In The Supreme Court of Bermuda

CIVIL JURISDICTION

Commercial List

2008: No. 282

BETWEEN:

MUTUAL HOLDINGS (BERMUDA) LIMITED

Plaintiff

-v-

MATSEN INSURANCE BROKERS, INC

Defendant

JUDGMENT

(in Court)

Date of trial: June 10, 2014

Date of Judgment: June 25, 2014

Mr. Ben Adamson, Conyers Dill & Pearman Ltd., for the Plaintiff

Mr. Mark Diel and Ms. Katie Tornari, Marshall Diel & Myers Limited, for the Defendant

Introductory

1. By a Specially Indorsed Writ issued on November 13, 2008, the Plaintiff sought damages in the amount of $165, 703 plus interest as monies due from the Defendant under a contract. The relevant contract was a shareholder agreement initially entered into as of March 1, 1998, and amended thereafter from time to time ("the Shareholder Agreement").

2. The Plaintiff's case was that the Shareholder Agreement was concluded as one aspect of the Defendant's participation in an Insurance Profit Centre ("IPC") "rent-a-captive" programme ("the Programme"), offered by the Plaintiff and its affiliate Mutual Indemnity (Bermuda) Limited ("Mutual Indemnity"). The main elements of the Programme included the following:

    (1) Legion Insurance Company and/or Villanova Insurance Company ("Legion"), affiliates of the Plaintiff issued insurance policies to the Defendant's clients;

    (2) Mutual Indemnity reinsured certain of Legion's risks;

    (3) the Defendant, an insurance agent which received commissions for insurance business it introduced to Legion, purchased a non-voting preference share in the Plaintiff for series Z31 on terms set out in the Shareholder Agreement;

    (4) the Shareholder Agreement entitled the Defendant to a dividend if the Programme was profitable, but obliged the Defendant to indemnify the Plaintiff in respect of any losses suffered by Mutual Indemnity in respect of the insurance risks relating to the Defendant's clients.

3. It was further alleged that in 2003, Legion was placed into liquidation by the Commonwealth Court of Pennsylvania, having been placed into rehabilitation the previous year. Mutual Indemnity commuted its liabilities to Legion on April 23, 2003 (with effect from December 31, 2001-"the Commutation") by paying US$ 165, 703[1] in respect of losses on the Programme. The Defendant was obliged to indemnify the Plaintiff in this amount under clause 3A of the Shareholder Agreement.

4. The Defendant's Defence and Counterclaim asserted that:

    (a) under clause 3A, the obligation to indemnify did not apply to unpaid reported losses or incurred but not reported losses ("IBNR"); and

[1] In fact the gross amount paid was $742,617, but the claim gave credit for monies advanced by the Defendant which were already in the Programme.

(b) a dividend payment was due to the Defendant in the total amount of US$121,422.11.

5. The issues in controversy substantially turned on the interpretation of the dividend and indemnity provisions of the Shareholder Agreement without, in the final analysis, any serious dispute about the underlying facts and/or figures.

The Witnesses

6. The Plaintiff filed a Witness Statement and called Mr. Leslie Dziwenka, a chartered accountant who is now a senior vice-president of Marsh IAS Management Services (Bermuda) Limited. Mr. Dziwenka, who has worked for the Plaintiff's group of companies for over 10 years, was responsible for calculating the Plaintiff's claim. He gave his evidence in a very straightforward manner and I readily accepted him as a credible witness.

7. The Plaintiff's witness explained how the programme worked. He described three risk layers:

(1) "the Loss Fund", made up of net premiums ceded by Legion to Mutual Indemnity;

(2) "the Gap", a layer of risk between the Loss Fund and the Aggregate Attachment Point ("AAP"), which was usually collateralised by the IPC client through a "Security Deposit";

(3) "the Third Layer" which, if pierced by paid losses, would be funded through third party reinsurance.

8. A pivotal paragraph in his Witness Statement encapsulated both the Plaintiff's subjective view of the Programme of which the Shareholder Agreement formed part, which of course was irrelevant to the contract's interpretation, and the construction contended for by the Plaintiff:

"*20. The purpose behind the IPC model was for the IPC Client to take on the risks which were not ceded to third party reinsurers. From the perspective of the IPC companies, the IPC business was fee based, not risk based. The risk for Mutual Indemnity and Mutual Holdings was credit risk: that the IPC Client would fail to abide by the Indemnity. A large part of my job was calculating and obtaining the necessary security or collateral to minimise credit risk.* "

9. Mr. Dziwenka admitted under cross-examination that the commutation amount paid to Legion was in respect of both paid losses and IBNR. The Commonwealth of Pennsylvania court (which was supervising the Legion liquidation) insisted on a $5 million increase on the total payment amount by Mutual Indemnity to Legion, which was applied *pro rata* throughout the various programmes. The parties to the commutation negotiated on the basis that paid losses of $817, 486 were due, and an estimated $561,984 in respect of IBNR. A discount of $217, 478 was given to Mutual Indemnity for early payment of the IBNR element of the Legion claim on the Z31 Programme, which was also credited with all earned premium (whether or not it was collected) and 100% of funds withheld (an item subject to some doubt). $715,050 was the agreed Commutation amount but it was increased by Court order to $742,617. The witness also demonstrated a clear worsening trend in terms of loss development, providing retrospective validation for the Commutation in commercial terms.

10. I accept Mr. Dziwenka's evidence that $742,617 was paid by Mutual Indemnity to Legion under the Commutation in respect of the Programme, less offsets of $492,914+$84,000 ($576,914) resulting in a net payment of $165, 703, the amount claimed by the Plaintiff.

11. He also conceded under cross-examination, that if the elements of these payments representing loss reserves and IBNR were taken into account for dividend calculation purposes but not taken into account for indemnity purposes, the Plaintiff's claim would be more or less extinguished. This question of construction of the Shareholder Agreement was the central controversy this Court is required to resolve.

12. However, Mr. Dziwenka did not concede and the Defendant did not establish that this would also result in the Defendant being entitled to receive by way of dividend the sum claimed in its Counterclaim.

13. Lynne Wallace was the Defendant's President from 2001 to 2007 and Senior Vice-President prior to that. She is a California Licensed Insurance Broker and also a Certified Property Casualty Underwriter. Her First Witness Statement primarily made the case that the Defendant was not liable as a matter of construction of the Shareholder Agreement (Clause 3A) and that without sufficient back-up for the demand, payment ought not to be made. It also asserted that the demand came as a shock as no financial data had previously been supplied (paragraph 16). In her Second Witness Statement, this point was further elaborated, with the assertion that before the August 15, 2003 payment demand, communications "*had been positive*" (paragraph 7). The arguments that the Commutation payment did not fall within the Shareholder Agreement, and ought not to be binding on the Defendant as it was consummated without consultation are then set out.

14. Ms. Wallace gave her oral evidence in a very frank manner and I found her to be an entirely credible witness. She admitted that her commercial experience was in the domestic insurance sphere and that, in effect, she was not confident or comfortable with the complex Programme and its reinsurance and financial dimensions. Her main practical concern was a lack of access to information once Legion went into rehabilitation/liquidation. The claims' handling process was transferred away from the private entity her company had previously dealt with, and it was impossible to penetrate the State liquidation system in communication terms. In addition, the information emanating from the Mutual Group was unhelpful at best and misleading at worst.

15. I accept that Ms. Wallace's concerns are entirely genuine, but they appeared to me in part to flow from the implicitly admitted fact that, despite her company entering into a complex commercial structure with onshore insurance and offshore reinsurance strands to it, she did not fully appreciate that, like all commercial bargains, it had both upside and downside to it. The fact that commissions were 'guaranteed' in respect of business the Defendant fed to Legion at the "front end" did not mean that the Defendant was guaranteed profits at the "back end", because those profits depended on the profitability of the Programme (First Dziwenka, paragraph 26). Nevertheless, Mr. Diel still made the point that while adequate financial information about the negative status of the Defendant's shareholding in the Plaintiff was duly supplied, it was delivered, in effect, in a package displaying 'smiley faces' rather than 'sad faces'.

16. David Alexander (as President of Mutual Indemnity) sent Lynne Wallace quarterly financial statements for "*Preferred Share Series 'Z31'*" in 2000 and 2001 under cover of letters which made no comments on the attached statements, but instead made generally positive and upbeat noises about the Mutual investments. A quick glance at the attached statements would have shown a consistent pattern in terms of negative shareholder equity; ($73,374.06) as at June 30, 2000, and after 2001 fairly consistently worse than ($300,000). I find that the covering letters to Ms. Wallace were far from misleading; but, at first blush, they seemed hardly helpful in that they failed to even hint at the bad news the statements contained.

17. However, I further find that the covering letters were, more likely than not, simply standard form letters with unique addressee information and share series numbers inserted at the top of each letter. I infer this in part from the May 30, 2002 letter from Mr. Alexander to Ms. Wallace, which Mr. Diel complained described the prospects post-Commutation in overly optimistic terms. That letter was clearly a standard form letter, which stated on page 1: "*If this proposal is accepted, we hope that a great deal of uncertainty will be removed, and we could address the dividend rights of our preferred shareholders.*" This was simply a

standard form letter sent to all preferred shareholders, some of whom might be entitled to dividends, some of whom might not, even though it was given a personal touch by being addressed to Ms. Wallace.

18. If the letters enclosing the Defendant's financial statements are carefully read with the possibility of their being standard letters in mind, it is immediately obvious from their contents that the letters are standard covering letters containing generic information, and not in any way intended to comment upon the attached individualised accounts. This does not undermine Ms. Wallace's surprise when the demand for an indemnity payment was initially received, or the validity of her wish to have been more fully and explicitly informed about the Programme's adverse development. But this analysis, in the absence of evidence that all IPC clients' programmes were running at a loss, also destroys any basis for inferring that the Plaintiff or its affiliates were consciously forwarding negative statements to shareholders such as the Defendant under cover of distractingly positive covering letters. After all, investment income generated by the Plaintiff was one facet of the dividend calculation formula under clause 2 of the Shareholder Agreement, alongside underwriting gains (or losses).

19. It is not necessary to formally record any findings on the issue of whether or not the Plaintiff and/or Mutual Indemnity ought to have engaged the Defendant, and by implication all the Plaintiff's preferred shareholders, in the negotiation process which led to the Commutation, for reasons of good business practice or as a matter of courtesy. However, it seems obvious that in legal terms, the Programme was structured in a way which did not envisage parties in the position of the Defendant being interposed into the insurance/reinsurance relationship. Such parties were apparently linked to the Programme only for the purposes expressly stated in the Shareholder Agreement.

20. In summary, I find that the Plaintiff's claim will succeed if its construction of the Shareholder Agreement is accepted and will fail if the Defendant's construction is accepted.

Construction of the Shareholder Agreement

21. The final recital of the Shareholder Agreement provides as follows:

> "***WHEREAS*** *this* ***AGREEMENT****, the* ***POLICY*** *and the* ***TREATY*** *together constitute a single insurance program (hereinafter the '****PROGRAM****') which is a uniquely negotiated single contract and no part of the* ***PROGRAM*** *would have been entered into without the others being in force.*"

22. Mr. Adamson quite rightly submitted that this recital demonstrated the connection between this Agreement and the related Programme, which was fundamental to an understanding of how the Shareholder Agreement should be construed. It was common ground that two clauses were relevant, clauses 2(C) and 3(A). Clause 2 sets out a dividend entitlement formula made up of the following elements:

    (a) investment income, if any, generated by the investment of the cash received for the purchase of the preferred share, net of administrative fees;

    (b) plus or minus investment income or loss generated by the investment of the cash received by Mutual Indemnity under the Treaty, net of administrative fees;

    (c) "*(C) Plus or minus the amount of underwriting gain or loss realized by* ***INDEMNITY*** *on the* ***TREATY*** *during the period ending March 31st preceding the* ***DIVIDEND DATE****. Underwriting gain shall be computed by the following formula:*

    Net premium received by ***INDEMNITY*** *after all deductions made by or paid to the* ***INSURANCE COMPANY*** *including ceding commissions, expenses and taxes (including the actual final cost of licenses, fees, assigned risk charges, guarantee funds etc. related to the* ***POLICY****) as provided in the* ***TREATY****; minus all losses and loss expenses incurred including loss and loss expense reserves for unpaid reported losses and for losses incurred but not reported; minus the applicable Underwriting Fee as shown in Appendix I; minus the actual costs incurred by* ***INDEMNITY*** *in establishing and maintaining a letter of credit in favor of* ***INSURANCE COMPANY*** *as required by the* ***TREATY***." [emphasis added]

23. For dividend purposes, it was clear that all losses, including unpaid loss reserves for reported losses and IBNR, in addition to paid losses, were taken into account and deducted from any investment and/or underwriting profit. A different position appertained as regards the calculation of the shareholder's indemnity obligations in the event of a net loss under clause 2. Clause 3 provides in material respects as follows:

    "*(A)* ***SHAREHOLDER*** *hereby indemnifies and holds* ***MUTUAL*** *and* ***INDEMNITY*** *harmless against the cumulative sum of paragraphs 2(A), 2(B) and 2(C) minus the cumulative amount of dividends paid, being less than zero at any point in time.*

    On receipt of each written demand by ***MUTUAL*** *or* ***INDEMNITY****,* ***SHAREHOLDER*** *agrees to pay* ***MUTUAL*** *or* ***INDEMNITY*** *within 30 days the amount by which the cumulative sum of the amounts calculated under*

paragraphs 2(A), 2(B) and 2(C) minus the cumulative amount of dividends paid pursuant to this Agreement, are less than zero minus all previous payments under this paragraph provided however that the definition of incurred losses and loss expenses in paragraph 2(C) shall for this purpose only include losses and loss expenses which have been paid or are likely to be paid within the following ninety(90) days." [emphasis added]

24. The most straightforward and natural reading of the underlined words above is that contended for by Mr. Adamson. Clause 2(C) has a broad definition of losses, thus reducing the scope for a dividend and operates in favour of the Mutual companies. To reduce the exposure of the shareholder to be required to pay under the indemnity clause, however, clause 3(A) adopts a narrower definition of losses and operates against the Mutual companies. And the reference to losses being "paid" means "paid by Mutual or Indemnity", because the purpose of the clause, contained in a non-insurance contract, is simply to indemnify the Mutual companies for losses they have actually suffered. As the monies claimed by the Plaintiff have in fact paid by Mutual Indemnity pursuant to the Commutation, it matters not for clause 3(A) purposes if the payment has been made in respect of loss reserves and/or IBNR.

25. The Defendant's interpretation required a more elaborate reading of clause 3(A). The broad point was that the Shareholder Agreement did not expressly contemplate payments made under a commutation agreement being taken into account. Mr. Diel and Ms. Tornari's Skeleton Argument submitted:

"*14. Mutual Holdings, as drafter of the Shareholder Agreement, could easily have included language into the Shareholder Agreement to reflect that liabilities paid by Mutual Indemnity or Mutual Holdings to Legion pursuant to a commutation agreement would be subject to indemnification from Matsen. No such language is included in the Shareholder Agreement*…"

26. This point was supplemented by reference to the more superficially attractive point that Article 8 (1) (e) of the Treaty between Mutual Indemnity and Legion (as amended by Amendment No. 7) itself only contemplated commutation payments being made by Mutual Indemnity in respect of "*existing liabilities*". What the Treaty provisions actually say is somewhat different:

"*1. The Company and the Reinsurer agree that the letter of credit provided by the Reinsurer may be drawn upon at any time and be used by the Company or its successors in interest only for one or more of the following reasons:*

...

> *e. To pay existing liabilities between the Company and the Reinsurer upon commutation of one or more reinsurance contracts.*"

27. I reject the suggestion that this has any bearing on the construction of clause 3A of the Shareholder Agreement for two principal reasons. Firstly, and most narrowly, clause 8(1)(e) of the Treaty, according to its terms, does not apply to a commutation of the Treaty itself, which is defined in the Treaty as the "Reinsurance Agreement", but merely contracts under the Treaty. More broadly, however, I find that while the Shareholder Agreement interacts with the Treaty and the various underlying contracts, it constitutes a self-contained agreement between the Plaintiff and the various preferred shareholders as to the dividend entitlements and indemnification obligations. In my judgment the Plaintiff's claim turns upon the rights and obligations of the Defendant *qua* shareholder. Authorities considering what liabilities a reinsurer is liable to meet by way of response to a claim by its reinsured, which the Defendant sought to rely upon to exclude 'liability' for estimated Legion losses, have no application to the legal relationship between the parties in the present case.

28. Mr. Adamson further relied upon two previous decisions of the Bermudian courts which he contended expressly supported the Plaintiff's case, in relation to the same commutation agreement and a substantially similar shareholder agreement. In *Mutual Holdings (Bda) Limited-v-Stateco Inc.*, Supreme Court Civil Jurisdiction 2005: 380, Judgment dated September 26, 2014 (unreported), Ground CJ held (albeit in a case which was apparently not defended):

> "*1. Having read the evidence and the submissions of Counsel, I am quite satisfied that Mutual Indemnity has paid Legion under the commutation $1,912,873, and I am quite satisfied that after setting off various other monies in the program that the amount left was $336,533-a shortfall in other words. I am satisfied that the plaintiff, Mutual Holdings (Bda), is entitled to claim that shortfall under the indemnity in the Shareholder Agreement, and in that respect, having looked at it with care, I accept Mr. Smith's argument as to the proper interpretation of paragraph 3A of the Shareholder Agreement, namely that "losses which have been paid" means losses paid by Mutual Indemnity and not losses paid by Legion, as I think was contended by the defendants. It seems to me, therefore, that the sums paid under the commutation are losses and loss expenses paid by Mutual Indemnity, and are four square within the indemnity provided in the Shareholder Agreement.*"

29. Mr. Diel for the Defendant quite rightly pointed out that the narrow point decided by Ground CJ was not in terms taken by his client in the present case. Here,

the complaint was that an IBNR element was included in the Commutation, not that the losses were not paid by Legion. However, if one looks at the substance of the Defendant's complaint in light of the reinsurance authorities relied upon, a broadly similar point is in issue: is it relevant to clause 3A that indemnification is being sought in relation to amounts paid by Mutual Indemnity to Legion in respect of underlying losses which have not actually been paid or, at least, reported? Ground CJ broadly held that irrespective of the position or status of the underlying claim made by the insured against Legion, the indemnity provisions of clause 3A were triggered by payment by Mutual Indemnity to Legion under the Commutation. This conclusion is entirely consistent with reading clause 3A in what I have characterised above as a straightforward manner as regards the meaning of the words "*losses and loss expenses which have been paid or are likely to be paid within the following ninety (90) days*".

30. The second case which Mr. Adamson relied upon to support the Plaintiff's case was *Mutual Holdings (Bda) Limited –v-American Patriot et al* [2010] Bda LR 46 which described the structure of the programme in that case in precisely the manner counsel contended for. Bell J held in that case:

> "288. *The first point made on behalf of the plaintiffs is that Mutual Holdings has suffered no loss under the relevant formula in the Shareholder Agreement, and cannot itself make a claim for indemnification in respect of a loss suffered by Mutual Indemnity…*
>
> *289. Let me start with the first argument, which is that Mutual Holdings has suffered no loss, and of course Mutual Indemnity not being a party to the Shareholder Agreement either in its original or amended form, cannot claim directly. But the claimant in the original proceedings was Mutual Holdings.*
>
> *290. It does seem to me that the facts of the case before me are identical to those in the case of Mutual Holdings v Stateco Inc (Civil Jurisdiction number 380 of 2005), in which Ground CJ delivered a short judgment on 26 September 2007. That case was concerned with a calculation of loss stemming from the Commutation Agreement, which the Chief Justice held fell within the definition of losses contained in the relevant paragraph of the shareholder agreement in that case. Although the losses were those of Mutual Indemnity, the Chief Justice expressed himself satisfied that Mutual Holdings was entitled to claim the shortfall under the indemnity provisions of the shareholder agreement in that case.*"

31. Again, I accept that in very narrow terms, the point raised by the defendants in the American Patriot case was not precisely the same as the point taken here; but nor was it precisely the same as the point taken in *Stateco*. Bell J was not troubled with fine distinctions, which he considered immaterial, between the arguments raised in the two cases. He considered it obvious that a substantially similar point was being taken; namely, that for technical reasons, a payment made by Mutual Indemnity under the

Commutation did not qualify as a loss for the indemnity calculation formula contained in the equivalent of clause 3A in that case. Bell J went on to find as follows:

> "*297.This is also no doubt the appropriate place to deal with the argument made for the plaintiffs that the losses evidenced by the Commutation Agreement have not been established so as to fall within the definition of Mutual Indemnity's losses leading to the indemnification obligation under the Shareholder Agreement.*
>
> *298. As the defendants submitted, this was not an internal accounting transfer, it was an actual payment of cash which caused an actual underwriting loss. There was nothing in the Shareholder Agreement which suggests that a loss made under these circumstances should be excluded, and again the judgment of the Chief Justice in Mutual Holdings v Stateco appears to be on point. I do not think that the losses evidenced by the Commutation Agreement can be discounted as the plaintiffs have sought to do. I should add that I reject the contention that American Patriot/the Hendricks were adversely affected by the Commutation Agreement. The table produced by Mr. Alexander in his witness statement shows that for the fourth year of the Programme, the commuted losses were substantially below the AAP figures for which American Patriot/the Hendricks would otherwise have been liable.*"

32. I fully endorse and follow the above approach to construing the indemnity obligations of a preferred shareholder which was adopted by Bell J in construing a similar shareholder agreement in relation to the same IPC programme in the *American Patriot* case. The Court of Appeal for Bermuda affirmed that the intent of the Shareholder Agreement was to indemnify the Mutual companies for "*any losses that the Program had suffered*": *American Patriot Insurance Agency-v-Mutual Holdings (Bda) Limited* [2011] Bda LR 47. Evans JA at paragraph 11 described the agreement in the following terms:

> "*11.The I.P.C. Client also entered into a Shareholder's Agreement with one of the group's holding companies, in this case Mutual Holdings (Bermuda) Ltd. (hereinafter 'Holdings'). Under it, Holdings agreed to issue a single Preference Share to the I.P.C. Client and to pay dividends equivalent to the amount of any profit made by the reinsurer Mutual Indemnity on the Client's program, whilst the I.P.C. Client undertook to indemnify Holdings against the amount of any losses that the Program had suffered (taking account in both cases of investment income received by Holdings). The Shareholder's Agreement, therefore, provided mechanism for transferring any underwriting gain or loss made by Mutual Indemnity to the IPC Client, and for giving the I.P.C. Client the benefit of any investment income received."*

33. The commercial rationale of the programme in the latter case, as described by both Bell J and the Court of Appeal for Bermuda was described by Lord Sumption, delivering the advice of the Judicial Committee of the Privy Council (*Mutual Holding (Bda) Limited-v-American Patriot Insurance Agency* [2013]UKPC 13), as follows:

> "*The commercial idea of the scheme was that the MRM Group would assume no risk, all losses and profits being ultimately for the account of AMPAT or Mr and Mrs Hendricks save insofar as they were reinsured by third party*

reinsurers. The documentation more or less achieved that result, provided that the losses did not exceed the upper limit of the fourth layer. However, once the losses exhausted the whole reinsurance programme, they would rest with Legion and Villanova. This was because the indemnity obligations of AMPAT and the Hendricks were limited to the liabilities of Mutual Indemnity as reinsurers of Legion and Villanova..."

34. If the commercial purpose of clause 3A was to ensure that the preferred shareholder indemnified the Plaintiff for all losses suffered on the Programme, it makes no sense to construe the clause as not applying to payments actually made by Mutual Indemnity under the Commutation. Such a construction would be inconsistent with the plain terms of the contract. The exclusionary words of clause 3A (*provided however that the definition of incurred losses and loss expenses in paragraph 2(C) shall for this purpose only include losses and loss expenses which have been paid or are likely to be paid within the following ninety (90) days*) are only engaged in circumstances where the relevant loss figures relied upon to support a claim on the indemnity relate to amounts which Mutual Indemnity has <u>not</u> paid and/or is unlikely to pay within the next 90 days.

35. It is true that the contractual wording under consideration in the *American Patriot* case may have been somewhat different to clause 3A in the present case, so that in strict terms the arguments raised by the Defendant are not precisely the same as the defences advanced in that case and rejected in the *Stateco* case. But the present Defendant advances in substance the same argument in a different way, contending yet again that the clear words of an indemnity ought to be ignored to achieve a result which is commercially favourable to the Defendant, but inconsistent with the commercial object of the indemnity clause.

Conclusion

36. For the above reasons, the Plaintiff's claim is allowed in the amount of $165, 703, with interest and costs. The Defence and counterclaim are dismissed. I will hear counsel on the terms of the final Order required to give effect to the present Judgment and, in particular, the issues of interest and costs.

Dated this 25th day of June 2014 _____

IAN R.C.KAWALEY CJ