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LETTER FROM WASHINGTON

INSURANCE REFORM TO HAVE LITTLE EFFECT ON CAPTIVES – SO FAR.

By Robert H. Myers, Jr.

The worldwide financial crisis and the very ambitious agenda of the Obama Administration have kept Congress extraordinarily busy. Will any of this frenetic activity have any effect on the regulation of captives?

Individual states have always handled insurance regulation in the United States with multi-state issues being considered through the good offices of the National Association of Insurance Commissioners ("NAIC"). Congress is now considering the reorganization of regulation of the entire financial services industry.

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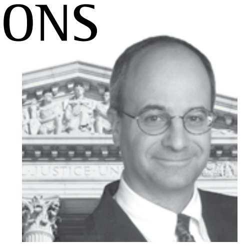
HASSETT'S OBJECTIONS



WASA v. LEXINGTON THE IMAGINARY REINSURANCE COVER

By Lewis E. Hassett

Reinsurance transactions carry inherent risks for both parties. One risk is the substantial increase in liability that can result from an unexpected or unfair court decision. In such situations, the facultative cedant must have comfort that its reinsurer will cover its share of the loss, at least when the reinsurance cover is worded similarly to the underlying insurance and a court has adjudicated important issues relating to the cedant's liability. While the insurance and reinsurance industry has some expectation of U.S. courts protecting insureds and claimants at the insurers'

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PLAYER'S POINT

OBSERVATIONS

By Thomas A. Player

The aftermath of the financial meltdown finds all financial institutions put in the same pile, including insurance. The Obama Administration and Congress is each calling for macro solutions based upon the premise that all financial institutions were equally deficient in oversight and regulation. My insight, if any, comes from being involved with the U.S. insurance industry for some 40-plus years. Perhaps my perspective is somewhat unique in that I have worked with management across most lines of insurance: life, health, property and casualty and reinsurance.

Based upon that experience and no "inside" information, allow me to set forth what I think is true.

- All of us in the industry know that the insurance operations of AIG did not bring down AIG; it was the London-based Financial Products subsidiary.
- To date, the U.S. insurance industry has weathered the financial storms in the face of unprecedented pressures in the form of Katrina, pandemics and financial market meltdown.
- Statutory accounting, coupled with risk-based capital measurements, have proven solid tools for solvency management.
- The same holds true for international insurance regulation.
- The NAIC developed and refined these tools and should be given fair credit.

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Inside this issue

Announcements

The Georgia Department of Insurance has proposed new regulations adopting the NAIC's Model Audit Rule regulation and making other changes to the existing Life Settlements regulation. A hearing to review the adoption of both regulations will be held on September 29 at the Georgia Department of Insurance. Comments for both regulations are due by September 28, 2009.

On September 10, **Jim Maxson, Joe Holahan** and **Michele Madison**, along with Kathleen Birrane and Mario Coniglio of MLF LexServ, LP, hosted a life settlements webinar entitled "After the Purchase: Tracking Insureds, HIPAA and Privacy Issues."

Dow Jones Private Equity Analyst has ranked Morris, Manning & Martin, LLP as a Top 50 law firm for its number of Venture Capital and Private Equity deals. MMM was the only Atlanta-based law firm on this prestigious list, which includes other national and global firms.

Jim Maxson spoke on "New Developments in Litigation" at the DealFlow Media's Life Settlements Conference held on September 14-16 in Las Vegas, Nevada.

Skip Myers will be speaking on federal insurance regulation at the National Risk Retention Association annual conference in Washington, DC on September 24.

On October 1, **Joe Holahan** will speak at the Life Insurance Settlement Association's 2009 Compliance Conference in Orlando, Florida on the topic of "Privacy and Security of Personal Data: Addressing the Legal and Reputational Risks."

On October 2, **Jim Maxson** is speaking on various issues pertaining to Securities and Life Settlements law at the Life Insurance Settlement Association's Compliance Conference in Orlando, Florida.

October 5-7, **Jim Maxson** and **Tony Roehl** will participate in the Association of Insurance Compliance Professionals' annual conference being held October 5-7 in Phoenix, Arizona. On October 5, both Jim and Tony will speak on the panel, "COLI, BOLI, STOLI: The Good, The Bad, The Ugly." On October 7, Tony will speak on an additional panel, "Compliance Issues Relative to the Senior Market."

Skip Myers will be speaking on the changing role of the NAIC at the annual meeting of the Captive Insurance Council of the District of Columbia on October 22.

Skip Myers will be speaking at the World Captive Forum in Bonita Springs, FL on November 10 on Preparing for More Regulatory Risks.

The ICCIE course on regulation of risk retention groups will be starting this year on November 30. **Skip Myers** will again be one of the lecturers. For more information please contact ICCIE www.iccie.org.

GALLAGHER GETS OKAY TO ACCEPT CONTINGENT COMMISSIONS AND NEW YORK PROPOSES NEW COMPENSATION DISCLOSURE RULES

By Tony Roehl

Two recent developments have thrust broker compensation back into the national spotlight. The most recent news on this issue was on July 28, when broker Arthur J. Gallagher & Co. ("Gallagher") announced that it reached a nationwide agreement with the Illinois Attorney General and Illinois Department of Insurance permitting it to once again accept contingent commissions. Gallagher's agreement with the Illinois regulators does not encompass Marsh, Aon or Willis, the remaining brokers who also agreed to end taking commissions in the aftermath of the 2004 investigation led by then New York Attorney General Elliot Spitzer.

While the net effect to Gallagher's balance sheet from accepting contingent commissions is expected to be modest (estimated at $10 million to the firm's earnings in 2011), the broader implication is more striking – that the results of the 2004 investigation, which turned up evidence at some of the larger brokers that contingent commissions were negotiated as a reward for steering business to certain insurers and bid rigging, may have run its course.

Marsh and Aon were quoted as reacting positively to the Gallagher news primarily because it vindicates their argument that there are dual systems of regulation for commissions in effect. Only the four largest public brokers agreed to give up contingent commissions and take on greater disclosure obligations while smaller brokers were free to continue their business practices generally unmodified. Willis continues to assert that contingent commissions create an inherent conflict that cannot be corrected by more transparency and disclosure. It is unclear whether Gallagher will voluntarily continue the disclosure obligations it was previously required to make in its previous settlement with the Illinois regulators.

While Gallagher will be relieved of its disclosure obligations under the former agreement with the Illinois regulators, the New York Insurance Department is moving in the opposite direction and has proposed a new producer compensation disclosure regulation. The proposed regulation, which is still in draft form and subject to additional revision, would require all insurance producers (including brokers) to disclose, before binding any insurance contract: (1) whether the insurance producer represents the purchaser or the insurer for purposes of the sale, (2) that the insurance producer will receive compensation from the selling insurer based on the insurance contract the producer sells (if applicable), (3) that the compensation insurers pay to insurance producers varies from company to company and from insurance contract to insurance contract, and (4) that at any time during the relationship, the purchaser may obtain detailed information about the source and the amount of compensation expected to be received by the producer for the sale and, in the alternative,

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quotes obtained or considered by the producer by requesting such information from the producer.

If the purchaser requests more information about the producer's compensation or alternative quotes, the producer must disclose in writing before the issuance of the insurance contract: (1) a detailed description of the nature, amount and source of any compensation to be received by the producer or its affiliates based in whole or in part on the sale, (2) a detailed description of any alternative quotes obtained or considered by the producer including the coverage, the premium and the compensation that the insurance producer would have received in connection with those alternative quotes, (3) a description of any material ownership interest the insurance producer or its affiliates have in the insurer issuing the insurance contract, (4) a description of any material ownership interest the insurer issuing the insurance contract or its affiliates have in the insurance producer, and (5) an explanation that the insurance producer is prohibited by law from accepting a commission rate that is less than the filed commission rate.

The additional disclosures must be made if the amount of compensation to be received by the producer is not known at the time that the initial disclosure is required to be made. In such an instance, the producer has to disclose a description of the circumstances that will determine the receipt and amount in value of such compensation and a reasonable estimate of the amount or value. The draft regulations, which are expected to be finalized by the end of the year, exempt out wholesale brokers and managing general agents from its scope, and any violation or contravention of the proposed rule would be deemed to be a violation of the New York Insurance Unfair Trade Practices Act.

The dichotomy between the Illinois and New York actions is clear. One state is moving to relax restrictions on broker compensation while the other is imposing additional disclosure requirements. What is unclear is which initiative will pick up momentum and be followed by other states. ❑

Anthony C. Roehl is an Associate in the firm's Insurance and Reinsurance and Corporate Practices. Mr. Roehl's principle 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.

NEW STATE LAWS REQUIRE DISCLOSURE TO CONSUMERS REGARDING LIFE SETTLEMENT OPTIONS

By James W. Maxson

"You Have the Right to Shop Around . . ." These seemingly banal words in the right context can be very powerful, as evidenced by the legislation enacted by the states of Maine, Oregon and Washington. Each of these states recently has revised its life settlement statute to ensure that life insurance policy owners are advised of their full range of options when they are deciding what to do with an unneeded or unwanted life insurance policy.

A life settlement is the sale of a life insurance policy for a lump sum greater than its cash value (if it has any) but less than its face value. Life settlements are not appropriate for every policy owner, but for some it provides an ideal means of realizing value from an otherwise illiquid asset. Historically, policy owners who found themselves with a policy that they no longer wanted or needed had only one option – to surrender the policy to the issuing carrier for whatever cash value it possessed. The creation of the secondary market for life insurance has given consumers another option – the ability to sell their unneeded policies for market value.

The secondary market for life insurance has existed in its present form for approximately two decades, but survey after survey has shown that only a small percentage of life insurance agents, and an even smaller percentage of the life insurance owning public, are aware of the life settlement option.

With the enactment of their revised statutes, the states of Maine, Oregon and Washington have ensured that policy owners resident in each of those states will be aware of and encouraged to consult with their financial and legal advisors about whether a life settlement is the right solution for them.

Specifically, in each state's life settlement law, it is now mandated that in instances where the policy owner is 60 years of age or older or, in Washington and Maine if the policy owner is known by the insurer to be terminally or chronically ill, the insurer must give the policy owner a brochure or document that advises consumers "Life insurance is a critical part of a broader financial plan. There are many options available, and you have the right to shop around and seek advice from different financial advisers in order to find the option best suited to your needs." 24-A M.R.S. §6808-A, sub-§4; Oregon S.B. 973 §22 (effective January 1, 2010); Washington SSB 5195 §13 (effective July 26, 2009). Further, all three states' laws require that the notice advise consumers of alternatives to the lapse of the policy, and provide the definition of common settlement industry terms. Additionally, these statutes state that the document or brochure "may include brief descriptions of common products available from providers, [which] must be discussed in general terms for informative purposes only and not identifiable to any specific" licensee or provider.

Insurers are required to give these disclosures in three specific circumstances:

1. When the policy owner has requested the surrender of the policy in whole or in part;
2. The policy owner has requested an accelerated death benefit; or
3. The insurer sends an initial notice that the policy may lapse.

Informing consumers of their rights is only the first step, but it is the most critical. If policy owners know that they have options, they can seek out the necessary expertise to assist them in making the decision that is the best one for each individual's life insurance needs. ❑

James W. Maxson is Of Counsel in the firm's Insurance and Reinsurance Practice and co-chair's 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. Jim received his bachelor's degree from Denison University and law degree from the Ohio State University School of Law.

CALIFORNIA'S PROPOSED PAY-AS-YOU-DRIVE REGULATION ILLUSTRATES STATE FLEXIBILITY IN REGULATING INSURANCE

By Jason Cummings

Even though states have regulated the business of insurance since its inception, many in Washington have called for the federal regulation of insurance. One argument in favor of state based regulation is that state insurance departments are best suited to regulate insurance as they are accessible and nimble, and can uniquely draft regulations that are tailored to the needs of their local consumers.

Recently, the argument that state insurance departments are accessible and nimble got a boost when the California Department of Insurance received support for its revised draft regulation allowing insurers to base premiums on the number of miles driven through so-called pay-as-you-drive insurance. The pay-as-you-drive regulation was originally conceived about a year ago to combat increasing gasoline prices by encouraging individuals to drive less. Pay-as-you-drive would allow insurers to offer policyholders automobile insurance coverage which calculates premiums based on the actual number of miles driven by the policyholder, as opposed to the traditional method of pricing premium based upon an estimate of miles. Pay-as-you-drive insurance is a way for policyholders to more accurately pay for the coverage they need by aligning their policy premium more closely to the number of miles the policyholder actually drives.

Under the pay-as-you-drive regulation, insurers would be able to create plans to sell policies based on either an estimate of miles, verified miles or prepaid miles. The miles driven by the insured would be verified through a variety of potential methods, including odometer readings taken by the insured, the insurer, an agent of the insurer, automotive repair dealers, or smog check stations, or by a device provided to the insured.

The latest revisions to the pay-as-you-drive regulation have led to even greater support for the regulation. The revisions include (1) a prohibition against the use of mileage recording devices if the device is used to collect information about the location of the insured or to establish automobile insurance rates; (2) discounts for policyholders who participate in a verified actual mileage program if the insurer offers both a mileage estimation program and a verified actual mileage program; (3) the required use of multiple mileage rating bands; and (4) the option to purchase only a fixed number of insured miles that would be priced on a mile-to-mile basis, including policies based upon either (a) a set time period which allows coverage to continue even if the block of insurance purchased expires (the insured would be charged for the miles driven in excess of the block of miles) or (b) a hybrid time and miles based policy (all coverage, except for automobile liability coverage, ends at the expiration of the block of miles).

As mentioned above, the pay-as-you-drive regulation as revised has received significant support in the industry for its flexibility in allowing insurers to offer verification and premium pricing methods which are attractive to consumers. Insurers have emphasized that the key elements attractive to the insurers are flexibility on pricing premiums, verified accurate mileage readings, and incentives for responsible driving behavior. California Insurance Commissioner Steve Poizner stated "pay-as-you-drive is a cutting-edge program that will create financial incentives for California motorists to drive less, leading to lower-cost auto insurance, less air pollution and a reduced dependence on foreign oil." The revised pay-as-you-drive regulation has also gathered support from privacy advocates, who previously opposed the pay-as-you-drive regulation because of the possibility that mileage would be recorded through an electronic device placed in the vehicle.

If adopted, proponents of the state regulation of insurance could point to the pay-as-you-drive regulation and its revisions as yet another example of the benefit of a system that allows experimentation at the state levels rather than a uniform national regime. The pay-as-you-drive regulation could be adopted by the end of the year. ❑

Jason Cummings is an Associate in the firm's Insurance and Reinsurance Practice. Mr. Cummings received his bachelor's degree from Wake Forest University and his law degree from Mercer University.

The firm is pleased to announce that Louise M. Wells has been named its new managing partner effective January 1, 2010. Louise has been with the firm for over thirty years. During that time she has had an active real estate practice focused on the development of residential communities. Louise offered, "I am honored to accept this responsibility. As a result of the firm's unique culture and entrepreneurial spirit, we have been responsive to the challenging market conditions. We have made smart strategic decisions that build upon the firm's solid platform, better positioning us to succeed and drive forward in the coming months and years."

Lew Hassett, who co-chairs the firm's Insurance and Reinsurance Practice Group, headed the transition committee that nominated Louise for the position. "Louise was an easy pick. She is well-known in the legal community and brings a business savvy so important in today's competitive environment," adds Lew.

PLAYER'S POINT

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- State regulation of insurance deservedly gets a black eye for inconsistent application and slow national market response.
- However, state regulation of insurance is not easily subject to overall political manipulation and knee-jerk responses.
- The NAIC has made some progress in endeavoring to streamline licensing and approval of new products. However, this process needs more improvement.
- Current NAIC leadership is on sound footing.

Given these "observations," at least in my opinion, care should be taken not to throw out the baby with the bath water. Some federal oversight and coordination is needed. But the core business of insurance is more complicated than banking and

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should be walled-off from the regulation of investment banking. More thought should be given to which products are regulated as insurance products and which are financial products to be sold by commercial banks and investment banks.

Currently, the NAIC is seeking the assistance of Congress to give it federal preemption powers in order to "beef" up its national regulatory prowess and effectiveness. As former D.C. Commissioner Larry Mirel writes in his thoughtful piece, "The Dilemma Faced by the NAIC," "...[T]he question is whether the NAIC, as a private organization, can be empowered by federal law to make and enforce rules that preempt state authority."[1] This is an old question to which answers have been sought for many years. My partner, Skip Myers, was instrumental in assisting the development of the 1986 Liability Risk Retention Act, which has stood the test of time in empowering a single state home regulator. Later, he published and promoted in favor of a national interstate regulatory compact.

Admittedly, these are different times and the goal is much more pervasive. The NAIC is seeking a way, as a private trade association, to provide federally enforced guidance in the national regulation of insurance. Surely a process can be found to provide federal oversight while not losing the considerable experience and expertise of state insurance regulation. ❑

Thomas Player is a Senior Partner in the Insurance and Reinsurance Practice. His areas of expertise include insurance and reinsurance, mergers and acquisitions, complex regulatory issues and dispute resolution. Tom received his bachelor's degree from Furman University and his law degree from the University of Virginia.

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1 "*The Dilemma Faced by the NAIC*," Lawrence H. Mirel, Wiley Rein LLP, available at fpn.advisen.com, August 26, 2009

LETTER FROM WASHINGTON

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Insurance is only a relatively small part of that entire industry. Commercial banks, investment banks, and non-bank financial institutions such as hedge funds are the focus of Congress's attention. In addition, other pressing issues such as healthcare reform, the budget, the ineffectiveness of the stimulus package, etc. have taken priority over financial services reform.

Nonetheless, Congress will respond in due course to the Obama Administration's proposals for financial regulatory reform. On June 17, 2009, the Treasury released Financial Regulatory Reform a New Foundation: Rebuilding, Financial Supervision and Regulation ("Treasury Report"), which outlined the Administration's views. Nothing in the Treasury Report and nothing currently pending before Congress would directly affect the regulation of captive insurance companies.

However, in this overwrought legislative environment, there are numerous opportunities for mischief. The alternative risk transfer industry needs to be vigilant. Most of the potential areas of concern will have an indirect effect upon the captive industry but could, nonetheless, be significant. Here are the issues that have come to light so far:

"Systemic Risk"

"Systemic risk" is the key focus of the Administration's efforts. While there is no clear definition of "systemic risk," there is the view that anything "too big to fail" qualifies. Much of the regulatory responsibility for managing "systemic risk" would fall on the Federal Reserve ("Fed") which would supervise "tier one" financial holding companies. The most sizeable insurance holding companies would fall within this category.

Office of National Insurance

The Treasury proposal would create the Office of National Insurance ("ONI") which would gather information, coordinate policy in the insurance sector, and identify problems in regulation which might contribute to a future financial crisis.

Financial Services Oversight Council

The Financial Services Oversight Council ("Council") would consist of various federal agency regulators. Its purpose would be to gather information and coordinate regulation during a financial crisis. Interestingly, neither any state insurance regulator nor the NAIC is included in this important council.

Consumer Financial Protection Agency

The Consumer Financial Protection Agency ("CFPA") would be created as an independent agency to oversee consumer protection of non-commercial financial products. While its jurisdiction would exclude most insurance products, it would have jurisdiction over credit insurance, title insurance, and mortgage insurance. Most of the insurance trade associations and the NAIC are vehemently opposed to this proposal.

Healthcare Reform

The reform of healthcare is a massive undertaking which will affect health insurers dramatically. In addition to the direct economic effects on the health insurance industry, the proposals being considered by both the House and the Senate include the creation of a Health Choices Commissioner which will have the authority to regulate marketing of health plan standards, oversight of a new health insurance exchange, coordination of benefits, and other functions which have previously been handled by insurance commissioners. This is a significant threat to state insurance regulation, at least in the area of health insurance, and is being actively opposed by the NAIC.

"Collateral Damage"

The legislative process presents opportunities for the adoption of legislative language that can be damaging either intentionally or unintentionally. Section 551 of the Senate version of the healthcare legislation contains language addressing "insurance fraud." Within that language is a limitation on risk retention groups ("RRGs") providing coverage to Multiple Employer Welfare Arrangements ("MEWAs"), which would eliminate the federal preemption of state laws. This could conceivably be damaging to RRGs because it represents the first time their authority has been limited by Congressional action. While the scope of this limitation may be relatively small, it demonstrates the opportunity for mischief that the legislative process presents.

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Reinsurance

There is an ongoing effort by certain U.S. reinsurers to limit the ability of U.S. insurers to reinsure with foreign affiliates. This effort was started in the 110th Congress and will become more visible as the insurance reform efforts make progress in this Congress. Treasury is, needless to say, interested in gaining tax revenue. This legislation could limit the reinsurance markets and thereby have a negative effect upon captives.

Other Legislation

Two pieces of insurance regulatory legislation which are likely to move in this Congress are the National Association of Registered Agents and Brokers Reform Act of 2009 (H.R. 2554) and the Non-Admitted and Reinsurance act of 2009 (H.R. 2571). Both bills died in the 110th Congress, but have been rewritten in the 111th Congress and are now on a fast track. The first bill would establish a facility for national or multi-state insurance agent licensing without preempting state agent regulatory laws. The second would facilitate multi-state operation of surplus lines programs and would restrict non-domiciliary state regulation of reinsurers. This bill (H.R. 2751) just passed the House by unanimous consent on September 9.

Conclusion

While captive insurance companies are not the targets of legislation in this Congress, they will be affected indirectly by the restructuring of the insurance regulatory system. Moreover, there is always the opportunity for "collateral damage." The captive industry will need to be particularly attentive during the next several months. ❑

This article is based upon one authored by Mr. Myers which recently appeared in Captive Review.

Robert "Skip" Myers is Co-Chairman of the firm's Insurance and Reinsurance Practice and focuses in the areas of insurance regulation, antitrust, and trade association law. Skip received his bachelor's degree from Princeton University and his law degree from the University of Virginia.

HASSETT'S OBJECTIONS

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and reinsurers' expense, insurers historically have not expected English courts to protect reinsurers from a cedant's claim for the reinsurer's share of such losses.

Until now. In a recent decision, the House of Lords held that, notwithstanding an American court decision governing the cedant's exposure, the reinsurer's liability was not governed by that adjudication. *See Wasa Int'l Ins. Co. v. Lexington Ins. Co.*, [2009] UKHL 40 (July 30, 2009). The result is that a cedant that paid a loss in accordance with a binding court decision will not be reimbursed under a facultative cover that even the Lords agree was "back to back" with the underlying policy.

The Lords' decision is wrong. It ignores the purpose of reinsurance and the realities of the reinsurance market. At best, the decision devalues reinsurance obtained through the London market. At worst, it is simple protectionism. *See Wasa*, par. 18 (Opinion of Lord Mance) ("The issue in this case is whether certain financial consequences can be passed by a Massachusetts insurer ... to two London reinsurers....").

Some background is in order. Lexington provided Alcoa with Difference in Conditions insurance, which provided property and business interruption cover between July 1, 1977, and July 1, 1980. The insurance contract did not include a choice of law clause but included a service of suit clause consenting to jurisdiction anywhere in the United States.

Lexington obtained facultative reinsurance for the same period through the London market. Several reinsurers participated, including the English reinsurers Wasa and AGF Insurance Ltd. The facultative contract was expressed to be "as original," and the Lords recognize the coverage provisions of the insurance and reinsurance as fundamentally the same.

Alcoa later was required by various governmental agencies to clean a number of its sites that sustained environmental damage between 1942 and 1986. Alcoa had no environmental coverage for some of the years in question and, therefore, would have significant uninsured losses, if each insurer was liable only for spills during its respective policy period.

Facing these issues, Alcoa sued Lexington and other direct insurers in the Superior Court of King County, Washington, arguing that all insurers were liable for all environmental damage, regardless of the occurrence date. The insurers maintained that liability must be allocated based on the occurrence dates. The Supreme Court of Washington, ostensibly applying Pennsylvania law, agreed with Alcoa. *See Aluminum Co. of Am. v. Aetna Cas. & Surety Co.*, 998 P.2d 856 (Wash. 2000). The court held that the policy's language, that it "insure[d] against all . . . damage to the insured property . . ., except as hereinafter excluded or amended" covered pre-existing damage, because the coverage language of the policy did not expressly state that it covered only losses occurring within the policy period. *Id.* at 883-885.

In light of this adverse decision, Lexington settled its exposure and dunned its reinsurers. Most paid, but Wasa and AGF did not. They argued that, regardless of the coverage afforded by the direct insurance, the reinsurance was governed by English law. A fundamental precept of English insurance law is that an insurer (or reinsurer) would be liable only for spills occurring during the policy period.

Wasa and Lexington sued for declaratory relief in the Commercial Court in London. After a decision in favor of the reinsurers, *Wasa Int'l Ins. Co. v. Lexington Ins. Co.*, [2007] EWHC 896 (Comm.), Lexington appealed to the Court of Appeal. The Court of Appeal found in favor of Lexington, holding that the issue was not choice of law, but whether the same or similar wording in the insurance and reinsurance contracts should be accorded the same meanings, i.e. whether the coverages should be treated as "back to back." *Wasa Int'l. Ins. Co. v. Lexington Ins. Co.*, [2008] EWCA Cir. 150.

The House of Lords reversed. While recognizing that the wording in the insurance and reinsurance contracts were fundamentally the same and that "almost invariably" this would render the reinsurers liable, even if English law would dictate a different decision, the Lords nonetheless found in favor of the reinsurers. The Lords noted that the period of reinsurance clause was fundamentally important, that the parties in 1977 could not have

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predicted that Pennsylvania law would apply to the underlying policy or that the policy would be construed in such a manner.

The reasoning is suspect. Since Alcoa was based in Pennsylvania, it is not surprising that the Washington court applied Pennsylvania law. *Aluminum Co.*, 998 P.2d at 862. Indeed, neither Alcoa nor Lexington disputed this issue on appeal. *Id.* Similarly, given the service of suit clause in the original policy, it is not surprising that litigation was commenced in Washington. Alcoa could sue Lexington in any state, and the forum state's choice of law clause would apply.

The Lords' focus on choice of law, notwithstanding the back to back coverages, is disconcerting. The tension is not just English law versus the law of a U.S. state, but could be between the laws of two U.S. states. Not all U.S. states would agree with the Washington Supreme Court. Carried to the limits of the Lords' logic, reinsurers could avoid liability if the cedant's liability was determined under the law of one U.S. state, while the reinsurer's liability was determined under the law of another U.S. state.

The Lords' statement that in 1977 the insurer and reinsurers could not have predicted the nature of the Washington court's holding, i.e. that Lexington would be liable for pre-existing pollution, probably is factually correct. It is unlikely that Lexington or the reinsurers would have covered this risk if they had understood the scope of risk accepted.

But, so what? That is part of what insurance and reinsurance are for. Neither insurance nor reinsurance heretofore has been subject to a "cockamamie court decision" exception to contractual liability.

The House of Lords' decision would not be particularly noteworthy if it merely followed from a cedant's settlement without a court decision. It is generally accepted that follow-the-settlements does not bind the reinsurer to settlements outside the terms of the insurance policy or the reinsurance agreement. But this is different. The *Wasa* case involved a facultative certificate covering the single underlying insurance policy at issue. The covering language was similar in both agreements, and a court of competent jurisdiction, i.e. the Supreme Court of Washington, held that the language allowed for joint liability throughout the period of environmental contamination.

The Washington court's decision is not easy to defend. While minimally supported by a literal reading of one portion of the insurance policy, i.e. the coverage language itself does not expressly limit the coverage to occurrences within the policy period, and a prior Pennsylvania court decision, the court's decision is completely divorced from the reality of the insurance marketplace and simply provided a windfall for Alcoa.

But the business world has been exasperated by American court decisions for years. Insurers should not be deprived of their reinsurance because a court makes a wrong decision. Any underwriting of coverage must account for that risk.

Wasa teaches two lessons. First, American judges need to understand that judicial decisions have economic consequences. In this case, an insurer that bargained for, and received premiums for, four years of risk suddenly is on the hook for over thirty years of losses. The London reinsurance market and court system have served notice that they no longer will serve as enablers to the continued confiscation of insurer assets by judicial fiat. Those that advocate broad tort and product liability cite the benefits of spreading societal costs throughout society. *Wasa* announces that the cost of expansive tort liability no longer will be spread throughout the world via the international reinsurance system. Rather, the cost will be spread solely within the U.S. insurance market and, therefore, U.S. society.

The second lesson of *Wasa* is that reinsurance through the London market is not as valuable or reliable as previously thought. If the reinsurer's liability under a back to back facultative cover does not follow an adjudication against the cedant, then it is of limited protection. If choice of law trumps back to back cover, then the reinsurers have an escape. The reinsurers need not test the protection via litigation in England or elsewhere; the threat to do so will be enough to trigger settlements at a discount.

One of three things is likely to happen. First, American courts may begin to consider the effect on an insurer when catastrophic losses are imposed that may not be covered by English reinsurance. In my view, that is unlikely to happen. To the contrary, American courts have a history of bankrupting corporations over expansive tort claims.

Second, American insurers may begin to insist on contractual protections, such as an express incorporation of the law of an American state or, better yet, exclusive U.S. jurisdiction. Of course, this is akin to closing the barn door after the horse's exit. English reinsurers bound to occurrence-based reinsurance will remain protected from past environmental and product coverages.

Third, American insurers may eschew the London market to avoid judicially created gaps in their reinsurance coverage. Indeed, state insurance regulators may restrict the use of English reinsurers on domestic risks or may require the application of the law of a U.S. state to English reinsurance contracts. This also would be of scant current benefit to American cedants with outstanding risks. But more importantly, regulatory action against English reinsurers would be deleterious to the continued primacy of the London reinsurance market.

An insurer, American or otherwise, must have confidence that its reinsurance program will pay when triggered. It is not unreasonable to require the ceding insurer to obtain a judgment of a court on a novel theory of law, rather than simply settling the case and passing all or part of the bill to the reinsurer. However, when the cedant goes to court to adjudicate the dispute and obtains a court ruling, the reinsurer should be bound. That is particularly true where the reinsurance is a facultative certificate issued for a particular underlying insurance policy with back to back cover.

One final note. The *Wasa* decision was one of the House of Lords' last as the highest court. The United Kingdom now has a United Kingdom Supreme Court. ❑

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