What is the Practical Effect of an Honorable Engagement Clause?

By

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I. Introduction

Since time out of mind, the arbitration clauses of reinsurance contracts have included language to the effect that arbitrators shall consider the contract as an honorable engagement, rather than merely a legal obligation, are relieved of all judicial formalities and may abstain from following the strict rules of law. One commentator described honorable engagement provisions thusly:

> In recognition of the traditional duty of utmost good faith, an honorable engagement clause instructs the arbitrators that the parties wish to resolve their disputes based on fairness and custom and practice of the reinsurance industry. An honorable engagement clause means that the arbitrators are not to resolve disputes solely based on the strict rules of law and contract interpretation. It frees the arbitrators from following the strict rules of law and allows for a more commercial and pragmatic approach to dispute resolution.[1]

But how does this clause work in real cases with real facts? The purpose of this article is to review selected caselaw on the use and interpretation of the honorable engagement clause.

II. Cases in Which Courts Cited Honorable Engagement Clause as Basis for Declining to Vacate Panel Award

First State Ins. Co. v. National Cas. Co., 781 F.3d 7 (1st Cir. 2015) was a case in which the arbitration panel ordered a claim payment protocol in which the reinsurer was to pay 75% of contested claims subject to a reservation of rights and further review of the claim. The reinsurer

sought to vacate the order on the basis that it exceeded the panel's power by rewriting the parties' agreement. The court declined to vacate the order ruling:

> We believe that an honorable engagement provisions empowers arbitrators to grant forms of relief, such as equitable remedies, not explicitly mentioned in the underlying agreement. This is a huge advantage: the prospects for successful arbitration are measurably enhanced if the arbitrators have flexibility to custom-tailor remedies to fit particular circumstances. An honorable engagement provision ensures that flexibility.
> We therefor hold that the honorable engagement provisions in the arbitration clauses of the underlying agreements authorized the arbitrators to grant equitable remedies. We further hold that the reservation of rights procedure is such a remedy.[2]

Another relevant case from the first circuit is *National Casualty Co. v. First State Ins. Group,* 430 F.3d 492 (1st Cir. 2005). This was an allocation case in which the reinsurer sought the cedent's internal documents as to the basis for allocation. The cedent claimed privilege but the panel ordered that they be produced nonetheless. The cedent refused and the panel ruled that a negative inference would result. Nonetheless, the panel found for the cedent and the reinsurer sought to vacate the panel order on several bases including panel misconduct by failing to hear pertinent evidence *i.e.* the documents for which privilege was claimed. The court declined to vacate observing:

> Here, the relevant contract provisions not only relieved the arbitrators of any obligation to follow the 'strict rules of law,' but also released the arbitrators from 'all judicial formalities.' In the face of a clause that broad, which makes no mention of the production obligations of the parties or of the discovery procedures to be followed, and which so fully signs over to the arbitrators the power to run the dispute resolution process unrestrained by the strict bounds of law or of judicial process, a party will have great difficulty indeed making the showing, requisite to vacatur, that their rights were prejudiced,[3]

In *Banco de Seguros del Estdo v. Mutual Marine Office, Inc.,*344 F.3d 255 (2nd Cir. 2003), the panel ordered pre-hearing security. Citing to the honorable engagement clause and a security clause for unauthorized reinsurers, the court found that panel's order did not violate the Foreign Sovereign Immunities Act or public policy and that by ordering it, the panel did not exceed their

authority. *See also*, *Petersen-Dean, Inc. v. National Union Fire Ins. Co. of Pittsburgh,* 2020 U.S. Dist. LEXIS 23667 (S.D.N.Y.) in which the court ruled that an arbitration panel did not exceed its authority under the relevant contract by ordering security.

An allegation of understated reserves during placement led to an arbitration in *United States Life Ins. Co. v. Insurance Commissioner,* 160 Fed. Appx. 559 (9th Cir. 2005). The panel ordered that the losses ceded to the reinsurer should be reduced by 10%. Citing the honorable engagement clause, the court found that the order was not contrary to public policy, was not a manifest disregard of the law or irrational and that the panel did not exceed its authority.

The panel award in the third of three arbitrations was challenged in *American Centennial Ins Co. v. Global Int'l Reinsurance Co.*, 2012 U.S. Dist. LEXIS (S.D. N.Y. 2012). The panel granted the reinsurer a 15% reduction in claims and loss adjustment expenses and the cedent sought to vacate the order on several bases including failure to provided reasoning for the award and that it "overruled" the prior two arbitrations. The court found that contractual language allowing the reinsurer adjustments on claim payments due to the cedent's acquisition, "[c]onsidered in light of the honorable engagement clause . . . the [Arbitration] Panel cannot be said to have intentionally ignored or contradicted an unambiguous contractual term." [4]

Harper Insurance Ltd. v Century Indemnity Co., 819 F.Supp.2d 279 (S.D.N.Y. 2011) involved a reinsurance treaty without a reports and remittances clause governing reporting of losses to reinsurers and payment by such reinsurers. The panel issued an order requiring the reinsurer to pay accepted losses within 106 days of billing plus 75% of disputed billings with written objections for disputed billings. The reinsurer objected arguing that protocol for payment of claims was not submitted to the panel. Citing the honorable engagement clause, the court observed:

> [Reinsurers] conflate the question of whether an *issue* was presented to the arbitrators with the question of whether a *potential remedy* was presented to the arbitrators. It is indisputable that arbitrators have no authority to rule on an issue not submitted to them. However there is no parallel per se rule that it is beyond the authority of the arbitrators to issue a remedy directed to an issue squarely before them unless it was requested by the parties.[5]

The reinsurers in the *Harper* case argued that the panel exceeded its authority in creating reports and remittances provisions. Again citing the honorable engagement clause, the court ruled:

> [I]t is plainly obvious that the contract, although it did not include a Reports and Remittances clause, expected a prompt flow of funds between the [reinsurers] and [the cedent] to cover claims in which the Agreement was 'involved.' The Panel ultimately concluded that its protocol best effectuated the parties' purpose. We cannot conclude that it did not have, at a minimum, a barely colorable justification for its decision.[6]

Certain Underwriters at Lloyd's London v. Argonaut Ins. Co., 2009 U.S. Dist. LEXIS 87827 (N.D. Ill. 2009) is a case in which the cedent filed a motion to vacate a panel award of attorneys' fees as exceeding the panel's authority. The court declined to do so:

> It was Argonaut's conduct over almost two years of litigation that Underwriters characterized as "bad faith" performance under the arbitration clauses and a breach of the duties imposed by the parties 'honorable engagement.' Argonaut initially demanded arbitration, then sought to avoid it. It failed to adhere to the straightforward requirements for appointing an arbitrator and then litigated a dispute over the meaning of the words 'thirty days' to a federal court of appeals. Argonaut's entire performance under its 'honorable engagement' - - and a determination that this performance was dishonorable and conducted in bad faith - - constitutes a proper bases for the arbitration panel's decision.[7]

On a grant of attorneys' fees, *see also Catalina Holdings (Bermuda) Ltd. v. Muriel,* 2020 U.S. Dist. LEXIS 59812.

III. Cases in Which the Courts Vacated Panel Orders Despite an Honorable Engagement Clause

PMA Capital Ins. Co. v. Platinum Underwriters Bermuda, LTD, 659 F. Supp. 2d 631 (E.D. Pa 2009) involved a profit sharing agreement with a deficit carryforward position. The issue posed by counsel to the panel was whether or not the reinsurer was entitled to carry losses forward into the 2003 underwriting year and if so, in what amount. Rather than answer those specific questions, the panel ordered the cedent to pay the reinsurer $6,000,000 and that thereafter, there would be no more deficit carryforwards. While acknowledging the discretion allowed the

panel under the honorable engagement clause, the court ruled that it did not allow the panel to read the deficit carryforward clause out of the contract:

> No court has held that such a clause gives arbitrators authority to re-write the contract they are charged with interpreting. . . .
> . . . .
> The 2003 'contract itself ' requires the enforcement of the Deficit Carry Forward Provision, not its elimination. . . . [I]t is obvious that the Arbitrators exceeded their authority on the Honorable Engagement Clause.[8]

Nationwide Mutual Insurance Co. v. Home Insurance Company, 330 F.3d 843 (6th Cir. 2003) involved a cessation by Nationwide to the Home. Subsequently, Home's book of business was taken over by CIGNA. (The decision does not reveal how exactly this take over was accomplished.) The arbitration panel decided that Nationwide was liable for certain administrative costs and ordered that they be paid to a CIGNA subsidiary rather than the Home. Notwithstanding the honorable engagement provision, the court ruled that the panel lacked the jurisdiction to order payment to a third party.

IV. Comments

The above caselaw indicates that pursuant to an honorable engagement clause, the courts will allow arbitration panels considerable latitude in interpreting reinsurance contracts and fashioning remedies. However, that latitude does not extend to ignoring or effectively changing the terms of reinsurance contracts.

ENDNOTES

1 Larry Schiffer, *The Honorable Engagement Clause (But I Thought I Had a Legal Contract,* IRMI Expert Commentary, March 2007.
2 781 F.3d 7 at 11 (internal citations omitted).
3 430 F. 3d 492 at 497 – 8.
4 2012 U.S. Dist. LEXIS 94754 *35.
5 819 F. Supp.2d 270 at 277 (S.D.N.Y. 2011)(emphasis in the original)
6 *Id.* at 278.
7 2009 U.S. Dist. LEXIS 87827 *15.
8 659 F. Supp. 631 at 637.