Custom and Practice on Treatment of Expenses in Facultative Certificates:

The Road Back from Bellefonte Re[1]

By

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I. Introduction

More than 30 years ago a federal district court in Manhattan handed down a decision that remains controversial, indeed generating litigation into 2020 (and perhaps beyond[3]). The decision involves facultative certificates which, traditionally, are very brief contracts drafted largely by underwriters for underwriters, using specialized industry terminology and built on the customs and practices of the industry. When isolated from the import of such terminology and customs and practices, these certificates can be misinterpreted by courts and such misinterpretation can be institutionalized as legal precedent. The purpose of this article is not to trace the legal arguments of the relevant cases but to demonstrate how proper use of custom and practice (alongside determined and creative lawyering) appear to have reversed the effect of bad rulings in *Bellefonte Re* and its progeny. .

II. Bellefonte Re Decisions

The seminal case in this matter is *Bellefonte Reinsurance Co. v. Aetna Casualty & Surety Co,.* 1989 U.S. Dist. LEXIS 10432 (S.D.N.Y.). The cedent, Aetna, was attempting to collect expenses in addition the liability limits of the Bellefonte Re's facultative certificate. While it was not evident in this decision, it was revealed in a later decision involving Aetna that: (1) the original Aetna policy reinsured by *Bellefonte Re* included <u>expenses within limits</u>; (2) in a settlement with the insured, Aetna agreed to pay expenses <u>in addition to limits</u>; and (3) some of the reinsurance certificates, including the one at issue in *Bellefonte Re*, <u>were not so endorsed</u>.[4] Thus, the real issue was whether expenses would be treated similarly (*i.e.* expenses within limits) in the original policy issued by Aetna and the facultative certificate or whether the facultative certificate would pay expenses in accord with Aetna's agreement to pay expenses to an insured

that was never agreed to by the reinsurer. Unfortunately, this real issue was not evident from the text of the opinion.

Bellefonte Re's facultative certificate contained clauses agreeing to follow the form of the underlying policy and to follow the fortunes[5] of the cedent plus a limits provision that did not mention expenses. Without benefit of expert testimony or extrinsic evidence, the court found no ambiguity in the language concerning limits holding that it capped both indemnity and expenses. The court found that the follow the fortunes provision in the certificate did not override other provisions in the certificate. Thus it appeared from the text of the opinion that the reinsurer was not obligated to pay expenses in addition to the limits of the certificate on a policy that paid expenses in addition to limits.

The appellate court affirmed, ruling that the district court had read correctly the limits provision in the facultative certificate and did not comment on the lack expert testimony on custom and practice. *Bellefonte Reinsurance Co. v. Aetna Casualty & Surety Co.,* 903 F.3d 910 (2nd Cir. 1990). The court ruled:

> We agree with the district court that 'the limitation is to be a cap on all payments by the reinsurer.' We hold that the district court correctly read the first two provisions of the reinsurance certificate to cap the reinsurer's liability and that the "follow the fortunes" doctrine does not allow Aetna to recover beyond the express cap stated in the certificates.[6]

III. Progeny of *Bellefonte Re*

Many in the insurance marketplace regarded the *Bellefonte Re* decisions as aberrations, contrary to longstanding custom and practice. I was the general counsel of a major US domestic reinsurer which would have benefited from these rulings. However, my company refused to take advantage of *Bellefonte Re* as being contrary our legal and client-relation responsibilities. We anticipated that *Bellefonte Re* would be bypassed or effectively overruled by subsequent decisions

It became impossible to dismiss *Bellefonte Re* as an aberration after *Unigard Security Insurance Co. v. North River Insurance Co.*, 4 F.3d 1049 (2nd Cir. 1993). Apparently without

benefit of any extrinsic evidence or expert testimony on custom and practice, the court followed *Bellefonte Re* dismissing the impact of any factual differences between the cases on the meaning of the limits in the facultative certificate: "The meaning of such provisions is not an issue of fact to be litigated anew each time a dispute goes to court."[7]

The next case in the timeline is *Aetna Casualty & Surety Co. v. Philadelphia Reinsurance Corp.* 1995 U.S. Dist. LEXIS 4806 (E.D. Pa.) which contains a brief reference to evidence of custom and practice of the reinsurance industry on paying expenses in addition to limits. Aetna argued factual differences between the instant case and *Bellefonte Re* but the court dismissed them on the basis that *Bellefonte Re* was based on an interpretation of the facultative certificate and not the facts of the case:

> *[T]he reinsurers' entire obligation is quantitatively limited by the dollar amount the reinsurers have agreed to reinsure.* Once the reinsurers have paid up to the certificate limits, they have no additional liability to Aetna for defense expenses or settlement contributions. Any other construction of the reinsurance certificates would negate the phrase "the reinsurer does hereby reinsure Aetna . . . *subject to the . . . amount of liability set forth herein."*[8]

Next came *Excess Insurance Co. v. Mutual Insurance Co.*, 3 N.Y. 3d 577 (N.Y. 2004) in which no extrinsic evidence or expert testimony on custom and practice is cited. The court followed *Bellefonte Re* and *Unigard* ruling that minor differences in the underlying fact situation did not change the meaning of the limits provision in the facultative certificate.

Excess Insurance was followed by *Pacific Employers Insurance Co. v. Global Reinsurance Corp. of America*, 2010 U.S. Dist. LEXIS 40506 (E.D. Pa.) in which the presence of expert testimony on custom and practice was not evident. The court followed *Bellefonte Re and Unigard* observing that minor variations in contract language did not change the cap on the reinsurer's exposure in the limits clause.

Next up was *Utica Mutual Insurance Co. v. Clearwater Insurance Co.,* 2014 Dist. LEXIS 162645 (N.D.N.Y.) in which the cedent offered to provide extrinsic evidence of custom and practice with respect to the issue of expenses in addition to limits. The court observed that

extrinsic evidence is allowed only to explain ambiguity. In light of prior decisions on point, the court found no ambiguity in the limits provision and found for the reinsurer.

IV. Cases Considering Custom and Practice

Eventually, some courts began to allow extrinsic evidence on the issue of expenses within or in addition to limits. The line of cases described above was distinguished on the basis of different certificate language in *Utica Mutual Insurance Co. v Munich Reinsurance America, Inc.,* 594 Fed. Appx. 700 (2nd Cir. 2014). The court found the certificate language on limits to be ambiguous and directed the court below on remand to consider extrinsic evidence of custom and practice in the industry.

The above ruling on ambiguity was followed in *Utica Mutual Insurance Co. v. R&Q Reinsurance Co*., 2015 U.S. Dist. LEXIS 93565 (N.D.N.Y.) in denying the reinsurer's motion for summary judgment. The court ruled that both parties should be given the opportunity to present extrinsic evidence on custom and practice.

The Second Circuit Court of Appeals significantly undercut the *Bellefonte Re* line of cases in *Global Reinsurance Corp. of America v. Century Indemnity Co.,* 843 F.3d 120 (2nd Cir. 2016). The court stated:

> [W]e find it difficult to understand the *Bellefonte* court's conclusion that the reinsurance certificate in that case *unambiguously* capped the reinsurer's liability for both loss and expenses. Looking only to the language of the certificate, we think it is not entirely clear what exactly the "Reinsurance Accepted" provision in *Bellefonte* meant. Evidence of industry custom and practice might have shed light on this question, but the *Bellefonte* court did not consider any such evidence in its decision, although it is unclear if any was presented.[9]

So saying, the court certified to the New York Court of Appeals the issue of whether the New York Court's decision in *Excess Insurance*, *supra*, constitutes a rule or strong presumption that the liability cap in a facultative certificate includes expenses, even when the underlying policy pays expenses in addition to limits.

In *Global Reinsurance Corp. of America v. Century Indemnity Co.,* 30 N.Y.3d 508 (2017) the New York Court of Appeals ruled that there is no such rule or strong presumption. Reinsurance contracts are to be interpreted according to the same rules as other contracts.

Following the above decision of the New York Court of Appeals, the Second Circuit ruled that its decisions in *Bellefonte* and *Unigard* on the facultative certificate in those cases were "premised on an erroneous interpretation of New York state law" and remanded the case to the district court with instructions to "construe each reinsurance policy in light of its language and, to the extent helpful, specific context." *Global Reinsurance Corp. v. Century Indemnity Co.*, 890 F.3d 74, 77 (2nd Cir. 2018). Clearly, the "context" included expert testimony on custom and practice.

V. Cases Using Custom and Practice to Support Expenses in Addition to Limits

Century Indemnity Co. v. OneBeacon Insurance Co., 173 A.3d 784 (Pa.Sup.Ct. 2017) is the appeal of trial court ruling that considered expert testimony on both sides of the issue of whether or not by custom and practice facultative certificates pay expenses in addition to limits when the underlying policies do so. The author was an expert on behalf of the cedent. The trial court found the relevant language to be ambiguous and that the better interpretation favored the cedent. The reinsurer appealed on the basis that the relevant language of the facultative certificate was unambiguous and that the trial court should have followed the *Bellefonte Re* line of cases.

Initially, the appellate court agreed with the trial court that the relevant portions of the facultative certificate were ambiguous.[10] Secondly, the appellate court ruled that the trial judge's decision to admit expert testimony on custom and practice was not an abuse of discretion.[11] The court found that this case was distinguishable from the *Bellefonte Re* line of cases both on the underlying facts and the wording of the facultative certificate and otherwise upheld the rulings of the trial judge .

The remand of the *Global v. Century* litigation is *Global Reinsurance Corp. of America v. Century Indemnity,* 2020 U.S. Dist. Lexis 36579 (S.D.N.Y.) in which Century, the cedent, had four

expert witnesses (including the author) and Global, the reinsurer, had two. Following the lead of the Second Circuit, the district judge observed that the *Bellefonte Re* line of cases had been severely undercut. It found that the facultative certificate was not an integrated contract. Through follow the form language, the certificate incorporated the terms and conditions of the underlying policy, including expenses in addition to limits, unless specifically stated otherwise in the certificate. The court found that payment of expenses in addition to limits by the reinsurer was consistent with the text of the limits clause. As to the role of Century's experts[12], the court stated:

> This textual interpretation is confirmed by the credible expert testimony regarding the relevant industry custom and practice. The Court credits Century's Experts' testimony that concurrency was significant enough to the history of reinsurance and to the reinsurance market that parties to reinsurance agreements considered whether the reinsurance and insurance should be concurrent when drafting contracts. The Court also credits Century Experts' testimony that concurrency was presumed, unless the [certificate] contained an explicit statement of non-concurrency. . . . The Century Experts offer more than enough credible evidence "to raise a fair presumption" that these principles were part of the reinsurance industry's customs and practices in the 1970's. Just as a knowledgeable member of the 1970's reinsurance industry would expect material terms like the types of risks covered and the indemnity limit to be expressly stated in the agreement, a knowledgeable insurer or reinsurer would also expect any non-concurrency as to the expenses also to be expressly stated. . . . Therefore, in this case, based on the reinsurance language and industry customs and practices in the 1970's elucidated through credible testimony, when there are losses, the reinsurer's liability as to expenses is not capped by any dollar amount although the amount is limited and calculated by a ratio in the certificate.[13]

Thus, *Bellefonte Re* and its progeny were effectively bypassed and isolated based, in part at least, on expert testimony on custom and practice.

VI. Comments

Many in the insurance industry believe that *Bellefonte Re* and its progeny was a result of: (a) a technical underwriting document; (b) based on incompletely stated customs and practices; (c) being interpreted by judges who were not offered or who did not accept expert testimony on technical underwriting terms and procedures as well as other customs and practices of the industry. Many welcome the apparent demise of this line of cases after decades of disruption of the facultative reinsurance industry.

ENDNOTES

[1] The author acknowledges and thanks two expert witness colleagues, Lydia B. Kam Lyew and Paul C. Thomson III, for their commentary on this article.

[2] *Mr. Hall is an attorney, a former law firm partner, a former insurance and reinsurance executive and acts as an insurance consultant as well 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. Copyright by the author 2020. Mr. Hall has authored over 100 articles and they may be viewed at his website: robertmhalladr.com.*

[3] The district court decision in *Global v. Century,* described in Section V, is under appeal.

[4] *Aetna Casualty & Surety Co. v. Philadelphia Reinsurance Corp.*, 1995 U.S. Dist. LEXIS (E.D. Pa.) 4806*6.

[5] In these decisions, as is common, "follow the fortunes" is used interchangeably with "follow the settlements". When used accurately, follow the fortunes is an underwriting concept dealing with nature of the risk insured while follow the settlements deals with the cedent's loss settlements. To avoid confusion, this article will use the terminology of the courts on point.

[6] 903 F.2d 910 at 913.

[7] *Unigard Security Insurance Co. v. North River Insurance Co.,* 4 F.3d 1049, 1071 (2nd Cir. 1993).

[8] 1995 U.S. Dist. LEXIS 4806*6, quoting *Bellefonte Reinsurance Co. v. Aetna Casualty & Surety Co.*, 903 F.2d 910 at 912-3 (2nd Cir. 1990). (emphasis in the original).

[9] *Global Reinsurance Corp. of America v. Century Indemnity Co.*, 843 F.3d 120, 126 (2nd Cir. 2016) (emphasis in the original).

[10] *Century Indemnity Co. v. One Beacon Insurance Co.,* 173 A.3d 784, 801 (Pa.Sup.Ct.2017).

[11] *Id.* at 804 – 5.

[12] Lydia B. Kam Lyew was Century's reinsurance underwriting expert. She offered testimony on the history of facultative reinsurance, facultative certificates and underwriting, following form

clauses, the need for concurrency between certificates and underling policies, facultative premium calculations and the application of these matters to the *Global v. Century* dispute.

William Manning was Century's ceding insurer underwriting expert. He offered testimony on client expectations and understanding of the coverage provided by facultative reinsurers, the pricing of such coverage and the application of these matters to the *Global v. Century* dispute.

Paul C. Thomson III was Century's claims expert. He offered testimony on the handling of facultative reinsurance claims both before and after *Bellefonte Re* and the application of this experience to the *Global v. Century* dispute.

Robert M. Hall was Century's expert on insurance policies and facultative certificate issues. He offered testimony on the integration of such documents, follow the form, concurrency of coverage, distribution of premium among reinsurers and application to the *Global v. Century* dispute.

[13] *Global Reinsurance Corp. of America v. Century Indemnity Co.*, 2020 U.S. Dist. LEXIS 36579 (S.D.N.Y.) *33 – 34 (internal citations omitted).