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# A brief review of reinsurance trends in 2017

**By Larry P. Schiffer, Esq., Eridania Perez, Esq., Kelly Mihocik, Esq., India Scarver, Esq., and Seth D. Osnowitz, Esq.**
***Squire Patton Boggs (US) LLP***

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Toward the end of 2017, the New York Court of Appeals began what might be a new trend by answering a certified question from the Second Circuit Court of Appeals on the *Bellefonte* principle in the negative. Courts also continued to issue rulings consistent with the longstanding principle that only arbitrators should decide matters within the scope of an arbitration clause.

While the courts' review of arbitration awards remains extremely limited, it was clear that courts would not hesitate to vacate an award where the arbitrator's conduct rises to the level of evident partiality. Finally, courts continued to interpret broadly the scope of discovery regarding reinsurance communications.

## ARBITRABILITY

In line with the longstanding principle that courts should decline to adjudicate issues within the scope of an arbitration clause, in *HDI Global SE v. Lexington Ins. Co.*, 232 F. Supp. 3d 595 (S.D.N.Y. 2017), a New York federal court made clear that an arbitrator must decide challenges to a contract. In the underlying case, the policyholder sought indemnification for a $66 million judgment under a professional liability policy issued in 2002 (2002 policy).

At first, the cedent argued that the 2002 policy contained a negligence trigger and the policyholder had not demonstrated that the loss arose out of professional negligence. The cedent eventually conceded that the 2002 policy did not contain a negligence trigger and paid the claim.

When the cedent sought to recover from the reinsurer, the reinsurer argued that it had not agreed to the 2002 policy, but that it had agreed to a policy that contained a negligence trigger, which the 2002 policy did not have.

The reinsurer sued in federal court and the cedent filed a motion to stay the lawsuit and compel arbitration. The reinsurer asked the court to stay arbitration and decide whether a contract even existed (i.e., that the contract was void for lack of mutual assent) because the reinsurer had not agreed to reinsure the 2002 policy.

The court reiterated the strong federal support for arbitration as a method of dispute resolution and relied on the Second Circuit's longstanding rule that, if the challenge is to the arbitration clause itself, an issue that goes to the making of the agreement to arbitrate, the court may proceed to adjudicate it.

If, however, the challenge goes to the interpretation of the contract, as was the case here (reinsurer claimed the loss was not covered by the terms of the policy), that issue goes to the arbitrator.

The court held that the reinsurer had executed a contract that contained a mutually agreed upon arbitration clause and had put forth no challenge to its formation. Thus, an arbitrator had to answer the issue of whether the policy covered the loss.

Similarly, in *National Union Fire Insurance Co. of Pittsburgh, PA v. Federal Insurance Co.,* No. 16-cv-8821 (S.D.N.Y. June 8, 2017), a New York federal court granted a petition to compel arbitration, stating that it would not rule on a speculative question relating to the real party-in-interest.

The parties had entered into a series of reinsurance agreements reinsuring certain excess workers' compensation policies. Although both parties agreed that they were required to arbitrate the dispute, a question arose over whether to include additional parties to the arbitration.

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The reinsurer claimed it was acting as a "front" for a pool of reinsurers known as the Pinehurst Accident Reinsurance Group (PARG). The parties disagreed over whether to include members of PARG as interested parties on the umpire questionnaire.

The parties filed cross petitions to compel arbitration. The cedent moved to compel arbitration between the parties without inclusion of PARG. The reinsurer claimed the intent and meaning of words in the original treaty directed the parties to arbitrate with entities that are the real parties-in-interest in the arbitration, including PARG.

The court noted that the real party-in-interest issue could present a question of arbitrability. Accordingly, citing the federal policy favoring arbitration, the court granted the cedent's petition to compel arbitration and granted, in part, the reinsurer's petition, leaving the arbiters to decide the issue.

In *Alabama Municipal Insurance Corp. v. Munich Reinsurance America Inc.*, No. 16-cv-948, 2017 WL 3927607 (M.D. Ala. Sept. 7,

2017), not only did the court hold that arbitration was proper, the court clarified what constitutes a waiver of the right to arbitrate.

The cedent sued for breach of contract. The cedent subsequently filed an amended complaint adding another reinsurance agreement between the parties and moved to stay pending arbitration under that agreement.

The reinsurer argued that the issue was not arbitrable because the claimed loss did not occur under that agreement and, therefore, there was no breach under the agreement.

The court found this to be a merit-based defense under the agreement referenced in the amended complaint, which contained an arbitration clause. Thus, any questions as to whether the alleged breach took place under the agreement referenced were for the arbitrator.

The reinsurer also argued that the cedent had waived arbitration. In rejecting this claim, the court stated that a party waives its right to arbitrate if, under the totality of the circumstances, the party has acted inconsistently with the arbitration right and, in doing so, has prejudiced in some way the other party.

The court rejected the reinsurer's argument that the cedent waived the right to arbitrate because it invoked the litigation process (i.e., filed suit, noticed depositions, participated in initial disclosures).

The court stated that any actions taken after the cedent filed its complaint should not constitute waiver because the cedent was simply following the court's scheduling order. The court also found that the reinsurer failed to show how it was prejudiced in any way by the cedent's conduct.

## COURT REVIEW OF ARBITRATION AWARDS

During 2017, courts did not stray from the pattern of limited review of arbitration awards, even when the arbitrator held that the issues involved had to be adjudicated in court. This was the case in *Mountain Valley Property Inc. v. Applied Risk Services Inc.*, No. 16-2189, 2017 WL 2981798 (1st Cir. July 13, 2017).

In *Mountain Valley*, an arbitrator issued an award finding that the parties' claims under a reinsurance participation agreement were not arbitrable and had to be adjudicated in court because of reverse preemption under the Nebraska Uniform Arbitration Act. That statute bans arbitration of insurance policies regardless of the parties' intent to arbitrate.

Despite this finding, the 1st U.S. Circuit Court of Appeals affirmed the denial of a motion to vacate the arbitration award.

The circuit court refused the arguments that the arbitrator's award showed a manifest disregard of the law and that the arbitrator exceeded his powers. The court found that the arbitrator's reasoning and conclusions were at the very least "colorable."

Under the Federal Arbitration Act (FAA), a court's authority to vacate or modify an arbitration award is exceedingly limited. When courts are moved to review an arbitrator's conduct, there must be a substantial showing of evident partiality, improper ex parte communications or some other serious misconduct prejudicing a party's rights.

In an exception to the general trend, in *Certain Underwriting Members at Lloyd's of London v. Insurance Company of the Americas*, No. 16-cv-323, 2017 WL 5508781 (S.D.N.Y. Mar. 31, 2017), a New York federal court vacated an arbitration award against reinsurers.

The court did so on the basis that the arbitrator's conduct had risen to the level of evident partiality for failing to disclose his significant business connections to one of the parties despite multiple opportunities to do so.

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During the arbitration proceeding, the cedent's arbitrator stated only that he knew the cedent's attorney with whom he had some potential business relations a decade earlier. He affirmatively stated that he had no connection to the cedent or a related company.

As the evidence in court revealed, however, the arbitrator was president and CEO of companies that shared an office suite with the cedent, had hired an officer of the cedent as his company's CFO, shared the same claims manager with the cedent and his company's counsel was previously a director of the cedent.

The court noted that, despite there not being a per se rule establishing that non-disclosure of material relationships constitutes evident partiality, the evidence in this case was significant enough to demonstrate evident partiality.

## CONTRACT INTERPRETATION

In the case of insolvency or runoff, it is critical to determine what contractual rights and liabilities have been purchased. If only the debts have been purchased and not the reinsurance contracts, then the right to enforce the arbitration clause in the underlying reinsurance contract will not exist.

Consistent with the trend of narrowly construing transferred rights under assigned reinsurance contracts, in *Pine Top Receivables of Illinois LLC v. Transfercom Ltd.*, 77 N.E.3d 657 (Ill. App. Ct., 6th Dist. 2017), an Illinois appellate court affirmed a decision denying a motion to compel arbitration in a reinsurance dispute arising over the reinsurance collection efforts of an insolvent insurance company.

The liquidator sold the insolvent's account receivables to an entity formed solely for the purpose of accepting and collecting receivables. In a prior case, the 7th U.S. Circuit Court of Appeals concluded that the assignment by the liquidator conveyed only the right to collect the debt and not the right to enforce the arbitration provision of the reinsurance contract.

In the 2017 case, the assignee sought to compel a different reinsurer to arbitrate under a different reinsurance contract.

In declining to consider whether the assignee could compel arbitration, based on the collateral estoppel or issue preclusion effect, the court found that the 7th Circuit had resolved the merits of whether the assignment of accounts receivable included the right to demand arbitration.

## *BELLEFONTE*

For years, reinsurers have made the traditional *Bellefonte* argument that the limits provision in a facultative certificate caps the amount the reinsurer is obligated for both losses and expenses. But, in an important ruling from the New York Court of Appeals, the court rejected the *Bellefonte* principle as a bright line rule and reiterated that, when interpreting an insurance or reinsurance contract under New York law, the regular rules of contract construction apply and each contract stands on its own terms, conditions and facts.

In *Global Reinsurance Corporation of America v. Century Indemnity Co.*, No. 124, 2017 WL 6374281 (N.Y. Dec. 14, 2017), the New York Court of Appeals answered in the negative the following certified question from the 2nd U.S. Circuit Court of Appeals:

> Does the decision of the New York Court of Appeals in *Excess Insurance Co. v. Factory Mutual Insurance Co.*, 822 N.E.2d 768 (2004) impose either a rule of construction, or a strong presumption, that a per occurrence liability cap in a reinsurance contract limits the total reinsurance available under the contract to the amount of the cap regardless of whether the underlying policy is understood to cover expenses such as, for instance, defenses costs?

*Excess* refers to the case that some argue put the *Bellefonte* principle under New York law.

In responding "No" to the certified question, the Court of Appeals explained that "under New York law generally, and in *Excess* in particular, there is neither a rule of construction nor a presumption that a per occurrence liability limitation in a reinsurance contract caps all obligations of the reinsurers, such as payments made to reimburse the reinsured's defense costs."

The court explained that, in *Excess,* it focused on the limited context of that case and the specific contract wording. The court in *Excess* did not face the question whether there was some blanket rule or presumption. Although the certified question was not explicitly limited to facultative reinsurance, the Court of Appeals took the question to be solely about facultative reinsurance.

While the New York Court of Appeals' answer to the 2nd Circuit's certified question was pending, a New York state intermediate appellate court affirmed the grant of partial summary judgment to reinsurers, but modified the judgment and declared that the cedent was not entitled to recover from the reinsurers any amounts exceeding the "reinsurance accepted" amount set forth in the facultative certificate. *Utica Mut. Ins. Co. v. Alfa Mut. Ins. Co.,* 154 A.D.3d 1287 (N.Y. App. Div., 4th Dep't Oct. 6, 2017). The court provided no analysis and no acknowledgement of the pending matter before the Court of Appeals.

In contrast, a Pennsylvania appellate court distinguished *Bellefonte* and affirmed a lower court's decision denying summary judgment to the reinsurer seeking to cap its liabilities based on the limits of a facultative certificate and granted judgment to the cedent on the claims for recovery of expenses. *Century Indem. Co. v. OneBeacon Ins. Co.*, 173 A.3d 784 (Pa. Super. Ct. Oct. 17, 2017).

In doing so, the court affirmed the lower court's determination that the facultative certificate was ambiguous, allowed and credited the cedent's extrinsic evidence, including expert testimony on custom and practice, and provided a detailed analysis of *Bellefonte* and its progeny. The court noted that this was a case of first impression for the Pennsylvania courts.

The number of cases that have distinguished *Bellefonte* has grown and now it appears that, with the New York Court of Appeals decision, this trend will continue.

## DISCOVERY

Courts in 2017 continued the trend of broadly interpreting the scope of discovery and carefully scrutinizing claims of work product and attorney-client privilege.

There were two notable cases on the scope of discovery and the cedent's loss reserve information. In *R&Q Reinsurance Co. v. St. Paul Fire & Marine Insurance Co.*, No. 16-cv-1473, 2017 WL 3272016 (E.D. Pa. Aug. 1, 2017), the cedent began defending the underlying claims in the 1980s, but did not provide notice to its reinsurer until 2013. Thus, one of the issues in dispute was whether the cedent provided prompt notice of the claims to the reinsurer.

The court determined that the cedent's historical loss reserves for the underlying policies were relevant to this issue and not protected by the work product doctrine. The court also determined that information regarding other reinsurers of the underlying policies was relevant to the notice issue.

The court further found that, because a protective order was in place to safeguard proprietary information exchanged between the parties, the cedent could not withhold or redact proprietary information requested by the reinsurer.

The trend continued in *ContraVest Inc. v. Mt. Hawley Insurance Co.*, No. 15-cv-304, 2017 WL 1190880 (D.S.C. Mar. 31, 2017), a bad faith action in which a South Carolina federal court also compelled a cedent to produce information on loss reserves and all communications with its reinsurer concerning the underlying claims.

The court determined that information on the cedent's loss reserves was relevant to assessing the validity of the insured's claims under an excess policy and the cedent had failed to carry its burden of showing that this information was protected by the work product doctrine.

Regarding the cedent's communications with its reinsurer, the court reasoned that these communications might reveal why the cedent changed its coverage positions.

In particular, the court determined that the discoverable communications were not limited to the underlying claims, but included communications about other claims by the insured under the same excess policy, because those communications would show whether the cedent changed its interpretation once it knew that it would have to provide coverage.

In *Baxter International Inc. v. AXA Versicherung*, 320 F.R.D. 158 (N.D. Ill. 2017), an Illinois federal court also granted an insured's motion to compel the cedent to produce litigation notices and post-litigation communications exchanged with its reinsurers and co-insurers on the basis that the information could contain admissions by the cedent on the scope of coverage.

The court rejected the cedent's argument that the communications were *per se* protected work product. Notably, the cedent had not made a relevancy challenge.

The court permitted the cedent to redact the amount of its reserves, stating that it was not convinced that the information was discoverable, but noted that it was willing to revisit its ruling.

In a case addressing privilege protections, *Utica Mutual Insurance Co. v. Munich Reinsurance Co.,* Nos. 12-cv-196 and 13-cv-743 (N.D.N.Y. Jan. 13, 2017), a New York federal court took a narrow view of the crime-fraud exemption to a claim of privilege.

The court affirmed a magistrate judge ruling denying a reinsurer's motion to compel production a cedent's document containing attorney notes.

The reinsurer argued that the document would help establish the cedent's attempt to defraud the reinsurer by engineering a settlement under which it received maximum reinsurance coverage. The attorney notes, the reinsurer argued, then fell under the crime-fraud exception.

The court affirmed that the crime-fraud exception did not apply because the party seeking the communication must demonstrate a factual basis for showing probable cause that a fraud or crime has been attempted or committed and that the communication was made in furtherance of the crime or fraud.

Because the reinsurer could not show that the notes were made in furtherance of the fraud, the motion to compel was denied. In denying the motion, the court reasoned it was not inherently improper for a cedent to consider its reinsurance contracts during settlement negotiations.

## VENUE

Courts continued to demonstrate that they would carefully scrutinize a party's request to change venue and consider the party's own actions in the course of litigation as defeating the request. In *R&Q Reinsurance Co. v. Allianz Insurance Co.,* No. 653744/2014, 2017 WL 3024262 (N.Y. Sup. Ct., N.Y. Cty. July 17, 2017), a New York state court denied a cedent's motion to dismiss the case for forum non conveniens, in part, due to the cedent's own actions in the course of litigation.

The reinsurer sued the cedent in New York state court for breach of contract and other related claims. The cedent removed the action to the federal court where the parties agreed there were no venue issues.

The federal court, however, proceeded to remand the case back to state court. The cedent then filed a claim against the reinsurer in California, but the California court dismissed it based on inconvenient forum, stating that, inter alia, the fact that the cedent filed counterclaims in New York suggested that the cedent was able to accommodate the New York forum.

Nevertheless, the cedent moved to dismiss the New York action.

The court found that the cedent had not met its burden of proof of demonstrating the inconvenience of New York as a forum.

The court reasoned that the parties' out-of-state domiciles and the need for the New York court to apply California law were unpersuasive because neither party was domiciled in California and courts commonly apply the law of other jurisdictions.

The court also rejected the cedent's claim of undue burden in holding discovery in New York, as more than 100,000 pages of relevant documents had already been produced in New York and a California venue would be just as inconvenient for some of the witnesses as a New York venue would be for others.

Further, the court pointed out that the cedent previously filed counterclaims in New York state court and attempted to remove the case to New York federal court.

## STATUTE OF LIMITATIONS

In *Pine Top Receivables of Illinois LLC v. Banco de Seguros del Estado*, No. 16-3499, 2017 WL 3379385 (7th Cir. Aug. 7, 2017), the 7th U.S. Circuit Court of Appeals affirmed dismissal of a case seeking to collect reinsurance proceeds assigned out of liquidation as untimely.

The court rejected the assignee's argument that Illinois law allowed the liquidator to ignore the statute of limitations and the terms of the treaties because Illinois insolvency law allows the offsetting of mutual debits and credits and provides no time limitation for doing so in a liquidation.

The court made clear that there is "no statutory basis for thinking that a liquidator has carte blanche to do the netting any time he pleases and thus to deprive reinsurers of the benefit of negotiated deadlines and extend the statute of limitations for well, potentially forever."

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## ABOUT THE AUTHORS





(L-R) **Larry P. Schiffer** is a partner in the New York office of **Squire Patton Boggs (US) LLP**, where he concentrates his practice in the areas of complex commercial litigation, and insurance and reinsurance litigation, arbitration and mediation. **Eridania Perez** is a partner with the firm in New York and focuses her practice on commercial litigation and international arbitration. She has tried cases in U.S. courts and arbitrated cases involving a wide range of insurance and reinsurance disputes, complex contractual disputes, as well as fraud and misrepresentation claims, and breaches of warranties and representations, among others. **Kelly Mihocik** is an associate in the Columbus, Ohio, office and focuses her practice on general and complex commercial litigation matters. **India Scarver** is also an associate in Columbus and focuses her practice on general business litigation with an emphasis on toxic tort litigation in federal and state courts, cybersecurity compliance and regulation, and contract disputes. **Seth Osnowitz** is an associate in Cleveland and his practice focuses on corporate matters, including mergers and acquisitions, capital markets transactions, corporate governance, and securities law compliance matters for private and public companies. A version of this expert analysis was first published in the March 2018 edition of the Squire Patton Boggs Reinsurance Newsletter. Republished with permission.