SQUIRE PATTON BOGGS

Reinsurance Newsletter

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Recent Case Summaries

Second Circuit Affirms Exception to *Functus Officio* Rule in Arbitration

General Re Life Corp. v. Lincoln Nat'l Life Ins. Co., No. 17-2496-cv, 2018 U.S. App. LEXIS 33340 (2d Cir. Nov. 28, 2018).

In affirming a March 2017 district court order confirming a clarified arbitration award, the Second Circuit now joins the Third, Fifth, Sixth, Seventh and Ninth Circuits in allowing an exception to the functus officio rule. The court recognized "an exception to functus officio: where an arbitration award is ambiguous, we hold that the arbitrators retain their authority to clarify that award."

In this case, the arbitrators clarified an award when the parties returned to the panel over a dispute of how to calculate the payments required by the award. In clarifying the award, a majority of the arbitration panel stated that the award contained ambiguities requiring clarification. The panel found that both parties were reading the award in a manner inconsistent with the language in the reinsurance agreement. The clarification itself stated that the final award was "not intended to and does not change the terms of the" reinsurance agreement.

In affirming the district court, the Second Circuit joins five other circuits in recognizing an exception to the doctrine where an arbitral award fails to address a contingency that later arises or when the award is susceptible to more than one interpretation (citations omitted). The court found that this exception was consistent with the well-settled rule that when asked to confirm an ambiguous award, the district court should instead remand to the arbitrators for clarification.

As articulated by the district court, and as confirmed by the Second Circuit, the arbitration panel does not become *functus officio* when it issues a clarification of an ambiguous award under the following three conditions: (1) the final award is ambiguous; (2) the clarification merely clarifies the award rather than substantively modifying it; and (3) the clarification comports with the parties' intent as set forth in the agreement that gave rise to the arbitration. As the court said, "[t]his narrowly drawn rule ensures that in those circumstances where an arbitral body issues an ambiguous award and must issue a clarification, it will do so in keeping with the twin objections of arbitration: 'settling disputes efficiently and avoiding long and expensive litigation'" (citations omitted).

In affirming, the Second Circuit found no ground to disturb the arbitrators' conclusion that the award was ambiguous. The court noted that it was appropriate, although not dispositive, to give due deference to the panel's finding of ambiguity. The court held that the clarification "simply explains that the Final Award was intended to be read in the context of the Agreement." Thus, said the court, the clarification did not rewrite the award.

Ramifications of *Global Re v. Century Indemnity* Evident in Second Circuit

Utica Mut. Ins. Co. v. Clearwater Ins. Co., Nos. 16-2535, 16-2824, 2018 U.S. App. LEXIS 165110 (2d Cir. Sept. 25, 2018).

In late 2017, the New York Court of Appeals, in *Global Reinsurance Corp. of Am. v. Century Indemn. Co.*, 30 N.Y.3d 508 (2017), provided guidance to the Second Circuit Court of Appeals on how New York law interprets reinsurance contracts and, in particular, the stated limits in facultative certificates and whether those stated limits are presumptive caps on the facultative reinsurer's liability. That guidance is evident in a recent case decided by the Second Circuit Court of Appeals in yet another dispute over facultative coverage for asbestos settlement liabilities.

In that case, the circuit court followed the New York Court of Appeals' guidance in *Global*, vacated judgment for the cedent and remanded the case back to the district court. On remand, the district court is to determine whether the facultative reinsurer is obligated to cover the asbestos-related claims expenses and whether the facultative reinsurer owes the cedent indemnification under its contracts based on the cedent's proven liability under its umbrella policies.

The cedent in this case issued many policies to an insured ultimately saddled with substantial claims for bodily injury arising out of asbestos exposure. The reinsurer facultatively reinsured several of the cedent's umbrella policies and participated in a facultative pooling arrangement. The primary policies issued by the cedent during a certain period did not include aggregate limits of liability. Ultimately, the cedent and the insured settled and after paying enough of the settlement to trigger its reinsurance, began ceding the settlement payments to the reinsurer. The cedent and reinsurer disputed the reinsurer's obligations and a declaratory judgment action was filed by the cedent.

The district court held that the stated limit of liability in the facultative certificates capped the reinsurer's obligations, but also held that the cedent's settlement allocation was reasonable and in good faith and was bound under a follow-the-settlements obligation.

On appeal, the question was whether the expenses the reinsurer pays are capped at the reinsurer's liability limit or must be paid in addition to it (the classic *Bellefonte* argument). Relying on *Global*, the Second Circuit vacated the district court's judgment. The court noted that the New York Court of Appeals in *Global* specifically cited the district court's opinion in this case as an example of a court improperly treating liability limits as unambiguously imposing a cap on liability. Noting that the reinsurer's liability was subject to the terms and conditions of the facultative certificates, the court held that the follow-the-form clause required that the reinsurer's liability must follow the cedent's liability unless the umbrella policies' terms and conditions were inconsistent with those of the certificates.

Holding that there were no inconsistencies, the court restated the proposition that, under New York law, a naked limitation of liability or reinsurance accepted clause does not inherently cap the reinsurer's liability at that amount. The cedent's umbrella policies, however, provided that the cedent had to reimburse the policyholder for expenses in addition to the limits. The circuit court held that the reinsurer's obligations under the certificates must track the cedent's obligations under the umbrella policies. Accordingly, when the reinsurer is liable to pay expenses, it must pay those expenses in addition to the stated liability cap.

The court remanded the case to the district court to determine whether the reinsurer is liable for the cedent's asbestos claims payments. That determination must be made under the cedent's liability under its umbrella polices. The umbrella policies provide that the cedent must pay expenses in addition to the limits for any occurrence not covered by the underlying scheduled policies or any other insurance collectible by the insured, but covered under the umbrella policies. The Second Circuit provided guidance to the district court by stating that if the umbrella policies do not insure asbestos-related expenses, then clearly the facultative certificates do not either.

The circuit court rejected the cedent's argument that the facultative certificates contained a follow-the-settlements clause and directed that the district court must resolve in the first instance whether the umbrella policies obligate the cedent to pay asbestos-related costs. Whether the cedent is obligated depends to the meaning of "not covered by" in the umbrella policies, an issue to be resolved by the district court.

The Second Circuit held that neither the facultative certificate nor the pooling agreement contained an express follow-the-settlements clause. The pooling agreement merely contained a claims cooperation cause and the clause required the approval of the settlement by the pool manager before it could be binding on the reinsurer. The court held that this was a condition precedent, the failure of which excuses performance by the other party. While the cedent argued impossibility, the Second Circuit held that the party whose obligation to perform depends on the prior occurrence of a stated condition need not perform if the condition is not met even if the condition is impossible to satisfy.

Ultimately, the court held that the reinsurer was not obligated under the reinsurance agreements to follow the cedent's settlement, but rather must indemnify the cedent according to the cedent's proven liability on the umbrella policies. The court vacated the judgment and rema*nded for trial the issue of the reinsurer's actual liability to the cedent.*

New York Appellate Court Grants Petition to Vacate Subsequent Awards After Finding Arbitration Panel Exceeded Its Authority

American Int'l Specialty Lines Ins. Co. v. Allied Capital Corp., No. 656341/16, 2018 N.Y. App. Div. LEXIS 7144 (N.Y. App. Div. 1st Dep't Oct. 25, 2018).

In a non-reinsurance case, a New York state appellate court reversed a prior judgment and granted a petition to confirm an original partial final award and vacate two subsequent awards issued by an arbitration panel.

The arbitration concerned an insurer's decision to deny coverage for the funding of a settlement in a separate action. The policyholder sought summary disposition on whether the insurer properly denied coverage and whether funding of the settlement and defense costs was a covered "loss" under its policies and, if so, in what amount. During the proceeding, the parties agreed that the panel would issue an immediate determination on liability and that a separate evidentiary hearing would take place on the calculation of the amount of defense costs if insurer was found liable.

The arbitration panel issued an award concluding that the policyholder was entitled to indemnification, but that the settlement payment did not amount to a "loss" as defined under the policies. A subsequent evidentiary hearing was ordered to determine the defense costs. The policyholder moved for reconsideration, but the insurer argued that the panel was barred from any reconsideration under the arbitration rules and the common law doctrine of *functus officio*.

The panel granted reconsideration and issued a corrected award. The panel concluded that the arbitration rules did not apply and that there was no agreement by the parties to bifurcate the issues and, thus, the original award was not a final award for purposes of *functus officio*. The panel then heard arguments on defense costs and issued a final award granting the policyholder in excess of US$7 million in damages, plus interest. The insurer filed a petition seeking to confirm the original award and vacate the subsequent awards, arguing that the panel exceeded its authority. The court denied the petition.

On appeal, the appellate division reversed the judgment. The court reasoned that the parties' submitted issues determined the arbitrators' scope of authority. Both parties agreed that the panel should make an immediate, final determination on liability and that the defense costs would be determined at a separate evidentiary hearing if the claims were covered. Once the panel made its liability determination, the panel was *functus officio*. Additionally, the arbitration rules did not apply to the proceeding because it was an ad hoc arbitration and the rules did not apply by default. The original award was confirmed and the subsequent awards were vacated.

New York Appeals Court Upholds Arbitral Award, Clarifies Standard for Manifest Disregard of the Law

Daesang Corp. v. NutraSweet Co., No. 655019/16 5973, 2018 WL 4623562 (N.Y. App. Div., 1st Dep't Sept. 27, 2018).

In a non-reinsurance case, a New York appeals court rejected a company's attempt to vacate portions of an arbitral award. The trial court had partially vacated the award, but the appellate court concluded that no grounds existed to deny confirmation of the award.

The respondent argued that the court should affirm on two grounds: (1) the arbitrators' manifest disregard of the law and (2) that "the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made." The respondent also argued, in the alternative, that the court should affirm because enforcing the arbitral award would be contrary to US public policy.

The court found that the panel's analysis was far from manifest disregard of the law because the panel had accepted the authority proffered, analyzed both parties' case law and "made a good-faith effort to apply to the facts of this case" the legal standard proffered. The court explicitly declined to opine on the soundness of the panel's analysis and decision because "a finding of manifest disregard of the law requires more than a simple error in law or a failure by the arbitrators to understand or apply it."

The court emphasized the broad deference afforded to arbitral awards by noting that the court's conclusion would not differ if the arbitrators' dismissal of the counterclaim had been erroneous or based on a misunderstanding of the arguments, "even if such a disposition would have constituted error reversible on appeal in a judicial proceeding."

Finally, the court rejected the alternative argument for affirmance, concluding that there was no basis to deny enforcement of the award on public policy grounds, because the arbitrators had not made a factual finding and the awards, on their face, did not indicate any violation of public policy.

In rejecting the public policy argument, the court noted that the Convention on the Recognition and Enforcement of Foreign Arbitral Awards' public policy defense should be narrowly construed and "should apply only where enforcement would violate our most basic notions of morality and justice."

Illinois Court of Appeals Holds That RPA's Arbitration Provision is Unenforceable

Onken's Am. Recylcers, Inc. v. Cal. Ins. Co., No. 4-18-0240, 2018 Ill. App. Unpub. LEXIS 1524 (Ill. App. Sept. 10, 2018).

Similar to the case discussed below involving a workers' compensation program with a Reinsurance Participation Agreement (RPA), the reinsurers in this case filed a demand for arbitration to recover unpaid insurance premiums, but the insureds refused to arbitrate and, instead, sued in Illinois state court. They alleged that the reinsurers fraudulently induced them into purchasing the policies and that the RPA modified the terms of the insurance policies by, among other things, increasing the premiums. The parties agreed to hold the arbitration proceedings in abeyance pending resolution of motions practice in state court relating to the RPA.

The RPA contained a Nebraska choice-of-law provision, as well as a delegation provision providing that the parties agreed to submit all disputes relating to the RPA to arbitration. An Illinois court of appeals affirmed the trial court's determination that the insureds' fraud claims were not subject to arbitration because they were reverse preempted by the McCarran-Ferguson Act and the Nebraska Arbitration Act. The court noted that, although the Federal Arbitration Act provides that generally arbitration provisions are enforceable, there is an exception when overridden by another congressional act. The McCarran-Ferguson Act provides that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by a State for the purpose of regulating the business of insurance . . .," and, here, the Nebraska Arbitration Act invalidated certain arbitration provisions contained in insurance contracts, including the arbitration provision in the RPA. See 15 U.S.C. §§ 1012(b); Neb. Rev. Stat. § 25-2602.01(f)(4). In making this ruling, the court rejected the reinsurers' arguments that the insureds had failed to directly challenge the delegation provision.

New York Federal Court Refuses to Substantially Narrow Contentious Reinsurance Dispute

Utica Mut. Ins. Co. v. Century Indem. Co., No. 6:13-CV-995, 2018 U.S. Dist. LEXIS 165110 (N.D. N.Y. Sept. 26, 2018).

This dispute involves a ceding company's billings to its reinsurer for losses from numerous underlying asbestos claims. In coverage litigation involving those claims, the policyholder argued that the primary policies (which were not reinsured) did not contain aggregate limits and that the ceding company had unlimited exposure. The policyholder and ceding company ultimately settled this dispute with a settlement agreement "worth $325 million" and the policyholder's agreements that the primary policies did have aggregate limits that had exhausted, and that the ceding company would pay further amounts under umbrella policies also issued to the policyholder (which were reinsured).

Both before and after this settlement, the ceding company billed amounts to the reinsurer under two facultative reinsurance certificates covering umbrella policies in effect during 1973 and 1975. After making some payments to the ceding company, the reinsurer stopped after learning information suggesting that the ceding company had granted the policyholder an additional US$140 million in coverage in exchange for the policyholder's agreement that the non-reinsured primary policies contained aggregate limits. Thereafter, the ceding company sued the reinsurer and, after contentious discovery disputes, the reinsurer asserted bad faith counterclaims against the ceding company.

In this decision, the court denied all but one of 10 summary judgment motions, which, if granted, would have substantially narrowed the case. The court denied cross-motions for summary judgment as to whether the ceding company's allocation was reasonable and in good faith and as to whether the reinsurer had issued a reinsurance contract for the 1975 umbrella policy, because the parties presented conflicting evidence on both issues. For the same reason the court denied the ceding company's motion for summary judgment against the reinsurer's bad faith claims and the reinsurer's motion for summary judgment that an endorsement to the 1973 umbrella policy did not bind the reinsurer.

The court also denied the reinsurer's motion for a summary judgment that collateral estoppel barred the ceding company's argument that the 1973 reinsurance contract required the reinsurer to pay defense costs. Although another reinsurer had arbitrated this issue involving a similar reinsurance contract, the reinsurer failed to establish "with clarity and certainty" what the prior arbitration had actually determined.

The court granted the reinsurer's summary judgment motion and dismissed three of the following ceding company's claims: (1) account stated, because the reinsurer had disputed the ceding company's billings within a reasonable time; (2) bad faith, because the ceding company had not produced evidence to rebut the presumption against bad faith; and (3) declaratory judgment as to future billings, because the ceding company had already issued final billings.

Finally, the court denied the reinsurer's motion for summary judgment seeking to dismiss the ceding company's claims on the 1975 facultative certificate due to lack of standing or, in the alternative, for failure to join an indispensable party. Even though the ceding company had assigned certain rights to collect proceeds from reinsurance recoveries to a third party, the reinsurer did not prove that the ceding company had assigned its rights to pursue underlying claims arising from breach of the reinsurance contracts.

Even though the court left many disputes outstanding, the court concluded by encouraging the parties to resolve those disputes without the court's further intervention.

Texas Appellate Court Affirms Summary Judgment on Failure to Provide Sufficient Evidence

Capitol Life Ins. Co. v. Newman, No. 05-16-01476-CV, 2018 Tex. App. LEXIS 7549 (Tex. App. Sep. 13, 2018).

A Texas appeals court reversed a trial court's grant of summary judgment for the insurer and affirmed summary judgment for the reinsurer and third-party administrator.

The policyholder sued the insurer asserting, among other claims, a breach of her annuity. The suit stemmed from multiple inquiries to the third-party administrator regarding an annuity, which the policyholder claimed had already or would soon mature. The third-party administrator responded to the policyholder that, after searching their records, they had not located any record of the annuity.

The insurer notified its reinsurer, but the reinsurer refused to defend or indemnify the claim. As a result, the policyholder filed third-party claims against the reinsurer and the third-party administrator for breach of contract.

In reversing summary judgment in favor of the insurer against the insured, the appellate court found that, because it was unclear whether the policyholder intended to surrender her policy by tendering it or whether she sought to exercise another option under the policy (e.g., requesting optional form of settlement or immediate payment of the minimum guaranteed payments), there was an issue of fact and summary judgment was inappropriate.

As for the summary judgment in favor of the reinsurer and third-party administrator, the court found that each party successfully argued that the insurer failed to provide sufficient evidence to support the elements required for the breach of contract claims against them. The court held that the insurer failed to provide enough evidence to raise an issue of material fact as to whether the insurer performed under the reinsurance agreement – an essential element in a breach of contract claim. Similarly, the court found insufficient evidence to conclude that the insurer had performed under the third-party administrative services agreement. As a result, the court affirmed summary judgment in favor of reinsurer and the third-party administrator.

Maryland Federal Court Permits Fraud Claims Involving Captive Reinsurance Transactions to Move Forward

Rich v. William Penn Life Ins. Co., No. GLR-17-2026, 2018 U.S. Dist. LEXIS 165057 (D. Md. Sept. 25, 2018).

A Maryland federal court recently denied in part a ceding company's motion to dismiss claims that it had defrauded purchasers of life insurance policies by allegedly misrepresenting its financial condition.

The plaintiff was the putative representative of owners of life insurance policies purchased from the ceding company. The putative class representative alleged that the ceding company had improperly increased the cost of the insurance (COI) for those policies due to the ceding company's financial instability, which the ceding company had allegedly concealed by entering into captive reinsurance transactions that inflated its statutory surplus and reduced the amount of cash reserves the ceding company was required to maintain. Before the COI increases, the ceding company had made various statements, including in corporate reports, indicating that the ceding company was financially stable.

In its motion to dismiss, the ceding company argued that the putative class representative could not have reasonably relied on statements made in the ceding company's corporate reports about its financial condition, because those reports also disclosed that the ceding company had entered into captive reinsurance transactions. The court rejected that argument because the complaint alleged that the reports did not include sufficient information regarding the captive reinsurance transactions to cause concern and because information regarding those transactions was not publicly available.

DC Federal Court Allows Amended Allegations Against Reinsurers

Vantage Commodities Fin. Serv., LLC. V. Assured Risk Transfer PCC, LLC, No. 1_17-cv-01451 (TNM), 2018 U.S. Dist. LEXIS 195588 (D.D.C. Nov. 16, 2018).

In a dispute between an insured and its complicated captive credit insurance program, the insured sued the reinsurers for breach of contract. That claim was dismissed and the insured sought leave to amend its complaint based on new allegations for breach of contract, breach of implied contract, promissory estoppel and unjust enrichment.

The motion court ruled that the insured failed to show a direct contractual relationship between itself and the reinsurers and denied the motion to amend for breach of contract. Nevertheless, the court found that the allegations in the amended complaint were sufficient to get by a motion to dismiss for the remaining new causes of action and allowed the amended complaint for those claims.

The court noted that the argument that the intermediaries who helped put together the program and place the reinsurance were agents of the reinsurers as opposed to agents for the insured was alleged sufficiently at this early stage. This agency argument will be key to sustaining these claims on a substantive basis down the road. The court noted that the promissory estoppel and unjust enrichment claims were alternative claims that cannot be sustained if the insured proves the existence of an implied contract with the reinsurers.

Finally, the court allowed additional time to serve the reinsurers in their home countries, but did not grant the request to allow service through the local regulator.

New York Court Dismisses Suit Finding Nebraska Forum Selection Clause Enforceable

Milmar Food Grp. II, LLC v. Applied Underwriters, Inc., No. EF003101-2017, 2018 N.Y. Misc. LEXIS 4100, 2018 NY Slip Op. 28295 (N.Y. Sup. Ct. Sept. 24, 2018).

In another case involving a workers' compensation program resulting in an RPA, the insureds sued cedents and the reinsurers in New York state court seeking, among other things, a declaration that the RPA was void and unenforceable because it required the insureds to pay premiums in excess of that due under their workers' compensation policies. The reinsurers moved to dismiss, arguing that the RPA designated Nebraska as the exclusive forum.

The court ruled that it did not have to decide whether Nebraska or New York law governed the enforceability of the RPA's forum selection clause because it was enforceable under either state's laws. The court rejected the insureds' arguments that their claims did not arise under or relate to the RPA. For each claim, the insureds argued that the RPA was invalid under New York law, which would require the court to interpret the RPA. Because the forum selection clause was enforceable, the claims against the reinsurers were dismissed without prejudice so that the action could be recommenced in Nebraska. The court also dismissed the insureds' claims against the cedents, finding that the reinsurers were necessary parties for a proper resolution of the dispute.

South Carolina Federal Court Denies *in Camera* Review of Reinsurance Documents

Contravest Inc. v. Mt. Hawley Ins. Co., No. 9:15-cv-00304-DCN, 2018 U.S. Dist. LEXIS 182196 (D. S.C. Oct. 24, 2018).

To resolve a discovery issue, a South Carolina federal court was tasked with determining which categories of documents were appropriate for *in camera* review. The parties disagreed on (1) whether work-product documents needed to be reviewed *in camera*; (2) whether the court had already ruled on the insurer's request for *in camera* review of certain reinsurance and reserves documents; and (3) whether the insurer may object to producing certain documents on the basis they reference mediation. For purposes of this summary, we focus on the reinsurance documents.

The insurer, in a motion to reconsider, requested the court conduct an *in camera* review of reinsurance documents to determine their relevance. The court denied the motion without explicitly addressing *in camera* review. The policyholders argued that, in denying the insurer's motion in full, the court denied the insurer's request for *in camera* review. The insurer argued that, because the court was silent on *in camera* review, the court had yet to rule on the issue. The court found that the magistrate had clearly recommended that the reinsurance documents were relevant. The court had affirmed that recommendation. The court also found that, while the court's opinion did not explicitly state that it denied the insurer's request for *in camera* review of the reinsurance documents, the order denied the insurers' motion in full, which included the request for *in camera* review. As such, the court held that the issue had been ruled upon, that it will not review the documents for relevance, and ordered the insurer to produce the documents.

Recent Speeches and Publications

Mary Jo Hudson will be speaking on "How Predictive Modeling and Artificial Intelligence is Transforming the Insurance Space – Assessing the Operational Challenges and Regulatory Risks," at the ACI's 15th Insurance Regulation Conference on March 12, 2019 in New York.

Eridania Perez moderated the Arbitrator and Umpire Seminar – 2018, "Making Hard Decisions on the Road to a Fair and Efficient Arbitration," on November 7, 2018, the day before the ARIAS•U.S. Fall Conference, at the New York Marriott Brooklyn Bridge.

Deirdre Johnson co-chaired the ARIAS•U.S. Fall Conference and Annual Meeting in Brooklyn, NY on November 7-9, 2018, participated in a discussion with former federal judge Shira Scheindlin as part of her keynote address and spoke on "Expanding ARIAS•U.S. to Policyholder and Direct Insurer Disputes: Delivering the Best Arbitrators and Mediators for ALL Insurance Disputes."

Larry Schiffer spoke on "ETHICS: Vacating an Award: Lessons from the *ICA v. Underwriters Decisio*n," on November 9, 2018, at the same conference.

Larry Schiffer's commentary, "Vacating a Reinsurance Arbitration Award for Evident Partiality" was published on IRMI.com in September 2018.

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