This issue combines reports and articles written by members of our Reinsurance and Arbitration Practice Groups. We are publishing this issue as a joint newsletter because of the frequent overlap of issues that are of interest and relevant to those involved in both practice areas.

Since our last report, there have been many significant developments in both of these practice areas. For example, the Seventh Circuit recently considered whether an arbitrator in a reinsurance dispute should have been disqualified for failure to fully disclose his relationship with the party that appointed him. A New York court has taken a different approach to the scope of review of an arbitration award than the very narrowly defined approach taken by the Seventh Circuit. We also summarize the defenses to the enforcement of foreign arbitral awards under the New York Convention. These, and other significant reinsurance and arbitration issues, are discussed in this report.

We trust that you will find this report useful and informative. The law in these practice areas develops constantly. At Jenner & Block, we make every effort to keep abreast of these developments. Please feel free to contact us if you have any questions or if we can be of any assistance.

Sincerely,

Richard T. Franch

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**Second Circuit Uses Forum Non Conveniens to Block Reinsurer’s Attempt to Confirm Foreign Arbitral Award**

by Lawrence S. Schaner

In a groundbreaking decision, the Second Circuit Court of Appeals recently held that the doctrine of forum non conveniens barred a Monaco-based reinsurer’s action to confirm a foreign arbitral award. The ruling is significant because it adds a potentially major new basis to the limited menu of grounds for opposing arbitral awards that are subject to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, commonly known as the New York Convention (the “Convention”). The case, *Monagasque de Reassurances S.A.M. (Monde Re) v. NAK Naftogaz of Ukraine and State of Ukraine*, 311 F.3d 488 (2d Cir. Nov. 15, 2002), appears to be the first reported U.S. decision to find that the Convention permits courts to dismiss actions to recognize and enforce foreign arbitral awards on the ground that a court in another country is a more convenient forum for the adjudication of the matter.

The dispute arose out of a contract between a Russian company, AO Gazprom (“Gazprom”) and a Ukrainian company, AO Ukragazprom, for the transportation of natural gas by pipeline across the Ukraine to destinations in Europe. As consideration, Ukragazprom was entitled to withdraw a certain amount of gas for its own benefit. It allegedly breached the contract by withdrawing more gas than it was authorized to withdraw. Gazprom obtained reimbursement

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for the value of the improperly withdrawn gas from its insurer, which in turn was reimbursed by Monde Re pursuant to a reinsurance agreement. Monde Re is a Monaco corporation, with an Australian parent, Reinsurance Australia Corp. Ltd.

In April 1999, Monde Re asserted its right in the place of Gazprom to arbitrate the dispute regarding the excessive gas withdrawal pursuant to an arbitration provision in the gas transportation contract. The claim was filed with the International Commercial Court of Arbitration in Moscow, Russia. During the arbitration, Nak Naftogaz of Ukraine (“Naftogaz”), a Ukrainian transporter of natural gas, assumed the rights and obligations of Ukrgazprom under the contract. In May 2000, the three-member tribunal, by a 2-1 decision, awarded Monde Re in excess of $88 million.

Monde Re filed a petition for the confirmation of the arbitral award in the United States District Court for the Southern District of New York. It sought confirmation and the entry of judgment against Naftogaz and the State of Ukraine (“Ukraine”), which was not a party to the arbitration, contending that Naftogaz was an agent, instrumentality or alter ego of Ukraine. Naftogaz and Ukraine filed motions to dismiss on various grounds, including the argument advanced by Ukraine that the district court should decline jurisdiction under the doctrine of forum non conveniens. On December 4, 2001, the district court granted Ukraine’s motion on forum non conveniens grounds and dismissed the action against Naftogaz as well.

On appeal, Monde Re argued that forum non conveniens could not be raised in a proceeding to confirm an award under the Convention. Its argument was based on the mandate of the Convention that: “Each Convention State shall recognize arbitral awards as binding and enforce them in accordance with the rules of procedure of the territory where the award is relied upon.” (Convention art. V) The defenses are recognized as being the exclusive grounds for opposing enforcement under the Convention. Forum non conveniens is not one of the listed exclusive defenses. Accordingly, Monde Re contended that the district court could not use the doctrine of forum non conveniens to dismiss its confirmation action.

The Second Circuit rejected this argument. It noted that enforcing courts are permitted under the Convention to apply their own procedural rules in deciding whether to enforce an arbitral award, provided that those procedures do not impose “substantially more onerous conditions” than are imposed on the enforcement of domestic arbitral awards. (Convention art. III.) Relying on Supreme Court authority that the doctrine of forum non conveniens is a procedural rather than a substantive rule and observing that the doctrine is applicable in domestic arbitration cases, the Second Circuit concluded that forum non conveniens could also be applied under the provisions of the Convention.

Having found the doctrine of forum non conveniens applicable, the Second Circuit reviewed the district court’s decision to dismiss the petition for abuse of discretion. The Second Circuit employed a three-part analysis, considering: (1) the degree of deference owed to Monde Re’s choice of forum; (2) whether there existed an adequate alternative forum; and (3) whether the so-called “private” and “public” interest factors favored adjudication in Monde Re’s chosen forum.

As for the first inquiry, the court observed that as a general matter a domestic petitioner’s choice of its home forum is entitled to more deference than a foreign petitioner’s choice of a U.S. forum. It also stated that the degree of deference was to be measured on a “sliding scale” basis with consideration being given to whether petitioner’s choice of a U.S. forum was “motivated by forum-shopping concerns,” and the degree to which the lawsuit or petitioner possessed a “bona fide connection” to the forum of choice. The Second Circuit found that, although Monde Re’s motivation for bringing its enforcement proceeding in the United States
was “not apparent,” it was clear that “the jurisdiction provided by the Convention is the only link between the parties and the United States.” The court, therefore, concluded that Monde Re’s choice of forum was entitled to little deference.
The Second Circuit found that Ukraine was an adequate alternative forum for the enforcement action. The court rejected Monde Re’s contention that Ukraine was inadequate because of general corruption in the body politic. The court concurred with the district court’s finding that “the meager and conclusory submissions of Monde Re” were insufficient to permit the court “to pass value judgments on the adequacy of justice and the integrity of [Ukraine’s] judicial system.”

Turning to the third inquiry, the Second Circuit explained that, in the typical case, the proceedings to enforce an arbitral award do not significantly implicate private interest factors, which pertain to the consequences to the litigants, because the proceedings are summary. However, here, the proceedings would not be summary because Monde Re sought to show that Ukraine should be bound to the result of the arbitration even though it was not a signatory to the arbitration agreement or a party to the arbitration. To show that Ukraine was Ukragazprom’s alter ego or that Ukragazprom was an agent of Ukraine would require extensive discovery and likely a trial. The Second Circuit observed that the evidence was not in the United States, the witnesses were beyond the subpoena power of the district court and pertinent documents were in the Ukrainian language. It, therefore, had little difficulty in concluding that the private interest factors “tip decidedly” in favor of forum non conveniens dismissal and that the entire proceeding would be more “easy, expeditious and inexpensive” if conducted in Ukraine.

The Second Circuit also concluded that the public interest factors favored dismissal, noting that the case had no connection with the U.S. other than the fact that the U.S. is a Convention signatory. It also observed that the central issues in the case were governed by the law of Ukraine, and that Ukrainian courts would therefore be better suited than U.S. courts for the resolution of those legal questions. Accordingly, the Second Circuit affirmed the district court’s decision to dismiss Monde Re’s petition on grounds of forum non conveniens.

At this point, it is too soon to know whether other Circuits will follow the Monde Re decision or how broadly or narrowly it will be construed. Certainly, the extensive factual issues presented by the petition suggest a basis for distinguishing the case from more routine enforcement proceedings. The case has the potential to restrict access significantly to U.S. courts for actions to enforce foreign arbitral awards. In any event, parties seeking to avoid the recognition and enforcement of a foreign arbitral award now have a new, potentially-potent defense at their disposal.

### Defenses to Enforcement Under the New York Convention

The 1958 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, better known as the New York Convention, 21 U.S.T. 2517, T.I.A.S. No. 6997, 330 U.N.T.S. 53 (“Convention”), is the key source of law governing the enforcement of foreign arbitral awards. Over 130 States, including the U.S., have ratified the Convention. The Convention lists seven grounds on which recognition and enforcement of a foreign arbitral award may be refused:

1. The parties to the arbitration agreement lacked capacity or the agreement was not legally valid;
2. A party was not given proper notice of the appointment of the arbitrator or of the arbitration proceedings or was otherwise unable to present his case;
3. The award deals with a matter not submitted to arbitration or beyond the scope of the submission;
4. The composition of the arbitral authority or the arbitral procedure was not in accordance with the agreement of the parties, or absent such agreement, not in accordance with the law of the country where the arbitration took place;
5. The award was not yet binding or had been set aside or suspended;
6. The subject matter of the dispute was “not capable of settlement by arbitration;” and
7. The recognition and enforcement of the award “would be contrary to public policy.”

Convention art. V(1) and V(2).
Does a party-appointed arbitrator’s failure to fully disclose a prior relationship demonstrate “evident partiality” that would permit a court to set aside an award? This issue arose in Sphere Drake Insurance Ltd. v. All American Life Insurance Co., 2002 U.S. Dist. LEXIS 8876 (N. D. Ill. 2002); rev’d 307 F.3d 617 (7th Cir. 2002); cert. denied 2003 U.S. LEXIS 2742 (April 7, 2003), when All American demanded arbitration with respect to balances allegedly due from Sphere Drake on several reinsurance contracts. Sphere Drake selected Ronald A. Jacks, a retired partner at Mayer Brown & Platt, as its appointed arbitrator. All American appointed a second arbitrator, and the parties agreed that the third member of the panel, the “umpire,” would be selected by the two party-appointed arbitrators. At an organizational meeting, the arbitrators disclosed their current and prior relationships with the parties. Arbitrator Jacks disclosed that he had “known of Sphere Drake over the years,” and that he was the party arbitrator for Sphere Drake in two pending arbitrations. The parties certified the panel, including Jacks, without objection.

After reviewing the transcript of the initial meeting, Jacks revised his disclosure. In a letter to the parties, he indicated that he had also provided limited corporate advice to a subsidiary of Sphere Drake and recommended his “former law firm, Mayer Brown & Platt, be retained to represent [the subsidiary] in an arbitration.” The parties did not object to the revised disclosure. Although Jacks had retired from Mayer Brown at the time he wrote the letter, it was revealed during discovery that he had been an active partner at the time of the referral. Furthermore, Jacks himself had been actively involved as counsel for Sphere Drake in the arbitration, as well as corporate counseling work, and billed approximately 380 hours on Sphere Drake matters.

Based on these facts, the district court vacated the arbitral award for “evident partiality” under 9 U.S.C. § 10(a)(2) of the Federal Arbitration Act, because Jacks failed to disclose his substantial attorney/client relationship with Sphere Drake. The court noted that most cases discussing the partiality did not deal with party-appointed arbitrators, but the court concluded that the parties’ right to approve the arbitral panel “could only be meaningfully exercised to the extent it was based on a full disclosure.” 2002 U.S. Dist. LEXIS 8876 at *22. The district court focused on the failure of the arbitrator to be “completely forthcoming” about his prior role as counsel for Sphere Drake, and further noted that Sphere Drake had not offered any explanation for this failure.

The Seventh Circuit reversed, rejecting the argument that the party-appointed arbitrator was “evidently partial” because he had previously represented Sphere Drake. The court further held that there was no requirement for a complete disclosure by a party-appointed arbitrator. A neutral arbitrator may be contractually required to make disclosures to those who select him; his failure to comply with these requirements may justify vacating an award because the arbitrator would have exceeded his authority. The Seventh Circuit found the lack of precedent dealing with the partiality of party-appointed arbitrators “unsurprising, because in the main party-appointed arbitrators are supposed to be advocates.” 307 F.3d at 620 (emphasis in original).

Furthermore, the Seventh Circuit held disclosure was not required for its own sake. The court found that the full truth would not have indicated Jacks’s partiality. The court based its opinion on the fact that the scope of disqualification under the Federal Arbitration Act is more limited than the rule applicable to federal judges. Judges are free to hear controversies involving former clients. Because Jacks met the standard of impartiality appropriate for federal judges, the court held that the disclosure requirement that had been imposed by the district court was not fatal to the arbitral award.
Who Pays for a Settlement When Factors Other Than the Legal Merits Are Involved
by Joel T. Pelz and Allan V. Abinoja

Under the “follow the fortunes” doctrine, reinsurers generally are bound to a cedent’s settlement with its policyholder. This doctrine, when properly applied and if it truly reflects the contractual agreement between the reinsurer and the cedent, is reasonable. It allows the cedent—the party with the greater knowledge of the underlying claim—to be primarily responsible for managing and either litigating or settling the claim; at the same time, it allows and requires the reinsurer to share in the risk without investing the time and expense necessary to evaluate the claim.1

But case law is clear that the reinsurer’s obligation to “follow” the fortunes or settlement of the cedent is not absolute. Rather, a “follow the fortunes” clause (explicit or implied) binds the reinsurer only where the cedent has acted honestly and has taken all proper and businesslike steps in making a settlement. See Am. Marine Ins. Group v. Neptunia Ins. Co., 775 F. Supp. 703, 708 (S.D.N.Y. 1991).

But what are the specific boundaries of a reinsurer’s obligation to “follow” a settlement, especially when the reinsurer argues that there are legitimate grounds for questioning that settlement? For example, if a cedent chooses to settle a claim for non-legal reasons, such as fear of a biased jury or of being subject to a large punitive damages or bad faith award, is the reinsurer nonetheless obligated to “follow” the settlement? To the limited extent that U.S. courts have addressed this issue, they have set a rather high standard for when reinsurers may not be obligated to “follow” settlements entered into by the cedent. See, e.g., Aetna Cas. and Sur. Co. v. Home Ins. Co., 882 F. Supp. 1328, 1346-47 (S.D.N.Y. 1995) (as long as the cedent acts in good faith and under-takes a “reasonable, businesslike investigation,” reinsurers will be bound to follow a settlement for a claim that reasonably falls within the scope of coverage provided in the policy) (emphasis added). However, two recent English cases have allowed reinsurers to challenge such settlements, especially where the cedents have based their decisions to settle on non-legal factors. These cases raise interesting issues that can effect both the conduct of the parties and the reinsurer/cedent relationship.

In Commercial Union Assurance Co. v. NRG Victory Reinsurance Ltd., 2 All ER 434 (C.A. 1998),2 the English Court of Appeal found that reinsurers were not obligated to “follow” a settlement by the cedents when the insurers decided to settle the underlying claim based on certain non-legal factors. Id. at *1. The Commercial Union case involved insurance coverage for the Exxon Valdez oil spill off of Prince William Sound in Alaska. Exxon, the policyholder, commenced proceedings against the cedents in Texas state court, claiming that the clean-up costs arising out of the oil spillage were covered by its General Corporate Excess policy. The cedents denied liability, but eventually agreed to settle the claim. They based their decision to settle on the opinion of Texas counsel, who filed an affidavit which stated in part:

“In my judgment, liability under Section 1 of the GCE was not going to turn simply upon construction of the policy language in light of the factual matrix. Rather, the outcome of the claim depended upon an interpretation of the parties’ intentions as to the meaning of the policy language, as determined by a Texas jury directed by a non-specialist Judge. Exxon Corporation was in the position to advance a straight-forward case

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1 Of course, the specific contractual language in the reinsurance policy or slip can change the analysis of whether the “follow the fortunes” doctrine should apply and can establish specific rules for any such application. Such specificity may be a good idea, but it is not common in practice. Thus, the comments discussed in this article are directed to a situation where there is only general or no contractual language on how to allocate the cost of a settlement.

2 Both English cases discussed in this article are available in the Lexis UK Database. Page citations refer to the pages of the PDF-formatted cases when downloaded from Lexis.
based on policy wording... Jurors are often unfavourable to insurers and biased against them when insurers are arguing for a limitation of cover. On the other hand, [the insurers’] case depended upon a complex explanation of the structure of Exxon Corporation insurance, the interplay between the GCE policy and the P & I Cover, market practices and market capacity, and the allocation of risks among the participants in the world-wide insurance market.”  

Therefore, even though the cedents recognized that they had valid legal defenses to coverage, they decided to settle the claim based on other, non-legal reasons. When they presented claims based on the settlement to their London reinsurers, the reinsurers denied coverage. The reinsurers argued that the cedents had not demonstrated any legal liability to Exxon. They argued that the affidavit suggested an unfavorable result would follow “at best, by reason of the jury’s inexperience and lack of expertise in insurance law, and at worst, by reason of bias in favour of an policyholder which had suffered heavy loss.”  

Another English Court of Appeal recently ruled that a reinsurer may proceed to trial on the issue of whether a cedent was “proper and businesslike” in settling its underlying claim. See Gan Ins. Co. v. Tai Ping Ins. Co., 2002 EWCA Civ 248 (CA 2002). The Gan case involved an all-risks insurance policy issued to cover the production and installation of machinery at a Taiwanese factory. In 1996, the factory was seriously damaged by fire, and the cedent settled the claim with the policyholder. However, the reinsurer refused to reimburse the cedent for the settlement. The reinsurer argued that the cedent had settled the claim for an amount “far exceeding any figure which could be justified.”  

The reinsurer also contended that the cedent had made “sweeping concessions” in response to, among other things, the policyholder’s threat to claim punitive damages, local business considerations, and damage to the cedent’s reputation and potential loss of business.  

Although the lower court granted summary judgment in favor of the cedents, the Court of Appeal reversed and set aside the judgment. The Court of Appeal found that the lower court had erred in finding that the liability of the cedents to Exxon under the policy had been sufficiently proven, so as to trigger reinsurance coverage. The court further pointed out that “[t]here should be an instinctive reluctance in any court . . . to conclude that such decision, whether in the form of a judge’s ruling or a jury’s verdict, will be not be arrived at according to law.”  

The court agreed and held that it would be wrong to refuse to allow the reinsurer to pursue this issue at trial. The final result of this case on return to the trial court is unknown, or at least unpublished. However, the mere fact that the reinsurer was allowed to contest its obligation to “follow” the settlement of the cedent is significant. The case may encourage cedents to
consider settlement opportunities more carefully—and to insure that they are settling for legitimate, legal reasons and not due to other, extrinsic factors.

These cases highlight the difficult position in which cedents can be placed when facing settlement decisions: they can either (1) litigate against the policyholder, asserting all reasonable defenses and attempting to prove conclusively that no liability exists, but also running the risk of a large judgment, or (2) settle, but risk the possibility that the reinsurer will not “follow” the settlement. Although the second risk has traditionally been rather slight, recent cases indicate that courts—at least in England—have been more likely to allow such challenges by reinsurers.

It is unclear whether U.S. courts will follow the direction of their English counterparts. The reported U.S. cases suggest a view that the reinsurer's obligation to “follow” a settlement is a rather firm commitment, excuses only in cases of bad faith or when the settlement included payment for obligations obviously outside of the policyholder risk. See Aetna Cas., 882 F. Supp. at 1346 (holding that a reinsurer “[m]ust indemnify the ceding company for payments it makes pursuant to a loss settlement under its own policy, provided that such settlement is not fraudulent, collusive or otherwise made in bad faith, and provided further that the settlement is not an ex gratia payment”); see also Mentor Ins. Co. v. Norges Brannkasse, 996 F.2d 506, 517 (2d Cir. 1993) (a reinsurer will be bound to the settlement when the insurer's good faith payment is at least “arguably” within the scope of the insurance coverage that was insured). The Second Circuit has even recognized that “[i]n some cases in which there is genuine ambiguity over what a settlement covers, a ‘follow the fortunes’ clause may oblige a reinsurer to contribute to a settlement even though it might encompass excluded items.” Am. Ins. Co. v. N. Am. Co. for Prop. and Cas. Ins., 697 F.2d 79, 81 (2d Cir. 1982) (emphasis added).

Even though the “follow the fortunes” doctrine is long-established and followed in the vast majority of cases, it is not a rule without exceptions. As shown by the two English cases described above, reinsurers may not be bound to “follow” the settlement of cedents when the settlement is reached based on non-legal reasons. Where the cedent has controlled the settlement process and where a settlement included payments attributable to considerations beyond the merits of the claim of the underlying policyholder, there may be good reason to allocate the risk and responsibility (at least in part) to the cedent.

Reasonable settlements based on a thorough factual and legal investigation of the claim and for monies covered by the reinsurance policy generally should be passed on to the reinsurer. Where, however, the cedent has not properly done the job to prevent or defend a claim, where a portion of the settlement amount may be due to the conduct of the cedent, or where the settlement (at least in part) is motivated by concerns such as business relationships of the cedent, the court should consider carefully whether these costs should be passed on to the reinsurer. It is both bad law and bad public policy to reward the cedent for not performing its job fully and competently.

Although it is undeniable that parties making settlement decisions do take into consideration a whole host of factors, including both legal and non-legal factors, these cases make it clear that in order to pass the loss to the reinsurers there should be legitimate, legal reasons for settling with the policyholder. Courts should not view this as an all or nothing issue. It may be that some, but not all, of the settlement amount should be borne by the reinsurer. In the end, increased communication between a reinsurer and a cedent may be the best way to guarantee that a settlement is arrived at fairly and the expense properly allocated.
The Seventh Circuit’s Novel View of the Review of Arbitral Awards for Manifest Disregard of the Law
by Richard T. Franch and Amy P. Minardo

Parties seeking to challenge an arbitration award may have more success in New York courts. This conclusion is suggested by a recent New York state appellate court decision that vacated an arbitration award of $25 million in punitive damages—using a rationale that probably would have been ignored by the Seventh Circuit under the same circumstances. In Sawtelle v. Waddell & Reed, 2003 N.Y. App. Div. LEXIS 1243 (1st Dept., Feb. 11, 2003), a successful mutual fund broker alleged that he had been terminated in retaliation for his testimony before the SEC regarding another broker. The arbitral panel awarded Sawtelle $25 million in punitive damages, finding that Waddell & Reed insinuated to Sawtelle’s former clients that he had mishandled investments, was untrustworthy, and had been involved in the embezzlement of client funds. A New York trial court reviewed this award under the Federal Arbitration Act, or FAA, 9 U.S.C. § 1 et seq., which reflects the strong federal policy in favor of arbitration agreements. The trial court confirmed the award.

On appeal, the Appellate Division vacated the punitive damages award, citing “manifest disregard of the law” by the arbitral panel. In the Second Circuit, an arbitral award may be set aside for “manifest disregard of the law” if: (1) the arbitrators knew of a governing legal principle yet refused to apply it or ignored it altogether, and (2) the law ignored by the arbitrators was well defined, explicit, and clearly applicable to the case. Halligan v. Piper Jaffray, Inc., 148 F.3d 197, 202 (2d Cir. 1998).

The Appellate Division held that the arbitral panel “completely ignored” applicable law. The court cited BMW of North America v. Gore, 517 U.S. 559 (1996), as the standard for determining whether a punitive damages award is grossly excessive and in violation of the Due Process Clause. The Gore factors for evaluating a punitive damages award are: (1) a comparison of civil or criminal penalties that could be imposed for comparable misconduct; (2) a comparison of the damages to “actual harm”; and (3) the reprehensibility of the defendant’s conduct. The Appellate Division held that an award that was arbitrary and excessive under Gore was arbitrary and excessive under the FAA. Neither party had asked the arbitral panel to apply Gore, and even though Gore was not an arbitration case, the Appellate Division held that the standard was “well-defined” and applicable. The court held that the panel’s $25 million award was grossly disproportionate to the compensatory damages, which were less than $2 million. Because the court found that the arbitral panel had acted in manifest disregard of the law, the court vacated the punitive damages award.

Manifest disregard of the law is one of several non-statutory grounds for setting aside an arbitral award, and this ground is now recognized by courts in every circuit. Montes v. Shearson Lehman Bros., 128 F.3d 1456, 1460 (11th Cir. 1997) (citing supporting authority from every circuit except the Fifth Circuit); Williams v. CIGNA Fin. Advisors, Inc., 197 F.3d 752, 759 (5th Cir. 1999) cert. denied 529 U.S. 1099 (2000) (recognizing this ground for setting aside an arbitral award in the Fifth Circuit, and recognizing that all the other circuits had already recognized this ground). The Eleventh Circuit is the least likely to find manifest disregard of the law, and the Second Circuit is the most likely to vacate an award on that ground. See Bonnie Roach, Recent Development: George Watts & Son v. Tiffany & Co., 17 Ohio St. J. on Disp. Resol. 503 (2002). The liberal approach of the Second Circuit on this issue supports the Appellate Division’s willingness to find a “well-defined” standard that may have surprised both parties in Sawtelle.

That result was unlikely to have occurred in the Seventh Circuit, where the court has taken a different approach to interpreting the manifest disregard of the law standard of review. In George Watts & Son, Inc. v. Tiffany & Co., 248 F.3d 577, 581 (7th Cir. 2001), Watts argued that he was entitled to attorneys’ fees under Wisconsin law,
and that the arbitrator’s failure to award those fees was manifest disregard of the law. In an opinion written by Judge Easterbrook, the court rejected this argument and confirmed the award by applying a novel interpretation of this standard: an award may be vacated for manifest disregard of the law only if the arbitrator directs the parties to violate the law.

This interpretation is based on the rationale that the arbitrator acts as the agent and delegate of the parties. The arbitrator therefore has the ability to decide anything that the parties could have determined by agreement. Judge Easterbrook said that the arbitrator has “considerable leeway so long as he respects the limits the parties’ contract and public law place on his discretion.” Watts, 248 F.3d at 581. Because Wisconsin law did not prevent parties from agreeing to pay their own legal fees, the court held, the award must be confirmed. Judge Williams, who concurred in the judgment, would have applied the standard used in the Second Circuit.

In another Seventh Circuit decision, the court cited Watts and noted parenthetically, “the plaintiffs wisely do not invoke the controversial non-statutory ground, ‘manifest disregard of the law,’ which we have limited to the situation in which the arbitral award directs the parties to violate the law.” IDS Life Insur. Co v. Royal Alliance Assoc. Inc., 266 F.3d 645 (7th Cir. 2001) (Posner, J.) The Seventh Circuit has also cited the Watts standard as justification for refusing to review an arbitral award for legal error. See, e.g., Baxter International, Inc. v. Abbott Laboratories 315 F.3d 829 (2003) (Easterbrook, J.); BEM, L.L.C. v. Anthropologie, Inc., 301 F.3d 548, 554 (7th Cir. 2002) (Posner, J.). Legal error is when an arbitrator attempts to apply the law but does so incorrectly, and unlike manifest disregard of the law, it is not a basis to vacate an award. Watts was probably cited in these cases to support the court’s view that the arbitrator is the agent of the parties.

Had Mr. Sawtelle’s case arisen in the Seventh Circuit, the $25 million award in his favor would probably have been upheld.

Had Mr. Sawtelle’s case arisen in the Seventh Circuit, the $25 million award in his favor would probably have been upheld. The court would not have reached the issue of proportionality of the punitive damages because the award did not direct the parties to violate the law. However, we must caution that even within the Seventh Circuit, there does not appear to be unanimity about the extent to which a court may review an arbitral award.
Breach of Utmost Duty of Good Faith is Independent From Interpretation of Reinsurance Contract
by Megan B. Poetzel

In a summary order, the Second Circuit recently held that a reinsurer’s claim that its reinsurance contracts are void due to the reinsured’s breach of the duty of utmost good faith is outside of the reach of an arbitration clause that covers “the interpretation” of the contracts. Gerling Global Reins. Co. - U.S. Branch v. ACE Prop. & Cas. Ins. Co., 42 Fed. Appx. 522, 2002 WL 1770725 (2d Cir. Aug. 1, 2002).

Gerling arose from a dispute over the responsibility for millions of dollars of liability A.P. Green Refractories Co. incurred as a result of asbestos litigation. ACE, A.P. Green’s insurer, agreed to indemnify A.P. Green for a portion of the liability, and then sought to recover reinsurance proceeds from Gerling based upon reinsurance certificates Gerling issued to ACE in 1982. While reviewing ACE’s underwriting files, Gerling discovered a letter indicating that, one month before ACE solicited the reinsurance from Gerling, ACE was aware that A.P. Green was named as a defendant “in asbestosis litigation for a substantial number of individuals.”

Under this duty, even “an innocent failure to disclose a material fact is sufficient” to void a reinsurance contract. Id. at 524 (quoting Christiana Gen. Ins. Corp. of N.Y. v. Great Am. Ins. Co., 979 F.2d 268, 278 (2d Cir. 1992)). Under this duty, even “an innocent failure to disclose a material fact is sufficient” to void a reinsurance contract. Id. (quoting Michigan Nat’l Bank-Oakland v. Am. Centennial Ins. Co., 89 N.Y.2d 94 (1996)). The Second Circuit thus held that, under the doctrine of utmost good faith, “if ACE knew about material information concerning the risk to be undertaken, but failed to disclose such information, then the certificates are voidable.” Therefore, the dispute over “what ACE knew and when ACE knew it” was “outside the purview of the certificates’ narrow arbitration clause.”

The Second Circuit agreed, reaffirming the basic principle of the duty of utmost good faith: “The relationship between a reinsurer and a reinsured is one of utmost good faith, requiring the reinsured to disclose to the reinsurer all facts that materially affect the risk of which it is aware and of which the reinsurer itself has no reason to be aware.” Id. at 524 (quoting Christiana Gen. Ins. Corp. of N.Y. v. Great Am. Ins. Co., 979 F.2d 268, 278 (2d Cir. 1992)). Under this duty, even “an innocent failure to disclose a material fact is sufficient” to void a reinsurance contract. Id.
A Wisconsin court recently ruled that a reinsurer must pay 80 percent of the defense costs incurred by its cedent in defending against a declaratory judgment suit brought by the insured. *Employers Ins. Co. of Wausau v. American Re-Insurance Co.*, No. 02-C-491-S (W.D. Wis. Mar. 7, 2003).

In 1985, Employers Insurance Company of Wausau (“Wausau”) issued an excess insurance policy to the Tribune Company (“Tribune”). Wausau ceded 80 percent of the potential liability on the Tribune policy to American Re-Insurance Company (“American Re”) under a facultative reinsurance certificate.

In 1992, Tribune was sued for environmental contamination. Tribune brought a declaratory judgment action against Wausau seeking a determination that Wausau had a duty to defend and indemnify. Wausau defended against Tribune’s declaratory judgment action, incurring legal expenses and costs of $531,062. Wausau ultimately settled the claim for $270,000. American Re paid 80 percent of the settlement amount but refused to pay any portion of the defense costs.

Wausau filed suit in the Western District of Wisconsin seeking indemnification of its declaratory judgment defense costs. Wausau contended that the costs were “allocated loss expenses” covered by the reinsurance certificate. Condition 3 of the certificate provided:

> “The Reinsurer shall be liable for its proportion of allocated loss expenses incurred by the Company in the same ratio that the Reinsurer's share of the settlement of judgment bears to the total amount of such settlement or judgment under the policy reinsured. The term ‘allocated loss expense’ means all expenses incurred in the investigation and settlement of claims or suits... Allocated loss expenses shall not include expenses incurred by the Company in regard to any actual or alleged liability that is not within the circumscribed provisions of the policy reinsured.”

American Re contended that the last sentence of Condition 3 placed declaratory judgment expenses outside the definition of allocated loss expenses.

The court granted summary judgment in favor of Wausau. The court held that the definition of allocated loss expenses—“all expenses incurred in the investigation and settlement of claims or suits”—encompassed expenses incurred in declaratory judgment actions attempting to avoid coverage. The parties did not intend the final sentence of Condition 3 to restrict the basic definition: “The most natural reading of the final sentence is that the parties intended to exclude from ‘allocated loss expenses’ those costs incurred in the investigation and settlement of claims other than claims for coverage under the terms of the policy.” Here, the expenses in dispute were incurred in regard to a claim alleged to be within the policy provisions, namely the claim that the policy covered environmental liability. *Id.* at 5.

The court held that a parallel provision in paragraph 1 of the reinsurance certificate removed any doubt as to the parties’ intent. Paragraph 1 provided that the reinsurer was not liable to indemnify the cedent for liability “beyond circumscribed policy provisions, including but not limited to punitive, exemplary, consequential or compensatory damages resulting from an action of an insured or assignee against the Company.” This provision clarifies that liability for insurer bad faith or other torts is not a part of the reinsurance obligation; rather, only claims pursuant to the policy itself are subject to reinsurance. The final sentence of Condition 3 “merely extends this clarification to also exclude expenses incurred in defending against such extra-contractual claims.” *Id.* at 5-6.

The court concluded that, if the parties had agreed that Wausau would bear all declaratory judgment expenses, “they would surely have employed language more direct than the last sentence of condition 3.” *Id.* at 8.

*Wisconsin Court Orders Reinsurer to Reimburse Declaratory Judgment Expenses*  
*by Jennifer A. Hasch*

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Update on Litigation Regarding Asbestos Documentation Requirements
by David M. Greenwald

In our Summer 2002 Reinsurance Reports, we discussed litigation over asbestos documentation requirements imposed by the London Market on policyholders and ceding insurers. We reported that, in February 2001, Equitas notified policyholders that, effective June 1, 2001, underwriters would impose new Documentation Requirements on asbestos bodily injury claims. The DR's establish onerous requirements that must be met before underwriters will reimburse asbestos-related bodily injury claims. Following introduction of the DR's, Equitas and the broader London Market promulgated document requirements to apply to reinsurance loss cessions resulting from payment of asbestos bodily injury claims ("RDR's"). The RDR's became effective on November 1, 2001.


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Upcoming Speaking Engagements

May 22–25, 2003
Center for International Legal Studies, The Law, the Lawyer and Alternative Dispute Resolution Conference
Heidelberg, Germany
“Recent Developments in U.S. Arbitration Law”
Lawrence S. Schaner

August 2–4, 2003
Center for International Legal Studies in cooperation with the Faculty of Law of the University of Chile
Santiago, Chile
“Recognition and Enforcement of Foreign Judgments”
Lawrence S. Schaner

August 8, 2003
The ABA Annual Meeting
San Francisco, California
"Deposition Technology: Taking it to Trial"
David M. Greenwald

October 1–2, 2003
Lloyd's and Equitas 2003 Conference
New York, New York
David M. Greenwald, Speaker and Member of Organizing Committee