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IN THIS ISSUE

Captive Insurance Companies: many large companies now use a captive insurance company as part of their risk management tool-box. But what happens where there is a large controversial claim by the Parent Company? This articles looks at the dangers and pit-falls in the world of captive insurance companies and highlights points where careful attention is needed when dealing with reinsurers.

Captive Insurance Company Claims: Problems that Can Arise When Captives Dispute (or Should Dispute) Claims Made by Their Parent

ABOUT THE AUTHOR

Rod S. Attride-Stirling is a founder and Chairman of ASW Law Limited. He specializes in commercial litigation and arbitration, as well as insurance and reinsurance. He is: Chairman of the Bermuda Insurance Act Appeals Tribunal and the Investment Business Act Appeals Tribunal, Deputy Chairman of the Insurance Advisory Committee, and a member of the US/Bermuda Tax Convention Advisory Committee. He is also a member of the IBA, ARIAS (US) and the Chartered Institute of Arbitrators. Rod is a former: President of the Bermuda Bar Association, and former Chairman of the Humans Rights Commission of Bermuda. Rod is the author of numerous articles and publications including the Bermuda chapters of two books: *International Insurance Law (*Oceana Publications); and *Insurance & Reinsurance, Jurisdictional Comparisons* (Thomson Reuters). He is a regular speaker at international reinsurance, arbitration and insolvency conferences. Rod is the Honorary Counsel of Mexico in Bermuda and is fluent in Spanish. He can be reached at rod.attride-stirling@aswlaw.com.

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Natalie T. Furniss
Vice Chair of Newsletters
Bricker & Eckler LLP
nfurniss@bricker.com

Introduction

A captive insurance company is an insurance company which is set up to insure the risk of its parent. It may be a single parent captive or a group or association captive. It may write some third party business but there are normally limitations on this.

The concept a "captive insurance" company was invented in Bermuda, in the 1960s by Fred Reiss of the International Risk Management Group. Mr Reiss coined the phrase "captive Insurance company". This is now a multi-billion dollar world-wide industry.

Whilst historically a primary reason for setting up a captive was a tax-driven one, now the reasons are principally to do with the more efficient management of risk and enabling companies to access directly (or more directly) the world reinsurance markets (which historically were seen as less expensive when accessed directly, rather than through the ordinary insurance markets).

The captive insurance industry was the first insurance industry in Bermuda, leading to the formation later of the commercial insurance industry in the mid-1980s (ACE was set up in 1985 and XL Insurance in 1986); and to what is now one of the largest insurance and reinsurance markets in the world (carefully floating in the middle of the Atlantic Ocean).

Contractual Relationships

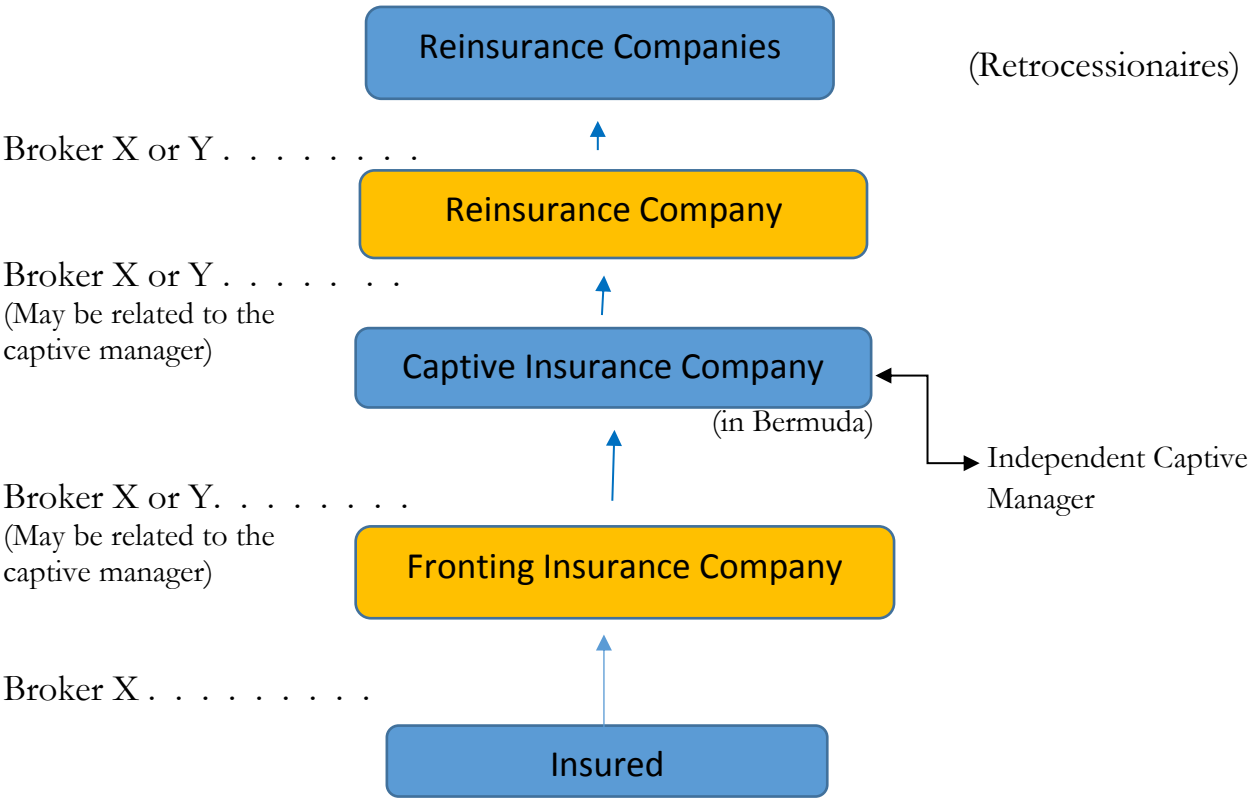
Given the nature of the relationship between Parent and Captive, it may be assumed that all will be well, and "disputes" are not likely to arise. In particular, it is assumed that there will never be issues of bad faith alleged. Experience however, has taught us that these may be unsafe assumptions.

In fact, there are several recurring issues that can arise between Parent and Captive, including:

- The management of the claim;
- Conflicts of interest; and
- The importance of acting in a proper and business-like manner.

These issues will be addressed in different forms in this paper. It is however important to have in mind the what a typical "reinsurance chain" looks like when it involves a captive insurance company. The typical chain looks something like that in the image below:

The Reinsurance Chain



Notification of a Claim

It is important to bear in mind that the captive insurance company must behave like a proper insurance company. This principle applies equally to single-Parent captives, association captives, rent-a-captives, and any other clever type of captive that the industry creates.

The Parent company should always bear in mind whether it has a contractual obligation to formally notify the Captive of any claim, and ensure that it abides by the precise wording of the Claims Notification Clause in the insurance policy, as between Parent and Captive. It is not sufficient for the Parent to assume that since the Risk Manager of the Parent, is also the president of the Captive that the knowledge of the one officer stands as notification to the other. Regardless of the realities, it is useful to develop the habit of reducing claim notifications to writing, and passing these notifications up the reinsurance contractual lines, promptly and in accordance with the various policy requirements.

It is imperative that the Captive insurance company give notice to its reinsurers or retrocessionaires, as the case may be, promptly and in accordance with the claims notification clause. Failure to give prompt notification can result in denial of coverage.

If there is a fronting company involved, then the fronting company should now remember that, even if it is 100% reinsured, that it still bears 100% of the risk, and that it too has a duty to deal with the claim in a proper and professional matter. The fronting company should give formal notice to the Captive or to whomever is the next link in the reinsurance contractual chain.

Managing the Claim

A claim has now been notified to the Captive. Several questions now arise. Is the Captive managed internally or externally, ie, is there a management company involved? Whichever is in place, they will likely have internal protocols that should be followed generally, in relation to claims on the Captive. When there is a large claim, different people will take a closer look when there are controversial coverage issues. This is not to say that generally no interest is taken in claims, but that with large claims, there is a larger interest, and more interest by more people, e.g. retrocessionaires, regulators, auditors, etc.

The balance of this paper will be devoted to this latter category of claims, i.e. large controversial claims in which contesting interests come into play.

The first question is who will be responsible for making decisions in relation to the claim. If there is a management company involved,

does their authority expressly extend to making final decisions on claims of this nature, or must they put such final decisions to the officers of the Captive or the board of directors of the Captive company.

It is noteworthy that the officers and directors of the Captive company are probably made up mostly of officers and directors of the Parent. In this case there is what many consider to be an immediately obvious conflict of interests. The directors of the Captive owe a fiduciary duty to the Captive, but in the face of a controversial claim, this duty may conflict with the fiduciary duty these directors owe to the Parent. For example, if the Captive takes independent legal advice, the Captive directors would normally be under a duty not to disclose the contents of such advice to adverse parties. But in the case of a Parent/Captive relationship, this becomes impossible (barring certain meta-physical exceptions that fall outside the scope of this discussion). If the risk manager for the Parent, is also the president and director of the Captive, he may find it difficult to build a "chinese-wall" around himself.

Different solutions have been used to deal with this potential conflict situation. One is to ignore it. The Captive simply makes all the decisions in the normal way. The reinsurers behind the Captive may be happy to accept that the officers or directors of the company can divorce themselves from the obligations they owe to the Parent (assuming there are such obligations), and deal with the claim fairly. It may be dangerous to assume that reinsurers or retrocessionaires will take this view.

Board of Directors Sub-Committees

Other possible solutions that have been used include appointing a sub-committee of the board of directors of the Captive, to make decisions on behalf of the captive. This sub-committee would be made of directors who are not employees or officers of the Parent, and they would have delegated to them all necessary decision-making and settlement authority in relation to the claim.

The identity and qualifications of the persons to whom such authority is delegated is crucial. Often lawyers from the firm that represents the Captive sit on its board of directors, and they may be considered to be ideal to act as impartial decision makers. This of course may not be so if the lawyers also act for the Parent, in either this or other matters. This may lead to another type of conflict of interests. A further difficulty may be that the persons on the board may not have experience in dealing with large controversial insurance or reinsurance claims. Further, there may not be sufficient or any Captive directors to appoint onto such a sub-committee.

Independent Claims Consultant

Another solution that has been used is to for the Captive to appoint an independent person as decision maker, for example an experienced claims consultant. This is not to say that the Captive will not employ the

services of attorneys to advise on coverage, or loss adjusters to investigate, but simply that these individuals would report to the independent claims consultant, to whom all decision making power and settlement authority has been delegated.

The timing of the appointment of the decision maker is crucial. It is not enough to appoint the decision maker immediately before entering into a settlement agreement, as between Parent and Captive. On the contrary the decision maker must be in place early, in order to make key decisions as to the appointment of attorneys, loss adjusters and other experts, and to deal with other key decisions that will affect the Captive's ability to properly defend a claim, which may not be covered by the insurance policy. The mere fact that an independent decision maker is appointed is not conclusive. The claim must still be adjusted and if necessary defended in a proper and business-like manner.

Delegation of Authority to the Management Company

The Captive and Parent may be happy (or willing) to delegate full decision-making and settlement authority to the Management Company. In this case there should be a careful review first of the management contract to ensure that the management company does not expose itself to criticism (or worse, liability). For example, the management company's agency contract may require it to act on the instructions of the Captive's board of directors, or to pass all documentation in its possession (including controversial legal advice) to the directors. The management company's discretion may be subject to limitations, which prevent it from acting unilaterally, without the consent of the Captive. The management company may, want to get an express waiver of liability in relation to the claim, and ensure that if it is obliged to take a position adverse to the Parent, that this does not conflict with any duty that it may owe to the Parent under some separate agreement that the management company may have with the Parent.

From a purely commercial perspective, the management company may not want to be responsible for a controversial claim, where it may be obliged to take positions that are clearly against the interest of the Parent. If a Parent makes a claim against its Captive for $500 million, and the management company, on behalf of the Captive, denies the claim, this may not warm the Parent to the people that it employs to manage its captive. In the negotiation of the settlement of a large and controversial claim, or the litigation or arbitration of such a dispute, it is not unheard of for parties to dig their heels in and take (bona fide but conflicting) tough positions. This often leads to a degree of animosity between litigants, which will not necessarily be conducive to a good future business relationship. For this reason alone, the management company should consider whether it is obliged to accept a decision-making role in relation to large controversial claims. If it is not so obliged it may choose to recommend to the Captive that it appoint an

independent decision maker, other than the management company. Of course the management company may take the view that it is precisely because of the need to have expert independent advice that it was appointed, and that after taking legal advice, it concludes that it has no conflict of interest and can and should accept a decision making role, even if this destroys their relationship with their substantive principal (the Parent).

Timing of Appointment of Independent Decision Makers

It may be the case that it was impossible to appoint an independent decision maker in relation to a claim at the outset. Alternatively it may be that no such decision maker was appointed because the Captive did not believe, at the outset, that it was necessary to do so, because the claim did not appear to be controversial when originally notified. In this case the claim would have been handled in the normal course. This illustrates why it is crucial that, those dealing with claims made against a Captive insurance company, always act in a proper and business-like manner.

Lawyers

Early decisions that must be made in relation to large claims, will include the decision to retain lawyers to advise in relation to the claim. The identity of the lawyers advising the Captive is important. The captive should appoint independent lawyers to advise in relation to the claim. It may be unwise to appoint the Captive's usual corporate lawyers if they are also the lawyers of the Parent, as they may have a conflict of interest.

The attorneys will review the relevant documentation, the facts and the law that applies to those facts. In time the lawyers will produce preliminary reports and eventually a final report to the Captive. This will contain information which by its very nature is privileged, and which an insurer would not normally have to disclose to its insured. To whom should the lawyer give his reports? If they are given to an officer of the captive, then this may be tantamount to giving privileged information to the insured who may have conflicts of interest, as discussed above.

Loss Adjusters

The lawyers will advise on coverage, but will likely recommend the appointment of an independent loss adjuster to investigate the claim (if none has been already appointed). Who appoints the loss adjuster may become an important question. The Captive, the Management Company, the independent claims consultant, the lawyers or a combination of the above might retain him. For privilege reasons it may be wise to have the attorneys retain the adjusters, but it is still important to see who makes the selection decision. There is some controversy over the use of so-called 'broker's-adjusters'. These are adjusters who have a reputation as traditionally being appointed by brokers, and who, it is said, have a predisposition to side with the

insured and against the insurer. Without going into the question of who is or what is a 'broker's adjuster' in detail, the Captive (and those making decisions on behalf of the Captive) should bear in mind that if the reinsurers behind the captive take the view, that the Captive simply "went through the motions," and did not properly adjust or defend the claim, they may take this as a ground for contesting liability.

The loss adjuster should adjust the claim in a proper and business like fashion. It should not deal with the investigation in a summary fashion simply because there is a Parent and Captive relationship. That is not to say that the Captive or the loss adjuster should act in bad faith to the Insured/Parent. On the contrary, the matter should be dealt with as if there were no special relationship, and this means that the adjuster should conduct as thorough an investigation as he would ordinarily.

Having established that the loss adjuster is doing his usual excellent job in investigating and adjusting the claim, one expects that the usual thorough reports will be produced. One will expect to see interim reports and a full and final report giving a detailed analysis of the claim, including a detailed Statement of Loss, with all proposed adjustments and supporting documentation, & etc. The next question is who will be entitled to see his reports. Here we may have to revisit the conflict of interest issues addressed above.

Claims Control and/or Co-Operation Clauses

There may be a claims control and/or co-operation type clause at various stages of the reinsurance chain. Such clauses might be in the contract between the insured and the Captive, insured and a fronting company, fronting company and Captive, Captive and outward reinsurer, and etc. These should be considered carefully, and be the subject of legal advice. The clause may give insurers (or reinsurers) the right to associate in the handling or defence of the claim or to take over control of the claim.

It would be dangerous for a Parent to fail to allow a Captive to associate in or control a claim, on the basis that it controls the captive and therefore the decision would be the same. In particular, the Reinsurers may insist on this right, which right, for the reinsurers, exists only vis-à-vis the Captive. The reinsurer will normally only have rights directly in relation to the reinsured. The failure to allow the insurer or reinsurer to exercise this right may be a ground for denying liability.

In the absence of a claims co-operation clause, reinsurers ". . . are not entitled at all to be actually involved in or consulted about the steps taken to settle the claim or the amount at which it should be settled" (Charman v. Guardian Royal Exchange Assurance plc [1992] 2 Lloyds Rep. 607 at 614, per Webster J.) Nevertheless, even where there is no claims co-operation clause, or specific contractual obligation to

notify a reinsurer of losses, the reinsurer is still entitled to information and documents, and answers to questions, showing how the claim was made and dealt with, sufficient to allow the reinsurer to contend that it was not dealt with in a business-like manner. It is always prudent, in any event, to advise the reinsurer and to keep the reinsurer advised during the course of negotiations to settle the claim. Where any large loss is involved--especially if there is an arguable legal issue as to coverage--it is also prudent to canvass the views of reinsurers.

The Captive should always bear in mind whose money is at stake. If the Captive has a relatively small retention and the bulk of the risk lies with reinsurers, then the Captive should be particularly sensitive of the need to keep its reinsurers fully appraised. The Captive should not enter into a settlement agreement, quantum agreement, or partial settlement agreement of a large controversial claim without either the reinsurers consent or where appropriate, after informing the reinsurers of the full particulars of the proposed settlement, and giving reinsurers the opportunity to either approve the settlement agreement in advance, or at least be informed in advance of the intended settlement agreement, so that the reinsurer can consider whether to associate with the settlement or take control of the dispute.

Follow the Settlements/Fortunes Clauses

A captive insurance company should not assume that if it enters into a settlement agreement with its parent, that the captive's reinsurers are necessarily bound to pay to the captive the amount of the settlement. As discussed above, the reinsurers will want to satisfy themselves in relation to several issues. Various questions arise, including: was there a follow the settlements clause, was there a claims co-operation clause, were the reinsurers consulted in relation to the settlement, did the reinsurers agree to the terms of the settlement, was there coverage under the insurance contract, was there coverage under the reinsurance contract, did the captive take all reasonable defences, did the captive act in a proper and business like fashion in the investigation and settlement of the claim?

It would be wrong to assume that in the absence of an express and sufficient follow the settlements clause, that one will be implied into the contract. It is also sometimes wrongly assumed that a follow the settlement clauses and follow the fortunes clauses are the same thing. There is even some US case law that supports this, but this is not necessarily the position outside the US. Whilst there is English case law that defines follow a settlements clauses, there is no such UK or Bermuda authority on the precise meaning of a 'follow the fortunes' clause.

Even if there is a follow the settlements clause, this will not be enforceable if the captive has not processed the claim in a proper and business-like manner, from an insurance company perspective. However assuming that they have done so, a properly

worded follow the settlements clause should be enforceable.

Conclusion

The safest conclusions to draw from this is that Captive insurance companies, their Parent companies and those making decisions for Captives, should always act in a proper and business-like manner. The Captive is an insurance company and in its handling of claims should always act as such. Because of its special relationship with its insured, it should have regard to conflicts of interests, and where appropriate take steps to address any conflict of interests, or the perception of such conflict.

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