Mealey's Fundamentals of Reinsurance Litigation & Arbitration
February 11, 2008 ■ Washington, D.C.

KEY PRINCIPLES AND CONCEPTS:

Jennifer R. Devery, Esq. and Ellen MacDonald Farrell, Esq.†
Crowell & Moring LLP
Washington, D.C.

I. The Duty Of Utmost Good Faith

A. Basic Principles

One of the most fundamental principles in reinsurance – indeed, what sets the reinsurance field apart from most other industries – is the concept of utmost good faith (also known as "*uberrimae fides*"). The duty originated in the context of marine insurance law, when underwriters had no practical means of inspecting reinsured ships or cargo in distant ports. *See generally* Barry R. Ostrager & Mary Kay Vyskocil, *Modern Reinsurance Law & Practice* § 3.01[d] (2d ed. 2000); *Sun Mut. Ins. Co. v. Ocean Ins. Co.*, 107 U.S. 485, 510 (1883) (discussing duty of disclosure as one of *uberrimae fidei*). The duty of utmost good faith has been described as follows:

> While trust and honesty are expected in primary insurance, in reinsurance they are requirements. Utmost good faith is often said to be an unwritten requirement of contractual continuity. As such, it arguably is a basic requirement of central importance to the essential structure of reinsurance. For example, a hallmark of reinsurance is each party's providing full and timely disclosure to the other party.

Reinsurance: Indemnifying Insurers for Insurance Losses, *in Reinsurance* 1, 24 (Robert W. Strain ed., rev. ed. 1997) (hereinafter Strain II).

Underlying the duty is the basic premise that each party to a reinsurance agreement owes the other party a high level of good faith in their dealings. *See, e.g., United Fire & Cas. Co. v. Arkwright Mut. Ins. Co.*, 53 F. Supp. 2d 632, 642 (S.D.N.Y. 1999) ("The duty of utmost good faith is a mutual one; it is an obligation of the reinsurer as well as of the cedent."); *Compagnie de Reassurrance d'Ile de France v. New England Reins. Corp.*, 57 F.3d 56, 88 (1st Cir.), *cert. denied*, 516 U.S. 1009 (1995) (noting the "reciprocal duty of utmost good faith"). In other words, "the reinsurer and reinsured are 'partners.'" *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F. Supp. 2d 49, 69 (D. Mass. 1998), *aff'd*, 217 F.3d 33 (1st Cir. 2000), *cert. denied*, 531 U.S. 1146 (2001). In fact,

---

† William C. O'Neill, Esq. and Michelle A. Jones, Esq., both of Crowell & Moring LLP, also contributed to this paper.

some courts have opined that the duty of utmost good faith is implied in all reinsurance contracts. *E.g. Unigard Sec. Ins. Co. v. North River Ins. Co.*, 4 F.3d 1049, 1066 (2d Cir. 1993) (noting the duty of utmost good faith is implied in all contracts); *Christiania Gen. Ins. Corp. v. Great Am. Ins. Co.*, 979 F.2d 268, 278 (2d Cir. 1992) (describing the relationship between cedent and reinsurer as "one of utmost good faith").[1]

B. Cedent's Duty to its Reinsurer

Because the ceding company typically has greater knowledge as to the risk being insured, the duty of utmost good faith ensures that this imbalance in knowledge will not be used unfairly to bind the reinsurer to a contract to which it did not agree. Thus, courts have recognized that part of the ceding company's duty is to "align its interest with those of the reinsurer." *North River Ins. Co. v. CIGNA Reins. Co.*, 52 F.3d 1194, 1216 (3d Cir. 1995). The cedent must place the reinsurer in the same situation as itself and give the reinsurer the same means and opportunity of judging the value of the risks. *Unigard,* 4 F.3d at 1069, *citing Christiania*, 979 F.2d at 280.

The cedent must disclose to its reinsurer at the time of the contract formation facts that, if revealed, would cause the reinsurer to either not issue the policy or to only do so at a higher premium. *Christiania*, 979 F.2d at 278. For example, in *Allendale Mut. Ins. Co. Excess Ins. Co.*, 992 F. Supp. 278, 282-84 (S.D.N.Y. 1998), a federal New York court found that an insurer violated the duty of utmost good faith when it failed to inform its reinsurers of recommendations in an engineer's survey report (as well as its failure to implement those recommendations) prior to execution of a new reinsurance contract.

In addition, the cedent must continue to disclose material information to its reinsurer after the contract is formed, *i.e.*, throughout the reinsurance relationship. *Mutuelle Générale Française Vie v. Life Assurance Co. of Pa.*, 688 F. Supp. 386, 398 (N.D. Ill. 1988) (cedent owed its reinsurer a fiduciary duty with respect to the administration of a reinsurance treaty). For example, in *Unigard*, the Second Circuit determined that the duty of utmost good faith required the cedent to notify its reinsurer of a settlement agreement that it had signed with its insureds, as the settlement agreement would affect the reinsurance agreement already executed by the parties. 4 F.3d at 1069.

On the other hand, a cedent does not have an obligation to disclose facts that are already known, or ought to be known by, the reinsurer. *Compagnie*, 57 F.3d at 80 ("courts recognize that the insured need not disclose 'what the insurer already knows or ought to know'"); *Sumitomo Marine & Fire Ins. Co. v. Cologne Reins. Co. of Am.*, 75 N.Y.2d 295, 303, 1990 N.Y. LEXIS 297 (N.Y. 1990) ("reinsured ordinarily has no obligation to disclose the terms upon which insurance has been granted where those terms are generally found in policies of that nature, for the reinsurer ought to be aware of such standard terms").

---

[1] This duty also applies to the relationship between retrocedent and retrocessionaire. *American Bankers Ins. Co. v. Northwestern Nat'l Ins. Co.*, 198 F.3d 1332, 1335 (11th Cir. 1999); *Allendale Mut. Ins. Co. v. Excess Ins. Co.*, 992 F. Supp. 278 (S.D.N.Y. 1998); *Compagnie*, 57 F.3d at 88.

C. Reinsurer's Duty to its Cedent

Likewise, a reinsurer is expected to deal fairly with its cedent. The reinsurer should inform the cedent of its intentions and practices, and provide timely notice if a claim reported by the cedent is not covered or may not be covered by the reinsurer. Strain II at 24; *see also* Section IV *infra*. Courts typically address the reinsurer's duty of utmost good faith in the context of a failure to pay the cedent's claims in good faith. *See, e.g., Compagnie*, 57 F.3d at 88 (under the duty of utmost good faith, reinsurer obligated to make claims payments absent a bona fide defense); *Arkwright Mut. Ins. Co. v. National Union Fire Ins. Co.*, 90 Civ. 7811 (AGS), 1995 U.S. Dist. LEXIS 11 (S.D.N.Y. Jan. 4, 1995) (cedent permitted to amend complaint to allege its reinsurer breached the duty of utmost good faith in summarily denying a claim, without investigation, made in good faith by the cedent).

A prime example of a reinsurer's breach of its duty of utmost good faith is *Commercial Union*, 217 F.3d 33, where the court determined that a reinsurer violated the duty by engaging in a "moving target" strategy (*i.e.*, raising a series of constantly shifting defenses) to delay paying the cedent's claims. The First Circuit concluded that "[u]tmost good faith ... requires a reinsurer to indemnify its cedent for losses that are even arguably within the scope of the coverage reinsured, and not to refuse to pay merely because there may be another reasonable interpretation of the parties' obligations under which the reinsurer could avoid payment." *Id.* at 43, *citing United Fire*, 53 F. Supp. at 642.

D. Similarity to Fiduciary Duties

There is some debate as to whether the duty of utmost good faith is, in effect, a fiduciary duty imposed upon the parties. A minority of courts has found so, concluding that the reinsurer is entitled to place its "highest faith" in the cedent's representations. *Mutuelle*, 688 F. Supp. at 398 (holding that the cedent owed its reinsurer a fiduciary duty with respect to the administration of a reinsurance treaty). *See also American Re-Insurance v. MGIC Investment Corp.*, No. 77 CH 1457 (Ill. Cir. Ct., Cook County, Ch. Div. Oct. 20, 1987) (noting that the nature of treaty reinsurance gives rise to a fiduciary relationship), *reprinted in* Robert W. Hammesfahr & Scott W. Wright, *The Law of Reinsurance Claims* 330-69 (1998).

As explained by the U.S. District Court for the District of Massachusetts in the context of treaty reinsurance:

> Both *uberrimae fidei* and fiduciary duty arise out of a relationship of vulnerability. In the case of a fiduciary, this relationship may sometimes result from an inherent vulnerability, as in the case of a layman who trusts a doctor, but more often it arises out of a purely conventional understanding that one party is permitted, as a matter of law, to trust the other in the managing of certain affairs. . . .
>
> Similarly, the relationship between reinsured and reinsurer under a reinsurance treaty is one of profound vulnerability. By entering into a proportional reinsurance treaty, a reinsurer essentially becomes the "silent partner" of the reinsured. Every risk that the reinsured chooses to cede under a treaty automatically imposes a risk on the reinsurer. All discretion lies with the

> reinsured and the reinsurer must "follow the fortunes" of the reinsured by indemnifying it for all payments made to its insureds in good faith. The reinsurer relies on the "utmost good faith" of the reinsured and the reinsured is aware of this.

Compagnie, 944 F. Supp. 986, 996 (D. Mass. 1996) (*on remand from* 57 F.3d 56).

However, other courts have found the duty in a reinsurance relationship to be merely quasi-fiduciary in nature – holding cedents to a heightened duty of disclosure, but not the "highest duty." *See, e.g., Unigard*, 4 F.3d at 1069 ("[n]evertheless, because information concerning the underlying risk lies virtually in the exclusive possession of the ceding insurer, a very high level of good faith—whether or not designated 'utmost'—is required"); *Christiania*, 979 F.2d at 280-81 ("no reason to label the relationship as 'fiduciary'"). *See also North River*, 52 F.3d at 1212-13 (following the *Unigard* standard that the reinsurance market depends upon a "high level of good faith"); *Am. Special Risk Ins. Co. v. Greyhound Dial Corp.*, 90 Civ. 2066 (RPP), 1996 U.S. Dist. LEXIS 14231, at *231 (S.D.N.Y. Sept. 26, 1996) (doctrine of utmost good faith obligates the parties to exercise the highest degree of good faith but is not a fiduciary relationship).

Other courts have equated the duty of utmost good faith to the lesser duty of good faith and fair dealing that is typically imputed to commercial contracts. *See, e.g., Reliastar Life Ins. Co. v. IOA Re, Inc.*, 303 F.3d 874, 878 (8th Cir. 2002) (under Minnesota law, the usual rules of contract law apply to the examination of reinsurance contracts); *Calvert Fire Ins. Co. v. Unigard Mut. Ins. Co.*, 526 F. Supp. 623 (D. Neb. 1980), *aff'd,* 676 F.2d 707 (8th Cir. 1982) (applying general principles of contract law to rescind a reinsurance contract based on the insurer's misrepresentations); *Int'l Surplus Lines Ins. Co. v. Fireman's Fund Ins. Co.*, No. 88 C 320, 1989 U.S. Dist. LEXIS 15626, at *10 (N.D. Ill. Dec. 29, 1989) (noting that the reinsurance relationship "operates in all significant respects as does a standard consumer-insurance company relationship"), *aff'd*, 998 F.2d 504 (7th Cir. 1993).[2]

E. Treaty v. Facultative Reinsurance

The extent to which the duty of utmost good faith is applied by courts to reinsurance contracts is sometimes dependent on the nature of the reinsurance at issue – that is, whether the reinsurance contract is a treaty or a facultative agreement. A treaty reinsurer must rely almost entirely on the cedent's representations during the negotiation and formation of the reinsurance contract, because it is obliged, by definition, to accept in advance certain types of the ceding company's covered business and does not engage in independent risk assessment. *Christiania*, 979 F.2d at 271. In the case of facultative reinsurance, however, the reinsurer has the option to

---

2 *See also United States v. Brennan*, 183 F.3d 139, 150 (2d Cir. 1999) (in case involving criminal conviction, notes there was substantial evidence to conclude that the reinsurance relationship at issue was not a fiduciary relationship); *Stonewall Ins. Co. v. Argonaut Ins. Co.*, 75 F. Supp. 2d 893, 910 (N.D. Ill. 1999) (concluding "a reinsurer owes no fiduciary responsibility to its reinsured"); *North River Ins. Co. v. Philadelphia Reins. Corp.*, 797 F. Supp. 363, 370 (D.N.J. 1992) (rejecting reinsurer's argument that cedent owed fiduciary duty to disclose attorney-client communications).

either accept or reject each risk submitted, and each facultative reinsurance certificate for a specific risk/policy involves separate and distinct negotiations between the parties. *Id.*; *Unigard*, 4 F.3d at 1054.

Because a treaty reinsurer may have less of an opportunity to independently investigate a particular risk and is more at the mercy of the cedent's underwriting and administrative functions, some courts have held cedents in a treaty relationship to a higher duty of utmost good faith. For example, in *In re Liquidation of Union Indem. Ins. Co. of N.Y.,* 89 N.Y.2d 94, 106, 1996 N.Y. LEXIS 3167 (N.Y. 1996), a New York court determined that under the duty of utmost good faith, the cedent's disclosure obligations were more broad in a treaty reinsurance arrangement. Further, in *Mutuelle*, 688 F. Supp. at 398, the court held that the cedent owed its reinsurer a fiduciary duty regarding the administration of the treaty in dispute, given that the cedent had sole contact with the policies and policyholders and was in the "dominant and influential position" with respect to reporting and administration obligations. *See also American Re-Insurance*, No. 77 CH 1457 (the nature of treaty reinsurance inherently required the reinsurer to place a great deal of trust in its cedent).

In contrast, other courts have held cedents to a lower duty of disclosure when the dispute involved facultative reinsurance. For example, in *International Surplus Lines,* 1989 U.S. Dist. LEXIS 15626, a federal Illinois court expressly rejected a facultative reinsurer's contentions that a fiduciary duty existed between the parties, or that the cedent breached a fiduciary duty by failing to disclose certain information as required by the facultative certificates at issue. The court distinguished the fiduciary duty found in *Mutuelle* based on the type of reinsurance at issue:

> Here, however, [the reinsurer] assumed a portion of the risk on a facultative policy. Because the reinsurance related to a single policy, [the reinsurer] was more likely to gather its own information or at a minimum more closely monitor [the cedent's] administration of that policy. Thus, [the reinsurer] was less likely to rely on the defendant's information. Here, moreover, the reinsurer retained the "faculty" to accept or reject each specific risk offered. Thus, [the reinsurer] had the incentive to gather information and assess risk on its own. Furthermore, [the reinsurer] had the option of rejection and was thus able to protect itself.

Id. at *15. *See also PXRE Reins. Co. v. Lumbermens Mut. Cas. Co.*, 342 F. Supp. 2d 752, 758-59 (N.D. Ill. 2004) (cedent had no obligation to inform treaty reinsurer of the specific characteristics of any contracts contained in the reinsurance portfolio because the parties were sophisticated entities and each could conduct its own review based on information that was fully available to both parties); *North River Ins. Co. v. Philadelphia Reins. Co.*, 797 F. Supp. 363 (D.N.J. 1992) (declining to extend *Mutuelle*'s finding of a fiduciary duty in the context of facultative reinsurance); *Int'l Ins. Co. v. Certain Underwriters at Lloyd's London*, No. 88 C 9838, 1991 U.S. Dist. LEXIS 12948 (N.D. Ill. Sept. 16, 1991) (questioning whether the distinction between facultative and treaty reinsurance should be determinative in assessing a cedent's duty of disclosure).

F. Evolution in the Reinsurance Market

Recent changes in the reinsurance market have affected the reinsurer-cedent relationship. As one commentator observed, "with the improved communications of the modern world, there is little reason for even the distance across an ocean to prevent knowledge of the risk." Steven W. Thomas, *Utmost Good Faith In Reinsurance: A Tradition In Need of Adjustment*, 41 Duke L.J. 1548, 1555-56 (1992). For example, reinsurance has shifted away from "gentlemen's agreements" to larger scale, more arms-length transactions between sophisticated corporate entities. Deborah F. Cohen et al., *Uberrimae Fidei and Reinsurance Rescission: Does a Gentlemen's Agreement Have a Place in Today's Commercial Market?*, 29 Tort & Ins. L.J. 602, 604 (1994). Accordingly, some courts and commentators have called into question the scope of the duty of utmost good faith in modern practice. *See, e.g., id.* at 621-22*; Unigard*, 4 F.3d at 1066. Yet, despite the changing nature of the industry, come courts still opine that the duty of utmost good faith "continues to be a controlling legal principle in the reinsurance industry." *E.g., Commercial Union*, 9 F. Supp. 2d at 69.

G. Recent Case Law

As indicated above, there is a wide range of court opinions regarding the duty of utmost good faith. This variance is reflected in recent case law interpreting the doctrine:

- *Suter v. General Accident Ins. Co. of Am.*, No. 01-2686 (WGB), 2006 U.S. Dist. LEXIS 48209 (D. N.J. July 14, 2006), *vacated* (D.N.J. May 24, 2007) – Primarily discussing follow the fortunes/follow the settlements, but notes that cedents are subject to a high level of good faith so that reinsurers do not have to engage in duplicative monitoring.

- *Employer Reins. Corp. v. Laurier Indem. Co.*, No. 8:03-CV-1650-T-17MSS, 2006 U.S. Dist. LEXIS 40451 (M.D. Fla. June 19, 2006) – Order adopting magistrate judge's report, which noted that reinsurers do not duplicate the functions of cedents and instead typically rely on their common interest with the cedents and on the industry custom of utmost good faith.

- *American Employers' Ins. Co. v. Swiss Reins. Am. Corp.*, 275 F. Supp. 2d 29 (D. Mass. 2003), *vacated and remanded*, 414 F.3d 129 (1st Cir. 2005) – Reinsurer unsuccessfully alleged that cedent's failure to obtain documentation on 27 environmental sites, which were the subject of a settlement between the insured and the cedent and for which the cedent sought indemnification, was grossly negligent and reckless conduct and a violation of the duty of utmost good faith.

- *Fireman's Fund Ins. Co. v. General Reins. Corp.*, No. C-0304406 JCS, 2005 U.S. Dist. LEXIS 43650, at *33-34 (N.D. Cal. Aug. 5, 2005) – Court notes that its decision that the reinsurer is obligated to indemnify cedent for declaratory judgment expenses is consistent with the duty of utmost good faith.

- *AXA Corp. Solutions v. Underwriters Reins. Co.*, No. 02 C 3016, 2004 U.S. Dist. LEXIS 22609 (N.D. Ill. Nov. 9, 2004) – Court finds that the duty of good faith or utmost good faith exists with respect to reinsurance arrangements under Texas law, and is applicable at contract formation as well as during performance of the obligations under the contract.

- *Folksamerica Reins. Co. v. Republic Ins. Co.*, No. 03 Civ. 6608 (VM), 2004 U.S. Dist. LEXIS 7547 (S.D.N.Y. amended May 6, 2004) – Rejecting cedent's attempt to raise an independent, private cause of action for breach of the duty of utmost good faith.

- *PXRE Reins. Co. v. Lumbermens Mut. Cas. Co.*, 330 F. Supp. 2d 981 (N.D. Ill. 2004); 342 F. Supp. 2d 752 (N.D. Ill. 2004) – Court rejects cedent's claim that reinsurance agreement imposed a duty of utmost good faith on its reinsurer under Illinois law, concluding that such a duty was not supported by the express terms of the agreement and was contrary to the agreement's integration clause.

- *Gerling Global Reins. Co. v. ACE Prop. & Cas. Ins. Co.*, 42 Fed. Appx. 522, 2002 U.S. App. LEXIS 15571 (2d Cir. Aug. 1, 2002) – Reaffirming the principle of the duty of utmost good faith that a cedent is required to disclose all material facts affecting the risk to the reinsurer.

II. Reinsurance As An Honorable Engagement

A. Basic Principles

The "honorable engagement," expressed in either in a stand-alone provision or within the terms of the arbitration clause, is simply the reinsurance contract itself – a contract that the parties have entered into with the highest integrity and in utmost good faith. This harkens back to the earliest reinsurance arrangements that were done on a handshake and the concept is a cornerstone of the relationship between insurers and reinsurers. *See Sumitomo Marine & Fire Ins. Co. v. Cologne Reinsurance Co.*, 75 N.Y.2d 295, 298, 552 N.E. 2d 139, 140 (N.Y. 1990) ("differences [were] often . . . settled by handshakes and umpires").

Many associate the honorable engagement principle with the arbitration clause in reinsurance contracts because, as discussed below, many arbitration clauses expressly state that when resolving parties' disputes, arbitrators are to view the contract as an honorable engagement. However, the principle is more broad than just the mechanism through which arbitrators are to resolve disputes. Some reinsurance clauses have stand-alone provisions which state that the contract is an honorable engagement. As one commentator has noted, this honorable engagement may impact, for example, how the cedent handles claims and reports to its reinsurer:

> The concept of an honorable engagement extends not only to the reporting requirements imposed on the ceding company but also to the defense and handling of claims. The company must retain the right to adjust and settle claims according to its own best judgment, and the reinsurer is obliged to pay as the

company pays. This honorable engagement concept imposes on the ceding company an obligation to adjust claims in a highly professional manner, particularly in the view of the fact that the reinsurer's money is at stake whenever the company's retention is exceeded.

Reinsurance Contract Wording (by Robert F. Salm), in *Reinsurance* 79, 92-93 (Robert W. Strain ed., 1987) (hereinafter "Strain I"). "Errors and Omissions" clauses also embody the honorable engagement principle. *Id.* Thus, while cedents and reinsurers are held to high standards in performing their contractual duties, if one party makes a mistake in performing those duties the other party will be permitted to unduly take advantage of the error (to avoid its own obligations under the contract).[3]

B. The Incorporation of the Honorable Engagement Principle into an Arbitration Provision

As noted, the honorable engagement principle is formally embodied in many reinsurance contracts through arbitration clauses. For example, ARIAS-U.S. has the following sample arbitration provision on its website:

> The arbitrators and umpire shall interpret this Agreement as an honorable engagement, and shall not be obligated to follow the strict rule of law or evidence. In making their award, they shall apply the vision and practice of the insurance and reinsurance industry, with a view toward effecting the general purpose of the Agreement." (Clause 1.1).

Likewise, the Brokers & Reinsurance Markets Association web site has examples of different arbitration clauses with honorable engagement-type language. For example, BRMA 6B states:

> The arbitrators shall interpret this Contract as an honorable engagement and not as merely a legal obligation; they are relieved of all judicial formalities and may abstain from following the strict rules of law.

BRMA 6E provides as follows:

> 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

---

[3] An example of an Errors and Omissions clause follows:

> Any inadvertent delay, omission or error shall not be held to relieve either party hereto from any liability which would attach to it hereunder if such delay, omission or error had not been made, provided such omission or error is rectified upon discovery.

Brokers & Reinsurance Markets Association Contract Wording Clause 14C.

> 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.

The parties' relationship leads to the expectation that, to the extent their disputes result in arbitration, the disputes will still be resolved in a business-like manner consistent with the custom and practice of the reinsurance industry. In recognition of the traditional duty of utmost good faith, an honorable engagement clause within an arbitration provision instructs the arbitrators that the parties wish to resolve their disputes in that manner. Thus, the arbitrators are not to resolve disputes solely based on the strict rules of law and contract interpretation, but rather, they are free from these strictures and may employ a more commercial and pragmatic approach to dispute resolution.

In the context of procedure, strict rules of evidence and procedure need not be followed and arbitrators traditionally exercise wide discretion in allowing parties to present evidence and arguments that might have been barred under the Federal Rules of Evidence (or corollary state rules).

Likewise, substantive case law affecting reinsurance issues may not be determinative in the face of an honorable engagement clause. Because the clause relieves the arbitrators from interpreting the reinsurance contract solely as a legal obligation, what the courts have said about the interpretation of a particular clause may not be quite the same interpretation given by experienced reinsurance practitioners. Federal courts, in the context of motions to vacate arbitration awards under the Federal Arbitration Act, have repeatedly interpreted honorable engagement clauses to confer broad powers on arbitrators over:

- Interim awards, such as compliance with contractual funding requirements/security: *Certain Underwriters at Lloyd's London v. Argonaut Ins. Co.* 264 F. Supp. 2d 926, 939 (N.D. Cal. 2003) (Thus, the arbitration panel was "implicitly empowered" by the contract to "formulate appropriate relief for any dispute submitted to it" – here, ordering compliance with contractual funding requirements by payment of cash or issuance of a clean, irrevocable letter of credit); *Banco de Seguros del Estado v. Mutual Marine Office*, 344 F.3d 255 (2d Cir. 2003); *Pac. Reins. Mgmt. Corp. v. Ohio Reins. Corp.*, 935 F.2d 1019, 1025 (9th Cir. 1991) (arbitral panel may order pre-hearing security in the form of an escrow account where the arbitration clause stated that the arbitrators were "relieved of all judicial formalities and may abstain from following the strict rules of law."); *British Ins. Co. of Cayman v. Water St. Ins. Co.*, 93 F. Supp. 2d 506, 516 (S.D.N.Y. 2000) (citations omitted) (confirming an arbitration panel's interim order requiring reinsurer to post security before arbitration hearing);

- Preclusive effect of prior awards: *North River Ins. Co. v. Allstate Ins. Co.*, 866 F. Supp. 123 (S.D.N.Y. 1994) ("In their broad arbitration clauses incorporated in each treaty, the parties agreed to let the arbitrators 'consider this contract an honorable engagement rather than merely a legal obligation' and the clauses absolved the arbitrators 'from following the strict rules of law.' Amer Aff. at Article XV. Thus, the arbitration agreements themselves are broad enough to encompass the power of the arbitrators to adopt or reject 'the strict rules of law,' i.e. the preclusive effect of a prior award.");

- Permissible types of remedies, such as:

    - Compound Interest: *In re Arbitration Between Northwestern Nat. Ins. Co. and Generali*, No. 00 Civ. 1135, U.S. Dist. LEXIS 5586 (S.D.N.Y. May 1, 2000); and

    - Reformation: *United States Life Ins. Co. v. Ins. Comm'r of the State of California*, 2005 U.S. App. LEXIS 25763, at *6 (9th Cir. Nov. 28, 2005) (court ruled that an arbitration panel's denial of rescission, and reformation of a contract to reduce the reinsurer's liabilities by 10%, was protected by the arbitrators' "wide latitude;" the arbitrators "acted well within the powers granted to them.").

However, while they are freed from following strict rules of law and contract interpretation, reinsurance arbitrators are still bound to resolve parties' disputes based on the reinsurance contracts before them – the honorable engagement clause is not an invitation to the arbitrators to ignore the provisions of those contracts. As one California court has put it:

> Although the arbitrators [are] not bound to follow legal procedures strictly, they are not, because of such freedom, released from the obligation to be guided by the basic agreement of the litigants.

Garamendi v. California Comp. Ins., 2005 Cal. App. Unpub. LEXIS 11799 (Cal. App. Dec. 21, 2005) (*citing e.g. DiMarco v. Chaney*, 31 Cal. App. 4th 1809, 1815, 1995 Cal. App. LEXIS 67 (Cal. App. 1995) (arbitrator exceeded his authority by denying attorney fees to the prevailing party contrary to the language of the contract)). Thus, an arbitration panel may not fashion a remedy that is not rationally related to the contract or select a remedy that is not authorized by law.

III. Follow the Fortunes

A. Basic Principles

This requirement provides the basis for another bedrock principle of reinsurance – that is, reinsurers may not second-guess cedents' reasonable, good-faith determination that risks were covered under underlying insurance policies, or their good faith interpretations of policy terms. According to one commentator, this concept originated when "underwriters agreed to share in the profits or losses of merchants as they conducted their trade around the world." *Special Clauses and Endorsements* (by John F. Langen) 583 in *Reinsurance Contract Wording* (Robert W. Strain ed., 3rd ed. 1998) (hereinafter Strain Contract Wording). In such circumstances, it would have been difficult or impossible for insurers to have had to have definitively proved coverage to their reinsurers for their every loss.

Clauses that embody follow the fortunes and related concepts (see below) are present in many, but not all, reinsurance contracts today. An example of a follow the fortunes clause follows:

> The Reinsurer's liability shall attach simultaneously with that of the reinsured Company, and all cessions to the Reinsurers by virtue of this Agreement shall be subject in all respects to the same risks, terms, conditions, interpretations, assessments, waivers, modifications, alterations, and cancellations as the respective insurance (or reinsurance) of the Company to which such cessions relate, the true intent of this Agreement being that the Reinsurers shall, in every case to which this Agreement applies and in the proportions specified herein, follow the fortunes of the Company in respect of risks the Company has accepted under insurance or reinsurance policies, binders, or contracts.

Id. at 584. Such clauses are particularly important given the proliferation in recent decades of contentious insurance coverage actions involving pollution, asbestos and other long tail claims. In such actions (for example), an insurer may vigorously assert defenses against coverage, but ultimately determine that a court would likely reject those defenses and find that the underlying claim was covered by its policy. Such insurer determinations may be made in good faith and in light of the realities of pro-policyholder courts or jurisdictions. Follow the fortunes (and related concepts, below) prevents reinsurers – in the context of contesting reinsurance claims – from asserting the very same defenses that insurers had themselves asserted against their policyholders but had then concluded might not defeat coverage.

Follow the settlements is intertwined with follow the fortunes.[4] A sample follow the settlements clause follows:

> All loss settlements made by the Company, under policies subject hereto, whether under policy terms and conditions or by way of compromise, shall be binding upon the Reinsurer, and, upon receipt of satisfactory proof of loss, the Reinsurer agrees to pay or allow, as the case may be, its share of each such settlement in accordance with this Contract.

BRMA 29A. Follow the settlements is aimed at preventing the reinsurer from re-litigating the coverage dispute: without it, "the costs and risks of litigation avoided by settling with the insurer would only be revived at the reinsurance stage." *Commercial Union Ins. Co. v. Seven Provinces Ins. Co., Ltd.*, 9 F. Supp. 2d 49, 66 (D. Mass. 1998), *aff'd in part*, 217 F.3d 33 (1st Cir. 2000). As long as the decision was made in good faith and the claim arguably comes within the scope of the insurance policy, the reinsurer is bound by the settlement. Whether the insurer's

---

[4] A third related concept is embodied through "follow form" clauses, which are "designed to make the terms of coverage under an excess policy or reinsurance policy . . . conform – subject to certain qualifications – to the coverage provided by an underlying policy . . . (citations omitted). *Am. Employers' Ins. Co. v. Swiss Reins. Am. Corp.*, 413 F.3d 129, 130 (1st Cir. 2005).

determination that the claim was arguably covered was reasonable is based on the circumstances at the time of the settlement. *Id.*

B. Are Follow the Fortunes/Settlements Obligations Implied Into Every Reinsurance Contract?

Some courts have held that the follow the fortunes "doctrine" is inherent in every reinsurance contract. *E.g., Int'l Surplus Lines Ins. Co. v. Certain Underwriters at Lloyd's, London*, 868 F. Supp. 917 (S.D. Ohio 1994). Other courts have held that there is no implied duty for a reinsurer to follow its cedent's fortunes as a matter of law without specific contractual language. *Am. Ins. Co. v. American Reins. Co.*, No. C 05-01218 JSW (N.D. Cal. Nov. 27, 1996); *see also Affiliated F.M. Ins. Co. v. Employers Reins. Corp.*, 369 F. Supp. 2d 217, 227 (D. R.I. 2005) ("This Court is hesitant to read terms into a contract given such divergent precedent" regarding whether follow the fortunes or follow the settlements obligations are implied into all reinsurance contracts.) *American Ins. Co.* opined that the former view, that a follow the fortunes or follow the settlements obligation is implied in all reinsurance contracts, is the minority and less well-reasoned one:

> The Court finds that the majority of courts addressing this issue, and the better reasoned opinions, have rejected the proposition that the 'follow the settlements' or 'follow the fortunes' doctrine may be read into every reinsurance policy as a matter of law. In the absence of any authority from Pennsylvania on this issue, the Court will not impute the minority, less well-reasoned position to a Pennsylvania court. Accordingly, the court finds that there is no conflict under California and Pennsylvania law, and thus, will apply California law and not read the 'follow the settlements' or 'follow the fortunes' doctrine into the reinsurance contract as a matter of law.

In *American Ins. Co.*, however, the court held that the ceding company would be able to introduce evidence of industry custom and practice to demonstrate that the follow the fortunes or follow the settlements obligations should be implied into a particular contract. *See id.*

C. Limitations on Follow the Fortunes/Follow the Settlements

A reinsurer does not have to follow the fortunes or settlements of its cedent if the reinsurer can establish that the cedent acted in a grossly negligent, bad faith, or in a fraudulent or collusive manner. *See, e.g., North River Ins. Co. v. CIGNA Reins. Co.*, 52 F.3d 1194, 1212 (3d Cir. 1995); *Seven Provinces*, 9 F. Supp .2d at 66. However, the "reinsurer bears the burden of showing bad faith on the reinsurer's part. The standard is a high one: the reinsurer must show 'gross negligence or recklessness' . . . or that the settlement was not even 'arguably' within the scope of the reinsurance coverage [citation omitted]." *Seven Provinces*, 9 F.Supp.2d at 66. Similarly, a reinsurer will not have a follow the fortunes obligation if the cedent acted unreasonably. *See, e.g., Int'l Surplus Lines,* 868 F. Supp. at 921.

A follow the fortunes or follow the settlements clause will not supplant other terms in a reinsurance contract. Courts have applied this principle in several contexts, including:

- in holding that a reinsurer was not liable for expenses in addition to the amount listed in the "Reinsurance Accepted" section in the facultative certificates at issue – *Bellefonte Reins. Co. v. Aetna Cas. & Sur. Co.*, 903 F.2d 910, 913 (2d Cir. 1990) ("To read the reinsurance certificates in this case as Aetna suggests – allowing the 'follow the fortunes' clause to override the limitation on liability – would strip the limitation clause and other conditions of all meaning; the reinsurer would be obliged merely to reimburse the insurer for any and all funds paid. Such a reading would be contrary to the parties' express agreement and to the settled law of contract interpretation. The 'follow the fortunes' clauses in the certificates are structured so that they coexist with, rather than supplant, the liability cap. To construe the certificates otherwise would effectively eliminate the limitation on the reinsurers' liability to the stated amounts.");

- in deciding aggregation issues – *Travelers Cas. & Sur. v. Certain Underwriters at Lloyd's of London*, 96 N.Y.2d 583, 596, 2001 N.Y. LEXIS 3241 (N.Y. 2001) (the ceding company could not rely on follow the fortunes language in its reinsurance treaties to "supplant" other terms in the contracts at issue. to aggregate underlying environmental claims);

- in addressing a reinsurer's obligations to reimburse an insurer for its *ex gratia* payments – *Granite State Ins. Co. v. Ace American Reins. Co.*, 2007 N.Y. Slip Op. 10464 (N.Y. App. Div. Dec. 27, 2007) (follow the fortunes or follow the settlements would not apply if the insurer made an *ex gratia* payment); and

- in rejecting an insurer's argument that a court could not examine the basis of its settlement to determine whether the settlement included payment for expense as well as indemnity, where the reinsurance agreement excluded coverage for expense payments – *Affiliated F.M. Ins. Co. v. Employers Reins. Corp.*, 369 F. Supp. 2d 217, 227 (D. R.I. 2005).

D. Recent Case Law

The below list briefly describes some recent cases discussing follow the fortunes and follow the settlements:

- *In the matter of the Liquidation of Midland Ins. Co.*, No. 41294/1986, 2008 N.Y. Misc. LEXIS 128, at *58 (N.Y. Sup. Jan. 14, 2008) – The court rejected the Liquidator's arguments that follow the settlements precludes one of Midland's reinsurers, Everest, from exercising its right (set forth in its reinsurance contracts) to investigate and to interpose defenses to policyholder claims against Midland in the liquidation. The court also found that Everest's rights to investigate and to interpose defenses, and other rights, "are discrete rights that neither give rise to, nor should be confused with, an all-encompassing right to be involved in the Liquidator's internal process of adjusting claims."

- *Granite State Ins. Co. v. ACE American Reins. Co.*, 2007 N.Y. Slip Op. 10464 (N.Y. App. Div. Dec. 27, 2007) – The appellate court affirmed the Supreme Court's denial of summary judgment; the court held that there were issues of fact as to whether exceptions to the follow the fortunes doctrine applied to the ceding company's claim.

- *Hartford Acc. & Indem. Co. v. Ace Am. Reins. Co.*, 2005 Conn. Super. LEXIS 3576 (Conn. Sup. Ct. Dec. 13, 2005), *rev'd*, 284 Conn. 744, 2007 Conn. LEXIS 511 (Dec. 25, 2007) – The Connecticut superior court rejected the ceding company's argument that the reinsurer was bound by "follow the fortunes" to accept the ceding company's single "accident" presentation. The Connecticut Supreme Court, in reversing the superior court, did not address follow the fortunes arguments.

- *Stonewall Ins. Co. v. Argonaut Ins. Co.*, No. 05-12305 (D. Mass. Nov. 19, 2007) (order on motion for summary judgment) – The federal district court rejected the ceding company's argument that its reinsurer was bound, under the follow the settlements in the parties' contract, to the ceding company's allocation of a settlement for asbestos claims as a matter of law. The allocation was in accordance with the ceding company's internal models of its potential exposure, but apparently not the models prepared by a larger defense group of which the ceding company was a member. According to the court: "Stonewall's decision to divide the settlement payment amongst the six policies in accordance with its internal models instead of the NERA/Brattle models used in the settlement negotiations is not a binding 'follow the settlement' decision."

- *Allstate Ins. Co. v. American Home Assur. Co.*, 837 N.Y.S.2d 138 (N.Y. App. Div. 2007) – The New York appellate court rejected ceding company's argument that reinsurer was bound by follow the fortunes to accept its one occurrence allocation, where that allocation was "neither reasonable nor based on good faith."

- *Suter v. General Accident Ins. Co. of Am.*, No. 01-2686 (WGB), 2006 U.S. Dist. LEXIS 48209 (D.N.J. July 14, 2006), *vacated* May 24, 2007– Follow the fortunes/settlements did not bind the reinsurer where losses stemming from defective heart valve losses did not reasonably fall within the cedent's policy; the insurer did not investigate the claims in a reasonable or business-like manner, and the insurer's allowance of the losses was grossly negligent and amounted to bad faith. Note after an appeal was taken to the Third Circuit, the parties settled this matter on the condition that the district court opinion be vacated, which it was.

- *National Union Fire Ins. Co. of Pittsburgh v. American Re-Ins. Co.*, 441 F. Supp. 2d 646 (S.D.N.Y. 2006) – The Southern District of New York held that the reinsurer was bound to follow its ceding company's allocation of losses from claims involving exposure to metalworking fluids. According to the court, "the issue is whether the payment by National Union was 'at least arguably within the scope of the insurance coverage that was reinsured.' [citation omitted] . . . American Re, as a reinsurer bound to follow the fortunes of its insured, is not entitled to a 'de novo' review of [National Union's] decision-making process."

- *Commercial Union Ins. Co. v. Swiss Reins. America Corp.*, 413 F.3d 121 (1st Cir. 2005) – The First Circuit held that follow the settlements language in the ceding company's reinsurance contracts would bind the reinsurer to pay three separate reinsurance "occurrences" – one for each year of a three-year insurance policy – but remanding for further proceedings on such issues as whether the settlement was in good faith. (See also the related case: *American Employers' Ins. Co. v. Swiss Reins. America Corp.*, 413 F.3d 129 (1st Cir. 2005).)

- *Travelers Cas. & Sur. Co. v. Gerling Global Reins. Corp.*, 419 F.3d 181 (2d Cir. 2005) – The Second Circuit held that follow the settlements language in the parties' contracts bound a reinsurer to accept its ceding company's allocation of asbestos claims as a single occurrence. The court stated: "we decline to authorize an inquiry into the propriety of a cedent's method of allocating a settlement if the settlement itself was in good faith, reasonable, and within the terms of the policies."

- *North River Ins. Co. v. ACE American Reins. Co.*, 361 F.3d 134 (2d Cir. 2004) – The Second Circuit held that the reinsurer was bound by follow the settlements to its ceding company's post-settlement allocation of losses from asbestos claims. Here, the reinsurer had argued that it was not bound because the post-settlement allocation differed from the ceding company's pre-settlement analyses. The court stated: "the follow-the-settlements doctrine extends to a cedent's post-settlement allocation decisions, regardless of whether an inquiry would reveal an inconsistency between that allocation and the cedent's pre-settlement assessments of risk, as long as the allocation meets the typical follow-the-settlements requirements, i.e., is in good faith, reasonable, and within the applicable policies."

IV. Notice Requirements

A. Basic Principles

It almost goes without saying that in order to be indemnified for a loss, an insurer must first notify its reinsurer of the claim that caused the loss, and provide information regarding such claim. Notice of underlying claims is important for several reasons. First, just as insurance companies set reserves for claims that might result in eventual payment under their insurance policies, reinsurers set reserves for claims that might result in eventual payment under reinsurance contracts. Notice enables reinsurers to set reserves. Second, many reinsurance contracts contain clauses that permit reinsurers to associate in their reinsureds' defense of claims.[5] Regardless of whether reinsurers often invoke the right to associate, notice enables

5 A sample right to associate clause follows:

When so requested in writing, the Company shall afford the Reinsurer or its representatives an opportunity to be associated with the Company, at the expense of the Reinsurer, in the defense of any claim, suit or proceeding involving this reinsurance, and

(continued…)

reinsurers to make that decision. Finally, when reinsurers renew existing contracts, premium may be based on the number and magnitude of claims and losses on those existing contracts. Notice of claims provides reinsurers with more information with which to gauge how much premium should be charged for future contracts.

There is a variety of notice provisions. Some notice provisions require "prompt" notice of any claim that may in the ceding company's judgment impact the reinsurance contract; others require the ceding company to notify its reinsurer of claims when the ceding company's reserves reach a specified percentage of its retention under the reinsurance contract (such as 50%); still others make notice a condition precedent to coverage under the reinsurance contract. Sample provisions follow:

> The Company shall advise the Reinsurer promptly of all losses which, in the opinion of the Company, may result in a claim hereunder and of all subsequent developments thereto which, in the opinion of the Company, may materially affect the position of the Reinsurer.

BRMA 26B.

> The Company shall notify the Reinsurer promptly of any occurrence which in the Company's estimate of the value of injuries or damages sought, without regard to liability, might result in a judgment in an amount sufficient to involve this certificate of reinsurance. The Company shall also notify the Reinsurer promptly of any occurrence in respect of which the Company has created a loss reserve equal to or greater than fifty (50) percent of the Company's retention specified in item 3 of the Declarations; or, if this reinsurance applies on a contributing excess basis, when notice of claim is received by the Company….

Travelers Indem. Co. v. Scor Reins. Co., 62 F.3d 74, 77 (2d Cir. 1995).

An insurer's failure to provide notice in accordance with its reinsurance contract may give rise to a "late notice" defense to payment. Whether the reinsurer will be able to prevail on such a defense may depend on several factors including (1) whether the ceding company failed to comply with its notice requirements; (2) whether notice was a "condition precedent" to recovery; and (3) whether there must be a showing that the reinsurer was prejudiced by the late notice and, if so, whether showing has been made.

(continued)

> the Company and the Reinsurer shall cooperate in every respect in the defense of such claim, suit or proceeding.

BRMA 8A.

B. Compliance with Notice Requirements

Some reinsurance contracts require "prompt" notice "of any occurrence which in the Company's estimate of the value of injury or damages sought, without regard to liability, might result in a judgment in an amount sufficient to involve" the reinsurance contract. Others require notice by a specific point in time that can be measured objectively – *e.g.*, when reserves equal 50% of the reinsurance retention.

A provision that requires notice when a claim might in the ceding company's view impact its reinsurance arguably gives the ceding company discretion in determining when to provide that notice.[6] According to the seventh circuit, the ceding company must act reasonably in using its discretion, and not sit "idly by." *Imperial Cas. & Indem. Co. v. Chicago Housing Authority*, 987 F.2d 459 (7th Cir. 1993); *Zenith Ins. Co. v. Employers Ins. of Wausau*, 141 F.3d 300, 306 (7th Cir. 1998)(a clause which required the ceding company to give "prompt notice to the Company [] of any event or development which, in the judgment of the Reinsured, might result in a claim upon the Company hereunder" provides some discretion to the ceding company, but this is "tempered by an objective standard requiring notice to [the reinsurer] within a reasonable time of its realization that the claim could implicate the reinsurance policy."). *See also Constitution Reins. Corp. v. Stonewall Ins. Co*., 980 F. Supp. 124, 129-30 (S.D.N.Y. 1997) (New York law interprets clauses requiring "prompt" notice as giving the ceding company a reasonable amount of time to provide that notice).

What constitutes adequate notice? *Constitution Reins. Corp.* addressed that issue when it held that the ceding company's notice was <u>in</u>adequate. The underlying claim in that case involved an automobile accident in which both parents of an infant were killed. The ceding company's first notice to its reinsurer did not indicate that the claim involved two deaths, just that "Plaintiff alleges assured sold liquor to an already intoxicated person resulting in auto accident. We follow form to underlying policy which specifically excludes liquor liability." 980 F. Supp. at 128 (citations omitted). The court found that this two-sentence notice did not provide basic facts and thus did not count for purposes of determining when the reinsurer received notice of the claim. *Id.* (a later letter which provided basic facts about the loss, such as that there were two deaths involved and the underlying claim had been settled for $14 million, "is the earliest documentation presented to the Court that arguably satisfies the notice requirement of the reinsurance contract").

Allstate Ins. Co. v. Employers Reins. Corp., 441 F. Supp. 2d 865 (N.D. Ill. 2005), took an approach different from that in *Constitution Reins. Corp.* There, the court rejected a reinsurer's

---

6 The First Circuit construed a clause which required notice "of any occurrence which in the Company's estimate of the value of injuries or damages sought, without regard to liability, might result in judgment in an amount sufficient to involve this certificate of reinsurance" as ambiguous. *Travelers Indem. Co. v. SCOR Reins. Co.*, 62 F.3d 74, 78 (1st Cir. 1995) (Connecticut law). The court affirmed the district court's admission of industry custom and practice to interpret this provision. *Id.*

argument that a ceding company's "blanket notice" of multiple claims was inadequate because the notice did not contain adequate information on the claims:

> ERC next suggests that Allstate's "sloppy," "bulk reporting" of 88 claims 21-27 years after the claims arose violates the prompt-notice requirement on its face. But the Treaty makes no mention of the manner in which Allstate must provide notice. In fact, the Treaty does not even specify that the notice must be written, let alone that it contain sufficient information for ERC to determine the basis of the claim. ERC's implicit argument is that Allstate's bulk-reporting violated Article XII because its notice of claims contained insufficient information. The Treaty, however, imposes no duty upon Allstate to provide detailed information when it reports claims to ERC that might exceed the Treaty retention. To the contrary, the Treaty contains an express provision that requires Allstate to "forward promptly to [ERC] copies of such pleadings and reports of investigation *as may be requested by [ERC]*." (emphasis added). In other words, the Treaty imposes upon ERC the obligation to seek additional information if it believes the information provided by Allstate in its notice is insufficient for it to conduct an investigation of the claim.

441 F. Supp. 2d at 872 (emphasis added). Note, though, that the court appears to have based its reasoning on the language of the reinsurance contract at issue.

C. Notice as a Condition Precedent

What if the ceding company does not provide timely or adequate notice? At least under New York law, reinsurers are not required to prove that they were prejudiced by the late notice if notice was a "condition precedent" to recovery, such as in the following clause:

> As a condition precedent, the Company shall promptly provide the Reinsurer with a definitive statement of loss on any claim or occurrence reported to the Company and brought under this Certificate which involves a death, serious injury or lawsuit.

Constitution Reins. Corp. v. Stonewall Ins. Co., 980 F. Supp. 124, 127 (S.D.N.Y. 1997).

In *Constitution Reins Corp.*, 980 F. Supp. at 130-31, the court stated that in failing to provide prompt "definitive statement of loss," the ceding company could not recover on that loss:

> In the instant case, however, the prompt notice provision clearly indicates that it is intended to serve as a condition precedent. . . . It follows that *Unigard* does not require a showing of prejudice in order for Constitution to enforce this express condition precedent. . . . Since the court finds that there exists no genuine issue of material fact that Stonewall violated the 'prompt notice' condition in the reinsurance agreement, the condition operates as a complete bar against Stonewall's recovering under the reinsurance policy.

Under Illinois law, providing notice is a condition precedent to coverage even in the absence of explicit "condition precedent" language in the reinsurance contract. *Allstate Ins. Co.,* 441 F. Supp. 2d at 875. Accordingly, under that law reinsurers do not need to establish prejudice in order to prevail on a late notice defense. *Id.* ("Allstate offers argues [sic] that ERC has failed to show prejudice. The law in Illinois, however, is clear that a notice requirement, such as the one contained in the Treaty, is a condition precedent to coverage. [citations omitted]")

D. Late Notice Where There is no Condition Precedent

Where compliance with notice provisions is not a condition precedent to coverage, then a showing of prejudice is generally required in order for a reinsurer to prevail on a late notice defense. *E.g.*, *British Ins. Co. of Cayman v. Safety Nat'l Cas.*, 335 F.3d 205, 214-15 (3d Cir. 2003) (concluding that the New Jersey Supreme court would require the reinsurer to show "the likelihood of appreciable prejudice in order to prevail on a late notice defense asserted against its reinsured." The fact that a reinsurer's "right to associate" might be impaired by the late notice does not automatically result in prejudice to the reinsurer.); *Unigard Sec. Ins. Co. v. North River Ins. Co.*, 79 N.Y.2d 576, 584, 1992 N.Y. LEXIS 1294 (N.Y. 1992) (reinsurer was required to prove that it was prejudiced by a ceding company's late notice; the fact that the reinsurer lost the right to associate with the ceding company in the defense of the underlying claim did not give rise to a presumption of prejudice).

Some courts require the reinsurer that is asserting a late notice defense to demonstrate that the late notice prejudiced it. *E.g.*, *Unigard,* 79 N.Y.2d at 584 (burden on the reinsurer). Under California law, the reinsurer must demonstrate "actual and substantial" prejudice. *National American Ins. Co. v. Certain Underwriters at Lloyd's London*, 93 F.3d 529, 538-39 (9th Cir. 1996).[7] On the other hand, at least one court has held that the ceding company has the burden of establishing that its late notice did not prejudice its reinsurer. *Security Ins. Co. of Hartford v. Trustmark Ins. Co.*, No. Civ. 3:00CV1247 (PCD), 2002 U.S. Dist. LEXIS 27348, at * (D. Conn. Sept. 4, 2002) (in the absence of gross negligence, the "burden is [] on the reinsured failing to provide timely notice to establish that the reinsurer was not prejudiced by the late notice").

What constitutes prejudice? According to the Second Circuit, the reinsurer must show "that it suffered tangible economic injury." *Unigard Security Ins. Co. v. North River Ins. Co.*, 4 F.3d 1049, 1069 (2d Cir. 1993). The fact that the reinsurer was denied its right to associate in the defense of the claim does not constitute prejudice. *Id.* at 1068. According to the Fourth Circuit, the reinsurer must demonstrate that it would have exercised its right to associate in the handling of the claim, that that the reinsurer would have obtained a better result by doing so. *Fortress Re, Inc. v. Central Nat'l Ins. Co.*, 766 F.2d 163, 166-67 (4th Cir. 1985).

---

[7] Under California law, reinsurers must immediately assert its late notice defense or the defense will be waived. *Nat'l Am.*, 93 F.3d at 538.

Even where reinsurers must generally prove prejudice in order to prevail on a late notice claim, they may not need to show such prejudice where the ceding company acted with gross negligence or bad faith. *E.g., Christiania Gen. Ins. Corp. v. Great Am. Ins. Co.*, 979 F.2d 268, 281 (2d Cir. 1992) ("failure to provide prompt notice may entitle the reinsurer to relief without showing prejudice if the reinsured acted in bad faith"). For example, in *Certain Underwriters at Lloyd's, London v. Home Ins. Co.*, 146 N.H. 740 (2001), the court determined that the ceding company had acted in bad faith where it did not have "formal guidelines for determining what claims were to be reported to its reinsurers;" did not "track its reinsurance;" and did not notify its reinsurers of the claim at issue for eleven years after it first received notice of that claim. Similarly, *Security Ins. of Hartford* noted:

> [i]f a ceding insurer has implemented routine practices and controls to ensure notification to reinsurers but inadvertence causes a lapse, the insurer has not acted in bad faith. <u>But if a ceding insurer does not implement such practices and controls, then it has willfully disregarded the risk to reinsurers and is guilty of gross negligence. A reinsurer, dependent on its ceding insurer for information, should be able to expect at least this level of protection, and, if a ceding insurer fails to provide it, the reinsurer's late loss notice defense should succeed</u>.

(emphasis added (quoting *Unigard*)). In that case, however, the retrocessionaire had not established that its retrocedent's late reporting of claims was in bad faith. *But see*, *e.g.*, *Zenith Ins. Co. v. Employers Ins. of Wausau*, 141 F.3d 300, 307 (7th Cir. 1998) (under Wisconsin law, refusing to recognize a bad faith exception to the prejudice requirement).

<u>V. The Remedy Of Rescission</u>

A. Basic Principles

As previously discussed, the relationship between a cedent and its reinsurer is governed by the duty of utmost good faith. Under that doctrine, the cedent is required to disclose all facts that may materially affect the risk being reinsured. To the extent a cedent fails to abide by that duty – for example, by misrepresenting or not disclosing material facts – a reinsurer may be entitled to rescind the reinsurance agreement.

Rescission is a declaration that the contract is void ab initio. *Christiania*, 979 F.2d at 278. When it is warranted, the "objective is to place the parties as nearly as possible in the position they were in prior to the execution of the contract," as if the contract never existed. *Calvert Fire*, 526 F. Supp. at 657. Given that this remedy is intended to recreate the status quo before the contract was entered into, the reinsurer will be required to refund premiums to the cedent and pay applicable interest. *Curiale v. AIG Multi-Line Syndicate, Inc.*, 225 A.D.2d 409 (N.Y. App. Div. 1996); *Curiale v. AIG Multi-Line Syndicate, Inc.*, 204 A.D.2d 237 (N.Y. App. Div. 1994); *Calvert Fire*, 526 F. Supp. at 657.

B. Difficulty in Successfully Bringing Rescission Claims

Decision makers typically view rescission as a draconian remedy, reserved for extreme cases of fraud, non-disclosure, or misrepresentation. *See* Kathleen M. Carroll & David N.

Kragseth, *Reinsurance Contract Formation*, 889 PLI/Comm 9, 15 (June 2006) (noting the "extreme nature" of the rescission remedy); P. Jay Wiker & Edward K. Lenci, *Utmost Good Faith & Rescission*, 756 PLI/Comm 147, 220 (Sept. 1997) ("rescission is considered a severe remedy").

To obtain rescission, a reinsurers must prove a number of elements, i.e., (1) that a non-disclosure or misrepresentation occurred, (2) that the non-disclosed or misrepresented fact was material, and (3) that the reinsurer justifiably relied on the non-disclosure or misrepresentation to its detriment. *See Christiania*, 979 F.2d at 278 ("A fact is material so as to void *ab initio* an insurance contract if, had it been revealed, the insurer or reinsurer would either not have issued the policy or would have only at a higher premium."); *Unigard Sec. Ins. Co. v. Kansa Gen. Ins. Co.*, No. 93-35008, 1994 U.S. App. LEXIS 35914, at *7 (9th Cir. Dec. 7, 1994) (must show justifiable reliance in order to prove misrepresentation); *CNA Reins. of London Ltd. v. Home Ins. Co.*, No. 85 Civ. 5681 (JFK), 1990 U.S. Dist. LEXIS 159, at *29 (S.D.N.Y. Jan. 10, 1990) (justifiable reliance is an element of a misrepresentation claim); *American Re-Insurance*, No. 77 CH 1457 ("the court must be convinced that the injured party had justifiably relied on defendant's words or silence").

Additionally, courts have determined that some statements – such as a cedent's opinion or statement of future intention – cannot form the basis for rescission. That is, if a cedent makes promises to its reinsurer about future conduct, a reinsurer cannot seek rescission for that alleged misrepresentation unless it can demonstrate that the cedent intended to not fulfill its promises or the statement was part of the cedent's scheme to accomplish a fraud. *International Ins.*, 1991 U.S. Dist. LEXIS 12948, at *47-48 (promises of future underwriting conduct – e.g., promises that cedent would raise rates and retain a certain percentage of the primary layer for its own account – not actionable unless part of scheme to accomplish a fraud). *See also John Hancock Prop. & Cas. Ins. Co. v. Universale Ins. Co.*, 147 F.R.D. 40, 46-47, 1993 U.S. Dist. LEXIS 2486 (S.D.N.Y. 1993) (statements regarding (future) premium income projections not actionable as misrepresentations unless they were known to be false when made); *Old Reliable Fire Ins. Co. v. Castle Reins. Co.*, 665 F.2d 239, 245 (8th Cir. 1981) (cedent's statements of future underwriting objectives not considered contractual promises); *Glacier Gen. Assurance Co. v. Cas. Indem. Exch.*, 435 F. Supp. 855, 860 (D. Mont. 1977) (statement of loss reserve is an opinion and is not a fraudulent misrepresentation unless statement is false and made arbitrarily and with the intent to deceive).

C. Fraud

Perhaps the clearest justification for granting rescission involves situations where the reinsurer proves that the cedent has committed fraud. *American Re-Insurance*, No. 77 CH 1457 ("Fraud is probably the most frequently stated basis on which courts are asked to cancel agreements."). *See also Mutuelle*, 688 F. Supp. at 392 (reinsurer may proceed on fraud theory for cedent's misrepresentations if it alleges with specificity all the requisite elements under Illinois law); *Int'l Ins.*, 1991 U.S. Dist. LEXIS 12948, at *62-63 (permitting certain fraud claims to proceed).

D. Negligent or Innocent Misrepresentation

A reinsurer may also attempt to rescind a reinsurance contract based on allegations that the cedent negligently or innocently failed to disclose or misrepresented material facts. In this context, the courts are split as to whether the reinsurer must prove that the non-disclosure or misrepresentation was intentional in order to be granted rescission. For example, in *Christiania*, the court held that "whether the [cedent's] duty to disclose has been breached is not affected by whether the failure is intentional or inadvertent." 972 F.2d at 279. Other courts have similarly held that even a cedent's innocent failure to disclose a material fact is sufficient to establish a breach of the duty of utmost good faith, and thus warrant rescission. *Calvert Fire*, 526 F. Supp. at 637 (intent to deceive not required to rescind contract; statement made without knowledge of its truth or falsity meets the scienter requirement); *A/S Ivarans Rederei v. Puerto Rico Ports Auth.*, 617 F.2d 903, 905 (1st Cir. 1980) ("Whether the nondisclosure of a known fact material to a marine risk was intended or not is beside the point; such nondisclosure voids the policy.").

However, some courts have determined that an innocent misrepresentation is not sufficient to warrant rescission. In *Compagnie*, 57 F.3d at 72-73, the First Circuit stated:

> We agree that a reinsurer like NERCO, having obtained by treaty the power to impose significant risks and liabilities upon plaintiff retrocessionaires, owed to them the utmost good faith in its dealings under the treaties. This means that, as the district court properly recognized, defendants owed plaintiffs a duty "to exercise good faith and to disclose all material facts." In the non-marine context, however, a claim of fraud may not be founded on innocent misrepresentation and concealment. Thus, the district court properly required the plaintiff to prove that the defendant made a false representation of a material fact with knowledge of its falsity for the purpose of inducing the plaintiff to act thereon, and that the plaintiff relied upon the representation as true and acted upon it to his damage.

See also North River v. CIGNA, 52 F.3d at 1212-16 (reinsurer must show gross negligence or recklessness by cedent and prejudice due to the cedent's conduct); *General Reins. Corp. v. Southern Surety Co. of Des Moines, Iowa*, 27 F.2d 265, 273 (8th Cir. 1928) (reinsurer must show either "intentional concealment of known material facts, or bad faith in refusing to ascertain such facts").

E. Special Circumstances: Insolvency and Waiver

Some courts are reluctant to rescind a reinsurance contract when the cedent is insolvent, believing that such a remedy would burden the insolvent company's policyholders, claimants, and the State. In *Glacier General*, 435 F. Supp. at 862, a Montana court refused to grant rescission because it felt that if the reinsurer was relieved of its obligation to reinsure the potentially insolvent cedent, "someone other than [the cedent] or its reinsurers will bear the burden." *See also Garamendi v. Abeille-Paix Reassurances*, No. C 683-233 (Cal. Super. Ct. June 25, 1991), *reported in Modern Reinsurance Law & Practice* § 11.03[a].

However, other courts have determined that a reinsurer is not barred from seeking rescission from an insolvent cedent. In *Stephens v. American Home Assurance Co.*, 811 F. Supp.

937, 947-48 (S.D.N.Y. 1993), *vacated & remanded on other grounds*, 70 F.3d 10 (2d Cir. 1995), the court determined that under New York law, a reinsurer is entitled to assert any affirmative defense (including fraud) and seek rescission, regardless of a cedent's insolvency. *See also In re Liquidation of Union Indem.*, 89 N.Y.2d at 108 (reinsurer's defense of fraud and entitlement to rescission not affected by insolvency).

A court may not grant rescission if it determines that the reinsurer waived its right to rescind the contract. *Associated Int'l Ins. Co. v. Odyssey Reins. Corp.*, No. 95-56374, 1997 U.S. App. LEXIS 6386, at *16 (9th Cir. April 2, 1997) ("an insurer [reinsurer] waives its fraud and mistake defenses when it accepts and retains a premium while on notice of the facts alleged"); *Compagnie*, 57 F.3d at 84 (if reinsurers renewed their annual participations in the reinsurance treaties after becoming aware of misrepresentations, "this could affect their right to recover in fraud for subsequent Treaty business, and might conceivably cast doubt as to their right to recover at all, on some theory of acquiescence or waiver"); *Security Mut. Cas. Co. v. Affiliated FM Ins. Co.*, 471 F.2d 238, 246-47 (8th Cir. 1972) ("[W]aiver is a voluntary relinquishment of a known right," and reinsurer's "routine preliminary activity" after loss was not sufficient evidence to find waiver).

F. Recent Case Law

Below is a brief description of some recent case law discussing the remedy of rescission:

- *Mills v. Everest Reins. Co.*, 410 F. Supp. 2d 243 (S.D.N.Y. 2006) – Liquidator for insolvent insurer sought rescission based on mutual mistake, equitable remedy of avoidance, fraudulent conveyance, and fraud. The court ruled on certain statute of limitations issues, and also determined that the mutual mistake and fraud claims were not pled with specificity.

- *Gerling-Konzern General Ins. Co. v. Noble Assurance Co.*, No. 2:06-CV-76, 2006 U.S. Dist. LEXIS 85027 (D. Vt. Nov. 1, 2006) – Reinsurer sought summary judgment on its claim for rescission based, in part, on negligent misrepresentation and material non-disclosures. The court determined that disputed issues of material fact existed and therefore summary judgment was inappropriate.

- *Continental Cas. Co. v. Certain Underwriters at Lloyd's London*, No. 02 Civ. 960 (TPG), 2004 U.S. Dist. LEXIS 4060 (S.D.N.Y. March 15, 2004) – Compelling arbitration where the principal issue will be whether the reinsurance contract can be rescinded based on allegations of fraudulent misrepresentation.

- *Van Enterprises, Inc. v AVEMCO Ins. Co.*, 231 F. Supp. 2d 1071 (D. Kan. 2002) – Court determines that under Kansas law, a stop loss/excess contract (treated the same as a reinsurance contract) cannot be rescinded unless an intent to deceive has been established.

- *Reliastar Life Ins. Co. v. IOA Re, Inc.*, 303 F.3d 874 (8th Cir. 2002) – Court analyzed Minnesota law to determine summary judgment motion, where retrocessionaires attempted to rescind contract based on allegations they were induced to enter into the contract by fraudulent misrepresentation. The court determined there was no evidence to support the retrocessionaire's claims.

- *Nichols v. American Risk Mgmt., Inc.*, No. 89 Civ. 2999 (JSM), 2002 U.S. Dist. LEXIS 22221 (S.D.N.Y. Nov. 18, 2002) – Retrocessionaire entitled to rescind contract (but was required to return premium and pay interest) based on an allegation that the retrocedent knew it was insolvent but failed to disclose that information prior to entering into the contract. The court did not address the issue of whether an innocent non-disclosure warranted rescission because it found ample evidence that the retrocedent's management was well aware of its financial problems.