CARRYING THE WEIGHT

BY BILL COFFIN

In a world of ever-increasing cost of risk, the role reinsurers play in corporate risk management strategies is taking on new importance. But the reinsurance world is undergoing its own challenges and changes, not the least of which is a sometimes turbulent legal and regulatory environment that even dedicated experts sometimes can get lost in. To shed some light on this, we recently met with David Attisani, a prominent reinsurance attorney with Choate Hall & Stewart LLP to discuss the current legal landscape for the reinsurance world, and why risk managers need to take notice.

Much has been said about the difficult regulatory environment the United States has made for foreign reinsurers to operate within the country. In your opinion, does international reinsurance regulation need to be reformed in the United States, and how?

I think in certain quarters, there is a question of uniformity. For example, the service of process acts, which take slightly different forms in different jurisdictions, can take different effects. For example, in some jurisdictions, foreign reinsurers are expressly required to post security before they can file a pleading. In other jurisdictions, that is expressly exempted. In some jurisdictions, service of process acts expressly apply to arbitration and in other jurisdictions, they are pretty clearly intended for court filings only.

The issue most people focus on is credit for reinsurance. The NAIC has been considering rewriting the regulations around credit for reinsurers to relax the collateral requirements in order to make various reinsurance placements eligible for credit for reinsurance at a lower credit threshold requirement. This is a bit of a balancing act. On the one hand, there is obviously great interest on the part of the state insurance commissioners to make sure that U.S.-domiciled ceding companies and ultimately policyholders are being adequately protected. On the other hand, if the barrier to foreign business is too high, then that doesn't help us because it deprives the U.S. market of capacity.

That said, while foreign reinsurers don't like the idea of having their money tied up to the extent that it is, the current regulations don't appear to be precluding the market from functioning. I think that is because a number of foreign reinsurers at the top of everyone's list—the Munich Res and the Swiss Res of the world, for example—are continuing to do robust business here because they represent Grade A security and because the U.S. market is a very fertile one. I think that what is needed is an empirical study—and I know the NAIC is undertaking these kinds of analyses in various committees—of how many times the funds have been tapped, for example, in the case of an insolvency or other problem. And if the answer is virtually never, or never other than the case of the London market, then I think it may be time to revisit this and consider whether we are creating a barrier that is impeding the flow of business in a way that is disadvantageous to everyone.

While the primary insurance P/C industry is having a banner year, especially in the United States, the reinsurance sector is still shaking off European windstorm losses and last year's hurricane season. Has the reinsurance sector's continuing financial burdens manifested itself in a more pernicious claims process? Why or why not?

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To the extent that pernicious is shorthand for "more disputes," I think that certainly there are more. Whenever you get a critical mass of industry people together in one place, there's generally widespread agreement that the number of reinsurance disputes increases every year. Now the trickier dimension of the question is whether you can draw a nexus between the reinsurers who are still "shaking off" the European windstorm and hurricane losses from last season. I think that would be a difficult line to draw.

The issues that seem to be driving a more aggressive claims culture are remnants of the asbestos problem, which is still an order of magnitude larger on many books than the European windstorm or hurricane losses. Not to say that they were not significant problems, because they are. But if you're looking at it from an industry-wide perspective, asbestos is still a much bigger problem.

Run-off companies are consistently growing in popularity. These are essentially servicing companies whose business it is, in exchange for a set sum of money, to run off a remaining book of business that is no longer being written as new business. There are many in the industry who believe that those companies tend to be more aggressive because they are not business partners in an ongoing relationship. The allegedly more aggressive practices of those companies, together with the continuing asbestos problem are likely drivers of the current claims culture to a much greater degree than last year's hurricane and windstorm losses.

What do you think are some of the most important legal decisions affecting the reinsurance industry in recent years? How are those decisions impacting not only the reinsurance industry, but the primary insurance industry as well?

The most recent decision I would point to as potentially having a great impact is the *Suter* decision. It is a federal court decision out of New Jersey that came down in July of 2005. It essentially took what was a moribund phrase in a lot of court opinions requiring that ceding companies exercise a degree of diligence and professionalism in their claims handling and gave it a new life. The decision suggested that, at least in the context of an insurance insolvency, this concept needs to be taken quite seriously. The claims need to be investigated and

properly handled before they can be passed on to reinsurers. So that may be a concept many courts have taken for granted for some time. There is a question in my mind as to how vigorously the *Suter* decision will be propagated throughout the industry or whether it is really context bound within the world of insolvencies. So that remains an open question, but it is a very recent decision that is (for now) significant.

There is also the *Travelers v. Gerling* federal court case from 2005 and the *ACE v. North River* federal court case from 2004, both out of the Second Circuit. They both tend to strengthen and, in some people's minds, extend the "follow-the-fortunes" doctrine. [*Follow-the-fortunes binds reinsurers to the good faith claims-handling decisions of its reinsureds. This allows reinsureds to make good faith claims decisions without having to relitigate those decisions with their reinsurer. - Ed.*]

Travelers v. Gerling was an asbestos nonproducts case in which the ceding company initially settled out all of its asbestos claims and then received a demand on the nonproducts side and paid the functional equivalent of another full set of limits. Although it wasn't precisely that number, they then turned around and tendered to the reinsurer as a single occurrence. The reinsurer said, "No, no, no, these are two occurrences—one for products, one for nonproducts. You can't tender the claim to us in a way that is inimical to the way that you settled the case on the direct side. The federal trial court agreed with the reinsurer but then it was reversed on the "follow-the-fortunes" ground in the Second Circuit.

ACE v. North River covers the follow-up problem from a different vantage point, although it gets us to the same general result. In *ACE v. North River*, the ceding company ran 83 different exposure analyses prior to the time of settlement. They settled the claim and then turned around and tendered it to the reinsurers based on a ground-up theory of allocation. The reinsurers pointed to the 83 different exposure analyses and said there was some inconsistency there. The court agreed, but it also said that the ceding company was entitled to essentially stake out the bounds of its exposure by running however many scenarios it wished. As long as there wasn't a fundamental inconsistency between the way the ceding company handled its claim and the way the loss was tendered the reinsurers must pay it under the "follow-the-fortunes" doctrine.

In 2000, the *Seven Provinces* case really imported the idea of bad faith into the reinsurance arena. Direct side insurance bad faith claims, meaning bad faith claims handling by insurance companies, alleged by policyholders, are nothing new. But that idea and that species of claim really was not popularized in the reinsurance arena until the *Seven Provinces* case. That wound up in the First Circuit and was decided in the First Circuit of Appeals in 2000. The court also helped to establish some of the basis for alleging bad faith between parties to a reinsurance contract, one of which is threatening to withhold payment of otherwise meritorious claims in order to leverage a bigger deal. Generally a commutation deal is one such ground. A second such ground was declining to acknowledge responsibility for writing the coverage in the first place. Third was declining to accept the ceding company's allocation even though it should have been clear to the reinsurer that the allocation was within the realm of reason.

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As the reinsurance industry bears the massive financial burden of the last few years of mega-catastrophe losses, to what degree should policyholders be concerned with the possibility of reinsurer insolvencies? Even if there is not a greater-than-average risk of insolvency within the industry, what would you say are the most important developments to watch for on this topic?

I don't think that policyholders should be concerned with the possibility of reinsurance insolvencies because the result of many of those unfortunate events has been increased consolidation. And the further result of increased consolidation is increased security, meaning that as the reinsurance market has consolidated, what has emerged are better, stronger companies that are generally offering better security. So it is likely that if you're looking at the question prospectively, you are buying better security if you're buying it from a major player than you were if you were buying it some years ago.

I am referencing the more traditional markets when I say that consolidation is generally a beneficial thing in terms of the resulting security, but there are specialty markets like Bermuda or start-ups like the last wave or two of Bermuda reinsurers, and I think that the jury is still out a little bit. We know that a massive amount of money is flowing into there—most recently through hedge funds—but a number of those companies remain untested. Until they endure major losses, we know that they are collecting premiums and doing a good job of selling business, but we won't know if they did a good job underwriting and claims handling until they are really tested. One thing to watch for is how those companies endure the first wave of major losses. I think another thing for policyholders to watch for is the strength of their own direct insurers. Meaning that the question presupposes that the policyholder would be focused on the reinsurance layers, but in fact, a good ceding company can endure a reinsurer insolvency even if it is a significant reinsurer on its book, and continue to

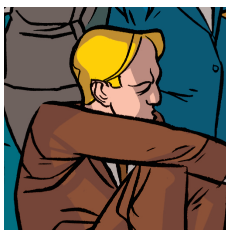
pay the policyholder's claims. I think that is a second development that a policyholder should be attentive to, the rating and wherewithal of its direct side insurer.

Long-tail exposures such as asbestos still have a long time to go before their impact is no longer felt by the insurance world. How is the reinsurance sector coping with the challenges of such exposures?

In a number of different ways. One would certainly be the increased popularity of commutations. Commutations have been around for a long time, but have attained a level of use and popularity that I wouldn't have imagined several years ago. I think that it is a way of closing off liabilities and using your expertise to do it, meaning relying on the skill of risk managers, claims people, lawyers and others to try to value liabilities in the present day and excise the problem from your book. That has become a very popular way to deal with these exposures.

A second way that companies are dealing with it is with a greater allocation of resources to issues like risk modeling and extrapolation. Decades ago, you were more likely to have ceding companies and reinsurers look at the scourge that is asbestos and conclude that these are real liabilities that need to be paid and then passed along to reinsurers. Given the climate that we talked about earlier, which is perhaps a greater appetite for dispute, there is also a greater appetite for drilling down into the details. What I am seeing more and more is bringing in experts on the ceding company side and reinsurance side to analyze massive amounts of data comprised of different claimants at different sites exposed to different products at different times under different circumstances. They analyze all that and when they get to the frontier of available knowledge, there is never a perfect history of which claimant was in which location at which time in one of these massive cases. There is a much greater willingness to extrapolate from the available information and so it becomes a contest of loss extrapolation models. And all of that tends to slow down the payment cycle and allow for a much greater degree of scrutiny of the data than was previously the case.

The last piece of my answer would be endemic to the London market. Some time ago, they instituted the reinsurance documentation requirements (RDR), which are requirements for the level of data that is required with respect to each claimant—social security numbers, proof that they were in a particular location at a particular time, elimination of certain doctors from the pool of doctors that are available to see claimants and pronounce that they have a particular injury, etc. However, the RDR has not yet been embraced generally by the community of U.S. ceding companies at large.



"I would start with a quality broker and an A-rated company, and I would negotiate the best deal I could with the best company available to write the business."

Reinsurance is the biggest business in the world that nobody knows about. As risk managers continue to access the reinsurance market directly in ever greater numbers (either through their captives or because they are simply skipping the primary market), what advice would you offer those customers beginning to deal with the reinsurance sector for the first time?

I have been engaged a few times to do pre-captive studies and advise risk managers as to whether they want to create a captive and access the reinsurance market by that avenue. You're correct that they are doing it in greater numbers, and it is interesting that they want to do it. I think that there are a number of things to pay attention to. In terms of advice, I would certainly recommend that they find a good, knowledgeable broker. Over the last several years, I have run into "brokers deluxe," which are brokerages in a particular market who have former practicing lawyers on staff whose job it is, in addition to knowing the business market, to troubleshoot contracts and to help identify areas where legal issues may arise. In general, the availability of more knowledgeable brokers has increased over time so a client entering the market in the way that you described should seek out someone who is knowledgeable.

The second piece of advice would be to pay attention to the quality of the security. It is tempting, once you wade in, to pay attention only to the terms that are being offered because it is a competitive market and obviously pricing and terms are the two most material factors. But there is a risk of not looking at the quality of the company you are buying security from. Where I would start would be with a quality broker and an A-rated company, and I would negotiate the best deal I could with the best company available to write the business.

What are the legal pitfalls that await the uninitiated?

The first thing I would pay attention to, which may be an occupational hazard on my part, is dispute resolution provisions. I want to know whether I am signing a contract that calls for arbitration or not. There are an increasing number of contracts which require mediation prior to arbitration. However, there are many cases in which that has become, at the back end, an unwanted impediment, meaning that everyone is trying to save money, so there is a little bit of a risk of creating additional, expensive

hoops to jump through. But the alternative dispute provision is very important, nevertheless, as is focusing on choice of law. You must consider if you are potentially and unwittingly choosing the law of a jurisdiction that may be inimical to your interests. In the same vein, the honorable engagement clause is quite important whether you are going to put your dispute in the hands of arbitrators and ask them to decide it based on industry custom and practice as an honorable engagement or whether you're hoping for more legalistic dispute resolution that is more akin to a court decision is a material choice.

It's also important to pay attention to whether you're buying coverage for ECO (extra contractual obligations). I think that sometimes ceding companies assume that they're going to buy it or have bought it, but certainly you want it to be specified. ECO is also a form of coverage that typically kicks in at a certain layer, and so you may be buying ECO coverage but it may only be ECO coverage above a certain dollar amount, so it is important to understand at what point it is actually triggered.

It is also important from the standpoint of the purchaser of reinsurance to have strong "follow-the-fortunes" and sole judge language in your contract. There certainly are a spate of cases that say that "follow-the-fortunes" is implied in every contract, though some courts have refused to ascribe to that view. But having the words in the contract becomes very valuable at the time any dispute matures. Same with sole judge wording. Sole judge wording is tricky because it can be quite broad, which certainly gives the purchaser of reinsurance an argument that it is the sole judge of everything. But on the other hand, specific sole judge language, which may relate to the party's definition of a particular term, like "risk" or "cause"—how many causes were there, how many occurrences were there—may be that much more valuable, so if you are able to properly identify or predict the areas of potential dispute, it may be worth it to focus on those and include them in the sole judge provision.

Finally, I would focus on the security issue and whether there is a letter of credit provision, whether LOCs need to be posted. Obviously, this can be quite helpful in ensuring that money has been put aside in the event that there is a dispute. ■

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