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REINSURANCE ARBITRATIONS

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Recorder: AKIVA ZOHAR

- o This session will be broken into two parts:
 - During the first segment, the reinsurance arbitration process will be discussed by individuals who have had hands-on experience. What is the process like? How does one prepare? What are the legal implications? What are the legal alternatives?
 - The second segment will be comprised of a dramatization of an arbitration hearing. The subject is one of immediate interest. The audience will be given a voice.

MR. MELVILLE J. YOUNG: We hope we've got an interesting session. Unlike many sessions in which I've been involved in the past, this one actually has had some advance preparation and I hope and trust that will be demonstrated. The people participating are Jim Horein, who is with Lincoln National; next is Denis Loring; next is Tom Clagg, a lawyer at Lincoln National; and next is Herman Schmit who is with NRG. Our recorder, Akiva Zohar, is with Cologne Reinsurance.

Briefly this is our plan. We are going to begin with Denis, who will talk about the arbitration process. This will be followed by Tom, who is going to talk about the legal aspects and alternatives to arbitration. Then Herman is going to talk about the use or misuse of the errors and omissions (E&O) clause. I hope that those of you who haven't had a chance to read the case will have a chance to briefly look through it. Then we are going to go through a mock arbitration. The case at hand involves a death claim involving someone who allegedly lied about his smoking habit. It's an arbitration between the reinsurer and the ceding company. Herman is representing the ceding company and Tom is representing the reinsurer. The other three of us are going to represent the arbitrators. We'll be going through the process, discuss the case and come to some conclusions. What we would like from the audience is some interaction during this process. You are, in effect, unofficial arbitrators and as such you can ask any questions about the case that you would like to ask or make any points that you would like to make, before we come to our conclusion. We will give you a chance, by a show of hands, to see what your opinion is prior to our vote.

MR. DENIS W. LORING: Why go to arbitration? There are several reasons. Perhaps the best one is that, if you do it right, you can get away with settling

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a dispute without lawyers. This is one of the most attractive features of the arbitration process. It's also quicker, cheaper, cleaner and with luck you can end up with an agreement that leaves both parties in a position to want to do further business together, instead of having been some sort of adversaries who will then part as enemies, never to be seen again.

Virtually all reinsurance treaties have arbitration clauses in them. There are different types of clauses but in general they follow a certain format: the number of arbitrators, where the arbitration may take place, how the arbitration should be done. What you will see here is sort of a generic successful arbitration: successful in the sense that we will come to a conclusion, whether it is successful in the minds of the parties involved we will have to see the outcome. Although we have prepared our presentation, we have not prepared the result of the arbitration. So you will learn it in real time.

Before one enters into formal arbitration, it is highly desirable to avoid it. Why not try face-to-face negotiation between the two disputing parties? It really never hurts to try once more. Arbitration is a process; it is not an end in itself. If, at any time before or during the arbitration process, the two parties see the chance to meet face to face and to agree on a settlement of their differences, the arbitrators have the responsibility to get out of the room quickly. You don't enter arbitration and say, "Now we are here and now we have to go through with it." The idea is to come to a resolution of the dispute. You can also try a sort of pre-arbitration which is an informal mediation with a third party, again informally.

If all that fails, we get down to the formal arbitration process, which usually works like this: each side picks an arbitrator. Now what does that mean? Are you picking an advocate or are you picking an arbitrator? One extreme is to pick an advocate, somebody who is going to be in your back pocket. You tell that individual about the case and ascertain that the person thinks the same way you do about the case before you say, "Yes, you are my arbitrator." The other extreme is to tell the person absolutely nothing about the case and say, "I want you to be my arbitrator. Will you do it, yes or no?" It is not desirable to go the first route. Arbitrators are supposed to come to a decision that is fair to all parties. They are not supposed to be in the pockets of the people who picked them. The other extreme doesn't work very well either, because if, for example, you want to arbitrate a case dealing with group loss reserves and you happen to have picked an individual variable life actuary as your arbitrator, you will probably not get a very good decision. My suggestion is to talk to the potential arbitrator enough to learn if the person can deal with the case, understands the types of issues that would be involved and would be comfortable dealing with them. But do not go so far as to say "and then what would you decide?"

Each side picks an arbitrator. The two arbitrators pick an umpire or a third arbitrator. This individual actually runs the arbitration. Hopefully the individuals have some experience with these things. Each arbitrator submits a list of people and they try to come to some agreement on an umpire. If they absolutely cannot agree, there is a classic clause that says we will leave the choice of final umpire to the President of the ACLI. Unfortunately the ACLI has recently come out with a letter that says that they don't want to be in the position of having to pick umpires. So now make it the President of the SOA if you wish. Or if that doesn't work, there is always the random draw case, which has been used, where the two arbitrators will each submit a list of names, strike them out until

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you have two, flip a coin and you pick the umpire. For fairly obvious reasons it's better if they agree.

The principles of arbitration are very simple, very straightforward and very key. The actual treaty wording is a starting point only. It is the intent of the parties, the usual business practices and those hallowed reinsurance words "the Gentlemen's Agreement" that rule the arbitration. This is not a question of rule of law, which is one of the reasons that one often has very messy arbitrations when lawyers are involved, because they are not used to participating in processes that aren't ruled by law. The arbitrators have a very wide latitude in both the content of the arbitration and the arbitration process. The time and place of the arbitration may be specified in the treaty; otherwise it is determined by the arbitrators. Obviously it needn't be at any particular location. Each side states its case in writing and sends that case to the other side and to the arbitrators. If time allows then each party can send a rebuttal of the other's case to the other party and to the arbitrators. The arbitrators can request specific material and perhaps specific witnesses. "Oh you don't want to pay this claim because you were never on the risk," "but yes we were on the risk." "We had a secretary who checked with the boss. Yes this is reinsured." "Can you produce this secretary?" This sort of thing. Again remember, it is not an advisory process in the way a courtroom is. What we are looking for is a resolution to a conflict that will be acceptable to both parties. The actual arbitration hearing is not a formal trial. The arbitrators set the tone and the format; the goal is to settle the dispute as expeditiously as possible.

Typically each side presents its case, with witnesses if warranted. The arbitrators can ask questions of the different sides. They can, unlike in some presidential debates, ask each party to respond directly to the other party, in terms of rebutting one statement or another. The key point for the arbitrators and for the parties involved is to be ready to move to a settlement at any time. I cannot stress this enough. An arbitration once started does not have to proceed to conclusion, if it looks as though a common ground can be reached between the parties. If at anytime the parties say that there may be something here and maybe we can settle it, do it. Get the arbitrators out of there; ideally they weren't supposed to be there to begin with. You needed them. If you don't need them any more, all the better. If necessary, there can be a second hearing, there can be more hearings. Again, that runs into time, that runs into money. The idea is to get to the decision as easily as possible. After all sides have presented their evidence and their witnesses, and the arbitrators have done all the questioning they care to do, the three arbitrators retire to a separate place and they decide.

Ideally the settlement should be negotiated and agreed to by all three arbitrators unanimously. If necessary, especially if there are some very cut-and-dried issues, it may be decided on a two-to-one vote. This of course emphasizes the importance of the impartiality of the umpire. It's ideal if all three are comparatively impartial. Clearly if one arbitrator is "in the pocket" of one of the parties and the second is in the pocket of the other, it is critical to have a umpire who is neutral. This is why the coin flip process of deciding an umpire has a very strong tendency not to lead toward better arbitrations. The arbitrators must reach a decision; that's what they are there for. If, for example, the two appointed arbitrators are at loggerheads, the umpire must come to a decision. That is the role of the panel and that is specifically the role of the umpire.

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If there is a financial settlement, it must be spelled out exactly: how many dollars from whom to whom and what is the timing of that settlement; when must the monies be paid. The arbitrators then return and write up the decision for the parties. They are not required, although obviously it is better if they do, to explain their decision. That remains within their discretion. Again depending on the specific situation, they have to judge what the needs of the parties are. After the arbitration breaks up, the appointed arbitrators can of course then explain the situation in greater detail to the specific parties in the arbitration if they so choose (if they have not already agreed otherwise). The umpire then formally writes up the decision: What was decided? How were the issues resolved? What are the payments, if any? What further action has each party been told to take by the arbitrators? This is sent to all parties in the arbitration and it then remains for them to act on.

MR. THOMAS L. CLAGG: This session is intended to focus on the arbitration process and it will. However, there are other methods of resolving disputes outside of formal litigation and aside from arbitration. During the 1980s the acronym ADR referring to Alternative Dispute Resolution has come into vogue. This concept has become increasingly popular and this interest has been spearheaded largely by the deficiencies existing in today's generally clogged and very expensive judicial system. I am speaking generally now in a business context not merely in a reinsurance context. ADR specialists come touting the many advantages of various forms of ADR, including arbitration to their clients. For a number of years, many large corporations have been experimenting with these techniques, mainly in large complex disputes, and some with very significant success. Thus far I am not aware of any life reinsurers seriously engaging in ADR methods other than arbitration. I'm not endorsing any other type of ADR for serious consideration on the part of the insurance industry, but I think we would be remiss were we not aware that there are at least a few other things going on out there. I know our company is constantly looking at and reviewing its own arbitration posture. I would like to comment very briefly on two other alternatives, although you should remember there are many other types of ADR techniques and they all have many shades of gray when it comes to putting them together. The key to all of these techniques is flexibility and the dislike for litigation and its weaknesses.

One form of ADR is known as a mini-trial. A mini-trial may take many forms; however, it requires a significant amount of cooperation between the parties in setting the rules for the proceedings. This can be said for any kind of ADR technique. Denis mentioned arbitration. The parties must get together and agree on some ground rules or you just never leave your office. Generally the parties agree that the case is complex and too costly to try in court. And usually a single judge selected by the parties will preside and ultimately render a decision if no settlement arises. This person is typically not an active judge. It may be a retired judge, it may be an attorney who specializes in this type of thing, or it may be a nonlawyer. He or she does not necessarily need to have a background in the industry in which the participants are engaged, but it truly helps. Ideally this person is experienced in the mini-trial concept. Again, the major hurdle is agreeing on the preliminary discovery procedures in moving forward. The big bonus is that the actual mini-trial will take place anywhere, anytime as agreed upon by the parties and not by the overcrowded docket of a court system. The benefit is that some formality of a trial can be preserved and, notwithstanding Denis' remarks earlier, there are some good things that can be found if you look real hard at the litigation process. However, much more control over this process may be exercised by the parties involved.

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A second form of ADR worth mentioning is one that, I believe, Denis did mention very briefly, and that is mediation. In this process the neutral third party or mediator makes it his business to help the two parties involved reach an accord. The mediator does not have to be an attorney and probably most of the time isn't. But he should have a working knowledge of the industry engaged in by the parties. He meets with the parties one at a time, jointly, one at a time again, whatever needs to be done. His major function is to keep the parties talking to one another and to offer constructive but neutral comment to both parties in hopes of driving them together. This is a relatively inexpensive tool that adds third party involvement to a dispute in a very nonthreatening and nonbinding manner. The process, however, may be abused by a party whose goal is nothing more than additional delay. Also the selection process can be a problem. To be effective, the mediator must be viewed by both parties as impartial. Once he loses that aura of impartiality his job is done. He won't proceed successfully any further. Given the role of the mediator, if the parties cannot agree on his identity, they are probably best advised to move on to arbitration or whatever alternative they have.

Arbitration historically has been and currently remains the ADR method of choice in the reinsurance industry. In truth, the reinsurance industry is something of a pioneer having used this form for many years. Lately, however, it has been subjected to increased scrutiny, with at least a few companies hinting that arbitration is on its way out. But, for all of its defects and detractors, it has survived for a long time and I suspect it will continue to do so.

You have heard Denis describe the arbitration process in some detail. I won't go over any of his remarks but I have been asked to address several questions relating to the legal aspects of arbitration. The first is do we have to arbitrate? I guess that in asking that question it depends on where you are coming from. The answer typically is, "no, you don't have to arbitrate." But once you do sign the treaty, agreeing to resolve your disputes by arbitration, you are contractually bound to engage in arbitration as the only means of resolving your disputes with the other party, unless (there is always this "unless"), both parties agree to some other method. You can always walk away from an arbitration provision, if the other party is willing, and engage in any other method of choice. The other most commonly asked questions are whether the arbitration is binding and whether it can be appealed. Usually that question is asked by one who has concluded an unsuccessful arbitration in their view. The quick and easy answer is that the arbitration finding is typically binding and there is no appeal to a higher or another forum. To do otherwise would operate in a method contrary to the previously described benefits of arbitration and contribute further to the cost and delay of a final decision which is, in the end, what we are looking for.

Having said all of this, I would like to introduce the Federal Arbitration Act into this discussion; this Act can have a very significant impact on the arbitration process, particularly if one party to the treaty attempts to abuse the process. For example, if there existed clear and compelling treaty language providing for arbitration, yet one party refuses to engage in the process at all, just ignores the other party, the Federal Arbitration Act empowers the U.S. District Court to compel arbitration. This requires one party to actually go into court and file a motion compelling or seeking the court to compel arbitration. This can be a very quick process. A reluctant party then is not likely to ignore the order of the U.S. District Court unless they're somehow immune from the reach of the court, which is not likely in our situation. I would point out that a dispute

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over the very existence of the treaty typically does not need to be arbitrated. In other words, if there is a dispute over whether the treaty was ever consummated, or if one party alleges that grounds exist for its rescission, an arbitration provision in the contract cannot and should not be controlling. If you were wondering what happens if two company-appointed arbitrators cannot agree on a third and an alternate method of selection was for some reason not provided or if an automatic arbitrator provided declines, well you may stop worrying as the Federal Arbitration Act has an answer for that situation too. It simply provides that the court will appoint the arbitrator. Of course, the court will utilize its own criteria in selecting that arbitrator. The best that can be said for that process is that the arbitration will not fail for a lack of an arbitrator, but I suspect it will be less than what we would all hope. One thing that is not commonly understood is that the Federal Arbitration Act empowers arbitrators to compel the attendance of persons at the arbitration as witnesses and require them to bring designated documents with them in the same manner as the U.S. District Court. I hope you all are aware of that. Seeing some of you in this room who have acted as arbitrators, I know some of you have exercised that power. However, this does not extend to pre-arbitration depositions but only to the arbitration itself. So you still have to have that measure of cooperation between the parties in what lawyers call the discovery process before your arbitration begins so that you can be prepared when the big day comes. In connection with this power to compel attendance, the reach of the U.S. District Court which will be enjoyed by the arbitrators as well is (1) within the federal district, (2) within a 100-mile radius or (3) perhaps within an entire state in which that district court sits.

What about the so-called improper arbitration award? "It was wrong." "It was simply wrong." "It cannot be." "It was a miscarriage of justice, even if it was done in our arbitration setting." What about that? Well it depends on what you mean by improper. If you as a party simply don't like the award, it really doesn't matter. The arbitrators are generally given fairly broad authority by the treaty in reaching their decision and they will be given considerable leeway in exercising that authority by the courts, if the courts are asked to pass judgment. The Federal Arbitration Act, however, does provide for vacating the arbitration award if the award was procured by corruption, fraud or something called "undue means." It all sounds very sinister.

Another provision of the Federal Arbitration Act, however, is a little bit more troublesome to some of us in this room. That provision calls for vacating an arbitration award, "Where there was evident partiality on the part of one or more of the arbitrators." Many of us, I'm sure, have seen cases where the allegiance of an arbitrator was quite obvious. Denis eluded to that as one of the generally accepted approaches and one approach that a number of companies subscribe to. How this section of the Federal Arbitration Act would impact on that situation is unclear. First of all, it is easily demonstrated that this is a generally accepted viewpoint of at least a significant part of the industry. I do think, however, that it flies directly in the face of the language of the Federal Arbitration Act and, as much as I tried, I could not find a single instance where a court had been asked to pass judgment on that. But I think anybody who is being asked to be an arbitrator ought to be aware of that.

Less controversial is a provision in the Federal Arbitration Act which allows for modification of the arbitration award, if the arbitrators make a mathematical error or incorrectly describe anything referred to in the award.

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One last feature of the Federal Arbitration Act which should be noted is a requirement that the treaty itself must reflect the desire of the parties to have any arbitration award reduced to a judgment. In other words, if you want the court to enforce the decision of the arbitrators, you must include a provision in your treaty allowing the court to enter a judgment on the award. Having done this the judgment may be enforced as though the court itself reached the decision. This allows the prevailing party to immediately execute on the judgment to get its dollars, otherwise it can be an even more extended process in getting the other side, the nonprevailing side, to perform.

There are a couple of other things and then I'll finish up. Denis mentioned the attributes of arbitration. I think his first one was getting rid of the lawyers. I agree, I think that is just fine. There are a couple of other things that I would like to mention as advantages to arbitration and then I would like to just throw in a couple of what I think might be advantages of litigation. Arbitration is usually more private and you don't do it in a courtroom with the press and other outsiders.

Arbitration better uses the experience and knowledge of the trier-of-fact. I mean compare an arbitrator in one of our arbitrations with whoever you happen to have selected in a courtroom as the judge. There is just no way that that judge is ever going to be able, in at least 99% of the time, to touch the experience of an arbitrator. You are less likely to get an excessive award. I think you all know what I mean by that; the extra-contractual damages, the runaway jury problem.

Now, on the other hand, litigation has a couple of things going for it, and one is that, whatever problems you may have in selecting the arbitrators, litigation gets you there quicker because you are simply assigned a judge. There is the use of precedence in litigation. In other words, you don't continually reinvent the wheel. If there are arbitrations going on in this country which involve the same issue you are involved with, you can't use them very effectively in an arbitration process, for the most part because of the privacy, but secondly the arbitrators are given a wide latitude in exercising their own judgment. What if you need a third party? Once in a while somebody thinks they need a third party involved in their dispute. The litigation system provides for easy third-party pleading. Not so in arbitration. There is a very formal discovery process, a negative factor on Denis' list. The discovery process, however, is much more likely to get everything that you will need to try your issue if you feel you need it. Part of this is accomplished through a very formal set of rules of evidence, another negative on Denis' list. Sometimes it depends on who you are talking to and how you view arbitration, so far as what is an advantage and a disadvantage of one process compared to another process.

MR. HERMAN H. SCHMIT: Denis and Tom have fairly well covered the procedural and the legal aspects of arbitration. I am not going to add to that but I do want to discuss one of the particular clauses in a reinsurance treaty that seems to be at the heart of many arbitrations.

Let me read to you a typical E&O clause that I pulled out of one of our treaties.

In the administration of reinsurance, ceded under this agreement, if either the company or the reinsurer fails to comply with any of the terms of this agreement, and if this is shown to be unintentional, and the result of a misunderstanding, oversight or clerical error, on the

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part of either the Company or the Reinsurer, then this agreement shall not be deemed, abdicated thereby but both companies shall be restored to the position they would have occupied had not such oversight, misunderstanding or clerical error occurred.

The origin of this clause goes back to the early Property and Casualty (P&C) treaties and I am talking about what those in the life business call automatic treaties (that's the only kind of treaties they know). It was the custom for the P&C industry to provide fairly elaborate bordereaux showing the risks reinsured and, in order to make sure that any particular risk inadvertently omitted from these bordereaux would still be reinsured, put an E&O clause in their treaty. On the face of it, the clause seems perhaps fairly innocuous so, you say, "how can there be so many problems in arbitration that deal with this question?" I will just throw a few samples out to you and you can make up your own mind, either as a cedent or a reinsurer, as to how these cases would be resolved.

First case, a very simple case, an automatic session, let's say is issued on July 1, 1988, the insured dies within two months of issue (September 1, 1988). At the time the cedent is preparing the papers to get a reinsurance recovery on this claim, he discovers that no premium payment has been made to the reinsurer and no notification has been made to the reinsurer that this risk is even reinsured. It turns out that there is perhaps a three-month backlog in its administrative department. Do we have an E&O situation here? In theory, you could argue that if you had a systematic backlog, there is some knowledge on the cedent's part and that perhaps this is not an isolated inadvertent omission. This is a systematic problem in the cedent's administration. In practice, however, that claim gets paid, the cedent expects to get paid and I think the reinsurer will pay that claim. That's a fairly simple example.

Let's take an example that gets a little trickier. Let's make it a facultative case issued ten years ago where a facultative submission was made to the reinsurer, the reinsurer made an offer and the underwriter's instructions to his clerk were not heeded. He told the clerk to place this case and it just never gets done. Despite efforts by the reinsurer to determine what the situation was, the reinsurer finally closes his file and nothing gets done. During this entire ten-year period the cedent doesn't do an audit to determine whether appropriate reinsurance is in place on its business. The insured dies after 10 years. Going back to the files the cedent realizes that this case should have been reinsured. Is this a case of the E&O clause? There are two questions that need to be answered. First, does a case first have to be reinsured before it's entitled to E&O protection? In other words, does E&O cover an error in the actual placement and purchase of reinsurance? Second, even if you accept the fact that this kind of an error, i.e., failure on the part of the clerk to actually formalize the reinsurance, is one of the errors covered by the E&O clause, does failure to detect this error over a 10-year period somehow void or diminish the reinsurer's liability? This perhaps is the kind of situation where arbitrators get their reputation for splitting the baby in half. When there are mitigating circumstances, sometimes the arbitrators will not vote fully one way or the other but come up with a compromise solution to the problem.

The important distinction in E&O matters is that the errors that are supposed to be covered by an E&O provision are limited to the errors made in administration of reinsurance. They are not the kind of errors that we make in the regular conduct of our business. Let me give you one example, this is not a typical one, but I think there are a few cases pending with situations very similar to

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this. A policy is issued, let's say, July 1, 1985, and lapses two years later on July 1, 1987. The policy lapses without any value and the reinsurance was appropriately placed in 1985 and appropriately cancelled in 1987. However, in the policyholder service administration, also a service department, a clerk misreads the duration and determines that there is extended term insurance and so informs the insured, in writing. The insured dies during this fictitious extended term period. Do we have reinsurance liability on this case? Is this an error in the administration of reinsurance or is this, as I maintain it is, an error in the conduct of our business, not covered by the E&O clause? I don't think it's unfair that we seek to limit the application of the E&O clause in reinsurance treaties because most of the business that we conduct we do so without an E&O safety net. If the clerk in your company who is in charge of purchasing fire insurance on your building lapses the fire insurance and the building burns down, there will be no Nationwide on your side, the building is down, there is no E&O protection. Similarly the limitation on the E&O provision cuts both ways. A reinsurer can make a clerical mistake, let's say an underwriter wants to decline a risk but the clerk mixes up the messages, and communicates an acceptance on that risk. The cedent depends on this message, issues the case and expects to have reinsurance. The reinsurer is not off the risk simply because he made an error. The point I am trying to make is that there are errors that are covered by the E&O clause and there are errors that are definitely not covered by the E&O clause. There are very strong, very different perceptions by cedents and reinsurers as to what kind of errors are and are not covered and until we get this one matter clarified, I think we are going to see more and more arbitrations with the arbitrators having to draw the line as to whether that particular error is covered.

MR. YOUNG: We are going to go right into the arbitration, as I mentioned. Our plan is for Herman to represent the ceding company, Tom's going to represent the reinsurer and the other three of us are going to be the panel of arbitrators. We would welcome questions from you to the arbitrators once they finish their participation. We obviously will also ask questions.

MR. SCHMIT: Let me put on my ceding company hat here. Members of the arbitration panel, my name is Donald Doe. I am here to plead the cause for the Excellent Life Insurance Company, more affectionately known as X Life in this proceeding. My title with X Life is Vice President of Policyholder Service, Vice President of Claims, Vice President of Underwriting and in addition, I have responsibilities for Office Supplies and Reinsurance Ceded. I am telling you all this so it's perfectly clear that this arbitration sets poor little old X Life against bad Y Reinsurance. I want to thank the arbitrators for agreeing to serve as arbitrators in this hearing, because we are great believers in arbitration. We think that your decision is likely to be quicker, less expensive and probably more in line with the treaty intent and general equity than we might expect from litigation. In our company, litigation is such a dirty word, that the president of my company is fond of quoting the devil's dictionary, in which he quotes Ambrose Bearse as defining a lawsuit as a machine that a man enters as a pig and comes out as a sausage. So perhaps it's not so much our affection for arbitration as our reluctance to litigate that we're happy we are here.

Your assignment will really not be much in the way of fact finding, rather we are asking you to make a judgment. And in order to help you in your assignment, I'd like to just tell you a couple of things about X Life and its relationship with Y Reinsurance. Until about seven or eight years ago, X Life was a very sleepy little company, we didn't do much business and weren't much of a

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reinsurance client. We always reinsure with Y Reinsurance, and they dutifully call on us once or twice a year and the reinsurance representative would take me out to lunch.

But about seven years ago we hired a new agency man and things haven't been the same since. We got into the new products, the term, we were one of the first companies to be out with reentry term. We were one of the first companies out with smoker/nonsmoker rates. Then, of course, with all of the exchanges in products, our business soared and we became a bigger client of Y Reinsurance. Instead of being taken out to lunch, now my wife and I would be taken out to football games and dinners. I realized we were a bigger client than we used to be.

You know the facts of the case; they are fairly simple. We issued a nonsmoker policy on a Ralph Roe. A young, healthy individual, except for the fact that he smoked, he killed himself in a motorcycle accident. It was then that we learned, from the hospital reports, during our claims investigation, that he had been a smoker. When this fact came to light we informed the attorney of the beneficiary that there was a question about whether the proceeds would be paid and we contacted our counsel to decide what to do.

We are a small company, we don't have in-house counsel, we have out-house counsel. Our counsel came back with a three-problem message. First of all, there had been some success in denying a case where the insured claimed to be a nonsmoker and actually was proven to be a smoker. Secondly, he gave us less than a 25% chance of succeeding in court to win a complete rescission of the policy. Thirdly, he said that from his discussions with the lawyer for the other side, he was convinced that a face amount adjustment would probably be acceptable to them.

Well, the President of our Company heard this and, I told you he doesn't like lawsuits anyway. He thinks a bad settlement is better than a good lawsuit. So, he was very attracted to the face amount adjustment. Before we decided to do that, we read our treaty. What kind of rights do we have? Are we allowed to make these decisions? So we turned to our treaty and looked at the settlement of claims section. I'll just read the first sentence, the rest of it is unimportant. It says, "Y Reinsurance shall accept the good faith decision of the reinsured in settling any claim or suit and shall pay at his home office each share of the net reinsurance liability . . ." and so on. Further down in the settlement of claims section, there is a clause that says that, "if the reinsured should contest or compromise any claim or proceeds and the amount of net liability is thereby reduced, these reinsurance liabilities shall be reduced in the proportion, etc."

Having seen these clauses we realized that we were entitled to make these decisions, and we made that decision, and Ladies and Gentlemen we would do it again tomorrow. We believe we acted in good faith; whether it's the right decision or not to have settled the way we did is secondary to the question. We acted in good faith, we acted within our treaty rights, and we frankly see this whole case as just another form of misrepresentation, where the reinsured can choose to resist a claim or to pay it and the reinsurer must follow.

Having said this, all I can say is that I respectfully submit to this panel that Y Reinsurance should pay X Life its share of the compromise proceeds. The policy was a \$2,000,000 policy which was settled for \$1,200,000, 90% of it had been

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reinsured with Y Reinsurance, so Y Reinsurance's liability on the compromise is \$1,080,000 and we respectfully ask this panel to award X Life \$1,080,000.

MR. CLAGG: Gentlemen of the panel, I am Vice President in charge of Life Underwriting for Y Reinsurance Company. As Mr. Doe has already told you, the Y Reinsurance Company has been in the business for many years and has reinsured the X Insurance Company for many years. We've enjoyed a long and mutually beneficial business relationship with X Insurance Company.

As a result Y Reinsurance Company does not lightly adopt its current position in connection with the Roe death claim. Only after carefully considering all of the ramifications of our position did we decide that we had to reject this claim for reinsurance benefits, which claim as Mr. Doe has stated is in the amount \$1,080,000. We attempted to analyze the circumstances of the claim from every viewpoint and came to the same conclusion each time. There was simply no justifiable reason to pay the underlying claim and likewise no justifiable reason to pay a reinsurance claim.

X and Y agree on many things relating to this case. First we agree that the applicant, Roe, flat out, misrepresented his smoking habits on his application. The evidence supporting this is irrefutable and, as Mr. Doe has indicated, they're not contesting this with us. Secondly, both parties agree that had the true smoking history been known at the time of underwriting, Mr. Roe would not have been issued a policy for \$2,000,000 at the time, or for the premium actually paid. Finally, both X and Y agree that as a result it would be inappropriate to pay the \$2,000,000 face amount to the beneficiary.

The next step is, of course, where his company and our company have found themselves disagreeing. X has determined that with the smoking history and premium actually tendered, it would have issued \$1,200,000 on Ralph Roe. Despite their knowledge of our feeling that X had no liability to pay any benefit whatsoever, X proceeded to negotiate a settlement with the beneficiary in the amount of \$1,200,000 and now seeks to have us fund 90% of that settlement. It is interesting to note that while settling with the beneficiary on the basis that it would have issued Mr. Roe a \$1,200,000 policy, X does not also seek to settle on that basis with this reinsurer. If, indeed, X would have issued Mr. Roe a policy in the face amount of \$1,200,000, X would have retained \$200,000 of that risk while ceding \$1,000,000 of the risk to Y.

That point is academic, however, as we are firmly of the opinion that we have no reinsurance obligation to X Insurance Company as it relates to the Ralph Roe claim. There are indeed several provisions of the treaty between our companies which are relevant to this dispute. First, we read on the first page of the treaty, "the liability of Y shall begin simultaneously with that of the reinsured X." Of course, X is not and was not legally liable for any policy benefits. It is our contention that, under the Roe policy, since X never incurred any liability, the liability of Y has not commenced to this day. A ceding company may of course make a gratuitous benefit payment based on business or any other considerations. However, in doing so, it should not assume that the reinsurer will participate in that payment.

On page 7, under the heading of Statement of Claims, Mr. Doe has already quoted that, "X accepts the good faith decision of the reinsured in settling any claim or suit and shall pay its share of net reinsurance liability upon receiving

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proper evidence." The key words here are "good faith decision" and "reinsurance liability." We feel that X did not exercise the requisite good faith in deciding to settle this claim for \$1,200,000. And as stated previously, we do not feel any reinsurance liability exists because no direct liability exists on the part of X. The same good faith standard is once again repeated and restated in the arbitration provision of the treaty and refers to generally all things involved in the reinsurance relationship between the parties. Just how does this treaty provision impact on the Ralph Roe case? Consider the question of X's liability under its insurance contract. Why would X feel the need to pay Roe's beneficiaries anything? Presumably, X would not feel that need unless, (1) it thought that it was either clearly liable, in which case it would have paid the face amount, or (2) that the liability was doubtful, in which case it would possibly have to negotiate a claim or a compromise of the claim. Since X paid something between zero and the full face amount, it would appear that X felt there existed some significant uncertainty as to that liability. On the other hand, Y feels that while legal liability may never be 100% clear, in this case it was sufficiently clear that no liability existed on the part of X, such that X could have easily defended this claim denial. The material misrepresentation existed and is not seriously in dispute. The basis for a rescission of the Roe policy clearly existed. Presumably, X would not hesitate to rescind the policy on the basis of material misrepresentation of past medical treatment, absent other mitigating factors not present in this case. Then why hesitate where the applicant grossly misrepresents his smoking habits? We have been told that, had the precise history been known originally X would nevertheless, have issued insurance albeit at higher rates. And even after death X could precisely compute the reduced amount of what the reinsurance would have been. Furthermore, it has been forwarded in this situation that there is a loose analogy to be drawn between the age adjustment, into here and this kind of adjustment, the kind of adjustment that X Insurance Company entered.

Any analysis of these arguments takes one to the conclusion that it is simply not relevant that one party to a contract could reconstruct what it would have done had the other party not deceived it when initially negotiating that contract. There, simply, in this case, was no meeting of the minds between Mr. Roe and the X Insurance Company. Why an insurer would seek to offer such generosity to the beneficiaries of the deceptive applicant is an interesting but academic question at this point. A two-pack-a-day smoking habit is something I believe that everyone would admit that the smoker would always be aware of. Finally, from an industry perspective, why would we want to encourage continued, intentional misrepresentation of smoking habits, by putting the deceptive applicant in a no-lose position? That is, if he is not caught he gets an undeserved premium decrease. If he is caught he is penalized only by being limited to the amount of insurance he actually paid for. It simply makes no sense. Obviously, no one would expect every such applicant to get caught. Thus the nonsmokers end up subsidizing the smokers once again. All of us can sympathize with an insurer in its attempts to balance the interests of a persistent beneficiary and anxious agent, as well as the insurance company itself in its inherent dislike for and perhaps lack of understanding of the litigation process, and of course its reinsurer. These are not always easy balancing acts. We understand that. That is one of the reasons we gave this particular case so much deserved analysis. Some of those interests may have been accorded a particular importance by X in the nonreinsured \$50,000 claim, which X previously compromised. Although it is noteworthy that in their \$50,000 claim there was no reinsurer input.

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In any event, the courts have clearly spoken this year, to the precise question involved here, and have given clear direction to any insurance company unsure of its liability in a fact situation similar to the one in the Roe case. I am going to quote from one case to you, because I think it needs to be referred to. I think it is very important as I will explain just a little bit later. In the case of *Mutual Benefit vs. JMR Electronics Corporation*, Mutual Benefit sought to rescind two \$250,000 key man insurance policies issued to JMR. The insured, who it was eventually learned, had a half-a-pack-a-day smoking habit, denied any cigarette use for at least 10 years. JMR sought as an appropriate remedy the amount that the premium actually paid would have purchased for a smoker. Not unlike our situation at all. The U.S. Court of Appeals rejected the beneficiary's argument and used this language, and this will be my only quote from this case, "If a fact is material to the risk, the insurer may avoid liability under a policy if that fact was misrepresented in an application for that policy whether or not the parties might have agreed to some other contractual arrangement had the critical fact been disclosed . . . A contrary result would reward the practice of misrepresenting facts critical to the underwriter's task because the unscrupulous . . . applicant "would have everything to gain and nothing to lose' from making material misrepresentations in his application."

Now with that language, all I can say is that we are sorry that the outside law firm used by the X Insurance Company felt and apparently advised that there was a 25% chance of prevailing in this case. We feel, obviously, that that chance was a whole lot higher. It is true that in exercising your powers as arbitrators you are not bound by strict rule of law, that is set forth in the treaty provision, in determining the rights and responsibilities of the parties to this treaty. However, this dispute does involve, to a large extent, an analysis of the legal liabilities of a reinsured or ceding company to its insureds or beneficiaries. In this context, I draw your attention the Mutual Benefit decision for the purpose of providing you with some guidance in ascertaining just what X's liability actually was to Roe's beneficiary. I believe that after careful thought you will agree that X had no such liability and thus no foundation exists on which to assert a reinsurance claim against Y. Without such foundation, a claim for reinsurance benefits is simply not a good faith claim.

MR. YOUNG: I've got several questions, but I'll start off with one. We are dealing with Excellent Life and Y Reinsurance. The question is, would you have accepted this risk at smoker rates if you were aware, at issue, that the person was a smoker? The second part of that, would you have done any additional underwriting or asked for additional requirements which were not asked for if you had known about Mr. Roe's smoking habit?

MR. SCHMIT: I think the answer is that yes we would have issued a smoker policy on Mr. Roe had we known that he was a smoker and either charged him more premium for the \$2,000,000 that he applied for or knocked the amount of the face amount down to \$1,200,000 which is what the premium he wanted to pay would have purchased. I'm not a great underwriter, because I have all these other jobs in the company as well, but I don't think we would have done other underwriting on the insured.

MR. CLAGG: Yes. I said earlier that we, in fact, would have reinsured some, I can't tell you what the amount would have been exactly, but there would have been reinsurance, but on different rates, on a totally different basis. I don't really think the question is relevant to the ultimate liability of X to its insurer. But, the answer to your question is yes.

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MR. LORING: Mr. Doe, in the material that you sent us before the actual arbitration hearing, you mentioned that this claim happened to be submitted by your agent, who was, coincidentally, your number one agent for the last three years. Perhaps there may have been some pressure, I understand it was even submitted directly to the President of the Company. Suppose this case had not been reinsured at all. Suppose you had been on the hook for the complete \$2,000,000. Now, when you settled the previous case, last year, where you paid 30 out of 50, that was before the Mutual Benefit precedent. But now, having that case in hand, if you were on the hook for the \$2,000,000, would you have still simply compromised for \$1,200,000 or would you have tried to rescind based on the Mutual Benefit precedent?

MR. SCHMIT: Well I'm not sure that Mutual Benefit is such a great precedent. In the Mutual Benefit case, the misrepresentation of the smoking was stipulated in the case. In other words, the other side agreed that smoking had been misrepresented in the application, and the only argument by JMR was that it was immaterial and there the judge definitely ruled it a material misrepresentation. If we knew that we could be 100% sure that we could have proved misrepresentation in court, yes we probably would have fought this case. But to think that just because one case was won the litigations of all misrepresentation cases are going to be won is terribly naive.

I can very easily see how it might be very difficult to prove misrepresentation on this case. I may know that Mr. Roe was a smoker and Y Reinsurance may know that Mr. Roe was a smoker, but to prove it in a court of law is something else. Here's a man who in his application only said that he hadn't smoked in the twelve months prior to application. He enters the hospital in a coma. The information given to the hospital admissions people is from his wife, who, probably under some stress, informs the hospital admissions people that yes, her husband has been a heavy smoker for 15 years. But I think once put on the stand it could well be that this woman might agree that he's quit at various times, but he's always gone back to smoking. Did he ever quit for two months, three months, six months? So, for the whole question of misrepresentation, you've got to prove that the insured didn't smoke for the 12 months prior to application. That's not easy to do and that's what prompted us to think that it might be a 25% shot. But to answer your question, yes, if it was \$2,000,000 of our money, I think we would have settled for \$1,200,000 because we are looking at it as a \$800,000 saving rather than \$1,200,000 gratuitous payment.

MR. JAMES R. HOREIN: My question would take you back to the events that took place between the date the claim was filed. You were aware that there was a claim on the part of Excellent Life. The facts that you presented to us suggest that you filed the information of the claim with Y Reinsurance, received a response from them and then based on the belief that they would follow you moved into the compromise with the beneficiary. I'd like to ask this question of each of you individually: on what facts was that belief based? You represented that a very warm relationship between the two companies would be one fact that would cause you to believe Y Reinsurance would go along. What other facts do you have that would suggest why Y Reinsurance would indeed go along with your compromise settlement? First, for Excellent Life then I would like to ask a variation of the same question to Y Reinsurance.

MR. SCHMIT: We didn't make the settlement with Mr. Roe's beneficiary because we thought Y Reinsurance was going to go along. They'd indicated they would not. But we felt we had no option. We had a treaty that gave us the right to

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settle claims and we knew or strongly suspected that when we settled the claim that we would end up here. We simply saw no way out. This claim was pending for awhile. It had to be settled or litigation begun and we were opposed to litigation. We believe that the treaty clearly says that the reinsurer has to follow the cedent. It doesn't say that the decision to fight a case lies with the party that has the greatest financial interest in it. If that's what we wanted it to say, we would write our treaties to say that. But it simply says that the reinsurer will follow the cedent. Now the treaty in other places talks about the cedent being required to consult, now we can agree to consult as we did with Y Reinsurance, but we cannot agree to agree. So we knew that they were probably not going to honor this thing and that we would end up in arbitration on it.

MR. HOREIN: Same basic question to the reinsurer. Do you have any facts in your long warm relationship with Excellent Life that would suggest that they would have taken this action, following the response that you gave them? You presented no references to the fact that you reviewed their contract and their application and to the terms and conditions there. Did you have any facts or any evidence that would suggest they would have gone ahead, based upon the response you gave them?

MR. CLAGG: No. As it has been discussed, we have that long relationship with X, we have advised in many claim payments over the years. What we attempted to do is, simply, give advice to X in a situation like this. Over the years that advice has been generally followed. Here we got no indication at all that this was anything but a claim that had available a very good defense posture for X, and they were bound and determined to pay this claim. And so when Mr. Doe suggests that the treaty requires us to follow their fortunes he's ignoring two words in there that require the Y to follow the good faith decisions of X in paying claims. Again we don't think it's a good faith insurance claim where they pay such a claim that has a strong defense available. They choose, for reasons known only to them, not to follow, but to pay the claim.

MR. JAMES M. GLICKMAN: One of the issues that wasn't dealt with by either side and, to me, would be a very important one and is ever more present in reinsurance contracts, is the consideration of whether the reinsurer is obligated to share in extracontractual damages? It would seem to me that if the direct insurer [X] feels that it is at major risk for extracontractual damages if it denies the claim and would not have reinsurer [Y] participation, then it would in fact be at major financial risk not to settle. However, as the facts are presented it seems that the direct insurer has no financial risk if in fact the reinsurer would assume it's extracontractual requirements if the direct insurer had chosen to contest. In the way the facts were presented, that would, in my mind, change the way the decision would go. I would like to hear some comments by the arbitrators in particular as to whether their decision would be different based on the element of the direct insurer's financial risk.

MR. SCHMIT: Our treaty with Y Reinsurance did exclude punitive or extracontractual damages as amounts recoverable by X Life from Y Reinsurance. I don't think it played a foremost role in our decision to pay this claim, but I do think it strengthens the theory that it is the cedent who makes the final decision in whether to contest the claim and that decision the reinsurer must follow. And it's with that arrangement that the exclusion of punitive or extracontractual damages makes any sense at all. Conceivably if we had chosen to do so, we could have gone to Y Reinsurance and told them that we would reluctantly fight

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this claim, but provided only that they would waive their extracontractual damage exclusion.

MR. CLAGG: Well as Mr. Doe says, there was no punitive damage issue in this particular case, in part because of the recognition on both of our parts that there was a significant basis on which to, at the very least, settle for less than the full face amount. And that in turn was more than likely based on the fact that you are talking about a \$1,000,000 case. Punitive damages typically are not found in seven figure life insurance cases, but otherwise, that is a problem we recognize. That is always a problem for the ceding company in a situation like this. But I don't think there is any difference between this kind of case and every other kind of case that must be handled on a day-to-day basis. That could be a factor in their thinking. Obviously, in our thinking, as a reinsurer, it didn't enter into it because it wasn't an issue in this case.

MR. A. GREIG WOODRING: Quick question for Y. How does your position change or how is it affected if the agent knew, or you suspect he should have known, that the person was a smoker?

MR. CLAGG: That makes all the difference in the world because we feel that this turns on the basic case. That is the case running between X and Roe's beneficiary. It's the intervening agent problem; and that makes that case a whole lot different. You have to realistically look at the case that they are going to have once they get in court. If they are not going to be able to use that misrepresentation because of any one of a number of factors, of course, that is going to be a factor in our decision. It was intentionally not introduced into this fact situation.

MR. ROBERT A. JOSEPHS*: Question for Mr. Doe. Would your decision on this particular case, as far as total denial, be different if the insured had died of coronary artery disease or cancer in light of the cigarette smoking, rather than the automobile accident?

MR. SCHMIT: Yes, it probably would have affected our lawyer's determination of our chances of success in the case. I think if he said we had a 75% chance of winning the case, then we might have gone along with it. But if it's our judgment that this is a tough case to win, we would go for this face amount adjustment.

MR. YOUNG: None of the opening speakers made reference to the following point. When the disputants are asking a panel to make a decision it is my understanding that they can agree that we will go to a panel and ask for, I am going to call it an "all or nothing decision," or we can go to a panel and simply say, you decide what the settlement is. So within the confines of this case, I'd like to ask you to define the latitude of our actions should the panel decide that the reinsurer pay to the X Company either \$1,080,000 or \$0, or are you giving us full authority to decide on any number we want to decide on?

MR. SCHMIT: I think you have that authority, whether we give it to you or not. It's your decision to come up with a resolution to this matter and that can range anywhere from \$0 to \$1,080,000; I guess those are the outside bounds.

* Mr. Josephs, not a member of the Society, is Northern Regional Manager at CNA Insurance Companies in Chicago, Illinois.

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MR. YOUNG: That leads us into what we are going to do. I'll tell you what we've decided that the ground rules should be. Next, we are going to ask you to vote. Then the three of us are going into forum and discuss the case in front of you for a couple of minutes. We will then come up with our vote and let you know what that is.

We've cut the categories down into four and I'd like to ask you to perhaps stand up so we can count heads. We would also like to ask you to stand up in two different groups: those of you who consider your viewpoint from that of a reinsurer as opposed to that of a primary company. I tend to think we might have more reinsurers here. The way we look at it, there are four options. One option is for the reinsurer to pay in full which is the \$1,080,000 that the insurer expects for the 90% of the \$1,200,000. Option two would be a \$1,000,000 settlement taking into account that if there was a \$1,200,000 issue the \$200,000 would have been paid by the ceding company. Option three would be no payment at all. Option four would be an undefined payment somewhere in between the no payment and the \$1,000,000, perhaps a 50/50 split or something along those lines. If I could get a quick vote and then we will go through our piece.

Results of the Vote:

| | OPTION | | | |
|------------|--------|--------|----------|----|
| RESPONDENT | 1 | 2 | 3 | 4 |
| VIEWPOINT | ALL | 1 MILL | 50/50(?) | 0 |
| REINSURER | 1 | 28 | 8 | 11 |
| PRIMARY | 1 | 10 | 4 | 2 |

Interesting. Now we will do our thing. What do you think?

MR. LORING: You sort of wish it were different but as far as I can see, the reinsurer has to pay \$1,000,000. You can't pay the \$1,080,000 because that means that the reinsurer has suffered through misrepresentation. If they actually ask for \$1,200,000 the ceding company pays \$200,000 and the reinsurer pays \$1,000,000. Perhaps he didn't act as expeditiously as he could. I'm sure he was influenced by the fact that it was his top agent. But I really think "follow the fortunes" has to predominate here and I don't see enough of a real breach of good faith to want to break into that. So I think the reinsurer's got to follow and pay the \$1,000,000 and the ceding company pay the \$200,000.

MR. HOREIN: Option A is \$1,080,000 and option B is \$0 and we really don't want you to come out any place in between. That's an option the two disputants have and it would have been a lot easier for us if you had said that. The second question I have before I give my response is an explanation of how I get my expenses covered for coming as a panel member. And I believe that is a point that maybe should have been mentioned up front. When you ask panel members to participate, you want to make that as neutral as possible, so ideally the award the disputants ask the panel to deal with should pay all the out-of-pocket expenses of the panel members so that becomes a nonissue. So having neither of those to influence me, I came down on the side of saying I believe the act of saying, "well I assume they will go with me and I am going to pay it anyway" is not a good faith act and I'd give them \$0.

MR. YOUNG: One thought I had was I do see some argument for the option which would go for the \$1,080,000 settlement. On the other side, I think that

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generally an underwriter would consider somebody's smoking habits to be something that would be important to the underwriting process. Therefore, it would be important to know that one might take other things into account. If somebody had a medical condition, even though it wasn't relevant to this claim, overweight, for example, or high blood pressure, combined with smoking habit, an underwriter might have rated the case rather than issue it as a standard smoker. So, for that reason alone, it seems to me like a fair settlement would lean toward the reinsurer's point of view, i.e., something less than the \$1,080,000. My inclination would be, if I knew more about the facts of the case, to go along with Jim's decision to pay nothing; I certainly wouldn't give more than what Denis gave; my inclination might be to go for something in between.

MR. LORING: Now you get to see the real arbitration in process. "All right, I want to go a million, he wants to go zero, what do you think is right?" "What do you want to do?" You laugh, this is what actually happens in arbitrations.

MR. HOREIN: It took him 10 minutes to say he doesn't know what he wants to give them. How much should we give them?

MR. LORING: Zero? Well, I still think a million is right, but obviously Mel thinks something in the middle, so what do you think a fair or reasonable compromise would be?

MR. YOUNG: I'd go for the 50/50 of the \$1,200,000.

MR. LORING: Okay. The result of the arbitration would be a split of the claim, \$600,000 from the reinsurer, \$600,000 from the cedent company.

MR. YOUNG: That would be our viewpoint. I would eventually guess that we perhaps could take averages of the audience's vote and we might come out to something a little bit higher than the \$600,000 reinsurance award, but the \$600,000 from your viewpoint might not have been too much farther from the average. So I think we didn't come that far off from each other.