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Insurance Practice

Reinsurance Redux

The redux on developments in the law of reinsurance

In This Issue

New York District Court Grants Summary Judgment for Reinsurer Where Insured's Loss Did Not Reach Attachment Point Necessary to Trigger Coverage

The United States District Court for the Southern District of New York granted summary judgment in favor of a reinsurer who had denied coverage to a cedent where the amount of loss claimed failed to reach the attachment point necessary to trigger reinsurance coverage because the interest component of a judgment against the underlying insured was not a "loss" under the terms of the reinsurance certificate. *Seneca Insurance Company, Inc. v. Everest Reinsurance Co.*, No. 11-7846(KBF), 2013 WL 5720455 (S.D.N.Y. Oct. 17, 2013).

The United States District Court for the Southern District of New York has granted summary judgment to Everest Reinsurance Company ("Everest Re") on its decision to deny coverage to Seneca Insurance Company, Inc. ("Seneca") when the amount of loss claimed by Seneca failed to reach the $5 million attachment point necessary to trigger Everest Re's obligation to pay covered losses or other expenses.

Seneca issued a Directors & Officers insurance policy ("Policy") to Kentucky Lottery Corporation ("KLC") and obtained excess coverage from Everest Re. Everest Re issued a Facultative Reinsurance Certificate to Seneca that provided $5 million in reinsurance coverage to Seneca for losses under the Policy in excess of $5 million. The Reinsurance Certificate contained notice provisions and other conditions which, among other things, set forth Everest Re's obligation to pay certain "loss" payments and certain payments other than for "loss."

KLC was embroiled in lengthy employment litigation that resulted in multiple trials, verdicts, judgments, and appeals. Ultimately, final judgments were entered against KLC in the amount of $6,783,097, inclusive of significant accrued interest. The trial court also awarded attorneys' fees for the plaintiffs and against KLC.

After the judgment was entered, Seneca submitted a cash call to Everest Re seeking payment for the portion of the judgment and award of attorneys' fees in excess of $5 million. Everest Re initially responded that it was still investigating its obligations and accused Seneca of failing to provide timely and proper notice and failing to comply with other provisions of the Reinsurance Certificate. Thereafter, Everest Re denied coverage for three reasons: (1) the inclusion of an award for punitive damages for intentional conduct not insurable under applicable state law; (2) late notice of the underlying litigation; and (3) lack of prior consent by Everest Re to the underlying trial proceedings. Seneca brought suit seeking payment under the terms of the Reinsurance Certificate.

The district court explained in its October 17, 2013 ruling that the question of whether Everest Re was obligated to pay Seneca under the Reinsurance Certificate turned on whether the interest amounts included in the judgments ($2,430,781.18) are properly considered "loss" or "interest on a judgment" under the Reinsurance Certificate. The court concluded that Everest Re's obligation to make payment other than for "loss" under the Reinsurance Certificate "cannot be calculated until its obligation to make a loss payment – a loss above its $5 million attachment point – is first determined." The court further held that "[i]f Everest Re has no obligation to make a loss payment, it has no obligation to make any of the other payments that are not loss under the Reinsurance Certificate. The plain meaning of the Reinsurance Certificate is that loss does not include, *inter alia*, interest on any judgment or award."

Seneca attempted to argue that the interest included in the judgment was not "interest on a judgment" – which is not considered a "loss" under the Reinsurance Certificate – but instead prejudgment interest. The district court rejected this argument for a number of reasons, including that the judgments stated clearly that they "bear interest at a rate of 6% from the date of original entry" and the final amounts that each

listed were calculated by compounding this interest rate through the date of the final judgments.

Seneca also argued that Everest Re waived its "attachment point defense" by failing to raise it specifically in its correspondence with Seneca denying coverage. In its correspondence with Seneca, Everest Re stated that it was "unable to provide Seneca with a commitment" and that it was "still investigating and considering its obligations, if any, under the terms of the applicable facultative reinsurance certificate." Everest Re also indicated that its arguments concerning the insurability of punitive damages for intentional conduct and lack of prior consent in the trial proceedings "bring the total incurred below the retention of the facultative certificate." The district court found that "[t]hese references clearly indicate that Everest Re was considering whether its obligation to make any loss payments or other payments under the Reinsurance Certificate had been triggered by the [final] judgments." Accordingly, the court granted summary judgment in favor of Everest Re.

Redux in Context:

- When determining whether the retention under a reinsurance contract has been breached, it is important to consider whether interest or an award of attorneys' fees are considered covered losses under the terms of the reinsurance contract.
- Even where a reinsurance contract provides for payments other than for loss, the obligation to make such payments may not be triggered until the loss retention has been breached.
- While general reservation of rights language may be sufficient to defeat waiver arguments, the better practice is to specifically list every potential reason why there may not be coverage in a reservation of rights letter.

Eastern District of Michigan Enjoins Arbitration Proceedings Because of *Ex Parte* Communications Between Counsel and Arbitrator

The United States District Court for the Eastern District of Michigan issued a preliminary injunction enjoining arbitration proceedings to allow an investigation into allegations of *ex parte* communications with an arbitrator and other improprieties. *Star Insurance Co. v. National Union Fire Insurance Co. of Pittsburgh*, No. 13-13807, 2013 WL 5182745 (E.D. Mich. Sept. 12, 2013)

On September 12, 2013, the United States District Court for the Eastern District of Michigan issued an order enjoining arbitration proceedings relating to a reinsurance contract covering workers' compensation business to allow for an investigation into *ex parte* communications between counsel and an arbitrator and other allegations that the arbitration proceedings were in breach of the governing reinsurance contract.

National Union Fire Insurance Company of Pittsburgh ("National Union") entered into a reinsurance contract with several insurers. The contract included an arbitration provision requiring all disputes to be decided by "active or retired disinterested officials" of insurance or reinsurance companies "not under the control of either party to this Agreement." The contract provided that all provisions were subject to the laws of Michigan. The contract further provided that the parties were to select a three-person panel – one arbitrator selected by each party and an umpire selected by the two arbitrators – and that any dispute "shall be submitted to the decision of the board of arbitration, composed of two arbitrators and an umpire."

After a dispute arose under the contract, the parties each selected an arbitrator and the arbitrators cast lots to select an

umpire. After a hearing, the panel issued an Interim Final Award addressing liability only. The insurers faced an arbitration award of as much as $25 million against them and submitted documentation to the panel as required by the Interim Final Award. However, when National Union submitted its attorneys' time entries in connection with a petition for fees, the insurers discovered multiple time entries evidencing *ex parte* communications regarding the Interim Final Award and the sufficiency of the insurers' documentation between counsel for National Union and the arbitrator selected by National Union. National Union's arbitrator also sat on panel discussions with National Union's attorney and law firm during the course of arbitration proceedings. Additionally, there were two separate motions allegedly granted by the panel without the knowledge or participation of the arbitrator selected by the insurers.

After discovering these facts, the insurers filed a complaint in state court to vacate, correct and/or modify the Interim Final Award and an emergency motion to stay all proceedings with the arbitration panel. The panel denied the emergency motion (over the dissent of the insurers' arbitrator) and the insurers filed a motion in the state court seeking review and appeal of the Interim Final Award. The case was removed to federal court.

National Union argued that the district court lacked jurisdiction because under the Federal Arbitration Act ("FAA"), the court's pre-award jurisdiction is limited to determining whether the contract is valid and whether arbitration is required. The parties acknowledged that a district court generally does not have jurisdiction unless an arbitration award is final, but the court held that under the FAA, a court may intervene if the underlying contract is "subject to attack under general contract principles," including when there are allegations of misconduct by an arbitrator after commencement of the arbitration proceedings. The court concluded that it had jurisdiction because the insurers' claim was grounded in a dispute over the underlying contract, as they were seeking a stay to allow an investigation into whether a breach of the arbitration provision had occurred instead of seeking to vacate or disturb the Interim Final Award.

Having determined that it had jurisdiction, the district court then held that the insurers were entitled to a preliminary injunction enjoining the arbitration. It found that the insurers would be irreparably harmed because the anticipated arbitration award of $25 million would injure their goodwill and reputation in the industry. The court further held that the insurers were likely to succeed on the merits in a breach of contract claim because certain decisions were made by a two-person panel instead of the contractually-required three-person panel. Moreover, under Michigan law, a court has authority to remove an arbitrator if his/her relationship to one party is not disclosed and an arbitration award can be vacated if the failure to disclose facts might reasonably lead to an appearance of bias. Accordingly, the court concluded that the *ex parte* communications alone were sufficient to have the arbitrator removed, which would in effect vacate the Interim Final Award. Finally, the court held that National Union would not be harmed if the arbitration were stayed because no award could be confirmed until these issues were resolved and that the public interest in the integrity of the arbitration process and upholding contracts outweighed the federal policy favoring arbitration.

Redux in Context:

- Although a court generally does not have jurisdiction to intervene in arbitration proceedings until an arbitration award is final, there is an exception when the underlying contract is subject to attack under general contract principles, particularly where there are allegations of arbitrator misconduct.
- Under Michigan law, an arbitrator can be removed if his/her relationship to a party is not disclosed.
- Under Michigan law, the failure to disclose facts that might reasonably lead to an appearance of bias is grounds for vacating an arbitration award.

Florida District Court Dismisses Claims for Reimbursement of Defense Costs Under Reinsurance Treaty and Equitable Estoppel

The United States District Court for the Middle District of Florida dismissed with prejudice an insurer's claims for defense costs from its reinsurer under either the terms of the reinsurance treaty or an equitable estoppel theory. *Public Risk Management of Florida v. One Beacon Insurance Co.*, No. 6:13-1067-Orl-31TBS, 2013 WL 5705575 (M.D. Fla. Oct. 18, 2013).

On October 18, 2013, the United States District Court for the Middle District of Florida dismissed with prejudice an action by an insurer seeking to recover the costs of defense from its reinsurer. The insurer had claimed that it was entitled to defense costs under the terms of its reinsurance treaty or under an equitable estoppel theory.

The insurance coverage dispute arose out of litigation between the City of Winter Garden, Florida ("Winter Garden") and Dewitt Excavating, Inc. ("Dewitt"). Public Risk Management of Florida ("PRM") issued insurance coverage to Winter Garden that was reinsured by OneBeacon Insurance Co. ("OneBeacon"). PRM insured against Winter Garden's public officials' errors and omissions policy ("PRM Policy") and PRM's reinsurance from OneBeacon in turn covered losses due to Winter Garden's public officials' errors and omissions covered under the PRM Policy. PRM claimed that it was obligated to fund Winter Garden's defense against Dewitt's claims and sought reimbursement from OneBeacon for the $286,941.07 in defense costs in excess of the OneBeacon Treaty's $200,000 retention.

The reinsurance dispute presented two questions to the district court: (1) whether the underlying Dewitt litigation set forth claims that could fairly be seen as falling within the PRM Policy, thus invoking PRM's duty to defend Winter Garden; and (2) whether the allegations in Dewitt's complaint can set forth a claim for equitable estoppel under Florida law. The district court answered both questions in the negative.

The district court explained that whether PRM had a duty to defend Winter Garden hinged upon whether the allegations in the Dewitt complaint fairly bring it within the PRM Policy. "If the allegations of the complaint leave any doubt as to the duty to defend, the question must be resolved in favor of the insured." The district court noted, however, that whether PRM had a duty to defend could not be determined by analyzing individual paragraphs of the complaint in a vacuum, but instead must be decided after examining the complaint as a whole.

The PRM Policy defined wrongful acts as "any actual or alleged error or miss-statement [sic], omission, act or neglect or breach of duty due to misfeasance, malfeasance, and non-feasance," and specifically excluded intentional breaches of contract. The allegations in Dewitt's complaint set forth a routine construction dispute that was grounded in its construction contract with Winter Garden, and, as PRM emphasized, alleged that Winter Garden provided "misleading information about the utility locations" and provided plans and specifications containing "errors and omissions." Dewitt did not assert a negligence claim. Notwithstanding the language in the complaint emphasized by PRM, the district court concluded that "there was no allegation of any purported wrongful acts by Winter Garden officials that gave rise to the Dewitt Action – the Construction Contract was the reason Winter Garden was obligated to pay Dewitt." Furthermore, the district court noted, "even if it were unclear whether the Dewitt Complaint may be construed as arising from a covered 'wrongful act,' the more specific exclusion of intentional breach would preclude coverage" since the complaint alleged an intentional breach – that Winter Garden refused to pay money owed to Dewitt.

PRM also asserted a claim for equitable estoppel as a basis for insurance coverage. Under Florida law, there are limited circumstances in which an estoppel theory may be used to create insurance coverage. "The general rule in applying equitable estoppel to insurance contracts provides that estoppel may be used defensively to prevent a forfeiture of insurance coverage, but not affirmatively to create or extend coverage." However, Florida courts recognize a narrow exception to this general rule "where to refuse [coverage] would sanction fraud

or other injustice. . . . Such injustice may be found where the promisor reasonably should have expected that his affirmative representations would induce the promisee into action or forbearance substantial in nature, and where the promisee shows that such reliance thereon was to his detriment."

PRM notified OneBeacon of the Dewitt action, and OneBeacon sent PRM a letter denying that the Dewitt action was covered. At PRM's request, OneBeacon later supplemented its denial letter with a reservation letter and proceeded under a reservation of rights to determine if the Dewitt action was covered. However, the reservation letter expressly stated that OneBeacon did not believe the Dewitt action implicated the reinsurance treaty and specifically addressed PRM's view on its duty to defend under the PRM Policy. PRM latched onto language from the reservation letter stating that "under the [reinsurance treaty], PRM has the duty to defend claims." The district court explained that this language simply acknowledged that PRM had a general duty to defend claims that fairly fell within the scope of the PRM Policy, not that PRM had a duty to defend the claims at issue here.

The district court also refused to find injustice under these circumstances since the bargained-for agreement between PRM and OneBeacon was based on the understanding that Winter Garden's intentional acts would not be covered.

Redux in Context:

- A reinsurer cannot be required to indemnify an insurer for the costs of defense if the insurer did not have a duty to defend under the applicable policy.
- Whether an insurer has a duty to defend is determined by examining a complaint as a whole, not by analyzing individual allegations in a vacuum.
- Refusal to pay money allegedly owing under a contract may be construed as an intentional breach that is excluded from insurance coverage.
- Under Florida law, equitable estoppel may be used affirmatively to create or extend coverage only under limited circumstances.

Seventh Circuit Affirms Decision of District Court Requiring Insurance Broker to Pay Rebate to Insurer Even After Termination of Agreement with Broker

The United States Court of Appeals for the Seventh Circuit affirmed the decision of the United States District Court for the Northern District of Illinois following a bench trial in which the district court determined that an insurer was entitled to a rebate under its contract with an insurance broker even though the contract was not renewed. *Homeowners Choice, Inc. v. Aon Benfield, Inc.*, – Fed. App'x –, No. 13-1846, 2013 WL 6670981 (7th Cir. Dec. 19, 2013).

The United States Court of Appeals for the Seventh Circuit affirmed the judgment of the United States District Court for the Northern District of Illinois following the bench trial of a dispute between an insurer and insurance broker. The Seventh Circuit concluded that the contract provision at issue was ambiguous and that it therefore was not error to construe the ambiguous terms against the broker who drafted the contract.

In 2007, Homeowners Choice, Inc. ("Homeowners") entered into a brokerage agreement with an insurance broker, Aon Benfield, Inc. ("Aon"), to obtain reinsurance. Thereafter, in February of 2009, representatives of the Homeowners and Aon met to negotiate a revenue-sharing agreement ("RSA") and orally agreed to terms whereby Aon would rebate a portion of its commission to Homeowners. Aon's representatives informed Homeowners that Aon would formalize the RSA in writing. The RSA drafted by Aon provided for payment of an Annual Fee ("the rebate") and stated that the Annual Fee would not be payable "subsequent to any decision by Client to terminate or replace Aon Benfield as its reinsurance intermediary-broker for any portion of the Subject Business."

Prior to the end of the contract period for the RSA, Homeowners provided notice that it was replacing Aon as its broker of record for the upcoming reinsurance period. When Homeowners requested the rebate payment, Aon refused and claimed that Homeowners was not entitled to the rebate because it had replaced Aon prior to the expiration of the RSA. Homeowners filed suit and the parties both moved for summary judgment. The court held that the RSA was ambiguous and held a bench trial where it determined that Aon was required to pay the full rebate under the terms of the RSA.

On appeal, Aon argued that the RSA was unambiguous and that Homeowners had forfeited its right to the rebate. Aon further argued that the court erred by applying the doctrine of *contra proferentem* – construing the terms of the RSA against the party that drafted the contract (Aon) – because it was unambiguous. The Seventh Circuit reviewed *de novo* the question of whether the contract was ambiguous. The sole issue was whether the term "Subject Business" refers to all of Homeowners' reinsurance contracts, including those formed after the agreement year, or whether it was limited to the defined agreement year. Since Homeowners did not terminate Aon as its broker for the agreement year, but rather the following year, it would be entitled to the rebate if the term "Subject Business" was limited to the agreement year.

The Seventh Circuit held in its ruling on December 19, 2013 that the term "Subject Business" was ambiguous because it could reasonably be read to mean (1) only reinsurance placed during the contract year; (2) all reinsurance agreements, including future agreements; or (3) all reinsurance placed and serviced by Aon. The court further held that Aon's interpretation was problematic because it would required Homeowners to renew the RSA for an additional year in order to receive the rebate, despite the fact that it was clearly a one-year agreement, and there would be no consideration for Homeowners for the one-year agreement if it forfeited the rebate absent a renewal. Because the Circuit Court concluded that the RSA was ambiguous, it was not error for the trial court to apply the doctrine of *contra proferentem* and construe the RSA against Aon. Accordingly, the Seventh Circuit affirmed the judgment against Aon requiring it to pay the rebate to Homeowners.

Redux in Context:

- The termination of a brokerage relationship does not necessarily relieve a broker of its contractual obligations for the period prior to termination.
- A reinsurance contract may be ambiguous if its terms are not clearly defined with respect to applicable contract periods.

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