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INSURANCE & REINSURANCE LAW REPORT

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AN HONOR MOST SENSITIVE: DUTIES OF MUTUAL COMPANY DIRECTORS IN THE CONTEXT OF SIGNIFICANT STRATEGIC TRANSACTIONS

By Daniel J. Neppl and Sean M. Carney[1]

"A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior…the level of conduct for fiduciaries [has] been kept at a level higher than that trodden by the crowd." — Benjamin Cardozo[2]

Introduction

Following the onset of the financial crisis in 2008 and the resulting volatility in the stock prices of many publicly traded insurance companies, many mutual insurance companies began touting their mutuality as a selling point to potential policyholders. Some mutual companies went so far as to center national marketing campaigns on the virtues of the mutual form, citing the absence of a shareholder constituency as an advantage permitting these companies and their managements to put the interests of their policyholder-members first. Implicit in this concept is the notion that directors of a stock insurance company owe fiduciary duties first to their shareholders and must oversee the company in furtherance of those duties, while directors of a mutual company owe their first and only duty to the policyholder-members. While this sounds simple in a television commercial, when policyholder-members have contractual rights in their capacity as policyholders and other rights in their capacity as members granted by statute and a company's organizational documents, questions arise as to how the duties owed by mutual directors differ from those owed by stock company directors and whether such duties are owed to policyholder-members in their capacity as policyholders, members or both. The answers to these questions can have a significant impact on how the directors of a mutual insurance company exercise their duties.

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The situations in which mutual company board members must take into account their fiduciary duties are many, but certain types of decisions warrant particular focus. Specifically, certain decisions should require special care and attention, including transactions in which the company will (i) merge or otherwise combine with another company, (ii) affiliate with another company, (iii) demutualize or reorganize itself into a mutual holding company or otherwise engage in a fundamental organizational restructuring, (iv) liquidate all or a material part of its operations, (v) enter into a transaction that involves a fundamental change in business operations (including a material acquisition, disposition, reinsurance arrangement or joint venture), or (vi) make a material change in the rights of policyholder-members. Mutual company boards should be briefed on their fiduciary duties prior to commencing deliberations on any of these matters, and should understand fully how their duties are discharged in these contexts. The framework for this decision-making is the subject of this article.

There is a wealth of legal authority and commentary from academics and practitioners addressing the duties that the directors of a stock company owe to shareholders in the context of a proposed business combination and certain other significant transactions. However, the same cannot be said of the duties that the directors (or trustees) of mutual insurance companies and mutual insurance holding companies[3] owe in similar circumstances. The relative lack of legal authority and commentary can be attributed, at least in part, to the facts that: (i) the statutes and case law governing the corporate form and director duties for mutual insurers are typically much less well developed than those governing stock companies;[4] (ii) transformative transactions

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1 The authors thank Greg Oguss and Brian W. Tobin for their significant contributions to this article.

2 *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).

3 Generally, when used herein, "mutual" and "mutual insurer" refer to both mutual insurance companies and mutual insurance holding companies.

4 A preponderance of stock companies are organized in Delaware. Delaware has an extremely well-developed and well-tended-to body of corporate law, which exists as a result of legislative initiatives, an active corporate law bar, and a high-quality judiciary that addresses key issues "

This lack of guidance has frustrated board members of mutual insurers and their advisors seeking to understand and satisfy their duties in the context of business combinations and other significant strategic transactions. The problem has become particularly acute as the pace of consolidation, reorganization and strategic transactions among mutual insurers has increased in recent years.

involving mutual insurers have occurred much less frequently than similar transactions involving insurance and non-insurance related stock companies; and (iii) policyholder-members historically have been less likely to bring suit against boards of directors for alleged misconduct than shareholders of stock companies. This lack of guidance has frustrated board members of mutual insurers and their advisers seeking to understand and satisfy their duties in the context of business combinations and other significant strategic transactions. The problem has become particularly acute as the pace of consolidation, reorganization and strategic transactions among mutual insurers has increased in recent years.[5]

Further underscoring the importance of boards understanding and appropriately exercising their duties in the context of a significant transaction, the frequency of litigation following large-scale business combinations generally has increased sharply in recent years.[6] From 2005 to 2013, the annual percentage of stock company business combination transactions over $100 million challenged in shareholder litigation rose from 39% to 97.5%.[7] While litigation is less common in mutual company transactions, the overall increase in the level of litigiousness surrounding substantial business transactions is concerning and makes it crucial that members of boards of directors of mutual insurers understand the scope of the duties owed to members in the context of these transactions.[8]

In this article, we will briefly review the fiduciary duties of stock company board members generally, which mutual boards should consider when evaluating proposed business combinations or other significant transactions. Next, we will consider whether, and to what extent, these duties apply to mutual insurers. Finally, we will conclude with a discussion of the so-called *Revlon* duties in a mutual company context, and whether such duties can or should be applied in the context of business combinations involving mutual companies.

Summary of Fiduciary Duties Generally

As a general matter, the fiduciary duties owed by stock company directors may vary from one state to another. While not controlling in other states, Delaware law often guides the decisions of courts in other jurisdictions on matters of corporate law and governance… Under Delaware case law, fiduciary duties of corporate directors are usually described in three categories: the duties of care, loyalty and candor.

To understand the duties that the directors of a mutual company may owe to their policyholder-members, one must first have a basic understanding of the duties that directors of a stock company owe the company's shareholders. As a general matter, the fiduciary duties owed by stock company directors may vary from one state to another. While not controlling in other states, Delaware law often guides the decisions of courts in other jurisdictions on matters of corporate law and governance; therefore, we will briefly summarize a director's fiduciary duties under Delaware law.[9] Under Delaware case law, fiduciary duties of corporate directors are usually described in three categories: the duties of care, loyalty and candor.[10] These duties can be summarized as:

- Duty of Care: The seminal *Van Gorkom* decision in 1985 stated a board's duty of care as the duty to inform themselves, individually and collectively, fully and in a deliberate manner prior to voting on a third-party transaction as significant as a merger or sale of the company.[11]
- Duty of Loyalty: A board's duty of loyalty is a commitment by the fiduciary to act not in self-interest, but in the interest of the beneficiary of the fiduciary relationship, *i.e.*, shareholders, in pursuing a proposed transaction.[12]

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5 We believe the trend towards consolidation among mutuals will continue as some mutual companies look to expand following a long period of great financial success, while others (particularly smaller or more niche-focused insurers) struggle with capital constraints, slow organic growth, high expense ratios, lack of diversification and issues involving succession planning.

6 *See* Jill Fitch et. al., *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform,* 93 Tex. L. Rev. 557, 558–59 (2015).

7 *Id.*

8 *See* Section III *infra* for a discussion of certain recent litigation relating to material business transactions of mutual insurers.

9 *See* note 4.

10 While a detailed description is beyond the scope of this article, in-depth analyses of such duties in the context of business combinations have been offered in countless other sources. *See, e.g.,* Holly J. Gregory, *The Board's Role in M&A Transactions,* Practical Law The J., May 2014; Frank Easterbrook, *Contract and Fiduciary Duty,* 36 J.L. & Econ. 425 (1993); Robert Cooter, *The Fiduciary Relationship: Its Economic Character and Legal Consequences,* 66 N.Y.U. L. Rev. 1045 (1991).

11 *Smith v. Van Gorkom,* 488 A.2d 858, 873 (Del. 1985). Further elaborations of the duty of care have stated directors are required to take an active and direct role, from beginning to end, in a merger or sale and may not be passive instrumentalities during the transaction. *See Citron v. Fairchild Camera and Instrument Corp.,* 569 A.2d 53, 66 (Del. 1989); *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d, 946, 954 (Del. 1985).

12 *See, e.g., Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 361 (Del. 1993).

- Duty of Candor: While not as universally adopted as the duties of care and loyalty, the Delaware Supreme Court has described the duty of candor as the board's duty to "disclose fully and fairly all material facts within [the board's] control that would have a significant effect" upon the shareholder's vote.[13]

Generally, a director is required to discharge his or her duties in good faith, which may be violated if the director intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.[14]

Absent special circumstances, judicial scrutiny of a corporate board's actions are typically governed by the business judgment rule, which "presumes that 'in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.' "[15] As a general rule, this presumption shields a board from liability for alleged errors in business judgment, providing the directors with latitude, and incentivizing them, to take risks with the goal of maximizing shareholder value over the long-term. For example, in *Shlensky v. Wrigley,* Phil Wrigley's refusal, as president and a director of the Chicago Cubs, to install lights at Wrigley Field to permit night games and raise additional revenue, even in the face of the team's continuing financial losses, was determined to be a protected business decision in the absence of a "clear showing of dereliction of duty."[16] The rationale for the business judgment rule was cogently expressed in *Dodge v. Ford Motor Co.*, in which the Court noted, "[J]udges are not business experts."[17]

However, there are exceptions to the business judgment rule, which, if triggered, subject a board's action to heightened judicial scrutiny. One such exception is when a company receives a hostile takeover bid, in which case, rather than applying the deferential standard of the business judgment rule, under Delaware law, a court will evaluate whether any defensive measures adopted by the board were reasonable in proportion to the nature of the perceived threat to shareholders' interests posed by the hostile bid.[18] A second exception occurs in a transaction where one or more directors have a conflict of interest and that conflict is not cured in some way, such as an affirmative vote in favor of the transaction by a majority of disinterested directors. Because of the potential for self-dealing, if such a transaction is challenged, a board would bear the burden of justifying its actions under a demanding "entire fairness" standard of review.[19] A third situation in which the business judgment rule may not apply is in the face of certain business combination transactions where a board's *Revlon* duties are triggered, subjecting the decision-making to enhanced scrutiny and generally requiring the board to get the best price reasonably available.[20]

13 *Stroud v. Grace*, 606 A.3d 75, 85 (Del. 1992).

14 *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 243 (Del. 2009) (discussing good faith in the context of alleged violation of the duties of care and loyalty). The duty of good faith is not thought to be a separate duty apart from the duties of care, loyalty and candor. *See, e.g., Nagy v. Bistricer,* 770 A.2d 43, 48, n.2 (Del. Ch. 2000) (dismissing an alleged breach of the 'duty of good faith' as a standalone claim by determining that "a director cannot simultaneously act in bad faith and loyally" but stating that "[i]f it is useful at all as an independent concept, the good faith iteration's utility may rest in its constant reminder (1) that a fiduciary may act disloyally for a variety of reasons other than personal pecuniary interest; and (2) that, regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes").

15 *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 52 (Del. 2006) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

16 *See Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. 1968).

17 *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

18 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985). Elaborating on the *Unocal* test in a later decision, the Delaware Supreme Court held that, if the defensive measures are neither coercive of shareholders nor preclusive of a bid being made by the potential acquirer, such measures must simply fall within the "range of reasonableness" in proportion to the perceived threat. *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387–88 (Del. 1995).

19 *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

20 The enhanced scrutiny of *Revlon* applies in three situations. First, during an active auction process when a company is seeking to sell itself or otherwise effect a break-up of the company. *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1989). Second, when, in response to an offer, a company "abandons its long-term strategy and seeks an alternative transaction" that involves a break-up of the company. *Id.* Third, when there is a sale or change of control of the company. *Paramount Commc'ns, Inc. v. QVC Network Inc.*, 637 A.2d 34, 43 (Del. 1994). In such situations, if the transaction involves cash or, in certain circumstances, mixed consideration (or, if the acquirer has a controlling shareholder, in a stock-for-stock sale), a board is thought to be in "*Revlon* mode," which imposes special duties on corporate directors with respect to both the negotiation process and the outcome of the transaction. *See In re Smurfit-Stone Container Corp. S'holder Lit.*, No. 6164-VCP, 2011 WL 2028076 (Del. Ch. May 24, 2011) (holding that *Revlon* applied in a transaction in which the acquirer's stock represented approximately 50% of the consideration); *but see In re Santa Fe Pacific Corp. S'holders Lit.*, 669 A.2d 59 (Del. 1995) (holding that *Revlon* did not apply in a transaction in which 33% of the consideration was in the form of cash). *Revlon* may also apply in a stock-for-stock sale

Beyond simply exercising its business judgment in good faith, when in *Revlon* mode, a corporate board has a duty to determine and effect the "best transaction" for the shareholders,[21] typically without considering the potential impact on the company's customers, employees or any other stakeholders who are not shareholders.[22] In these situations, the role of the board famously shifts from "defenders of the corporate bastion to auctioneers" charged with achieving the best transaction.[23] A key rationale for the existence of *Revlon* duties is the fact that shareholders no longer hold any interest in the company following the sale of the company. As a result, a business combination in which the target's shareholders give up their ownership interest in the corporation represents their final chance to obtain a control premium and maximize the value of their shares. Following the logic of this rationale strictly, when *Revlon* duties are triggered, it would be improper for a board to evaluate an offer by weighing factors unrelated to pricing or other significant deal-specific elements, such as closing conditions and termination provisions.

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Derivative Suits Stemming from Significant Strategic Transactions Involving Mutuals

Because of members' dual status as both policyholders and members/owners of a mutual, at the very least, one might expect the *Revlon* analysis to be more nuanced in the context of a business combination involving a mutual insurance company. However, that is not to suggest that fiduciary duties, including *Revlon* duties, should be taken lightly or that they are a mere theoretical concept when it comes to relevant considerations for mutual boards. Breaches of these obligations can lead to real world costs; for example, a class action brought by former members of Harleysville Mutual relating to alleged breach of fiduciary duty was settled in 2012 for $26 million.[24] Given the risk of potential litigation, a prudent mutual board should carefully consider whether and to what extent it owes its policyholder-members fiduciary duties and should be aware of how the appropriate exercise of those duties may differ from the requirements faced by stock company boards.

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We will consider below whether and to what extent the duties of a mutual company board of directors include an obligation similar to the *Revlon* duty directors of a stock company can owe their shareholders.

Application of Fiduciary Duties to Mutual Company Boards

Members of a mutual insurance company differ from policyholders and shareholders in stock insurance companies in a number of ways that are relevant to any consideration of the duties the directors of a mutual company owe to their policyholder-members. While some commentators have described a policyholder-member's interest in a mutual company as an ownership interest,[25] there are important distinctions between a shareholder's ownership interest in a stock company and a policyholder's membership interest in a mutual. In a stock insurance company, shareholders posses voting rights, the right to share in the company's profitability through dividends and growth, the right to access certain information and the right to freely transfer their shares. Policyholders of stock insurance companies generally only have a contractual relationship with their insurance company governed by the terms of their insurance policy. Unlike shareholders, members of a mutual insurance company are required to be policyholders as well, and their status as members is directly tied to their ownership of an insurance policy issued

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if the acquirer has a controlling shareholder. *QVC Network Inc.*, 637 A.2d at 42–43 (applying *Revlon* in a stock-for-stock sale involving an acquirer with a controlling shareholder).

21 Over the years, judicial interpretation of the requirements of *Revlon* has undergone a significant evolution. While *Revlon* was initially interpreted as a mandate to accept the "best price" available, the doctrine has come to represent an obligation to achieve the "best transaction," which can include consideration of, in addition to price, various other factors such as feasibility, financing, closing certainty and the acquirer's identity, background and future plans for the company. *See, e.g., Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1281 (Del. 1989); *Paramount Commc'ns, Inc. v. QVC Network Inc.*, 637 A.2d at 44.

22 As discussed in note 38, the requirement to ignore concerns other than deal mechanics does not strictly apply in a state that has adopted an "other constituency" statute.

23 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986). While *Revlon* cast the notion of the best transaction as the one with the "best price," a more holistic view of *Revlon* duties has emerged over time. *See supra* note 21.

24 Nationwide Mutual Ins. Co., *Nationwide Announces Settlement on Harleysville Policyholder Class Action Litigation* (October 11, 2012).

25 *See* Theodore Allegaert, Note, *Derivative Actions by Policyholders on Behalf of Mutual Insurance Companies*, 63 U. Chi. L. Rev. 1063 (1996).

by the mutual (or, in the case of a mutual holding company, its applicable subsidiary). Unlike common stock and other securities, this membership interest is not transferable and when the insurance policy lapses, cancels or is otherwise terminated, any related membership interests are also extinguished.[26] Significantly, the Securities and Exchange Commission (the "SEC") has relied on opinions of counsel of mutual companies to determine that a membership interest is not a security for federal securities law purposes.[27] Moreover, a mutual member generally does not have a right to share in the profitability of the mutual company through dividends[28] or growth nor does a member generally have access to information in the manner and to the extent of a shareholder of a publicly traded stock company. On the other hand, certain similarities to stock ownership interests do exist: members of a mutual company generally have the right to vote in the election of directors and certain other significant matters concerning the company, including mergers and demutualizations, and they generally have the right to share in a mutual's surplus in the event of a demutualization or liquidation.

Although the issue is not entirely free from doubt, it is likely, and certainly prudent to assume, that a competent court examining the question would determine that directors of a mutual insurance company owe their company's members a fiduciary duty roughly equivalent to the fiduciary duties that directors of a stock company owe their company's shareholders. As in matters of corporate law generally, any consideration of the scope of a mutual board's fiduciary duties must be analyzed under the laws of the applicable mutual insurer's state of domicile. As noted above, there is significant case law evaluating the nature and scope of fiduciary duties owed by directors of a stock company (though much of this law resides in Delaware). In contrast, case law addressing the duties owed by directors (or trustees) of mutual insurance companies to their policyholder-members is relatively sparse. While courts in many states do not appear to have directly considered the issue of exactly what duties directors of mutual companies owe their policyholder-members, the near-universal position of courts that have considered this issue is that mutual directors do, in fact, owe a fiduciary duty to the company's members.[29] However, these jurisdictions are less consistent when setting forth the nature and scope of these fiduciary duties. As a general rule, courts approach the question of mutual fiduciary duties in one of two ways, either (1) suggesting that the fiduciary duties applicable to boards of stock companies apply to mutual insurers wholesale, or (2) stating that stock company fiduciary duties apply generally, but allowing that such duties may be of a different scope when applied to a mutual board.[30] Unfortunately, courts taking the latter view have largely failed to provide directors of mutual companies or their legal advisers with detailed explanations of the exact differences in scope and application.

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26 *See, e.g.,* Del. Code tit. 18 § 4910 (stating that each policyholder "is a member of the insurer during the period of insurance").

27 *See, e.g., Federal Life Ins. Co. (Mut.),* 2015 WL 5118692 (S.E.C. No-Action Letter, Aug. 31, 2015); *Nat'l Life Ins. Co.,* 1998 WL 643861 (S.E.C. No-Action Letter, Sept. 18, 1998); and *FCCI Mut. Ins. Co.*, 1998 WL 144687 (S.E.C. No-Action Letter, Mar. 30, 1998).

28 Some mutuals pay a form of "dividends" pursuant to the contractual terms of their insurance policies or in the form of policy credits. In addition, while the organizational documents of many mutual companies permit the declaration and payment of dividends to members in their capacity as members, the actual payment of such dividends (in contrast to those paid under policies) does not appear to be a common practice.

29 *See Ormond v. Anthem, Inc.*, 799 F. Supp. 2d, 910 (S.D. Ind. 2011) (denying a motion to dismiss on the grounds that mutual boards owe fiduciary duties to their members); *Rieff v. Evans*, 630 N.W.2d 278, 287 (Iowa 2001) (finding that a member has standing to bring a derivative claim against a mutual company); *Drain v. Covenant Life Ins. Co.*, 712 A.2d 273 (Pa. 1998) (same); O'Donnell v. Sardegna 646 A.2d 398 (Md. 1994) (finding that standing did not exist for a member of a cooperative, discussing the distinctions between a cooperative and mutual and implying that standing would exist in a mutual context); *Elgin v. Alfa Corp.*, 598 So.2d 807 (Ala. 1992) (finding that a member has standing to bring a derivative claim against a mutual company); *Noonan v. Northwestern Mut. Life Ins. Co.,* 687 N.W.2d 254 (Wis. Ct. App. 2004) (overturning a lower courts' grant of a motion to dismiss, finding that mutual boards owe fiduciary duties to their members), *cert. denied*, 689 N.W.2d 56 (Wis. 2004); *Lower v. Lanark Mut. Fire Ins. Co.* 502 N.E.2d 838 (Ill. App. 1986) (finding that a former member did not have standing as they voluntarily terminated their status as a "shareholder" of a mutual, but stating that the member had such standing prior to termination); *Heritage Healthcare Servs. v. Beacon Mut. Ins. Co.,* 2004 R.I. Super. LEXIS 29 (R.I. Super. Ct. 2004) (dismissing a derivative member claim for pleading particularity reasons, while stating in dicta that mutual boards owe fiduciary duties to their members); *see also* notes 30 and 32; *but see* note 31.

30 *Compare Amabile v. Lerner,* 166 A.2d 603 (N.J. Super. Ct. Ch. Div. 1960) (determining that a mutual is subject to the same fiduciary responsibilities as a stock corporation) and *Heritage Healthcare Servs.*, 2004 R.I. Super. LEXIS 29 (granting a motion to dismiss for pleading particularity reasons, but stating in dicta that directors of mutual insurance companies owe the same fiduciary duties to members as stock company boards owe to their shareholders) *with Silverman v. Liberty Mut. Ins. Co.,* 13 Mass. L. Rep. 303 (Mass. Sup. Ct. 2001) (holding that fiduciary duties exist, but expressly declining to determine the scope of those duties in a case involving a mutual merger) *and Ormond*, 799 F. Supp. 2d at 937 (allowing a breach of fiduciary duty claim to proceed following a demutualization, predicting that Indiana courts would determine that directors of mutual insurance companies owe fiduciary duties to their members in certain contexts).

We are aware of one case that stakes out a minority position. In *Shah v. Metro Life Ins. Co.,* the New York Supreme Court dismissed a derivative claim for breach of fiduciary duty following a demutualization transaction, holding that mutual boards do not owe a fiduciary duty to members and that the relationship between the mutual's board and the company's members is purely one of contract.[31] Although this case remains good law in New York,[32] ultimately it should be viewed with caution, as the court in *Shah* failed to draw a critical distinction, namely, that policyholder-members of a mutual insurance company occupy two distinct roles. First, they are policyholders, with contractual and regulatory rights under applicable insurance laws and regulations essentially identical to policyholders of a stock insurance company. Second, they are members, with certain ownership-like rights in the mutual that are much more analogous to the shareholders of a stock company. In focusing only on members as policyholders, the court in *Shah* seemingly failed to differentiate the rights and obligations possessed by members in their capacity as members and the rights possessed by members in their capacity as policyholders. Perhaps in part because of the court's failure to acknowledge this distinction, courts in other states have expressly declined to follow *Shah* when considering the question of fiduciary duties owed by mutual directors to the mutual's members.[33]

One key rationale for the existence of corporate fiduciary duties is the bifurcation of ownership (vested in shareholders) and control (vested in the board of directors) of a corporation.

Notwithstanding the outlier conclusion in *Shah,* public policy considerations would seem to favor a view that directors of a mutual company should owe a fiduciary duty to their members in their capacity as members. One key rationale for the existence of corporate fiduciary duties is the bifurcation of ownership (vested in shareholders) and control (vested in the board of directors) of a corporation. Requiring directors to adhere to the high standards required of a fiduciary when managing the affairs of a corporation helps to ensure that stock company directors prioritize shareholders' interests, even though a board's incentives may not necessarily align with such interests.[34] This is critical because shareholders have neither the economic incentive—as they may individually own only a fraction of the company — nor the ability — as they are not privy to all of the data and information available to the board — to fully and reasonably monitor board conduct. Like stock companies, mutuals have a similar bifurcation of incentives and interests between their members and directors.

Moreover, mutual members arguably have even less practical ability and incentive to monitor board conduct. Mutual membership is generally significantly more diffuse than corporate ownership, with each mutual member typically afforded one vote per policyholder or per insurance policy held, decreasing incentives for individual members to take an interest in the operation of the mutual when compared to the incentives of large shareholders of stock companies. Additionally, stock companies with at least $10 million in assets and more than 2,000 shareholders (or more than 500 shareholders who are not accredited investors) generally are required to file periodic, detailed GAAP financial and other reports with the SEC and to make timely disclosures of material developments that impact the company, including the entry into material definitive agreements and changes in the board and management. Such disclosures are not only publicly and readily available for free online, but for larger companies these reports are also scrutinized by Wall Street analysts, securities brokers and other market watchers. Furthermore, investor advisory firms, such as Institutional Shareholder Services and Glass Lewis, monitor public companies and regularly make recommendations on proxy votes. While some financial information is filed by mutual insurance companies with state insurance regulators and the National Association of Insurance Commissioners, mutual insurance companies do not have publicly traded stock and are not subject to SEC

31 *See Shah v. Metro. Life Ins. Co.,* 2003 N.Y. Misc. LEXIS 2016 (N.Y. Sup. Ct. 2003) (determining that the relationship between a mutual and its policyholders is one of contract and that any fiduciary obligations of directors arise from statute instead of common law), *aff'd as to fiduciary duties by Fiala v. Metro. Life Ins. Co.,* 6 A.3d 320, 322 (N.Y. App. Div. 2004).

32 *See Ormond v. Anthem, Inc.*, 799 F. Supp. 2d 910, 937 (S.D. Ind. 2011) ("the Court believes this is an issue where reasonable minds could disagree, as evidenced by the body of New York case law holding that a mutual company did not owe fiduciary duties with respect to claims arising out of a demutualization").

33 *Id; see* also note 30.

34 *See generally* Larry E. Ribstein, *Fencing Fiduciary Duties,* 91 B. U. L. Rev 899, 901.

reporting requirements, analysts and securities brokers are not regularly reviewing, scrutinizing and reporting on these companies, and investor advisory firms are not reviewing and making recommendations regarding their proxy votes. As a result of this relative lack of member and outside oversight when compared to stock companies, it is perhaps even more important that the boards of mutual companies be held to the high standard of fiduciaries when overseeing their companies' affairs.

In any event, prudent mutual company boards should assume they are subject to this high standard. In most regular, routine circumstances, the prudent exercise of fiduciary duties by directors of a mutual company would likely mirror the prudent exercise by directors of a stock company. Thus, directors of mutual companies would be wise to familiarize themselves with the detailed guidance available on how boards should properly exercise their duties, what to take into consideration, and when and how to rely on management and outside advisers in fulfilling their duties.[35]

However, where interests of members differ from the interests of shareholders in a manner relevant to a board decision, directors of a mutual company should take those differences into account in fulfilling their duties. Nowhere are these differences more apparent or more relevant than when a mutual company board is faced with the prospect of a business combination or some other material transaction.[36]

…where interests of members differ from the interests of shareholders in a manner relevant to a board decision, directors of a mutual company should take those differences into account in fulfilling their duties. Nowhere are these differences more apparent or more relevant than when a mutual company board is faced with the prospect of a business combination or some other material transaction.

Mutual Insurance Companies and *Revlon*

Business combinations of mutual companies can differ significantly in form and structure from stock company business combinations. As a result, post-transaction outcomes for members can be extremely different than outcomes for shareholders. If a stock company is acquired for cash, shareholders will be paid cash consideration for their shares and, thereafter, most former shareholders will no longer have any connection to the company. In such a situation, the *Revlon* duty to "get the best deal/price" makes sense. Mutual company business combinations, however, come in a variety of forms, many of which leave policyholders with a legacy policyholder interest in the company following the transaction, even if their membership interest is "extinguished" in exchange for some consideration. This distinction poses substantial challenges for the application of *Revlon* in the mutual context.

Despite such challenges, given the high-profile nature of consolidation transactions generally and the litigation risk associated with large-scale business combinations, it is critical that mutual directors be fully briefed on and understand their duties when evaluating a potential transaction and that they properly document their fulfillment of those duties. This is true whether the transaction impacts members' interests directly, as in a demutualization or merger, or indirectly, as in a joint venture or affiliation transaction. While mutual boards do owe members fiduciary duties not dissimilar to the duties that corporate boards owe to shareholders, the analysis required under *Revlon* is significantly less straightforward in the mutual context as a result of the distinctions in post-transaction outcomes noted above. As discussed in Section II, in the sale of a stock company that triggers *Revlon* duties, price and other significant deal-specific elements, such as the form of consideration, financing and the likelihood

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35 *See In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959, 967 (Del. Ch. 1996) (discussing the responsibilities of stock company boards to monitor the company's compliance with law while holding that a proposed settlement of a fiduciary duty claim against the directors of a healthcare company was reasonable after the company paid substantial criminal and civil penalties following allegations of kickbacks to contractors).

36 A thorough discussion of the forms of mutual company business combination and other material transactions is beyond the scope of this article, but can include, among others: (i) a sponsored demutualization, where the mutual insurer converts to a stock company and is simultaneously acquired by another person or entity, in which the mutual's members relinquish their membership interests in exchange for consideration that may take the form of cash, policy credits, stock or the right to acquire stock in the company or the acquirer; (ii) a mutual merger, where the mutual enters into a merger agreement with another mutual, and the members of the mutual and the members of its merger partner become members of the combined company; (iii) an affiliation, where the mutual enters into an affiliation agreement with another company that provides for the sharing of business functions such as underwriting, reinsurance, claims handling, and/or asset management and potentially involves the mutual ceding control of the board of directors to the other company; (iv) a traditional demutualization, in which members relinquish their membership interests in exchange for consideration or subscription or other rights, typically achieved through an initial public offering or similar capital raising transaction; (v) a joint venture, where two parties combine operations either by contractual arrangement or by contributing to a new, jointly-owned enterprise; and (vi) a mutual holding company or similar corporate restructuring.

of closing, are typically thought to be the most important considerations for a board. Much like a stock company sale, in a mutual change of control, price and other deal-specific elements related to a potential transaction are crucial factors that directors should carefully consider to satisfy their duties as directors of their company.

...because mutual members are also policyholders, it is not clear that price would or should be the sole overarching concern when evaluating a potential transaction (as it clearly would be for the vast majority of shareholders in a stock company considering a similar transaction).

However, because mutual members are also policyholders, it is not clear that price would or should be the sole overarching concern when evaluating a potential transaction (as it clearly would be for the vast majority of shareholders in a stock company considering a similar transaction). Critically, a mutual member's interest in the company is not fully extinguished upon the consummation of such business combination, because the member's status is inextricably linked to their status as a policyholder. As policyholders, members are likely to remain very interested in many aspects of their insurer following a business combination. Among other things, policyholders will rightly be concerned with how well their insurer will be managed, whether it will be able to meet its obligations to its policyholders over time, and whether the business combination will result in increased premiums or reduced benefits under their insurance policies. If one accepts the premise that these are legitimate concerns of members, then it follows that a board, when prudently exercising its fiduciary duties, should also be able to take these and other legitimate concerns into account when evaluating whether to pursue any particular business combination, even one that results in the extinguishment of the policyholder-members' membership interests.

...an argument can be made that mutual directors should, in addition to considering price and other deal-related terms, give substantial weight to the stability and reputation of the acquirer and the surviving entity, since that is likely to be a primary concern of the members with respect to a proposed change of control or some other transformative transaction.

Take, for example, a life insurance policyholder, who pays premiums today for the expectation of a payout in years or even decades in the future; a sale to a company with a lower A.M. Best Company rating or poor track record of dealing with its policyholders may create a greater risk that, following such a sale, the insurer is less likely to be there to pay insurance claims in the future. Therefore, because mutual members are, by definition, also policyholders of the mutual, a strong argument could be made that a mutual board should not blindly seek the best price, even in a transaction where the *Revlon* duty would otherwise appear to apply. Indeed, an argument can be made that mutual directors should, in addition to considering price and other deal-related terms, give substantial weight to the stability and reputation of the acquirer and the surviving entity, since that is likely to be a primary concern of the members with respect to a proposed change of control or some other transformative transaction.

In considering the extent to which the *Revlon* standard should be applied in the context of a mutual business combination, it is useful to recall that the primary rationale for *Revlon* is the extinguishment of a shareholder's ownership interests following a change of control, which is the totality of most shareholders' interests (*i.e.,* any shareholder that is neither an employee nor a customer of the target company). Because such a transaction represents a shareholder's final opportunity to maximize his or her investment, it is often argued that this obligates the board to manage an auction process in such a way as to protect the shareholders' "right to obtain a control premium."[37] Whether or not this interpretation is an unduly restrictive reading of what *Revlon* actually requires, its underlying rationale is not strictly compelling in the context of a mutual business combination given that, as noted above, a mutual member's interest is not fully extinguished following a merger or sale. This distinction suggests mutual directors should have greater flexibility with respect to satisfying their fiduciary duties to members in evaluating a takeover bid and/or running an auction and that they should be permitted to afford comparably greater weight to the effects of the proposed transaction on members in their capacities as both members and policyholders.[38]

37 *See, e.g., In re Smurfit-Stone Container Corp. S'holder Lit.,* 2011 WL 2028076, *13 (noting that *Revlon* applies when "there is no tomorrow for the corporation's present stockholders, meaning that they will forever be shut out from future profits generated by the resulting entity").

38 Furthermore, consideration should be given to whether there is an applicable "other constituency" statute that would permit directors to consider factors other than deal terms when evaluating a potential acquirer's offer. Other constituency statutes typically expressly allow directors, in evaluating transformative transactions, to weigh numerous factors besides deal terms, which, in an insurance industry context, could arguably include the proposed acquirer's reputation with respect to claims handling, in addition to the impact that the transaction may have on various non-shareholder (or non-member) stakeholders, such as the company's employees, suppliers and the local community. However, to the extent another constituency statute applies, given wide variations in statutory wording and the lack of interpretive guidance for courts to rely on, such

Conclusion

While a handful of courts have addressed the issue, in most jurisdictions, there is no definitive legal guidance on the scope of the fiduciary duties mutual boards owe to the company's members in the context of a significant strategic transaction. Although the substantial legal authority concerning corporate fiduciary duties provides some guidance, there are key differences between the structure of mutual insurance companies and corporations that may impact the necessary analysis. Additionally, there are compelling policy arguments that some corporate fiduciary duties, in particular those required by *Revlon*, should not be applied wholesale to mutual boards because the interests of members are not necessarily extinguished in a change of control transaction and members' concerns with respect to such a transaction are apt to be very different from the concerns of shareholders confronting a similar situation.

Nonetheless, despite such structural distinctions and compelling policy arguments, given the possibility of legal challenge following the consummation of any large-scale transformative transaction, a prudent mutual board contemplating such a transaction should assume that the full body of corporate fiduciary duties applies to their deliberations and decisions, including, in some form, the requirements of *Revlon*.

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statutes may be of limited practical value to directors who are weighing potential transformative transactions. Although Delaware is not among the states with an other constituency statute, as of early 2015, at least 28 states had in place some type of other constituency statute. *See* C8-5 Business Law Monographs §5.02 (listing the following states as having other constituency statutes: Arizona, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Massachusetts, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, New Mexico, New York, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Wisconsin and Wyoming). Other observers have commented at length on the inherent tension between *Revlon* and other constituency statutes. *See, e.g.*, Anthony Bisconti, *The Double-Bottom Line: Can Constituency Statutes Protect Socially Responsible Corporations Stuck in* Revlon *Land*, 42 Loy. L.A. L. Rev. 765 (2009) (arguing such statutes do little to encourage corporate social responsibility given *Revlon*'s dominance and the fact that legislators have not provided any framework to address the tension between protecting shareholder interests and encouraging companies to be socially responsible).

IS THE SUPREME COURT "PRO-ARBITRATION"? THE ANSWER IS MORE COMPLICATED THAN YOU THINK

By Susan A. Stone and Daniel R. Thies

...many believe that the Court is more likely than not to enforce arbitration clauses and uphold arbitration awards on appeal.

Over the last decade, the Supreme Court's jurisprudence on the Federal Arbitration Act ("FAA") has created an impression, at least in the popular press, that the Supreme Court is "pro-arbitration." As *The New York Times* wrote in 2013, "[i]n the eight years since Chief Justice Roberts joined the Court, it has...made arbitration the favored way to resolve many disputes." Adam Liptak, *Corporations Find a Friend in the Supreme Court,* N.Y. Times, May 4, 2013, at BU1. Based on this perception, many believe that the Court is more likely than not to enforce arbitration clauses and uphold arbitration awards on appeal.

Rather than operating on the basis of a single "pro-arbitration principle," the Supreme Court's FAA jurisprudence actually reveals two distinct principles at work.

Although this view is not completely inaccurate, it obscures some important nuances of the Supreme Court's jurisprudence over the past 10 years. Rather than operating on the basis of a single "pro-arbitration principle," the Supreme Court's FAA jurisprudence actually reveals two distinct principles at work. The first is what might be called the "Consent Principle," which states that "[a]rbitration is strictly a matter of consent, and thus is a way to resolve those disputes—*but only those disputes*—that the parties have agreed to submit to arbitration." *Granite Rock Co. v. Int'l Broth. of Teamsters,* 561 U.S. 287, 299 (2010) (citations and quotation marks omitted). This principle arises because of the fundamental fact that "an arbitrator derives his or her powers from the parties' agreement to forgo the legal process and submit their disputes to private dispute resolution." *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.,* 559 U.S. 662, 682 (2010). Without consent, there can be no arbitration.

The second principle is what the Supreme Court calls the "national policy favoring arbitration," as embodied in the FAA itself. *Buckeye Check Cashing, Inc. v. Cardegna,* 546 U.S. 440, 443 (2006). This principle arises because "the FAA was designed to promote arbitration," with the goal of "encourage[ing] efficient and speedy dispute resolution." *AT&T Mobility LLC v. Concepcion,* 131 S. Ct. 1740, 1749 (2011) (citations omitted).

So long as these two principles are both pointing in the same direction and thus operating in tandem—such as when the Supreme Court holds that state law prohibitions on agreements to arbitrate are preempted, *see, e.g., Marmet Health Care Center, Inc. v. Brown,* 132 S. Ct. 1201 (2012) (per curiam)—the Supreme Court's decisions might justly be called "pro-arbitration." Just as often, however, these two principles are opposed—that is, vindicating the agreement of the parties would limit the use of arbitration to resolve disputes or require overturning an arbitrator's award. These latter cases cannot unambiguously be called "pro-arbitration." Moreover, it is these latter cases that provide the most insight into the Supreme Court's FAA jurisprudence, and teach the majority of the lessons that are of interest to those in the world of reinsurance arbitration.

Questions of Arbitrability: Together the Consent Principle and the Policy in Favor of Arbitration Triumph Over State Law

The category of cases in which the two principles most often operate in tandem are those that decide whether a particular dispute is arbitrable. This category of cases includes those in which the question is whether the arbitrability of the dispute is itself arbitrable. That is, when a litigant challenges the enforceability of an arbitration clause in a contract, who decides if the arbitration clause is enforceable—the court, or an arbitration panel?

The Supreme Court's jurisprudence has established some basic principles for resolving this question, based on § 4 of the FAA, which provides that a court must order arbitration after it is satisfied that "the making of the agreement to arbitrate" is not at issue.

The Supreme Court's jurisprudence has established some basic principles for resolving this question, based on § 4 of the FAA, which provides that a court must order arbitration after it is satisfied that "the making of the agreement to arbitrate" is not at issue. 9 U.S.C. § 4. Under that language, the Court had long ago held that courts must decide any challenges to the validity of the arbitration clause itself, whereas challenges to the validity of the contract as a whole must be arbitrated. *Prima Paint Corp. v. Flood & Conklin Mfg. Co.,* 388 U.S. 395 (1967).

In the last decade, several cases tested whether this principle applied also to state courts, particularly in the face of state laws seeking to assign the decision away from arbitrators. In the first, *Buckeye Check Cashing, Inc. v. Cardegna,* the Court reaffirmed that "regardless of whether the challenge is brought in federal or state court, a challenge to the validity of the contract as a whole and specifically to the arbitration clause, must go to the arbitrator." 546 U.S. 440, 449 (2006). The second, *Preston v. Ferrer,* went yet further and held that this principle applies even in the face of a state law assigning exclusive original jurisdiction to a state administrative agency. 552 U.S. 346 (2008). Thus, the validity of a contract between an actor and his talent agent must be decided by the arbitrator, even though the California Talent Agencies Act assigned the decision to the state Labor Commissioner. A third case, *Rent-a-Center v. Jackson,* took another pro-arbitration step beyond *Buckeye,* holding that a challenge to the validity of an arbitration agreement itself may still go to an arbitrator if the parties' contract specifies that this "gateway issue" is itself arbitrable (at least so long as a party does not challenge the validity of the clause stating that the gateway issue is arbitrable). 561 U.S. 63, 69-70 (2010). In all three cases the Court's holding vindicated both the parties' contracts—which provided for arbitration to resolve their disputes—and the federal policy in favor of arbitration over conflicting state laws.

More recently, the Supreme Court has repeatedly asserted these principles against state courts refusing to recognize that the FAA preempts state law. In *Marmet Health Care Center, Inc. v. Brown,* 132 S. Ct. 1201 (2012), the West Virginia Supreme Court had held that an arbitration clause in a nursing home admittance agreement that was applicable to personal injury or wrongful death claims was unenforceable under state public policy. In a 9-0, *per curiam* opinion, the Supreme Court reversed, holding that the FAA preempted the state's rule, again citing both the need to enforce the parties' agreement and the "federal policy in favor of arbitral dispute resolution." *Id.* at 1203 (citation omitted). Two other cases with 9-0, *per curiam* decisions similarly reversed state supreme court decisions refusing to enforce arbitration clauses on state law grounds. *See Nitro-Lift Techs., L.L.C. v. Howard,* 133 S. Ct. 500 (2012); *KPMG LLP v. Cocchi,* 132 S. Ct. 23 (2011).

To be sure, questions of arbitrability do not always present situations in which the Consent Principle and the policy in favor of arbitration point in the same direction. For example, the Supreme Court's most recent decision in *DIRECTV v. Imbrugia*, No. 14-462 (Dec. 14, 2015), represents yet another example of the Court overturning a state court's invalidation of a binding arbitration provision in a consumer contract, this time including a class action waiver. Once again, the Court invoked the "federal policy favoring arbitration" to hold that the class arbitration waiver was effective despite contrary California law. *Id.* slip op. at 10. The Court acknowledged, however, that a contractual term making the arbitration clause ineffective where it was invalidated by "the law of your state" probably reflected the parties' understanding that class arbitration waivers would be ineffective in California. *Id.* at 1-2. The policy in favor of arbitration nonetheless trumped that understanding and the Consent Principle.

In another example, *Granite Rock v. International Brotherhood of Teamsters*, the underlying question was whether a collective-bargaining agreement ("CBA") containing a no-strike provision was in force at the time of a strike by the union that was a party to the agreement. Because the CBA contained an arbitration provision, under § 4 of the FAA all questions arising under the contract would typically go to an arbitrator after a court had satisfied itself that a valid contract had been formed. *See* 9 U.S.C. § 4. In *Granite Rock*, however, the dispute was *when* a contract took effect, not precisely *whether* a contract had ever been formed, and the arbitrability of that question was unclear.

The labor union had argued, and the court of appeals had held, that the federal policy in favor of arbitration made the result clear. The court of appeals noted that the FAA's "permissive policies in respect to arbitration counsel that any doubts concerning the scope of arbitral issues should be resolved in favor of arbitration." *Granite Rock*, 561 U.S. at 298 (quotation marks and citation omitted). Thus, because the question of when a contract was formed was distinct from the question of whether it was formed—the only question the FAA reserved for judicial determination—the court of appeals sent the dispute to arbitration. The Supreme Court reversed, however, noting that the federal policy in favor of arbitration "cannot be divorced from the first principle that underscores all of our arbitration decisions: Arbitration is strictly a matter of consent." *Id.* at 299. Moreover, if the contract was not in force on the date of the strike, the parties could not have consented to arbitrate a dispute arising from that strike. Accordingly, the date of contract formation was—like the question of whether a contract existed—a threshold question that required judicial determination. *Id.* In other words, the Consent Principle triumphed over the federal policy in favor of arbitration.

In most questions of arbitrability presented to the Supreme Court, the two principles point in the same direction, requiring the Court to vindicate both the parties' agreement to arbitrate and the FAA's endorsement of arbitration over conflicting state laws.

Still, cases like *Granite Rock* are few and far between. In most questions of arbitrability presented to the Supreme Court, the two principles point in the same direction, requiring the Court to vindicate both the parties' agreement to arbitrate and the FAA's endorsement of arbitration over conflicting state laws. The Supreme Court's arbitrability decisions have therefore gone a long way to creating the popular impression that the Supreme Court is "pro-arbitration."

Conflicts in Federal Law: Together the Consent Principle and the Policy in Favor of Arbitration Triumph Over Substantive Federal Rights

Another class of cases in which the Consent Principle and the federal policy in favor of arbitration point the same way are those in which the FAA is pitted against another federal statute. These cases generally present the question of whether an agreement to arbitrate is trumped by the need to ensure the vindication of a substantive right granted by another federal statute.

For example, in *14 Penn Plaza LLC v. Pyett*, 556 U.S. 247 (2009), the Court faced the question of whether individual union members could consent to arbitrate their claims under the Age Discrimination in Employment Act ("ADEA") through a collective bargaining agreement. To resolve the question, the Court first invoked the National Labor Relations Act's provision that a union can bind its members through collective bargaining. *Id.* at 255. Because of that provision, the individual union members had effectively consented to arbitration, and "having made the bargain to arbitrate, the party should be held to it" absent congressional intent to preclude a waiver of the right to litigate in court. *Id.* Moreover, Congress's decision to grant a substantive right, such as in the right not to be fired because of age in the ADEA, was insufficient to foreclose the operation of an arbitration clause, given the FAA's endorsement of arbitration as an adequate forum for the vindication of such rights. *Id.* at 265-67. The Court thus wove together both the Consent Principle and the federal policy in favor of arbitration to justify its enforcement of the arbitration agreement.

In *CompuCredit v. Greenwood*, 132 S. Ct. 665 (2012), the Court took these principles one step further to establish a kind of "clear statement rule" for Congress to override the FAA's directive to enforce the right to arbitrate. *See id.* at 672 ("Had Congress meant to prohibit these very common provisions in the [Credit Repair Organizations Act], it would have done so in a manner less obtuse than what respondents suggest."). In the absence of such clear congressional intent, the "liberal federal policy favoring arbitration agreements" and the need "to enforce agreements to arbitrate according to their terms" would ensure that arbitration agreements would be enforced. *Id.* at 669.

Finally, in *American Express Co. v. Italian Colors Restaurant*, 133 S. Ct. 2304 (2013), the Court endorsed the same principles even when the practical effect of an arbitration agreement was to preclude the enforcement of federal antitrust law. Thus, even though Italian Colors Restaurant had demonstrated that the cost of individual arbitration was far more than any one individual litigant could reasonably expect to recover, and that no litigant would thus bring an individual arbitration proceeding, the Court enforced a class arbitration waiver. *Id.* Once again, the power of the parties' consent to that provision, combined with the FAA's strong policy in favor of enforcing such agreements, carried the day, even though it meant that the right of an antitrust victim to sue was completely vitiated. Accordingly, when combined, the Consent Principle and the federal policy in favor of arbitration are a powerful combination, resulting in another class of "pro-arbitration decisions."

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Judicial Review of Arbitration Awards: The Two Principles Collide

In a third class of cases, the Consent Principle and the policy in favor of arbitration conflict, and the outcome of the conflict has been mixed. The first case in this category involved an arbitration agreement in which the parties agreed on a broad standard of review, under which the Court could overturn an award "(i) where the arbitrator's findings of facts are not supported by substantial evidence, or (ii) where the arbitrator's conclusions of law are erroneous." *Hall Street Assoc., L.L.C. v. Mattel, Inc.,* 552 U.S. 576, 580 (2008). The Consent Principle obviously pointed in the direction of upholding this agreement.

The Court, however, held that the FAA provided the exclusive grounds for overturning an arbitration decision through the FAA's expedited confirmation procedures.[1] The Court rejected Hall Street's argument based on the Consent Principle, and held instead that the FAA's provisions on overturning an arbitration decision should be read "as substantiating a national policy favoring arbitration with just the limited review needed to maintain arbitration's essential virtue of resolving disputes straightaway." *Id.* at 588. Moreover, "[a]ny other reading opens the door to the full-bore legal and evidentiary appeals that can render informal arbitration merely a prelude to a more cumbersome and time-consuming judicial review process, and bring arbitration theory to grief in post arbitration process." *Id.* (citation, alteration, and quotation marks omitted). In other words, the FAA prevents contracting parties from agreeing to what the Court considered to be an inferior arbitration process. The policy in favor of arbitration thus trumped the parties' agreement.

The opposite principle prevailed in *Stolt-Nielsen S.A. v. Animalfeeds Int'l Corp.*, 559 U.S. 662 (2010), which reviewed an arbitrator's decision that an arbitration agreement allowed class arbitration. Two aspects of the agreement were relevant: first, the parties had agreed that the question of class arbitration should itself be submitted to an arbitration panel. *Id.* at 668. Second, they stipulated that their settlement agreement was silent on the question of class arbitration, meaning that "there's been no agreement that has been reached on that issue." *Id.* (citation omitted). The arbitration panel attempted to fill this vacuum by citing "a consensus among arbitrators that class arbitration is beneficial in a wide variety of settings." *Id.* at 673. Based on this conclusion about what the Court called "public policy," the panel allowed class arbitration.

In this case, however, the Court held that a policy favoring arbitration could not trump the Consent Principle, and that "[t]he panel's conclusion is fundamentally at war with the foundational FAA principle that arbitration is a matter of consent." *Id.* at 684. Because the parties had stipulated that their agreement was silent on the question of class arbitration, they could not have agreed to class arbitration, and no policy in favor of arbitration could overcome that lack of consent. Moreover, the arbitrator could not

1 The FAA specifies that an award may be vacated through expedited judicial review only where the award was procured by "corruption, fraud, or undue means," where there was "evident partiality or corruption" in the arbitrators, where the arbitrators are guilty of misconduct in refusing to hear evidence, or where the arbitrators exceeded their powers or failed to issue an award on the subject matter submitted to them. *See* 9 U.S.C. § 10(a). The FAA also lists a limited number of circumstances in which a court can modify an arbitration award. *See* 9 U.S.C. § 11.

independently reach a conclusion based on "public policy" in the absence of some foundation in the parties' contractual agreement.

Ironically, this conclusion led the Court to ignore the other aspect of the parties' agreement, which had been to let the panel decide class arbitrability. The Court's decision usurped this power by holding that the only reasonable decision the panel could make was that there was no class arbitration. *Id.* at 677. Nonetheless, on the whole *Stolt-Nielsen* represents a vindication of the Consent Principle over the policy in favor of arbitration. Moreover, that principle led the Court in this case to a decision one might fairly describe as "anti-arbitration."

The Court's decisions in *Hall Street Associates* and *Stolt-Nielsen* are hard to square. In the first case, the Court held that the FAA limits the parties' ability to consent to particular arbitration procedures. In the second, the Court held that the FAA makes consent the "foundational principle" of arbitration. The third case in this category represents a sort of compromise between the two positions.

The Court's opinion therefore clarified the ruling in Stolt-Nielsen: *the problem there was not that the arbitrator's decision lacked a* sufficient *basis in the contract, but instead that it lacked "*any *contractual basis."*

In *Oxford Health Plans LLC v. Sutter*, 133 S. Ct. 2064 (2013), the Court again faced an arbitrator's decision that an arbitration agreement allowed class arbitration. This time, however, the arbitrator had explicitly referenced the text of the parties' agreement as the basis of his conclusion. The Court found that decision to be poorly reasoned — a concurring opinion noted that "[w]ere we reviewing the arbitrator's interpretation of the contract *de novo*, we would have little trouble concluding that" it was incorrect, *id.* at 2071 (Alito, J., concurring) — but nonetheless upheld the arbitrator's decision. The Court's opinion therefore clarified the ruling in *Stolt-Nielsen:* the problem there was not that the arbitrator's decision lacked a *sufficient* basis in the contract, but instead that it lacked "*any* contractual basis." *Id.* at 2069 (majority opinion). In other words, so long as an arbitrator claims to be basing her decision on the parties' agreement — even if that claim is debatable — the Court will uphold the decision. *Id.* at 2070 ("So long as the arbitrator was 'arguably construing' the contract…a court may not correct his mistakes…").

One can read this outcome as an attempt to harmonize the Consent Principle and the policy in favor of arbitration. That is, an arbitrator must at least pay lip service to the parties' agreement by advancing a rationale that is at least plausibly interpreting the parties' agreement. Because of the policy favoring arbitration, however, a court will not look behind the veil to pick apart this rationale. *Oxford Health Plans* thus attempts to mediate the conflict between the two principles by establishing a framework for the review of arbitration decisions that accounts for both.

Lessons for Reinsurance Arbitrations

What lessons can those involved with reinsurance arbitration learn from this description of the Supreme Court's cases? The first lesson is that it is too simplistic to say that the Court is "pro-arbitration." When the question is whether a particular dispute is arbitrable, it is true that the Court will generally uphold an arbitration agreement against conflicting state law. Moreover, it is now well established that the need to provide a forum for the effective vindication of a substantive federal right will only rarely justify a refusal to enforce an arbitration agreement. The basis for such decisions is not, however, a simple "pro-arbitration" orientation. Instead, such decisions are based on a dual adherence to both the federal policy favoring arbitration, as embodied in the FAA, and the basic principle that arbitration is a matter of consent. Where these two principles point in the same direction, parties can be confident that the law will uphold their arbitration agreements.

When the two principles conflict, as they often do when the question is whether a court should uphold an arbitration decision, however, the outcome will not be so clear. In these cases, the policy in favor of arbitration counsels upholding an arbitrator's decision. When doing so does violence to some aspect of the parties' agreement, however, a conflict will ensue. Parties should be aware that when the two principles are thus opposed, and in the absence of on point precedent, the outcome of the case will be more uncertain.

The Court's jurisprudence in this area also provides an obvious lesson for arbitrators, who should ensure that their decisions are grounded as much as possible in the contractual agreement of the parties. If an arbitrator fails to at least arguably interpret the contract, a general policy in favor of arbitration will not be sufficient to ensure that the decision holds up on appeal. Such decisions will be vulnerable to attack in court.

This lesson is particularly important for reinsurance arbitrators, who often base decisions on custom and practice in the insurance industry. To be sure, such decisions are usually not as untethered as the "public policy" concerns of the arbitrator in *Stolt-Nielsen*. For one thing, reinsurance contracts themselves generally point to consideration of custom and practice when they include provisions relieving the arbitrators from following the strict rule of law and allowing them to consider "equitable" principles. Nonetheless, arbitrators would still be wise to attempt to tether their decisions to a particular contractual provision whenever possible.

Is the Supreme Court pro-arbitration? Yes, it is, but it is also pro-enforcement of the parties' contractual agreements, and the two principles do not always point in the same direction. A full understanding of the Supreme Court's jurisprudence over the past decades requires an appreciation of both principles and the situations in which one or the other triumphs.

Is the Supreme Court pro-arbitration? Yes, it is, but it is also pro-enforcement of the parties' contractual agreements, and the two principles do not always point in the same direction.

REMEDIES FOR THE ROGUE ARBITRATOR

By William M. Sneed

The typical reinsurance contract arbitration involves a tri-partite panel of arbitrators, with each party appointing an arbitrator and a separate process governing appointment of the third arbitrator (known as "the umpire"). As parties and counsel well know, nothing happens in a tri-partite arbitration until all three panel members are appointed. Even then, however, a smooth path to final award is not guaranteed. The panel itself can exhibit dysfunction, interfering with a prompt resolution of the dispute. This article examines some examples of panel breakdown and how they have been addressed.

The No-Show Arbitrator

The panel should deliberate together on disputed issues, procedural and substantive alike. What if one arbitrator doesn't participate? Not responding to emails, missing conference calls, or even not attending hearings. It has been known to happen. *See* H. Smit, "Delinquent Arbitrators and Arbitration Counsel," 20 *Am. Rev. Int'l Arb.* 43, 44-46 (2009). Depending on how the arbitration clause reads, a no-show strategy may not completely derail an arbitration. But many arbitrators will hesitate to proceed without full participation, even if the failure to participate seems designed to disrupt the proceeding.

There is almost no case law in the United States addressing this unusual situation, which presents a problem for the panel in the first instance.

There is almost no case law in the United States addressing this unusual situation, which presents a problem for the panel in the first instance. Assuming the no-show arbitrator is party-appointed, the umpire will need to make a record of the behavior before deciding on how to confront it (whether kept within the panel, or reported out to the parties or their counsel). The confrontation should be factual and matter-of-fact in tone, as it could give rise to accusations of bias. The immediate goal is to end the non-participation. Failing that, the umpire should ensure that the record reflects the unexcused non-participation, notwithstanding proper notification to the delinquent arbitrator.

The decision in *Companion Property & Casualty Insurance Co. v. Allied Provident Insurance, Inc.,* 2014 U.S. Dist. LEXIS 136473 (S.D.N.Y. Sept. 26, 2014) ("*Companion v. Allied*"), recounts just such an effort by the umpire in a case where one party-appointed arbitrator essentially ceased active participation due to illness. The panel in that case granted an interim award of pre-hearing security against the reinsurer, who moved to vacate on the basis that two of the three panel members ruled without the participation of the arbitrator appointed by the reinsurer. The court rejected the argument, painstakingly recounting the umpire's efforts to engage the non-participating arbitrator and to address the problems caused by his illness.

Deliberations Without All Panel Members

As illustrated by the allegations in *Companion v. Allied*, this situation is the flip side of non-participation. Two of the three panel members deliberate without the third, who is "frozen out." The arbitration clause may provide that the panel can rule by majority vote, but that does not envision that a tri-partite panel becomes a bi-partite panel. An award entered under these circumstances may be subject to challenge under the Federal Arbitration Act ("FAA"), which includes the following grounds for vacating an award: where the award was procured by corruption or undue means, where there was evident partiality or corruption in the arbitrators, where the arbitrators were guilty of misconduct, including "any other misbehavior by which the rights of the parties have been prejudiced." *See* 9 U.S.C. § 10(a)(1)–(3).

These types of allegations, along with others (relating to *ex parte* contact), played a prominent role in *Star Insurance Co. v. National Union Fire Insurance Co.*, No. 13-13807, 2013 U.S. Dist. LEXIS 130379 (E.D. Mich. Sept. 12, 2013) ("*Star*"), a case in which a federal judge enjoined a reinsurance arbitration, which was at a stage where the panel had determined liability, but had not issued a final damages award. One of the elements for an injunction is likelihood of success on the merits, which the court addressed as follows:

> Plaintiffs are likely to prevail on their breach of contract claim for the failure to submit disputes before a three party panel. The Treaty says that any dispute, "shall be submitted to the decision of the board of arbitration, composed of two arbitrators and an umpire." Treaty, Article 21. Yet, Plaintiffs' arbitrator, Arbitrator Schlaybaugh, was not involved in two major decisions which impact whether Plaintiffs will be liable for over $25 million dollars. Arbitrator Schlaybaugh says that one of the issued orders changed the language of the Final Interim Award to Plaintiff's detriment.

2013 U.S. Dist. LEXIS 130379, at **17-18.

The court went on to find the defendant's counter-argument—that the third arbitrator was copied on e-mails respecting the decisions he claimed to be excluded from—unavailing because the arbitrator claimed that he had explained to the other panel members that he would be unavailable during a brief vacation. *Id.* at *18.

The Sixth Circuit reversed the decision, dissolved the injunction, and remanded for dismissal of the case — but not on the merits. *Savers Prop. & Cas. Ins. Co. v. Nat'l Union Fire Ins. Co.*, 748 F.3d 708 (6th Cir. 2014). Rather, the court found that judicial review of the arbitration was not available until the panel issued a final award:

> For the foregoing reasons, we reverse the judgment of the district court, dissolve the injunction, and remand the case for dismissal without prejudice. This is not to suggest that Meadowbrook is without remedy, or that the arbitrators' decision-making will forever be protected from judicial review. Meadowbrook is entitled to its day in court to challenge the fairness of the proceedings and the partiality of the arbitrators — just not until the panel has concluded its work and issued a final award.

748 F.3d at 722.

While finding that the challenge was premature, the court also noted that the issues would eventually be "raised in a motion to vacate under 9 U.S.C. § 10 or Michigan Court Rule 3.602(J) following the conclusion of the proceedings and the issuance of a final arbitration award." *Id.* at 720.

Improper *Ex Parte* Contact

In many reinsurance arbitrations in the United States, the arbitrators authorize *ex parte* communications between parties and the respective party-appointed arbitrators. *See* ARIAS*US. "Practical Guide to Reinsurance Arbitration Procedure" §3.9 (2004 Rev. Ed.): "At the Organizational Meeting, the Panel should establish a date for the cut-off of all *ex parte* communications between parties and the Panel members." Comment A to this section notes that possible dates for the cut-off of *ex parte* communications include "(a) the Organizational Meeting; (b) the end of discovery; (c) the filing of pre-hearing briefs; or (d) commencement of the hearing."

Conceivably, an arbitrator may violate the *ex parte* cut-off rule established in a case. That was one of the allegations in the *Star* case discussed above. The parties seeking an injunction in that case argued that the arbitration should be halted while they investigated what they alleged to be improper *ex parte* communications between counsel for their opponent and the arbitrator appointed by the opponent. They learned of the *ex parte* contact when reviewing the supporting documents for their opponent's fee petition — namely, attorney bills including time entries that detailed the dates of arbitrator-counsel contact.[1] The Sixth Circuit resolved this issue in the same way it resolved the issue respecting the alleged non-involvement of the third arbitrator — by finding the challenge to the fairness of the proceeding premature and

The Sixth Circuit resolved this issue in the same way it resolved the issue respecting the alleged non-involvement of the third arbitrator—by finding the challenge to the fairness of the proceeding premature and noting that the eventual arguments would be made in a motion to vacate a final award under 9 U.S.C. § 10.

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1 It appeared that the dispute about the propriety of the *ex parte* contact might turn on whether the cut-off of *ex parte* communications ended when the panel issued its liability ruling. *See* Star, 2013 U.S. Dist. LEXIS 130379, at *14.

noting that the eventual arguments would be made in a motion to vacate a final award under 9 U.S.C. § 10.

Improper *ex parte* communications between arbitrators and parties can provide grounds for a motion to vacate, most likely under the "evident partiality" or "misconduct" prongs of 9 U.S.C. § 10. *See, e.g., Lefkovitz v. Wagner*, 395 F.3d 773, 779 (7th Cir. 2005): "The defendants argue that the **arbitrator** engaged in ***ex parte*** **communications** and also exhibited bias in favor of the plaintiffs, and either type of behavior could be a basis for refusing to confirm an **arbitrator's** award."

But a mere showing of unauthorized *ex parte* contact is insufficient in and of itself. Something more must be shown, as this discussion in a reinsurance case illustrates:

> *Ex parte* evidence to an arbitration panel that disadvantages any of the parties in their rights to submit and rebut evidence violates the parties' rights and is grounds for vacation of an arbitration award. *See* 9 U.S.C. § 10(c); *see Totem Marine Tug and Barge, Inc. v. North Am. Towing, Inc.*, 607 F.2d 649, 653 (5th Cir. 1979). Appellants point to communication between PRMC, PRMC's arbitrator, and the umpire, but not appellants' arbitrator, in late fall 1986 concerning balances possibly due PRMC under the Agreements as an instance of an *ex parte* communication that violated their due process rights.
>
> However, the information communicated between the two panel members was common information routinely sent to the appellants in monthly balance statements. As such, it was readily accessible to appellants' arbitrator. Further, even if appellants' arbitrator had no reason to request the information between late fall 1986 and September 1987 because PRMC had not yet submitted a claim for the loss payments, all parties were on official notice in September 1987 that PRMC was claiming balances due. Appellants had ample opportunity, both before the panel formally considered setting up an escrow account four months later in early 1988 and before it finally issued the IFO in July 1988, to dispute the amount of the balances possibly due or to produce figures of their own. Appellants cannot claim that the earlier communication deprived them of notice or any right to dispute the evidence offered in September 1987 and later in 1988.

Pac. Reinsurance Man. Corp. v. Ohio Reinsurance Corp., 935 F.2d 1019, 1025 (9th Cir. 1991).

Courts require a party challenging an award on the basis of improper *ex parte* communications to show prejudice. *See Everett v. Paul Davis Restoration, Inc.*, 771 F.3d 380, 387 (7th Cir. 2014) ("Non-prejudicial *ex parte* communications are not a basis for vacatur."); *Mut. Fire, Marine & Inland Ins. Co. v. Norad Reinsurance Co.*, 868 F.2d 52, 57 (3d Cir. 1989) ("Even if we assume, as appellants contend, that the evidence they proffered establishes that the arbitrators engaged in some form of *ex parte* contacts, we nevertheless conclude that the arbitration award can stand because the appellants have failed to carry their burden of showing how these contacts prejudiced them."); *Employers Ins. Co. v. Certain Underwriters at Lloyd's*, No. 09-cv-201-bbc, 2009 U.S. Dist. LEXIS 89945, at *13 (W.D. Wis. Sept. 28, 2009) ("Not all *ex parte* communications destroy impartiality, even under the American Bar Association's Code of Ethics…")

Showing prejudice from an ex parte *communication, which—by definition—did not involve the challenging party, can be a tall order.*

Showing prejudice from an *ex parte* communication, which — by definition — did not involve the challenging party, can be a tall order.

Disclosing Panel Deliberations

A case that drew the attention of many in the reinsurance arbitration community involved allegations that a party-appointed arbitrator leaked panel deliberations and draft panel rulings to counsel for the party that appointed him. *Nw. Nat'l Ins. Co. v. Insco, Ltd.*, No. 11 Civ. 1124 (SAS), 2011 U.S. Dist. LEXIS 113626 (S.D.N.Y. Oct. 3, 2011) ("*NNIC v. Insco*"). By the time the opposing party (NNIC) learned of the alleged leak, the arbitrator (appointed by Insco) had resigned.

NNIC petitioned the federal court to disqualify counsel for Insco, and Insco argued that the court should decline to entertain the request and instead let the arbitration panel consider the issue. The court rejected that argument, noting that the subject matter concerned substantive state law regarding the legal profession. In addition, the panel had refused to consider the matter.

The court considered the matter in detail and disqualified Insco's counsel:

> [D]isclosure of the foregoing discussions tended to taint the proceedings, and to the extent there is any doubt, it should be resolved in favor of disqualification. In an age in which electronic communications play a central role in arbitrator deliberations, it is imperative that such communications remain as protected as all other forms of private panel interactions. Deliberate action to obtain such records is a disservice to the integrity of the adversarial process, and is strictly and unambiguously prohibited. Allowing parties to obtain confidential panel deliberations would provide an unfair advantage in the legal proceedings and have a chilling effect on the ability of arbitrators to communicate freely.

Id. at **36-37.

Insco argued that the panel communications it received were "legitimately discoverable" for the purpose of proving the alleged lack of impartiality of the arbitrator appointed by NNIC. 2011 U.S. Dist. LEXIS 113626, at **25-26. The court dismissed this argument, emphasizing that even in cases where an arbitrator can be deposed regarding claims of bias or prejudice, courts do not permit inquiry into the thought processes underlying their decisions. *Id.* at *29, citing *Hoeft v. MVL Group, Inc.*, 343 F.3d 57, 67 (2d Cir. 2003), *overruled on other grounds as stated in ATSI Commc'n, Inc. v. Shaar Fund, Ltd.*, 547 F.3d 109, 115 (2d Cir. 2008). The court went on to note that it "was not proper at any time for arbitrators to…assist a party in post-arbitral proceedings, except as is required by law." *Id.* at *30. Here, the court cited to the ARIAS*US Code of Conduct, Canon VI, comment 3.

The decision in *NNIC v. Insco* was appealed; but the appeal was later dismissed pursuant to a settlement of the dispute that NNIC and Insco were arbitrating, mooting the disqualification of counsel issue. The district court decision concerns disqualification of counsel, but it provides lessons for arbitrators in terms of proper and improper conduct. As the court put it, deliberate action to obtain internal panel communications "is strictly and unambiguously prohibited." *Id.* at *36.

Resignation

Occasionally, a party-appointed arbitrator resigns before the arbitration concludes. This circumstance can set off a scramble respecting appointment of a replacement. It is not unheard of for the opposing party to seek judicial appointment of the replacement, under the theory that the contract does not specify party appointment of *replacement* arbitrators. In *NNIC v. Insco*, NNIC sought a judicial arbitrator appointment after the arbitrator appointed by Insco resigned. *Nw. Nat'l Ins. Co. v. Insco, Ltd.,* No. 11 Civ. 1124 (SAS), 2011 U.S. Dist. LEXIS 50789 (S.D.N.Y. May 12, 2011). This was before the dispute respecting leaked panel e-mails came to light. The court rejected NNIC's request, finding that Insco had the right to appoint the replacement. *Id.* at *13: "The lack of a specific provision in the Reinsurance Agreement establishing a method for replacing arbitrators does not deprive Insco of its right, under the Reinsurance Agreement, to a party-appointed arbitrator."

A more complicated resignation scenario unfolded in *Insurance Co. of North America v. Public Service Mutual Insurance Co.*, 609 F.3d 122 (2d Cir. 2010) ("*INA v. PSM*"). In that case, after the full panel unanimously granted one party (PSM) summary judgment on one of the claims at issue, the losing party (INA) moved to reconsider. Before that motion was fully briefed, the arbitrator appointed by INA resigned based on ill health. INA argued that an entirely new panel needed to be appointed, and PSM disagreed. The district court agreed with INA, based on a line of authority providing that a new panel is appointed when a party-appointed arbitrator dies while the arbitration is pending. PSM appealed. During the course of the appeal, PSM learned that the arbitrator who had resigned due to ill health was taking arbitration appointments again, having apparently recovered his health. PSM asked him to re-join the Panel, and he refused. PSM moved the district court under Fed. R. Civ. P. 60(b) to reconsider its order directing appointment of a new panel.

The district court did reconsider its earlier order, and ended up re-appointing the arbitrator who had resigned. Now INA appealed, arguing that the rule was appointment of a new panel when an arbitrator resigns or dies. The Second Circuit disagreed:

> [A]pplying a broad rule requiring that a new panel be convened to vacancies occasioned by resignations would open the door to significant potential for manipulation…While no one contends that the instant case involved such manipulation, it would be tempting for a party to pressure its party-arbitrator, implicitly or explicitly, to resign following an adverse ruling so that it could get another shot at winning before a new panel.

609 F.3d at 130.

The moral of this case is that courts will scrutinize claims that an entirely new panel needs to be convened after a party-appointed arbitrator resigns.

The moral of this case is that courts will scrutinize claims that an entirely new panel needs to be convened after a party-appointed arbitrator resigns. Relying on the Second Circuit's decision in *INA v. PSM,* the court in *Companion v. Allied* held that vacancy occasioned by a resignation does not call for a new panel. 2014 U.S. Dist. LEXIS 136473, at ** 37-38.

Breach of Confidentiality

Arbitrations are typically confidential, and ARIAS*US has a standard confidentiality agreement that contemplates signature by the arbitrators. What if one of the arbitrators breaches confidentiality, disseminating arbitration information that was supposed to remain confidential?

Conceivably, an arbitrator breaching confidentiality would be subject to a court action, whether one seeking damages or injunctive relief. Arbitral immunity may have a bearing on any such claim. Most courts have held that arbitrators are quasi-judicial officers immune from liability for acts committed within the scope of their duties. *See, e.g., Pfannenstiel v. Merrill, Lynch, Pierce, Fenner & Smith,* 477 F.3d 1155, 1158-1159 (10th Cir. 2007). Immunity extends, however, only to decisional acts. *Id.* A breach of confidentiality may or may not be a decisional act.

Arbitral immunity was not an issue in *Trustmark Insurance Co. v. John Hancock Life Insurance Co.*, 631 F.3d 869 (7th Cir. 2011), but the case provides a good example of a decisional act in the context of confidentiality. In that case, a party (Trustmark) claimed that the arbitrator appointed by its opponent (Hancock) had breached a confidentiality agreement governing an earlier arbitration between the same two parties. The same arbitrator had been appointed by Hancock in the prior arbitration, and the dispute in the second arbitration concerned in part what weight to give to the award in the first arbitration. A majority of the panel in the second arbitration (including the arbitrator appointed by Hancock) ruled that the first award could be considered. Trustmark responded by seeking an injunction of the second arbitration. The district court granted the injunction, finding that the arbitrator appointed by Hancock was not "disinterested" due to his prior involvement.

The Seventh Circuit squarely reversed, holding that the arbitrator's prior knowledge did not render him interested in the dispute. The court also found that the second panel was entitled to construe the confidentiality agreement from the first arbitration. This was part of the decisional process the arbitrators were entitled to conduct: "Arbitrators are entitled to decide for themselves those procedural questions that arise on the way to a final disposition, including the preclusive effect (if any) of an earlier award." *Id.* at 874.

Conclusion

Notwithstanding the cases discussed above, most arbitrations run smoothly. But arbitrators should be ready for the exceptional case, which can be occasioned by another arbitrator or counsel. The remedy for rogue behavior may rest within the panel, or it may require judicial intervention. Judicial relief can be hard to come by, given the procedural and substantive hurdles to be cleared; but the truly egregious case has a way of catching a court's attention.

…arbitrators should be ready for the exceptional case, which can be occasioned by another arbitrator or counsel. The remedy for rogue behavior may rest within the panel, or it may require judicial intervention. Judicial relief can be hard to come by, given the procedural and substantive hurdles to be cleared; but the truly egregious case has a way of catching a court's attention.

UNRINGING THE *BELLEFONTE*? — NEW DEVELOPMENTS REGARDING THE COST-INCLUSIVENESS OF FACULTATIVE CERTIFICATE LIMITS

By Alan J. Sorkowitz

Sometimes called by practitioners "the *Bellefonte* issue," the question of the cost-inclusiveness of the stated limit of liability in a facultative reinsurance certificate has been a controversial one for over 20 years. The issue has created a conflict between the courts of different jurisdictions; between courts and arbitrators; and, needless to say, between reinsureds and reinsurers. There have been new developments on this topic of late, which should be studied by every practitioner in the field who wants to be current on this perpetually difficult issue.

The Issue

A facultative reinsurance certificate, particularly an older certificate, is likely to set forth, on its first page, a "Reinsurance Accepted" amount, sometimes described as the "limit" or "limit of liability." This is usually in the form of a blank filled in with a dollar figure, and often is expressed in the alternative as a part of, or percentage of, the limits of the policy reinsured. Frequently, there is also a stated dollar amount over which the Reinsurance Accepted amount shall be excess.

On its "Terms and Conditions" page, which is usually the second page, the certificate is also likely to include a follow-the-fortunes provision, stating that the reinsured's payment or settlement of claims shall be "binding upon" the reinsurer, and requiring the reinsurer to pay its share of such payments or settlements.

Crucially, the certificate is also likely to include a provision on the second page requiring the reinsurer to reimburse the reinsured for a specified share of the expenses incurred in connection with the adjustment of the claim. Such a provision might read as follows:

> All claims involving this reinsurance, when settled by the Company, shall be binding on the Reinsurer, which shall be bound to pay its proportion of such settlements, *and in addition thereto, in the ratio that the Reinsurer's loss payment bears to the Company's gross loss payment, its proportion of expenses incurred by the Company in the investigation and settlement of claims or suits*.[1]

Let us assume that the reinsured pays a claim in such a way that the indemnity loss is within the limit of Reinsurance Accepted, but that the total payment exceeds that limit when expenses are added in. Is the reinsurer obliged to pay only its share of the limit of Reinsurance Accepted, or is it also responsible for its share of the overage created by the expenses?

For example, assume that the Reinsurance Accepted amount is $5 million.[2] Assume further that the reinsured, on account of a major claim under the reinsured policy, pays $4 million to (or on behalf of) the insured on account of the loss and incurs $2 million in legal and other adjustment expenses defending the claim. Is the reinsurer liable to the reinsured for $5 million (the stated limit of the reinsurance), or for $6 million (the total amount paid)?

…is the limit of Reinsurance Accepted "cost-inclusive," such that it applies to both indemnity and expense, or "non-cost-inclusive," such that the reinsurer may have liability over and above the limit for expenses?

Stated differently, is the limit of Reinsurance Accepted "cost-inclusive," such that it applies to both indemnity and expense, or "non-cost-inclusive," such that the reinsurer may have liability over and above the limit for expenses?

1 The form of language set forth above is taken from the *Bellefonte* decision itself, described more fully below. Emphasis has been supplied. It is important to note that this language is only an example; nearly all certificates vary in their precise terms and, indeed, that is part of the overall issue, again as discussed below.

2 As noted above, the Reinsurance Accepted amount is more likely to be phrased as something like "$5 million part of $10 million excess of $1 million." To highlight the issue that concerns us, however, we will treat the Reinsurance Accepted amount as a simple dollar figure that is not excess of another figure.

The *Bellefonte* Decision

The United States Court of Appeals for the Second Circuit addressed this issue in *Bellefonte Reins. Co. v. Aetna Cas. & Sur. Co.*, 903 F.2d 910 (2d Cir. 1990). That case presented the cost-inclusiveness issue in classic form, as the reinsured paid the policyholder's claim in the full amount of the limit, and incurred substantial defense expenses as well. The court ruled in favor of the reinsurer, holding that the reinsurance limit is cost-inclusive and acts as a firm cap on the reinsurer's entire liability under the certificate, whether for indemnity loss or expense.

The reinsured argued that the follow-the-fortunes language in the certificate, requiring the reinsurer to pay its share of any and all losses, compelled the reinsurer to pay more than the Reinsurance Accepted limit. The court rejected this argument, holding that the follow-the-fortunes language was intended to "coexist with, rather than supplant," the Reinsurance Accepted language. 903 F.2d at 913. The result of this synthesis of clauses was that the reinsurer was bound to pay its share of all judgments and reasonable settlements (giving effect to the follow-the-fortunes doctrine), *but only up to* the amount of the stated limit (giving literal effect to the Reinsurance Accepted language). The court opined that this result was required by the principle that contracts should be construed "so as to give effect to all of their material provisions." 903 F.2d at 912, citing *Spencer, White & Prentis, Inc. v. Pfizer Inc.*, 498 F.2d 358, 363 n.23 (2d Cir. 1974). To allow the follow-the-fortunes language to create a payment obligation in an amount in excess of the limit of liability "would strip the limitation clause…of all meaning." 903 F.2d at 913.

Next, the court rejected the argument that the reinsurer was liable for defense expenses over and above the Reinsurance Accepted amount because its liability for such expenses was stated by the certificate to be "in addition" to its liability for settlements. According to the court, the "in addition" language was not intended to mean that liability for expenses was outside the limit of liability; its intent was "merely to differentiate the obligations for losses and for expenses." In other words, by characterizing the liability for expenses as "in addition" to the liability for losses, the court concluded that the certificate was "merely outlin[ing] the different components of potential liability," not placing one inside the limit and one outside it. 903 F.2d at 913.

In reaching this conclusion, the court emphasized the introductory language on the certificate's first page, which provided that the reinsurance was "subject to the terms, conditions and amount of liability set forth herein." If the entire agreement was "subject to" the limit of liability, the court reasoned, the "in addition" language could not take the liability for expenses outside that limit. 903 F.2d at 914.

In reaching this conclusion, the court emphasized the introductory language on the certificate's first page, which provided that the reinsurance was "subject to the terms, conditions and amount of liability set forth herein."

Unease With *Bellefonte* and Its Progeny

The Second Circuit's holding in *Bellefonte* came as a surprise to some in the reinsurance industry. As one commentator has stated, the decision "created great consternation in the industry." Robert M. Hall, "Expenses in Addition to Limits and Facultative Certificates" (2010) available at http://www.robertmhall.com/articles/ExpenseFacCerArt.pdf (2010). The opinion has been described as "one of the most important—and, at least in some circles, controversial—decisions in reinsurance jurisprudence." Robert A. Kole, "NY Courts Are Both Affirming and Limiting Bellefonte," *Law360*, Feb. 24, 2015, available at http://www.law360.com/articles/624465/ny-courts-are-both-affirming-and-limiting-bellefonte.

Some of the "consternation" may have stemmed from a sense that the result in *Bellefonte* was contrary to a putative general consensus in the industry, shaped through a long course of dealing among insurers and reinsurers together with rulings by many arbitration panels. Under this supposed general consensus, the "limits" provisions of a facultative reinsurance certificate apply to the insurer's (and hence the reinsurer's) liability for *indemnity* loss, which is the primary focus of any contract of insurance (or reinsurance). Under this school of thought, a reinsurer's liability to reimburse an insurer for defense expenses is separate and apart from the indemnity obligation and, where the reinsurance certificate indicates (as it did in *Bellefonte*) that the defense expense obligation is "in addition to" the indemnity limit, that obligation is not capped by the stated limit on indemnity loss.

Furthermore, the "consternation" was arguably fueled by the fact that the court in *Bellefonte* held the reinsurance certificate before it to be unambiguous, thus obviating any extrinsic evidence as to its meaning. For some in the industry, this conclusion seemed to cut off all debate on the cost-inclusiveness issue. The court viewed the contractual language as bringing defense expenses within the limit of liability, without any opportunity for argument as to the intent of the parties, the facts and circumstances relating to the making of the reinsurance agreement, or the customs and practices of the industry.

Nevertheless, *Bellefonte* became the law of the land, at least within the boundaries of the Second Circuit. Indeed, in *Unigard Secur. Ins. Co. v. North River Ins. Co.*, 4 F.3d 1049 (2d Cir. 1993), the Second Circuit reaffirmed *Bellefonte*. In *Unigard*, the court stated that the facultative certificate had language "virtually identical" to the one in *Bellefonte*, and ruled that the follow-the-fortunes language therein "did not override the limitation on liability." 4 F.3d at 1070. *Bellefonte* was followed by the lower federal courts within the Second Circuit, of course, *see, e.g., Allendale Mut. Ins. Co. v. Excess Ins. Co.*, 992 F. Supp. 271 (S.D.N.Y. 1997), and by district courts in other circuits as well. *See, e.g., Pacific Employers Ins. Co. v. Global Reins. Corp.,* 2010 U.S. Dist LEXIS 40506 (E.D. Pa., Apr. 23, 2010).

In *Excess Ins. Co. v. Factory Mut. Ins. Co.*, 3 N.Y.3d 577 (2004), the New York Court of Appeals adopted the *Bellefonte* rule for the courts of the State of New York. In *Excess*, the reinsurance agreement was even more succinct than the typical facultative certificate; it may have been a stamped slip or perhaps an acknowledged cover note. Apparently, the only provisions pertinent to the cost-inclusiveness issue were a "Limit" provision and a single "Conditions" paragraph. The "Limit" provision identified the limit of the reinsurance as $7 million per any one occurrence. The "Conditions" paragraph included (a) a following form clause, making the reinsurance subject to the "same valuation, clauses and conditions as contained in the original policy"; and (b) a follow the settlements clause, requiring the reinsurers to "follow the settlements of the Reassured in all respects and to bear their proportion of any expenses incurred." The Court of Appeals, citing *Bellefonte*, held that the "Limit" provision "is intended to cap the reinsurers' total risk of exposure," 3 N.Y.3d at 584, and thus the follow the settlements language cannot be read so as to require any additional payments, lest that language "render meaningless the liability cap negotiated." 3 N.Y.3d at 583.[3]

…an observer might have concluded that Bellefonte *was black letter law and that the cost-inclusiveness issue had been decided once and for all. Such a conclusion, however, would have been premature, as the industry unease with* Bellefonte *never fully went away.*

After *Excess*, an observer might have concluded that *Bellefonte* was black letter law and that the cost-inclusiveness issue had been decided once and for all. Such a conclusion, however, would have been premature, as the industry unease with *Bellefonte* never fully went away. There were contrary voices, and on rare occasions they attracted judicial support. For example, in *TIG Premier Ins. Co. v. Hartford Acc. Indem. Co.*, 36 F. Supp. 2d 348 (S.D.N.Y. 1999), the Southern District of New York, applying the substantive law of California, held that there was a question of fact as to whether the limit in a facultative certificate having wording similar to the *Bellefonte* certificate was cost-inclusive. California is more hospitable than New York to the admission of extrinsic evidence, and the court held that such evidence was admissible to determine whether there was a "latent ambiguity" in the certificate.

3 Judge Susan Phillips Read filed a vigorous dissenting opinion challenging the majority's rationale on two key points. Judge Read opined that, unlike the certificates in *Bellefonte* and *Unigard*, the certificate at issue did not include language explicitly making the reinsurance transaction "subject to" the stated limit. *Id.* at 588. She also asserted that the majority had paid too much attention to the follow the settlements language in the "Conditions" paragraph and too little to the "following form" language; since the latter adopted the terms and conditions of the underlying policy, it was plausible that the parties to the reinsurance certificate intended that the reinsurance limit would be cost-exclusive, as the underlying policy's limit was. *Id.* at 585.

New Developments

On December 4, 2014—nearly a quarter of a century after *Bellefonte* and 10 years virtually to the day after *Excess*—a new dimension was added to the cost-inclusiveness debate. The new contribution came from precisely the same place as *Bellefonte*: the United States Court of Appeals for the Second Circuit. The case was *Utica Mutual Ins. Co. v. Munich Reinsurance America, Inc.*, 594 F. App'x 700 (2d Cir. 2014).

In *Utica Mutual*, the cedent and reinsurer had executed a facultative reinsurance certificate having the following introductory language:

> The Reinsurer agrees to indemnify the Company against losses or damages which the Company is legally obligated to pay under the policy reinsured, resulting from occurrences taking place during the period this Certificate is in effect, subject to the reinsurance limits shown in the Declarations…

594 F. App'x at 703. The certificate also stated:

> The Reinsurer shall be liable for its proportion of allocated loss expenses incurred by the Company in the same ratio that the Reinsurer's share of the settlement or judgment bears to the total amount of each settlement or judgment under the policy reinsured…

Id.

After the cedent paid out the full limits of the underlying policy plus substantial sums in defense expense, it sought the reinsurance certificate limit plus a share of the expenses from the reinsurer. The reinsurer contended that it was not responsible for any amounts above and beyond the reinsurance certificate limit. The district court granted summary judgment to the reinsurer, citing *Bellefonte*, *Unigard*, and *Excess*. The Second Circuit, however, vacated the judgment, holding that the certificate was ambiguous and that it would be necessary for the district court to consider extrinsic evidence as to whether the limit was intended to be cost-inclusive.

The court began its analysis by observing that the cedent's interpretation of the certificate as non-cost-inclusive was one reasonable construction of the language. The court stated that, because only the reinsurer's obligation to indemnify the cedent for "*losses or damages*" was explicitly made "subject to the reinsurance limits," it was reasonable to conclude that the obligation to indemnify for *expenses* was not subject to those limits. 594 F. App'x at 703.

The court stressed, however, that the cedent's interpretation was not the only reasonable one. It noted that expenses might plausibly be considered to be part of "losses or damages," in which case the reinsurer's obligation to pay them would indeed be "subject to the reinsurance limits" and thus not the reinsurer's obligation beyond the stated limit. 594 F. App'x at 703.

Faced with two reasonable interpretations of the certificate language, the court held that it was ambiguous, and that the certificate's proper interpretation could not be determined on summary judgment without the benefit of extrinsic evidence. 594 F. App'x at 704.[4]

Faced with two reasonable interpretations of the certificate language, the court held that it was ambiguous, and that the certificate's proper interpretation could not be determined on summary judgment without the benefit of extrinsic evidence.

In the portion of the opinion that will be most gratifying to those who never accepted the rationale of *Bellefonte*, the Second Circuit distinguished and limited *Bellefonte* and *Unigard*. The court stated that those opinions,

> [t]urned on a provision in the policies [i.e., certificates] at issue that expressly made all of the reinsurers' obligations "subject to" the limit of liability; they did

4 The court adopted the definition of ambiguity set forth in *Lightfoot v. Union Carbide Corp.*, 110 F.3d 898, 906 (2d Cir. 1997): "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." *Id.* at 703. The court, however, made the determination that the certificate was ambiguous without the benefit of testimony from experts familiar with the reinsurance industry.

> not hold that a limit of liability, without such "subject to" language, is presumptively expense-inclusive.

594 F. App'x at 704.

The Second Circuit also commented on *Excess*. It recognized that *Excess* can "arguably" be viewed as holding that "a limit of liability, standing alone, is presumptively expense-inclusive, because it serves to cap a reinsurer's total exposure (for losses and expenses) at a specific, negotiated amount." 594 F. App'x at 704. The Second Circuit held, however, that any such presumption can be rebutted, and that the rebuttal evidence need not be so strong as "express language or a separate limit for expenses." *Id.* The court held that in the particular case before it, the certificate's statement that "losses or damages" are "subject to" the reinsurance limit "reasonably implies that expenses are not," thus overcoming any presumption of cost-inclusiveness. *Id.*

The *Utica Mutual* decision is a "Summary Order" of the Second Circuit, not signed by an individual judge and not published in the official Federal Reporter. It bears a legend reminding readers that "Rulings by Summary Order do not Have Precedential Effect." Its impact is thus a matter subject to debate.[5] 594 F. App'x at 700. It has, however, already spawned one notable new precedent.

In *Century Indem. Co. v. OneBeacon Ins. Co.*, 2015 Phila. Ct. Com. Pl. LEXIS 25 (Mar. 27, 2015), the Pennsylvania Court of Common Pleas, Philadelphia County, joined *Utica Mutual* in distinguishing and limiting *Bellefonte*. In *Century*, the introductory language to the facultative certificates at issue stated that the reinsurance "was subject to the general conditions set forth on the reverse side hereof." The "General Conditions" side of the page provided, among other things, that the reinsurer would be responsible for its proportionate share of settlements "and in addition thereto…its proportionate share of expenses…incurred by the" reinsured. The Pennsylvania court denied the reinsurer's motion for summary judgment limiting any recovery to the stated reinsurance limit, which was made in explicit reliance on *Bellefonte*.

The court pointed out that the case presented, in essence, the reverse of the *Bellefonte* fact pattern. Instead of the entire reinsurance transaction, including the general conditions, being subject to the stated limit as in *Bellefonte*, the transaction, including the limit, was subject to the "General Conditions." Thus, the "slight variations" in the certificate language mandated a precisely contrary result. Indeed, the court commented: "If anything, the terms of the certificates may have created a presumption of *expense-exclusiveness*." 2015 Phila. Ct. Com. Pl. LEXIS 25 at *8 (emphasis in original).

The court also stated that, in light of *Utica Mutual, Bellefonte* cannot be taken as establishing "a blanket rule that all limits of liability are presumptively expense-inclusive." Instead, such a presumption may or may not arise, based on the precise language of the "subject to" clause, and even if it does arise, it may be overcome by examination of the certificate as a whole. 2015 Phila. Ct. Com. Pl. LEXIS 25 at *7. A similar result was reached in *Utica Mut. Ins. Co. v. R&Q Reins. Co.*, 13-cv-01332 (BKS) (N.D.N.Y. June 4, 2015). In that case, the district court relied upon the Second Circuit *Utica Mutual* decision (which it described as "instructive" even if not "precedential") in holding that a facultative certificate was ambiguous as to cost-inclusiveness.

Conclusions

The next steps in the ongoing cost-inclusiveness debate cannot be predicted with any degree of certainty. Would the Second Circuit decide *Bellefonte* the same way today if faced with the same certificate language? Does *Bellefonte*—which held a certificate unambiguous on its face—have any meaning at all in jurisdictions that allow extrinsic

5 The legend refers to Federal Rule of Appellate Procedure 32.1 and Second Circuit Local Rule 32.1.1. Both of those rules allow citation of Summary Orders issued after January 1, 2007, but the latter rule prescribes that Summary Orders "do not have precedential effect." Thus, the *Utica Mutual* decision is not officially published and without "precedential effect," yet has been published in the Federal Appendix for all to see and comments upon weighty issues. What all this means in terms of its impact on the state of the law is a topic beyond the scope of this article.

evidence to be admitted to prove "latent ambiguity"? And what of New York, the state where so many reinsurance disputes are litigated? Will it give full effect to the apparent holding in *Excess* that the mere statement of a reinsurance limit creates a presumption of cost-inclusiveness, which some have said goes even further than *Bellefonte*? There are no ready answers.

Two things appear clear, however. The first is that there are no longer any simple answers — if there ever were — to the cost-inclusiveness issue. Blanket statements such as "all facultative reinsurance certificates are cost-inclusive and the reinsured cannot recover any amounts beyond the stated limit" are no longer valid. Each case will be decided only after careful parsing of the language of the applicable certificate.

Second, those in the reinsurance industry who were never comfortable with the holding of *Bellefonte* will now, emboldened by new developments, continue their efforts to limit or overrule it, leading to further litigation on this difficult topic.

…there are no longer any simple answers—if there ever were—to the cost-inclusiveness issue. Blanket statements such as "all facultative reinsurance certificates are cost-inclusive and the reinsured cannot recover any amounts beyond the stated limit" are no longer valid. Each case will be decided only after careful parsing of the language of the applicable certificate.

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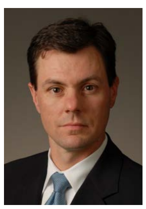

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