MARCH 2013

Contacts:
Amy S. Kline
215.972.8567
akline@saul.com
Sean T. O'Neill
215.972.7159
soneill@saul.com
Braden A. Borger
215.972.7176
bborger@saul.com
Matthew J. Smith
215.972.7535
msmith@saul.com
Brian P. Simons
215.972.7194
bsimons@saul.com
Patrick F. Nugent
215.972.7134
pnugent@saul.com

Saul Ewing LLP

Insurance Practice

Reinsurance Redux

The redux on developments in the law of reinsurance

In This Issue

New York Court of Appeals Reverses Decision Requiring Reinsurers to Follow the Fortunes on Asbestos Settlement Where There Were Questions of Fact With Respect to Reasonableness of Reinsured's Settlement Decisions

United States Fid. & Guar. Co. v. American Re-Insurance Co. 2013 NY Slip Op 00784, 2013 WL 451666 (N.Y. Feb. 7, 2013).

The New York Court of Appeals reversed the decisions of the Supreme Court and Appellate Division and held that there were questions of fact as to whether reinsurers were required to follow the fortunes with respect to settlement allocations of asbestos claims, where the reinsured failed to allocate any portion of settlements to bad faith.

On February 7, 2013, the New York Court of Appeals reversed the decisions of the Supreme Court, New York County and the Appellate Division which had, respectively, granted and affirmed summary judgment in the amount of $262 million (plus statutory interest) for cedents United States Fidelity and Guaranty Company and St. Paul Fire and Marine Insurance Company (collectively "USF&G") against reinsurers American Re-Insurance Company ("American Re") and Excess and Casualty Reinsurance Association and its pool members ("ECRA" and together with American Re, the "Reinsurers").

From 1948 until 1960, USF&G insured Western Asbestos Company ("Western Asbestos"), a distributor of asbestos products. The business of Western Asbestos was taken over in the 1960s by Western MacArthur Company ("MacArthur"). In 1993, MacArthur initiated underlying coverage litigation against USF&G in California state court seeking damages and a declaration that USF&G had a duty to defend and indemnify MacArthur against asbestos-related personal injury claims. In 2002, USF&G settled the underlying coverage litigation for approximately $987 million. As part of the settlement, MacArthur was to file for bankruptcy, and a trust was to be created to assume MacArthur's asbestos-related liabilities.

Upon settlement of the underlying coverage litigation, USF&G billed the Reinsurers for a portion of the settlement. USF&G calculated the Reinsurers' share of the settlement at approximately $391 million. The Reinsurers declined to pay and this litigation followed (some Reinsurers settled with USF&G, leaving approximately $262 million, not including interest, in dispute).

The Supreme Court granted summary judgment to USF&G, and the Appellate Division affirmed. The courts held that the Reinsurers were obligated to follow the fortunes of USF&G's settlement of the underlying coverage litigation. The Court of Appeals, however, modified the Appellate Division's order.

The Court reaffirmed the principle of follow the fortunes that such clauses "require deference to a cedent's decisions on allocation." The Court continued, however, by noting that "to say a cedent's allocation decisions are entitled to deference is not to say that they are immune from scrutiny." Rather, an allocation is subject to an objective reasonableness standard such that the "reinsured's allocation must be one that the parties to the settlement of the underlying insurance claims might reasonably have arrived at in arm's length negotiations if the reinsurance did not exist." Furthermore, the Court rejected USF&G's argument that the validity of the allocation was established simply by virtue of the fact that the allocation used in billing the Reinsurers was the one that USF&G agreed upon with the underlying insurance claimants.

Therefore, the Court held that, under a follow the settlements clause such as presented here, "a cedent's allocation of a settlement for reinsurance purposes will be binding on a reinsurer if, but only if, it is a reasonable allocation, and consistency with the allocation used in settling the underlying claims does not by itself establish reasonableness."

The Court then applied these principles to three assumptions underlying USF&G's settlement allocation that were subject to challenge by the Reinsurers:

- *First*, the USF&G allocation attributed all of the settlement amount to claims within the limits of the underlying policies, and none of the settlement amount to the claims that USF&G acted in bad faith during the course of the underlying asbestos

litigation. The Court found evidence in the record from which a fact finder could conclude that an allocation giving no value to the bad faith claims was unreasonable. The evidence included: (a) "a significant risk of an adverse verdict on the bad faith claims," (b) the potential finding that USF&G "assigned inflated values to claims other than the bad faith claims," (c) that the demand immediately before settlement included value for bad faith claims, and (d) the Bankruptcy Court's finding that surrender of the bad faith claims in the settlement were part of the "benefits provided." On this record, the Court found that it was "impossible to conclude, as a matter of law, that parties bargaining at arm's length, in a situation where reinsurance was absent, could reasonably have given no value to the bad faith claims." Rather, the Court found that this issue must be decided at trial.

- Second, the USF&G allocation assigned the maximum value per claim ($200,000) to claimants with lung cancer. Evidence of record demonstrated, however, that the asbestos claimants' expert valued lung cancer claims at less than half that amount. One inference from this was that claims falling below the Reinsurers' retention were undervalued. The Court found an issue of fact, therefore, as to whether the values assigned to the various claims could reasonably have been agreed on in an arm's length bargain in the absence of reinsurance.
- *Third*, the USF&G allocation attributed all of the losses to a single insurance policy, rather than prorating them over the many policy years in which claimants were exposed to asbestos. On this point, the Court found no evidence from which a fact finder could infer that the allocation was unreasonable. The Court rejected the Reinsurers' arguments that USF&G improperly adopted the rules of "continuous trigger," "all sums" and "no stacking," and that the "Other Reinsurance" clause of the USF&G policies forbade the allocation of all losses to one policy year.

Finally, the Court rejected the Reinsurer's contention, in the alternative, that the reinsurance treaty was retroactively amended to increase the retention per loss to $3 million, an amount far in excess of any loss for which USF&G could have been liable.

Redux in Context

- Although reinsurers are required to show deference to a cedent's decisions on allocation where there is a follow the fortunes clause under New York law, such decisions must be objectively reasonable.
- A cedent's settlement allocation to its reinsurers is not presumptively valid because it is consistent with the allocation used in the underlying claim.
- When considering the reasonableness of settlement allocations, courts may consider whether there should have been allocations for bad faith claims, whether claims were overvalued and whether losses should have been prorated over multiple policies.

The Washington Supreme Court Holds That State Statute Invalidates Mandatory Arbitration Provisions in Insurance Contracts

State Department of Transportation v. James River Insurance Co., 292 P.3d 118 (Wash. 2013).

In an *en banc* decision, the Washington Supreme Court affirmed the decision that a Washington state statute, which prohibits any agreement in insurance contracts from depriving the court of jurisdiction of an action against the insurer, voided mandatory arbitration provisions in insurance contracts.

On January 17, 2013, the Washington Supreme Court held that a state statute prohibited mandatory arbitration provisions in insurance contracts in an *en banc* decision. James River Insurance Company ("James River") issued two insurance policies to Scarsella Brothers Inc. for liability relating to work on a highway project and the Washington State Department of Transportation ("WSDOT") was added as an insured under the policies. WSDOT was sued by persons killed or injured in an accident at or near the project and tendered its defense to James River. WSDOT accepted the tender under a reservation of rights and demanded arbitration of the parties' coverage disputes pursuant to a mandatory arbitration provision in the insurance policies.

WSDOT filed a declaratory judgment action seeking a declaration that the mandatory arbitration provision was void and unenforceable under a Washington statute which prohibits insurance contracts from "depriving the courts of this state of the jurisdiction of action against the insurer." James River filed a counterclaim and sought to compel arbitration. The trial court denied James River's motion to compel arbitration and James River appealed.

The *en banc* panel of the Washington Supreme Court held that the meaning of the statute must be discerned from looking at the entire phrase "jurisdiction of action against the insurer" as opposed to just the word "jurisdiction" and that the use of the full phrase shows an intent to protect the right of policyholders to bring an original action against the insurer in state court. Binding arbitration agreements deprive the state courts of the jurisdiction they would normally possess in an original action to review the substance of the dispute between the parties. Accordingly, the court held that the statute "is properly interpreted as a prohibition on binding arbitration agreements" and that the arbitration provision at issue was unenforceable.

The court further held that the state statute prohibiting mandatory arbitration provisions is not preempted by the Federal Arbitration Act because the statute is shielded from preemption by the McCarran-Ferguson Act. While state statutes prohibiting arbitration agreements that are inconsistent with the Federal Arbitration Act are generally preempted, there is an exception when the statute was enacted "for the purpose of regulating the business of insurance" within the meaning of the McCarran-Ferguson Act. The court concluded that the Washington statute at issue regulates the business of insurance "because it is aimed at protecting the performance of an insurance contract by ensuring the right of the policyholder to bring an action in state court to enforce the contract." Therefore, the court held that the statute was shielded from preemption.

Redux in Context

- Mandatory arbitration provisions in insurance policies are prohibited in the state of Washington and will not be enforced.
- State statutes that prohibit mandatory arbitration provisions are not preempted by the Federal Arbitration Act if they are enacted for the purpose of regulating the business of insurance.

New York State Court Holds That Umpire Who Would Resolve Disagreement Between Arbitrators Should Be Chosen Before Arbitration Commences

In re American Home Assurance Co., – N.Y.S.2d – , 2013 WL 172210 (N.Y. Supr. Ct. Jan. 15, 2013).

The New York Supreme Court for New York County held that when an arbitration provision calls for the selection of an umpire to resolve any disagreement between the two arbitrators selected by the parties during arbitration, the umpire should be chosen before the arbitration commences as opposed to after a disagreement arises between the arbitrators.

On January 15, 2013, the New York Supreme Court for New York County held that it had the authority to appoint an umpire

when two arbitrators selected by the parties failed to do so and that an umpire should be selected before the arbitration commences. National Union Fire Insurance Company of Pittsburgh, P.A. ("National Union") and Clearwater Insurance Company ("Clearwater") were parties to multiple reinsurance contracts. One of the reinsurance contracts provided that all disputes "shall be submitted to the decision of two arbitrators, one to be chosen by each party and in the event of the arbitrators failing to agree, to the decision of an umpire to be chosen by the arbitrators." Two other reinsurance contracts provided that any dispute "shall be referred to three arbitrators, one to be chosen by each party and the third by the two so chosen." The parties each appointed their own arbitrators, but an umpire or third arbitrator was never selected by those two arbitrators and National Union therefore sought the appointment of an umpire/third arbitrator by the court.

New York law provides that a court may appoint an arbitrator if the arbitration provision does not provide a method of selecting one or the method fails. The court held that it had the power to appoint an arbitrator regardless of who was to blame for the failure to select one, because the statute provides authority to appoint an arbitrator whenever the contractual method fails, regardless of the reason.

The parties also disagreed with respect to the method of selecting an umpire/third arbitrator that the court should use. National Union asked the court to select from among the three individuals proposed by their arbitrator or to otherwise use a ranking method prescribed by ARIAS-US. Clearwater asked the court to use a "strike and draw" method, which it claimed was the customary practice in the insurance industry, or to otherwise select from among the three individuals proposed by their arbitrator. The strike and draw method called for each side to strike two of the three candidates proposed by the other side and the umpire to be selected by random draw from the two remaining candidates.

New York law does not set forth any substantive criteria for appointment of an umpire or third arbitrator and the reinsurance agreements at issue did not provide a method, so the court adopted an approach similar to the one used in a recent decision by the Supreme Court of New York County, where the judge adopted the ranking method but modified it to incorporate the methods proposed by both parties. The court decided to combine the methods proposed by the parties, such that the strike and draw method would be used to select two candidates, one each from the three arbitrators proposed by each party, and then the rankings method would be used to select the umpire from among those two. In the event of a tie in the rankings, the umpire would be drawn by random lot.

Finally, Clearwater argued that a full arbitration needed to be held before an umpire was selected, because an umpire was only needed if the two arbitrators did not agree as to the resolution of the disputes. The court recognized that the two decisions to address the issue of whether an umpire may be appointed before a disagreement among the arbitrators arises, and thus whether an umpire may be appointed and be present at the hearing before the arbitrators, reached different conclusions. The court concluded that it was more practical to select an umpire in advance of arbitration because it "avoids the additional expense of having to conduct more than one arbitration in the event of a disagreement between the arbitrators. In addition, the umpire would see the proof as it is presented before the arbitrators."

Redux in Context

- In New York, courts have the power to appoint an umpire or arbitrator whenever the arbitration provision is silent as to the method of selection or the proscribed method fails.
- In New York, courts are not required to follow certain criteria or employ a specific method when selecting an arbitrator; however, when possible, courts may try to combine the rival methods proposed by the parties.
- In New York, unless specifically prohibited from doing so under the terms of the arbitration provision, the parties should select an umpire/third arbitrator needed to resolve disagreements between the other arbitrators before the arbitration commences.

Minnesota District Court Stays Reinsurance Case Pending Arbitration Of Claims

Sec. Life Ins. Co. of Am. v. Sw. Reinsure, Inc., No. 11-1358, 2013 WL 500362 (D. Minn. Feb. 11, 2013).

The United States District Court for the District of Minnesota granted defendants' motions to stay pending arbitration in a complex reinsurance security dispute.

On February 11, 2013, the United States District Court for the District of Minnesota entered a stay on all claims brought by the plaintiff insurance company even though some of the defendant reinsurers were not signatories to the reinsurance agreements requiring arbitration of claims. Beginning in 1995, Security Life Insurance Company of America ("Security Life"), through its predecessor, entered into a series of reinsurance agreements, two with a company that was later acquired by Libre Insurance Company ("Libre") and one with Sierra Family Life Reinsurance Company, each of which contained arbitration clauses. In 2005, Security Life executed a trust agreement with INA Trust FSB ("INA") and Ideal Insurance Company ("Ideal") to secure payment of a portion of the obligations under the reinsurance agreements. The trust agreement, however, did not contain an arbitration clause.

A dispute arose when, without Security Life's knowledge or approval, INA allegedly transferred all of the funds out of the trust account to Fifth Third Bank, where the funds are being held in trust under a new trust agreement to which Security Life is not a party. Security Life brought suit against INA and Ideal and the reinsurers, among other defendants, for breaches of the various agreements, fraud, unjust enrichment, breach of fiduciary duty and breach of duty of good faith and fair dealing and seeking injunctive relief and a constructive trust.

Libre asked Security Life to submit its claims for arbitration. When Security Life refused, Libre and the other defendants filed motions to dismiss or, in the alternative, to stay the case pending arbitration. Although Libre was not a signatory to the reinsurance agreements, the court determined that a "non-signatory to an arbitration agreement may enforce the agreement against a signatory under an equitable estoppel theory . . . when (a) a signatory's claim 'makes reference to or presumes the existence of the written agreement' containing the arbitration clause; or (b) the claim involves a close relationship between signatory and non-signatory parties, raising 'allegations of substantially interdependent and concerted misconduct.'" Because all of Security Life's claims against Libre were founded on Libre's assumption of the reinsurance agreements or substantially interdependent and concerted misconduct by Libre and the other defendants, the court concluded that Libre could enforce the arbitration agreements under an estoppel theory. The court further determined that the broad language in the arbitration clauses encompassed not only claims based on the reinsurance agreements themselves but also those related to the trust agreement since Libre's obligations under that agreement arose out of its obligations under the reinsurance agreements. The court likewise rejected Security Life's waiver defense, finding that Libre avoided waiver by asserting its arbitration rights in its first responsive pleading.

The court also found that the broad arbitration provisions in the reinsurance agreements, which required arbitration of claims "arising out of," "arising under, out of, or in connection with, or in any manner relating to" the reinsurance agreements, covered tort claims arising from the same set of operative facts as claims for breach of the agreements. Similarly, the court determined that non-signatories to an agreement are entitled to enforce an agreement's arbitration clause when "the core of the dispute is the conduct of the nonsignatories in fulfilling a signatory's promises." The court rejected Security Life's waiver arguments against some of the other defendants, finding that Security Life would not be prejudiced by any delay caused by arbitration since the court would stay these other defendants' claims even if they were not arbitrable. The court noted its "discretion to stay third party litigation that involves common questions of fact that are within the scope of the arbitration agreement." The court explained that "[w]ithout a stay, there is a potential for double recovery. Alternatively, if [Security Life] loses in arbitration, then [its] claims against [a defendant whose claims are not arbitrable] may fail under collateral estoppel." The court also noted the potential for confusion and inconsistent rulings absent a stay.

Finally, although courts have discretion to dismiss an action rather than stay it when the entire controversy will be resolved by arbitration, the court here concluded that the number of nonarbitrable claims in the amended complaint and the interconnected web among the parties and claims required a stay pending arbitration.

Redux in Context

- Non-signatories to arbitration agreements may be able to compel arbitration under an estoppel theory when claims are premised on those agreements.
- It is unlikely that a party will be deemed to have waived arbitration if it asserts its arbitration rights in its first responsive pleading.
- Courts may stay a case pending arbitration even if some claims are not arbitrable when not doing so could cause confusion or result in inconsistent rulings.
- Courts have discretion to dismiss a case rather than stay it when the entire controversy will be resolved through arbitration.

Connecticut District Court Grants Motion To Amend Complaint In Suit Against Reinsurer

Travelers Indem. Co. v. Excalibur Reinsurance Corp., No. 3:11-CV-1209, 2013 WL 424535 (D. Conn. Feb. 1, 2013).

The United States District Court for the District of Connecticut granted an insurer's motion to amend its complaint against a reinsurer after determining that additional claims for account stated and violation of Connecticut Unfair Trade Practices Act were plausible and would not prejudice the reinsurer.

On February 1, 2013, the United States District Court for the District of Connecticut granted The Travelers Indemnity Company's ("Travelers") motion to amend its complaint to add two new claims against reinsurer Excalibur Reinsurance Corporation ("Excalibur"). Travelers allegedly obtained new information during discovery that provided a basis to bring additional claims for account stated and violation of Connecticut Unfair Trade Practices Act ("CUTPA").

Traveler's predecessor in interest – Gulf Insurance Company ("Gulf") – issued primary and excess Errors and Omissions (E & O) policies to an insurance and reinsurance broker. Gulf purchased a reinsurance policy to which Excalibur (then known as PMA Capital) had subscribed. Two insurance companies made claims against the broker, and Travelers entered settlement agreements whereby Travelers paid the broker negotiated amounts from its E & O policies. Travelers sought from Excalibur its portion of the reinsurance covering the underlying claims. Excalibur did not pay and Travelers brought a claim for breach of contract.

A deposition of an Excalibur employee and a telephone call with another Excalibur employee allegedly revealed material facts previously unknown to Travelers, which facts served as the basis for Travelers' account stated and CUTPA claims. Travelers moved to amend its complaint to nearly a year after initiating the action. Excalibur opposed Travelers' motion to amend as being untimely and failing to state viable claims.

The court explained that a party may amend its pleading only with the opposing party's consent or the court's leave, and that leave should be freely granted when justice so requires. The court noted that Excalibur had not claimed that it had been prejudiced by the timing of Travelers' motion. The case was in its early stages and trial had not been scheduled. Additionally, the deposition, which revealed the new information serving as one of the bases for the new claims, occurred approximately six weeks before Travelers filed its motion. The court considered this prompt action on Travelers' part. Thus, the court rejected Excalibur's argument that the motion was not timely made.

Turning to the legal sufficiency of the two additional claims, the court rejected Excalibur's factual arguments as not factoring into a plausibility analysis under Iqbal and its progeny. The court explained that it must "accept[] the truth of well-pleaded

factual allegations, and consider[] whether they state a claim that is plausible on its face." The court found that the facts alleged in Travelers' proposed amended complaint stated a plausible claim for an implied account, stating: "The contracts and treaty of reinsurance created the relationship of Excalibur as debtor and Travelers as creditor. Travelers submitted to Excalibur claims for specific amounts it calculated Excalibur was obligated to pay under these contracts and treaty. Excalibur received these claims, held them, and did not pay them."

Travelers' second new claim alleged that Excalibur intentionally employed business practices to take advantage of "the float" by "holding on to monies as long as possible, even in derogation of the letter and spirit of contractual obligations owing to others." The court found that Travelers' proposed amended complaint stated a plausible claim against Excalibur for violations of CUTPA. The court concluded that Excalibur had failed to provide a basis for denying Travelers leave to amend its complaint.

Redux in Context

- Courts are more likely to permit amendments to bring additional claims when leave to amend is sought promptly after discovering facts in discovery giving rise to additional claims.
- Under Connecticut law, it may be an unfair trade practice for a reinsurer to dispute and/or delay its review of claims for payment under reinsurance agreements in order to retain premiums for a longer period of time to take advantage of the float.

Baltimore, MD
500 East Pratt St.
Charles O. Monk, II
410.332.8668

Boston, MA
131 Dartmouth St.
Richard D. Gass
617.723.3300

Chesterbrook, PA
1200 Liberty Ridge Dr.
Michael S. Burg
610.251.5750
Nathaniel Metz
610.251.5099

Harrisburg, PA
2 North Second St.
Eric L. Brossman
717.257.7570

Newark, NJ
One Riverfront Plaza
Stephen B. Genzer
973.286.6712

New York, NY
555 Fifth Ave.,
Michael S. Gugig
212.980.7200

Philadelphia, PA
1500 Market St.
Bruce D. Armon
215.972.7985

Pittsburgh, PA
One PPG Place
Jay L. Panzarella
412.209.2510
David R. Berk
412.209.2511

Princeton, NJ
750 College Rd. E
Marc A. Citron
609.452.3105

Washington, DC
1919 Pennsylvania Ave, NW
Mark L. Gruhin
202.342.3444
Andrew F. Palmieri
202.295.6674

Wilmington, DE
222 Delaware Ave.
Wendie C. Stabler
302.421.6865
William E. Manning
302.421.6868