**FDCC – REINSURANCE EXCESS AND SURPLUS LINE SECTION NEWSLETTER**

## ANNUAL MEETING – THE BROADMOOR

It is great to see that so many section members have signed up for The Broadmoor. It is going to be a great meeting. Last year, I was at the London 2012 Olympics, an awe-inspiring experience. At the theme party this year, we will get to meet some of the athletes who helped to deliver that great Olympic spectacle and will do so again at Brazil 2016. It will be fascinating to learn about the dedicated and no doubt gruelling training that lies behind it all.

We also like to think that we provide some great training at the FDCC. This year again, we have inspirational speakers and another top quality CLE programme. And, of course, there is The Broadmoor itself … If you haven't registered yet, there is still time. Be inspired.

**Our Section Meeting – Thursday 1st August at 7.30am**

This is your chance to join in a discussion of what is really of interest to section members. We will be considering current issues that you want to discuss and the direction that you would like to see the section move in. In recent times, we have had little more than a short period at the end of a joint CLE session to do this. However, this year, we are doing something different from the usual. We want this to be a meeting of like-minded people, sharing the same professional interests – that is what the FDCC sections are all about**. However, to meet, to interact and to get to know each other better, we have to be there.**

**I am seeking input from you as to topics for discussion that are relevant to our practices. They may come from some of the cases and developments reported below, or they may be issues that we are seeing as practitioners now, but upon which there have been no decisions … yet.**

**PLEASE LET ME KNOW NOW IF YOU HAVE OTHER TOPICS YOU WOULD LIKE TO DISCUSS AT THE MEETING.**

This is a new departure that cannot work unless we are there to make it work. **So please, make the effort to get up bright and early and be at the section meeting for 7.30 on Thursday 1st August.**

## FEATURED CASE ANALYSIS

### New York Court of Appeal upholds reinsurers' right to review loss allocation by cedant

Reversing the Appellate Division's victory for a cedant, the New York Court of Appeals has ruled in USF&G v. American Re, No. 1 (N.Y. February 7, 2013) that a trial court should not have granted summary judgment for USF&G with respect to the claimed obligations of reinsurers to reimburse it for a large settlement that it paid to resolve a California asbestos suit where disputed issues of fact remained as to what portion of the settlement should be attributed to bad faith claims and whether USF&G inflated the value of non-meso claims to cover for the fact that it had not assigned any value for the bad faith claims.

The Court of Appeals declared that the cedant's allocation determinations are due a certain amount of deference, if only because "deference to a cedant's decisions makes for a more orderly and predictable resolution of claims." The Court of Appeals emphasized, however, that there are limits to this deference. In particular, a reinsurer is only bound by allocation decisions that are made in good faith and are objectively reasonable. While an allocation is not unreasonable merely because it furthers the self-interest of the cedant by increasing the reinsured recovery, "the reinsured's allocation must be one that the parties to the settlement of the underlying insurance claims might reasonably have arrived at in arm's length negotiations if the reinsurance did not exist." Importantly, the Court of Appeals also ruled that reasonableness does not exist just because the cedant's reinsurance allocation methodology mirrors the assumptions used in settling with the policyholder. The court archly noted that "in many cases claimants and insureds far from being indifferent, will enthusiastically support insurers' efforts to fund a settlement at reinsurers' expense."

In the second phase of its opinion, the court proceeded to consider whether USF&G's allocation decisions in this case were reasonable as a matter of law in ceding this loss to its reinsurers based on the assumptions:(1) that all of the settlement amount was attributable to claims within the limits of USF&G's policies, and none of it to the claims that USF&G acted in bad faith when it refused to defend MacArthur in asbestos litigation; (2) that claims by claimants suffering from lung cancer had a value of $200,000 each, while certain other claims had values of $50,000 or less; and (3) that USF&G's entire payment should be attributed to the policy in force in 1959 -- the last full year in which USF&G was Western Asbestos's liability insurer. Could these assumptions "reasonably have been the basis for an arm's length settlement among the asbestos claimants, MacArthur and USF&G if reinsurance were not in the picture?"

In this case, it was clearly to USF&G's advantage not to attribute any portion of its settlement to the bad faith claims, as bad faith damages were not a reinsured "loss in connection with each policy." However, the court found that there was significant evidence that USF&G might have faced a bad faith verdict had it not settled. In particular, the court observed that a jury could have found that USF&G "knew, well before it admitted, that it did indeed provide such coverage, and that its litigation position was an irresponsible attempt to exploit the fact that, with the passage of time, the policies it issued had disappeared." The court suggested that even though USF&G's alternative argument that it did not owe coverage by "operation of law" to the corporate successor of its named insured might have been plausible, one reasonable basis for avoiding coverage did not nullify the bad faith denial on the basis of missing policies. The court took note of the fact that the California Superior Court had found questions of fact concerning USF&G's possible bad faith and had not only denied its motion for summary judgment on these grounds before trial but had also denied, at the outset of the coverage trial, a motion in limine to exclude some evidence thought to be relevant to those claims.

In light of these facts, the Second Circuit concluded that "it was therefore arguably not reasonable, at the time the coverage litigation was settled, to say that the bad faith claims had no value." Further, it found that USF&G might have assigned inflated values to non-meso claims to offset the lack of any valuation for bad faith. The court also took note of the fact that McArthur had included a bad faith dollar demand in earlier negotiations with USF&G and that bad faith claims had been discussed with the Bankruptcy Court in approving a plan of reorganization for McArthur

In its settlement and cession to reinsurers, USF&G had assigned a value of $200,000 to each of the underlying asbestos claims, even though an expert for the underlying claimants had estimated the value of the non-meso claims as only being worth $91,174. Under the circumstances, the Court of Appeals found a second issue of fact with respect to "whether the values assigned to lung cancer, asbestosis, pleural thickening and other cancer claims could reasonably have been agreed on in arm's length bargaining in the absence of reinsurance."

On the other hand, the Court of Appeals validated USF&G's right to allocate the entire settlement to its 1959 policy year, even though pro-ration to the entire insured period would have placed most of the loss within the $100,000 deductible and largely eliminated any cession to reinsurers. The court found that this allocation fairly reflected California's law with respect to the trigger of coverage, allocation and stacking as regards long-tail claims and that it was undisputed that, if forced to spike its claims in a single policy year, McArthur would have chosen 1959 as it had the highest limits and the broadest number of claimants. The court acknowledged that the California Supreme Court's adoption of a continuous trigger in Montrose was specific to the wording of "occurrence" forms, whereas these old USF&G policies were written on an "accident" basis but also found that it was not unreasonable for USF&G to conclude that this distinction would not ultimately be persuasive to a California court. The court ruled, therefore, that summary judgment had been properly granted to USF&G on this aspect of this allocation.

*This is important not only for reinsurance practitioners, but also for those handling the insurance settlements as recoverability of loss allocations under reinsurances goes to the insurers' (i.e. the reinsured's) bottom line.*

(submitted by Michael Aylward – Morrison, Mahoney Millar (Boston)

**THE IMPORTANCE OF CHOICE OF LAW**

Two cases, one in England and one in New York, highlight the importance of choice of law clauses. In New York, AIU Insurance Company v TIG Insurance Company (No 07-7052, 213 US Dist LEXUS 41716 (SDNY Mar 25, 2013)), related to a facultative reinsurance of AIU by TIG, which provided that prompt notice should be given to TIG of an occurrence or accident which appeared likely to involve the reinsurance. Notwithstanding this, AIU received a demand for payment of asbestos claims from Foster Wheeler in 2003, but did not notify TIG until 2007. TIG denied the claim on the grounds of late notice. The reinsurance contract did not contain a governing law clause. AIU commenced proceedings in the New York Courts, asserting that, under New York law, TIG had to show prejudice and that there was none. However, the New York Court found that Illinois law applied - the facultative certificates had been issued there and required AIU to submit claims to a Chicago intermediary. Under Illinois law, no prejudice was required and so TIG obtained summary judgment, dismissing the claim, from the New York Court in circumstances in which it would not have done so had New York law applied.

A month earlier in London, the Commercial Court had handed down its judgment in Astra Zeneca Insurance Company v XL Insurance (Bermuda) Limited. Astra Zeneca was insured by its captive Astra Zeneca Insurance Company, which in turn was reinsured by XL Insurance, Bermuda. The reinsurance was a "Bermuda form" contract, which classically provides for New York law, but arbitration in London. Unusually, this had been amended to provide for English law and the parties had agreed to the jurisdiction of the English High Courts, rather than to arbitration (thereby depriving the Bermuda form of its two most characteristic properties). The policy also provided coverage for defence costs by including them in the definition of damages. The change to the applicable law was crucial. Under New York law, coverage extends to bona fide settlements without having to prove actual liability, whereas under applicable English law, Astra Zeneca had to prove actual liability. Moreover, as defence costs were included in the definition of damages, they were only recoverable where damages were recoverable, so if there were no damages recoverable from Astra Zeneca Insurance, then equally defence costs were not recoverable either. Again, this is perhaps an unlikely outcome had New York law applied.

The clear message is that if the consequences of a choice of law clause, or lack of one, are not thought through, then you may find the law of unintended consequences also applies!

## 9/11 – HOW MANY LOSSES?

12 years after the attack on the Twin Towers, and this question is still being asked. It is a point that has been raised in numerous reinsurance claims, but has been the subject of very few Court decisions. Different companies with different wordings and different views have treated it in different ways. The Court of Appeal's second circuit in World Trade Centre Properties v Hartford Fire Insurance Company [2003] 345F154 found that the damage was the result of a single "occurrence". In that policy, "occurrence" was defined to include losses attributable directly or indirectly to one cause or one series of similar causes – a very wide wording.

In February this year, the first English Court judgment on the subject was handed down in Aioi Nissan Dowa Insurance Company v Heraldglen and Advent Capital (No 3) Limited [2013] EWHC154 (Comm). The wording in this reinsurance contract was narrower – a loss constituting one or more occurrences or series of occurrences "arising out of one event". Initially the issue went to arbitration in which the tribunal concluded that the losses were caused by two occurrences, arising from two events.

In reaching its conclusion, the Tribunal applied the judgment of Rix J in Kuwait Airways Corporation v Kuwait Insurance Co SAK [1996] 1 Lloyd's Rep 664, in which Rix J had applied the 'unities' doctrine originally submitted by Mr Michael Kerr QC in the Dawson's Field Arbitration (1972). On this basis the questions to be considered could be summarized as follows:

i. Was there unity of time?

ii. Was there unity of location?

iii. Was there unity of cause?

iv. Was there unity of intent?

Mr Michael Kerr QC, in Kuwait Airways had specified that when applying these principles, one should view the situation and circumstances as an informed observer. Rix J arguably took this one step further by stating the viewpoint should be that of "an informed observer placed in the position of the insured."

Under the English Arbitration Act 1996 there are very limited grounds to appeal from an Arbitration award (other than misconduct of the Tribunal). However, S69 of the Arbitration Act provides that a party can appeal to the High Court on a specific question of law, provided it was in front of the tribunal, but only with leave of the court. In order to obtain that leave the court must be satisfied, on the basis of the findings of fact in the award (which cannot be questioned):

- that the decision of the tribunal on the question is obviously wrong, or
- that question is one of general public importance and the decision of the tribunal is at least open to serious doubt, and
- that despite the agreement of the parties to resolve the matter by arbitration, it is just and proper in all the circumstances for the court to determine the question.

The appellant obtained leave and appealed the Arbitration award on the following grounds:

i. The Tribunal had not confined its analysis to whether the attacks on the Twin Towers were one event; instead it had given too much attention to the number of loss events arising out of the hijackings of all four flights;

ii. The Tribunal had erred in interpreting the "unity of cause" principle as an obligation to consider the cause of the losses in general; the appellant argued that unity of cause is, in fact, unity of operative peril;

iii. The Tribunal had failed to appreciate that although hijacking and terrorism were operative perils, it did not necessarily follow that the losses arose out of the same event;

iv. The Tribunal placed too much emphasis on the hijacking peril;

v. When analysing from the viewpoint of an informed observer, the Tribunal did not have regard to Rix J's additional requirement that it be "in the position of the insured";

vi. "Event" should have been given a broad meaning and that the Tribunal had not correctly construed the aggregation clause;

vii. The Tribunal gave insufficient regard to the purpose and intent behind the hijacking and crashes.

However, Field J rejected those contentions. He found that the Tribunal had accurately summarised the law, concluding that the Tribunal was "entitled… to find that there were two separate causes for the insured losses because there were two successful hijackings of two aircraft" and that it was "entitled to find for the reasons they gave that there was no sufficient unity of time or location to have arisen out of one event, notwithstanding that the Twin Towers were part of an overall complex and notwithstanding the relative closeness in time between the commencement of each flight and the subsequent crashes." The court confirmed that "loss" and "occurrence" are not the same thing, but the differences between "occurrence" and "event" can change depending on context and on the particular policy wording.

The court's conclusion was that the Tribunal had accurately identified the applicable law and made "no error of law". Hence the decision was one that it was open to the Arbitrators to make and in making it they (i) correctly applied the law; (ii) had regard to all materially relevant matters; and (iii) did not take into account impermissible considerations.

It was not for the court to decide whether the decision that the World Trade Center attack was two events was actually correct. Indeed, the Judge gave no indication of whether he would have reached the same conclusion had he heard the case itself. Although the court found that it was open to the Tribunal to decide that the attack was two events, it may equally have been open to the Tribunal, in applying the same principles of law and having regard to the same factors, to conclude that it was a single event, and had the Tribunal done so, that decision too should have been upheld by the court. Accordingly, another tribunal could reach a different conclusion. Although clearly this tribunal's decision would be persuasive in respect of the wording it dealt with, a different wording could lead to a different result, especially as the words "loss", "occurrence", "cause" and "event" are not always used consistently in reinsurance wordings.

## OTHER CASE UPDATES & NEWS

### California Court of Appeal Defies Supreme Court on Stacking Issue

On remand from the California Supreme Court, which directed the Court of Appeal to realign its opinion in Kaiser Cement and Gypsum Corp. v. ICSOP, 196 Cal. App.4th 140 (2011) to accord with the Supreme Court's more recent stacking analysis in State of California v. Continental Ins. Co., 55 Cal. 4th 186 (2012), the Second District has now ruled in Kaiser Cement and Gypsum Corp. v. ICSOP, B222310 (Cal. App. April 8, 2013) that it maintains the view that the policies that Truck Insurance issued to Kaiser cannot be stacked and that Truck's primary indemnity obligation cannot exceed the "occurrence" limit of $500,000. In contrast to the environmental claims considered by the Supreme Court in State of California, the Court of Appeal declared in this case that the policies at issue contained language barring inter-policy stacking as they stated that, "The limit of the company's liability as respects any occurrence involving one or any combination of the hazards or perils insured against shall not exceed the per occurrence limit designated in the Declarations." The court ruled that this language was "facially inconsistent with permitting Kaiser to recover from Truck more than the occurrence limit for a single occurrence." The court took note of the fact that the policy did not state that the per occurrence limit was the limit of the company's annual liability or the limit of the company's liability under any specific policy but rather stated that it was the "limit of the company's liability." The court distinguished State of California, declaring that the Supreme Court's analysis was merely a default rule that could not stand in cases where there was contrary policy language precluding stacking. The Court rejected Kaiser's contention that language in the excess policies requiring that all underlying insurance be exhausted as a precondition to coverage solely pertained to the single underlying primary policy, declaring that "underlying insurance" was meant to mean not only scheduled insurance but any other collectible primary insurance as well. While therefore reaffirming this principal of "horizontal exhaustion," the Court of Appeal nonetheless agreed with Truck and Kaiser that under the language of the 1974 primary policy to which Kaiser had assigned these claims, Truck was only responsible for a single $500,000 policy limit not, as the excess carriers contended, one limit per occurrence per year or one limit per occurrence per policy.

**Second Circuit Refuses To Impose Drop Down in Insolvency**

The U.S. Court of Appeals Second Circuit has refused to apply its seminal 1928 opinion in Zeig to disputes under liability policies. In Ali v. Federal Ins. Co., 11-5000 (2nd Cir. June 4, 2013), the court held that where excess D&O policies required that the underlying insurance coverage be exhausted "as a result of payment of losses thereunder" the insured could not recover for its excess liabilities over the attachment point of the insolvent underlying insurance. The Second Circuit declared that Zeig made no sense in the context of liability insurance and that, in any event, these claims involved insolvencies, not "below limits" settlements.

**Washington Supreme Court Voids Arbitration Clause in Surplus Policy**

The Washington Supreme Court has ruled that a surplus lines policy's requirement that insurance disputes be arbitrated was void as being in conflict with RCW 48.18.200(1)(b), which prohibits insurance contracts from "depriving the courts of this state of the jurisdiction of action against the insurer." In State of Washington v. James River Ins. Co., No. 87644-4 (Wash. January 17, 2013), the court rejected the insurer's argument that the State's claim was contrary to the modern view of arbitration, as well as the historical understanding of arbitration in Washington. Further, the court refused to find that RCW 48.18.200(1)(b) was preempted by the Federal Arbitration Act, declaring instead that as a statute regulating the business of insurance, it was protected from preemption by the McCarron-Ferguson Act.

**Other Litigation News – USA**

- The Washington Supreme Court in a landmark decision, found that insurance companies could not rely on the attorney/client privilege to avoid disclose of communications with outside Counsel related to the investigation, evaluation, negotiation or processing of bad faith insurance claims. In its judgment, it stated that to "permit a blanket privilege in insurance bad faith cases because of the

participation of lawyers hired or employed by insurers would unreasonably obstruct discovery of meritorious claims and conceal unwarranted practices" (Cedell v Farmers Insurance Company of Washington, 295F.3d 239 (2013)).

- A report issued by the New York State Department of Financial Services on 11th July 2013 [?] highlighted a practice among almost a quarter of New York life insurers of operating a process which it referred to as "shadow insurance". This involves reinsurance through a wholly owned subsidiary, a captive generally other than through a third party domiciled outside of New York State, rather than through a third party. The report alleges that insurers are using such arrangements to avoid stricter New York State regulatory requirements and to reduce the amounts that the insurers have to set aside as reserves. The report calls for regulators to crack down on this growing practice.

- Resolute Management has filed suit in the Business Litigation cession in Boston, alleging that Transatlantic Re is tortiously interfering with its reputation and reinsurance business by unilaterally halting payment on millions of Dollars of asbestos claims owed under various reinsurance contracts with the underwriting entities whose asbestos claims are now being handled by Resolute. In an unusually detailed Complaint, Resolute alleges that Transatlantic Re is seeking to escape the consequences of an unwise investment in acquiring reinsurer, Allegheny, and is retaliating against Resolute for its refusal to commute these agreements.

## MEANWHILE IN LONDON

- The Financial Secretary to the Treasury, Greg Clark, has stated that it is the government's plan to put the UK insurance industry at the heart of its focus in driving UK economic growth. This has been welcomed by the Association of British Insurers, as insurers are among the country's top exporters.

- In view of the increased incidence of flooding in the UK, the government and the insurance industry have reached a tentative agreement on the creation of Flood Re, to be funded by a levy on home insurers.

- The government has announced the intention to enact a scheme for sufferers of diffuse mesothelioma where it is not possible to trace the employer or its insurer concerned. This is proposed to be funded by a market share based levy on insurers.

## …AND FINALLY YOUR NEWS

**If you have any news – appointments, cases won, awards for you or your firm, or any other news that you would like other member to know about don't be shy – let me know so that it can be published in the Newsletter. Send it to Stephen.Carter@cpblaw.com .**

**I hope to speak with you on the forthcoming section conference call (details to follow) and to see you at the Broadmoor.**

**Have a great summer**

**Chair:**
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