa v Lexington cited above the House of Lords held, for example, that a reinsurance contract, if it is governed by English law, does not respond to an American insurer which is required to pay in response to American notions of insurer-liability, unless it can be shown that the insurer's liability arose during the currency of the English policy. In these circumstances it is inevitable that differing conclusions may be arrived at by courts in England from those that would be arrived at in (at any rate some) states in America.

This might not greatly matter if common rules existed to determine the proper law of the relevant insurance policy. But inevitably different jurisdictions may have different rules to determine that question. Judge Conti's preliminary assessment is that it is unlikely that English law will be held to govern the policy in issue in this case. Mr Jacobs has accepted, however, that there is at any rate a good arguable case that an English court (if the proceedings continue) will hold that English law governs the policy. That again is a position which the court in each country has to accept.

… Comity (2)

In proceedings that raised substantially similar issues to the Faraday action in (1) above, Ace European Group & Others sought declarations in the English Commercial Court that the excess layer policies they had written were governed by English law (Howden North America Inc and Anor v Ace European Group & Others [2012] EWCA Civ 1624). As in Faraday, insurers had to seek Court permission to serve Howden out of the jurisdiction. This was granted at first instance, but the Court of Appeal (comprising different Judges from those that heard Faraday) set aside the order.

In arriving at a decision opposite to that in Faraday, the Court relied on crucial differences between the two sets of proceedings, including the following:

The Faraday proceedings had been commenced before Howden applied to join them in proceedings in Pennsylvania, whereas the Ace proceedings were commenced in London after Ace had been joined in Pennsylvania. By the time of the Ace hearing, the Pennsylvania Court had already given a written judgment stating that, under Pennsylvania conflict of laws rules, English law was unlikely to apply to these policies. Insurers in Ace did not argue that a decision of the English Court would establish issue preclusion in Pennsylvania, merely that it would assist the Pennsylvania Court.

However, the Court of Appeal in Ace concluded that a declaration of the English Court would not be useful, particularly as the Pennsylvania Court had already stated it was unlikely to find English law applied and canl, in any event, hear evidence of English law. The Court of Appeal also commented that given that the Pennsylvania Court was exercising competent jurisdiction, the English proceedings could be an illegitimate pre-emptive strike against enforcement of any properly given Pennsylvania judgment.

--Rights of Equitable Contribution (TX)

In a case where an excess insurer stepped in to defend its policyholder after the primary insurers refused to do so but was thereafter declared not to have any subrogation rights due to the fact that the insured had assigned its rights away pursuant to a bankruptcy, the Fifth Circuit has ruled in Continental Cas. Co. v. North American Capacity Ins. Co., No. 10-20262 (5th Cir. May 30, 2012) that the Texas Supreme Court's

2007 opinion in Mid-Continent Ins. Co. v. Liberty Mut. Ins. Co., 236 S.W.3d 765 (Tex. 2007) did not preclude the umbrella carrier from obtaining a subrogated recovery against the primary insurers for the defense costs particularly as disallowing an excess carrier's right of recovery under such circumstances would encourage primary insurers to breach their duties and place their own interests above those of their insureds. The court ruled that the primary insurers should not be able to argue that an excess carrier's rights of subrogation were barred by the insured's "empty shoes." In light of conflicting language among the primary policies, the Fifth Circuit ruled that the insurers must share the costs of defense equally.

In an Ohio environmental cleanup case where the insured settled with numerous carriers before obtaining a judgment against its excess insurer, the Sixth Circuit has ruled in OneBeacon America Ins. Co. v. American Motorists Ins. Co., No. 10-4530 (6th Cir. May 17, 2012) that the carrier should not be entitled to pursue equitable contribution claims against carriers that had "exhausted" their limits through earlier settlements. The Sixth Circuit opined that "adopting OneBeacon's position would fundamentally undermine current settlements and discourage future settlements. . . ." as it would eliminate incentives to settle, call into question the stability of existing agreements and spawn a never ending series of contribution and indemnification disputes.

--*What Constitutes "Exhaustion"?*

Following the approach pioneered by the California Court of Appeal in Qualcomm and the Fifth Circuit last year in Citigroup, the Appellate Division of the New York Supreme Court has ruled in J.P. Morgan Chase & Co. v. Indian Harbor Ins. Co., 947 N.Y.S.2d 17 (App. Div. June 12, 2012) that requirements in an excess insurance policy that underlying limits be actually paid as a condition to excess coverage are not ambiguous and are not satisfied by the policyholder's agreement to absorb the gap between the actual policy limits and the amount that the policyholder settled for.
Section Newsletter Editor Mike Aylward recently authored an article on the recent trends in exhaustion case law in DRI's For The Defense.

--*Exhausting Underlying Insurance?*

Despite arguments by excess insurers that Corning must pay a separate "per occurrence" deductible for each individual asbestos claim against it, the Appellate Division of the New York Supreme Court has ruled in Mt. McKinley Ins. Co. v. Corning, Inc., 2012 NY slip op 04398 (App. Div. June 7, 2012) found that factual issues remained with respect to whether these claimants could be grouped together as involving exposures in the same time and place and distinguished cases in which courts had found multiple "occurrences" under policies that didn't define "occurrences" or lacked language requiring that exposures to similar conditions "shall be considered as arising out of one occurrence."

--**REINSURANCE RULINGS**

--*Is A Stop Loss Agreement "Reinsurance"? Not! (TX)*

The Texas Supreme Court has ruled that stop loss insurance sold to self-funded employer health benefit plans is not reinsurance and is therefore subject to regulation by the Texas Department of Insurance. In holding that these stop loss agreements were in the nature of "direct" insurance, the court ruled in Texas Dept. of Ins. v. American National Ins. Co., No. 10-0374 (Tex. May 18, 2012) that American National should have treated monies paid to it as "direct written premium" for which taxes were owed to the state. The Texas court rejected American National's argument that an employer who self-funds a health benefit plan for its employees is an "insurer" in the "business of insurance" and therefore a reinsurer when it purchases

stop loss insurance. The court concluded that the TDI's position was reasonable and not contradicted by the Insurance Code and should therefore be given effect.

--*Cedant Failed To Prove Renewal of Facultative Agreements (MA)*

In a dispute between two former CU affiliates, the First Circuit has affirmed a Massachusetts District Court's declaration that CU's successor failed to show that its facultative reinsurance arrangements remained in effect after the first year. In OneBeacon America Ins. Co. v. Commercial Union Assur. Co. of Canada nka Aviva Ins. Co. of Canada, No. 11-2072 (1st Cir. July 11, 2012), the court took note of the fact that the facultative certificate evidencing Aviva's reinsurance undertakings for the 1980-81 policy year did not extend facultative coverage in later years. The court took particular note of the fact that an endorsement to the 1981 renewal of the Aviva treaty expressly excluded coverage for the policyholder whose asbestos claims had generated OneBeacon's demand.

--*Follow the Settlements*

In *Amlin Corporate Member Limited v Oriental Assurance Corporation [2012] EWCA Civ 1341*, the English Court of Appeal upheld the Commercial Court in refusing to stay English proceedings in which reinsurers sought a declaration that they were not liable under a reinsurance contract, despite it containing a "follow the settlements" provision and the existence of underlying proceedings in the Philippines.

The action related to the loss of Oriental's insured vessel "Princess of the Stars" in typhoon "Frank" off the Philippines coast. Amlin reinsured Oriental in a contract expressly subject to English law and jurisdiction which included the words *"…follow all terms, conditions and settlements of the original policy issued by the Reinsured to the Insured"*. There was also a typhoon warranty in both original policy and reinsurance, stipulating that the vessel would not sail out of port when there was a typhoon warning or when her route might cross a typhoon's path.

Amlin sought a declaration in the English Commercial Court that it was not liable to Oriental because of the typhoon warranty (and likewise, Oriental was not liable to its insured). As a matter of case management, Oriental sought to stay the English action pending the outcome of the action in the Philippines relating to the claims against Oriental.

The Commercial Court declined to exercise its discretion to stay the action. The Court of Appeal found that the judge's discretion had not been exercised on an incorrect basis. It acknowledged that this would force Oriental to argue for cover under the typhoon warranty in the English action notwithstanding that it was arguing the opposite in the Philippines litigation. It was also considered reasonable for the Judge to have taken into account the "glacial" progress forecast in the Philippine Court (10 years).

As to "Follow the Settlements", Oriental argued that a reinsurer must wait for the underlying settlement before assessing its own liability. However, the Court commented that this would make reinsurance an exception to the normal rule that a stay of proceedings that have been properly brought can only be granted in rare and compelling circumstances. It pointed to the well-established fact that a "follow the settlements" provision will have no application if the loss does not fall within the terms of the reinsurance cover.

--*New York Court of Appeals To Address Follow The Fortunes*

The New York Court of Appeals has agreed to accept review of the First Department's ruling in USF&G v. American Re-Ins. Co., 2012 NY slip op 00421 (1st Dept. January 24, 2012) that USF&G's reinsurers must

reimburse it for $420 million out of a total of $975 million that it paid to Western MacCarthur to settle asbestos claims.

--*Discovery*

A federal district court has ruled in Granite State Ins. Co. v. Clearwater Ins. Co., No. 9-10607 (S.D.N.Y. April 30, 2012) that a ceding insurer seeking reinsurance for certain asbestos losses must produce all documents prepared for it by any consultant or third party concerning projected reserves for asbestos exposures. Judge Eaton ruled that the requested discovery was relevant to Clearwater's defense that AIG had failed to implement reasonable practices for reporting large losses to its reinsurers. The court rejected Granite State's argument that the only issue was whether it had any reporting procedures in place, not whether such procedures were adequate or reasonable to ensure timely reporting to its reinsurers.

--COVERAGE/BAD FAITH

Alabama: Potentially Responsible Party Letter Qualified as Suit Under CGL Policy

The United States District Court for the Northern District of Alabama certified a question to the Alabama Supreme Court: "Under Alabama law, is a 'Potentially Responsible Party' ('PRP') letter from the Environmental Protection Agency ('EPA'), in accordance with the Comprehensive Environmental Response Compensation and Liability Act ('CERCLA') provisions, sufficient to satisfy the 'suit' requirement under a liability policy of insurance?" The Alabama Gas Corporation ('Alagasco') was issued such a letter by the EPA. In a subsequent suit in Alabama Federal Court, Travelers, Alagasco's insurer, disclaimed coverage because the requirement of a "suit" under the policy was not met by the letter. The federal court certified the question to Alabama, which answered the question in the affirmative. *(Travelers Casualty and Surety Company v. Alabama Gas Corporation, 1110346 (Al. Dec. 28, 2012).)*

--**OTHER DEVELOPMENTS OF NOTE**

The Federal Insurance Office has announced that it will undertake an analysis of domestic and international regulation of reinsurance in the United States

DRI has published a compendium of articles and case law addressing excess and umbrella insurance coverage issues. The cost of the DRI Excess and Umbrella Insurance State By State Compenidum (CD version) is $125 for DRI members, $155 for others.

Five former executives of AIG and Gen Re have entered into a plea agreement to avoid a second criminal trial for reinsurance fraud. Under the terms of the agreement, the defendants agreed to pay fines of $100,000 to $250,000 and have entered into deferred prosecution agreements whereby the indictments against them will be dismissed in a year if no further misconduct occurs. Ronald Ferguson and the other defendants had been convicted of fraud by a Connecticut jury but the conviction was thrown out last year by the Second Circuit. The case had been scheduled for re-trial in January 2013.

I look forward to seeing all y'all in San Antonio for what promises to be another great meeting.