ABA-TIPS Insurance Coverage Litigation Committee
Mid-Year Meeting ▪ Phoenix, Arizona ▪ February 2010

Claims for ECO/XPL and (Re)Insurability of Punitive Damages

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Introduction

Insurance companies often face litigation brought by policyholders alleging bad faith and seeking punitive damages due to perceived misconduct in handling policyholder claims. Hurricane Katrina and other recent events have demonstrated the danger that insurers and reinsurers face in this regard, and they highlight the need for parties to closely examine their contracts to determine whether a reinsurer is bound to reimburse its cedent for claims that may fall outside the confines of the underlying policy's coverage or that may exceed an underlying policy's limits. This paper provides an overview of the reinsurability of those types of claims.

ECO and XPL Basics

Reinsurance claims that fall outside of the confines of an underlying policy's coverage are commonly referred to as "extracontractual obligations," ECO for short. The reinsurance industry defines ECO as:

> Monetary awards required by a court of law against an insurer for its negligence to its insured. Such payments required of an insurer to its insured are extracontractual in that they are beyond the insurance contract . . . . A reinsurance treaty may cover these damages and, if so, will specify covered situations, percentages applicable, and required premium charges.

Reinsurance 762-63 (Robert W. Strain ed., rev. ed. 1997). ECO claims are claims brought by the underlying insured against its insurance carrier, seeking damages arising out of the insurer's alleged faulty handling or defense of a claim. One distinguishing characteristic of an ECO claim is that it falls *outside* of the coverage provided by the underlying insurance policy. An example of an ECO claim is a punitive damages award assessed against an insurance company based on the insurer's bad faith failure to pay its insured in a timely fashion.

Claims that are in excess of an underlying policy's limits are referred to as XPL claims, defined as:

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> A loss sustained by a reinsured company when required by a court to pay an amount of loss in excess of the policy's limit (which loss would have been included in the policy's coverage if the policy limit were higher) and resulting from an error or omission by the reinsured company in defending its policyholder, thereby exposing the policyholder to a loss in excess of the policy limit.

Id. at 773. While an XPL claim also pertains to the faulty handling or defense of an insurance claim, XPL claims differ from ECO claims in that they are claims brought against the insured by a third party. Additionally, XPL claims are claims that would be covered by the underlying policy *but for* the policy limits. An example might be where the insured is required to pay an award in favor of a third party in excess of the policy limit after the insurer wrongfully failed to accept a settlement offer with the third party within the limit (regardless of whether the award consisted of compensatory damages, interest, or punitive damages).

The similarities and differences between ECO and XPL claims can be summarized as follows:

	ECO	**XPL**
Allegations by the Plaintiff	Faulty handling or defense of a claim	Faulty handling or defense of a claim
Judgment	Against the cedent by the original insured	Against the insured by a third party
Relationship to Policy Limits	No relationship to policy limits	In excess of the primary insurer's policy limits
Coverage for the Original Claim	Outside the coverage of the original policy	Covered under the original policy

The question for reinsurers and cedents alike is whether reinsurance is available to cover ECO or XPL claims. As will be discussed below, the answer to that question depends on a number of factors, including but not limited to whether the reinsurance contract contains specific clauses providing for such coverage, if a separate E&O policy exists that provides similar coverage, to what extent the reinsurer was involved in the claims handling and/or is required to follow the cedent's fortunes, and whether state laws on the insurability of punitive damages are applicable.

ECO & XPL Clauses

<u>*Relevant Case Law*</u>

Generally speaking, a reinsurer's liability to its cedent is determined by the parameters of the reinsurance contract entered into by the parties. Thus, it is often the case that unless the reinsurance contract provides for ECO/XPL coverage, a reinsurer will not be required to reimburse a cedent for such claims. (This is important, as many older reinsurance contracts do not contain provisions that specifically provide coverage for ECO or XPL claims.) However, this is not always the case – in the absence of a specific clause, a court or arbitration panel may still find the reinsurer liable for ECO/XPL claims. For example, in the case of *Peerless Ins. Co. v. Inland Mut. Ins. Co.*, 251 F.2d 696 (4th Cir. 1958), the U.S. Court of Appeals for the Fourth Circuit required a reinsurer to share in an excess of policy limits judgment even though the contract did not expressly provide such coverage. The judgment was based on the cedent's bad faith failure to settle a motor vehicle liability action within its policy limits. Even though the reinsurance agreement did not specifically provide for XPL coverage, the court found that the reinsurer was liable for those losses. Particularly relevant to the court's decision was the fact that the reinsurer had been actively involved in the handling of the claim and expressly left the defense and settlement of the claim in the cedent's discretion. The court also noted that the reinsurer stood to benefit if the below-limits settlement offer was accepted, and that the reinsurer was bound to follow the cedent's fortunes.

On the other hand, other courts have determined that ECO/XPL coverage only exists to the extent the reinsurance contract explicitly provides for that coverage. For example, in *Employers Reinsurance Corp. v. American Fidelity & Cas. Co.*, 196 F. Supp. 553 (W.D. Mo. 1959), the question before the court was whether Employers Re was liable for amounts American paid to its insured in excess of the primary policy's limits – due to American's "bad faith" failure to settle the claim within the primary policy's limits. The court determined that the reinsurer was not liable for the XPL claim because the reinsurance contract between the parties did not specifically provide for XPL coverage. The court also distinguished this case from *Peerless*, noting that there was no follow the fortunes clause (as there had been in *Peerless*) and that the reinsurer was not involved in the underlying claim (as was the case in *Peerless*).

The notion that a reinsurer is not liable for ECO/XPL liabilities unless the contract specifically provides for that coverage also finds support in the case of *Pringle v. Standard Life & Accident Ins. Co.*, 391 N.E.2d 677 (Ind. Ct. App. 1979). *Pringle* involved the assumption of a book of business from a company in receivership pursuant to a court-approved reinsurance contract, which specifically excluded ECO and XPL. An insured of the company in receivership brought an ECO claim against the reinsurer. The court rejected that claim, stating that any extracontractual liability that was not expressly assumed by the reinsurer remained with the cedent. Similarly, in *Reliance Ins. Co. v. General Reinsurance Corp.*, 506 F. Supp. 1042 (E.D. Pa. 1980), a Pennsylvania federal court determined that a cedent's payment to a policyholder represented a compromise of a punitive damages judgment arising from the intentional acts of the insurer's representatives (rather than payment for compensatory damages). Because coverage for punitive damages was not specifically mentioned in the underlying policies or the reinsurance contract, reinsurance coverage was unavailable to the cedent. *Id.* at 1050. *See also American Ins. Co. v. North Am. Co. for Property & Cas. Ins.*, 697 F.2d 79 (2d Cir. 1982) (where insurer's settlement was primarily designed to compensate insured for a punitive damage award that was not covered by the underlying policy or reinsurance contract, reinsurer was not liable for damages even though the contract contained a follow the fortunes clause). Thus, while the follow the fortunes doctrine or the reinsurer's involvement in the underlying claim may have some bearing on the issue of coverage for ECO/XPL claims, the contract language is of great significance.[2]

ECO/XPL Clauses

ECO and XPL clauses are fairly new developments. The XPL clause dates back to the 1940s and became more widespread through the 1970s, at which point the XPL clause was revised and a new ECO clause was created. *See generally* John F. Langen, *Special Clauses & Endorsements*, *in Reinsurance Contract Wording* 582, 586-95 (Robert W. Strain ed., 3d ed. 1998); Robert W. Hammesfahr & Scott W. Wright, *The Law of Reinsurance Claims* 228-29 (2d ed. 1998). One purpose of these clauses was to permit cedents to aggressively handle claims without worrying about their reinsurance. In other words, if reinsurance coverage was not expressly provided by way of an ECO or XPL clause, a cedent might be tempted to settle a claim within the policy limits even if that claim might be defensible. Indeed, because the reinsurer would reap the reward of a cedent contesting a claim and reducing the ultimate loss, it made sense to have the reinsurer share in the risk of the cedent's claims-handling actions and contribute to any losses that might result.

Today, ECO and XPL clauses come in many forms and sizes – from simple, short provisions to quite lengthy and detailed clauses.[3] While the clauses used by reinsurers and cedents will vary, certain key elements are typically present in all of them. *One*, these clauses will explain that reinsurance coverage for ECO and/or XPL liabilities is provided to a certain degree:

> This Contract shall protect the Company, within the limits hereof, in connection with ultimate net loss in excess of the limit of its original policy . . . . (BRMA 15A)
>
> This Contract shall protect the Company within the limits hereof, where the ultimate net loss includes any Extra Contractual Obligations. (BRMA 16A)

Two, these clauses will define what losses are covered, and may in fact provide examples of specific claims that are covered:

> [S]uch loss in excess of the limit having been incurred because of failure by it to settle within the policy limit or by reason of alleged or actual negligence, fraud, or bad faith in rejecting an offer of settlement or in the preparation of the defense or

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2 *Cf. Reid v. Ruffin*, 469 A.2d 1030, 1034 (Pa. 1983) ("The reinsurer's only obligations are toward the reinsured/original insurer and arise out of their contract."); *Aetna Cas. & Surety Co. v. Philadelphia Reinsurance Corp.*, No. 94-2683, 1995 U.S. Dist. LEXIS 7742 (E.D. Pa. June 6, 1995) (noting that a follow the fortunes clause does not make a reinsurer liable for risks beyond what was agreed upon in the reinsurance contract).

3 Attached are examples of clauses drafted by the Brokers & Reinsurance Markets Association ("BRMA").

> in the trial of any action against its insured or reinsured or in the preparation or prosecution of an appeal consequent upon such action. (BRMA 15A)
>
> The term "Extra Contractual Obligations" is defined as those liabilities not covered under any other provision of this Contract and which arise from the handling of any claim on business covered hereunder, such liabilities arising because of, but not limited to, the following: failure by the Company to settle within the policy limit, or by reason of alleged or actual negligence, fraud, or bad faith in rejecting an offer of settlement or in the preparation of the defense or in the trial of any action against its insured or reinsured or in the preparation or prosecution of an appeal consequent upon such action. (BRMA 16A)

Three, most clauses will contain a fraud exception:

> However, this Article shall not apply where the loss has been incurred due to fraud by a member of the Board of Directors or a corporate officer of the Company acting individually or collectively or in collusion with any individual or corporation or any other organization or party involved in the presentation, defense or settlement of any claim covered hereunder. (BRMA 15A; BRMA 16A)

More recent clauses may also address other specific issues, such as establishing the date of loss for purposes of the ECO/XPL coverage, requiring the cedent to abide by "counsel and concur" language,[4] providing for separate limits of liability for purposes of the ECO/XPL coverage, etc. The more specific and accurate parties can be in drafting language for the ECO/XPL clause, the greater guidance they will have when an ECO/XPL situation arises. The presence of a specific ECO or XPL clause, however, may not always resolve the issue. That is, as with any contract, the clauses in question cannot address every conceivable situation.

<u>*Other Relevant Issues*</u>

Other issues may factor into whether there is reinsurance coverage for ECO/XPL liabilities. For example, one situation that parties may face is whether and to what extent an ECO clause in a reinsurance contract provides coverage if there is also a separate errors & omissions (E&O) policy available providing coverage for the same loss. If an E&O policy is also applicable, reinsurers may argue that the E&O policy should provide coverage first, before the ECO clause can be triggered. Most commentators that have addressed this issue have concluded that absent specific priority language in the reinsurance contract, E&O protection will apply before the more general ECO coverage. *See*, *e.g.*, Richard M. Shaw, *Casualty Excess of*

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[4] *See*, *e.g.*, *Ruffin*, 469 A.2d 1030 (advice and consent provision in reinsurance contract did not establish that reinsurer had sufficient control over the cedent's settlement decisions to support a direct action by the original insured against the reinsurer for failure to settle a claim within the policy limits); *Employers Reinsurance Corp. v. Mid-Continent Cas. Co.*, 358 F.3d 757, 773-74 (10th Cir. 2004) (generally discussing counsel and concur language in a reinsurance clause providing coverage for punitive damages).

Loss, *in Reinsurance Contract Wording* 270, 342-43 (Robert W. Strain ed. 3d ed. 1998) ("[T]he priority of application of the separate E&O coverages must be provided. The more typical approach is to require the coverage to apply before the application of the ECO or XPL coverage."); BRMA White Paper, *Treatment of ECO and XPL Exposures*, at 6, *in* Journal of Reinsurance (Spring 2001) ("the rule-of-thumb or typical approach is that E&O protection applies before the more general ECO coverage"). More recent reinsurance contracts may contain specific provisions addressing this,[5] and the applicable E&O policy may also address this issue.[6] Thus, close review of the reinsurance contract as well as the E&O policy should be undertaken if this situation arises.

Additionally, non-contractual issues may bear on the issue, particularly if the reinsurance contract is silent as to ECO/XPL liability, given that most reinsurance disputes are resolved in arbitration, not litigation. Indeed, the arbitration clause in a reinsurance contract will often explain that the arbitrators are not bound by strict rules of law, should view the contract as not merely a legal obligation, and should give effect to the general purpose of the contract in making their award. Accordingly, arbitrators may consider the reinsurer's involvement in the handling of the claim at issue, as the *Peerless* court did. In this regard, both parties should consider: did the reinsurer know what was going on with the underlying claim and the cedent's handling of that claim, did the reinsurer have a chance to get involved in the claims handling, did the reinsurer acquiesce to the cedent's claims handling, and did the reinsurer itself become actively involved in the claims handling.[7] The *Peerless* case is also instructive in demonstrating how important a follow the fortunes clause may be in determining a reinsurer's liability. Similarly, any documentation that provides evidence of the parties' intent when they negotiated and entered into the reinsurance contract could be important, as could any evidence regarding the parties' course of dealing throughout their relationship. Moreover, in a situation where the cedent settles a case involving bad faith claims handling allegations, the parties should consider whether and to what extent the settlement amount can be allocated solely to the bad faith allegations. Reinsurers will also need to consider how the resolution of an ECO/XPL dispute might impact their retrocessional recoveries.

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[5] A simple example of an ECO clause that also addresses the priority of E&O coverage can be found in Strain's *Reinsurance Contract Wording* treatise: "Coverage hereunder of any Extra Contractual Obligations [or Losses in Excess of Policy Limits] shall apply excess of any Errors and Omissions insurance purchased by the Reinsured that provides coverage for that loss, whether recovered or not." Michael Hollenbach, *Surplus Share*, *in Reinsurance Contract Wording* 140, 192 (Robert W. Strain ed., 3d ed. 1998).

[6] For example, the E&O policy may contain an other insurance clause requiring "other policies" to pay out before the E&O policy, but also specifically state that these "other policies" do not include reinsurance ECO/XPL coverage.

[7] This inquiry may also raise questions about any claims cooperation and access to records clauses in the reinsurance contract, as well as privilege issues.

State Laws re: Insurability of Punitive Damages

Parties to a reinsurance contract may also need to address whether state law has any bearing on the reinsurance recoverability of ECO claims. In particular, parties to a reinsurance contract may dispute the applicability of state laws on the insurability of punitive damage awards.

A number of states prohibit insurance of punitive damage awards as a matter of public policy. An example of this is California, which prohibits insurance coverage of directly assessed punitive damages. *See* Cal. Ins. Code. § 533 ("An insurer is not liable for a loss caused by the wilful act of the insured; but he is not exonerated by the negligence of the insured, or of the insured's agents or others.").[8] This is because punitive damages are designed to be *extraordinary* remedies, reserved for intentional and/or willful bad conduct. In other words, punitive damages are meant to punish a wrongdoer. The California Supreme Court explained the rationale for this rule as follows:

> [A]n insured may not shift to its insurance company, and ultimately to the public, the payment of punitive damages awarded in the third party lawsuit against the insured as a result of the insured's intentional, morally blameworthy behavior against the third party. To allow such recovery would (1) violate the public policy against permitting liability for intentional wrongdoing to be offset or reduced by the negligence of another; (2) defeat the purposes of punitive damages which are to punish and deter the wrongdoer; and (3) violate the public policy against indemnification for punitive damages.

PPG Indus., Inc. v. Transamerica Ins. Co., 975 P.2d 652, 658 (Cal. 1999). Thus, courts in these states will not enforce contracts obligating an insurer to pay punitive damages awarded against the insured. The question for parties to a reinsurance contract, then, is this: if a cedent is faced with a punitive damages award based on its alleged wrongful conduct toward its insured, can it obtain reinsurance coverage for that award in a state that has a policy against insuring punitive damages?

In states where this policy exists, a reinsurer may try to argue that the state's public policy prevents the insurer from obtaining reinsurance coverage for a punitive damages award. In turn, a cedent may respond that the state rule is not all-encompassing. For example, many of the states that prohibit insuring punitive damages will allow insurance coverage for damages that are assessed against a company for vicarious liability. In a case of vicarious liability, a company only has indirect responsibility for the wrongful conduct – the quintessential example being where an employer is held vicariously liable for its employee's actions. *See, e.g., Arenson v. National Auto. & Cas. Ins. Co.*, 286 P.2d 816, 818 (Cal. 1955) (general rule that an insurance

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[8] *See also*, *e.g.*, *Public Serv. Mut. Ins. Co. v. Goldfarb*, 425 N.E.2d 810 (N.Y. 1981) (New York prohibition against insuring punitive damage awards). A 2008 chart summarizing state laws on the insurability of punitive damages can be found on Munich Re America's website: http://www.munichreamerica.com/content/rl/postjudgment.pdf.

policy indemnifying an insured against liability due to his own willful wrong is void as against public policy has no application to a situation where the plaintiff is not personally at fault). Similarly, other states only prohibit the insurance of punitive damages when the punitive damages result from intentional acts. *See* Michael Hollenbach, *Property Per Risk Excess of Loss Reinsurance*, *in Reinsurance* 78, 104 (Robert W. Strain ed., rev. ed. 1997).

Moreover, the reinsurer likely will have to demonstrate that the state law or public policy at issue is applicable to reinsurance – or, put another way, that the ECO coverage provided in the reinsurance contract is in fact insurance, not reinsurance. At least one court deciding an XPL issue has lent support to this notion. In *Ott v. All-Star Ins. Co.*, 299 N.W.2d 839 (Wisc. 1981), an injured third party tried to institute a direct action against the reinsurer under applicable state law. Because the state law permitted direct "insurance" actions, the reinsurer tried to argue that the XPL clause was not insurance (but rather reinsurance) and therefore the reinsurer could not be sued directly. The court, however, determined that XPL coverage is direct insurance (because the cedent's liability for failure to settle was not a proper subject for reinsurance) and was independent of the reinsurance relationship.

The New York State Insurance Department has also addressed this issue. In 2005, the Department's Office of General Counsel issued an opinion stating that the Department had no objection to a New York authorized reinsurer providing reinsurance coverage to a non-New York insurer in relation to an underlying policy that provides punitive damages coverage, when the policy is issued and delivered in a jurisdiction that permits punitive damages to be insured. State of New York Insurance Department, Office of General Counsel opinion, "Reinsurance of Punitive Damage Coverage," dated December 21, 2005. But the opinion went on to explicitly state:

> It should be emphasized that this opinion does not apply to extra-contractual obligations, under which a reinsurer provides coverage to a ceding insurer for the ceding insurer's liabilities arising from its handling of a claim under the underlying policy, including, but not limited to, liabilities arising from the failure of the ceding insurer to settle claims with in the policy limits, and alleged or actual negligence, fraud, or bad faith in rejecting an offer of settlement or in the preparation of the defense or in the trial of any action. As previously enunciated in our November 18, 2002[9] and earlier opinions, an insurer may not provide extra-contractual coverage for fraud, bad faith and punitive damages in New York.

Nevertheless, it may be difficult (particularly before an arbitration panel of reinsurance professionals) to convincingly demonstrate that an ECO clause in a reinsurance agreement is not

[9] *See* State of New York Insurance Department, Office of General Counsel opinion, "Extra-contractual obligations and reinsurance contracts," dated November 18, 2002 (noting that per N.Y. Ins. Law § 1102(b), a New York domestic reinsurer cannot issue a reinsurance agreement that may include indemnification of a cedent's extra contractual obligations, whether the risk insured against is located within New York State or outside New York, unless the reinsurance agreement contains a savings clause stating "in no event shall coverage be provided to the extent that such coverage is not permitted under New York law").

reinsurance. A more recent case illustrates this point. *Hartford Fire Ins. v. Lloyd's Syndicate*, No. 3:97CV00009 (AVC), 1997 U.S. Dist. LEXIS 10858 (D. Conn. July 2, 1997) pertains to a dispute over the confirmation of an arbitration award. In the case, the parties were fighting over reinsurance contracts that contained ECO clauses. After Hartford, the cedent, was levied with a punitive damages award arising out of its handling of two policyholder claims, its reinsurers refused to provide reinsurance coverage. The dispute was arbitrated, and the panel ultimately required the reinsurers to indemnify Hartford for the punitive damage losses (over $400,000). On cross-motions to confirm and vacate the award, the court upheld the arbitration award.

In requesting the award be vacated, the reinsurers asserted that insuring punitive damages was against the public policy of Connecticut (the arbitral forum). Thus, they argued that the award should be vacated under the standards set forth in the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 9 U.S.C. § 201 *et seq.* ("Convention"), which provides for vacatur when "the recognition or enforcement of the award would be contrary to the public policy of that country." Convention, Article (2)(b). The court, however, rejected this argument, noting that in this international context a particular state's public policy is irrelevant – one must look to national public policy. And because the court determined that there was no U.S. national public policy (i.e., consensus) against insuring punitive damages, the award should be confirmed. The court also noted that due to the honorable engagements clause in the reinsurance contracts, it was relieved from following strict rules of law.

Thus, when faced with a claim for reinsurance coverage for a punitive damages award, the parties must address, at a minimum: (1) which state law applies,[10] (2) whether that state prohibits the insurability of punitive damages as a matter of public policy and under what circumstances, (3) whether that state public policy would apply in the reinsurance context, (4) whether any specific contract language exists that explicitly provides for such coverage, and (5) whether other language in the contract – such as a follow the fortunes or honorable engagements clause – bears on the issue.

Recent Examples

Recent events have demonstrated that punitive damage awards remain an issue for insurers and reinsurers. For example, the insurance fall-out from the Hurricane Katrina disaster may ultimately lead to reinsurance disputes over ECO and XPL claims. Thousands of Katrina-related lawsuits have been filed against insurers since 2005, leading to some rather large settlements and punitive damage awards that may ultimately impact a carrier's reinsurance coverage. Indeed, in addressing a punitive damages award against State Farm in a case pertaining to its handling of Katrina claims, one judge ominously noted: "The philosophy or attitude or position adopted by the defendant that lasted throughout the consideration of plaintiffs' claim is reprehensible enough to warrant deterrence. What effect it may have remains to be seen, but substantial harm resulted from defendant's conduct, which was neither isolated

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10 Indeed, the contract's choice of law clause should be examined to determine whether it operates to the exclusion of other obligations provided for under the contract.

nor mere accident." *Broussard v. State Farm Fire & Cas. Co.*, No. 1:06CV6 LTS-RHW, Order, dated Jan. 31, 2007.[11]

Similarly, the global financial crisis may lead to future ECO/XPL issues. For example, recently the Chief Investment Officer of Stanford Financial Group sued her D&O insurers for, *inter alia*, punitive damages of $40 million – asserting that the insurers acted in bad faith by not timely responding to her notices of claim and due to their undue delay and refusal to provide her with a defense. *See Pendergest-Holt v. Lloyd's of London et al.*, Plaintiff's Original Petition, No. 09-3133 (Tex. Dist. Ct. Mar. 17, 2009).[12] However, in a context such as this, special attention should be paid to any fraud exceptions contained in the applicable ECO/XPL clause.

A recent court decision is also of interest. In *Continental Casualty Company. v. ACE American Insurance Company,* Continental had issued an insurance policy to ACE that provided coverage for losses arising from insurance claims made by ACE's own policyholders for alleged wrongful acts. *See Continental Cas. Co. v. ACE Am. Ins. Co.*, No. 07 Civ. 958 (PAC), Opinion & Order, dated Mar. 31, 2009. In the underlying action, ACE's insured sued ACE alleging that ACE breached its own policy by denying coverage. Accordingly, the insured sought civil penalty interest for ACE's failure to timely pay the policy limits and sought punitive damages for ACE's alleged bad faith. ACE ultimately settled the matter for $11.68 million and billed Continental for the amount above the Continental policy's $10 million deductible.

Continental, however, asserted that ACE's settlement of its insured's claims was not covered by the parties' policy because (1) ACE had failed to satisfy the "consent to settlement" clause, and (2) the amount of potentially insured loss was less than the $10 million deductible because part of the settlement amount related to uninsured loss (i.e., civil penalties and punitive damages that were not insurable under the contract). In March 2009, the Southern District of New York ruled that ACE did not satisfy the policy's "consent to settlement" clause and therefore Continental was not liable for ACE's loss. Due to that ruling, the court did not engage in a full analysis of the second issue, but it did determine that because ACE had significant exposure for civil penalties and punitive damages, the settlement amount should have been allocated between insured and uninsured loss, which would have left Continental liable for a total uninsured loss less than the policy's deductible. This decision illustrates the potential importance of determining what portions of a cedent's settlement with its insured is related to extracontractual losses (e.g., punitive damages) when the contract either limits or prohibits reinsurance of such liabilities.

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[11] A more recent example is a Georgia Supreme Court decision finding that a bad faith claim and an "excess judgment" against an insurer was possible if the insurer put unreasonable conditions on a settlement offer, even if that offer was within the policy limits. *See Fortner v. Grange Mut. Ins. Co.*, 686 S.E.2d 93 (Ga. 2009).

[12] Ms. Pendergest-Holt was seeking a defense from her insurers in connection with a lawsuit brought against her by the SEC, two civil class action lawsuits, and criminal felony charges.

Given this climate, it is important for both parties to a reinsurance agreement to thoroughly evaluate the contractual language to determine whether it permits reinsurance recovery for ECO/XPL liabilities. They should not only review the actual ECO/XPL clause at issue, but the entire contract, as well as any applicable E&O policies. As detailed above, state law may also be important. Additionally, the parties should consider any relevant negotiation/placement materials, any relevant communications exchanged throughout the relationship, and the extent to which the reinsurer was involved in the cedent's claims handling. Moreover, the parties must consider whether a dispute over such coverage will ultimately be decided by a court or an arbitration panel and how that might affect their chances of success, as arbitrators may utilize a slightly different analysis than a court would – i.e., placing more emphasis on arguments of an equitable nature or based on long-held industry concepts, such as the doctrine of utmost good faith and honorable engagements.

But perhaps the wisest course of action is to be proactive in avoiding disputes altogether by engaging in clear and frequent communication, both initially in the contract formation/drafting stage and throughout the relationship.

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