BAD FAITH AS A SUBSTITUTE FOR PREJUDICE

IN LATE NOTICE DISPUTES

by

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I. Introduction

Many courts now require that the reinsurer demonstrate prejudice as a result of late advice of a claim by the cedent.[1] This often can be difficult to demonstrate. However, a line of cases is developing which allows the cedent to substitute for prejudice the bad faith of the cedent in reporting claims. Such substitution is represented most recently by *Ins. Co. of State of PA. v. Argonaut Ins. Co.,* 2013 U.S. Dist. Lexis 110597 (S.D.N.Y.). The purpose of this article is to explore this line of cases through selected decisions.

II. Selected Caselaw

The seminal case on point is *Christiania General Ins. Corp. v. American Ins. Co.*, 979 F.2d 268 (2nd Cir. 1992). In this case, the cedent wrote a layer of excess liability insurance on American Honda Motor Co. which sold ATV vehicles and ceded certain of its risk to the reinsurer via facultative reinsurance. The cedent became aware of claims involving the ATV vehicles and in the Spring of 1987 performed an audit which indicated that the cedent's layer would be pierced and that its reinsurers should be notified. The reinsurers were not notified until months later and when the cedent made a cash call, the reinsurer in this case filed a declaratory judgment action alleging late notice.

The court found a lack of prejudice to the reinsurer but observed: "At most, a reinsured's failure to provide prompt notice may entitle the reinsurer to relief without showing prejudice if the reinsured acted in bad faith."[2] However, the court found no evidence of bad faith.

The Second Circuit expanded on the application of bad faith to late reporting in *Unigard Security Ins. Co. v. North River Ins. Co.,* 4 F.3d 1049 (2nd Cir. 1993). This case involved an excess insurer which had joined the Wellington facility seeking facultative reinsurance recoverables for asbestos-related losses. The Wellington facility had an allocation formula which required participants to pay some claims or expenses for which they might not otherwise be liable. The cedent had notified its treaty reinsurers that it had joined the Wellington facility but, apparently, had inadvertently failed to so notify its facultative reinsurers.

The *Unigard* court explored the concept of utmost good faith in the reinsurance relationship noting:

> 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 ex ante contracting costs.[3]

The court found that the cedent was required to notify the facultative reinsurer that it had joined the Wellington facility but that this breach of its duty of good faith was not sufficient to nullify the reinsurer's obligation to pay the claim:

> We thus think that the minimum standard for bad faith should be gross negligence or recklessness. If a ceding insurer has implemented routine practices and controls to insure notification to reinsurers but inadvertence causes a lapse, the insurer has not acted in bad faith. But if a ceding insurer does not implement such practices and controls, then it has willfully disregarded the risk to reinsurers and is guilty of gross negligence. A reinsurer, dependent on its ceding insurer for information, should be able to expect at least this level of protection, and, if a ceding insurer fails to provide it, the reinsurer's late notice defense should succeed.[4]

The Supreme Court of New Hampshire followed *Chrisitiania* and *Unigard* in *Certain Underwriters at Lloyd's London v. Home Ins. Co.*, 783 A.2d 238 (N.H. 2001). This claim involved pollution losses and the insured asked the cedent to notify all excess insurers and reinsurers in 1984 but the cedent did not do so until it had settled the claims in 1995. The reinsurance contact gave the reinsurer the right to exercise complete control over the investigation and disposition of the claims. The reinsurer denied the claims based on late notice and violation of its duty of good faith to maintain proper systems and procedures to notify reinsurers of claims. The court found for the reinsurer noting the cedent's lack of a system to report claims to reinsurers:

> The record portrays Home as a bureaucracy lacking effective communication and continuity among departments. As a result, Home did not attempt to find its "policy file" to determine whether any reinsurance was available until 1995, *eleven years* after it first received notice of the potential loss at the Blackbird Mine. Further, Home's attempt to locate the "policy file" came after it made multiple decisions about the Blackbird claim and the pending litigation which, under its reinsurance policy, should have been make by, or at least have involved, London Reinsurers.

> Home's assistant vice president of reinsurance claims, [X], testified that Home did not have any formal guidelines for determining what claims were to be reported to its reinsurers and that Home 'didn't track its . . . reinsurance'.
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> . . . X, however, soon discovered that she had no information concerning Home's reinsurance with London reinsurers. . . . [Nobody] who testified for Home ever read the reinsurance policy at issue and, as the trial judge found, "Home made no effort at all to even determine what its obligations were under the Reinsurance Policy, never mind comply with them." We reiterate that the good faith standard between reinsurers and reinsureds exists so that the reinsurer is provided the same means and opportunity to judge the risks as the reinsured. What occurred in this case was not simply an inadvertent failure to notify a reinsurer, but a grossly negligent and reckless disregard of the risks to the reinsurer.[5]

The latest in this line of cases is *Ins. Co. of the State of PA. v. Argonaut Ins. Co*., 2013 U.S. Dist. Lexis (S.D.N.Y.) which involved asbestos-related losses and was decided under California law. The court found that the excess insurer was obligated to notify its facultative insurer of relevant losses in 2002 but did not do so until 2009. In the interim, the reinsurer had entered into a number of commutations with its retrocessionaires. The district court found a lack of material prejudice to the reinsurer but predicted that California state courts would adopt the *Christiania* and *Unigard* line of thought as to bad faith as a substitute for prejudice. The court commented:

> Accordingly, a requirement that the reinsured implement adequate practices and controls with respect to the provision of notice is minimally burdensome and consistent with the expectation of parties entering into a reinsurance agreement.[6]

III. Commentary

There are few, if any, situations in which a ceding insurer is not motivated to supply accurate information to its reinsurer in a timely manner. The cost of reinsurance is significant and it can be vital to a cedent in maintaining its credit rating, if not its solvency.

In the great majority of cases, failure to supply timely and accurate information results from bad systems, bad data and/or human error. The *Underwriters at Lloyd's v. Home* case is a very extreme (and very rare) example thereof and its significance may be mitigated in two ways. First, Home teetered on the edge of insolvency for many years until it was finally placed into liquidation in 2003. In such situations, it is not unusual for internal systems, such as reinsurance reporting, to break down and critical personnel to seek greener pastures. Second, the reinsurance treaty in question gave the reinsurers the right to complete control over investigation and settlement of the relevant claim but they did not even learn of the claim until after it was settled. It is very rare that a reinsurer has this right and this is a significant distinguishing factor.

Perhaps the significance of this line of cases is that there is a point at which the courts will not allow the failure of a cedent to report losses in accordance with a reinsurance contract to be overcome by a lack of demonstrable prejudice or the concept of follow the settlements.

ENDNOTES

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[1] *See e.g. Christiania General Ins. Corp. v. Great American Ins. Co.,* 979 F.2d 268, 274 (2nd Cir. 1992).

[2] 979 F.2d 268 at 281.

[3] 4 F.3d 1049 at 1054.

[4] *Id.* at 1069.

[5] 783 A.2d 238 at 241-2. (Emphasis in the original.)

[6] 2013 U.S. Dist. Lexis 110597*45.