Business Arguments Undercutting Bellefonte Re

By

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I. Introduction

One of the more controversial reinsurance decisions in living memory is *Bellefonte Reins. Co. et al. v. Aetna Casualty and Surety Co.,* 903 F.2d 910 (2nd Cir. 1990) ("Bellefonte Re"). It held that the limit of liability in a facultative certificate unambiguously capped the reinsurer's liability for losses and expenses. Stated differently, even though the underlying policy paid expenses in addition to limits, the facultative certificate did not thus creating a gap in reinsurance coverage for the ceding insurer. Other courts have followed this decision.

This case was shocking to the industry since it was contrary to custom and practice generally as to how insurance and reinsurance is layered but also specifically as to facultative cessions. I was the general counsel of a major U.S. reinsurer when this case was handed down and I and my colleagues considered this very bad law. Although it provided reinsurers an opportunistic means of avoiding paying the cedent's expenses, it was contrary to the expectations of the parties and the manner in which layers of insurance and reinsurance are structured.

One industry observer wrote: "Commentators also criticized the Second Circuit for rendering a decisions that was utterly as odds with decades-of custom and practice."[1] Other commentators have written that "the industry generally views [Bellefonte and its progeny] as diametrically opposed to long standing practice . . . ."[2] Another refers to expense in addition to limits as one of the "time-honored traditions of reinsurance . . . ."[3] While reinsurance arbitrations are confidential, rumor has it that the insurance and reinsurance executives who make up these panels give short shrift to Bellefonte and it progeny. From and industry standpoint, Bellefonte Re is an anomaly.

However a number of recent decisions have begun to undercut Bellefonte Re ruling that critical language in the facultative certificate is ambiguous and that extrinsic evidence can be used to interpret it. These decisions include *Global Reins. Corp of Am. v. Century Indem. Co.,* 2017 N.Y. LEXIS 3723; *Century Indem. Co. v. OneBeacon Ins. Co*., 2017 Pa. Super. LEXIS 806; *Utica Mut. Ins. Co. v. R & Q Reins. Co.,* 2015 U.S. Dist. LEXIS 93565 and *Utica Mut. Ins. Co. v. Munich Reins. Am. Inc. Inc.,* 2014 U.S. App. LEXIS 22765.

As it happens, my expert testimony for the cedent was involved in three of the above cases. The purpose of this article is to present the business arguments that support facultative reinsurers paying expenses in addition to limits when the policies they reinsure pay expenses in addition to limits.

II. Willingness of the Courts to Consider Business Arguments

Several of the courts in the cases cited above suggested that expert testimony on industry custom and practice is relevant not just to resolve an ambiguity but also to determine whether an ambiguity exits. With respect to the admissibility of expert testimony concerning the custom and usage of the language in facultative certificates, the Pennsylvania Superior Court stated: "Where terms are used in a contract which are known and understood by a particular class of persons in a certain special or peculiar sense, evidence to that effect is admissible for the purpose of applying the instrument to its proper subject matter."[4]

The New York Court of Appeals expanded on this concept:

> "Reinsurance, like any other contract, depends upon the intention of the parties to be gathered from the words used, taking into account, when the meaning is doubtful, the surrounding circumstances. . ." Particularly where an agreement is "negotiated between sophisticated, counseled business people negotiating at arms length, . . . courts should be extremely reluctant to interpret an agreement as impliedly stating something which the parties have neglected to specifically include." Court should be mindful that the certificate, which serving as written confirmation of a contract, might not in and of itself constitute the fully integrated agreement."[5]

Thus, extrinsic evidence of custom and practice is relevant to both determine ambiguity in the contract language and to resolve it.

III. Business Arguments for Interpretation of Facultative Certificates

A. Facultative Certificates are not Integrated Contracts

Facultative reinsurance is typically written on a two sided form with the front of the form containing variable information such as the name of the insured and ceding insurer, dates of coverage, type of insurance covered, policy limits, ceding company retention and the limits of the reinsurance provided. The back of the form contains standardized language which "follows the form" of the underlying insurance, except where otherwise stated in the facultative certificate.[6] Stated differently, the facultative certificate is not an integrated form.

For purposes of both brevity and consistency with the underlying insurance, the facultative certificate essentially incorporates by reference the terms and conditions of the underlying insurance. This assures both consistency and concurrency of coverage between the insurance policy and its reinsurance coverage. If the parties do not desire concurrency of coverage, it is custom and practice to so note specifically on the facultative certificate.

Bellefonte Re and its progeny rule that despite the fact that an underlying policy pays claims expenses in addition to limits, the facultative certificate does not. As will be demonstrated below, this it would extremely unusual for this to occur intentionally. In fact, it would be very difficult for a reinsurer to market a facultative certificate that did not follow the limits structure of underlying policies.

B. Defense Costs Within Limits v. In Addition to Limits

1. Defense Within Limits is the Exception

The issue of defense costs within or in addition to limits is a critical one in the insurance industry. Insureds with products liability, directors and officers' liability or professional liability exposure often face heavy litigation expenses when claims are made. If such expenses erode limits of liability, there may be little left to pay claims once they are resolved. For instance:

> Claims made against design professional, especially those claims involving architects and engineers, often involve defense costs equal to or in excess of settlement or judgment amounts, largely as a result of the complexity of the claims and the use of experts.
> . . . .
> When the policy limits are exhausted – whether through the payment of claims to third parties or through payment of defense costs – the insurance company's obligation to provide coverage and a defense terminates, and the insured is exposed to any additional liability for both defense costs and any resultant settlement or judgment.[7]

In addition, there are concerns that defense within limits creates an inherent conflict of interest between the insurer and the insured. While the insurer may be more concerned about paying defense costs to avoid liability, the insured may be more concerned about eroding limits.[8]

Because of these concerns, some states have placed limitations on the ability of insurers to use defense within limits policies. For instance, Nebraska issued a Department of Insurance Bulletin requiring insureds purchasing such policies to sign a disclosure that explains the impact of a defense within limits provision.[9] Oklahoma prohibited such provisions except within specified classes of business and even then requires on the declaration page a "bolded conspicuous notice that the contract contains defenses expenses within the limit of liability" and requires that this page be filed with the insurance department.[10]

The issue of defense within limits is equally important for insurance companies when they purchase reinsurance. Cedents need to know where their limits of liability end and the layer of reinsurance begins so that they can evaluate their exposure and price the insurance product appropriately. As a result, the issue of defense within or in addition to limits is a high profile issue throughout the insurance industry and insurance buying public.

2. Concurrency of Coverage and Limits

In my experience, the drafting of primary policies umbrellas, excess policies and facultative certificates is a multi-disciplinary effort involving lawyers, underwriters and claims executives. From these colleagues, as well as the regulatory issues noted immediately above, I learned three things: (a) it is custom and practice for expenses to be in addition to limits unless the contract specifically states otherwise; (b) a defense within limits clause must be specific and conspicuous; and perhaps most important (c) that it is custom and practice that there be no gaps in coverage limits between primary policies, excess or umbrella policies or facultative certificates. There is certain be a gap in coverage limits if one of a chain of insurance or reinsurance contracts contains a defense within limits provision and the others do not.

IV. Conclusion

The rulings of *Bellefonte Re* and its progeny are contrary the custom and practice of the market. They inject gaps in coverage when the insurance industry strives for concurrency of limits. They fail to recognize that the follow the forms language, which is ubiquitous to facultative certificates, embodies the intent that the facultative certificate provides uniform coverage unless the contract very specifically states otherwise. Expert testimony in this regard will help cedents avoid the result in Bellefonte Re and courts appear to be increasingly open to such testimony.

Endnotes

1 Michael Goldstein, *For Whom Does the Bellefonte Toll"? It Tolls for Thee" Http://corporate.findlaw.com/corporate-governance/for-whom-does-bellefonte-toll-it -tolls-for-thee.html.*

2 Eugene Wollan, *Handbook of Reinsurance Law,* § 2.05 [A] Aspen Publishers, 2003 Supplement.

3 E. Paul Kanefsky, *Court Denies Indemnity for Expenses above Reinsurance Limits, http://internationallaw office.com/newsletters//detauk,asoz?g=2ed9bac9-lee8-4fcd-9c91-0c83fd9ff460.*

4 2017 Pa. Super. Lexis 806 *40 quoting *Resolution Trust Corp. v. Urban Redevelopment Auth. of Pittsburgh,* 638 A.2d 975 at 973 (Pa. 1994).

5 2017 N.Y. LEXIS *11 – 12 (internal citations omitted).

6. Robert M. Hall, *Expenses in Addition to Limits in Facultative Certificates,*§ 1, Reinsurance, Vol. 3 at 4 (2010) (hereinafter "Hall").

7. William E. Kelly Jr. and Lynn A. Toops, *Dealing with Defense-Within-Limits Policies in Design Professional Claims,* Construction, Vol. 17 No. 2 Winter 2008. The article cites a case in which the insurer paid approximately $1.9 million in lawyer fees and costs under a professional liability policy with a $2 million limit of liability.

8. Jordan S. Stanzler, *Defense-Within-Limits Policy Presents Conflicts Minefield,* http://www.stanzlerlawgroup.com/publications/pub26.htm.

9. CB-103 Bulletin, November 19, 2001.

10. Oklahoma Insurance Commissioner Order *In Re Allowing Defense Within Limits in Certain Liability Policies,* March 22, 2011.