IS THE OBLIGATION OF UTMOST GOOD FAITH DEAD IN ILLINOIS?

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I. Introduction

Utmost good faith between reinsurer and cedent is a critical component of the custom and practice of the reinsurance industry. However a series of related cases interpreting Illinois law hold that utmost good faith (meaning a fiduciary duty) does not exist in that state. The purpose of this article is to examine this case law in light of other case law which recognizes and establishes a legal standard for the obligation of utmost good faith.

II. Recent Illinois Case Law

The cases in question are *PXRe Reinsurance Com. v. Lumberman's Mutual Cas. Co., 2004 U.S. Dist. Lexis 9343 (N.D.Ill.)* (PXRe I), *PXRe Reinsurance Com. v. Lumberman's Mutual Cas. Co. 300 F.Supp.2d 981 (N.D.Ill. 2004)* (PXRe II) and *PXRe Reinsurance Com. v. Lumberman's Mutual Cas. Com., 2004 U.S. Dist. Lexis 21552 (N.D.Ill.)* (PXRe III). The facts of the dispute are relevant to the future significance of these cases and, therefore, will be explained in some detail.

A. The Facts

Lumberman's sold to Alea an existing book of business consisting of 350 treaties written on or before September 30, 1999. Lumberman's took back losses in excess of a 75% loss ratio. Effective April 10, 2000, Lumberman's ceded to PXRe a portion of this stop loss exposure. The treaty between Lumberman's and

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PXRe contained an integration clause which denied any representations or warranties except as stated in that contract.

Prior to the cession to PXRe becoming effective, that company performed a four day due diligence examining 80 files representing 70% of the subject premium. Subsequent to the cession becoming effective, PXRe performed a routine audit and reviewed a file which, apparently, had been available during the initial due diligence but had not been reviewed. PXRe alleged that this file contained indications of a side agreement by which Lumberman's agreed to assume unprofitable business in return for future profitable business. Rescission litigation ensued and PXRe sought extensive discovery which Lumberman's resisted. This resulted in the motion to compel which is the subject of the rulings in question.

B. <u>The Rulings</u>

PXRe based its motion to compel production of Lumberman's documents on *uberrmiae fidae* or the utmost good faith owed to each other by the parties to a reinsurance agreement. Judge Sadur, who decided all three of the *PXRe* cases, chose to characterize this as an assertion that the cedent acted in a fiduciary capacity with respect to the reinsurer.

In PXRE I, the court found that under Illinois law, an insured does not act in a fiduciary capacity with respect to its insurer and that the better view is that the same rule applies between a cedent and reinsurer. In addition, any such rule would not serve to override the terms of the treaty itself:

> No case suggests that the . . . express negation of any warranties, representations or other agreements that are not in the document itself, is somehow contrary to public policy so as to be overridden by *uberrimae fidae* or any other doctrine.[1]

The Judge Shadur ruled that Lumberman's could not be compelled to cull through its files to obtain evidence of side deals since those documents were made available in the original due diligence process.

PXRe II was a motion for reconsideration of the motion to compel based on utmost good faith. Judge Shadur in this case characterized utmost good faith as a "superfiduciary standard."[2] In bold terms, Judge Shadur rejected the motion:

> As PXRe's counsel would have it, *uberrimae fidae* plays the role of the 800 pound canary, able to sing whenever and wherever it wishes. That doctrine assertedly applies to every reinsurance relationship irrespective of its particular circumstances - - irrespective of the contractual limitations that the parties may have chosen to impose in the course of

> entering into such a relationship. But PXRe tenders not a single authority for such a notion - - for the idea that the *uberrimae fidae* concept operates as a powerful public policy doctrine that trumps any express boundaries with which knowledgeable and sophisticated parties may instead have elected to circumscribe their contractual relationship.[3]

In PXRe III, the Judge Shadur continued to characterize the reinsurer's argument as "breach of fiduciary duty (under the label 'uberrimae fidae')."[4] He dismissed this claim for lack of a fiduciary duty.

III. Other Cases Interpreting Illinois Law

In his *PXRe* decisions, Judge Shadur had to distinguish his prior decision of *Mutuelle General v. Life Assurance Co. of Pa.,* 688 F.Supp. 386 (E.D.Ill. 1988), which also interpreted Illinois law. In this case, the reinsurer alleged that the cedent violated its fiduciary duty to the reinsurer, such duties arising from: (a) the custom and practice of the reinsurance industry; (b) a treaty provision stating that the cedent was to act with the "highest faith"; and (c) the allegation that the cedent acted as the agent for the reinsurer. Judge Shadur found a fiduciary relationship to exist based on the "highest faith" language and an agency relationship resulting from cedent's duties in administering policies, forwarding premium and investigating and paying claims.[5]

Mutuelle General was quickly followed by two cases from the same court questioning Judge Shadur's opinion. In *International Surplus Lines Ins. Co. v. Fireman's Fund Ins. Co.,* 1989 U.S. Dist. Lexis 15626 (N.D.Ill.), the reinsurer alleged a fiduciary relationship in order to benefit from an extended statute of limitations. The court described the standards for a fiduciary relationship:

> To establish the existence of a fiduciary relationship, it must be demonstrated that confidence was reposed in one party to a relationship resulting in that party's domination and influence over the other party. Where the parties relate to each other in this manner, the law imposes upon the party in whom trust was reposed, a high degree of responsibility in its dealings with the other party. The purpose of imposing such an obligation is to protect the dominated party from abuse by the dominating party.[6]

This court found that other courts had recognized a duty of utmost good faith between reinsurers and cedents but ruled that this did not rise to the level of a fiduciary relationship.[7]

Similarly, the court in *International Ins. Co. v. Certain Underwriters at Lloyd's*, 1991 U.S. Dist. Lexis 12948 (N.D.Ill.) the ruled "we are not in a position to abolish the traditional distinction between a general duty of good faith owed

between contracting parties dealing at arm's length and the more exacting duty of candor owed by fiduciaries."[8] The court went on to find that a cedent is not the agent of the reinsurer and that for this additional reason, there was no fiduciary relationship.[9]

IV. Comments on Illinois Case Law

For purposes of drawing distinctions, the *PXRe* cases involved an unusual fact situation. The reinsurer was participating on a stop loss cover for a loss portfolio transfer of a fixed and existing book of business. First, this is a relatively rare transaction. Second, there is no ongoing underwriting meaning that the reinsurer does not rely on the cedent to perform underwriting functions with utmost good faith. Third, the treaty contained an integration clause with a disclaimer of representations and warranties, which, historically at least, is quite unusual in property and casualty reinsurance contracts. Finally, the reinsurer performed extensive due diligence which failed to reveal the issue which caused the dispute. While these distinctions which can be used to isolate the *PXRe* decisions, the more fundamental issue is the law of utmost good faith.

In *Mutuelle Generale*, Judge Shadur was quick to find the high standards for a fiduciary relation in the ordinary relationship between a cedent and reinsurer and "highest faith" language in the treaty. This decision was quickly distinguished and isolated by other judges interpreting Illinois law. While subsequent decisions made much of differences in treaty language and facultative vs. treaty contracts, the real issue remained achievement of the high standards for a fiduciary relationship. As both of these subsequent decisions noted, a duty of good faith or utmost good faith does not a fiduciary relationship make.

Apparently reacting to these decisions, Judge Shadur, in the *PXRe* decisions, applies the standards for a fiduciary relationship to the issue of utmost good faith. This misinterprets these subsequent decisions and applies a standard for utmost good faith which is unnecessarily high. As is noted below, other courts have described standards for utmost good faith which are more appropriate.

V. Case Law from Other Jurisdictions

A case in which the cedent allegedly withheld material information was decided by the United States Supreme Court in *Sun Mutual Ins. Co. v. Ocean Ins. Co.*, 107 U.S. 485 (1883). With respect for the standard for revelation of material information by the cedent, the Court ruled:

> In respect to the duty of disclosing all material facts, the case of reinsurance does not differ from that of an original insurance. The obligation in both cases is one *uberrimae fidae.*

> . . . It is the duty of the assured to place the underwriter in the same situation as himself; to give to him the same means and opportunity of judging of the value of the risk; . . .[10]

Stated differently, each party to the reinsurance transaction must hold the interests of the other party equally as dear as its own interests.

The *Sun Mutual* case was cited more recently in a late notice and misrepresentation case, *Christiania General Ins. Corp. v. Great American Ins. Co.*, 979 F.2d 268 (2nd Cir. 1992), for the proposition: "The relationship between a reinsurer and a reinsured is one of utmost good faith, requiring the reinsured to disclose to the reinsurer all facts that materially affect the risk of which it is award and of which the reinsurer itself had no reason to be aware."[11]

Following on the heels of *Christiania* is *Unigard Security Ins. Co. v. North River Ins. Co.*, 4 F.3d 1049 (2nd Cir. 1993) which deals with late notice and concealment of material information. Initially, the court discussed the commercial support for utmost good faith:

> The reinsurance relationship is often characterized as one of "utmost good faith." This utmost good faith may be viewed as a legal rule but also as a tradition honored by ceding insurers and reinsurers in their ongoing commercial relationships. Historically, the reinsurance market has relied on a practice of the exercise of utmost good faith to decrease monitoring costs and extant contracting costs. Reinsurance works only if the sums of reinsurance premiums are less than the original insurance premiums. Otherwise, the ceding insurers will not reinsure. For the reinsurance premiums to be less, reinsurers cannot duplicate the costly but necessary efforts of the primary insurer in evaluating risks and handling claims. Reinsurers may thus not have actuarial expertise, (citation omitted), or actively participate in defending ordinary claims. They are protected, however, by a large area of common interest with ceding insurers and by the tradition of utmost good faith, particularly in the sharing of information.[12]

Quoting *Sun Mutual*, the *Unigard* court ruled: "As discussed above, 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 risk.'"[12] Thus, the *Unigard* court repeats the rule of the *Sun Mutual* court that utmost good faith means that each party to the reinsurance contract must hold the interests of the other party as dear as its own interests.

The rule of law articulated in *Sun Mutual* and *Unigard* are supported by courts in other jurisdictions: *ReliaStar Life Ins. Co. v. IOA Re*, 303 F.3d 874 (8th Cir. 2002); *American Bankers Ins. Co. v. Northwestern National Ins. Co.*, 198 F.3d 1332 (11th Cir. 1999); *AXA*

Corporate Solutions v. Underwriters Reinsurance Co., 2004 U.S. Dist. Lexis 22609 (N.D.Ill.) (interpreting Texas law).

VI. Conclusion

The *PXRe* cases are distinguishable from the vast majority of reinsurance transactions on the facts. In addition, these cases were wrongly decided on the law since they impose the very high standards for a fiduciary relationship on the doctrine of utmost good faith.

Utmost good faith is the custom and practice of the reinsurance industry protecting both cedents and reinsurers when they are vulnerable to negligent or otherwise wrongful practices by a counterparty to the reinsurance transaction. The legal standard that has emerged from this custom and practice is that each party to the reinsurance transaction must hold the interests of the other party as dear as its own interests.

ENDNOTES

[1] 2000 U.S. Dist. Lexis 9343 *8.
[2] 330 F.Supp. 2d 981 (N.D.Ill.2004) at 982.
[3] 330 F.Supp. 2d 981 (N.D.Ill 2004) at 983.
[4] 2004 U.S. Dist. Lexis 21552 (N.D.Ill) *7.
[5] 688 F.Supp. 386 (E.D.Ill. 1988) at 398.
[6] 1989 U.S. Dist. Lexis (N.D.Ill.) *7-8.
[7] *Id.* *9-10.
[8] 1991 U.S. Dist. Lexis (N.D.Ill.) *52.
[9] *Id.* at 58.
[10] 107 U.S. 485 at 510.
[11] 979 F.2d 268 at 278.
[12] 4 F.3d 1049 at 1054.
[12] 4 F.3d 1049 at 1069.