Reinsurance Update

March 2011

In this edition, the Case Note highlights an interesting decision from the Seventh Circuit, which reversed the district court’s injunction of an arbitration proceeding due to alleged arbitrator partiality. The London Market Update draws attention to two recent decisions, one of which addresses principles of exhaustion and the other of which examines whether “inherent vice” may be the proximate cause of a loss where external and fortuitous acts are also at issue. Finally, the US Legislative Update comments on a Notice of Proposed Rulemaking by the Financial Stability Oversight Council regarding the regulation of nonbank financial entities which could pose a systemic threat to the US economy.

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Seventh Circuit Addresses Arbitrator “Disinterest” and Scope of Authority, Reversing District Court on All Grounds


A US Case Note

In Trustmark Insurance Co. v. John Hancock Life Insurance Co., the Seventh Circuit Court of Appeals reversed the district court’s opinion that had temporarily enjoined a pending reinsurance arbitration since January 2010. In the underlying proceeding, Trustmark Insurance Co. ("Trustmark") had obtained a temporary injunction from the district court to prevent the arbitration from continuing as long as John Hancock Life
Insurance Co.’s (“Hancock”) party-appointed arbitrator remained on the panel. Trustmark had argued, and the district court agreed, that Hancock’s party-appointed arbitrator was not a properly “disinterested” arbitrator, due to his earlier service as Hancock’s party-appointed arbitrator in a prior arbitration involving the same parties. The district court further held that the arbitrators in the current proceeding were not permitted to construe the confidentiality agreement governing the prior arbitration because that agreement did not contain an arbitration clause.

The Seventh Circuit reversed the district court on all grounds. First, it held that Trustmark had failed to demonstrate the touchstone requirement of the injunctive relief it sought: irreparable injury. Under the Federal Arbitration Act, a party who believes a panel has exceeded its powers is free to seek a denial of the enforcement of any award. See 9 U.S.C. § 10 (a)(4). As such, the court found that the only potential injury in allowing the arbitration to proceed would be the “delay and the out-of-pocket costs of paying the arbitrators and legal counsel.” The court noted that it had previously held that such an argument in support of irreparable injury is frivolous. Second, the court held that Hancock’s party-appointed arbitrator’s service in the prior arbitration did not vest him with a disqualifying interest in the outcome of the present proceeding. Rather, the requirement that an arbitrator be “disinterested” refers to “lacking a financial or other personal stake in the outcome” – not lacking factual knowledge of the dispute. Finally, the court held that the current panel was permitted to construe the confidentiality agreement governing the prior arbitration, despite its lack of an arbitration clause, because it was ancillary to the panel’s appointment to resolve the parties’ reinsurance dispute.

Recent Decisions from the Supreme Court and the Commercial Court

London Market Update

Teal Assurance Company Ltd v W R Berkley Insurance (Europe) Ltd & Anor [2011] EWHC 91 (Comm)

In the recent case of Teal Assurance Company Ltd v W R Berkley Insurance (Europe) Ltd & Anor, the Commercial Court was asked to
consider when the top excess layer of a professional indemnity programme was triggered.

Teal was a captive insurer which underwrote various layers of a professional indemnity programme for Black & Veatch (“B&V”). Policies underwritten by Teal and another insurer provided cover of US$60 million in excess of B&V’s self insured retention (the “Underlying Tower”). The Underlying Tower responded to worldwide claims in respect of B&V’s liabilities to third parties and necessary costs and expenses incurred in mitigation attempts. Teal also provided cover for liability in excess of the Underlying Tower (the “Original Policy”) which was reinsured through the claimants under an excess reinsurance policy (the “Excess Policy”). Both the Original and the Excess Policies excluded US and Canadian claims.

A number of claims were made against B&V during the policy period. These included (1) non-American claims for alleged design defects in respect of which mitigation costs had already been incurred; and (2) alleged design defects for power plants in the US in respect of which mitigation costs were expected to exceed the Underlying Tower.

The issue in dispute was whether it was open to B&V to present its claims in any order it saw fit to maximise its recoveries. If it was, then B&V could choose to present its losses in such a way that the American claims would exhaust the Underlying Tower and the non-American claims would fall under the Original Policy thus allowing a claim under the Excess Policy. The claimants argued that B&V’s entitlement to an indemnity arose when B&V’s liability was established and ascertained or when losses were incurred. The Commercial Court endorsed this principle and held that the losses eroded the tower in the order in which they had been suffered by B&V. Since the non-American losses had already been incurred, they should be presented to the Underlying Tower and would not, therefore, reach the excess layer.

This decision reaffirms the principle that an insured must present its losses in a chronological order for the purposes of determining the exhaustion of primary and excess layers.

In the case of *Global Process Systems Inc v Syarikat Takaful Malaysia Berhad*, the Supreme Court was asked to consider whether the proximate cause of a loss was the perils of the sea or the inherent vice.

Global Process Systems ("GPS") purchased an oil rig which they required to be towed from Texas to Malaysia. During the course of the voyage, three of the rig’s legs broke. The experts agreed that the loss occurred as a result of fatigue cracking which had developed as a result of the motion of the sea in addition to a final “leg-breaking” wave. However, it was common ground that there had been nothing unusual about the weather conditions during the voyage.

The marine cargo policy in question covered “all risks of loss and damage to the subject matter insured” but excluded “loss, damage or expense caused by inherent vice or nature of the subject matter insured.” At first instance it was held that there was an inherent inability of the legs to withstand the normal incidents of the voyage and so the proximate cause of the loss was inherent vice. This decision was overturned by the Court of Appeal. The Supreme Court dismissed the insurers’ appeal from the Court of Appeal’s decision and held that the proximate cause of the loss was a question of fact to be determined applying the common sense of a business or sea-faring man. The exceptional set of circumstances combined with the “leg-breaking” wave in this case was held to be sufficiently external and fortuitous to support a finding that inherent vice was not the proximate cause of the loss.

Although this decision specifically concerned marine cargo insurance, it has a wider interest in the context of property insurance and reinsurance, as it may be inferred that, where an accident or casualty which is sufficiently external and fortuitous acts to cause a loss, inherent vice will not be the proximate cause of that loss.

**Proposed Rulemaking to Address the Regulation of Nonbank Financial Entities**

**US Legislative Update**

On January 26, 2011, the Financial Stability Oversight Council ("FSOC"), which was created under the Dodd-Frank Wall Street Reform and
Consumer Protection Act, published a Notice of Proposed Rulemaking describing the criteria the FSOC will apply to determine if nonbank financial companies should be designated as systemically important and, therefore, subject to heightened supervision by the Federal Reserve. The proposed rule would establish a regulatory framework for determining systemic importance based on regulatory considerations in a number of broad categories, closely tracking the standards set forth in the Dodd-Frank Act.

The proposed rule states that a nonbank firm that falls into financial distress is more likely to pose a systemic threat to the US economy if the firm is large, provides critical financial services for which there are few substitutes, and is highly interconnected with other financial firms or markets. Moreover, the proposed rule notes that firms that are highly leveraged, have a high degree of liquidity risk or maturity mismatch, and are under little or no regulatory scrutiny are more vulnerable to financial distress and therefore pose a greater systemic threat to US financial stability. The FSOC will apply criteria such as leverage, liquidity risk and maturity mismatch, as well as existing regulatory scrutiny to assess a firm's vulnerability to financial distress, and will use quantitative metrics and its own judgment to determine whether a firm should be designated as systemically important and supervised by the Board.

Insurers and reinsurers have expressed concern over the details – or, rather, the lack of details – in the proposed rule, noting that the proposed standards lack the specificity companies need to determine if they will be considered systemically important. Insurance industry commentators have also noted that the proposed rule does not take into consideration unique aspects of the insurance sector and insurance regulation.

Finally, there has been significant concern raised across the spectrum – from industry, state regulators, and members of Congress, including Rep. Barney Frank – noting that FSOC is drafting rules that affect the insurance industry when two of the three FSOC members with insurance expertise have yet to be appointed. Missouri Insurance Director John Duff is the only insurance representative on the FSOC. He is a nonvoting member. The two open slots are to be filled by an independent insurance expert and the director of the Federal Insurance Office.
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