Gentlemen's

To cede, or not to cede; that is the question;
Whether tis better in the end to suffer
The casualties and claims of hazard and catastrophe
Or take precaution gainst their sea of troubles
And by reinsuring ease them?

—Author Unknown

Agreement

What practitioners should know about reinsurance

By James A. Johnson

Reinsurance is a contract of indemnity between insurance companies defined by a historical relationship. One company, the reinsurer, agrees with another, the cedent, to indemnify it against a loss, which the cedent has assumed under a separate and distinct contract of insurance. There are two basic types of reinsurance, facultative and treaty. Facultative involves ceding part or all of an individual policy to a reinsurer as distinguished from treaty, which covers all, or specified classes of a reinsured's policies, at a specified percentage. A facultative reinsurance policy offers individual risks to the reinsurer, who has the right (faculty) to accept or reject it. A treaty reinsurance policy is automatic and binds the reinsurer to accept all risks ceded to it of a certain type or category.

This article provides guidance to practitioners on reinsurance. A fundamental purpose of reinsurance is to permit an insurer to reduce its reserve requirement. By using reinsurance, an insurer can spread the risk it undertakes over a larger number of policies, reducing the amount of reserves required to maintain its business and increase its profitability. The reinsurance relationship is characterized by the mutual duties of "utmost good faith" and "follow the fortunes," that obligate the reinsurer to indemnify the ceding insurer for all losses paid by the ceding insurer on the reinsured policy. In short, it is a commercial transaction between sophisticated companies governed by equity and utmost good faith.

Follow the Fortunes

"Follow the fortunes," or "loss settlements," means that, within the terms and conditions set forth in the reinsurance agreement, the reinsurer assumes the original risk in the same way as the cedent. Thus, reinsurers are responsible for the payment of a loss insured under the original policy. A reinsurer cannot second guess the good faith reinsured's decision to waive defenses to which it may be entitled.[1] Reinsurance contracts are considered gentlemen's agreements, or honorable engagements built on trust and confidence. However, the philosophies of "follow the fortunes" or "follow the settlements" do not obligate the reinsurer to follow settlements that are categorically outside the scope of the original policy between the cedent and its insured.[2]

Because of the unique relationship between the parties and the dearth of decisional law, traditional contract interpretation and analysis is not always followed to resolve disputes. Evidence of custom and practice in the reinsurance industry is used by the courts to determine rights and obligations of the parties and to impose follow the settlements, as a matter of law. *North River Ins Co v CIGNA Re* involved a dispute for reimbursement of defense cost paid in excess of policy limits. The court held that it is an implicit agreement in every reinsurance contract, as a matter of law.[3]

In *Bellefonte Reinsurance Co v Aetna Casualty & Surety Co,* however, the court held that the reinsurer's obligation to follow the fortunes of the cedent did not extend beyond the stated amount in the facultative certificates.[4] This decision was premised on the uncontroverted evidence of the parties' past conduct and course of dealings. Indemnity, cost, and expenses were subject to the express cap in each certificate.

Regardless of custom and practice, the Michigan Court of Appeals reversed the trial court and opined that the "follow the fortunes" doctrine may not be read into a reinsurance contract. Without an express provision to "follow the fortunes," liability of the reinsurer can only be imposed by the terms of the reinsurance contract.[5] Relying on *Michigan Millers Mutual Ins Co v North Am Reinsurance Corp,*[6] the court said that liability for reimbursement or indemnity depends on the language in the reinsurance contract and not whether the underlying insurer may have made payment to an insured. In Michigan, indemnity in a reinsurance contract without a "follow the fortunes" clause is not what the reinsured paid, but what he was legally bound under his policy to pay, by reason of the loss.

Fast Facts:

Facultative reinsurance involves ceding part or all of an individual policy to a reinsurer as distinguished from treaty at a specified percentage.

A treaty reinsurance policy is automatic and binds the reinsurer to accept all risks ceded to it of a certain type or category.

The reinsurance relationship is characterized by the mutual duties of "utmost good faith" and "follow the fortunes."

Declaratory Judgment Expenses

In a reinsurance contract are declaratory judgement expenses recoverable by the cedent? The cedent will assert that the follow the fortunes doctrine requires the reinsurer to indemnify for this expense. The reinsurer will maintain that liability for declaratory judgement expense is not part of the insurance liability ceded to the reinsurance contract and that it is not incurred as part of the claims handling process, but arises from an adversarial proceeding and it is extracontractual. In the context in which the question is raised, the answer is a resounding "No." Declaratory judgment expense is not a risk inherently or customarily the subject of reinsurance and is incurred by a cedent as part of the administration of its own business.

If an ambiguity exists in the express terms of a reinsurance contract, however, extrinsic evidence of the parties' intent, course of performance, and custom and practice will be considered.[7] *Affiliated FM Ins Co v Constitution Reinsurance Corp* was remanded from the Massachusetts Supreme Judicial Court (No. 89-24111) to the trial court. On September 15, 1998, a superior court jury sitting in Dedham found on special questions that Affiliated is entitled to recover declaratory judgment expenses. A facultative reinsurance certificate was issued by Constitution Re in 1976 in which the jury answered "yes" to the question if the parties had a common understanding that declaratory judgment expenses would be covered under the agreement.

Affiliated is not instructive outside Massachusetts because of today's legal climate and the significant changes in the reinsurance industry. Without a specific grant of coverage for declaratory judgment expense, the follow the fortunes concept cannot create coverage where none exists.[8] The traditional reinsurance relationship is changing, and many disputes previously arbitrated are being litigated. The venerable concepts of utmost good faith and follow the fortunes between the parties have deteriorated. One big reason is the astronomical losses engendered by toxic tort, environmental, asbestos, and breast implant claims.

Regardless of custom and practice, the "follow the fortunes" doctrine

These so-called gentlemen's agreements secured by a handshake are things of the past. For example, a dispute over whether a reinsurer is liable to a cedent for approximately $1,000,000 in expenses over the $150,000-limit of the facultative certificate was the subject of forum shopping under the guise of a motion to transfer from U.S. District Court in New York to California. U.S. District Judge Jed Rakoff in New York denied the transfer motion based on judicial economy and on the fact that the dispute will be resolved by interpretation of the underlying contract.[9]

Arbitration

US v Fabe provides some guidance on whether a reinsurer can compel a liquidator to arbitrate, rather than litigate, in the insolvent insurer context.[10] The primary issue was if a state law enacted for the purpose of regulating the business of insurance is preempted by federal law. The McCarran-Ferguson Act provides that "[n]o act of Congress shall be construed to invalidate, impair or supersede any law enacted by any state for the purpose of regulating, the business of insurance, unless such act specifically relates to the business of insurance."[11]

The answer under McCarran turns on whether the state statute was enacted to regulate the insurance business and whether enforcing arbitration invalidates, impairs, or supersedes a state insurance law. The sixth circuit in *Fabe* held that insolvency provisions of a state insurance code regulate the insurance business and prevail over the inconsistent federal statute. The U.S. Supreme Court affirmed in part and reversed in part, opining that the McCarran-Ferguson Act partially precludes application of the federal priority statute but only to the extent that the state priority statute affects the rights and interests of policyholders.

Finally, enforcing an arbitration provision depends on the particular state statute at issue. If there is no federal-state conflict, McCarran issues do not arise, and arbitration will generally be required under the Federal Arbitration Act.[12] Neither Michigan,[13] Massachusetts,[14] nor Texas[15] preclude arbitration in their liquidation statutes.

Conclusion

Although reinsurance practice may be unfamiliar to most lawyers, it is premised on insurance contract law and the historical relationship discussed above. Reinsurance policies are legal instruments, the result of an arm's-length commercial transaction between negotiating equals. Contract wording is key, so it is important that ambiguity be left in the conference room and that indemnity provisions be drafted with clarity. Attachment points, expenses, caps, follow the fortunes, and arbitration and forum selection clauses should be set out with specificity.

Typical phrases in the underlying Commercial General Liability policy are "legally obligated to pay as damages because of bodily injury or property damage" and "this insurance applies to bodily injury and property damage only if the bodily injury and property damage is caused by an occurrence that takes place in the coverage territory." With the information in this article, reasonably experienced trial lawyers with good negotiation and mediation skills can open a new page in their trial notebook. ✦

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Footnotes

1. *Christiana Gen Ins Corp v Great American Ins Co,* 979 F2d 268, 280 (CA 2, 1992; *International Surplus Lines Insurance v Certain Underwriters at Lloyd's,* 868 F Supp 917, 920 (SD Ohio 1994).
2. *North River Ins Co v Philadelphia Reinsurance Corp,* 831 F Supp 1132, 1142 (D NJ 1993); *Michigan Millers Mutual Ins Co v North American Reinsurance Corp,* 182 Mich App 410, 452 NW2d 841 (1990).
3. *North River Ins Co v CIGNA Re,* 52 F3d 1194 (CA 3, 1995).
4. 903 F2d 910 (CA 2, 1990); *Allendale Mut Ins Co v Excess Ins Co,* 970 F Supp 265 (SD NY 1997).
5. *Michigan Township Participating Plan v Federal Insurance Co,* 233 Mich App 422, 592 NW2d 760 (1999).
6. Supra, n 2.
7. *Affiliated FM Ins Co v Constitution Reinsurance Co,* 416 Mass 839, 626 NE2d 878 (1994).
8. See John S. Butler & Robert M. Merkin, Reinsurance Law (rev. ed. 1993); Otmar Schmidlin, The Scope of Reinsurance Coverage: The Costs of Declaratory Judgments and the Problem of Punitive Damages in International Reinsurance: Asbestos Claims 90 (1988).
9. Mealey's Litigation Reports: Reinsurance, Vol. 8, No. 22, March 25, 1998.
10. 508 US 491 (1993), See, e.g., *Nichols v Vesta Fire Ins Corp,* 56 F Supp 2d 778 (ED KY 1999) reh'q denied; *Suter v Munich Reinsurance Co,* 223 F3d 150 (CA 3, 2000).
11. 15 USC 1012(b).
12. 9 USC 2.
13. MCL 500.8101 et seq.
14. MGL ch. 175 § 180A et seq.
15. Tex Ins Code Ann § 21.28.1 and § 21.8-A.1 (Vernon's 1981).

the Michigan Court of Appeals reversed the trial court and opined that may not be read into a reinsurance contract.