Cut-Throughs, Commutations and Arbitrability

By

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I. Introduction

This article focuses on two cases with many similarities: *Trenwick America Reins. Corp. v. CX Reins. Co. Ltd.*, 2014 U.S. Dist. Lexis 70823 (D.CT) and *Trenwick America Reins. Corp. v. Unionamerica Ins. Co.,* 2013 U.S. Dist. Lexis 97518 (D.CT). They involve the same retrocessionaire, the same court, were decided by the same judge and involve a cut-through between the same reinsurer and retrocessionaire. In general terms, they reach the same result: the claim of the cedent against the retrocessionaire pursuant to the cut-through must be decided by arbitration. However, a number of the decisions of the court in reaching this conclusion are worthy of note.

II. Facts

A. Trenwick v. Unionamerica

Trenwick and Chartwell, which was later merged into Trenwick (hereinafter collectively "Trenwick"), reinsured Commercial Casualty Insurance Company of Georgia (hereinafter "CCIC") pursuant to contracts containing the following language in the arbitration clause: '[A]ny dispute between [CCIC] and any Reinsurer arising out of or in connection with this Agreement, including its formation or actual validity, will be submitted to the decision of a board of arbitration."[1]

The reinsurance contracts contained a "no third party beneficiary clause" but also attached a schedule with a cut-through clause[2] providing that if CCIC was unable to pay claims to its cedents due to financial impairment, Trenwick would make up the difference. When CCIC became insolvent, Trenwick declined to pay. Unionamerica sought to arbitrate the dispute and Trenwick took the position that Unionamerica had no right to arbitrate pursuant to the treaty between Trenwick and CCIC.

B. Trenwick v. CX Re

The facts in this case are very similar to those in the case above but with one important difference. The cedent, CX Re billed Trenwick for losses in August of 2012. In February 2013, Trenwick and the estate of CCIC entered into a commutation agreement that purported to release all claims and obligations

between the parties.[3] Trenwick contended that CX Re's right to arbitrate with Trenwick ended pursuant the commutation agreement which terminated the relationship between Trenwick and CCIC.

III. Arbitrability

A threshold question in both cases was arbitrability *i.e.* whether this was a dispute for the courts or an arbitration panel. A leading case on point is *Painewebber Inc. v. Bybyk,* 81 F.3rd 1193 (2nd Cir. 1996). In that case a client filed a claim against Painewebber with the National Association of Securities Dealers (hereinafter "NASD") and pursuant to NASD rules, and the client's signed agreement, the claim was referred for arbitration. Painewebber filed a court action challenging certain of the claims as time barred and the issue was whether this challenge should be resolved by an arbitration panel or the courts.

The *Painewebber* court stated the rule on arbitrability as follows:

> The role of the courts in reviewing matters subject to arbitration, therefore, is limited to determining two issues: i) whether a valid agreement or obligation to arbitrate exists, and ii) whether one party to the agreement has failed, neglected or refused to arbitrate, in whole or in part. Thus, "unless the parties clearly and unmistakably provide otherwise, the question of whether the parties agreed to arbitrate is to be decided by the court, not the arbitrator." In other words, the court must determine whether a given issue falls within the scope of the parties' undertaking to accept arbitration.
>
> That said, the parties themselves may provide that the arbitrator, not the courts, shall determine whether an issue is arbitrable.[4]

The *Painewebber* court went on to find that the following language was sufficiently broad to evidence an agreement that an arbitration panel, rather than the courts, should determine arbitrability: "[A]ny and all controversies which may arise between [the client] and PaineWebber concerning any account, transaction, dispute or the construction, performance, or breach of this or any other agreement . . . shall be determined by arbitration.[5]

Similarly the courts found the language in the arbitration clauses in the Trenwick cases[6] were sufficiently broad to allow an arbitration panel to determine the arbitrability of those disputes.[7]

IV. Impact of the Cut-Through

A schedule to the treaty between Trenwick and CCIC contained the following language:

> In the event [CCIC], due to insolvency or financial impairment, fails to pay an obligation under the Quota Share, the Reinsurers agree to pay Unionamerica the excess liability

> amount due under the Reinsurance Agreement subject to all terms and conditions of said Agreement.[8]

Trenwick argued that the above language was merely a "loss payee" clause, that Unionamerica was not in privity with Trenwick and that Unionamerica had no right to arbitrate absent a specific grant of such right in the schedule.

There is a considerable amount of case law on the subject of cut-throughs being an exception to the usual rule that third parties do not have rights under the reinsurance contract:

> As a general rule, reinsurance contracts are contracts of indemnity, which give the original assured no right of action against the reinsurer. However, the reinsurer may agree to be directly liable to the original assured.[9]

The earlier *Trenwick* court found that the relevant schedule language quoted above constituted such a cut-through and held that it provided Unionamerica a right to arbitrate its dispute with Trenwick.[10]

V. Commutation Agreement as Termination of the Cut-Through

As noted in § II. B, *supra,* in the second Trenwick case, the estate of CCIC and Trenwick entered into a commutation agreement after CX Reinsurance first asserted a claim under the cut-through. The commutation agreement purported to settle and discharge all obligations and liabilities between CCID and Trenwick.[11] In addition, the cut-through provision contained the following language:

> This Reinsurance Assumption Agreement shall continue in effect, subject to termination in the event of cancellation or termination of the Excess of Loss Reinsurance Agreement. Upon the occurrence of any such event, [CX Re] shall be notified by the Reinsurers of such action not less than thirty (30) days prior to the effective date of cancellation or termination of this Reinsurance Assumption Agreement. In no event shall cancellation or termination of this Reinsurance Assumption Agreement affect Reinsurers' obligation to pay amounts properly payable to [CX Re] by virtue of this Reinsurance Assumption Agreement. Commutation of the Excess of Loss Reinsurance Agreement in accordance with the terms thereof shall relieve Reinsurers of all liability, known or unknown, under this Reinsurance Agreement.[12]

In considering this confusing, if not contradictory language, the court made several point. First, the duty owed to a third party beneficiary cannot be withdrawn after the beneficiary changes its position based thereon or brings suit on it.

Second, the termination of an agreement with an arbitration clause does not necessarily terminate the obligation to arbitrate disputes within the ambit of the cancelled agreement. In *Ace Capital Re Overseas Ltd. v, Central United Life Ins. Co.,* 307 F.3d 24 (2nd Cir. 2002), Central United ceded 100% of a book of business to ACE which produced losses. Central United's president signed a proposal to terminate the

reinsurance contract at issue, amend others and enter into new reinsurance contracts for a new block of business (hereinafter "Proposal"). The Proposal did not contain an arbitration clause. When a dispute arose over the Proposal, Ace contended that it was not arbitrable since the Proposal did not contain an arbitration clause and that the arbitration clause in the terminated agreement did not cover the Proposal. The court found the dispute arbitrable on the basis that a broad arbitration clause in the terminated contract was actionable and that collateral matters may be included if "the claim alleged 'implicates issues of contract construction or the parties' rights and obligations under it."[13]

In *Sun Life Asssurance Co. of Canada v. Liberty Mutual Ins. Co.,* 2009 U.S. Dist. Lexis 114694 (S.D. Cal.) the parties conducted an actuarial arbitration of a proper commutation sum. One party asked the court to confirm the award thereby resolving all issues between the parties and terminating the reinsurance relationship. The other party resisted this effort since it was seeking interest. The court ruled that the interest issue would have to be determined by arbitration:

> The court cannot terminate the relationship without interpreting those contracts. Because the court would have to interpret the contracts to decide whether Sun Life owes interest on the commutation amount and whether the relationship should be terminated, this dispute arises with respect to the reinsurance contracts. Therefore, it must be determined by arbitration.[14]

Likewise, the *Trenwick v. CX Re* court decided that the confusing if not contradictory language of the cut-through provision quoted above must be interpreted by an arbitration panel.[15]

VI. Commentary

There are business reasons for reinsurers to enter into cut-throughs since they assist ceding companies obtain and retain business that would have eluded them for financial security reasons.[16] Should they come into play due to the insolvency of the ceding company, they present significant impediments to a reinsurer running off or commuting the book of business. Should these impediments turn into disputes, the case law noted above demonstrates that there is a high likelihood that the disputes would be subject to arbitration.

ENDNOTES

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[1] *Trenwick America Rein. Corp. v. Unionamerica Ins. Co.,* 2013 U.S. Dist. Lexis 97518 *3-4.

[2] For an examination of the business reason for cut-through clauses and the problems they engender, *see* Robert M. Hall, *Cut-Through and Guarantee Clauses*, X Mealey's Reins. Rpt. No. 21 at 18 (2000), also available at the author's website: robertmhall.com.

[3] The relevant language reads as follows:

> It is the intention of the Parties that the releases contained in [the Commutation Agreement] shall operate to fully and finally settle and discharge each Party's past, present and future claims, causes of action, obligations and liabilities to the other party hereto whether known or unknown, reported or unreported, suspected or unsuspected, by either or both Parties, accrued or yet to

accrue, arising directly or indirectly under or in connection with the Reinsurance Agreements . . . .

[4] *Painewebber Inc. v. Bybyk,* 81 F.3d 1193 at 1198 (internal citations omitted).

[5] *Id.* at 1196.

[6] *See* text accompanying fn. 1.

[7] *Trenwick America Reins. Corp. v. Unionamerica Ins. Co.,* 2013 U.S. Dist. Lexis 97518 *17; *Trenwick America Reinsurance Corp. v. CX Rein. Co. Ltd.,*2014 U.S. Dist. Lexis 70823 *13.

[8] *Trenwick America Reins. Corp. v. Unionamerica Ins. Co.,* 2013 U.S. Dist. Lexis 97518 *13.

[9] *Jurupa Valley Spectrum, LLC v. National Indem. Co.*, 555 F.3d 78, 89 (2nd Cir. 2009)(citations omitted); *see also Callon Petroleum Co. v. National Indem. Co.*, 472 Fed. Appx. 57, 58 (2nd Cir. 2012)

[10] *Trenwick America Reins. Corp. v. Unionamerica Ins. Co.,* 2013 U.S. Dist. Lexis 97518 *15-6.

[11] *See* note 3, *supra.*

[12] *Trenwick America Reins. Corp. v. CX Reins. Co. Ltd.,* 2014 U.S. Dist. Lexis *11.

[13] *ACE Capital Re Oveseas Ltd., v. Central United Life Ins. Co.,*307 F.3d, 24 at 27.

[14] *Sun Life Assurance Co. of Canada v. Liberty Mutual Ins. Co.,* 2009 U.S. Dist. Lexis 114694 *5-6.

[15] *Trenwick America Reins. Corp. v. CX Reins. Co. Ltd.,*2014 U.S. Dist. Lexis 70823 *12.

[16] *See* note 2, *supra.*