DISCOVERY FROM INTERMEDIARIES:

REPORT ON DEVELOPMENTS

IN REGULATION AND CASE LAW

By

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I. Introduction

In the course of insurance and reinsurance arbitrations, counsel often find it useful to obtain pre-hearing depositions and documents from third parties such as intermediaries. Intermediaries may be critical witnesses in that they often design the reinsurance program, identify markets, draft the contract, process premium and loss payments, allocate them among treaty years and handle all correspondence between the cedent and reinsurer. As such, the intermediary may possess critical information concerning the intent of the program and how it operated. Unfortunately, intermediaries often resist subpoenas for documents and/or testimony.

There is a considerable split in the case law on the authority of a court to enforce a subpoena issued by an arbitration panel obtain discovery from intermediaries.[1] This results from the language of Section 7 of the Federal Arbitration Act:

The arbitrators . . . may summon in writing any person to attend before them or any of them as a witness and in proper case to bring with him or them any book record, document or paper which may be deemed material as evidence in the case.

Some courts have interpreted such language to mean that a district court is without power to enforce a subpoena for pre-hearing documents and/or testimony.[2]

Efforts have been made to seek a regulatory solution to the problem of obtaining pre-hearing documents or testimony from intermediaries. The purpose of this article is to provide a progress report on such efforts and to examine some recent case law which suggests a partial, albeit inadequate, remedy to the problem.

II. Regulatory Developments

A. An Overview

Most states have enacted licensing laws for intermediaries along the lines of the Reinsurance Intermediary Model Act adopted by the National Association of Insurance Commissioners (hereinafter "Model"). The Model as been adopted as an accreditation standard which demonstrates the quality of state regulation of the insurance industry. The following language was proposed as an amendment to the Model in order to allow licensing states to discipline intermediaries, including revocation of license, for violation of the following:

1. A RB [reinsurance broker] or RM [reinsurance manager] shall comply with any order of a court of competent jurisdiction or a duly constituted arbitration panel requiring the production of non-privileged documents by the RB

or RM, or the testimony of an employee or other individual otherwise under the control of the RB or RM with respect to any reinsurance transaction for which it acted as a RB or RM.

2. Compliance shall be subject to the right of the RB or RM, and the parties to the transaction, to object to the court or arbitration panel concerning the nature or scope of the documents or testimony or the time within which it must comply with the order. Failure to comply with the order shall be deemed to be a material non-compliance with the Act. However, in no event shall this section be construed to require more than one appearance by the same witness in a single action or arbitration.

This language is a compromise reached through negotiations between the author and representatives of a prominent intermediary. From a litigator's standpoint, it is not ideal. It obligates the intermediary to appear only once in the proceeding and, in effect, gives the intermediary standing to protest the nature and scope of the subpoena.

In response, the language is a compromise designed to recognize the time and trouble necessary for a third party, albeit a critical one, to participate in an arbitration proceeding. Counsel have one opportunity to gain the documents and testimony necessary to build their case. Arbitrators have the necessary experience to draw appropriate conclusions from documents and depositions and relate them to live testimony at the hearing.

Secondly, due process considerations support the right of the intermediary to protest the nature and scope of the subpoenas. Oftentimes, third party subpoenas do not receive the same degree of scrutiny as those directed at parties unless there is somebody with an interest to raise appropriate objections.

B. Objections of Intermediaries

At early stages in the effort to amend the Model, intermediaries voiced a variety of objections. Perhaps the primary objection against this proposed amendment is that discovery has become a major burden in arbitrations and that cedents and reinsurers will turn away from the arbitration process as result. Implied, but unstated, was the threat that intermediaries will recommend that their clients not put arbitration clauses in their reinsurance agreements.

Few would argue that there are no problems with discovery in arbitrations.[3] Nonetheless, this was a curious argument for intermediaries to make for several reasons. Initially, it is an attempt to select the appropriate dispute resolution mechanism for the principals based on the convenience of the agent. Moreover, it advocates a default mechanism (litigation) in which there are virtually no limitations on discovery from intermediaries. Stated differently, the proposed alternative (litigation) is worse from the standpoint of intermediaries than the proposed regulatory solution.

In fact, the current status of the law on discovery from intermediaries is more costly than the proposed alternative. Section 7 of the FAA currently allows parties to subpoena intermediaries to bring documents and testify at the hearing. In effect, this allows the equivalent of a discovery deposition (which usually is much longer than ultimate testimony) and review of related documents at a hearing at which there will be many more individuals billing by the hour, usually at a rented facility. In terms of documents, a recent Second Circuit case[4] is instructive in that the third party witness brought 300 boxes of documents to the arbitration hearing. Obviously, a deposition and review of documents before the hearing is much more cost effective.

Another argument of intermediaries was that this effort is unconstitutional in that it is an attempt to overturn a federal statute through a state regulation. While creative, this argument is untrue but if true, would mean the end of state regulation of insurance.

The problem arises from a gap in the authority of a district court to enforce a third party subpoena. State regulation of appropriate intermediary behavior pursuant to a licensing statute cannot be said to overrule a federal statute, especially when the issue is the lack of a federal statute on point. Moreover, the argument necessarily implies that there must be a federal statute specifically authorizing states to regulate intermediaries in order for them to do so. This was hardly an argument designed to appeal to state regulators or legislators. Indeed, this bulked-up vision of

federal pre-emption would be an unpleasant surprise to those many state legislatures which have enacted state arbitration statutes.

3. Current Status of the Regulatory Effort

The amendment to the Model described in subsection A above was approved by the Interested Persons Group to the NAIC Reinsurance Task Force without dissent. The Task Force exposed the language for comment at the December 2005 NAIC meeting and adopted it without dissent at the March 2006 meeting. It was approved by the Financial Conditions Committee as the same meeting. In June 2006, the full NAIC approved the amendment to the Model.

The next step at the NAIC would be to consider, at its March 2007 meeting, whether this amendment should be made part of the state accreditation standards. Frankly, it is questionable whether or not the NAIC will do so given the narrow scope of the amendment. However, if the NAIC did chose to do so, it would be a very strong incentive for states to adopt the amendment. Several prominent states have indicated an interest in adopting the amendment and this may be sufficient to produce the desired effect.

The amendment is supported by the Reinsurance Association of America but it is not at the top of their legislative agenda. ARIAS US has declined to take a position on this matter to date.

III. Case Law Developments

Hay Group, Inc. v. E.B.S. Acquisition Corp et al., 360 F.3d 404 (3rd Cir.2004) involved an attempt to obtain documents prior to an arbitration hearing. Judge (now Justice) Alito writing for the majority ruled that there was no power under Section 7 of the FAA to enforce a subpoena for documents under such circumstances. However, a concurring opinion by Judge Chertoff suggested a means to the desired end:

Under Section 7 of the Federal Arbitration Act, arbitrators have the power to compel a third party witness to appear with documents before a single arbitrator, who can then adjourn the proceedings. This gives the arbitration panel the effective ability to require delivery of documents from a third-party in advance notwithstanding the limitations of section 7 of the FAA. In many instances, of course, the inconvenience of making such a personal appearance may well prompt the witness to deliver the documents and waive presence.[5]

As recognized by other commentators,[6] this would allow one or more of the panelists to preside over sworn testimony, accompanied by subpoenaed documents, prior to a hearing on the merits.

IV. Subsequent Caselaw Supporting Hay Concurring Opinion Approach

In Odfjell ASA et al. v. Celanese AG et al., 348 F.Supp. 283 (S.D.N.Y. 2004), the court initially denied enforcement of pre-hearing subpoenas to third parties for depositions. However, the arbitration panel later issued subpoenas "to appear and testify in an arbitration proceeding" which was prior to the scheduled hearing on the merits. Counsel for the third parties argued that this was an attempt to evade the court's initial ruling. The court enforced the subpoenas ruling:

(Section 7) of the FAA plainly contemplates that not every appearance before an arbitrator will consist of a full-blown trial-like hearing, for it provides that the arbitrators may summon the witness to come "before them or any of them." In practical terms, this means that, while the necessity of appearing before at least one arbitrator will prevent parties to an arbitration from engaging in the extensive and costly discovery that is the bane of civil litigation, at the same time preliminary proceedings can proceed expeditiously before a single arbitrator to deal with preliminary questions of admissibility, privilege, and the like before the full panel hears the more central issue.[7]

After the subpoenas were enforced, a decision was rendered on an appeal. Stolt-Nielsen SA v. Celanese AG, 430 F.3d 567 (2nd Cir. 2005). Counsel for the third parties argued that Section 7 of the FAA required a trial-like setting

for a district court to enforce subpoenas for testimony and documents from a third party. They argued that the wording of the subpoenas was merely a subterfuge to evade the limits of Section 7.

The court of appeals ruled that the subpoenas were well within the authority of the arbitration panel under Section 7 of FAA noting certain factors which, the court stated, did not necessarily need to be present in each case to justify the subpoenas. These factors were: (1) the third party was not ordered to appear for a deposition but to give testimony before the arbitration panel and all three arbitrators were present; (2) the arbitrators heard the testimony of the third party and ruled on evidentiary issues; (3) the testimony provided became part of the arbitration record. The court rejected the argument that testimony could be required only at a trial-like final hearing. The court noted other situations in which testimony might be required:

So, too, arbitrators may need to hear testimony or receive evidence on preliminary issues – such as whether an arbitration clause is enforceable or whether a claim is barred by relevant statute of limitations – in advance of an ultimate hearing on the substantive merits of the underlying claims in the arbitration.[8]

The court of appeals did not comment specifically on the issue of testimony before a single arbitrator.

V. Conclusion

The effort to find a regulatory solution to the issue of discovery from intermediaries has been quite successful to date. However, it is not yet enacted into law in any state. Active support by ARIAS US would be helpful.

The line of cases described above is certainly not an ideal or complete solution to the problem of third party discovery in reinsurance arbitrations. One or all members of the panel must assemble with counsel and the witness for what may be a lengthy and difficult excursion through facts and documents which would better be performed through a discovery deposition. However, it is an option for a panel when a critical third party witness declines to honor a pre-hearing subpoena for documents and/or testimony.

ENDNOTES

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[1] Cohen, Royce F., Lewin, Robert, Lewner, Andrew S., Jacobson, Michele J., *Obtaining Discovery from Reinsurance Intermediaries and Other Non-Parties – Updated Caselaw and Commentary,* ARIAS – US Quarterly, Third Quarter 2005 at 2 [hereinafter "*Cohen"*]; Hall, Robert M., *Intermediaries and Discovery in Reinsurance Arbitrations,* Mealey's Litigation Report: Reinsurance December 2, 2002 at 30.

[2] *Id.*

[3] *See* Hall, Robert M., *How to Make Reinsurance Arbitrations Faster, Cheaper and Better*, on the author's website robertmhall.com.

[4] Stolt-Nielsen SA et al. v. Celanese AG et al., 430 F.3d 567 (2nd Cir.2005).

[5] 360 F.2d 404, 413 (3rd Cir.2004).

[6] *Cohen* at 14.

[7] 348 F.Supp. 283 at 287.

[8] 430 F.3d 567 at 578.