

# REINSURANCE ISSUES FROM THE GROUND UP

Michael Blair

Robert Giuliano

Barbara Murray &

Michael Bolechowski

# Disclaimer

- Opinions and comments are for educational purposes only and are designed and stated as such and they are not necessarily those of the speaker or the company that employs them

# Outline of Presentation

- Because of time limitations we will skip over many of the basics but we will discuss the essential reinsurance relationship and try to pass on our collective experience on how to make it work

# The Basics -- The Arrangement

- Reinsurance is best conceptualized as "insurance of insurance companies."
- Stated another way, the insurance of one insurer by another by means of which the reinsured is indemnified for loss under insurance policies issued by the reinsured to the public.

# Reinsurance Plans

- In addition to these basic concepts, reinsurance involves various plans and underwriting methods.

# Proportional Plans

- Quota share/co-insurance. Under this type of plan the loss or risk is shared proportionately.
- Surplus share. The face amount of the policy or the policy limit depending on the type of insurance is shared on a quota basis.

# Non-Proportional Plans

- Stop Loss/Excess Loss. The reinsurer on a particular loss pays an amount above the attachment point.
- Stop Loss Aggregate. An aggregate attachment point is defined and the reinsurer pays the claims over that amount.
- Loss Trigger/Franchise. If losses exceed the trigger point which is set, the insurer pays all claims down to a particular amount.
- Horizontal Excess of Loss. This plan contemplates the adding of additional reinsurers.

# There Are Two Types Of Reinsurance Contracts:

- Treaty Reinsurance
  - Under The Pure Treaty Contract, The Reinsured Cedes A Block Of Business On An Ongoing Basis To The Reinsurer.
  
- Facultative Reinsurance
  - This Type Of Reinsurance Deals With A Specified Risk Insured By A Particular Policy Or Group Of Policies. The Reinsurer Individually Underwrites The Specific Risk

# Industry Usage

- In addition, a principle that appears to be unique to the interpretation of reinsurance arrangement is that the courts, in interpreting the arrangement, will look to industry usage and practices and all communications and documentation utilized by the cedant and reinsurer. Specifically the courts will look to the course of dealing between the parties.

# Utmost Good Faith... *uberrimae fidei*

A reinsurer may face bad faith exposure if, for example:

- (1) The reinsurer refuses to acknowledge the existence of its own reinsurance contract. *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.* (D. Mass. 1998).
- (2) The reinsurer repeatedly asks the same questions, even though it has already received sufficient responses. *Stonewall Ins. Co. v. Argonaut Ins. Co.* (N.D. Ill. 1999) Reinsurer violated utmost duty of good faith by asking unreasonable questions about underlying settlement and feigning an inability to understand the settlement.
- (3) The reinsurer declines to satisfy acknowledged or apparent obligations as leverage for commutation or as a means to renegotiate its bargain. *Seven Provinces*, 217 F.3d at 42.

# Utmost Good Faith

May cedents act in bad faith?

- The duty of utmost good faith (*uberrimae fidei*) is reciprocal. *Stonewall Ins. Co.*, 75 F. Supp.2d at 895.
  - Cedents must disclose all material facts to reinsurers. *E.g. Compagnie De Reassurance D'ile De France v. New England Reins. Corp.*, 57 F.3d 56, 72-73 (1<sup>st</sup> Cir. 1995).
  - Cedents must provide appropriate information to reinsurers. *E.g. Michigan Nat'l Bank-Oakland v. Am. Ins. Co.*, 651 N.Y.S.2d 383, 389 (1996) (failure of cedent to disclose its insolvency justified rescission of reinsurance treaty).
  - Cedents must avoid putting their own interests above the reinsurers' interests. *E.g. Hartford Accident & Indem. Co. v. Columbia Cas. Co.*, 98 F. Supp.2d 251 (D. Conn. 2000) (drawing inference regarding self-service where cedent allocated entire multi-site loss to only one site, thereby maximizing its reinsurance recovery); *Independence Ins. Co. v. Republic Ins. Co.*, 447 S.W.2d 462, 469-70 (Tex. App. 1969) (cedent engaged in bad faith by paying an uncovered claim, where its president and general counsel had a financial stake in claim).

# Obligations Of Reinsurer To Reinsured

- Generally, the obligations of reinsurer are defined and governed by the reinsurance arrangement. Specifically, the reinsurance arrangement is one of indemnity and the reinsurer owes nothing to the reinsured until the claim has been paid.

# Obligations Of Reinsured To Reinsurer

## ■ Notice of Claim

- Most reinsurance arrangements require that the reinsured provide the reinsurer with prompt notice. The courts have not precisely defined what is considered prompt notice and what should trigger the notice. The courts have indicated that the timeliness of the notice is judged by an objective standard and that custom and usage in the reinsurance industry judge the nature and reasonableness of the notice.

# Underwriting And Claims Handling

- It is consistently recognized that the cedant must exhibit competent underwriting and claims handling and specifically that it must act “honestly and [has] taken all proper and businesslike steps” in investigating and resolving the claims. It appears most courts require more than the mere negligence in the handling of a claim in order for the reinsurer to rescind the agreement. For example, the Third Circuit Court of Appeals requires that the “misadjustment” be as a result of gross negligence or reckless conduct.

# Following Fortunes

- Doctrine insulates cedents. Reinsurers bear a “very heavy burden” to show bad faith in order to defeat application of the “follow” doctrine. *Travelers Cas. & Sur. Co. v. Gerling Global Reins. Corp. of America*, 419 F.3d 181, 193 (2<sup>nd</sup> Cir. 2005).

# Following Fortunes ... Not Misfortunes

- The follow the fortunes clause does not rewrite the terms of the arrangement. The majority of courts have supported such a conclusion. *See Am. Ins. Co. v. N. Am. Co. for Prop. & Cas. Ins.*, 697 F.2d 79 (2d Cir. 1982)... holding that despite a follow the fortune clause, the reinsurer is only liable for a loss of the kind reinsured.

# Following Fortunes

- ... "encompasses settlements that are arguably beyond the strict limits of the cedent's underlying policies". Cedent's interpretation of liability must be reasonable and in good faith, the reinsurer cannot second guess. *Commercial Union v Swiss Re* 431 F. 3<sup>rd</sup> (1st Cir. 2005).

# Following Fortunes

- Ceding company is not required to select an allocation that minimizes reinsurance recovery...post settlement allocation is subject to “follow the fortunes” regardless of pre-settlement allocation. *Travelers v Gerling Global* 419E.3<sup>rd</sup> 181 (2<sup>nd</sup> Cir. 2005).

# Following Fortunes

- Focus on coverage determinations and compromises, what was the exposure?
- Criticizing the evaluation of exposure can be viewed as second guessing.
- Reinsurer must prove
  - Unreasonableness
  - Fraud/Bad Faith

# Following Fortunes

- Reinsured may fall short too
  - Inconsistent allocation and settlement negotiations
  - Insured's negotiating position and final allocation
  - Actual settlement and final allocation

# Following Form

- Closely related to a follow the fortune clause. It generally provides:

“concurrency between the policy of reinsurance and the reinsured policy is presumed, such that a policy of reinsurance will be construed as offering the same terms, conditions and scope of coverage as exists in the reinsured policy. That is, it exists in the absence of explicit language in the policy of reinsurance to the contrary.”

# Following Settlements

- “. . . requires the reinsurer to cover the settlement made by the reinsured, as long as the settlement is reasonable, and the settlement is not fraudulent, collusive or made in bad faith.”

*Stonewall Ins. Co. v. Argonaut Ins. Co.*, 75 F. Supp.2d 893 (N.D. Ill. 1999).

- The doctrine does not override the specific terms of the reinsurance contract.

*Travelers Cas. And Sur. Co. v. Certain Underwriters at Lloyd's of London*, 734 N.Y.S.2d 531, 540 (Ct. App. 2001).

# Reinsurance Disputes

- Payment of Premium
- Aggregation of Losses
- Allocation over multiple years/layers
- Occurrences
- DJ Expenses

# Reinsurance Disputes

- Exclusions and Warranties
- Access to books and records
- Production of reinsurance documents
- Notice and the right to associate

# Reinsurance Disputes

- Understand the loss, contract, issue and financial risk.
- Know your witnesses.
- Pick up the phone!
- Regular Bad Debt Analysis.
- Manage the process, do not let the process manage you.

# Claims Reviews

- How are claims selected?
- Why are they conducted?
- What information do companies want to gather in regards to staffing, volume, case count & company procedures?

# Claims Reviews...

- Reserving philosophy & procedures
- File quality & content
- Internal reporting & diary system
- Litigation/settlement approach
- Unique coverage positions
- Reinsurance reporting

# Routine Access

- Reinsurers routinely obtain access to their cedent's files, including material that would be privileged as against the cedent's policyholder.

*Commercial Union Ins. Co. v. Swiss Reinsurance America Corp.*, 2003 WL 1786863 (D. Mass. March 31, 2003).

- Disputes often arise between insurers and their reinsurers over the type and scope of claim information insurers are required to provide their reinsurers.
- Issues arise mainly regarding privileged communications between insurer and its coverage counsel regarding the insurer's exposure to claims against its policyholder under its contracts.

# Access To Records v. Privilege

- Insurer Incentives:
  - Full disclosure to get reinsurance claim paid quickly;
  - Do not create documents that could undermine coverage position.
  
- Reinsurer Incentives:
  - Reimburse ceding insurer for amounts properly payable under reinsured contracts.

# Access To Records v. Privilege

- Reinsurance contracts usually contain an Access to Records clause which typically provides access to all records pertaining to a reinsurance contract at issue:

“The Reinsurers may at all reasonable times inspect by their agents or any other authorized person at the Home Office of the Company the books, accounts and all documents referring to the business under this Agreement or concerning the subject matter hereof”.

# Access To Records v. Privilege

- Duty of Utmost Good Faith
  - Possession of information in reinsurance relationship is one-sided with cedent possessing virtually all relevant information, and the reinsurers almost completely dependent on cedent to share information. Courts can enforce cedent's duty of utmost good faith to require full disclosure of information.

# Access To Records v. Privilege

- Common Interest Doctrine
  - The disclosure of privileged material to a third party will not result in a waiver if the parties share a common interest in the case.
  - The determinate is whether the parties demonstrate actual cooperation toward a legal goal.

# Access To Records v. Privilege

- Common Interest Doctrine
  - Reinsurance contracts. The common interest doctrine does not automatically waive the insurer's attorney-client or work product privileges. Party asserting privilege has the burden of proving each element of the privilege claimed.
  - No waiver of the attorney-client privilege when documents are shared with third parties having a "community of interest."

# Aggregation

- Difference of policy language versus reinsurance contract
- Batch clauses
- Products versus non-products
- Single year versus multi-year policies
- Loss versus expense
- Toxic waste sites
- Premises claims

# Occurrence-overview

- Occurrence
- How determined
- Number of occurrences
- Multiple sites

# Occurrence...continued

- How disputes arise
- Trigger of coverage issues
- Policy wording and how wording may impact what may be considered an "occurrence"

# Occurrence...continued

- Limits of coverage
- Policy aggregates—product/premises
- Remuneration issues...Dana Case in Indiana in 2001 and Mass Electric Case in 2002
- Batch Clauses
- Anti-Stacking Issues...deemer and non-cumulation clauses...Spaulding in NJ and Hiraldo in NY

# Occurrence...continued

- Annualization—multi year policies
- Combined single limit policies
- External factors impacting occurrence decisions
- Legal tests for counting occurrences
  - Cause
  - Effect
  - events

# Allocation

- Declaratory Judgment expenses
- Settlements of both toxic waste & asbestos claims
- Single year versus multiple year policies
- Signatory versus non-signatory payments
- Settlements into trusts & escrow accounts

# Allocation--continued

- Trigger Theories
- Start/stop Dates
  - Asbestos, environmental & mass tort
- Responsibility for Orphan Shares
  - Insurer insolvency
  - Uninsured years, coverage limitations & Exclusions
  - Choosing to go bare

# Allocation--continued

- SIR's
  - General Rule
  - Issues of proration
- Deductibles
- Availability of Insurance
- Inadequate Insurance

# Dispute Resolution

- Compromise between parties
- Arbitration versus litigation
- Treaty versus facultative
- Mediation

# Dispute Resolution-- continued

- Communication is Key
- Do Your Homework
- Read your Treaty
- Know Your Underwriter
- Know what files are available

**THE END**