

July 2005

In This Issue...

Article

Follow the Settlements vs. Broad Discovery Rights: How Willing Are Courts To Grant Reinsurers Access To the Settlement Materials of their Cedents? ..... 1

Recent Decisions

Arbitration Panel May Not Order Deposition of Non-Party: Subpoena Invalid ... 2

Federal Court Abstention of Reinsurance Dispute Improper ..... 3

Seventh Circuit Holds Refusal To Compel Arbitration Proper... 3

New York Court Refuses To Appoint Arbitrator On Behalf of Cedent ..... 4

Contacts

Reinsurance Group Contacts... 4

Since its founding in 1901, Hunton & Williams has prided itself on excellence and hard work. Over the course of the last 100 years, the firm has experienced tremendous growth and currently consists of more than 850 attorneys in 17 offices in the United States, Europe, and Asia.

Follow the Settlements vs. Broad Discovery Rights: How Willing Are Courts To Grant Reinsurers Access To the Settlement Materials of their Cedents?

In the continuing environment of complex long-tail toxic and environmental claims, reinsurers and their cedents are regularly faced with the question of whether reinsurers are bound by the settlement decisions of their cedents with respect to the method of allocation of losses. Historically, the follow the settlements doctrine required a reinsurer to reimburse its cedent for good faith and reasonable settlement allocations. The inclusion of a follow the settlements clause in the reinsurance agreement only served to strengthen the principle that a reinsurer was bound by the reasonable and good faith settlements of its cedents. Recently, however, several courts have allowed reinsurers to obtain access to their cedent's settlement negotiations and evaluations regarding the method of allocation of losses to question the cedent's settlement allocations despite the existence of this well established doctrine

For example, in American Re Ins. Co. v. United States Fidelity and Guar. Co., 2005 N.Y. App. Div. LEXIS 5922 (N.Y. App. Div. 1st, Dep't June 2, 2005), a New York Appellate Court upheld a decision by the lower court requiring the cedent to produce evidence relating to a \$987 million settlement between the cedent and its policyholder. In an effort to determine whether any portion of the settlement amount constituted a payment for release of bad faith claims against the cedent, the reinsurer asked its cedent to produce

information regarding the method in which the cedent allocated its settlement payment to the various liability policies. The cedent refused on the grounds that the follow the settlements doctrine prevented the reinsurer from second-guessing its "good faith" decision to settle the underlying claims. The discovery referee ordered the cedent to produce the requested information and the cedent appealed the decision. In upholding the decision of the referee, the Appellate Court determined that "the so-called 'settlement privilege' is inapplicable since the reinsurers seek the settlement-related materials for a purpose other than proving the [cedent's] liability in the underlying coverage action." The Appellate Court also ruled that the information sought was material and necessary to the reinsurer's defense in the action and therefore, the information constituted an exception to the follow the settlements doctrine.

Additionally, in Affiliated F.M. Ins. Co. v. Employers Re Corp., 2005 U.S. Dist. LEXIS 8932 (D.R.I. May 12, 2005), while not specifically part of the holding by the court, the district court did allow the reinsurer to "look behind" the settlement agreement and allowed discovery of settlement materials. However, it is important to note that the district court determined that certain amounts paid under the settlement agreement may not have been covered by the reinsurance

continued on page 2

continued from page 1

agreement at issue and therefore, the reinsurer was entitled to conduct further discovery to analyze what portion, if any, of the settlement could not be billed to the reinsurer. The district court also



noted that the reinsurance agreement at issue did not contain an express follow the settlements clause.

These cases may be used by reinsurers to argue that they are entitled to discovery of settlement negotiations

and evaluations in an effort to demonstrate that certain amounts billed under a settlement allocation are not properly covered by the reinsurance agreement. These cases, however, appear to be a departure from previous cases and the more recent decision by the Second Circuit in *North River Insurance Company v. ACE American Reinsurance Company*, 361 F.3d 134 (2d Cir. 2004). In *North River* the Second Circuit held that absent some competent evidence of bad faith, a reinsurer could not “look behind” a settlement and obtain insight into the settlement negotiations which would only serve to undermine the follow the settlements doctrine. While the Second Circuit determined that the follow the settlements doctrine does not provide carte blanche protection to all allocation decisions made by the cedent, the doctrine does protect the post settlement allocation decisions of the cedent as

long as the settlement allocation meets the requirements of good faith, reasonableness, and is arguably covered by the policies. The *North River* case may be used by cedents to argue that any reasonable method of allocation of loss used by the cedent in the settlement of claims is protected from inquiry and discovery by the reinsurer.

Until case law in this area becomes more fully developed, the conflicting viewpoints with respect to the scope of the follow the settlements doctrine may lead to further litigation as courts and arbitrators grapple with how to balance the principles favoring the follow the settlements doctrine, such as lower transaction costs, with broad civil litigation discovery rules. Cedents should continue to carefully consider all of their post settlement allocation decisions if they intend to seek reinsurance for such settlements and reinsurers will need to carefully consider the costs and benefits of challenging a cedent's allocation method.

## Arbitration Panel May Not Order Deposition of Non-Party: Subpoena Invalid

A federal district court recently ruled that it is beyond the power of an international arbitration panel to order a non-party to appear for a pre-hearing deposition under the Federal Arbitration Act. See *Atmel Corp. v. LM Ericsson Telefon, AB*, No. M8-85 (S.D.N.Y. 2005). In *Atmel*, Sony Ericsson Mobile Communications, Inc. (“Sony”) moved to quash a deposition subpoena issued to it by arbitrators on behalf of Atmel Corporation (“Atmel”). Sony asserted that arbitrators lacked power to compel a pre-hearing deposition of a non-party. The court agreed.

The court stated that “[t]he weight of judicial authority favors the view that the Federal Arbitration Act, 9 U.S.C. §7 does not authorize arbitrators to issue subpoenas for discovery depositions against third parties.” The court explained that while the statute allows arbitrators to compel non-parties to attend a hearing before the arbitrator, it does not provide for pre-hearing discovery.

The Court distinguished an arbitrators’ implied power to compel the production of documents pre-hearing from the power to compel depositions pre-hearing. It explained that the Federal Arbitration Act’s grant

of power to arbitrator’s compel production of documents at a hearing necessarily implies a lesser power to require that the documents be produced before the hearing. But the court held that no such analog is appropriate for compelling the appearances of witnesses themselves. The court reasoned that requiring witnesses to appear twice, once for a discovery deposition, and again to provide testimony at a hearing, would increase the burden on non-parties and therefore could not be seen as an implied power, such as controlling the timing of the production of documents.

## Federal Court Abstention of Reinsurance Dispute Improper

The United States Court of Appeals for the First Circuit has held that a federal court should not have abstained from hearing a case regarding set-off rights under reinsurance agreements in favor of state liquidation proceedings. See *Sevigny v. Employers Ins. of Wausau*, No. 04-2411, 2005 U.S. App. LEXIS 10708 (June 9, 2005). In *Sevigny*, Home Insurance Company (“Home”) and an entity related to it, US International Reinsurance (“USI Re”), entered into reinsurance agreements with Employers Insurance of Wausau (“Wausau”). Wausau acted as the reinsurer to Home under certain agreements. Home and USI Re acted as Wausau’s reinsurer under other agreements.

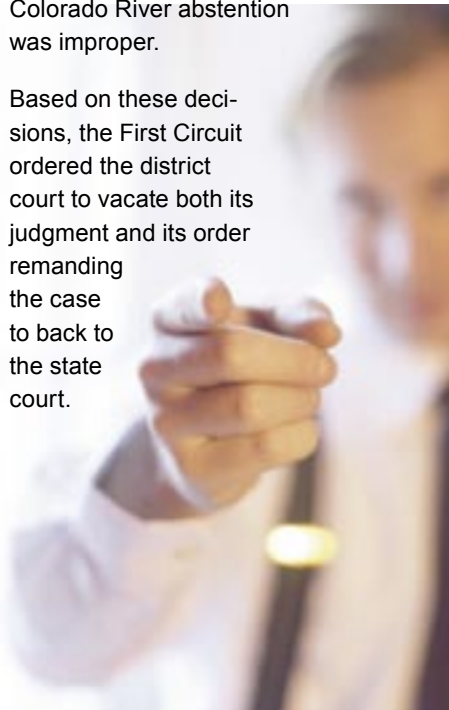
In the mid 1990’s, Wausau began to set-off amounts it owed to Home under some agreements, with amounts that it was owed by USI Re under other agreements. Home and USI Re objected and the matter was arbitrated. One of the issues in the arbitration was whether the credits and set-offs were “mutual.” Home asserted that there was no mutuality because credits and set-offs involved obligations of different entities. But the arbitration panel concluded that the set-offs were “proper and valid.”

Home was placed in liquidation on June 13, 2003, in New Hampshire. The liquidation order enjoined the set-off of any debts, but made an exception for mutual debts by reinsurers based on a New Hampshire statutory provision. The insurance commissioner subsequently filed suit in New Hampshire Superior Court and moved for an order that Wausau was not entitled to set-off debts because no mutuality existed. Wausau removed the case to federal court, but the district court remanded under the Burford and Colorado River abstention doctrines. Wausau appealed the remand.

The First Circuit held that the remand was improper because neither the Burford or Colorado River abstention doctrines applied. The Burford abstention doctrine “prevent[s] federal courts from bypassing a state administrative scheme and resolving issues of state law and policy that are committed in the first instance to expert administrative resolutions.” The First Circuit reasoned the insurance commissioner’s state court action sought only to interpret a state statute governing set-offs.

The First Circuit also rejected that Colorado River abstention applied. The Colorado River doctrine allows federal courts to abstain from certain actions based on, among other things, the development of the state court action and impact of the litigation on the state. With little explanation, the First Circuit held that the circumstances of the dispute over set-offs were not analogous to those in *Colorado River Water Conservation District v. United States*, 424 U.S. 800 (1976), and therefore Colorado River abstention was improper.

Based on these decisions, the First Circuit ordered the district court to vacate both its judgment and its order remanding the case to back to the state court.



## Seventh Circuit Holds Refusal To Compel Arbitration Proper

The United States Court of Appeals for the Seventh Circuit recently upheld a lower court’s refusal to compel arbitration because the insurance policy permitted, but did not compel arbitration. See *BCS Ins. Co. v. Wellmark Inc.*, 2005 WL 1324846 (7th Cir. June 1, 2005).

BCS Insurance Company (“BCS”) provided errors and omissions coverage to Wellmark from 1994 to 1997. The 1994-96 policies contained mandatory arbitration clauses, but the 1997 policy allowed the policyholder, at its option, to settle disputes with binding arbitration. Four class action lawsuits had been brought in 1994, 1995, 1996, and 1997 against Wellmark, who settled the lawsuits and sued BCS for coverage. The district court ordered arbitration of the claims under the 1994-1996 policies, but refused to order arbitration for the claim under the 1997 policy.

BCS appealed and argued that a “relation back” clause in the 1997 policy, incorporated the mandatory arbitration provision contained in the earliest policy. The Seventh Circuit disagreed. It held that while the “relation back” clause of the policy may or may not operate to limit the availability or scope of coverage, it did not apply to arbitrability. The Seventh Circuit reasoned that “[w]hatever effect the ‘relation back’ clause might have on the existence of coverage, the application of deductibles, and the limits of liability, it does not modify the arbitration clause.”

## New York Court Refuses To Appoint Arbitrator On Behalf of Cedent

A New York Supreme Court justice refused a request by certain Lloyd's of London syndicates ("Lloyds") to appoint an arbitrator on behalf of cedent Mutual Marine Office, Inc. ("Mutual Marine"). See *Certain Underwriters at Lloyd's v. Mutual Marine Office, Inc.*, No. 603452/04 (N.Y. Sup. Ct. 2005). The court held that Mutual Marine had no obligation to use the arbitrator selected for it by Lloyds and therefore the court refused to make the appointment.

In *Mutual Marine*, Lloyds reinsured Mutual Marine under various reinsurance treaties. The treaties contained two different arbitration provisions. Some treaties, the "court appointment treaties," called for a single arbitrator. If the parties did not agree on a single arbitrator within 30 days, the parties would each choose arbitrators who would select an umpire. If the respondent did not appoint an arbitrator, it allowed the claimant to apply to a court to make the appointment.

Other treaties, the "party appointment treaties" called for three arbitrators and allowed either party to pick two of the three arbitrators if the other party did not select an arbitrator within 30 days of the demand. The two arbitrators would then select a third. Mutual Marine demanded arbitration concerning a dispute under certain of the treaties, but did not specify which ones.

Lloyds requested that the court appoint an arbitrator for Mutual Marine asserting that Mutual Marine failed to timely appoint an arbitrator "within thirty days of making the demand for arbitration." The court determined that although Mutual Marine did not specify which treaties it made its demand under, based on the language of its demand, it must have been the court appointment treaties. The court then reasoned that these treaties set no time limit restriction on the claimant, Mutual Marine, to give notice of its arbitrator and only allowed Mutual Marine to select an arbitrator for the respondent, Lloyds, if Lloyds did not timely select one, but they did not allow Lloyds the same right. Consequently, the court denied Lloyds request to appoint an arbitrator for Mutual Marine.

## Contacts

**Walter J. Andrews**

Partner  
(703) 714-7642  
wandrews@hunton.com

**Lon A. Berk**

Partner  
(703) 714-7555  
lberk@hunton.com

**Paul E. Janaskie**

Partner  
(703) 714-7538  
pjanaskie@hunton.com

**Edward J. Grass**

Partner  
(703) 714-7649  
egrass@hunton.com

**Robert R. Lawrence**

Counsel  
(703) 714-7561  
rlawrence@hunton.com

**Samantha B. Miller**

millers@hunton.com  
(703) 714-7651

**Stephanie P. Manson**

smanson@hunton.com  
(703) 714-7674

**Steven W. McNutt**

smcnutt@hunton.com  
(703) 714-7624

Hunton & Williams represents cedents and reinsurers in disputes involving reinsurance and advises clients on reinsurance issues. For more information about Hunton & Williams Insurance and Reinsurance Practice, please visit [www.hunton.com](http://www.hunton.com).

McLean Office • 1751 Pinnacle Drive • Suite 1700,  
Tysons Corner • McLean, VA 22102

© 2005 Hunton & Williams LLP. These materials have been prepared for informational purposes only and are not legal advice. This information is not intended to create an attorney-client or similar relationship. Please do not send us confidential information. Past successes cannot be an assurance of future success. Whether you need legal services and which lawyer you select are important decisions that should not be based solely upon these materials. Photographs are for dramatization purposes only and may include models. Likenesses do not necessarily imply current client, partnership or employee status.