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Be Careful With NY Honorable Engagement Provisions

Law360, New York (February 20, 2013, 12:21 PM ET) -- "Honorable engagement" provisions are a holdover from the days when reinsurance agreements were often made on an informal basis between individuals who had longstanding business relationships but lacked the kind of detailed information that is often integral to modern reinsurance transactions. This level of trust may seem antiquated to some, but honorable engagement provisions still play a prominent role in modern reinsurance agreements.

These provisions expand the already sizable discretion of arbitrators and can significantly impact the adjudication of reinsurance disputes. This article explores the application of honorable engagement provisions under New York law.

As claims related to Superstorm Sandy mature, many insurers will cede losses to their reinsurers. Due to the volume and variety of claims, together with a wide assortment of policy provisions that will be implicated, some reinsurance disputes and even arbitration may follow.

Many of the facultative and treaty reinsurance agreements that may respond to programs experiencing Sandy-related losses, and in particular, those placed through reinsurance markets outside the United States, are likely to contain arbitration provisions with honorable engagement language.

Many reinsurance agreements provide that the agreement should be interpreted as "an honorable engagement and not merely a legal obligation." Such provisions often also contain language stating that arbitrators are "relieved from all judicial formalities and may abstain from the strict rules of law." A typical arbitration provision may contain language similar to the following:

All arbitrators shall interpret this Contract as an honorable engagement rather than as merely a legal obligation. They are relieved of all judicial formalities and may abstain from following the strict rules of law. They shall make their award with a view to effecting the general purpose of this Contract in a reasonable manner rather than in accordance with a literal interpretation of the language.[1]

The core concept is that the obligations of the parties go beyond those imposed chiefly by law or the strict wording of the agreement. Instead, the parties' obligations encompass extra legal duties, including those arising from industry custom and practice.

As explained by one reinsurance commentator, the purpose of the honorable engagement provision is "to prevent either party from placing a meaning on technical phraseology of the agreement which was not the real intent of the agreement."[2] Commentators suggest that the practical effect of such language is that arbitrators may be effectively relieved of any obligation to follow the strict rules of law regarding issues such as construction of the agreement, procedure and evidence, as long as the arbitration hearing is fair.[3]

Accordingly, arbitrators may be more likely to consider extrinsic evidence of contractual intent or custom and practice, even where contractual provisions may seem unambiguous at first blush.[4]

Reinsurance agreements containing honorable engagement provisions have come before the state and federal courts of New York. Under New York law, honorable engagement provisions have been held to require the parties to act in good faith.[5] The inclusion of this type of wording has also been construed to demonstrate an intent of parties to have disputes resolved by individuals "familiar with the practical intricacies of their type of relationship and disposed to give weight to nonlegal factors like business ethics."[6]

New York courts have also held that the existence of an honorable engagement provision may allow arbitrators to adopt or reject the "strict rules of law."[7] This may substantially lower the odds that an award will be disturbed on the grounds that the arbitrators exhibited a manifest disregard for the law.

As a practical matter, this also allows parties in reinsurance disputes in New York to advance arguments that may be rooted in extrinsic evidence or may even run contrary to substantive New York law. The persuasiveness of such arguments will depend on the individual proclivities of the selected arbitrators, emphasizing the need for careful consideration during the appointment process.

The existence of an honorable engagement provision grants arbitrators additional flexibility.[8] This additional discretion can significantly change the outcome of a dispute and the type of award issued that may be issued by the arbitrators. For example, the U.S. District Court for the Southern District of New York upheld an award including compound interest because the panel was not bound by New York, allowing only simple-interest law in light of the honorable engagement clause in arbitration agreement.[9]

Although expanded, the power granted to arbitrators by an honorable engagement provision is not absolute. Arbitration awards may of course be vacated or modified when there is manifest disregard for the law, manifest disregard for the parties' agreement or when arbitrators exceed their powers.[10]

Nonetheless, according to the Second Circuit, "arbitrators have wide discretion to order remedies they deem appropriate" when an arbitration agreement contains an honorable engagement clause.[11] Awards that: do not violate explicit provisions of the contract itself, affect the "contract's purpose in a reasonable manner" and contain an explanation that the award "effectuates the agreement of the parties" may survive judicial scrutiny when an honorable engagement clause is present.[12]

This increased arbitral discretion can be a double-edged sword. On one hand, it may allow for the introduction of important legal arguments or evidence that a party could not normally advance in a court of law or arbitration hearing. On the other hand, it can create additional uncertainty as to the anticipated outcome of arbitrated disputes.

This is particularly true when a reinsurance agreement contains both a choice-of-law provision and honorable engagement language. The existence of both provisions can create an internal tension, and ultimately, the honorable engagement provision may hold more influence.

For example, New York's Southern District has held that when this type of provision is included, arbitrators are "free to disregard New York substantive law" — even when an arbitration is conducted in New York and governed by New York law.[13] This can be advantageous, however, when the parties wish to avoid legal technicalities.

In the wake of Superstorm Sandy's significant impact on insurers and reinsurers, it is inevitable that some reinsurance disputes will arise. If the reinsurance agreement at issue contains honorable engagement language, the parties should exercise an additional level of care when researching and selecting arbitrators.

The inclusion of this language affords an additional level of arbitral flexibility and opens the door to arguments that would be unlikely, or even precluded, if New York law was strictly applied. Insurers and reinsurers should also bear in mind that the presence of honorable engagement language can present additional hurdles when challenging an arbitration award.

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[1] Contract Wording, Brokers & Reinsurance Markets Association (2005). http://www.brma.org/frommembers/frommemcontractwd01.htm (follow "Arbitration BRMA 6A-6" hyperlink).

[2] See John L. Baringer, The Reinsurance Market The Assuming Reinsurer, in Reinsurance, 343 (Robert W. Strain ed. 1980).

[3] See Jonathan F. Bank & Patricia Winters, Reinsurance Arbitration: A U.S. Perspective, in Law & Prac. of Int'l Reinsurance Collections & Insolvency 553, 576-77 (Spector & Milligan-Whyte eds. 1988).

[4] See Barry R. Ostrager & Mary Kay Vyskocil, Modern Reinsurance Law and Practice, § 14 (1996).

[5] Pink v. American Surety Co., 28 N.E.2d 842, 844 (N.Y. 1940).

[6] Holiday Inns, Inc. v. Aetna Ins. Co., 1978 U.S. Dist. LEXIS 19930, *17-18 (S.D.N.Y. Jan. 26, 1978), quoting Fed. Commerce & Navigation Co. v. Kanematsu-Gosho, Ltd., 457 F.2d 387, 390 (2d Cir. 1972), quoting Note, Judicial Review of Arbitration Award on the Merits, 63 Harv. L. Rev. 681 (1950).

[7] North River Ins. Co. v. Allstate Ins. Co., 866 F. Supp. 123, 129 (S.D.N.Y. 1994).

[8] Id.

[9] Nw. Nat'l Ins. Co. v. Generali Mexico Compania de Seguros, S.A., 2000 U.S. Dist. LEXIS 5586 (S.D.N.Y. May 1, 2000).

[10] Am. Centennial Ins. Co. v. Global Int'l Reinsurance Co., 2012 U.S. Dist. LEXIS 94754, *18-36 (July 9, 2012).

[11] Banco de Seguros del Estado v. Mut. Marine Office, Inc., 344 F.3d 255, 261 (2d Cir. 2003).

[12] Harper Ins. Ltd. v. Century Indem. Co., 819 F. Supp. 2d 270, 280 (S.D.N.Y. 2011), distinguishing PMA Captial Ins. Co. v. Platinum Underwriters Berm., Ltd., 400 Fed. Appx. 654, 656 (3d Cir. 2010)

[13] St. Paul Fire & Marine Ins. Co. v. Eliahu Ins. Co., 1997 U.S. Dist. LEXIS 8916 at *25 (S.D.N.Y. June 26, 1997), aff'd 152 F.3d 920 (2d Cir. 1998).