SHOULD REINSURANCE CONTRACTS BE CONSTRUED AGAINST REINSURERS (UPDATED)?[1]

By

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I. Introduction

Notwithstanding the best efforts of the insurance industry's contract drafters, insurance and reinsurance contracts are sometimes found to be ambiguous when bathed in the light of the specific facts of a claim or other dispute. When alternative means of resolving a contractual ambiguity fail, the construction doctrine of "*contra proferentem*" (literally "against the offeror") is sometimes used to resolve the matter. This doctrine is often used to construe policy language against an insurer in a dispute with a policyholder on the basis that the policy is a contract of adhesion with the policyholder having little bargaining power with the insurer.

Noted industry commentators opine that the doctrine has little application in the reinsurance context.[2] However, a recent case suggests that this doctrine has continuing vitality in the reinsurance context. *Kiln PLC v. Advantage Gen. Ins. Co.*, 80 So. 3rd 429 (FL. Ct. App. 2012). The purpose of this article is to examine selected case law concerning the application of the *contra proferentem* to justify a carve-out that would free reinsurance contracts from the application of the *contra proferentem* doctrine.

II. Drafting Reinsurance Contracts

A. Nature of the Marketplace

While sophistication varies among ceding insurers, they certainly bear little resemblance to the large majority of policyholders. Insurers cannot be licensed in a state without demonstrating that they are staffed by insurance professionals. These professionals have ready access to reinsurance experts, such as intermediaries, to assist in negotiating and drafting reinsurance contracts.

In addition, the large majority of cedents are also reinsurers. Those primary companies which do not maintain a specific reinsurance profit center commonly assume reinsurance as a matter of reciprocity with trading partners and within their holding company systems. Professional reinsurers also cede risk to retrocessionaires who, in turn, cede their own risk. The analogy to unsophisticated insureds is tenuous when the issue is whether a reinsurance contract should be interpreted in favor of one financial institution over another based simply on which institution happens to be the cedent in the relevant transaction.

B. Clauses Required for Credit for Reinsurance

All states have laws and/or regulations that determine the circumstances under which a cedent may take financial statement credit for reinsurance. These laws have a considerable impact on the language of reinsurance contracts. For instance, they require, as a condition for credit for reinsurance, that reinsurance contracts contain provisions that:

- Establish the criteria for an acceptable trust fund
- Identify the contracts for which trust funds are established
- Stipulate that certain types of assets are to be maintained in the trust fund
- Require the cedent to take all steps necessary to liquidate the assets placed trust
- Stipulate that assets in the trust may be withdrawn at any time by the cedent and used for specified purposes
- Establish the criteria for an acceptable letter of credit
- Identify the contracts for which a letter of credit is established
- Allow a letter of credit to be withdrawn at any time by the cedent and be used for specified purposes
- Require that the reinsurer be subject to service of suit in the US
- In the event of insolvency of the cedent, require payment of reinsurance "without diminution" to the receiver of the cedent.[3]

While not technically a part of the credit for reinsurance laws and regulations, the Examiner's Handbook of the National Association of Insurance Commissioners requires an "intermediary clause" which places credit risk on the reinsurer if the reinsurance intermediary converts premium or loss funds to the intermediary's own use. Similarly, state regulators have declined to grant or renew licenses when they believed setoff clauses in reinsurance contracts were out of step with state receivership law or policy.[4]

Credit for reinsurance laws and regulations and the Examiners Handbook do not require specific language for the above clauses relying instead on a general description. However, standardized language has coalesced over time based, in part, on insurance regulators withholding credit for reinsurance due to language, which they believed, did not comply with relevant laws and regulations.

Given that clauses required for credit for reinsurance are mandated by law, it is questionable whether they should be construed against reinsurers. Since the presence of these clauses works a substantial financial benefit to the cedent, an opposite construction might be considered.

C. Intermediaries

Most reinsurance in the world is placed through reinsurance intermediaries. One of the functions of intermediaries is to negotiate and draft treaty language. While the intermediary clause places the credit risk of the intermediary on the reinsurer, the intermediary is the agent of the cedent for other purposes.[5] In this circumstance, it must be questioned whether a reinsurance contract should be construed against the reinsurer when it is drafted by the agent of the cedent.

D. Treaty Reinsurance

Reinsurance treaties, which cover many risks of a predetermined nature, are often negotiated by the parties over months, if not years. There is often considerable give and take between the cedent and reinsurer as to its final form. Cedents sometimes present the reinsurer with desired clauses and, in some cases, an entire reinsurance contract as an example. As a result, the final product may be a blend or compromise of language desired by the cedent and reinsurer making problematical attribution of authorship of the contract or particular clauses thereof.

E. Facultative Reinsurance

Facultative reinsurance, traditionally written on individual risks, is considerably different from treaty reinsurance. Facultative reinsurance is much more immediate in that it focuses on a specific risk presented for coverage in the near future rather than large blocks of business which turn over annually at a predetermined time. As a result, there are seldom months of time to craft a facultative reinsurance agreement.

For these reasons, facultative reinsurance is usually written on a "facultative certificate" which contains the variable information concerning the risk on the front and the contractual language on the back. Given the effort to limit the contract language to one page, extensive elaboration is not possible. However, this is counterbalanced by the fact that a specific risk with specific characteristics is being reinsured rather than a general class of unknown risks, as is the case with treaty reinsurance.

The contractual language on the certificate is standardized on a reinsurer-by-reinsurer basis. While cedents and reinsurers sometimes negotiate side agreements dealing with difficult issues (*e.g.* declaratory judgment expenses), this is not generally the case. As a result, facultative certificate language commonly receives less input from cedents than does treaty language. Nonetheless, cedents are free to negotiate the terms of facultative certificates, and have considerable leverage to do so, or to direct their business to other reinsurers offering more favorable terms.

III. Impact of Case Law

A. Cases Finding a Presumption Against Reinsurers

The rule in the Seventh Circuit is that ambiguous reinsurance contracts are construed against reinsurers. *Zenith Insurance Co. v. Employers Insurance of Wausau*, 141 F.3d 300 (7th Cir. 1998) dealt with the interpretation of a prompt notice requirement in a facultative certificate under Wisconsin law. Construing the clause against the reinsurer the court stated:

> In cases dealing with primary insurance contracts and insured parties, Wisconsin follows the common rule that ambiguities in the contract are to be construed in favor of the insured party. [citations omitted] (noting that

> Wisconsin's rule for construing ambiguities against the drafter "has particular force . . . where there is a substantial disparity of bargaining power between the parties.")
> . . . Almost fifty years ago, this court, contrary to the view adopted by the Second Circuit in *Unigard*, concluded that under Wisconsin law the court must construe ambiguities in reinsurance contracts in favor of the reinsured. *Employers Mutual Liability Ins. Co. v. Underwriters at Lloyd's*, 117 F.2d 249, 252 (7thCir.1949) *aff'g* 80 F.Supp. 353, 355 (W.D.Wis.1948). We can find nothing in Wisconsin law that indicates Wisconsin courts believe that we had misstated the law in *Employers Mutual*. . . From a policy standpoint, some of the interests protected by the general rule that insurers bear the brunt of contractual ambiguities are just as applicable to reinsurance cases, and others are not. For example, one important reason why Wisconsin courts construe insurance contracts in favor of the insured party relates to that party's reasonable reliance interests. That interest is similar whether one is speaking of a primary policy and the beneficiary or a reinsurance policy and a primary reinsurer. . . We would need more recent evidence from Wisconsin contradicting *Employers Mutual* to justify a carve-out that would free reinsurance policies from Wisconsin's general rules of interpretation for insurance policies.[6]

In essence, the court followed the *Employers Mutual* in the absence of any Wisconsin case law to the contrary. However, the case followed does not appear to turn on the *contra proferentem* concept.

Employers Mutual Liability Ins. Co. v. Underwriters at Lloyd's, 117 F2d 249 (7th Cir. 1949) involved a product liability claim which was paid by the cedent and for which the cedent sought reimbursement from its reinsurer. The reinsurer claimed that the loss did not fall within the product liability coverage of the policy and should not have been paid. This decision presents what the industry now regards as a classic follow the settlements issue: Can the reinsurer second-guess the cedent's reasonable coverage decisions? While the court was not conversant with industry phraseology, it clearly recognized the issue: "In other words, Lloyd's by their reinsurance contract stepped into the shoes of Employers Mutual to the extent of the latter's liability to the insured." *Id.* at 252. In it's holding, the court declined to apply the *contra proferentem* rule:

> We think the rule of construction must be invoked against Lloyd's not because they issued the reinsurance contract but for reason that they assumed the liability of Employers Mutual, which liability encompasses, if necessary, the resolution of doubt against it. *Id.*

Stated differently, the court ruled against the reinsurer, not because it issued the reinsurance contract but because it assumed the risk of close coverage calls by the cedent *i.e.* follow the settlements.

Nonetheless, *Employers Insurance* was followed in *National Union Fire Ins. Co. v. American Re-Insurance Co.*, 2005 U.S. Dist. Lexis (S.D.NY. 2005). The posture of this case was a motion for reconsideration by the reinsurer with respect to interpretation of pollution exclusion under Ohio law. The court denied the motion stating:

> Hence, *Employers Insurance* stands for at least two points: (1) the Ohio courts have declined to follow New York law, and (2) under general contract principles, even reinsurance contracts are to be construed against the drafter.
>
> Here, because Ohio law rather than New York law applies, and because it is undisputed in any event that American Re drafted the pollution exclusion clause, the motion for reconsideration and reargument must be denied. *Id.* at *10.

Employers Mutual was cited favorably in a footnote in *Fontenot v. Marquette Casualty Co.*, 247 So.2d 572, 580 (La.1971) which involved a direct action by a claimant against the reinsurer of an insolvent reinsurer. Despite the favorable citation, the court rejected the notion that any ambiguity in the reinsurance contract authorized a recovery from one not in privity with the reinsurer. As a result, *contra proferentem* was not the basis of the court's holding.

The *contra proferentem* concept was cited in *Mountain States Mutual Casualty Co. v. Peerless Casualty Co.*, 160 F.Supp. 303 (D.Mon 1958), which was a suit for reformation or interpretation of an amendment to the reinsurance contract brought by the cedent. The court granted the interpretation desired by the cedent but cited a number of factors for its conclusion including its own interpretation of the amendment in question, the correspondence between the parties, the good faith obligation between cedent and reinsurer, the obligation of the reinsurer to follow the settlements of the cedent and the rule "that contracts of reinsurance should be liberally construed in favor of the reinsured." *Id.* at 307. As a result, it is difficult to determine what factor the concept of *contra proferentem* had in the court's decision.

The *contra proferentem* concept also appeared in *Justice v. Stuyvesant Ins. Co.*, 265 F.Supp. 63 (S.D. W.Va. 1967), *which* involved a dispute over a minimum annual premium. The court observed, in *dicta*, that ambiguities in the reinsurance contract should be interpreted against the reinsurer, citing to a 1946 edition of C.J.S. Insurance, before interpreting the contract in favor of the reinsurer.

In *Transit Casualty Company in Receivership v. Certain Underwriters At Lloyd's*, 963 S.W.2d 392 (Mo.Ct.App. 1998), the receiver of Transit sued the reinsurers who petitioned the court to compel arbitration. The case turned on a perceived conflict between the arbitration and service of suit clauses.[7] The court initially observed that ambiguities in reinsurance contracts would be construed against the party who drafted the contract, citing as support a case that did not involve reinsurance.[8] The court stated that the reinsurers admitted to drafting the service of suit clause and then proceeded to construe it against them on the basis that they could have drafted it in a fashion, which would have had the desired interaction with the arbitration clause. The court failed to consider (*see* Section II B, *supra*) that the service of suit clause is a standardized provision based on credit for reinsurance law and one which the cedent would have surely have demanded for financial statement purposes if the reinsurer had not included it in the contract.

In addition, there is the recent case of *Kiln PLC v. Advantage General Insurance Co. Ltd.*, 80 So.3d 429 (Ct.App.FL 2012) which involved reinsurance of an aircraft liability policy and whether such reinsurance covered injuries to aircraft passengers rather than employees of the airline. The cedent sought reinsurance from Lloyd's of London and at the time, such reinsurance could be obtained only through a Lloyd's broker. The reinsurer provided the language of the reinsurance coverage to the Lloyd's broker who, allegedly, understood it was not intended to cover passengers. However, the language was unclear on point. The trial court granted summary judgment on the coverage issue in favor of the cedent. The appellate court cited the *contra preferentem* doctrine in reversing and remanding the case for more examination of extrinsic evidence, including the issue of whether the Lloyd's broker was the agent of the reinsurer or cedent.

IV. Case Law Finding No Presumption Against Either Party

The Second Circuit is the leading source of authority for the proposition that *contra proferentem* should not be applied to reinsurance contracts. The earliest case on point is *Great American Ins. Co. v. Fireman's Fund Ins. Co.*, 481 F.2d 948 (2nd Cir. 1973) which involved a dispute over a cancellation notice. The court stated: "Although ordinarily we would be disposed to interpret the language of an ambiguous notice in favor of the insured and against the insurer, we consider that this general rule should not apply when both the insured and insurer are 'large insurance companies long engaged in far flung activities in that field of economic endeavor.'"[9]

The next Second Circuit case in the series is *United States Fire Ins. Co. v. General Reinsurance Corp.*, 949 F.2d 569 (2nd Cir. 1991). This was a suit between two excess insurers to allocate a loss between them. The court stated:

> Presently, "contra preferentem [sic] is used only as a matter of last resort after all aids to construction have been employed and have failed to resolve the ambiguities in the written instrument." [citations omitted] The New York courts have specifically stated that the rule "is not applicable in a contest between two insurance companies." [citations omitted]
> . . . Where the dispute is between two insurance companies, both parties are sophisticated business entities, familiar with the market in which they deal and armed with relatively equivalent bargaining power; hence the contra insurer rule serves little purpose. *Id.* at 573-4.

The third Second Circuit case is *Unigard Security Ins. Co. v. North River Ins. Co.*, 4 F.3d 1049 (2nd Cir. 1993) in which the reinsurer asserted a late notice defense. A certain question was certified to the New York Court of Appeals. With respect to the *contra proferentem* doctrine, the Second Circuit stated:

> (W)e believe that this canon of construction does not apply in this matter. In answering the certified question, the New York Court of Appeals used an analysis based on "general contract principle[s]" [citation omitted] and made no reference whatsoever to such a canon of construction. We believe that the

> Court of Appeals was implicitly recognizing that reinsurance contracts are negotiated at arm's length by two sophisticated parties [citation omitted] and that canons of construction that protect individual purchasers of original insurance policies do not apply to reinsurance. [citation omitted] . . . Indeed, reinsurers are so dependent upon ceding insurers for information, that application of a canon construing the reinsurance contract against the reinsurer would be highly anomalous. *Id.* at 1065.

In the fourth Second Circuit case, *British International Ins.Co. v. Seguros La* Republica, 342 F.3d 78 (2nd Cir. 2003), the court declined to apply the *contra proferentem* doctrine in a dispute over coverage for declaratory judgment expenses: "New York law enforces reinsurance contracts without resort to the *contra proferentem* rule that is sometimes used in the context of direct insurance." *Id.* at *8.

In *Professional Consultants Ins. Co. v. Employers Reinsurance Co.*, 2006 U.S. Dist. Lexis 24170 (D.Vt. 2006) the court followed the Second Circuit cases with respect to a dispute over limits in a treaty stating:

> There is a stronger case, however, for not applying [*contra proferentem* doctrine] and treating the agreement like any other contract because a key policy rationale for the [doctrine] – unequal bargaining power – is absent where the reinsured is a sophisticated party and who bargained for he contract language. *Id.* at 12.

Massachusetts has rejected the *contra proferentem* concept for reinsurance contracts. *Boston Ins. Co. v. Fawcett*, 258 N.E.2d 771 (Mass.1970) was a dispute over the application of a retention. The court stated:

> We note also that all the parties to the litigation are large insurance companies long engaged in far-flung activities in that field of economic activity. We are accordingly not disposed to invoke the rule based on a presumed disparity of experience or acumen that "ambiguities in the policy are to be construed against the insurer." [citation omitted] Rather, we impute to all parties the ability to use appropriate language to make clear the risks against which the reinsurance is issued. *Id*. at 775.

This position was confirmed more recently by the Supreme Judicial Court in *Affiliated FM Ins. Co. v. Constitution Reinsurance Corp.*, 626 N.E.2d 878 (Mass. 1994) which focused on declaratory judgment expenses under a facultative certificate. The court stated:

> Affiliated contends that, if there is doubt concerning the scope of expenses, the doubt should be resolved against Constitution, the drafter of the certificate. Although there is a rule of construction that certain writings are to be construed against the author of the doubtful language, [citation omitted] that rule must give way to the primary objection that a contract is to be construed to reflect

the intention of the parties. *Id.* at 881.

Similarly, the federal district court for Massachusetts did not apply the *contra proferentem* doctrine against a reinsurer with respect to a facultative certificate in *Commercial Union Ins. Co. v. Seven Provinces, Inc.*, 9 F.Supp.2nd 49 (D.Mass. 1988). "Although the first page of the certificate bears the name of Seven Provinces, both parties acknowledged that the certificate was made up of a series of standardized forms routinely used by Sayre & Toso, who was at the time the agent of each." *Id.* at 54.

V. Conclusion

The *contra proferentem* doctrine is a rule of construction of contracts that interprets ambiguous contracts against the drafter. It is based, largely, on a supposition of very unequal bargaining power that justifies that approach.

While this doctrine has some justification in primary insurance, it does not support construing reinsurance contracts against reinsurers. Some terms in reinsurance contracts are mandated by regulation, primarily for the benefit of cedents. Reinsurance intermediaries, who are the agents of cedents for most purposes, draft most reinsurance contacts. Insurers and reinsurers are large financial institutions, fully capable of protecting their contractual interests through lawyers and contract specialists. There can be, and often is, substantial give and take between insurers and reinsurers over contract language.

Some courts have retained a *stare decisis* approach to construction of reinsurance contracts based on assumptions that do not fit the modern reinsurance model, as described above. Other courts, such as those in the Second Circuit, have recognized the realities of reinsurance relationships and have long since discarded *contra proferentem* as a rule of construction for reinsurance contracts.

ENDNOTES

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[1] This is an update of an article originally published in 2000.

[2] John Nonna and Marc Abrams, *Custom and Usage Evidence Regarding Insurance Contracts*, www.law.con/jsp/cc/PubArticleCC.jsp?id=900005444078(2005); Eugene Wollan, *Handbook of Reinsurance Law,* Aspen Publishing §2.01[D] (2003).

[3] *See e.g* Ill. Admin. Code §1104.10 et seq.

[4] A number of years ago, the insurance department of California had what is locally dubbed an "underground rule" concerning setoff clauses. The department declined to grant licenses to companies that had reinsurance contracts with setoff clauses that had been found by the California Supreme Court to be consistent with receivership law. *Prudential Reinsurance Co. v. Superior Court*, 842 P.2d 48 (Cal.1992). This practice ceased only after suit was filed by the Reinsurance Association of America.

[5] *In the Matter of Pritchard & Baird, Inc.*, 8 B.R. 265, 269-70 (D.N.Y. 1980).

[6] 141 F.3d 300, 304-5 (7th Cir. 1998).

[7] For more case law on this topic *see* Robert M. Hall, *Does a Service of Suit Clause in a Reinsurance Contract Bar Removal of a Dispute to Federal Court?* Reinsurance Vol. 2 No. 8 at 4 (2010). It is also available at the author's website: robertmhall.com

[8] *Id.* at 397. The cited case was *Graue v. Missouri Property Ins. Placement Facility*, 847 S.W.2d 779 (Mo. 1993) and involved the apparent authority of an insurance agent with respect to a premium notice issued by a primary company.

[9] *Id.* at 954. The court was quoting language from *Boston Ins. Co. v. Fawcett,* 258 N.E.2d 771 (Mass.1970)