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TRENDS IN REINSURANCE DISPUTES

By Michael Lum

A queue of potentially massive claims related to financial products and major economic events, such as Madoff and the collapse of Lehmans Brothers, indicates that the reinsurance industry should brace itself for an upturn in disputes.

It is almost 3 years since the financial crisis, commonly known as the "credit crunch", first emerged on the front pages of our daily newspapers, starting on this side of the Atlantic with the collapse of Northern Rock in September 2007. This was followed almost a year later with the collapse of Lehman Brothers worldwide and the US Treasury rescue of AIG. As with all economic downturns, the bad times are likely to expose mind-boggling sharp practice that went unnoticed during the times of plenty, and the Madoff and Stanford *ponzi* scheme scandals are no exceptions. Other examples which have particularly hit home this side of the Atlantic include the prevalence of mortgage fraud, in which surveyors, solicitors and other professionals are often implicated, not just the borrowers.

In winter 2008, both US and UK litigators rubbed their hands with glee in anticipation of the upturn in litigation that would inevitably follow from the financial crisis. Much to their surprise, litigation trickled through slowly, as investors came to terms with the scale of the crisis and companies looked to shore up their balance sheets and to preserve their liquidity in the face of the threat of economic ruin. The patient litigators, however, have not been disappointed.

The raft of suits that have been filed more recently, predominantly in the US, arising from the financial crisis is great in number and in variety. They include claims filed against the administrators of pension funds; negligence and fraud suits by investors against the investment funds, hedge funds and the "fund of funds" that invested in the Madoff and Stanford *ponzi* schemes; securities and shareholder suits against the directors and officers of companies for the drop in the company's share price; and claims against the rating agencies for the ratings they gave the "toxic" mortgaged back securities that are said to have been the cause of the financial crisis. The issues in these suits are complex and it is not surprising that the amounts claimed are massive. For example, in April this year, the largest pension fund in the US won a court ruling allowing it to pursue Moodys, Standard & Poor and Fitch, alleging that it lost over USD1 billion on failed asset backed securities.

The defendants in such suits have turned to their D&O, E&O / Professional Indemnity and Civil Liability insurers. Given the potential amounts being claimed, these insurers have in turn looked to their reinsurance arrangements to ease the pain.

Although it is early days, these claims are likely to be very much on reinsurers' radars following notifications that were made when the

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claims were first pursued. As these claims are now being determined in court or, more often, are being settled, the reinsurance industry, which has had a relatively benign claims experience in recent years, is likely to face calls for payment in the near future. Given the amounts at stake, reinsurers are likely to look very closely at their strict rights and obligations, which may, in some cases, lead to disputes.

These reinsurance disputes, as always, are likely to be more acute where the underlying claims against the insureds have been settled as, in this case, liability can be more opaque than where there has been a court determination. Since most of the significant suits arising from the financial crisis have been brought in the US where they will be tried before a jury, we are likely to see more claims being settled for fear of an adverse jury verdict in the current climate of public hostility against bankers and financial institutions and the bad publicity that often comes with it.

Apart from the issue as to whether the liability of the insureds has been satisfactorily established, other common issues that we anticipate will arise may revolve around the application of the original policy's exclusions for fraudulent or dishonest activities. For example, one area of particular relevance to D&O claims is whether or not such exclusions would apply in circumstances where tacit "admissions" by the insureds or "findings of fact" may have been made in regulatory proceedings but not in the context of the civil suits.

Other issues are likely to arise in relation to the application of aggregation provisions in non-proportional reinsurance contracts. This could be particularly challenging for reinsureds if their reinsurance responds on an "event" basis, as it is often difficult to find a relevant event by which to aggregate a plurality of liability losses. For example, is "mortgage fraud" an event?

Whereas disputes between reinsurers and their reinsureds have, in the past, resulted in some high value or legally complex battles in the courts, this next wave of disputes looks more likely to be resolved behind closed doors. This is because the trend of resolving disputes by negotiation is likely to continue, particularly if the recent consolidation in the reinsurance market continues, as it will be all the more important for reinsurers to avoid public fallings out. Also, most reinsurance agreements now contain arbitration clauses. As a result, reinsurance disputes are likely to be arbitrated confidentially, outside industry or public knowledge. Although, an arbitral party could appeal to the courts, in which case the award could become public knowledge, such appeals are likely to be rare as they are only available on specific and limited grounds.

An important implication of the trend towards confidential arbitrations is that it may have the effect of depriving the industry of crucial guidance where the dispute involves an important principle of law. Be that as it may, there is little evidence to suggest that the impending reinsurance disputes will buck this trend.

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