Briefing

Spring 2015

Insurance & Reinsurance

Discoverability Of Reinsurance Communications

SUMMARY: There have been a number of recent cases dealing with the discoverability and privileged nature of cedent/reinsurer communications in actions between the ceding company and the underlying insured. While the common interest doctrine often is invoked in these situations, only one of these cases directly addresses the applicability of the doctrine to the cedent/reinsurer relationship. The other cases turn on issues such as whether the documents are exempt from production because of the attorney-client privilege or work-product doctrine or the propriety of the document requests at issue. To the extent these cases suggest a trend in this area, it is that courts impose a high burden on the party resisting discovery (typically the cedent) to prove a factual basis exists for classifying documents as privileged or work-product or to establish the applicability of the common interest doctrine.

National Union Fire Insurance Co. of Pittsburgh, Pennsylvania v. TransCanada Energy USA, Inc., 990 N.Y.S.2d 510 (App. Div. 2014) involved a discovery dispute in a declaratory judgment action where the insureds challenged the insurers' privilege designations of documents created prior to the carriers' rejection of the insureds' claims. The insurers had retained legal counsel to prepare a coverage opinion. The court said the record showed counsel was primarily engaged in claims handling, which the court said was "an ordinary business activity for an insurance company." The court held that documents created in the ordinary course of business do not become privileged simply because they were created by an attorney. The court did not address the applicability of the common interest doctrine because it found the documents were not privileged.

In *National Union Fire Insurance Co. of Pittsburgh, PA v. Donaldson Co.*, 2014 U.S. Dist. LEXIS 85621 (D. Minn. June 24, 2014), the insured contended the carriers engaged in bad faith by waiting eight years, until just before mediation, to raise the issue that more than one deductible applied to the insured's claims under a batch clause. A Magistrate Judge had allowed discovery of reinsurance communications between the primary insurers and their reinsurers. On review by the District Court, the insurers argued that reinsurance information was not discoverable for purposes of interpreting an unambiguous policy, but did not address the insured's argument that the information sought was discoverable in relation to the bad faith claim. The District Court noted that there was conflicting case law as to the discovery of reinsurance information in the context of a bad faith claim, but found that the split in authority was not enough to conclude the Magistrate Judge's decision to allow the discovery was contrary to law or clearly erroneous. The

INSIDE THE BRIEFING

Discoverability Of Reinsurance Communications | p.1

Sixth Circuit Rules Arbitrator, Not Court, Is To Decide Whether Arbitration Clause Is Enforceable | p.4

Delaware Supreme Court Clarifies "Manifest Disregard" Standard Used When Determining Whether To Vacate Arbitrator's Award | p.5

Michigan Federal Court Denies Motion To Seal Arbitration Award, But Agrees To Seal Portion Of Award Identifying Non-Parties | p.6

New York Federal Court Reproaches Party Seeking To Vacate Arbitration Award For Agreeing To Arbitration But Then Asking Court To Strictly Apply The Law | p.6

Arizona
Delaware
Illinois
Michigan
New Jersey
Pennsylvania
Washington, DC
West Virginia

District Court also said the reinsurance information could potentially be relevant to what and when the insurer knew about the handling of one of the underlying lawsuits. This made the information sufficiently relevant to the insured's bad faith claim to be discoverable. The common interest doctrine was not at issue.

Harleysville Lake States Insurance Co. v. Lancor Equities, Ltd., 2014 U.S. Dist. LEXIS 154685 (N.D. Ill. Oct. 31, 2014) involved a discovery dispute in a declaratory judgment action brought by Harleysville which sought a ruling that a property damage claim was not covered because the insured failed to properly maintain its building's sprinkler system. The insured countered with a claim under Illinois insurance law (215 Ill. Comp. Stat. § 5/155(1)) providing for attorney's fees, costs and a penalty in cases where the insurer's action or delay was vexatious or unreasonable. The insured sought discovery of all reinsurance contracts and communications relating to Harleysville's reinsurance coverage of all first-party property claims beginning in 2009. The insured did not provide much in the way of rationale for why it needed the requested documents; it simply contended the reinsurance agreements were discoverable and the remaining documents may lead to the discovery of admissible evidence. The insurer responded that the reinsurance information was not admissible to vary the unambiguous terms of the policy and that the common interest doctrine protected the communications. The court allowed discovery of any reinsurance agreement that applied to the claim at issue, citing F.R.C.P. 26(a)(1)(A) which requires the disclosure of any insurance agreement that may indemnify a party for the claim being litigated, but denied the request for other reinsurance documents because it was "plainly too broad." The court agreed with Harleysville's assertion that communications with its reinsurers may be protected by work-product or the "common interest extension of the attorney-client privilege." The court said it would not compel Harleysville to produce the communications since to do so would likely generate disputes about privilege and work-product. While the court recognized the potential application of the common interest doctrine in seeking to avoid what it considered unnecessary privilege disputes, it did not analyze whether or not the doctrine applied in this case.

Progressive Casualty Insurance Co. v. Federal Deposit Insurance Corp., 2014 U.S. Dist. LEXIS 140709 (N.D. Iowa Oct. 3, 2014) involved a declaratory judgment action in which Progressive sought a ruling that its Directors & Officers policy did not cover claims asserted by the FDIC against former officers and directors of a bank. Progressive challenged a Magistrate Judge's ruling that it had improperly redacted on work-product and attorney-client privilege grounds certain communications between Progressive and its reinsurers. The Magistrate Judge held the work-product doctrine did not apply because the documents were created and distributed to reinsurers in the ordinary course of business for business purposes.

The District Court held that the Magistrate Judge did not clearly err in rejecting work-product protection for the documents at issue, concluding that communications between Progressive and its reinsurers were prepared in the ordinary course of business and not in anticipation of litigation. The court said Progressive admitted that the documents were prepared in the ordinary course of business, that they were business planning documents, that neither Progressive nor the reinsurers were involved in giving legal advice or mapping litigation strategy in any individual case, and that the communications served numerous business functions. Progressive argued some specific documents or portions of documents were prepared in anticipation of litigation and hence were subject to work-product protection. Specifically, Progressive said some documents were prepared by claims attorneys at the managing general agent for the agent's and Progressive's internal use. Progressive provided these documents to reinsurers in case updates required by the reinsurance agreements or in response to reinsurers' requests. The documents contained assessments of coverage and liability issues, reserve data, and plans for future handling of the claims.

The District Court noted that the Magistrate Judge had not considered Progressive's argument for "piecemeal" application of the work-product doctrine to specific documents or parts of documents. Nevertheless, the District Court concluded the Magistrate Judge's ruling had encompassed Progressive's objection. The fact that specific documents or sections of documents were prepared by claims attorneys does not necessarily establish that they are entitled to work-product protection. Also, preparation of documents by claims attorneys for internal use does not necessarily prove the internal use was in anticipation of litigation. In addition, given that Progressive conceded the documents were provided to reinsurers as case updates pursuant to the reinsurance agreements, the District Court held Progressive had acknowledged the specific documents and parts of documents were prepared in the ordinary course of business.

The District Court recognized that in certain situations opinion work-product that was incorporated into a document prepared in the ordinary course of business could retain its protected status, but found there was no basis to conclude that the Magistrate Judge's decision was clearly erroneous in holding Progressive failed to carry its burden of showing work-product protection was warranted. In short, there was no basis to overrule the

Magistrate Judge's finding that the documents, in their entirety, were created in the ordinary course of business.

The District Court then turned to the applicability of the attorney-client privilege to the disputed discovery. Progressive acknowledged it had voluntarily disclosed privileged communications to reinsurers and a broker, but contended the privilege was preserved under the common interest doctrine. The Magistrate Judge rejected this argument, holding that even if the doctrine was available under Iowa law, it only applied if the parties share a common legal interest. According to the Magistrate Judge, the relationship between Progressive and its reinsurers and broker was commercial and financial in nature, not legal. The Magistrate Judge noted that the unique circumstances of the reinsurance business do no automatically create a common legal interest. He found Progressive did not show that the reinsurers were actively participating in its litigation and legal defense or had any obligation to do so. Also, Progressive did not present any evidence establishing a joint strategy or legal enterprise with its reinsurers. Thus, the Magistrate Judge held, Progressive waived any privilege by providing the documents to third parties.

The District Court agreed with the Magistrate Judge's analysis and findings. The District Court noted that the common interest doctrine requires a two part showing that: 1) the common interest is legal, not solely commercial, and evidenced by an agreement, though not necessarily in writing; and 2) the exchange of privileged information was done in the course of formulating a common legal strategy. The District Court held that Progressive failed to show the Magistrate Judge was clearly erroneous on either point. The District Court cited to other cases that had rejected a categorical finding that the common interest doctrine applies in the cedent/reinsurer relationship. In so concluding, the District Court noted reinsurers do not have a duty to defend their reinsureds while insurers have such a duty with respect to their insureds. The District Court held that Progressive and its reinsurers did not have a common legal interest merely because the reinsurers may be obligated to pay Progressive's losses. Rather, the relationship between the parties was commercial and financial. The mere fact that the reinsurers had the right to participate in the defense of the underlying claim was not enough to establish a common legal interest given the lack of evidence of any joint legal strategy or legal enterprise. The District Court also concluded Progressive failed to establish that any exchange of documents was in furtherance of a common legal interest or was a matter of legal necessity, rather than in furtherance of Progressive's commercial or financial relationship with its reinsurers.

IMPORT OF PROGRESSIVE DECISION: Courts around the country are split on whether the common interest doctrine applies to attorney-client communications sent by a cedent to its reinsurers. While some courts have held the doctrine does apply to preserve the privilege, others have held the doctrine is not applicable and the privilege is waived if a cedent sends documents to its reinsurers (or allows them to be reviewed) that contain privileged attorney-client communications.

Cedents are understandably desirous of explaining to their reinsurers why they paid an underlying claim; indeed, the reinsurance relationship may compel them to do so. In this regard, insurers commonly send communications to their reinsurers containing the insurers' attorneys' evaluations of the insureds' claims, sometimes in the form of letters prepared by the insurers' coverage counsel. In fact, coverage counsel's candid assessments of the strengths and weaknesses of a cedent's case may be the best way to communicate such information to reinsurers. In addition, reinsurance agreements typically have terms allowing reinsurers to audit their cedents' claims files. In either case, reinsurers may receive or review privileged communications between cedents and their counsel.

In coverage actions against their carriers, insureds regularly seek discovery of communications between insurers and their reinsurers because the insureds think they will contain a treasure trove of information, including the cedents' candid assessments of their coverage positions. Since the law on the common interest doctrine varies by jurisdiction, the takeaway for cedents is that they must assume their insureds may be able to obtain in discovery in coverage litigation privileged communications the carriers send to their reinsurers.

Nevertheless, there are some steps cedents can take to maximize the chance a court will find the common interest doctrine applies to protect the cedents' attorney-client communications. One, the cedent may require its reinsurers to sign confidentiality and non-waiver agreements. Two, a cedent could request its reinsurer to invoke its right to associate (if present in the reinsurance agreement) (although many reinsurers may be reluctant to do so). Three, the communications could be sent to reinsurers directly by the cedent's coverage counsel with a letter expressly acknowledging the common legal interest and need to develop a common legal strategy with regard to the underlying claim. Four, the cedent could wait until the underlying coverage action is concluded before sending privileged

communications to its reinsurers.

None of these steps will guarantee a court will rule the common interest doctrine protects the cedent's attorney-client communications, however, which is something cedents need to always bear in mind.

Sixth Circuit Rules Arbitrator, Not Court, Is To Decide Whether Arbitration Clause Is Enforceable

SUMMARY: In *Milan Express Co. v. Applied Underwriters Captive Risk Assurance Co.*, 2014 U.S. App. LEXIS 20637 (6th Cir. Oct. 23, 2014), the Sixth Circuit held that the threshold issue of arbitrability was to be decided by an arbitrator under the parties' broad arbitration agreement. Thus, the arbitrator, not the court, was to decide whether the arbitration clause was enforceable under Nebraska law.

Milan and Applied Underwriters entered into a reinsurance participation agreement which contained an arbitration clause that said: "[a]ny dispute or controversy . . . shall be fully determined in the British Virgin Islands under the provisions of the American Arbitration Association." The clause also provided that "all" disputes between the parties relating "in any way to" the construction, enforceability, or breach of the agreement "shall be . . . finally determined exclusively by binding arbitration." The agreement also stated that it was to be governed by Nebraska law.

A dispute arose regarding the payment of premiums and fees. Milan filed a lawsuit against Applied Underwriters in the U.S. District Court for the Western District of Tennessee, together with a motion seeking to prevent arbitration of the dispute. As support for its motion, Milan asserted that the arbitration provision was unenforceable under a Nebraska statute that invalidated arbitration provisions contained in "an agreement relating to an insurance policy other than a contract between insurance companies." In response, Applied Underwriters filed a motion seeking to compel arbitration.

The district court granted Milan's motion. The court held it, not an arbitrator, had the authority to decide the threshold question of whether the dispute was arbitrable. The court also ruled the arbitration clause was unenforceable under Nebraska law. Applied Underwriters appealed.

On appeal to the Sixth Circuit, Applied Underwriters argued the express terms of the arbitration provision required the question of arbitrability to be decided by an arbitrator, not the court. The Court of Appeals agreed, finding that the parties "mutually and comprehensively agreed" to resolve all of their disputes by arbitration. Following the U.S. Supreme Court's decision in *Rent-A-Center, West, Inc. v. Jackson,* 561 U.S. 63 (2010), the Sixth Circuit held the agreement demonstrated "the parties manifestly intended to submit the threshold question of arbitrability to the arbitrator. This agreement, too, is enforceable like any other contract in accordance with its terms."

The appellate court noted a court must first resolve any challenge to the *validity* of an arbitration agreement before it may compel arbitration if the challenge is on common law grounds for rescinding contracts, such as unconscionability or fraud. However, the court noted Milan did not raise this argument. "Rather, Milan's challenge, to the arbitration clause as a whole, is limited to the argument that it is unenforceable under Nebraska law. Milan *may* be right about this, but enforceability is a question the parties expressly agreed to submit to arbitration, an agreement Milan has not challenged on fraud or unconscionability grounds." (Interestingly, the court did not address whether Milan's challenge to the arbitration clause under Nebraska law was preempted by the Federal Arbitration Act.)

Finding that the question of arbitrability should be decided by an arbitrator, not a court, the Sixth Circuit vacated the district court's decision, but did not decide whether Applied Underwriters was entitled to an order compelling arbitration. Since the parties' agreement provided that arbitration proceedings were to be conducted in the British Virgin Islands, the court said the district court lacked authority to specifically enforce the arbitration clause. The Court of Appeals also observed that two counts in Milan's complaint sought relief (for fraudulent and negligent misrepresentation) that did not arise under the agreement and, thus, arguably were not subject to arbitration. Rather than dismissing Milan's complaint in its entirety, the Sixth Circuit said the district court could have decided to stay proceedings pending arbitration of the arbitrable claims. Since the parties had not briefed how the matter should proceed on remand, the Court of Appeals directed the district court to "take up afresh the question of how best to move forward."

IMPORT OF DECISION: The Milan case demonstrates that courts will enforce a broad arbitration clause provided it is clear and unambiguous. If the parties expressly agree an arbitrator is to decide whether their dispute is subject to arbitration, courts will uphold their agreement. However, where the validity of the arbitration clause, itself, is in dispute, for example, where a party alleges the clause was induced by fraud or is subject to rescission, such issues will be decided by a court.

Delaware Supreme Court Clarifies "Manifest Disregard" Standard Used When Determining Whether To Vacate Arbitrator's Award

SUMMARY: While arbitration remains the primary battleground when wars between reinsurers and cedents are waged, the fight sometimes spills into the courts where an arbitrator's decision may be called into question and either upheld or overturned by a judge. The standard used by a court to determine whether an award should be overturned is a strict one where even apparent error by the arbitrator may not be enough to vacate the decision. Drawing on the Federal Arbitration Act ("FAA") and relevant federal case law, the Supreme Court of Delaware clarified this in *SPX Corporation v. Garda USA, Inc.*, 94 A.3d 745 (Del. 2014), holding that to vacate an arbitral award based on "manifest disregard of the law," a court must find the arbitrator "consciously chose to ignore a legal principle, or contract term, that is so clear that it is not subject to reasonable debate."

SPX Corp. ("SPX") and Garda USA ("Garda") entered into a stock purchase agreement pursuant to which SPX sold its subsidiary to Garda. The purchase price was subject to adjustment based upon differences in SPX's pre-closing and post-closing balance sheets. Under the agreement, incurred but not reported claims ("IBNR") related to workers' compensation liabilities were required to be included by SPX when calculating its liabilities and loss reserves on its balance sheets. SPX did not include its workers' compensation IBNR on its post-closing balance sheet. Garda contended SPX improperly undervalued the subsidiary's loss reserves on its balance sheet leading up to the sale and therefore inflated the price to be paid for the subsidiary under the stock purchase agreement.

The parties agreed to arbitrate their dispute about how the figures on SPX's balance sheet were calculated on the date of the acquisition. The arbitrator determined, without explanation, that Garda had not demonstrated that SPX failed to comply with the terms of the stock purchase agreement in calculating the loss reserves and was not required to restate its balance sheets.

Garda then filed suit in the Delaware Chancery Court – a court of equity within the Delaware State Court system – seeking to have the arbitral award vacated. SPX argued it had used actual reserves and that IBNR was unnecessary since the claims were closed. Garda pointed out that the closed claims remained subject to potential new payments arising from recurrence or worsening of claimants' injuries, and that immediately after closing, SPX's own actuary and an independent consultant estimated the reserves were between $3 million and $3.9 million, as opposed to the $1.336 million amount included by SPX on its balance sheet used for the sale. The Chancery Court found the arbitrator had manifestly disregarded the terms of the stock purchase agreement and vacated the arbitrator's decision because the agreement unambiguously required inclusion of IBNR in the reserves. SPX appealed to the Delaware Supreme Court.

The Supreme Court reversed the Chancery Court's ruling. In doing so, the Court invoked the Delaware Arbitration Act and equated the relevant section of this Act to the FAA. The Delaware Arbitration Act (§ 5714(a)(3)) provides that an arbitration award will be vacated when "[t]he arbitrators exceeded their powers, or so imperfectly executed them that a final and definite award upon the subject matter submitted was not made." Federal cases turning on the language in the FAA that tracks this provision establish that vacatur is authorized when the arbitrator acts in "manifest disregard" of the law, meaning that the arbitrator "(1) knew of . . . [a clearly defined] relevant legal principle, (2) appreciated that this principle controlled the outcome of the disputed issue, and (3) nonetheless willfully flouted the governing law by refusing to apply it." Furthermore, as long as the arbitrator is "even arguably construing or applying the contract and acting within the scope of his authority, that a court is convinced that he committed serious error does not suffice to overturn his decision."

According to the Supreme Court, the arbitrator's decision in this case "rationally can be derived from either the agreement of the parties or the parties' submissions to the arbitrator" since the parties' arbitration briefs establish that they presented two potential interpretations of the stock purchase agreement's relevant provision to the arbitrator. SPX had argued its calculation of loss reserves was done in a manner that was consistent with the methods used to prepare the subsidiary's financial statements, as required by the stock purchase agreement. Garda argued the agreement expressly required inclusion of IBNR. The Supreme Court found that a reasonable inference existed that the arbitrator adopted SPX's interpretation of the stock purchase agreement and, while that interpretation may have been wrong, it was not wholly without basis in either the contract or the parties' submissions. Accordingly, the arbitrator's decision was not subject to vacatur under the "manifest disregard of the law" standard.

IMPORT OF DECISION: Drawing from federal case law interpreting the FAA and the relevant language of the Delaware Arbitration Act, the Delaware Supreme Court made clear in this case that to vacate

an arbitrator's award, a party must be able to jump over the perilously high bar of proving the arbitrator showed a "manifest disregard" of a known principle of law when deciding a dispute. If the arbitrator's decision can somehow be rationally derived from the evidence or even from the parties' submissions and arguments to the arbitrator, the arbitrator's award is not in manifest disregard of the law and is not subject to vacatur. Such is the landscape when entering the battlefield of arbitration.

Michigan Federal Court Denies Motion To Seal Arbitration Award, But Agrees To Seal Portion Of Award Identifying Non-Parties

SUMMARY: **In *Amerisure Mutual Insurance Company v. Everest Reinsurance Company,* 2014 U.S. Dist. LEXIS 153013 (E. D. Mich. Oct. 29, 2014), the court denied a motion to seal an arbitration award and the parties' briefs relating to a motion to confirm the award, holding that the longstanding tradition of public access to the courts required such documents be in the public domain. The court did, however, order the portion of the award identifying non-parties to be sealed.**

Amerisure Mutual Insurance Company and Everest Reinsurance Company entered into a confidentiality agreement in their reinsurance arbitration which required the final award to be kept confidential. The agreement also required that certain court filings be sealed. After the arbitration panel issued an award in its favor, Amerisure brought an action seeking to confirm the award. Everest opposed confirmation and sought to have the award vacated.

Amerisure filed a motion asking the District Court for permission to file its brief in support of confirmation under seal, citing the parties' confidentiality agreement. Everest opposed the motion to seal in part, contending the District Court should only seal portions of the award that 1) identified and contained testimony of non-parties to the arbitration and 2) reflected substantive rulings of the panel majority. Everest argued that public disclosure of the substantive rulings could harm its financial interests. Everest claimed that disclosure of the "unhelpful" panel rulings might lead to future litigation between Everest and its other reinsureds. This would be unfair, Everest said, because those rulings were supposed to remain confidential.

The District Court granted Amerisure's motion to seal in part and denied it in part. In reaching its decision, the District Court cited the Sixth Circuit's "long-established legal tradition" of public access to court documents, and observed that "[o]nly the most compelling reasons can justify non-disclosure of judicial records." The District Court noted that sealing portions of the Final Award that identified and related to non-parties was "consistent with these governing principles" and was appropriate to protect the privacy rights of the third parties. The District Court further stated that while the risk of disclosure of confidential business data or trade secrets might justify sealing court records, the risk of "embarrassment, incrimination, or exposure to further litigation" did not justify sealing the records. Accordingly, the District Court refused to grant Amerisure's motion to file the award under seal in its entirety, but instead permitted only certain aspects of it relating to third parties to be filed under seal. The remainder, including the substantive rulings of the panel majority, was not permitted to be filed under seal.

IMPORT OF DECISION: **While it is very common for parties to a reinsurance arbitration to enter into a confidentiality agreement providing that any related court filings be sealed, courts will not always grant motions to seal. Frequently, courts will deny or limit such motions based on the public's right to access court documents.**

New York Federal Court Reproaches Party Seeking To Vacate Arbitration Award For Agreeing To Arbitration But Then Asking Court To Strictly Apply The Law

SUMMARY: **In *Associated Industries Insurance Company, Inc. v. Excalibur Reinsurance Corporation,* 2014 U.S. Dist. LEXIS 169163 (S.D.N.Y. Nov. 26, 2014), an arbitration panel granted a cedent most of the relief it had sought. Unsatisfied with a partial victory, the cedent filed a petition to vacate the award, arguing the panel had not properly applied the follow the fortunes doctrine. A federal district court in New York denied the petition and upheld the panel's compromise decision. The court also admonished the cedent for, on the one hand, agreeing to arbitrate disputes while, on the other, seeking the level of judicial review only available in court.**

Associated, as the reinsured, and Excalibur, as the reinsurer, entered into two reinsurance treaties that contained provisions relieving the arbitrators from following judicial formalities or the rules of evidence. The treaties provided that the arbitrators were to make their decisions according to the practice, customs, and usage of the insurance and reinsurance businesses. The

opinion does not say whether the treaties contained express follow the fortunes provisions, but the discussion makes clear the court found the doctrine applied to the case.

The arbitration panel issued an award giving Associated substantially all the relief it had requested. Nevertheless, the cedent sought to vacate the award, arguing the panel exceeded its powers by manifestly disregarding the law (the follow the fortunes doctrine) in reducing (or compromising) the amounts of certain of its claims. In the arbitration, Excalibur had argued that two exceptions to the doctrine existed: (1) Associated handled certain claims in a grossly negligent manner; and (2) two of Associated's claims payments were *ex gratia*.

The court first held that the "manifest disregard of law" ground for vacating an award remains available in the Second Circuit based on *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.*, 548 F.3d 85 (2nd Cir. 2008). The court next turned to the standard of review. Noting that the arbitrators did not explain the reasons for their award, the court stated that in such case, a court will uphold the award if it can discern any valid ground for it. The court also cited various decisions holding that the "manifest disregard of law" standard is exceedingly difficult to satisfy.

The court observed that since all of the members of the arbitration panel were experienced industry professionals, there could be no question that they were aware of the follow the fortunes doctrine. Thus, the court reasoned, the only question was whether the modest discounts awarded by the panel resulted from some egregious impropriety on the arbitrators' part. To prevail, the court said, Associated must prove, not that the arbitrators reached the wrong result, but that they disregarded the follow the fortunes doctrine entirely.

The court then discussed the panel's resolution of five specific Associated claims. The first claim was disallowed in its entirety. Excalibur argued Associated's claims payment was *ex gratia* because the insured's late notice to Associated voided coverage. The court said if the arbitrators found the payment was gratuitous, then the follow the fortunes doctrine did not apply. Noting that the arbitrators were not required to follow "judicial formalities," the court ruled the panel's decision to deny the claim was consistent with the panel's acceptance of Excalibur's *ex gratia* argument. The court refused to consider the merits of the parties' arguments because the claim was for the arbitrators to decide. The court said the panel's decision to disallow the claim did not demonstrate any manifest disregard of the follow the fortunes doctrine.

With respect to a second claim, the panel awarded Associated 50% of what it had sought. Excalibur argued the claim payment was *ex gratia* because it arose in 2004, not 2003. Excalibur only participated in the 2003 treaty year. The court said it was possible the panel concluded the 2003 treaty year was answerable for only a portion of the claim, which would explain why the panel awarded Associated 50% of the claim and denied the balance because it was *ex gratia*.

Excalibur argued Associated did not conduct a reasonable investigation of a third claim, contending it should be disallowed in its entirety. The panel, however, only gave Excalibur a 15% discount. Although the court did not expressly say so in its opinion, it appears the court believed the panel gave Excalibur a 15% discount because it felt there was some merit to the reinsurer's contention Associated had not reasonably investigated the claim.

The panel also discounted a fourth claim by about 13% because, the court assumed, the arbitrators were persuaded Associated's conduct was "tinged with bad faith." The panel gave Excalibur a $150,000 discount on Associated's fifth claim, evidently because it concluded there was some merit to the reinsurer's argument that Associated's grossly negligent claims handling resulted in a higher cost to resolve the claim.

The court recognized that the panel evidently compromised certain of Associated's claims because Excalibur had demonstrated some degree of bad faith or gross negligence in the claims handling. The court held that arbitrators, unlike the courts, "are entitled to reach equitable compromise solutions as long as they do not entirely disregard the law." Even if courts, constrained by strict legal principles, could not have awarded Associated "a partial loaf" under the follow the fortunes doctrine, arbitrators are not restricted by judicial formalities and are permitted to do so.

The court found that the panel did not disregard or misapply the follow the fortunes doctrine. Rather, the court concluded the panel likely applied certain of the doctrine's exceptions. The court said the fact that the arbitrators granted almost all of Associated's claims actually suggests they demonstrated a healthy respect for the follow the fortunes doctrine.

The court said it failed to see why the panel's conclusion that the evidence suggested some degree of bad faith, which warranted reductions to the cedent's claims, constituted misconduct, let alone a manifest disregard of the law. It also appears the court was somewhat annoyed by the fact that Associated had largely prevailed in the arbitration, yet refused to accept the minor compromise discounts ordered by the panel.

In its conclusion the court said:

> If parties want the luxury of judicial review and

reasoned results that require strict application of the law, without the sort of compromises that often characterize arbitral awards, they should not agree to arbitration clauses. Having done so, they should not be heard to complain when the arbitrators do what arbitrators so often do – reach compromise verdicts that can easily be justified by taking a particular view of the evidence.

IMPORT OF DECISION: This decision is important for several reasons. One, it holds the "manifest disregard of law" ground for vacating an arbitral award remains viable in the Second Circuit. Two, it recognizes (and upholds) a panel's right to render compromise decisions. Three, it reinforces that parties who agree to arbitrate their disputes have no right to *de novo* judicial review applying strict rules of law.

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