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LETTER FROM WASHINGTON

THE FEDS ARE COMING (AGAIN)!

By Robert H. Myers, Jr.

During the past twenty years, we have witnessed numerous forays by the Federal Government into the regulation of insurance, and the resistance thereto by the states. In the past, it seems that the proposals have been more direct, e.g., repealing the McCarran-Ferguson Act or establishing a federal chartering alternative to state regulation.

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PLAYER'S POINT

THE SUB-PRIME MESS: INADEQUATE ENTERPRISE RISK MANAGEMENT

By Thomas A. Player

With the 20-20 vision of hindsight in analyzing the sub-prime fallout, it is painfully obvious that many seemingly well run organizations were deep in a risky business. For example, those risks involved in sloppy underwriting, over-valued assets, tenuous accounting practices, unreliable guarantors, and shaky counterparties.

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HASSETT'S OBJECTIONS

SUPREME COURT "PROMOTES" ARBITRATION

By Lewis E. Hassett

In the Winter 2003 Hassett's Objections entitled "But We Don't Want All or Nothing," I addressed the split in the Circuits on whether an arbitration agreement may require a reviewing court to apply an enhanced standard of review. The Fifth, Fourth and Third Circuits had held that federal courts would enforce a contractually-designated enhanced standard of review. *Gateway Techs., Inc. v. MCI Telecomms. Corp.*, 64 F.3d 993, 996 (5th Cir. 1995); *Syncor Int'l Corp. v. McLeland,* Case No. 96-2261 (4th Cir. 1997); *Rodeway Package System, Inc. v. Kayser*, 257 F.3d 287 (3rd Cir. 2001). The Ninth and Tenth Circuits had rejected enhanced standards of review. *See Kyocera Corp. v. Prudential-Bache Trade Servs., Inc.*, 341 F.3d 987 (9th Cir. 2003) (en banc); *Bowen v. Amoco Pipeline Co.*, 254 F.3d 925 (10th Cir. 2001). An enhanced standard of review allows the expertise of the arbitration panel to control with respect to evidence, industry custom and conclusions but subjects those decisions, and the application of legal principles to those decisions, to impartial judicial review. Some parties feared that, just as a trial judge can make human errors, so can an arbitrator. The downside to an enhanced standard of review is delay and the dilution of industry custom.

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Announcements

Lew Hassett has been appointed to the Editorial Board of Reinsurance, published by Harris Martin Publishing.

Jessica Pardi and **Joe Cregan** won an administrative hearing before the Georgia Workers' Compensation Appeals Board wherein the insurer is now allowed to collect an additional $750,000 in workers compensation premium owed by an employer.

Skip Myers spoke to the Federal Bar Association conference on insurance taxation on May 29 in Washington, DC.

Joe Cregan and **Stacey Kalberman** recently assisted a large Canadian insurer in obtaining final regulatory approval from the Georgia Department of Insurance for the acquisition of a Georgia domestic life/health insurer that was licensed in an additional 48 states.

Chris Petersen recently traveled to the Kingdom of Saudi Arabia to brief the Board of Directors for the Council of Cooperative Health Insurance chaired by His Excellency, the Minister of Health on strategic options regarding major medical insurance. Mr. Petersen is part of a World Bank team that is assisting Saudi Arabia in developing a regulatory structure to facilitate the development of a private health insurance system in the Kingdom.

As in past years, **Dick Dorsey** and **Joe Cregan** represented several Morris, Manning & Martin clients in the 2008 session of the Georgia General Assembly, whose session adjourned on April 4th.

Chris Petersen will be speaking at the "Meet the Health Policy Makers" conference on health care reform, which will be held in Washington, DC, July 10-11, 2008. Mr. Petersen will be part of a panel of state policy experts that will examine state approaches to health care reform.

Attending the Summer NAIC Meeting in San Francisco on behalf of various clients are **Chris Peterson, Skip Myers, Joe Cregan** and **Joe Holahan.**

FIFTH CIRCUIT REJECTS APPLICATION OF DISCOVERY RULE IN CLAIM AGAINST REINSURANCE BROKER

By Benjamin T. Erwin

In *TIG Insurance Co. v. Aon Re, Inc*., Case No. 05-11450 (March 13, 2008), the Fifth Circuit Court of Appeals, applying Texas law, held that the discovery rule did not toll the statute of limitations applicable to a cedant's claim against its reinsurance broker. Ruling that the broker's alleged failure to provide full information to a potential reinsurer should have been known by the cedant, the Fifth Circuit affirmed the trial court's grant of summary judgment in favor of the broker. *Id.* at 8.

The dispute arose from TIG's desire to reinsure some workers' compensation policies written by TIG and to retrocede some workers' compensation risks written by Virginia Surety Company and reinsured with TIG. *Id.* Generally, TIG would retain liability for workers' compensation claims up to $1 million with the reinsurer/retrocessionaire to provide excess cover for losses over $1 million. *Id.*

TIG retained Aon Re, Inc. to solicit and negotiate proposals for reinsurance. *Id.* TIG provided Aon Re with information about TIG's workers' compensation business, including historical loss data for the Virginia Surety business. *Id.* Using the information provided, Aon Re put together a package of underwriting information to provide to prospective reinsurers. *Id.* In May of 1998, Aon Re sent information to WEB Management LLC, which was acting as an agent for United States Life Insurance Co. ("U.S. Life"). *Id.* According to Aon Re, this information included a "Claims Diskette" containing historical loss data for Virginia Surety dating back to 1994. *Id.*

TIG met with Aon Re in June of 1998 to discuss the quotes received. *Id.* TIG was interested in the quote from U.S. Life, although TIG personnel were concerned that the quote was too low compared to others. *Id.* Some at TIG believed that Aon Re may not have provided complete loss information to U.S. Life. *Id.* In fact, TIG's actuary criticized Aon Re's submission, believing that it may have been incomplete. *Id.* Despite these concerns, TIG accepted U.S. Life's offer on June 29, 1998, binding coverage effective April 1, 1998. *Id.* The parties executed a reinsurance treaty, signed by TIG on October 6, 1998, and by U.S. Life's agent on its behalf on November 12, 1998. *Id.* The treaty covered losses for three years beginning April 1, 1998, subject to cancellation at any time by TIG. *Id.*

On January 1, 1999, TIG cancelled its treaty with U.S. Life prospectively, allowing it to continue in force to cover claims arising out of losses occurring between April 1, 1998 and January 1, 1999. *Id.* Despite the treaty's continuing effect for such losses, U.S. Life stopped paying claims in the summer of 2001. *Id.* at 2. TIG demanded arbitration under the treaty, demanding payments of nearly $9 million. *Id.* In the arbitration, U.S. Life claimed that it

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had the right to rescind the treaty because Aon Re, as TIG's agent, had provided U.S. Life with materially incomplete information. *Id.* The arbitration panel found in favor of U.S. Life, specifically finding that Aon Re had omitted information regarding the Virginia Surety historical loss data. *Id.*

Following the arbitration decision, TIG filed suit against Aon Re, claiming negligence, negligent misrepresentation, breach of fiduciary duty, and seeking common law indemnity. *Id.* Aon Re moved for summary judgment, arguing that: (1) the negligence, negligent misrepresentation, and breach of fiduciary duty claims were barred by the statute of limitations; (2) the discovery rule does not apply to defer accrual of these causes of action; and (3) TIG's common law indemnity claims failed as a matter of law. *Id.* The trial court agreed with Aon Re, granting its motion for summary judgment on all three issues. *Id.* TIG then appealed these decisions to the Fifth Circuit Court of Appeals. *Id.*

The Fifth Circuit began by analyzing Aon Re's statute of limitations defense. *Id.* at 3. Applying Texas law, negligence and negligent misrepresentation claims must be brought not later than two years after the cause of action accrues. *Id.* Breach of fiduciary duty claims must be brought not later than four years after the cause of action accrues. *Id.* TIG claimed that it did not suffer any legal injury until the arbitration panel's decision rescinding the treaty on May 5, 2004. *Id.* Aon Re, however, contended that TIG's causes of action accrued in June of 1998 when the parties agreed to the reinsurance treaty. *Id.*

The Fifth Circuit agreed with Aon Re, finding that a legal injury to TIG occurred when TIG entered into the treaty, because the treaty was defective from its inception as a result of Aon Re's misrepresentations. *Id.* Despite TIG's belief that it could not have sued Aon Re prior to the arbitration, because it had not yet suffered any damages, the Fifth Circuit noted that Texas law provided an avenue for TIG to seek relief: it could have filed a negligence suit, and then abated that suit until any proceedings against third parties are commenced and resolved. *Id.* at 4. No matter how slight, the legal injury suffered by TIG entering into the reinsurance treaty provided the basis for its causes of action against Aon Re to accrue. *Id.* Accordingly, the Fifth Circuit affirmed the trial court's finding that TIG's causes of action accrued in June of 1998. *Id.*

The Fifth Circuit also rejected TIG's contention that the "discovery rule" tolled the statute of limitations for TIG's claims. *Id.* at 5. Under the discovery rule, a cause of action does not accrue, and the statute of limitations does not begin to run, until a plaintiff knows, or through exercising reasonable diligence should have known, of the facts giving rise to a cause of action. For the discovery rule to apply, the nature of the injury must be inherently undiscoverable and the injury itself must be objectively verifiable. *Id.* This rule is applied categorically. That is, although a particular injury may not have been discovered, if it is of the type of injury that could be discovered, the discovery rule will not apply under Texas law. *Id.* at 6.

In the present case, the Fifth Circuit found that the injury suffered by TIG was not inherently undiscoverable. *Id.* at 7. As the injury was the consummation of the reinsurance treaty with U.S. Life, TIG could have discovered the misrepresentation by Aon Re had it exercised reasonable diligence. *Id.* at 6. Although the discovery rule has been applied in cases where one party is relying on another for expertise it does not possess, such as with an accountant or attorney, TIG did not rely on any superior expertise or superior knowledge from Aon Re to obtain reinsurance coverage. Instead, TIG used Aon Re as an intermediary. *Id.* at 7. Because the injury to TIG was not inherently undiscoverable, the Fifth Circuit affirmed the trial court's decision not to apply the discovery rule to toll the statute of limitations. *Id.*

Lastly, TIG claimed that the trial court erred in finding that its common law indemnity claim against Aon Re failed as a matter of law. *Id.* TIG sought to recover from Aon Re those unreinsured liabilities attributable to the Virginia Surety portion of its business and to recover the costs and expenses of its arbitration with U.S. Life. *Id.* Under Texas law, "only a vestige of common law indemnity remains," and this vestige includes only purely vicarious liability. *Id.* However, any vicarious liability TIG may have had from the tortious misrepresentation by Aon Re was extinguished when U.S. Life chose in the arbitration to forego any claim for damages and seek only the equitable remedy of rescission. *Id.* With no vicarious liability for the wrongs of Aon Re, TIG could not prevail on a claim for common law indemnity. *Id.* at 8. No Texas court has applied common law indemnity to a claim for damages sustained from a rescission, and the Fifth Circuit chose not to "expand state law beyond its presently existing boundaries." *Id.* ❑

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RUM POINT BEACH OR THE LINCOLN MEMORIAL: WHERE BEST TO LOCATE YOUR CAPTIVE?

By Bill Winter

True or False: By establishing your captive insurance company in an exotic island locale, you will enjoy the best beaches, your company will gain instant international status, and, best of all, *you will not have to pay taxes*. Answer? False. At some point all of us must pay our income taxes. However, in certain situations, an offshore captive may provide a valuable deferral of U.S. income taxes.

Clients regularly ask the question: should my captive be domestic or offshore? Should I choose Washington, D.C. or the Cayman Islands? By establishing your captive as a reinsurance captive and not conducting any business activities inside the U.S., you may gain the benefit of a significant U.S. tax deferral. For most other captives covering U.S. risks, and especially for captives issuing

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direct policies, no significant tax advantage is gained by choosing Rum Point Beach over the Lincoln Memorial. Under the current U.S. tax rules, three main factors are involved: the ability to deduct unpaid losses, the ability to avoid premium taxes, and the cost of bringing cash home.

Deducting Unpaid Loses

Federal income tax rules allow captives to deduct paid losses from their taxable income. In addition, captives may deduct the discounted present value of any *unpaid* losses (adjusted, in part, based on actuarially anticipated losses). This generally translates into a tax deduction that equals or exceeds premium income, leaving little or no income to be taxed regardless of the captive's domicile. For example, assume a captive reinsures P&C policies. The reinsurance captive receives $1 million in annual premiums in exchange for reinsuring up to $10 million of risk over a four year period. Assume the captive has $60,000 in operating expenses and paid losses of $240,000 in the first year (all of which are deductible for income tax purposes). In addition to this $300,000 tax deduction, the reinsurance captive would be entitled to deduct the discounted present value of the $9.76 million in unpaid losses, adjusted based on the actuarially anticipated losses.[1] Assume the present value of those unpaid losses in year one is $1.1 million. For federal income tax purposes, the captive has a net operating loss of $400,000 (*i.e.*, $1 million of premium income less $1.4 million of deductions). Moreover, the deduction for unpaid losses is adjusted annually, keeping taxable income to a minimum. While some limitations and restrictions may apply, one can see how the captive will not be paying federal income taxes anytime soon. Because the deduction for unpaid losses already minimizes or eliminates the captive's income taxes, no significant income tax advantage is gained by locating your captive offshore.

Premium Taxes

While captives may not pay significant income taxes, they still must contend with premium taxes. For a domestic captive, they will pay premium taxes in any state where they write business. For an offshore captive, they potentially are subject to both a federal excise tax and state premium taxes. The federal excise tax applies to all foreign insurers.[2] The excise tax equals 1 percent of gross premiums on life and reinsurance policies covering U.S. risks and 4 percent of gross premiums on casualty policies covering U.S. risks. In addition, an offshore captive may be subject to state premium taxes if they "transact business" in a given state. The concept of "transacting business" is beyond the scope of this article; suffice it to say this is a very liberal standard that may impose premium taxes on an offshore captive if any business activities occur (or are deemed to occur) within the state (whether by issuing policies directly, issuing under self-procurement statutes, or through unrelated agents).

If a captive is not paying income taxes (as a result of its deduction for discounted unpaid losses), then its next largest tax expense likely will be premium taxes. Assume for example that a state's premium tax rate is 2.25 percent of gross premiums. If the captive generates $1 million in premiums for issuing P&C policies in that state, the captive will owe $22,500 in premium taxes. If the captive is offshore, you must add to this an additional 4 percent excise tax, or $40,000, making the offshore captive more costly.

Now assume that the captive is writing only reinsurance business and that the direct insurer is a large multinational insurance company. By forming an offshore captive and conducting all business activities outside the U.S. (including soliciting the direct insurer outside the U.S., negotiating the reinsurance treaty outside the U.S., and signing the reinsurance treaty at the offshore captive's foreign offices), the offshore captive likely has avoided "transacting business" in any state. As a result, the offshore captive has removed the 2.25 percent premium tax from the cost equation and has reduced the foreign insurer excise tax to 1 percent—for a total tax cost of $10,000 on $1 million of premium income. The offshore captive has effectively minimized both its income and premium taxes. If the captive avoids paying significant losses over the policy term, then you may be depositing $990,000 a year (*i.e.*, $1,000,000 in premium less the $10,000 excise tax) into an offshore bank account to grow tax-deferred. Apply conservative investing and the laws of compound interest and suddenly you have a very cash-rich captive. Not to mention the sugar-sand beaches surrounded by sapphire waves.

Bring Cash Home

Fast-forward to the end of our offshore captive's policy period and assume the captive has significant surplus cash. Upon distribution of the surplus cash to the offshore captive's U.S. parent, the U.S. parent will be required to include the cash as ordinary income, taxable at a 35 percent federal rate (plus any state income taxes). The tax-deferral ends here. At some point, profit from an offshore captive is eventually subject to U.S. income taxes. While an offshore reinsurance captive that does not conduct business in the U.S. may temporarily defer paying U.S. income taxes, in most other situations a domestic captive pays the same or less taxes than its offshore counterpart. In summary, if your decision to locate a captive is based strictly on taxes, you may want to consider locating closer to the Lincoln Memorial than Rum Point Beach. And no matter where your captive is located, always consider hiring an experienced captive tax professional. With careful planning, you may save enough money for that vacation in the Cayman Islands.❑

William M. Winter is a partner in the firm's tax and insurance groups. His practice focuses on addressing U.S. tax matters for growing businesses, with an emphasis on helping U.S. and foreign companies successfully expand their business overseas. Mr. Winter received his bachelor's degree from University of Illinois and law degree from Emory University School of Law.

1 Section 846 of the Internal Revenue Code and the related Federal income tax regulations provide guidelines for determining the discount rate and for determining loss payment patterns, both of which affect calculation of the total deduction.

2 The foreign insurer excise tax would not apply to foreign insurers that have made an election to be treated as a domestic insurance company under Section 953(d) of the U.S. Internal Revenue Code.

EULOGY TO THE AGENT'S COUNTERSIGNATURE

By Stacey D. Kalberman

On April 10, 2008, the United States Court of Appeals for the Ninth Circuit hammered the final nail into the coffin of the countersignature laws of the various states. *Council of Insurance Agents & Brokers and Rebecca Restrepo, v. Alice Molasky-Arman*, Case No. 04-17271. Following recent decisions by federal courts in Florida, South Dakota, Puerto Rico and the U.S. Virgin Islands, the federal appellate court ruled in favor of the eradication of the last of the countersignature laws in the U.S. and its territories.

A once common requirement, the movement to repeal the countersignature laws began in earnest in the 1990's even prior to advances in state reciprocity of agency licensing laws such as NARAB I and II. The history of the countersignature laws dates back to the early twentieth century when states passed the laws as a consumer protection measure. The regulations requiring non-resident agents to receive sign off by a local resident agent were originally intended to ensure compliance with local insurance laws.

By the 1990's, technology made the countersignature laws an anachronism of regulation. Seemingly the only barrier to their removal from state law books was the commissions provided to resident agents. The few states who maintained their countersignature laws into the twentieth century were some of the most egregious. Florida required that the resident agent receive fifty percent of the full commission, while in Nevada the resident split was five percent of the total commission. The pain of paying local agents for their signature was felt keenly by producers who placed multi-state policies. In the end, the Council of Insurance Agents and Brokers (CIAB) took on the individual state court battle, which overturned the countersignature laws in the few remaining states.

The federal court decisions found the countersignature laws to be an unconstitutional barrier to interstate commerce as a violation of the Privileges and Immunities Clause of the Constitution. That Clause bars state laws which discriminate against citizens of other states where the discrimination is based solely on the fact of citizenship and does not advance a substantial state interest. The intent of the Privileges and Immunities Clause was to place citizens of each state on an equal footing by providing the same economic privileges to all citizens regardless of state citizenship. Ensuring economic parity would result in economic unity for the nation. *Supreme Court of Virginia v. Friedman,* 487 U.S. 59 (1988).

In the Nevada case, the CIAB challenged the constitutionality of the Nevada countersignature law, Nev. Rev. Stat. § 680A.300, alleging that a California agent, Rebecca Restrepo, was forced to forfeit approximately $ 50,000 annually due to the requirements of the Nevada signature law. The loss in income as a result of the countersignature law was causing her to suffer immediate economic injury.

The Nevada Commissioner argued that the state's countersignature law protected Nevada consumers by providing a local point of contact for policyholders. Having the involvement of a local agent to provide counsel on coverage issues, assist in the claims process, and protect Nevada residents from unqualified or unlicensed insurance agents, was a substantial state interest that justified the law's disparate treatment between resident and non-resident agents.

The federal court was not convinced. Citing the Eleventh Circuit case striking down the Florida countersignature law (*Council of Ins. Agents and Brokers v. Gallagher*, 287 F. Supp. 2d 1302 (N.D. Fla. 2003)), the Ninth Circuit dismissed the Commissioner's local agency rationale and stated "the notion that an agent cannot provide assistance outside his home state is nonsense; whatever may have been said when people traveled by horseback and communicated by regular mail, today people communicate by telephone and facsimile and e-mail and overnight courier...; state boundaries pose no obstacle." *Id.* at 1312. The Court concluded that the discriminatory treatment of non-resident agent and brokers was over-inclusive because "[E]recting a fence at the [Nevada] border does nothing to promote geographic proximity". A licensed non-resident agent may actually be closer in proximity to the consumer than a licensed resident agent who lives hundreds of miles across the state from the consumer.

As a final matter, the Ninth Circuit rejected the argument that Nevada's law protected consumers from unqualified or unlicensed insurance agents. Stating that "…residency does not equate with professional competence" and that the record did not contain any evidence that "licensed nonresident agents and brokers are inherently less trustworthy or less competent insurance professionals than Nevada's resident agents," the case for countersignature laws was closed for the last time. ❑

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THE OTHER SIDE OF THE STORY: LESSONS LEARNED FROM GENERAL REINSURANCE CORPORATION V. ARCH CAPITAL GROUP, LTD. ET. AL. FOR DEPARTING EXECUTIVES

By R. Jason D'Cruz and Abena Antwi

Editor's Note: *The Spring 2008 edition of the MMM Review addressed the scenario of departing executives from the company's perspective. This article addresses the scenario from the departing executives' perspective.*

You are one of the Senior Vice Presidents of a successful insurance company (the "Company"). You serve as the head of the Company's Property Facultative (Prop Fac) reinsurance division. You just celebrated your thirty-year anniversary with the Company. Your contributions helped build one of the strongest Prop Fac divisions in the industry. Your team works well together. They like working for you. Unfortunately, many of them are considering leaving the Company.

Last year, the Company was acquired. With the acquisition came new management. They do not care how things were done in the past. They do not care that you have thirty years of experience. They want things done their way, and their way differs significantly from your way. Employees who complain are largely ignored.

Recently, one of the Company's largest competitors approached you to lead a new Prop Fac division. After long and careful deliberation, you decided to accept the job.

Because this is a new division, it has no employees or infrastructure. Although this move is an exciting opportunity, you are not sure where to start. Can you start looking for talent from your old team? Can you look for business by soliciting your old clients? Can you use the structure and business strategies you developed at your former employer? What should you do?

Prior to proceeding any further, you should:

- Obtain copies of all agreements you signed with the Company during your tenure. The Company should have provided copies at or around the time you signed them. If you do not have copies, you should request them.
- Determine what obligations you may have to the Company both before and after your employment terminates. At your level of management, the agreements are likely to contain restrictions on your ability to use or disclose the company's confidential information and trade secrets, use or disclose customer information, recruit company employees, solicit the company's customers, and/or compete against the company.
- Engage (or have your prospective new employer engage) a lawyer experienced in restrictive covenants, trade secrets and employee duties to review the agreement and provide advice on how to proceed. The lawyer should also review any agreements the Company may have with any other employees you would like to hire. Laws regarding restrictive covenants vary from state to state, and are constantly changing. The lawyer will be able to decide whether the agreements would be enforceable in the state in which the Company would seek to enforce them and will be able to advise you about your legal options. Those options may include filing a declaratory judgment action to have the covenants deemed invalid by a court.
- When you leave the Company, do not take any Company property with you unless the Company has given its express written consent for you to do so. Do not (i) download information from the Company server, (ii) copy your email box, (iii) forward your emails to an outside account, or (iv) take your rolodex or contact database. Return all Company property, documents, and data, whether in written or electronic form, and advise any employees you hire to do the same. Obtain written confirmation/inventory from the Company that you have returned property and information.

Following these steps may help you and your new employer avoid the kind of lawsuit initiated by General Reinsurance ("Gen Re") against former executives who went to work for a competitor. *General Reinsurance Corporation v. Arch Capital Group, LTD. et al.*, Case No. X05cv07011668S (October 17, 2007). Several Gen Re executives dissatisfied with their work circumstances collectively began exploring options for employment elsewhere. One executive took the lead in discussing opportunities with some of Gen Re's competitors. He also took the liberty of discussing some of Gen Re's confidential and proprietary information including, the amount of money Gen Re could "put up" on any single risk, the substance of a conversation with Gen Re's CEO about its future business strategy, statistics about Gen Re's historical and recent profit ratio, employee productivity, its maximum and average risk size, salary and compensation structure, the number of outstanding reinsurance certificates, total annual premiums, its five largest clients, and the number of Gen Re's reinsurance certificates that were sold without competitive bidding. *Id.* at *11-*13. The Court found all of these actions to be improper. Further, the executive discussed the possibility of "extracting" forty of Gen Re's Prop Fac employees and targeting the same clients they served at Gen Re. *Id.* at 11.

Gen Re sued the employees for breach of fiduciary duty, tortious interference with contract and business expectancies, and alleged violations of a state Unfair Trade Practices Act. The discovery process exposed many of the improper conversations the executives

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had during their job search. "Essentially, Gen Re charged the individual defendants plotted to move a substantial portion of [its Prop Fac] business to [their new employer] along with [Gen Re's] personnel, trade secrets, proprietary information and business plan and charged that all were, and are, planning to use these assets to unfairly create and operate out of whole cloth a business competitive to Gen Re's [Prop Fac] division." *Id.* at *3.

The court agreed with Gen Re regarding the bulk of these claims and granted a temporary injunction in its favor. However, although a large portion of Gen Re's Prop Fac division employees also left to join their former bosses in the competitor's employ, the court determined that the executives had not engaged in any improper activities with respect to the employees. Because the executives did not ask the employees to join them at the competitor, their conduct was lawful; they simply told the employees they were leaving to join the competitor. The employees left Gen Re of their volition and none of them had contracts prohibiting their employment with a competitor.

Following the steps outlined above will help a departing executive avoid many of the mistakes made by the Gen Re executives. Leaving your current employer is hard enough. Don't become the next poster child for what <u>not</u> to do when departing! ❑

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MAY V. SHALL — WHICH MANDATES ARBITRATION?

By Cindy Chang

"The parties *may* submit any disputes arising out of this Agreement to binding arbitration."

"The parties *shall* submit any disputes arising out of this Agreement to binding arbitration."

These clauses appear to be distinct—the first being permissive and the latter being compulsory. However, when determining whether arbitration is mandatory under a particular agreement, most courts do not recognize this distinction.

Under the Federal Arbitration Act ("FAA"), 9 U.S.C. § 1. *et seq*., a contract involving interstate commerce is "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. Many states also have substantially similar arbitration provisions. *See, e.g*., D.C. Code § 16-4301.

Despite the strong presumption favoring arbitration, the Supreme Court has repeatedly held that the presumption is not boundless. "[A]rbitration is a matter of contract and a party cannot be required to submit to arbitration any dispute which he has not agreed so to submit." *AT&T Techs., Inc. v. Commc'ns Workers of Am*., 475 U.S. 643, 648 (1986). "Arbitration under the [FAA] is a matter of consent, not coercion," and the FAA simply pre-empts state laws that regard arbitration agreements differently than other contracts. *Volt Info. Sciences, Inc. v. Bd. of Trs. of Leland Stanford Junior Univ*., 489 U.S. 468, 479 (1989).

Nevertheless, most courts addressing the question hold that language providing that a party "may" submit a dispute to arbitration requires mandatory arbitration. For example, in *United States v. Bankers Insurance Company*, 245 F.3d 315 (4th Cir. 2001), the Fourth Circuit held that an arbitration agreement's use of "permissive phraseology" was not dispositive. 245 F.3d at 320. The arbitration clause in question provided:

> If any misunderstanding or dispute arises between the Company Bankers and the FIA with reference to any factual issue under any provisions of this Agreement. . . such misunderstanding or dispute *may* be submitted to arbitration for a determination that shall be binding upon approval by the FIA.

(emphasis added).

The court held that the arbitration clause mandated arbitration because if it did not, it "would render the clause meaningless for all practical purposes" since parties "could always voluntarily submit to arbitration." 245 F.3d at 321 (*quoting Austin v. Owens-Brockway Glass Container, Inc.* 78 F.3d 875, 879 (4th Cir. 1996)). Instead, the court interpreted the use of "may" to give the aggrieved party the choice to arbitrate or abandon the claim. *Id.* Other courts agree. *See, e.g., Local 771, I.A.T.S.E. v. RKO Gen., Inc., WOR Div*., 546 F.2d 1107, 1115-16 (2d. Cir. 1977) (holding arbitration was exclusive remedy under contract dispute even through the terms specified the parties "may submit" to arbitration); *Atkins v. Louisville and Nashville R.R. Co*., 819 F.2d 644, 647-49 (6th Cir. 1987) (holding arbitration mandatory where clause uses "may"); Bonnot v. Congress of Independent Unions, 331 F.2d 355, 359 (8th Cir. 1964) ("The obvious purpose of the 'may language is to give an aggrieved party the choice between arbitration or the abandonment of its claim.").

Arguably, a permissive arbitration clause that provides detailed rules and procedures for an arbitration is not meaningless, but rather, provides how an arbitration will occur should the parties voluntarily agree to submit their dispute to arbitration. *See Bell Atl. Corp. v. CTC Comm'ns Corp*., 1998 U.S. App. LEXIS 20160, * 6 (2d Cir. 1998) (holding a permissive arbitration clause is not meaningless because it establishes the applicable rules if the parties voluntarily submit their dispute to arbitration). *See also Briggs & Stratton Corp. v. Local 232, Int'l Union Allied Indus. Workers Am*., 36 F.3d 712, 715-16 (7th Cir. 1994) (holding arbitration is

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"optional" under clause that uses "may"); *Gangemi v. Gen. Elec. Co.*, 532 F.2d 861, 866-68 (2d Cir. 1976) (holding an arbitration clause that used "may" was permissive in the context of other provisions in the contract).

Thus, because courts may interpret permissive arbitration clauses to be mandatory, parties that seek to use arbitration as a voluntary method to resolve disputes should carefully consider the language used in arbitration agreements. ❑

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UPDATE ON GEORGIA LIFE SETTLEMENTS BILL

By Joseph L. Cregan

In last quarter's newsletter, I advised readers of a comprehensive rewrite of Chapter 59 of the Georgia Insurance Code relating to life settlements. The bill was introduced by Senator Ralph Hudgens (R Northeast Georgia), who is the current Chair of the Senate Insurance and Labor Committee. Although the bill passed the relevant Senate committees and Senate floor fairly easily, it failed to pass the Georgia House.

The primary reason for the bill's lack of success in the House -- and particularly with the House Insurance Committee -- appears to be the relative newness of the Life Settlements Act itself. It was only passed in 2005. It appeared that at least some of the members of the House Insurance Committee wanted to allow the industry more time to adapt to the existing law and for the existing law to "absorb" more prospective licensees.

Senator Hudgens is very likely to be re-elected in the next election cycle and has expressed a determination to continue studying the life settlements industry and to reintroduce a similar bill when the General Assembly reconvenes in January of 2009. Of course, we will continue to monitor this and other Georgia legislation of interest to the insurance industry and others following developments in Georgia's insurance market.❑

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HASSETT'S OBJECTIONS

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The Supreme Court of the United States has resolved the split in the Circuits. In *Hall Street Assocs., LLC v. Mattel, Inc*., Case No. 06-989 (March 25, 2008), the Court rejected contractually enhanced standards of review under the Federal Arbitration Act ("FAA"). The arbitration clause at issue allowed a federal district court to reject an award where the arbitrator's findings of fact were not supported by substantial evidence or where the arbitrator's conclusions of law were erroneous. This is the standard of review applicable to reviews of federal trial court decisions. *See Pullman-Standard v. Swint,* 456 U.S. 273, 287-288 (1982).

At the outset, the Court noted that the FAA requires a court to confirm an arbitration award unless it is vacated, modified or corrected as per Sections 10 and 11 of the FAA. "Section 10 lists grounds for vacating an award, while Section 11 names those for modifying or correcting one." *Id*. at 5. The Court concluded that "[w]e now hold that Sections 10 and 11 respectively provide the FAA's exclusive grounds for expedited vacatur and modification" of an arbitration award. *Id.* at 3. Accordingly, it is now established that parties cannot contractually agree to an enhanced standard of review under the FAA.

But the Court's opinion did not end there; it implicated two additional points. First, the Court seemed not to accept the judicially created "manifest disregard of law" ground for rejecting an arbitration award. In *Wilko v. Swan,* 346 U.S. 427, 436-37 (1953), the Court noted that "the interpretations of the law by the arbitrators in contrast to manifest disregard [of the law] are not subject, in the federal courts, to judicial review for error in interpretation…." Since then, federal courts have recognized manifest disregard of law as an additional ground to reject an arbitration award. *See e.g. Barnes v. Logan,* 122 F.3d 820, 821-822 (9th Cir. 1997); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker*, 808 F.2d 930, 933-934 (2nd Cir. 1986). Even the Supreme Court has acknowledged that standard. *First Option of Chicago v. Kaplan*, 514 U.S. 938, 942 (1995) ("parties [are] bound by [an] arbitration's decision not in manifest disregard of law").

In *Hall Street,* the Court quoted *Wilko* and noted that "some Circuits have read that language as "recognizing manifest disregard of the law as a further ground for vacatur on top of those listed in Section 10." *Id.* at 7. Without expressly rejecting the manifest disregard of law standard *per se*, the *Hall Street* court detachedly speculated that perhaps the standard merely was shorthand for other grounds for review, i.e., "when the arbitrators were guilty of misconduct or exceeded their powers." *Id.* at 8 (punctuation omitted). The Court then noted that "the text compels a reading of the Sections 10 and 11 categories as exclusive." Based upon that language, it is difficult to conclude that manifest disregard of the law continues as a ground for vacating an arbitration award under the FAA. Rather, manifest disregard of law now is relevant only to

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the extent it evidences misconduct, corruption or the exceeding of authority.

Hall Street was decided on March 28, 2008, but already has spawned different opinions in the lower courts. *Compare Ramos-Santiago v. United Parcel Svc*., Case No. 07-1024 (1st Cir., April 24, 2008) ("We acknowledge the Supreme Court's recent holding in *Hall Street* . . . that manifest disregard of law is not a valid ground for vacating or modifying an arbitral award . . . under the [FAA]."), with, *Haliburton Energy Svcs., Inc. v. NL Indus.*, Case No. H-05-4160 (S.D. Tex., March 31, 2008) (Recognizing that *Hall Street* "calls into question whether the manifest disregard standard" remains a valid ground for rejecting an arbitration award, but applying the standard and upholding the award "in an abundance of caution"), and, *Chase Bank USA, NA v. Hale,* Case No. 60/044/07 (N.Y. Sup. March 31, 2008) (manifest disregard of law standard survives Hall Street).

The second curious aspect of the Court's opinion is its invitation to parties to seek more expansive review outside the FAA. *Id.* at 13. "The FAA is not the only way into court for parties wanting review of arbitration awards; they may contemplate enforcement under state statutory or common law, for example, where judicial review of a different scope is arguable." *Id*. Presumably, the court is inviting parties to incorporate the review provisions of other arbitration laws into their arbitration agreements.

A reasonable interpretation of *Hall Street* is that, even aside from a heightened standard of review, parties that want application of the "manifest disregard of law" standard should incorporate a particular state's arbitration laws. Some states, such as Georgia, have statutorily incorporated the manifest disregard of law standard. *See* Off. Code Ga. Ann. § 9-9-13(b)(5). Other states, following the Supreme Court's lead in *Wilko*, 346 U.S. at 436-437, have judicially engrafted the manifest disregard of law standard onto their state's arbitration statutes. *See, e.g*., *Weiner v. Jones*, 610 S.E.2d 850 (S.C. App. 2005); *Bohlmann v. Byron John Pritz* and *Ash, Inc.*, 96 P.3d 1155 (Nev. 2004); *Liberty Mut. Ins. Co. v. Open MRI of Morris & Essex, L.P.,* 813 A.2d 621 (N.J. Law Div. 2002). Other courts have refused to adopt the manifest disregard of law standard. *See, e.g*. *Moore v. Omnicare, Inc.,* 118 P.3d 141 (Idaho 2005); *Coors Brewing Co. v. Cabo,* 114 P.3d 60 (Colo. App. 2004); *Hunter, Keith Indust., Inc. v. Piper Capital Mgt., Inc*., 575 N.W.2d 850 (Minn. App. 1998).

The manifest disregard of law standard is imprecise. While courts agree that it implies more than legal error, they do not agree on how much more. Some courts interpret the standard to justify the rejection of an arbitration award only where the purportedly disregarded law is well-defined and the record reflects that the arbitrator willfully ignored the governing law. *See Merrill Lynch, Pierce, Fenner & Smithy, Inc. v. Bobker,* 808 F.2d 930, 933-34 (2d Cir. 1986); see also *Bowen v. Amoco Pipeline Co*., 254 F.2d 925, 937 (10th Cir. 2001); *Barnes v. Logan*, 122 F.3d 820, 821-22 (9th Cir. 1997); *Prudential-Bache Sec., Inc. v. Tanner*, 72 F.3d 234, 239 (1st Cir. 1995); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Jaros*, 70 F.3d 418, 421 (6th Cir. 1995); *Lee v. Chica*, 983 F.2d 883, 885 (8th Cir. 1993); *Upshur Coals Corp. v. United Mine Workers*, 933 F.2d 225, 228 (4th Cir. 19912); *News Am. Publ'ns, Inc. Daily Racing Form Civ. v. Newark Typographical Union, Local* 103, 918 F.2d 21, 24 (3d Cir. 1990); *Sargent v. Paine Webber Jackson & Curtis, Inc*., 882 F.2d 529, 532 (D.C.Cir. 1989). The Fifth Circuit does not review the arbitrator's subjective disregard of law, but focuses on whether the award is contrary to law and would cause a significant injustice. See *Williams v. Cigna Fin. Advisors,* 197 F.3d 752, 761-762 (5th Cir. 1999).

The Supreme Court appears to have evolved from early cases pre-empting state laws as inconsistent with the federal policy of promoting arbitration; to focusing on the terms of the parties' agreement, even if inconsistent with the FAA; to now refusing to adjust the federal standard as per the parties' agreement. *See Moses H. Cone Mem. Hosp. v. Mercury Const. Corp.,* 460 U.S. 1, 24 (1983) (FAA evidences "liberal federal policy favoring arbitration, notwithstanding any state . . . policies to the contrary"); *Volt Info Svcs. v. Board of Trustees of Leland Stanford Junior University,* 489 U.S. 468 (1989) ("There is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate"); *Hall Street, supra* (FAA "substantiat[es] a national policy favoring arbitration with just the limited review needed … [for] resolving disputes straightaway," but parties can eschew FAA in favor of state arbitration law). A cynic could view the court as hostile to arbitration under the guise of supporting it. The FAA now comes in only one flavor: the arbitrator's decision on the merits is final no matter how cockamamie or unjust, and no matter the parties' agreement as to review, so long as the limited statutory grounds of review do not apply.

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PLAYER'S POINT

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Looking back on my last article about Enterprise Risk Management ("Not Just Another Industry Y2K", Player's Point, Fall 2006), the problems cited in that article regarding Reliance and Conseco are child's play compared to today's sub-prime problems. In this crisis, the likes of Bear Stearns, Citigroup, Lehman Brothers, Bank of America, and UBS, to name but a few, have been hard bitten by the risk flu. This does not include our brethren in the insurance business, including MBIA, AMBAC, and AIG.

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Practical Experience

The most comprehensive insight to date as to the anatomy of risk management failure following the sub-prime meltdown has been the UBS Shareholder Report[1] . Because of the staggering U.S. sub-prime losses, the Swiss Federal Banking Commission requested that UBS make a report to it on the key factors relevant for understanding the principal root causes leading to the sub-prime losses. The Shareholders Report is a by-product of that dialogue. Although somewhat lengthy, the Shareholders Report is an excellent discussion of a very complicated business model and what went wrong. Many times in the Report, mention was made of a failure to demand a holistic risk assessment. In particular, one section of the Report puts the cause of problems in the investment banks' governance as a "Failure to Demand a Holistic Risk Assessment: it appears that the focus of the investment bank was revenue growth and filling the gap to competitors."

At AIG, a similar experience was playing out. Management was unaware of its growing risk profile, especially in the trading of sophisticated investments known as credit default swaps.

There is no question but that it is extremely difficult to evaluate the types of sophisticated business models being undertaken by the likes of UBS and AIG. Assessing the risk profile of each such business initiative is daunting. Understanding the risk profile of the relationships among these sophisticated and risky investment strategies is extremely challenging.

However, one must conclude that no matter how challenging, there must be devised a better way to assess the overall risk levels of enterprises and to inform managers, both Boards of Directors and officers, of the quantity and quality of enterprise risk. For example, a Board of Directors needs to know whether its enterprise is taking on more risk or less risk. If more risk, is the premium or profit commensurate with the risk? This would seem to be a fundamental obligation of oversight.

Role of the SEC

It is predictable that there is a great hue and cry as to whether the Securities and Exchange Commission was adequately minding the store on oversight of investment banks. The stress of the sub-prime meltdown has revealed flaws in the regulatory system showing that the SEC may not have all the tools necessary to regulate either investment banks or rating agencies. This article will not address the effectiveness of the SEC, nor touch on any of the several reorganization suggestions. However, we would urge the SEC to take a leadership role in calling for Enterprise Risk Management to step up to a higher level of responsibility within the public company governance scheme. In my view, blaming or relying on the SEC side-steps the issue.

1 See, http://www.ubs.com/1/e/investors/agm.html, and find **Shareholder Report on UBS's Write-Downs**, under "Annual General Meeting 2008."

Management Responsibility

Responsibility for sub-prime mistakes falls squarely on the shoulders of directors and officers of the companies. It was on their watch that reckless business practices and excessive risk appetites flourished. It was on their watch that a race for earnings caused prudent management and diligent risk oversight to be ignored. It was on their watch that large management bonuses were generated from record earnings, while the underlying basics of the business were getting more risky.

What does this crisis teach us about Enterprise Risk Management? First, ERM is not yet a mature process influencing management actions. Second, ERM is viewed more as a secondary discipline than a primary management tool. Third, to be effective, ERM must be given peer respect.

A Recommendation

Perhaps ERM should either become a separate Board Committee on the same level as the Audit Committee, with both reporting directly to the Board of Directors; or, the ERM Committee should be a sub-committee of the Audit Committee. There should be standards requiring risk management experience for the chairman of the ERM Committee much like the elevated standard for chairman of the Audit Committee. The Corporation should either publish a risk management report annually which accompanies the annual audit, or there should be a separate attachment to the audit report. For example, the format of such a report could include an overall assessment of the level of risk affecting the Corporation, and whether that risk level has increased or decreased since the last reporting period.

The SEC could provide invaluable assistance by urging such an analysis. If these standards were adopted by public companies, history has shown private companies would soon follow suit. ❑

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LETTER FROM WASHINGTON

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However, during this Congress, the proposals have been more varied. They could be perceived as probes into a defense of state regulation that used to be uniform, but is now scattered or, in some quarters, non-existent.

There are really four sorts of proposals that would, if enacted, affect insurance regulation. As described in more detail below, they are based on different regulatory models or approaches: (1) federal chartering; (2) federally imposed self regulatory organizations (SRO) for licensing; (3) federal, i.e., Treasury oversight of the insurance business; and (4) federally imposed "lead state" regulation.

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Because 2008 is an election year, the result in Congress is likely to be the same as in most prior Congresses; i.e., nothing. However, these bills may be laying the groundwork for some significant change in the future.

Optional Federal Charter

As in the prior Congress, Senators John Sununu and Tim Johnson introduced the National Insurance Act of 2007 (S. 40). If passed, S. 40 would create an Office of National Insurance within the Treasury and a Commissioner of National Insurance to be appointed by the President. It would create an entire alternative regulatory structure for those insurers and insurance agencies electing to become organized under federal law. A parallel system of regulation would continue to exist under the States. This is the most ambitious of all the insurance regulatory reform efforts, and it has attracted the most attention from both proponents and opponents. It is destined to languish, again, in this Congress.

Federal Oversight

The Chairman of the House Financial Services Committee, Representative Paul Kanjorski, introduced the Insurance Information Act of 2008 (H.R. 5840). This legislation would create within the Treasury an office with broad authority to investigate the business of insurance and to create a home for insurance expertise within a federal agency. The ability of the Federal government to preempt State law would be limited to matters affecting the ability of the United States government to enforce international agreements. Nonetheless, H.R. 5840 is perceived by many as the first step towards federal regulation. The fact that the bill is being sponsored by the Chair of the House Financial Services Committee will guarantee it some action, at least in the House, during this Congress.

Self Regulatory Organization for Licensing

The National Association of Registered Agents and Brokers Reform Act of 2008 (H.R. 5611 or "NARAB II") is designed to facilitate multi-state licensing for insurance producers. It is a new iteration of the establishment of an association by the same name ("NARAB I") in the Gramm-Leach-Bliley Act ("GLBA"), which would have only come into effect had a majority of States not created substantially similar licensing regimes. The problem is that not all the States have adopted identical regulatory processes, and other multi-state licensing problems remain.

NARAB II is an odd mix of structural and regulatory ingredients, including preemption of state law "while preserving the right of States to license, supervise, and discipline insurance producers," federal court jurisdiction, deference to the state of domicile of the producer, and the creation of a federally chartered non-profit corporation in the District of Columbia under D.C. law. H.R. 5611 is being sponsored by the larger insurance trade associations, which would retain a majority of the seats on the NARAB II board of directors (the remaining seats would be occupied by state regulators). There would be ultimate oversight of NARAB II by the President.

The States have been attempting, through their compliance with NARAB I and the creation and operation of the National Insurance Producer Registration database ("NIPR"), to address the issue of the time and expense required to register in multiple states. NARAB II attempts to cut the Gordian Knot.

However, NARAB II is subject to a variety of legal challenges due to its highly unusual structure. The foremost challenge would be that legislative authority cannot be delegated to an agency or other body that is not "politically accountable". *Chevron v. Natural Resources Defense Council,* 467 U.S. 837, 865-866 (1984). Although the "Non-delegation doctrine" is complicated by inconsistency in the cases interpreting it, it is likely that this bill will undergo a rewrite before being seriously considered by Congress.

"Lead State" Regulation

The House passed the Non-Admitted and Reinsurance Reform Act of 2007 (H.R. 1065) almost a year ago. It was essentially the same legislation the House passed in the 109th Congress. It would streamline the regulation of the surplus lines market by creating a uniform system of surplus lines premium tax allocation and remittance by the state of domicile of the insured. All other states would have to defer to that state's decisions. Similarly, the home state regulator of a ceding insurer would be entrusted with the authority to make all credit for reinsurance determinations. Other states would be prohibited from applying their laws to credit for reinsurance.

This is the "lead state" model first introduced by the Congress into insurance regulation by the Product Liability Risk Retention Act of 1981 and then supplemented by the Liability Risk Retention Act of 1986. That Act is the subject of a recently introduced bill – the Increasing Insurance Coverage Options for Consumers Act of 2008 (H.R. 5792) – sponsored by Representative Dennis Moore (who was also a sponsor of the surplus lines legislation). H.R. 5792 would amend the Liability Risk Retention Act by expanding the Act to include commercial property coverages (in addition to the commercial liability coverages currently allowed). Importantly, it would mandate that corporate governance requirements created by the NAIC be implemented by the risk retention group's ("RRG") state of domicile. It would also allow participation in an insurance insolvency guaranty association consisting entirely of other RRGs (which is prohibited under the current legislation).

Both of these "lead state" bills need further work to placate opponents. No insurance legislation will pass this Congress in the political year if any significant opposition exists. ❑

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