

Are Reinsurers Liable for Tort Damages for Breach?

by

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I. Introduction

Arbitration panels can and do grant tort damages (*i.e.* costs, attorneys' fees and punitives) against cedents or reinsurers based on egregious behavior even when central issue is one of breach of contract.¹ While arbitrators are allowed a good deal of latitude in fashioning appropriate remedies, are the courts more constrained in granting tort remedies for breach of contract? The purpose of this article is to examine relevant case law on point to clarify whether or not tort damages are available to cedents claiming breach of contract against reinsurers in court proceedings.

II. California Case Law

California Joint Powers Ins. Authority v. Munich Reinsurance America, Inc., 2008 U.S. Dist. Lexis 56654 (C.D. Cal.) involved a suit under California law by a self-insurance retention pool against its reinsurer for tortious breach of the implied contract of good faith and fair dealing. In reviewing California law, the court noted that the covenant of good faith and fair dealing is intended to effectuate the contractual intentions of the parties and for this reason, breach of such covenant traditionally has been limited to contract rather than tort remedies.

Under California law, a departure from this tradition is justified when the breach of the covenant violated strong public policy, such as the obligations of an insurer to its insured. In such a situation, insureds possess unequal bargaining power and are purchasing insurance not for commercial advantage but to avoid personal calamity. Cedents, on the other hand, possess substantial bargaining power and purchase reinsurance to increase their ability to write business and attain other commercial advantages. As a result, the court concluded that the California Supreme Court would find that there is insufficient justification for granting tort remedies for what is essentially a claim of breach of contract.

In *Stonewall Ins. Co. v. Argonaut Ins. Co.*, 75 F.Supp.2d 893 (N.D.Ill. 1999), a jury awarded a cedent punitive damages for breach of its duty of good faith and utmost good faith. When the cedent asked the court to enter judgment on this award, the court examined California law on point and concluded:

California law is clear: tort damages are generally not available for a breach of contract. The California Supreme Court has identified the reasons for denying tort recovery in breach of contract cases: (1) the different objectives underlying tort and contract

breach; (2) the importance of predictability in assuring commercial stability in contractual dealings; (3) the potential for converting every contract breach into a tort, with accompanying punitive damage recovery; (4) the preference for legislation in affording appropriate remedies. Further, the court has noted that restrictions on contract remedies serve to protect the freedom to bargain over special risks and to promote contract formation by limiting liability to the value of the promise.²

After reviewing the rationale for the exception to this rule for insureds, the court stated why a similar exception is not necessary for cedents' claims against reinsurers:

A reinsurer's breach of a reinsurance contract is more comparable to this "ordinary" breach of a commercial contract. A reinsured has the ability to diversify its risks, and a reinsurance contract may cover only a specified portion of a potential loss. . . . Moreover, the breach does not directly affect the original insured, for the reinsured is still liable as an original insurer and the reinsurer has no contact with the original insured. This court acknowledges that a reinsurer's breach of the duty of good faith ultimately may seriously affect the reinsured's ability to provide coverage to its other original insureds. . . . Nonetheless, this court does not believe that recognizing the ripple effects of such a breach warrants a finding of public interest comparable to when an original insurer does the same against its original insured.³

The court went on to find that there is no fiduciary obligation owed by a reinsurer to its cedent and that under California law, a cedent cannot recover tort damages for the reinsurer's breach of good faith.⁴

Central National Ins. Co. of Omaha v. Prudential Reins. Co., 241 Cal. Rptr. 773 (Ct. App. 1987) involved a jury award of tort damages for a reinsurer's bad faith refusal to pay a claim. The court ruled that such damages are not available in California and in the process:

[E]numerated [the] characteristics that must be present in contracts for purposes of serving as predicates of tort liability: (1) the contract must be such that the parties are in inherently unequal bargaining positions; (2) the motivation for entering the contract must be a nonprofit motivation, *i.e.* to secure peace of mind, security, future protection; (3) ordinary contract damages are not adequate because (a) they do not require the party in the superior position to account for its actions, and (b) they do not make the inferior party 'whole'; (4) one party is especially vulnerable because of the type of harm it may suffer and of necessity places trust in the other party to perform; and (5) the other party is aware of this vulnerability.⁵

III. Case Law from Other Jurisdictions

Bernstein v. Centaur Ins. Co., 606 F.Supp. 98 (S.D.N.Y. 1984) was a suit by two receivers under New York law against a reinsurer in which the receivers sought damages for the reinsurer's alleged bad faith. The reinsurer moved to strike on the basis that it was merely a request for punitive damages which are not available in a contract action absent fraud. The court granted the motion ruling:

Punitive damages are not permitted in a breach of contract action in New York absent fraud aimed at the public generally, evincing a high degree of moral turpitude, and demonstrating such wanton dishonesty as to imply a criminal indifference to civil obligations. . . .

Plaintiffs have not alleged any fraud and can suggest no greater public wrong than their own inability to pay the claims of their insured as a result of defendant's breach. This is not the kind of wrong to the public that requires exemplary damages.⁶

Commercial Union Ins. Co. v. Seven Provinces, 9 F. Supp.2d 49 (D.Mass. 1998) *aff'd* 217 F.3d 333 (1st Cir. 2000) *cert. denied* 531 U.S. 1146 (2001) is a watershed case due to several of its rulings. The ruling relevant to this article was an award of double the compensatory damages plus attorneys' fees and costs pursuant to Mass. Gen L. ch. 93A which "allows one business to sue another over conduct that is 'unfair' including acts that are associated with the breach of contract."⁷ The court found that the reinsurer's "continued refusal to honor its obligations, combined with its constantly shifting and often meritless objections to payment, constituted an egregious breach of its duty of utmost good faith and a violation of Mass. Gen. ch. 93A § 11."⁸

See also Axa Corp. Solutions v. Underwriters Reins. Co., 2004 U.S. Dist. Lexis 22609 (N.D.Ill.) in which the court declined to grant summary judgment on a motion to the effect that a claim for breach of utmost good faith is not viable under Texas law.

IV. Conclusion

There is a relatively small body of case law dealing with the recovery by cedents of tort damages in a court proceeding based on breach of contract. Nonetheless, the case law that exists follows the general rule that such damages are not available in a breach of contract action and that the exceptions that exist for the insured – insurer relationship do not apply to the cedent – reinsurer relationship. Nonetheless, an opportunity for tort damages exists in those states with an "unfair practices act" of sufficient scope to cover the breach of business to business contracts.

Endnotes

¹ The author is a certified as an arbitrator and umpire by ARIAS – US and has served on over 100 arbitration panels.

² 75 F.Supp.2d 893 at 907 (internal citations and quotation marks omitted).

³ *Id.* at 910 (internal citations and quotation marks omitted).

⁴ *Id.* at 910-1.

⁵ 241 Cal. Rprt. 773 at 784.

⁶ 606 F.Supp. 98 at 100.

⁷ 9 F.Supp.2d 49 at 64 (internal citations omitted).

⁸ *Id.* at 71.