A "STORM WARNING" FOR THE REINSURANCE INDUSTRY

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Recent cases have highlighted the importance of the "storm warnings" doctrine in reinsurance and arbitration cases. This doctrine states that when a party receives "company-specific information" or "storm warnings" that it is being defrauded, it comes under a duty to inquire into the circumstances. When such a duty arises, the statute of limitations begins to run. Since this issue arises most frequently in cases involving fraud claims, for which the statute of limitations in most states is one year, it is especially important to note what kind of information might constitute a "storm warning." This article will address the key factors of the storm warnings doctrine and how it has been applied in reinsurance and arbitration cases.

I. The Genesis of the "Storm Warnings" Doctrine

The 1993 *Dodds v. Cigna Securities Inc.* decision began a series of storm warnings cases in the Second Circuit. Like most of its successors, *Dodds* was a federal securities case, subject to a "one-year-after-discovery / no-later-than-three years" statute of limitations. *Dodds v. Cigna Sec. Inc.*, 12 F.3d 346, 349 (2d Cir. 1993). Plaintiff alleged that defendant fraudulently induced her to purchase various securities unsuitable for her, and which she did not discover to be unsuitable until a meeting with her accountant. *Id.* at 348. The court found, however, that the limitations period was triggered earlier than plaintiff's meeting with her accountant, at the time she received prospectuses that warned of the risky nature of the ventures. *Id.* at 350-52. The information she received constituted "at least a 'storm warning' to a reasonable investor with conservative instincts sufficient to raise a duty to inquire further." *Id.* at 352. As a result of the triggering of the limitation period by the storm warning, her claims were held time-barred. *Id.*

Dodds, in announcing the storm warnings doctrine, drew on language in *Cook v. Avien Inc.*, 573 F.2d 685 (1st Cir. 1978), a securities case alleging fraudulent sale of notes. *Id.* at 690. The court found that "financial data available to the purchasers provided them with sufficient

storm warnings to alert a reasonable person to the possibility that there were either misleading statements or significant omissions involved in the sale of the notes." *Id.* at 697-98. Since the purchasers could not show that they then inquired with reasonable diligence, the storm warnings triggered the running of the statute of limitations. *Id.* at 698. The storm warnings doctrine has been recognized by the United States Supreme Court. *See Merck & Co. v. Reynolds*, 130 S.Ct. 1784 (2010).

II. The Elements of the "Storm Warnings" Doctrine

The storm warnings doctrine is stated fairly uniformly. The limitations period begins to run after the plaintiff "obtains actual knowledge of the facts giving rise to the action or notice of the facts, which in the exercise of reasonable diligence, would have led to actual knowledge." *Shah v. Meeker*, 435 F.3d 244, 249 (2d Cir. 2006). This constructive or inquiry notice of fraud is provided by "company-specific information probative of fraud," or "storm warnings." *In re Converium Holding AG Sec. Litig.*, 1:04-cv-07897-DLC, slip op. at 39-40 (S.D.N.Y. Dec.28, 2006). Such warnings, though, merely identify the time when the facts would have prompted a reasonably diligent plaintiff to begin investigating; the limitations period begins to run when a reasonably diligent plaintiff would have discovered the facts constituting the violation. *See Merck*, 130 S.Ct. at 1798.

Storm warnings, if found to exist, give rise to a duty of inquiry. *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 168 (2d Cir. 2005). The duty is placed upon the plaintiff if the circumstances would suggest to a person of ordinary intelligence the probability that she has been defrauded. *Id.* There must be a probability, not just a possibility, of wrongdoing in order for the duty to arise, and thus for the information to be considered a storm warning. *See Shah*, 435 F.3d at 249. Noteworthy is the governing standard of the "reasonable" investor of "ordinary intelligence." In *Dodds*, for example, it was unavailing for plaintiff to argue that her poor educational background meant she could not understand the storm warnings. *See Dodds*, 12 F.3d at 351. Regardless, when the duty has arisen, if the plaintiff still fails to inquire into the circumstances, knowledge of the fraud will be imputed to the plaintiff as of the day the duty arose. *Lentell*, 396 F.3d at 168. If the plaintiff does inquire, knowledge of what a reasonable

investor in the exercise of reasonable diligence should have discovered about the fraud will be imputed as of the date the inquiry should have revealed the fraud. *Id.* On the date knowledge is imputed, the limitations period begins to run. *Id.*

Further twists in the storm warnings doctrine exist. In many cases, the plaintiff will retort that storm warnings were negated by "reliable words of comfort from management." *LC Capital Partners v. Frontier Ins. Grp.*, 318 F.3d 148, 155 (2d Cir. 2003). It is not common for this argument to succeed, since the duty to inquire will only dissipate if an investor of ordinary intelligence would reasonably rely on the statements to allay the investor's concern. *Id.* Accordingly, "reassuring" statements that are "mere expressions of hope" about the viability of fraudulent conduct are not enough. *Id.* at 156. Additionally, financial information will only trigger a duty to inquire if it relates directly to the alleged misrepresentations and omissions. *In re Converium*, 1:04-cv-07897-DLC, slip op. at 40; *see also In re Complete Mgmt. Inc. Sec. Litig.*, 153 F. Supp. 2d 314, 337 (S.D.N.Y. Mar. 30, 2001) ("courts have generally found that a storm warning must *contradict* the allegedly false or misleading statement"). However, storm warnings need not detail every aspect of the fraudulent scheme; a totality of the circumstances test applies. *AXA Versicherung AG v. New Hampshire Ins. Co.*, No. 08-2521-cv, 2010 WL 3292927, at *3 (2d Cir. Aug. 23, 2010).

III. The "Storm Warnings" Doctrine in Reinsurance and Arbitration Cases

AXA Versicherung AG v. New Hampshire Ins. Co. involved a claim of fraudulent inducement with respect to two reinsurance facilities. AXA alleged that AIG misrepresented that it would treat the facilities as facultative obligatory, but administered them as purely facultative, and that AXA would not have entered into a purely facultative reinsurance contract. *Id.* at *2. As a result, AXA alleged, AIG was able to offload unacceptable risks onto the reinsurers. *Id.* AIG contended that there were storm warnings in the form of reinsurance contract wordings and other documents which formed a basis for a duty to inquire. The Court agreed with AIG, finding that storm warnings existed in the form of signed wordings which the Court found clearly indicated the manner in which AIG intended to operate the reinsurance facilities, contrary to the alleged misrepresentations. *Id.* at *3. Because these storm warnings made it so clear that the

facilities were being operated as facultative obligatory, it did not matter that AIG continued to misrepresent the nature of the operations; AXA could not reasonably rely on such words of comfort. *Id.* at *4.

AXA was not the first case where the nature of the reinsurance business was at the heart of a storm warnings debate. *In re MBIA Inc.* saw plaintiffs bring a securities fraud class action alleging that defendant improperly treated a series of transactions as reinsurance agreements, when in fact they were a loan, in order to defer recognition of a large loss. *In re MBIA Inc.*, No. 05 Civ. 03514 (LLS), 2007 WL 473708, at *1, *6 (S.D.N.Y. Feb. 14, 2007). Discussing when plaintiff had received inquiry notice, the Court stated that such notice could exist in "any financial, legal, or other data available to the plaintiffs," including articles published in the financial press. *Id.* at *6 (quotation marks and alterations omitted). In this case, press releases, news articles, and a report by a well-known hedge fund investor all put plaintiffs on notice of the probability of misrepresentation and deception. *Id.* at *7. Specifically, one report had explicitly stated that the transactions were not reinsurance, but rather a "loss-deferral, earnings-smoothing device." *Id.*

In the face of these clear warnings, plaintiffs faced an uphill battle to argue they had not received inquiry notice of fraud, but again, plaintiffs retorted that they were reassured by words of comfort from management. Specifically, they pointed to the company's denial of the allegations in the hedge fund investor report. *Id.* at *8. But the Court swept aside this objection, noting that defendant's response was a non-specific, blanket denial rather than a pinpointed retort. *Id.* Additionally, the press release issued by defendant was held too "vague and general" to really convince an investor that there was no wrongdoing. *Id.* The Court therefore held that plaintiffs were obligated to inquire further well before the limitations period began and the claims were dismissed as time barred. *Id.* at *9.

In re MBIA saw plaintiffs who could not argue that they were defrauded by a sham reinsurance arrangement because it had been made obvious by press releases and reports. In *Converium*, it was not the press releases but the reinsurer's transactional activity itself that provided storm warnings to plaintiffs. *See In re Converium*, 1:04-cv-07897-DLC, slip op. at 44. Plaintiffs were investors in an initial public offering of a reinsurance business which had been

suffering from inadequate loss reserves. *Id.* at 4. Both before and after the IPO, the under-reserving was disguised in a series of public statements and reserve adjustments that painted the company's problems as temporary and inherent to the insurance industry. *Id.* at 12-18. The company did not make any mention of a study by Deloitte revealing a $437 million reserve deficiency. *Id.* at 16.

Despite all this activity, the Court found that the large number of reserve-related charges over a short period of time – four increases in the tens of millions in one year alone, accounting for three quarters of the claimed reserve deficiency – put investors on notice that the company had systemic reserving problems. *Id.* at 42-44. By virtue of these storm warnings, plaintiffs' claims were time barred. *Id.* at 44. In a similar case, plaintiffs alleged that misrepresentation in the way the reinsurer reported its ceding commission income inflated the company's stock price. *Cross v. 21st Century Holding Co.*, No. 00 Civ. 4333 MBM, 2001 WL 34808272, at *1, *5 (S.D.N.Y. Aug. 6, 2001). Storm warnings were found to exist in a Form 10-QSB filed by the reinsurer that made clear that the company had previously misstated the manner in which ceding commission income was recognized. *Id.* at *5. In this case, as in *Converium*, plaintiffs could not effectively argue they had been defrauded since the reinsurer could not hide the nature of its reinsurance transactions and accounting. The claims were time barred in both cases.

Somewhat in contrast, *Compagnie de Reassurance d'ile de France v. New England Reinsurance Corp.* found no storm warnings where reinsurance treaties performed poorly. *See* 944 F. Supp. 986, 1006 n.30 (D. Mass. 1996). The Court disagreed that plaintiff reinsurers had a duty to inspect the ceding reinsurer's books, as was their right under the treaties, simply because the reinsurance treaties performed "disastrously from outset." *Id.* The Court noted that the treaties performed better than the market as a whole in an environment in which the entire insurance industry was suffering disastrous losses. *Id.* In such a volatile atmosphere, therefore, there could be no storm warnings of internal fraud since it would be reasonable to assume that the treaties were suffering losses due to external pressures. *Id.* Unlike cases which have found that storm warnings did exist, there were no allegations here of contemporaneous written documents that contradicted the basis of the later litigation claim.

Arbitration cases may also offer an atmosphere in which storm warnings may arise. In two cases, the arbitration itself functioned as a storm warning. In *J. Geils Band Employee Benefit Plan v. Smith Barney Shearson, Inc.*, a fraud claim in an ERISA context, the Court found that numerous storm warnings should have alerted plaintiffs to a discrepancy in bond swap figures, and added that documents produced during arbitration proceedings were "yet more dark clouds on the horizon" that should have alerted plaintiffs' attention. 76 F.3d 1245, 1260 (1st Cir. 1996). In another securities fraud suit, the Court found that plaintiffs should have discovered the scheme to defraud based on an arbitration proceeding commenced by a non-party, in which strong allegations of the scheme were laid bare. *In re Sterling Foster & Co. Sec. Litig.*, 222 F. Supp. 2d 216, 254 (E.D.N.Y. 2002). These cases suggest that arbitration proceedings often put plaintiffs on inquiry notice prior to or during the course of litigation.

IV. Conclusion

Storm warnings may be found in a variety of ways in reinsurance and arbitration cases, including press releases and articles, reports by independent consultants, the reinsurance contracts or transactions themselves, or information exposed during an arbitration. Parties to reinsurance agreements should be alert to inconsistencies in information that come to their attention about the agreements or the underlying business transactions, processes or data, and if any information is received which raises questions as to the accuracy of prior material representations, it may be prudent to err on the side of inquiring about such differences. Failing to do so may result in the loss of an opportunity to avoid a larger problem or in the unforeseen running of a statute of limitation period.

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