REINSURANCE COVERAGE OF

EXCESS OF POLICY LIMITS CLAIMS AND

EXTRA CONTRACTUAL OBLIGATIONS

by

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Introduction

The primary purpose of reinsurance is to allow the cedent to lay off to the reinsurer a portion of the losses covered by the cedent's policies. Sometimes, however, the cedent wishes the reinsurer to assume the risk of the manner in which the cedent handles losses as well as the losses themselves. This risk of the manner in which losses are handled is generically called "Extra Contractual Obligations" since such losses are outside the insurance policy issued by the cedent. However, this risk actually breaks down into two parts. "Excess of Policy Limits" ("XPL") is a loss which is covered by the policy but for which the cedent has become liable for a loss in excess of policy limits due to mishandling of the claim *i.e.* failure to settle within policy limits. In its more technical use, Extra Contractual Obligations ("ECO") arise from wrongful actions unrelated to covered losses *i.e.* deceptive sales practices.

Reinsurers can and do agree to cover XPL and ECO claims pursuant to explicit clauses.[1] However, there is significant controversy over the obligation of an insurer to pay such claims when there is no explicit clause on point in the reinsurance contract. The purpose of this article is to explore case law on a reinsurer's obligation with respect to XPL and ECO claims in the absence of a specific assumption of such liability.

Are XPL and ECO Encompassed Within the Risk Ordinarily Assumed by a Reinsurer?

Since the this issue became of significant financial interest in the 1980's, it has been debated at some length with the arguments strongly aligned with roles (*i.e.* cedent or reinsurer) of the debaters. There is, however, some case law which assists in answering this question.

Pringle v. Standard Life & Accident Ins. Co., 391 N.E. 2d 677 (In.Ct.App.1979) involved reinsurance and assumption of a book of business from a company in receivership pursuant to a court-approved reinsurance contract which specifically excluded ECO and XPL. An insured of

the company in receivership brought an ECO claim against the reinsurer. The court rejected this claim stating:

The risk assumed by the reinsurer, . . . is determined by the contract of reinsurance. (citation omitted) The trial court correctly interpreted the language of the reinsurance agreement. Any extracontractual liability was expressly not assumed by (the reinsurer) and remained with (the cedent).[2]

This suggests that XPL and ECO are not an inherent part of the risk transferred in a reinsurance contract.

Through addendum 5 to the reinsurance contract, the reinsurer (North Star) agreed to provide XPL coverage to the cedent (All-Star) in Ott v. All-Star Ins. Co., 299 N.W.2d 839 (Wis.1981). An injured third party attempted to collect on an XPL claim directly from the reinsurer under a direct action statute *i.e.* one that allows and injured party to sue directly the insurer of the wrong doer. The reinsurer argued that the third party could not make such a direct recovery since it was not a party to the reinsurance contract and, therefore, was not in privity with the reinsurer. The court ruled for the claimant on the basis that the XPL coverage was insurance of the cedent's errors and omissions exposure and not reinsurance of the cedent's liability under its policies:

[A]n insurer's liability to his insured for tortious failure to settle within policy limits is 'extra-contractual.' Because such liability is not a risk against which protection is extended to the insured, it cannot . . . be a proper subject for 'reinsurance.' By definition such risk cannot be reinsured. The subject matter of Addendum 5 is not reinsurance. . . .Addendum 5 in the present case must be held to constitute direct liability insurance running from North Star to All-Star against the latter's liability to its own insured for tortious failure to settle. North Star is subject to direct action by (the insured).[3]

American Re-Insurance Co. v. Insurance Commissioner, 696 F.2d 1267 (9th Cir.1983) involved a claim by the insured of an insolvent cedent against the reinsurer. The cedent alleged that the reinsurer had a duty to effectuate prompt and fair settlement of claims against the insured and should be liable for consequential damages for failure to do so. It appears that the reinsurance contract did not specifically include XPL or ECO coverage. The court found no responsibility on the part of the reinsurer for any failure to effectuate prompt and fair settlement of claims.

Nonetheless, the issue of a reinsurer's liability for XPL or ECO, in the absence of a specific assumption thereof, is not so clear as to avoid arbitration. The cedent wished to arbitrate this issue pursuant to a broad arbitration clause in Nationwide General Ins. Co. v. Investors Ins. Co., 332 N.E. 2d 333 (N.Y.1975). The lower court found that the XPL claim was not arbitrable since the reinsurance contract did not cover it. The Court of Appeals reversed stating:

Petitioners have refused payment on the ground that the claim does not come within the letter of the agreement and the appellant urges that the agreement is to be liberally construed. This is a dispute 'touching the construction meaning or effect of the agreement' and the courts may not stay arbitration by deciding on the merits whether or not the claim is tenable. A claim need not be tenable in order to be arbitrable.[4]

Existing case law seems to accept the proposition that XPL and ECO claims are not encompassed with the risk of loss under policies which is ordinarily transferred pursuant to reinsurance agreements. Nonetheless, a reinsurer may specifically assume or exclude such exposure. Should a reinsurer choose to provide XPL and/ECO coverage, it may be doing so in the role of a primary errors and omissions insurer, which carries regulatory as well as liability ramifications.[5]

What Impact on the Reinsurer's Liability if It Becomes Involved in Defending the Loss?

Mutual Fire and Inland Marine acted as a 100% front for Homestead Insurance Company in New Jersey, where Homestead was not licensed, in Venetsanos v. Zucker, Facher & Zucker, 638 A.2d 1333 (Sup.Ct.1994). Homestead and its affiliates produced the business, underwrote it and adjusted and defended claims: "Total control of this risk and the claims made thereunder were reposed in a broker-managing agent and an insurer unadmitted in New Jersey, both presided over by Beitler (CEO of Homestead), and all with the same holding company. Mutual's technical status as a primary insurer was almost incidental."[6]

Homestead failed to settle a claim within policy limits and Mutual Fire was placed in receivership. The insured sued Homestead for consequential damages for failure to settle, not for reinsurance proceeds which were owed to the estate of Mutual Fire. The court ruled that Homestead had undertaken the duty to properly settle the insured's claim and could be held liable for failure to do so:

We recognize and endorse the general rule that an original insured does not enjoy a right of direct action against a true reinsurer. (citation omitted) It is settled that an ordinary treaty of reinsurance merely indemnifies the primary insurer against loss rather than against liability. Where, however, the reinsuring agreement itself provides, or the conduct of the reinsurer demonstrates that it takes charge of and manages defense of suits against the original insured, the reinsurer may be held to be a 'privy' to the action. In such cases, . . . the insured (has) been allowed to proceed directly against the reinsurer.[7]

A similar fronting arrangement[8] was involved in Keightley v. Republic Ins. Co., 946 S.W. 2d 124 (Tex.Ct.App.1997). When the cedent became financially impaired, the reinsurer took complete control of the claim handling process[9] resulting in an XPL claim against the reinsurer. The claim took the form of two statutory actions, for unfair deceptive trade practices in the business of insurance and for deceptive trade practices generally, and two common law based on breach of duty of good faith and fair dealing and negligence. Given the fact that the reinsurer had undertaken to handle the insured's claim, the court found that the insured could pursue one statutory and one common law claim that did not require privity.

Reinsurers commonly monitor the claims of their cedents and comment thereon. Reinsurers sometimes become actively involved in the investigation and defense of claims by their cedents. At some level of involvement, reinsurers share the cedent's obligations to the insured handle claims in a fair and efficient fashion. The point at which this takes place, however, is not yet clear.

What is the Effect of a Follow the Fortunes Clause on the Reinsurer's Liability?

Peerless Ins. Co. v. Inland Mutual Ins. Co., 251 F.2d 696 (4th Cir.1958) involved a third party claim under a policy which was reinsured on an excess of loss basis pursuant to a treaty which stated that "the liability of the Reinsurer shall follow that of the Company is (*sic*) every case."[10] Peerless, the reinsurer, appointed an attorney and former claims adjuster to monitor the case and he concluded that the case was one of clear liability. The adjuster for the cedent, Inland, disagreed and refused to settle within policy limits even when the cedent's retention was exceeded by the settlement offers the cedent was willing to tender. While fully informed of the negotiations, the attorney for Peerless failed to insist that the matter be settled within policy limits. The lower court, which as affirmed by the Court of Appeal, noted:

Under this evidence, I find that Peerless actively participated in the negotiations for settlement of the Arms litigation. It was Peerless which stood to gain if the (below limits) offer were accepted by Arms; the rejection of Arms' (limits) offer was made for Peerless' benefit with (the) knowledge and consent (of the Peerless' attorney).[11]

In holding that Peerless was liable for its proportionate share of the XPL claim that followed, the court stated:

Therefore, we are not here concerned with, and hence express no opinion as to what might have been the rights, obligations and liabilities of Inland and Peerless inter sese if Inland had held back from Peerless any significant information, or if Inland had refused to settle within the policy limits without consulting Peerless, or if Peerless had recommended settlement within the policy limits, and Inland had refused. Our holding is that, under the facts of this case, where Peerless knew as much about the Arms case as did Inland; where Peerless' appreciation of the risks was different from and sounder than Inland's; where Inland had already committed itself to $5,000, the risk retained by it, and stood to gain rather than lose by a settlement within the policy limits; and where Peerless was freely and frankly consulted by Inland and Peerless left the decision in Inland's hands, that decision became the decision of Peerless as well as Inland; Peerless is bound along with Inland by that decision whether sound or unsound, favorable or unfavorable; and that as the liability of Peerless 'shall follow that of' Inland, Peerless is liable for two-thirds of the cost to Inland of a concededly proper settlement of the Yeats - Inland litigation. In defending the action against Yeats, the companies were unquestionably engaged in a join-enterprise (citation omitted), the losses arising from which should be bourne in accordance with their respective interests in the enterprise.[12]

The reinsurer had no involvement in the underlying claim and the reinsurance contract lacked a follow the fortunes clause in Employers Reinsurance Corp. v. American Fidelity and Casualty Co., 196 F.Supp. 553 (W.D.Mo.1959). In ruling that the reinsurer was not liable for an XPL claim the court distinguished Peerless:

By the terms of the instant reinsurance contracts, the 'reinsurer's liability does not follow that of the reinsured' but is singularly one of indemnity after the reinsured has discharged its liability to the primary insured. That being so, absent a charge of 'specific bad faith' on the party of (the

reinsurer) in respect to a duty owed to (the cedent) it is difficult to determine any legal basis for the claims (the cedent) here makes against (the reinsurer).[13]

It is possible to read the different rulings of the Peerless and Employers Reinsurance courts as turning on the follow the fortunes clause in the first case and the lack of it in the second. However, such a reading may be superficial. The Peerless court emphasized the reinsurer's heavy involvement in the defense of the claim which is theme discussed *supra* with respect to the decisions of the Venetsanos and Keihtley courts. In distinguishing Peerless in another follow the fortunes case, the Second Circuit characterized the Peerless decision as follows: "The court in that case, however, found that the reinsurer played such a substantial role in the settlement of the underlying claim that it acted as a co-insurer." Bellefonte Reinsurance Co. v. Aetna Casualty and Surety Co., 903 F.2d 910 (2nd Cir.1990). As a result, reinsurer involvement in claim handling may be the determinative factor rather than the follow the fortunes clause.

Secondly, there is a basis to argue that ECO and XPL exposure is different from that insured by the cedent pursuant to the policy and which is assumed by the reinsurer. *See* Ott v. All-Star, *supra.* If this is the case, follow the fortunes may not serve to expand the liability assumed by reinsurer. *See e.g.* Calvert Fire Ins. Co. v. Yosemite Ins. Co., 573 F.Supp. 27 (E.D.N.C.1983).

Conclusion

Excess of Policy Limits and Extra Contractual Obligations of the cedent may be assumed by the reinsurer, however, these are different obligations than those ordinarily transferred and may constitute direct errors and omissions insurance rather than reinsurance. Absent an explicit transfer of this risk, a reinsurer may be held liable for Excess of Policy Limits and Extra Contractual Obligations if the reinsurer becomes heavily involved in the adjustment and defense of claims. If can be argued that a follow the fortunes clause in the reinsurance contract may cause the reinsurer to be liable for Excess of Policy Limits and Extra Contractual Obligations, however, case law to date is inconclusive on point.

Endnotes

1]. The Contract Reference Book prepared by the Brokers & Reinsurance Market Association contains this example of an ECO clause:

This Contract shall protect the Company for any Extra Contractual Obligations within the limits hereof. The term "Extra Contractual Obligations" is defined as those liabilities not covered under any other provision of the Contract and which arise from the handling of any claim on business covered hereunder, such liabilities arising because of, but not limited to, the following: failure by the Company to settle within the policy limit, or by reason of alleged or actual defense or in the trial of any action against its insured or reinsured or in the preparation or prosecution of an appeal consequent upon such action.

The date on which any Extra Contractual Obligation is incurred by the Company shall be deemed, in all circumstances, to be the date of the original disaster and/or casualty. However, this Article shall not apply where the loss has been incurred due to fraud by a member of the Board of Directors or a corporate officer 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 or any claims covered hereunder.

[2]. *Id.* at 685.

[3]. *Id.* at 847.

[4]. *Id.* at 336.

[5]. It is arguable, for instance, that the reinsurer must possess a primary license to write liability business and must comply with rate and form approvals.

[6]. *Id.* at 1338.

[7]. *Id.* at 1338 - 9.

[8]. While the text of the case is not explicit on point, the author has confirmed that the reinsurer assumed 100% of the risk.

[9]. The court noted that:

Republic (the reinsurer) assigned a claims manager to manage the Morish claims and other claims against National County (the cedent) insured; dealt directly with National County's defense counsel; investigated, evaluated, negotiated, and settled such claims; employed independent insurance adjusters and lawyers in defending the claims and paid attendant litigation expenses; exercised settlement authority over the claims; and established and funded a band account in Nationals County's name.

Id. at 127.

[10]. *Id.* at 702.

[11]. Inland Mutual Ins. Co. v. Peerless Ins. Co., 152 F.Supp. 506 (S.D.W.Va.1957).

[12]. 251 F.2d at 704.

[13]. *Id.* at 561.