NOTICE TO REINSURERS, RIGHT TO ASSOCIATE

AND PREJUDICE

by

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I. Introduction

Reinsurance contracts commonly contain a provision that requires the cedent to provide notice to the reinsurer of claims which may impact the reinsurance. The wordings for such provisions vary. For instance, they might require "prompt" notice of such a loss. If the reinsurance is on an excess of loss basis, it might require notice when the ground up loss reserve equals 50% of the cedent's retention or when the loss involves certain types of serious bodily injury *e.g.* death, dismemberment etc.

Notice clauses sometimes provide the reinsurer with a right to associate with the cedent in the investigation and defense of the underlying claim. It is the author's experience that it is very rare for reinsurers to avail themselves of this contractual right.[1] However, it is a right that can be undermined if the timing of the cedent's notice of the loss does not provide the reinsurer with an opportunity to exercise it. The purpose of this article is to examine selected case law to determine the manner in which the courts treat the right to associate as part of the reinsurer's general defense of late notice.

II. Cases Finding Breach of Right to Associate without Demonstration of Prejudice

An early case on point is *Keehn v. Excess Ins. Co. of America*, 129 F.2d 503 (7th Cir. 1942) which applied Illinois law. In this case, judgment was entered against the cedent and an unsuccessful appeal taken prior to notice to the reinsurer. The reinsurance contract stated that "[t]he reinsurer shall have the right and opportunity to associate with the [cedent] in the defense and control of any claim or suit or proceeding relative to an accident where the claim or suit involves this reinsurance."[2] The cedent's argued that there is no proof that the outcome would have been different if notice had been given as

the contract required. Citing Illinois case law relating to notice by insureds to insurers, the court found that the failure of the ceding insurer to give notice to the reinsurer as required by the contract and the deprivation of the right to associate "constitute prejudice without any actual proof that the results of the litigation would have been different."[3]

Notice was given to the reinsurer more than a year after judgment on a claim was paid in *Highlands Ins. Co. v. Employers' Surplus Lines Ins. Co.*, 497 F.Supp. 169 (E.D. La.1980). The reinsurance contract required prompt notice and gave the reinsurer the right to associate with the cedent in the defense of the any claim or suit. Citing to case law relating to claims by insureds against insurers, the court found that under the laws of either Texas or Massachusetts, the cedent's delay in notice to the reinsurer was unreasonable. The cedent argued for a distinction in the notice provisions of insurance vs. reinsurance contracts and for the latter, notice should not be interpreted as a condition precedent to liability. The court rejected this distinction on the basis that such clauses serve the same purpose in both types of contracts *i.e.* to afford an opportunity to participate in the defense of the claim.

In *Jefferson Ins. Co. of NY v. Fortress Re, Inc.*, 616 F.Supp. 874 (S.D.N.Y.1984), (*rehearing denied* 616 F.Supp. 874) the court was interpreting North Carolina law. The reinsurance contract required notice to the reinsurer when it appeared "likely" that the claim would involve the reinsurance. The notice clause also gave the reinsurer the right to associate with the cedent in the defense and control of any claim or suit. The underlying claim was for significant bodily injury for which the cedent put up minimal reserves and failed to notify its excess of loss reinsurer. In the pre-trial conference, the cedent's representative realized the extent of the claimant's injury, greatly increased the reserve and ultimately settled within the reinsurer's layer. The court rejected the cedent's argument that its subjective evaluation determined whether the claim was "likely" to penetrate the reinsurer's layer since reasonable inquiry would have put the cedent on notice of the seriousness of the injuries. Further, the court stated that "[t]o permit such a defense would effectively read the 'opportunity to defend' clause out of the contract and leave [the reinsurer] at the mercy of [the cedent's] passive perceptions."[4]

Travelers Ins. Co. v. Buffalo Reins. Co., 735 F.Supp.492 (S.D.N.Y.1990) (*vacated on other* grounds, 739 F. Supp. 209 (S.D.N.Y.1990)) was decided on New York law as it was before *Unigard Security Ins. Co. v. North River Ins. Co.,* 594 N.E.2d 571 (N.Y. 1992), *infra.* The facultative certificates required notice to the reinsurer of claims which the cedent reasonably believed to impact the reinsurer and reserved to the reinsurer the right to associate in any claim or suit. Applying the same standard for notice as between an insured and an insurer (no prejudice need be shown if notice is late), the court found that notice was impermissibly late. As to right to associate, the court stated:

> [T]he Reinsurers expressly reserved the right to associate with the full cooperation of [the cedent] in the defense of any claim, suit, or proceeding which may involve the reinsurance Certificates. The fact that reinsurers rarely defend in the same manner as primary insurers is not a meaningful distinction with respect to the interpretation of notice provisions. . . . The Court perceives no reason to deprive a reinsurer of its rights

to associate in the defense of claims simply because the reinsured is itself an insurance company. [5]

III. Cases Requiring Demonstration of Prejudice for Breach of Right to Associate

Unigard Security Ins. Co. v. North River Ins. Co., 594 N.E.2d 571 (N.Y. 1992) involved an issue concerning late notice which was certified to the Court of Appeal from the U.S. District Court for the Southern District of New York. The reinsurance contract in question called for prompt notice of a loss likely to involve the reinsurance and reserved to the reinsurer the right to associate with the cedent in the defense and control of any claim or suit.

The Court of Appeals noted that under New York law, the notice provision of a primary policy operates as a condition precedent to coverage and that prejudice is not required. However, the court noted significant differences between notice to an insurer and notice to a reinsurer:

> A reinsurer is not responsible for providing a defense, for investigating the claim or for attempting to get control of the claim in order to effect an early settlement. Unlike the primary insurer, it may not be held liable to the insured for breach of these duties. Settlements, as well as the investigation and defense of claims are the sole responsibility of the primary insurer; and settlements made by the primary insurer are, by express terms of the reinsurance certificate, binding on the reinsurer. Thus, failure to give the required prompt notice is of substantially less significance for a reinsurer than for a primary insurer.[6]

The court went on to rule that a reinsurer must demonstrate prejudice in order to avoid payment of a claim based on late notice.[7]

To the reinsurer's argument concerning impairment to its right to associate, the court ruled likewise that prejudice must be proved by the reinsurer:

> We agree that there are cases in which the reinsurer's right to associate may be impaired by late notice from the reinsured. Nonetheless, because of the critical distinctions between a primary insurer's right to control the investigation and defense of a claim and a reinsurer's "right of association" with the ceding companies, we cannot agree with [the reinsurer's] contention that the risk of such impairment is sufficiently grave to warrant applying a presumption of prejudice. Accordingly, there is no sound reason to depart from the general contract law principle that a breach will excuse performance only if it is material or demonstrably prejudicial.[8]

After the New York Court of Appeal decided this issue of state law, the case was eventually decided in *Unigard Security Ins. Co. v. North River Ins. Co.,* 4 F.3d 1049 (2nd Cir. 1993). In finding no demonstrable prejudice for the loss of the right to associate, the court ruled:

> [The reinsurer] bears the burden of showing that it suffered tangible economic injury because [the cedent] failed to give timely notice of the signing of the Wellington Agreement. Because its only claim of injury is based solely on the claim that the loss of contractual rights is prejudicial in and of itself, it has not met that standard.[9]

Christiana General Ins. Co. v. Great American Ins. Co., 979 F.2d 268 (2nd Cir.1992) was an appeal of a summary judgment ruling under New York law in favor of cedent that involved an excess insurer and notice to its reinsurer. The issue was whether or not the cedent failed to advise the reinsurer in a timely fashion when it became evident that losses would penetrate the reinsurer's layer thus violating the notice provisions in the reinsurance contract, which included a right to associate. During the course of its opinion, the court identified the primary function of prompt notice to the reinsurer:

> [T]o enable [the reinsurer] to set proper reserves covering anticipated losses, to decide whether it wishes to exercise its right to associate in the defense of a particular claim, and to establish premiums that accurately reflect past loss experience.[10]

The appellate court reversed the lower court ordering that the issue of prejudice be sent to the jury. While the reinsurer had conceded that it could not prove prejudice from the alleged two month delay, the court theorized that at trial, the reinsurer might be able to demonstrate some prejudice to the jury.

A cedent's motion for summary judgment against the reinsurer, apparently under New York law, provided the context for *Insurance Company of Ireland v. Mead Reins. Corp.,* 1994 U.S. Dist. Lexis 15690 (S.D.N.Y.). The cedent argued, and the court rejected, the notion that the cedent's subjective opinion of the magnitude of the underlying claim determined whether or not it had to give notice. The reinsurer alleged late notice which prejudiced it in various ways, including inability to associate in the defense of the underlying claim. The court ruled that prejudice was an issue of fact for the jury and commented:

> The burden is squarely on the reinsurers to demonstrate that there is a triable issue of fact as to whether they were prejudiced by [the cedent's] allegedly late notice. Absent such a showing, it is irrelevant whether or not notice was late.[11]

British Ins. Co. of Cayman v. Safety National Casualty, 335 F.3d 205 (3rd Cir. 2003) was the appeal of a district court decision to the effect that New Jersey courts would not require prejudice for late notice under a reporting clause that contained a right to associate. The appellate court reversed stating:

> Since a reinsurer is not obligated to investigate, litigate, settle or defend claims, the "failure to give the required prompt notice is substantially less significance for a reinsurer than for a primary insurer." Consequently, prompt notice is not as critical to a reinsurer as it is to a primary insurer, and ritualistic adherence to prompt notice clauses in reinsurance contracts in the absence of prejudice to the reinsurer does little more

> than provide the reinsurer with a convenient and inequitable avenue to escape from its obligations under it policy with its reinsured. [12]

In support of its ruling, the court noted that reinsurers seldom exercise their right to associate and the primary exposure of the cedent on claims gives it "as much, if not more reason to ensure that a claim is properly investigated and defended."[13]

The lower court ruled that a standard notice requirement, with right to associate, was a condition precedent in *Security Mutual Casualty Co. v. Century Casualty Co.*, 531 F.2d 974 (10th Cir. 1976). The reinsurer had received notice of certain death claims after the insured had been found liable and post-trial motions had been denied. Applying Colorado law, the appellate court reversed ruling:

> In reinsurance contracts, like the one before us, the investigation and defense of the claim is usually left to the primary insurer. Although [the reinsurer] was given the right to associate in the defense of claims, when it so desired, such participation was not so essential as it is for a primary insurer. [The cedent] had as much reason as [the reinsurer] to see that the death claims in the Anderson Aviation litigation were properly investigated and defended. [14]

California law on late notice was at issue in *Ins. Co. of Pennsylvania v. Assoc. International Ins. Co.*, 922 F.2d 516 (9th Cir. 1990). An excess insurer allegedly was tardy in providing notice to its reinsurer of the accumulation asbestos related losses and settlement efforts. The lower court rule that the cedent had violated the notice requirement in the reinsurance contract and, among other things, prejudiced the reinsurer's right to associate. The appellate court reversed ruling that prejudice is not established by: (1) inability to participate in investigation and defense of the claim; or (2) the end result. It actually must be demonstrated that there was a substantial likelihood the reinsurer's participation could have defeated the claim or resulted in a smaller award or settlement.

Fortress Re, Inc. v. Penn Re, Inc., 766 F.2d 163 (4th Cir. 1985) involved a notice sent to the reinsurer three days before the trial. The reinsurance contract contained a right to associate. Interpreting North Carolina law, the lower court ruled that the notice unquestionably was late, that the reinsurer was thereby prejudiced and, as a result, granted summary judgment to the reinsurer. The appellate court reversed and ordered a trial on the prejudice issue:

> Summary judgment was inappropriate because there are genuine issues of material fact. Without attempting to catalog all of these issues, it is sufficient to note that they include questions of what [the reinsurer] would have done had it received timely notice and whether its intervention would have produced a more favorable result.[15]

An excess insurer gave notice to its reinsurer of the claim after a jury verdict which penetrated the reinsurer's layer in *Newcap Insurance Co. v. Employers Reins. Corp.*, 295 F.Supp. 2d 1229 (D. Kan. 2003).

The reinsurance contract gave the reinsurer a right to associate. Interpreting Kansas law, the court granted summary judgment on the issue of late notice but required a trial on the issue of whether or not the reinsurer suffered substantial prejudice as a result.

Travelers Ins. Co. v. Central National Ins. Co., 733 F.Supp. 522 (D. Conn. 1990) involved liability of an employer to an employee for burns. The reinsurance contract contained a right to associate. The cedent initially reserved the loss as within its retention but in mid-1986 increased its reserve to penetrate the reinsured layer and the reinsurer was notified. The reinsurer took no action to associate before the claim was settled in 1987. Interpreting Connecticut law, the court found no prejudice since the reinsurer had ample opportunity to associate after it received notice and before the settlement but chose not to do so.

IV. Commentary

From the above caselaw, it appears that some states apply a primary-oriented rule to reinsurance *i.e.* that late notice is inherently prejudicial since it impairs the right of the insurer (or reinsurer) to defend that claim. However, more courts have adopted the rule that proof of prejudice should be required for reinsurers since it is the duty of cedents (and not reinsurers) to investigate, adjust and settle claims. Perhaps more to the point, these rules do not seem to vary based on the presence or absence of a right to associate in relevant reinsurance contract. Stated differently, a contractual right to associate does not seem to have an impact on whether or not prejudice must be demonstrated by the reinsurer. However, it may have a significant impact on the finding of prejudice (or no prejudice) by a trier of fact.

ENDNOTES

[1] *See also Travelers Ins. Co. v. Buffalo Reins. Co.,* 735 F. Supp. 492, 499 (S.D.N.Y. 1990); *Unigard Security Ins. Co. v. North River Ins. Co.*, 594 N.E.2d 571 at 575 (N.Y. 1992); *British Ins. Co. of Cayman v. Safety National Casualty,* 335 F.3d 205 at 214 (3rd Cir. 2003); *Travelers Ins. Co. v. Central National Ins. Co.,* 733 F.Supp. 522 at 530 (D. Conn. 1990); 14 *Appleman on Insurance: Law of Reinsurance*, § 105.7 at 384 (2d ed. 2000).

[2] 129 F.2d at 504.

[3] *Id.* at 505.

[4] 616 F.Supp. at 879.

[5] 735 F.Supp. at 499.

[6] 594 N.E.2d at 583.

[7] *Id.*at 584.

[8] *Id. at* 583.

[9] 4 F.3d at 1069.

[10] 979 F.2d 268 at 274.

[11] 1994 U.S. Dist. Lexis 15690 *22 (S.D.N.Y.).

[12] 335 F.3d 205 at 213 quoting *Unigard Security Casualty*, 594 N.E.2d at 574.
[13] *Id.* at 214.
[14] 531 F.2d 974 at 978.
[15] 766 F.2d 163 at 166.