CLOUD TECHNOLOGY, ALTERNATIVE DISPUTE RESOLUTION, AND THE INSURANCE INDUSTRY: THE FUTURE HAS ARRIVED (REALLY THIS TIME)

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This Paper has been prepared for general information and is not intended to be relied upon as legal advice.
CLOUD TECHNOLOGY, ALTERNATIVE DISPUTE RESOLUTION, AND THE INSURANCE INDUSTRY: THE FUTURE HAS ARRIVED (REALLY THIS TIME)

By George H. Friedman

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Introduction

Over twenty years ago, the author of this paper evaluated emerging technologies and predicted how they might impact alternative dispute resolution ("ADR"). Four years later, after the emergence of the internet, he updated his predictions to gauge the impact of this new medium. Now Chairman of the Board of Arbitration Resolution Services, Inc. ("ARS") – the world's first completely cloud-based ADR provider – he measures what really happened and predicts the future of emerging technologies on ADR in general and on insurance industry ADR in particular.

- The past: how accurate were prior predictions about email, imaging, electronic fund transfers, computerization, and the "new" fax technologies? What other unforeseen technologies – like the web, digital audio recording, Wi-Fi, mobile apps, and videoconferencing – came upon the scene and impacted the ADR world?

- The present: how is technology being used to improve the delivery of ADR services today in the insurance industry? What is the impact on the arbitration and mediation processes?

- The Future: Where will we be five years from now? Will cloud-based arbitrations and mediations overtake "brick and mortar" case filings? Will the in-person hearing become a thing of the past? What new technologies will emerge and how will they impact ADR?

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Past Predictions and Present Realities

Going back to check on past predictions – especially technology prognostications – is always fraught with peril and is often comical. On the latter, a magazine published in 1950 made some bold predictions about the future. It’s humorous to see not only how the authors overreached, but also what they didn’t see coming. For example, we must have missed the advent of jet-propelled turbo cars. On the other hand, it seems that we have exceeded greatly the prediction by former IBM chairman Tom Watson who in 1943 said “I think there is a world market for maybe five computers.”

In 1993, I evaluated emerging technologies and predicted how they might impact ADR. Four years later, after the emergence of the internet, I updated my predictions to gauge the impact of this new medium. I made the following prediction:

The future seems destined to bring dramatic changes to the way online disputes are resolved, and ultimately affect the way arbitrations and mediations are administered for a wide range of disputes beyond the online realm. For parties and their representatives, the near future will bring about the development of virtual alternative dispute resolution, with all communications and information related to the case available through their computer at any time from any place.

I think I pretty much nailed this.

What’s Ahead for ADR and Technology?

Now we come to the author’s favorite part: predicting the future. Why? Because, while you can certainly disagree with me, you can’t definitively say I’m wrong unless you claim to be a visitor from the future.

There’s a great scene in the classic 1967 movie The Graduate where a family friend of new college graduate Ben Braddock (played by Dustin Hoffman) gives some sage advice about the future to young Ben. With great fanfare, he leads up to a one word prediction: “Plastics!” Bearing in mind that my predictions from 1993 were precisely on target, but that there were lots of things most of us just didn’t see coming, I offer my predictions for the next five years written as though I have returned from five years in the future. Here’s my word prediction: “C-ODR” which stands for complete - online dispute resolution services. This is a term developed by Arbitration Resolution Services.

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4 Francis, Devon, Will We Drive Turbo Cars? 156:6 POPULAR SCIENCE 98 (June 1950), available at https://books.google.com/books?id=Fy0DAAAAMBAJ&pg=PA98&ots=TLoxBU21MY&dq=Will%20We%20Drive%20Turbo%20Cars&hl=en&sa=X&ved=0ahUKEwij6Oj9z47KAhUtQbAKHaiHC3oQ6AEIGzAM#v=onepage&q=Will%20We%20Drive%20Turbo%20Cars&f=false


6 See Friedman, supra n. 2, at 201-2.

7 See Friedman, supra n. 3, at 716.
Services, Inc., whose Board I chair. On what basis do I return from the future to report this to you? Let me explain.

- **Overall**: By the end of 2018, web-based ADR overtook “brick-and-mortar” arbitration case filings. How did this happen? The dramatic and rapid advances in technology made the choice an easy one, much like Amazon and other web-based entities have challenged brick-and-mortar shopping as the preferred method of commerce.\(^8\) Put differently, why drag yourself to a hearing and wait around for snail-mail when you can accomplish the same things via the cloud in a fraction of the time and cost?\(^9\)

- **Consumer demand drove the shift to cloud-based ADR**: Events that will unfold over the next several years fueled the shift to online ADR. Here’s how it played out:

  Patient Protection and Affordable Care Act: A little-noticed provision in the Act\(^10\) (a/k/a “Obamacare”), requiring that health insurers establish external review of claims decisions, led to a massive number of claims. In late 2015, Congress amended Obamacare to give patients the right to require “expedited online arbitration” of disputed healthcare claims with their health insurers.\(^11\) Case filings soared after patients realized the extent of coverage and provider limitations.

  Natural Disasters: It turned out the climate change folks were right when they said we were in for some rough sledding in terms of weather.\(^12\) Given the positive experience with Hurricane Sandy claims, which were handled through

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mediation at American Arbitration Association ("AAA").\textsuperscript{13} Online ADR became the preferred way natural disaster insurance claims got resolved. The driver was Hurricane Ella, which devastated the mid-Atlantic in fall 2016. Congress, which had to be relocated after the storm, passed the bi-partisan "Hurricane Ella Relief Act" giving insureds the right to require "expedited web-based arbitration" of property-damage claims with their insurers. Given the huge number of relatively small claims, C-ODR led the way.

Financial Markets: As some financial soothsayers had predicted, both the stock and bond markets crashed at the same time in 2016. Thereafter, as had happened in the past, the Financial Industry Regulatory Authority ("FINRA") was inundated with crash-related arbitration claims.\textsuperscript{14} Case filings ultimately broke the old record of 8,945 set in 2003\textsuperscript{15} in the wake of the “tech wreck.” To address the growing post-crash caseload at FINRA, the SEC in late 2016 approved a rule giving investors the option of a completely web-based arbitration system for “simplified” cases\textsuperscript{16} involving under $50,000.

JOBS Act: The JOBS Act\textsuperscript{17} allowed crowdfunding portals such as Kickstart and Indiegogo to issue stock, once the SEC wrote rules governing the process. While investor disputes with crowdfunding portals sponsored by broker-dealers were subject to FINRA arbitration, disputes involving non-broker portals were at first not. This gap allowed the non-FINRA regulated portals to establish whatever dispute resolution system they desired, many of which were to the investor’s detriment.\textsuperscript{18} Eventually, the SEC reread a July 2013 comment letter which had

\textsuperscript{13} See AAA, Storm Sandy, available at http://www.adr.org/aaa/faces/aoe/gc/government/statenaturaldisasterprograms/sandy?_afrLoop=871659751549087&_afrWindowMode=0&_afrWindowId=19czoplq3p_1#%40%3F_%afrWindowId%3D19czoplq3p_1%26_afrLoop%3D871659751549087%26_afrWindowMode%3D0%26_adf.ctrl-state%3D19czoplq3p_41 <visited 7/20/2015>.

\textsuperscript{14} FINRA operates the largest alternative dispute resolution forum for resolving securities disputes. About a third of the cases are customer-broker disputes. The other third consists of intra-industry disputes, mostly employment. See http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics <visited 7/20/2015>.

\textsuperscript{15} See http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/ <<visited 7/20/2015>>.


observed that most disputes arising out of crowdfunding would be relatively small, and that traditional “brick-and-mortar,” paper-based arbitration was not a solution. The letter had concluded:

“We urge the SEC to consider rulemaking that establishes an efficient, fair, inexpensive cloud-based means for resolving crowdfunding disputes.”

In late 2015 the SEC eventually issued crowdfunding rules that permitted use of arbitration, including predispute arbitration agreements, but required that arbitrations be conducted online in view of the relatively small claims involved and the fact that almost all disputes arose out of an online transaction.

Fueled by these developments, cloud-based ADR case filings in 2018 for the first time eclipsed paper-based filings. How did this happen?

- **The world was ready for cloud-based ADR:** It turned out ADR participants were ready for cloud-based ADR, and in fact led the charge. We got an inkling of this from the results of participant polls conducted during a webinar hosted the AAA way back in November 2013. Oh, and futurist George Friedman moderated the program, titled “ADR and Emerging Technologies.” The poll results had a consistent theme: parties, attorneys, arbitrators and mediators were ready to embrace cloud-based alternative dispute resolution and thought this was where the future was clearly headed. This one really happened. Really. Also, attorneys got encouragement from the federal judiciary when judges speaking at the “LegalTech New York 2014” event said that attorneys needed to get up to speed on technology and how it impacts the practice of law. When federal judges make suggestions, lawyers listen.

- **Hearings were mostly done online:** Again, why go to a hearing in person if you can do it online? Improved videoconferencing technology drove this change. Virtual hearing rooms were established in different cities so participants didn’t have to travel to a distant city. And, where party demand required that parties, counsel, and arbitrators all convene in the same physical place for a hearing, they conducted the hearing in a “wired” hearing room complete with Wi-Fi and 3D videoconferencing.

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This one actually happened in 2014 when FINRA was inundated by arbitrations in Puerto Rico resulting from bonds issued by the Commonwealth. The sudden influx of cases became a problem for FINRA because the local panel of arbitrators was not very large. As it had done in the past, FINRA imported arbitrators from nearby locations, but the logistical challenges became very difficult, and FINRA also turned to videoconferencing to conduct hearings.

- **Paper became passé:** As ADR providers expanded their online services for case filing, case management, document, image and video uploading, arbitrator selection, calendaring, and bill payment, fewer parties and arbitrators were willing to use paper. Eventually discounts were offered to parties using these systems, and by 2017 extra fees were assessed to those who insisted on using paper for correspondence or bill payment. Some Luddites sent letters of complaint, but they weren’t read because they were written on paper.

- **Mobile apps came to predominate:** Last, as phones will continued to continue to shrink in size and expand in functionality, the concept of a phone you hold in your hand became viewed as a transitional technology, just like what happened with fax machines. Just as the author predicted in 2014, phones came to be worn as wristwatches and the web streamed directly to “heads-up” displays on eyeglasses. And audio came with the glasses.

**Conclusion**

More than fifteen years ago, the author made the following prediction:

*For years, commentators have predicted that the future would bring the benefits of online technology to our paper-laden method of resolving disputes. The future, quite clearly, has arrived.*

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24 See Friedman, *supra* n. 3, at 716.
Trust me, the future belongs to those who embrace C-ODR, with the emphasis being on complete, comprehensive, online alternative dispute resolution. If you disagree, we can debate it five years from now!
ANALYTICS IN PROPERTY CASUALTY INSURANCE
PRICING AND UNDERWRITING

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Analytics in Property Casualty Insurance Pricing and Underwriting

I. INTRODUCTION

Analytics – “the patterns and other meaningful information gathered from the analysis of data” (Dictionary.com) – are nothing new in insurance. Some principles of actuarial science, in fact, date back to the 17th century. Analytics, however, have taken on a new significance in most large insurance companies in the past five years or so. Actuaries remain vitally important, but increasingly insurers are building analytical teams including a new breed of researchers and analysts – many with the title of “data scientist.” These teams use new technologies to discover patterns in massive quantities of data (“Big Data”), which in turn are used to build models to improve marketing, claims management, pricing and underwriting.

“Predictive analytics” and “predictive modeling” are the terms used to describe the processes behind these model-building exercises. Predictive analytics can be thought of as a system to calculate a score, based on a variety of weighted inputs, that represents the likelihood of some specific event or behavior occurring. Perhaps the best known example of predictive analytics is credit scoring, which weighs numerous factors to produce a single number that indicates how likely it is that a person pays his or her bills on time. The use of predictive analytics is a comparatively recent phenomenon in insurance, but predictive models have been used in other types of businesses for many years.

For insurance marketing purposes, predictive analytics can identify those insureds who are most likely to buy certain insurance products or to switch insurers. In the claims area, predictive analytics have been successful at flagging potentially fraudulent claims. Predictive analytics also have proved valuable in identifying optimal claims management strategies.

Pricing has traditionally been the domain of the actuary, but increasingly statisticians, data scientists and others are having a say in the pricing process. Predictive analytics can be an effective way to identify sub-segments that represent a greater or lesser probability of having a claim, enabling an insurer to more accurately price policies and capitalize on narrow market inefficiencies.

II. BIG DATA AND ANALYTICS

Big Data is the fuel that propels predictive analytics.

Historically, insurers relied on claims information and information from submissions to price and underwrite business. The largest insurers had enough information to do their own ratemaking studies, while the rest relied on the Insurance Services Offices (ISO) and other rating bureaus, which aggregated information from large numbers of insurers. This aspect of ratemaking was – and continues to be – the domain of the actuary.

Traditional actuarial techniques rely almost exclusively on structured numeric data. Other data within an insurance company, however, can provide useful information. Text information in inspection reports and claim examiner notes, for example, can provide new insights if they can be statistically analyzed and combined with other data sources. Additionally, insurers have discovered that various sources of external information may provide further insights into risk factors. These include scientific studies, social media websites, court records, regulatory filings and a wide array of governmental databases.
Monitoring and analyzing discussions on social media sites, for example, could give underwriters advance notice of products that are potentially problematic and likely to produce lawsuits.

Many of the potentially useful external data sources are very large and difficult to work with. This is the world of Big Data. Technology research firm, Gartner, in its IT Glossary, defines Big Data as “high-volume, high-velocity and high-variety information assets that demand cost-effective, innovative forms of information processing for enhanced insight and decision making.” Big Data can be structured data – the type of data contained in traditional databases for use by computers – or, more likely, it is unstructured data such as social media postings, news articles or court documents. Big Data also includes the output of digital sensors; audio data, such as recordings of customer service calls; and video data, such as images from security cameras.

In the past, organizations integrated various databases into what became known as a "data warehouse." In the world of Big Data, the operational term now is "data lake." A data warehouse stores structured information in a way that facilitates analysis and reporting using traditional information technology processes. A data lake, on the other hand, is a data repository that holds a vast amount of raw data – including unstructured data – in its native format until it is ready for analysis. Data lakes are made possible by vast and relatively inexpensive storage capacity, typically in “the cloud” – third-party data centers that typically rely on shared resources to achieve economies of scale.

Previously, enormous quantities of data – especially unstructured data – were not especially useful because the technology did not exist to make sense of it. Over the past decade, that state of affairs has changed dramatically. Google and Yahoo in particular, with their need to ingest and make sense of the entire Internet, were at the forefront of new technologies to analyze an enormous volume of information. Tools such as Hadoop, which enable the analysis of huge data sources, combined with technologies that convert unstructured data into structured data, have made possible the discovery of valuable information buried deep in previously impenetrable data sources.

III. DATA MINING, TEXT MINING AND PREDICTIVE ANALYTICS

The processes by which data is converted into useful information for predictive analytics are called data mining and text mining. Data mining analyzes structured data to discover hidden relationships that could be useful for predicting certain outcomes. Text mining creates structured data from unstructured data.

Text mining enables computers to make sense of information locked away in almost every type of digital text data source, whether call center notes, articles from scientific journals or news stories. At the core of text mining is natural language processing – the ability of a computer to derive representations of meaning from human language. Computers now can take in huge volumes of text, and through natural language processing and various statistical techniques, extract relevant data elements for analysis.

Data mining is the process of uncovering patterns within and among data sets. Data mining tools use a variety of artificial intelligence technologies to analyze data from many different angles to identify correlations. One of the earliest commercial applications of data mining was analyzing supermarket scanner data to identify buying patterns. In the world of insurance, one of the first and most successful uses of data mining was in flagging potentially fraudulent claims. Through data mining, certain factors, such as a claimant driving an unusually long distance to visit a chiropractor, were discovered to be frequently associated with insurance fraud.
Text mining and data mining uncover factors that are found to be correlated with a certain outcome. A predictive model calculates the likelihood of that outcome occurring based on the presence and prevalence of those various factors. In one model that scores the accuracy of an insurance application and its potential for fraud or rate evasion, nearly 100 different variables were identified through data mining and incorporated into the model’s calculations.

IV. PREDICTIVE ANALYTICS AND INSURANCE

Traditional actuarial models are a form of predictive analytics that have long been used in insurance. Actuaries compare claims data to various characteristics of policyholders to determine which characteristics are most predictive of claim frequency and severity. Age and sex, for example, have long been known to be meaningful factors for automobile insurance ratemaking. Young male drivers, as every parent of a teenage boy knows, are statistically more likely to have an accident than many other categories of drivers, and are charged a higher premium.

In recent years insurers have discovered that new analytical tools and techniques can be the basis of competitive advantages, setting off a race among the largest insurers to build teams with expertise in Big Data and predictive analytics. Continuing with the young male driver example, new analytical tools are able to more finely segment that broad category to identify which young male drivers are the better risks. In fact, by using telematics, which will be discussed later in greater detail, insurers are able to underwrite and price business based on the behaviors of individual drivers – how fast they drive and how frequently brake hard, for example – which greatly reduces the significance of a category such as “young male.” Consultant Towers Watson has shown that those personal auto insurers that are most sophisticated in their pricing capabilities materially outperform their competitors (Towers Watson 2011 Predictive Modeling Survey).

A 2013 survey by Earnix and ISO (2013 Insurance Predictive Modeling Survey) found that all insurance companies that write more than $1 billion in personal insurance use predictive modeling, as well as 69 percent of the smaller companies that took part in the survey. Insurers have been slower to adopt predictive modeling for commercial insurance – especially for large commercial risks – but the trend is increasingly towards the use of these tools for all lines. Some of the benefits of predictive modeling, according to survey respondents include profit increase (85 percent), risk reduction (55 percent), revenue growth (52 percent) and operational efficiency improvement (39 percent).

Predictive modeling is transforming claims management in forward-looking companies. In workers’ compensation, automobile liability, general liability, and medical professional liability, predictive modeling enables insurers to identify problematic claims soon after they are reported, and to quickly allocate the resources necessary to mitigate losses. Predictive models also are used throughout the lifecycle of a claim to identify emerging problems and to flag potentially fraudulent activity.

Other uses of predictive modeling in insurers include product development and marketing, where predictive analytics can help insurers tailor their product offerings to fit the needs of specific customer segments. In personal lines, for example, demand for certain products changes over time as consumers move through various phases of their lives. Predictive analytics can help identify new product opportunities, as well as up-selling and cross-selling strategies, as policyholders progress through their lifecycles.

A. Predictive analytics in pricing and underwriting
The Earnix/ISO survey found that the most common use of predictive analytics is for pricing, where 71 percent of respondents use predictive modeling either always or frequently. More precise segmentation is typically the goal. Within every rating class established by traditional actuarial ratemaking methodologies are better and worse risks. Insurers with the tools to differentiate among risks within a class will have a clear competitive advantage over those that do not.

In addition to better underwriting decisions and more precise pricing, predictive models can improve underwriting efficiency. Good risks can flow through the process with minimal underwriter involvement, freeing up the underwriter to address issues with poorer risks.

Telematics-supported usage-based insurance (UBI), another application of Big Data and predictive analytics, represents a new era in automobile insurance underwriting and pricing. Vehicle telematics, which involve devices that collect and transmit data about vehicle use and driver behavior, enable insurers to use true causal risk factors to more accurately assess risks and develop more precise rating plans. According to a Deloitte report on telematics (Overcoming speed bumps on the road to telematics), “the genie is out of the bottle. The industry as a whole is not likely to go back to relying only on its traditional methods of assessing auto risk.”

One of the challenges facing insurers in developing and deploying telematics-based programs is managing and analyzing the large amount of data produced by telematics devices. According to analytics company SAS in a report on telematics (Telematics: How Big Data Is Transforming the Auto Insurance Industry), 100,000 vehicles will produce roughly a terabyte of data each year. As the costs of data storage, and the technology for analyzing large quantities of data, fall, the number of insurers offering telematics-based programs is expect to grow.

Other forms of machine-to-machine communication also have the potential to improve insurance underwriting and pricing, as well as to enhance safety. The Internet of Things, in which sensors, computing and communications technology are integrated within everyday objects to make them more useful, undoubtedly will result in an abundance of valuable data. For example, home automation, or “smart home” technology – which enables consumers to automate such things as security systems, climate control, lighting and entertainment devices – is growing in popularity, and provides insurers the opportunity to use real-time data for risk assessment and loss prevention. Similar benefits can be attained for smart commercial buildings. Additionally, in the commercial realm, sensing devices connected to pressure vessels such as boilers, water systems, pumps, etc. can provide underwriters with real time information on changes in risk profiles, and can alert the appropriate individuals as problems are identified.

Other commercial insurance segments where predictive analytics already are having an impact on underwriting include cyber and products liability. In cyber insurance underwriting, models weigh an array of factors associated with network security and assign a score, similar to a credit score, which is indicative of how vulnerable a company is to a data breach. For medical device manufacturers, models provide underwriters insights into which products are most likely to fail.

One of the more sophisticated uses of predictive analytics for underwriting purposes – as well as for insurance company internal risk management applications – is identifying emerging risks. Text mining tools scour scientific studies, various government databases and social media sites searching for clues to potentially problematic substances and products. At the present, these tools are being used to identify
potential issues with medical devices, pharmaceutical products and chemicals, but they soon will be used to provide advance warning for a wide array of casualty risks. One leading vendor of this service has announced that the ability to “rigorously manage and underwrite more than 100 emerging risks from nanomaterials to fracking” is just around the corner.

V. BIG DATA, PREDICTIVE MODELING, PRIVACY AND DISCRIMINATION

Big Data and predictive analytics are transforming insurance underwriting and pricing, often benefitting policyholders as well as insurers. Not everyone is pleased, however, about the implications for privacy, or the possibility of inadvertently identifying rating factors that are unfairly discriminatory.

Privacy advocates are sounding warning bells about how much privacy is being sacrificed to corporate interests as companies amass, connect, and use personal information. As people conduct their lives online, data is captured and stored about websites visited, purchases made, queries searched, and messages and images posted on social media, among countless other activities. An enormous amount of information can be directly known about individuals and much more can be inferred. A study from the University of Cambridge, for example, demonstrated that race, age, and sexual orientation can be accurately determined by one’s Facebook likes. In one widely reported case, retailer Target used predictive analytics to determine which young female customers are likely pregnant, sometimes even before the women knew.

In the United States there is no single law that broadly covers the issue of privacy. Instead, at the federal level, there is a patchwork of more than 20 laws with privacy provisions. These laws apply primarily focus on three areas, healthcare, financial services and children. Most other types and uses of data are unregulated or fall into legal gray areas. Where companies often get into trouble over privacy issues is when they violate their own, voluntary privacy policies. According to the Federal Trade Commission, "When companies tell consumers they will safeguard their personal information, the FTC can and does take law enforcement action to make sure that companies live up these promises."

Even if a company’s use of Big Data a predictive analytics stays within legal boundaries, customers still may be displeased about how their data is being treated. Privacy advocates claim that it is in an organization’s best interest to provide full disclosure, both to cultivate goodwill and to avoid creating incentives for restrictive and burdensome privacy legislation. They also encourage data collectors to make it easier for customers to opt in or out of having their information used.

Beyond privacy considerations, refinements in pricing, underwriting, and marketing, which are enabled by predictive analytics, may result in significant regulatory challenges for insurers, particularly as concerns the well-established prohibition on unfair discrimination. Output from predictive models could result in “digital redlining,” which disproportionately, though perhaps inadvertently, affects protected classes. According to a White House Report (Big Data: Seizing Opportunities, Preserving Values), "big data could enable new forms of discrimination and predatory practices.”

The use of credit scores for underwriting is illustrative of the types of challenges insurers face. Credit scores were found to be highly valuable in insurance pricing, but their use had an adverse impact on minorities. Consequently, prohibitions or limitations on the use of credit scores for personal lines insurance pricing purposes are now common.
In some cases, predictive analytics is being swept into prohibitions on “price optimization,” a controversial practice of basing rates in part on factors not related to a customer’s risk profile. A concern is that predictive analytics is being used to identify price sensitive policyholders, with insurers varying premiums by the likelihood of a policyholder defecting to a lower cost competitor. The California Insurance Commissioner, for instance, issued a notice announcing that “any use of price optimization in the ratemaking/pricing process or in a rating plan is unfairly discriminatory in violation of California law.” The notice defined price optimization as “any method of taking into account an individual’s or class’s willingness to pay a higher premium relative to other individuals or classes.”

VI. THE FUTURE OF ANALYTICS IN INSURANCE

According to Towers Watson, “the most significant “push” factor by far for predictive models is increased competition” (The Future of Predictive Modeling: Man versus Machine?). Sophistication in predictive analytics will continue to grow in significance as a competitive differentiator. Those personal lines insurers that are most adept at using predictive models already have been shown to outperform their competitors. Most likely a similar story will emerge as more companies apply these tools to commercial risks. The race to build expertise in Big Data and predictive analytics among insurers is likely to intensify.

Predictive analytics are not the end of the story, however. Some analysts see cognitive computing as the next major technological advance in insurance underwriting. Cognitive computing technologies emulate human thought processes, but with the ability to ingest and analyze vastly more data than humans are capable of. IBM’s Watson, a computer that soundly beat two human Jeopardy champions in a 2011 competition, is perhaps the best known example of cognitive computing. At least one vendor is already advertising a cognitive computing product for underwriting.

Increasing technological sophistication does not take place in a social, legal or regulatory vacuum. Addressing privacy and other concerns, while maximizing the potential opportunity, will be a continuing balancing act. New technologies and new techniques of underwriting and pricing will be especially challenging for regulators, who are charged with assuring that insurance rates are adequate, but not excessive or unfairly discriminatory. In the past, ratemaking methodologies evolved slowly – in part because of the conservatism of regulators. Fast evolving technologies and a highly competitive environment, however, make rapid change inevitable.
3000 YEARS OF WORLD WIDE WEB:
THE MECHANICS AND EVOLUTION OF THE INTERNATIONAL MARITIME LEGAL ENVIRONMENT:

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Alexander von Ziegler has authored numerous publications in his fields of specialization. He has served as Secretary General of the International Union of Marine Insurance (1992-1997) and Secretary General to the Comité Maritime International (1996-2003). He continues to hold posts in many national and international organizations, including as member of the Executive Counsel of the Comité Maritime International (since 2013). He was also a member of the Swiss delegation at UNCITRAL tasked with creating a new Transport Convention (Rotterdam Rules).

After graduating from the University of Zurich School of Law in 1981, he obtained a Master of Laws from Tulane University, New Orleans (maritime law program, LL.M. in Admiralty) in 1984. He was admitted to the bar in Switzerland in 1988 after joining Schellenberg Wittmer that same year, and became a partner in 1993. Since 1990 he has been lecturing at the University of Zurich, where, in 1999, he became Associate Professor (assistant professor) and in 2005 Professor (titulary professor) for International Trade Law where he teaches transport, trade and insurance law.
I. THE MECHANICS OF INTERNATIONAL TRADE, COMMERCE AND MARITIME TRANSPORT

Umpteen thousand goods are bought and sold, packaged, consolidated, shipped, unloaded, cleared through customs, stored and delivered every day. Umpteen thousand transport documents, packing lists and insurance certificates are processed in the documentation departments of banks every day. Umpteen thousand goods are transported in a never-ending transport flow from one point on the globe to another, placed in the retail trade or processed and then sent back on a journey round the world again in a different shape or form.

This is the world of international trade and commerce. What appears superficially to be chaos turns out to be a cleverly thought-out system. Since the business of trade and commerce extends across the whole world, it needs a uniform standard which must also be embodied in law. How should this be done? What are the particularities of such a standardization of the law of international trade and commerce?

In attempting to answer this question, I should like to use the term of "law of trade and commerce" for describing those legal relationships under private law which the parties involved in overseas trade use for the execution of an international export or import transaction. Trade law is not, therefore, an independent field of law in the proper meaning of the word, but a special and specially developed part of the legal everyday life of international trade. It comprises the phenomenon of international trade in goods under private law.¹

I will, furthermore, deal with "harmonization" in the field of trade law and more specifically "maritime" law. We use the term "harmonization" broadly so as to also cover all instruments aimed at achieving a certain uniformity of law. Thus we are speaking, on the one hand, of uniform law in the form of the international conventions, but, on the other hand, also of the alternatives, such as model laws, uniform customs and practice and pre-formulated standard clauses, which are all aimed at the standardization, alignment or harmonization of the law.²

Every simple trade transaction involves a large number of legal relationships which repeatedly involve international points of contact and continuously interact with one another. Trade law deals with the legal side of such transactions, in particular with the following four legal transactions:

- The international sale of goods and, in particular, the special features of a sale in which goods are transported to a destination according to the seller’s or the buyer’s instructions (depending on the agreed delivery system³ and the trade terms⁴ chosen by the parties);
- The contracts of carriage and the legal relationships with the various carriers⁵ and

¹ This in contrast to the broader term “trade law”, which also comprises the legal environment created and governed by national, regional and international trade agreements regulating, as a matter of public law, the level of freedom of trade.


⁴ See, e.g. the trade terms FOB (free on board) and CFR (cost and freight) pursuant to INCOTERMS 2010 (ICC Publication No. 715, Paris 2010).

intermediaries used for the logistics involved in transportation;

- The **financing** of the sale of goods and payment of the price by means of a documentary letter of credit, and also
- The **transport insurance contract**, i.e. insurance against the risks of damage or loss of goods during transport.

Each one of these legal transactions is, naturally, international. This alone suggests that attempts at legal standardization in the field of trade and commerce law are bound to occupy a very special position.

Each of these transactions involves the use of a vessel, the call of ports and usage of terminals, each involving a great number of very diverse legal relationships, contracts and extra-contractual exposures. Each vessel sailing the seven Seas of this globe is flying her own flag and with this subject to its own foreign legal system, travelling waters of multiple other jurisdictions and the High Sea. At the same time, each and every such legal relationship must obey one immanent and inherent requirement: the legal structure must, to the greatest level feasible, be harmonized so that the legal basis supporting the transaction will not in itself create unnecessary frictions; frictions which will melt away every margin otherwise available to the different industries involved in this amazing coexisting and interwoven global trade system.

To create and preserve this legal standardization and to adapt it to the increasingly rapid developments of the economic and technological environment is of vital importance for world trade and, therefore, for the whole global economy. In standardizing this body of law, it is important to ensure that the harmonizing instrument produced lives up to these special standards and particularities and satisfies the special requirements of legal everyday life of all participants in the business of international trade.

And, in view of the overall topic of our gathering, i.e. "Staying Ahead of Accelerating Changes and Emerging Issues", this task of creating and preserving harmonized legal structures will become more and more difficult considering the pace at which developments are flooding our universe, while at the same time a growing net of all manner of national, regional or global regulations is creating invisible barriers to the way business is conducted. While the first 2'850 years of the "word wide web" of overseas trade could almost be considered the 8th wonder of the world and stood apart from otherwise quite archaic legal developments domestically, today - with the explosion and revolution of technical possibilities, with the worldwide tidal wave of globalization and the accelerating development of international legal principles, the development and adaptation to the new challenges will increasingly pose a huge challenge to the international trade and maritime law community, i.e. the involved industries, the law-making community, the international organizations but also the domestic political institutions.

II. **THE MECHANICS OF LAW MAKING IN INTERNATIONAL MARITIME LAW**

A. **Starting Point**


6 **Uniform Customs and Practice for Documentary Credits**, 2007 Revision (UCP 600); ICC Publication No. 600, Paris 2007.

7 Marine Insurance contracts have been standardized, at least within the national markets, and traditionally follow the principles set out in the terms established by the London market: Institute Cargo Clauses. F.D. Rose, *Marine Insurance: Law and Practice, 2nd ed.*, London 2012, p. 120 and pp. 703-733. H.J. Enge, *Transportversicherung, 2nd ed.*, Wiesbaden 1987, p. 34.
and commerce has constituted a transcultural phenomenon since times immemorial.\textsuperscript{8} We have traces of such harmonizing transcultural law making dating back 3'000 years. This is in contrast to most other fields of law, which have been developed primarily as an internal (tribal and later national) regulatory structure, which largely regulated internal circumstances for a particular political entity.

The law of trade and commerce in ancient times, which is often described as "lex mercatoria" or, with regard to maritime law, as "lex maritima", always concerned transnational circumstances and naturally developed into separate, independent transnational law largely standardized by trade practice. It left behind traces in Greek and Roman law and in the collections of court rulings of the most important trading centers in the Middle Ages across the Mediterranean and the Atlantic up to the Baltic.\textsuperscript{9}

As a separate law independent of national law, trade law also survived various radical changes in the world order. As an autonomous separate law, its development was quite independent from the various developments in general law within the different legal systems.

A turning point came about with the important national codifications of the 19th century.\textsuperscript{10,11} These comprehensive national legislations achieved \textbf{national} harmonization of law in the field of domestic law. At the same time, however, they destroyed the autonomous and international development of trade and commerce law as a transcultural separate law because the major legislators of the 19th century also included the principles of the so called "lex mercatoria" into their national system of law. This nationalistic trend deprived world trade of the chance to satisfy its intrinsic need for \textbf{international} harmonization and unification.

Against this background, it is hardly surprising that a massive movement towards unification of laws was unleashed precisely in the area of trade law - just at a time when, in the rest of private law, the development of law was regarded as a \textbf{purely (internal) governmental} matter and hardly any thought was given to international harmonization.\textsuperscript{12}

As stated already, the situation was different with trade law, which, with standardization (or more precisely, re-standardization) could draw on the familiar, internationally tried, tested and accepted unified substantive law. It is, therefore, not surprising that the unification efforts were able to \textbf{concentrate} directly and solely on \textbf{substantive law}. This very special starting position explains why it was not necessary to follow the route of the internationally standardized conflict-of-law rules preferred for the standardization of the rest of private law.\textsuperscript{13} Nor could the uniform conflict-of-law rules have met the special needs of trade and commerce, for it is not sufficient for a businessman in a multi-international interlocked transaction to know when which law will be applied. To overstate the argument, for the players of world trade, the application of national laws involved in a particular transaction is mere chance and can only play a subordinate role in the strong need for logistical and legal standards.\textsuperscript{14} Only a truly standardized law (i.e. uniform substantive law) will bring about the expected and needed level of predictability in the legal environment in which the transaction will be conducted. Trade law thereby becomes the prototype for an area of law to be unified on an international scale, since trade by definition operates in a truly international (and even multi-international) sphere frequently using the same pattern\textsuperscript{15} while facing the probability of

\textsuperscript{8} See, e.g. R. Wagner, \textit{Handbuch des Seerechts} (Leipzig 1884) vol. I, pp. 55 et seq.
\textsuperscript{11} A paramount example is the astonishing work of J.M. Pardessus in his "\textit{collection de lois maritimes antérieures au XVIII siècle}" (Paris 1828 - 1845), which formed part of the basis for his contribution to the French Code de Commerce.
\textsuperscript{12} R. Goode (supra n. 11) p. 54.
\textsuperscript{13} R. David (supra n. 11) at p. 141.
\textsuperscript{14} Ibid, p. 11: "National legal systems are ill-fitted to govern international relationships".
\textsuperscript{15} Underlying sales contract with various interfaces to separate contracts of carriage, letters of credit and transport insurance.
being brought before a variety of national courts.¹⁶

B. Need for Unification and Harmonization of Commercial and Trade Law

A further important particularity of trade and commerce law is the special need and objectives for harmonization. The harmonization and unification of law outside the particular field of trade law basically starts with the need of various countries for improved governmental co-operation, if not co-existence or even political integration. By contrast, the starting point for the harmonization or unification of trade law¹⁷ is always to be found in the “materialistic” and “pragmatic” yearning of people involved in trade for standardized and efficient rules. Trade presupposes unified rules which make the transaction and any potential problems predictable (i.e. calculable). These standards achieved by the internationally unified rules remain identical, although for each transaction of the same kind, different legal systems are affected on a case by case basis. Despite what one might think, trade law is not created by cosmopolitan minds, but is generally inspired by the naked need and yearning for an efficient unified standard under which the trade transactions can be performed as efficiently (and as profitably) as possible.¹⁶ The stronger and the more relevant a particular obstacle is, the more this issue will form the nucleus for further unification.¹⁸

All too often, artificial “needs” are “created” by those who advocate in favor of a new harmonizing instrument for reasons other than pure and pragmatic trade efficiency. To embark on such projects is dangerous, since due to the lack of sufficient support by trade and industry, the instrument will probably face problems of acceptance in all the stages from creation to ratification.²⁰ Despite the immense number of transactions, one scarcely resembles another. The ever-decreasing profit margins of world trade necessitate the smooth and efficient execution of not only the logistical, but also the legal processes. Any uncertainty and any loss of smooth coordination affect profit adversely and, therefore, undermine the mechanism of world trade.

C. Substance of Uniform Law

Once the particular starting point and need for unification and harmonization are identified, it is possible to comprehend the particularities as regards the substance of the uniform law. The most successful tools in the area of trade and commercial law are not legal masterpieces, but sometimes extremely pragmatic documents. These tools for the standardization of law solve the practical problems according to the principle of “functionality” rather than by trying to harmonize the different legal traditions dogmatically.

A good example of this pragmatic approach can be found in the INCOTERMS²¹ (especially the pre-1990²² versions). The International Chamber of Commerce started to collect different forms of

¹⁶ R. David (supra n. 11) p. 38.
¹⁷ R. Goode (supra n. 11) pp. 54 et seq.
¹⁸ This materialistic approach is quite different from attempts by scholars and international organizations such as UNIDROIT to re-gain uniformity in the field of commercial law by re-formulating principles as a “quasi jus commune”. R. David (supra n. 11) p. 17. Products of that kind are the “Principles of International Commercial Contracts” prepared by UNIDROIT (third edition adopted in 2010) or the ”Principles of European Contract Law (PECL)” whose parts were published in 1995, 1999 and 2002.
¹⁹ R. Goode (supra n. 11) p. 56.
²⁰ One example are the Hamburg Rules of 1978 which, due to the lack of trade support, have never achieved uniformity.
²¹ International Commercial Terms; published by the International Chamber of Commerce (ICC), currently in the version of 2010 (supra n. 5).
²² The revisions after 1980 (i.e. in 1990, 2000 and 2010) were conducted with a great emphasis on creating systematic standard contractual rules, rather than with a view to collecting in a pragmatic way and without ambitions for systematic beauty the usages and customs of the trade applied to trade terms used by international commerce.
interpretation of the different “trade terms” back in 1930. These have led to today’s pre-formulated standard clauses with which the parties to the contract of sale can define the issues involved in an overseas sale. A further example is the seemingly strangely fragmented structure (at least strange to Continental-European eyes) of the Hague Rules of 1924, which merely standardize certain aspects of the law of carriage of goods by sea. In doing so, they have adopted a format of a model bill of lading insofar as the text of the Convention has been written as if it were a standard text of contractual terms for bills of lading.  

In addition, the interlocking of the different legal relationships of a trade transaction means that harmonization is achieved not only on an international level. Beyond that, it is necessary to also strive for harmonization of the interdisciplinary interfaces between the individual legal relationships. The interdisciplinary role of the bill of lading is mentioned here as an example. The bill of lading is known chiefly as the documentation of the contract of carriage and, in addition, assumes the role of an acknowledgement of a receipt of goods and a certification of claim to delivery of said goods at the place of destination. In addition to its original function, in case of sale (e.g. according to INCOTERMS FOB / CIF) the bill of lading also takes on the function of proof of delivery in accordance with the law relating to the sale of goods (with respect to time, quantity and quality). This sort of sales transaction can be repeated countless times with the same bill of lading (i.e. the one and only contract of carriage) in a series of purchases (string sales). In the documentary credit relationship, the same document has the function of triggering payment by the bank and constitutes to a certain extent the collateral security for the trade financing. This interdisciplinary role of the bill of lading explains the special importance of the harmonization of law in this field.

The necessity for unification and interdisciplinary harmonization has recently been recognized by UNCITRAL in the context of its work on the Model Law on Electronic Commerce. A new project that the Comité Maritime International (CMI) had embarked on under the auspices of UNCITRAL may be the best example of an instance in which this interdisciplinary approach was followed. This project concerned a harmonizing exercise which attempted to lay down principles for the law on international transportation which could clarify the various interfaces between the sales contract and the contract of carriage of goods by sea. This exercise, first in the hands of the CMI, then, once a draft was completed, of UNCITRAL, led to a UN Convention on Contracts for the International Carriage of Goods Wholly or Partly by Sea, or what is today referred to as the “Rotterdam Rules”. At the same time it solved a multitude of challenges that modern trade and transportation had to tackle. First and foremost, the harmonization of the law on Carriage of Goods by Sea, initially achieved in 1924 in form of the very successful Hague Rules, was threatened due to the lack of responsiveness and agreement on how to update this body of law on an international level. Many national governments or regional political entities were preparing updated legislation on national or regional levels. Those initiatives would have destroyed a harmonized regime for this crucial element of law, had they all be un-responded by an international answer to the need of reform. The revised regime (including a modernized liability regime and the recognition of electronic commerce) now offers governments a very sustainable and well balanced alternative to individual national solutions. Further, and in my opinion of equal importance, the Rotterdam Rules have safeguarded that all the interfaces to the many other trade

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23 It is interesting that as a result of protest in particular by delegations of Continental-European countries, a Protocol of Signatures to the Hague Rules made clear that the Contracting States were free to incorporate the substance of the Hague Rules in an appropriate form into their own national legislation.

24 These “string sales” are found primarily in trade with commodities.


contracts (sales and purchase / finance and letter of credit, / pre- and post- carriage) were properly
dealt with and that solutions could be found that mirror not just the interests of the parties to the
contract of carriage but also of third parties who rely on those terms and in particular on the
documentation (i.e. Bill of Lading)\textsuperscript{29}.

III. METHODOLOGY AND PROCESS OF THE HARMONISATION AND UNIFICATION OF LAW

If these special features are combined, it is hardly surprising that the standardization of trade law
can largely be attributed to \textit{private initiatives}, to \textit{private preparatory work} and to the project
management of \textit{private, non-governmental international organizations} (International
Chamber of Commerce, Comité Maritime International, International Law Association, IATA)\textsuperscript{30}. In
contrast, success was not forthcoming where inter-Governmental organizations dispensed with
this private cooperation. On the contrary, such attempts led to a regrettable dissipation of the
previously standardized law. A supreme example of such a failure can be seen in the Hamburg
Rules of 1978\textsuperscript{31}, with which UNCITRAL and UNCTAD attempted to create in the area of maritime
transportation law a mostly politically motivated rival regime to the Hague Rules which had - in
turn - come into being through private initiative and preparation.

The co-operation of non-governmental international organizations is of vital importance even when
drawing up Conventions.\textsuperscript{32} The Comité Maritime International (CMI) is to be mentioned primarily
in this respect. The CMI has been promoting the unification of maritime law for more than 100
years.\textsuperscript{33} The organization has drafted and passed a total of 35 maritime conventions or protocols
to date at diplomatic conferences held by the Belgian government and subsequently
by UNCTAD and the International Maritime Organization (IMO).\textsuperscript{34} This permanent position and
function in the global process of harmonization of maritime law deserves a special analysis which
follows in a separate chapter.\textsuperscript{35}

The interest of trade and commerce in a logistical and legal harmonization also
explains why many fields of international trade law can be harmonized successfully to-
tally without government participation. There is a broad range of alternatives to the
Convention as a type of harmonizing instrument, even to the model law\textsuperscript{36}. One prominent example
is the collection of uniform principles which are applied by the parties as a matter of contract law
(Uniform Rules; Standard Clauses/Terms)\textsuperscript{37}. Examples are the INCOTERMS of the International

\textsuperscript{29} A. Von Ziegler, \textit{Rotterdam Rules and the Underlying Sales Contract}, in CMI Yearbook 2013, page 273 et seq.
\textsuperscript{32} This fact was clearly confirmed at the ICC/ Unidroit Symposium (18 January 1997) in Rome, where a number of
international (non-governmental and inter-governmental) organizations discussed the methods, the co-ordination and
the collaboration in the process of harmonization of commercial law: ICC/UNIDROIT, \textit{The Harmonisation of Commercial
Law} (summary record of meeting).
\textsuperscript{33} F. Wiswall, \textit{Comité Maritime International, A Brief Structural History of the First Century} (Maine 1997); F. Berlingieri,
Ziegler (supra n. 2) pp. 728 et seq.
\textsuperscript{34} For a list of the CMI Conventions see e.g. A. von Ziegler (supra n. 2) pp. 742 et seq.
\textsuperscript{35} It is interesting to note that the Principles of International Commercial Contracts prepared by
UNIDROIT in 1994 are quite distinct from the harmonized commercial law referred to in this article:
The need for such “principles” was not defined by trade but by academics; the method did not include a review of the
actual pragmatic needs and actual practice of trade and the instrument was drafted without
the close involvement of trade. This explains why this body of law, however interesting - and eventually

\textsuperscript{36} Regarding the alternative to conventions in form of Model Law see, e.g. S. Lebedev, “Legislative means of unification”,
\textsuperscript{37} See, in general, M.J. Bonell, “Non-legislative means of harmonisation”, in: \textit{Uniform Commercial Law in the Twenty-
Chamber of Commerce\textsuperscript{38}, which are applied world-wide today and form a recognized collection of standardized trade terms for application in international sales of goods. The same global recognition is enjoyed by the Uniform Customs and Practice for Documentary Credits (UCP 600)\textsuperscript{39}, also of the International Chamber of Commerce, without which the financing of world trade would be inconceivable today. Another, rather ancient, example for the unification of law by private instrument is to be found in the York Antwerp Rules\textsuperscript{40} relating to the principles on general average, which are universally applied and have sometimes even been introduced ‘as is’ into national codification.\textsuperscript{41}

This harmonization on a private and completely voluntary basis is explained by the fact that the trade sector is not only the “initiator” of the harmonization process, but also the “creator” of the standard rules as a result of its direct influence in the non-governmental organizations (ICC / CMI). Even more importantly, the same trade sector is also the “user”, who relies on this internationally recognized legal standard when executing various transactions. This personal union of “initiator, creator and user” ensures that the standard rules are followed by the trade sector and - as a consequence - adapted whenever it as user- is initiating a revision.

As long as it is possible to mobilize experts and practitioners from the different branches of trade in this process, trade law is guaranteed to continue to develop pragmatic and just standards on an international level. Only thus can it be ensured that harmonization will do justice to the special features and particularities of international trade and commerce.

IV. FURTHER DEVELOPMENT BY MEANS OF REVISION AND PROTOCOLS

Trade law, on the one hand, is a conservative body of law. It is conservative in that it can only either grow at the same pace as there is a (recognized) need for innovation worldwide or develop in line with an internationally recognized development of trading practice. On the other hand, trade law would suffocate without a certain dynamic.

The knack is to ensure that trade law develops more or less consistently world-wide, so that legal harmonization, once successfully achieved, is not lost. It is very important that the revision process not be carried out in the same euphoria of (re)-unification as happened at the beginning of the century. Existing uniformity is a very valuable “commodity” and should not be challenged without real cause and need by adding protocols or by revising the instrument.\textsuperscript{42} The great number of under-ratified and under-recognized instruments of “second generation” proves that the balance of interests (unification - dynamism) has often been misjudged by those entities undertaking the revision.\textsuperscript{43}

This explains why there has been an extremely pragmatic approach towards trade and maritime law to date, especially as regards revision proceedings. The “protocols” or revisions are thus often reactions to specific “surprises”. By this, I mean, for example, unforeseen Court decisions or the monetary or technical development of the environment in which trade is conducted.\textsuperscript{44} As a result the protocols are quite often “ugly” harmonizing instruments which surround the “mother

\textsuperscript{38} INCOTERMS 2010 (supra n. 5).
\textsuperscript{39} UCP 600 (supra n. 7).
\textsuperscript{40} Latest Revision dated 4 June 2004.
\textsuperscript{41} See, e.g. Art. 122 Section 2 of the Swiss Maritime Code referring - as a matter of national law – to the private codification of the law on General Average as harmonized by the CMI as York-Antwerp-Rules in their current version.
\textsuperscript{42} A. von Ziegler, Alternatives and Methods of Unification or Harmonisation of Maritime Law (II Diritto Marittimo 1999) pp. 235, 238.
\textsuperscript{43} As the most recent example, I would like to mention the revisions of the INCOTERMS 2000 and 2010, which addressed only minor points, most of which were neither points of great practical importance, nor offered any actual improvement to INCOTERMS 1990, nor solved major problems raised under the application of the INCOTERMS 1990.
\textsuperscript{44} See e.g. A. von Ziegler (supra n. 40) pp. 232 - 239.
convention" like satellites. Where the revisions are tackled for political or academic proposes, the process of harmonization risks coming into conflict with the original need of trade and commerce: the need for efficient and predictable harmonization of the legal processes in the international and interdisciplinary environment of trade and commerce. Both the INCOTERMS for the sales contract and the maritime law under the Hague Rules face this challenge today. Both have just been revised. In both projects, trends can be seen which conflict with this basic need for a pragmatic and reality-focused approach, for motives which until now were alien to trade law. It is all the more important that any further harmonization or unification of the law do justice to the special features and particularities of international trade law.

V. THE WORK OF THE COMITÉ MARITIME INTERNATIONAL (CMI) IN PARTICULAR

A. A BRIEF HISTORICAL OVERVIEW

The origins of the Comité Maritime International (CMI) can be traced to the early 1880s, when a group of Belgian politicians and traders first introduced to the International Law Association (ILA) the idea of codifying what were considered at the time the customs of international maritime trade (/ex maritima) in the form of uniform international law. This quite ambitious idea was tested at two diplomatic conferences organized under the auspices of the Belgian Government, in 1885 and 1888. However, both diplomatic conferences failed to produce such an international law, and as a result the ILA withdrew from further involvement in the unification of maritime law. This is the background to the foundation of CMI, which was formally created in Brussels in June 1897, as an association subject to Belgian law and with an initial membership of eight National Maritime Law Associations.

The Belgian origins of CMI as well as the experiences of the first two diplomatic conferences in Brussels of 1885 and 1888 laid the foundations for a long-standing partnership between CMI and the Belgian Government, a co-operation which has led to a number of so-called Brussels Conventions in the field of maritime law. After almost 70 years of very successful diplomatic conferences held in Brussels, the international law-making process was changed with the founding of the Legal Committee of the International Maritime Organisation (IMO) in 1968, as a result of the oil pollution caused by the "Torrey Canyon" accident. From then on, the IMO took over from the Government of Belgium as the host organization for diplomatic conferences in the field of maritime law. As a result, CMI's role underwent some change, but it continued nevertheless to be the preparatory body for a number of draft conventions submitted to IMO and also to UNCTAD, including the 1993 International Convention on Maritime Liens and Mortgages and the Draft International Convention relating to the Arrest of sea-going ships (which was submitted to a Conference in late 1998).


See, generally, the list of the Brussels Conventions under III(a) below. The last "Brussels Conventions" were the 1979 Protocols to the Hague Rules of 1924 (SDR Protocol) and to the Limitation of Liability Convention of 1957. CMI Yearbook 2014, pp. 475 and 493.

See F. Berlingieri, op. c/t., pp. 1264-1266.

The first IMO Convention was in response to the "Torrey Canyon" disaster, namely the International Convention on
Since its creation in 1897, CMI has operated under its Constitution, which has been revised several times over the hundred years of its existence, most recently at the Genoa Assembly in 1992. 49 Under this revised Constitution the ruling body of CMI is the Assembly which, among others, elects the officers of CMI. The President 50 of CMI presides over the Assembly, the Executive Council and the International Conferences and is assisted by a Secretary-General, 51 a Treasurer and an Administrator, who is responsible for the CMI offices in Antwerp. The President of CMI is also Chairman of the Executive Council which, in turn, is comprised of two Vice-Presidents and eight Executive Councilors. In appointing members of the Executive Council, all nominated by the Nominating Committee for election by the Assembly, great care is taken to ensure that the international nature of CMI is reflected by representation from almost all continents. In addition to this policy, the CMI Constitution of 1992 has further established a clear term of office for all positions, enabling proper rotation and securing widespread representation of members as officers of CMI.

Under the CMI Constitution, membership is restricted to national maritime law associations which are formed under the applicable laws of the member countries. CMI currently has a membership made up of 55 such associations from all over the world. Thanks to the diversified and highly qualified membership within each national maritime association, CMI is able to draw on very substantial "human resources" and expertise within its own ranks. As well as recognizing the actual membership of national maritime associations, CMI also recognizes Titular Membership for individuals appointed by the Assembly upon the proposal of the associations concerned. The appointment is an honorary one and is made in recognition of services rendered to CMI by the candidates and of their reputation in legal and maritime affairs. In addition, Titular Membership can be extended to individuals in countries where the establishment of a maritime law association is underway but not yet complete. In 1992, a new category of membership was created in view of the changed environment in which CMI finds itself. For some years now, the harmonization process has been dependent on direct dialogue and strong co-operation links between international non-governmental and inter-governmental organizations. CMI has therefore established Consultative Membership, which is extended to international inter-governmental and non-governmental organizations, 52 and which should help to ensure ongoing and regular in-depth dialogue among the organizations, thereby assisting the overall efforts of the international community to harmonize areas of maritime and trade law. CMI in return enjoys Observer or even Consultative Member Status with other International Organizations, most prominently so with the United Nations.

B. THE ROLE AND WORKING METHODS OF CMI

1. Working Method under the CMI Constitution

The CMI Constitution states that its objective is to contribute by all appropriate means and activities to the unification of maritime law in all its aspects. A great number of international

49 See CMI yearbook 1992, pp. 6-23.
50 The President of CMI is elected for a full term of four years and is eligible for re-election for one additional term. In general, the duty of the President is to supervise the work of the International Subcommittees and to ensure the continuity and development of the CMI’s work (Art. 9 CMI Constitution).
51 Pursuant to the Constitution (Art. 11), the Secretary-General is responsible for the non-administrative preparations for International Conferences and Seminars convened by the CMI and for maintaining liaison with other international organizations.
52 See CMI Yearbook 2014, pp. 138-141. Today CMI recognizes 23 International Organizations, of which two are inter-governmental bodies, as Consultative Members.
conventions were created under CMI auspices in fields such as collision, salvage, limitation of liability, bills of lading and maritime liens. Until recently, CMI was primarily concerned with issues related to private maritime law, as was also reflected in the CMI Constitution until 1992. In 1992, the Constitution was amended to include "the unification of maritime law in all its aspects", thereby expanding CMI's scope of action and involvement beyond the boundaries of private maritime law.

The Executive Council appoints Working Groups to deal with issues that it believes are worth pursuing. Based on the report of the Working Group, the Executive Council establishes a CMI-International Sub-Committee to which every national association which is a member of CMI can appoint a delegate. The Sub-Committee prepares a draft document and reports to the Executive Council and the Assembly. It is at this stage that a preliminary decision is taken as to the form of the instrument to be prepared (Report, draft Convention, Standard Rules, Model Law, Legal Guidelines, etc.). The International Sub-Committee finally draws up a report for the Assembly and a draft instrument which is the subject of further discussion during an international CMI Conference.

During the CMI Conference, the participants discuss the instrument and make final adjustments and amendments. In a Plenary Session at the end of the Conference, the outcome of the work of the International Sub-Committee is discussed and voted on by the delegations of the respective national Maritime Law Associations represented at the Conference. It only becomes an official CMI document after it has been approved by the Assembly, usually following a CMI Conference. Thanks to this procedure a number of compromises can be reached on different levels. Since CMI membership is drawn chiefly from circles focusing on commercial issues (representatives of the maritime industry, maritime lawyers, academics in the field of maritime law), accepted commercial interests involved are represented during this procedure. This guarantees that the end product of a CMI Conference is usually already the outcome of a compromise, at least within the relevant commercial circles.

An International Sub-Committee remains in existence only until it has completed its task and submitted a final report to Executive Council. It is usually dissolved when the prepared instrument is adopted. This means that CMI does not have permanent International Sub-Committees, the only exception being its permanent European Section (Euro section).

A new procedure is a consequence of the changed environment in which international harmonizing instruments are adopted these days. During the first part of the century, CMI submitted its draft documents directly to the Brussels diplomatic conference and as a result its impact on the law-making process was direct. Today, the draft conventions prepared by CMI are submitted to intergovernmental organizations active in the field of maritime and trade law, primarily the International Maritime Organization (IMO), the United Nations Commission on International Trade Law (UNCITRAL) and the United Nations Commission on Trade and Development (UNCTAD). These intergovernmental organizations then initiate the consultative and preparatory work in accordance with their own working methods and following their own principles and constitutions. At this stage, as during the actual diplomatic conference, CMI offers valuable assistance to the conference and to the host organization. This new form of activity has led to increased cooperation within the international organizations which is becoming increasingly important and is greatly appreciated by CMI.

The resources on which CMI is able to draw through its national member associations are extremely important when it comes to drafting international harmonizing instruments and its resources and know-how can also be made available to help other international organizations in
their work. The most recent example of this type of support is the involvement of a CMI representative in UNCITRAL's work on Electronic Commerce (EDI) and, to some extent, in Unidroit's work on International Interests in mobile equipment.

2. Choice of the harmonizing instrument (convention, model law, contractually incorporated rules, legal guidelines, principles of conduct, etc.)

Since CMI is a non-governmental organization dealing almost exclusively with private law aspects of maritime trade and shipping, the primary aim of the regulations prepared under its auspices is the unification of maritime law for the benefit of efficient, safe - and therefore prosperous - international commerce. Harmonization and, to some degree, uniformity are a commercial necessity on which trade has depended since the birth of commerce and on which it continues to depend today, as it will in the future.

When choosing the relevant harmonizing instruments, CMI always bears in mind the needs of commerce. It asks itself which harmonizing instrument is likely to offer the higher degree of legal certainty, the greater efficiency and brings to commerce a fair and balanced legal basis for the transaction contemplated under the regulation. While attempting to answer these questions CMI might consider the following points: Is a uniform regulation necessary? Is it sufficient in a given situation for the legal situation merely to be harmonized (e.g. in the form of Model Laws) rather than to establish a uniform law (e.g. in the form of a Convention)? What is the degree of urgency? Are the regulations likely to find sufficient political support? Are the interested parties likely to incorporate uniform rules on a voluntary basis and will this be sufficient? Will the necessary uniformity only be achieved by imposing compulsory mandatory rules?

Depending on the answers to the above questions, it is possible to choose the nature of the harmonizing instrument and to define the outcome to be pursued by CMI. In its work so far, CMI has chosen the following harmonizing instruments: (draft) International Conventions and Standard Rules (to be incorporated into contracts), as well as Legal Guidelines or Principles of Conduct.

a. (Draft) International Conventions

In the past, international conventions were the main technique used by the international community for the purpose of unifying the law. It will therefore come as no surprise that until World War II, almost every harmonizing instrument prepared by CMI was a convention. CMI always chose to harmonize and regulate the substantive law and considered it sufficient to adopt unified conflict of law rules. The harmonization of substantive law also seemed a logical solution in the field of maritime law, which traditionally could rely on internationally accepted trade usage, if not *lex mercatoria* / *lex maritima*.

As a non-governmental organization, CMI has no power or authority to host a diplomatic conference leading to an international convention. However, CMI's history shows that it has in the past been the preparatory body for the great majority of all international conventions in the field of private maritime law. CMI draft documents were adopted at CMI Conferences and then considered by a diplomatic conference hosted, initially, by the Belgian Government and later by international organizations such as IMO and UNCTAD. With the change from the Brussels diplomatic conferences to the conferences hosted by international governmental organizations such as IMO, UNCTAD and UNCITRAL, the impact of CMI has become in a sense more remote, less direct. In the days of the Brussels Conferences, the compromises found within CMI were endorsed almost entirely by the diplomatic conference, whereas in today's environment a CMI draft is re-discussed in full after its submission to the inter-governmental organization and is therefore subject to new and sometimes substantial changes before it is finally adopted: Today, a draft prepared by CMI is
submitted to a UN body, which may decide to accept it as a basis for its work on the subject and, if so, to analyze and amend it to a greater or lesser extent. As a consequence, the draft submitted to a diplomatic conference is no longer a CMI draft, but a draft prepared by that UN body.\textsuperscript{58} Nowadays, therefore, the form of the proposed harmonizing instrument - e.g. whether it should or should not be an international Convention - will depend upon CMI’s pre-agreed co-operation with such International Organizations and its mandate therefrom.

It is unfortunately true that an international convention presents a number of important disadvantages. First, more than any other harmonizing instrument, a convention is the result of a great number of compromises which may occur at any time, whether in the drafting stage or in the instrument’s application by national courts. Compromises and consultation very often affect the clarity and coherence of the instrument. Furthermore, the stages from the adoption of the convention by a Conference up to the ratification procedure (subject to reservations), implementation, enactment (with changes) or incorporation often open up new areas of disunity, a fact particularly visible today in the field of the law relating to the Carriage of Goods by Sea. Last but not least, conventions are very difficult to update. Protocols to international conventions are complex instruments insofar as they create new conflicts of application and, again, destroy the uniformity achieved by the enactment of the convention itself.\textsuperscript{59}

CMI will, therefore, obtain all possible assurances that any new draft Convention or draft Protocol which CMI might produce will be included on the agenda of an International inter-governmental Organization in good time. CMI is currently developing other approaches for harmonizing aspects of maritime law to cover situations where such assurance cannot be obtained or where adoption and ratification of an International Convention are unlikely.

\textbf{b. Standard Rules; Model Contracts}

While it is true that the overwhelming majority of CMI’s harmonizing instruments are international conventions, it is equally true that outstanding results have also been achieved in the shape of standard rules or standard contracts.

Perhaps the most important of these are the York-Antwerp Rules regarding General Average.\textsuperscript{60} CMI has been the guardian of these important rules for the last 50 years.\textsuperscript{61} Their great success within the shipping community proves that a harmonizing instrument may also consist of standard rules which are voluntarily incorporated into a contract by the commercial parties. The weakness of such standard rules is that they are only successful if a number of conditions are met. Reference is made in particular to the condition whereby regulations covered by the standard rules should reflect a commercial reality which might be referred to as \textit{lex mercatoria} or \textit{lex maritima}. The regulations of General Average as embodied in the York-Antwerp Rules are an eloquent example of unification by standard rules relating to traditional principles laid down in the Rhodian law and the Roman principle of \textit{lex Rhodia dejactu}. It is interesting that as soon as rules drafted in the form of Model Contract Terms deviate from commercial usage or generally agreed principles, they

\textsuperscript{58} F. Berlingieri, "The Work ...', \textit{op. cit.}, pp. 1264-1266.

\textsuperscript{59} Here again, the situations in the law of Carriage of Goods by Sea as well as in the law of Transportation by Air (Warsaw Convention with all its Protocols) are prominent examples. By the Convention for the Unification of Certain Rules for International Carriage by Air, 28 May 1999 (Montreal Convention), certain uniformity was achieved. There is hope that the same will be achieved in maritime law once the entire community of nations will have ratified the United Nations Convention on Contracts for the International Carriage of goods wholly or partly by Sea, 11 December 2008 (Rotterdam Rules).


\textsuperscript{61} The York-Antwerp Rules have their origins in rules set out by commercial interests in 1860 and later compiled by the International Law Association. As of 1947, CMI was entrusted with the guardianship of this important body of maritime practice.
become an object of discussion - if not dispute - in the international shipping world. Signs within the insurance industry now seem to indicate that the York-Antwerp Rules will share this fate and only time will tell whether new discussions within the maritime industry will lead to yet another revision of these Rules.

The success of standard rules depends on whether or not the solution they offer reflects fair and reasonable treatment of the transaction they propose to regulate. This is where an international organization has to be particularly careful not to make itself the advocate of a particular industry and not to merely help an industrial sector to ratify its own contractual terms. In this context CMI has, as mentioned above, offered to provide a platform for all interested international organizations to discuss the liability issues with regard to classification societies and to work on standard contractual terms for the underlying contract between the ship owner and the classification society, as well as the contract between governments and classification societies for statutory surveys.

It should also be noted that standard contractual rules enjoy great success only if the subjects they regulate and the solution they dictate reflect an actual need and concern within the relevant commercial circles. Their attractiveness lies either in the fair and reasonable solution they achieve among international organizations (e.g. the CMI standard contract terms regulating the responsibilities of classification societies), or in their reliance on technical expertise in a particular area (e.g. the CMI standard rules on sea waybills and on electronic bills of lading).

One important restriction is, of course, that uniform rules or standard rules do not work where competition and commercial interests are too strong and where at the end of the day only mandatory rules are able to achieve uniformity. In such a situation one must, however, be very careful in determining whether or not it is absolutely necessary for the commercial parties to behave in a uniform way or whether it is only necessary for the applicable law to be unified in the form of non-mandatory rules. The difference is that if the applicable law is unified in the form of non-binding rules, the parties are free to tailor the content of their own contract and thus deviate from the harmonizing instrument, be it on points of detail or more substantially.

c. Legal Guidelines and Principles of Conduct

One important restriction for Standard Rules is that they can only work where contractual relationships are at stake. They will hardly ever work where non-contractual issues (arrest; liens; tort liability) have to be solved. Thus, tort situations are traditionally subject to international conventions or model laws, since only applicable laws (and not contracts) can regulate tort. This will usually place the harmonizing organization in a dilemma, since unifying the law through an international convention can only be successful if, and insofar as, a number of substantial obstacles can be overcome. CMI has recently tried to solve this problem by using a new type of harmonizing instrument, namely the Guidelines and Principles of Conduct, which may prove to have a certain harmonizing influence also in tort cases.

One example of this latter aspect is the resolution passed by the XXXVth Conference of the Comité Maritime International in Sydney (October 2-8, 1994), adopting the Guidelines on Oil Pollution Damages and recommending their wide dissemination and application. These Rules concern the admissibility and assessment of claims for oil pollution damage and aim to assist the

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62 See under II(a) above and under IV(c) below.
63 See also under IV(c) below.
64 See also under IV(c) below.
application of the 1969 Civil Liability Convention (CLC),\textsuperscript{68} the principal international instrument governing civil liability for oil pollution from ships. In applying this Convention it was recognized that the divergent decisions of different national courts on the admissibility and assessment of claims for oil pollution damages undermine the uniform application of the Convention, which was initially prepared by CMI. Of course, the proper international harmonizing instrument would have been yet another Convention or Protocol to the CLC, but a realistic evaluation of the feasibility of such a project demonstrated that there would be little chance of success. CMI therefore decided rather to develop "Guidelines" as a useful tool for judges or other deciding bodies around the world looking for international applicable standards when operating under the CLC Convention.

C. CONVENTIONS PREPARED BY CMI

Looking at the impressive list of conventions in the field of international maritime law, it is clear that the (possibly very ambitious) original idea of codifying the entire international maritime law has to some degree been achieved by producing draft conventions submitted to diplomatic conferences in Brussels and later to the IMO\textsuperscript{69}. In this way CMI has gradually attained quite a remarkable degree of international unification in the field of maritime law. Not all of the conventions prepared by CMI, however, have found adequate support and not all are in force today. The CMI Executive Council is investigating these harmonizing instruments, seeking to identify the reasons why they were not ratified by a sufficient number of Member States. It is far too early to foresee what the results of this investigation will be, but it is possible that it may lead to further CMI work in the area and eventually to a new draft convention to be submitted to the international governmental organizations for consideration.

The most recent products are certainly the so-called Rotterdam Rules\textsuperscript{70} as well as the draft "Convention on Foreign Judicial Sales of Ships and their Recognition\textsuperscript{71}. Both of them await their Recognition in the international maritime community.

VI. THE PARTICULARITIES OF THE APPLICATION OF INTERNATIONAL MARITIME LAW

The particularities described in the article are not just stopping with the process of law-making but are quite clearly seen when applying the maritime law principles in practice, i.e. in a particular case. Lawyers involved in maritime litigation must develop a high degree of respect for rules of different and very often contradicting jurisdictions, which often only cover small pieces of the entire case. They have to disentangle a web of contractual and other legal relationships between the different players involved in the transaction or casualty. Those persons and entities are almost by definition scattered all over the world and many conflicting interests will call for different actions and positions. Thus every case may well start by opening a map of the world, listing all possible involved parties, listing all different legal relationships and applying for each of these a check on jurisdiction and applicable law (conflicts of law). This may look like the lawyer’s paradise, but may indeed soon turn into hell. The first reason for this is that the cases may not always involve a multi-million USD litigated value which would justify all this scrutiny. But scrutiny is necessary as there


\textsuperscript{69} The Conventions are reproduced in: CMI, \textit{International Conventions on Maritime Law, Antwerp/Stockholm 1987}. This publication was recently updated and will be published as Handbook of Maritime Conventions in early 1998.

\textsuperscript{70} United Nations Convention on Contracts for the International Carriage of goods wholly or partly by Sea, 11 December 2008 (Rotterdam Rules).

\textsuperscript{71} Done at Beijing on 19 December 2012, amended at Dublin in 2013 and at Hamburg in 2014. The Conventions are published in the \textit{Handbook of Maritime Conventions}. 16
is the sword of Damocles called “client”, who will not accept that some of his rights were lost due to lack of a careful analysis. Time bars, in maritime law often in the region of one year, are again not very helpful as things have to move quickly and efficiently, often with a simultaneous battle for evidence that may lay with un-cooperating third parties far from the parties involved, scattered around the globe and often hiding behind shell entities.

This requires a solid and tested network covering all the corners of the world. Ports like Duala in Cameroun may be a place to which all your focus suddenly shifts, and time and quality is of the essence. Also you develop a great interest and respect for foreign (if not in some instances strange) legal principles both in procedural and substantive law issues. You also develop a great interest and respect for very practical and technical matters and the marvellous people worldwide who will attend to them. This paper may have given the wrong impression that maritime law is highly academic. This is wrong; it is highly particular and deserves an academic analysis. In the daily practice it is hands on, but extremely complex, as is the maritime business, or the business insuring the different risks that maritime trade involves. All of those professions have coped with this complexity since about 3’000 years, always with the technical means available at the time.

In today’s increasingly accessible world, which has become entirely globalized, and thanks to the internet connecting all of us on a 24/7 basis, this challenge has been changed. What is today’s biggest challenge is to cope with the possibilities that technology and globalization offer: in other words complexity has not been reduced, but has changed, and I think has even grown in the last few decades.

So when looking back: What a great decision I made when I decided to disregard banking law as a career path but rather registered at Tulane to study maritime law, despite the fact that parents and friends repeatedly emphasized that Switzerland would maybe not be the best place to specialize in maritime law.

Again the decision was a good one, even today, 33 years later.
U.S. P&C INSURANCE – OUTLOOK 2015
DETERIORATING FUNDAMENTALS
DRIVING FURTHER M&A

Written in conjunction with the

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Analyst
USB

Author: Brian Meredith
U.S. P&C Insurance - Outlook 2015
Deteriorating Fundamentals Driving Further M&A; Favor "Self Help" Stories

2015 relative performance of P&C insurance stocks likely similar to 2014
P&C insurance stocks modestly underperformed the market and other financials in 2014, rising 8.9%. For 2015, we expect similar relative stock performance as we did in 2014, with the caveat that if interest rates rise, the group is likely to underperform more significantly. On average, we are looking for 2015 growth in BVPS x/AOCI plus dividends of 9.3%, modestly below 2014’s average of 10.7%.

Key themes for 2015
While we expect commercial lines pricing will continue to deteriorate in 2015, it will remain disciplined as insurers strive to retain ROEs. That said, competition will increase with terms and conditions, in our view. Moreover, M&A activity is likely to remain robust as buyers seek to diversify and grow in a difficult organic growth environment, and sellers re-evaluate the advantages of being independent in a softening pricing environment. We also expect continued growth of alternative capital, which will pressure reinsurance industry pricing and returns, and continue to spread into other lines of reinsurance and primary insurance. In personal lines, we expect price competition to emerge in homeowners’ insurance after several years of significant price increases and there is a risk that loss frequency increases in personal auto insurance after the significant drop in gasoline prices. Industry returns will also be under pressure as low interest rates will continue to pressure investment income for most companies and loss reserve releases will decelerate.

Our top picks for 2015 are mainly "self-help" stories – HIG and WSH
We believe that the stocks with restructuring ("self-help") stories will outperform peers in 2015 as returns continue to improve despite a deteriorating fundamental environment. In our coverage universe, our top picks are both "self-help" stories, HIG and WSH. We see HIG continuing to drive ROE improvement in 2015 through underwriting margin improvement and greater than expected share buyback. For WSH we see cost savings resulting in strong margin expansion and free cash flow growth in 2015.

Figure 1: We are changing price targets for the following companies:

<table>
<thead>
<tr>
<th>Company</th>
<th>Ratings</th>
<th>New Price Target</th>
<th>Old Price Target</th>
<th>Change</th>
<th>Driver</th>
</tr>
</thead>
<tbody>
<tr>
<td>ALL</td>
<td>Neutral</td>
<td>$69</td>
<td>$65</td>
<td>4</td>
<td>roll-forward of BVPS to 4Q 2015</td>
</tr>
<tr>
<td>AXS</td>
<td>Buy</td>
<td>$54</td>
<td>$52</td>
<td>2</td>
<td>roll-forward of BVPS to 4Q 2015</td>
</tr>
<tr>
<td>RE</td>
<td>Neutral</td>
<td>$175</td>
<td>$171</td>
<td>4</td>
<td>roll-forward of BVPS to 4Q 2015</td>
</tr>
<tr>
<td>RNR</td>
<td>Neutral</td>
<td>$101</td>
<td>$105</td>
<td>-4</td>
<td>lower expected 2016 ROE</td>
</tr>
<tr>
<td>WRB</td>
<td>Neutral</td>
<td>$52</td>
<td>$51</td>
<td>1</td>
<td>roll-forward of BVPS to 4Q 2015</td>
</tr>
</tbody>
</table>

Source: UBS estimates
Outlook 2015 – P&C Insurance

Property casualty insurance stocks underperformed the broader equity markets and financials in 2014 despite relatively light catastrophe losses (especially for reinsurers) and declining interest rates. Performance varied significantly with personal lines insurers generally having the best performance. Moderating commercial lines prices, a higher than normal level of non-catastrophe weather activity, a challenging reinsurance market and expectation of rising interest rates likely contributed to the group’s underperformance in 2014.

For 2015, we expect similar relative stock performance as we did in 2014, with the caveat that if interest rates rise, the group is likely to underperform more significantly. On average, we are looking for 2015 growth in BVPS x/AOCI plus dividends of 9.3%, modestly below 2014’s average of 10.7%. Fundamentals are likely to continue to deteriorate with commercial lines and reinsurance price competition intensifying, terms and conditions getting more generous, investment income pressure, and underwriting margin pressure from lower loss reserve releases. This will lead to peak ROE’s for the group and potential deterioration as we head into 2016. On a positive note, we expect the pick-up in M&A activity we have seen recently to persist, capital management should continue to be robust and the favorable loss trend environment in commercial lines should continue to help underwriting margins.

We believe it will once again be a stock picker’s market in 2015. The winners among P&C underwriters will likely be the companies that can generate improving ROEs through 2016, despite the challenging fundamental outlook. These are largely the “self-help” stories in our view, where outsized capital management, expense savings, or re-underwriting will drive ROE improvement. In our coverage universe, the names we are recommending that we would highlight as “self-help” stories are AXS, HIG, and WSH.

The key themes in our view for 2015 will be:

(1) Commercial lines pricing continues to deteriorate, but, remains disciplined. Competition increases with terms and conditions.

(2) M&A activity will remain robust as buyers seek to diversify and grow.

(3) Alternative capital continues to grow pressuring reinsurance industry pricing and returns.

(4) Low interest rates continue to pressure investment income for most

(5) Diminishing loss reserve releases

(6) Competitive pressures increase in personal lines

What are the likely key themes for 2015?

1) Commercial insurance pricing continues to deteriorate.

U.S. commercial insurance pricing continues to get more competitive as casualty loss trend remains benign, weather losses have moderated the last two years and the industry remains overcapitalized. While we expect pricing to continue to deteriorate in 2015, if interest rates remain low, we expect price competition to

We expect P&C insurance stocks to deliver similar relative stock performance in 2015 as they did in 2014

Figure 2: 2014 Performance

<table>
<thead>
<tr>
<th>Index</th>
<th>2014 Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>UBS P&amp;C Index</td>
<td>+8.9%</td>
</tr>
<tr>
<td>S&amp;P Composite</td>
<td>+10.9%</td>
</tr>
<tr>
<td>S&amp;P Financials</td>
<td>+12.6%</td>
</tr>
<tr>
<td>S&amp;P Banks</td>
<td>+11.4%</td>
</tr>
<tr>
<td>S&amp;P Life Insurance</td>
<td>+1.0%</td>
</tr>
</tbody>
</table>

Source: FactSet and UBS
moderate some as insurers seek to sustain ROE's (currently running around 10-11% on an accident year basis for the major commercial lines insurers). While we might see some increased pressure on pricing for small and middle commercial risks, we do not see pricing falling into negative territory as the major U.S. insurers are likely to strive for ROEs not dropping below 9% to 10% levels. We believe these levels are in-line with major insurers’ cost of capital, as well as their thresholds for incentive compensation plans.

**Figure 3: Accident Year ROEs Stabilized**

That said, if interest rates rise meaningfully, we expect the excess capital in the industry and low loss trend will prevail resulting in an increase in price competition. Additionally, we see commercial lines insurers increasing their risk appetite through more generous terms and conditions, and broadening risk appetite. While more generous terms and conditions, and broader risk appetite may not be immediately noticeable in results, it has potentially serious implications for future profitability, especially if the industry sees an acceleration in loss cost inflation.

**Figure 4: Commercial Insurance Pricing Trends (Y/Y Price Change)**

Source: SNL, company reports and UBS; Companies included: ACE, AWH, AFG, ACGL, AHL, ALTE, AXS, CB, CINF, CNA, ENH, ERIE, THG, HCC, MGL, MRH, PRE, PTP, PRA, RE, RLI, RNR, TRH, TRV, VR, WRB, XL.

Source: Towers Perrin Commercial Lines Pricing Survey (CLIPS), MarketScout, Council of Insurance Agents and Brokers’ quarterly Commercial P/C Market Index, and UBS.
2) M&A activity will remain robust as buyers seek to diversify and grow

We believe that the industry consolidation that accelerated towards the end of 2014 (RNR and PTP, XL and Catlin deals) will continue into 2015. All of the catalysts that were existent in 2014 continue into 2015. In the reinsurance space, buyers continue to consolidate programs and are dealing with fewer reinsurers, which is driving smaller reinsurers to diversify or look for partners. Additionally, the influx of alternative capital and excess capacity in the traditional market has depressed returns in the once very profitable property catastrophe reinsurance business, forcing reinsurers to look to other areas to deploy capital (including M&A). In both the reinsurance and primary commercial lines space, the increasingly competitive pricing environment is making organic growth more challenging, causing companies to look to M&A to utilize excess capital and leverage operating platforms. Lastly, as long as loss costs remain benign, loss reserves should be generally redundant for targets, reducing the balance sheet risk in a deal. We have included a list of potential M&A candidates (see Figure 13 at the end of the report), screening for companies with market capitalizations over $150 million but below $10 billion, whose stock is currently trading below 1.5x book value.

We also believe that in light of the limited opportunities for the deployment of excess capital, the companies not keen on M&A will continue to be active in repurchases of their shares in 2015, and/or are likely to pay special dividends. We forecast the reinsurers under our coverage will repurchase 6.0% of their shares in 2015, compared to our estimate of 7.3% for 2014 (including the 5.5% actually repurchased through the first nine months of 2014).

3) Alternative capital continues to grow, pressuring reinsurance industry pricing and returns

The inflow of alternative capital into the reinsurance marketplace accelerated in 2014. Per Guy Carpenter, alternative capital represented 18% of property catastrophe reinsurance limits at year-end 2014, up from 15% in 2013 and 12% in 2012. In addition to the excess capital already existent in the reinsurance industry, this inflow of alternative capital is putting pressure on pricing and returns. Moreover, this capital is spreading into other areas of reinsurance and is impacting primary insurance through quota-share reinsurance agreements. We believe this trend will continue with only a major catastrophe loss and/or a rise in interest rates slowing the growth.

In addition to growing alternative capital, the traditional reinsurance capital grew as well. It has been nine years since a category three hurricane made landfall in the U.S. Traditional reinsurance capacity remains plentiful and reinsurance pricing has declined across most regions and lines of business at the latest reinsurance renewals. Terms and conditions have also been under increasing competitive pressure. At January 1 renewals, property catastrophe rates on loss free accounts were down across all regions (down double digits in the U.S.), and the latest renewals were also marked by broadening terms and conditions. Casualty reinsurance pricing declined as well, with continued pressure on commission rates and excess of loss rates down up to double digits in the U.S. and Lloyd’s market.
With increased capacity of traditional reinsurers coupled with alternative reinsurance capital, we expect reinsurance pricing, as well as terms and conditions, to be under increasing pressure in 2015, barring a material catastrophic loss.

4) The headwind of declining investment book yields remains in place for most companies in 2015

New money fixed income yields continue to be below current book yields for some property-casualty insurance companies, which will continue to put downward pressure on their investment income. The companies with very short duration investment portfolios (such as PGR, RNR and VR) are likely to see stable investment yields which could rise somewhat if the Fed starts raising the rates. We expect stable or only marginally higher investment yield on fixed income or total portfolio for 4 of our re/insurers (ACGL, PGR, RNR and VR) in 2015. For the rest of our group we anticipate an average 10 basis point year-over-year decline in the investment yield in 2015. For our coverage universe, our forecast of pre-tax investment income for 2015 is equal to 8.7% of year-end 2014 tangible equity, on average, compared to our expectation of 8.5% for 2015.

Figure 7: Investment yields in 3Q14 versus current ‘AA’ U.S. corporate yields

![Graph showing investment yields for various companies in 3Q14 compared to current ‘AA’ U.S. corporate yields.]

Notes: * fixed income, ** excludes income from alternative investments, *** P&C only, excludes partnership income, **** P&C only
Source: Company reports, SNL and UBS estimates.

5) Diminishing Loss Reserve Releases

The favorable loss cost environment over the past few years continues to result in loss reserves redundancies for commercial-lines re/insurers. Moreover, many insurers have been adjusting initial loss picks down for the favorable loss cost environment, which creates a diminished cushion if loss cost inflation emerges. We expect prior-year loss reserve releases to decrease in 2015 as older-year reserve releases dwindle and companies increasingly recognize the favorable loss cost trends in loss picks. We estimate that loss reserve releases as a percentage of beginning loss reserves, on average, will decline from 2.5% in 2014 to 2.0% in 2015 for our covered universe. Our EPS estimates for 2015 include a 21% benefit from loss reserve releases (in-line with 21% in 2014).

6) Competitive pressures increase in personal lines

Several years of price increases and more affordable catastrophe reinsurance protection is resulting in personal lines insurers once again looking to grow their...
homeowners’ insurance business. The competitive pressures could result in narrowing underlying margins for homeowners’ insurance in 2015. For personal auto insurance, low gas prices could result in higher loss frequency, pressuring underwriting margins in 2015. We also see the recent news that Google will sell personal lines insurance online as meaningful and could become a bigger story in 2015. If successful, the price transparency that Google and other personal lines insurance aggregators create will have a depressing impact on personal auto insurance returns in the long term. It could also be a catalyst for M&A as the most efficient operators will likely gain share at the expense of the less efficient operators.

What may surprise on the upside or downside?

- **Commercial lines pricing.** Although stabilization or modest deceleration seem most likely, a major catastrophe loss, deterioration in investment portfolios or increase in claims inflation could cause a re-acceleration in commercial insurance pricing (which could benefit share prices).

- **Worse-than-expected loss trends.** A shifting judicial system and/or improving economy could result in a reversal from the generally favorable U.S. tort environment of the past seven years. Such a change could drive up accident-year loss ratios and reduce reserve releases (perhaps causing net adverse development) in commercial lines re/insurance.

- **Rising interest rates.** While rising interest rates would be a positive for the industry’s earnings and ROE, historically P&C insurance stocks have underperformed other financial services names in periods of rising interest rates. Also, higher interest rates could result in increased price competition for casualty insurance.

What are the likely key catalysts in 2015?

- **Fourth Quarter Results.** Some companies will provide guidance for 2015, which, given the current pricing environment and low interest rate environment, could be worse than expected. Also, re/insurers are likely to re-assess their capital positions at the end of the year and some likely will announce increases to their share buyback authorizations.

- **Mid-year 2015 reinsurance renewals.** This is the major renewals date for property and casualty reinsurance, primarily in the U.S. Worse-than-expected pricing would be a negative catalyst for the reinsurance stocks. Another round of price reductions similar to declines observed at January 1, 2015 would likely render pricing for property catastrophe reinsurance inadequate.

Our Top Picks

*The Hartford (HIG)*

**Investment Thesis:** We see continued upside potential for the stock from BVPS growth (aided by accretive stock repurchases) and P/B expansion from the current discount to BV thru improvement in ROE and risk profile. We believe capital management could be $1bb greater than the company’s current guidance through 2015 as the risk profile of Talcott is significantly reduced and the run-off is happening faster than anticipated.
Also, we expect continued improvement in the underwriting profitability of its Group Benefits and P&C insurance businesses, which should drive improved ROE’s. After years of rate increases and declining market share, we expect HIG to grow its top line y/y in Group Benefits for the first time since 2009. In P&C insurance, HIG continues to achieve rate increases in excess of loss trends despite the competitive pricing environment. This, coupled with expense efficiencies, should result in underwriting margin improvement through 2016.

**Valuation:** Our price target of $47 is based on 1.05x our estimated 12/31/15 BVPS excl AOCI.

**2015 Catalysts:** We see the update on the Talcott Resolution as a potential positive catalyst for the stock. We believe that changes to the stress assumptions, the continued elevated run-off, and discussions with regulators could lead to $800m or more of dividends out of Talcott, providing upside to company guidance on capital management.

**Willis Group Holdings (WSH)**

**Investment Thesis:** We see Willis Group Holdings (WSH) hitting an inflection point in 4Q14 after multiple years of margin contraction. A slowdown in hiring, easier revenue growth comps in its Global segment, and some expense savings from the Operational Improvement Program will help WSH expand operating margins after three years of declines. The expense savings and improved revenue growth should lead to margin expansion through 2018; we see high-teens growth in operating EPS over the next three years.

The margin expansion and reduced pension fund contributions should lead to 20%+ compound annual growth in free cash flow per share through 2018. The free cash flow growth will enable WSH to fund potential acquisitions, such as the remaining 70% stake in Gras Savoye and any deal with Miller Insurance. We believe that even if revenue growth is weaker than expected, the expense savings from the Operational Improvement Program will drive margin expansion, limiting downside for the stock.

**Valuation and Price Target:** Our 12-month price target of $50 is based on an EV/EBITDA multiple of 11.5x our next twelve months EBITDA estimate. The target multiple assumes no expansion in WSH’s EV/EBITDA multiple.

**Catalysts for 2015:** An announcement regarding the potential acquisition of the remaining 70% of Gras Savoye should come in 2Q14, as WSH must decide whether it will exercise its option by April 30, 2015. We believe that the Gras Savoye acquisition could be accretive as early as 2016 if it is funded with cash.
Appendix

P&C Industry Historical Valuations

Figure 9: Price-to-Book Ratio

![](image1.png)

Source: SNL, FactSet and UBS; UBS Large Cap P&C Re/insurer Index.

Figure 10: Relative Price-to-Book ratio

![](image2.png)

Source: SNL, FactSet and UBS; UBS Large Cap P&C Re/insurer Index.

Figure 11: Price-to-Earnings Ratio

![](image3.png)

Source: SNL, FactSet and UBS; UBS Large Cap P&C Re/insurer Index.

Figure 12: Relative Price-to-Earnings Ratio

![](image4.png)

Source: SNL, FactSet and UBS; UBS Large Cap P&C Re/insurer Index.
Figure 13: Screen of Small to Mid-Cap ($150m - $10bb) P&C Insurance Companies Trading Below 1.5x Book Value

<table>
<thead>
<tr>
<th>Institution Name</th>
<th>Ticker</th>
<th>Market Capitalization ($M)</th>
<th>CEO's Age (years)</th>
<th>Insider/ Stakeholder Total % Owned (%)</th>
<th>Price/ Book (%)</th>
<th>3-YR Avg P/B</th>
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EMCI  
458  
60  
60.4  
94  
90

Meadowbrook Insurance Group, Inc.*  
MIG  
418  
56  
7.2  
93  
72

Baldwin & Lyons, Inc.  
BWINB  
371  
62  
31.6  
94  
98

Hallmark Financial Services, Inc.  
HALL  
216  
47  
4.2  
87  
78

Blue Capital Reinsurance Holdings Ltd.  
BCRH  
155  
46  
0.3  
88  
90

Source: SNL and UBS; * companies are a party to an M&A deal (a buyer or an acquisition target)

**North America Coverage**

**Figure 14: P&C Insurance Coverage**

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<td>11.9%</td>
<td>11.3%</td>
<td>1.6x</td>
</tr>
<tr>
<td>Intact Financial (2)</td>
<td>IFC</td>
<td>Buy</td>
<td>82.50</td>
<td>87</td>
<td>5%</td>
<td>5.63</td>
<td>6.65</td>
<td>14.7</td>
<td>12.4</td>
<td>2.3%</td>
<td>15.7%</td>
<td>16.8%</td>
<td>2.3x</td>
</tr>
<tr>
<td>Progressive</td>
<td>PGR</td>
<td>Neutral</td>
<td>26.54</td>
<td>26</td>
<td>-2%</td>
<td>1.75</td>
<td>1.85</td>
<td>15.1</td>
<td>14.4</td>
<td>1.2%</td>
<td>16.7%</td>
<td>16.7%</td>
<td>2.6x</td>
</tr>
<tr>
<td><strong>Financial Guarantors</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assured Guaranty</td>
<td>AGO</td>
<td>Buy</td>
<td>25.39</td>
<td>30</td>
<td>18%</td>
<td>3.15</td>
<td>2.75</td>
<td>8.1</td>
<td>9.2</td>
<td>1.7%</td>
<td>10.5%</td>
<td>7.8%</td>
<td>0.8x</td>
</tr>
</tbody>
</table>

(1) Dividend yield for BCRH is based on our forecast of the 2014 dividend. (2) Canadian dollar.

Source: FactSet and UBS estimates.

**Statement of Risk**

Increasingly competitive pricing and/or accelerating loss cost inflation may lead to lower-than-expected earnings. A spike in interest rates or catastrophe losses could materially affect growth in book value and stock prices.

U.S. P&C Insurance - Outlook 2015  
13 January 2015  
UBS 10
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UBS Investment Research: Global Equity Rating Definitions

<table>
<thead>
<tr>
<th>12-Month Rating</th>
<th>Definition</th>
<th>Coverage¹</th>
<th>IB Services²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy</td>
<td>FSR is &gt; 6% above the MRA.</td>
<td>47%</td>
<td>37%</td>
</tr>
<tr>
<td>Neutral</td>
<td>FSR is between -6% and 6% of the MRA.</td>
<td>42%</td>
<td>32%</td>
</tr>
<tr>
<td>Sell</td>
<td>FSR is &gt; 6% below the MRA.</td>
<td>11%</td>
<td>21%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Short-Term Rating</th>
<th>Definition</th>
<th>Coverage¹</th>
<th>IB Services²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy</td>
<td>Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.</td>
<td>less than 1%</td>
<td>less than 1%</td>
</tr>
<tr>
<td>Sell</td>
<td>Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.</td>
<td>less than 1%</td>
<td>less than 1%</td>
</tr>
</tbody>
</table>

Source: UBS. Rating allocations are as of 31 December 2014.
1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category. 4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

KEY DEFINITIONS: Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months. Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium). Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock’s price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation. Short-Term Ratings reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case. Equity Price Targets have an investment horizon of 12 months.

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UBS Securities LLC: Brian Meredith; Marie Lunackova, CFA; Jason Efkeman.
## Company Disclosures

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Reuters 12-month rating</th>
<th>Short-term rating</th>
<th>Price</th>
<th>Price date</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACE Limited</td>
<td>ACE.N</td>
<td>Buy</td>
<td>N/A</td>
<td>US$112.00</td>
</tr>
<tr>
<td>Allstate Corp.</td>
<td>ALL.N</td>
<td>Neutral</td>
<td>N/A</td>
<td>US$69.70</td>
</tr>
<tr>
<td>American International Group</td>
<td>AIG.N</td>
<td>Neutral</td>
<td>N/A</td>
<td>US$52.36</td>
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<tr>
<td>Aon plc</td>
<td>AON.N</td>
<td>Neutral</td>
<td>N/A</td>
<td>US$93.44</td>
</tr>
<tr>
<td>Aspen Insurance Holdings</td>
<td>AHL.N</td>
<td>Buy</td>
<td>N/A</td>
<td>US$43.15</td>
</tr>
<tr>
<td>Assured Guaranty</td>
<td>AGO.N</td>
<td>Buy</td>
<td>N/A</td>
<td>US$25.39</td>
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<tr>
<td>Axis Capital Holdings Ltd.</td>
<td>AXS.N</td>
<td>Buy</td>
<td>N/A</td>
<td>US$48.79</td>
</tr>
<tr>
<td>Blue Capital Re</td>
<td>BCRH.N</td>
<td>Buy</td>
<td>N/A</td>
<td>US$17.68</td>
</tr>
<tr>
<td>Chubb Corporation</td>
<td>CB.N</td>
<td>Buy</td>
<td>N/A</td>
<td>US$101.07</td>
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<tr>
<td>Everest Re Group, Ltd.</td>
<td>RE.N</td>
<td>Neutral</td>
<td>N/A</td>
<td>US$169.71</td>
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<tr>
<td>Greenlight Capital Re Ltd</td>
<td>GLRE.O</td>
<td>Buy</td>
<td>N/A</td>
<td>US$32.10</td>
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<tr>
<td>Intact Financial Corporation</td>
<td>IFC.TO</td>
<td>Buy</td>
<td>N/A</td>
<td>US$82.50</td>
</tr>
<tr>
<td>James River Group Holdings Ltd</td>
<td>JVR.R.O</td>
<td>Buy</td>
<td>N/A</td>
<td>US$22.96</td>
</tr>
<tr>
<td>Marsh &amp; McLennan Companies, Inc.</td>
<td>MMC.N</td>
<td>Buy</td>
<td>N/A</td>
<td>US$56.10</td>
</tr>
<tr>
<td>PartnerRe Ltd.</td>
<td>PRE.N</td>
<td>Buy</td>
<td>N/A</td>
<td>US$112.42</td>
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<tr>
<td>Progressive Corporation</td>
<td>PGR.N</td>
<td>Neutral</td>
<td>N/A</td>
<td>US$26.54</td>
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<tr>
<td>RenaissanceRe Holdings Ltd.</td>
<td>RNR.N</td>
<td>Neutral</td>
<td>N/A</td>
<td>US$94.91</td>
</tr>
<tr>
<td>The Hartford Financial Services Group</td>
<td>HIG.N</td>
<td>Buy</td>
<td>N/A</td>
<td>US$40.31</td>
</tr>
<tr>
<td>Travelers Companies</td>
<td>TRV.N</td>
<td>Neutral</td>
<td>N/A</td>
<td>US$105.20</td>
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<tr>
<td>Validus Holdings, LTD.</td>
<td>VR.N</td>
<td>Buy</td>
<td>N/A</td>
<td>US$39.74</td>
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<tr>
<td>W. R. Berkley Corporation</td>
<td>WRB.N</td>
<td>Neutral</td>
<td>N/A</td>
<td>US$50.25</td>
</tr>
<tr>
<td>Willis Group Holdings Limited</td>
<td>WSH.N</td>
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<td>N/A</td>
<td>US$44.35</td>
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<tr>
<td>XL Group plc</td>
<td>XLN</td>
<td>Neutral</td>
<td>N/A</td>
<td>US$35.54</td>
</tr>
</tbody>
</table>

Source: UBS. All prices as of local market close.

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FOREWORD

Judge Richard A. Posner

Remarkably little is known to the general public, or even to the practicing legal profession, about judges—the way they decide cases, the system they use to allocate work between staff (mainly law clerks) and themselves, their work ethic, their psychology, the extralegal influences that play on them. Much less is known about them than about other government officials, both executive and legislative, and other professionals, such as the lawyers who litigate court cases and the members of the various branches of the medical and military professions.

One reason is that, whereas these other professions I’ve mentioned are also very old, the legal profession, including the judiciary, hasn’t changed a great deal, at least from the outside, compared to the other professions. The continuity between Roman law and legal institutions of the third century A.D. and modern law in most of the world, including the United States, is striking. And over this long period of gradual change, judges have developed a strategy of maximizing their autonomy, job security, and power. The strategy has several struts: secretiveness, impartiality (what Aristotle called “corrective justice,” often misunderstood by modern jurispruders), a pretense of passivity (“the law made me do it”), mystification (jargon), and political sensitivity.

These are survival strategies and shouldn’t be disparaged unduly because courts are valuable institutions of governance, and to maintain their power they need the strategies I’ve listed, though they tend to overuse them.

The ones I want to stress are secretiveness and passivity. Judges are far more reluctant to reveal the inner workings of their institution than other government officials and far more prone to deny the discretionary authority that they wield. Blackstone described English judges as the “oracles of the law,” meaning that the law spoke through the judges the way Apollo spoke through the oracle at Delphi, and judges continue to represent themselves—though not by invoking the oracle at Delphi, no longer a familiar figure to Americans—to be transmitters rather than originators.

By being secretive and appearing passive, judges get away with exercising a good deal of power—benign power for the most part, but still power—which is to say discretion to confer real benefits and impose real costs, whereas the judge who mechanically applies the law—who is the law’s ventriloquist’s dummy—is transmitting rather than exerting power. (Actually that judge will often be fooling himself because often the law is not clear enough to be applied mechanically to the case before him.) Judges find facts, take many cases away from juries and decide the cases themselves, have largely created constitutional law by treating the Constitution’s vague phrases as authorization rather than direction, and have done the same with many statutes. But they hide behind a veil of modesty. And they get away with it in part because

---

1 Judge Richard A. Posner has sat on the Court of Appeals for the Seventh Circuit in Chicago since 1981, serving as its Chief Judge from 1993 to 2000. A prolific writer, he has authored some forty books and innumerable articles on judging and the law. He is the recipient of numerous awards, including the Learned Hand Medal for Excellence in Federal Jurisprudence. His latest book, Reflections on Judging, was published in 2013.
their staffs, mainly law clerks, are almost as secretive as the judges. Because law is adversarial, secretiveness comes naturally, to judges and their staffs and to lawyers engaged in litigation or negotiation, both being forms of struggle.

How is the veil of secrecy to be penetrated? One tactic is the confessional. Judges will on occasion acknowledge the personal element in judging. The author of this book quotes a famous confessional passage by Cardozo. Earlier, Holmes had made a similar, though somewhat more guarded, confession (well, it wasn’t really a confession because he was not yet a judge, though when his statement was published he was only months away from becoming one) when he said on the first page of his classic work *The Common Law* (1881): “The life of the law has not been logic: it has been experience. The felt necessities of the time, the prevalent moral and political theories, intuitions of public policy, avowed or unconscious, even the prejudices which judges share with their fellow-men, have had a good deal more to do than the syllogism in determining the rules by which men should be governed.”

Academic lawyers, notably in the eras of legal realism and critical legal studies, sought without success to strip the veil. Those movements faded, to be replaced by social scientific studies, in political science and later in economics and psychology as well, that sought, for example, by examining judicial behavior, often in statistical terms—correlating for example the political slant of federal judicial decisions with the party of the appointing president—to uncover the real springs of decision, masked by the rhetoric of judicial decision making and often outside the conscious awareness of the judge. This book uses a different technique, that of the interview. Mr. Cohen is a skillful and tenacious, though invariably courteous, interviewer. He has picked as the interviewees federal district judges who have presided in famous, publicity-attracting cases, cases most likely to challenge a judge’s fidelity to a passive, formalistic—which is to say traditional—mode of judicial decision making, and he has focused the interviews on those cases.

We learn a good deal about these judges. And one thing we learn is that judges, even when in the hands as it were of a skillful and persistent and unawed interviewer, are very reluctant to acknowledge a personal element in judging even in the most atypical and challenging case. There have been plenty of cases involving the prosecution of con men; but Bernard Madoff was not a run-of-the-mine con man. There have been in the last half century more constitutional cases concerning sex than one can count; but the case in which one of Mr. Cohen’s interviewees, Vaughan Walker (incidentally a former student of mine), ruled on the constitutionality of forbidding homosexual marriage was more novel and fraught than any since *Roe v. Wade*. And so with the other cases discussed in the book.

So the judges are guarded, and that is one limitation of the interview method of piercing the veil. But another is the problem of self-knowledge. There is no inconsistency in saying that Judge X is utterly sincere in disclaiming any personal element in his decisions yet some of his decisions cannot be explained in formalistic, but only in personal, terms. There is no inconsistency because few if any people have total self-awareness. Indeed, people are great self-deceivers. Judges’ response to the occasional case in which the conventional guides to decision making don’t yield a result is likely to be influenced or even determined by priors (prior beliefs, which is to say beliefs they bring to the case rather than derive from evidence or the other orthodox materials of judicial decision making pressed upon them in the litigation) of which they may be unaware and by basic psychological dispositions, such as attitudes toward authority. And
these priors and dispositions may not emerge in an interview because they reside for the most part at the unconscious level of thought.

The reader will learn a great deal about trial judges from this book, but the aura of mystery will remain.

R.A.P.
Almost 100 years ago, our great jurist Benjamin N. Cardozo declared the seemingly unthinkable—that jurists are people, limited, affected, and influenced just as others may be. As he wrote:

There has been a certain lack of candor in much of the discussion of the theme, or rather perhaps in the refusal to discuss it, as if judges must lose respect and confidence by the reminder that they are subject to human limitations. I do not doubt the grandeur of the conception which lifts them into the realm of pure reason, above and beyond the sweep of perturbing and deflecting forces. None the less, if there is anything of reality in my analysis of the judicial process, they do not stand aloof on these chill and distant heights; and we shall not help the cause of truth by acting and speaking as if they do. The great tides and currents which engulf the rest of men, do not turn aside in their course, and pass judges by.\(^2\)

Without saying it in so many words, Cardozo wondered what makes one judge different from another, what informs the thinking of one judge but not his colleague. Do judges concede, or even recognize, these influences? And, when they do, if they do, how does a judge rise above them? Are they compelled—ethically, if not legally—to disclose them? These are the overriding questions explored in this book through the prism of controversial, and difficult, decisions 13 jurists have made.

Cardozo understood and articulated better than anyone that judges are human beings, not gods, and that however lofty their pronouncements, however hard they strive for the objective and impersonal, they will invariably fail in that endeavor. The judges who make the hard decisions are men and women with personal worries and concerns, achievements and failures. And lawyers and litigants should embrace their humanity—we probably wouldn’t want to appear before an Ivy League magna who only knows about life through what she reads in a law book. Indeed, a judge’s human frailty in not being totally objective is often his strength. The passion he or she brings to a decision is frequently what distinguishes the great judge from the mundane.

Fundamentally, wasn’t Cardozo really asking what makes a judge? Would rulings be disparate because one worked his way through school, while another was born with a silver spoon in his mouth? Can a judge, born in a communist country, ever really put aside his Orwellian nightmare (or was it a reality?) that Big Brother is upon us, or will he forever be distrustful of government? And if so, is that so bad?

But far more than just the upbringing of a person goes into the mix. Who was the man or woman before he or she became a judge? Was he an academic? A war veteran? Did his prior life (or current life) consist of interests outside the law? And what of her gender, his religion, her race, his sexual status? Can a black judge objectively hear a case where racial discrimination is alleged? Can a female judge command the attention—and the respect—of an Islamic extremist?

Does being gay require a judge to recuse himself when the case before him will decide whether same-sex marriage violates the Constitution?

Will conversations around the dinner table and the observations of family and friends translate into how a judge thinks or rules? Can judges who worked in the shadow of the Pentagon or the Twin Towers on 9/11 really be impartial when deciding issues related to that day and its aftermath?

Will the thought of “bad press” (or good press, for that matter) inform their choices? Is she a Democrat or a Republican? Can a church-going judge—appointed to the bench with support from the conservative right—put aside the expectations of others (and perhaps his own beliefs) when deciding the politically loaded question of whether school children should be taught that evolution is nothing more than a theory and that other theories are just as viable? Was she a prosecutor or a defense attorney or maybe both? And did those experiences make her more drawn, as a judge, to positions typically urged from the table of the courtroom from which she practiced? Or perhaps more skeptical? Does he support charities, and which?

Most important—how does he process all of this “baggage,” as it were? Does the judge—should the judge—simply look at the case law and decide cases without emotion, without biases, without, what Freud might have called in *The Interpretation of Dreams*, the “residue of the day”? What is the import of the subtle ebbs and flows of each day, or the “great tides and currents,” that inform him in his judicial craftsmanship? And, perhaps even more compellingly—are judges unable to empathize or even sympathize with litigants who come before them?

A here unidentified late judge—a brilliant man, revered by all lawyers who appeared before him—once sat on the federal court somewhere in New York. He came to the bench a great liberal, sympathetic—maybe even empathetic—to most every criminal defendant who had suffered through a childhood of poverty or poor parentage. That is, until the day he was mugged at gunpoint in the park across from the courthouse, an incident that drastically changed the way he sentenced, particularly when weapons were involved.

Did this judge acknowledge the differences in his sentencing, before and after the mugging? And was he required to disclose the robbery to those who appeared before him? But what if the change to harshness in how he would sentence defendants, especially for gun offenses, was gradual? And what if it occurred because he was “burned” too often by recidivists, after one too many implored: “If you show me leniency, giving me probation, you will never, ever see me in a courtroom again?” Would we want a judge to be impervious to his earlier bench experiences, both good and bad? A more difficult question, to be sure.

Yes, to that one judge, this incident was—as Judge Cardozo declared—a “reminder that [judges] are subject to human limitations.” It surely influenced, maybe even captivated, the manner in which—perhaps the philosophy of how—he would thereafter assess and mete out punishment.

But what of Cardozo’s “tides and currents”—the far more profound issues—such as the role of the courts when the other branches of government fail, or come up short; death or mandatory sentences for crime; the state’s role as caretaker (or, some might say, dictator) for the
downtrodden; the government’s regulation of the markets; the (semipermeable) wall of separation between church and state; rights to privacy in a post-9/11 world; and other like issues of great moment?

How does a judge react to events he has experienced, or has observed firsthand? Does he personalize, however subtly, his life experiences when he dispenses justice or seek to maintain objectivity and balance? Does he compartmentalize his life on the bench, perhaps falsely believing that he has separated his decision making from his “real world”? In other words, does he believe his experiences, his background, his encounters have not informed his decisions? Or does she inwardly acknowledge those influences and, having done so, believe that they were properly discarded or addressed?

Put differently, is he truly able—and is it desirable—to exemplify the blindfolded woman who holds in her hands the scales of justice? Should he even try to replicate Lady Justice’s model of pursuing justice, blind indeed to all that goes on around her? That is, should he be impervious to all but the counterweights that represent a case’s differing views on the scale suspended from her left hand?

At bottom, can anyone seriously argue in opposition to what Cardozo posited, that judges are not—at a minimum, in some subliminal way— Influenced by the human dynamic of life, including the subtle biases they picked up along the way? The way in which different judges actually perceive the cases or controversies before them is often markedly disparate. Some judges—“activist judges”— may, directly or with nuance, attempt to engineer change in how they decide cases, when they believe that the legislation or policies don’t adequately deal with a particular social or economic ill. And when they do, do they seek to accomplish something far beyond what the litigants before them have actually sought?

I have selected specific (generally, well-known) cases for the free-flowing dialogues that follow from the thousands of cases to which these 13 (alphabetized) judges have been assigned—those that have raised critical questions about justice, policy, precedent, the law, and the way in which the currents and tides of their lives and of our ever-changing society have influenced those rulings. But have the judges been open, even aware, of what experiences have influenced their rulings? And where judges acknowledge awareness of these potential influences—of their “priors,” as Judge Posner would articulate it—are they fully candid, to themselves and others, about whether, and to what degree, it has informed their rulings? Or have they contrarily decided, after inwardly acknowledging the “awareness,” that they can or did fairly decide the case, so that they needn’t publicly reveal themselves?

Indeed, these judges and I might not always agree about what is—and perhaps, what should be—the mindset and role of individuals once they have ascended the bench. Of course, the personal opinions I offer during these dialogues are sometimes expressed in my role as devil’s advocate. Those opinions are hardly important, except insofar as they may reflect the opinions of some readers hereof.

Nonetheless, this sometimes disparity in our respective views, which may surface occasionally in these pages, does not in any way detract from one’s respect for the master of
judicial introspection, Benjamin N. Cardozo—to whose enduring memory I dedicate what follows.

JC
May 14, 2014
CHAPTER 5
JUDGE ALVIN K. HELLERSTEIN

There’s no such thing as purity in judgment. Without facts and context, judgment becomes abstract—you lose out on the passion of judging. Justice does not require absolute purity, but a check on bias. —Judge Alvin K. Hellerstein, September 30, 2013

Judge Alvin K. Hellerstein

Judge Alvin K. Hellerstein was appointed to the Southern District of New York by President William J. Clinton in 1998 and, as of 2011, holds senior status. Judge Hellerstein is considered smart, tough, and direct—he is not afraid to share his thoughts about the cases and counsel before him.

The 10,000+ September 11 tort cases discussed here, which consumed his docket for more than a decade, are only some of the 9/11-related cases over which Judge Hellerstein presided. He addressed the wrongful death cases brought by the families of 95 people killed in the plane crashes, the insurance and other claims for compensation made by the owner of the Twin Towers, and many others.

In addition, he maintained a full docket of cases, which included Freedom of Information Act cases against the Department of Defense and CIA concerning captured enemy combatants, ruling for the release of the Abu Ghraib photographs but against the American Civil Liberties Union when it sought to force the CIA to release secret documents involving terror detainees, holding that national security should not be at risk. In another, he rebuked federal prosecutors and law enforcement, finding that they made a decision to tell “perhaps the truth, but not the whole truth.” And in an infamous case (at least to New Yorkers, transplanted or otherwise), Judge Hellerstein resolved a three-year battle between companies that each claimed the right to use the coveted name “H&H Bagels.” Notwithstanding that the case turned on the mundane—the Lanham Act and Bankruptcy Code—Judge Hellerstein made sure to expound and educate, tracing the bagel from its Eastern European roots to the tenements of New York.

Judge Hellerstein graduated from Columbia College and Columbia Law School, where he was an editor of the law review. Upon graduation in 1956, he clerked for Judge Edmund L. Palmieri in the Southern District of New York. Judge Hellerstein next served as a First Lieutenant in the Judge Advocate General Corps. From 1960 to 1998, he was in private practice at Stroock & Stroock & Lavan LLP, where—he co-chaired its litigation department, where he, among other things, represented defendants in complex securities cases. In addition to his professional accomplishments, Judge Hellerstein has tirelessly supported charitable activities, serving as president and then chair of the Board of Jewish Education and on various committees of UJA-Federation. Judge Hellerstein remains active in professional associations and publishes scholarly articles, including three concerning the 9/11 cases.

3 Judge Hellerstein and the author are friends of more than 25 years, having been law partners before Judge Hellerstein took the bench.
Notably, in his chambers, as was in his office when he practiced law, hangs a framed calligraphy that says, in Hebrew, the Biblical call: “Justice, Justice, Shalt Thou Pursue.”

Judge Hellerstein sits in New York City.

Managing and Settling the 9/11 Tort Cases

We can all remember where we were on the otherwise sky blue morning of September 11, 2001, when two planes crashed into the Twin Towers. That day was devastating; the days and weeks following were a blur, particularly if you lived in New York City and watched what would come to be known as “Ground Zero” burn well after the attacks. But most of us went back to our lives—back to family, back to work, and back to the trivialities that make up our days.

But what of the more than 60,000 firefighters, police, medical workers, contractors, and volunteers who, over the course of some ten months, engaged in operations 24/7—first searching for survivors and, after a time, human remains—and who worked tirelessly to remove whatever was left of the Towers and clear the site?

It is difficult to conceive of the magnitude—ultimately, there were more than 11,000 plaintiffs who brought separate, but related, actions against the City of New York, the Port Authority, the Army Corps of Engineers, and the private contractors who supervised the work at Ground Zero. Those plaintiffs evidenced symptoms of more than 300 different diseases that they claimed were caused or exacerbated by the noble—yet hazardous—work they performed.

To ensure monies were available to help those who became ill—and to ensure that the defendants (including the City of New York) did not become bankrupt from the claims—Congress enacted legislation within days of the attack that created a no-fault Victim Compensation Fund, which would ultimately be available to a broad range of injured victims and bystanders who suffered health consequences as a result of the 9/11 attacks.

All of these cases, guided by the related case rule in the Southern District of New York, landed in the courtroom of Judge Alvin K. Hellerstein, a lifelong New Yorker whose courtroom, and office before that, sat a half-mile from the Twin Towers. It was possible—even likely—that Judge Hellerstein personally knew some who died in the disaster. Did he know the now-widows and widowers who came before him as plaintiffs? Had he worked—perhaps, dined—with any of the parties? Did he disclose his relationships and, if so, to what end?

Having been handed these cases, Judge Hellerstein had to first develop a matrix—with computer-generated statistical analyses—to address the claims and defenses in a way to ensure fairness to all parties. It would be impossible in this discussion to detail the ways in which he managed these cases, giving consideration to the plights of the plaintiffs as well as the contentions of the defendants. Indeed, the cases were so numerous, and the claims so diverse, that a special master was appointed with the primary task of organizing the claims so that there could be a reliable count of the plaintiffs involved and the specific harm they sustained, which were ultimately categorized by severity.
By all accounts, the defendants’ counsel took a scorched-earth approach, litigating every aspect of the case and ultimately charging several hundred million in fees and expenses. By the time the case was ready for the first wave of staggered trials, 1,200 depositions had been taken and more than 100 motions were pending. With the prospect of trial, the parties reviewed their claims—the number of plaintiffs who suffered only minor injuries and those that sustained serious injury. Could those who were seriously hurt be fairly compensated without exceeding the likely available funds? Was the City of New York immune from suit, or was it an “employer” to some, so that different rules applied? Would the defendants have succeeded in Daubert hearings so that plaintiffs could not present expert testimony, thus losing their ability to receive compensation as a matter of law?4

Given the innumerable issues, the lawyers did what lawyers must often do—in 2010, before a single witness was called, they announced that they had settled: $575 million would be paid to the plaintiffs (with additional monies up to $657 million available under certain circumstances). Of that, counsel demanded approximately $200 million—the third of the recovery set forth in their retainer agreements. In response, Judge Hellerstein did what judges rarely do—he rejected the settlement even though no party in court stood up to oppose it. His action was applauded—in both the courtroom and the press. But what were his reasons? Was he concerned that counsel for plaintiffs—who had worked on a contingency and who borrowed millions to fund the lawsuits, including to pay the more than $3 million in court filing fees alone—were to receive too much of the pie? Was he concerned that the fund was withholding too much money for potential future claims, even though nine years had passed since the Towers fell? Or was the settlement insufficient because it simply did not give the plaintiffs enough money?

And in rejecting the settlement, Judge Hellerstein necessarily acknowledged that these cases were not “class” actions, which would have unequivocally subjected the terms to a fairness hearing. Did Judge Hellerstein inwardly—or even outwardly—question whether he had the authority to reject the terms? Was he concerned that a party, rather than accept his decision and go back to the settlement table, would appeal his ruling? Or did he conclude that, given that the attorneys represented so many plaintiffs, there was an inherent conflict—that they may have settled the cases of those severely hurt for less than they could have received at trial in an attempt to also settle the claims of those with minor injuries? Indeed, because of the sheer number of plaintiffs, was it the lawyers—and not the parties—who controlled the settlement? And did these factors allow him to resolve counsels’ “conflict” by becoming the arbiter of what was “fair,” notwithstanding that the settlement proposed was one made between parties to a litigation with the advice of competent counsel on one side, and plaintiffs’ counsel alone on the other (subject to ratification by the represented plaintiffs)?

The parties did go back to the table and three months later arrived at a settlement for approximately $150 million more than initially proposed. Controversial and determined to the end, Judge Hellerstein cut plaintiffs’ attorneys’ fees to 25 percent—amounting to roughly $185 million in legal fees—and denied them the right to receive interest (more than $6 million) on the $30 million they borrowed to fund the suits.

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Yes, despite the admirable work they performed and that, in Judge Hellerstein’s words, counsel “took on the cause” and “financed this cause at great, great expense,” he determined that the settlement monies (or was it their work?) did not justify their fees. Did Judge Hellerstein consider the loans taken by plaintiffs’ counsel to fund the case and the personal guarantees they were required to give the lenders?

Did Judge Hellerstein—himself a litigator in private practice for 38 years prior to taking the bench—put aside what he personally knew about what it meant to be a litigator? Indeed, did he consider what he would have done differently had he been counsel for the plaintiffs? As defense counsel, would he have subscribed to a combative, take-no-prisoners plan of attack?

Was Judge Hellerstein concerned that, by rejecting the settlement, he would force parties to trial, even though it likely meant certain plaintiffs would receive nothing because it was probable they would not meet their Daubert proofs? Or did he roll the dice on their behalf, believing that if there was $575 million in settlement funds, there was indeed more? And did he see it as his job to play chicken simply because he alone thought the lawyers were getting too much money, and because aggressively “pursuing justice” was ultimately a responsibility that motivated him throughout the litigation?

And what did Judge Hellerstein think of the final settlement and how its terms would be disclosed to the plaintiffs (a percentage of whom had to approve the terms)? Having obtained a “fair” settlement—or as fair as he believed could be achieved—did Judge Hellerstein believe it was his job to meet with the plaintiffs to explain the terms to them? And did he advocate in favor of the settlement, believing it was the best plaintiffs could hope to gain?

The Dialogue

**JC:** In talking about the so-called 9/11 cases that you handled over the last ten years or so, we could discuss many different issues; but I wanted to concentrate on what led you to initially reject the settlement mutually proposed by both sides.

But before we go into that—I have wondered about this macro issue: Everyone in New York knew someone, directly or indirectly, who died on 9/11, or suffered serious injury or disease resulting from it. These chambers are literally in the shadow of the World Trade Center. Looking out this window on 9/11, you could have seen the billowing smoke. Like most New Yorkers, for two months afterwards, if you were downwind from the World Trade Center, you could still smell the horrific odor from that ad hoc putative cemetery as far away as five or six miles . . .

**AKH:** I could smell it every day when I entered this Courthouse.

**JC:** Despite the catastrophe that was almost adjacent to this Courthouse, you were called upon to sit on a case involving thousands of people who suffered in the aftermath of those 3,000 murders. If you were sitting, instead, in Kansas or Montana or Tennessee, you might have been able to be reasonably objective about what was pending before you. Could that possibly have been so for a judge where the facts were so proximate to you and your daily life?
AKH: I think that putting on the robes, or sitting at a desk like this, trains you to be objective. It trains you to be aware of your biases—given that we all have biases—to try to judge the case according to its merits and not according to your biases. In the cases I sat on, there was no “good” side or “bad side.” I dealt with people who on both sides were innocents. The people who claimed to have suffered injury were suing the City or aviation companies or insurance companies who insured the City and the aviation companies, the private contractors and the like. None were bad individuals or entities in the conventional sense. Maybe some were negligent, but no one was bad. There were very few workplace injuries. So it’s not a question of good guys against bad guys.

JC: But even with no good guys or bad guys, there were victims—maybe not all 10,000 plaintiffs . . .

AKH: Yes, some were seriously injured. Some were along for the ride.

JC: But knowing that some were indeed seriously injured, was it possible—despite your “objectivity” training—for you to be as objective as if you had lived elsewhere and hadn’t encountered, both on the street and in the media, day after day, month after month, the post-9/11 suffering?

AKH: What I saw, smelled and heard, had nothing to do with the conditions of the plaintiffs. The plaintiffs might be entitled to recovery, but they had to prove their cases. Anticipating this interview, I tried to develop some of the things that I thought about. One recollection was my determination that the cases had to be aired—everyone had to be given a shot to prove his case. In that sense, I did have a bias to advance the merits. Second, I was particularly aware of a very heavy social responsibility. I was aware of a bias in society about plaintiffs’ lawyers, about insurance companies, about people who might not have suffered injury but still sought a recovery. And I wanted to run this case, as best I could, in a way that the man on the street would find respectful of everyone, without letting anyone take advantage of anyone else. I wanted this process to be a credit to the courts and to the judicial system—to basically show that they worked. Indeed, I had a very close relationship to some people involved in the case.

JC: By “some people,” you mean parties?

AKH: Yes. The earliest litigation had to do with the Special Victim Compensation Fund and the special master. One problem was trying to define just what the Fund was supposed to do. Some of the estates of those who died were people of extreme wealth who could make substantial recoveries if they sued. If they went into the Compensation Fund, they feared they wouldn’t get their full due. And yet, the Fund was supposedly open to all. So they brought a lawsuit claiming that the Fund was not constructed lawfully. They wanted it changed to eliminate what they perceived to be the ceiling of recovery. Ultimately I held that there was no ceiling. But in this context, certain aspects of the case concerned me greatly as to bias.

First, I was reading affidavits and declarations of widows of people I actually knew. Indeed, Cantor Fitzgerald had been a client of mine, and I had litigated for them. Its principals were guests when I was inducted as a judge. I had worked with the people who died, and was
compelled to read the affidavits of their widows. I had previously enjoyed breakfast at the Cantor Fitzgerald offices that were destroyed. And so I had an intimate knowledge of the parties.

I also wanted very much for the Fund to succeed because, to the extent it succeeded, it removed pressures in the cases before me and made more possible that there would be enough money for everyone entitled to recovery. This is because the Fund was funded by appropriations from Congress, and it had no ceiling. Ultimately, [Kenneth] Feinberg paid out over $6 billion. If that money had not been paid out by the Fund, it may have affected the ability of the carriers to pay out cases that were sustained against them. So I badly wanted that Fund to succeed. Third, I wanted to be sure that plaintiffs had the right to choose between them. That choice was not procured by pressure or by fraud. I wanted it open. So I tried to construct the whole thing as an open proceeding. With regard to the people and parties I knew, I knew people on both sides very well. So when I first became aware of this, I wrote a letter describing my conflicts, so that if people wanted to challenge me we could consider that . . .

JC: When you say you knew people on both sides, who on the defendants’ side would you have known?

AKH: I gave Feinberg his first job.

JC: He was a party?

AKH: He was. It was Collaio v. Feinberg. Mark Muller and I had been friends for 20 years—he represented the aviation plaintiffs, many of them.

JC: Aren’t you sort of making my point? Given the relationships that you had—relationships you wouldn’t have had sitting in Omaha or Nashville or Montana—were you able, in your own mind, to do what you needed to do as “pure” judge, uninfluenced by the possibility of personal bias?

AKH: There’s no such thing as purity in judgment. Without facts and context, judgment becomes abstract—you lose out on the passion of judging. Justice does not require absolute purity, but a check on bias. I’ll go back to the Biblical signpost above your head: “Justice, Justice shalt thou pursue.” Why does the Bible, which does not like to repeat a word, repeat “justice”? There are many interpretations, but the one I like best is that “Because justice is elusive it must be found. There must be a search for it. One must have a passion to find justice.” To the extent that you treat this as just another aviation accident you lose the sense of the passion to do justice because there has been an outrage. That outrage must find its way into the sorting-out of the lawsuit.

JC: You mentioned before that you were aware going in that there was some bias against plaintiffs’ lawyers. I assume you meant that they are in it “for the buck.”

AKH: That’s not what I meant.

JC: What did you mean?
AKH: I came to believe that one set of plaintiffs’ lawyers had not screened their cases and were bringing cases to create a mass. In that way it would create leverage to help plaintiffs’ side against defendants. And there were certain things that I found out in the course of presiding over the cases that fortified that view. But I would say that I myself didn’t have a bias against these lawyers.

JC: No. I’m not saying that you had a bias against them, but that you felt that the public might have some bias against them.

AKH: The public is biased against trial lawyers. There have been various measures in Congress and various epithets used about trial lawyers. That’s what I was referring to. I don’t have any bias against lawyers—I was one, as you know, for 38 years before I became a judge.

JC: So of the roughly 10,000 plaintiffs in the combined cases . . .

AKH: More. There were 11,000 filed cases dealing with people claiming injury from working on the World Trade Center.

JC: Did you have a sense of what percentage of those were bogus claims?

AKH: “Bogus” is not a good way to put it. When enough discovery had come in to allow us to take a statistical sampling, we found that almost a third of the cases had no observable damage—that people who claimed damages could produce no medical tests to support their claims. And then we also found that about eight or nine percent of the cases, when pushed, resulted in plaintiffs failing to show up. They didn’t show up for discovery, or were duplicate claims.

JC: When you didn’t accept the term bogus, does that mean that you concluded there may have been actual injuries, but they weren’t observable?

AKH: Yes. Compensable injury requires proof—you need some proof that you suffered an injury.

JC: When you say you’re bothered that some of the plaintiffs’ lawyers didn’t screen their cases sufficiently, it’s that they didn’t screen the cases to determine which were compensable?

AKH: Yes. And accordingly they were doing their clients a disservice. Under New York law you have until a manifestation of injury to sue. It’s possible that some individuals who had suits filed on their behalf did so because they had a cough or something like that, that would create a case with a small recovery. Or maybe no recovery.

JC: Was there anything that you could do to insure that the plaintiffs were legitimate plaintiffs in the sense that their injuries could be compensable?

AKH: Yes.

JC: What did you do?
AKH: We designed a discovery program requiring every plaintiff to respond with sworn
answers to interrogatories designed to obtain disclosures—where they worked; when they
worked; what kinds of safety devices were they given; what instructions were they given. Thus,
everyone had to tell something about the essential facts of this case. If people didn’t respond, I
dismissed their cases—indicating to me that those whose cases were dismissed never really
wanted to sue in the first place. Or at least many of them.

JC: How many cases got dismissed that way?

AKH: A thousand. Not all were dismissed. Rather, I was beginning to put them in a
posture of dismissing them when the settlement came along. Because of the interest of the
insurance company in taking care of every potential claimant, many of these cases were
included. When they didn’t show up the second time around, I dismissed them.

JC: If this case were a “class action,” you would have had far greater supervisory
power.

AKH: Yes and no. I would have been able to supervise a fairness hearing regarding fees
and with the fairness and value of the overall settlement. I did that anyway. But there would have
been specific provisions of law in Federal Rule 23 giving me this right. However, once a
settlement is approved, typically the judge does not have oversight responsibilities. He could
have, but he doesn’t really have it in terms of the distribution of the money. That’s left to the
plaintiffs’ lawyers. Sometimes there are different plaintiffs at different subclasses, and the judge
has some power there. But typically there’s very little oversight on the administration of a fund.
By the way, I arranged the cases as aggregates of individual actions, I had supervisory power
from beginning to end.

JC: There’s a view that some have held that you arrogated—I don’t use that word as
an ad hominem—to yourself, powers that you really didn’t have because you were displeased
with the settlement proposed by both parties.

AKH: I don’t agree with that word. I did gather to myself powers. There are two
paradigms in settling civil actions. [Federal] Rule [of Civil Procedure] 23(e), the class action
rule, accords the judge the duty to conduct a fairness hearing with regard to the settlement and
fees. And Rule 41 allows dismissal at plaintiffs’ request without a court order. If all parties settle,
under Rule 41 there’s no provision for a judge to supervise or review or sign off on the
settlement. There’s a practice in the Southern District of New York giving the judge that
signature power but it’s not necessary—it’s a case that would be settled by the decision of the
parties and lawyers alone, without the judge, particularly if the judge is not asked to do anything.
So, I had to confront the situation where it was neither a class action nor individual action. And if
I didn’t “arrogate”—as you use the term—this power to review and supervise, there was great
danger of inadequacies in these cases.

JC: With great respect to you, the plaintiffs and the defendants, both sides presumably
well represented, wanted this resolution. Plaintiffs’ counsel—capable lawyers, by most
accounts—decided that the sum proposed was sufficient for their clients. Why did you feel the
need to get involved?
AKH: When you settle a case for a client, who settles? Whose signature is critical . . . The client.

JC: Right.

AKH: Who has the right of approval?

JC: The client.

AKH: Who gives the instructions to the lawyer?

JC: The client.

AKH: In this case the agreement was between one party—the insurance company representing the City—and the lawyers for the plaintiffs, subject to ratification by ninety-five percent of their clients. Those that didn’t ratify were basically opting to continue their lawsuits. That’s a different paradigm.

JC: You’re basically saying that these lawyers, in entering into this settlement, had a conflict with their own clients?

AKH: Potentially.

JC: Isn’t that the case in every single individual case?

AKH: No.

JC: With a single plaintiff automobile accident, the lawyer thinks that if the case is settled for a million bucks his share will be $333,000. He wants that settlement rather than litigate a case that he might lose. The client wants to go for broke and demand $3,000,000 or go to trial. That lawyer too is conflicted, isn’t he?

AKH: No. The paradigm there is the lawyer recommending the settlement to the client. But the client has the final decision. I’m confronted with that almost daily. Part of the judge’s job is to try to accomplish settlements. Parties want to settle and the judge can facilitate the settlement. But it’s always subject to the client’s review. In many instances the lawyer will tell me “I wish I could settle but my client doesn’t want to.” In the case of these 9/11 cases—these aggregates—it didn’t break that way. The money that was offered was not individual. It was for the group. There was an upside and a downside.

And the mode of settlement for class actions—Judge Weinstein has called these aggregates “quasi class actions”—I didn’t use that. I mentioned it when I justified what I did. But the hallmark of what we’re doing is “fairness.” And fairness is very hard to measure if one lawyer represents a lot of clients. How do you measure fairness when the lawyer has to look to settle en masse? Are the really good cases being compromised in order to settle the weaker cases? Are the weaker cases getting more than they should be entitled to because of the defendant’s desire to get releases from everyone? If a lawyer has been carrying the case for five or six years, borrowing at compound interest at rates going to 16 and 17 percent, is a lawyer
independent when it comes to the opportunity to settle? Will he give the clients fair advice? Will he describe his potential conflict adequately? I think all these have to concern the judge and cause the judge to be more active in reviewing the case than the judge might be if it were one party against another.

JC: Let me be blunt in my next question.

AKH: As opposed to the previous questions?

JC: Even more so in this instance, my friend. Were you more bothered by the clients not getting enough of the pie, or by the lawyers getting too much of the pie?

AKH: Both. Because my experience with settlement is that defendants want to put up a certain sum and are indifferent to how it’s divided.

JC: But the lawyers made a considerable investment in this case.

AKH: I was respectful that these lawyers had carried the case and brought it to the point where it could settle—that they had done a great job in doing that. They had proved their endurance, their zealotry, and that they were ready to take the case when other lawyers might not have been ready to.

JC: And they made a considerable investment of their own funds.

AKH: Yes, all that.

JC: The lawyers had made substantial investments of time and money for filing fees, experts and the like. Yet you were concerned that the plaintiffs weren’t getting enough of the pie and the lawyers getting too much of it? Does that mean you’re bothered generally with plaintiffs’ lawyers in contingency cases?

AKH: No.

JC: In class action cases do you typically reduce the plaintiff lawyers’ recovery?

AKH: Sometimes I add, sometimes I subtract.

JC: Sometimes you “add” to the plaintiffs’ lawyers’ recovery?

AKH: They ask for a certain amount, generally a liberal amount in relation to both percentage of recovery and in terms of what we call lodestar. So I typically don’t give percentages of recoveries. I typically give the lodestar plus or minus a bonus or discount to reflect success, or lack of success, and quality of their work.

JC: Had you given thought in the 9/11 cases to, instead of rejecting the settlement outright, bringing in a monitor to assess whether the plaintiffs were satisfied with their recoveries—rather than, sort of locus parentis, deciding for yourself that it wasn’t good enough?
**AKH:** How would I assess whether they got enough of the settlement? Compared to what? Compared to getting nothing? Compared to getting what they deserved? That’s a difficult question.

You know why I believed the settlement was not enough? It’s very hard to analyze a complicated settlement like this and say whether it’s enough. You go to people experienced in settling personal injury cases, and settlements are all over the place. It’s a function of the individual case. The extent of the injuries. The way the person has suffered. The ability to prove a case. Other considerations. It’s very hard to do. So certain things affected me. One, the nature of the potential conflicts that I talked about. This was not a party driven settlement but rather lawyer driven, based on large categories of numbers that could not really be related to the merits of particular cases. Two, it drove from an analysis of the nature of the insurance recovery. Three, it reflected what I had experienced in the case.

So all the money for the settlement was coming from FEMA. FEMA had given the City a billion dollars to fund its defense and to pay the liabilities and litigation expenses of the City and its contractors. When the number was first agreed to by the lawyers, and I announced it to the assembled throng of plaintiffs and their lawyers, I commented that now the case is easy to settle. And the plaintiffs’ lawyers said, “No, we need a lot more.” And they went into intensive discovery. To find out the insurance situation for all the individual contractors caused six months of proceedings, I think. Lots of motion practice. So now they were settling for a fraction of that. So I asked myself, why was a billion dollars too little at one time and much too much now? And so I thought the plaintiffs settled for less than they might have gotten.

Secondly, and apropos of that, I thought there was a disparity in bargaining power. Even though the plaintiffs got all they could get, their lawyers didn’t have the leverage, because the lawyers were overextended through borrowing. Third, the insurance company was not a continuing insurance company. It was a “single purpose” insurance company. Except for this case, they had no other purpose in life—so they were holding back much more money than I thought they needed to. That indicated to me that there was more that they should have been spending on this case. Those considerations, among others, led me to believe that the settlement was insufficient.

**JC:** While this was going on, given that you had been in practice for some 38 years, did you consider what you would have done differently were you the plaintiffs’ lawyers or the defendants’ lawyers?

**AKH:** I wouldn’t have been a plaintiffs’ lawyer in a case like this. But I did do some plaintiffs’ cases. And, whether I’d be a plaintiff’s lawyer or a defendant’s lawyer, I would like to think that I would have handled the case in a more disciplined fashion than either of these sets of lawyers did.

**JC:** “Disciplined” meaning what?

**AKH:** As a defendant I wouldn’t have spent the money they spent, at least I would like to think that. If I were the plaintiffs’ lawyer I would have screened my cases and done much
more to bring everyone along. But my experience probably isn’t important here because I was not a products liability lawyer.

JC: Whether you were a products liability lawyer or not, you were a complex case litigator. You certainly would have had some ideas. As a more “disciplined” lawyer, you would have done something different. For example?

AKH: I think they were litigating too many issues. It’s hard to understand all that goes on in a case and I’m not sure that’s a sensible position for me to take. It may be more of a bias.

JC: As a plaintiffs’ lawyer, wouldn’t it have been extraordinarily difficult to tell a possible victim—a first responder, for example, who honestly believed that he had contracted some horrible disease from the 9/11 dust—“Look pal, I don’t think you have a case because I don’t see the medical reports supporting your claim. Sorry, but I’m rejecting you as a client”?

AKH: That’s not how the cases were taken on by the lawyers. They’re taken in union halls or firemen’s associations or policemen’s associations and they’re signed up. There’s a book, “City of Dust,” that discusses how some of these cases were brought.

JC: Again, you say you were bothered by the fact that the lawyers weren’t more disciplined. I’ve also heard you to say that you felt that the amount of litigation that was going on in the defense side caused unnecessary work on the plaintiffs’ side.

AKH: Typically, the way to defend in a case like this or in a class action is to wear out the plaintiffs’ lawyers.

JC: Take too many depositions, and the like?

AKH: Yes.

JC: And since they’re getting paid on an hourly basis, there’s no investment on their side—whereas the plaintiffs’ counsel would have to redouble their efforts with no guarantee of compensation for their time.

AKH: It’s an asymmetrical motivation. The plaintiffs’ lawyers are thus motivated to economize. And the defendants’ lawyers are motivated to increase their fees.

JC: What can a judge do to stop that?

AKH: I don’t know. Try to control the case. Try to move the case in stages. Try to get the people to account for the depositions they take to make sure they have a firm idea of what they expect to get from those depositions. And to make judgments according to practicality.

JC: Are you saying there’s some flaw in the litigation process that allows lawyers to do this kind of thing?
AKH: It’s not a perfect process. I don’t have any recommended solutions. What I try to do is just to go from meeting to meeting to plan with the lawyers what the next stages are and to try to exert whatever judicial power I have to keep things in balance.

JC: Did you give them the sense during these meetings or court appearances that you were disturbed that they were running up the clock?

AKH: Yes.

JC: And what did they say in response to that?

AKH: They didn’t. These are my observations that I expressed to the lawyers.

JC: When you rejected the settlement . . .

AKH: I would say there was abuse on both sides.

JC: Well, the abuse on the plaintiffs’ side wouldn’t be running up the clock.

AKH: It was their unwillingness to make their cases clear—trying to obfuscate the good cases with the bad cases.

JC: You’re basically saying that the settlement process leads to settling cases for . . .

AKH: It’s the whole process. It starts with the pleading. And plaintiffs’ lawyers try to make sure they can cover everything by their pleading so they’re not giving precise notice. At pre-trial meetings, I tried to get more precision on the part of the plaintiffs’ pleadings so that we can handle the case in a more intelligent way, but I couldn’t get it.

JC: When you rejected the settlement the first time it was presented to you, did you do an analysis in deciding that you wanted to reject it, or were the numbers just so bothersome on their face that you said “I’m not going to accept this”?

AKH: I read the agreement. I considered what was being held back and that was much too much.

JC: Please explain “being held back.”

AKH: In reserve by the insurance company, in case there would be later cases. I didn’t think there would be later cases, or that they would amount to anything.

JC: And you thought that the legal fees were too high?

AKH: And I thought the plaintiffs’ legal fees were too high and that if the plaintiffs’ lawyers didn’t have all those fees that the plaintiffs themselves would get more of that money.

JC: Did you consider telling them the number that you wanted to accept as a settlement?
AKH: No.

JC: Is there a reason?

AKH: Because the bargaining process was theirs, not mine.

JC: But weren’t you getting involved in the bargaining process?

AKH: Uncomfortably so.

JC: Why didn’t you take that extra step and say, for example, “I need another hundred million dollars for these plaintiffs”?

AKH: You know how negotiations go. If the judge says a hundred million dollars, the parties will try him at 50 million dollars or 60 million dollars. I left it open. The way it came out is that the insurance company put in an additional 50 million dollars and that money was going to the seriously injured. They enlarged the fields of those who would be entitled to seek recovery to include more cancer patients. They created a better process. The plaintiffs’ lawyers, by reducing their fees from the 33-1/3 that they wanted to 25 percent, yielded another 50 million dollars into the pot. And they were able to negotiate the abatement of liens that amounted to maybe another 50 million dollars, or even more. So the ultimate settlement in its net effect was probably worth $150 million more than the first one. Plus, I think my active involvement in the case led to settlement with the Port Authority and other defendants that added another $75 million to the case.

JC: Needless to say, the 9/11 cases will have been viewed now and in history as the hallmark of your judicial career. Is it the most important thing you have done as a judge?

AKH: In the concept of administering a large number of cases and not letting it bog down my overall calendar—because I continued drawing the same number of cases as every other judge—I think it was a big achievement. In the sense of bringing justice and resolution to a large number of people, I think it was a big achievement. But you, Joel, have heard me talk about justice in smaller cases that gives me even more satisfaction.

JC: Since our readers wouldn’t otherwise know that you and I are good friends, they would also not know that some years ago, while this case was proceeding in its heyday, I had the sense and worry—and maybe expressed it to you in these terms—that the overall case seemed to be grinding you down.

AKH: At times it did.

JC: Because of the legal work that you were being required to administer, or the pain that people had suffered that was before you on a daily basis, month after month, year after year?

AKH: No, not really.

JC: What was it?
AKH: It was that I felt that I didn’t have a solution to the case. At various times I just didn’t see a light at the end of the tunnel. I was feeling defeated by the sheer complexity and magnitude of the cases and, in that sense, I felt oftentimes depressed that I would not be equal to the task.

JC: Obviously that turned out not to be true.

AKH: I didn’t know it then. It reminds me of a time as a trial lawyer where I really had delivered a good summation in a case and I won even though I had no right to win. One of my colleagues in the firm said, “You know Al, I’d like to read your summation.” I said, “There’s only one problem. There’s no typed summation.” I hadn’t asked the court reporter to take it down. So, “Why didn’t you ask the reporter to take it down?” I said “I didn’t know before I began it that it would be so good.” [laughter.] That may seem immodest, but that’s the way I feel about this.

JC: If another tragedy like this occurred and you were assigned the case of this magnitude, what would you do differently?

AKH: Probably every step would be different. You read the judicial manual for complex litigation, you read some articles, you do other things. But basically this case was unparalleled. It had no precedent. There were several hundred different types of injuries to address. The magnitude of cases—eleven thousand. It defied easy resolution. There was jockeying among the different lawyers at the beginning. To get all this in one place and under some kind of management. It proved to be very difficult. I made a decision, first, that there would not be a class action. And the second major decision was that I would not surrender control to the lawyers. I needed to create a discovery program that could be automated, that could be subject to computer analysis, that would allow everybody equal footing to understand the cases, including the court. And under some kind of a schedule that would drive inexorably towards resolution at some reasonably prompt point. And that was very difficult because plaintiffs do not want to be definite and certain in their pleadings. They want to plead in a conclusory fashion. They often don’t know enough about their own plaintiffs. They have too many to make this kind of analysis. They don’t want to put themselves into a box and make it easier for the defendants to shoot at that box. So they try to be amorphous and to surround the defendants with huge numbers of cases to create uncertainty on their part. Defendants want to run their cases to take some of the élan out of the plaintiffs’ lawyers and to grind down the case to make it difficult for the plaintiffs to recover. And these two motivations, these two tendencies were not jelling in a way that would allow me to grab hold of the case.

My two special masters, the professors, were appointed initially because I couldn’t get accurate numbers of how many cases there actually were. There were wide differences between the plaintiffs’ counts and the defendants’ counts. And unless I knew the number of cases and what they were, I couldn’t really grab hold of the cases. That was hard to do. Plaintiffs would bring cases to me, removed from the state supreme court, in batches of a hundred. I insisted that each plaintiff have his own index number. Otherwise I’d never get control. Otherwise I’d never get a sequence of cases. And that was done. And so gradually I got control of the case. And then the special masters were able to find a wonderful computer company that could work with us and I was trying to develop a core discovery program that was acceptable to gradation in terms of
what a computer can analyze. We were able to achieve that. And as a result I was able to get a substantial amount of discovery disclosures in each and every case. Typically sampling takes place, the lawyers are asked to pick a couple of cases, and we’ll try them. And we’ll try some more cases until some number comes out and we get the valuation of the cases, and a few different kinds of scenarios and then there can be an overall settlement. I didn’t feel this could work. There were too many injuries. There was too much complexity. And I didn’t want to surrender control of the cases to the lawyers.

And so I developed a paradigm, and I think this could be a matrix for all these aggregate cases. So that everyone, lawyers and judge and special masters would have the same set of reliable data points. And they could then look at the case and consider similarities, patterns and derive values. And then go into a sampling of intensive discovery which would be a check on the reliability, because if the answers did not support the interrogatory answers then we’d know there was some problem. And we’d get very good information about each case and then make another sampling to select cases to go to trial. And that’s how we laid it out. And in the context of that the settlement was reached.

**JC:** You went on a bit of a “road show” to “sell” the settlement to the plaintiffs, didn’t you?

**AKH:** To “sell” is to express the view of some of my critics in the court.

**JC:** As I recall it, you did that over my personal advice to you. Did you find that any of the plaintiffs were unhappy that you rejected the original settlement?

**AKH:** None. When I announced in court that the settlement was not enough—that there was too much for the lawyers and not enough for the plaintiffs—I was embarrassed at the applause I got. The Daily News put me on its front Sunday page. There was one word on the front cover. It said, “Finally.” There was an overwhelmingly favorable response. I told the parties that if they could come up with a settlement that I would find reasonable I would create a procedure by which we would go out to the people where they lived and explain the settlement to them so that they could make the decision for themselves.

And I would let people know what my views were. When the settlement came in, I approved it, I approved it as fair and reasonable, not perfect. It was not perfect because I didn’t think that it included enough of the cancer cases. The cancer cases were hard to prove as to causation and since the settlement was not a compensation scheme but a settlement, the consensus view among the lawyers and others was that the settlement should not be just giving money to people who couldn’t prove the likelihood that their sicknesses derived from their work on 9/11. I felt differently. I felt the converse also was true. You couldn’t disprove it. When people went to work at the WTC site, they were healthy. Then they got sick. And in their minds the work was a contributing cause to their sickness and there should be some allowance for them in the settlement. But I never achieved that.

**JC:** Did you get criticism for the “road show”?

**AKH:** No. I spoke about it with some of my colleagues, and based on their early criticisms I adapted modified procedures and the procedures worked. Instead of my making the
presentation I had a full complement of lawyers on the case with a court reporter and with court officers—we in effect extended the Southern District of New York into Staten Island and into Queens to reach most of the people. It was virtually the same as if it were in my courtroom, which obviously couldn’t happen with the sheer numbers of plaintiffs involved. I invited the press and I had each side explain their views on the case. I regulated the procedure. I spoke also. Ken Feinberg spoke—he was the special master for appeals from determinations by the administrator of the settlement. And in effect we had the same kind of presentation that we would have had in the Southern District of New York, bringing it to where the people were.

**JC:** What was the core criticism by your colleagues?

**AKH:** They thought it was inappropriate for the judge to go out and advocate the settlement. And I thought there was some point to what they said—that there had to be a distinction between explaining the settlement and advocating the settlement. Nonetheless, I had a view and I was going to express it. I do think the procedure I created was enormously improved by the criticisms I received.

**JC:** But at the end of the day you did advocate, didn’t you?

**AKH:** I presented my views. People asked me what I thought. I said I thought the settlement was not perfect, but reasonable. And people came and expressed their views and some people were regretful that they could not qualify and there was debate at some of the meetings. There were people who came up and spoke against it and that engendered debate. The debate was more by the people involved than by me. I didn’t debate.

**JC:** Last question. If another mass tort case were to be rolled out to Judge Hellerstein should the plaintiffs’ lawyers, or defendants’ lawyers, or both, be troubled by it being assigned to you?

**AKH:** I hope not. I hope not. I don’t know if they criticize me as being fair or unfair, hard or not hard. Obstructive or not. In my own mind, I think I moved the cases towards a resolution that was fair. I think I was respectful of both sides, and I think both sides felt that they had a very good day in court. And a judge who can produce that, I think the judge is doing his work.

You know, an adversary procedure motivates people sometimes to go to excess. And when there’s a check on excess and when people go into the median and substantial justice gets done, I think everyone is basically pleased. And I think the fact that over 99% of the eligible people approved the settlement—both those that were getting small amounts of money and those getting sizable amounts of money—is a very powerful approval. I don’t know of any settlement that has achieved a 99% plus vote of approval. I don’t know of anything in life that gets a 99% plus vote of approval.

And I guess that’s the best reflection of what I did and frankly, what I’m very proud of having achieved.
AM I SECURE? NEVERMIND, THE HACKER JUST TOLD ME NO.

A CASE STUDY OF CYBER SECURITY INCLUDING LEGAL PROTECTIONS, INSURANCE CONCERNS AND SECURITY STRATEGIES

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APPENDIX A, STATE LAW RELATING TO PERSONALLY IDENTIFIABLE INFORMATION ............................................................. 19
I. INTRODUCTION.

Companies and organizations have been the victims of security and data breaches since the late 90s, and unfortunately, as discussed below, the statistics are not showing a decline in these breaches. As such, Section II of this article assesses security and data breaches, how breaches are caused and the costs associated with breaches, and Section III discusses the federal and state regulations and statutes that govern personally identifiable information ("PII"), breaches related to PII, notification relating to breaches and disposal requirements for PII. Section IV addresses insurance risk and, more specifically, cyber risk, and Section V explains the manner in which negligence actions are brought as a result of a security or data breach and the limitations to those claims.

II. DATA BREACHES.

Advances in technology over the past 10 years have drastically changed the way most companies do business. Today, companies operate almost exclusively through electronic mediums and have an increasingly mobile work-force that use websites and intra-nets, who advertise and communicate via social media, etc. Most companies communicate through e-mail, and, thus, electronic files have largely replaced paper files with lap-tops/tablets and mobile phones to place sensitive data in the “Cloud”. Companies have always collected, maintained, and utilized various types of confidential data and information. However, in today’s society, all data has value to someone, whether it’s the company itself, a client, a customer, an employee of the company or some other third-party. Additionally, many small to mid-sized companies outsource the management of their computer networks, and, in many cases, the maintenance of their data.

Overtime, there have been three important changes in the information age: (1) most of the data is now collected and maintained via electronic means; (2) the data is being exchanged and manipulated via electronic mediums; and, (3) the data is more widely accessible – the workforce is mobile, ergo so is the data.

Security and data breaches are not new occurrences, but the past few years have brought many high profile data breaches in the national news. We need only look to Target and Home Depot for the most recent examples of devastating data breaches. See John Winn & Kevin Govern, Identity Theft: Risks and Challenges to Business of Data Compromise, 28 Temple J. Sci. Tech. & Envtl. L. 49, (2009) (discussing data breaches as early as 1989 and data breaches of networks at TJ Maxx/Marshalls, Barnes & Noble, Bank of America, Wells Fargo, Stanford University, Princeton University, The Veterans Administration, Fannie Mae and the City of San Francisco between 2007 and 2009); see also Matthew J. Schwartz, 6 Worst Data Breaches of 2011, Information Week, http://www.informationweek.com/news/security/attacks/232301079 (2011) (discussing significant data breaches in 2011, including Sony, Epsilon, RSA, Sutter Physician Services, Tricare and Science Applications International Corporation
("SAIC") and NASDAQ). "A news report from the Privacy Rights Clearinghouse ("PRC") notes 535 breaches during 2011, involving 30.4 million sensitive records," which brought the PRC's total number of reported data breaches in the United States from 2005 to 2011 to 543 million. See Schwartz, 6 Worst Data Breaches of 2011; see also The Top half Dozen Most Significant Data Breaches in 2011, Privacy Rights Clearinghouse, https://www.privacyrights.org/top-data-breach-list-2011 (December 16, 2011). This, however, should be viewed as a "conservative number" because the PRC generally learns of data breaches when the breach receives media attention and many data breaches do not. Id.

The Ponemon Institute, a research think tank that "conducts independent research on privacy, data protection and information security policy," has "tracked endpoint risk in organizations, the resources to address the risk and the technologies deployed to manage threats" since 2010. See http://www ponemon org/ and Ponemon Institute, 2013 State of the Endpoint, available at http://www ponemon org/library/2013-state-of-the-endpoint-1 (December 2012) (hereafter cited as "State of the Endpoint") (The 2013 State of the Endpoint study was sponsored by Lumension and conducted by the Ponemon Institute.). The Ponemon Institute's 2013 State of the Endpoint study revealed that one of the top concerns relating to data breaches "is the proliferation of personally owned mobile devices in the work place," such as laptops, smart phones, tablets and other mobile data-bearing devices because the devices are not secure. See 2013 State of the Endpoint, supra, at 1. Other risks to the security of a company's data include, but are not limited to, malware, cyber-attacks, "vulnerabilities in third-party applications," "the use of cloud computing infrastructure and providers," "removable media" (i.e., CDs, DVDs, etc.), "mobile/remote employees" and "negligent insider risk." Id. at 1 and 5. Another risk includes "spear-phishing" emails, which are sent to targeted individuals in hope that the individuals will open the emails or click on the links contained within the emails creating a "backdoor for the attacker to breach the targeted organization." See Internet Security Threat Report 2014, Symantec Corporation, 2013 Trends, Volume 19, at page 25: http://www symantec com/security_response/publications/threatreport jsp (April 2014) (hereafter "Internet Security Threat Report 2014").

The top three industries that were targeted in spear-phishing attacks in 2013 were: (1) governmental entities; (2) professional service organizations and (3) non-traditional professional services organizations. Id. at page 29. However, cyber related exposure is not just a problem for larger companies. According to a 2013 report by Symantec, in 2012 fifty percent (50%) of the attacks were directed at businesses with less than 2,500 employees, with the largest segment being companies with less than 250 employees. Id. at page 30. Hackers view smaller companies as "easy targets," as the companies often have less sophisticated security systems in place protecting their data. Id. Moreover, the costs associated with data and security breaches are high. Below several risks faced by companies that have suffered data and security breaches are discussed.
A. Financial and Reputation Risks.

In addition to the costs to the individual who has been a victim of the security/data breach (i.e. misuse of his/her credit information, the cost of credit monitoring, etc.), companies that suffer such breaches are exposed to significant costs ranging from indemnifying each individual customer, the cost of notifying each individual customer of the breach, the cost of coordinating with each credit reporting agency, assisting law enforcement in its investigation of the breach and the cost of possible system upgrades, etc. See Winn & Govern, supra, at 52; see also 2013 State of Endpoint, supra, at 12 (Noting that forty-six percent (46%) of companies surveyed reported that their Information Technology operating expenses have increased, and, of those sixty-four percent (64%) say the significant reason for this increase is malware incidents.).

This is not to mention the public relations nightmare each company must face and the response to the crisis itself. The reputation of a company is at the very core of its business. A company builds its “reputation” slowly over time but can lose it in an instant. Loss of client trust and confidence can cause significant long term financial harm to any business, and a data breach is a severe blow to the very heart and soul of a company that can destroy its reputation overnight.

The Ponemon Institute has conducted annual studies on the costs associated to companies that suffer data breaches for the past nine (9) years. See Ponemon Institute, 2014 Cost of Data Breach Study: United States, at 1, available at www.ibm.com/services/costofbreach (May 2014) (hereafter cited as “2014 Cost of Date Breach Study”) (IBM sponsored the Ponemon Institute’s ninth annual study of the cost of data breaches for 2014.). According to the results of the Ponemon Institute’s 2014 Cost of Data Breach Study: United States, which defined a data breach as “an event in which an individual’s name plus Social Security number, medical record and/or financial record or debit card is potentially put at risk- either in electronic or paper format,” “[t]he average cost for each lost or stolen record containing sensitive confidential information increased from $188 to $201. Id. at 4 and 5. Of the $201, “$134 pertains to indirect costs including abnormal turnover or churn of customers.” Id. at 5. “The total average cost paid by the organizations [also] increased from $5.4 million to $5.9 million.” Id. at 1. Further, although prior studies have shown that the costs of data breaches born by the companies over the past two years has declined, the 2014 study showed that the costs to companies and organizations increased. Id. “The primary reason for the increase is the loss of customers following a data breach due to the additional expenses required to preserve the origination’s brand and reputation.” Id. “In fact, the average rate of customer turnover or churn increased by 15 percent since last year.” Id. And, while a company’s reputation is an intangible, its cost is significant. According to a study by the Gartner Group, approximately 40% of companies that experience data or security breaches are out of business within 6 months of the breach. See Roberta J. Witty, Research Roundup: Business Continuity Management And IT Disaster Recovery Management 4Q10, Gartner, Inc. (January 21, 2011). Further, for
companies that outsource their management of computer networks and data, the companies’ bottom line and reputation are, in many ways, tied directly to the reliability and security of the third-party vendors. Having a Public Relations firm in place immediately, at the point of breach, however, could be the life raft that keeps a company afloat, allowing it to survive.

Additionally, litigation costs incurred by the breached companies/organizations to defend against law suits and fines have more than doubled over the last eight years, on a percentage basis. Id. at 18. “[C]lass actions also expose businesses to intrusive and disruptive pre-trial discovery process as [well as] the possibility of punitive or even trebled damages.” See Winn & Govern, supra, at 55.

Even though security and data breaches are on the rise, companies and organizations have ways to proactively combat the breaches and data security. As discussed in Section III below, both federal and state governments have enacted regulations and statutes governing an individual’s PII in an effort to limit breaches. Individual companies have several effective tools available for reducing Information Technology (“IT”) risks, such as “privilege management,” “vulnerability assessment,” “security event and incident management,” “endpoint management & security suites/platforms,” “endpoint firewalls,” “device control,” “application control firewall,” “application control/whitelisting,” “anti-virus & anti-malware,” employee “training and awareness programs,” “expanded use of encryption,” “additional manual procedures and controls,” “security certification or audit,” etc. See 2013 State of Endpoint, supra, at 16 and 2014 Cost of Data Breach Study, supra, at 17.

III. THE FEDERAL AND STATE DUTIES IMPOSED ON PARTIES WHO HOLD AND STORE PERSONAL IDENTIFIABLE INFORMATION.

Given the number of security data breaches that have occurred over the past decade and a half, federal and state governments have enacted regulations and statutes governing PII, PII disclosure, notification of breaches of PII data and disposal of records containing PII.

Notably, the federal sector has shifted its focus from criminal enforcement to the regulation of businesses that gather, maintain and disburse PII. See Winn & Govern, supra, at 54. For example, the Gramm-Leach-Bliley Act (“GLB Act”), 15 U.S.C. § 6801-6809, provides consumer credit safeguard provisions for financial institutions and requires financial institutions “to protect the security and confidentiality of those customers’ nonpublic personal information.” 15 U.S.C. §§ 6801-6809; see also Winn & Govern, supra, at 57. The GLB Act requires that financial institutions establish standards “relating to administrative, technical, and physical safeguards (1) to insure the security and confidentiality of customer records and information; (2) to protect against any anticipated threats or hazards to
the security or integrity of such records; and (3) to protect against unauthorized access to or use of such records or information which could result in substantial harm or inconvenience to any customer." 15 U.S.C. § 6801(b). Financial institutions are also required to provide consumers a "clear and conspicuous disclosure of its policies and practices governing the protection and disclosure of nonpublic personal information of consumers. 15 U.S.C. § 6803. Subject to a few enumerated exceptions, the GLB Act prohibits a financial institution from disclosing any nonpublic personal information to a nonaffiliated third party unless (1) the consumer is "clearly and conspicuously" provided notice that the information may be disclosed to a third party; and (2) the consumer is given prior opportunity to direct the financial institution to not disclose the information; and (3) the consumer is given an explanation of how to opt out of the disclosure. 15 U.S.C. § 6802. Further, although the GLB Act does not provide consumers a private right of action for an alleged violation; the Act does grant enforcement authority to "the Bureau of Consumer Financial Protection, the Federal functional regulators, the State insurance authorities, and the Federal Trade Commission ("FTC")." 15 U.S.C. § 6805; see also Wood v. Greenberry Financial Services, Inc., 907 F. Supp. 2d 1165, 1186 (9th Cir. 2012) (holding that the GLB Act "does not provide for a private right of action.").

The Federal Trade Commission ("FTC"), 15 U.S.C. § 41 et seq., "is empowered, among other things, to (a) prevent unfair methods of competition, and unfair or deceptive acts or practices in or affecting commerce; (b) seek monetary redress and other relief for conduct injurious to consumers; (c) prescribe trade regulation rules defining with specificity acts or practices that are unfair or deceptive, and establishing requirements designed to prevent such acts or practices; (d) conduct investigations relating to the organization, business, practices, and management of entities engaged in commerce; and (e) make reports and legislative recommendations to Congress." See http://www.ftc.gov/enforcement/statutes/federal tradecommission-act and 15 U.S.C. §§ 41-58. The FTC has also established the "standards for safeguarding customer information," which "sets forth standards for developing, implementing, and maintaining reasonable administrative, technical, and physical safeguards to protect the security, confidentiality, and integrity of customer information." 16 C.F.R. §§ 314.1 - 314.5. While enforcing multiple federal laws, the FTC "has imposed heavy fines for rules violations and requires affected business to self-report data breaches." See Winn & Govern, supra, at 54. The FTC filed for civil enforcement against Nationwide Mortgage in 2004 and against Sunbelt Lending Services in 2005 for their failures to comply with the GLB Act’s data protection requirements to protect private data under the GLB Act. Id.; see also In the Matter of Nationwide Mortgage Group, Inc. and John D. Eubank, Federal Trade Commission, 042-3104 (2005) and In the Matter of Sunbelt Lending Services, Inc., Federal Trade Commission, 042-3153 (2005). In 2005, the FTC found that BJ’s Wholesale Club created unnecessary risks to its consumers by "(1) storing information longer than 30 days; (2) allowing anonymous employees access to consumer accounts; (3) failing to encrypt data; (4) failing to secure wireless access
portals and (5) failing to detect intrusions or conduct follow-up security investigations. As part of the settlement to the FTC’s action BJ’s Wholesale Club agreed to “write off $16,000,000 in claims for reimbursement from related fraudulent credit card purchases” and to 20 years of FTC supervision.” See Winn & Govern, supra, at 54 and In the Matter of BJ’s Wholesale Club, Inc., Federal Trade Commission, 042-3160 (2005). Further, in a recent decision, the United States District Court for the District of New Jersey held that the FTC has the authority to take action against companies that fail to provide and maintain “reasonable and appropriate data security” for the PII they hold. See F.T.C. v. Wyndham Worldwide Corp., 10 F. Supp. 3d 602, 2014WL1349019 (D. N.J. 2014).


The Fair and Accurate Credit Transactions Act of 2003 ("FACTA") amended the FCRA by adding sections that are "intended primarily to help consumers fight the growing crime of identity theft." See https://www.privacyrights.org/facts-facta-fair-and-accurate-credittransactions-act. FACTA established regulations relating to fraud detection and provided a process to allow consumers to alert credit rating agencies of alleged misuse of their financial data or accounts that affect their credit ratings. See Winn & Govern, supra, at 55-56. It also establishes disposal guidelines and requirement for employers who maintain documents containing employee data and or consumer information. Id.

The Health Insurance Portability and Accountability Act ("HIPAA"), 45 C.F.R. §160.101, et seq. and §164.102, et seq., also “establishes nation-wide security standards for electronic health care information.” 45 C.F.R §§ 160.102, 160.103, 164.103 and 164.104; see also Winn & Govern, supra, at 58. HIPPA applies to “doctors, clinics, hospitals, pharmacies,...laboratories” and “any businesses that maintain self-insured employee health care plans.” Id. HIPPA “may also apply to certain collection agencies, health insurers and lawyers.” Id. However, at least one jurisdiction has held that law firms that do not represent “covered entities, which are health plans, health care clearinghouses, healthcare providers who transmit health information electronically, and business associates of covered entities who perform functions on behalf of these entities” are not regulated under HIPAA. State Farm Mut. Auto. Ins. Co. v. Kugler, 840 F. Supp. 2d 1323, 1328 (S.D. Fla. 2011) (The United States District Court for the Southern District of Florida held, while addressing the issue of whether non-party law firms’ clients’ medical records were afforded protection by HIPAA, that HIPPA applies only to
“covered entities” and law firms who do not represent “covered entities are not regulated under HIPAA.”).


These laws have no borders. A company must follow the law in the state in which the individual resides. So, if a breach results in the exposure of 5,000 records and the individuals impacted live in 40 different states, the company must notify based on the 40 states’ laws. Failure to properly and timely notify in accordance with the laws can result in significant fines, which are often “per record” but usually subject to a “per breach” cap. Additionally, the time frames provided by each state’s laws for notifications to the consumer vary widely, and some states’ laws require that the company who suffered the breach notify the Attorney General in addition to the consumer.

IV. INSURANCE AND CYBER RISK.

What is cyber risk insurance? Insurance is one of the most basic ways for anyone to manage different risks. A majority of companies and organizations purchase commercial general liability insurance (“CGL”) policies to help cover them from risks such as theft, flood, fire, earthquake, negligence, etc. If a company suffers a security or data breach, it may assume that it will be covered under its CGL. However, “[t]he standard CGL policy was never designed to cover lost
profits, loss of goodwill, or any intangible losses," and, as such, companies should obtain cyber risk insurance policies that are specifically tailored towards cyber liabilities to protect themselves from cyber related losses. See Lance Bonner, Cyber Risk: How the 2011 Sony Data Breach and the Need for Cyber Risk Insurance Policies Should Direct the Federal Response to Rising Data Breaches, 40 Wash. U. J. L. & Pol’y 257, 269 and 270 (2012), see also Retail Ventures, Inc., et al. v. National Union Fire Ins. Co. of Pittsburgh, PA., 691 F. 3d 821, (6th Cir. 2012) (Where plaintiff, the insured, sued the defendant insurance company asserting claims for a declaratory judgment, breach of computer fraud rider in a commercial crime insurance policy and for breach of the insurance company’s duty of good faith and fair dealing. The insurance company asserted a counterclaim seeking a declaratory judgment in its favor. Both parties were asking the court to interpret the terms of the insurance policy following a cyber-breach suffered by DSW when the insurer attempted to deny insurance coverage because the claims arose from “third party theft of proprietary confidential customer credit card information.”)

Commercial general liability insurance ("CGL") policies vary depending on the insurer and the insured’s need, “but most CGL policies are based on standard policies drafted by the Insurance Services Office, Inc. ("ISO").” Id. at 270. Further, GCL policies do not provided unlimited coverage. Id. “In 1965, the ISO modified its standard CGL policy to make it explicit that the only losses covered under its standard policy were losses for physical damages or loss of property.” Id. The standard CGL policy’s lack of coverage for “intangible assets” has proven to be a problem for companies that seek to “recover for losses incurred as a result of data breaches.” Id. Additionally, recent changes to the standard CGL policy “explicitly exclude electronic data from the definition of tangible property.” Id. at 271; see also Commercial General Liability Coverage Form (CG00011204), ISO (2003), available at www.ramsgate.com/forms/CG001.pdf (Section V, Definitions (17)(b), provides, in part, “[F]or the purposes of this insurance, electronic data is not tangible property. As used in this definition, electronic data means information, facts or programs stored as or on, created or used on, or transmitted to or from computer software, including systems and applications software, hard or floppy disks, CD-ROMS, tapes, drives, cells, data processing devices or any other media which are used with electronically controlled equipment.”). Most traditional insurance products also specifically exclude coverage for fines and penalties, as well as regulatory actions/investigations, and, even if coverage is afforded in these insinences, insurers generally provide a low sub-limit for defense only.

Given the limitations of coverage that exist under the standard CGL, “insurers and companies with potential cyber risk liability have sought new insurance products to cover these new risks.” See Bonner, supra, at 271-272. Today, “many of the largest insurers now provide cyber risk policies to fill these gaps. Policies include coverage for data compromise, network risk, computer data coverage, and other various cyber liabilities.” Id. at 272; see also Richard D. Milone, Emerging Insurance Coverage Issues in 2011 and Beyond, Insurance Law 2012 Top Lawyers on Trends and Key Strategies for the Upcoming Year, 2012
Examples of coverage provided under cyber liability policies include: network security liability for the unauthorized access of databases, identity theft, and disruption of services; privacy liability for invasion of privacy, trespass, eavesdropping, and breach of company’s privacy policies; [and] data loss liability for virus attacks, information corruption, computer theft and fraud, and security threats to networks, etc.”).

As a relatively new insurance product, coverages and value added services vary greatly from one insurer to another, but a comprehensive, well negotiated cyber risk policy can offer significant protection to the insured, including protection against resulting third-party lawsuits; for loss of income and various expenses resulting from a failure of the company’s technology or a failure of technology at the vendor level; for the defense of regulatory actions resulting from a data breach, as well as related fines and penalties; and via pro-active/pre-breach risk management services, such as cyber-related newsletters/alerts, employee training in network security and cyber exposures, access to state surveys of breach notification laws, network vulnerability scans, specialists support lines, assistance in drafting written information security plans and breach response plans, etc.

However, “[w]hen implementing these policies, insurers often require potential policy holders to provide an inventory of their computer software, past cyber threats, documentation of their employee hiring policies,...answers to a multitude of IT-related questions[, and] may [even] require changes in policies and practices before providing coverage.” Bonner, supra, at 272. Cyber risk liability policies are also “often rife with exclusions that are difficult for policyholders to understand at the purchasing stage, and often leave the policyholders vulnerable to ‘gotcha’ arguments that erode the value of coverage.” Milone, supra, at *5. For example, some cyber risk liability policies exclude coverage when the computer that is breached is not breached via Internet or network hacking but through the computer being lost or stolen; or coverage may be excluded if the insurer finds that the insured did not take “reasonable steps to design and maintain appropriate security.” Id.

To that end, a simple review of any given cyber risk liability policy is typically insufficient in terms of gaining a full picture of the coverage available, as most cyber insurers have a host of manuscript endorsements providing various coverage extensions that address recent issues and exposures. Further, many insurers are willing to tailor coverage based on specific or unique exposures, and companies need to have internal employees, outside risk managers and insurance purchasers to assist the business with being knowledgeable of the most up-to-date coverage offerings. Along those same lines, policyholders should review all of the insurance policies they hold to determine if coverage for any security or data breach claims might be found within. Id. In addition to coverage under CGL and cyber liability policies, “depending on the facts of a given loss, there may [also] be good arguments for coverage under Directors’ and Officers, Errors and Omissions, Business Interruption, and Media Liability policies.” Id.
V. CONTRACTUAL REQUIREMENT OF CYBER INSURANCE.


The trickle-down effect of the SEC guidance is becoming more and more apparent, especially in the professional service firm arena. Any professional service firm or company that does business with a Governmental Entity or a Public Company (or seeks to do business with such) will likely find that having a cyber-insurance policy is essential to growing, or even maintaining, their client base. Companies without a cyber-insurance policy in place will soon find themselves at a competitive disadvantage.

Professional service firms and companies in all industries are finding that cyber risk insurance is simply becoming a business requirement. Existing business agreements are being reviewed and amended to address cyber-related exposures connected to the business relationship, whether it’s a client contract, an engagement letter, a vendor contract or a non-disclosure agreement. This market change is putting many companies in a “fire-drill” situation. Rather than turn business away, the company will rush to the insurance market looking to purchase a cyber-insurance policy immediately, any cyber-insurance policy, so they can comply with the new requirement. Unfortunately, a rushed purchase of a cyber-insurance policy often times leaves companies with a policy that is not optimal from either a coverage standpoint or pricing, or both. Cyber-insurance policies are still at the point, and may always be, where a potential insured will benefit significantly from carefully negotiating coverage and pricing.

VI. CYBER RISK, NEGLIGENCE AND TORT.

It is well-established that tort liability and a duty of care can be imposed by statute and common law. Although there has been debate over the years with regard to the specific number of elements involved, there is no debate that the tort of negligence is divided into “elements” that must be proven in order for a party to prevail on his/her claim. David G. Owen, The Five Elements of Negligence, 35 Hofstra L. Rev. 1671 (2007). The Restatement (Third) of Torts establishes “five (5) elements of a prima facie case for negligence.” Restatement (Third) of Torts: § 6 Liability for Negligence Causing Physical Harm, cmt. b. (2010); see also Owen, supra, at 1673. The first element is a question of law that must be determined by the court; whether the defendant owed a duty to exercise reasonable care to the plaintiff. See Restatement (Third) of Torts: § 6 Liability for Negligence Causing
Physical Harm, cmt. b; see also Hackmann v. Missouri American Water Co., 308 S.W. 3d 237, 239 (E.D. 2009) ("Whether a duty exists is purely a question of law."). If defendant is found to have a duty to exercise reasonable care towards plaintiff, the next four factual elements of the prima facie case, in which plaintiff alleges defendant negligently caused him/her physical harm must be evaluated: (1) whether the defendant failed to exercise reasonable care; (2) whether defendant’s action were the factual cause of the physical harm; (3) whether the plaintiff actually suffered a physical harm and (4) whether defendant’s actions were the "harm within the scope of liability, (which has historically been called "proximate cause")." Restatement (Third) of Torts: § 6 Liability for Negligence Causing Physical Harm, cmt. b.

A. Duty.

In relation to the element of whether defendant had a duty to exercise reasonable care, it is traditionally held that "an actor ordinarily has a duty to exercise reasonable care." Restatement (Third) of Torts: § 6 Liability for Negligence Causing Physical Harm, cmt. f; see also Hackmann, 308 S.W. 3d at 239 ("A legal duty owed by one to another may arise from at least three sources: (1) it may be prescribed by the legislative branch; (2) it may arise because the law imposes a duty based on the relationship between the parties or because under a particular set of circumstances an actor must exercise due care to avoid foreseeable injury; or (3) it may arise because a party has assumed a duty by contract or agreement whether written or oral.").

However, there exists "categories of cases where careless conduct does not always give rise to liability for resulting harm, where negligence claims may be barred or limited, [for example situations]...involving harm to third parties that may result from the negligence of certain types of actors, such as manufacturers, professionals, employers, social hosts, and probation officers;...and harm that negligence may cause to nonphysical interest, especially emotional harm and pure economic loss." See Owen, supra, at 1675-1676; see also Restatement (Third) of Torts: § 6 Liability for Negligence Causing Physical Harm, cmt. f ("the duty of reasonable care can be displaced or modified in certain types of cases...").

It is within these categories of cases of no or questionable duty scenarios that one can find the majority of the data breach litigation. For example, in 2011 Sony made national headlines as hackers accessed Sony’s clients’ PII, including names, home addresses, email addresses, birth dates, network passwords, user login information and possibly even credit card information. See Bonner, supra, at 258-260. Shortly after the breaches, "Zurich American Insurance Company, one of Sony’s insurers, filed suit in New York state court asking the court for a release from any duty to defend or indemnify Sony as to claims surrounding the data breaches." See Milone, supra, at *2 and Bonner, supra, at 258. "Zurich’s complaint does not articulate its position with any particularity, only asserting that the data breach liability does not qualify as “bodily injury,” “property damage,” or “personal
or advertising injury” under its policies, and that certain unidentified exclusions bar coverage.” Milone, supra, at *3. On February 21, 2014, the New York Supreme Court found that Zurich was not required to provide a defense or indemnify Sony to the claims surrounding the data breaches because Sony’s insurance policy only covered a publication causing injury made by Sony. David Harmon, Cyber Liability in the Wake of High-Profile Hacking, http://www.insurancecoveragecorner.com/policy/are-you-covered-recent-trends-in-cyberliability/ (April 15, 2014). The Court further held that “although the breach by the hackers did result in a publication as defined in the policy, the publication of the personal information was made by a third-party, the hackers.” Id.

Sony filed an appeal from this decision to the intermediate appellate court in New York, and the parties reached a settlement before the intermediate court had opportunity to rule upon the questions presented. http://www.insurancejournal.com/news/east/2015/05/01/366600.htm

While it is probable that the decision will be appealed, for now “[t]he suit brought to light the growing realization among businesses that traditional commercial liability policies will not cover damages and other costs incurred as a result of a data breach.” Bonner, supra, at 258.

B. Harm.

Whether an individual who has suffered a breach of his/her PII has standing to sue the company or organization that held his/her PII has been at the core the majority of negligence actions relating to cyber breaches. To maintain a civil action in Court, a plaintiff must have “standing” as established in Article III of the United States Constitution. See U.S. Const. Article III, § 2. The United States Supreme Court has also clearly held that the plaintiff has the burden of establishing standing. See Daimler Chrysler Corp. v. Cuno, 547 U.S. 332, 342 n. 3 (2006). To do so a plaintiff must demonstrate: (1) that he/she has suffered an injury in fact, “an invasion of a legally protected interest which is (a) concrete and particularized and (b) actual or imminent, not conjectural or hypothetical;” (2) causation, that a “causal connection” exists between the alleged injury suffered and the conduct complained of; and (3) redressability to demonstrate Article III standing. See Lujan v. Defenders of Wildlife, 504 U.S. 555, 560-561 (1992) (footnote, citations and internal quotation marks omitted). However, in the realm of security and data breaches the courts are divided on what is required of plaintiff to demonstrate an “injury-in-fact” that is sufficient enough to confer Article III standing. The issue relates to harm, “when is a consumer actually harmed by a data breach- the moment data is lost or stolen, or only after the data has been accessed or used by a third party?” Burton v. MAPCO Express, Inc., 47 F.Supp.3d 1279 (N.D. Ala. 2014), quoting In re Science Applications International Corp. (SAIC) Backup Tape Data Theft Litigation, 45 F. Supp. 2d 14 (D.C. 2014).
Some courts have held that in order to have Article III standing plaintiffs must not only demonstrate unauthorized access to or abuse of their PII, but also actual economic loss as a consequence” to the access and/or abuse. Id. at *3, citing In re Barnes & Noble Pin Pad Litigation, 2013 WL 4759588 *6 (N.D. Ill. 2013) (The Burton Court ultimately held that if the plaintiff could not “plausibly allege and ultimately prove actual damages (for example, an allegation that the charges on his account were not forgiven, and he had to pay for the charges), then the Court must dismiss his negligence claim for lack of subject matter jurisdiction because he cannot plead an Article III case or controversy.”), see also Katz v. Pershing, LLC, 672 F. 3d 64, 71 (1st Cir. 2012) (holding that “[i]t is the requirement of an actual or imminent injury ensures that the harm has either happened or is sufficiently threatening; it is not enough that the harm might occur at some future time.”).

In Polanco v. Omnicell, Inc., the court held that following a data breach the plaintiffs’ “allegations of hypothetical future injury were insufficient to establish standing because the plaintiffs had not yet suffered any injury and would not suffer an injury unless and until their conjectures came true.” Polanco v. Omnicell, Inc., 988 F. Supp. 2d 451, 467 (D. N.J. 2013). Specifically, the court determined that “where there is an absence of evidence suggesting that the data had been or would ever be misused the plaintiffs’” allegations of an increased risk of identity theft resulting from a security breach were insufficient to establish standing.” Id. (internal citations and quotation marks omitted). In Pisciotta v. Old Nat’l Bankcorp., the court concluded that “without more than allegations of increased risk of future identity theft, the plaintiffs have not suffered a harm that the law is prepared to remedy.” Pisciotta v. Old Nat’l Bankcorp; 499 F. 3d 629, 639 (7th Cir. 2007).

However, other courts have found that the mere threat of future identity theft when accompanying a claim of data breach is sufficient to confer Article III standing. See Burton, supra note 91, at *3-4, citing Resnick v. AvMed, Inc., 693 F. 3d 1317 (11th Cir. 2012) and Krottner v. Starbucks Corp., 628 F. 3d 1139, 1142-43 (9th Cir. 2010).

It is not clear how the courts will ultimately decide the questions of whether an insurer has to defend an insured in security and data breach litigation under non-cyber risk liability insurance policies; what extent an insurer has to defend an insured under cyber risk insurance policies and what must a plaintiff show to have standing to maintain a lawsuit for security and data breaches. Given that these issues are in their infancy in the courts, companies, organizations and insurance providers should carefully watch the court’s future decisions relating to security and data breaches.
VII. AVOIDING THE CYBER ATTACK.

A. Understanding Loss From Cyber Breaches.

The notion that cyber breaches can be prevented has been disproved by a decade of extensive, comprehensive, and successful cyber breaches at a range of governmental and private sector targets. Rather, we should be pursuing the reduction of loss, so that when a cyber breach occurs, the victim can sustain or resume normal business activities as quickly as possible while minimizing damage and remediation costs.

Cyber risk insurance is one mechanism to offset loss, but the decision to purchase a policy and how to design it must be made in the context of the company’s overall exposure to cyber loss. This is the central challenge facing cyber insurance industry: to understand the real dimensions of cyber loss in business terms so that insurance providers and their customers are communicating clearly and making informed decisions. This is difficult for many companies because the process of connecting the threat of cyber attacks to potential dollar loss is neither rigorous nor comprehensive and cannot serve as the sound basis for risk decisions.

Understanding that companies, legal counsel, and insurance professionals need to build the foundation for quantifying cyber loss, requires an understanding of what is cyber risk.

B. Understanding Cyber Risk.

How much should a business spend on cyber security? The answer should be: Enough to keep cyber loss at a sustainable level. Note the term is a sustainable level, not zero level; as cyber breaches cannot be prevented.

Cyber loss encompasses the dollar impact of a cyber-event: the legal and technical costs of remediation the attack itself, plus lost sales, degraded productivity, reputational damage, and deteriorated market position. Cyber loss is separate from cyber cost, which is the expense of cyber security countermeasures such as equipment, personnel, training, and outside services. An appropriate level of cyber security investment—cyber cost—should be calculated without the expectation that it will prevent cyber loss, but instead that it will keep cyber loss at a level where it is manageable.

A company’s sustainable level of cyber loss is its cyber risk tolerance, and setting this threshold is a strategic risk decision. The Chief Executive Officer ("CEO"), Chief Operating Officer ("COO"), and other corporate leadership personnel should define the company’s overall cyber risk tolerance. Setting a low level of sustainable loss often entails a higher investment in cyber security and insurance, and vice versa. Cyber security leadership such as the Chief Information Officer (CIO) and Chief Information Security Officer (CISO) should have candid
discussions with experts in the field regarding the impact of cyber breaches on the company’s business operations. When the leadership team has determined the level of sustainable cyber loss, the CIO and CISO should direct the adjustment and implementation of cyber policy and countermeasures to bring the overall cyber security program in line.

This is not a one-time process, but rather an ongoing dialogue between company leadership and the cyber security team. Cyber risk tolerance is a function of the company’s financial position and should therefore be re-evaluated as that position changes. As cyber adversaries evolve, the business impacts of their cyber-attack will also change. Finally, cyber costs will fluctuate as new threats emerge. This is because adversaries are constantly developing new tactics, and the company’s business activities may bring it to the attention of new adversaries. The CIO and CISO should track business activities alongside indicators of new threat actors and capabilities, and should inform company leadership whenever changing threat conditions require increased resources to keep cyber losses at the sustainable level.

Thus CIOs and CISOs must specify how a given threat could cause a financial loss for the company. Though this is considered an almost impossible task, it is achievable, though it requires a fundamental change in how cyber professionals think about threat and risk.

C. **Quantifying Cyber Loss.**

Most CIOs and CISOs are not equipped to serve as subject matter experts on the impact of cyber breaches on the company. This is not a deficiency on the part of these individuals but rather a reflection on the inadequacies of the bottom-up approach of cyber threat assessment. When asked to come up with a budget for cyber security, most cyber security professionals will analyze a company’s cyber infrastructure, evaluate how it can be breached, and then identify the cyber security products and services best able to prevent those breaches. This process, no matter how rigorous, is utterly inadequate to address the real strategic question, which is: What cyber breach scenarios will cause financial loss to the business, and how should we prioritize mitigating them? The only way to answer that question is to conduct a risk assessment process that begins outside the organization, where threats originate.

D. **Threat-based Risk Assessment.**

Scott Borg, chief economist of the U.S. Cyber Consequences Unit (http://usccu.us), has developed a four-step risk assessment methodology that places cyber loss in the context of business. A CIO or CISO should work with the cyber security team—both analysts and technical personnel—to address a sequence of questions that guide decision-making towards informed policy options.
1. **Threats:** Which cyber threat actors are both motivated to attack your business and also capable of conducting cyber-attacks against you? This defines your threat landscape and specific threat scenarios: attacker profiles, their attack tactics, and their most likely targets in your company.

2. **Consequences:** Now that we know your cyber threat landscape, what are the consequences to the business of each threat scenario, and what is the potential dollar loss that would result? This assigns a cyber-loss value to threat scenarios so that their severity can be compared in business terms.

3. **Vulnerabilities:** Once you have quantified the potential cyber loss, what are the vulnerabilities in your business system that would enable each breach to occur, and the dollar cost of fixing them? This assigns cyber cost to the mitigation of each threat scenario.

4. **Risk by policy:** Finally, you must decide what combinations of accepted losses and costs keep you within your overall sustained cyber loss threshold? This yields a series of cyber security policy options, each informed by threat, quantified potential loss, and cost of remediation.

   This process places cyber options in the language of business leadership. When the CIO and CISO present their cyber security strategy to corporate leadership, they can discuss cyber threat scenarios in terms of business outcomes. This has been the missing piece in most cyber security decision-making at the corporate leadership level.

**E. Consequences And Loss Quantification.**

All businesses manage risk and already follow formal and informal risk assessment processes to make business decisions. However, when it comes to cyber threat assessment, the step that most businesses perform incorrectly (or skip altogether) is that of defining consequences: assigning a dollar value to the outcomes of cyber breach.

The conventional methodology for quantifying cyber loss is to focus on the dollar cost of cyber assets. Under this analysis, the potential cyber loss to a business is some function of how much each computer and network device costs to operate, repair, or replace. According to Borg, this is incorrect: cyber loss cannot be calculated by adding up the cost of the equipment and software the business has installed. Instead, an informed estimation of cyber loss derives from understanding the role each cyber system plays in the business' overall process of generating value, how data breach or damage impacts that value creation process, and how that impact translates into negative business effects.
To do this, the CIO and CISO must break the business down into its component units and examine each one. What inputs—information or resources—does this business unit receive from others to do its work? What processes does this business unit perform on its information or resource inputs in order to fulfill its function? What outputs does this business unit create and pass on to others? If one part of the functional flow within the business unit were to fail or be impeded in some way, how would the business unit react? What role does each functional flow play in generating profit for the company, and which ones are most crucial?

A company must study the cyber systems used in this business unit and how necessary they are to its functions. If the email system were to go down, can this business unit continue to function or is it dead in the water? Does this business unit rely completely on receiving customer orders from the corporate website, or is there a backup fax ordering system? If the file server were to crash, are there paper records to serve as backup? Is this business unit a major user of the corporate intranet to assemble and track products? Does this business unit need to interact hourly with commercial transport services via the Internet to ship products to customers? Are suppliers connecting to this business unit over virtual private networks (“VPN”) or Internet portals to perform crucial steps in the business unit’s functions? Consider also the role that information plays in business value. Does this business unit handle and store customer data and credit card information? Does this business unit create and store intellectual property? Do the people in this unit discuss sensitive company information over email?

Walk through the effects that a breach on an information system in this business unit would have. A breach can take many forms: customer data could be stolen, network equipment can be co-opted, intellectual property could be taken, trade secrets could be appropriated, legal strategies and financial secrets could be revealed prematurely and more. Look at known cyber breaches and technology failures for examples of the impact of data loss and system failure on a business over time.

Finally, consider the near-term and long-term effects on the overall business as the breach plays out. Many cyber breaches require remediation costs but don’t have lasting impact on the overall business. Most companies have already experienced website or email outages from routine technical glitches and have figured out how to keep working without them.

But some information and cyber systems are critical. What is the impact to the business if the shipping department misses a day of shipping because a cyberatiack has paralyzed the company’s intranet and there’s no way to generate shipping labels for three hundred customer packages? What is the impact if financial results are leaked a week ahead of the quarterly report? What is the impact if a single engineer’s laptop is lost in a taxi, versus the theft of a shared engineering laptop that has accumulated three years of design documents from multiple engineering projects? What is the impact if a competitor gains a comprehensive list of all the
company’s products currently in development? What is the impact if the network is compromised and used to penetrate the networks of six key clients, and just one of them withdraws its business and sues you for negligence?

The goal of this process is to create an accurate, but not necessarily precise, measure of the relative dollar value impact of breach of every cyber system in each business unit in the company. From this, it is possible to build an overall picture of the key cyber systems that need to be protected to ensure the company continues to generate profit. Accuracy is important: the estimation of loss should be as comprehensive as possible and consider micro and macro factors, damage over time, the market position of competitors, legal liability and so forth. The team working through this process should be encouraged to reach out to the company’s leadership, legal department, compliance and audit department, human resources, and other business units to get answers to questions as they arise.

However, precision is not as critical: the objective is not to determine that this loss will be $72,000 while that one will be $78,000. Rather, the objective should be to organize cyber losses into groups of financial impact: for example, these losses can be remedied with internal resources and would cost less than $20,000 each to fix; these other losses need to be addressed by an outside cyber response team, and could cost from $50,000 to $75,000 each, but won’t have any lasting effect on the business; these losses will require extensive outside support, will hurt the business reputation and drive away customers, and will cost closer to $300,000 each in losses and remediation costs; while this loss would damage market position and investor value and would likely incur legal liability, and, over the long run, could cost as much as $1,000,000 or more. Even rough order of magnitude estimations can support prioritization of cyber systems for protection in order to preserve the key profitable functions of the business and avoid financial harm. Placed within the threat-based risk assessment process, these loss estimates can justify the costs of cyber defenses that reduce their likelihood.

VIII. CONCLUSION.

Security and data breaches are an unfortunate but very real risk for all companies and organizations in today’s society; however several tools exist to help protect companies from suffering a breach that should be actively utilized. Companies and organizations should also create a clear and unambiguous commitment to a privacy policy that defines how PII will be collected, stored, and disposed. Moreover, companies, organizations and insurance providers must keep a watchful eye on the decisions being made by the court across the nation on cases relating to security and data breaches, cyber risks and insurance coverages for the losses relating to breaches, as this is an evolving area of the law.
APPENDIX A
STATE LAWS RELATING TO PERSONALLY IDENTIFIABLE INFORMATION

As discussed above forty-seven states have enacted legislations requiring private or government entities to notify individuals of security breaches involving their PII. See Security Breach Notification Laws, supra. Many of the states’ laws also contain “provisions regarding who must comply with the law…; definitions of “personal information”;…; what constitutes a breach…; requirements for notice …; and exemptions…” and disposal of PII. Id., see also Data Disposal Laws, supra. Additionally, all fifty states and the District of Columbia have enacted legislation that allows a consumer to place a security freeze on his or her credit report, which “can help the person track whether an identity thief is using the person’s information to set up bogus accounts.” Consumer Report Security Freeze State Laws, supra.

<table>
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<tr>
<th>STATE</th>
<th>SECURITY BREACH NOTIFICATION LAWS</th>
<th>SECURITY FREEZE LAWS</th>
<th>DISPOSAL OF RECORDS LAWS</th>
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<tr>
<td>Alabama</td>
<td>NO</td>
<td>Ala. Code § 8-35-1, et seq. (applies to any consumer)</td>
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<td>State</td>
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<td>Del. Code Ann. tit. 6, §12B-101, et seq.</td>
<td>Del. Code Ann. tit 6, §2201, et seq. (applies to any consumer, including a representative of a “protected consumer” who is under the age of 16 at the time the request is made or to an incapacitated person or a person for whom a guardian or conservator has been appointed)</td>
<td>Del. Code Ann. tit. 6, §5001C to 5004C, tit. 19, §736 (applies to government employees and businesses)</td>
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<td>Florida</td>
<td>Fla. Stat. §§ 501.171, 282.0041, 282.318(2)(i) (2014 S.B. 1524, S.B. 1526)</td>
<td>Fla. Stat. §501.005 (applies to any consumer, including a representative of a “protected consumer” who is under the age of 16 at the time the request is made or to a person represented by a guardian or other advocate)</td>
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<td>Georgia</td>
<td>Ga. Code §§ 10-1-910-912, 46-5-214</td>
<td>Ga. Code § 10-1-193, et seq. (applies to any consumer residing in the state, including a representative of a “protected consumer” who is under the age of 16 at the time the request is made or to an individual represented by a guardian or conservator)</td>
<td>Ga. Code § 10-15-2 (applies only to businesses)</td>
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<td>Illinois</td>
<td>815 ILCS §§ 530/1 to 530/25</td>
<td>Ill. Rev. Stat. ch. 815, §505/2MM (applies to any consumer, including a representative of a disabled person or to a representative of a minor under the age of 18)</td>
<td>20 ILCS 450/20, 815 ILCS 530/30, 815 ILCS 530/40 (applies to government and businesses)</td>
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<td>Indiana</td>
<td>Ind. Code §§ 4-1-11, et seq. and 24-4.9, et seq.</td>
<td>Ind. Code §24-5-24-1 et seq. (applies to any consumer, including a representative of a &quot;protected consumer,&quot; an individual who is either under the age of 16 at the time the request is made or an interdicted person for whom a curator has been appointed or to an incapacitated person or to a person for whom a guardian or conservator has been appointed)</td>
<td>Ind. Code. §§ 24-4-14-8, 24-4.9-3-3.5(c) (applies only to businesses)</td>
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<td>Iowa</td>
<td>Iowa Code §§ 715C.1 and 715C.2</td>
<td>Iowa Code §714G.1 et seq. (applies to any consumer who is a resident of the state, including a representative of a &quot;protected consumer,&quot; an individual under the age of 16 at the time the request is made or to an incapacitated person or to a protected person for whom a guardian or conservator has been appointed)</td>
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<td>Louisiana</td>
<td>La. Rev. Stat. §§ 51:3071, et seq. and 40:1300.111 to 40:1300:116 (2014 H.B. 350)</td>
<td>La. Rev. Stat. §9:3571.1 (applies to any consumer, including a representative of a “protected consumer,” an individual either under the age of 16 at the time of the request or an interdicted person for whom a curator has been appointed or an incapacitated person or to a protected person for whom a guardian or conservator has been appointed.)</td>
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<td>Md. Code Com. Law §14-3501, et seq. and Md. State Govt. Code §§10-1301 to 10-1308</td>
<td>Md. Commercial Code Ann. §1212.1 et seq. (applies to any consumer, including a representative of a “protected consumer,” an individual either under the age of 16 at the time the request is made or an incapacitated person or a protected person for whom a guardian or conservator has been appointed. A protected consumer includes an individual</td>
<td>Md. Code, Comm. Law § 14-3503, Md. State Govt. Code §§10-1301 to 10-1303 (applies to government and businesses)</td>
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<td>Michigan</td>
<td>Mich. Comp. Laws §§ 445.63 and 445.72</td>
<td>Mich. Comp. Laws §445.2511 et seq. (applies to any consumer, including a representative of a “protected consumer,” an individual who is under the age of 16 at the time the request is made or an incapacitated person or a protected person for whom a guardian or conservator has been appointed)</td>
<td>Mich. Comp. Laws § 445.72a (applies to government and businesses)</td>
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<td>Minnesota</td>
<td>Minn Stat. §§ 325E.61 and 325E.64</td>
<td>Minn. Stat. § 13C.016, et seq. (applies to any consumer)</td>
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<td>Mississippi</td>
<td>Miss. Code § 75-24-29</td>
<td>Miss. Code §75-24-201, et seq. (applies to identity theft victim only)</td>
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<td>Montana</td>
<td>Mont. Code Ann. § 2-6-504 and 30-14-701, et seq.</td>
<td>Mont. Code Ann. §30-14-1726, et seq. (applies to any consumer, including a parent or guardian in the case of a minor or of an incapacitated person, or to a conservator in the case of a protected person)</td>
<td>Mont. Code Ann. §30-14-1703 (applies only to businesses)</td>
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<td>Protection (applies to any consumer)</td>
<td>Annotations (applies only to businesses)</td>
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<td>New Mexico</td>
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<td>N.M. Stat. Ann. §56-3A-1, et seq.</td>
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<td>N.D. Cent. Code § 51-30-01, et seq.</td>
<td>N.D. Cent. Code §51-33-01, et seq.</td>
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<td>Ohio</td>
<td>Ohio Rev. Code §§ 1347.12, 1349.19, 1349.191 and 1349.192</td>
<td>Ohio Rev. Code Ann. §1349.52, et seq.</td>
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<td>Oklahoma</td>
<td>Okla. Stat. §§ 74-3113.1 and 24-161 to 24-166</td>
<td>Okla. Stat. tit. 24, §149 (applies to any consumer)</td>
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Note: The annotations and protections vary depending on the jurisdiction and the specific laws in place for consumer protection.
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<td>South Carolina</td>
<td>S.C. Code § 39-1-90 (2013 H.B. 3248)</td>
<td>S.C. Code §37-20-110, et seq. 2014 Act 145, (applies to any consumer, including a representative of a “protected consumer,” an individual who is under the age of 16 at the time a request is made or an incapacitated person or a protected person for whom a guardian or conservator has been appointed)</td>
<td>S.C. Code §37-20-190, S.C. Code 30-2-310 (applies to government and businesses)</td>
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<td>NO</td>
<td>S.D. Codified Laws Ann. §54-15-1, et seq. (applies to identify theft victims only)</td>
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<td>Virginia</td>
<td>Va. Code §§ 18.2-186.6 and 32.1-127.1:05</td>
<td>Va. Code §59.1-444.1, et seq. 2014 Chapter 570 (applies to any consumer who is a resident of the state, including a representative of a &quot;protected consumer,&quot; an individual either under the age of 16 at the time the request is made or an incapacitated person for whom a guardian or conservator has been appointed)</td>
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<td>Wisconsin</td>
<td>Wis. Stat. §134.98</td>
<td>Wis. Stat. §100.54, et seq. (applies to a victim of identity theft or a consumer, including a representative of a &quot;protected consumer,&quot; an individual who is under the age of 16 at the time the request is made or an individual for whom a guardian or conservator has</td>
<td>Wis. Stat. §134.97 (applies only to businesses)</td>
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REGULATORY CHALLENGES IN A GLOBAL ECONOMY

Written in conjunction with the

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This Paper has been prepared for general information and is not intended to be relied upon as legal advice.
Overview

Insurance Regulation remains in the forefront before the United States Congress. Recent Congressional action has centered on:

(i) the establishment of appropriate capital requirements for insurers;

(ii) the impact of international regulatory standards and role of the Federal Reserve Board and the Federal Insurance Office in developing such standards; and

(iii) the Financial Oversight Council (“FSOC”) process for designating (and un-designating) non-bank financial companies as systemically important.

Since the 2008 financial crisis in the United States, the federal government has made more flexible capital standards for those insurers regulated by the Federal Reserve (systemically important insurers). For instance, the Insurance Capital Standards Clarification Act of 2014 (the so-called “Collins Fix”) allowed the government flexibility to tailor capital standards to such insurers without requiring a bank-centric approach. The Federal Reserve is reportedly considering an industry proposal that would rely heavily upon existing state-based capital requirements. As domestic insurers expand their international operations and the business of entities within their insurance holding company systems which conduct business internationally, convergence of regulation is inevitable.

While the Federal Reserve Board is providing more flexibility with respect to U.S. insurers’ capital standards the systemically important insurers, on the international front, the International Association of Insurance Supervisors (“IAIS”), continues to meet to address capital standards as well as resolution matters.

I. CAPITAL STANDARDS

The international capital standards (“ICS”) set forth by the IAIS apply to internationally active insurance groups (“IAIGs”). The IAIS defines an IAIG as a large, internationally active
group that includes at least one sizeable insurance entity. There are two criteria for an international group to be identified as an IAIG:

(i) international activity – premiums written in not fewer than three jurisdictions, and percentage of gross written premium outside the home jurisdiction is not less than 10% of the group’s total gross written premiums;

(ii) size – based on a rolling 3-year average, total assets of not less than $50 billion U.S.D., or gross written premium of not less than $10 billion U.S.D.

At the recent New York and Tokyo IAIS meetings, held just after launch of the 2015 Quantitative Field Testing, the field testing was discussed. Field testing is expected to continue through September 2015. Also at the most recent meetings, the IAIS heard presentations from industry stakeholders, many of which were focused on the valuation and asset classification components of the ICS. IAIS representatives clarified that development of the ICS will be an iterative process, and that the capital standards will continue to develop over time.

From June 18 through 19, the IAIS and its stakeholders met once more at the IAIS’ global seminar and stakeholder dialogue in Macau. The supervisors made presentations on the ICS, as well as provided overviews of comments received in response to the ICS public consultation.

The IAIS has two additional capital-related meetings scheduled in 2015. On August 4, the IAIS will hold a stakeholders’ meeting in Basel focused on comments received during the ICS consultation and the Higher Loss Absorbency (“HLA”) capital standards, which was scheduled to be released for public consultation in June. The HLA is a capital standards potentially applicable to GSIIIs that will apply on top of the basic capital requirements (“BCR”) and is designed to address the insurers’ systemic importance in the international financial system standards. The HLA is still scheduled for adoption by the end of 2015. The last IAIS stakeholder meeting will be held on October 5, 2015 in Basel after the HLA consultation closes.
and the IAIS has had an opportunity to consider ICS consultation comments in the IAIS’ September meetings.

II. RESOLUTION MATTERS IN THE U.S. AND ABROAD

Resolution matters are expected to remain front and center both nationally and internationally throughout 2015. Both the IAIS and the Financial Stability Board (“FSB”) continue to discuss resolution matters:

A. IAIS Resolution Matters

The IAIS Resolution Working Group (“ReWG”) has focused on revising the international core principals (“ICPs”) related to resolution (primarily ICP 12), which are expected to be vetted for consultation in early 2016. The ICPs are designed to provide a globally accepted framework for the supervision of the insurance sector. All jurisdictions that are members of the IAIS agree to implement insurance regulatory regimes that comply with ICP Standards. The ICPs will form the basis for ComFrame module 3, element 3, which is the segment of ComFrame that deals with resolution matters. ComFrame is a set of international supervisory requirements focusing on the effective group-wide supervision of IAIGs and GSIs. IAIS member jurisdictions will be expected to adopt or revise their insurance regulatory systems to comply with ComFrame elements, thereby assuring further convergence in U.S. and international regulations.

ComFrame Module 3 is anticipated to be exposed for further consultation in the second quarter of 2016 and field tested (by supervisors) in the first quarter of 2017.

The ReWG is also considering whether the banking capital concept of loss-absorbing capacity has useful application in the context of resolving a GSII. Initial recommendations are expected late in 2015 or early in 2016.

B. FSB
The FSB also has a resolution working group which is considering various resolution issues related to GSIIss. With considerable input from the IAIS, the FSB group is working on a guidance paper related to critical functions and resolution strategies that supervisors of GSIIss should consider adopting. The FSB group is also contemplating the structure and use of Crisis Management Groups (“CMGs”) for GSIIss, including the role of policyholder protection schemes and creditor committees.

III. SUPERVISORY COLLEGES

Supervisory colleges are generally viewed as a regulatory tool to enhance supervisory cooperation and coordination of international insurance holding companies. The intent is to provide windows into the full organization so that all of the organization’s regulators, regardless of which country they may operate from, can view the individual entities as well as the whole organization.

Both national and international efforts towards development of supervisory colleges is no doubt an offshoot of the 2008 financial crisis. In April of 2008, the then financial stability forum (now the FSB) issued a report to the Capital G-7 Finance Ministers and Central Bank Governors. The report outlined a comprehensive set of recommendations for strengthening the global financial system. One critical recommendation was the operationalization and expanded use of supervisory colleges for certain global financial institutions.

It is expected that supervisory colleges will provide a permanent platform for enhancing the mutual trust and exchange of information among international regulators regarding entities within the group and should enable regulators to better assess risks that are emerging beyond their borders and outside their respective authorities. The IAIS defines a supervisory college as:

A forum for cooperation and communication between the involved supervisors established for the fundamental purpose of facilitating
the effectiveness of supervision of entities which belong to an insurance group, facilitating both the supervision of the group as a whole on a group-wide basis and improving the legal entity supervision of the entities within the insurance group.

In 2009, the IAIS developed a guidance paper recognizing the need for flexibility in the design, membership and establishment of supervisory colleges and accommodating the organizational structure, nature, scale and complexity of group risks and the level of international activity and interconnectivity within the group. The IAIS Guidance Paper also addresses factors to consider in implementation of a supervisory college framework, including, its form and membership, the role and possible functions of the supervisory college, and the interrelationship between a designated group-wide supervisor and the supervisory college. In October of 2011, the IAIS adopted its updated insurance core principles (“ICPs”) which essentially elevated the process set forth in the IAIS Guidance Paper to a higher level of standards. Adoption of the revised ICPs are having considerable impact and influence on jurisdictions with regard to the degree and timeliness of their ICP implementation, especially for jurisdictions subject to recurring IMFSFAPs and IAIS and FSB assessments.

In July through August of 2012, the IAIS developed a Common Framework for the supervision of internationally active insurance groups (ComFrame) which operationalizes the application of the ICPs with regard to IAIGs and provides clear expectations concerning supervisory colleges of IAIGs. An IAIG is generally considered a group that includes at least one insurance legal entity and fulfills ComFrame criteria as set forth in parameter M1E1-1-2 (the largest insurance groups in insurance asset size and premium could conduct more than 10% of their operations outside the home jurisdiction and are operating in three jurisdictions or more). A supervisory college is the designated mechanism by which an IAIG is identified. In June of
2014, the Basel Committee on Banking Supervision published a consultative document, its revised good practice principles for supervisory colleges.

The IAIS has been developing guidance and best practices related to supervisory colleges at the international level through the IAIS insurance groups and cross-sectoral subcommittee and assisting jurisdictions with the implementation and operationalization of such colleges through the IAIS supervisory cooperation subcommittee. The IMF is also assessing whether jurisdictions will have enhanced regulatory cooperation and coordination through the development of supervisory colleges.

U.S. state insurance regulators both coordinate and participate in supervisory colleges. Indeed, many states have incorporated provisions within their insurance amended holding company laws, providing for supervisory colleges and ensuring the confidentiality of materials shared among the regulators. State insurance commissioners can participate in a supervisory college with other regulators charged with supervision of such insurers or their affiliates, including other state, federal and international regulatory agencies. Information exchanged in a supervisory college context between regulators is held strictly confidential and is subject to an applicable confidentiality agreement.

From a practical standpoint, all of the group’s regulators meet once per year, led by the regulator of the ultimate parent of the holding company, to discuss the entity’s business, risks arising from such business and how the entity controls these risks and business strategy of the entity for the coming year. The company typically makes a presentation of issues requested by the regulators and then answers questions posed by the regulators. Some colleges result in “to do” items for the company and requirements for the company to keep the various regulators
informed as to various issues of interest. The specifics of the protocol are expected to evolve over time as the IAIS develops further guidance in this area.

IV. GROUP SOLVENCY REGULATION

A. NAIC Group Solvency Issues Working Group

In 2015, the Group Solvency Issues (E) Working Group of the NAIC Financial Condition (E) Committee was charged with the continued development of potential enhancements to the current regulatory solvency system as it relates to group-insolvency-related issues. Part of this charge includes development of required procedures for state regulators to use when leading and participating in supervisory colleges. Interestingly, part of the Group Solvency Issues Working Group 2015 charge also addresses viewing the Insurance Holding Company System Regulatory Act (NAIC Model No. 440) and the Insurance Holding Company System Model Regulation (NAIC Model No. 450) to consider amendment to address issues that have arisen subsequent to the adoption of the Models by the NAIC in 2010. Model Act amendments to implement supervisory colleges, to enhance and standardize corporate governance and to adopt Enterprise Risk Standards, cognizant of both the international aspect to insurance enterprises and the diverse and systemic risk inherent in insurance holding company systems, are also addressed below. The Group Solvency Issues Working Group is particularly concerned with the development of procedures to implement a consolidated public hearing for acquisitions involving multiple jurisdictions under NAIC Model Nos. 440 and 450. Finally, the Group Solvency Issues Working Group is expected to finalize the ORSA pilot project that began in 2014 and to complete applicable outputs from the project, including a report to the Financial Condition (E) Committee.
B. **Key NAIC Holding Company Act Amendments**

As noted above, in view of the 2008 financial crisis and the globalization of the insurance business models, U.S. insurance regulators have begun to modify their group supervisory framework and have been increasingly involved in developing an international group supervisory framework. The effects experienced by U.S. insurers in the wake of AIG Holding Company System’s near collapse caused U.S. insurance regulators to re-evaluate the group supervisory framework. Beginning in 2008, as part of the NAIC Solvency Modernization Initiative (“SMI”), U.S. insurance regulators considered the financial crisis, and studied the AIG model and the potential impact of non-insurance operations on insurance companies within the same holding company group.

Through SMI, U.S. insurance regulators are devising plans for a revision to group supervision, maintaining the “walls” but enhancing the “windows” of the system, fostering communication between regulators and developing supervisory colleges to enhance access and collection of information from groups. A view towards prudential standards employed in other insurance regulatory structures abroad is also folded into the SMI.

To those ends, the NAIC adopted the revised Insurance Holding Company System Regulatory Act (Model # 440) and the Insurance Holding Company System Model Regulation with reporting forms and instructions (Model #440) in 2010. The revisions included the following:

- expanded ability to evaluate an entity within an insurance holding company system;
- enhancements to the regulator’s right to access books and records and compel production of information;
- establishment of expectation of funding with regard to regulator participation in supervisory colleges;
enhancement in corporate governance such as board of directors and senior management responsibilities;

expansion to the insurance holding company system annual registration statement (Form B) to broaden the requirements to include financial statements of all affiliates;

a new Form F (Enterprise Risk Report) has been introduced for firms to identify and report their enterprise risk.

These NAIC Model Act changes, along with ORSA, and the global group supervision through the IAIS group supervision have become a common point of regulatory focus all over the world, not only in the United States. Group supervision is an element of the European Union’s solvency II Directive, and as is noted above, is being discussed by the IAIS.

V. U.S. ORSA REQUIREMENTS VS. THE EUROPEAN ASSESSMENT STANDARDS

In the wake of the 2008 global financial crisis when American International Group faced financial uncertainty and threatened a similar knock off effect of other large global insurers, various state insurance regulators realized the need for enhanced ability to assess the holding companies’ financial condition, as a whole, as it impacted an insurer within the holding company system.

In 2011, the NAIC votes to adopt the U.S. Own Risk and Solvency Assessment requiring insurance companies to issue their own assessment of their current and future risk through an internal risk self-assessment process. ORSA is now embedded in the IAIS standards and is in various stages of implementation in the United States, Europe and other jurisdictions. Large- and medium-sized U.S. insurance groups and/or insurers are required to regularly prepare and conduct an ORSA starting in 2015. Additional capital assessments evaluating prospective solvency should be added to the state insurance supervisory framework, and are included in ORSA to complement RBC as a financial regulatory safeguard.

A. ORSA Guidance Manual
The NAIC ORSA Guidance Manual adopted by the NAIC Executive (EX) Committee in March 2012 provides information for insurers on performing an ORSA and documenting risk policies and procedures. The Guidance Manual and the NAIC Risk Management Own Risk and Solvency Assessment Model Act (#505) facilitate identification, assessment, monitoring, prioritization and reporting on an insurer’s material and relevant risks, using techniques that are appropriate to support risk and capital decisions and further provide a group-level prospective on risk and capital, as a supplement to the existing legal entity view.

B. When ORSA Applies

ORSA applies to individual U.S. insurers that write more than $500 million of annual direct written and assumed premium, and/or insurance groups that collectively write more than $1 billion of annual direct written and assumed premium. Insurers subject to ORSA will be required to assess the adequacy of each of their risk management frameworks, current and estimated projected future solvency position; to internally document the process and results of the assessment and to provide a confidential, high level ORSA Summary Report annually to their lead state regulator (if the insurer is a member of an insurance group) and, upon request, to the domiciliary state regulator. As these ORSAs will be new to many of the non-global insurer entities, as well as new to the US state regulators, preliminary meetings are being held to walk the regulator through the process and to allow the regulator to challenge an insurer on its assumptions underlying their ORSA.

C. European ORSA requirements

The ORSA requirements in Europe will vary in a limited fashion among the various member states of the ECC. However, they all have one central theme -- solvency. Under Solvency II, an insurer either can choose to adopt the standard model that determines how much
capital it must hold, or develop its own internal model, fine tuned to its specific risks. While the latter option is preferable to many larger insurers as it typically results in lower capital retention thereby allowing for greater investment opportunities, it is complicated and costly to develop and maintain.

The insurer seeking to develop its own internal model must be able to demonstrate to its regulator that it has contemplated numerous potential risks and catastrophes for which it is potentially valuable. Additionally, it must place a value on such risks and catastrophes and determine at what point it would no longer be viable. Finally, the ORSA is subject to change on a regular basis, particularly in connection with dynamic companies. The insurer must be able to regularly adjust its ORSA and explain all of the underlying assumptions to its regulator. Further, the regulators often ask the insurers to model additional scenarios to further test anticipated risks.

VI. UNIFORM REGULATORY GUIDELINES REGARDING CYBERSECURITY IN THE INSURANCE INDUSTRY

Cybersecurity risks have become more significant as critical consumer financial and health information is increasingly stored in electronic form. Data security risks increase as electronic storage increases. Recent high profile data breaches have led state regulators to work toward strengthening insured defense against attacks. The NAIC Executive (EX) Committee recently appointed the Cybersecurity (EX) Task Force to serve as the central focus for insurance regulatory activities relating to cybersecurity.

A. NAIC Guidelines – adopted April 17, 2015

Since the adoption of its April 2015 Cybersecurity Guidelines, the NAIC Cybersecurity Task Force is coordinating efforts with state insurance regulators to conduct examinations that would verify insurance companies are making appropriate efforts to protect confidential data. States are performing certain limited scope examinations over specific insurers, but the NAIC
offered no additional comment. Even while the limited exams are taking place, a detailed effort to help regulators conduct examinations to determine whether insurers have proper cybersecurity management procedures is the subject of some insurance industry concern. There are also plans to amend the Financial Condition Examiner’s Handbook to provide guidance for state regulators.

B. **State Measures**

(i) The New York Division of Financial Services is one of the first to investigate cybersecurity measures within an insurer. New York has made known its intention to conduct targeted market conduct exams with respect to cybersecurity issues in the insurance industry, to consider cybersecurity as part of enterprise risk reporting and on March 26, 2015 sent letters to larger insurers operating in New York, seeking detailed information on their cybersecurity measures. New York continues to consider new regulations for financial institutions, including banks and insurance companies, and establishing cybersecurity standards applicable to their relationships with third party service vendors.

(ii) Other state specific measures.

Connecticut has also adopted a law that will apply to all insurers licensed to write accident and health insurance in the state. This new law provides a laundry list of requirements that such an insurer must have in place in connection with cybersecurity measures. Like the focus of the New York regulators, security systems within an insurer’s operations is critical as is management of third parties that have access to an insurer’s system that houses financial, privacy and personal information.

Overall, insurers will be required to maintain detailed Information Security manuals and processes. Specific measures implemented for protecting all identifiable and health information will be required. Training of individuals who handle such information (as with HIPAA
requirements) also likely will be expected. Further, it is anticipated that processes will include
detailed reviews of breaches (and likely near breaches) and remediation in connection with such
breaches. Disciplinary measures against violators within the insurer will be expected, as will
reactive measures against third-party vendors who breach the insurer’s practices. Finally, all
regulators are coming to expect the insurers to ensure that regular reports regarding information
security and potential data breaches are reported to the group’s risk committees and relevant
boards.

C. **Cybersecurity Risk Management**

(i) cybersecurity policy/procedures;

(ii) training of key staff;

(iii) establish notice and remedies in the event of breach;

(iv) consider external auditors to identify weaknesses in internal policies,
procedures and practices;

(iv) consider purchasing cyber risk coverage.

Cyber liability policies should include one or more of the following types of
coverages:

- liability for security or privacy breaches; this would include loss of
  confidential information by allowing, or failing to prevent, unauthorized
  access to computer systems;
- the cost associated with a privacy breach, such as consumer notification,
  customer support and costs of providing credit monitoring services to
  affected consumers;
- the cost associated with restoring, updating or replacing business assets
  stored electronically;
- business interruption and extra expense related to security or privacy
  breach;
- liability associated with libel, slander, copyright infringement, product
  disparagement or reputational damage to others when the allegations
  involve a business website, social media or print media;
• expenses related to cyber extortion or cyber terrorism;
• coverage for expenses related to regulatory compliance for billing errors, physician self-referral proceedings and emergency medical treatment and active Labor Act proceedings.