REINSURANCE BASICS FOR THE CLAIMS PROFESSIONAL RELATIVE TO BAD FAITH CLAIMS*

PETER J. HILDEBRAND, JD & CPCU
PETER HILDEBRAND LLC

INTRODUCTION

While surveying the voluminous literature available relative to bad faith claims in general and the application of reinsurance to those claims in particular, I was unable to locate any recent articles that focused on what claims professionals should consider while performing their role in the process. As such, the intent of this paper is to provide an additional resource for claims handlers, supervisors and managers to better understand how reinsurance applies to their bad faith claims and how they can better satisfy company obligations to their reinsurers.

This paper will examine numerous provisions found in a wide variety of reinsurance contracts. There is limited uniformity in the language used in reinsurance contracts. It is critical to remember that each contract is unique and that the claims professional should research the applicable contract and identify the specific wording that applies to their circumstances. The wordings used in this paper are merely intended to be representative of typical language that is found in today's reinsurance marketplace.

REINSURANCE 101: OVERVIEW ON THE IMPORTANCE OF REINSURANCE

The term "reinsurance" is not commonly heard outside the insurance community. Even within the insurance company environment, few people really have a clear understanding of the impact of reinsurance. "Technically speaking, reinsurance is insurance. A reinsurance agreement falls within the 'business of insurance' as that concept applies under the McCarran-Fergusan Act, rendering federal securities law inapplicable." Couch on Insurance, Sec. 9.9 FN 5. More simply stated, reinsurance is insurance typically bought by one insurance company (the Cedant) from another insurance company (the Reinsurer) in order to reduce the Cedant's exposure or share of the risk in return for a share of the premium. Reinsurance is one of many risk transfer mechanisms we learn about in CPCU classes and is widely used by insurance professionals and risk managers alike.

The reasons to buy reinsurance are far too numerous to address in this paper. However, expert commentators reference the following basic purposes served by reinsurance:

> The laying off of risk by means of reinsurance traditionally serves three basic purposes. First, reinsurance can increase the capacity of the insurer to accept risk. The insurer may be enabled to take on larger individual risks, or a large number of smaller risks, or a combination of both. Secondly, reinsurance can promote financial stability by ameliorating the adverse consequences of an unexpected accumulation of losses or of single catastrophe losses, because these will, at least in part, be absorbed by reinsurers. Thirdly, reinsurance can strengthen the solvency of an insurer from the point of view of any regulations under which the insurer must operate which provide for a minimum 'solvency margin', generally expressed as a ratio of net premium income over capital and free reserves." O'Neill and Woloniecki, The Law of Reinsurance in England and Bermuda 4 (1998).

Everyone knows that the insurance industry has experienced major catastrophic events, such as Hurricane Katrina or the attack on the World Trade Center, which demonstrate both the need for reinsurance and how reinsurance fulfills the purposes outlined above. It is especially critical for smaller companies trying to grow their business while being faced with demanding surplus requirements and annual rating reviews by A. M. Best with its variety of financial testing criteria.

REINSURANCE 102: TYPES OF CONTRACTS & TERMINOLOGY

It is nearly impossible to meaningfully address reinsurance coverage for bad faith claims without having a working knowledge of the most common types of reinsurance and the terminology involved.

"Treaty Reinsurance" is defined as "reinsurance under a broad agreement of all risks in a given class as soon as they are insured by the direct insurer." Black's Law Dictionary, 8th Edition, p.1312. The New York courts have explained the difference between treaty and facultative reinsurance as follows:

> Treaty reinsurance policies" cover a specified class of policies, for example, property damage policies or earthquake insurance, underwritten by the ceding insurer or insurers.
>
> Unlike a treaty reinsurer who must accept all covered business, the facultative reinsurer assesses the unique characteristics of each policy to determine whether to reinsure the risk, and at what price; thus, a facultative reinsurer retains the faculty, or option, to accept or reject any risk. Affiliated F.M. Ins. Co. v. Employers Reinsurance Co., 369 F Supp 2d 217, D. R. I. May 12, 2005.

The reinsurer that accepts a facultative risk will issue a "facultative certificate" reflecting the terms of its acceptance.

When reinsurance is issued on the basis of "excess of loss", the cedant agrees to accept a set amount of loss (the Retention) and cedes all sums in excess of that sum to the reinsurer subject to the contractual limits of the reinsurance. When reinsurance is issued on a "pro rata" basis, the cedant retains a percentage of the loss and cedes the remaining percentage to the reinsurer. There are instances where the reinsurer accepts 100% of the loss and uses the cedant as a fronting carrier. Another possibility is to use the treaty coverage for certain classes of business, but supplement it with facultative reinsurance where the account falls outside the class, either because of its size, the type of its operations or its desire for higher limits. There are many variations on how to structure a reinsurance program, limited only by the imagination of the reinsurers, their brokers and the risk managers involved.

REINSURANCE 103: REINSURANCE & CONTRACT LAW

Generally, reinsurance treaties or facultative certificates are considered contracts by the Courts which interpret them consistent with the contract law of that jurisdiction.

> The fundamental rules or principles governing the construction and interpretation of contracts generally apply equally to contracts of reinsurance. The form of the reinsurance contract, while distinctive in nature, is often similar to a contract of original insurance. It is the nature and heightened complexity or sophistication that sets the reinsurance contract apart and necessitates its own area of law within the broader context of insurance law. Couch on Insurance, Sec 9.9 FN 1-4.

Under the *Rule of Contra Proferentem*, contracts which may reasonably be construed to have more than one meaning are interpreted against the drafter, particularly when the policy is a standard form supplied by the drafting party. For this reason, courts routinely construe ambiguities in insurance policies against the insurer.

Reinsurance contracts are sometimes interpreted differently than insurance policies. The court in Employers Reinsurance Corp.v. Mid-Continent Cas. Co., 358 F.3d 757, 10th Cir. (Kan.), Feb 17, 2004, opined that the Contra Proferentem rule of interpretation (providing that ambiguous contract language must be construed against its drafter), is particularly suitable for standard insurance contracts where the insured does not have opportunity to negotiate or bargain, but the rule is less appropriate in reinsurance agreements because the parties typically have comparable bargaining power in negotiating terms of their contracts.

Reinsurance often presents unique issues of contract law. For example, one New York court held that black letter contract rules do not apply perfectly to interpretation of a facultative certificate that contains a "follow the form" clause, because the clause incorporates the wording of the underlying policy. See Travelers Cas. & Sur. Co. v. Ace American Reinsurance Co., 39 F. Supp 2d 659, S.D.N.Y., 2005. Oct 12, 2005.

The courts have well established that reinsurance contracts are contracts of indemnity, rather than liability. Couch on Insurance, Sec 9.9 FN 8. A state court has held that as a contract of indemnity, the payment of a claim by the reinsurer does not arise until the cedant has first paid the claim. North River Ins. Co. v Ace American Reinsurance Co.,361 F. 3d 134, 2nd Cir. (N.Y.), Mar15, 2004. However, the approach taken by the U.S. Supreme Court has been to not condition a reinsurer's obligation to pay on the payment of the loss by the reinsured unless the contract specifically provides otherwise. Fidelity & Deposit Co. v Pink, 58 S. Ct. 162, 164, 302 US 224, 229-30 (1937).

The courts have further held that an ordinary contract of reinsurance, in the absence of provisions to the contrary, operates solely as between the reinsurer and the reinsured. Ainsworth v. Gen. Reinsurance Corp., 751 F.2d 962, 965 (8th Cir. 1985). The reinsurer is not directly liable to the original insured. Unigard Sec. Ins. Co., Inc v N. River Ins. Co., 4 F. 3d 1049, 1054 (2d Cir. 1993). In a reinsurance contract there is no privity of contract between the reinsurer and person insured. Citizens Cas. v. Am. Glass Co., 166 F. 2d 91, 95 (7th Cir. 1948). Needless to say, the insured entity does not want to see the cedant go into insolvency, for they will have a very difficult time collecting any time soon from the liquidator, who will be pursuing collection of the ceded reinsurance.

Another contractual issue routinely faced in reinsurance matters relates to Conflict of Laws. Since reinsurance contracts are routinely issued in one state and delivered to a broker or cedant in another state, it is important to research what law applies to your contract interpretation. Examine your reinsurance contract for any choice of law provisions. Needless to say, the law of bad faith in some states is certainly more onerous than others. Some states have limited case law governing reinsurance contract construction, while others like New York have a well defined group of cases that serve as precedent for the industry.

A CRITICAL CLAIMS FUNCTION: REINSURANCE LOSS REPORTING

The vast majority of claims submitted to reinsurers are set-up, monitored and promptly paid to the cedant. However, there are occasional situations where the reinsurer will question or even contest a claim. Timeliness of reporting claims is among the most frequent issues raised by reinsurers. Timeliness of reporting the bad faith aspect of a previously reported claim is another source of contention. Why is timely reporting so important to reinsurers? Here are some basic reasons why reinsurers insist on timely reporting:

1. FINANCIAL INFORMATION: The Reinsurer must reserve their exposures just like the Cedant, project payment of future settlements and promptly pay billings.

2. PRICING: The Reinsurer will need to know both the frequency and severity of reportable claims, in addition to reserve and settlement information, to properly price the reinsurance contract renewal.
3. AUDIT: The Reinsurer has a right to review the Company's records and usually does this in conjunction with an annual or semi-annual audit. In addition to verifying financial information, the audit helps them to evaluate quality of claim handling. Timely reporting helps the Reinsurer ascertain the necessity of an audit and the amount of resources necessary to do it.
4. RIGHT TO ASSOCIATE: A Reinsurer may want to utilize their own expertise and attorneys to minimize their exposure under the reinsurance contract, especially on claims where they have a high level of specialization or experience. Delayed notice may preclude effective association.
5. RIGHT TO COUNSEL/CONSULT: If the reinsurer does not have prompt notice and sufficient information about the claim, any right to counsel/consult with the Company is effectively defeated.
6. RIGHT TO CONCURRENCE: Often the Reinsurer may have more money at risk than the Company, so the reinsurer wants to have a final say in the ultimate settlement. Delayed notice may delay concurrence and jeopardize coverage.

The custom and practice in the industry is to report claims through the reinsurance broker on the account. If the cedant has contracted directly with the reinsurer in order to save the broker commission, then the cedant will report directly to the claim unit of the reinsurer. Two common ways to report claims include an individual loss report on large losses using a standard form or by regular submission of a bordereau. The term "bordereau" is simply a fancy word for a description of reinsurance risks with basic information on the type of risks covered, the policies issued and the loss information on reported losses. The bordereau is ideal for reporting on quota share or pro rata contracts where there are a high volume of smaller claims.

MANDATORY CLAIMS REPORTING OF INDIVIDUAL LARGE LOSSES

Our focus will be on the reporting of large losses individually. The typical contractual requirement for reporting large losses will contain language requiring "prompt" or "timely " notice as suggested by the following provision:

> The Company shall give prompt written notice to the reinsurer of any claims or loss which in the sound judgment of the Company may result in a Net Loss to the Reinsurer and of all subsequent important developments involving that claim or loss.

The term "prompt" is not defined in the reinsurance contract. Other contracts that require "timely" notice also fail to define the term. Either term may be equally susceptible to multiple court interpretations. Whether the insurer acted with the requisite promptness when providing the reinsurer with a definitive statement of loss is often a fact question. See

Folksamerica Reinsurance Co. v Republic Ins. Co., not reported in F. Supp 2d, 2003, WL22852737, S.D.N.Y. 2003, Dec 02,2003. Therefore, as a practical matter, claim professionals may wish to adopt the following approach:

1. Always report the claim in **writing.**
2. Consider reporting financial changes relative to reserves and settlement demands or offers close in time to their implementation.
3. In practice, if there is any doubt as to whether a loss need be reported, "sound judgment" may lead to report on a precautionary basis. Some **precautionary notices** can be first and final and for information purposes only.
4. Remember there is a continuing obligation to report material developments.

The wording of some reinsurance contracts makes prompt notice a condition precedent to payment by the reinsurer. In a Pennsylvania case, the court held that the requirement of notice to the reinsurer when a reserve was raised over 50% was not a condition precedent. The provision failed to set out the number of days that sufficed for prompt notice, did not say the reinsurer was relieved of showing prejudice and did not clearly provide that the reinsurer would be relieved from payment absent prompt notice. See Folksamerica Re v Republic Ins Co., op. cit.

From the cedant's perspective, if your reinsurer raises the issue of late notice in writing, be sure to take their position seriously and ascertain which state's law will apply. Most states require the reinsurer to show the likelihood of appreciable prejudice in order to prevail, see British Ins. Co. of Cayman v. Safety Nat. Cas. 335 F3d Cir (N.J.), Jul. 03, 2003. Under New York law, the reinsurer must show prejudice to prevail on a late notice defense. Unigard Sec. Ins. Co, Inc. v. North River Ins Co., 762 F. Supp. 566, S.D.N.Y., Apr. 23, 1991. The condition precedent language is stronger in favor of the reinsurer, but the Courts may still not enforce the contract language absent obvious prejudice as in the Folksamerica case. Of course, if the cedant acts in bad faith in its handling of the claim, the reinsurer may not be required to show prejudice from late notice in New York.

Most reinsurance contracts make mandatory the reporting of certain categories of claims. Excess of loss contracts will require reporting of all losses where the indemnity reserve meets or exceeds a certain dollar threshold. The contract may select a specific sum, such as $100,000, or it may specify a reporting threshold at a percentage of the cedant's retention. If cedant has a $250,000 per claim retention, and must individually report all claims at or greater than 50% of the retention, any claim with an indemnity reserve of $125,000 or more must be reported.

A second category of claims that a reinsurer may make subject to mandatory reporting involves certain serious injuries. The language on reportable injuries in one reinsurance contract recently reviewed included the following criteria:

1. Brain damage or alleged brain damage.

2. Quadriplegics or Paraplegics
3. Amputation or loss of use of one or more limbs
4. Major burns
5. Severe lacerations or disfigurement resulting in serious cosmetic surgery
6. Extended hospital, wheelchair or walker confinement
7. Fatalities
8. Serious back injury involving multiple surgeries
9. Loss of sight or hearing
10. Sexual molestation or abuse
11. High wage loss or total loss of economic livelihood
12. Any claim involving purchase of an annuity, wherein ultimate payment will exceed Company retention.

Other types of claims that require mandatory reporting under some contracts may include: (1) Toxic tort claims; (2) Occupational exposure claims such as asbestosis (especially mesothelioma) or silicosis claims; and (3) Class Actions. Unusual claims not easily capable of evaluation may be good candidates for precautionary reporting. If the claims professional follows the rule of thumb that "when in doubt, report", the cedant should minimize the number of late reporting issues that arise.

MANDATORY REPORTING OF BAD FAITH CLAIMS

A third category of claims subject to mandatory reporting involves your ECO and XPL claims including unfair claim practice allegations, bad faith and extra limits situations. The controlling language in reinsurance contracts pertaining to ECO and XPL varies in description of the conduct or circumstances involved. One rather elaborate provision requires reporting as follows:

> 1. Any time a lawsuit is instituted against the Company wherein pleadings allege **unfair claim handling** on the part of the company, a **violation of any insurance claim handling law, statute or regulation**, or any time a claim **alleges "bad faith" claim handling** on the part of the Company.
> 2. Any time a policyholder has assigned its right under a reinsured Policy to another person or entity.
> 3. Any time there is a verdict in excess of policy limits or an offer of settlement in excess of policy limits otherwise covered hereunder.
> 4. Any time the Company has offered to settle a claim in an amount equal to the reinsured policy limit and such offer has been rejected by the plaintiff.

Given the broad scope of the above reporting provisions related to ECO/XPL, a wide variety of claims are mandatory reporting. Note that there is no exception for frivolous or unfounded allegations. Given that it has become common practice in some venues to allege bad faith when contesting even a routine coverage denial, the reinsurer requiring strict compliance with this provision may find itself deluged with precautionary reports. To avoid unneeded reporting, the reinsurer and the cedant need to have a clear understanding on what the reinsurer requires for this category of claims.

ECO/XPL COVERAGE PROVISIONS

Although it is a rare situation when a cedant is faced with a legitimate challenge to its claim handling practices or a verdict that exceeds policy limits, it is just those situations for which it obtains the protection of reinsurance. Most reinsurance contracts combine coverage for XPL (loss in excess of limits) and ECO (extra contractual obligations) into the same contract article or section. To distinguish between the two types of coverage, claims personnel may wish to look upon XPL as extra limits coverage and ECO as claims handling coverage.

Although there is no standard wording for these provisions and the language varies as and between various reinsurers and their contracts, the following sample language should suffice as an example of what to expect:

> EXTRA LIMITS COVERAGE:
>
> In the event a company pays or is held liable to pay an amount in excess of its policy limit, but otherwise within the terms of the policy, this is generally defined as XPL or "loss in excess of policy limits".
>
> CLAIM HANDLING COVERAGE:
>
> In the event the Company pays or is held liable to pay any punitive, exemplary, compensatory or consequential damages **other than XPL** because of alleged or actual bad faith or negligence on its part in rejecting a settlement within policy limits, or in discharging its duty to defend or prepare the defense in the trial of an action against its policyholder, or in discharging its duty to prepare or prosecute an appeal or in otherwise handling a claim, this is generally defined as ECO or "extra contractual obligations."

Although the above provision is self-explanatory, it should be noted that many claims may have both an ECO and an XPL component. Likewise, a reinsurance contract may respond differently to ECO or XPL losses. For example, a treaty may cover XPL at 100% and ECO at 80%. On continuing occurrence claims, the cedant needs to carefully review the contract wording for each applicable year of coverage. Both the coverage and wording can change year to year, as can the participation of the subscribing reinsurers and the cedant's pro rata share.

The ECO/XPL article or coverage section also contains other standard provisions such as the following;

A. OCCURRENCE: An extra contractual obligation shall be deemed to have occurred on the same date as the loss covered or alleged to be covered under the policy.
B. FRAUD: The contract does not apply to an extra contractual obligation incurred by the Company as a result of "any fraudulent and/or criminal act by any officer or director of the Company acting individually or collectively or in collusion with any individual or corporation ….. involved in the presentation, defense or settlement of any claim covered hereunder."
C. RECOVERY: Recoveries from "any form of insurance or reinsurance which protects the Company against claims the subject of this Article shall inure to the benefit of this Contract."
D. SEVERABILITY: If any provision "shall be rendered illegal or unenforceable by the laws, regulations or public policy of any state, such provision shall be considered void in such state, but this shall not affect the validity or enforceability of any other provisions of the Contract or the enforceability of such provision in any other jurisdiction."

The reinsurance contract will have a section containing general conditions that apply to its coverage and all the sections in the contract. The above conditions are particular terms that apply just to the ECO/XPL coverage. The occurrence provision deems that the loss date for ECO is the same as the underlying loss date. This precludes having multiple loss dates in different treaty years. The recovery provision protects the reinsurer from a situation of double recovery, especially if the cedant had an Errors and Omissions Policy that would cover claim handling mistakes.

PRO RATA REINSURANCE: OTHER PROVISIONS WHICH MAY VARY RELATIVE TO ECO/XPL COVERAGE

As previously mentioned, pro rata reinsurance allows the cedant to retain a percentage of all losses and to cede the remaining percentage to the reinsurers. Pro rata reinsurance is available for both casualty coverage and property coverage. There are specific provisions to watch for in Pro Rata Casualty Reinsurance Coverage such as the following:

1. PERCENTAGE OF LOSS: Typically the reinsurance contracts that I have dealt with provide coverage for either 80%, 90% or 100% of the ECO or XPL loss, but the percentage is subject to negotiation.

2. SUBJECT TO CONTRACT LIMITS. Be sure **all** applicable contracts are promptly notified, usually through the broker.

3. NO RESTRICTIONS VS WRITTEN NOTICE: Some ECO/XPL articles omit mention of notice, while others state specifically that coverage shall not apply "unless the company gives written notice to the reinsurer promptly following the Company's first knowledge of

an action against it alleging negligence or bad faith, and affords the Reinsurer an **opportunity to be associated** with the Company in the defense of said action." If the ECO/XPL article omits mention of notice, the notice requirement in the general conditions section applies. If the ECO/XPL requires written notice, do remember that you may have to provide additional notice of the bad faith claim even though the claim has been reported previously under the general notice requirement.

4. COUNSELING REQUIREMENTS: Since reinsurers often have claim professionals with substantial experience in high exposure claims, they may contractually require less sophisticated cedants to counsel with them. Typical language may state that coverage shall not apply "**unless the Company counsels with the Reinsurer and affords the Reinsurer an opportunity to be associated** with the Company in the defense of the action against the Company prior to or at the time of the trial which results in the loss in excess of the policy limits or, if there is no claim for loss in excess of policy limits, promptly following the Company's first knowledge of an action against it alleging negligence or bad faith."

5. CONCURRENCE: Since reinsurers often have the bulk of the money at risk, they sometimes add a contractual requirement that cedant get their concurrence in addition to counseling. Typical language may state that coverage shall not apply "**unless the Company counsels with the Reinsurer and secures the Reinsurer's written concurrence** with respect to the Actions to be taken…"

Pro Rata Property Reinsurance Coverage has similar language to the above provisions with possibly one significant difference. The pro rata property contracts that I have reviewed are written for only ECO with language similar to the following:

> In the event the Company pays or is held liable to pay punitive, exemplary, compensatory or consequential damages (hereinafter called "extra contractual obligations") because of alleged or actual bad faith or negligence on its part in handling a claim under a policy subject to this Contract.

This difference most probably relates to the difference between the First Party coverage provided in the underlying property insurance policy and Third Party coverage provided in the underlying casualty insurance policy. It would be unusual to experience an Extra Limits result under a property policy.

EXCESS OF LOSS REINSURANCE & ULTIMATE NET LOSS

There are so many variables to the types of Excess of Loss Reinsurance provisions that an exhaustive study would far exceed the space available to discuss, so we will address just a few of the more common ones.

The definition of "Ultimate Net Loss" (UNL) is the key point of reference in determining the scope of recovery under the reinsurance contract. Loss Adjustment Expense (LAE) is typically a significant part of cedant's recovery as well. The definition of UNL will usually address the treatment of expenses on either a pro rata basis or by including LAE in UNL subject to its limits. The following case examples demonstrate how the difference in policy terms can impact cedant's ultimate recovery:

> CASE EXAMPLE #1 – ABC Insurance Company contracts with XYZ Reinsurer on an Excess Per Risk basis which defines UNL as follows:
>
> **"Ultimate net loss"** as used herein is defined as the sum or sums **(including prejudgment interest, but not including litigation expenses or any other loss adjustment expense**) paid or payable by the Company in settlement of claims and in satisfaction of judgments rendered on account of such claims, after deduction of all salvage, all recoveries and all claims on inuring insurance or reinsurance, whether collectible or not. Nothing herein shall be construed to mean that losses under this Contract are not recoverable until the Company's ultimate net loss has been ascertained.
>
> ABC retains $250,000 per risk and XYZ reinsures $750,000 in excess of the retention. The contract defines LAE to include adjustment and litigation expenses, and reimburses LAE on a pro rata basis. ABC settles a claim for $500,000 while incurring $30,000 in LAE. The reinsurance recovery is $250,000 in loss plus $15,000 in pro rata LAE (50%) equaling $265,000.
>
> CASE EXAMPLE #2 – Same as #1 except the LAE is included within the definition of UNL as follows:
>
> **"Ultimate net loss"** as used herein is defined as the sum or sums **(including litigation expenses, interest on judgments and all other loss adjustment expense, except office expenses and salaries of the Company's regular employees**) paid or payable by the Company in settlement of claims and in satisfaction of judgments rendered on account of such claims, after deduction of all salvage, all recoveries and all claims on inuring insurance or reinsurance, whether collectible or not. Nothing herein shall be construed to mean that losses under this Contract are not recoverable until the Company's ultimate net loss has been ascertained.

The reinsurance recovery is the UNL of $530,000 ($500,000 loss plus $30,000 LAE) less the retention ($250,000) equaling $280,000.

CASE EXAMPLE #3 – Same as #1 except the settlement is $1,000,000 and the LAE is $40,000. The reinsurance recovery is $750,000 plus pro rata LAE of $30,000 (75%) for a total equaling $780,000.

CASE EXAMPLE #4 – Same as #2 except the settlement is $1,000,000 and the LAE is $40,000. the reinsurance recovery is capped at the $750,000 limit because UNL includes expense.

EXCESS OF LOSS REINSURANCE WITH ECO COVERAGE

When ascertaining whether there is coverage for ECO/XPL, the definition of UNL is again the place to look. For example, in the following language from an Excess Per Risk contract, the reinsurance contract redefines the definition of UNL to include extra contractual obligations and includes a separate definition for ECO as follows:

> "**Ultimate net loss**" as used herein is defined as the sum or sums (**including extra contractual obligations and prejudgment interest, but not including litigation expenses or any other loss adjustment expense**) paid or payable by the Company in settlement of claims and in satisfaction of judgments rendered on account of such claims, after deduction of all salvage, all recoveries and all claims on inuring insurance or reinsurance, whether collectible or not. Nothing herein shall be construed to mean that losses under this Contract are not recoverable until the Company's ultimate net loss has been ascertained.
>
> "**Extra contractual obligations**" as used herein shall mean **_____________% of any punitive, exemplary, compensatory or consequential damages paid or payable by the Company as a result of an action against it by its insured or its insured's assignee, which action alleges negligence or bad faith on the part of the Company in handling a claim under a policy subject to this Contract.** An extra contractual obligation shall be deemed to have occurred on the same date as the loss covered or alleged to be covered under the policy. Notwithstanding anything stated herein, this Contract shall not apply to any extra contractual obligation incurred by the Company as a result of any fraudulent and/or criminal act by any officer or director 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.

Again, typical ECO percentages are subject to negotiation and may be 80%, 90% or 100%. By having cedant retain an additional percentage of ECO losses, the cedant may be less likely to take undue risk in their claims decisions. In conjunction with the above wording, the LAE will most likely be pro rata in addition to limits. If the reinsurer were to place notice restrictions on the above excess per risk coverage, the language would be like the following:

> However, the extra contractual obligations coverage afforded hereunder shall not apply **unless the Company gives written notice to the Reinsurer promptly following the Company's first knowledge of an action** against it alleging negligence or bad faith, and **affords the Reinsurer an opportunity to be associated with the Company in the defense of said action.**

CASE EXAMPLE #1 -- ABC Insurance Company contracts with XYZ Reinsurer on an Excess Per Risk basis defining UNL and ECO as per the above Sec. A with 80% coverage for ECO. ABC retains$150,000 per loss and settles an excess verdict for the $300,000 policy limit plus an additional $100,000 to compromise a substantial punitive award. UNL equals $300,000 in loss plus 80% of the Extra Contractual settlement ($80,000) for a total UNL of $380,000 and the reinsurer pays $230,000 in excess of the $150,000 retention.

EXCESS OF LOSS REINSURANCE FOR EXCESS CASUALTY OR MULTI-LINE REINSURANCE

The provisions reviewed in the previous section related to Excess Per Risk reinsurance. In reviewing similar provisions for excess casualty and multi-line reinsurance, there are some similarities and some differences. The treatment of LAE is similar in that excess casualty reinsurance will usually reference LAE as either Pro Rata or as part of UNL. In practice, be sure to check how the expenses for **declaratory relief actions** are treated under the reinsurance contract. Sometimes defense costs and coverage expenses are treated differently. Notice provisions are also similar. One area of difference may occur in the definitions of ECO/XPL. When the definition of UNL includes both "loss in excess of policy limits" and "extra contractual obligations", the defined terms will often clarify Company and reinsurer obligations under the contract, as demonstrated by the following:

> "Loss in excess of policy limits" and "extra contractual obligations" as used herein shall be defined as follows:
>
> 1. **"Loss in excess of policy limits"** shall mean ____________% of any **amount paid or payable by the Company in excess of its policy limits**, but otherwise within the terms of its policy, as a result of an action against it by its insured or its insured's assignee to recover **damages the insured is legally obligated to pay to a third party claimant because of the Company's alleged or actual negligence or bad faith in rejecting a settlement within policy limits, or in discharging its duty to defend or prepare the defense** in the trial of an action against its insured, or in discharging its duty to prepare or prosecute an appeal consequent upon such an action.
>
> 2. **"Extra contractual obligations"** shall mean ____________% of **any punitive, exemplary, compensatory or consequential damages, other than loss in excess of**

policy limits, paid or payable by the Company as a result of an action against it by its insured, its insured's assignee or a third party claimant, which action alleges negligence or bad faith on the part of the Company in handling a claim under a policy subject to this Contract. However, the extra contractual obligations coverage afforded hereunder **shall not apply unless the Company counsels with the Reinsurer and secures the Reinsurer's written concurrence with respect to the actions to be taken to defend or control the action** against the Company prior to or at the time of the trial which results in the loss in excess of policy limits or, if there is no claim for loss in excess of policy limits, promptly following the Company's first knowledge of an action against it alleging negligence or bad faith, it being understood and agreed that:

a. If **any subscribing reinsurer hereon does not respond to the Company's request for concurrence within 15 days after receipt thereof, said subscribing reinsurer shall be deemed to have concurred with the Company**; and

b. If more than one subscribing reinsurer participates in this Contract, concurrence by the subscribing reinsurers whose percentage shares, when added together, represent **a majority interest** herein **shall constitute concurrence by the Reinsurer**.

There are numerous points of interest in the lengthy provisions above. First, the ECO and XPL provisions are separate and distinct with the option of different percentages of participation. This again raises the potential for an allocation issue. Who gets to allocate the payments from a settlement that contains both ECO/XPL? Typically the reinsurer must accept the allocation method used by the cedant as long as it is reasonable and consistent with the wording in the reinsurance contract.

The aforementioned contract terms require both counsel and concurrence. The typical language usually includes counsel with a right to associate. This stronger language in favor of the reinsurer may not be an issue when you are dealing with one reinsurer and they have followed the case for some time .However, the dynamics of dealing with multiple reinsurers, some foreign and some domestic, can get very complicated. Often cedants can focus on the lead reinsurer and the other participating reinsurers defer to the position of the lead. The above provisions clearly attempts to overcome the difficulty in getting concurrence by giving the reinsurers 15 days to concur. It also allows for concurrence if the reinsurers with the majority interest provide concurrence. The burden to concur shifts to the reinsurer once it receives the request, for a failure to respond will be deemed concurrence.

THE PRINCIPLE OF UBERIMAE FIDES AND THE FOLLOW THE FORTUNES DOCTRINE

It is well established that cedants are held to a duty of utmost good faith in their handling of claims submitted to a reinsurer. This is the ***Principle of Uberimae Fides****.* See Unigard Sec. Ins. Co, Inc. v. North River Ins Co., 762 F. Supp. 566, S.D.N.Y., Apr. 23, 1991, for confirmation that the *Principle of*

Uberimae Fides applies in New York and other states.   It would seem only fair that the duty would apply mutually to both the reinsurer and the cedant. At least one state court so interprets the law when it comments as follows:

> Seven Provinces' behavior was particularly egregious when seen in the context of the mores of the reinsurance industry, an industry which has operated for centuries on the principle of "uberrimae fidei". (Cedant's expert) testified to the traditional mores of the industry: that reinsurance is "an honorable engagement," in which "gentlemen's agreements" were secured by a handshake. Under this view, the reinsurer and the reinsured are "partners," who owe each other a duty of "utmost good faith." <u>Commercial Union Ins. Co. v. Seven Provinces Ins. Co.,</u> Ltd. 9 F. Supp. 2d 49, D. Mass., 1998.

Most reinsurers promptly pay claims. In a second Massachusetts decision involving the same parties, the Court found a violation of Sec. 93A of the state's unfair competition statute and doubled recovery against the reinsurer. The reinsurer used every means to avoid payment of a claim, including repeated requests for more information and forcing the cedant into litigation to collect their money. The reinsurer changed its position and alleged defenses on numerous occasions. The Massachusetts court held that the reinsurer violated the duty of utmost good faith as the reinsurer withheld performance due under the contract to renegotiate the bargain and force a compromise of a valid claim. <u>Commercial Union Ins Co. v Seven Provinces Ins. Co</u>, 217 F.3d 33, C.A. 1 (Mass), 2000.

In practice, if a claims professional is faced with repeated delays and requests from the reinsurer on a rather straightforward request for payment, what should be done? Provide immediate compliance, persist in repeatedly responding and then enlist the assistance of the broker to collect your money. Document your repeated requests for payment leaving a strong paper trail to support your position. Build a reputation of uncompromising persistence in pursuing your reinsurance recoveries. Failure to collect the money within 90 days of the billing may have a negative financial impact on cedant's profitability.

A doctrine closely aligned to the *Principle of Uberimae Fides* is the **Follow the Fortunes Doctrine**. This doctrine serves to ensure that the costs of the reinsurance transaction do not become economically prohibitive. It ensures that the reinsurers need not duplicate or monitor the adjustment efforts of the reinsured and the reinsured will not be denied indemnification because of errors in an adjustment that was carried out in a sound, businesslike manner. <u>Affiliated F. M. Ins. Co. v. Employers Reinsurance Co.</u> 369 F. Supp 2d 217, D.R. I. May 12, 2005. The Follow-the-fortunes doctrine extends to cedant's post-settlement allocation decisions as long as the allocation meets the typical follow-the-fortunes requirements: i.e. is in **good faith, reasonable and within the applicable policies**. <u>Travelers Cas. & Sur. Co, v. Gerling Global Reinsurance Corp. of America</u>, 419 F 3d 181, C.A.2 (Conn.) Aug 18,2005. In other words, the cedant, in addition to its duty to act in good faith in its handling of the claim, must be reasonable in the presentment of the claim to the reinsurer within the confines of the insurance coverage.

What is “reasonable” is often a question of fact. In another Travelers/Gerling dispute, the Court held for the reinsurer that the follow-the-fortunes and follow-the-settlements clauses in the reinsurance certificates did not require the reinsurer to adopt a single occurrence approach on asbestos matters where the cedant had long abandoned that position in the underlying litigation. Travelers Cas. & Sur. Co. v. Gerling Global Reinsurance Corp. of America 285 F. Supp. 2d 200, D. Conn., 2003, Sep 30,2003. This appears to be a decision where the Court found the cedant’s position to be unreasonable.

As a general rule issues on good faith and reasonableness are litigated with expert witnesses called to testify on the custom and practice within the industry. Needless to say, these types of issues can go both ways.

How far does the reinsurer have to go in following the cedant’s fortunes? In North River Ins. Co. v Ace American Reinsurance Co., 361 F. 3d 134, 2nd Cir. (N.Y.) Mar 15, 2004, the Court clarified this issue:

> "Follow-the-fortunes doctrine" binds reinsurer to accept cedant's good faith decisions on all things concerning underlying insurance terms and claims against underlying insured: coverage, tactics, lawsuits, compromise, resistance or capitulation.
>
> "Follow-the-fortunes doctrine" insulates reinsured's liability determinations from challenge by reinsurer unless they are fraudulent, in bad faith, or payments are clearly beyond scope of original policy or in excess of reinsurer's agreed-to exposure.
>
> Reinsurance contract is essentially contract of indemnity which does not arise until reinsured has paid a claim.

While a “follow the fortunes” clause in a reinsurance certificate does not obligate reinsurer to pay settlements which encompass losses outside the scope of coverage, the reinsurer is bound to reimburse insurer for payments made on the insured’s behalf so long as the payments are reasonably encompassed within the bounds of coverage. See Unigard Sec. Ins. Co. V. North River Ins Co., 762 F Supp. 566, S.D.N.Y.., Apr 23, 1991., which held that an insurer may possess and waive arguable defenses to coverage without altering the duty of a reinsurer to indemnify the ceding insurer for the coverage payment.

Many reinsurance contracts include an article which requires the reinsurer to follow the fortunes of the cedant. If the doctrine contractually applies, then based upon North River v. Ace, reinsurers really have limited options in challenging basic claim handling decisions by the cedant, some of which involve ECO/XPL type conduct. In order to protect themselves, they can include the various ECO/XPL provisions previously reviewed that give them a right to associate, a right to counsel and consult and in some instances a right to concur in the settlement decision. They can deny payment when the submitted claim involves fraud on behalf of the cedant, both based upon case law and the wording of the ECO/XPL contract language. Of course, they must be able to prove fraud with clear and convincing evidence which is a higher burden of proof.

Alternatively, if the reinsurance contract is silent as to following the fortunes of cedant, the reinsurer can argue that the doctrine is inapplicable. The case law is split as to whether the doctrine applies absent specific contractual reference, so carefully examine your reinsurance contract and check applicable state law to clarify your position.

SUMMARY OF PRACTICE TIPS FOR CLAIMS PROFESSIONALS

Reinsurance provides tremendous benefits to the cedant but at a substantial cost. The handling of reinsurance involves a wide variety of contracts with unusual provisions. Reinsurance claim reporting is best handled by Claim Professionals with specialized knowledge and experience with these contracts, the brokers and the reinsurers. There is no simple answer as to what the best approach should be for any given insurance company, given the wide variance in company size, types of policies written, and the large dollars involved.

Here is a list of practice tips that a company might consider in reviewing the effectiveness of its reinsurance program. Given the nature of your corporate structure and the extent of reinsurance used in your company, some may not be feasible and some may already be in place.

1. Centralize claim handling of reinsurance in one department or unit by keeping reporting and collection in the hands of the same specialized personnel. This allows your claim professional to take ownership over the whole process and avoids communication problems that occasionally impede or delay collection of recoveries.
2. Automate the reinsurance reporting process by programming your claims system to generate the reinsurance loss notices and billings.
3. If your claims system cannot accommodate reinsurance tracking, consider purchase of one of the reinsurance systems currently on the market. Studies show that they can help pay for themselves by finding additional recoveries.
4. Design a reporting form that meets the requirements set by **all** reinsurers, or alternatively, have your broker assist in obtaining one from the lead reinsurer.

In the handling of Bad Faith claims and ECO/XPL type exposures, consider the following:

1. Use management controls to identify and monitor every claim that involves bad faith or alleged bad faith in the Claims Department.
2. Flag each bad faith case in your claims system and report to the reinsurers.
3. Report even frivolous bad faith claims, at least on a precautionary basis.
4. Assign bad faith cases to a claims specialist who understands the company’s reinsurance program and the law of good faith and fair dealing.

5. Upon receipt of a new bad faith case assignment, require the claim specialist to review the applicable reinsurance before submitting the reinsurance loss notice.
6. If the reinsurer has a right to associate, counsel/consult or concur, ascertain from their claims department if they chose to do so and document the file accordingly.
7. The claim specialist and their manager should have each bad faith claim on diary and see that routine updates are sent to the reinsurer consistent with any continuing reporting requirements of the reinsurance contract.
8. Maintain a separate reinsurance folder or file to contain all reinsurance communications and document all communication with either the broker or the reinsurer. (This may be done using an email folder as well.)
9. Reinsurance disputes should be handled by claims management and the file immediately reassigned upon receipt of a reservation letter from the reinsurer.
10. Establish reserves on the ECO/XPL exposure, separate and distinct from the loss and LAE reserves posted on the claim.
11. Submit precautionary reinsurance reports on any case coming up for trial where the result may remotely exceed the cedant's retention.
12. Report claims involving negligent or bad faith claim handling mistakes to your E&O insurer immediately upon receipt. You are dealing with claims-made and claims-reported policies with stringent notice requirements.
13. Before making multi-million dollar XPL/ECO settlement decisions, consider getting a second opinion from other approved panel counsel to verify your analysis and support your ultimate decision.
14. If the reinsurance contract requires concurrence, convey that additional information to the reinsurer with sufficient time for their response.
15. Maintain excellent rapport with your broker and the claims professionals employed by the reinsurers who work on your account. This is a relationship business and fewer disputes arise when you're on the same team.

In conclusion, not all of the above practices need to be implemented in every company. Claims management can chose what works best for them given the structure of their claims department and sophistication of their claims system, the terms of their reinsurance contracts and the nature of their book of business. Good claim handling will generally limit the number of claims of alleged bad faith, but it is always best to be well prepared to handle and report such claims when they do arise.

ABOUT THE AUTHOR

Peter Hildebrand is the President of Peter Hildebrand LLC, an insurance and reinsurance consulting business. Mr. Hildebrand has spent 30 years in the insurance industry including the past 25 years as a senior level claims executive in four different insurance companies. He received his Bachelor of Arts degree in Economics (Honors Program) from the University of Wisconsin- Madison, summa cum laude, and was awarded membership in Phi Beta Kappa and various other honor fraternities. He continued his studies at University of Wisconsin Law School, where he received a Juris Doctor degree three years later. He is admitted to practice law in the State of Wisconsin and is a member of the Wisconsin State Bar Association, DRI, ABA and ARIAS.

As a former trial attorney, Mr. Hildebrand provides a unique blend of legal and insurance experience when assisting attorneys and their clients. He has lectured before groups for many years on insurance related topics. Mr. Hildebrand has been hired to consult and/or testify for both plaintiffs and defendants on a wide variety of insurance and reinsurance issues including the following: insurance coverage, claims handling practices, good faith and fair dealing, bad faith, litigation management, reasonableness of attorney fees, excess judgments and duties between primary and excess insurers.

For more information, here is his contact information:

Peter Hildebrand, LLC
3418 Woodshire Crossing
Marietta, GA 30066
(404) 384-0716 (mobile)
(678) 560-3728 (fax)
pjhildebrand@bellsouth.net