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Reinsurance Update

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This edition provides an update of recent developments of interest to the global reinsurance industry. On the US side, the US Case Note highlights a recent Ninth Circuit decision addressing a United States district court's ability to act to disqualify an arbitrator while the arbitration is still pending. The US Regulatory Note addresses Congress's reauthorization of the Terrorism Risk Insurance Act and changes to the Act. On the European side, the London Case Note focuses on a recent case from the English Commercial Court that reemphasizes the effect and finality of settlement agreements. The EU Regulatory Update addresses important Solvency II updates.

US Case Note

In *In re Sussex*, --- F.3d ----, No. 14-70158, 2015 WL 327558 (9th Cir. Jan. 27, 2015), the US Court of Appeals for the Ninth Circuit granted a petition for *writ of mandamus* to vacate a district court's order disqualifying an arbitrator while the arbitration was still pending. The Ninth Circuit held that the arbitrator's alleged "evident partiality" under 9 U.S.C. § 10(a)(2) of the Federal Arbitration Act was not "such an extreme case, if one exists" to justify departing from the general rule that courts should not intervene in an ongoing arbitration. *Id*. at *7.

The matter was initially filed as a district court action, but submitted to arbitration. During the course of the arbitration, the arbitrator became involved in the business of litigation financing, forming a company to invest in "high-value, high-probability legal claims and litigations." *Id*. at *1. Defendants learned of the arbitrator's litigation financing activities and filed a motion to disqualify the arbitrator with the district court.

The district court granted the motion, citing Ninth Circuit authority for the proposition that intervention in ongoing arbitration proceedings was possible in "extreme cases." *Id*. at *2, citing *Aerojet–General Corp. v. Am. Arbitration Ass'n,* 478 F.2d 248 (9th Cir.1973). The district court concluded that the arbitrator's litigation financing activities "suggested he had a financial interest in the outcome of the arbitration," which created "a reasonable impression of bias sufficient to meet the § 10(a)(2) standard" of the Federal Arbitration Act, which allows a district court to vacate an arbitrator's award in the event of "evident partiality." In addition, the district court cited the breadth of that the arbitration proceedings, which involved 385 plaintiffs, and noted that the matter was still in the early pre-discovery stages, and concluded that these factors militated in favor of early intervention and disqualification of the arbitrator. *Id*.

Plaintiffs petitioned the Ninth Circuit for a *writ of mandamus* to vacate the district court's order. The Ninth Circuit granted the writ, concluding that, under the Federal Arbitration Act, a district court's authority "is generally limited to decisions that bookend the arbitration itself," and that, while in *Aerojet* it did allow for the possibility of an "extreme case" where the lack of intervention would result in "severe irreparable injury" from an error that could not "effectively be remedied on appeal from the final judgment," it had never actually approved of such intervention. *Id*. at *5. As the Ninth Circuit noted, this "consistent refusal to identify" such an "extreme case," "brings our case law into harmony with our sister circuits, the majority of which expressly preclude any such mid-arbitration intervention." *Id*. at *5.

With respect to the district court's intervention, the Ninth Circuit concluded that "the district court's ruling was clearly erroneous as to the legal standard for 'evident partiality' and the nature of equitable concerns sufficient to justify a mid-arbitration intervention." *Id*. at *6. The Ninth Circuit specifically held that the arbitrator's "modest efforts" to start a litigation financing company were "best described as attenuated and insubstantial" to the parties' claims. *Id*. (quotations omitted). Regarding the latter, the Ninth Circuit held the financial harm that could result from the "cost and delay" of addressing the arbitrator's potential partiality at the end of the arbitration "do not constitute the sort of 'severe irreparable injury' or 'manifest injustice' that could justify" mid-arbitration intervention. *Id*., quoting *Aerojet*, 478 F.2d at 251. In addition to the district court's clear error, the Ninth Circuit held the writ was justified "because the district court's mistaken application of *Aerojet-General's* dicta in a published order may cause confusion, encourage similar erroneous approaches, and leave district courts to wonder whether and when to intervene." *Id*. at *8. *In re Sussex* reaffirms the extreme difficulty parties have in seeking interim relief from the district court during the pendency of a an arbitration proceeding.

The case can be found here.

US Regulatory Note

On January 12, President Obama signed into law legislation reauthorizing the Terrorism Risk Insurance Act (TRIA) for six years. The reauthorization comes on the heels of quick congressional action in January after failing to reauthorize TRIA last December, prior to its expiration on December 31, 2014.

TRIA was originally enacted in response to the terrorist attacks of September 11, 2001. TRIA created a temporary three-year Terrorism Insurance Program (the "Program") in which the government would share some of the losses with private insurers should a foreign terrorist attack occur. This Program was extended in 2005 and again in 2007. The 2007 reauthorization ended December 31, 2014. Congress's failure to reauthorize TRIA last year caused the Program to expire on that date. The subsequent legislation reauthorizing TRIA is the first major legislation passed by the new 114th Congress.

With a few important exceptions, the legislation leaves the Program largely unchanged. The major changes are:

1. Extension: The Program is extended for six years, expiring on December 31, 2020.

2. Trigger: The Program trigger, which is currently $100 million in annual aggregate insured losses, will be increased in phases to $200 million. The trigger will increase $20 million per year every year for five years starting in 2016.

3. Co-Share: The insurer co-share will increase from 15 percent to 20 percent. Starting on January 1, 2016, the co-share will increase 1 percent a year for five years.

4. Recoupment: The amount that the federal government will recoup increases from the current $27.5 billion to $37.5 billion. The recoupment amount increases $2 billion per year starting in 2015. Starting in 2020, recoupment will be the lesser of $37.5 billion or the annual average of the sum of insurer deductibles for all insurers participating in the Program for the prior three calendar years. Determination of such sum will be made pursuant to regulations to be issued by the Treasury Department. Finally, the rate of recoupment will increase from 133 percent to 140 percent.

Thus, under the reauthorized Program:

- A terrorist act must cause at least $5 million in insured losses to be certified for TRIA coverage;
- The aggregate insured losses from a certified act of terrorism triggering government coverage to begin will increase by $20 million each year from $100 million in 2015 to $200 million in 2020;
- An individual insurer must meet a deductible of 20 percent of its annual premiums for the government coverage to begin;
- Once the above thresholds are satisfied, the government covers 85 percent of losses (decreasing to 80 percent by 2020) due to terrorism, up to a cap of $100 billion;
- If insured losses are under $27.5 billion (increasing to $37.5 billion by 2020), the government is required to recoup 140 percent of its outlays. As insured losses rise above the monetary thresholds, the government is required to recoup a progressively reduced amount of the outlays. At a certain high insured loss level, which will depend on the exact distribution of the losses (*i.e.*, if overall losses exceed the industry retention level), the government would no longer be required to recoup outlays, but would retain the discretionary authority to do so.

Because the TRIA program was not reauthorized before expiring on December 31, 2014, there was a gap in coverage. In order to address regulatory and coverage issues caused by the gap, the Department of the Treasury issued guidance on February 4 related to implementing the reauthorization of TRIA. In so doing, Treasury noted that it intends to issue formal regulations for notice and comment, but that the interim guidance may be relied upon unless or until Treasury promulgates final rules.

The guidance focuses on transition issues and on the requirements for the requisite notices of coverage that are required. The guidance does not address the "retroactivity" of the statute in any way to January 1st (when the old law expired), but it does create some relief for insurers that policyholders with respect to the "springing exclusions" and other changes in terms/conditions that may have gone into effect when the old law expired.

Specifically, the guidance covers offers of coverage and the requisite notices that must be provided to policyholders that have purchased terrorism coverage reinsured under the Act:

1. *Offers of Coverage.* An insurer is required to make a new offer of terrorism coverage that does not materially differ from the terms/conditions of the underlying coverage by April 13, 2015 to any covered commercial policy currently in place that excludes terrorism coverage unless
   - The policy included a conditional terrorism exclusion or change of terms/conditions rider for which the insurer notifies the policyholder in writing by April 13, 2015 on which the insurer is forbearing or is withdrawing or
   - The policyholder previously declined a terrorism offer of coverage for that policy and the price of that coverage did not materially differ from the price the insurer would have offered after enactment of the 2015 Reauthorization Act.
2. *Notices.* With respect to the notices insurers must provide to disclose the premium charged for insured losses under the TRIA program and the share of those losses borne by the federal government, the guidance clarifies the following:

- Notices that comply with the 2015 requirements must generally be provided by April 13, 2015.
- Notices no longer need be provided at the time of a policy's "purchase" as the Act eliminated that requirement; the notices need be provided now only at the time of offer and renewal of the policy.
- The NAIC's revised TRIA Model Disclosure Forms satisfy the Act's requirements. These Notices incorporate the technical corrections necessary to conform with the Reauthorization Act.
- An insurer that provided a Notice prior to January 12, 2015 (the date the new Act was signed into law) is not required to provide a revised Notice to the policyholder; Notices provided on or after January 12, 2015 do need to comply with the new Notice requirements.

The legislation can be found here.

London Case Note

In *Starlight Shipping Company v Allianz Marine and others,* the English Commercial Court has emphasised the principle that settlement agreements are generally intended to provide resolution of disputes between the parties, and reiterated the importance of careful drafting of settlement agreements should a party wish to maintain the right to pursue other persons.

The vessel Alexandros T, owned by Starlight Shipping Company ("Starlight"), sank on May 3, 2006 resulting in a total loss. Starlight was insured for the loss by a range of insurers from both the companies market ("CMI") and the Lloyd's Market ("LMI"), as well as Hellenic Hull Mutual Association PLC ("Hellenic"). Following the loss, Starlight commenced proceedings in the Commercial Court against the CMI and the LMI, claiming an indemnity under the vessel and fleet policies. Hellenic simultaneously commenced an arbitration seeking a declaration of non-liability under their policy. These claims were settled in December 2007 and January 2008, pursuant to settlement agreements subject to English law and the exclusive jurisdiction of the English courts.

Starlight subsequently commenced proceedings in Greece against employees and agents of the insurers (including the solicitors who acted for them in their defense of the policy claim), seeking damages in respect of the insurers' handling of the claims. In the present case, Mr. Justice Flaux had to decide whether the proceedings in Greece breached the settlement agreements between the insureds and the insurers.

The settlement agreements referred to settlement of all claims against *"Underwriters"*, which was a defined term and did not refer to employees or agents. However, the judge held that, on a proper construction of the settlement agreements, the term *"Underwriters"* included the insurers' employees and agents. Moreover, since the insureds claimed that the insurers and their employees and agents were joint tortfeasors, by settling with the insurers without specifically reserving their position against joint tortfeasors, under well-established principles, the insureds' claims against joint tortfeasors, such as employees or agents, were also discharged.

The judge held that, having accepted various sums in full and final settlement of any and all claims against the *"Underwriters"* (which he had held to include employees and agents), the insureds had made a continuing promise not to sue Underwriters. That promise or undertaking could be enforced by a decree of specific performance.

In addition, the judge held that the employees and agents were an identified class of third parties who were intended to have the benefit of the settlement agreements, and, therefore had the right to rely on the Contracts (Rights of Third Parties) Act 1999. As a result, they were entitled to damages for breach of the insureds' promise not to sue.

The judge emphasized the principle that settlement agreements are intended to provide a finality of disputes and to avoid the possibility that insurers would remain on risk for additional claims against their agents (which under standard indemnity principles would be passed on to the insurer as principal). Further, the settlement agreements contained an indemnity from Starlight to its insurers, which would have resulted in the claims against the insurers' agents being passed back to Starlight in any event. The judge held that these circular claims could not have been intended by the parties when they had settled the policy claims.

This decision applies principles of law which have been long-established, but serves as a reminder of the importance of careful drafting of settlement agreements, particularly where a party wishes to preserve rights against other persons who are not parties to the current litigation or arbitration. For insurers and reinsurers, it is also a helpful restatement of the principle that settlements by (re)insurers are generally intended to provide a clean break, giving certainty and finality to their exposure.

The case can be found here.

EU Regulatory Update

Important Solvency II texts published in EU's Official Journal and by EIOPA

In EU jargon, the 2009 Solvency II Directive, as "recast" and then amended in 2012 and 2014 (Omnibus II), is a level 1 text, *i.e.* it is a framework text which sets out the broad principles and rules for the supervision of insurance and reinsurance, and for carrying on insurance and reinsurance business. It refers to numerous secondary rules (level 2) to be adopted and referred to as "implementing measures" and "delegated acts". The European supervisory authority, EIOPA, is then entrusted with development of "implementing technical standards" (known as level 2.5). EIOPA also develops guidelines (level 3).

On October 10, 2014, the European Commission adopted a Commission Delegated Regulation. On January 17, the Official Journal of the European Union published this Regulation, which entered into force the following day. The rules are nearly 800 pages, as follows:

- Pillars I (valuation and risk-based capital requirements), II (enhanced governance) and III (increased transparency) to page 198;
- Insurance groups from pages 199 to 219;
- Third country equivalence and final provisions to page 226; and
- 26 annexes from pages 227 to 797, comprising a list of "lines of business" and various highly technical rules as well as some 500 pages of tables ("correlation coefficients") for various risks, such as windstorm, earthquake, flood, hail and subsidence.

The published document is available here.

To complement this text, EIOPA has just issued level 3 Guidelines covering the following aspects:

- Valuation of Technical provisions and Contract Boundaries;
- Ancillary Own Funds, Classification of Own Funds; Ring Fenced Funds and Treatment of related undertakings;
- Look-through approach; Basis Risk; Application of Outwards Reinsurance arrangements; Treatment of market and counterparty risk; Application of the life underwriting risk; Health catastrophe risk; Loss Absorbing Capacity of technical provisions and Undertaking Specific Parameters;
- Group Solvency;
- Application of Internal Models;
- Operational functioning of Colleges of Supervisors;
- Methodology for Equivalence assessments; and
- Supervisory Review Process.

The guidelines are available here.

EIOPA reports on further progress by first wave candidates for Solvency II equivalence

On December 19, 2014, the European Insurance and Occupational Pensions Authority (EIOPA) launched public consultations on three reports setting out its advice to the European Commission on the equivalence of the supervisory systems of Switzerland, Bermuda and Japan for the purposes of the Solvency II Directive. EIOPA's reports update the 2011 analysis of the efforts made by the three jurisdictions to align their supervisory systems with Solvency II standards.

The reports cover all three areas of equivalence: reinsurance, group solvency calculation and group supervision and are therefore particularly important for reinsurers which are headquartered in the three jurisdictions since, if their jurisdictions are recognized as equivalent, their contracts with EU insurers will be treated in the same way as those concluded with EU reinsurers and the EU Member States will not be able to impose collateral requirements.

The overall conclusion of EIOPA remains the same as in 2011: all three jurisdictions meet the equivalence criteria but with certain caveats. However, the detailed assessments reflect the progress being made in each jurisdiction.

EIOPA finds the Swiss system "equivalent' under all assessment principles except one: public disclosure requirements are assessed as "largely equivalent". This concern should be addressed through further changes to Swiss legislation in 2015. The positive assessment is no surprise, since Switzerland has been at the forefront of introducing a Solvency II-like regime from the start of the equivalence process.

The advice on Japan (which is only assessed for reinsurance) is relatively unchanged. The Japanese system is deemed "equivalent" or "largely equivalent" with the exception of the solvency regime, which

EIOPA deems “partly equivalent”. Again, the advice notes that further scheduled changes in Japanese legislation will improve this finding.

Regarding Bermuda, the updated advice reflects the jurisdiction’s significant progress. EIOPA has extended its assessment to include life (re)insurance business, as well as non-life, but captives remain excluded. Bermuda is found “equivalent” or “largely equivalent” for non-life (re)insurance business in all three equivalence areas and the further legislative changes in 2015 should address a number of EIOPA’s concerns. In relation to life (re)insurance business, EIOPA finds Bermuda “partly equivalent” under some principles and at the same time highlights Bermuda’s ongoing program to fully align the legal framework for life (re)insurers to Solvency II rules. Bermuda therefore seems to be in a very good position to obtain a positive equivalence decision at least for large non-life (re)insurers (Bermudian classes 3B and 4) and group supervision.

The consultation period ended on January 23. EIOPA will now finalize the three reports and submit them to the European Commission which will then take the final decision on equivalence of the three jurisdictions. It is uncertain how the Commission will exercise its discretion in the areas where EIOPA has found the supervisory systems “largely equivalent” or “partly equivalent”. In addition, while the equivalence assessment is in the first place a technical, outcome-based exercise, the Commission decisions themselves are in the form of delegated acts. Before the delegated act recording the equivalence decision is legally binding, it must be submitted to the European parliament and the Council of Europe, both of whom have the right to object. This specific legislative procedure creates an additional (political) component to what is an intensive and technically challenging process for the three third-country jurisdictions.

The Commission is expected to take its final decisions on equivalence of Switzerland, Bermuda and Japan before summer 2015.