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Insurance Practice

Reinsurance Redux

The redux on developments in the law of reinsurance

In This Issue

Texas Court of Appeals Holds that Insurer's Consent was Not Required for Modification of a Reinsurance Agreement to be Enforceable

Arch Reinsurance Co. v. Underwriters Service Agency, Inc., No. 02-10-00365-CV, 2012 WL 1432556 (Tex. Ct. App. Apr. 26, 2012).

On April 26, 2012, the Texas Court of Appeals held that an insurer's consent was not required for the modification of a reinsurance agreement to be enforceable. State National, Arch Reinsurance Company ("Arch") and Underwriters Service Agency, Inc. ("Underwriters") had entered into a quota share reinsurance agreement and general agency agreement whereby Underwriters acted as the insurance agent for State National for the sale of homeowner policies reinsured by Arch. Arch reinsured 100 percent of the risk such that Underwriters remitted all premiums to Arch but retained a commission. The reinsurance agreement provided that Arch and Underwriters could not assign their rights or obligations under the agreement without the written consent of State National. Likewise, the reinsurance agreement provided that it could only be modified by a written agreement executed by all the parties.

Three days before resigning, a representative of Arch executed a modification of the reinsurance agreement with Underwriters that would increase Underwriters' commission. Arch claimed that the modification was not authorized and State National never reviewed or signed it. Arch filed suit for breach of contract and declaratory relief, claiming that the modification was unenforceable on multiple grounds, including fraudulent inducement and lack of written consent by State National.

Even though State National did not review or sign the modification, the court held that the modification was enforceable because State National was not adversely affected. The court reasoned that although the modifications reallocated the risk of loss, the addendum did not shift any of that risk back to State National. Thus, State National's consent was not necessary to modify the reinsurance agreement as between the Arch and Underwriters. The court also held that the modification did not violate the reinsurance agreement's prohibition against assignments without written consent because the modification did not assign away any of Underwriter's rights.

Arch also argued that the modification, if valid, was not retroactive as a matter of law and therefore could not discharge amounts owed by Underwriters to Arch prior to the effective date of the modification. The court disagreed and affirmed the jury's determination that Arch had agreed to the modification to discharge Underwriters' liability to return commissions.

Finally, the court affirmed the grant of summary judgment to Underwriters on Arch's fraudulent inducement claim. Arch had claimed that Underwriters failed to disclose the amount of return commission it owed Arch and affirmatively misrepresented its financial condition. The court rejected the non-disclosure claim on the basis that Arch had failed to prove that the decision to modify the reinsurance agreement was based on Underwriters' representations as to the commissions. The court likewise held that Arch had failed to prove that it relied on the financial representations made by Underwriters when agreeing to the modification.

Redux in Context:

- Despite contractual language to the contrary, a party's consent may not be required to modify a reinsurance agreement so long as that party is not adversely affected by the modification.
- A claim for fraudulent inducement cannot succeed where there is no evidence that a party actually relied on the non-disclosures or affirmative misrepresentations when making its decision to enter into a reinsurance agreement or modify the terms thereof.

Southern District of New York Affirms Order Compelling Production of Document Relating to Insurer's Reserve Practices

Granite State Insurance Co. v. Clearwater Insurance Co., No. 09 Civ. 10607 RKE, 2012 WL 1520851 (S.D.N.Y. Apr. 30, 2012).

On April 30, 2012, the United States District Court for the Southern District of New York affirmed a magistrate judge's order compelling the production of documents relating to a reinsurer's claim that its ceding insurer's failure to provide timely notice of claims was the result of bad faith reserve practices. Granite State Insurance Company ("Granite State") brought suit against its reinsurer Clearwater Insurance Company ("Clearwater") seeking indemnification for asbestos claims. Clearwater had refused to pay the disputed claims on the basis of late notice.

Clearwater moved to compel the production of documents relating to any analysis of Granite State's reserves for asbestos claims. Clearwater argued that such documents were relevant to its affirmative defense that Granite State had failed to implement reasonable and adequate practices and procedures to ensure the proper reporting of claims. The magistrate judge ordered the production of any analysis of the adequacy of Granite State's reserves for asbestos claims. Granite State then moved to set the magistrate's order aside on the grounds that it was based on a misinterpretation of *Unigard Security Insurance Co. v. North River Insurance Co.*, 4 F.3d 1049 (2d Cir. 1993), and that the documents sought were irrelevant because Granite State manually provided timely notice of claims.

In *Unigard*, the Second Circuit held that a reinsurer need not show prejudice to succeed on a late notice defense if the cedent acted in bad faith in failing to provide timely notice. The *Unigard* court further held that the standard for bad faith was gross negligence or recklessness, such that the failure to implement routine practices and controls to ensure notification to reinsurers would qualify as bad faith.

Granite State argued that the standard under *Unigard* was whether the ceding insurer has any practices in place, and not whether such practices were adequate or reasonable. As such, Granite State claimed that Clearwater was only entitled to discovery regarding whether any practices and procedures existed and that the quality of those practices and procedures was irrelevant to a bad faith defense. Granite State further argued that it had in fact provided timely notice manually, and so discovery into its automated notification systems was irrelevant.

The district court rejected both of Granite State's arguments and held that Clearwater's discovery request was within the broad scope of discovery permitted by the Federal Rules of Civil Procedure. The information sought was directly relevant to Clearwater's defense, the merits of which should not be decided on a discovery motion. The court noted that Granite State appeared to interpret *Unigard* too narrowly, as it would make little sense if a bad faith defense could be automatically defeated by the existence of any procedure, regardless of how unlikely it was to ensure that complete and prompt notice was provided to a reinsurer. The court further held that evidence concerning the adequacy and reasonableness of Granite State's notification procedures was relevant to whether Granite State acted in good faith and whether notice was sent in any form.

Redux in Context:

- Under New York law, the existence alone of practices and procedures to ensure that a reinsurer receives adequate and timely notice of claims may be insufficient to defeat a late notice defense based on bad faith.
- Under New York law, the adequacy and reasonableness of a ceding insurer's practices and procedures to ensure timely notice of claims are relevant to a late notice defense based on bad faith.

United States Court of Appeals for the Federal Circuit Affirms Decision to Compel Arbitration of Licensing Dispute

Promega Corp. v. Life Technologies Corp., 674 F.3d 1352 (Fed. Cir. 2012).

On March 28, 2012, the United States Court of Appeals for the Federal Circuit affirmed a district court's decision to compel arbitration of a dispute relating to an alleged breach of a license agreement and patent infringement. In 1996, Research Genetics, Inc. ("Research Genetics") and Promega Corporation ("Promega") entered into a license agreement for various patents relating to genetic identification. The agreement included an arbitration clause, which provided that "all controversies or disputes arising out of or relating to the agreement or relating to the breach thereof, shall be resolved by arbitration." The agreement also provided that the agreement could not be assigned without the express written consent of the other party.

In 2001, Research Genetics merged with its parent company, Invitrogen Corporation ("Invitrogen"). Promega granted written consent to assign Research Genetics' rights under the agreement to Invitrogen. Two years later, Promega again granted Invitrogen written consent to assign its rights to IP Holdings, a wholly-owned subsidiary of Invitrogen. In 2008, Invitrogen merged with Applied Biosystems Inc. and became Life Technologies Corporation ("Life Technologies"), with IP Holdings remaining a wholly owned subsidiary of Life Technologies.

In 2010, a dispute arose over the amount of fees and royalties due to Life Technologies under the agreement. Life Technologies demanded arbitration, but Promega filed suit in the Western District of Wisconsin seeking a declaratory judgment of non-arbitrability and alleging patent infringement. Promega claimed that Life Technologies was not entitled to demand arbitration because IP Holdings' rights under the agreement had never been assigned to Life Technologies. In response, IP Holdings served Promega with a demand for arbitration and filed a motion to compel arbitration in the district court. After limited discovery regarding whether IP Holdings' rights had been assigned, the district court entered an order compelling arbitration and held that IP Holdings was entitled to demand arbitration under the agreement and that it was irrelevant whether IP Holdings was merely a "puppet" of Life Technologies.

On appeal, Promega raised several arguments which were rejected by the Federal Circuit Court of Appeals. The Circuit Court held that the rights under the agreement remained with IP Holdings, a corporation in good standing, and that a valid agreement to arbitrate existed between Promega and IP Holdings. The court specifically noted that Promega could not "have it both ways" by arguing that IP Holdings could not compel arbitration because it intended to assign its rights to Life Technologies, but Life Technologies could not compel arbitration because Promega never granted written consent to the assignment.

Because the Federal Arbitration Act ("FAA") favors arbitration when the parties contract for that mode of dispute resolution, the court held that permissive language in the contract becomes mandatory when the other party requests arbitration. In rejecting Promega's argument that the parties only intended small disputes to go to arbitration, the court further held that imposing limits on broad arbitration clauses such as the one at issue would be inconsistent with the presumption in favor of arbitration. The court also held that Promega cannot now claim that the arbitration terms it agreed to are unfair because they would limit discovery, concluding that limitations on discovery do not warrant a departure from the FAA's mandate to enforce arbitration provisions. Finally, the court held that its duty to compel arbitration was not altered by the fact that

Promega's patent infringement claims remained pending in the district court, as the FAA requires piecemeal litigation when necessary to give effect to an arbitration agreement.

Redux in Context:

- Courts will resolve ambiguities in favor of arbitration, even when there are questions as to whether a right to arbitration was assigned.
- Courts will not limit the scope of an arbitration clause to reflect the unexpressed intent of the parties.
- Courts will compel arbitration even if piecemeal litigation will result.

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