Cat Bond Litigation: Unambiguous Bond Documents Cause Court To Dismiss With Prejudice Complaint Seeking to Claw Back Payments Made From a Cat Bond Reinsurance Trust

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The United States District Court for the Southern District of New York has dismissed, with prejudice, claims relating to the triggering of the Mariah Re severe weather event cat bond. *Mariah Re Ltd. v. American Family Mutual Insurance Co.*, 2014 WL 4928976 (S.D.N.Y. Sept. 30, 2014). Mariah Re, the special purpose vehicle reinsurer, sued American Family Mutual Insurance Company ("American Family"), the ceding insurer, ISO Services, Inc. (d/b/a/ Property Claim Service ("PCS")) and AIR Worldwide Corp. ("AIR"). The cat bond provided coverage for certain severe weather risks. The coverage trigger was based upon the provision of a catastrophe bulletin by PCS and an event report by AIR. The activities of PCS were governed by a document called the PCS License Agreement, while the activities of AIR were governed by a document called the Calculation Agent Agreement. The reinsurance obligations of Mariah Re were collateralized by a reinsurance trust that was funded at $100 million.

After a severe weather event occurred, American Family sought and received a payment from the reinsurance trust in the amount of $100 million, resulting in the complete loss of the bond's principal to the bond investors. The cat bond's investors disputed American Family's entitlement to the payment of $100 million, and Mariah Re sued to recover the payment, to obtain damages and to obtain declaratory relief.

<u>The Determination of the Amount Payable Under the Reinsurance Agreement</u>

The key to this dispute is how the insured losses were calculated for the purpose of entitling American Family to a payout pursuant to the terms of the Reinsurance Agreement it had entered into with Mariah Re. PCS and AIR had roles in the determination of the amount of the insured losses. PCS was responsible for issuing

Catastrophe Bulletins, which are reports that provide basic information about weather events and estimate corresponding weather-related losses on a state-by-state basis. AIR was retained to calculate the amount that Mariah Re owed to American Family under the Reinsurance Agreement.

AIR agreed to review the data provided by PCS and determine, on a state-by-state basis, whether any weather-related damage occurred in a "metro area." If AIR determined that the estimated loss for a state occurred in a "metro area," it was to multiply the estimated loss for that state by a contractually-defined "metro payout factor." If, on the other hand, AIR determined that the weather-related damage in a state did not impact a "metro area," it was to multiply the estimated loss for that state by a lower "non-metro payout factor." AIR was to set out its conclusion, including whether the metro designation was implicated, in an Event Report. American Family could request funds from the reinsurance trust based upon an Event Report.

It was not disputed that a qualifying severe weather event occurred. PCS issued its Catastrophe Bulletin ("the Original Bulletin"), which provided its estimate of the losses on a state-by-state basis. This Bulletin did not provide details as to the areas of Kansas affected by the weather event, although it stated that the impact "pounded a swath from Kansas to Wisconsin …." PCS published three different loss estimates as the data developed, and then issued its "Final Estimate of Insured Property Damage" report. On the very next day, PCS provided additional information which purported to describe the impact of the weather event within Kansas. The Original Bulletin plus the Kansas specific information was the equivalent of a five page document, and was referred to as the Revised Original Bulletin.

AIR made its calculations and issued its Event Report based upon the Revised Original Bulletin. According to the allegations of the Amended Complaint, although the amount of the estimated insured property loss in the Original Bulletin and the Revised Original Bulletin were the same, the additional Kansas specific information in the Revised Original Bulletin caused AIR to classify some of the losses as metro losses, resulting in the application of the higher metro payout factor, when under the Original Bulletin such losses would have been classified as non-metro losses, and subject to a lower payout factor. Basing the reinsurance payment on the Revised Original Bulletin resulted in a payment to the exhaustion level of the bond, while payment based on the Original Bulletin would not have reached the exhaustion level of the bond.

The loss payable under the Reinsurance Agreement as calculated by AIR using the Revised Original Bulletin resulted in American Family being entitled to a payout from the reinsurance trust of the full trust amount of $100 million, resulting in a substantial loss for the bond purchasers. American Family requested a payment of $100 million from the trustee of the reinsurance trust, and noted in its request for payment that the investors objected to AIR's $100 million calculation and to its use of the Revised Original Bulletin, but contended that there was no basis for delaying the release of the requested $100 million to American Family. This position was based upon an explicit provision of the Reinsurance Agreement and Reinsurance Trust Agreement, which provided American Family the unqualified right to obtain funds from the reinsurance trust based upon AIR's Event Report. Such a provision is of course required by many state laws in order for the reinsurance to qualify for full financial statement credit by American Family. The prospect of the bond investors being able to block payment to American Family from the reinsurance trust would be troubling to many ceding insurers who are involved in cat bonds, and might have a significant impact upon the attractiveness of cat bonds to ceding insurers. The trustee made the requested payment to American Family

The Court's Resolution of the Issues

Mariah Re sought to have the court interpret the bond documents in such a way as to prevent AIR from using the Revised Original Bulletin in preparing its Event Report, partially though claims against PCS for breach of the PCS License Agreement and against AIR for breach of the Calculation Agent Agreement. The court found that the contracts were not ambiguous, and that they clearly set forth the process to be used in calculating losses, the issuance of Catastrophe Bulletins and Event Reports, and the entitlement to and the amount of payments under the Reinsurance Agreement and the Reinsurance Trust Agreement.

The court found that Mariah Re was attempting to impose restrictions or conditions on the conduct of PCS and AIR which were not contained in their contracts, and the court declined to permit Mariah Re to “rewrite the documents” to impose additional restrictions it did not seek in the negotiation of the documents. Specifically, the court held that although the information contained in the Revised Original Bulletin did not change the amount of the insured loss from that contained in the Original Bulletin, it did shift the allocation of the loss amount between metro and non-metro areas, but that the documents did not preclude such a reallocation of the loss amount by AIR after the issuance by PCS of its final estimate of insured losses.

Once the court reached the decision that the cat bond documents were unambiguous, and provided for the allocation of responsibilities and the methodology with respect to the issuance of the Catastrophe Bulletin and the Event Report and the determination of the losses payable under the Reinsurance Agreement, its analysis of the specific legal claims and theories was fairly straightforward. The court dismissed the breach of contract claims based upon the unambiguous terms of the contracts, dismissed the claims for breach of the implied covenant of good faith and fair dealing as being duplicative of the breach of contract claims and dismissed the unjust enrichment and conversion claims against American Family based upon its contractual entitlement to payment under the Reinsurance Agreement.

Conclusion

This lawsuit had the potential for causing uncertainty and perhaps having an adverse impact on the development of the cat bond market generally. One of the principal attractions to a ceding insurer of having a fully collateralized reinsurance trust as part of a reinsurance structure is the elimination of collection risk compared to non-collateralized reinsurance obligations. If ceding insurers were exposed to a serious risk of not being able to obtain funds from a reinsurance trust based upon the type of allegations set forth in this case, the resulting uncertainty may well have made cat bonds somewhat less attractive to ceding insurers as an alternative to fully collateralized traditional reinsurance, which historically has not had this type of collection risk. Although the structure of this cat bond was unlike indemnity-based cat bonds, which now represent the majority of the new issues, it still had the potential for creating uncertainty in the cat bond market, and the fact of the lawsuit was considered to be a risk factor in the marketing of some indemnity-based cat bonds. This decision should help to ameliorate such uncertainty.

This decision highlights the importance of clear contract provisions concerning the administration of cat bonds, in particular the methodology to be used to calculate when amounts are payable under the cat bond's reinsurance agreement and reinsurance trust agreement, and the amount of such payments. If such language is ambiguous in any respect, there is a much greater risk of litigation, disruption of the administration of a cat bond, and of the administration of the bond not meeting the expectations of all parties. While some may contend that this dispute suggests the need for a quicker alternative dispute resolution mechanism for disputes concerning cat bonds to minimize the disruption of the ongoing administration of such bonds, to the extent that many triggering events will be of sufficient magnitude to result in the complete exhaustion of the amount placed in the reinsurance trust, the duration of the dispute resolution process should not present a high level of concern.

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