



Insurance Reinsurance Managed Healthcare Review

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Fall 2012

HASSETT'S OBJECTIONS

**IT'S BAAAACK!!
IMAGINARY
CONSENT TO CLASS
ARBITRATIONS**

By Lewis E. Hassett

After the Supreme Court's 2010-2011 term, businesses generally were pleased with the development of class action law. During the previous term, the Court had held that an arbitration may not proceed as a class arbitration unless both parties agreed to do so. *Stolt-Nielsen S.A. v. AnimalFeeds Int'l. Corp.*, ___ U.S. ___, 130 S.Ct. 1758 (2010). Such an agreement could not be inferred from silence and could not be based on public policy considerations. Rather, a class arbitration



cannot be held without proof the parties "agreed to authorize class arbitration." *Id.* at 1776.

This holding was reiterated in *AT&T Mobility LLC v. Concepcion*, ___ U.S. ___, 131 S.Ct. 1740 (2011), which barred enforcement of California's rule holding contractual prohibitions on class arbitration to be unconscionable in certain contracts of adhesion. The Supreme Court noted that it is "hard to believe" that defendants ever would agree to class arbitration and thereby "bet the company with no effective means of review." *Id.* at 1752.

After those two cases, it appeared businesses were immune from class arbitration if they had not expressly agreed to it. Of course, those holdings could be of scant value to insurers in states that prohibit the enforcement of arbitration clauses in insurance contracts. *See* Ga. Code Ann. § 9-9-2(c); Miss. Code Ann. § 83-11-109 (uninsured motorist coverage); Neb. Rev. St. § 25-2602.01; S.C. Code Ann. § 15-48-10; Ark. Code Ann. § 16-108-230; Nev. Rev. St. § 689B.067

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**DRAFTING
REINSURANCE
AGREEMENTS:
THE ACCESS TO
RECORDS CLAUSE**

By Joseph T. Holahan

The access to records clause, sometimes called the inspection or audit clause, is a common fixture in reinsurance agreements and serves an important function. It enables the reinsurer to track the performance of the agreement and maintain an accurate view of the business ceded. More specifically, it allows the reinsurer to ensure the cedent is complying with the terms and conditions of the agreement, including timely reporting of losses and calculation of premiums. In addition, it allows the reinsurer to assess whether the cedent's reserving practices are adequate and assess the cedent's competence in underwriting and claims handling.

Traditionally, the access to records clause has assumed a fairly streamlined form. The standard clause can be as short as a sentence or two. For example, it is common to find agreements with an access



to records clause as follows:

The Reinsurer and its designated representatives shall have free access at all reasonable times to all books and records of the Company that pertain in any way to this reinsurance.

This formulation relies heavily on the parties' mutual duty of utmost good faith, as many standard reinsurance clauses do. No details are provided concerning where and when an audit may be conducted (other than at "all reasonable times"). Nor are there any limitations on

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CATASTROPHE-LINKED SECURITIES AND THE CAPITAL MARKETS

By James W. Maxson



The convergence of volatile markets, interest rates approaching zero and the world-wide economic slow down has forced institutional investors, such as pension funds, to seek non-traditional ways to generate returns. Some are exploring insurance-linked securities (“ILS”) as possible investments. ILS are defined broadly as financial contracts driven by insurance loss events. ILS allow reinsurers to utilize alternative risk-transfer mechanisms; provide investors with an investment opportunity generally uncorrelated to the financial markets, interest rates or the global economy; and provide investment advisors with a unique opportunity to grow assets.

Typical ILS include catastrophe bonds (“CAT Bonds”), industry loss warranties, portfolios of collateralized reinsurance and longevity-linked instruments (such as life settlements). After the recent Great Recession, the market for CAT Bonds has grown more rapidly than other forms of ILS.

The purpose of a CAT Bond is to transfer risks related to certain catastrophes and natural disasters from an issuer or sponsor (often an insurer or reinsurer) to investors. In essence, the capital markets, via interested investors, take on the risks of a specified catastrophe or natural event (such as a hurricane or earthquake) in return for above-market rates of return. Should a specified catastrophe or event occur, the issuer will receive the money invested to assist in covering their losses, and the investors will lose their principal. If the event does not occur, the investors will receive return of their capital plus the agreed-upon interest.

The use of ILS has surged in the last several years. According to a report released in July by Swiss Re Ltd., the first half of 2012 was the most active first half for the issuance of these securities since 2007, with about \$3.6 billion of CAT Bonds, issued in 16 transactions and 28 tranches, entering the market.¹

Like any new and rapidly growing market, ILS have garnered regulatory scrutiny. The National Association of Insurance Commissioners has issued commentary on ILS.² Additionally, expansion of the definition of

¹ http://media.swissre.com/documents/ILS_Market_Update_public_Version_F.pdf

² http://www.naic.org/cipr_topics/topic_insurance_linked_securities.htm

Announcements

Morris, Manning & Martin is pleased to announce that it has been named **Best Onshore Law Firm of 2012** by *Captive Review*. MMM was selected from a group of seven leading national law firms nominated by industry representatives. The honor was presented at the U.S. Captive Services Awards Dinner on September 10 in Chicago, Illinois.

On July 19, **Joe Holahan** spoke at the Reinsurance Association of America conference on Re Contracts: The Art of Designing Reinsurance Contracts and Programs.

On August 7, **Skip Myers** spoke at the Vermont Captive Insurance Association annual meeting on a panel entitled “Taxation of Captives 102” in Burlington, Vermont. This event is the largest U.S. conference on captives and typically is attended by over 1,000 participants.

On September 26, **Jim Maxson** moderated a panel entitled “The Evolving Regulatory Landscape” at the 2012 European Life Settlement Association Investor Summit in London.

On September 28, **Jessica Pardi** gave an update on Georgia laws affecting surplus lines carriers at the Fall 2012 Surplus Lines Law Group meeting hosted and sponsored by the Mississippi Surplus Lines Association at the Beau Rivage Resort in Biloxi.

On October 2, **Chris Petersen** spoke at the Association of Insurance Compliance Professionals national conference on “The Micro-Markets for Ancillary Insurance Products in a Post-Healthcare Reform World.” Regulators from North Carolina and Texas were also on the panel.

On October 10, **Skip Myers** spoke on a panel with insurance regulators addressing current issues in the regulation of captive insurers at the National Risk Retention Association annual meeting in Washington, D.C.

On October 19, **Skip Myers** discussed the formation and operation of a risk retention group at the annual meeting of counsel for the Physician Insurers Association of America in Boston, Massachusetts.

Lew Hassett and **Ben Vitale** have been retained by an automobile insurer to defend multiple actions in Mississippi state court attacking the sale of ancillary products. The firm has represented insurers in three recent class actions in three different jurisdictions and obtained dismissal or full summary judgment in each.

On October 31, **Skip Myers** spoke on the formation and operation of a risk purchasing group at the annual meeting of the Target Markets Association in Scottsdale, Arizona.

On November 13, **Skip Myers** spoke on U.S. Insurance Regulatory Reform in Luxembourg.

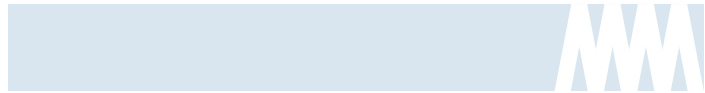
On January 10, **Tony Roehl** will provide a post-election update on health insurance reform to the Macon Chapter of Georgia Health Underwriters.

Lew Hassett and **Lisa Wolgast** recently settled two preference actions brought by the trustee of Brooke Corporation and its affiliates in Kansas. The firm represented two unaffiliated MGAs.

“commodity pool” in both Dodd-Frank and the Consumer Protection Act to include any form of enterprise operated for the purpose of trading in “swaps,” coupled with the Commodity Futures Trading Commission (“CFTC”) and the SEC adopting a broad definition of the term “swap” for purposes of Dodd-Frank and the Commodity Exchange Act, creates uncertainty regarding whether issuers of ILS are commodity pools requiring the registration of commodity pool operators and commodity trading advisors with the CFTC.

While ILS provide a unique and efficient way for insurers to spread their risk and raise capital from the markets, due to their extremely speculative nature and the fact that the future regulation of ILS remains in flux, investors considering an investment in ILS should review carefully the programs and the past results of such offerings before making an investment decision. □

James W. Maxson is a Partner in the firm’s Insurance and Reinsurance Practice and co-chairs the firm’s Life Settlement Practice. Mr. Maxson concentrates his practice in corporate and regulatory matters for the life settlement industry, as well as focusing on mergers and acquisitions and securities transactions. Mr. Maxson received his bachelor’s degree from Denison University and law degree from Ohio State University.



OPPORTUNITIES TO REDUCE EFFECTIVE TAX RATE FOR GEORGIA PREMIUM TAXES

By Tony Roehl and Jason K. Cordon



Benjamin Franklin said, “A penny saved is a penny earned.” This saying is doubly true when using tax credits to lower the amount of premium or surplus lines taxes due in Georgia.

The insurance industry is used to thinking about premium taxes as an inevitable liability that accrues regardless of a company’s profits or operating results. But for insurance companies, risk retention groups and surplus lines brokers with Georgia premium or surplus lines tax liabilities, there are multiple ways to reduce tax liability through the use of premium tax credits.

Premium tax credits equate to a dollar for dollar reduction in the premium tax due and were created by the Georgia Legislature to reward certain investments in Georgia. Georgia currently has three premium tax credits for investments in low-income housing¹, clean energy², and the creation of new jobs in Georgia.³ This article focuses on low-income housing tax credits (“LIHTCs”) because these credits are the most widely available of the three credits and the only ones that apply to risk retention groups and surplus lines brokers in addition to insurance companies.

¹ Off. Code Ga. Ann. § 33-1-18.

² Off. Code Ga. Ann. § 48-7-29.14.

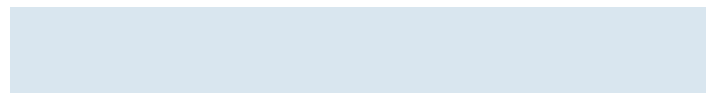
³ Off. Code Ga. Ann. § 33-8-4.1.

Overview

Pursuant to the Tax Reform Act of 1986, federal low-income tax housing tax credits (“Federal Credits”) were authorized under Section 42 of the Internal Revenue Code (“IRC”). Subsequently, several states, including Georgia in 2001, enacted a parallel incentive authorizing state low-income housing tax credits (“Georgia Credits”). Federal Credits and Georgia Credits are utilized to encourage private business to provide a source of funding for certain affordable housing projects (“Affordable Housing Projects”).

In order to generate Federal and Georgia Credits, the Affordable Housing Project must be operated and maintained in accordance with prescribed rules under Section 42 of the IRC. Under this Section, Federal Credits are available with respect to “qualified low-income residential properties”; that is, residential rental properties in which: (a) 20% or more of the aggregate residential rental units are occupied by tenants with incomes of 50% or less of area median income, as adjusted for family size or (b) 40% or more of the aggregate residential rental units are occupied by tenants with incomes of 60% or less of area median income, as adjusted for family size (each test being the “Minimum Set-Aside Test” which must be satisfied). Additionally, the gross rent charged to tenants of units comprising the Minimum Set-Aside cannot exceed 30% of the applicable Set-Aside income (i.e., 50% or 60% of area median income) for a family of a specified size. Georgia Credits are allowed for projects placed in service after January 1, 2001 which qualify for Federal Credits.

Federal Credits and Georgia Credits are generated during the first ten years of an Affordable Housing Project’s operation. However, the Affordable Housing Project must comply with the rules set forth in Section 42 of the IRC for the first 15 years of its operation, otherwise



some of the credits would be subject to recapture. The Georgia Department of Community Affairs administers the Georgia Credit program subject to rulings from the Georgia Department of Revenue and Department of Insurance.

How Georgia Credits Work

A robust secondary market for Georgia Credits has developed, and insurers can obtain such credits from a number of participants in the tax credit industry, ranging from large financial institutions to specialized tax credit funds to developers. Under Section 42 of the IRC, Federal Credits are available to the owners of Affordable Housing Projects. Typically, an entity taxed as a partnership for income tax purposes (the “Property Partnership”) will own the Affordable Housing Project. An affiliate of the developer will serve as the general partner of the Property Partnership, and tax credit investors are admitted as the limited partners—which may include a separate limited partner for the Federal Credits and a separate limited partner for the Georgia Credits.

In exchange for a capital contribution to the Property Partnership, the limited partners are entitled to a share of the Project Partnership’s cash distributions as well as an allocation of a specified portion of the Project Partnership’s tax attributes, which include the Federal Credits and/or the Georgia Credits. Georgia Credits may be allocated among some or all of the partners of the Project Partnership in any manner agreed to by such persons. This is true even if a partner is not allocated or allowed any portion of the Federal Credits available to the Project Partnership. The limited partnership agreement of the Project Partnership will specifically provide an allocation of the Georgia Credits among the partnership’s partners as agreed to by them.

The investments are also considered to be Georgia situated investments for purposes of calculating Georgia’s premium tax abatement for companies that invest assets in the state.⁴

Economics - Reducing Effective Premium Tax Rate

Generally, the capital contribution made by an insurer to a Project Partnership is based on a discount vis-à-vis the total amount of the Georgia Credits to be allocated to the insurer. The discounting creates a positive rate of return on funds which would have otherwise be paid as taxes. An eligible insurer, risk retention group or surplus lines broker⁵ that has been allocated Georgia Credits files Form IT-HC (typically provided by the bank) with its Georgia return. Georgia Credits normally are delivered in the first quarter for the previous tax year. As mentioned, the Georgia Credits offset premium and surplus lines taxes dollar for dollar. For example, \$100 of Georgia Credits will offset \$100 of Georgia premium or surplus lines taxes due. Any unused Georgia Credits may be carried forward for up to three years but cannot be applied to previously filed returns.

There is a risk that the Georgia Credits could be recaptured if the underlying property no longer qualifies for the Federal Credits. To

⁴ See Off. Code Ga. Ann. § 33-8-5.

⁵ While Georgia Credits are available to offset surplus lines tax, the surplus lines broker arguably must purchase the Georgia Credits individually since the surplus lines tax is paid by the broker.

guard against that risk, the general partner (and its principals) of the Project Partnership may provide a guaranty to the limited partner in the event that the amount of Georgia Credits allocated to the insurer is less than projected. A market for insurance coverage against recapture is also beginning to form. In the event of recapture, the insurance policy would be triggered to pay out the economic value of the lost credits.

The Georgia low-income housing tax credit program benefits Georgians by subsidizing the cost of low-income housing, and it can be used by premium and surplus lines tax payers to lower their total tax cost. Of course, before investing in any partnerships that generate LIHTCs, insurers should consult with their tax and legal advisors. □

Tony Roehl is Of Counsel in the firm’s Insurance and Reinsurance and Corporate Practices. Mr. Roehl’s principal areas of concentration are insurance regulation and corporate matters involving entities within the insurance industry. Mr. Roehl received his bachelor’s degree from the University of Florida and his law degree from the University of Michigan.

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RECENT RECALLS LEAD TO COVERAGE DISPUTES AND POLICY CHANGES

By Jessica F. Pardi



We are all too familiar with stories of contaminated food and drugs that sicken and even kill consumers. Given the increasing number of product recalls and their enormous financial impact, it is not surprising the demand for recall insurance has increased exponentially in the middle market.

Why has the number of recalls increased so dramatically? The answer is twofold. First, food and drug regulators have increased scrutiny on producers and become much better at identifying the sources of illnesses caused by contaminated food and medicines. Second, in January of 2011, Congress passed the Food Safety Modernization Act (“FSMA”). The FSMA gave the U.S. Food and Drug Administration the power to order recalls.

Most recall coverage has two components. First-party coverage insures the policyholders’ losses associated with removing a product from the market, evaluating contamination levels, notifying consumers and other third parties and destroying the product if necessary. Third-party coverage insures against losses from claims brought by vendors and retailers for their costs associated with the recall.

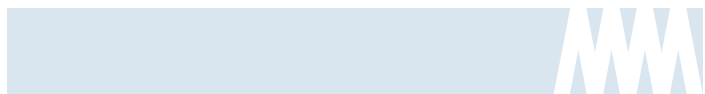
To date, insurers have provided meaningful coverage for recalls, but as recalls and losses escalate, so too will coverage disputes and

litigation. Three likely areas of contention are as follows: 1) whether there is coverage for contamination unlikely to cause illness; 2) whether contamination must occur during manufacturing to be covered; and 3) whether reasonable expectation of contamination (as opposed to actual contamination) is sufficient to trigger coverage.

Because recall insurance is a relatively new coverage, many of its components remain unchallenged in the courts. This too is changing rapidly, and because the claims at issue often are high dollar, both claimants and insurers are willing to fight. Take for example *Daniele Int'l, Inc. v. Penn-Star Ins. Co.*, filed on October 9, 2012, in the U.S. District Court for the District of Rhode Island (C.A. No. 12-709). Daniele is suing Penn-Star for \$33,181,174.00, the amount of a default judgment Daniele was awarded against Penn-Star's insured, Wholesome Spice & Seasonings, Inc. The default judgment was issued in litigation over a 2010 recall of salami contaminated with salmonella that was traced back to peppercorns sold by Wholesome. Daniele had purchased 50,000 pounds of the pepper and claims extensive testing by regulators failed to identify any potential source of salmonella other than Wholesome's pepper. The \$33.2 million judgment purportedly encompasses recall expenses, lost profits and reputational damage. Daniele has alleged a direct right of recovery against Penn-Star. (Complaint, ¶ 20). Presumably, Daniele will have to prove coverage for Wholesome's claim, and with the amount at stake, Penn-Star likely will launch an aggressive defense.

While insurers such as Penn-Star do not want public coverage disputes to deter possible insureds from purchasing recall insurance, insurers must look at the long term ramifications of legal precedent possibly broadening the scope of coverage of recall policies. Finally, insurers should consider narrowing recall policy language to limit coverage to actual and harmful contamination occurring during manufacturing. □

Jessica F. Pardi is a Partner in Morris, Manning & Martin's Insurance and Reinsurance Practice. Ms. Pardi's practice includes reinsurance arbitrations, complex coverage disputes, bad faith matters, managing general agency disputes and life settlement controversies. Ms. Pardi received her undergraduate degree from Boston University and her law degree from the University of Virginia.



HASSETT'S OBJECTIONS

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(group health insurance). The majority of decisions uphold insurance-specific restrictions on arbitrability based upon the McCarran-Ferguson Act, which allows state law to control the insurance industry unless Congress expressly provides otherwise. See *Am. Bankers Ins. Co. of Fla. v. Inman*, 436 F.3d 490 (5th Cir. 2006); *McKnight v. Chicago Title Ins. Co.*, 358 F.3d 854 (11th Cir. 2004). But at least one recent decision questions whether such statutes reverse or preempt the Federal Arbitration Act ("FAA"). See *Bixler v. Next Fin. Group, Inc.*, 858 F. Supp.2d 1136, (D. Mont. March 14, 2012) (state statute barring



forced arbitration of insurance contracts does not preempt FAA).

Apparently, even non-insurers celebrated *Stolt-Nielsen* too early. Over the last year, several decisions have inferred a business's agreement to class arbitration where the agreement facially was silent. In some cases, the inference was quite flimsy. In *Jock v. Sterling Jewelers, Inc.*, 646 F.3d 113 (2nd Cir. 2011), an arbitrator's decision to hold a class arbitration was upheld, because it "cannot be construed to prohibit class arbitration" and there was "no mention of class claims." The Second Circuit held that only two judicial questions were presented. The first is whether the question of class arbitrability properly was referred to the arbitrator and "whether the agreement or the law categorically prohibited the arbitrator from reaching" the issue of class arbitrability. *Jock*, 646 F.3d at 123.

The Third Circuit agreed with the *Jock* decision. In *Sutter v. Oxford Health Plans, LLC*, 675 F.3d 215 (3rd Cir. Apr. 4, 2012), the Court affirmed an arbitrator's class arbitration award, finding that an agreement to allow class arbitration need not be express. The arbitrator had inferred authorization for class arbitration from the following arbitration clause:

No civil action concerning any dispute arising under this Agreement shall be instituted before any court, and all such disputes shall be submitted to final and binding arbitration in New Jersey, pursuant to the Rules of the American Arbitration Association with one arbitrator.

Id. at 223.

As is evident, nothing in that arbitration clause refers to class arbitration. Instead, the arbitrator inferred an intent to allow a class arbitration because, otherwise, a class proceeding could not be brought in any forum. Of course, avoiding a class adjudication in any forum was part of the business' objectives in choosing arbitration.

More recently, in *Fantastic Sam's Franchise Corp. v. FSRO Ass'n. Ltd.*,

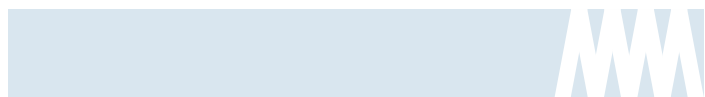
683 F.3d 18 (1st Cir. June 27, 2012), the court held that an agreement to class arbitration could be inferred from the broad scope of the arbitration clause and a change in the franchise agreement form to remove a prohibition on class arbitration. Several district courts have addressed the issue and have followed the Second and Third Circuits. See, e.g., *Southern Commc'ns Servs., Inc. v. Thomas*, 829 F. Supp.2d 1324, 1340 (N.D. Ga. 2011), *appeal pending*, No. 11-15587 (11th Cir.); *Amerix Corp. v. Jones*, No. 11-2844, 2012 WL 141150, at *6 (D. Md. Jan. 17, 2012); *Louisiana Healthcare Serv. Indem. Co. v. Gambro A.B.*, 756 F. Supp.2d 760, 768 (W.D. La. 2010); *Smith & Wollensky Restaurant Group Inc. v. Passow*, 831 F. Supp.2d 390 (D. Mass. 2011).

Going the other way is the Fifth Circuit's decision in *Reed v. Florida Metropolitan Univ., Inc.*, 681 F.3d 630 (5th Cir. May 18, 2012). That court expressly rejected the *Jock* and *Sutter* decisions, holding that the arbitrator must have a contractual basis to hold a class arbitration, and a combination of a broad arbitration clause and the absence of an express prohibition cannot authorize a class arbitration.

The losers in *Sutter* have petitioned the Supreme Court to review the Third Circuit's decision. *Oxford Health Plans v. Sutter*, U.S. Supreme Court, Case No. 12-135. The Supreme Court has not yet decided whether to hear the case.

Unless and until the Supreme Court rules otherwise, businesses should draw three lessons from these lines of cases. First, be careful in referring questions of arbitrability to the arbitrator. Second, be careful in drafting an arbitration clause to incorporate rules of various organizations or the arbitration laws of a particular state. A business should ensure that incorporated arbitration rules or state law do not authorize class arbitrations. Third, to avoid a flimsy inference from an anti-arbitration court, the prohibition on class arbitration must be express and coextensive with the arbitration clause itself. □

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DRAFTING REINSURANCE AGREEMENTS: THE ACCESS TO RECORDS CLAUSE

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what records may be audited.

More recently, the access to records clause has begun to take on the characteristics of a comprehensive audit clause, similar to those found in other types of commercial contracts where, as in reinsurance, the parties' fortunes are closely tied and compliance by one of the parties with ongoing operational requirements is a central issue. A more detailed and comprehensive clause can be beneficial to both the cedent

and the reinsurer by offering greater protections and certainty for both. On the other hand, going beyond the standard, terse formulation may require more time to negotiate.

Digging into the details of the clause requires consideration first of the type of records subject to audit. The reinsurer, of course, will want to define the scope of audit broadly, perhaps with language like the following:

The Reinsurer and its designated representatives shall have free access at all reasonable times to all books and records of the Company that pertain in any way to the policies reinsured under this Agreement or business related to such policies.

The cedent, on the other hand, may want to place reasonable limitations on the scope of records subject to audit with language such as the following:

The Reinsurer and its designated representatives shall have free access at all reasonable times to any of the policy, underwriting, accounting or claims files of the Company relating to the business reinsured under this Agreement.

Defining the types of files subject to audit may help avoid overly broad and onerous audit requests. The cedent may also wish to limit access to certain locations where records are kept and specify that the right of access applies not only to the reinsurer, but also to the cedent.

In addition, the cedent may want to place limits around the time and manner of access—for example, by limiting access to normal business hours and requiring prior notice. Specifying additional limitations on time and manner of access also can help avoid misuse of the access to record clause where a dispute has arisen, as is done in the following provision:

Inspection of books and records under this Article shall be made during normal business hours following 15 days prior written notice, which notice shall include the details and initial scope of the inspection. Inspection shall be conducted without undue interference to the Company's business activities and in accordance with reasonable industry practices.

An audit request often is the first step in what may become a dispute between the reinsurer and its cedent. If small but important details are left out of the governing language, these omissions may slow or otherwise impede an audit. For example, access to records clauses often fail to specify whether the reinsurer may copy records subject to inspection. Without an express right to copy, the cedent is within its rights to refuse copying absent an arbitration panel or court order.

The need to audit may well arise long after the reinsurance agreement has terminated and the business is in runoff. Thus it is wise to specify that the right to access survives termination of the agreement.

Another issue to consider is whether the reinsurer will need to inspect records held by third parties, such as managing general agents, underwriting agents, claims adjusters or third-party administrators. Language such as the following will help ensure free access to such records:

The Company shall cause such third parties as may maintain any records subject to inspection under this Article to allow the Reinsurer and its designated representatives free access to inspect and copy such records under the same terms and conditions as apply to the Company under this Article.

Another issue to consider, this time from the cedent's perspective, is how to protect the confidentiality of records subject to audit. Requiring the reinsurer to maintain confidentiality and to require its auditors to do the same is not enough. A cautious cedent will want the right to require any third-party auditor to enter into a confidentiality agreement with the cedent. This approach allows the cedent to enforce the right of confidentiality directly against the auditor.

For this reason, cedents sometimes condition access on the execution of a reasonable confidentiality agreement between the cedent and any auditor. Merely requiring a reasonable confidentiality agreement, however, has the potential drawback that what the auditor considers reasonable might not square with the terms of confidentiality the cedent desires. To avoid this problem, the cedent may want to attach a copy of the confidentiality agreement it intends to use to the reinsurance agreement and have the access to records clause require execution of the specified agreement before an auditor is granted access.

Access to records clauses sometimes allow the cedent to deny access if the reinsurer is not current on all payments due under the agreement. For obvious reasons, such a condition is not popular with reinsurers. If the cedent insists, a compromise may be to allow the cedent to deny access if there are any undisputed balances due. The reinsurer also may want the right to withhold payment if the cedent fails to grant access when required by the agreement.

In recent years, both cedents and reinsurers have become more concerned with establishing guidelines in the access to records clause to protect the privilege of records relating to claims—for example, coverage opinions—when such records are subject to audit. These concerns were heightened by a 2010 opinion from the U.S. District Court of the District of Oregon involving TIG Specialty Insurance Company (“TIG”).¹

In that case, a group of TIG’s policyholders, Regence Group, initiated litigation against TIG seeking a declaration that TIG was obligated to pay defense and settlement costs arising from certain claims. While this litigation was pending, TIG became involved in an arbitration proceeding with its reinsurers. In the course of the arbitration, the reinsurers sought files relating to the litigation with Regence Group, including coverage opinions, litigation reports and communications with TIG’s coverage counsel.

TIG resisted disclosure of these materials but ultimately was ordered by the arbitrators to produce the documents, subject to a statement by the arbitration panel that production did not constitute waiver of any privilege and was subject to a confidentiality agreement governing the arbitration.

¹ *Regence Group v. TIG Specialty Ins. Co.*, 2010 U.S. Dist. LEXIS 9840 (D. Or. Feb. 4, 2010).

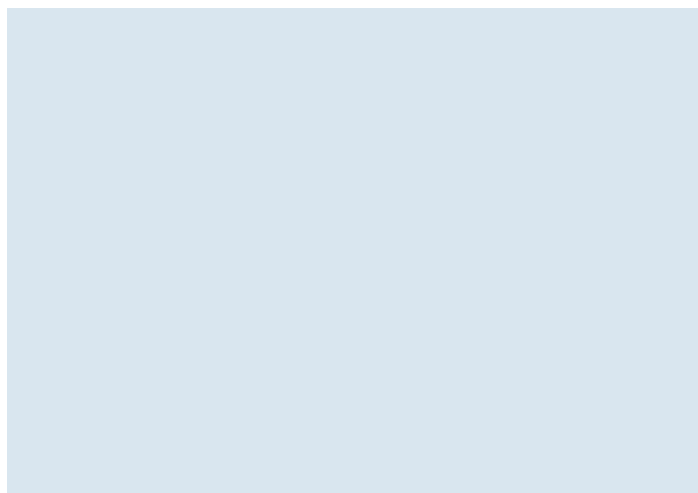
Regence Group sought discovery of the items disclosed by TIG to its reinsurers. TIG resisted, arguing that the documents were privileged and that compelled disclosure in the arbitration proceeding did not waive the privilege. The court disagreed, holding that even though disclosure of the documents was compelled, TIG had waived the privilege by disclosing them to the reinsurers when the parties’ interests were not aligned. According to the court, the interests of TIG and its reinsurers were not aligned because they were opposing parties in the arbitration.

The TIG case likely is an outlier, but it highlights the importance of taking steps to preserve the privilege for documents disclosed to a reinsurer. Courts have long recognized that parties with aligned legal interests may share privileged documents related to their common interests without waiving the privileged status of the documents. In the TIG litigation, the Oregon District Court failed to recognize that TIG and its reinsurers had a continuing common interest in defeating the underlying action brought by Regence Group, notwithstanding the fact that their interests had diverged with respect to the matters at issue in the arbitration.

Cedents and their reinsurers may wish to specify in the access to records clause procedures that the parties will follow to preserve the privileged status of documents subject to disclosure, whether disclosure is voluntary or compelled. Such procedures might include disclosure only under a confidentiality agreement specifying the parties’ common interest, disclosure in arbitration only under a protective order and ruling that the parties share a common interest or, in appropriate circumstances, disclosure only after final settlement or adjudication of any underlying claim relating to privileged materials.

The access to records clause is an important element in any reinsurance agreement. Crafting a clause that is specific about the parties’ mutual intent offers protections for both the cedent and the reinsurer and can help avoid disputes that may arise if the clause is overly general in its terms. □

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