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DEWEY & LeBOEUF

Reinsurance Newsletter

Dewey & LeBoeuf is again advising and sponsoring Falconbury's Reinsurance Contract Wordings and Disputes conference, which will take place on October 6-7, 2010, in Hamilton, Bermuda. The conference is designed as a practical seminar on contract wording and disputes issues, including contract certainty, emerging risks, notice and information clauses, follow-the-fortunes, credit risk issues, the interplay between the entire agreement and arbitration clauses, and a mock reinsurance dispute. We hope to see you in Bermuda.

Contact Falconbury for more information at bookings@falconbury.co.uk or visit their Web site at <http://www.falconbury.co.uk/course/training/reinsurance-contract-wordings-and-disputes-bermuda>.

Recent Case Summaries

Supreme Court Addresses Court's Role in Arbitration

Rent-A-Center, West, Inc. v. Jackson, 130 S. Ct. 2772 (2010).
Granite Rock Co. v. Int'l Brotherhood of Teamsters, 130 S. Ct. 2847 (2010).

In two recent non-reinsurance cases, the U.S. Supreme Court weighed in on the role of the court in deciding issues related to arbitration. In *Rent-A-Center*, the question was the enforceability of a provision in the arbitration agreement delegating to the arbitrator disputes over the interpretation, applicability, enforceability, or formation of the agreement. The Court decided by a five to four vote that where an arbitration agreement includes a provision that the arbitrator will determine enforceability of the agreement, if a party challenges the agreement as a whole, the challenge is for the arbitrator, but if the challenge is to the delegation provision, the challenge is for the court. In *Granite Rock*, the issue was whether the date the parties ratified a collective bargaining agreement was a matter for the arbitrator or for the court. The Court held that the question of when the ratification

occurred was for the court and not the arbitrator to resolve.

The majority opinion in *Rent-A-Center* contains useful language supporting the notion that arbitration is a matter of contract and that the Federal Arbitration Act (FAA) requires courts to enforce arbitration agreements according to their terms. But unless the challenge is to the precise agreement to arbitrate, the courts may not intervene under § 2 of the FAA. The *Granite Rock* opinion contains the typical language found in many arbitration decisions: whether parties have agreed to submit a particular dispute to arbitration is generally an issue for judicial determination. The Court reiterated the basic arbitration framework under its decisions: (a) a court may order arbitration of a particular dispute only where the court is satisfied that the parties have agreed to arbitrate that dispute, and (b) the court must resolve any issue that calls into question the formation or applicability of the specific arbitration clause, including the scope and enforceability of the arbitration clause, and whether the clause was agreed to and when that agreement was formed where there is no provision committing these issues to an arbitrator for decision

(e.g., like in *Rent-A-Center*). Thus, the Court restated that the court's duty is to interpret the agreement to determine whether the parties intended to arbitrate the issues raised and to discharge that duty by applying the presumption of arbitrability only where a valid enforceable arbitration agreement is ambiguous about whether it covers the particular dispute and adhering to the presumption and ordering arbitration only where the presumption has not been rebutted.

While neither of these decisions involve insurance or reinsurance, these clarifications of the court's role in addressing challenges to an arbitration agreement are important to reinsurance arbitrations in general.

Second Circuit Holds That When an Arbitrator Resigns, a Replacement Arbitrator Is Appointed and Not an Entirely New Panel

Ins. Co. of N. Am. v. Public Serv. Mut. Ins. Co., 609 F.3d 122 (2d Cir. 2010).

The Second Circuit Court of Appeals has concluded that if a vacancy arises on an arbitral panel due to a panel member's resignation, an entirely new panel need not

be convened. Rather, the appointment of a replacement member, either by the party or pursuant to the provisions of Section 5 of the FAA is proper. This decision brings the Second Circuit in line with the decisions of other federal courts of appeal, including the Seventh and Eighth Circuits.

In the underlying dispute, the cedent initiated an arbitration seeking reimbursement from its reinsurer for payments made for the settlement of certain pollution claims. A three-member panel was constituted and included a party-appointed arbitrator for each of the cedent and the reinsurer. During the arbitration process, the reinsurer's party-appointed arbitrator tendered his resignation for medical reasons. The cedent argued that a replacement arbitrator should be appointed by the reinsurer, or by a court pursuant to the FAA. The reinsurer took the position that an entirely new panel had to be constituted. With the parties unable to reach an agreement, the remaining panel members found that the cedent would be unduly prejudiced if an entirely new panel was convened and suggested that if the reinsurer was unwilling to proceed with a replacement arbitrator, the parties should seek guidance from a court.

The reinsurer filed a petition in New York federal court seeking a stay of the arbitration proceedings, an order disqualifying the remaining panel, and an order compelling a new arbitration with an entirely new panel. The cedent opposed. The district court initially sided with the reinsurer and ordered a new panel. In doing so, the court extended the rule applicable in the event of the death of an arbitrator. In those circumstances, the general rule is that a new panel is convened. Subsequently, a factual development led to the court's reconsideration: the arbitrator who had resigned had once again begun actively seeking appointment to arbitration panels. Because of the arbitrator's current availability, the district court found that special circumstances warranted a departure from the general rule it had applied and that it could reappoint the arbitrator who had resigned. If the arbitrator was unwilling or unable to rejoin the panel, then the reinsurer would have to appoint a replacement arbitrator. The reinsurer appealed.

In affirming the district court's decision on reconsideration, the Second Circuit went further than the district court. The district court had concluded that the general

rule applicable when an arbitrator dies could be extended to cases when an arbitrator resigned, but that the special circumstances here warranted a different approach. The Second Circuit, however, held that the general rule premised on the death of an arbitrator did not apply at all. The Second Circuit expressed concern that applying a broad rule requiring that a new panel be convened to vacancies occasioned by resignation would open the door to significant potential for manipulation. A party could pressure its party-appointed arbitrator to resign in response to adverse rulings and thus seek a second shot at winning. While there was some potential for prejudice in having to proceed with a panel with only one new member, the Second Circuit found that this concern did not outweigh the potential for manipulation if the rule were otherwise.

Newer arbitration clauses tend to address this problem by specifying what happens when an arbitrator becomes unavailable. Where there is no language in the arbitration clause, in the Second Circuit, this rule now applies.

Tenth Circuit Affirms Motion to Compel Arbitration But Reverses on Application of Statutory Post-Judgment Interest Rate

Newmont U.S.A. Ltd. v. Ins. Co. of N.A., Nos. 08-1347 and 08-1370, 2010 U.S. App. LEXIS 17018 (10th Cir. Aug. 11, 2010).

The Tenth Circuit Court of Appeals has affirmed a district court's order compelling arbitration, but reversed on the district court's application of a statutory post-judgment interest rate instead of the interest rate set forth in the parties' agreements. This case arises out of a captive's reinsurance of general liability policies written by the cedent for a mining company. Each of the reinsurance agreements contained an arbitration clause. Each also stated that the other party will pay interest at a set monthly rate on all amounts not paid within the time required by the agreement to commence at the time the payment is required under the agreement.

Governmental claims against the mining companies were brought, resulting in a declaratory judgment action filed against the cedent. The parties settled the declaratory judgment action in a 1997 settlement agreement for a particular

site. In 2002, the parties entered into a second settlement agreement resolving other claims. A subsidiary of the insured sued the cedent in 2000 seeking coverage for environmental liabilities at another site. The cedent drew on a letter of credit to reimburse itself for expenses defending the subsidiary's claim and sought additional costs for the defense of the claim. Ultimately, the cedent demanded arbitration over the dispute on reimbursement for the subsidiary's claim and the insured and the reinsurer filed suit.

The district court compelled arbitration, stayed the action pending completion of the arbitration, and after the arbitration panel issued an award for the cedent, confirmed the award, but modified the rate of interest from the rate set forth in the contract (as the arbitration award had allowed) and replaced it with statutory interest, with post-judgment interest from the date of the order.

On appeal, the circuit court affirmed the order compelling arbitration. The court rejected the reinsurer's contention that the issue of arbitrability was for the arbitrators because the court could not conclude that parties clearly and unmistakably provided for arbitra-

bility to be heard by the arbitrators. The court agreed that the arbitration clause was a broad clause and that the reimbursement dispute fit within the arbitration provision. The court also rejected the argument that the settlement agreements repudiated post-expiration arbitrability.

As to post-judgment interest, the court found that the district court erred in replacing the contract's interest rate with the statutory interest rate. The circuit court held that the arbitrators had the authority to decide the post-judgment interest issue. The circuit court also held that interest was to run from the accrual date, which was the date of entry of the judgment, not the date of the district court's decision.

Third Circuit Upholds Reinsurer's Removal of Case to Federal Court

Ario v. The Underwriting Members of Syndicate 53 at Lloyds for the 1998 Year of Account, No. 09-1921, 2010 U.S. App. LEXIS 17195 (W.D. Pa., Aug. 18, 2010).

The Third Circuit Court of Appeals has reversed in part, affirmed in part, and remanded a district court's judgment involving cross-motions to confirm and vacate an arbitra-

tion award. Following the reinsurers' refusal to pay claims arising under four reinsurance treaties, the cedent demanded arbitration and both sides agreed that the issue was arbitrable. The arbitration panel issued an award rescinding three of the four treaties. The cedents went into liquidation and in the course of the liquidation proceeding the liquidator filed a motion to confirm in part and vacate in part the arbitration award in state court.

The reinsurers removed the case to federal court under 9 U.S.C. § 205 (the part of the FAA that enforces the U.N. Convention on the Recognition and Enforcement of Foreign Arbitral Awards) and the liquidator moved to remand the case to state court. The district court denied the motion to remand, accepted jurisdiction, and confirmed the arbitration award. It also imposed Rule 11 sanctions against the liquidator's counsel for its motion to remand on the basis that there was no basis in law for the motion. The cedents appealed, arguing that the district court lacked subject matter jurisdiction over the dispute because the parties had selected the Pennsylvania Uniform Arbitration Act (PUAA) to govern the arbitration in their reinsurance treaties and had

thereby opted out of the FAA in its entirety.

The circuit court affirmed the district court's confirmation of the arbitration award, ruling that the applicable vacatur standards were those of the FAA rather than those of the PUAA and that the removal was proper under 9 U.S.C. § 205. The court further held that although parties may select state-law arbitration standards, parties may not opt out of the FAA in its entirety, and that FAA vacatur standards apply presumptively to Convention awards rendered and enforced in the United States. While the right of removal under 9 U.S.C. § 205 may be waived, in this case, the court found that the reinsurance treaties did not show the parties' clear and unambiguous intent to substitute the PUAA vacatur standards for those of the FAA.

The Third Circuit also reversed the district court's decision to grant Rule 11 sanctions against the liquidator's counsel for the motion to remand, determining that it had not been patently lacking in merit.

New York Federal Court Denies Petition to Appoint Umpire Arbitrator Because Arbitration Agreement Provided a Sufficient Method for Appointment

R.A. Wilson & Assoc., Ltd. v. Certain Interest Underwriters at Lloyd's London, No. 10-CV-2232, 2010 WL 2133950 (E.D.N.Y. May 26, 2010).

A New York federal court denied an insurance producer's motion to enjoin the selection of an umpire arbitrator in a pending arbitration, and *sua sponte* dismissed the producer's action.

The insurance producer and an underwriter were in a dispute arising from an insurance policy, and, pursuant to an arbitration agreement in the policy, the parties were compelled to proceed in arbitration. Under the terms of the arbitration agreement, each party was entitled to choose a party arbitrator and a third arbitrator was to be appointed by the two party arbitrators, or, if the party arbitrators failed to agree, by a neutral third party (the appointer). The arbitration agreement did not specify, however, the exact process for selection of the umpire. When the party arbitrators failed to agree on the selection of the umpire, the producer petitioned

the court to establish a method for the appointment of the umpire under the FAA.

The FAA states that where no method for appointing an arbitrator is provided in an arbitration agreement, either party may apply for appointment of the arbitrator by the court. In denying the producer's motion, the court noted that while the arbitration agreement did not "specify the specific process that the party arbitrators or appointer must use in selecting the umpire ... this [was] not a failure to adequately define the 'method' for choosing the umpire." Rather, the court interpreted the arbitration agreement as granting the party arbitrators and the appointer the discretion to use their professional judgment in selecting the umpire.

There have been a number of cases where parties could not agree on the selection of an umpire and the courts have refused assistance because the arbitration clause provided for a selection method in broad strokes. One method to avoid these disputes is to specify in the arbitration clause how impasses to umpire selection will be resolved with sufficient detail to avoid having to run to court.

Connecticut Appellate Court Affirms Remand of Arbitration Award for Clarification Without Review of the Merits

Hartford Steam Boiler Inspection & Ins. Co. v. Underwriters at Lloyd's, 994 A.2d 262 (Conn. App. Ct. 2010).

In a non-reinsurance dispute, a Connecticut intermediate appeals court denied a request to vacate an arbitration award by one competing insurer. The court affirmed that it was procedurally proper for a trial court to remand an award to an arbitration panel for clarification of the grounds of the award without requiring the panel to review the merits of the award.

Two insurers issued policies that covered the insured's coal plant. The plaintiff insurer provided boiler and machinery insurance while the defendant insurer provided "all risks" property insurance. When an explosion destroyed the coal plant, both insurers disclaimed coverage and the insured invoked the Loss Adjustment Endorsements in both policies that, among other things, required arbitration over the insurers' liability under the policies for the loss.

The arbitration panel allocated \$14 million in liability to the plaintiff insurer's policy but only \$7 million

in liability to the defendant insurer's policy. The plaintiff insurer then challenged the award at the trial court level. The trial court remanded the award to the arbitration panel for clarification of the facts and evidence supporting the award, but did not remand for reevaluation of the merits. In the interim, the plaintiff insurer appealed the trial court's remand to the Connecticut Supreme Court, which affirmed the trial court's order.

At the appellate court, the plaintiff insurer then challenged the trial court's authority to remand the award for clarification and the court's subsequent confirmation of the clarified award. The plaintiff insurer argued that remand was improper, that the arbitration panel had not properly clarified the award upon remand, and that *ex parte* communication between one of the arbitrators and the defendant insurer required that the award be vacated. The appellate court affirmed the trial court's remand, relying on the previous ruling of the Connecticut Supreme Court, which held that remand for clarification without review of the merits was proper. The court noted that reevaluation of the merits would undermine expeditious resolution of the dispute, the primary policy of arbitration. The court also ruled that the panel's clarification was suffi-

cient since the panel had included “findings of fact and conclusions . . . as necessary to support the award.” Lastly, the court decided that the *ex parte* communication did not harm the plaintiff insurer or bias the award because the communication did not involve the merits of the arbitration and occurred after the panel initially issued the award.

Florida Federal Court Confirms Arbitration Award of Attorney Fees Where Parties Waived Right to Judicial Determination and Upholds Removal Jurisdiction Where Reinsurer Was Not an Indispensible Party

First Auto. Serv. Corp. v. First Colonial Ins. Co., No. 3:07-cv-682-J-32TEM, 2010 U.S. Dist. LEXIS 66974 (M.D. Fla. Jun. 16, 2010).

A Florida federal court confirmed an arbitration panel’s award of over \$500,000 in attorney fees and costs in favor of an insurer against its insureds and rejected a motion to vacate an order compelling arbitration based on the claim that the court did not have jurisdiction to hear the matter on removal because the reinsurer was an indispensable party.

This case involves a dispute between a risk retention group and its related reinsurer. Apparently,

the cedents attempted to join their reinsurer’s retrocessionaire in the action to defeat diversity jurisdiction before the federal court. The court had earlier dismissed the retrocessionaire from the case as having been fraudulently joined. On the cedent’s motion to vacate, the cedent claimed that the retrocessionaire was an indispensable party because it reinsured the cedent’s reinsurer 100 percent on the risk making it the real party in interest. The court rejected the motion and the claim that the reinsurance relationship was fraudulently concealed and misrepresented. The court also pointed out that the retrocessionaire had no liability to the underlying cedent because there was no privity of contract.

As to the award of attorney fees, the arbitration panel stated in its decision that it had authority to award attorney fees pursuant to the bad faith exception to the “American Rule” and where the parties had, by their actions, filings, and submissions, expressly waived their right to have only a court decide the issue of attorney fees.

In its analysis, the court found that the insureds’ only colorable challenge to the award related to the panel’s authority to award attorney fees. Arbitration of the dispute was compelled under the FAA.

Florida law, however, provided the substantive law considered by the panel. The panel cited the bad faith exception to the “American Rule” as the basis for its award of fees to the insurer, and found that any right to have a court determine entitlement to attorney fees under Florida law was expressly waived by the parties.

The court found that Florida courts have held that no express agreement devoted exclusively to the question of attorney fees is necessary, and the parties may, by their actions expressly waive their right to insist that only a court decide the issue. The court held that based on the parties’ arbitration agreement and the record both sides agreed to submit the issue of attorney fees and costs to the arbitration panel and waived any right that they may have had under Florida law for a judicial determination on those issues.

The court ultimately held that no statutory bases existed to vacate or modify the panel’s award and that the insureds did not establish that the award of fees was procured by corruption, undue means, improper partiality, or misconduct that would otherwise warrant that the award be vacated.

Second Circuit Vacates Judgment on Statute of Limitations Ground in Spite of Affirming Finding of Fraud

AXA Versicherung AG v. New Hampshire Ins. Co., No. 08-2521-cv (2d Cir. Aug. 23, 2010) (Summary Order).

The Second Circuit Court of Appeals, in a non-precedential order, has affirmed a judgment finding that the reinsurer's allegations against the cedent sounded in fraud and were therefore properly before the court, but has vacated the monetary judgment against the cedent because the reinsurer's claim was untimely under New York's statute of limitations for fraud. This case was reported in our June 2010 Reinsurance Newsletter at 2.

This is the second time this case has been to the circuit court following a jury verdict in favor of the reinsurer finding fraudulent inducement concerning two reinsurance facilities entered into between the parties. The first question that was remanded to the district court was whether the reinsurer's allegations sounded in contract as opposed to fraud. The Second Circuit affirmed the district court's finding that the allegations

sounded in fraud and were properly before the court rather than being arbitrable. The court stated that the allegations were all misrepresentations of present fact and not future intent. The reinsurer's allegations were not general allegations that the cedent entered into the contracts while lacking intent to perform, which would be insufficient to support a fraud claim. Rather, the cedent fully performed, but as the court found, misrepresented the present fact of precisely how the reinsurance facilities would operate from their inception.

On appeal, the cedent raised a statute of limitations defense, which had been rejected by the district court. It was successful on appeal. The circuit court found that the reinsurer was on inquiry notice of a potential fraud well before two years before it commenced suit in 2005. One of the key pieces of evidence relied on by the Second Circuit for its reversal was that the contractual documents received and signed by the reinsurer, by their terms, were sufficient to put the reinsurer on inquiry notice that there was a misrepresentation. The court found that these documents, together with other evidence and facts, met the totality-of-the-circumstances test and demonstrated that the reinsurer

should have discovered the fraudulent conduct at least by September 2000. The court held that the reinsurer's failure to inquire imputed to it knowledge of the alleged fraud and rendered its fraudulent inducement claim time-barred. The court also stated that the reinsurer's failure to carefully read the wording was legally irrelevant to the inquiry. The circuit court concluded that a reasonable reinsurer cannot turn a blind eye to repeated circumstances indicating that it may be a victim of fraud. Thus, the reinsurer now enjoys a pyrrhic victory; its allegations were properly characterized as fraud, but it brought its fraudulent inducement claim too late and a substantial judgment in its favor has been vacated.

Fraud in the inducement claims must be brought as early as possible after discovery. While not precedential, the Second Circuit's analysis is helpful in understanding the "storm warnings" that courts will look for in determining when the plaintiff should have discovered the fraudulent conduct.

Third Circuit Court of Appeals Holds Follow-the-Fortunes Binds Reinsurer to Cedent's Post-Settlement Allocation Unless Cedent Makes Allocation Decisions Primarily for the Purpose of Increasing Its Reinsurance Recovery

Travelers Cas. and Sur. Co. v. Ins. Co. of N. Am., 609 F.3d 143 (3d Cir. 2010).

The Third Circuit Court of Appeals has largely upheld, but partially reversed, the holdings of a district court and its post-trial orders, finding that while the cedent had not purposely manipulated its allocation of settlement funds in order to reach a layer of coverage that was reinsured by a third party, once it did reach that layer of coverage its allocations to certain reinsured policies went over policy limits. These findings reduced the amount that the reinsurer was responsible for, but did not excuse it from its duty to follow the cedent's coverage decisions.

The cedent had issued three types of coverage for claims involving certain chemical products and/or the safety testing of silicone breast implants. These three coverages were: (i) primary, (ii) buffer, and (iii)

excess. The primary policies were subject to captive reinsurance. They covered non-products claims plus non-US products claims. They all had a per-occurrence limit; only a few had aggregate limits. While they covered defense expenses, the policies from 1976-1982 did not count defense costs towards policy limits, and captive reinsurance would not pay defense costs unless the cedent was making indemnity payments to the insured/captive reinsurer. The buffer policies were subject to captive reinsurance and covered US products claims and some products coverage in excess of the primary policies. The excess policies had non-captive reinsurance and they covered products and non-products claims in excess of the primary and buffer policies.

The insured sought coverage for claims regarding both the chemical products and the implants. After lengthy negotiations, a net settlement of \$137 million was agreed with the cedent: \$20 million for the chemical products claims allocated to the excess policies and some older policies; \$80 million for the implant claims. None of the payments were to be allocated to post-1982 primary policies or buffer policies. The settlement agreement, however, did not clearly lay out how

the \$80 million should be allocated among the policies.

The cedent decided to characterize the \$80 million as only being indemnity coverage, despite the fact that at the time the insured had spent large amounts in defense costs but had not incurred any actual liability yet. It then applied the \$80 million using a "fill the bathtub" method within each type of coverage: first the pre-1983 primary policies, and then the excess policies. Of the excess policies, two had policy periods of three years, and the cedent decided to allocate funds as if the per-occurrence limits applied separately to each policy year. The cedent admits that these decisions, among others explicitly agreed to in the settlement such as those allowing the allocation to bypass some of the primary and buffer layers, may have had the effect of increasing the reinsurer's share of the loss, although that was not their express intention.

The reinsurer refused to pay any of the costs assigned to it, and the cedent brought the underlying action for breach of contract, in which it relied on the follow-the-fortunes doctrine. The reinsurer stated that its challenge was only to the post-settlement allocation,

and not to the settlement itself. The court found that as the cedent had not acted in bad faith in making these decisions, the reinsurer was not released from following the settlement. The Court also found that the allocation of funds up to a per-occurrence limit for each policy year rather than for the policy period was improper and reduced the reinsurer's share of the loss.

The circuit court upheld these decisions, stating that the follow-the-fortunes doctrine does apply to post-settlement allocations, and defining the cedent's duty of good faith as "a duty not to take advantage of the reinsurer's dependence on the decisions made by the insurer. . . . In the post-settlement allocation context, this means that an insurer breaches this duty when it makes allocation decisions primarily for the purpose of increasing its reinsurance recovery." This breach can only be found where the reinsurer (i) provides "direct evidence that the insurer was motivated primarily by reinsurance considerations" or (ii) shows that the insurer's explanation of its reasoning is not credible. The circuit court stated "We make clear, however, that the insurer's negative duty not to make allocation decisions primarily in order to increase

reinsurance recovery does not translate into a positive duty on the part of the insurer to minimize its reinsurance recovery."

The court also opined on two post-trial orders issued by the district court. The first was that, as a federal court in Pennsylvania with diversity jurisdiction over the case, it must calculate prejudgment interest using Pennsylvania rates despite the fact that the reinsurance contracts were under New York law. The Third Circuit reversed this order, positing that the Pennsylvania Supreme Court would likely consider this analysis to involve a substantive rather than procedural treatment, and that New York law should therefore be applied. The second was that the reinsurer's post-judgment interest did not begin to accrue until the court's order quantifying the amount of prejudgment interest owed to the cedent was issued, which the Third Circuit affirmed.

Ninth Circuit Court of Appeals Holds "Follow-the-Settlements" Doctrine Does Not Impose Liability on a Reinsurer of an Excess Insurer Not in Privity With the Primary Insurer

Texas Farmers Ins. Co. v. Lexington Ins. Co., No. 08-55835, 2010 U.S. App. LEXIS 10427 (9th Cir. May 21, 2010) (Not for Publication).

The Ninth Circuit Court of Appeals has upheld summary judgment against a primary insurer, finding that where an excess policy had not been triggered, the reinsurer of the excess insurer is not obligated by the "follow-the-settlements" doctrine to pay a portion of the settlement amount.

The primary insurer had issued medical malpractice policies to the insured with coverage up to \$5 million for a period ending in mid-2001, at which time it reduced its coverage to \$1 million and the insured purchased \$10 million in excess coverage from the cedent. The reinsurer facultatively reinsured 100 percent of the excess policy. A patient of the insured subsequently filed a claim for medical malpractice primarily relating to treatment received after the issuance of the excess coverage. The patient and

the insured reached a settlement that covered all claims.

In upholding summary judgment against the primary insurer, the court stated that it “view[s] this case as a dispute between a primary insurer...and an excess insurer ([reinsurer]), even though [reinsurer] did not have a direct relationship with the insured.” As such, the bulk of the court’s opinion discusses the various arguments supporting the finding that the primary insurer was entirely responsible for covering the settlement because the excess policy, and therefore the reinsurance, had not been triggered.

Nonetheless, one argument advanced by the primary insurer was that the “follow-the-settlements” doctrine was applicable to these facts and that the reinsurer, who stood in the shoes of the excess carrier because of the following form facultative contract, was responsible for part of the settlement owed by the excess insurer. The court rejected this argument, stating that as the reinsurer was not reinsuring the primary insurer it could not incur any liability to the primary insurer under the “follow-the-settlements” doctrine.

Florida Federal Court Holds that Obligee’s Attempted Service of Process Under the Inter-American Convention on Letters Rogatory and Additional Protocol Was Defective

Folksamerica Reinsurance Co. v. Constructora del Litoral, S.A., 2010 Fla. Slip Op 20560 (S.D. Fla. Jun. 18, 2010).

In a non-reinsurance case, a Florida federal court denied a principal’s motion to dismiss an obligee’s action for insufficient service of process, and granted the obligee an additional 60 days to perfect service, despite finding that service of process was improper.

The obligee’s cause of action arose from the principal’s failure to indemnify the obligee for amounts paid in connection with surety bonds issued for a construction project in Ecuador. When the obligee’s initial attempt to serve the principal failed, it sought to effect service under the Inter-American Convention on Letters Rogatory and Additional Protocol. The obligee attempted to effect service under the Convention by filing a letter rogatory with the United States Central Authority and sending pleadings, summonses, and other documents to the Ecu-

dorian Central Authority, and ultimately an Ecuadorian Court. The Ecuadorian Central Authority provided the obligee with notice that the principal had been served.

In holding that the obligee’s service of process was improper, the court noted that the Central Authority’s notification confirmed “only that the general processes and transnational protocols of the Inter-American Convention were adhered to,” not that the principal received notice of the suit. The court held that service was defective because, in violation of the Convention’s requirements, (i) service was not adequate under Ecuadorian law, (ii) a “Certificate of Execution” was not executed by the Ecuadorian Central Authority, and (iii) the pleadings served on the principal did not include two key exhibits, which were referenced in the complaint and formed the basis of the lawsuit. Although any one of these defects, standing alone, might not have been fatal, the court stated that, taken together, the multiple deficiencies compelled it to conclude that service was improper. Nonetheless, the court denied the principal’s motion to dismiss the action, and granted the obligee an additional 60 days to perfect service.

Pennsylvania Federal Court Denies Cedent's Motion for Reconsideration and Certification Where No Clear Error of Law and No Persuasive Argument for Immediate Appeal

Pac. Employers Ins. Co. v. Global Reinsurance Corp. of America, No. 09-6055, 2010 U.S. Dist. LEXIS 56758 (E.D. Pa. Jun. 9, 2010).

A Pennsylvania federal court denied a cedent's motions for reconsideration or certification of final order or interlocutory appeal finding that the cedent's argument for reconsideration was essentially a disagreement with the court's decision not an error of law and certification was not justified because the other claims in the case were closely related and therefore should be decided before appeal.

The case stemmed from a facultative reinsurance contract that provided coverage above a \$1 million retention. See June *Reinsurance Newsletter* at 9. The cedent's claim payments exceeded the \$1 million retention and the cedent made a claim under the facultative certificate. When the cedent failed to pay the amount owed under the reinsurance contract, the cedent brought an action for breach of contract and sought a declaratory judgment of

its rights under the contract. The reinsurer argued that its maximum liability was \$1 million, the limit of liability set forth in the contract. The insurer argued that the reinsurer was obligated for up to \$1 million of loss plus its pro rata share of expenses related to the claim. The court held that the language of the facultative reinsurance contract was unambiguous and clearly stated that the \$1 million limit of liability encompassed expenses. Therefore, the court declared the reinsurer's maximum liability under the contract to be \$1 million.

The cedent filed a motion for reconsideration of the court's order or in the alternative for certification of final order or interlocutory appeal. The court noted that a motion for reconsideration should only be granted where there is new evidence, an intervening change in the controlling law has occurred or there was a clear error of law. The cedent argued that the court's ruling regarding the reinsurer's maximum liability contained a clear error of law. The court noted that a point of disagreement between the court and the litigant does not constitute an error of law. The court held that the cedent's argument that the court should have conducted a choice of law analysis was procedurally improper because the cedent had previously argued that

there was no conflict of law. In addition, the court stated that a choice of law analysis was not required because it was interpreting the plain meaning of the language in the reinsurance contract. The cedent also argued that the court should have allowed it to present extrinsic evidence to support its interpretation of the limits provision of the reinsurance contract because the contract language was ambiguous. The court held that the contract language was clear and unambiguous and therefore extrinsic evidence was not appropriate. The court therefore held that there was no error of law and dismissed the insurer's motion for reconsideration.

The court stated that certification of final order is generally disfavored. The court held that the cedent failed to establish that there was no just reason for delay of the appeal. Because the other claims in the case were closely related to the maximum liability issue and were also open for appeal, there was sound reason to delay the appeal until the other claims were decided. In addition, the court held that the cedent had failed to show that there was substantial ground for difference of opinion that would justify certification for interlocutory appeal. The court noted that the cedent had produced only one case in support of its arguments and this was not

enough to support its request for certification. Also, the court noted that resolution of the other issues in the case might make the issue of the reinsurer's maximum liability moot, so there was no reason for immediate appeal. The court therefore denied the cedent's motions for certification of final order and interlocutory appeal.

Illinois Federal Court Orders Production of Reinsurance Policy Even Where Judgment Unlikely to Exceed Self-Insurance Cap

Hartman v. Am. Red Cross, No. 09-1302, 2010 U.S. Dist. LEXIS 46126 (C.D. Ill. May 11, 2010).

In this non-reinsurance case, an Illinois federal court granted a motion to compel the production of the defendant insured's reinsurance policy. In its decision, the court upheld the well-established rule that insurance policies are generally discoverable and must be produced as part of initial disclosures in civil litigation where monetary damages are sought. The rule requires production if the insurance coverage "may" be called upon.

Here, the defendant insured argued that its reinsurance policy was not discoverable because the case could not reach the cap of its self insured retention of \$1 million given

certain "facts" of the case, including plaintiff's hourly wage at the time of the underlying events. The court rejected the insured's assertion and, in partially granting plaintiff's motion to compel, held that "where punitive damages and attorney fees are sought and are recoverable in addition to uncapped compensatory damages, it is conceivable, perhaps remotely so but conceivable nevertheless, that the case's value could exceed the self insurance cap." The court further held that the insured's valuation based on "facts" that had not yet been established was not enough to negate the general rule that insurance agreements are discoverable.

New York State Court Grants Cedent Summary Judgment on Asbestos Settlement Ceded to Reinsurers Partially Based on Follow-the-Settlements Principles

U.S. Fidelity & Guar. Co. v. Am. Re-Insurance Co., No. 604517/02 (N.Y. Sup. Ct. Aug. 20, 2010).

A New York state court has granted summary judgment to a cedent on the cession of a substantial asbestos settlement with its insured to its reinsurers and has denied motions for partial summary judgment by the reinsurers contesting the validity of the cession. The decision is fact-intensive and involves

the settlement of nearly \$1 billion in asbestos injury-related claims made against the cedent's insured and ceded to policies and reinsurance contracts going back to 1959.

The reinsurers moved for partial summary judgment on various grounds, including that they should not be liable for payments made to asbestos claimants who received less than the cedent's retention. The cedent moved for summary judgment for breach of contract and breach of the implied covenant of good faith and fair dealing for not paying the amounts ceded under the reinsurance contracts.

In denying the reinsurers' motions and granting the cedent's motion, the court relied, in part, on the follow-the-settlements clause in the reinsurance contracts. The court quoted the leading Second Circuit cases on follow-the-settlements and found that the reinsurers were not alleging bad faith or *ex gratia* payments, but were asking the court to examine the actual distribution of settlement funds made to specific claimants. The court rejected the request because it violated the follow-the-settlements standard that requires the cedent's settlement agreement to be made in good faith and at least arguably within the scope of coverage. Because, stated the court, that "[a]

ny further inquiry into the actual recovery of each claimant would constitute the kind of re-litigation that the follow the fortunes doctrine is designed to avoid,” the reinsurers’ challenge must be rejected.

One of the reinsurers also challenged the settlement and allocation methodology, which was rejected by the court because the cedent was not required to choose the method with the least impact on its reinsurers. The court also rejected a claim that the treaty’s retention should be retroactively reformed, finding that there was not sufficient evidence to raise an issue of fact as to either mutual mistake or fraud by the cedent.

In granting the cedent’s motion for summary judgment, the court stated that neither reinsurer made a sufficient showing of bad faith to require trial.

New York State Court Rules That Follow-the-Settlements Does Not Apply When Cedent Does Not Make a Reasonable Investigation Into Claims

Am. Home Assurance v. Am. Re-Ins., No. 602485/06 (N.Y. Sup. Ct. May 27, 2010).

A New York state court has ruled that the follow-the-settlements

doctrine did not bind reinsurers when the cedent did not conduct a reasonable investigation before entering into a settlement of environmental losses.

The cedent entered into a settlement concerning claims covering damages from the insured’s environmental contamination lawsuits. When the cedent billed the reinsurers for their portion of the claims, the reinsurers questioned whether the underlying policies actually covered the claims. The facultative certificates included language binding the reinsurers to pay claims settled by the cedent, but the underlying policies included two exclusions for punitive damages and pollution claims. The policies also required that the cedent exhaust all underlying insurance and self-insured retentions before attaching liability to policies.

The cedent eventually sued the reinsurers for refusing to pay the settlement claims, arguing that the follow-the-settlements doctrine required the reinsurers to accept the cedent’s payments. The court granted the reinsurers’ motion for summary judgment after finding that the cedent had not conducted a reasonable investigation into whether the underlying policies covered the claims that

were settled. The court found that the claims were excluded from coverage by both the punitive damages and pollution exclusions. Further, the court determined that the cedent could not prove that it had exhausted all underlying insurance coverage, including the insured’s self-insured retention, or that the losses from the environmental contamination lawsuits occurred during the coverage period of the policies.

Pennsylvania Court Holds Breach of Reinsurance Contract Claim Did Not Accrue Until Demand for Payment Was Made and Denied

Ario v. Underwriting Members of Lloyd’s of London Syndicates 33, 205 and 506, 996 A.2d 588 (Pa. Commwlth. 2010).

A Pennsylvania trial court has denied the reinsurers’ motion for summary judgment based on the statute of limitations, which sought dismissal of a cedent’s claim for breach of facultative reinsurance certificates for non-payment of reinsured losses, and granted summary judgment in favor of the liquidator, holding that a claim for indemnification under a reinsurance contract did not accrue until the demand for payment was made. The loss

took place in 1998 and the cedent, now insolvent, paid the insured's claim in 2000. The cedent gave notice to one of its intermediaries, but failed to notify the intermediary that placed the business with the reinsurers in this case. After the cedent became insolvent, the liquidator identified the billing error and notified the reinsurers of the claim in 2008. The reinsurers denied the claim and this action was commenced.

In denying the reinsurers' motion, the court went through an elaborate analysis of when a cause of action for breach of contract accrues and the choice of law used to determine the applicable statute of limitations. The court discussed when contract formation takes place—here when the final cover note was received and accepted by the cedent because of a slight alteration to the original signed slip—and determined that the New York statute of limitations should apply. Based on New York law and relying on *Continental Cas. Co. v. Stronghold Ins. Co.*, 77 F.3d 16 (2d Cir. 1996), the court concluded that the reinsurers were not obliged to pay until they received notice and a demand. Accordingly, the cause of action for breach of contract did not accrue until the demand for payment was made and denied by the reinsurers.

Because that happened in 2008 and the action was commenced within months of the denial, the action was timely under any potentially relevant statutes of limitation.

The reinsurers also moved for summary judgment on the failure of the cedent to provide timely notice, but the court denied this prong of the motion because of material disputes of fact as to whether the parties agreed to a time for notice.

Recent English Case Summaries

Business Interruption Losses and the Test of Causation

Orient-Express Hotels Ltd v Assicurazioni Generali SpA (UK Branch) [2010] EWHC 1186 (Comm).

The High Court in London was recently asked to consider the key principles governing business interruption (BI) losses and, in particular, the “but for” test of causation. This case was an appeal under s.69 of the Arbitration Act 1996 challenging certain of the arbitration tribunal's findings on questions of law arising out of the arbitration award.

The insured owned a hotel in New Orleans, which suffered significant physical damage caused by hurricanes Katrina and Rita. The insured

had a combined property damage and BI policy with the latter cover available only where losses were caused as a direct result of physical damage to the hotel.

Two issues arose on the appeal: First, concurrent causes of loss and second, the application of the Trends Clause contained in the policy. On the first issue, the question was whether the policy covered loss concurrently caused by physical damage to the hotel *and* by loss of attraction to the local area. The insured contended that it was entitled to recover all BI losses under the policy, even if those losses were also concurrently caused by damage to the vicinity. The insurers maintained that the insured could only recover BI losses that would not have arisen had the damage to the hotel not occurred. The insured could not satisfy this “but for” test and so the insurers paid for prevention of access and loss of attraction (which were subject to lower sub-limits), but declined the main claim on the ground that the hotel would not have received custom anyway due to curfews imposed in the city and its mandatory evacuation.

It was accepted that the losses suffered by the insured were the result of two concurrent, independent causes (namely, (i) the damage

to the hotel, and (ii) the damage to the surrounding area). It was also accepted, as a principle of English law, that where there are two proximate causes of a loss, only one of which is covered, the insured may recover on the basis that it is sufficient that one of the causes is an insured peril, provided that the other cause is not excluded. Based on the construction of the policy, which referred to losses directly caused by the hurricanes, the arbitration tribunal held that the “but for” test was the appropriate one to apply.

On appeal, the insured argued that an exception to the interdependent rule should be made in this instance and the principle applied to losses caused by two independent concurrent causes on the grounds of fairness and reasonableness. While Justice Hamblen saw “considerable force” in the insured’s argument, he did not find that the arbitration tribunal had erred in law. The policy was found to provide a “but for” test and the question of whether this was fair and reasonable was a matter of fact for the arbitration tribunal.

On the second issue, the policy’s Trends Clause detailed adjustments to be made to account for the trend

of the business and other special circumstances affecting the business such that the recoverable loss would represent the results which would have been obtained but for the property damage. The Trends Clause specifically allowed for recovery of losses based upon earnings prior to the hurricanes, with adjustments to be made to provide for variations in or special circumstances affecting the business either before or after the damage or which would have affected the business had the damage not occurred.

The arbitration tribunal found that the operation of the Trends Clause took into account the hurricanes as “special circumstances” and thus held that the hotel’s earnings would have been affected irrespective of the physical damage to the hotel. The court upheld this finding.

With the 2010 hurricane season now taking place, this case illustrates the need for careful drafting when using common BI policies and the need to ensure that specific catastrophe risks are covered.

Recent Regulatory Developments

Dodd-Frank Wall Street Reform and Consumer Protection Act – Effect on Reinsurers

President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) into law on Wednesday, July 21, 2010. The Act, with its objective to “restore responsibility and accountability in [the U.S.] financial system,” will have a wide-reaching impact, if not immediately felt. Many provisions in the Act are focused, of course, on the banking industry rather than the insurance industry. The focus of this note is on the provisions of the Act that impact reinsurers, particularly the creation of the Federal Insurance Office (FIO) and key portions of the Nonadmitted and Reinsurance Reform Act (the NRRRA), Subtitle B (State Based Insurance Reform) of Title V of the Act. The NRRRA becomes effective on July 21, 2011; one year after President Obama signed the Act into law.

Federal Insurance Office

The Act creates the FIO within the U.S. Department of the Treasury, which will be headed by a Director appointed by the Secretary of the Treasury (the Secretary). The FIO is intended, in part, to remedy the current lack of insurance expertise at the federal level. The scope of FIO's oversight extends to all lines of insurance except health insurance, long-term care insurance, and federal crop insurance. The FIO is charged with "monitor[ing] all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system." See Tit. V., Sec. A., § 313(c)(1)(A). It is empowered to gather information from the insurance industry, analyze the data, and issue reports. The FIO has fairly broad authority and may require insurers (and their affiliates) to submit data and respond to FIO subpoenas. See Tit. V., Sec. A., § 313(e). Before seeking to obtain data, the FIO is required to obtain necessary information on insurers from publicly available sources. See Tit. V., Sec. A., § 313(e)(4).

The Act also provides the FIO, jointly with the Secretary and U.S.

Trade Representative (USTR), with the power to enter into agreements with foreign governments for the recognition of prudential measures for the business of insurance or reinsurance. See Tit. V., Sec. A., § 313(r)(2); 314. Furthermore, in entering into these agreements, the FIO will have the authority to preempt state law if it is determined that a state law is inconsistent with the international agreement and treats a non-U.S. insurer less favorably than a U.S. insurer. See Tit. V., Sec. A., § 313(f).

Impact/Implications

The immediate, direct impact of the FIO on the re/insurance industry will probably be minimal, in part because the authority granted to the FIO is well short of a regulatory role. The re/insurance industry (other than health insurance) will continue to be regulated at the state level in the U.S., with limited intervention on the part of the FIO.

The FIO may have a powerful impact on the reinsurance industry in due course. The FIO's most substantial authority is its authority to enter into international agreements on insurance and reinsurance and to preempt inconsistent state laws. This authority could ultimately

result in bilateral or multilateral agreements that could achieve "mutual recognition" between and among signatory countries on reinsurance regulation in general or to collateral reduction/elimination in particular.

Before entering into any agreements, the FIO, jointly with the Secretary and USTR, must first consult with four Congressional Committees to explain the nature of the proposed international agreement, how it will achieve purposes and objectives of the legislation, and what effect it will have on existing state insurance laws. See Tit. V., Sec. A., § 314(b). Thus, any significant regulatory ability of the FIO will require further Congressional guidance and input. Furthermore, if an international agreement were to be entered into by the FIO, its ability to preempt state insurance laws is limited both by subject matter and by a mandatory multi-phase process, which includes consultation with USTR, notice to the state(s), and notice to the four Congressional committees. See Tit. V., Sec. A., § 313(f). Given these various constraints, as well as the need to fund and staff the new office, it is unlikely the FIO will be able rapidly to exercise

much authority beyond entering into non-controversial international agreements.

Nonadmitted Insurance and Reinsurance Reform Act

The NRRRA portion of the Act, which was originally introduced in 2006 and approved by the House of Representatives in successive Congresses, is intended to eliminate regulatory inefficiencies associated with state-based surplus lines insurance and reinsurance regulation. Most commentary concerns changes to surplus lines regulation, a subject that will occupy state insurance regulators between now and July 21, 2011, when the NRRRA provisions go into effect. The cumulative impact of the NRRRA's measures that aim to simplify the placement and handling of multi-state commercial lines risks should go some way toward reversing declining surplus lines premium totals in recent years.

Credit for Reinsurance

Currently, states indirectly regulate the business of reinsurance through credit for reinsurance rules, which, in some cases, are applied extraterritorially to ceding insurers licensed in their state regardless of whether the ceding insurer is domiciled in their state. The Act proposes to

end the possibility of extraterritorial application of credit for reinsurance laws by providing that a ceding insurer's state of domicile will be the single point of regulation for credit for reinsurance, provided that state is NAIC-accredited or has financial solvency requirements substantially similar to those required for NAIC-accreditation. See Tit. V., S.B., § 531.

Additionally, no state other than the state of domicile may (i) restrict or eliminate arbitration, (ii) require a particular state's law to govern the reinsurance agreement, or (iii) impose standard terms different from those in the reinsurance contract. See Tit. V., S.B., § 531(b). Other states are prohibited from requiring any financial information other than what the domiciliary state requires. See Tit. V., S.B., § 532.

Solvency Regulation

As to US reinsurer solvency regulation, the reinsurer's domiciliary state (if it is NAIC-accredited) will be "solely responsible for regulating the financial solvency of the reinsurer" and no non-domiciliary state will be able to seek additional financial information from the reinsurer. See Tit. V, S.B., § 532. For this

purpose "reinsurer" is defined as an insurer that:

- i. is principally engaged in the business of reinsurance;
- ii. does not conduct significant amounts of direct insurance as a percentage of its net premiums; and
- iii. is not engaged in an ongoing basis in the business of soliciting direct insurance.

Tit. V, S.B., § 533(4).

Impact/Implications

While the Act is not the sweeping US reinsurance collateral reform that some reinsurers have been seeking for years, this is nonetheless a significant development. States such as California that have historically sought to apply their credit for reinsurance rules extraterritorially will not be able to do so once the Act is effective, and therefore when negotiating reinsurance contracts with US ceding insurers, reinsurers need only consider the law of the ceding insurer's state of domicile. Should the ceding insurer be domiciled in a state such as Florida that has relaxed its collateral requirements for credit for reinsurance, then the reinsurer need only worry about meeting the "lesser"

requirements of the state, and not about any other states. Indeed, the Act potentially opens the door for other states to enact similar reforms to their credit for reinsurance laws, and we understand that several states are currently considering reforms. In the interim, however, the general requirement of 100 percent collateral for unauthorized, unaccredited reinsurers remains the standard in all states but Florida.

Conclusion

Although the provisions discussed above are the key parts of the Act that address the insurance industry, there are other areas where insurers may potentially be impacted by this legislation, such as Systemic Risk Oversight, the creation of an Orderly Liquidation Authority, and the Bureau of Consumer Financial Protection. It is not yet clear the degree to which these other developments may affect the insurance industry. Much work remains to be done by the federal government and by state insurance regulators on NRRRA implementation before the full impact of the legislation will be clear.

Recent Speeches and Publications:

John Nonna and Larry Schiffer will both be participating on panels at the ARIAS-U.S. Annual Meeting and Conference on November 4-5, 2010, in New York. John will be speaking on "Arbitration vs. Litigation," and Larry will be speaking on "The Use and Enforcement of Arbitration Clauses."

John Nonna and Larry Schiffer will be chairing the Falconbury's Reinsurance Contract Wordings and Disputes conference on October 6-7, 2010, in Hamilton, Bermuda. John will be speaking on "Follow-the-Fortunes: Life after *Lexington v. Wasa*, and Larry will be participating in the mock dispute.

Eridania Perez will be participating as a facilitator of a case study at the Reinsurance Association of America's Re Claims 2010, on September 16, 2010, in New York.

Eridania Perez spoke on "Legal Issues in Contract Wording: Lessons Learned from the US and UK" at the Reinsurance Association of America's Re Contracts, The Art of Designing Reinsurance Contracts

and Programs, July 22, 2010, New York City.

Larry Schiffer participated in HB Litigation's 17th Annual Insurance Insolvency and Reinsurance Roundtable Audiocast, Live Q&A, June 24, 2010.

Larry Schiffer's Commentary, "Prejudice My Reinsurer Is In Runoff. What Do I Do Now?" was published on IRMI.com, the Web site of International Risk Management Inc., in June 2010.

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