Penny Wise, Pound Foolish: How it Applies to Reinsurance Agreements

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Words of warning. We all know them. The old catch phrases that we hear again and again. One of the most repeated, yet seemingly just as often forgotten is "penny wise, pound foolish." Which in modern reinsurance parlance translates to: take the time to review and draft reinsurance agreements with care (and even, god-forbid, have outside counsel review) before signing them. Particularly in this day of computers and word processors, the cut-and-paste contract is more prevalent than ever, and often the cause of much pain. By now everyone is familiar with the complaints about reinsurance arbitrations. Too costly. Too time consuming. The process is broken. It comes down to the flip of a coin. Yet when it comes time to draft a reinsurance agreement how much time and effort is actually put into drafting the more common and recurring clauses. All too often the answer is to simply take what was used before.

The recent case, American Home Assurance Company v.Clearwater Insurance Company, 958 N.Y.S.2d 870 (Sup. Ct. 2013) is a good example of the importance of carefully reviewing arbitration provisions before signing the contract. The court devised its own method for umpire selection in which each side nominated five candidates. Three were then stricken by the other side. Each side then ranked the remaining four candidates in order of preference. The individual with the highest ranking would be selected. If there was a tie, the umpire was drawn by random lot from the two candidates with the highest ranking.

The cedents – American Home Assurance Company and National Union Fire Insurance Company of Pittsburgh – commenced arbitrations against Clearwater under three reinsurance treaties. All three treaties provided for each party to appoint an arbitrator. One of the treaties said the dispute was to be submitted to the two arbitrators and that if they failed to agree, then the dispute was to be decided by an umpire chosen by the arbitrators. This treaty also said that if the arbitrators failed to agree on the umpire, either party could petition the New York state court to appoint the umpire. The other two treaties stated the two party appointed arbitrators were to choose the umpire, but were silent concerning how the umpire was to be appointed if the arbitrators could not agree. Under New York law the court may appoint an arbitrator if the contract does not have a selection method or if the method fails. NY CLS CPLR § 7504. In this case, the cedents petitioned the New York Supreme Court (trial court) to appoint an umpire from the three individuals the cedents' arbitrator had proposed. Alternatively, the cedents suggested

that the court use the ranking method prescribed by ARIAS-US. Clearwater said the court should use the "strike and draw" method claiming it was the usual and customary procedure for umpire selection in the industry. Alternatively, the reinsurer argued the court should appoint the umpire from the three individuals it had proposed.

The court determined that neither the treaties nor state law provided a procedure for selecting the umpire. Instead of selecting one of the proposed approaches, the court decided to combine the "ranking" and "strike and draw" methods to create a new procedure following the lead of one of his colleagues in an earlier case. The court ruled that each side was to select five candidates and then strike three from the opponent's list, leaving two candidates from each side. The parties were then to rank the remaining candidates, with the highest ranking candidate being named umpire. In the event two individuals tied, the umpire would be determined by the drawing of lots for those two candidates. The court ordered the parties to adopt this new method to determine the umpire in all three disputes even though one of the treaties provided that the dispute was to be submitted to the umpire only in the event the two party appointed ar-

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bitrators could not agree upon a finding in the underlying arbitration. The court determined that the parties' disagreement upon the method of selecting an umpire created the need for an umpire under the treaty, and that appointing the umpire before the arbitration would save time and expenses and would avoid the need for a second arbitration at which the umpire would need to hear the evidence again.

The New York Supreme Court's decision illustrates the value of an agreed-upon umpire selection method in a reinsurance contract in order to avoid the time and expense of litigating over umpire selection. Failure to provide for umpire selection in the agreement can lead to loss of control over the process and add another layer of expense to the arbitration process. The case serves as a good example of the gaps that often exist in treaties, state law, and federal law with respect to reinsurance arbitration procedure. Finally, in addition to providing a new method for umpire selection, this decision demonstrates how the courts may fashion their own solutions to the parties' disputes in ways not advocated or anticipated by either party or by the express terms of the governing treaty. Which brings us back to our words of warning. Spend the extra time and expense necessary while negotiating a reinsurance agreement to be sure you know and understand it completely. There should be no words, sentences or phrases that you do not understand. Pay particular attention to the arbitration provision. Make sure you know what it does and does not cover. Disputes and disagreements are inevitable. Cedents and reinsurers will arbitrate and even litigate. However, the process does not need to be left to chance, the whims of a judge or be a mess. Make the effort to get the contract right at the outset when negotiation is easiest. When entering a contract, no one ever thinks this will be the one I end up in court over so they tend to be penny wise when drafting a negotiating only to end up much the poorer when things don't work out.