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TRAVELERS V. GERLING: A NON-PRODUCTS ASBESTOS ALLOCATION PUZZLE

BY: WILLIAM M. SNEED

In recent years, major asbestos defendants such as Armstrong World Industries, Babcock & Wilcox, and Owens-Corning have pursued insurance coverage for "non-products" asbestos losses. See, e.g., "Panel to Rehear Arguments on Armstrong's Non-Products Claims Coverage," *Mealey's Litigation Reports: Reinsurance*, Vol. 14, No. 13 (Nov. 3, 2003); "Insurer Not Released from Non-Products Claims Coverage, Louisiana Judge Rules," *Mealey's Litigation Reports: Reinsurance*, Vol. 14, No. 9 (Sept. 4, 2003). The liabilities in these cases can be enormous. And as such losses have been paid by insurers, reinsurance disputes have followed. See, e.g., *North River Ins. Co. v. ACE American Reinsurance Co.*, No. 00 Civ. 7993 (JSR), 2002 U.S. Dist. LEXIS 5536 (S.D.N.Y. Mar. 29, 2002).

The most recent judicial treatment of non-products asbestos losses and reinsurance is the decision in *Travelers Cas. & Sur. Co. v. Gerling Global Reinsurance Corp.*, 285 F.Supp.2d 200 (D. Conn. 2003) ("*Travelers v. Gerling*"), which addresses whether a reinsurer is bound by its cedent's allocation of a non-products asbestos settlement payment. This article discusses the *Travelers v. Gerling* decision, examines the court's rationale, and highlights the significance of the decision. Before turning to the decision itself, a brief overview of non-products asbestos theory is helpful.

Non-Products Asbestos Coverage

General liability policies typically set forth limits of liability on a "per occurrence" basis and also on an "aggregate" basis. The "per occurrence" limit is the maximum amount the insurer will pay for each "occurrence" under the policy. The "aggregate" limit is the maximum amount the insurer will pay, regardless of the number of occurrences. In past decades, the "aggregate" limit in a liability policy generally applied only to losses arising from particular hazards, such as the "products" or "completed operations" hazards. These terms are defined in the liability policy, and sample definitions follow:

Products Hazard

"Products Hazard" includes personal injury and property damage arising out of the Named Insured's Products¹ or reliance upon a representation or warranty made at any time with respect thereto, but only if the personal injury or property damage occurs away from premises owned by or rented to the Named Insured and after physical possession of such products has been relinquished to others.

¹ "Named Insured's Products" is another defined term and usually means goods or products manufactured, sold, handled or distributed by the named insured.

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Completed Operations Hazard

"Completed Operations Hazard" includes personal injury and property damage arising out of operations or reliance upon a representation of warranty made at any time with respect thereto, but only if the personal injury or property damage occurs after such operations have been completed or abandoned and occurs away from premises owned by or rented to the Named Insured.

Of course, the preceding definitions are examples only, individual policy definitions may vary, and the variations can be significant. The general point is that under policies issued in years past, some types of losses (e.g., products/completed operations) may be subject to an aggregate limit, whereas other types of losses (e.g., premises or operations, also referred to as "non-products") may not be.

The volume of asbestos bodily injury losses expanded throughout the 1980's, and coverage disputes between asbestos defendants and their insurers proliferated. Major court battles ensued over what policy or policies were "triggered" by an asbestos claim: the policy in place when the injured party was exposed to asbestos, the policy in place when the injured party manifested an asbestos injury, or some variation or combination of the two. However, this initial wave of coverage litigation *did* not address whether particular asbestos losses fell within the products/completed operations hazards of the triggered insurance policies.

Over the years, major asbestos defendants have teetered and collapsed under the onslaught of asbestos claims, liability insurers have paid out billions of dollars for asbestos losses, and both insurers and policyholders have treated the losses as falling within the products/completed operations hazards of the policies.

Not all policyholders agree. Some contend that an insurer claiming exhaustion of aggregate limits presumes that the subject asbestos losses fall within the products/completed operations hazards that are subject to an aggregate limit, a presumption that may be unwarranted.

Over the years, major asbestos defendants have teetered and collapsed under the onslaught of asbestos claims, liability insurers have paid out billions of dollars for asbestos losses, and both insurers and policyholders have treated the losses as falling within the products/completed operations hazards of the policies. As a consequence, asbestos losses have usually been subject to aggregate limits - meaning that insurers that have paid out their aggregate limits for asbestos losses can assert policy exhaustion and deny further coverage.

Not all policyholders agree. Some contend that an insurer claiming exhaustion of aggregate limits presumes that the subject asbestos losses fall within the products/completed operations hazards that are subject to an aggregate limit, a presumption that may be unwarranted. An informative article setting forth this policyholder position is "The New Frontier: Non-Products Coverage For Asbestos Claims," *Mealey's Litigation Reports: Insurance*, Vol. 12, No. 16 (Feb. 24, 1998). In this article, the authors rely on the New York Court of Appeals decision in *Frontier Insulation Contractors, Inc. v. Merchants Mut. Ins. Co.*, 690 N.E.2d 866 (N.Y. 1997), to argue that asbestos claims alleging bodily injury resulting from an asbestos defendant's activities before that defendant relinquished control of the asbestos product are not subject to the products hazard or any aggregate limit applicable to the products hazard. Under this theory, when an asbestos defendant installs an asbestos product and allegedly injures claimants during the course of the installation activities, the resulting claims do not fall within the products/completed operations hazard under the definitions quoted above.

If this theory were accepted, then an insurer could be faced with asbestos losses from some policyholders which are arguably not subject to any aggregate limit. The insurer's liability would be subject only to the "occurrence" limit, suggesting that coverage disputes over the number of "occurrences" involved in the non-products losses will follow.

The Travelers/Owens-Corning Dispute

Travelers (the actual issuing company was Aetna Casualty & Surety) insured Owens-Corning Fiberglas Corporation ("OCF") under primary and excess liability policies from 1952 through 1979. The primary limits were \$1 million per occurrence and in the aggregate, with the aggregate limit applicable to the products/completed

operations hazards. The excess limits were \$25 million per occurrence and in the aggregate, with the aggregate limit applicable to the products/completed operations hazards. According to the court, the total per occurrence limits for all of the Travelers policies issued to OCF was \$273.5 million.² *Travelers v. Gerling*, 285 F. Supp. 2d at 202.

OCF manufactured and distributed an asbestos-containing insulation product known as Kaylo. In addition, OCF operated a separate contracting division that installed, maintained, and removed asbestos-containing insulation materials, including Kaylo. OCF has been a major asbestos defendant for years, and its asbestos liabilities are massive. The *Travelers v. Gerling* court noted testimony that OCF's asbestos liabilities approached \$10 billion. *Id.* at 202-04.

Beginning in the 1970's, OCF faced thousands of lawsuits for bodily injury caused by exposure to asbestos and tendered them to Travelers. Both Travelers and OCF treated the asbestos bodily injury claims as losses falling within the products/completed operations hazards. By the early 1990's, Travelers had paid OCF over \$400 million in indemnity and defense costs, exhausting the aggregate limits of the policies for products/completed operations losses. *Id.* at 203.

Following this exhaustion, OCF began to submit its asbestos bodily injury claims as falling outside the products/completed operations hazards. According to OCF, the asbestos claims fell within the non-products coverage because (a) the claims arose from its contracting division's work, (b) the claimants were exposed to asbestos during the course of OCF's installation activities, and therefore (c) the injury took place *before* OCF had relinquished control of the asbestos product to others and *before* OCF had completed its contracting operations, rendering the products/completed operations hazards inapplicable. *Id.*

Travelers and OCF were parties to the Wellington Agreement, a comprehensive settlement agreement between many asbestos defendants and insurers reached in 1985. The Wellington Agreement resolved a number of coverage issues, but also left some open, providing in certain instances that policies would apply "as written." The Wellington Agreement also included an alternative dispute resolution mechanism with respect to future disputes, calling for mediation and arbitration. *Id.*

By 1993, Travelers and OCF were arbitrating the non-products coverage claim. OCF moved for summary judgment in the arbitration, seeking a declaration that Travelers was obligated under the non-products coverage of its policies to defend and indemnify any asbestos claim that arose out of any asbestos exposure taking place during OCF's contracting operations. OCF also argued that each asbestos claimant was a separate occurrence under the Travelers policies or, alternatively, that each job site where OCF conducted its contracting operations was a separate occurrence. OCF conducted contracting operations at over seven hundred job sites. *Id.* at 203, 206.

This number of occurrences issue was of central importance. If OCF was correct that asbestos losses arising out of its contracting operations did not fall within the products/completed operations hazards of the Travelers

² As the court also stated that Travelers insured OCF from 1952 through 1979 and the total per occurrence limits of all policies was \$273.5 million, it would appear that Travelers did not issue a \$1 million primary and a \$25 million excess policy to OCF in each year. Presumably, this level of coverage was not reached until the later years.

The *Travelers v. Gerling* court noted testimony that OCF's asbestos liabilities approached \$10 billion.

According to OCF, the asbestos claims fell within the non-products coverage because (a) the claims arose from its contracting division's work, (b) the claimants were exposed to asbestos during the course of OCF's installation activities, and therefore (c) the injury took place *before* OCF had relinquished control of the asbestos product to others and *before* OCF had completed its contracting operations, rendering the products/completed operations hazards inapplicable.

If OCF was correct that asbestos losses arising out of its contracting operations did not fall within the products/completed operations hazards of the Travelers policies, then the aggregate limits in the Travelers policies did not apply.

policies, then the aggregate limits in the Travelers policies did not apply. Under these circumstances, the pertinent limit in the Travelers policies was the occurrence limit; and the magnitude of Travelers' exposure turned on how many occurrences were involved in the alleged non-products claims.

Travelers argued that all of OCF's asbestos liabilities, products and non-products alike, arose out of one occurrence for which Travelers had already paid its full occurrence limits. Thus, Travelers claimed that its earlier payment of over \$400 million for OCF asbestos losses exhausted both the aggregate limits applicable to product/completed operations claims, as well as the single occurrence limit applicable to all of OCF's asbestos losses. Travelers had support for this single occurrence position. OCF itself had taken a single occurrence position in connection with an asbestos coverage dispute with another carrier. *International Surplus Lines Ins. Co. v. Certain Underwriters and Underwriting Syndicates at Lloyd's*, 868 F. Supp. 917, 919 (S.D. Ohio 1994) (under excess policies containing a \$1 million deductible for each and every occurrence, OCF "took the position that the asbestos claims against it arose from one occurrence - the decision to manufacture and sell products containing asbestos"). *Travelers v. Gerling*, 285 F. Supp. 2d at 204.

Presumably, OCF's counter to the "one occurrence" argument based on its earlier position was that the occurrence analysis with respect to non-products claims somehow differed from the occurrence analysis applicable to products/completed operations claims.

The OCF summary judgment motion remained pending before the arbitrator for almost two years without a ruling. Before the motion was decided, Travelers and OCF negotiated a settlement, whereby Travelers agreed to pay roughly \$273.5 million over several years for asbestos-related claims and environmental claims. The settlement agreement did not include an allocation of the settlement payment. *Id.* at 205.

The Travelers/Gerling Dispute

When presenting the loss to its reinsurers, Travelers attributed \$257 million of the settlement payment to non-products asbestos losses; and it ceded the losses as a single non-products asbestos occurrence under the Travelers primary and excess policies. Gerling facultatively reinsured some of the Travelers excess policies issued to OCF, but did not reinsure any of the Travelers primary policies issued to OCF. Gerling rejected the loss cession, and Travelers sued Gerling to recover under the facultative contracts. *Id.* at 205-06.

Gerling moved for summary judgment in the litigation, arguing that the non-products asbestos losses could not be considered a single non-products asbestos occurrence under the Travelers policies. Echoing a position that OCF had asserted in the arbitration, Gerling argued that each job site was a separate occurrence under each year of coverage from Travelers. According to Gerling, if the \$257 million in non-products asbestos payments were spread across the applicable years of Travelers coverage to OCF and among the seven hundred job sites, then each site would receive an allocation well below \$1 million in each policy year, thus confining the loss to the Travelers primary policies which Gerling did not reinsure and keeping the loss from the Travelers excess policies that Gerling did reinsure. *Id.* at 207.

Travelers responded that Gerling was improperly trying to re-litigate the number of occurrences issue that Travelers and OCF were arbitrating when they reached a compromise settlement. Travelers argued that the follow the fortunes doctrine required Gerling to accept Travelers' allocation as long as it was reasonable when made and not executed in bad faith. As support for this standard of review, Travelers cited to *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F. Supp. 2d 49, 67-68 (D. Mass. 1998), *aff'd*, 217 F.3d 33 (1st Cir. 2000) ("*Seven Provinces*"), and *North River Ins. Co. v. ACE American Reinsurance Co.*, No. 00 Civ. 7993 (JSR), 2002 U.S. Dist.

According to Gerling, if the \$257 million in non-products asbestos payments were spread across the applicable years of Travelers coverage to OCF and among the seven hundred job sites, then each site would receive an allocation well below \$1 million in each policy year, thus confining the loss to the Travelers primary policies which Gerling did not reinsure and keeping the loss from the Travelers excess policies that Gerling did reinsure.

To demonstrate the reasonableness of its allocation, Travelers pointed out that the single non-products occurrence allocation was consistent with the amount of the settlement (slightly less than the \$273.5 million in limits available under all Travelers policies for a single occurrence). Travelers also argued that its allocation was consistent with the manner in which OCF's non-products claim was settled, namely a compromise between the Travelers position that no further occurrence limits were available following the earlier payment of a full set of occurrence limits for the products losses, and the OCF position that many occurrence limits were available on either a per claimant or a per site basis. Travelers also emphasized OCF's earlier single occurrence position for asbestos losses when trying to avoid the \$1 million "each and every occurrence" deductible under certain excess policies. *Id.* at 208.

Gerling replied that neither Travelers nor OCF had argued for a separate, single non-products occurrence in the arbitration. Gerling highlighted testimony that Travelers and OCF did not reach an agreement that the non-products losses arose from a separate, single non-products occurrence. In addition, Gerling claimed that the follow the fortunes doctrine was inapplicable because Travelers' allocation violated the terms of the reinsurance contracts. According to Gerling, its facultative certificates incorporated the definition of "occurrence" in the Travelers policies reinsured, which definition required a multiple occurrence finding with respect to the OCF non-products losses. Gerling cited to several court decisions involving a multiple occurrence determination under allegedly analogous circumstances. *In re Prudential Lines, Inc.*, 158 F.3d 65 (2d Cir. 1998); *Stonewall Ins. Co. v. Asbestos Claims Man. Corp.*, 73 F.3d 1178 (2d Cir. 1995), *modified on denial of reh'g*, 85 F.3d 49 (1996); *Metropolitan Life Ins. Co. v. Aetna Cas. & Sur. Co.*, 765 A.2d 891 (Conn. 2001); *Travelers Cas. & Sur. Co. v. Certain Underwriters at Lloyd's*, 760 N.E.2d 319 (N.Y. 2001). Notably, all of these cases were decided *after* Travelers reached its non-products settlement with OCF in September 1995. *Travelers v. Gerling*, 285 F. Supp. 2d at 207-10.

The court ruled in favor of Gerling, concluding that "under the facts of this case, Gerling is not bound by Travelers' allocation of its settlement payments to OCF among the various primary and excess insurance policies it issued to OCF." *Id.* at 210.

The Court's Rationale

Much of the court's opinion concerns why the follow the fortunes doctrine does not apply. The court's rationale seems to be that the deferential, "follow the fortunes" standard of review does not necessarily apply when a reinsurer challenges a cedent's settlement or allocation decision. Whether the doctrine applies depends on the nature of the reinsurer's challenge. The following passage illustrates the court's view:

Gerling's multiple occurrence position does not challenge Travelers' allocation by advancing a coverage position which Travelers did not press when deciding to settle the arbitration with OCF. Instead, Gerling's position mirrors OCF's arbitration position. Its position of policy interpretation, even if known by Travelers at the time of the OCF settlement, would thus not have disincentivized that settlement because it was not the position Travelers was advancing against OCF. The record evidence of Travelers' and OCF's settlement demonstrates that Travelers wanted to extract itself from the coverage

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dispute with OCF for as little dollar exposure as possible, however achieved, and OCF and Travelers came to a settlement without any agreement on the occurrence issue. Put simply, by refusing reinsurance coverage on the basis of Travelers' single occurrence allocation, Gerling is not punishing Travelers for not going to the mat with OCF on the single occurrence position it advanced – a situation which the follow the fortunes doctrine was promulgated to prevent.

Id.

Under this theory, the follow the fortunes doctrine should apply only when sustaining the reinsurer's challenge to the cedent's decision to settle would discourage the cedent from settling: "The rationale for invoking the doctrine and binding the reinsurer applies where not doing so would discourage the cedent from good faith settlement with its insured. In other words, the reinsurer is not permitted to tell the cedent it should not have relinquished or 'abandoned' its coverage or litigation position by the fact of its settlement." *Id.* at 211.

According to the court, the follow the fortunes doctrine applies when the reinsurer challenges the cedent's allocation decision by resurrecting the cedent's underlying coverage argument against its policyholder and using that argument against the cedent because sustaining this type of reinsurer challenge would lead cedents to forego settling, out of the fear that a reinsurer will argue that the cedent should not have settled but should have continued to dispute coverage with its policyholder. Thus, if Gerling had challenged Travelers' allocation by arguing that there was no non-products asbestos coverage available to OCF under the Travelers policies because all asbestos losses were a single occurrence and Travelers had already paid its single occurrence limit for asbestos losses, then the follow the fortunes doctrine would have applied. However, because Gerling did not challenge Travelers' allocation on this basis, but instead argued the OCF position that each of the seven hundred job sites was a separate occurrence, the follow the fortunes standard did not apply. *Id.* at 211-12.

Although the court's reasoning appears to stem from the notion that Gerling's challenge did not "punish" Travelers for moving away from its no coverage position, the exact parameters of the court's rationale are difficult to discern.

Although the court's reasoning appears to stem from the notion that Gerling's challenge did not "punish" Travelers for moving away from its no coverage position, the exact parameters of the court's rationale are difficult to discern. Consider the following passage, which arguably does criticize Travelers for moving away from its no coverage position:

By contrast, the salutary purpose of the [follow the fortunes] doctrine has no application to a reinsurer's coverage challenge where the cedent's allocation is based on a position the cedent earlier abandoned in order to settle with the insured. In such a situation, the reinsurer is placing itself in the position of the cedent, that is, following the cedent's settlement.

Id. at 211.

This passage is confusing and, if meant to suggest that Travelers' allocation was based on the coverage position it was asserting before it settled with OCF, erroneous as well. The Travelers allocation was based on a single non-products occurrence. The position Travelers was asserting before it settled with OCF was that there were no remaining occurrence limits available because all asbestos losses constituted a single occurrence for which Travelers had already paid its occurrence limits. These are not the same position.

The court also discussed the significance of the compromise Travelers reached with OCF:

Travelers and OCF had advanced polar opposite positions in the arbitration creating a situation in which a victory for one meant total defeat for the other. The fact that Travelers settled with OCF for \$273.5 million (or for any sum at all), while not an endorsement of OCF's multiple occurrences theory, objectively establishes that Travelers did not persevere in the one occurrence theory of its subsequent allocation. The testimony of Walker and Borom [Traveler's witnesses] about their subjective intent in settling OCF's claims does not change this conclusion. Both admit that the settlement was approached along the lines of paying out a sum that was within one additional set of occurrence limits for non-products claims, that is, adding to the one set of occurrence limits already paid out for OCF's products claims another set of occurrence limits to be paid for OCF's non-products claims. Such admission must be construed at least as a failure to persist in its one occurrence coverage defense and some movement toward the multiple occurrence position taken by OCF, given that Travelers had characterized dichotomization between one occurrence for products claims and one occurrence or occurrences for non-products claims as "utterly irrelevant to the application of the single limits requirement." [Citing to a Travelers brief in the arbitration with OCF.]

Id. at 211-12.

Several problems leap from this text. First, it seems to equate the Travelers position argued against OCF in the arbitration (all asbestos losses constitute a single occurrence), with the basis on which Travelers presented the non-products settlement to reinsurers (all non-products asbestos losses constitute a single occurrence); and those positions are not at all equivalent. Second, although the court earlier stated that the follow the fortunes doctrine does not permit a reinsurer "to tell the cedent it should not have relinquished or 'abandoned' its coverage or litigation position by the fact of its settlement," the preceding passage appears to do just that - taking Travelers to task for not persevering in its no coverage position. *Id.* at 211.

After this discussion, the court returned to the subject of what OCF had espoused: "Forcing Gerling to follow an allocation based on a single occurrence theory OCF opposed and did not accept in settlement would be tantamount to binding Gerling to any allocation theory Travelers professed they alone followed." *Id.* at 212. The court then summarized its analysis: "Under these circumstances, holding Gerling to Travelers' allocation does not promote the goal of the 'follow the settlements' doctrine to incentivize settlement and reduce litigation because Travelers is not being told that it should not have settled on any basis other than its single occurrence position." *Id.*

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³ In this regard, the court stated that it had no basis for accepting or rejecting the allocation formula proposed by Gerling (spread the non-products payment evenly across all years of coverage and all seven hundred job sites) because the record did not show how payments would actually stack up if each job site were considered a separate occurrence. *Id.* at 200.

Although it rejected Travelers' allocation, the court did not order a different allocation.³ Nevertheless, the opinion does display a multiple occurrence mindset. At the end of its opinion, the court noted the "growing body of decisions that weigh against a one occurrence position," referring to the multiple occurrence decisions cited by Gerling. *Id.* at 213.

As for the *Seven Provinces* and *North River* decisions, which applied a follow the fortunes standard when reviewing cedent allocation decisions, the court distinguished *Seven Provinces* on the basis that the reinsurer "sought improperly to hold the cedent accountable for giving in on coverage issues...[whereas] Gerling does not fault Travelers for failing to persist with its single occurrence theory." With regard to the *North River* decision, the court held that it was "based solely on the reasoning" of *Seven Provinces*. *Id.*

The Significance of *Travelers v. Gerling*

While a notable decision because it addresses important and timely issues, *Travelers v. Gerling* should not be influential for several reasons.

First, the decision is difficult to follow and internally inconsistent. Many of the passages quoted above suffer from double negatives that obscure the court's meaning. Also, although the court's rationale seems premised on the fact that Gerling did not "punish" or "fault" Travelers for compromising the "all asbestos losses are one occurrence" position it asserted in the arbitration, several parts of the opinion do criticize Travelers for ending up with a compromise that moved towards the OCF position that there were remaining occurrence limits available for non-products losses. Consequently, the court applied a standard that is never properly articulated.

Second, the court's view that the follow the fortunes doctrine prohibits only certain forms of reinsurer second-guessing finds no support in the case law. Courts have construed the follow the fortunes doctrine as a general anti-second guessing rule, to prevent reinsurers from re-litigating the coverage dispute which the cedent compromised. See *Christiania Gen. Ins. Co. v. Great Am. Ins. Co.*, 979 F.2d 268, 280 (2d Cir. 1992); *Aetna Cas. & Sur. Co. v. Home Ins. Co.*, 882 F. Supp. 1328, 1346 (S.D.N.Y. 1995). If the door is opened to certain forms of second-guessing, then the protection against re-litigation is watered down, and the follow the fortunes protection is illusory. Reinsurers are encouraged to re-litigate; and cedents are discouraged from settling, even if the reinsurer supposedly re-litigates without advancing those arguments that the cedent espoused before settling. Two of the more egregious illustrations of this point are (a) the court's reliance on "multiple occurrence" court decisions that did not exist when Travelers settled with OCF, and (b) the court's citation to Travelers' arguments against OCF in the underlying arbitration. This decision tells Travelers and other cedents facing complex, high-stakes coverage disputes involving novel issues that a compromise settlement decision can be re-litigated, complete with twenty-twenty hindsight and use of the cedent's pre-settlement coverage arguments against it. A cedent facing such prospects may decide that the safest course is to have its allocations determined by court judgments.

Third, the court's emphasis on whether OCF "agreed" with the single non-products occurrence position is problematic. Review of a cedent's settlement allocation decision should not be based on whether the policyholder formally agreed to that allocation. Compromise settlements typically do not involve either side embracing particular positions or theories respecting the dispute being settled. Quite the opposite; in most settlements, both sides expressly disclaim any acceptance of formal liability or non-liability. Also, the cedent oftentimes does not know what led the policyholder to compromise, rendering it difficult to state what theory of coverage is enshrined in a settlement. Moreover, the nature of many settlements is a sheer compromise, where neither side's position is accepted. A

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cedent finding itself in this no-man's land cannot explain what shared theory of coverage is supposedly embedded in the compromise. A timely example is the ongoing property coverage dispute respecting the World Trade Center. The policyholder claims that it is entitled to two occurrence limits, one for each tower destroyed. The insurers claim that only one occurrence limit is available. As each occurrence limit exceeds \$3 billion, a great deal of money is at stake. See *World Trade Center Prop., L.L.C. v. Hartford Fire Ins. Co.*, 345 F.3d 154 (2d Cir. 2003). A likely compromise is for the insurers still litigating to pay more than one but less than two occurrence limits. If this happens and a court considering the resulting reinsurance dispute wants to know whose theory of coverage is set forth in the settlement, no clear answer exists.

Fourth, the court's treatment of *Seven Provinces* is inadequate. The court distinguished *Seven Provinces* as a case where the reinsurer "sought improperly to hold the cedent accountable for giving in on coverage issues." *Travelers v. Gerling*, 285 F. Supp. 2d at 213. That is a very small part of *Seven Provinces*, which instead stands for the broader proposition that a deferential, follow the fortunes type standard should govern review of the cedent's settlement allocation decisions, as well as the cedent's settlement decisions. *Seven Provinces Ins. Co.*, 9 F. Supp. 2d at 68. The reinsurer in *Seven Provinces* wanted to foist its own preferred allocation of an environmental coverage settlement on the cedent, and the court rejected this approach. A major factor in the *Seven Provinces* court's decision was the very real prospect of a cedent being "whipsawed" by its different reinsurers, each of whom argues for its own reasonable allocation method. Since the cedent must make some allocation and any allocation will have critics, the court fashioned a deferential standard of review for cedent allocation decisions. The *Travelers v. Gerling* decision never acknowledges the real holding in *Seven Provinces* and never recognizes the "whipsaw" problem and other practical realities of settlement that led the *Seven Provinces* and *North River* courts to the deferential standard of review.

This may be the most disappointing aspect of the *Travelers v. Gerling* decision. The court seemed poised to debate the notion that a follow the fortunes standard should govern a cedent's allocation decisions, perhaps taking the *Seven Provinces* and *North River* holdings head on. Instead, the court sidestepped that debate, improperly distinguished the two decisions on other grounds, and ended up with a confusing and contradictory focus on whether the reinsurer "punishes" the cedent for compromising the coverage position it asserted pre-settlement.

CONCLUSION

Non-products asbestos claims will continue to be asserted, and the complex "occurrence" issues that surround such losses will likely be disputed by policyholders and cedents. As for how such losses can be ceded to reinsurers, the *Travelers v. Gerling* decision has introduced some uncertainty. In one sense, the decision reflects that courts are still defining the exact contours of the cedent's discretion in allocating a settlement payment.

As time passes, more certainty should emerge. The pro-cedent decision in *North River* is presently on appeal before the U.S. Court of Appeals for the Second Circuit. Travelers has already appealed the *Travelers v. Gerling* decision to the same court. The decisions in these appeals should clarify the landscape.

The *Travelers v. Gerling* decision never acknowledges the real holding in *Seven Provinces* and never recognizes the "whipsaw" problem and other practical realities of settlement that led the *Seven Provinces* and *North River* courts to the deferential standard of review.

LITIGATING THE CLAIM FOR DECLARATORY JUDGMENT EXPENSES: A PRACTICAL PERSPECTIVE

BY: NEIL H. WYLAND AND HANNAH R. RUEHLMAN

Reinsurance coverage for the expenses a ceding company incurs in litigating coverage disputes with its policyholder has long been a subject of dispute. Reinsurance contracts generally indemnify a cedent for its loss payments and expenses (*i.e.*, legal fees and other allocated costs) for the investigation and settlement of policyholder claims. Whether such expenses include declaratory judgment costs incurred by a ceding company in contesting coverage under its policies remains a point of contention between cedents and reinsurers.¹ Evaluation of the issue turns on the contract language at issue, often supplemented by extrinsic evidence such as placing file correspondence, underwriter testimony, the course of the parties' performance under the contracts, and industry custom and practice.

Typically, disputes over the issue were resolved in confidential arbitrations. More recently, however, the issue has been addressed in litigation.

Typically, disputes over the issue were resolved in confidential arbitrations. More recently, however, the issue has been addressed in litigation.² These different fora take significantly different approaches towards extrinsic evidence. In litigation, rules of contract interpretation and common law doctrines such as the parol evidence rule limit the use of extrinsic evidence. In arbitration, by contrast, reinsurance contracts frequently relieve arbitrators from "judicial formality" and the application of "strict rules of law respecting evidence." These differences are especially important to declaratory judgment coverage disputes, where the subject reinsurance contracts may be decades old and the underwriters deceased. In such instances, a party's ability to advance or oppose the admission of extrinsic evidence, such as expert testimony on custom and practice, can determine the outcome of the litigation.

This article considers the dispute over declaratory judgment expenses from the standpoint of the litigator; if the issue is to be decided by a court, what evidence will the court consider and how should that evidence be presented?

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Analysis of the Reinsurance Contract

As with any contract issue in litigation, the parties (and courts) look first to the contract itself to determine whether declaratory judgment expenses are clearly covered or clearly excluded. If the language is unambiguous and susceptible of only one plain meaning, then courts will enforce it as written, without reference to extrinsic evidence. If the language is ambiguous, courts may refer to extrinsic evidence (often called parol evidence) to resolve the ambiguity, but not to vary the terms of the contract.

Ambiguity, however, is often in the eye of the beholder. For example, the Massachusetts Supreme Judicial Court and the United States District Court for the Western District of Wisconsin reached opposite conclusions about coverage for declaratory judgment expenses when analyzing generally similar contract language. Compare *Affiliated FM Ins. Co. v. Constitution Reinsurance Corp.*, 626 N.E.2d

¹ See generally L.J. Davis, "Concerning the Coverage of Declaratory Judgment Expenses," *Tort & Ins. L.J.* (Spring 1995).

² For years, the only U.S. case to address the issue was *Affiliated FM Ins. Co. v. Constitution Reinsurance Corp.*, 626 N.E.2d 878 (Mass. 1994). In the past two years, however, three U.S. federal courts have ruled on the issue. See *Employers Reinsurance Corp. v. Mid-Continent Cas. Co.*, 202 F.Supp.2d 1221 (D.Kan. 2002); *British Int'l Ins. Co. v. Seguros La Republica, S.A.*, 342 F.3d 78 (2d Cir. 2003), *motion to vacate denied by No. 01-9079*, 2003 U.S. App. LEXIS 24394 (2d Cir. Dec. 4, 2003); and *Employers Ins. Co. v. American Re-Insurance Co.*, 256 F. Supp. 2d 923 (W.D. Wis. 2003).

878, 880 (Mass. 1994) ("*Affiliated FM*") (finding that reinsurance contract covering "expenses . . . incurred by the [reinsured] in the investigation and the settlement of claims or suits" was ambiguous and thus required consideration of extrinsic evidence) *with Employers Ins. Co. v. American Re-Insurance Co.*, 256 F. Supp. 2d 923, 925 (W.D. Wis. 2003) ("*Wausau*") (finding "no question" that phrase "expenses incurred in the investigation and settlement of claims or suits" unambiguously includes a cedent's declaratory judgment expenses).

Moreover, the analysis of whether a contract word or phrase is ambiguous may refer to extrinsic evidence. In this regard, courts generally recognize two forms of ambiguity in written contracts. First, a contract may be ambiguous on its face, often called "patent ambiguity." For example, a contract is patently ambiguous if it contains two conflicting provisions or undefined terms that are facially ambiguous. Second, a contract may be clear on its face, but ambiguous when considered in conjunction with objective external evidence. The second type of ambiguity is called "latent ambiguity." For example, a contract calling for the sale of Party A's home has a latent ambiguity if Party A owns two homes. As one court explained, latent ambiguity "is present when, although the agreement itself is a perfectly lucid and apparently complete specimen of English prose, anyone familiar with the real-world context of the agreement would wonder what it meant with reference to the particular question that has arisen." *Fed. Deposit Ins. Corp. v. W.R. Grace & Co.*, 877 F.2d 614, 620-21 (7th Cir. 1989).

Accordingly, although seemingly contrary to fundamental tenets of contract interpretation, a majority of U.S. courts will consider extrinsic evidence to determine whether a contract is ambiguous.³ Moreover, if an ambiguity is found, courts generally will consider further extrinsic evidence to resolve the ambiguity.

If the court does refer to extrinsic evidence, a rough hierarchy of such evidence becomes apparent. Evidence concerning the parties' intent at the time of contract execution and their intent as demonstrated by their performance before a dispute arose are generally considered the most persuasive extrinsic evidence. The next level is evidence of course of dealings between the parties under related contracts between the parties or under contracts with other parties. Finally, there is expert evidence concerning custom and practice in the industry. We address these categories in turn.

1. Evidence of The Parties' Intent At Contracting and During Performance

The placement of reinsurance contracts can generate significant correspondence among cedents, reinsurers, and reinsurance intermediaries.

³ See generally *The Great A&P Tea Co. v. Checchio*, 762 A.2d 1057, 1061 (N.J. 2000) (when a contract appears unambiguous on its face, courts may consider extrinsic evidence including that of "surrounding circumstances and conditions" to aid in interpretation); see also *Morey v. Vannucci*, 64 Cal. App. 4th 904, 912 (Cal. Ct. App. 1998) (court may consider extrinsic evidence to expose an ambiguity "as long as such evidence is not used to give the instrument a meaning to which it is not reasonably susceptible"); *Owens v. McDermott, Will & Emery*, 736 N.E.2d 145, 154 (Ill. App. Ct. 2000) (parol evidence may be used "to clarify the definition of terms in determining whether a contract is ambiguous"); *Alexander & Alexander Servs., Inc. v. Certain Underwriters at Lloyd's*, 136 F.3d 82, 86 (2d Cir. 1998) (applying New York law) ("An ambiguity exists where the terms of a contract could suggest more than one meaning when viewed objectively by a reasonably intelligent person who has examined the context of the entire integrated agreement and who is cognizant of the customs, practices, usages and terminology as generally understood in the particular trade or business.") (citations and internal quotation marks omitted).

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A party may also seek to introduce evidence of treatment of declaratory judgment expenses under other reinsurance contracts between the parties, or even with other parties.

Placing correspondence is often persuasive evidence of the parties' intent at the time of contracting. Unfortunately, such evidence rarely addresses declaratory judgment expenses squarely, which were much less common before the explosion of mass tort litigation in the 1980's. Current testimony from the underwriters of the reinsurance contract is valuable evidence. Such testimony, however, is becoming increasingly rare, as involved contracts are often thirty, forty, or fifty years old and underwriters' memories have faded (or the underwriters are deceased). Moreover, even if a court can discern the parties' intent at the time of contracting, it is useful to examine how that intent may have evolved during the parties' performance under the contracts.

During the course of performing under the reinsurance contracts, the parties may have developed understandings in handling cessions of declaratory judgment costs. Courts afford such "practical construction" significant deference. See *Reconstruction Fin. Corp. v. Sherwood Distilling Co.*, 200 F.2d 672, 676 (4th Cir. 1952) ("[T]he interpretation placed upon a contract by the parties themselves, before a dispute has arisen, is entitled to the greatest weight.").

In fact, one recent case discussed the reinsurer's prior payment of declaratory judgment expenses (albeit in bordereau form) before determining that the contract language was unambiguous and encompassed payment of declaratory judgment costs. See *Employers Reinsurance Corp. v. Mid-Continent Cas. Co.*, 202 F.Supp. 2d 1221, 1225-26 (D. Kan. 2002).

2. Other Evidence Concerning The Parties' Intent Regarding Coverage of Declaratory Judgment Expenses

Evidence concerning prior cessions of declaratory judgment expenses under a particular reinsurance contract is not always available. The issue may have been resolved in compromise negotiations or confidential arbitrations and may not be appropriate for use in open court. Or declaratory judgment expenses may not have been ceded under the contract at issue. In such circumstances, the parties may seek to introduce a variety of evidence. In some instances, a party may have made a public statement concerning treatment of declaratory judgment expenses. For example, in the context of the Asbestos Claims Facility and the Wellington Agreement, the London Market publicly stated that:

Whether reinsurers are obliged to meet expenses incurred by the cedant in coverage litigation will depend upon the terms and conditions of the reinsurance contract. From the legal analysis conducted upon the majority of wordings subscribed by the London Market, we are advised that such expenses are recoverable. Indeed, in many major loss situations in the past our cedants have been involved in coverage litigation prior to reaching settlement, and the expense so incurred has formed part of their claim presentation. However, in the context of asbestos coverage litigation, allegations are often made against the cedant of an extra-contractual nature, which may not be within the scope of the protection afforded by the reinsurance contract. In such cases it may be necessary to negotiate a breakdown of litigation costs to ensure that the cedant retains for its own account expenses incurred in defense of its unreinsured exposures.

Asbestos: The London Response, A Presentation to the European Liability Congress of the Cologne Re, Berlin (April 16-18, 1985) at 14.

A party may also seek to introduce evidence of treatment of declaratory judgment expenses under other reinsurance contracts between the parties, or even with other

parties. A ceding company may proffer evidence of payment of declaratory judgment expenses by other reinsurers on the treaty or seek discovery on whether the reinsurer, when acting as a cedent, bills declaratory judgment expenses under similar reinsurance contract language. Reinsurers, in turn, may seek evidence on a cedent's treatment of declaratory judgment expenses when acting as a reinsurer. Both parties may seek discovery of claim manuals and internal guidelines on the issue, and contemporaneous reinsurance contract forms maintained by the other. These types of evidence are often challenged on the basis of relevancy.

3. Industry Custom and Practice

A third common form of extrinsic evidence is evidence of industry custom and practice. In general, courts will consider the testimony of an expert witness who "is cognizant of the customs, practices, usages and terminology as generally understood in the particular trade or business," to clarify a contract term, or to add or imply a new term. *British Int'l Ins. Co. v. Seguros La Republica, S.A.*, 342 F.3d 78, 82 (2d Cir. 2003), *motion to vacate denied by* No. 01-9079, 2003 U.S. App. LEXIS 24394 (2d Cir. Dec. 4, 2003) ("*BIIC*").

Affiliated FM illustrates the value of custom and practice evidence to clarify a contract term. *Affiliated FM*, 626 N.E.2d at 878. In that case, the trial court granted summary judgment for the reinsurer, finding that the facultative reinsurance certificate at issue was unambiguous and did not encompass the cedent's declaratory judgment expenses. The Massachusetts Judicial Supreme Court accepted a direct appeal and vacated the ruling. The court focused on the contract term "expenses," and concluded that the term was ambiguous as to coverage of declaratory judgment expenses.

In reaching this conclusion, the court declared that evidence of "valid [industry] usages known to the contracting parties, respecting the subject matter of the agreement" could be used to illuminate the parties' intentions "upon the theory that the usage forms part of the contract." *Id.* at 882 (citations omitted). But not all forms of such evidence were equally persuasive to the court. Evidence from legal treatises and commentaries in print at the time of contract placement informed the court's inquiry. *Id.* at 880. Of greater relevance, the court indicated, was testimony concerning industry custom and usage at the time. *Id.* at 882. Frequently, this takes the form of expert affidavits and testimony. The use of such evidence in a declaratory judgment coverage dispute was at issue in a recent case, *BIIC*.

BIIC concerned coverage for declaratory judgment expenses under a series of facultative reinsurance certificates. Significantly, the certificates did not use the term "expense," but provided that they were subject to the "same risks, valuations, conditions and endorsements...as may be assumed by [the cedent], and loss, if any hereunder." *BIIC*, 342 F.3d at 82. The parties agreed that New York law governed the dispute. The cedent advanced two principal arguments. First, it asserted that the "same risk" language, taken as a whole, was so vague as to be impossible to interpret without reference to industry custom. *Id.* The court disagreed. Viewed from the standpoint of someone cognizant of industry customs and practices, the court found, the phrase was not ambiguous, nor had the cedent linked any contract term with a particular custom, practice or usage in the reinsurance industry. *Id.* at 83 n. 4.

In the alternative, the cedent argued that even if the contract language was unambiguous, an agreement to reimburse declaratory judgment expenses should be implied in the certificates based on industry custom and practice. *Id.* at 83. In order to use custom and practice evidence to imply a new contractual term, the court declared, the omitted term must be "fixed and

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The trade usage, the court summarized, must be "so well settled, so uniformly acted upon, and so long continued as to raise a fair presumption that it was known to both contracting parties and that they contracted in reference thereto."

By understanding the categories of extrinsic evidence and their applicable evidentiary standards, a party can best develop its arguments in litigation on this issue.

invariable" in the industry and that the party sought to be bound must be shown either to have been aware of the custom, or that the custom's existence was "so notorious" that the party should have been aware of it. *Id.* at 84. The trade usage, the court summarized, must be "so well settled, so uniformly acted upon, and so long continued as to raise a fair presumption that it was known to both contracting parties and that they contracted in reference thereto." *Id.* (internal citations omitted).

In support of its position, the cedent offered the affidavits of two reinsurance industry experts. *Id.* at 84. The first affiant spoke to the experience of his company in invariably paying declaratory judgment costs. However, the practice of one company, the court stated, generally is insufficient to establish a trade usage. *Id.* The second affiant stated that in his experience, it was the custom and practice of reinsurers to pay declaratory judgment expenses. This was different, the court noted, from averring that reinsurers *invariably and always* paid such expenses. These affidavits, the court declared, did not establish that the reinsurer knew of the alleged custom to pay declaratory judgment expenses or that the custom was "so notorious" in the industry that the reinsurer should have been aware of it. Moreover, the court noted, neither expert had testified that declaratory judgment expenses had been paid under contract language similar to that of the subject certificates. *Id.* Accordingly, the court determined that the involved certificates did not cover declaratory judgment expenses.

CONCLUSION

Resolving a dispute over reinsurance coverage of declaratory judgment expenses in litigation rather than in arbitration has a significant impact on what evidence may be adduced beyond the four corners of the contract. While perhaps not dispositive, such evidence has the potential to tip the balance. By understanding the categories of extrinsic evidence and their applicable evidentiary standards, a party can best develop its arguments in litigation on this issue.

PREVENTING CLASS ACTIONS THROUGH ARBITRATION CLAUSES: CASES, QUESTIONS, AND DRAFTING ISSUES

BY: JOEL S. FELDMAN AND JOHN M. MEJIA

Arbitration can be an effective alternative to the court system for the resolution of disputes between insurers and insureds. As courts become more willing to enforce arbitration clauses, it is becoming increasingly common for businesses to include these clauses in their contracts with customers. One feature that has begun to appear with more frequency in arbitration clauses – a bar on class actions – has recently become a source of significant legal controversy.

Different courts have taken opposing views on whether to enforce arbitration clauses negating the parties' ability to bring a class action. Those opinions expose a wider debate with broad implications: when the policy favoring arbitration collides with the principle espousing class actions, which should come out the winner? Courts in several jurisdictions have found that a properly drafted arbitration clause may validly prohibit class actions, no matter how strong the policy in favor of allowing such actions. Several drafting principles may be gleaned from these cases.

Conflicting Precedents

A. Green Tree Fin. Corp v. Bazzle

In *Green Tree Fin. Corp. v. Bazzle*, 123 S.Ct. 2402 (2003), the Supreme Court confronted the validity of an arbitration clause that barred class actions. A South Carolina trial court in *Green Tree* certified a class action, and then entered an order compelling arbitration. The arbitrator then administered the proceeding as a class arbitration, and awarded \$11 million to one class and \$9 million to a second class. The South Carolina Supreme Court upheld the awards. It reasoned that since the contracts were silent with respect to class arbitration, then proceeding to arbitrate the class claim was proper. *Id.* at 2406. *Green Tree* appealed to the United States Supreme Court.

The Supreme Court avoided directly ruling on the validity of a mandatory arbitration clause that precludes class actions. *Id.* at 2408. It found that the arbitrator, not the court, must decide whether the arbitration clause allowed for or precluded class arbitration. *Id.* at 2405. Because the arbitrator never made that determination, it vacated and remanded the case for the arbitrator to determine the issue.

The procedural ruling in *Green Tree*, however, did not prevent an informative debate between the plurality and the dissent on whether the arbitration clause in question allowed class arbitration. In his dissent, Chief Justice Rehnquist, joined by Justices O'Connor and Kennedy, argued that a court (not an arbitrator) should decide whether the arbitration agreement allowed class arbitration. More interestingly, the dissent went further, finding that the arbitration clause clearly precluded class arbitration:

When the policy favoring arbitration collides with the principle espousing class actions, which should come out the winner?

These provisions...make quite clear that petitioner must select, and each buyer must agree to, a particular arbitrator for disputes between petitioner and that specific buyer ... [P]etitioner [therefore] had the contractual right to choose an arbitrator for each dispute with the other 3,734 individual class members, and this right was denied when the same arbitrator was foisted upon petitioner to resolve those claims as well.

Id. at 2410-11.

We thus know that three justices of the Supreme Court appear willing to uphold the validity of an arbitration clause that precludes class actions. The plurality never expressed an opinion on this issue, as it ruled that the arbitrator was the only person with the authority to interpret whether the arbitration clause allowed class arbitration and remanded for that determination. However, several courts recently have addressed the specific question of whether a mandatory arbitration clause that precludes class actions can be valid. The rulings fall on both sides of the aisle.

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B. Szetela v. Discover Bank

Szetela v. Discover Bank, 97 Cal. App. 4th 1094 (Cal. Ct. App. 2002), *cert. denied*, 537 U.S. 1226 (2003), is emblematic of the cases finding it unconscionable to enforce an arbitration clause barring class actions. In *Szetela*, Discover mailed the plaintiff an amendment to the cardholder agreement that included an arbitration clause waiving both parties' right to class arbitration. *Id.* at 1096-97. In 2000, the plaintiff joined a New Jersey class action against Discover alleging improper charges. *Id.* at 1097. The court in that action compelled individual arbitration between the plaintiff and Discover, and the plaintiff recovered \$29. *Id.* The plaintiff appealed, asking a California state appellate court to strike the class arbitration bar as procedurally and substantively unconscionable and let him proceed as part of a class. *Id.* at 1099.

The *Szetela* court found that the arbitration agreement, coupled with a class action prohibition, was unconscionable and unenforceable under California law. *Id.* at 1096. Procedural unconscionability, said the court, is established when "the weaker party is presented the clause and told to 'take it or leave it' without the opportunity for meaningful negotiation." *Id.* at 1100 (internal citation omitted). The plaintiff "received the amendment to the Cardholder Agreement in a bill stuffer." *Id.* In addition, under the language of the amendment, plaintiff was told to "take it or leave it," which was procedurally unconscionable to the court. *Id.* Substantive unconscionability, the court explained, arises when the contractual terms are harsh or oppressive. *Id.* Here, the California appellate court found the provision manifestly one sided. The court noted that the named plaintiff and those he sought to represent likely would not seek redress in small claims court for the very tiny amount of damages each class member claims. *Id.* at 1101. Focusing on "[t]he potential for millions of customers to be overcharged small amounts without an effective method of redress," the court thus struck the agreement's ban on class actions.¹ *Id.*

C. Hutcherson v. Sears Roebuck & Co.

Hutcherson v. Sears Roebuck & Co., 793 N.E.2d 886 (Ill. App. Ct. 2003), *appeal denied*, __ N.E.2d __ (Ill. 2003) (litigated by, among others, attorneys now with Sidley Austin Brown & Wood LLP), is representative of the cases that enforce arbitration clauses precluding class adjudication. In *Hutcherson*, the plaintiffs filed a class action based on improper charges to their Sears credit card accounts. *Id.* at 887-88. Sears

***Hutcherson v. Sears Roebuck & Co.* is representative of the cases that enforce arbitration clauses precluding class adjudication.**

¹ A California case which found the opposite of *Szetela*, *Discover Bank v. Superior Court*, 105 Cal. App. 4th 326 (Cal. Ct. App. 2003), has been accepted for review by the California Supreme Court, *Discover Bank v. Superior Court*, 65 P.3d 1285 (Cal.2003).

sought to compel arbitration pursuant to an arbitration clause in their contracts with the plaintiffs, but the trial court denied their motion. *Id.* at 889. The *Hutcherson* court reversed. *See id.* at 900. The *Hutcherson* court found that the arbitration clause, including its ban on class actions, was neither procedurally nor substantively unconscionable.

The *Hutcherson* court found that defendants satisfied procedural unconscionability even though, as in *Szetela*, Sears notified plaintiffs of the new arbitration clause by mail. *Id.* at 888. Procedural unconscionability arises "with 'unfair surprise,' fine print clauses, mistakes or ignorance of important facts or other things that mean bargaining did not proceed as it should." *Id.* at 891 (internal citation and quotation marks omitted). The procedural implementation of the arbitration provision banning class actions was acceptable because the original agreement stated it could be amended; the amendment regarding arbitration was conspicuous, clear and in capital letters; and, critically, it was not a take or leave it situation because "the card holders also were allowed to opt out of the amendments without causing their balances to become due and payable immediately." *Id.* at 894.

As for substantive unconscionability, the court in *Hutcherson* expressly rejected the analysis of *Szetela*. But the court in *Hutcherson* was armed with a critical fact that it repeatedly cited in upholding substantive unconscionability: the arbitration clause at issue required defendants to advance the arbitrator's fees. Moreover, defendants could demand that plaintiffs return the fees only if the arbitrator determined that the claim was frivolous. *Id.* at 895-96. The substantive facts thus were unlike *Szetela*, where the arbitration clause constituted a "get out of jail free" card because no putative class member would bring his or her claim in small claim court when only a minimal amount of money is at issue. To the contrary:

In this case, the arbitrator's decision is final and binding on SNB. Moreover, SNB undertakes the burden of all arbitration fees at the customer's request. SNB would remain responsible for the fees even if the customer loses but the arbitrator finds the claims were not frivolous.

Id. at 895.

The court then cited several cases upholding arbitration clauses barring class actions, concluding that "[a]lthough we recognize the importance of class actions as a tool for protecting consumers, we cannot ignore the strong policy that favors enforcement of arbitration provisions." *Id.* at 896. Thus, it was not unconscionable for the arbitration clause to preclude class adjudication. *Id.* at 888.

Policy Debate

Two policy considerations conflict in resolving the issue of whether a mandatory arbitration clause can preclude class actions. In voiding such clauses, several courts have identified the policy consideration of allowing consumers with relatively small claims to band together to pursue their cause and attempt to vindicate their rights. *See, e.g., Ingle v. Circuit City Stores, Inc.*, 328 F.3d 1165, 1175-76 (9th Cir. 2003); *Luna v. Household Fin. Corp.* III, 236 F. Supp. 2d 1166, 1178 (W.D. Wash. 2002). The court in *Ingle* captures the underpinnings of this position by emphasizing that the class action device is "an invention of equity." *Ingle*, 328 F.3d at 1175 (quoting *Hansberry v. Lee*, 311 U.S. 32, 41 (1940)). *Ingle* further adopts the logic that the class action "rests upon considerations of necessity and paramount convenience, and was adopted to prevent a failure of justice." *Id.* (quoting *Weaver v. Pasadena Tournament of Roses Ass'n*, 198 P.2d 514, 516 (Cal. 1948)).

On the other hand, in upholding arbitration clauses that preclude class

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"Although we recognize the importance of class actions as a tool for protecting consumers, we cannot ignore the strong policy that favors enforcement of arbitration provisions."

***Hutcherson* provides a good blueprint on how effective drafting can overcome these infirmities and result in court enforcement of arbitration clauses that preclude class certification.**

Companies can maximize their chances of obtaining enforcement of these clauses by following basic drafting rules.

adjudication, other courts embrace the policy which favors enforcing arbitration clauses whenever possible, especially in light of the Federal Arbitration Act. See, e.g., *Snowden v. CheckPoint Check Cashing*, 290 F.3d 631, 639 (4th Cir.), cert. denied, 537 U.S. 1087 (2002); *Hutcherson*, 793 N.E.2d at 896. *Snowden* contains reasoning typifying this position, highlighting the fact that "Congress enacted the FAA in 1925 in order 'to reverse the longstanding judicial hostility to arbitration agreements that had . . . been adopted by American courts, and to place arbitration agreements upon the same footing as other contracts.'" *Snowden*, 290 F.3d at 639 (quoting *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 24 (1991)). Cases favoring arbitration also point to "a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary." *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983).

Courts thus face a real dilemma when asked to choose between two conflicting policy decisions. The force of both of these policy considerations has not been lost on the courts, which has resulted in inconsistent and somewhat unpredictable holdings. This can create uncertainty for corporations, as it becomes difficult to know whether class claims are precluded or allowed. But effective drafting can result in valid, mandatory arbitration clauses that preclude the possibility of class certification.

Drafting Issues

Most courts that have voided arbitration clauses precluding class actions have found that the defendant's procedure in instituting the clause lacked fundamental fairness and/or the prohibition of class certification significantly undermined the consumer's ability to bring their grievance. *Hutcherson* provides a good blueprint on how effective drafting can overcome these infirmities and result in court enforcement of arbitration clauses that preclude class certification. It teaches that three simple drafting rules can maximize a corporation's ability to preclude class actions.

The first two rules apply to procedural conscionability. While basic, it is fundamental that notice of the arbitration provision prohibiting class arbitration must be in conspicuous and clear language, preferably in capital letters. Second, it is important to offer the consumer the ability to decline any amendment adding a mandatory arbitration clause without incurring negative economic consequences. Offering consumers the right to decline the amendment regarding arbitration without their balances becoming due and payable immediately accomplishes this goal in a financing setting. In an insurance setting, offering return of the cash balance or cash value without surrender charges similarly should pass muster. (Some state insurance codes, however, restrict in varying degrees the inclusion of an arbitration clause within an insurance contract.)

Finally, as for substantive unconscionability, companies must afford the consumer the ability to bring their claim. The mechanism utilized in *Hutcherson* is simple, expedient and fair: pay the consumer's costs of arbitration and require that the consumer reimburse those costs only upon a finding that the claim was frivolous.

Conclusion

As more and more corporations add arbitration clauses precluding class certification, the issue of these clauses' validity will continue to loom large in corporate litigation. Companies can maximize their chances of obtaining enforcement of these clauses by following basic drafting rules. Offering to pay expenses for bringing the arbitration claim appears to be an excellent procedural safeguard that helps to ensure that the clause passes the test of substantive unconscionability. Notice of the clause in conspicuous, comprehensible language is likewise critical. Finally, affording the ability to opt out of the contract without incurring economic damage advances procedural conscionability. If these simple rules are followed, then companies significantly enhance their ability to enforce mandatory arbitration clauses that preclude class actions.

CUTTING-THROUGH *KOKEN V. LEGION*: THE DOCTRINE OF THIRD-PARTY LIABILITY

BY: DEBORAH L. COTTON AND ANDREW C. SHOENTHAL

Developments in the liquidation of Legion Insurance Company and its sister company, Villanova Insurance Company (collectively, "Legion"), give reinsurers pause for concern. Although there may be uncertainties in the law of reinsurance, some propositions are widely accepted: reinsurance is a contract of indemnity, parties to reinsurance agreements must treat each other with utmost good faith, and a reinsurer typically must follow the fortunes of its reinsured. To this list, many would add that an original insured has no claim against a reinsurer absent a "cut-through" clause, novation, or assumption agreement. However, *Koken v. Legion Ins. Co.*, 831 A.2d 1196 (Pa. Commw. Ct. 2003), *appeal docketed*, No. 183 M.D. 2002 (Pa. July 29, 2003) ("*Legion*"), may indicate a new willingness for courts to challenge this principle in insolvency proceedings of fronting companies. In *Legion*, the Commonwealth Court of Pennsylvania held that four policyholders had demonstrated contractual rights as third-party beneficiaries of certain reinsurance contracts and thus could seek direct payment from reinsurers, despite express anti-cut through language in certain of the subject reinsurance contracts. The *Legion* decision represents a new high water mark in direct liability cases, and highlights the tensions inherent in insurance delinquency proceedings, where competing policies of giving effect to insureds' reasonable expectations, enforcing express contract provisions, and ensuring an equitable distribution of insufficient assets collide.

This article discusses the *Legion* opinion and analysis, contrasts it with a more restrictive ruling on direct liability in another Pennsylvania liquidation, and suggests a few ways in which reinsurers can try to minimize the possibility of direct liability.

Traditional Notions of Privity and Direct Liability

No privity of contract exists between a reinsurer and a policyholder. Accordingly, a policyholder generally cannot assert a claim sounding in contract against a reinsurer. See *Unigard Sec. Ins. Co. v. North River Ins. Co.*, 594 N.E.2d 571, 574 (N.Y. 1992) ("[A] reinsurance contract operates solely between the reinsurer and the ceding company [the insurer]; it confers no rights on the insured."). Absent contractual language to the contrary, the insolvency of the ceding company ordinarily does not create privity between a reinsurer and a policyholder where it is otherwise absent. See, e.g., *Reid v. Ruffin*, 469 A.2d 1030, 1034 (Pa. 1983).

Similarly, courts have generally rejected the argument that claimants and policyholders may recover reinsurance proceeds as third party beneficiaries of reinsurance agreements. See, e.g., *Leff v. NAC Agency, Inc.*, 639 F. Supp. 1426, 1429 (E.D. Mich. 1986) (policyholders are "mere incidental beneficiaries" and not "true third party beneficiaries" of reinsurance agreements); *Skandia America Reinsurance Corp. v. Schenck*, 441 F. Supp. 715, 724 (S.D.N.Y. 1977) ("New York courts have refused to consider the insured a third party beneficiary of the reinsurance treaty even if the insurer has become insolvent.").

However, there are exceptions to the general rule that claimants and

The *Legion* decision represents a new high water mark in direct liability cases, and highlights the tensions inherent in insurance delinquency proceedings, where competing policies of giving effect to insureds' reasonable expectations, enforcing express contract provisions, and ensuring an equitable distribution of insufficient assets collide.

However, there are exceptions to the general rule that claimants and policyholders cannot proceed directly against a reinsurer following the insolvency of the ceding company.

The Commonwealth Court of Pennsylvania approved a set of guidelines under which reinsurers could make direct payments to Reliance policyholders that would extinguish their liability to the Reliance estate.

The *Legion* court permitted a group of policyholders to proceed directly against Legion's reinsurers as third-party beneficiaries of the subject reinsurance contracts, despite the absence of cut-through clauses in most of the reinsurance contracts and express prohibitions against direct liability in certain of the contracts.

policyholders cannot proceed directly against a reinsurer following the insolvency of the ceding company. Contractual liability between a reinsurer and an original insured may be created by use of "cut-through" clauses¹, novations or assumption agreements.

Cut-through clauses typically require a reinsurer to pay claims directly to the insured in the event of the ceding insurer's insolvency. Courts usually uphold cut-through clauses. See, e.g., *China Union Lines, Ltd. v. Am. Marine Underwriters, Inc.*, 755 F.2d 26, 30 (2d Cir. 1985); *Am. Re-Insurance Co. v. Ins. Comm'n of Calif.*, 527 F.Supp. 444, 453 (C.D. Cal. 1981), *aff'd*, 696 F.2d 1267 (9th Cir. 1983); but see *Warranty Assoc. v. Commonwealth Ins. Co.*, 114 D.P.R. 166 (P.R. 1983) (finding cut-throughs void as improper preferences). Some courts have allowed direct recovery by a policyholder against a reinsurer where the ceding company is a fronting insurer. See, e.g., *Venetsanos v. Zucker, Facher & Zucker*, 638 A.2d 1333 (N.J. Super. Ct. 1994); *Great Atlantic Life Ins. Co. v. Harris*, 723 S.W. 329 (Tex. Ct. App. 1987).

Two recent Pennsylvania court decisions have considered the circumstances under which policyholders should have direct access to reinsurance. Their analyses and divergent conclusions shed light on this important issue.

1. The *Reliance* Liquidation

On October 3, 2001, Pennsylvania regulators placed Reliance Insurance Company ("Reliance") into liquidation. Thereafter, a number of Reliance policyholders sought direct access to reinsurance proceeds. The Commonwealth Court of Pennsylvania approved a set of guidelines under which reinsurers could make direct payments to Reliance policyholders that would extinguish their liability to the Reliance estate. See *Koken v. Reliance Ins. Co.*, No. 269 M.D. 2001 (Pa. Commw. Ct. April 26, 2002) ("*Reliance*"). The guidelines provide that a reinsurer of Reliance is not relieved of its duty to pay reinsurance proceeds directly to the Liquidator unless all of the following factors are present: (i) the reinsurance contract includes a direct payment clause that complies with Pennsylvania's insolvency statute, (ii) the reinsurer or the insured seeks and receives the approval of the Liquidator and the Court before a direct payment is made, and (iii) the Liquidator has applied the requirements of section 221.34 of Pennsylvania's insolvency statutes. 40 P. S. § 221.34. Additionally, the reinsurer must provide the Liquidator with a signed statement showing that the reinsurer has agreed to undertake a direct coverage obligation with the insured and that the insured has agreed to such an arrangement. *Id.* The *Reliance* court has approved numerous petitions for direct payments under these guidelines.

2. The *Legion* Liquidation

In *Legion*, by contrast, another judge from the Commonwealth Court of Pennsylvania took a more expansive view towards direct liability between original insureds and reinsurers.² The *Legion* court permitted a group of policyholders to proceed directly against Legion's reinsurers as third-party beneficiaries of the subject reinsurance contracts, despite the absence of cut-through clauses in most of the reinsurance contracts and express prohibitions against direct liability in certain of the contracts. A brief summary of the history of Legion and the relationship among Legion, its policyholders and reinsurers, illuminates the court's analysis.

¹ Some distinguish between cut-through clauses and cut-through endorsements. When this distinction is made, a cut-through clause typically refers to a cut-through agreement contained in the reinsurance agreement, whereas a cut-through endorsement generally refers to a cut-through agreement in the underlying insurance policy. Both seek to achieve the same result and this article will use the term "cut-through clauses" to encompass both terms.

² With respect to the *Reliance* guidelines, the *Legion* court observed that "those guidelines, while instructive, are not binding in the Legion and Villanova insolvency." *Legion*, 831 A.2d at 1234 n.88.

Legion was based in Pennsylvania and transacted insurance business in all 50 states, principally as a fronting company for various commercial lines of business. As a fronting company, Legion retained little, if any, underwriting risk and relied heavily upon reinsurance receivables. Between 1999 and 2002, Legion's liabilities mounted dramatically and its reinsurance collections stalled. By February of 2002, A.M. Best had downgraded Legion to a B rating, causing many of Legion's insureds, who require an insurer to have an A- or better rating, to cease doing business with Legion. On March 28, 2002, Pennsylvania officials placed Legion into rehabilitation. *Legion*, 831 A.2d at 1201-05.

Legion's finances did not improve in rehabilitation and, in August of 2002, the Legion Rehabilitator filed a petition to liquidate Legion. Legion's parent objected, and several large Legion policyholders sought leave to intervene to object as well. The court granted intervention to four major policyholders: Pulte Homes, Inc., Psychiatrists' Purchasing Group, Inc., Rural/Metro Corp., and American Airlines, Inc. (collectively the "Intervenors"). The Intervenors argued that a "standard liquidation" would harm their interests and not advance the needs of Legion. Legion, they contended, did not act as a typical insurer, but rather as a fronting company that bore no true underwriting risk and had no involvement in claims handling. The Intervenors negotiated directly with the reinsurers, they asserted, and the reinsurance procured was for their benefit, not Legion's. Moreover, guaranty funds offered no meaningful relief to Intervenors, they stated, because the size of their claims dwarfed the maximum payments under such funds and many of the Intervenors were not eligible for guaranty fund coverage because of the net worth limitations of most jurisdictions. In response, the Pennsylvania Insurance Commissioner argued that, *inter alia*, direct access is not available in the absence of a "precisely worded cut-through endorsement that accords with the Reliance guidelines." *Id.* at 1233-34.

The court acknowledged the general rule in insolvencies to deny policyholders and claimants direct access to reinsurance proceeds. However, the court stated, this was merely a "general rule that applies in the traditional insurer/reinsurer context" and the right of direct access is established on a "case-by-case basis." *Id.* at 1234. Examining the reinsurance relationships "in their entirety" among the Intervenors, Legion and the subject reinsurers, the Court determined that this general rule found little purchase here, where Legion retained no underwriting risk, neither adjusted nor funded claims, and did not place the reinsurance to which Intervenors sought access. *Id.* at 1234-35. The relevant reinsurance was placed directly by reinsurers, and annual meetings concerning the Intervenors' insurance needs typically were not attended by Legion officials. Accordingly, the court ruled that the Intervenors were third-party beneficiaries because it was the intention of all parties that Legion would serve only as a "pass-through" between the Intervenors and the reinsurers. *Id.* at 1239.

This decision, the court concluded, comports with rulings in other cases in which claimants were afforded direct access to reinsurers of an insolvent fronting company. *See, e.g., Venetsanos*, 638 A.2d 1333; *Great Atlantic Life Ins. Co. v. Harris*, 723 S.W. 329; *Klokner Stadler Hurter Ltd. v. Ins. Co. of the State of Pennsylvania*, 785 F. Supp. 1130, 1134 (S.D.N.Y. 1990). The majority of cases rejecting direct access to reinsurance of an insolvent insurance company, the court found, either did not involve a fronting insurer or involved key facts or contract language that were distinct from the case at bar. *Id.* at 1238 n. 94.

Allowing Intervenors access to reinsurance proceeds, the court continued, would not create an impermissible preference under Pennsylvania law. This preference argument lacked factual support in the record, the court determined, and Pennsylvania statutes already authorize direct access to reinsurance proceeds in certain circumstances. *Id.* at 1240, *quoting* 40 P.S. § 221.34 ("Payment made directly to an insured or other creditor shall not diminish the reinsurer's obligation to the insurer's estate except when the reinsurance contract provided for direct coverage

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To the extent that the relevant reinsurance contracts do not authorize cut-throughs, the court found, it is empowered in receivership proceedings to reform the contracts to "reflect the parties' intent ... [and] to avoid prejudice to policyholder rights."

It has been long settled, the court observed, that the constitutional provisions protecting the obligation of contracts against state action are "directed only against impairment by legislation and not by judgments of courts...."

In light of *Legion*, reinsurers of fronting companies may wish to consider additional steps to insulate themselves from direct liability

By structuring the reinsurance arrangement as a separate agreement from the underlying insurance policies, in both word and deed, a reinsurer can minimize the likelihood of subjecting itself to direct liability should its ceding company become insolvent.

of an individual named insured and the payment was made in discharge of that obligation."). Interpreting that statutory exception to authorize cut-throughs only under precise language, as urged by the Legion Rehabilitator, would be overly narrow as the industry recognizes a variety of cut-through wordings and no one form should be the "holy writ," the court declared. *Id.* at 1240-41.

To the extent that the relevant reinsurance contracts do not authorize cut-throughs, the court found, it is empowered in receivership proceedings to reform the contracts to "reflect the parties' intent ... [and] to avoid prejudice to policyholder rights." *Id.* at 1242. Nor does direct access impair contracts in violation of the United States and Pennsylvania Constitutions, the court determined. *U.S. Const.*, art. I, § 10; *Pa. Const.*, art. I, § 17. It has been long settled, the court observed, that the constitutional provisions protecting the obligation of contracts against state action are "directed only against impairment by legislation and not by judgments of courts...." *Id.* at 1243 (internal citations omitted).

Finally, the court ruled that policyholders similarly situated to the Intervenors may likewise seek direct access to reinsurance, and it ordered the Pennsylvania Insurance Commissioner to prepare a procedure allowing for such access. *Id.* at 1248.

The Pennsylvania Insurance Commissioner has appealed the *Legion* ruling directly to the Pennsylvania Supreme Court; enforcement of the ruling has been stayed pending the appeal.

Lessons from *Legion*

The *Legion* court took an aggressive position on policyholders' rights to direct access to reinsurance. This approach troubles many, who note the express prohibition against direct access in many of the relevant reinsurance contracts and the public policy embodied in insurance insolvency statutes which seek an equitable sharing of reinsurance recoverables among all claimants. Furthermore, the Intervenors were sophisticated entities that understood the risks in purchasing insurance from a fronting insurer.

Many will also take issue with the court's interpretation of case law, such as *Venestanos*, in which direct access was implied by the parties' conduct where, unlike here, the conduct of the parties was the only guide to the parties' intent, as the reinsurance contract "has not been found and cannot, therefore, be examined as to its terms." *Venestanos*, 638 A.2d at 1334.

Although the *Legion* decision is on appeal and its future uncertain, reinsurers of fronting companies should take notice of the opinion and the analysis underlying it. Reinsurer conduct may unwittingly create direct liability to policyholders or claimants, even where the relevant reinsurance contracts contain express prohibitions against direct access. In light of *Legion*, reinsurers of fronting companies may wish to consider additional steps to insulate themselves from direct liability. For example, reinsurers may insist that their ceding companies remain involved with the underlying risks and claims handling, as well as the placement and negotiation of reinsurance coverage. Reinsurers may also try to require cedents to retain some portion of the risk. By structuring the reinsurance arrangement as a separate agreement from the underlying insurance policies, in both word and deed, a reinsurer can minimize the likelihood of subjecting itself to direct liability should its ceding company become insolvent.

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REINSURANCE LAW REPORT

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