EXPENSES IN ADDITION TO LIMITS

AND

FACULTATIVE CERTIFICATES

By

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I. Introduction

It is custom and practice in the property and casualty industry to pay allocated loss adjustment expenses in addition to limits unless otherwise specifically stated.[1] Usually this obligation is stated clearly in insurance policies and reinsurance treaties. Sometimes, however, facultative certificates are not clear on this point, largely due to their brevity *i.e.* the effort to encompass the entire certificate on the front and back of one page. Ironically, this brevity also leads, in some cases, to the omission of an arbitration clause which would allow industry practitioners, familiar with custom and practice, to resolve the dispute. The purpose of this article is to examine selected caselaw over the last 20 years which highlights this continuing drafting problem in some facultative certificates.

II. Caselaw Interpreting Expenses as Within Limits

The initial case on point, and one that created great consternation in the industry, is *Bellefonte Reins. Co. et al. v. Aetna Casualty and Surety Co.,* 903 F.2d 910 (2nd Cir. 1990). The facultative certificate in question contained the following provisions:

> "[Provision 1]
>
> [Reinsurer] . . . does hereby reinsure Aetna . . . (hereinafter called the Company) in respect of the Company's contract hereinafter described, in consideration of the payment of the premium and subject to the terms, conditions, and amounts of liability set forth herein, as follows . . . .
>
> [Provision 2]

> Reinsurance Accepted: $500,000 part of $5,000,000 excess of $10,000,000 excess of underlying limits . . .
>
> [Provision 3]
>
> The Company warrants to retain for its own account . . . the amount of liability specified . . . above, and the liability of the Reinsurer specified . . . above [*i.e.* the amount of reinsurance accepted] shall follow that of the Company . . . .
>
> [Provision 4]
>
> All claims involving this reinsurance, when settled by the Company, shall be binding on the Reinsurer, which shall be bound to pay its proportion of such settlements, and in addition thereto, in the ratio that the Reinsurer's loss payment bears to the Company's gross loss payment, its proportion of expenses . . . incurred by the Company in the investigation and settlement of claims or suits . . ."

The reinsurer conceded that it was liable up to $500,000 pursuant to Provisions 1 and 2 but contested any liability for expenses in addition to such limits.

The cedent's first argument was the follow the fortunes concept embodied in Provision 3 required the reinsurer to pay, in addition to limits, expenses reasonably incurred in the defense of a claim. The court rejected this argument ruling:

> To read the reinsurance certificates in this case as [the cedent] suggests – allowing the "follow the fortunes" to override the limitations on liability – would strip the limitation clause and other conditions of all meaning; the reinsurer would be obligated merely to reimburse the insurer for any and all funds paid. Such a reading would be contrary to the parties' express agreement and to the settled law of contract interpretation.
>
> The "follow the fortunes" clauses in the certificates are structured so they coexist with, rather than supplant the liability cap. To construe the certificates otherwise would effectively eliminate the limitation on the reinsurer's liability to the stated amount. [2]

The cedent next contended that the obligation to pay expenses "in addition thereto" in Provision 4 obligated the reinsurer to pay such expenses in addition to limits. The court rejected this argument stating:

> We read the phrase "in addition thereto" merely to differentiate the obligations for losses and expenses. The phrase in no way exempts expense costs for the overall monetary limitation in the certificate. The monetary limitation is a cap on all payments under the certificate. In our view, the "in addition thereto" provision merely outlines the different components of liability under the certificate. It does not indicate that either component is not within the overall limitation.[3]

In *Unigard Security Ins. Co. v. North River Ins. Co.,* 4 F.3d 1049 (2nd "Cir. 1993) the cedent argued that a "follow the form" clause in the facultative certificate required the reinsurer to pay expenses in addition to limits. The court noted that the "follow the form" clause was subject to contrary language in the certificate and followed *Bellefonte* given the similarity on the language in the respective certificates on the limit of liability. In addition, the court rejected arguments based on past practice to vary the terms of the certificate.

In *Allendale Mutual Ins. Co. v. Excess Ins. Co.*, 992 F.Supp. 271 (S.D.N.Y. 1997) , the cedent tried to make a distinction between property insurance, involved in this case, and the casualty insurance involved in *Bellefonte* and *Unigard*. The court rejected this distinction ruling:

> Reinsurers of property insurance policies have the same interest in controlling their maximum exposure as do reinsurers of liability insurance policies. Thus, *Bellefonte* and *Unigard* holdings that the limit clauses define the reinsurers' bargained-for maximum exposure to liability inclusive of all costs and expenses are applicable . . . .[4]

Significantly, the *Allendale* court observed that the facultative certificate in this case was issued after the *Bellefonte* decision and if the cedent had desired expenses in addition to limits, it could have bargained for it.

A facultative certificate with a $7 million limit of liability was involved in *Excess Ins. Co. v. Factory Mutual Ins. Co.,* 822 N.E.2d 768 (N.Y. 2004). After extended litigation over a property loss, the cedent sought to recover a $7 million loss payment plus $5 million in expenses pursuant to a follow the settlements clause. The court rejected the argument that the follow the settlement s clause altered the limit in the certificate and followed *Allendale* on the lack of distinction between property and casualty business. The court commented:

> [T]his case well illustrates such an injustice [*i.e* .limitless liability] as [the cedent] now seeks to saddle the reinsurers with a portion of the liability bill that exceeds the negotiated policy limit by more than 70%. To permit such a result would render the liability cap a nullity.[5]

Handed down earlier this year*, Pacific Employers Ins. Co. v. Global Reins. Corp. of America,* 2010 U.S. Dist. Lexis 40506 (E.D.Pa.) concerned a facultative certificate which had limits and "in addition thereto" language very similar to that in *Bellefonte* and follow the form language very similar to that in *Unigard.* The court rejected the argument that the limit applied only to loss payments and followed *Bellefonte.*

III. Caselaw Interpreting Expenses as Being in Addition to Limits

A pre-*Bellefonte* case on point is *Penn Re, Inc. v. Aetna Cas. and Surety Co.,* 1987 U.S. Dist. Lexis 15252 (E.D.N.C). The certificate contained a $1.5 limit of liability and the type of follow the settlements, follow the form and "in addition thereto" [Provision 3] language described in caselaw above. The court found that Provision 3 was broader than the provisions dealing with losses and, on this basis allowed expenses in addition to limits:

> Thus, Provision 3 is not limited to [the cedent's] liability for the risks which the underlying insurance policies covered, but requires that, in addition thereto, plaintiffs pay their proportion of suit costs and expenses. Accordingly, the court concludes that the contract language found in Provision 3 obligates [the reinsurer] to pay their proportion of settlements involving insured risks and it further obligates plaintiffs to pay their proportion of suit costs and expenses in addition to such "settlement" accounts.[6]

The *Penn Re* holding has been rejected by subsequent decisions in *Bellefonte* and cases which follow it.

TIG Premier Ins. Co. v. Hartford Acc. & Indem. Co., 35 F.Supp.2d 348 (S.D.N.Y. 1999) interpreted California law which is more liberal that the law in some other states (*i.e.* New York) in allowing use of extrinsic evidence to show latent ambiguity in contractual language. The court noted that the certificate at issue contained limit of liability language similar to that in *Bellefonte*. Nonetheless, the court denied the reinsurer's motion for summary judgment based on the expert opinions and other evidence offered by the cedent that it was the custom and practice of the industry to pay expenses in addition to limits at the time the parties entered into the facultative contract.

IV. Commentary

The courts which have rejected the notion that expenses should be paid in addition to limits have done so on the basis that extrinsic evidence (*i.e.* of custom and practice) shall not be used to vary the plain language of the facultative certificate. 20 years after the *Bellefonte* decision, the solution should be obvious - **redraft the standard terms of the facultative certificate to match custom and practice.**

Competitive issues seem to support such a solution. It is doubtful that reinsurance underwriters issuing facultative certificates similar to those used in *Bellefonte, Unigard* or *Allendale* intended to provide reinsurance with expenses within limits. To do so would put them at a significant competitive disadvantage with respect to other reinsurers. It is more likely that the *Bellefonte* line of cases results from *ad hoc* claim decisions based on poorly drafted facultative certificate language. As is suggested by the *Pacific Employers* decision, handed down in 2010, these poorly drafted certificates remain in play even today.

ENDNOTES

[1] *See* the dissenting opinion in *Excess Ins. Co. Ltd. v. Factory Mutual Ins. Co.,* 822 N.E.2d 768, 775-6 (N.Y. 2004) and secondary sources cited therein; *TIG Premier Ins. Co. v. Hartford Acc.& Indem. Co.,*35 F.Supp.2d 348, 351 (S.D.N.Y. 1999); *Pacific Employers Ins. Co. v. Global Reins. Corp of America,* 2010 U.S. Dist Lexis 40506 n. 6 (E.D.Pa.).

[2] 903 F2d 910 at 913.

[3] *Id.*

[4] 992 F.Supp. 271 at 276.

[5] 822 N.E.2d 768 at 776.

[6] 1987 U.S.Dist. Lexis 15252*21.