

## **Honorable Engagement Provision in Arbitration Provision of Reinsurance Agreements Assists Court of Appeals in Holding that Arbitral Award Should Be Confirmed**

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In *First State Insurance Company v. National Casualty Co.*, 781 F.3d 7 (1st Cir. 2015), the U.S. Court of Appeals for the First Circuit (the “Court of Appeals”) affirmed a district court’s refusal to vacate an arbitration award resolving claims under excess of loss reinsurance agreements. In doing so, it interpreted the reinsurance agreements and addressed the operation and effect of an “honorable engagement provision” in the reinsurance agreements’ arbitration provision. The district court’s docket is sealed, and its opinion is not available for public viewing.<sup>1</sup>

### **Factual Background**

First State Insurance Group (“First State”) and National Casualty Co. (“National Casualty”) are parties to eight excess of loss reinsurance agreements pursuant to which National Casualty agreed to reinsure losses arising from various products liability, asbestos and environmental claims made against First State based upon First State’s direct writings and First State’s reinsurance of direct writings by other insurance companies. The reinsurance agreements contained a follow the fortunes provision.

All loss settlements made by the Reinsured, provided they are within the conditions of the Reinsured’s original policies and within the terms of this Contract, shall be unconditionally binding upon the Reinsurer and the Reinsurer’s share shall be payable at the same time and in the same

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<sup>1</sup> Because the opinion of the district court is not public, and the statement of facts in the First Circuit’s opinion is somewhat sparse, the author has had to rely upon somewhat conflicting statements of fact in the appellate briefs to set forth the factual background of the dispute between the parties.

manner as the Reinsured may elect to pay, upon reasonable evidence of the amount paid or to be paid being given by the Reinsured.

First State settled some claims and billed National Casualty under the reinsurance agreements. National Casualty declined to pay. Each reinsurance agreement contained a binding arbitration agreement, and First State demanded arbitration. A total of ten claims for payment were arbitrated in a single arbitration proceeding, pursuant to a consolidation agreement of the parties.

At least one of the issues underlying the payment dispute concerned First State's liability to one of its insureds, Owens-Corning Fiberglass, for asbestos non-product liability claims. The issue was whether Owens-Corning's liability involved one or multiple occurrences. National Casualty contended in its appellate brief that "[w]hile multiple occurrences would multiply First State's exposure to [Owens-Corning], one occurrence would maximize both the chance that First State would reach the threshold of reinsurance coverage and the amount of potential reinsurance coverage."

First State contended in its loss submission to National Casualty that its loss settlements involved a single occurrence. National Casualty believed that all asbestos losses could not be a single occurrence and that First State had selected this approach to maximize its reinsurance recovery, and declined to pay on that basis.

### **The Course of the Arbitration**

The arbitral panel decided to consider the contract interpretation issues presented by the parties first. During discovery in the arbitration First State declined to produce certain documents on the basis of attorney-client privilege and the work product doctrine. National Casualty filed a motion to compel production of the documents that First State had withheld. The arbitration panel granted the motion to compel, and ordered First State to produce the documents. However, concerned about the possible impact of producing the documents on on-going coverage litigation, First State refused to comply with the panel's discovery order.

National Casualty sought a stay of the arbitration pending briefing on the prejudicial impact of First State's violation of the discovery order. Among other positions, National Casualty contended that First State's refusal to comply with the panel's discovery order amounted to a breach of the contractual arbitration provision, permitting it to terminate the arbitration. The panel, however, decided to proceed with the schedule. Discovery was "completed" and a hearing on the merits of the contract

interpretation issues was held while First State continued to withhold the documents in question. National Casualty filed a Petition in district court seeking a declaration that it was entitled to terminate the arbitration agreement. This issue allegedly was mooted by the panel proceeding to a final hearing.

After the merits hearing, the panel ruled in favor of First State on the contract interpretation issues. First State filed a Petition to confirm the award, and National Casualty amended its pending Petition to seek to vacate the arbitral award on three grounds: (1) First State's failure to comply with the panel's discovery order constituted a breach of the arbitration provision, permitting National Casualty to terminate the arbitration; (2) the final arbitration hearing was fundamentally unfair due to arbitrator misconduct; and (3) the arbitration award was procured by undue influence. The district court denied National Casualty's request to vacate the arbitral award and instead confirmed the award. National Casualty appealed.

### **The Court of Appeal's Opinion**

The Court of Appeals commenced its opinion by noting that attempts to vacate an arbitral award "normally faces a steep uphill climb: the scope of judicial review of arbitration awards is 'among the narrowest known in the law.'"

#### **Whether National Casualty's request to vacate the arbitral award was timely**

The Federal Arbitration Act requires that a party seeking to vacate an arbitral award apply to a district court within 90 days after the promulgation of the award. 9 U.S.C. §12. National Casualty filed its petition to vacate more than 300 days after the promulgation of the award, although it contended that its motion to dismiss First State's Petition to confirm the award, which was filed within the 90 day window, was, in effect, a request to vacate the award. The Court of Appeal held that "[i]t is clear beyond hope of contradiction that National did not meet the 90-day statutory deadline." However, the Court of Appeal declined to rule on this basis, citing authorities for the proposition that it could ignore this potential jurisdictional or standing question since the record provided a clear basis for the easy resolution of the merits of the appeal.

#### **Whether the arbitral panel exceeded its authority**

National Casualty contended that the arbitral panel had exceeded the scope of its authority because instead of interpreting the reinsurance agreements, it re-wrote them by: (1) requiring National Casualty to pay billings that may not fall within the terms and

conditions of the agreements; and (2) foreclosing or substantially impairing its broad access rights under the inspection and audit provisions of the agreements. The legal standard for establishing that an arbitral panel exceeded its authority is by now well established, with only a few exceptions, although its application is fact specific.

The Court of Appeals rejected the contention that the panel had exceeded its authority, finding that the arbitral award, by its very terms, constituted the resolution of disputed interpretations of the reinsurance agreements, and that the arbitral award appropriately tracked the plain language of the reinsurance agreements. It rejected National Casualty's contention that this case presented "one of the rare instances in which the vacation of an arbitration award is warranted because the arbitrators exceeded the scope of their powers by re-writing the terms of the parties' agreements." The Court of Appeals held that even if the arbitrators had committed serious legal error, it was bound to affirm the confirmation of the arbitral award unless it was clear that the arbitral award did not "draw its essence" from the underlying reinsurance agreements, a standard which is very difficult to satisfy.

The Court of Appeals also noted that under the reinsurance agreements, National Casualty's obligation to pay losses was independent of its inspection and audit rights.<sup>2</sup> The Court of Appeals noted that National Casualty was not without a potential remedy, however, because if it pays a billing from First State (whether or not subject to a reservation of rights), National Casualty retained the contractual right to audit the claims even after the promulgation of the final arbitral award, and to seek recoupment through a subsequent arbitration should it conclude that payment was improperly made.

#### The role of the honorable engagement provision of the reinsurance agreements

Finally, National Casualty contended that the panel erred by fashioning a claim payment protocol which obligated it to pay claims submitted by First State, subject to a reservation of rights, prior to completing its contractual right to inspect records and audit the claims. Rejecting the contention that the claim protocol did not "draw its essence" from the reinsurance agreements, the Court of Appeals found that the payment protocol was a reasonable interpretation of several provisions of the reinsurance agreements.

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<sup>2</sup> First State had sought declaratory relief from the panel as to whether National Casualty could condition payment of claims under the reinsurance agreements on its contractual right to inspect First State's files. First State's flaunting of the panel's discovery order apparently was not a factor in the analysis of the Court of Appeal.

This conclusion was fortified by the presence of an honorable engagement provision in every reinsurance agreement. While such provisions have been included in many reinsurance agreements for many years, few courts have articulated the practical effect of such a provision. The Court of Appeals noted that the honorable engagement provision directed the arbitrators to consider each agreement as an “honorable engagement rather than merely a legal obligation” and further stated that the arbitrators “are relieved of all judicial formalities and may abstain from following the strict rules of law.” Noting that this was the first instance in which the Court had been called upon to address the operation and effect of an honorable engagement provision in an arbitration provision, the Court of Appeals held that the honorable engagement provisions empowered the arbitrators to grant forms of relief, including equitable remedies, not explicitly mentioned in the reinsurance agreements. The Court of Appeal viewed the honorable engagement provisions as enhancing the prospects for a successful arbitration because they provided the arbitrators with the flexibility to custom-tailor remedies to fit particular circumstances.

### **Conclusion**

The decision of the Court of Appeals to proceed to the consideration of the merits of the appeal in this case despite the fact that National Casualty’s request to vacate the arbitral award was not submitted within 90 days of the promulgation of the award should not lead one to ignore that deadline, since many courts have treated the failure to comply with that deadline as a sufficient basis to dismiss a request to vacate an award. The failure of the arbitral panel and the courts to address the refusal of First State to comply with the arbitral panel’s discovery order may be viewed by some as a compromise of the integrity of the arbitral process, but perhaps this issue was addressed in the sealed record of the district court. Perhaps the most interesting portion of this opinion is the Court of Appeals’ statements as to the practical operation and effect of an honorable engagement provision, which may effectively broaden the already broad discretion of arbitrators in resolving contract-related issues and fashioning remedies in certain factual circumstances, in conjunction with the other provisions of the reinsurance agreements at issue.

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