

## **RESTORING CONFIDENCE IN THE REINSURANCE ARBITRATION PROCESS - A CRITICAL ASSESSMENT**

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Over the past twenty years, reinsurance arbitrations have evolved into litigation equivalents in both expense and length. As a result, there are now fewer advantages to arbitration over litigation than there once were. The primary remaining advantages of arbitration over litigation are: the ability to control the process, and the opportunity to have a dispute heard by experienced industry professionals who have a good sense for industry custom and practice, and generally understand how and why insurance and reinsurance companies act as they do.

Two principal factors threaten to eliminate the remaining advantages that arbitration offers over litigation: 1) the apparent willingness of panels to be guided by judicial precedent, rather than by drawing upon their own experience and resort to industry practice, and 2) the potential for bias in the rendition of awards. The inability to gauge whether the arbitrators, in a particular case, are prepared to bring their acquired wisdom into the hearing room and apply it in a completely objective manner, is a major concern to all participants. Unless these factors can be eliminated or mitigated, reinsurance arbitration retains no advantage as an alternate dispute resolution mechanism, while still being burdened with the inherent procedural deficiencies.

### **How We Got Here**

To a large extent the business of reinsurance is self-policing. It has historically relied on a built-in barometer, a “checks and balances” system whereby the marketplace would dictate appropriate conduct. Cedents and reinsurers alike would push back when they perceived that the envelop was being stretched too far, and the message would be delivered. So then, in a very real sense, accepted market practice was established by the participants’ conduct -- if companies were out of step with that practice, they would find themselves losing relationships, and perhaps, embroiled in controversy. This served to be a healthy process, particularly for an industry that historically has shunned conflict. Rather than call undesired attention to themselves unless absolutely necessary, participants would quietly resolve their conflicts by negotiating compromises or accommodations on future business.

Beginning in the early 1990's, things began to change significantly. The volume of reinsurance disputes began to escalate dramatically. The emergence, growth and influence of ARIAS can probably be attributed to the rapid acceleration of reinsurance disputes. A number of factors contributed to the increase in reinsurance disputes, including

- 1- the severity of losses,

- 2- the continuing emergence of exposures for cumulative injury claims involving multiple different claim types, e.g., asbestos, environmental and other toxic tort claims,
- 3- the erosion of long term relationships,
- 4- the entry of companies into runoff and into receivership, and
- 5- reserve strengthening and the general weakening in financial conditions of insurers and reinsurers alike.

The list is by no means exhaustive.

The increase in the volume of cases transformed reinsurance arbitration into big business. Companies began to delegate more and more control of the cases to outside counsel. Law firms accumulated a large volume of cases such that they could dedicate a practice group exclusively to the handling of reinsurance disputes. Arbitrators began to generate significant income, and in some instances, were able to transform retirement into full-time hourly billing opportunities. Arbitrators became much more involved in the control of the proceedings. The number of arbitrators began to grow exponentially. Market clout and patronage became -- and continues to be -- a significant factor in how the game is played.

From the perspective of most, the reinsurance arbitration process is worth salvaging, notwithstanding that some contracts are now written without arbitration clauses or with restricted arbitration clauses. But in order for it to once again become the process that the industry has come to depend upon, we must eliminate or reduce the factors that threaten its utility and effectiveness. We must restore confidence in the process.

## **REINSURANCE ARBITRATORS MUST PROTECT THE INTEGRITY OF THE BUSINESS**

### **1. Is There A Place For Legal Precedent Where The Arbitration Itself Has No Precedential Value To The Industry?**

Reinsurance arbitrators need not be judges. The courts accept that there will be instances where the case will be decided differently in arbitration than it would have been decided had the matter been litigated in court. Arbitration provisions constantly remind panelists that they are relieved from following strict rules of evidence, that they should not necessarily be guided by the literal words in the contract, and that they should consider the parties' relationship as an honorable undertaking. But, too often, when the rubber meets the road, we seem to forget about all of this, about accepted or acceptable industry practice. The lawyers cite judicial precedent to arbitrators as they would to a court, as if those decisions might bind the arbitrators or as if there is precedent from one arbitration to the next.

Do we really want our arbitrators to serve as judges? Do we want our industry arbitrators to be guided by how the judiciary has construed the doctrine of “follow the settlements”? If so, would it not be more efficient and appropriate to have reinsurance disputes resolved in the courts? We seem to be able to accept different outcomes in arbitration than in court when it comes to issues of contract interpretation,<sup>1</sup> but we continue to struggle when it comes to the scope of the doctrine of follow the settlements.

a) **Follow The Settlements**

Judicial expansion of the scope of follow the settlements has had a profound impact on the arbitration process. Courts have treated this theory of implied consent so that it appears to accommodate essentially anything a cedent chooses to do, so long as the reinsurer cannot prove fraud. Cedents will generally urge arbitrators to be guided by these judicial decisions whereas reinsurers will either attempt to distinguish the cases from the facts at issue in the current case or by bluntly asserting that the courts have misconstrued or misapplied basic industry tenets. Reinsurers contend that these judicial decisions -- particularly those applying follow the settlements to the allocation process -- are in collision course with the duty of utmost good faith and throw the system out of balance by encouraging cedents to be creative in making allocation determinations.

Until the emergence of cumulative injury claims implicating multiple policies and policy years, allocation of losses and the effect on the reinsurance billing process was simply not a consideration. And, in practice, prior to the Massachusetts federal court’s decision in *Commercial Union v. Seven Provinces*, 9 F.Supp.2d 49 (D. Mass. 1998), cedents did not maintain that follow the settlements applied to the reinsurance billing process, and that therefore, reinsurers could not question their allocation determination. Rather, cedents contended that the allocation is 1) consistent with its perception of the exposure that the underlying claims presented to its policies, and/or 2) consistent with the settlement and negotiations leading to that settlement -- i.e., the allocation “follows” the “settlement.”

These judicial decisions have also had an affect upon the relationship between cedents and reinsurers, as well as the manner in which they conduct their affairs. In a very real sense, these judicial decisions have contributed to the molding of industry practice.<sup>2</sup> But because there continues to be a huge divide between cedents and reinsurers as to whether follow the settlements applies to the allocation process, there remains the question of whether the duty to “follow the allocation” is accepted industry practice.

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<sup>1</sup> By way of example, rules of contract construction prevent courts from considering extrinsic evidence to alter the terms of a contract that are otherwise clear and unambiguous on their face. Arbitrators routinely consider and rely upon contemporaneous documents housed in the parties’ underwriting files and the parties’ course of dealing even where they directly contradict contract language.

<sup>2</sup> Reinsurers might argue that these decisions have corrupted the follow the fortunes doctrine.

Given their debatable relevance to arbitration, why should these judicial decisions be taken into account in the panel's analysis? On the other hand, why should cedents have to forfeit benefits created by the judiciary and on what basis should arbitrators be permitted to disregard the law? At a minimum, whether or not legal precedents should be determinative, cedents have the right to cite legal authorities which support their position and to argue the persuasiveness of the cases. At the end of the day, this all may be much ado about nothing. Because arbitrators generally do not issue reasoned awards, participants will be uncertain as to whether reinsurance arbitrators are buying into what the courts are telling us about follow the settlements, or whether they are just concerned that their failure or refusal to follow the law will result in undesired attention being directed to them during an appeal of their award to a court.<sup>3</sup>

Many would contend that a panel's mandate is dictated by the reinsurance contract and industry custom and practice, not by case law, and not by the legal and public policy considerations judges must consider. Moreover, since arbitrators are not judges (lacking the training, resources, and ethical constraints), a court will better serve insurers and reinsurers seeking an application of law. To the extent insurers and reinsurers are seeking an application of industry custom and practice to resolve their dispute, arbitration serves better -- provided arbitrators are prepared to fulfill their duties in a completely objective manner.

## **2. Participants Must Believe That The Process Is Fair**

Do parties enter into the arbitration process on an equal footing? While there are exceptions which are dependent on the particular issue being addressed, the short answer is, "No". While the industry does not maintain statistics, cedents prevail in the majority of reinsurance disputes. There are multiple factors at play here, but the doctrine of follow the fortunes is largely (and expectedly) responsible for the imbalance.<sup>4</sup> Follow the fortunes creates a presumption of regularity in the underwriting, cession, claim-handling and settlement practices undertaken by the ceding company, and operates much like a presumption of good faith. Cedents need only establish that they operated in a responsible manner and attempted to discharge their obligations in a reasonable fashion. This presumption of regularity is also consistent with the recognition that distribution of insurance risk is essential for the industry to survive.

The industry itself has purposely created this hurdle for reinsurers, and this in part may account for the historical absence of large numbers of reinsurance disputes. This is the playing field that the industry, rather than the courts, has created for resolution of reinsurance disputes. A different question is, whether parties enter into the arbitration process believing that they have equal chances of prevailing -- and still maintain that belief after the umpire has been selected. If the answer to this question is also "No", and assuming that both sides are advancing their arguments in good faith, then this is not a balanced playing field and it is not one that the industry

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<sup>3</sup> Or, as alluded to later, are the decisions a function of arbitrators desiring to acquire or maintain patronage from industry participants who regularly appear in reinsurance arbitrations?

<sup>4</sup> Another contributing factor is the unwillingness of so called "deadbeat reinsurers" to accept responsibility and the tendency to trump up questionable defenses to payment

has created for itself. A significant imbalance here may well account for why so many participants have lost faith in the process.

### **ELIMINATING BIAS FROM THE PROCESS**

The prospect of completely removing bias from the process is easier said than done. This is a two-headed monster, consisting of partiality as well as institutional bias. Institutional bias is a function of the industry experience unique to the particular arbitrator. It is difficult or impossible to forget about or ignore 30 years of professional experience and approach the case as a blank canvass. The best we can reasonably hope for is to mitigate institutional bias and guard against partiality.

There is certainly enough blame to distribute. All participants in the reinsurance arbitration process share in the responsibility for having permitted the process to be taken down this road -- from the lawyers attempting to construct umpire slates with candidates perceived to be willing to support their clients' positions to arbitrators being sensitized to who may have championed their appointment in the present case and sensitive to where their next appointment may be coming from. We have reached the point where winning the umpire coin toss is perhaps the single-most important event in the case.

We have come to accept a certain amount of bias in order to derive the benefit of obtaining the expertise of industry professionals. While not an ideal situation, there are many who feel that it is still better than putting one's fate in the hands of a judge who may not have a firm grasp on industry practice, or who may be all too willing to create or perpetuate bad law, or who has no interest in adjudicating a dispute between two insurance companies. While reinsurance arbitrators do not have to account to anyone for their decisions, they can be counted upon to care about their decisions. Confidential though they may be, arbitration outcomes are some of the very worst kept secrets in this business. If you've ever attended an ARIAS Convention, you know what we're talking about.

### **How We Restore Balance**

Recognizing and accepting practicalities and human frailties, there are still ways to resuscitate the process and to restore confidence. Here are a few suggestions that immediately come to mind. They are by no means exhaustive.

- 1- Cedents and reinsurers alike must regain control over the reinsurance arbitration process. Delegating that control to the lawyers and to the arbitrators has enabled those who profit most from the system to be expected to effectuate meaningful change. That is unlikely to happen. Companies being compelled to agree upon a mutually acceptable umpire candidate would be a place to start. Alternatively, requiring all umpire nominees to be free of any prior relationships with the arbitrating companies, their counsel, or the party-appointed arbitrators would be a step in the right direction. A procedure could also be developed to have the umpire pool consist solely of "umpire only" candidates or retired judges. In almost all cases, there is an abundance of expertise in the companies, the lawyers

and the party-appointed arbitrators. It is not necessary that the umpire, too, be a skilled reinsurance professional. How about providing for a maximum permissible number of engagements as party-appointed arbitrator for any single company or group of companies? Such a limitation could restore a degree of independence to those who would or could otherwise be counted upon for a vote, and would also spread arbitrator appointments among the other 80% of qualified candidates who never seem to get appointed.

2- Reasoned Awards - requiring arbitrators to stand behind and support their decisions by making express factual findings and conclusions could mitigate the potential for bias or partiality.

3- Enlarging disclosure responsibilities in meaningful ways - the parties should have an opportunity to discern how prospective umpires have ruled in substantially similar cases. There are obviously confidentiality considerations that need to be taken into account and substantially more detail would have to be provided up front to potential umpire candidates. However, these are not insurmountable obstacles.

4- Along the same lines as enlarging disclosures would be the creation of a central repository for reasoned awards - all that would be necessary would be the redaction of the identify of the participants (parties and counsel) in the prior proceedings. This practice has brought structure to the Admiralty arbitration process. While not to be cited as a basis for *stare decisis*, decisions that arbitrators authored in prior matters, and most pertinently, in matters presenting substantially similar issues, would be equally available to participants.

Changes such as these come with a price and some discomfort. But, as we've heard in other contexts, "No pain, no gain." From the companies, a dedicated and concerted effort would be required. From the service providers, there would have to be the recognition that restoring the process to a level playing field is the only way for the process to succeed and survive. The goose that laid the golden egg has already been taken to the woodshed. Soon, there will be nothing left to preserve.

It is imperative that, assuming each side is acting responsibly and with a good faith belief in its position, both sides to a reinsurance dispute embark upon the process with an equal expectation of prevailing. But it is of even greater importance that each side emerge from the process with the belief that the proceeding was conducted fairly and impartially, and that the arbitrators carried out their charge with an open mind.

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