

Utmost Good Faith--Follow the Fortunes, The Theory and The Reality: What Are the Implications for Cedents and For Reinsurers?

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1. UTMOST GOOD FAITH

1. The Origin and Basis of the Doctrine of Utmost Good Faith.

2. The principle that the relationship between parties to a reinsurance agreement requires the exercise of utmost good faith has early roots. Hastie v. DePeyster, 3 Cal. R. 190 (NU 1805). This duty of utmost good faith, *uberrima fides*, is given weight in various contexts, essentially to create a standard of conduct that a cedent must satisfy in order to reap the benefits of its reinsurance agreement.

The two areas most frequently the subject of focus on issues relating to whether the duty of utmost good faith has been fulfilled are in the placement/underwriting of business and the submission of claims to a reinsurer. While the former tends to concern whether a prospective cedent, in presenting the specifics of the coverage it seeks to reinsure, has been both forthright and forthcoming in respect of what it recognizes a reasonable reinsurer would want to know, the latter concerns qualitatively similar questions about whether the cedent has been forthcoming regarding the underlying claim for which reinsurance recovery is sought. Additional--and not unrelated--issues that address the obligation of a reinsurer to "follow the fortunes" of its reinsured are frequently enmeshed in the overall analysis of the reinsurer's obligation to pay claims.

Under historical industry practice, and following the principle of utmost good faith, reinsurance contracts were considered "honorable engagements," and long-term relationships based on trust and confidence were the norm. The cedent took care in the underwriting of its business, provided material information to the reinsurers, and took the interests of its reinsurers into consideration when settling claims. For its part, the reinsurer did no contest the cedent's claim practices, and paid the claims upon demand.

A dictionary definition of utmost good faith is, perhaps, only marginally helpful: "*Uberrima Fides*" -- the most abundant good faith; absolute and perfect candor or openness and honesty; the absence of any concealment or deception, however slight." Black's Law Dictionary, 1520 (6th Ed. 1990). To the same effect, courts have held that "the duty of good faith requires the ceding insurer to place the reinsurer in the same [situation] as himself [and] to give to him the same means and opportunity of judging--- the value of the risks. Unigard Security Ins. Co., v. North River Ins. Co., 4 F.3d 1049, 1069 (2d Cir. 1993).

While the level of openness embodied in the dictionary definition would appear to be unquestionably great, the interpretation of the term's meaning by those courts to address it, especially in the most recent decisions, has tended to ease the standards, often to the benefit of cedents.

3. The Nature of Cedent's Duty

4. As is the case in respect of the placement of primary insurance, the risk taker---in the reinsurance context, the reinsurer--- is presumed to enter into the contract whereby it agrees to assume an indemnity obligation with a full understanding of the risk for which coverage is sought. That understanding is the product of information gleaned from a number of sources including the insured in the case of primary coverage or the cedent in the case of reinsurance.

While the doctrine of utmost good faith is generally premised on an existing relationship between parties, thus suggesting that a contractual relationship already has come into existence, it is frequently the fact that in analyzing whether a cedent has adequately disclosed to the reinsurer facts material to the risk, court will advert to the doctrine notwithstanding that the disclosure would necessarily have taken place before the contractual relationship began. In Couch on Insurance, the obligation to disclose is explained as follows:

§80-77 - Duty to Disclose.

In effecting a contract of reinsurance, it is incumbent upon the original insurer to communicate to the reinsurer all the facts of which it has knowledge which are material to the risk, and where it states as a fact something untrue, with intent to deceive, or where it states a fact positively as true, and which tends to mislead, the policy is avoided where such statement or fact materially affects the risk; also, any undue concealment or intentional withholding of facts material to the risk, which ought in good conscience to be communicated by the original insurer, avoids the contract, without regard to whether the knowledge or information with respect to material facts was acquired by the original insurer previously or subsequently to the writing of the original contract.

Couch on Insurance 2d (Rev. ed.) §80:77.

The foregoing is relatively straightforward. The cedent is required (1) to be truthful concerning all material facts and (2) to disclose---not conceal---those facts "which ought in good conscience to be communicated" to the reinsurer. While the concept is clear, the application of that concept is far from simple. As the case law reflects, a number of issues that are not initially apparent bear upon the resolution of the question of whether a reinsurance contract is vulnerable because of the manner in which the risk was presented when coverage was sought.

The principle that an insurer seeking reinsurance coverage has an unqualified duty to make full and accurate disclosures of all facts material to the risk, i.e., those facts that a reinsurance underwriter would normally want to consider when evaluating whether to assume coverage, can be found in numerous decisions, both ancient and recent. See Sun Mut. Ins. Co., v. Ocean Ins. Co., 107 US 485 (1883); New Hampshire Ins. Co. v. Philadelphia Re Ins. Corp., No. C-88-378, Slip Op. at 18 (N.D.Cal. March 1990)

The penalty that may be imposed for a cedent's failure to fulfill its duty of disclosure is that the reinsurance contract will be voided. Generally, a reinsurer can rescind a reinsurance contract based on a cedent's misrepresentation if the misrepresentation or non-disclosure was made with an actual intent to deceive or the matter represented was

material. Based on this general rule of law, a reinsurer could rescind a reinsurance policy even if the cedent innocently misrepresented a material fact. See Christiania Gen. Ins. Corp. of N.Y. v. Great American Ins. Co., 979 F.2d 268, 279 (2d Cir. 1992) ("whether the duty to disclose has been breached is not affected by whether the failure is intentional or inadvertent"); Imperial Fire Ins. Co. of London v. Home Ins. Co. of New Orleans, 68 F. 698, 704 (5th Cir. 1895) (a "concealment which is only the effect of accident, inadvertence, or mistake is equally fatal to the contract as if it were designed"). In addition, several courts have held that a reinsurer also may rescind a policy if the cedent intended to deceive the reinsurer, even if the matter misrepresented did not increase the risk of loss. See e.g., F.D.I.C. v. Underwriters of Lloyd's of London, Fidelity Bond No. 834/FB9010020, 3 F. Supp. 2d 120, 140 (D. Mass. 1998) (the court, interpreting a Massachusetts statute, held that a reinsurer can demonstrate materiality of the misrepresentation by showing either that the misrepresentation was made "with actual intent to deceive" or that it "increased the risk of loss").

The issue of materiality has been the subject of considerable discussion in the case law, and the evolving law on the subject reflects differences of view among the courts. In Christiania, 979 F.2d at 278, the court defined a material fact as one the "had it been revealed, the insurer or reinsurer would either not have issued the policy or would have [done so] only at a higher premium."

Various other courts have articulated the same general proposition, one which itself raises a number of additional issues. For example, is materiality to be determined by an objective or a subjective standard?

An objective standard focuses upon the actions an "average, reasonable" reinsurer would have taken, while subjective standard focuses on what the particular underwriter writing the risk would have done upon receipt of underwriting information from the cedent. In both arbitration and litigation, cedents seeking to overcome efforts by reinsurers to rescind reinsurance because of non-disclosure argue for a subjective standard, that is, to require reinsurers to produce the individual who actually underwrote the coverage---or other concrete evidence---to prove that, had the information been fully disclosed, the policy would not have been written on the same terms.

Inasmuch as the majority of disputes over reinsurance are subject to resolution by arbitration, the case law addressing the subject of what must be shown in warrant rescission has limited application and impact; certainly it is neither a precedent binding in arbitration proceedings no, indeed, even representative of an overall trend on how the issue is most likely to be decided. Nonetheless, a number of English court decisions reflecting the evolution of reasoning are instructive on the relevant considerations to be taken into account in evaluating potential rescission issues. (1)

In 1984, the Court of Appeal, in a case entitled Container Transport International, Inc. and Reliance Group Inc. v. Oceanus Underwriting Association (Bermuda) Ltd., *Lloyd's Law Reports* (1984), Vol. 1 at p. 476 examined the question of whether a reinsurer was entitled to rescind its contract because of the cedent's failure to disclose certain facts concerning the risk. The defendant, which had both directly insured Container Transport International, Inc. ("CTI") and reinsured the run-off of the coverage provided by its

predecessor, Lloyd's contended that CTI had submitted an inaccurate and incomplete claim history and had concealed prior underwriters' refusal to re new coverage. Because the case involved marine insurance, the court turned to the English Marine Insurance Act, which specifically states that the contract of insurance is based upon "the utmost good faith" and that if either party fails to so act, the contract may be avoided by the other party. The court commented at length of the duty imposed:

The duty of disclosure---is one aspect of the overriding duty of the utmost good faith---
The actual insurer is thereby entitled to the disclosure to him of every fact which would influence the judgment of a prudent insurer in fixing the premium or determining whether he will take the risk. The latter words---must comprise any terms, and not only the level of premium, which an insurer might require in the wording of the cover, e.g., warranties, franchises, deductibles, exceptions, etc. The word "judgment"----to quote the Oxford English Dictionary to which we were referred--- is used in the sense of "the formation of an opinion." To prove the materiality of an undisclosed circumstance, the insurer must satisfy the Court on a balance of probability---by evidence or from the nature of the undisclosed circumstance itself---that the judgment, in this sense, of a prudent insurer would have been influenced if the circumstance in question had been disclosed. The work "influenced" means that the disclosure is one which would have had an impact on the formation of his opinion and on his decision making process.

The thrust of the court's discussion cannot be overlooked. Quite clearly, the court considered the duty of the cedent as an extremely elevated one. Of greatest importance, however, was the court's pronouncement that the framework for judging the materiality of the fact not fully and accurately disclosed was that of a "prudent" insurer. Thus, the evidence called for on the issue would come not from the actual underwriter of the business but, rather, from an expert. While the Oceanus opinion goes on to discuss how various different types of evidence from the underwriter who accepted the risk might be presented as well, the opinion makes clear that a case of rescission would require objective proof of what a prudent underwriter would want to know when considering the risk, rather than subjective proof from the actual underwriter about what was important to that individual.

Following the Oceanus decision, insurers and reinsurers seeking rescission had a substantial basis for arguing that their cases would not be fatally flawed merely because the original underwriter would not be offering evidence. Certainly, in the context of reinsurance controversies where the contracts often went back to coverage written many years earlier, it was frequently difficult--if not impossible--to present the individual underwriter himself or herself. Thus, Oceanus threw a life raft to those insurers and reinsurers.

Unfortunately for some, the Oceanus decision did not remain the prevailing law in England. In Pan Atlantic Insurance Company Ltd. v. Pine Top Industrial Co., The Times (H.I. July 27, 1994), the court, in evaluating the rescission issue, reached a conclusion that was quite different and, indeed, is now prevailing law. In that matter, the court concluded that actual reliance must be demonstrated by the particular underwriter as part

of a reinsurer's proof of materiality. In particular, the court noted that the decision in Oceanus "that a defense of misrepresentation or non-disclosure can succeed even if the actual underwriter's mind was affected is contrary to common sense and justice."

5. **CEDENT'S DEFENSES TO MISREPRESENTATIONS.**

6. If a reinsurer seeks to rescind a reinsurance contract based on a cedent's misrepresentation, the cedent has available to it several potential defenses. For instance, there is legal authority for the proposition that even an intentional concealment of a material fact can be waived by a reinsurer, typically by accepting the validity of the coverage notwithstanding its knowledge that the cedent had engaged in misrepresentation and/or nondisclosure. Compagnie de Reassurance D'Ile de France v. New England Reinsurance Corp., 57 F.3d 56 (1st Cir. 1995), cert. denied, 516 U.S. 1009 (1995).

Moreover, in the analysis of whether a cedent has violated its duty to disclose, a presumption exists that the party to which disclosure is required will have general knowledge concerning the market in which it is writing coverage; thus, there is not duty to disclose information that the reinsurer would be expected to know by virtue of its participation in the reinsurance market. "[I]n determining what information is so material as to require disclosure by the insured, *sua sponte*, court recognize that the insured need not disclose 'what the insurer already knows or ought to know'" (citations omitted). Compagnie de Reassurance, 57 F.3d at 80. See also Sumitomo, 552 N.Y. S. 2d at 895, 75 N.Y.2d at 303 (a reinsured is obliged to disclose to potential reinsurers all material facts concerning the original risk, and failure to do so generally entitles the reinsurer to rescission of the contract; but the 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).

A reinsurer's claim for rescission may also be defeated upon a showing that its reliance on the cedent's misrepresentation or non-disclosure was not reasonable. Garamendi v. Abeille-Paix Reassurances, No. C683-233 (Cal. Super. Ct. L.A. County, June 25, 1991). To determine whether the reinsurer's reliance was reasonable, court often look at factors such as the parties past dealings, the sophistication of the parties, and the means by which the reinsurer could have learned the truth of the matter misrepresented. American Re-Ins. Co. v MGIC Inv. Corp., No. 77 CH 1457, slip op. at 31 (Ill. Cir. Ct. Cook County Oct. 20, 1987).

7. **The Deterioration of the Relationship Between Cedents and Reinsurers.**

8. It has been argued by some that "utmost good faith does not accurately describe the modern relationship of sophisticated insurers bargaining at arms length." See Unigard, 4 F.3d at 1066. The deterioration of the relationship between cedents and reinsurers also can be traced to the rising number of participants in the reinsurance market, and the increase in the amount in dispute, primarily the result of environmental and toxic tort for litigation. (2) Whether the anticipated influx of Y2K and technology claims will have a further negative impact on the relationship remains to be seen.

The first sign of the judicial weakening of the standard of utmost good faith is found in Christiania, 979 F.2d at 280. The Christiania court was "unable to adopt" the

reinsurer's characterization of the relationship between a reinsured and reinsurer as being fiduciary. "To the contrary," the court stated, "because these contracts are usually negotiated at arms' length by experienced insurance companies, there is no reason to label the relationship as fiduciary." Id. at 280-81 (citations omitted).

The reasoning behind the Christiania decision was adopted in Unigard where the Second Circuit Court of Appeals discussed the standard of utmost good faith. In that case, the district court held that a ceding company can violate the duty of utmost good faith even if it inadvertently fails to disclose material information. Unigard Security Ins. Co. v. North River Ins. Co., 762 F. Supp. 556 (S.D.N.Y. 1991), citing Hare & Chase v. National Surety Co., 60 F.2d 909, 912 (2d Cir.), cert. denied, 287 U.S. 662 (1932). On appeal, while the Second Circuit suggested that the utmost good faith principle was inviolate, it seems to have lowered the standard, making it more difficult for reinsurers to prove that the cedent acted in bad faith:

We thus think that the proper minimum standard for bad faith should be gross negligence or recklessness. If a ceding insurer deliberately deceives a reinsurer, that deception is of course bad faith. However, if 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. 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.

Unigard, 4 F.3d at 1069.

The First Circuit Court of Appeals in Compagnie De Reassurance, 57 F.3d at 72-73, while agreeing that the reinsured owed a duty of utmost good faith to the reinsurer in all dealings under the treaties, actually seemed to go one step further in the weakening of the duty. Essentially, it rejected the idea that an innocent misrepresentation violates the duty, and equated the good faith standard of common law fraud.

9. **The Interplay Between Placing Information and Contract Wording.**

An issue that can be significant but thus far has received little attention in the courts concerns the effect to be given to the reinsurance wording ultimately agreed upon by the parties when that wording calls for a result that may be at odds with representations that were made in placing information. A simple hypothetical example highlighting the problem might involve a representation by the cedent that it will not write a particular class of business, followed by the drafting of a contract that includes coverage for that particular class of business (and contains no exclusion eliminating the liability for such business). While one could debate whether, in light of the representation, it would be appropriate to require exclusionary language in the contract, the cedent certainly has a legitimate argument that if the reinsurer did not want to cover such a class of business, it could have excluded it as it did for a number of other matters. Moreover, if the reinsurance contract is mandatory, e.g., a quota share treaty requiring that all business falling within its coverage to ceded to that treaty, it is questionable whether the reinsured would be entitled in any event to refrain from ceding the business to that treaty.

The conundrum presented by the scenario described above cannot be easily resolved. As is often the case with various after-the-fact disputes, the positions taken by the parties to the disputed

contract are very much the product of whether the business has been profitable. Where losses have been heavy, the reinsurer may scrutinize the business in an effort to find a basis to reduce the cessions and, ultimately, its liabilities. Under such circumstances, the reinsurer may argue that the reinsurance contract should be rescinded because of the cedent's non-disclosure of misrepresentation. Reinsurers also may advance the alternative argument that, at the very least, the cession so of the forbidden business should be backed out.

On the other hand, when the experience of the business is positive and profits are available, it would not be surprising to find reinsurers arguing that, in view of the mandatory nature of the coverage, the cedent's failure to cede certain business---even though that business was not contemplated---was a breach of the treaty and that the profits on such cessions should be proportionately passed on to the reinsurer. Given the lack of case law on the subject, there is not definitive pronouncement on how this issue should be resolved. It would seem, however, that the reinsurer may well have the option of choosing rescission when the business reflects an overall loss, notwithstanding that it might accept "forbidden" risks if they turned out satisfactorily in terms of experience. What is relatively clear, however, is that the reinsurer would have to be consistent; it could not pick and choose particular cessions.

1. FOLLOW THE FORTUNES

The standard of utmost good faith is not limited to the underwriting or contract formation phase of the reinsurance/cedent relationship. Rather, the obligation of utmost good faith carries through to the parties' relationship into the claims-handling process. Once the claims-handling process begins, the parties' continued good faith relationship is manifested in the "follow the fortunes" or "follow the settlements" concepts.

1. Introduction

2. Courts pay considerable attention to the "follow the fortunes" provision, a clause that has appeared in reinsurance contracts (3) since at least the eighteenth century. (4). Pursuant to contract wording requiring that a reinsurer follow the fortunes, the reinsurer is generally required to indemnify the cedent for all claims paid in good faith and reasonably within the coverage provided under the reinsured policy.

"The purpose of the follow the settlements (5) doctrine is to prevent the reinsurer from second guessing the settlement decisions of the ceding company." Aetna Cas. & Sur. Co. v. Home Ins. Co., 882 F.Supp. 1328, 1346 (S.D.N.Y. 1995). One English court has stated that the principle that a reinsurer will follow the fortunes of its cedent exists because "[T]he original insurer of today might be the reinsurer of tomorrow; and trusting each other to act in the utmost good faith and saving the expense to reinsurers of disputing claims which the original insurers did not dispute, they agreed to insert in policies of reinsurance a clause applying their reinsurance to the original insurer's policies subject to the same terms and conditions and to pay as might be paid upon." Insurance Co. of Africa v. Scor (U.K.) Reinsurance Co., 1 Lloyd's Rep. 312 (C.A. 1984).

3. Limitations on Follow the Fortunes

The New York Court of Appeals in Unigard Sec. Ins. Co. v. North River Ins. Co. 79 N.Y. 2d 576, 583, 584 N.Y.S. 2d 290 stated that the "follow the fortunes" clause in most reinsurance agreements "leaves reinsurers little room to dispute the reinsured's conduct of the case." Despite

this generally understood broad proposition, there exist a number of well-recognized exceptions.

1. **The Good Faith Requirement**

While the first limitation on "follow the fortunes" is that the cedent must have acted in good faith, the good faith standard has not been clearly articulated by the courts in the context of reinsurance claims. It has become even more difficult to define as courts have attempted to adjust the standard to reflect the realities of the current reinsurance market.

Several courts have equated the general duty of good faith with following all "proper and businesslike steps" in the claims settlement process. See e.g., American Marine Ins. Group v. Neptunia Ins. Co., 775 F.Supp. 703, 709 (S.D.N.Y. 1991), aff'd 961 F.2d 372 (2d Cir. 1992); Insurance Co. of N. Am. V. U.S. Fire Ins. Co., 67 Misc. 2d 7, 322 N.Y.S.2d 520, 523, aff'd 42 A.D. 2d 1056, 348 N.Y.S.2d (1971). (6)

In the Ninth Circuit decision, National American Ins. Co. of Am. V. Certain Underwriters at Lloyd's of London, No. 94-55047 (9th Cir. 1996)(published in Mealey's Litigation Reports Reinsurance Vol. 7, #8 (August 26, 1996), the cedents expert testified that where coverage under the primary policy is disputed, as long as the cedent hires coverage counsel and follows its advice, the cedent has satisfied the good faith requirement.

Limits to this line of reasoning have been found by some courts. In the English case Charman v. Guardian Royal Exchg. Assur. PLC., 2 Lloyd's Rep. 607 (Q.B. 1992), the court rejected the cedent's argument that the mere fact that it had appointed a competent loss adjuster was enough to satisfy the requirement that the ceding company act in a businesslike fashion. The court held that if the loss adjuster did not act in a businesslike fashion, the cedent might be held to have breached its obligations.

While various conclusions can be drawn from the cases, it seems abundantly clear that courts have been more than willing to lower the good faith standard. (7) Consequently, it is increasingly difficult for reinsurers to prove that their cedents' conduct fell short of the mark and to avoid following the fortunes of these decisions. As a practical matter, however, one can legitimately question the significance of these decisions. Despite a higher standard imposed on cedents in the past, proving bad faith has always been a difficult task. While courts may have stated that the duty owed by a cedent is one of utmost good faith, courts may have stated that the duty owed by a cedent is one of utmost good faith, courts and arbitration panels seemingly have not allowed reinsurers to avoid their obligations simply on the basis of a cedent's inadvertent errors, but instead tend to require some form of intentional misconduct. The modern standard, even while appearing to soften the requirement of good faith, brings the same result more often than not.

1. **"Follow the Fortunes" Does Not Create Coverage Where None Would Otherwise Exist Under the Cedent's Policy.**

The second limitation on the "follow the fortunes" doctrine is that the reinsurer is not liable for claims outside the scope of the cedent's policy. See Mentor Ins. Co. (U.K.) Ltd. V. Brankasse, U996 F.2d 506, 517 (2d Cir. 1993). This limitation has created some controversy inasmuch as the entire point of the concept is to prevent the reinsurer from litigating or relitigating a claim based on defenses that could have been raised by the cedent in disputing

coverage for the underlying claim. Courts do not want to place cedents in the "untenable position" of raising defenses in coverage disputes that could later be used against them by reinsurers seeking to avoid coverage under their contracts. Consequently, courts have established a standard that makes it very difficult for reinsurers to argue that the cedent's payments are outside the scope of the reinsured policy. North River Ins. Co. v. CIGNA Reinsurance Co., 52 F.3d 1194, 1204 (3rd Cir. 1995). (8)

In International Surplus Lines Ins. Co. v. Certain Underwriters and Underwriting Syndicates at Lloyd's of London, 868 F. Supp. 917 (S.D. Ohio 1994), for example, the court stated that this limitation on the "follow the fortunes" doctrine requires the court only to decide whether the cedent acted reasonably. This is a very different analysis from one seeking to determine whether coverage would have existed if, in fact, the insured had not settled the claim.

[This] standard is purposefully low. Were the Court to conduct a de novo review of ISLIC's decision-making process, the foundation of the cedent reinsurer relationship would be forever damaged. The goals of maximum coverage and settlement that have been long established would give way to a proliferation of litigation.

Id. at 920. See also Insurance Co. of the State of Pa. V. Grand Union Ins. Co., 1 Lloyd's Rep. 208 (Hong Kong Ct. App. 1989) ("to permit reinsurers to go back to the alleged strict construction of the policy would destroy the value of the [follow the settlement] clause"); North River, 52 F.3d at 1206 ("follow the fortunes' doctrine creates an exception to the general rule that contract interpretation is subject to de novo review").

The result of this deferential standard is clear. If the cedent has acted in good faith, so long as the settlement is reasonably within the coverage provided under the reinsured policy, the reinsurer must pay. One court has stated that for the reinsurer to avoid coverage, the loss must be "categorically outside of the scope of coverage; such a settlement might make good business sense to the cedent, but it would not trigger a duty on the part of the reinsurer." Aetna Cas. & Sur. Co. v. Home Ins. Co., 882 F. Supp. at 1357. (Emphasis added.) That same court later stated: [I]t is only when the ceding company pays a claim that is manifestly outside the scope of the cedent's policy coverage that the reinsurer may successfully challenge the ceding company's interpretation and avoid the obligation to follow its settlement fortunes." Id. (Emphasis added.) See also Christiania, 979 F.2d at 280 ("a reinsurer is not obligated to indemnify the payments clearly beyond the scope of the original policy"). (Emphasis added.) Other courts have stated that only ex gratia (9) payments are outside the scope of follow the fortunes. See Christiania, 979 F.2d at 280; State Automobile Mut. Ins. Co. v. American Re-Insurance Co., 748 F. Supp. 556, 561 (S.D. Ohio 1990); Insurance Co. of N. Am. V. U.S. Fire Ins. Co., 67 Misc. 2d 7, 322 N.Y.S.2d 520.

Despite this very high burden, there have been some decisions in which courts have found that reinsurers are not liable for claims because they were outside the scope of the reinsured policy. In American Ins. Co. v. North Am. Co. for Prop. & Cas. Inc., 697 F.2d 79 (2d Cir. 1982), the cedent's policy explicitly excluded punitive damages from coverage. The dispute between the reinsurer and the cedent arose when the cedent settled a number of cases involving damages caused by the use of Styrofoam insulation. One of the settled cases involved a judgment against the manufacturer for approximately \$900,000. Of that amount, \$750,000 was an award for punitive damages. The reinsurer refused to pay on the ground that the claim was specifically excluded under the cedent's policy.

The court recognized that where "there is genuine ambiguity over what a settlement covers, a 'follow the fortunes' clause may oblige a reinsurer to contribute to a settlement even though it might encompass excluded items." Id. at 81. The cedent argued that it entered into the settlement for a variety of reasons having nothing to do with the punitive damages issue, including a fear that, on appeal, the compensatory award might be increased. The cedent also argued that the settlement agreement was ambiguous and, therefore, the "follow the fortunes" doctrine required the reinsurer to pay the loss as presented. Based on the facts, however, the court held there was no coverage. "It is clear that the settlement here was primarily designed to compensate Dow for a punitive damage award that is excluded from the reinsurance policy." Id.

As a practical matter, in drafting a settlement agreement with its insured, the cedent/insurer generally will prepare wording that is as broad as possible. While this may be desirable in the context of resolving insurer/insured conflicts, it can lead to potential reinsurance collection problems. If the settlement agreement is too broad, it arguably may cover claims that are clearly or manifestly outside of the reinsured policy. Reinsurers may rely on the threat of litigation. To prevent such a problem, cedents sometimes limit the terms of their settlement, where possible, to make it clear that the monies are only being allocated to covered claims.

1. **The Cedent's Claim Must Fall Within the Scope of the Reinsurance Contract**

The above analysis is based on the premise that the terms of typical reinsurance contract follow those of the underlying policy, for example, where the reinsurance contract contains a "follow the form" provision. (10). In that context, the argument has been made that the reinsurer's right to contest the settlements should be limited because "the interest of the direct insurers and reinsurers are broadly the same and it is not imprudent for the reinsurers to put themselves unconditionally in the hands of their reinsured for the settlement of claims which will be passed on to them." Hill v. Mercantile & Gen. Reinsurance Co. PLC (House of Lords, July 24, 1996) (reported in Mealey's Litigation Reports Reinsurance, Vol. 7 at B1 (August 14, 1996)).

Where, the terms of the reinsurance contract differ materially from the underlying policy, however, the interest of the reinsured and cedent are no longer identical, and a reinsurer may not want to rely on the claims handling practices of the cedent since "it may well happen that a claim under the direct policy does not require the determination of issue which are crucial to liability under the reinsurance." Id. The reinsurer's right to decline to pay for unreinsured risks "is particularly important in facultative reinsurance where the reinsurer accepts only specific risks." North River, 52 F.3d at 1207. (11)

A reinsurer is not liable for risks beyond that which was agreed upon in the reinsurance certificate. See, e.g., North River, 52 F.3d at 1207; Michigan Millers Mut. Ins. Co. v. North American Reinsurance Corp., 182 Mich. App. 410, 452 N.W.2d 841 (1990); J. Appleman & J. Appleman, 13A Insurance Law and Practice, § 7698, at 556 (1976) ("despite a 'follow the fortunes clause' the reinsurer is only liable for a loss of the kind reinsured"). Quite often the reinsurance contract explicitly limits the type which will bind the reinsurer to the cedent's fortunes. Under these circumstances, the reinsurer can always argue that the cedent's claim is beyond the scope of the reinsurance agreement.

The principle was most recently applied by the House of Lords, which held that "follow the fortunes" did not apply where the reinsurer could show that the terms of the reinsurance contract

did not cover the paid claim. See Hill v. Mercantile & General Reinsurance Co. (House of Lords, July 24, 1996)(reported in Mealey's Litigation Reports, Reinsurance Vol. 7 at B1 (August 14, 1996)). The Hill case involved losses incurred as a result of the Gulf War. Specifically, when Iraq invaded Kuwait, Iraqi forces seized fifteen aircraft from the Kuwaiti airport and removed them to Iraq. Seven of these aircraft were later destroyed on the ground by Allied Forces between January and February 1991. The remaining eight aircraft were eventually returned.

Difficulties arose in the Hill case because the reinsurance contracts did not all cover the same risks. The duration of some of these contracts differed; while most extended into 1991, several of the higher level contracts covered only the January 1990 to December 31, 1990 period. Consequently, the latter reinsurers argued that they were not liable because the aircraft were not destroyed until 1991.

The pertinent "follow the fortunes" clause in those contracts provided:

All loss settlements by the Reassured including compromise settlements and the establishment of funds for the settlement of losses shall be binding upon the Reinsurers proving such settlements are within the terms and conditions of the original policies and/or contracts and within the terms and conditions of this reinsurance.
(Emphasis added.)

Stating that the phrase "within the terms and conditions of this Reinsurance" was clear and unambiguous, the court found that the reinsurers were not bound by settlements made earlier down the reinsurance chain:

The reinsurers undertake to protect the reinsured against risks which they have written, not risks which they have not written. To allow even an honest and conscientious appraisal of the legal implications of the facts embodied in an agreement between parties down the chain to impose on the reinsurers risk beyond those which they have undertaken and those which the reinsured have undertaken would effectively re-write the outward contract. (12)

Therefore, even where the claim is settled in good faith and well within the terms of the cedent's insurance, where the risk is outside of the scope of the reinsurance contract, there is no coverage. "Follow the fortunes" will not serve to expand coverage (or create coverage) where clearly none exists.

Because reinsurers generally have not prevailed in coverage disputes where the reinsurance contract contains a "follow the fortunes" clause, much attention is paid to a reinsurer that successfully defends a claim. In Hill, the court tried to respond to the cedent's concern that to allow a reinsurer to raise such defenses would cause chaos in the market. The court noted that "allowing the defenses to be maintained will leave not only the validity but also the size of the claims and their incidence on various claims in suspense." Notwithstanding of the contract even where there were good policy reasons in favor of such approach. See also, Hiscox v. Outhwaite, 2 Lloyd's Rep. 524 (Q.B. 1991)(finding that settlements under the Wellington Agreement were not

covered by the reinsurance policy and rejecting the cedent's argument that the reinsurers were receiving the benefits of the Wellington Agreement that included a smaller total claim).

It is worth noting that the Hill court also may have been responding to the opinion of Lord Justice Staughton in Axa Reinsurance (UK) Ltd. v. Feld, [1996] 1 Lloyd's Rep. 26 (C.A. 1995), where he states that "[t]he huge capacity of the Lloyd's market to spawn litigation has become all too obvious in recent times. Where there is an attempt to restrict it, as the follow settlement clause, it should receive full faith and credit from the Courts. [T]here is here an attempt to avoid the proliferation of disputes, which should be given a wide rather than a narrower construction."

Another case where this seemingly unremarkable principle was applied is State Automobile Mut. Ins. Co. v. American Reinsurance Co., 748 F.Supp. 556. In that case, the cedent issued a builders risk policy that included coverage for a building, its contents, and loss of income. Coverage was then expanded to a second building that was then under construction. Coverage for that building was limited; there was no coverage for contents and loss of income. The reinsurer facultatively reinsured this risk.

Without informing the reinsurer, the cedent combined the two policies into one blanket policy that provided contents coverage for both buildings. The new structure was then destroyed by fire, and a dispute arose over coverage for the contents. While the court found that the cedent's payments were not ex gratia because they were reasonably within the terms of the underlying policy, it still held that the reinsurer was not liable for damage to contents or for loss of income, because "a reinsurer cannot be held liable beyond the terms of its contract merely because the primary reinsurer has agreed to expand the underlying primary agreement."

Like the principle that the "follow the fortunes" doctrine has no application to risks not within the terms of the reinsurance agreement, there also is authority for the proposition that a reinsurer will not be liable for amounts exceeding the stated coverage limits in the reinsurance contract.

In Bellefonte Reinsurance Co. v. Aetna Cas. & Sur. Co., 903 F.2d 910, 912-13 (2d Cir. 1990), (13) the court stated that "[t]o 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."

"Follow the fortunes" clauses "coexist" with liability limits, rather than supersede them. Id. See also Unigard, 4 F.3d at 1071; Aetna Cas. & Sur. Co. v. Philadelphia Reinsurance Corp., No. 94-2683 1995 U.S. Dist. LEXIS 7742 (E.D. Pa. June 7, 1995); Neptunia, 775 F.Supp. at 708; International Surplus Lines Ins. Co. v. Fireman's Fund Ins. Co., No. 88 C 320 1990, U.S. Dist. LEXIS 12470 (N.D.Ill. Sept. 20, 1990) ("a follow the fortunes clause cannot create liability that is inconsistent with the actual provision defining the scope of reinsurance"); Calvert Fire Ins. Co. v. Yosemite Ins. Co., 573 F.Supp. 27, 29 (E.D.N.C. 1983) (reinsurer's liability followed the cedent's fortunes only to the extent of the express limits).

The "follow the fortunes" doctrine has been widely applied over time in such manner that reinsurers are almost always held liable to pay as the cedent has paid. For reinsurers to prove that the cedent acted in bad faith or that the claim was beyond the scope of the underlying coverage is

an uphill battle. A number of decisions however, have opened the door for a greater number of reinsurers to contend that a particular loss is not within the scope of the underlying policy or the reinsurance contract.

Peerless Ins. Co. v. Inland Mut. Ins. Co., 251 F.2d 696 (4th Cir. 1958), is instructive on how a cedent should conduct itself in connection with the claims handling activities that may lead to a reinsurance claim. In Peerless, the excess-of-loss reinsurer sued the cedent for negligence and bad faith when a verdict was entered in excess of policy limits after the cedent had refused to settle the action.

In finding for the ceding company, the court relied, inter alia, on the following facts:

1. That the reinsurer was fully advised of the commencement and the progress of the suit;
2. That the reinsurer's assistant secretary personally reviewed the cedent's file and discussed the file with the cedent; and
3. That the reinsurer was consulted about the settlement offer that was made and rejected prior to the verdict.

The court found that by taking these steps, "the companies were unquestionably engaged in a joint enterprise---in accordance with their respective interests in the enterprise." Id. at 704.

One need not take a position as to whether the court was accurate in characterizing the relationship between the parties as a joint enterprise. What this case and those cited above stand for is the proposition that the applicability of "follow the fortunes" rests to a large extent in the hands of the ceding company. If the ceding company has poor claims handling procedures, and fails to provide information to its insurers, the chances that the reinsurer will not be required follow the cedent's fortunes significantly increase. If, on the other hand, the cedent makes an effort to keep the reinsurer informed, the risks of limitation, and the risks of failing to collect reinsurance, are minimized.

D. Is "Follow The Fortunes" Implicit In Every Reinsurance Contract?

One of the most heavily debated issues in reinsurance is whether "follow the fortunes" applies even when there is not such language in the contract. While this issue seems somewhat academic inasmuch as virtually all reinsurance treaties written today contain some type of "follow the fortunes"/"follow the settlements" language, the true implications of this debate are great. In increasing numbers, decades-old policies, considered by both cedents and reinsurers to be closed, suddenly have become the subject of claims. As discussed below, a number of the reinsurance contracts that cover these claims do not contain "follow the fortunes"/"follow the settlements" provisions; given contradictory holdings from well respected courts, the issue is likely to continue to be litigated.

A number of courts have stated that "follow the fortune" is inherent in every reinsurance contract even if no such provision is written into the contract. In International Surplus Lines Ins. Co., v. Certain Underwriters and Underwriting Syndicates at Lloyds of London, 868 F. Supp. 917, a dispute arose between the reinsurer and the cedent concerning whether the reinsurer was bound by the cedent's decision to treat some 85,300 asbestos personal injury claims as a single occurrence. In finding that the reinsurer was bound by the cedent's claims handling process, the court state that "[I]t is commonly understood that reinsurers must 'follow the fortunes' of their

insured. This fact may be formally express in an agreement of reinsurance. Even if it is not, the "Follow the Fortunes" doctrine applied [*sic*] to all reinsurance contracts." Id. at 920.

Similarly, in Aetna Cas., 882 F.Supp. at 1349-50, the court noted conflicting authority (14) but stated that "the weight of authority" supported the proposition that the "follow the settlements" doctrine was implicit in all contracts of reinsurance. That court gave great weight to the uncontroverted testimony of Aetna's expert witness, William Gilmartin, on this issue. When asked if the "follow the fortune" doctrine required specific language to invoke its protections, Mr. Gilmartin testified that the doctrine is inherent in the transaction of reinsurance.

Moreover, as a matter of policy the court stated that "[I]t would be difficult to imagine how reinsurance transactions could function in the absence of such an undertaking, given such large covers as were written in this case." Therefore, the court found that "it is customary within the insurance industry for reinsurers to follow the claim settlement decisions of the ceding company even in the absence of an explicit loss settlements clause." Id. at 1350. (15)

A third case that may provide support for the proposition that the "follow the fortunes" doctrine is inherent in the relationship between cedents and their reinsurers is the Third Circuit's decision in North River Ins. Co. v CIGNA Reinsurance Co., 52 F.3d 1194, discussed more fully above. In that case the facultative reinsurance contract contained the following language: "All claims involving this reinsurance, when settled by [North River], shall be binding on [Cigna Re], which shall be bound to pay its proportion of such settlements."

The district court stated that since the cedent was ordered to pay the disputed claim by an arbitrator, the claim technically was not "settled," and therefore, was beyond the scope of the contract language. On appeal, the Third Circuit reversed the lower court's decision, stating that the district court read the clause too narrowly. "Despite the explicit reference to 'settlements' in the typical 'follow the fortunes' clause, it is well settled that the principle applies generally to all outcomes of coverage disputes, whether in the form of settlements or judgments." Id. at 1205. In coming to this decision, the court relied extensively on cases and authority stating the inherent and broad nature of "follow the fortunes."

Recently, however, the Ninth Circuit rejected the proposition that "follow the fortunes" is implicit in every reinsurance contract as a matter of law. National American Ins. Co. of N. Am. V. Certain Underwriters of Lloyd's of London No 94-55047 (9th Cir. 1996)(published in Mealey's Litigation Reports, Reinsurance. Vol. 7, #8 (August 26, 1996)). In that case, the district court had found that "follow the fortunes" was implicit in all reinsurance contracts, relying primarily on the testimony of Mr. William Gilmartin, which went largely uncontroverted. (Mr. Gilmartin, of course was the same expert who testified in Aetna, above.)

The Ninth Circuit initially agreed with the district court, affirming the lower court's opinion on the implicit nature of the principle. In August 1995, the Ninth Circuit affirmed the lower court's decision a second time when it denied the reinsurer's petition for rehearing, although, at that time, the Court of Appeals deleted its references to the ISLIC and Aetna cases cited above.

In February 1996, however, on its own initiative (though apparently responding to criticism over the decision), the court issued an order requiring the parties to brief the issue relating to the implication of the obligation to follow the settlements. This time, the court found that, under

California law, when there is no "follow the fortunes" provision, a reinsurer has the right to assert the same coverage defenses that might have been available to the reinsured against the insured at the time of settlement.

After examining the record, the court stated that the reinsurers had provided sufficient evidence demonstrating that the relationship between the parties was not one of following the fortunes. The court stated, however, that this did not prevent the cedent from presenting evidence at trial demonstrating that the custom of the parties was that the reinsurer would follow the fortunes.

While in theory National American may make it more difficult for cedents to claim that reinsurance policies implicitly require the insurer to follow the fortunes, it is noteworthy that prior to National American, there were only a few cases that had held that "follow the fortunes" was implicit, and it is not certain that those cases would have stood the test of time. In ISLIC the statement was made in an almost passing fashion. In Aetna the court relied on the uncontroverted testimony of the cedent's expert. Moreover, as noted, arbitrators, who decide the vast majority of reinsurance disputes, are not bound by the decision of those courts or any other court.

What is clear is that in cases where there is no "follow the fortunes" clause in the contract, determining if the doctrine is implicit will likely require a trial. Both parties will present expert testimony on this issue, and because the experts may nullify each other on the question of industry custom, more persuasive at trial might be the actual custom of the parties themselves, *i.e.*, did the reinsurer previously follow the fortunes of the ceding company?

CONCLUSION

The doctrine of *uberrima fides* is constantly evolving, with at least some forums equating a breach of the duty of good faith with gross negligence or recklessness. Notwithstanding this apparent trend toward the weakening of the duty of utmost good faith, relevant case law demonstrates that both the cedent and the reinsurer continue to have reciprocal obligations with respect to their reinsurance transactions. These obligations, whether rising to the level of utmost good faith or some lesser standard, do not conclude once the reinsurance agreement is in place; rather, the duty continues to govern parties' transactions throughout the term of the reinsurance agreement and throughout the claims process.

ENDNOTES

1. There are few decisions offering guidance on this precise issue inasmuch as reinsurance disputes traditionally have been resolved through arbitration rather than in the courts. See Sumitomo Marine & Fire Ins. Co., Ltd. - U.S. Branch v. Cologne Reinsurance Co. of Am. 75 N.Y.2d 295, 552 N.Y.S.2d 891; Ott v. All-Star Ins. Corp., 99 Wis.2d 635, 299 N.W.2d 839, 845 (1981). Given the dearth of case law, judges routinely look to decisions in courts of all jurisdictions, including courts of foreign countries.
2. For example, in the introduction of the English decision Toomey v. Eagle Star Ins. Co., Ltd., 1 Lloyd's Rep. 516 (C.A. 1994), the court stated:

3. [f]or a long time the agreement was operated without apparent difficulty. Claims in respect of the relevant years of account were regularly settled by the Syndicates and as regularly reimbursed by Eagle Star in accordance with the agreement. Recently, however, a huge increase of claims, mostly, I was told, arising from personal injuries sustained in the United States as a result of asbestosis or from damage to property in the United States caused by pollution have been made on the syndicates in respect of the 1965 and prior years. Since mid 1991 Eagle Star has refused to pay claims made by Syndicates under the agreement.

See also Steven W. Thomas, Note, *Utmost Good Faith in Reinsurance: A Tradition in Need of Adjustment*, 41 Duke L. J. 1548, 1558-61 (1992).

4. Many, but not all, reinsurance contracts contain a "follow the fortunes" provision. A much-debated issue is whether this doctrine is implicit in each reinsurance contract and applies even in the absence of such a provision.
5. See *Hastie v. DePeyster*, 3 Cal. R. 190 (N.Y. 1805) (reviewing French precedent discussing the effect of the "follow the fortunes" clause).
6. While the concept of "follow the settlements" is arguably narrower than "follow the fortunes
7. One court has indicated, however, that the duty to act in businesslike fashion is a requirement separate from the duty to act in good faith. *Aetna Cas.*, 882 F. Supp. At 1351 ("subject to the ceding company's duty of utmost good faith, and the requirement that investigations---be reasonable and businesslike, the [follow the fortunes] doctrine leaves it to the ceding company to make the settlement decision in the first instances, which settlement is then binding upon the reinsurers.") (Emphasis added.)
8. See Marcy B. Tanker, Stephen P. Chawaga, *Utmost Good Faith After NERCO and North River*. *Mealey's Litigation Reports Reinsurance*, Vol. 6 at 12, 15 (August 23, 1995)(noting that while many courts have stated that they are not altering the doctrine of utmost good faith, "in finding that the reinsurers before them met the standard despite some suspect conduct, the courts have contributed to eliminating the term 'utmost' from the doctrine").
9. See also *Aetna Cas.* 882 F.Supp. at 1346 ("Absent such a rule, an insurance company would be obliged to litigate coverage disputes with its insured before paying any claims, lest it first settle and pay a claim, only to risk losing the benefit of reinsurance coverage when the reinsurer raise in court the same policy defense that the original insurer might have raise against its insured").
10. An *ex gratia* payment has been described as a payment that is "made by one who recognizes no legal obligation to pay but who makes payment to avoid greater expenses as in the case of a settlement by an insurance company to avoid costs of a suit." *Black's Law Dictionary* 573 (6th ed. 1990).
11. A following form clause in reinsurance policy incorporates all terms and conditions of the reinsured policy into the reinsurance contract. *Aetna Cas.*, 882 F. Supp. At 1345.
12. There has been some debate over whether the "follow the fortunes" doctrine even applies to facultative reinsurance, as it does to treaty reinsurance. In treaty reinsurance, the reinsurer agrees to indemnify the cedent for losses incurred under all policies issued by the cedent to its insured. In contrast, facultative reinsurance is obtained by the ceding company for a specific risk or policy with the reinsurer evaluating the risk before agreeing to reinsure it. Some reinsurers point to the fact that a facultative reinsurer is an

active participant in underwriting the specific risk, and did not agree to the general claims handling practices of the cedent. This argument has been rejected by a number of courts, and it would appear that the issue is settled in favor of the doctrine's application. See Aetna Cas., 882 F. Supp. At 1348; Unigard, 584 N.Y.S.2d at 293 & n.2; Bellefonte Reinsurance Co. v. Aetna Cas. & Sur. Co., 903 F.2d 910 (2d Cir. 1990).

13. The court also noted that the purpose of "follow the fortunes" does not transfer well to the situation where the reinsurer is at a distance from the direct insurance since "a remote reinsurer, who may know nothing beyond the identity of his reinsured, and the terms of his own cover, could hesitate to entrust his liabilities to a stranger, which is what will happen if all the reinsurance's down the chain embody unqualified follow settlements clauses."
14. The Bellefonte decision is considered controversial by many in that it goes against industry custom and practice. It has been ignored by a number of arbitration panels.
15. There is a split on this issue. Compare Henry T. Kramer, The Nature of Reinsurance in Reinsurance 11-12 (R.W. Strain, ed. 1980)(duty to follow fortunes "may or may not be expressed in an agreement of reinsurance but nevertheless exists for all"); Klaus Gerathewohl, 11-12 (R.W. Strain, ed. 1980)(duty to follow fortunes "may or may not be expressed in an agreement of reinsurance but nevertheless exists for all"); Klaus Gerathewohl, Reinsurance Principles and Practice, § 2.5..1 at 466 (1980)(the "fundamental follow-the-fortunes principle" applies irrespective of whether it is expressed in the contract) with C. E. Golding, The Law of Reinsurance Claims 129-30 (1994); Graydon S. Staring Reinsurance, § 18:8 at 28 (1993)("without a follow the fortunes clause, the reinsurer will probably not be bound---by a settlement of claim without its consent"); Hoffman, Common Law of Reinsurance Loss Settlement Clauses 679 (noting the split in authority).
16. Another case that is often cited for this proposition is Mentor Ins. Co. (U.K.) Ltd. v. Norges Brankasse, 996 F.2d 506 (2d Cir. 1993). Although the reinsurance agreement in that case contained a "follow the fortunes" provision, the special master, whose opinion was adopted by the court, stated that "custom and practice in reinsurance includes the principle of 'Follow the Fortunes'" Id. at 516. See also Ambassador Ins. Co., Inc. v. Fortress Re., Inc. No. C-79-101-G Slip Op. (M.D.N.C. 1983)(noting that it is 'customary' for reinsurers to follow the fortunes of their reinsureds).