

LEGAL FOCUS

Major legal challenges for reinsurers

THESE are interesting times in the reinsurance industry. On the one hand, the good news is the industry is enjoying hardened rates. On the other, reinsurers have faced exceptionally large exposures, including claims resulting from September 11 and asbestos, as well as concerns on the balance sheet side of the business, where solvency has been increasingly in the spotlight. In this article we outline three of the legal challenges the industry now faces.

US liability claims

One of the biggest challenges to the industry is the continuing long-tail claims awaiting resolution in the US. There is a range of such claims, including environmental exposure to chemicals such as TCE and PCE.

One particular problem is the subset resurgence of litigation over asbestos. In the 1980s there was a large wave of claims in the US against asbestos manufacturers and suppliers. Many of those defendants were put out of business, and a large part of the liabilities ended up in the London reinsurance market.

The size of the losses was enormous. Between 1987 and 1992 Lloyd's paid \$14bn in asbestos claims, and this led to the creation of Equitas.

The crest of that first wave of claims passed some years ago, but we are now seeing a second wave. This time the defendants are typically users of asbestos, rather than producers — for example, car manufacturers that used asbestos in vehicle components. In most cases the plaintiffs have no symptoms of serious illness but are claiming based on their exposure to the product, which might cause them to become ill many years down the line.

According to Rand Corporation, over 600,000 people

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have filed asbestos claims against more than 8,400 US companies. Tillinghast-Towers Perrin estimates cumulative asbestos liabilities will reach \$200bn. Defendants are typically notifying under their general liability policies, which usually provide wider coverage than product liability policies. Many reinsurers have revised their underwriting guidelines, so that they will not cover any asbestos-related claims at all. But reinsurers face a large tail of asbestos claims made before such exclusions took effect.

Dealing with these claims is likely to be a substantial drain on the industry. For example, Ace last year increased its reserves for asbestos claims by \$2.2bn, over 80% of which was expected to be recoverable from its reinsurers.

Wordings

A systemic challenge that plagues the insurance and reinsurance industries is the need to improve the quality of documentation. It is a tru-

sion between getting the deal done and spending excessive amounts of time detailing precisely what is agreed. Getting into the details of exactly what is and is not to be covered means focusing discussions down from the wood and into the trees, and if no claim arises, then spending much time doing this may be viewed as unproductive.

Alternative risk transfer transactions have thrown into stark relief the different practices in the insurance industry and other financial industries. Bankers spend considerable time getting contractual documents accurate and finalised before the transaction is signed off, and they are often amazed to see the sketchiness of some insurance wordings.

The extreme example is where insurance coverage is provided, but on terms that are to be agreed. This causes obvious problems if a claim arises before the final wording is drawn up. The most prominent recent example of this was the property coverage of

where it is inevitably difficult to reach any consensus.

In September Lloyd's chief executive Nick Prettejohn noted: "There are a number of features of our industry process at which any outsider would wonder. The concept of multi-million-pound exposures being assumed without a precisely-agreed contract is peculiar to our industry."

He lamented that the Lloyd's market alone spends £500m (\$919m) annually on legal advice as part of the claims process. The challenge for the industry is to move more of this advice and analysis to the front end of the deal, rather than leaving coverage uncertainties to be resolved as part of the claims phase.

Although this will require something of a shift in culture, we see encouraging signs that this is happening.

Because of the nature of the contracts, drafting reinsurance terms tends to be less of a problem than drafting primary coverage. The drafting point that most commonly causes confusion in reinsurance is probably the use of the expression "as



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see what the parties would have intended, but the English courts have been invoked on several occasions. So the safer option is to flesh out the expression whenever there could be real uncertainty over how the two contracts will work together.

Regulation

Certain members of the industry also face challenges in the form of regulation on both sides of the Atlantic. In London the Financial Services Authority issued a consultation paper last year that proposed the formal capital requirements for insurers and reinsurers in the UK be made more onerous than the minimum set by the EU. Most reinsurers comfortably exceed these margins but, given the uncertainty in the financial markets, this is a change some would prefer not to have imposed upon them. At the same time, the EU is drafting a reinsurance directive that is expected to be adopted by the European Commission in late spring. This directive, which will be broadly based on the current regime for insurers, will require all reinsurers in the EU to become regulated.

Over in the US, "alien" reinsurers are concerned by the American Credit for Reinsurance laws, which in effect require them to post collat-

eral to US cedants. Unless such collateral is given, the cedant is not permitted to take account of potential reinsurance recoverables, and so in practice such reinsurers tie up substantial amounts of capital in trust funds or similar arrangements at a time when that capital may be badly needed elsewhere.

These restrictions do not apply to US reinsurers, and some European and offshore reinsurers complain the playing field is being tipped to their disadvantage. Lloyd's chairman Lord Levene, for example, has called the situation "frankly absurd".

Conclusion

We have pointed out three challenges that reinsurers face: ongoing liability exposures, legal uncertainties arising from the drafting of the insurance contracts, and regulatory challenges. Reinsurance is a risk industry, and there is good reason to believe it will rise to those challenges.

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ism that if insurance and reinsurance agreements were recorded more effectively, the scope for much litigation and arbitration would be removed at a stroke. This is nothing new. There is an age-old ten-

the World Trade Center, but we have come across innumerable smaller-scale examples of such arrangements. Trying to negotiate the wording after a loss has arisen puts both parties in a situation

original", without further explanation as to exactly how the terms of the underlying insurance and the reinsurance are meant to interact.

Often a dose of common sense is all that is needed to