Reinsurer Coverage of Cedent's Bad Faith

By

Robert M. Hall

[Mr. Hall is a former insurance and reinsurance executive and law firm partner and acts as an arbitrator of insurance and reinsurance disputes and as an expert witness. He is a veteran of over 200 arbitration panels and is certified as an arbitrator and umpire by ARIAS - US. The views expressed in this article are those of the author and do not reflect the views of his clients. *Mr. Hall has authored over 100 articles and they may be viewed at his website: robertmhalladr.com.]*

!. Introduction

Reinsurers have a choice as to coverage of bad faith awards imposed on clients pursuant to an extra contractual obligations clause[1] ("ECO") or an excess of policy limits clause[2] ("XPL"). If reinsurers specifically agree to such clauses, it means that such damages are part of the coverage provided to the cedent. However, the reinsurer may choose to exclude specifically such coverage which has the desired effect.[3] But what if the contact is silent on coverage of bad faith damages? Is the outcome impacted by the presence of a follow the settlements (sometimes called a follow the fortunes) clause.? This purpose of this article to examine selected caselaw on the latter two points.

II. Coverage for Bad Faith Damages When the Reinsurance Contract is Silent on Coverage.

An early case on point is *Employers Reinsurance Corp. v. American Fidelity & Casualty Co.*, 196 F. Supp. 553 (W.D. Mo. 1959). When the cedent failed to settle within limits, the insured secured a bad faith judgment against the cedent. The cedent sought to hold the reinsurer liable for the bad faith judgement on the basis of a joint interest or venture between the cedent and reinsurer. The reinsurance did not include a follow the settlements clause but the cedent argued that it should be inferred from the relationship. The court rejected the cedent's arguments observing that the cedent was attempting to gain indemnity for its own bad faith and finding that there was no joint venture with respect to the cedent's bad faith.

Reliance Insurance Co. v. General Reinsurance Corp., 506 F. Supp. 1042 (E.D. Pa. 1980) involved a bad faith award against Reliance for its mishandling of an auto insurance claim. Reliance sought coverage for a settlement from the reinsurer of the umbrella policy issued by Reliance on the same risk. Neither the umbrella nor the relevant facultative certificate specifically covered or excluded bad faith judgments. The court declined Reliance's characterization of the settlement as compensatory damages and ruled for the reinsurer:

> It is manifest that Reliance cannot recover for its losses unless the losses are covered by the terms of the Excess Umbrella and reinsurance certificate. . . . Thus, Reliance can prevail in this suit only if that loss, suffered as a result of the settlement of the punitive damage judgment, falls within the coverage of the insurance policy and reinsurance certificate. We have concluded that Reliance's loss is not so covered.[4]

III. Coverage for Bad Faith Damages When the Reinsurance Contract Contains a Follow the Settlements Clause

An early case on bad faith damages and follow the settlements is *Peerless Insurance Co. v. Inland Mutual Insurance Co.,* 251 F.2d 696 (4th Cir. 1958). The ceding insurer kept the reinsurer advised on a suit arising out of an automobile accident that resulted in an excess verdict. The reinsurance contract contained a follow the settlements clause. Under the facts of this case, the court found that the reinsurer was liable for the excess verdict:

> Our holding is that, under the facts of this case, where [the reinsurer] knew as much about the [underlying] case as did [the cedent]; where [the reinsurer] was freely and frankly consulted by [the cedent] and [the reinsurer] left the decision in [the cedent's] hands, that decision became the decision of [the reinsurer] as well as [the cedent]; [the reinsurer] is bound along with [the cedent] by that decision whether sound or unsound, favorable or unfavorable; and that as the liability shall "follow that of" [the cedent]. . . In defending the action against [the insured], the companies were unquestionably engaged in a joint enterprise . . ."[5]

The treaty contained an ECO clause as well as a follow the settlements clause in *Arrowood Indemnity Co. v. Assurecare Corp.* 2012 U.S. Dist. LEXIS 134369 (N.D. Ill.). The cedent settled a bad faith claim and then billed the reinsurer for a portion of the settlement. The court found

that under the follow the settlements clause, the reinsurer must show "gross negligence, recklessness, [or] bad faith on the part of the reinsured or that the settlement was not even arguably with the scope of the reinsurance contract."[6] The court rejected the reinsurer's argument that the underlying settlement was outside the scope of the treaty coverage citing the ECO clause in the treaty.

United States Fidelity & Guaranty Co. v. American Re-Insurance Co., 20 N.Y.3d 407 (2013) involved a large settlement by the cedent which included bad faith claims. The reinsurers objected, on various bases, to the manner in which this settlement was allocated to the reinsurers including the failure to attribute any of the settlement to the alleged bad faith which was not covered by the reinsurers. With respect to the follow the settlements clause in the relevant treaties, the court stated:

> [U]nder a follow the settlements clause like the one we have here, a cedent's allocation of a settlement for reinsurance purposes will be binding on a reinsurer if, but only if, it is a reasonable allocation, and consistency with the allocation used in settling the underlying claim does not by itself establish reasonableness.[7]

The court went on to find that the decision to allocate no value to the bad faith claims was not in good faith and could not be made binding by the follow the settlements clause citing an earlier case in which the court held:

> [A] follow the settlements clause does not alter the terms or override the language of reinsurance policies (*sic*) and rejected a cedent's attempt to "allocate" to certain reinsurance treaties losses that the treaties simply did not cover.[8]

IV. Commentary

Absent a clause specifically covering or excluding bad faith claims in the reinsurance contract, it is challenging to derive a rule from the above caselaw. It can be argued by a reinsurer that a bad faith claim is simply not within the scope of an insured (or reinsured) loss or that a follow the settlements clause has been stretched beyond the breaking point in an effort to cover a doubtful claim. However, the outcome of such disputes is highly dependent on the facts involved.

ENDNOTES

[1] Liabilities not covered by the insurance policy and which arise from negligence, fraud or bad faith in the handling of a claim.

[2]. Liability for a covered claim in excess of policy limits due to the insurer's negligence, fraud or bad faith in handling the claim.

[3] *Schuetta v. Auroa National Life Assurance Co.,* 30 F. Supp.3d 800 (E.D.Wis. 2014); *Reliance Insurance Co. v. River Road Recycling, Inc.,* 20003 U.S. Dist. Lexis 9400 (E.D. La.); *Pringle v. Standard Life & Accident Ins. Co.,* 391 N.E. 2d 677 (In. Ct. App. 1979).

[4] 506 F. Supp. 1042 at 1050.

[5] 251 F.2d 696 at 703.

[6] 2012 U.S. Dist. LEXIS 134368*11 (internal citations omitted).

[7] 20 N.Y.3d 407 at 441 – 2.

[8] *Id*. at 402, citing to *Travelers Casualty & Surety v. Certain Underwriters at Lloyd's of London*, 96 N.Y.2d 583 (2001).